VIOLETARCH

Institutional Research

Midcap Compendium

The V 20 Factor

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Index

Foreword

BSE Midcap Index has corrected by around 35% in 2011, and stocks now trade at a steep discount to historical trading averages, even after some recovery in 2012. This reflects investor pessimism and expectations of deterioration in the business environment. In our view, bottom-up stock-picking assumes greater significance in such an environment, needless to mention that it provides the opportunity to create wealth in the long run.

Accordingly, we have selected twenty stocks (V20) on the basis of: 1) market leadership position, 2) attractive earnings CAGR (23.5%) prospects over FY12-14E, 3) strong management track record, and 4) undemanding valuations on P/E or P/BV or EV/EBITDA basis to capture the medium term growth prospects.

We have screened these stocks to understand how they fare against each other and pecking order for investors among our selected ideas (refer page 8 for categorization criteria). With each company scoring an odd number 1 or 3 or 5 (below average, average and above average, respectively) on each of these variables, the aggregate score will range between 6 and 30, with 30 being the company that has scored above average on all the selected criteria.

We have rated these companies based on the aggregate score they have garnered and made three categories for grouping the companies that score on comparable levels. Category-I have stocks, which score more than 10% than the median score of the sample, whereas Category-III have stocks, which score 10% less than the median and the rest fall into Category-II.

Key characteristics depicted by most of the selected V20 stocks

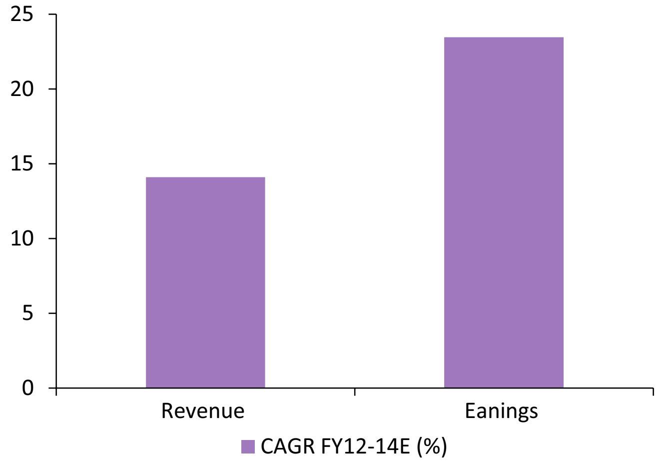
- Market leadership position – enjoy operating leverage benefits,
- Attractive growth prospects – robust end-market demand,
- Strong management track record – critical for scaling the business to another level, and
- Valuations – trading at a discount to historical averages.

Key takeaways

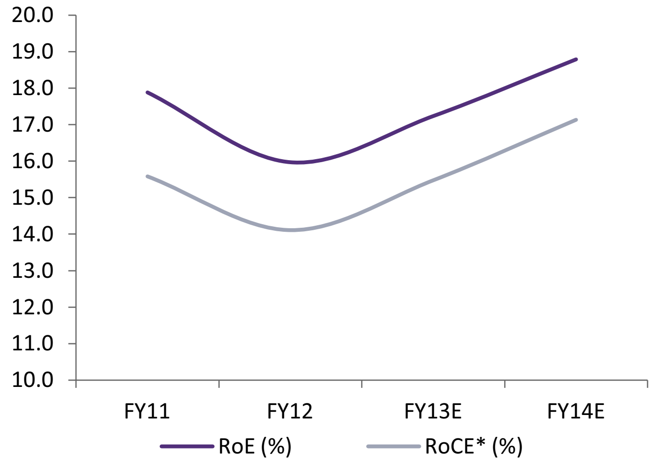
- The revenues are expected to post a decent CAGR at an average of 14.1% over FY12-14, **led by companies like CEBBCO, Delta Corp, Arshiya and KPIT Cummins.**
- Earnings are expected to post a healthy CAGR of 23.5% over the same period, led by 1) margin expansion on the back of benefits from lower input costs, 2) operating leverage benefits and 3) savings on interest cost front. **The companies which are expected to be leaders on this front are Indoco Remedies, CEBBCO, Dishman and Arshiya.**

- V20 stocks enjoy healthy return ratios with average RoCE (excluding Financials) and RoE for FY14 at 17.1% and 18.8%, respectively, **led by IT companies (KPIT and Mindtree) and financials (J&K and Shriram Transport). Among others, Rallis and CEBBCO fare better than its peers.**

Earnings growth to surpass the revenue growth…



… leading to improvement in return ratios



Source: Company, Violet Arch Research
** Excluding Financials*

- On valuation front, V20 stocks are trading at 11.0x and 8.4x on FY13E and FY14E earnings, respectively, which are at attractive levels considering the healthy return ratios and growth prospects for our universe. On P/BV basis the V20 stocks are trading at 1.6x and 1.4x on FY13E and FY14E basis.

– Shailesh Kanani and Kunal Motishaw

V20 stocks

Category	Company	CMP (Rs)	TP (Rs)	Upside (%)	Mcap (Rs mn)	Revenue (Rs mn) FY12	Revenue FY13E	Revenue FY14E	CAGR (FY12-14E)	EPS (Rs) FY12	EPS FY13E	EPS FY14E	CAGR (FY12-14E)	P/E (x) FY12	P/E FY13E	P/E FY14E	EV/EBITDA (x) FY12E	EV/EBITDA FY13E	EV/EBITDA FY14E	P/BV (x) FY12	P/BV FY13E	P/BV FY14E	RoE (%) FY12	RoE FY13E	RoE FY13E	RoCE (%) FY12	RoCE FY13E	RoCE FY14E
Category-I	Apollo Tyres	97	120	23.5	48,890	121,533	133,775	144,511	9.0	8.8	12.1	14.1	26.9	11.1	8.0	6.9	6.2	4.7	4.0	1.7	1.4	1.2	16.8	19.5	19.0	13.6	14.7	15.0
	CEBBCO	94	135	43.6	5,165	4,686	6,515	9,700	43.9	7.4	10.4	16.9	51.0	12.7	9.0	5.6	8.9	6.1	4.1	2.0	1.7	1.4	17.2	20.3	27.4	14.5	16.0	20.2
	Delta Corp	71	86	22.1	15,820	3,649	4,013	6,233	30.7	1.9	2.3	3.8	40.2	36.5	31.0	18.6	18.8	15.5	9.2	2.1	2.0	1.8	6.3	6.6	10.2	9.4	9.4	15.7
	HIL	490	780	59.2	3,657	8,602	10,283	11,721	16.7	81.2	98.1	111.7	17.3	6.0	5.0	4.4	4.2	3.5	3.1	0.7	0.9	0.8	18.9	19.8	19.4	15.8	16.6	16.6
	Indoco Remedies	71	87	23.1	6,543	5,688	6,767	8,186	20.0	4.1	8.2	10.9	34.0	17.5	8.6	6.5	8.8	6.1	4.8	1.7	1.4	1.2	9.7	16.7	18.6	11.7	15.2	17.4
Category-II	Arshiya Intl.	136	179	31.6	8,004	10,573	14,217	17,923	30.2	20.5	27.0	42.6	44.1	5.8	4.5	2.8	10.7	7.1	4.4	0.8	0.7	0.6	13.9	15.7	20.0	7.9	9.9	12.6
	Balkrishna Inds.	273	329	20.5	26,385	28,200	36,260	43,690	24.5	27.8	35.7	41.2	21.7	9.8	7.6	6.6	7.8	6.1	5.3	2.4	1.9	1.4	28.1	27.8	24.5	13.5	12.4	12.0
	KPIT Cummins	128	163.2	27.2	23,413	15,000	21,719	25,088	29.3	8.0	11.8	14.8	36.5	16.1	10.9	8.6	11.2	6.9	5.4	3.3	2.6	2.0	22.1	26.5	26.3	15.7	20.3	20.4
	MOIL	259	321	24.0	43,478	8,996	9,710	10,719	9.2	24.5	28.2	31.7	13.8	10.6	9.2	8.2	5.2	3.7	2.7	1.8	1.5	1.3	16.8	16.8	16.3	19.1	18.9	18.1
	MRPL	60	83	38.4	108,068	537,703	593,319	674,158	12.0	4.9	1.1	7.8	25.4	12.1	54.0	7.7	7.9	14.8	4.4	1.5	1.5	1.3	12.6	2.8	17.1	10.6	3.8	17.2
	Radico Khaitan	118	143	21.4	15,617	11,439	13,793	16,158	18.9	5.7	7.3	9.5	28.8	24.6	16.1	12.4	12.5	9.0	7.7	2.2	2.0	1.7	9.5	13.1	15.0	10.0	11.8	13.0
	Rallis India	138	167	20.8	26,895	12,749	14,949	17,611	17.5	5.1	7.5	9.3	29.6	26.7	18.2	14.6	13.0	10.4	8.6	4.8	4.2	3.6	17.9	23.1	24.8	26.5	30.9	34.7
	Titagarh Wagons	320	433	35.2	6,426	8,909	10,747	11,713	14.7	41.5	52.1	54.2	14.3	7.7	6.1	5.9	4.0	3.2	2.4	1.0	0.8	0.7	12.5	13.6	12.3	18.5	17.6	16.4
Category-III	Dishman	100	132	32.3	8,054	11,241	12,630	14,062	11.8	7.0	12.0	14.7	44.9	14.2	8.3	6.8	7.3	5.6	4.6	0.9	0.7	0.7	6.1	9.0	9.7	5.0	7.6	8.1
	ITNL	182	218	20.1	35,668	56,056	66,985	72,015	13.3	25.5	25.4	30.6	9.6	7.1	7.2	5.9	9.3	10.1	10.5	1.3	1.1	1.0	19.9	16.6	17.3	13.3	10.7	9.4
	Mindtree	687	880	28.1	28,308	19,152	23,783	27,453	19.7	53.1	75.1	80.0	22.8	13.0	9.2	8.6	8.4	5.3	4.5	3.0	2.3	1.8	25.2	28.1	23.5	24.8	35.5	30.5
	Unichem Labs	196	236	20.7	17,689	9,025	10,396	12,006	15.3	9.0	11.9	15.8	32.4	21.8	16.4	12.4	13.3	10.3	8.0	2.5	2.2	2.0	11.6	13.6	16.0	9.9	11.8	14.0

Financials

Category	Company	CMP (Rs)	TP (Rs)	Upside (%)	Mcap (Rs mn)	NII (Rs mn) FY12	NII FY13E	NII FY14E	CAGR	NIM (%) FY12	NIM FY13E	NIM FY14E	Profit After Tax (Rs mn) FY12	PAT FY13E	PAT FY14E	CAGR	RoA (%) FY12	RoA FY13E	RoA FY14E	RoE (%) FY12	RoE FY13E	RoE FY14E	P/E (x) FY12	P/E FY13E	P/E FY14E	P/BV (x) FY12	P/BV FY13E	P/BV FY14E
Category-I	Bank of Maharashtra	48	58	20.4	28,536	72,140	86,062	99,323	17	3.2	3.3	3.4	4,308	5,271	7,313	17	0.5	0.5	0.6	9.9	10.7	13.6	8.6	6.6	5.4	0.7	0.7	0.6
Category-I	J&K Bank	911	1205	32.3	44,169	48,356	58,376	70,400	21	3.6	3.7	3.8	8,033	9,846	12,344	21	1.5	1.5	1.5	21.2	21.9	22.7	8.6	7.2	5.5	1.1	0.9	0.8
Category-II	Shriram Transport	625	752	20.3	141,507	56,735	64,568	74,999	15	3.1	3.3	3.4	12,575	14,993	17,723	15	3.1	3.3	3.4	23.1	22.5	21.7	11.5	11.3	9.4	2.4	2.0	1.6

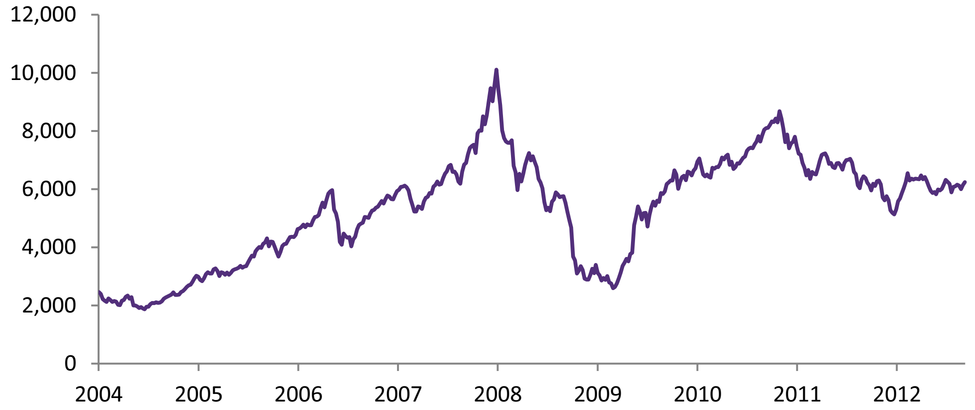
Source: Company, Violet Arch Research

Why Midcaps now?

Currently, the BSE Midcap Index stands at May 2006 levels even as GDP has grown 140% and the BSE Midcap Index (trailing) EPS by 50% between FY06 and FY12. The P/B multiple of the index has de-rated by 50% from 2.0x to 1.0x during the period. We witnessed some revival in mid-cap stocks year-to-date led by quality stocks. Top 25% stocks (62 out of 247 stocks) of the BSE Mid-cap Index returned at least 45% year-to-date. We see a further improvement for the BSE Midcap Index led by improving sentiment, fall in interest rates, lower commodity prices and attractive valuations (still). As sales growth has been sustained despite the weak economy, we believe stabilization/improvement in profit margins will lead to an earnings revival for the BSE Midcap Index.

Accordingly, we have selected twenty stocks (V20) on the basis of: 1) market leadership position, 2) attractive earnings CAGR (23.5%) prospects over FY12-14E, 3) strong management track record, and 4) undemanding valuations on P/E or P/BV or EV/EBITDA basis to capture the medium term growth prospects.

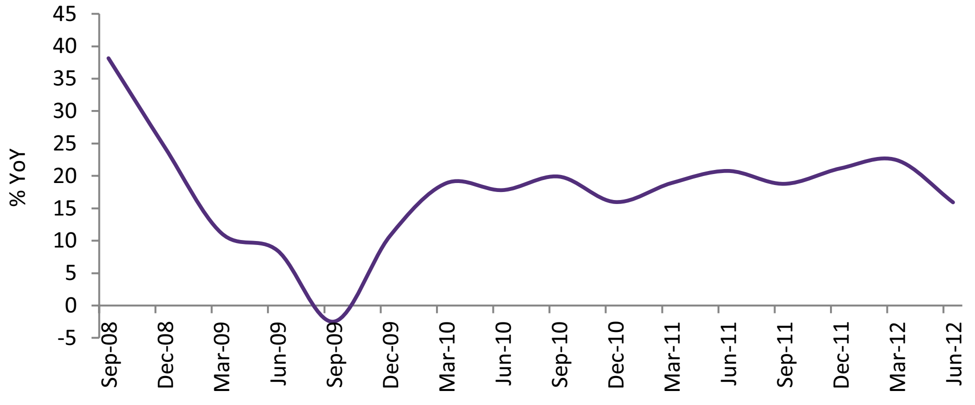
BSE Midcap Index



Source: Bloomberg

The BSE Midcap Index was mainly impacted by the fall in operating margins, though revenue growth remained strong. Revenue growth averaged 19.6%, though GDP growth slowed down significantly over the last four quarters. This is also in contrast to FY09-10 when revenue growth slipped into the negative zone/single-digit growth despite higher GDP growth. As interest rates ease and government initiatives restore confidence, revenue growth is likely to sustain or improve in the coming quarters.

Revenue growth sustained despite GDP slowdown

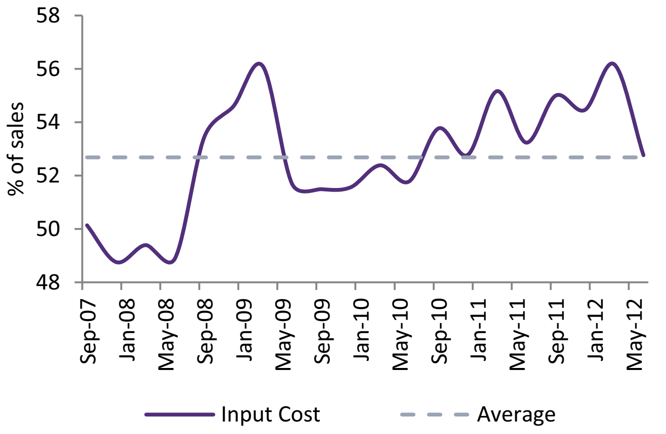


Source : Bloomberg, Violet Arch Research

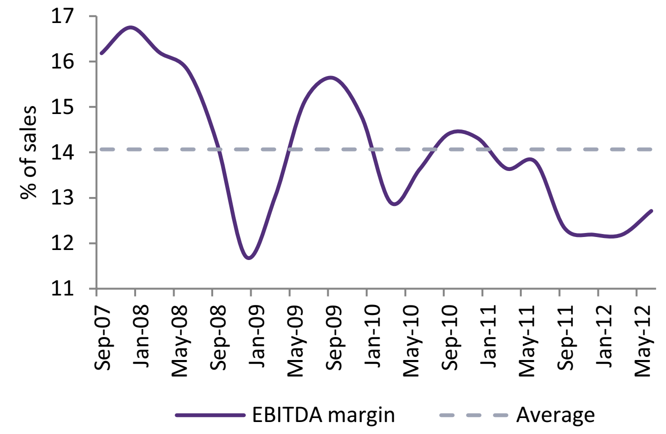
The BSE Midcap Index's EBITDA margin declined from its 2QFY10 peak of 14.4% to a low of 12.2% in 4QFY12. The margin recovered slightly in 1QFY13, led by lower input costs, and the trend, we believe, should sustain. Raw material costs (as % of sales) increased by 440bps from 1QFY11 to 4QFY12, initially hit by the global commodity run-up and, subsequently, by the INR depreciation. 1QFY13 witnessed a slight improvement in operating margins due to lower input costs. Currency appreciation will also help earnings in the form of lower input costs and a reversal of forex losses.

We believe upside risks to input prices remain limited going forward. According to IMF, metals price index is down 10% YTD (till Aug'12, $ terms), which would benefit Indian companies with a lag effect. Since 6 Sep 2012, as ECB, Fed and Japan announced further quantitative easing measures, CRB commodity index is up by just 0.6%. This is due to weak China economic data, which has become the major driver for commodity prices in the recent years. Thermal coal prices which were at $120 at the start of the year, fell to $90 and stayed there for the last three months (stayed at same levels even after the announcement of recent quantitative easing measures). Input costs will also benefit from currency appreciation going forward. For example, Indian steel prices rose by 4% YTD even as steel prices fell by 15% YTD in China due to INR depreciation. With recovery in INR (appreciated by 4% in Sep'12), some correction in input prices should be expected in the coming quarters.

Finally, some relief on input costs



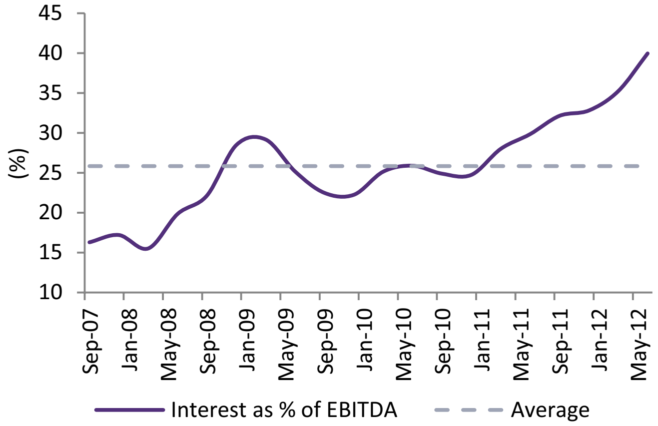
EBITDA margins stabilized over the last few quarters



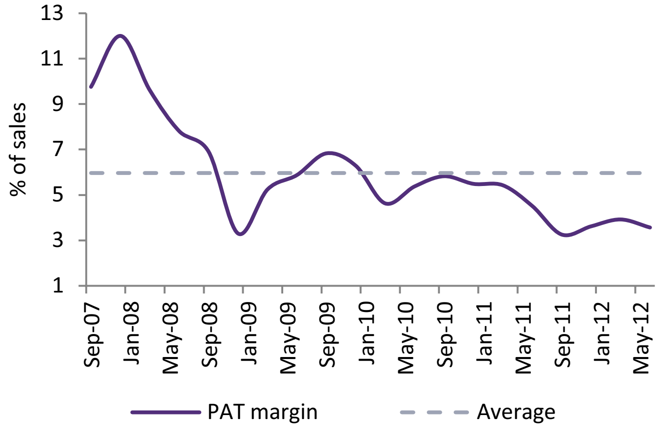
Source: Company, Violet Arch Research

The BSE Midcap Index's interest costs as % of EBITDA increased from 24.7% in 3QFY11 to 40.0% in 1QFY13. This, along with rising input costs, has led to earnings contraction, despite revenue growth. In recent months, while interest rates have peaked out, the liquidity situation has improved significantly. Commercial paper rates have fallen to the lowest levels in two years, and most banks have started cutting deposit and lending rates. The midcap companies will see benefits in the coming quarters. Thus, earnings are likely to benefit from both revenue growth and margin improvement going forward.

Interest costs eat away profits



PAT margin



Source: Company, Violet Arch Research

Thus, we see an improvement in midcap earnings going forward, led by lower inputs, interest costs and the absence of forex losses. A significant assumption is that the currency won't depreciate further from current levels.

Against this backdrop, the BSE Midcap Index has corrected by around 35% in 2011, and stocks now trade at a steep discount to historical trading averages, even after some recovery in 2012. This reflects investor pessimism and expectations of deterioration in the business environment. In our view, bottom-up stock-picking assumes greater significance in such an environment, needless to mention that it provides the opportunity to create wealth in the long run.

We have further screened our 20 stocks to understand how they fare against each other and pecking order for investors among the selected ideas. We have used the following six criteria for the same

- **Market leadership position,**
- **Attractive growth prospects,**
- **Strong management track record,**
- **Undemanding Valuations,**
- **Upside from current levels and**
- **Sharpe ratio (risk adjusted returns)**

With each company scoring an odd number 1 or 3 or 5 (below average, average and above average, respectively) on each of these variables, the aggregate score will range between 6 and 30, with 30 being the company that has scored above average on all the selected criteria

Relative positioning of V20

Company	Market leader	Growth prospects	Track record	Valuations	Upside	Sharpe Ratio
Apollo Tyres	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
Arshiya Intl.	✓✓	✓✓✓	✓	✓✓✓	✓✓✓	✓✓✓
Balkrishna Industries	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
Bank of Maharashtra	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
CEBBCO	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓
Delta Corp	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
Dishman	✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓
HIL Ltd	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓
Indoco Remedies	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
ITNL	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓
J&K	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓
KPIT Cummins	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓
Mindtree	✓✓	✓✓✓	✓✓	✓✓	✓✓	✓
MOIL	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓
MRPL	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓
Radico Khaitan	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓
Rallis India	✓✓✓	✓✓✓	✓✓	✓✓	✓✓	✓✓✓
Shriram Transport	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
Titagarh Wagons	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓
Unichem Labs	✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓

Source : Company, Violet Arch Research; ***Sharpe ratio: Risk adjusted return***

Above Average✓✓✓ Average✓✓ Below Average✓

We have rated these companies based on the aggregate score they have garnered and made three categories for grouping the companies that score on comparable levels. Category-I have stocks, which score more than 10% than the median score of the sample, whereas Category-III have stocks, which score 10% less than the median and the rest fall into Category-II.

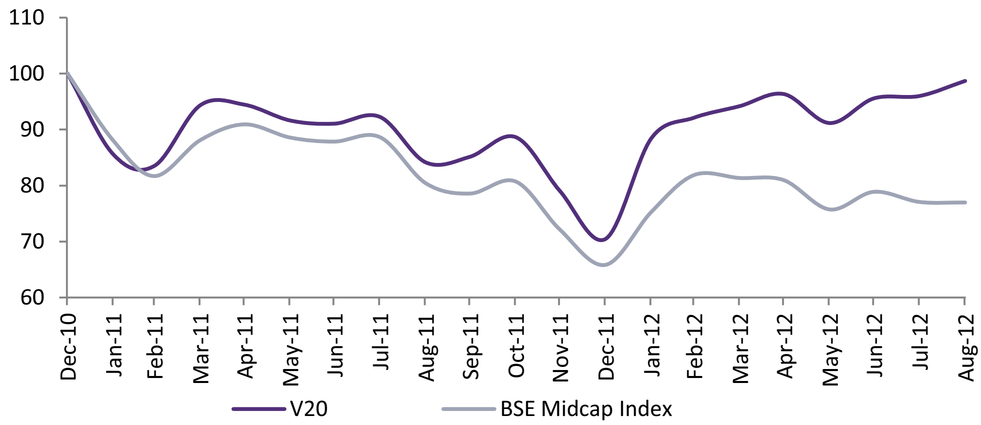
	BB	Company	Mcap (Rs mn)	CMP (Rs)	TP (Rs)	Upside (%)
Category-I	APTY IN EQUITY	Apollo Tyres	48,890	97	120	23.5
	BOMH IN EQUITY	Bank of Maharashtra	28,536	48	58	20.4
	CEBB IN EQUITY	CEBBCO	5,165	94	135	43.6
	DELTA IN EQUITY	Delta Corp	15,820	71	86	22.2
	HYI IN EQUITY	HIL	3,664	490	780	59.2
	INDR IN EQUITY	Indoco Remedies	6,543	71	87	23.2
	JKBK IN EQUITY	J&K	44,169	911	1205	32.3
Category-II	ARST IN EQUITY	Arshiya Intl.	8,004	136	179	31.6
	BIL IN EQUITY	Balkrishna Inds.	26,385	273	329	20.5
	KPIT IN EQUITY	KPIT Cummins	23,413	128	163	27.2
	MOIL IN EQUITY	MOIL	43,966	259	321	24.0
	MRPL IN EQUITY	MRPL	108,048	60	83	38.4
	RDCK IN EQUITY	Radico Khaitan	15,617	118	143	21.2
	RALI IN EQUITY	Rallis India	26,895	138	167	20.8
	SHTF IN EQUITY	Shriram Transport	141,507	625	752	20.3
	TWL IN EQUITY	Titagarh Wagons	6,426	320	433	35.2
Category-III	DISH IN EQUITY	Dishman	8,054	100	132	32.3
	ILFT IN EQUITY	ITNL	35,668	182	218	20.1
	MTCL IN EQUITY	Mindtree	28,308	687	880	28.1
	UL IN EQUITY	Unichem Labs	17,689	196	236	20.6

Source : Company, Violet Arch Research

We have compared the performance of V20 to the constituents of the BSE Midcap index over the last few years on earnings, return ratios and stock performance. V20 earnings grew by a CAGR of 13.9% between FY08 and FY12 compared to 1.4% for the BSE Midcap constituents. We estimate FY12-14E earnings at a CAGR of 23.5% for V20. The median ROE for V20 (for the same period) stood at 22.2% as against 19.9%.

To compare the stock performance, we have prepared an index for V20 based on their free-float market capitalization (see chart below). V20 outperformed the BSE Midcap index by 23% YTD.

Relative out-performance of V20



Source: Violet Arch Research

This outperformance corroborates with our view that V20 stocks are backed by strong fundamentals as compared to BSE Midcap Index. Further, given our robust earnings expectations from V20 over FY12-14, we expect the outperformance to continue, which would be further fuelled by current attractive valuations.

Company Section

VIOLET ARCH

COMPANY REPORT

Equity Research I Automobile

21 September, 2012

Apollo Tyres Ltd.

The Untiring Champ

Absolute Rating	BUY
Target Price	Rs 120
Upside	24%

We initiate coverage on Apollo Tyres Ltd. (APTY) with a Buy rating. Natural rubber prices, after a 10% correction in the last six months, are showing a declining trend. Going forward, this would lead to margin expansions, with natural rubber constituting around 40% of the company's total raw material content. The completion of truck and bus radial capacity expansions by 2HFY13 is expected to give a fillip to Apollo Tyres' free cash-flow. We believe that the margin expansion is a bigger positive for earnings than the risk of volumes moderating due to a slowdown in the M&HCV OEM segment. With the company's stock available at a P/E of 6.7x on FY14E EPS of 14.1, it seems to be an attractive pick.

Replacement demand, exports and radialization to drive industry growth

In the last three years, the Indian automobile industry has witnessed robust growth. The domestic commercial vehicles (CV) segment clocked a CAGR of 27.6% over FY09-12, while the passenger cars segment logged a CAGR of 19% during the same period. We expect this robust growth to translate into a CAGR of around 8% in the domestic replacement market over FY13-14E. Radial tyres offer a truck driver a cost advantage of about 36% per km over cross-ply tyres in a scenario of no over-loading and good roads.

Stable raw material prices and improving product mix to boost margins

Prices of natural rubber have witnessed an exponential increase of around 151% over April 2009-April 2011. Since April 2011 domestic rubber prices have corrected about 20% till date. With the slowdown in China, demand for natural rubber is expected to moderate. Hence, natural rubber prices are expected to soften from hereon. This, coupled with improving product mix in favour of the replacement market, is expected to drive the EBITDA margin going forward.

Capex cycle complete, free cash-flow and debt/equity to improve

Apollo Tyres had undertaken a capex of Rs 23bn for the Chennai Greenfield capacity to manufacture truck and bus radial tyres. The company is expected to complete the capex with a capacity of 450 tonnes per day (tpd) by September 2012. Benefits of the capex are expected to accrue with improved free cash-flow to the firm, debt/equity and RoCE ratios.

European subsidiary to aid consolidated margin; South African subsidiary expected to break even

The European subsidiary's outlook on volume growth has been subdued. It is expected to remain flat. However, the high EBITDA margin of 14-18% it enjoys adds incremental value to the consolidated business. Besides, the domestic business is able to leverage the distribution network of the subsidiary to market its 'Apollo' brand tyres in the continent.

Valuation

The stock is currently trading at an attractive 6.9x P/E, EV/EBITDA of 4.0x and P/BV of 1.2x on FY14 EPS of Rs 14.1. With the expectation of expansion in margins and free cash-flow, we assign a P/E of 8.5x (a 5% premium to its historical average P/E of 8.1x) to its FY14 EPS of Rs 14.1. We Initiate coverage on Apollo Tyres with a Buy rating at a target price of Rs 120, with an upside of 23.5% from current levels.

Consolidated Y/E Mar(Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	88,677	121,533	133,775	144,511
EBIDTA	9,651	11,661	14,618	16,260
EBIDTA margins (%)	10.9	9.6	10.9	11.3
EBIDTA growth (% YoY)	(17.2)	20.8	25.4	11.2
Adj. Net profit	4,408	4,415	6,092	7,106
Adj. profit margins (%)	(22.8)	0.2	38.0	16.6
Adj. profit growth (%)	5.0	3.6	4.6	4.9
Standalone EPS	8.7	8.8	12.1	14.1
Standalone EPS growth (%)	(22.2)	(6.9)	48.6	16.6
P/E (x)	11.1	11.1	8.0	6.9

Source: Company, Violet Arch Research

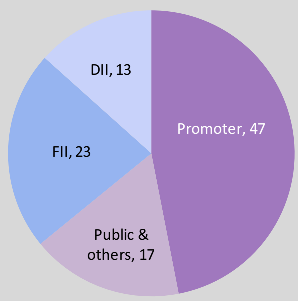
Stock data

CMP	Rs 97
Reuters Code	APOL.BO
Bloomberg Code	APTY IN
Equity Shares o/s (mn)	504
Market Cap (Rs mn)	48,890
Market Cap (USD mn)	920
3m Avg daily t/o(US$ mn)	5.5

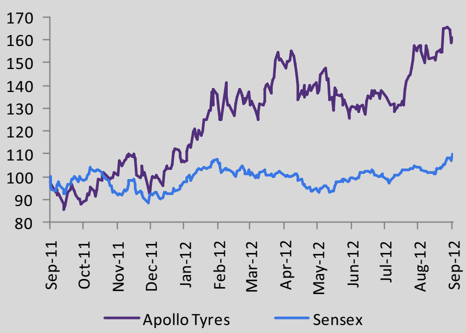
Stock performance

52-week high/low			Rs 102/52
	1M	3M	12M
Absolute (%)	2.3	23.0	67.4
Relative (%)	(2.7)	12.5	51.4

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull case	Base case	Bear case
Standalone volume growth (%)	10.0	5.0	0.0
Standalone Realisation growth (%)	8.0	4.0	2.0
Standalone revenue growth (%)	18.8	9.2	2.0
Standalone EBITDA (Rs mn)	12,579	10,310	8,730.03
Inc/decrease from base case (%)	22.0		(15.3)
Standalone EBITDA margin (%)	**12.0**	**10.7**	**9.7**
Consolidated revenue growth (%)	15.0	8.0	2.0
Consolidated EBITDA margin (%)	**12.5**	**11.3**	**9.8**
Consolidated EPS (Rs)	**18.3**	**14.1**	**9.9**
Inc/decrease from base case (%)	30.0		(29.2)
Multiple (x)	9.0	8.5	7.5
CMP	97.0	97.0	97.0
Target Price (Rs)	**165**	**120**	**75**
Upside (%)	**70.1**	**23.5**	**(22.8)**

Source: Company, Violet Arch Research

Particulars	FY11	FY12	FY13E	FY14E
Standalone volumes (MT)	303,600	388,608	404,152	424,360
Standalone realisation (Rs)	180,846	209,926	218,323	227,055
Consolidated EBTIDA margin (%)	10.9	9.6	10.9	11.3

Source: Company, Violet Arch Research

Base case

- Standalone business tyre volume growth at 4% / 5% to 404,152mt / 424,360mt in FY13E / FY14E. The M&HCV segment would experience a moderate growth of 2% / 3% in FY13E / FY14E.
- Standalone net realization growth of 4% each in FY13E and FY14E, respectively. Realization growth on the back of a 30% CAGR growth in Truck and bus radial segment.
- European volume growth of 0% and 2% in FY13E and FY14E, respectively.
- EBITDA margin of 10.5% and 10.7% in FY13E and FY14E, respectively for the domestic business (standalone); 16.6% and 16.8% in FY13E and FY14E, respectively, for the European business. Consolidated EBITDA margin of 10.9% and 11.3% in FY13E and FY14E, respectively.
- Domestic natural rubber price assumptions (RSS 4 Kottayam) of Rs 180/kg and Rs 170/kg for FY13 and FY14E, respectively. Landed price for Apollo Tyres at Rs 200/kg and Rs 190/kg for FY13 and FY14E, respectively (around 10% logistics and tax cost on RSS 4 Kottayam for the company).

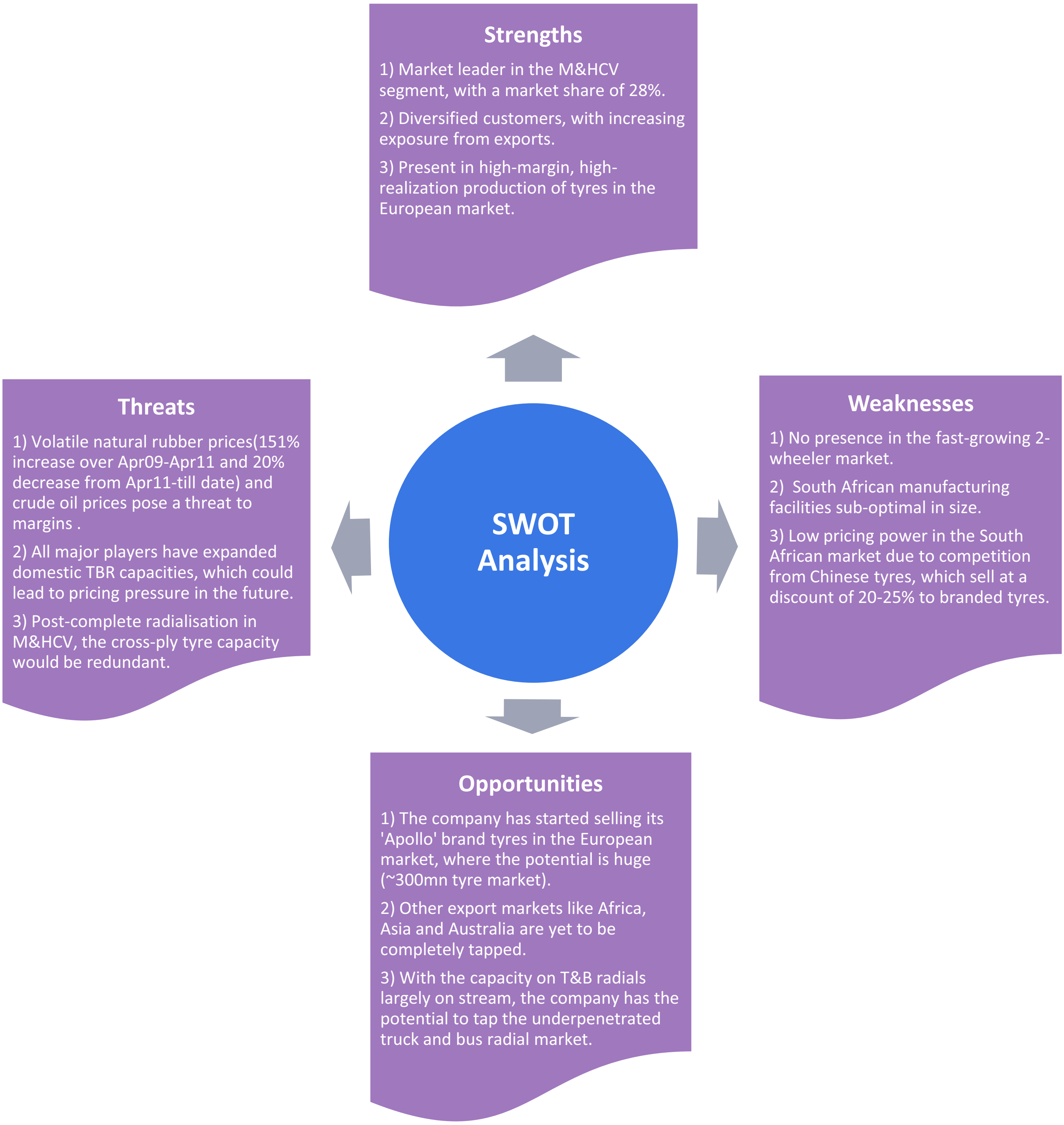
Bull case

- M&HCV OEM demand revives and grows at 5% / 8% in FY13E / FY14E, thereby aiding domestic tyre volume to grow by 8% / 10% in FY13E / FY14E. Natural rubber prices decline further leading to consolidated EBITDA margin at 12.5% in FY14E.

Bear case

- Volume growth of domestic business to be flat in FY14E. Natural rubber prices increase depressing consolidated EBITDA margin to 9.8% in FY14E.

SWOT Analysis



Source: Violet Arch Research

Investment Arguments

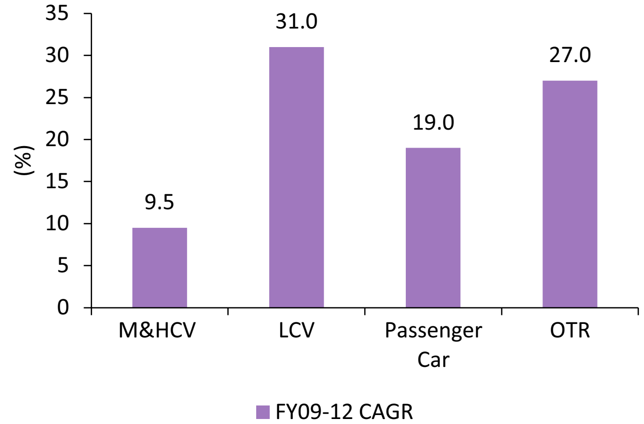
Replacement demand, exports to drive revenue growth

In the last three years, the Indian automobile industry has witnessed robust growth. The CV segment clocked a CAGR of 27.6% over FY09-12, while the passenger car segment logged a CAGR of 19% during the same period. The M&HCV segment, which contributes around 65% of APTY's revenues, registered a CAGR of 9.5%, while the LCV segment, which constitutes about 9% of total revenues, grew at a faster pace of 31% over FY09-12.

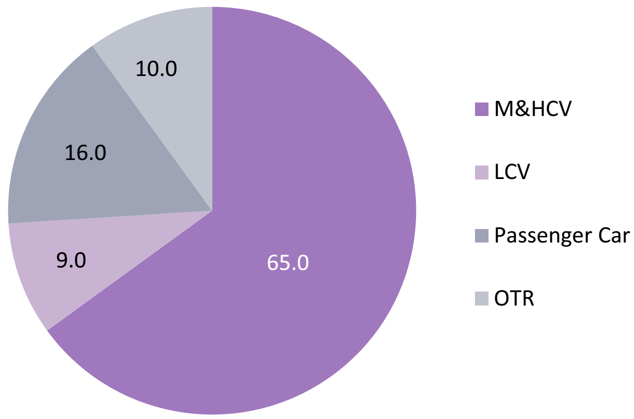
We expect this robust growth to translate into a CAGR of 8% in the domestic replacement market over FY13-14E. The lifespan of a truck and bus tyre varies anywhere between 9 and 15 months based on usage. Passenger car tyres have a lifespan of 3-4 years.

Out of 65% of the contribution from the truck and bus segment (M&HCV), around 70% share comes from the replacement market, while about 30% comes from the OEM segment.

CAGR of auto categories over FY10-12



Revenue contribution from categories



Source: Company, Violet Arch Research

APTY has been expanding its operations aggressively in the export market to counter the cyclicality in the domestic market. While it has set up offices in the Middle East, plans are afoot to expand its footprint in the rest of Asia and Australasia. The 'Apollo' brand tyres would continue to be exported to Europe by selling them to its European subsidiary to be marketed in the region. We expect export revenues to log CAGR of around 18% during FY13-14.

Structural shift towards radial tyres to aid realisations

The Indian tyre industry is undergoing a structural shift towards radial tyres from cross-ply tyres, particularly in truck and bus tyres. The contribution of radial tyres in the truck and bus segment currently is around 20%, while for passenger cars is about 98%. In developed countries penetration of radial tyres in truck and bus segment is as high as 90-95%. The global average is currently at around 65%.

Radial tyres sell at a premium of around 20% to cross-ply tyres. Incidentally, all the recent capacity additions of tyre companies have been in radial tyres. Also, radial tyres, which offer better fuel efficiency, have a longer lifespan vis-à-vis cross-ply tyres.

In ideal road and driving conditions radial tyres are about 36% more cost-efficient than bias ply-tyres. For companies, radial tyres would offer a similar EBITDA margin as bias ply tyres during the initial years due to lower capacity utilization and on account of some discount to selling price to create awareness.

Cost economics of radial *vs.* bias ply tyres for truck and bus segment

Truck Tyre	Tyre type	
	Cross Ply	Radial
Cost of tyre (Rs)	17,000	20,400
Replacement cycle (km)	60,000	96,000
Cost of Tyre / 100 Km (Rs)	28	21
Cost advantage per Km (%)	**-**	**25**
Mileage (km/litre)	3.6	4.0
Mileage advantage per km (%)	**-**	**11**

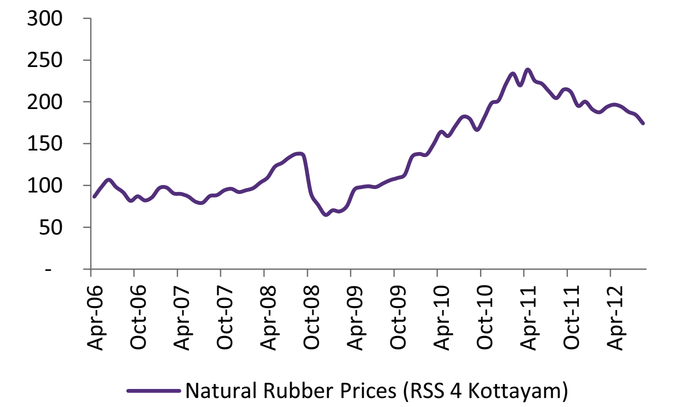
Source: Company, Violet Arch Research

Softening raw material prices to drive EBITDA margin of domestic business

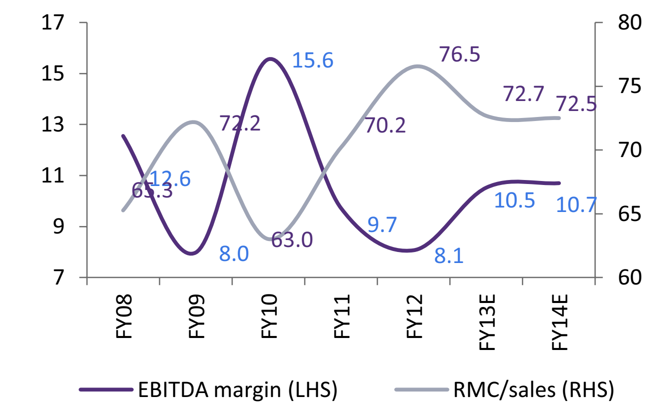
Tyre companies' EBITDA margins are extremely sensitive to raw material prices such as natural rubber, carbon black and synthetic fibre. In the last couple of years, natural rubber prices increased exponentially, which impacted EBITDA margins of Apollo Tyres.

According to RCMA Commodities Asia Group, production of natural rubber will exceed usage by 299,000 metric tonnes in 2013. This is expected to bring down prices of natural rubber, which had increased in the last couple of years, due to strong global demand as well as a shortfall in supply, partly because of floods in Thailand, which is one of largest producers of natural rubber. Thus, EBITDA margins of the domestic business stand to gain. Moreover, higher growth in the export market and replacement sales vis-à-vis the OEM market is expected to further aid margins.

Natural rubber prices volatile with a declining trend…



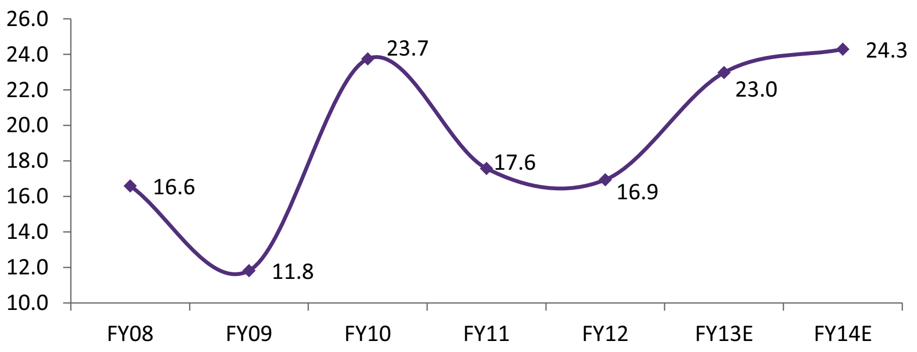
…. highly influential on EBITDA margins (Standalone)



Source: Company, Violet Arch Research

Consequently, standalone EBITDA/kg is expected to increase by 36.1% in FY13E to Rs 23 and by 6% in FY14E to Rs 24.3, nearing its peak achieved in FY10.

EBITDA/kg to improve substantially in the coming years

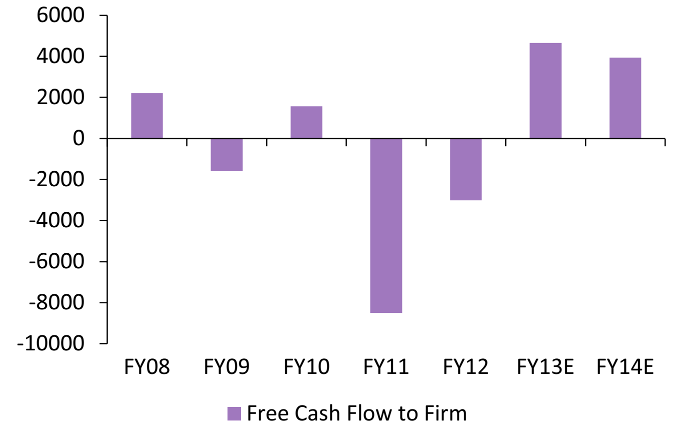


Source: Company, Violet Arch Research

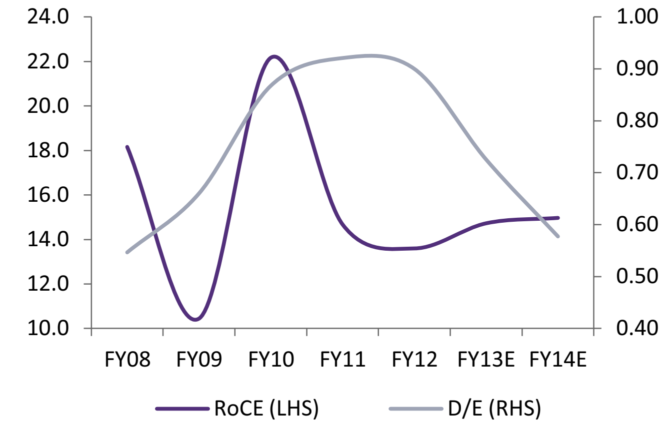
Capex cycle near completion, free cash-flow to firm up and debt/equity to improve

Apollo Tyres had undertaken a capex of Rs 2,300mn in Chennai, a Greenfield capacity to manufacture truck and bus radial tyres. The company is expected to complete the capex with a capacity of 450tpd by September 2012. Thus, the consolidated net debt is expected to subside from 2HFY13. Benefits of the capex are expected to accrue with improved free cash-flow to firm, debt/equity and RoCE ratios.

Free cash-flow to firm to improve (Rs mn)



RoCE to stabilize, while D/E expected to decline



Source: Company, Violet Arch Research

Subsidiaries to aid consolidated margins and offer synergy

Apollo Vredestein, the European subsidiary, specializes in ultra-high performance tyres and winter tyres. Winter tyres are high-realization and high-margin products. Incidentally, around 33% of total tyres manufactured by the subsidiary are winter tyres. Its volume growth in FY13-14 is expected to remain muted due to a slowdown in the EU, while its margins, which are currently superior to the domestic business, are expected to improve further on account of softening natural rubber prices.

The South African subsidiary has been reeling under pressure due to penalties on cartels, adverse exchange rates and lower pricing power on account of a high proportion (around 50%) of cheap Chinese imports into the country. With lower natural rubber prices envisaged in the short term, we expect South African operations to break even during FY13. Hence, the consolidated EBITDA margin is expected to get a boost.

Revenues (Rs mn)	FY11	FY12	FY13	FY14
India	54,905	81,579	88,236	96,353
South Africa	11,831	13,049	14,761	15,508
Europe	22,344	28,499	30,779	32,650
EBITDA (Rs mn)				
India	5,336	6,583	9,287	10,310
South Africa	710	(34)	221	465
Europe	3,821	4,685	5,109	5,485
EBITDA margin (%)				
India	9.7	8.1	10.5	10.7
South Africa	6.0	(0.3)	1.5	3.0
Europe	17.1	16.4	16.6	16.8
Consolidated EBITDA margin (%)	**10.9**	**9.6**	**10.9**	**11.3**

Source: Company, Violet Arch Research

Key Risk and Concerns

Sustained slowdown in M&HCV segment to further hamper growth and impact EBITDA margins; CCI order of cartelization an overhang

The truck and bus category constitutes around 65% of domestic revenues, of which 40% is from the OEM segment. Recently, the M&HCV segment has witnessed a significant slowdown due to rising interest rates, and slowing GDP and IIP numbers (YTD de-growth of 12%). Sustained de-growth in this segment would not only hamper Apollo Tyres' OEM sales, but also the subsequent replacement demand in the coming years, thereby leading to under-utilization of expanded capacities and subsequent impact on EBITDA margins.

The pending CCI of cartelization on tyre companies remains an overhang on the stock.

Increased exposure to crude derivatives to adversely impact margins

Natural rubber prices have been declining over the last couple of quarters, while carbon black and nylon fabric have remained firm. Increased radialization in the M&HCV segment can further increase crude-linked raw material exposure for Apollo Tyres. With uncertainties over crude prices and exchange rates, EBITDA margins could remain under pressure in spite of the softening of natural rubber prices.

Redundancy of existing cross-ply capacities can impact margins

With rising radialization of truck and bus tyres, existing cross-ply capacities can become redundant soon. This could lead to under-utilization of capacities in the future and impact operating margins of Apollo Tyres. The company has started converting a certain portion of its cross-ply tyres into speciality tyres.

Chinese imports pose a threat to Apollo Tyres' expanded capacity

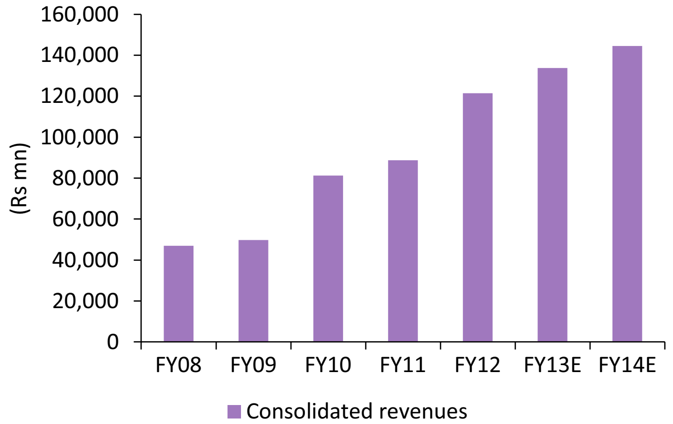
Imports of Chinese tyres have been an irritant to domestic tyre manufacturers for some time. The current market share of imported Chinese tyres in commercial vehicles is estimated at 5-6%. Often, these imported tyres sell at prices lower than the cost of production of domestic players. If the anti-dumping duty is withdrawn, it could exert pressure on pricing power on the expanded capacities of domestic tyre companies.

Financial Outlook

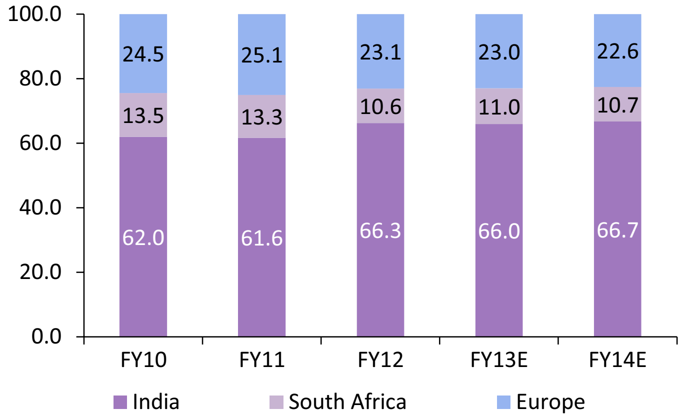
Revenue CAGR to be 9.0% over FY12-14E

Apollo Tyres' consolidated net revenues grew at a CAGR of 23.1% over FY07-12 to Rs 121.5bn. We expect its net revenues to grow at a CAGR of 9.0% during FY12-14E. We expect revenues from Indian operations to grow by a CAGR of 8.7%, while revenues of the European subsidiary and South African operations to register a CAGR of 7% and 9%, respectively, over FY12-14E.

Consolidated net revenue trend



Geography-wise revenue (%)

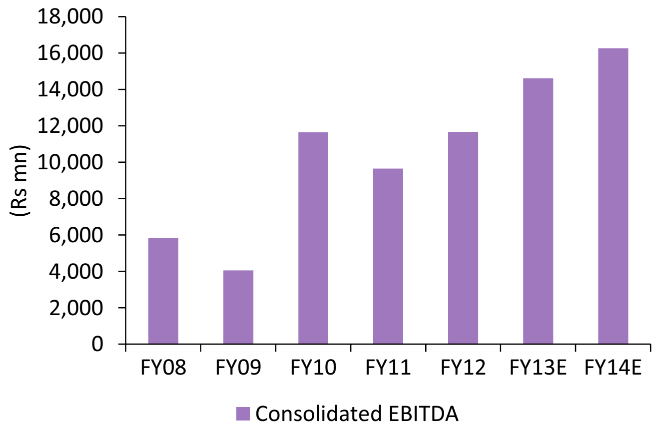


Source: Company, Violet Arch Research

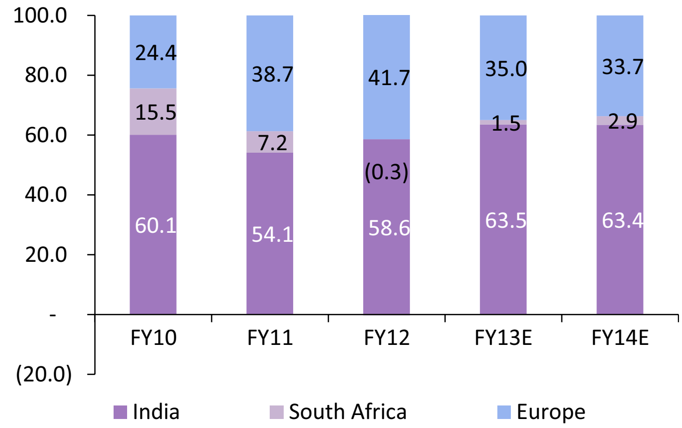
EBITDA CAGR to be 18.1% over FY12-14E

Apollo Tyres' EBITDA grew at a CAGR of 24.8% over FY07-12 to Rs 11.7bn. We expect its EBITDA to log a CAGR of 18.1% during FY12-14E. We expect EBITDA from Indian operations to log a CAGR of 25.1%, while EBITDA of the European subsidiary to register a CAGR of 8.2% over FY12-FY14E. The South African Subsidiary is expected to post positive EBITDA of Rs 479mn in FY14 from a loss of Rs 34mn in FY12. The consolidated EBITDA margin is expected to be at 10.9% in FY13 and 11.3% in FY14.

Consolidated EBITDA trend



Geography-wise EBITDA contribution-trend



Source: Company, Violet Arch Research

PAT CAGR to be 26.9% over FY12-14E

Apollo Tyres' consolidated Adj. PAT logged a CAGR of 30.2% over FY07-12 to Rs 4.4bn. We expect its PAT to log a CAGR of 26.9% during FY12-14E to Rs 7.1bn. The PAT margin is expected to be at 4.9% in FY14, while EPS at Rs 14.1.

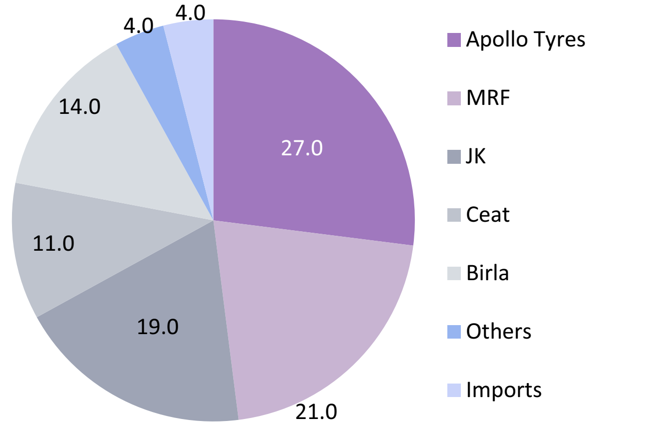
Valuation

Apollo Tyres is currently trading at a P/E of 6.9x, EV/EBITDA of 4.0x and P/BV of 1.2x. We believe that raw material prices peaked out last year, and hence the EBITDA margin of the company is expected to get a boost in the coming years. With the capex at the fag-end, the free cash-flow to firm is expected to be positive. Thus, we value the company at a P/E of 8.5x (a 5% premium to its historical average P/E of 8.1x) its FY14E EPS of Rs 14.1 and arrive at a target price of Rs 120, implying a 23.5% upside from current levels.

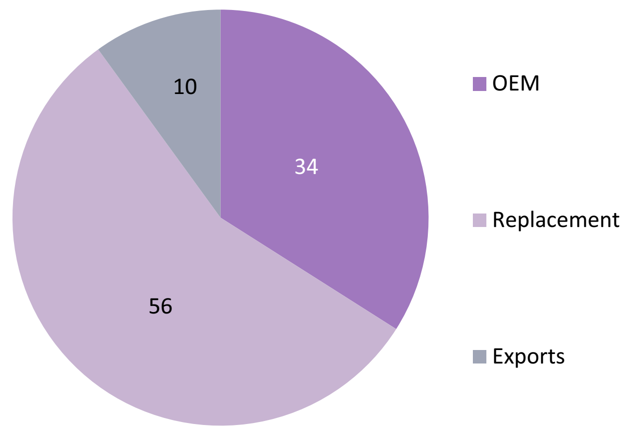
Company Background

Apollo Tyres Ltd. is a leading manufacturer of tyres in India, with a presence in CV, passenger vehicles and tractor tyres. The company has nine manufacturing facilities, with a recent greenfield capacity at Chennai to be completed in the second half of the year. It has also acquired subsidiaries in Europe and South Africa to expand its operations at the global level. The company acquired the European subsidiary at a consideration of Rs 2.5bn in FY10, while the South African subsidiary at Rs 2.9bn in FY07. The European subsidiary has been a successful acquisition, with margin accretions and stable profits, while South African subsidiary has been plagued by competition from Chinese players.

Domestic market share of truck and bus segment (%)

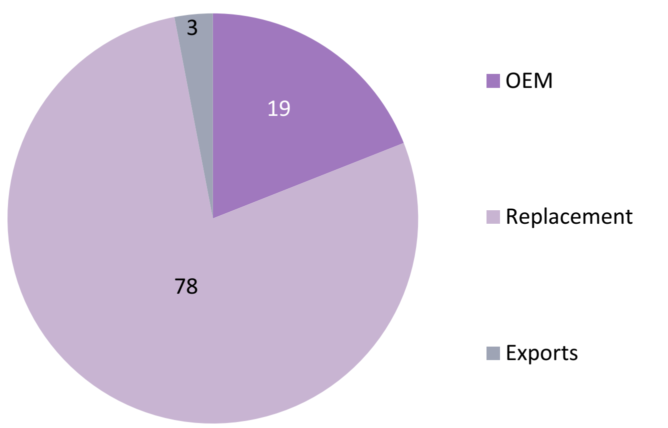


Domestic segment-wise revenue share (%)

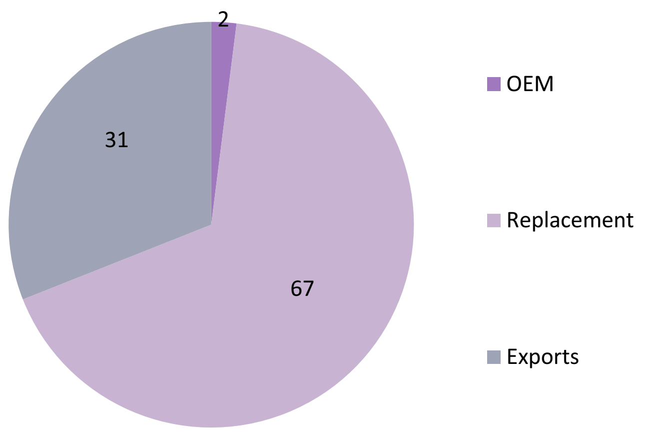


Source: Company, Violet Arch Research

European subsidiary segment-wise share (%)



South African subsidiary segment-wise share (%)



Source: Company, Violet Arch Research

Financial Summary (Consolidated)

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**88,677**	**121,533**	**133,775**	**144,511**
growth (%)	9.2	37.1	10.1	8.0
Operating expenses	79,026	109,872	119,157	128,251
EBITDA	**9,651**	**11,661**	**14,618**	**16,260**
growth (%)	(17.2)	20.8	25.4	11.2
Depreciation	2,719	3,256	3,756	3,888
EBIT	**6,932**	**8,405**	**10,861**	**12,372**
Interest paid	1,970	2,873	2,961	2,815
Other income	509	326	332	337
Exceptional items	-	(294)	-	-
Pre-tax profit	5,471	5,565	8,232	9,894
Tax	1,063	1,444	2,140	2,788
Effective tax rate (%)	19.4	25.9	26.0	28.2
Minority interest	(0)	(0)	-	-
Income from JV/associates	(6)	(23)	-	-
Net profit	**4,402**	**4,098**	**6,092**	**7,106**
Adjusted net profit	**4,408**	**4,415**	**6,092**	**7,106**
growth (%)	(22.8)	0.2	38.0	16.6
Shares o/s (mn nos)	504	504	504	504
Consol EPS	8.7	8.8	12.1	14.1

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net fixed assets	36,673	42,486	41,992	42,842
Net Intangible assets	2,098	2,396	2,502	2,618
Investments	**112**	**158**	**166**	**174**
Current assets				
Inventories	17,538	19,991	21,678	23,629
Sundry Debtors	9,517	11,458	12,828	13,857
Cash and Bank	1,909	1,730	5,120	7,579
Other current assets	-	153	153	153
Loans and advances	5,215	5,548	5,769	6,127
Total assets	**73,060**	**83,920**	**90,206**	**96,979**
Shareholders' funds	**24,125**	**28,328**	**34,015**	**40,648**
Share capital	504	504	504	504
Reserves & surplus	23,621	27,824	33,511	40,144
Minority interest	8	8	8	8
Total Debt	22,219	25,497	24,673	23,461
Deferred Tax Liability	**3,162**	**4,025**	**4,131**	**4,464**
Curr Liab & prov				
Current liabilities	19,235	21,034	22,257	22,824
Provisions	4,312	5,028	5,123	5,575
Total liabilities	48,935	55,592	56,192	56,331
Total equity & liabilities	**73,060**	**83,920**	**90,206**	**96,979**

Cash Flow

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Profit before Tax	5,471	5,565	8,232	9,894
Adjustments for:				
Depreciation	2,719	3,256	3,756	3,888
Other Non-cash adjustments	1,832	2,825	2,894	2,749
Operating Profit before Working Cap Changes	**10,023**	**11,646**	**14,883**	**16,530**
Adjustments for:				
(Increase)/Decrease in Sundry Debtors	(1,213)	(1,192)	(1,370)	(1,029)
(Increase)/Decrease in Loans and Advances	(547)	(469)	(221)	(358)
(Increase)/Decrease In Inventories	(7,502)	(2,369)	(1,687)	(1,951)
Increase/(Decrease) in Current Liabilities and Provisions	4,050	930	1,422	777
Cash generated from Operating Activities	**4,810**	**8,546**	**13,028**	**13,968**
Direct Taxes Paid	(647)	(953)	(2,216)	(2,539)
Net Cash from Operating Activities	**4,163**	**7,593**	**10,812**	**11,430**
Cash Flow From Investing Activities				
Capital expenditure	(10,926)	(7,895)	(3,262)	(4,737)
Change in investments	(59)	(52)	(8)	(8)
Other investing cash flow	98	(112)	67	67
Net Cash (used) in Investing Activities	**(10,887)**	**(8,059)**	**(3,204)**	**(4,679)**
Cash Flow From Financing Activities				
Issue of equity	-	-	-	-
Issue/(repay) debt	899	4,026	(824)	(1,212)
Dividends paid	(441)	(293)	(434)	(264)
Interests Paid	(1,801)	(2,769)	(2,961)	(2,815)
Other financing cash flow	6,498	(654)	-	-
Net Cash from / (used in) Financing Activities	**5,155**	**309**	**(4,219)**	**(4,291)**
Closing cash	**1,909**	**1,730**	**5,120**	**7,579**

Financial Ratio

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	8.7	8.8	12.1	14.1
Adj EPS growth (%)	(22.8)	0.2	38.0	16.6
EBITDA margin (%)	10.9	9.6	10.9	11.3
Pre-tax margin (%)	6.2	4.6	6.2	6.8
ROE (%)	20.1	16.8	19.5	19.0
ROCE (%)	14.7	13.6	14.7	15.0
Turnover & Leverage ratios (x)				
Asset turnover (x)	1.5	1.6	1.6	1.6
Leverage factor (x)	3.0	3.0	2.7	2.4
Net margin (%)	5.0	3.6	4.6	4.9
Net Debt/Equity (x)	0.8	0.8	0.6	0.4
Working Capital & Liquidity ratio				
Inventory days	94	85	91	91
Receivable days	36	31	33	34
Payable days	82	57	57	53
Valuations				
PER (x)	11.1	11.1	8.0	6.9
Price/Book value (x)	2.0	1.7	1.4	1.2
EV/EBITDA (x)	7.2	6.2	4.7	4.0

21 September, 2012

Bank of Maharashtra

The Network Spreads

Absolute Rating	**BUY**
Target Price	**Rs 58**
Upside	**20%**

Bank of Maharashtra (BoM) is a Pune-based PSU bank. At the end of FY12, it had an extensive network of 1,589 branches and business of Rs 1,325bn. The bank has a healthy CASA ratio, given the fact that around 53% of its branches are in rural and semi-urban areas. Over the last couple of years, its margins have improved consistently on account of healthy growth in CASA and CD ratios. We expect the same to continue. We initiate coverage on the stock with a Buy rating and at a target price of Rs 58, with around 20% upside from the CMP.

CASA on uptick, expect it to continue

With a relatively high CASA ratio, BoM enjoys high penetration in rural and semi-urban areas of Maharashtra. The CASA ratio of the bank grew from 35.7% in FY09 to 41.3% in FY12. We expect the same to remain at a healthy level of around 41% till FY14E.

Improvement in NIM due to growth in CASA and CD ratios

NIM of BoM has improved from 2.1% in FY10 to 3.2% in FY12 on account of an improvement in the CASA ratio and the credit-deposit (CD) ratio, which has grown from 63.7% to 73.3% from FY10 to FY12. We expect NIM to improve over the next two years, largely due to sustainability of CASA at around 41% levels till FY14E, while the CD ratio is likely to improve to 75.8% by FY14E.

Growth in Maharashtra has been impressive

Gross State Domestic Product (GSDP) for Maharashtra grew at 11.4% CAGR between FY05 and FY11 versus national GDP growth of 8.6%. The state contributes 15.0% of the national GDP, with 9% of the population. BoM has huge presence in Maharashtra (~65% of its branch network in the state alone) & so its closely tied to the fortunes of the state as the bank has the highest number of branches in Maharashtra after SBI in the state which has allowed the bank to grow in-line with the state's progress over the past decade.

Expect improvement in operating efficiency

We expect an improvement in cost-efficiency on account of income growth. Besides, the management has decided to reduce hiring over the next couple of years. The cost-to-income ratio of the bank shot up as high as 59.8% in FY11. Subsequently, it came down to 46.7% in FY12. We expect the cost-to-income ratio to come down to around 40% by FY14E. We expect the cost to average assets to decline from 1.8% in FY12 to 1.6% in FY14E.

Growth in return ratios

The return ratios of the bank have been low for the last two years. However, with profit growth clocking a CAGR of 30.3% between FY12 and FY14E, we expect RoA to improve from 0.5% in FY12 to 0.6% in FY14E, while RoE to increase from 9.9% in FY12 to 13.6% in FY14E.

Valuation

Currently trading at Rs 48, the stock is available at a price-to-adjusted book value (P/ABV) of 0.6x FY14E. With improvement in NIM, better operating efficiency and lower credit costs to aid growth in profits of BoM, we expect profits to grow at a CAGR of 30% between FY12 and FY14E. We value the bank's business at a P/ABV of 0.7x FY14E, a slight discount to the historical average at 0.8x due to increase in restructured assets, concerns on SME/MSME portfolio and fall in return ratios (RoE at 13.7% in FY14E as against 16.4% in FY10 and RoA at 0.6% in FY14E as against 0.7% in FY10). We initiate coverage on the stock with Buy rating and at a target price of Rs 58, with an upside of around 20% from the CMP.

Standalone Y/E Mar 31 (Rs mn)	FY11	FY12	FY13E	FY14E
Net Interest Income	19,684	25,171	30,603	37,122
Growth (%)	51.9	27.9	21.6	21.3
PPP*	10,055	16,844	21,382	26,847
Growth (%)	8.9	67.5	26.9	25.6
Profit After Tax	3,304	4,308	5,271	7,313
Growth (%)	(24.8)	30.4	22.3	38.7
NIM (%)	2.8	3.2	3.3	3.4
ROAA (%)	0.4	0.5	0.6	0.8
ROAE (%)	9.7	9.9	10.7	13.6
EPS (Rs)	10.2	3.1	3.7	4.5
ABV (Rs)	76.8	66.2	71.9	81.0

*Source: Company, Violet Arch Research; *PPP – Pre-provisioning Profit*

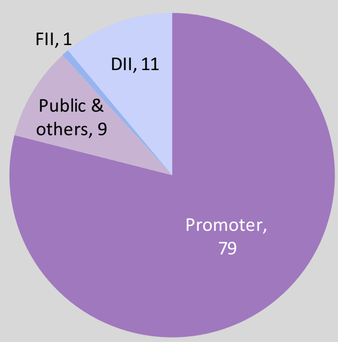
Stock data

CMP	**Rs 48**
Reuters Code	BMBK.BO
Bloomberg Code	BOMH IN
Equity Shares o/s (mn)	590
Market Cap (Rsmn)	28,536
Market Cap (USD mn)	536
3m Avg daily t/o(US$ mn)	0.1

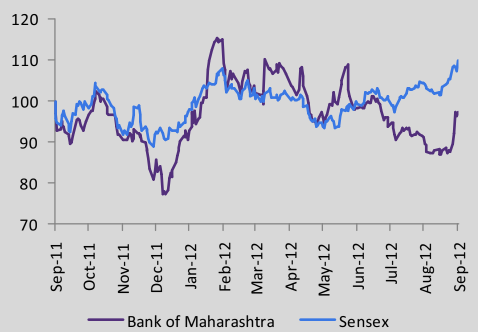
Stock performance (%)

52-week high / low			**Rs 59/38**
	1M	**3M**	**12M**
Absolute (%)	6.1	(1.0)	1.6
Relative (%)	4.7	(9.0)	(8.1)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

Particulars	FY14E		
	Bear	Base	Bull
Loan Growth (%)	17.0	20.0	22.0
NIM (%)	3.0	3.4	3.7
Slippage Ratio (%)	2.0	1.8	1.4
ABV (Rs.)	72.5	81.0	92.0
ROE (%)	9.9	13.6	19.5
P/ABV (x)	0.5	0.7	0.9
Target Price (Rs.)	36.2	58.3	82.8
CMP (Rs.)	**48.4**	**48.4**	**48.4**
Upside / (Downside) (%)	**(25.1)**	**20.4**	**71.1**

Source: Company, Violet Arch Research

Key Assumptions

Particulars (%)	FY11	FY12	FY13E	FY14E
Deposit Growth	5.6	14.5	18.0	18.0
Loan Growth	16.3	19.6	20.0	20.0
CD Ratio	70.1	73.3	74.5	75.8
NIM	2.8	3.2	3.3	3.4
RoA	0.4	0.5	0.5	0.6
RoE	9.7	9.9	10.7	13.6

Source: Company, Violet Arch Research

Base case

- We have factored in a 20% loan growth in FY14E. We have estimated deposit growth to be at 18%, thereby a credit-deposit ratio of 75.8% in FY14E as against 73.3% in FY12. The reason for our assumptions about business growth being slightly higher than the industry's is on account of the bank's expansion plans (which would lead to an improved CD ratio) and due to the setting up of new additional branches (which would result in better CASA ratio).
- For FY14, we expect the bank's margins to improve on healthy credit growth as a result of focus on high-yielding portfolio, growth in the CASA ratio and improvement in CD ratio. We expect slippages of the bank to reduce to 1.8% from 2% in FY13E (on account of the economic slowdown and corporate downgrades). The provision on the NPA-to-slippages ratio is on the higher side for the bank. The healthy recovery in FY14, coupled with higher provisions, should help the bank to control asset quality.
- Given the improvement in NIM, better operating efficiency and the lower credit cost, we expect profits of the bank to grow at a CAGR of 30.3% between FY12 and FY14E. This, in turn, would help the bank to improve its return ratios. Thus, we expect RoA to improve to 0.6% by FY14E and RoE to increase to 13.6% by FY14E.

Bear case

- We have factored in around 17% loan growth in FY14E. We expect slightly higher slippages at 2%. Hence, NIM is likely to decline to 3%, with a slight deterioration in CASA growth as against our base case assumption. The decline in business growth will take its toll on asset quality and NIMs. This would lead to lower income and higher provision, which would impact profit growth and thereby return ratios. Thus, we expect RoE to be at 9.9% in the bear case as against 22.3% in the base case in FY14E.

Bull case

- We have factored in around 22% loan growth in FY14E. We expect lower slippages at 1.2%. Hence, NIM is likely to improve to 3.7%, with higher growth in CASA as against our base case assumption. The robust business growth and better margins, along with lower provisions, would help healthy profit growth. This, in turn, would improve return ratios. Thus, we expect RoE to be at 19.5% in the bull case as against 13.6% in the base case in FY14E.

SWOT Analysis

SWOT Analysis

Strengths

1) CASA ratio has remained healthy.

2) The ratio has been improving for the last 3 years.

3) CASA per branch is on the superior side compared to peers.

4) High presence in rural and semi-urban areas has been helping in CASA growth.

5) CASA has helped in improving NIM.

6) Credit-Deposit ratio has been improving, which has helped improve NIM.

7) Asset quality has been improving over the last three years.

8) Focus on Maharashtra pays off well in terms of rural and semi-urban presence.

Weaknesses

1) High employee cost compared to industry average at Rs.0.81 mn against Rs.0.72 mn.

2) Lower productivity ratios.

3) Return ratios have been on the lower side.

4) High NPAs from the agriculture portfolio at 5.5% of the agriculture portfolio.

Opportunities

1) Lower corporate portfolio, which provides opportunity to grow the book.

2) The bank is focusing on improving its share in high-yielding home loans and real estate.

3) Branch network expansion should aid in CASA and business growth.

Threats

1) Further slowdown in the economy will impact asset quality and earnings of the bank.

2) The textile sector exposure is a cause of concern, as the bank has been witnessing slow repayments from this portfolio.

3) Capital adequacy ratio is on the lower side and BoM needs a capital infusion to sustain its tier-I ratio which is currently at 8.3%, above RBI's comfort level of 8%.

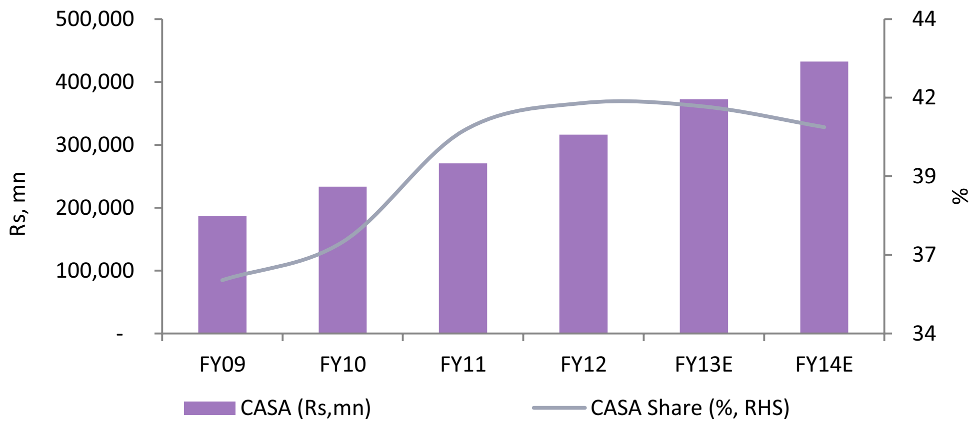
Source: Violet Arch Research

Investment Arguments

Uptick in CASA

BoM's main strength lies in its CASA ratio. The bank has a high penetration in rural and semi-urban regions of Maharashtra, enabling the bank to enjoy a higher CASA ratio. Its CASA ratio has improved from 35.7% in FY09 to 41.3% in FY12. We expect the CASA ratio to remain at a healthy level of around 41% till FY14E. The CASA book has grown at a CAGR of 19.3% between FY09 and FY12, while deposits have grown at a CAGR of 13.6% during the same period. Besides, BoM's dependency on bulk deposits has been on the lower side. This, coupled with an improvement in the CASA share, has helped the bank to curtail its cost of funds. These factors have contributed to a considerable improvement in margins of the bank.

CASA details

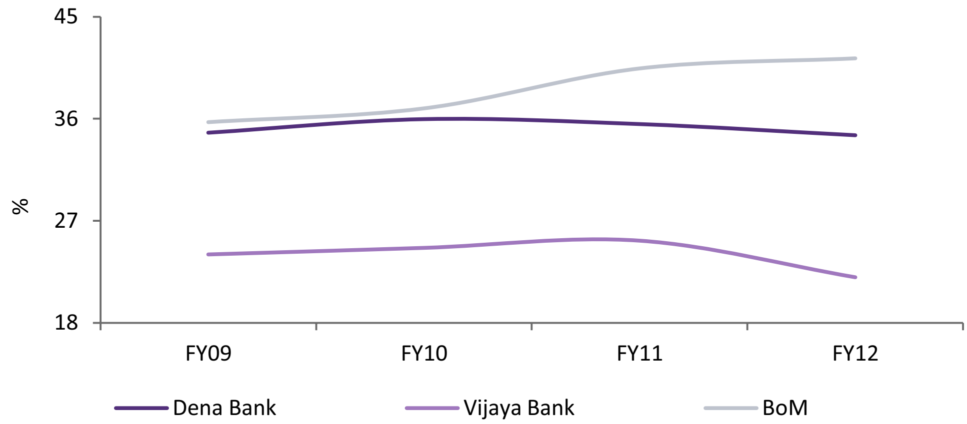


Source: Company, Violet Arch Research

CASA growth better than peers

We have taken Dena Bank and Vijaya Bank for a peer comparative study. BoM scores over its peers in terms of CASA per branch and CASA growth. The CASA ratio of BoM has improved from 35.7% in FY09 to 41.3% in FY12, Dena Bank's ratio has moved marginally downwards from 34.8% in FY09 to 34.6% in FY12, and Vijaya Bank's ratio from 24% in FY09 to 22% in FY12.

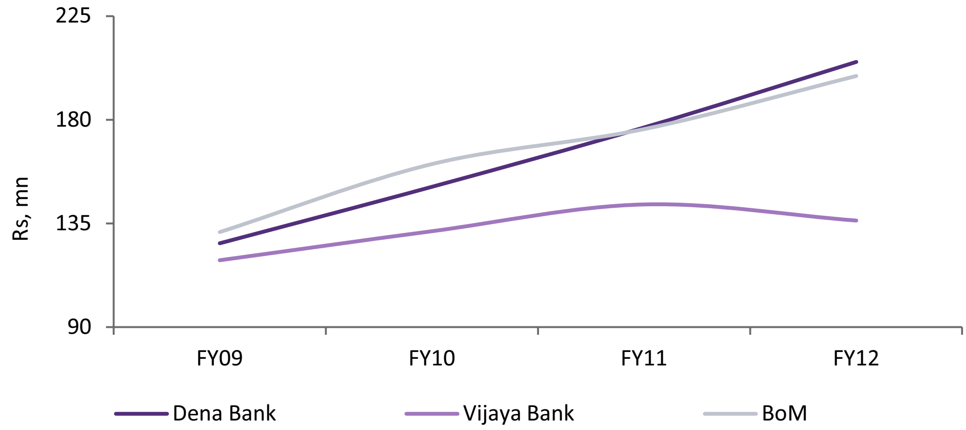
CASA ratio (%)



Source: Company, Violet Arch Research

Dena Bank's CASA per branch has improved from Rs 126.4mn in FY09 to Rs 205.1mn in FY12, while that of Vijaya Bank has moved upwards from Rs 119mn in FY09 to Rs 136.3mn in FY12. BoM's CASA per branch has grown from Rs 131.2mn in FY09 to Rs 199.1mn in FY12.

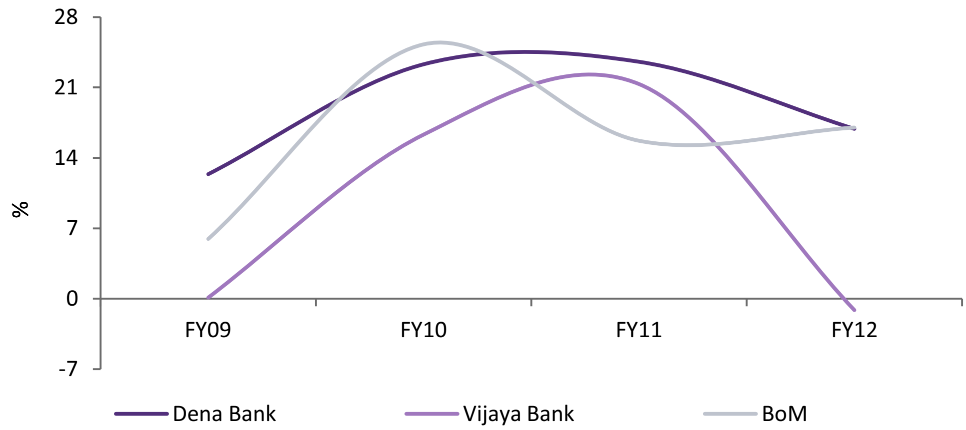
CASA per branch (Rs, mn)



Source: Company, Violet Arch Research

Dena Bank registered a healthy CAGR of 17.5% between FY09 and FY12 in its CASA book, while the same was at 4.6% for Vijaya Bank during the period. It was at 14.9% for BoM for the period.

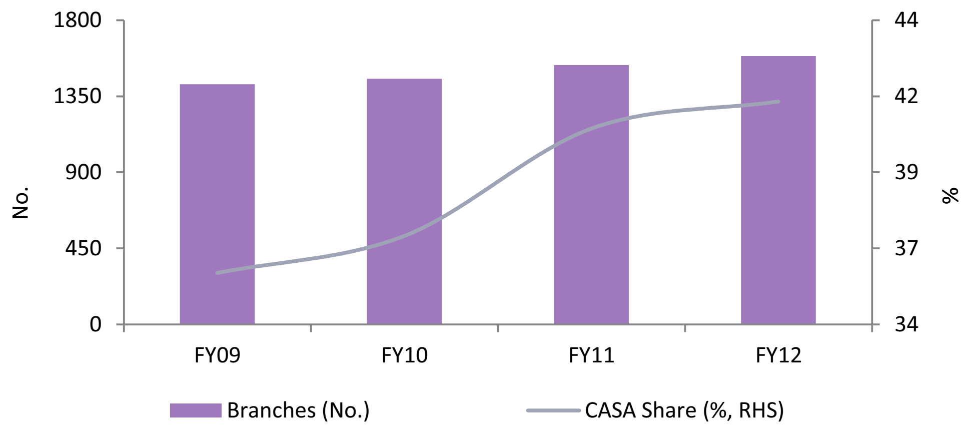
CASA growth (%)



Source: Company, Violet Arch Research

In the last four years, BoM has added 168 branches, with its CASA ratio growing from 35.7% in FY09 to 41.3% in FY12.

Branch and CASA share

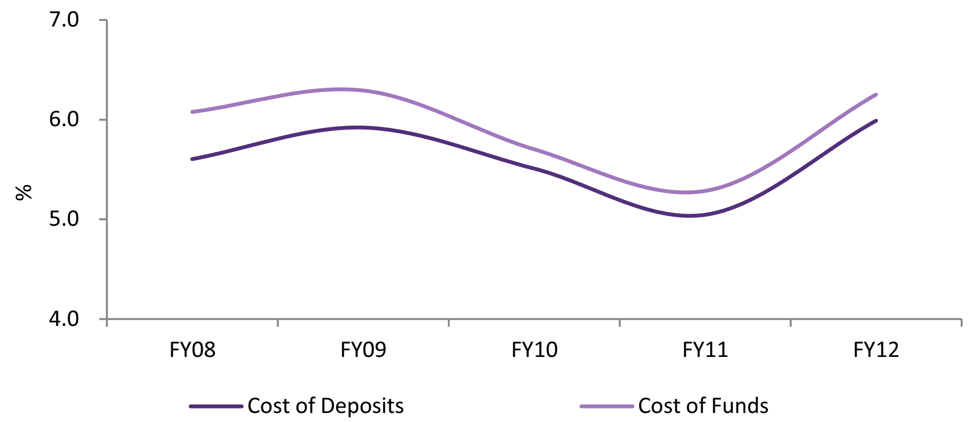


Source: Company, Violet Arch Research

Healthy CASA growth help sustain CoD at lower side

The healthy improvement in the CASA share has helped the bank to sustain its CoD at the lower side. In fact, the CoD has moved merely by 20bps from 5.9% in FY09 to 6.1% in FY12, while the CoF has remained flat at 6.3% between FY09 and FY12.

Cost

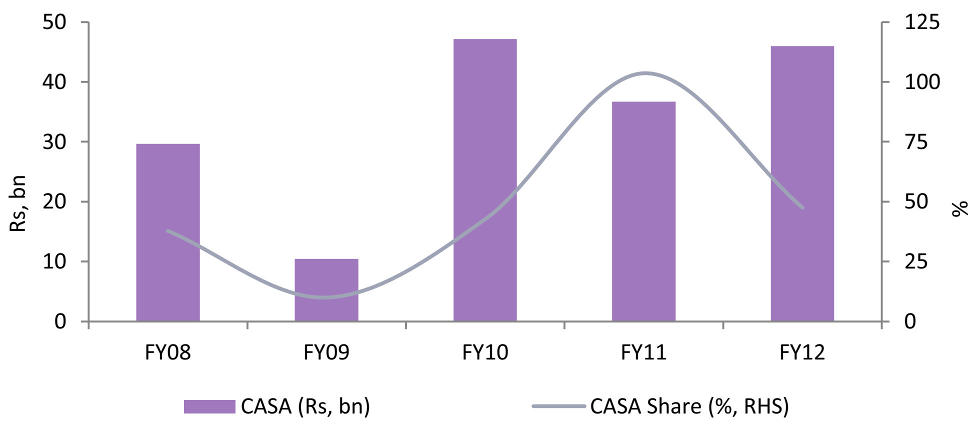


Source: Company, Violet Arch Research

Robust incremental CASA share

On an average, the incremental CASA to deposit ratio of the bank has been around 40%, mainly on account of BoM's extensive network in rural and semi-urban areas.

Incremental CASA details

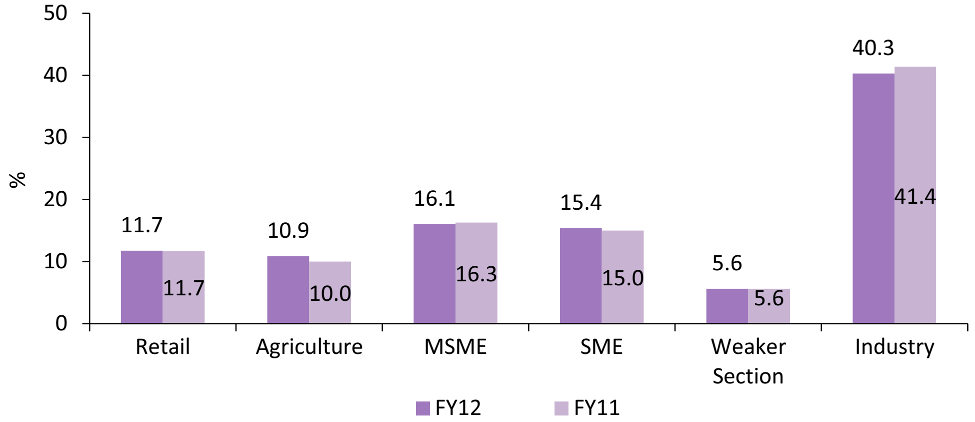


Source: Company, Violet Arch Research

Loan book fairly balanced

BoM's loan book is fairly balanced and not concentrated in a particular segment. In FY12, the bank's corporate loan portfolio formed around 40% of the loan book, while the retail book about 12% of the loan book. In the retail portfolio, home loans formed 74% of the loan book. We expect home loans and real estate book to drive loan growth in the retail segment. The bank has recently launched a "Maha Super Housing Loan Scheme". Under the scheme, the bank intends to offer loans at 10.5% (one on the lower side in comparison to peers such as IDBI Bank that offers at 11.5%) on Rs 10mn with zero processing fees. The interest rate offered under this scheme is the lowest amongst peers. The yield on real estate loans are generally on the higher side in the range of 15-16%, which should aid in margin improvement. SMEs and MSMEs together constitute around 31.5% of the loan book. The bank is aiming to improve its yields in this portfolio. Out of 209 branches it intends to set up in FY13, BoM is planning 100 branches in Maharashtra alone, primarily targeting SMEs and MSMEs as well as the agriculture sector. The agriculture loan book has witnessed an improvement. Currently, it is at 10.9% of the loan book. BoM intends to achieve a 13.5% growth target for the agriculture loan book. In FY12, the overall loan growth was at a healthy 19.6; mainly led by the agriculture portfolio, which grew by 29.8%, while SMEs & MSMEs increased by 20.2% and the retail portfolio grew by 19.8%, largely supported by other loans (except home loans).

Advance break-up (%)



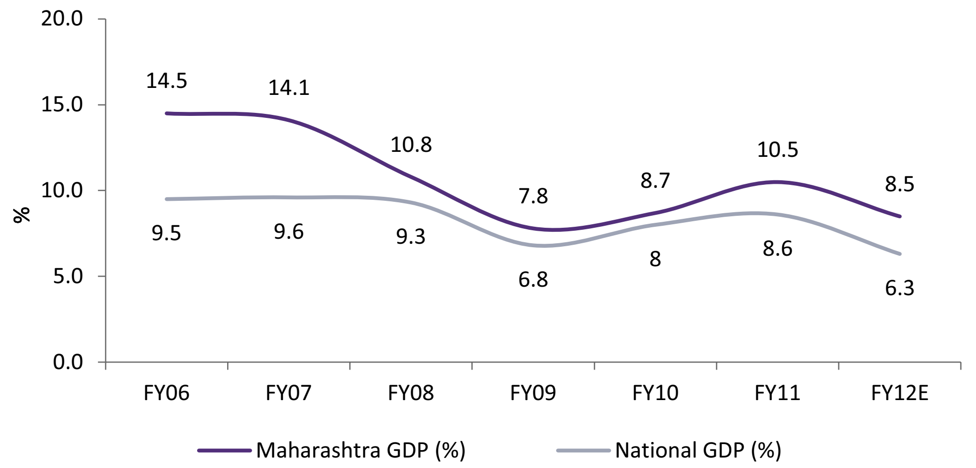
Source: Company, Violet Arch Research

Economy of Maharashtra

Bank of Maharashtra has a huge presence in Maharashtra (~65% of its branch network in the state alone) and so its closely tied to the fortunes of the state as the bank has the highest number of branches in Maharashtra after SBI in the state which has allowed the bank to grow in-line with the state’s progress over the past decade. Maharashtra is the largest state by GDP and accounts for 15% of national GDP. The state's favourable economic policies of 1970s have helped flourish business and economy, thereby making it the leading industrial state in India. Services contribute to around 61% of GDP of Maharashtra, 28% is contributed by the industry and 11% by agriculture and allied activities.

Maharashtra is one of the major hubs for auto sector, along with Chennai, NCR and upcoming Gujarat. Maharashtra and Uttar Pradesh are the major producers of sugarcane and the base of sugar industry.

Maharashtra's GDP growth rate (%)

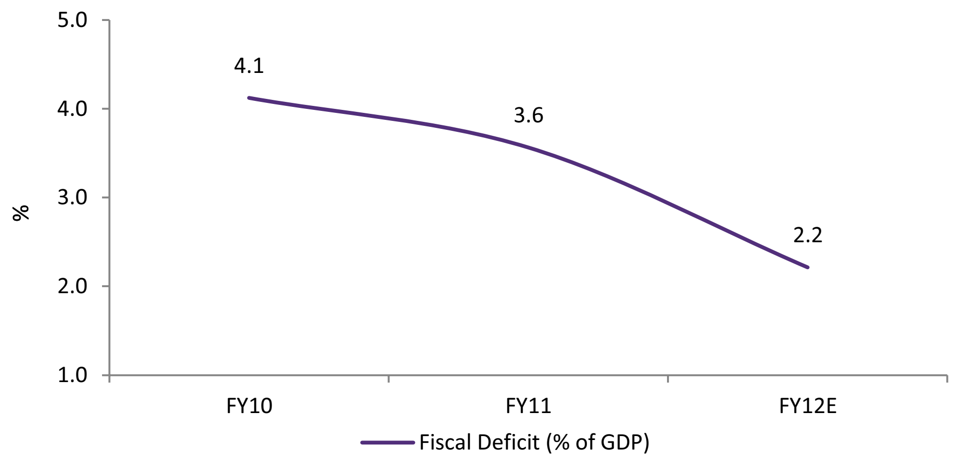


Source: Company, Violet Arch Research

Improvement in fiscal deficit in the state

Maharashtra's fiscal deficit (as a percentage to GDP of the state) has improved over the years as a result of efforts being made in this direction. The gross fiscal deficit in the state was at 5.7% in 2003-04. However, it has come down to 3.6% in FY11 and is expected to be around 2.2% in FY12 (estimated).

Maharashtra's fiscal deficit (%)

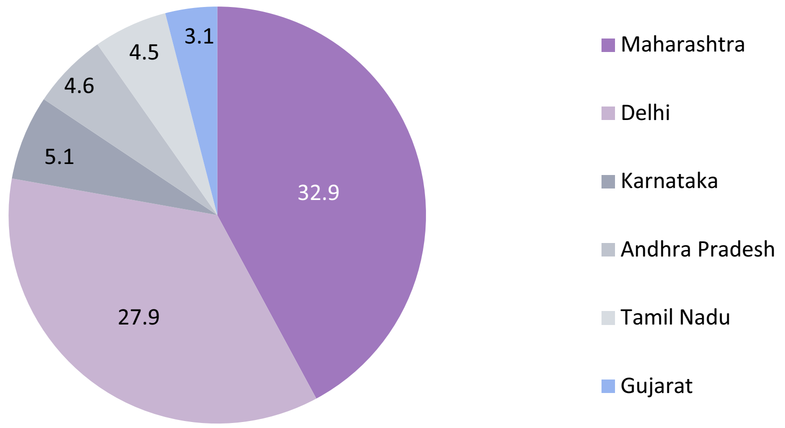


Source: Company, Violet Arch Research

The state has attracted highest FDI inflow and investment

Over the last three fiscals, Maharashtra has attracted the highest FDI inflow and investment. The share of the state stood at 32.9% of total inflows, followed by Delhi at 27.9%, Karnataka at 5.1%, Andhra Pradesh at 4.6%, Tamil Nadu at 4.5% and Gujarat at 3.1%.

Top destination of FDI in India (%)

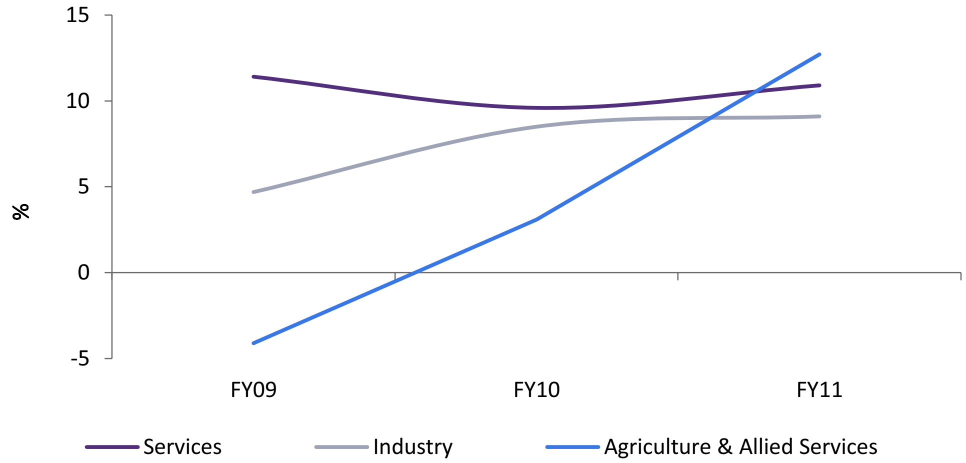


Source: Company, Violet Arch Research

Growth across major sectors in Maharashtra

Growth in the three key sectors in Maharashtra has been robust, particularly the improvement in growth in agriculture and services has been impressive. The services sector has grown at 10-11% over the last three years, while the growth rate in industry has picked up from 4.7% in FY09 to 9.1% in FY11. The growth rate in agriculture and allied services has improved from -4.1% in FY09 to 12.7% in FY11.

Growth rate in sectors (%)

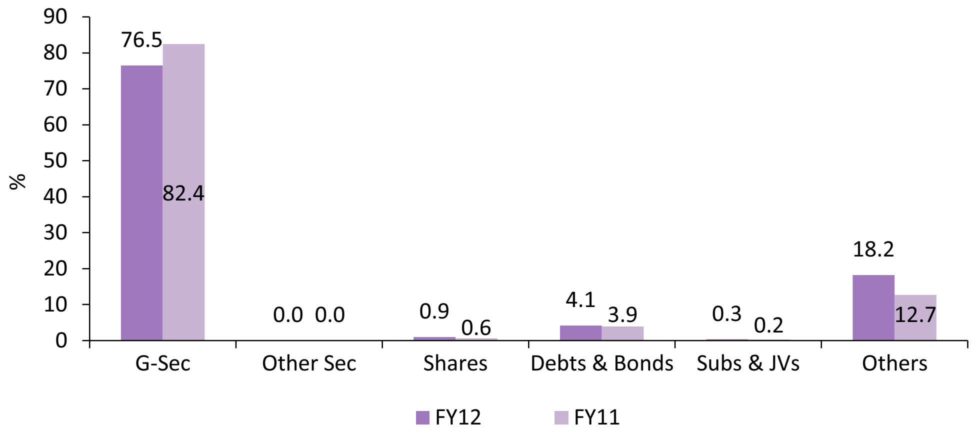


Source: Company, Violet Arch Research

While investment book remains healthy, RIDF portfolio a concern

The investment book of BoM grew at a healthy CAGR of around 16.9% between FY08 and FY12. However, the investment-deposit ratio improved marginally from 29.4% in FY08 to 29.9% in FY12. The G-sec-to-deposit ratio declined from 27.7% in FY11 to 22.9% in FY12. The RIDF portfolio is a cause of concern, since the bank has not been able to meet the PSL target. The RIDF-to-investment book ratio has increased from 9% in FY11 to 13.2% in FY12.

Investment break-up (%)

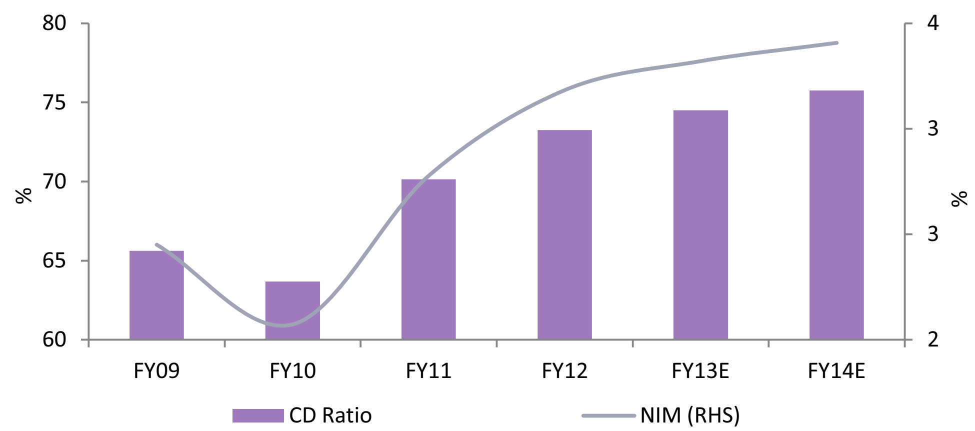


Source: Company, Violet Arch Research

NIM has been improving over the last few years

Backed by healthy growth in CASA and improvement in the CD ratio, BoM's margins have improved over the last few years. We expect the margin improvement to continue. While the CD ratio of the bank has improved from 63.7% in FY10 to 73.3% in FY12, NIM has improved from 2.1% in FY10 to 3.2% in FY12. During the same period, the yield on advances has grown from 9% to 10.7%, while the cost of funds has increased from 5.7% to 6.3%. We expect the CD ratio to improve to 75.8% by FY14E and NIM 3.4% by FY14E. The improvement in margins is not only due to the CD ratio, but also on account of its greater focus on the high-yielding segments of real estate and home loans, supported by the SME portfolio.

Ratios (%)

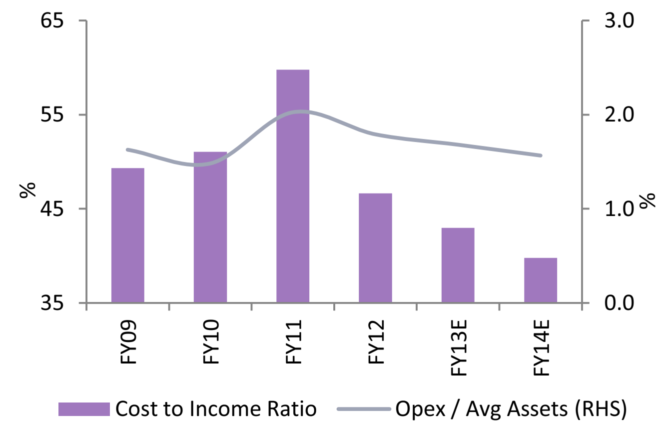


Source: Company, Violet Arch Research

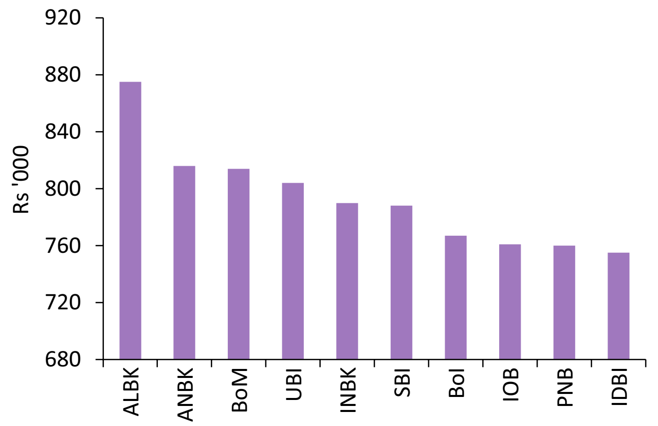
Expect improvement in cost-efficiency

We expect an improvement in cost-efficiency on the back of income growth. Besides, the management has decided to reduce hiring over the next couple of years. We expect a curtailment in the cost per employee, which is higher compared to peers. The cost-to-income ratio of the bank shot up as high as 59.8% in FY11. Subsequently, it came down to 46.7% in FY12. We expect the cost-to-income ratio to come down further to around around 40% by FY14E. We expect the cost to average assets to come down from 1.8% in FY12 to 1.6% in FY14E.

Operating efficiency (%)



Cost per employee (Rs, '000)



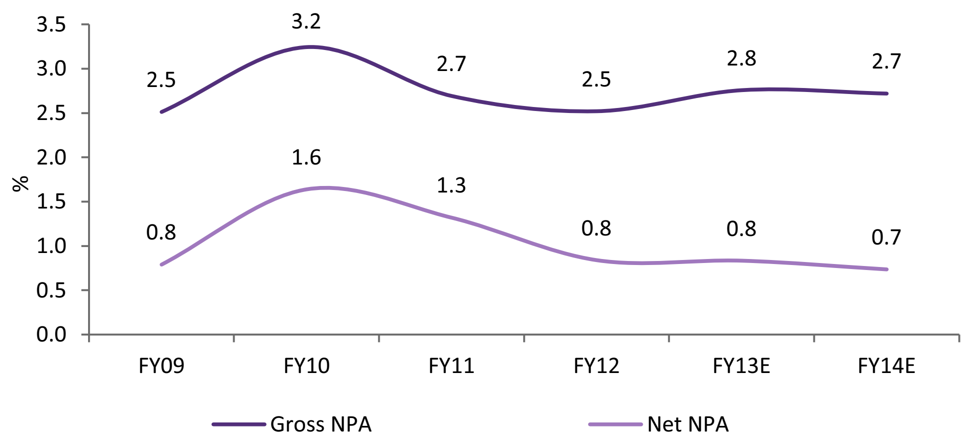
Source: Company, Violet Arch Research

Asset quality

The bank's asset quality has improved over the last few years. While GNPAs reduced from 3.2% in FY10 to 2.5% in FY12, NNPAs came down from 1.6% in FY10 to 0.8% in FY12. During the same period, the slippage ratio reduced 2.35% in FY10 to 1.7% in FY12, while the provision on the slippages ratio improved from 28.6% in FY10 to 76.9% in FY12.

However, we expect a slight deterioration in asset quality, given the lower GDP growth and stress seen in various sectors. Therefore, we have been conservative in our estimates on the bank's asset quality and expect higher provisions.

Asset quality (%)

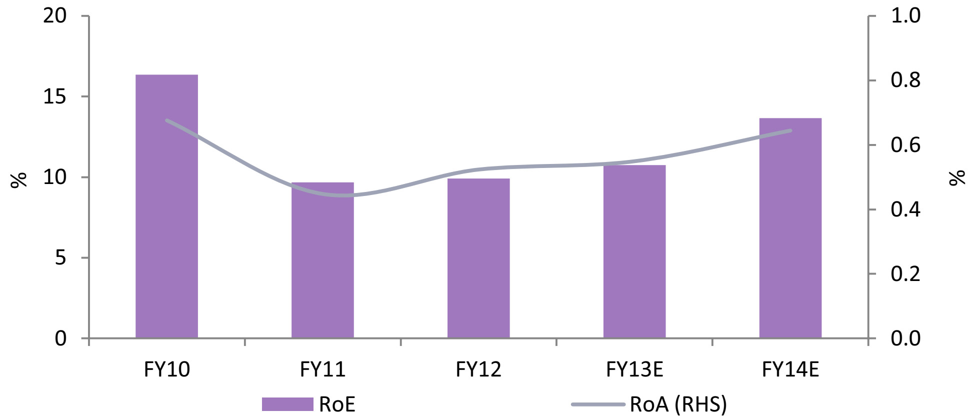


Source: Company, Violet Arch Research

Return ratios to improve

BoM's return ratios had taken a hit in FY11 when RoA fell to 0.4% from 0.7% in FY10 and RoE dropped to 9.7% in FY11 from 16.4% in FY10. This was mainly on account of the preference share conversion in FY11 and also on account of de-growth in PAT by 24.8% in FY11, largely because of higher provisions. The bank's provision expenses increased by 74.1% in FY11 over FY10. However, going forward, we expect return ratios to improve, given the fact that despite making conservative estimates on asset quality, we expect RoA to improve to 0.6% by FY14E and RoE to increase to 13.6% by FY14E.

Return ratios (%)



Source: Company, Violet Arch Research

Key Risk and Concerns

Productivity ratios lower than peers

BoM's productivity ratios are lower than its peers. The business per branch and per employee is way below its peers, namely, Dena Bank and Vijaya Bank. Its profit per branch and per employees is also on the lower side compared to its peers.

Earnings impact on account of high NPAs and opex

The bank's higher-than-anticipated NPAs and its inability to curtail opex would lead to lower-than-estimated earnings, which could affect our book-value estimates.

Further slowdown in economy may affect the growth rate

If the slowdown in the economy persists, then our growth estimates on the business of the bank may be affected, leading to an impact on earnings. There has been a slowdown in the industry segment across the country, increase in restructured books of majority of banks for the failures of the company's repayment to banks. The continuation in the slowdown over the next few months may impact our growth estimates. Currently, credit growth for the industry is at 16.6% as against 17% projected by the RBI. Demands for fresh projects have not yet come in.

With the slowdown in the economy, real estate lending has taken a hit. We believe that despite the management targeting the real estate portfolio for growing their retail book, the recent decrease in interest rates will take time to come into the system.

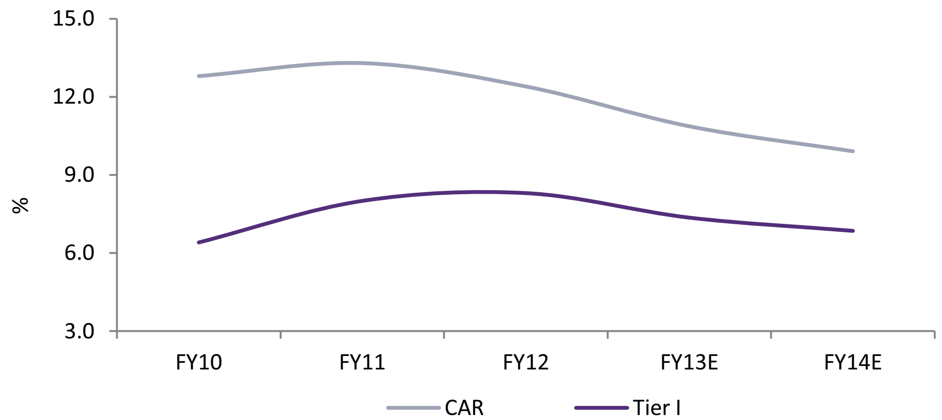
Restructured assets

BoM's outstanding restructured book, which formed 5.76% of advances, stood at Rs 32.3bn at the end of FY12. We believe that restructured accounts will increase in FY13, given that the accounts of SEBs of Punjab and Maharashtra together would constitute around Rs 17bn. BoM had restructured loans worth Rs 11bn for Rajasthan SEB in Q3FY12. We believe that the increase in restructured assets higher than expectations would hamper our earning estimates.

Capital adequacy ratio

BoM's capital adequacy ratio (CAR) stood at 12.4%, with tier-I at around 8.3% at the end of FY12. Given the kind of growth that the bank envisages, we expect it to raise funds over the next one year or so. As the bank plans to raise money from the market or through government, it can impact our estimates on return ratios. The inability of the bank to raise money from the government and improve its core capital may impact its ratings, thereby the earnings of the bank.

Capital adequacy ratio (%)



Source: Company, Violet Arch Research

Financial Outlook

BoM had a healthy business growth of around 15.3% (CAGR) between FY09 and FY12. During the period, the bank's CD ratio improved, which enabled it to earn higher core interest income. Advances of the bank grew by a healthy CAGR of 17.8% as against a deposit CAGR of 13.6% between FY09 and FY12. We expect the business of BoM to grow at a CAGR of 18.9% till FY14E. The improvement in its CASA ratio over the last couple of years has contributed towards better margins.

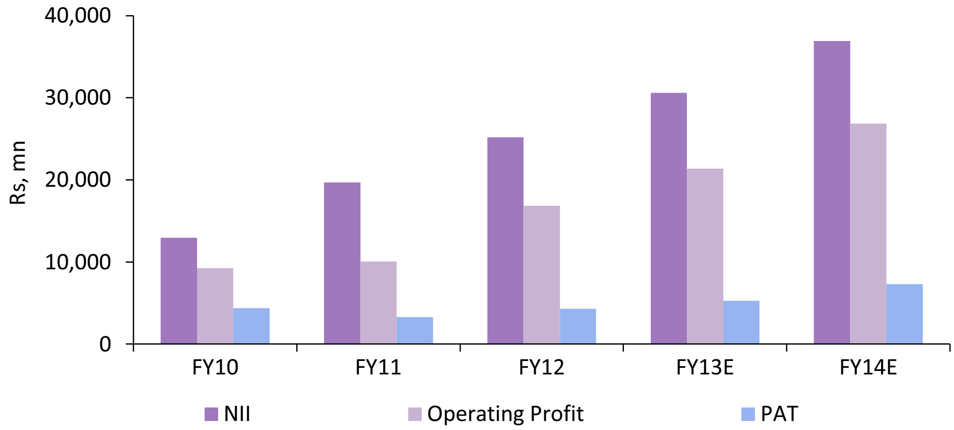
BoM's interest income from advances grew at a healthy CAGR of 18.5% from FY09 to FY12. This was mainly on account the CD ratio improving from 65.6% in FY09 to 73.3% in FY12. With the focus now on high-yielding portfolios such as real estate, home loans and SMEs MSMEs, we expect the healthy growth rate to continue. The income from investments increased at a robust CAGR of around 20% between FY09 and FY12. Overall, the interest income grew at a CAGR of around 15.7% between FY09 and FY12.

BoM's net interest income (NII) grew at a healthy CAGR of 26.1% between FY09 and FY12. With sustainability of CASA at ~41%, we expect net interest income (NII) to register a CAGR of 21.4% from FY12 to FY14E. We expect NII to grow from Rs 25.2bn in FY12 to Rs 37.1bn in FY14E.

With the operating cost moderating due to reduced hiring and on account of the management's decision to bring down the cost per employee, we expect the pre-provisioning profit (PPP) to grow at a CAGR of 26.2% between FY12 and FY14E. We expect the operating expenses to average assets ratio to come down from 2% in FY12 to about 1.7% in FY14E.

Going forward, we expect the credit cost to increase marginally from 1.3% in FY12 to 1.4% in FY14E. Despite the increase in the credit cost, on the back of healthy operating profit growth, we expect the bank's net profit to grow at a healthy CAGR of around 30.3% over FY12-14E, which will help in improving its return ratios.

Financial performance (Rs, mn)



Source: Company, Violet Arch Research

Valuation

Healthy CASA ratio to continue and thereby improvement in NIM

We expect the CASA ratio to continue to remain at healthy levels of around 41% till FY14E on account of BoM's strong presence in rural and semi-urban areas. The bank is planning to set up 209 branches in FY13, of which 100 branches would be in rural and semi-urban areas of Maharashtra, which would provide geographical strength. The sustainability of CASA at healthy levels should keep the cost of deposits in check. With focus on high-yielding products and high-potential segments, coupled with an improvement in the CD ratio, we expect margins to improve.

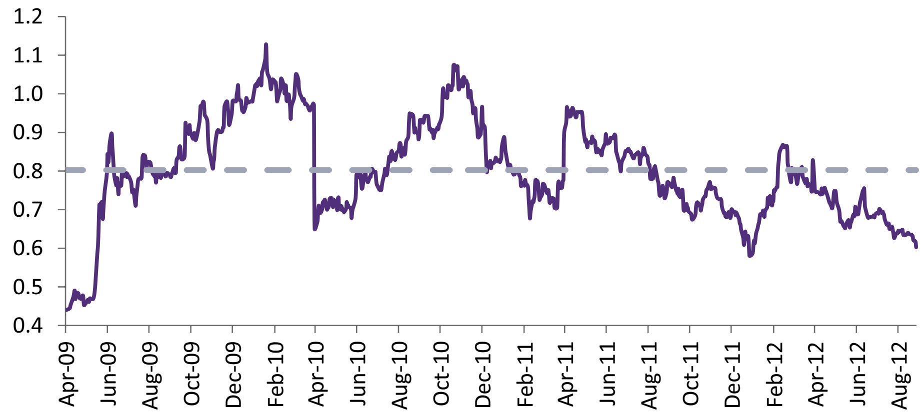
Improvement in NIM and operating efficiency to aid profit growth

We expect NII growth at a CAGR of 21.4%, leading to an improvement in NIM. We expect the cost-to-income ratio to come down, which should aid profit growth and improve return ratios. Despite a conservative stance on asset quality of the bank, we still expect a CAGR of 30.3% between FY12 and FY14E profits.

Target price at 20% upside

Currently trading at Rs 48, the stock is available at a price-to-adjusted book value (P/ABV) of 0.6x of FY14E. Thanks to the improvement in NIM, better operating efficiency and the lower credit cost, profits of BoM are expected to grow at a CAGR of 30% between FY12 and FY14E. This, in turn, would help in improving return ratios of the bank. We value the bank's business at a P/ABV of 0.7x FY14E, a slight discount to the historical average at 0.8x due to increase in restructured assets, concerns on SME/MSME portfolio and fall in return ratios (RoE at 13.7% in FY14E as against 16.4% in FY10 and RoA at 0.6% in FY14E as against 0.7% in FY10). We initiate coverage on the stock with Buy rating and at a target price of Rs 58, with an upside of around 20% from the CMP.

Price to Adj. Book Value (x)



Source: Company, Violet Arch Research

Company Background

Bank of Maharashtra was incorporated in September 1935. It started operations in February 1936. In April 1946, the Maharashtra Executor & Trustee Company Pvt. Ltd. was incorporated as a wholly owned subsidiary of the bank. In July 1969, Bank of Maharashtra was nationalized along with 13 other banks. In 1998, the bank attainted the autonomous status, which helped to provide more and more services with simplified procedures without the intervention of the government. In 2000, it incorporated Magic eMoney Ltd. (MeM), a joint venture of Bank of Maharashtra, Dena Bank, NextStep Infotech Pvt. Ltd. (NSIPL), and Magic Software Enterprises (MSE), Israel, continued to undertake departmental projects.

During 2007-08, the bank also launched two group insurance schemes, namely, Maha Suraksha Deposit Scheme for all types of deposit account-holders and Maha Grih Suraksha for home loan borrowers. Also, it entered into a distribution agreement with 15 select asset management companies during the year. It opened 20 new branches, and upgraded 10 extension counters into full-fledged branches. Besides, it also set up three currency chests during the period.

In March 2008, two regional rural banks, namely, Aurangabad Jalna Gramin Bank and Thane Gramin Bank, were amalgamated into one unit under the name, Maharashtra Godavari Gramin Bank, with head office at Aurangabad and operations spread across nine districts of Maharashtra. As on March 2012, BoM's business stood at Rs 1,326bn, with an extensive network of 1,536 branches.

Key milestones

1936	**Commenced operations on 08-02-1936 in Pune**
1946	Deposits crossed Rs One-crore mark.
	Formed fully owned subsidiary, The Maharashtra Executor & Trustee Company.
	First branch outside Maharashtra opened in Hubli (Karnataka).
1969	Nationalised along with 13 other banks.
1976	Marathwada Grameena Bank, first RRB established on 26-08-1976.
1979	"Mahabank Agricultural Research and Rural Development Foundation", registered as a public trust, was established for undertaking research and extension work and to provide more extensive services to farmers.
1986	Thane Grameena Bank sponsored.
1991	"Mahabank Farmer Credit Card" was launched.
	Entered into the domestic credit card business.
2004	Public issue of shares – 24% owned by the public; listed in the BSE and the NSE.
2005	Bancassurance and Mutual Fund distribution business started.
2006	Branch CBS project started.
2010	100% CBS of branches achieved.

Source: Company, Violet Arch Research

Financial Summary

Income Statement

Rs,mn	FY11	FY12	FY13E	FY14E
Interest Earned	55,631	72,140	86,062	99,323
Interest Expended	35,947	46,969	55,458	62,401
Net Interest Income	19,684	25,171	30,603	36,922
Other Income	5,309	6,407	6,904	7,674
Net Income	24,993	31,578	37,507	44,596
Operating Expenses	14,937	14,734	16,125	17,749
Operating Profit	10,055	16,844	21,382	26,847
Provisions	6,177	10,254	13,335	15,925
Profit Before Tax	3,878	6,590	8,047	10,922
Tax	574	2,281	2,776	3,604
Profit After Tax	3,304	4,308	5,271	7,318

Balance Sheet

Rs,mn	FY11	FY12	FY13E	FY14E
Equity Share Capital	10,697	11,776	11,776	11,776
Reserves & Surplus	29,012	35,451	39,054	44,565
Net Worth	39,714	47,231	50,835	56,346
Deposits	668,447	765,287	903,038	1,065,585
Borrowings	30,766	38,248	47,409	63,935
Other Liabilities	25,714	30,476	36,571	43,885
Total Liabilities	764,642	881,241	1,037,853	1,229,751
Investments	224,911	229,114	263,481	303,003
Advances	468,808	560,598	672,717	807,261
Other Assets	70,923	91,530	1,01,656	1,19,488
Total Assets	764,642	881,241	1,037,853	1,229,751

Key Ratios

Particulars (%)	FY11	FY12	FY13E	FY14E
Growth Matrix				
Deposits (%)	5.6	14.5	18.0	18.0
Advances (%)	16.3	19.6	20.0	20.0
Total Business (%)	9.8	16.6	18.8	18.9
NII (%)	51.9	27.9	21.6	20.6
Operating Expenses (%)	55.0	(1.4)	9.4	10.1
Operating Profit (%)	8.9	67.5	26.9	25.6
Provisions (%)	74.1	66.0	30.0	19.4
Profit After Tax (%)	(24.8)	30.4	22.3	38.8
Ratios (%)				
NIM (%)	2.8	3.2	3.3	3.4
Cost to Income (%)	59.8	46.7	43.0	39.8
ROAA (%)	0.4	0.5	0.5	0.6
ROAE (%)	9.7	9.9	10.8	13.7
Pre-Prov ROAA (%)	1.4	2.0	2.2	2.4
Pre-Prov ROAE (%)	29.4	38.7	43.6	50.1
Gross NPA (%)	2.7	2.5	2.8	2.7
Net NPA	1.3	0.8	0.8	0.7
CAR (%)	13.3	12.4	10.9	9.9
Tier I (%)	8.0	8.3	7.4	6.8
BV (Rs.)	82.6	70.1	76.2	85.6
Adj BV (Rs.)	76.8	66.1	71.9	81.0
P/ABV (x)	0.63	0.73	0.67	0.60

VIOLET ARCH

COMPANY REPORT

Equity Research | Auto

21 September, 2012

CEBBCO

Containers and More

Absolute Rating	**Buy**
Target Price	**Rs 135**
Upside	**44%**

We initiate coverage on Commercial Engineers Body Builders Co. Ltd. (CEBBCO) with a Buy rating. CEBBCO is the largest commercial vehicle body builders in India. With the M&HCV segment undergoing a structural change from selling only chassis to selling fully-built vehicles (FBVs) to customers, CEBBCO is all set to benefit in the coming years. Given the fact that the penetration of FBVs in the M&HCV segment is currently at a mere 20%, OEMs have a target of turning the same into 100% over the next five years. We expect CEBBCO to benefit substantially from this structural change. We believe that the current price does not entirely capture growth prospects of FBVs and hence we initiate coverage with a Buy.

Structural shift to FBVs, key driver to CEBBCO's revenues in ensuing years

With the M&HCV segment undergoing a structural change from selling only chassis to selling fully-built vehicles (FBVs) to customers, CEBBCO is all set to benefit in the ensuing years. In the organized market, CEBBCO is a market leader, with a market share of 35%. Currently, the fully-built vehicle market is around 20% of the total truck market, the rest is sold in the form of chassis alone. Over the next five years, the penetration level of FBVs is expected to be up to 100% as targeted by OEMs. Thus, we expect CEBBCO to log a CAGR of 32.7% in FBV volumes over FY12-14E. Further, subject to capacity availability, CEBBCO can serve the replacement market, where EBITDA margins are in the range of 30-35%.

TRIFAC scheme to add incremental value

CEBBCO benefits from the TRIFAC scheme. Under this scheme, the company can get a subsidy of 75% on the incremental sales tax payable during the year. It expects to receive Rs 2.3bn (Rs 1bn under CV expansions and Rs 1.3bn for the railway project at Deori) in the next five to seven years. This would add incremental value to the company. We estimate the net present value (NPV) of the benefits at Rs 16/share discounting Rs 1.85bn benefit over the next five years.

De-risking revenue concentration: Foray into railways

CEBBCO's Deori railway plant has received RDSO's approval. It is now eligible to bid for new wagons for the Indian Railways. We have incorporated sales of 497 and 1,000 wagons in FY13 and FY14, respectively. Thus, the railway segment is expected to log revenues of Rs 871mn and Rs 2,000mn in FY13E and FY14E, respectively.

Valuation

The stock is currently trading at an attractive 5.6x P/E on FY14E EPS of Rs 16.9. The company does not have a direct comparable, due to the ongoing structural change in the industry. While earnings is expected to be at 52% CAGR over FY12-FY14E commanding premium valuations, we have assigned lower multiple (7x to core earnings) as the FBV industry is characterized by low entry barriers. We value the stock on an SOTP basis, with the core business valued Rs 119 and NPV value of the TRIFAC scheme at Rs 16.0. We initiate coverage on CEBBCO with a Buy rating and at a target price of Rs 135 with a 43.6% upside.

Standalone Y/E 31 Mar (Rs Mn)	FY11	FY12	FY13E	FY14E
Revenues	2,122	4,686	6,515	9,700
EBITDA	130	702	1,114	1,697
EBITDA margin	6.1	15.0	17.1	17.5
EBITDA growth (%)	(64.5)	441.5	58.7	52.4
Adj. Net Profit	57	408	571	930
Adj. Profit growth (%)	(71.9)	615.9	39.9	62.9
Net profit margin (%)	2.7	8.7	8.8	9.6
FDEPS	1.0	7.4	10.4	16.9
FDEPS growth (%)	(71.9)	615.9	39.9	62.9
P/E (x)	90.6	12.7	9.0	5.6

Source: Company, Violet Arch Research

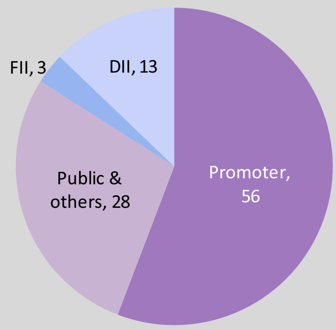
Stock data

CMP	**Rs 94**
Reuters Code	CEBB.BO
Bloomberg Code	CEBB IN
Equity Shares o/s (mn)	55
Market Cap (Rs mn)	5,165
Market Cap (USD mn)	97
3m Avg daily t/o(US$ mn)	0.7

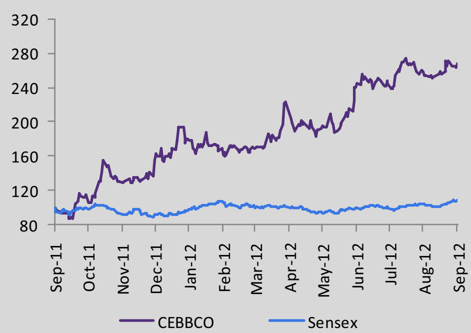
Stock performance (%)

52-week high / low			**Rs 105/30**
	1M	**3M**	**12M**
Absolute	4.0	9.8	179.4
Relative	(1.1)	(0.7)	163.4

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull case	Base case	Bear case
FBV penetration (%)	45.0	40.0	25.0
CEBBCO market share (%)	40.0	35.0	25.0
FBV volume growth (%)	63.6	28.0	2.3
FBV volumes (units)	49,319	38,580	30,824
FBV realisation (Rs)	204,904	198,797	176,963
Railway wagons (units)	1,200	1,000	500
Receivable days	60	85	110
EBITDA margin (%)	19.0	17.5	15.0
PAT (Rs mn)	1,389	930	401
Core EPS (Rs)	25.3	16.9	7.3
Inc/decrease from base case (%)	49.3		(56.9)
Core Multiple (x)	8	7	5
Core Price (Rs)	202	119	36
NPV of TRIFAC scheme (Rs / share)	17	16	15
CMP (Rs)	94	94	94
Target Price (Rs)	**220**	**135**	**52**
Inc/decrease from base case (%)	63.0	-	(61.6)
Upside (%)	**133.6**	**43.6**	**(45.0)**

Source: Company, Violet Arch Research

Particulars	FY12	FY13E	FY14E
FBV volumes (units)	21,900	30,140	38,580
FBV realization	204,621	186,276	198,797
Railway volumes (units)	-	497	1,000
Railway realization (Rs mn)	-	1.8	2.0

Source: Company, Violet Arch Research

Base case

- Volume growth of 37.6% / 28% in FBV volumes due to the increase in penetration of FBV market to 30% / 40% in FY13E / FY14E from current levels of 20%. We expect M&HCV goods carrier sales to remain flat over this period. Hence, FBV sales are inelastic to M&HCV sales goods carrier growth due to low penetration. Expect CEBBCO to maintain its market share in FBV segment at 35% over the same period.
- Net realization of the FBV segment to decline by 9% and grow by 6.7% in FY13E / FY14E, respectively. A decline in net realization in FY13E due to a higher proportion of low realization load body segment FBV product sales.
- Railway segment expected to sell 497 / 1,000 wagons at a realization of 1.8mn / 2mn in FY13E / FY14E. Net present value of the TRIFAC scheme stands at Rs 16 by discounting at WACC of 11.5%.

Bull case

- FBV penetration to be at 45% in FY14, with CEBBCO increasing its market share to 40%. Thus, volumes to grow 63.6% to 49,319 units. The railway segment to meet management guidance of 1,200 wagons in FY14E.

Bear case

- FBV penetration to be at 25%. CEBBCO's volume growth to be at 2.3% to 30,824 units. The railway segment's sales of 500 wagons, due to the inability of the company to win orders. Expect receivable days to go up to 110 days, thereby increasing interest expenses by Rs 65mn. EPS to be at Rs 7.3.

SWOT Analysis

Strengths

1) Present in an industry that is on the path of a structural shift. Insulated from M&HCV sales slowdown for this reason.

2) Fungible railway wagon capacity of 2,000 units gives it scope for utilising it on FBV sales in a scenario of a lack of orders from the railways.

3) Access to all major OEMs, with a robust EBITDA margin of 17%. A market leader, with a 35% market share.

Threats

1) Lower-than-expected conversion to FBVs by OEMs (25% in FY14E instead of 40% assumed by us) would lead to flat growth in FBV volumes and threaten any capacity expansions planned by the company.

2) The high-margin FBV business (17% in OEM and 30-35% in replacement market) can lure more players into the market, which may impact the market share going forward.

SWOT Analysis

Weaknesses

1) High cash credit cycle of around 75 days.

2) Low entry barriers could put pressure on EBITDA margins in the long run.

3) New in the railway segment , with low pricing power could impact the EBITDA margin.

Opportunities

1) Market leader (35% market share) in an industry that is expected to grow six times in the next five years.

2) Foray into the railway segment, with additional capacity in place, would be revenue accretive (to contribute 22% to revenues in FY14E from 1% in FY12).

3) Replacement market of FBVs attracts EBITDA margins of 30-35%. Opportunity to tap the repalcement market of around 4mn units, mainly catered currently by unorganised players.

Source: Violet Arch Research

Investment Arguments

Structural shift to FBVs by M&HCV players, key driver to CEBBCO's revenues

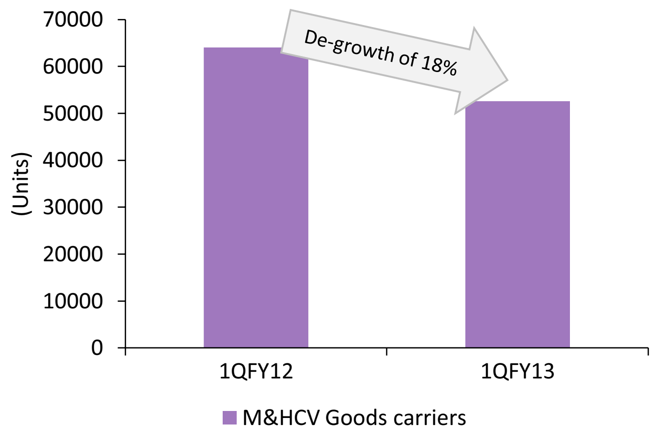
The M&HCV segment is undergoing a structural shift from selling only the chassis to fully-built vehicles to customers. Traditionally, OEMs used to sell the chassis to customers, who, in turn, built the body around it. However, fleet-owners with an inferior quality body take around two months to build. In a fully-built vehicle, an OEM sells the vehicle to the customer along with the body. The customer benefits by way of full-funding on the FBV vis-à-vis part funding, restricted to the chassis, in the traditional method. The customer can put the fleet to use immediately, rather than wait for two months for the completion of the vehicle body. FBVs also have superior efficiency, given its light weight, which result in higher payloads.

OEMs outsource the body-building to professional body-builders such as CEBBCO, Hyva Pvt. Ltd., Utkal Automobiles, and Duch Lanka Trailer Manufacturers Ltd. In the organized market, CEBBCO is a leader, with a market share of 35%. Currently, the fully-built vehicle market accounts for around 20% of the total truck market, and the rest is sold in the form of chassis alone. Over the next five years, the penetration level of FBVs is expected to be up to 100% according to OEM's expectations. With this shift to FBVs, OEMs are expected to benefit in terms of higher revenues and margins, besides better quality products.

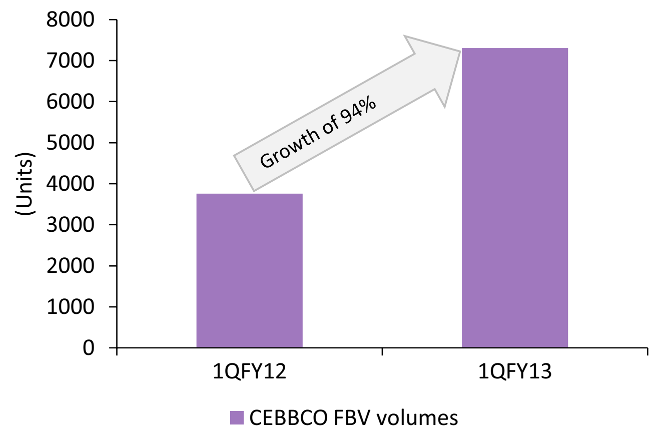
Not a victim of diminishing M&HCV sales

Due to its high exposure to M&HCVs, it is often assumed that CEBBCO's revenues would also be cyclical in nature. This tendency is especially apparent now with a severe slowdown in M&HCV goods carrier. However, the M&HCV segment is undergoing a structural change from selling only chassis to selling FBVs. The penetration of FBVs by OEMs in FY12 is estimated at just 20%, up from 10% in FY11. As per targets set by OEMs, this is expected to reach 100% by FY17. On the back of increasing penetration of FBVs, we expect CEBBCO to log a FBV volume CAGR of 32.7% over FY12-FY14E.

Decline in M&HCV goods carrier sales…



… does not imply the same for CEBBCO FBV sales



Source: Company, Violet Arch Research

OEMs have targeted a 100% conversion to FBV sales from chassis sales by FY17E from the current 20%. *CEBBCO's* estimation indicates a conversion target of 80% by FY17E. Even with our conservative assumption of 70% penetration, the FBV market is expected to grow at a CAGR of 36% over FY12-17 vis-a-vis M&HCV goods carrier's CAGR of 6% over the same period. With the company seeing vast growth potential in the FBV business, the capacity has been increased by 50% to 32,000 units by Sep 2012.

Particulars	FY10	FY11	FY12	FY13E	FY14E	FY15E	FY16E	FY17E	CAGR FY12-FY17E
M&HCV goods carriers (units)	198,400	252,000	274,680	260,946	273,993	301,393	331,532	364,685	
yoy growth (%)		**27.0**	**9.0**	**(5.0)**	**5.0**	**10.0**	**10.0**	**10.0**	**5.8**
FBV penetration (%)	10.3	10.5	20.0	30.0	40.0	50.0	60.0	70.0	
Potential of FBV market (units)	20,495	26,410	54,936	78,284	109,597	150,696	198,919	255,280	
yoy growth (%)		**28.9**	**108.0**	**42.5**	**40.0**	**37.5**	**32.0**	**28.3**	**36.0**

Source: Company, Violet Arch Research

Tax structure introduced in Budget 2013 favourable to CEBBCO

The tax structure introduced in the Budget 2013 is expected to give a boost to the FBV market. This, in turn, will benefit the market leader, CEBBCO. The excise duty for a truck being sold as a chassis alone would attract excise duty of 14%. However, customers purchasing FBVs would have to pay only 12% excise duty. This would further provide incentives to fleet operators to purchase FBVs, rather than chassis.

De-risking revenue concentration: Foray into railways

With around 97% of revenues accruing from the FBV business, CEBBCO has plans to de-risk its revenue concentration in this segment. The company has incurred a capex of Rs 1.3bn to set up a manufacturing facility, with a capacity of 2,000 wagons and 120 EMU coaches per annum. This is a fungible capacity, which could also be used to manufacture commercial vehicle bodies in case of any delays in wagon orders.

The company’s Deori railway plant has received Research Design and Standards Organization’s (RDSO) approval. It is now eligible to bid for new wagons for the Indian Railways. The company has already received order for 247 wagons worth Rs 480mn from Braithwaite, a subsidiary of the Indian railways. The company expects to receive 250-500 wagons on a trial order in the next railway tender. We have incorporated an order book of 497 and 1,000 wagons for FY13 and FY14, respectively.

Thus, the railway segment is expected to log revenues of Rs 871mn and Rs 2bn in FY13 and FY14E, respectively.

Railways	FY13E	FY14E
Wagons (units)	497	1,000
Realisation (Rs mn)	1.8	2.0
Revenues (Rs mn)	871	2,000
As % of total revenues	13.3	22.0

Source: Company, Violet Arch Research

Currently, CEBBCO has Titagarh Wagons and Texmaco Rail as major competitors. The company is a small player compared to the two majors, but has a larger basket of offerings. CEBBCO offers wagons, components, coaches and refurbishments to the Indian railways. Refurbishment also increases the life of a wagon by 12 years, while reducing its weight by around one tonne because of the use of stainless steel. Incidentally, the wagon opportunity in India is estimated at Rs 60bn.

Removal from Tata Motors' bill discounting scheme a positive for EBITDA margin

Prior to 4QFY12, Tata Motors used to discount CEBBCO's invoices for 30 days and pay the company upfront in three days. Tata Motors used to charge 1.65% as discount to CEBBCO, which adversely affected its EBITDA margin. In 4QFY12, CEBBCO managed to free itself from the vendor bill discounting scheme of TATA Motors. Following the removal from the bill discounting scheme, Tata Motors began to pay CEBBCO after a period of one month, though did not discount invoices. In turn, CEBBCO would be required to take working capital loans, which could increase its interest costs. As a result, CEBBCO's PBT margin would be positively impacted by 0.8-0.9%.

Project Replica: Replacement market project offers significant potential

Recently, CEBBCO made a foray into the replacement market of M&HCV bodies. Currently, this market is dominated by unorganized players. The replacement cycle of bodies is 2-5 years, depending on usage and type of M&HCVs. According to the company estimates, around 4mn vehicles would require replacements. However, it does not have the capacity to cater to this market. In 1QFY13, it started its dispatch to this market, selling 615 units (around 8% of FBV volumes and around 11% of FBV revenues). Being a high-realization and high-margin business, replica bodies' average realizations in 1QFY13 stood at Rs 243,902, 32% higher than blended FBV realizations of Rs 184,729 in the quarter. The EBITDA margin in this segment is also substantially high at 30-35% vis-à-vis the EBITDA margin of 17% in the OEM segment.

We expect the company to sell 2,500 units of FBVs in the replacement market in FY13 and 2,800 units of FBVs in FY14, a y-o-y growth of 13%. We expect the replacement market to contribute 10% of FBV revenues and 8% of total revenues in FY14. In the event of a significant capacity expansion, we could expect a further upside in this high-margin segment. We expect the company to expand its total FBV capacity by 23% to around 37,000 units in FY14.

TRIFAC scheme to add incremental value

CEBBCO benefits from the Trade and Investment Facilitation Corporation Ltd. (TRIFAC) scheme, viz., Industrial Investment Promotion Assistance (IIPA). Under this scheme, the company would be entitled for a subsidy of 75% of incremental sales tax payable during the year. CEBBCO expects to receive Rs 2.3bn (Rs 1bn under the CV expansion and Rs 1.3bn for the Deori railway project) in the next seven years. The sales tax subsidy will be adjusted in the subsequent year at the time of sales tax assessment. The company would receive the amount typically towards the end of every year. This is expected to add incremental value to the company and to our target price. We estimate the net present value (NPV) of benefits at Rs 16 per share by discounting only cash-flows of the next five years, to be conservative.

Particulars	FY13E	FY14E	FY15E	FY16E	FY17E
Before tax benefit (Rs mn)	300	350	400	400	400
After tax benefit (Rs mn)	201	235	268	268	268
WACC (%)	11.5				
NPV (Rs mn)	**891**				
Value per share (Rs)	**16**				

Source: Company, Violet Arch Research

Key Risk and Concerns

Railways, a long gestation project

Typically, the Indian railways would place orders for a minimum of 250-300 wagons to new wagon manufacturers in the first two years. CEBBCO, being a new entrant, would be able to bid only for trial orders at least for the first two years. Further, the company is less likely to have the pricing power in this segment among established players such as Titagarh Wagons and Texmaco Rail. With low pricing power, the company's EBITDA margin in the segment could be under threat.

Volatile cash credit cycle

CEBBCO's cash credit cycle has been highly volatile due to delayed payments from OEM clients. Although it has significantly improved in the last fiscal, the company still runs the risk of delayed payments from its foray in the railways business, thereby adversely affecting the cash credit cycle. However, given this venture is at a nascent stage, we have not factored in the same. Pertinently, it should be noted that we have factored in a 20% increase in cash credit cycle for FY13 for its CV business.

Cash credit cycle	FY08	FY09	FY10	FY11	FY12	FY13E	FY14E
Inventory days	109	127	179	166	52	52	52
Receivable days	75	49	116	53	81	85	85
Payable days	85	203	201	144	72	65	65
Cash credit cycle	**99**	**(27)**	**94**	**74**	**61**	**72**	**72**

Source: Company, Violet Arch Research

Low entry barriers could lead to margin squeeze

The body-building business has low entry barriers. With the EBITDA margin extremely attractive at 17%, we could see new entrants or existing players expanding their capacities to garner market share from CEBBCO. This could lead to a price war, which may impact margins adversely.

FBV realization volatile, with changing product mix

The FBV realization/unit has been volatile due to the changing product mix internally. While tippers and replica FBVs are high-realization products with average selling price in excess of Rs 200,000, load bodies and defence trailers have been volatile with realization slipping below Rs 200,000 in 1QFY13. Thus, going forward, a higher mix of this segment would hamper the blended realization of the company, thereby affecting its revenues.

Realizations (Rs/unit)	1QFY13	1QFY12	yoy growth (%)
Tippers	214,180	201,794	6.1
Load bodies, defence, trailers	155,583	218,443	(28.8)
Replica bodies	243,902	N.A.	
Blended FBV Realization	**184,729**	**208,566**	**(11.4)**

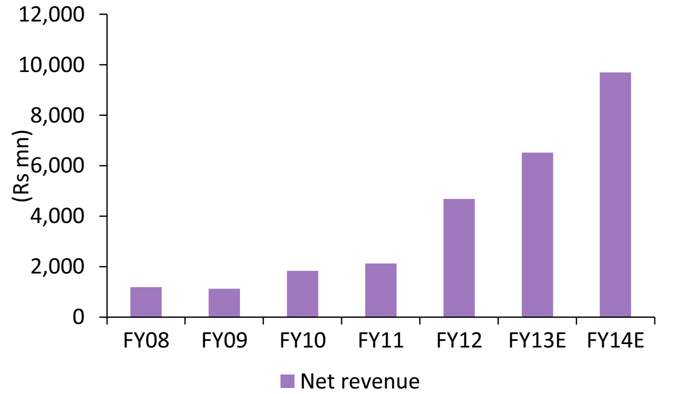
Source: Company, Violet Arch Research

Financial Outlook

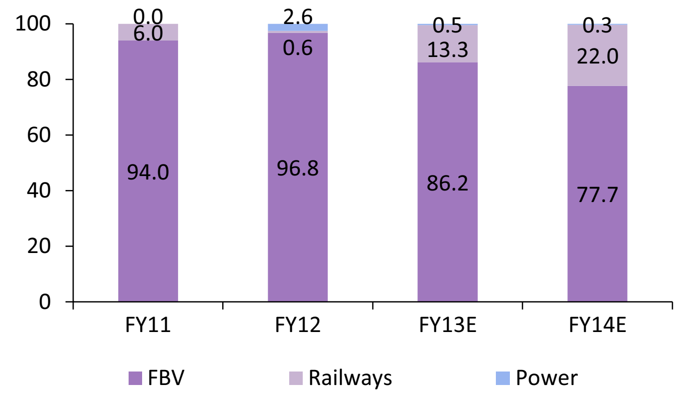
Revenue CAGR to be 43.9% over FY12-14E

CEBBCO's net revenues grew at a CAGR of 37.4% to Rs 4.7bn over FY07-12. We expect its net revenues to grow at a CAGR of 43.9% to Rs 9.7bn during FY12-14E. Revenues of the FBV segment are expected to grow at a CAGR of 30.8% over FY12-14E on the back of a 32.7% CAGR in FBV volumes. The railway segment is expected to grow at a CAGR of 738% over FY12-14E to Rs 3.6bn. The contribution of the railway segment to total revenues is expected to go up from 1% in FY12 to 22% in FY14E.

Standalone net revenue trend



Segmental revenue contribution (%)

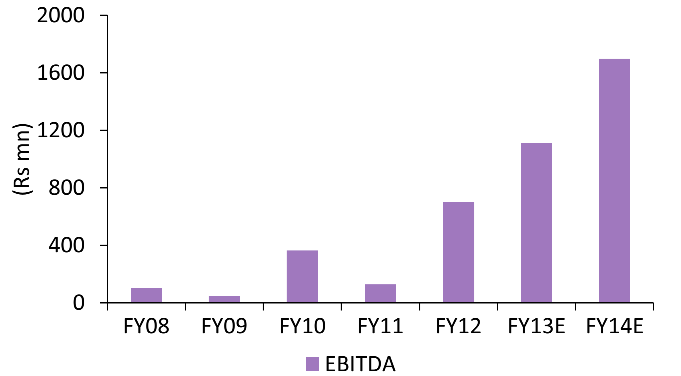


Source: Company, Violet Arch Research

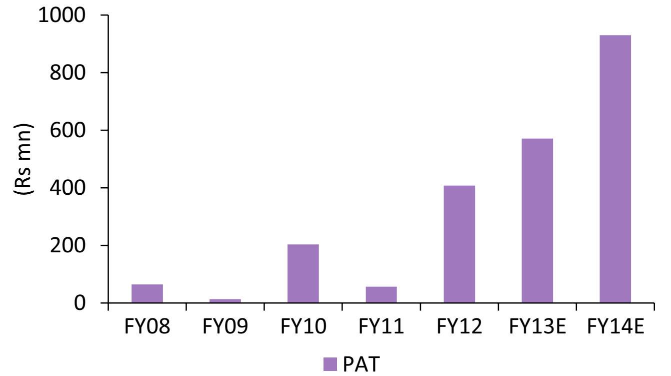
EBITDA CAGR to be 55.5% over FY12-14E

CEBBCO's EBITDA grew at a CAGR of 43.1% to Rs 702mn over FY07-12. We expect its EBITDA to log a CAGR of 55.5% during FY12-14E to Rs 1.7bn. The company's foray into the replacement market would aid margins as it attracts EBITDA margin to the tune of 30-35%. We expect EBITDA margins of the company to be 17.1% in FY13E and 17.5% in FY14E.

EBITDA trend



PAT trend



Source: Company, Violet Arch Research

PAT CAGR to be 51.0% over FY12-14E

CEBBCO's PAT logged a CAGR of 41.6% to Rs 4.7bn over FY07-12. We expect its PAT to log a CAGR of 51.0% to Rs 930mn during FY12-14E. The PAT margin is expected to be at 8.8% in FY13E and 9.6% in FY14E. Its adj. EPS is expected to be Rs 10.4 and Rs 16.9 in FY13E and FY14E, respectively.

Valuation

Currently, CEBBCO is trading at a P/E of 5.6x on FY14E EPS of Rs 16.9. With the FBV business undergoing a structural change, the company is poised for a strong CAGR in PAT of 52.6% over FY12-14E. Due to the capex involvement, the company could generate only a minimum free cash-flow in the near future. Also, the industry is characterized by low entry barriers. Taking these factors into consideration, we assign a P/E of 7x its FY14E core EPS of Rs 16.9 to arrive at a price of Rs 118. Further, we add the net present value of Rs 1.85bn expected by the company over the next five years as sales tax benefit. Thus, we arrive at an SOTP target price of Rs 135. We initiate coverage on CEBBCO with a Buy rating at a 43.6% upside from current levels.

P/E	FY14E
EPS (Rs)	16.9
Multiple applied (x)	7
Core business Price (Rs)	119.0
NPV of TRIFAC scheme (Rs)	16.0
Target Price (Rs)	135
CMP (Rs)	**94**
Upside (%)	**43.6**

Source: Company, Violet Arch Research

Company Background

Incorporated in 1979, Commercial Engineers and Body Builders Company (CEBBCO) is the largest player in the fully-built vehicles (non-passenger) segment in India, with a 30-35% market share in an Rs 11-bn industry. It has six manufacturing facilities, with four units located in Jabalpur and one each in Indore and Jamshedpur, which enjoy excellent proximity to major OEMs. CEBBCO focuses on three verticals: fully-built vehicle (FBV), railways and power. The company's clients include heavyweights such as Tata Motors, Ashok Leyland, Eicher Motors, Man Force Motors and Vehicle Factory Jabalpur (Defence). CEBBCO's product portfolio spans across tippers, tankers, cargo, refrigerator-fitted vehicle bodies, wagons, and coaches.

Application	Products
Commercial Vehicles	
Mining & Road Construction	Tipper bodies
	Tanker bodies
Goods Transportation	Refrigerator-fitted vehicle bodies /containers
	Load cargo bodies
	Trailer bodies
Solid Waste Management	Skip loaders
	Garbage bin collectors
Municipal Applications	Water tanker bodies
	Light recovery vehicle bodies
	Garbage tippers
Defence	Troop carrier vehicle bodies
	Prison van bodies
	Water bowser bodies
Miscellaneous Applications	Vehicle bodies for transportation of animals
	Fire engine bodies
	Ambulance bodies
Railways	
Railways Components	Upgradation and refurbishment of BOXN wagons
	Components for locomotives
	Components for BOXNR wagons
	Components for coaches
Power	
Boilers and ESP	Structurals for boilers and electrostatic precipitators (ESPs)

Source: Company, Violet Arch Research

Financial Summary - Standalone

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**2,122**	**4,686**	**6,515**	**9,700**
growth (%)	16.0	120.9	39.0	48.9
Operating expenses	1,992	3,984	5,401	8,002
EBITDA	**130**	**702**	**1,114**	**1,697**
growth (%)	(64.5)	441.5	58.7	52.4
Depreciation	39	64	112	132
EBIT	**91**	**638**	**1,002**	**1,565**
Interest paid	93	93	172	200
Other income	74	23	23	23
Exceptional items	0	0	0	0
Pre-tax profit	**73**	**568**	**852**	**1,388**
Tax	16	160	281	458
Effective tax rate (%)	21.6	28.1	33.0	33.0
Minority interest	-	-	-	-
Income from JV/associates	-	-	-	-
Net profit	**57**	**408**	**571**	**930**
Adjusted net profit	57	408	571	930
growth (%)	(71.9)	615.9	39.9	62.9
Shares o/s (mn nos)	54.9	54.9	54.9	54.9
EPS	1.0	7.4	10.4	16.9

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net fixed assets	1,191	2,314	2,868	3,114
Net Intangible assets	-	0	0	0
Investments	384	7	1	1
Current assets				
Inventories	692	497	686	1,023
Sundry Debtors	306	1,037	1,517	2,259
Cash and Bank	260	57	15	76
Other current assets	-	15	15	15
Loans and advances	437	746	763	823
Total assets	**3,270**	**4,674**	**5,866**	**7,311**
Shareholders' funds				
Share capital	549	549	549	549
Reserves & surplus	1,624	2,032	2,482	3,217
Minority interest				
Total Debt	**461**	**1,108**	**1,690**	**1,907**
Deferred Tax Liability	**12**	**85**	**85**	**85**
Curr Liab & prov				
Current liabilities	618	853	1,026	1,530
Provisions	7	46	33	23
Total liabilities	**1,097**	**2,093**	**2,835**	**3,545**
Total equity & liabilities	**3,270**	**4,674**	**5,866**	**7,311**

Cash Flow

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Profit before Tax	73	568	852	1,388
Adjustments for				
Depreciation	39	64	112	132
Other operating cashflow	69	77	149	177
Operating Profit before Working Cap Chgs	**180**	**709**	**1,114**	**1,697**
Adjustments for				
(Increase)/Decrease in Sundry Debtors	204	(451)	(480)	(742)
(Increase)/Decrease in Loans and Advances	0	0	(17)	(59)
(Increase)/Decrease In Inventories	(157)	195	(189)	(337)
Increase/(Decrease) in Current Liabilities and Provisions	9	160	173	504
Cash generated from Operating Activities	**236**	**613**	**601**	**1,063**
Direct Taxes Paid	(81)	(45)	(281)	(458)
Net Cash from Operating Activities	**155**	**568**	**320**	**605**
Cash Flow From Investing Activities				
Capital expenditure	(801)	(1571)	(667)	(378)
Change in investments	(377)	377	6	(0)
Other investing cash flow	24	(131)	23	23
Net Cash (used) in Investing Activities	**(1155)**	**(1325)**	**(638)**	**(355)**
Cash Flow From Financing Activities				
Issue of equity	1,404	0	0	0
Issue/(repay) debt	(86)	648	583	216
Dividends paid	0	0	(134)	(205)
Interests Paid	(93)	(93)	(172)	(200)
Other financing cash flow	0	0	0	0
Net Cash from / (used in) Financing Activities	**1225**	**555**	**277**	**(189)**
Opening cash	**34**	**260**	**57**	**15**
Closing cash	**260**	**57**	**15**	**76**

Financial Ratio

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	1.0	7.4	10.4	16.9
Adj EPS growth (%)	(71.9)	615.9	39.9	62.9
EBITDA margin (%)	6.1	15.0	17.1	17.5
Pre-tax margin (%)	3.4	12.1	13.1	14.3
ROE (%)	4.0	17.2	20.3	27.4
ROCE (%)	3.7	14.5	16.0	20.2
Turnover & Leverage ratios (x)				
Asset turnover (x)	0.8	1.2	1.2	1.5
Leverage factor (x)	1.8	1.7	1.9	1.9
Net margin (%)	2.7	8.7	8.8	9.6
Net Debt/Equity (x)	0.1	0.4	0.6	0.5
Working Capital & Liquidity ratio				
Inventory days	166	52	52	52
Receivable days	53	81	85	85
Payable days	144	72	65	65
Valuations				
PER (x)	90.6	12.7	9.0	5.6
Price/Book value (x)	2.4	2.0	1.7	1.4
EV/EBITDA (x)	41.4	8.9	6.1	4.1

VIOLET ARCH

COMPANY REPORT

Equity Research | Infrastructure

21 September, 2012

Delta Corp Ltd.

"Delta" in the Story

Absolute Rating	**BUY**
Target Price	**Rs 86**
Upside	**22%**

One of the leading companies in Indian gaming space, Delta Corp Ltd. has a presence in the country's arguably most attractive destinations, Goa and Daman. The company also has interests in real estate, though it plans to exit the same in the next couple of years and zero in on the gaming and hospitality business. Growing traction in the overall gaming market, thanks to rising disposable incomes, changing spending habits and low base have been driving 40-50% end-market growth for the company. Its first-mover advantage and scale of operations in the gaming business have generated healthy margins (EBIT margins of around 25%), while RoCE is set to improve, with more properties becoming operational. On a consolidated basis, we expect an impressive jump of 30.7% and 38.8% in revenues and EBITDA, respectively, over FY12-14 (despite the drying up of its real estate business), largely on account of its end-market growth and increase in operational properties in gaming business. Potential for upside from opening new properties and entering into newer geographies, including Daman and Sri Lanka, remain high. We initiate coverage on the stock with a Buy recommendation at an SOTP target price of Rs 86 with an upside of 22.2%.

Multi-level growth drivers

Delta is well placed to benefit from three potential levels of growth. First, the overall market has grown at 40-50% per annum. We expect this growth to gather further momentum as the middle-class spend continues to pick up. Second, the share of travel and leisure spending is expected to be the second-fastest growing component among all consumer expenditure categories, driven by changing spending habits. Third, restricted supply has ensured competition remains at low levels, since the gaming and casino business in India is limited to only Goa, Sikkim and Daman. The confluence of these points and thanks to its leadership position, Delta is in the sweet spot.

India's leading gaming company with first-mover advantage

Delta Corp is the first Indian company to identify the enormous potential of casino gaming in India and is looking to expand its footprint to cater to this market. Goa has issued six live offshore licences, of which three are owned by Delta. Goa's regulations on land-based casinos allow for a casino only in 5-star hotels. With an 80% offshore market share and three gaming licences, Delta is a market leader, as no further licences are expected to be issued. All other players either have limited resources/capital for further expansion or do not envisage large potential in the business. Besides, Delta has already raised the requisite capital to expand its business in Goa and Daman.

Valuation

We have valued Delta on a SOTP basis, valuing its gaming business at 14x FY14E gaming EBITDA of Rs 1.4bn at an EV of Rs 16.8bn lower than Asian gaming operators on account of lower RoCE generated by the company's gaming operations and uncertainty over regulatory norms in India vis-a-vis Asian peers. In addition, we have added value from the Daman venture, the hotel and the casino in Panjim, and the real-estate business on a P/BV basis separately. Our 12-month target price is Rs 86. We rate the stock a Buy.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	3,760	3,649	4,013	6,233
Growth (%)	142.9	(2.9)	10.0	55.3
EBITDA (%)	49.2	27.6	29.5	31.1
Adj. Net Profit	1,661	433	511	851
Adj. EPS (Rs)	8.2	1.9	2.3	3.8
EPS growth (%)	-	(76.8)	20.0	66.8
PER (x)	8.6	36.5	31.0	18.6
Price/Book value (x)	2.3	2.1	2.0	1.8
AROE (%)	37.8	6.3	6.6	10.2
AROCE (%)	31.8	9.4	9.4	15.7
EV/Net sales (x)	4.6	5.2	4.6	2.9
EV/EBITDA (x)	9.3	18.8	15.5	9.2

Source: Company, Violet Arch Research; FY11 profits are inflated due to onetime gain from real estate segment

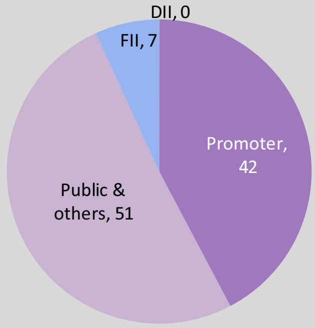
Stock data

CMP	**Rs 71**
Reuters Code	DELT.BO
Bloomberg Code	DELTA IN
Equity Shares o/s (mn)	224
Market Cap (Rs mn)	15,820
Market Cap (USD mn)	297
3m Avg daily t/o(US$ mn)	4.0

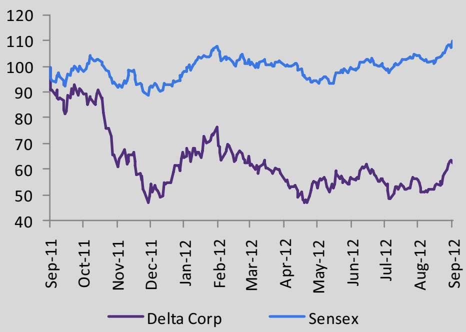
Stock performance (%)

52-week high / low			**Rs 111/52**
	1M	**3M**	**12M**
Absolute	11.0	9.8	(37.3)
Relative	6.2	(0.3)	(47.2)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull Case	Base Case	Bear Case
Revenue (Rs mn)	5,730	4,684	3,724
Revenue growth (%)	99.5	80.3	60.8
EBITDA (Rs mn)	1,824	1,405	964
EBITDA margin (%)	31.8	30.0	25.9
EV/EBITDA multiple (x)	16.0	14.0	10.0
Other investments	14.6	14.6	14.6
Total - SOTP target price (Rs/share)	**106**	**86**	**38**
CMP (Rs)	**71**	**71**	**71**
Upside (%)	**49.7**	**22.2**	**(37.8)**

Source: Violet Arch Research

Key Assumptions

Implied gaming business details (Rs mn)	FY11	FY12	FY13E	FY14E
GGR of Casino Royale	779	1,240	1,612	1,934
GGR of Caravela	132	190	190	190
GGR of Horseshoe	-	-	-	1,440
Revenue from Daman	-	-	-	1,120
Gaming EBITDA margin (%)	23.5	24.1	25.5	30.0

Source: Company, Violet Arch Research; GGR – Gross gaming revenues

Base case

- We are expecting revenues from two new casinos in FY14. However, we have factored in a six-month delay and 20% lower revenue than the guidance (Horseshoe – Rs 1,440mn and Daman – Rs 1,120mn) given by the management to factor in the delays in commencing of properties, as witnessed in the past.
- Incremental revenues are expected to accrue from two new casinos; we expect operating leverage benefits from them in FY14. Hence, we have factored in a jump in EBITDA margins to 30.0% from 24.1% in FY12.
- Since we do not have any Indian-listed companies in the gaming space, we have observed trading multiples enjoyed by foreign gaming operators over the past few years. US casino operators, which are operating in mature markets, are not the right benchmark. Therefore, the closest comparison would be with Asian peers, which are witnessing robust growth rates. We have given multiples closer to the lower end of the long-term trading range for Asian gaming operators, note that the Indian environment and acceptability of the gaming business are far different and hence such high multiples are not commendable.

Bull case

- We have not considered a discount to management guidance of two new casinos and factor in to be operational by 2HFY13. The revenues expected from the same are Rs 1,800mn and Rs 1,400mn, respectively.
- Operating leverage benefits are expected to kick in from FY14 as operational properties would start clocking EBITDA margins upwards of 40.0%.

Bear case

- Revenues from two new casinos (Horseshoe and Daman) are factored in with a six-month delay in FY14 and 50% lower revenue than the guidance given by the management.
- Given the lower contribution of gaming revenues the margins are expected to be subdued at 25.9%.

SWOT Analysis

Strengths

1) Leading gaming company in India, with three out of six live gaming licences in Goa and 80% market share.

2) Delta enjoys the first - mover advantage, with a presence in most attractive locations in India, and have witnessed growth of >40% on quarterly basis for last eight out of nine quarters.

3) High entry barrieers to business as we believe there would no further issue of licences in near to medium term.

Threats

1) Regulatory changes being a politically sensitive issue and is one of the biggest threat.

2) Increase in issue of licences, which might lead to enhanced competition, given the low capital intensity nature of business.

3) Delay in commissioning of projects due to various approvals and regulatory hurdles.

SWOT Analysis

Weaknesses

1) Delta has incurred capex and created infrastructure for all three off-shore casinos, whereas currently it has only two operational casinos, leading to higher overheads, and there has been a consistent delay in the same.

2) Delta's core business is not scalable, given the licence requirements and various other procedural formalities.

Opportunities

1) Rising Indian GDP growth, favourable demographics (median age of just 26 years) and rising income levels (% of population enjoying an annual income of >Rs 0.2mn is expected to leap from 5% in 2005 to 21% in 2015)are the major growth drivers for end market.

2) Gaming space has limited supply (Goa, Sikkim and Daman regions where gaming is allowed) and abundance of demand that creates ample of opportunities for incumbent and

3) Share of travel and leisure spending is expected to be the second-fastest growing component at 10.1% among all consumer expenditure categories, driven by changing spending habits over FY09-14E.

Source: Violet Arch Research

Investment Arguments

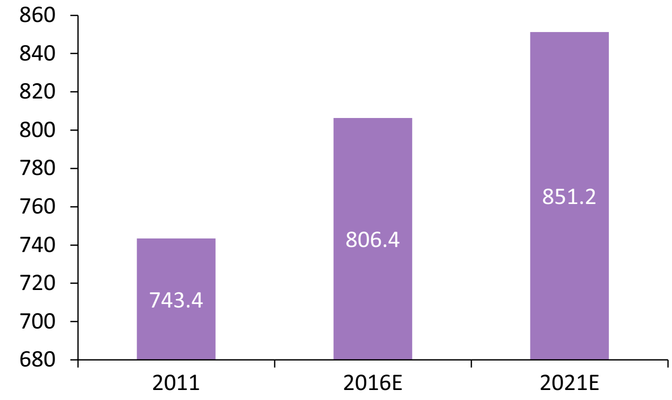
Multi-level growth drivers

Delta is well placed to benefit from three potential levels of growth. First, the overall market has grown at 40-50% per annum. We expect this growth to gather further momentum as the middle-class spend continues to pick up. Second, the share of travel and leisure spending is expected to be the second-fastest growing component among all consumer expenditure categories, driven by changing spending habits. Third, restricted supply has restrained competition at low levels, since the gaming and casino business in India is limited to only Goa, Sikkim and Daman. The confluence of these points and thanks to its leadership position, Delta is in the sweet spot.

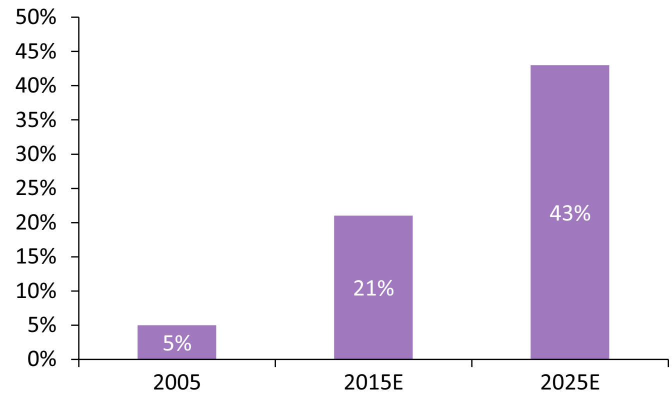
Indian gaming market – Strong demand, tight supply

The Indian economy has consistently been growing, with the percentage of population enjoying an annual income of Rs 200,000 expected to increase in the coming years. It is expected to leap from 5% in 2005 to 21% in 2015 and further to over 40% in 2025. Also, India has a large young population, with a median age of just 26 years, who are seeking new forms of entertainment. Armed with high disposable incomes and a greater willingness to spend, evidently the middle-class will continue to drive the entertainment and gaming industry for the years to come.

Population between age of 15-59 years (mn)



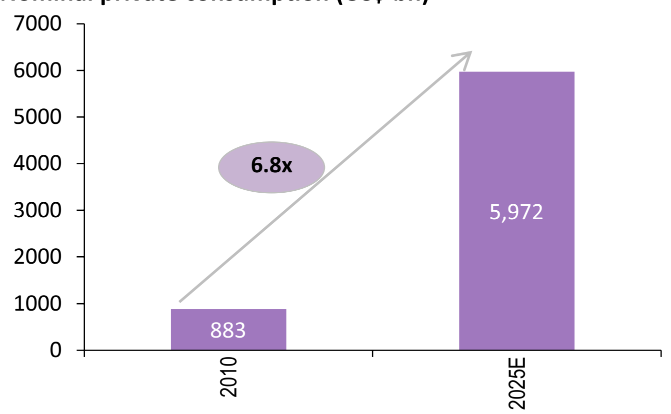
% of population with annual income over Rs 200,000



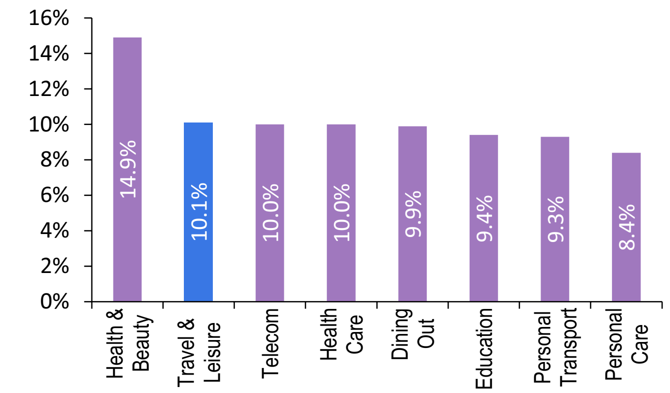
Source: Company, Violet Arch Research; McKinsey

Further, the long-term prospects throw up a pretty picture, with India consistently achieving the second-highest GDP growth rate over the last few years, leading to strong growth in per capita income. Also, private consumption is expected to grow at around seven times in the next 15 years, with travel and leisure spend poised to be the second-fastest growing among all consumer expenditure categories.

Nominal private consumption (US$ bn)



2009-2014E Consumer spending growth



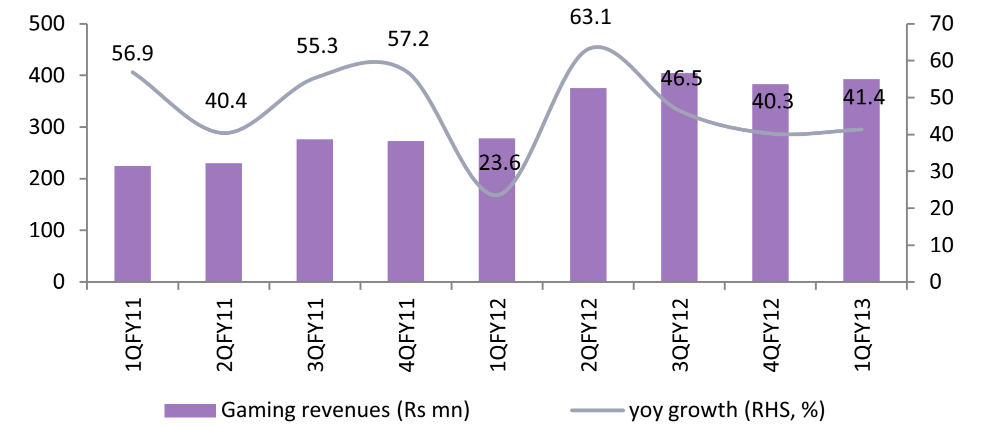
Source: Company, Violet Arch Research; Economic Intelligence Unit

Against this backdrop, while India has witnessed enormous amounts of wagering in various forms of gambling such as lottery tickets (the industry is valued at USD 12.5bn), cricket ($1.5bn wagered in a single world cup match) and horse racing (annual turnover of more than $350mn), the annual turnover of casinos was less than USD100mn.

Therefore, with the burgeoning middle-class and the influx of tourists (tourism accounts for a third of the large chunk of foreign exchange earnings, contributing 2.5% to India's GDP), we believe that the Indian gaming market has a lot of untapped potential.

Currently, the gaming and casino business in India is limited only to Goa, Sikkim and Daman. To put things in perspective, since the recent legalisation of the Indian casino industry, revenue generated from casinos in Goa have grown at an annual rate of over 50%, vindicating the untapped potential story.

Robust show on gaming revenues front over the last few quarters



Source: Company, Violet Arch Research

India's leading gaming company with first-mover advantage

Delta Corp is the first Indian company to identify the enormous potential of casino gaming in India and is looking to expand its footprint to cater to this market. Goa has issued six live offshore licences, of which three are owned by Delta. Goa's regulations for land-based casinos allow for a casino only in 5-star hotels. With an 80% offshore market share and three gaming licences, Delta is a market leader, as no further licences are expected to be issued. All other players either have limited resources/capital for further expansion or do not envisage large potential in the business. Besides, Delta has already raised the requisite capital to expand its business in Goa and Daman.

Delta raised around Rs 3.0bn through a preferential allotment of shares and warrants to several investors, including the promoters. We also estimate Rs 2.2bn of operating cash-flows over the next two years. A capex of Rs 1.3bn has been planned, mainly to promote growth and investment in properties such as Daman and Sri Lanka, and Ramada Hotel & Casino. Therefore, the funding part of the planned capex is already in place. The total gaming positions of the company is set to grow fivefold, with the commencement of Kings Casino in Goa and Thunderbird Resorts in Daman. A well-capitalized balance sheet will enable it to move quickly to seize new growth opportunities and continue to benefit from the first-mover advantage.

Delta has India's most attractive locations – Goa and Daman

Goa is widely touted as the growing gaming capital of India. It is a popular tourist destination, famous for its beaches and long stretch of coastline (131km). According to the latest data, Goa attracts around 2mn tourists annually and around 12% of all foreign tourist arrivals in the country, who spend around USD 350mn annually. Further, the gaming and entertainment tax in Goa is a mere 15% of gross gaming revenues compared to 39% in Macau and almost 50% in some states in the US. This substantially increases the profitability potential of the business.

Further, Goa is located in close proximity to major Indian cities, an hour's flight from Mumbai, Bangalore, Chennai, 1.5 hours from Hyderabad and 2.5 hours from Delhi. It is well positioned to become the gaming hub of South Asia, with potential to attract visitors from other regions such as Southeast Asia and the Middle East.

Goa is located within 3-hour flight from all regions in India and Sri Lanka

Region	Population
South Asia	
India	1,216
Sri Lanka	22
Bangladesh	156
Pakistan	184
SE Asia / China	
China	1,337
Malaysia	28
Thailand	67
Other	
Vietnam	88
Russia	140
Middle East	360

Source: Company, Violet Arch Research

Daman, favourably positioned to be leading gaming and leisure destination

Daman is located along the coast of Gujarat, but governed by the same gambling act as Goa. The main attractions of Daman are its proximity to Mumbai (2.5 hours' drive) and contiguity to Gujarat. Further, given the ban on gaming and alcohol in Gujarat, Daman attracts many visitors.

As in the case of Goa, Delta also enjoys the first-mover advantage in Daman. Only two in – principle gaming licences have been granted, and both are owned by Delta. New land-based licences are granted only if a 5-star hotel is built as in the case of Goa.

City	Population (mm)	Distance from Daman (km)
Mumbai	12.5	~180km
Surat	4.5	~120km
Vadodara	1.8	~250km
Ahmedabad	5.5	~350km

Source: Company, Violet Arch Research

Sri Lanka venture – Long-term potential

Sri Lanka had been ravaged by civil war for almost two and a half decades. In 2009, civil war finally ended, and Sri Lanka began the process of reviving its economy. Ever since, it has made swift progress, and stands out today as one of the fastest-growing countries in Asia-Pacific. With pristine beaches, abundant wildlife, ancient history and modern cities, Sri Lanka is a hot tourist destination. Over the last two years, the tourism industry in Sri Lanka has witnessed an unprecedented boom. The number of visitors to Sri Lanka is expected to touch the 1-million mark in 2012 compared to 855,975 in 2011. Due to its close proximity, Sri Lanka has always been a preferred tourist destination for Indians, and hence they account for almost a third of all tourists to Sri Lanka.

In a move to boost its tourism industry, Sri Lanka legalised casino gambling in November 2010. The country is well positioned to become one of the major gaming hubs of South Asia, due to its potential to attract additional visitors from nearby countries such as China, Australia and Malaysia.

Delta is exploring possible avenues for expansion in attractive markets such as Sri Lanka. It plans an investment of Rs 4.5bn to build a luxury hotel comprising 400 rooms with a 100,000 sq ft casino. However, the plans are at the nascent stage, and the company also plans to rope in some strategic investors given the huge capital commitment required.

Key Risks and Concerns

Regulatory changes – Inherent business risks

Changes in regulations/laws are the biggest threat to the gaming business being a politically sensitive issue. Major regulatory changes can negatively impact business dynamics. For example, recently there has been an increase in gaming tax rates from 10.0% to 15.0%, licence fee rose from Rs 50mn per annum to Rs 65mn per annum. But it was countered by a decrease in entry tax from Rs 2,000 to Rs 500, which offset the negative impact. But, going forward, such changes may impact the business.

Further, one of the conditions under the in-principle approval relating to a casino licence is to obtain a no-objection certificate (NOC) from the Captain of Ports (Government of Goa). If the NOC is not obtained, then the Home Department of Goa can issue a show-cause notice as to why the licence should not be cancelled. Also, gambling in Goa is governed by the Goa, Daman & Diu Public Gambling Act, 1976. Goa does not a defined gaming regulatory body.

We note that, after the recent change in power in Goa (BJP has won elections in Goa, with a simple majority for the first time), the new CM has indicated the shifting of six offshore casinos from the Mandovi River, possibly into the Arabian Sea, though over a period of time. Any such drastic change might impact the overall going concern concept.

Economic slowdown

Goa's entertainment and gaming industry is likely to be affected by regional, national and global economic conditions. A general economic downturn may result in a change of discretionary spending patterns, which could adversely impact Delta's operations and profitability.

Management bandwidth

Delta's push towards different geographies or segments may constrain the management bandwidth, leading to slippage on the core business.

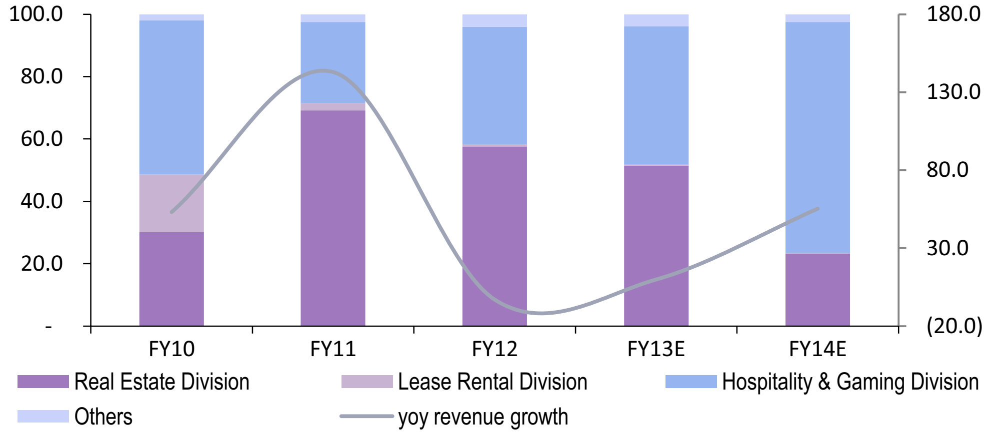
Financial Outlook

FY14 revenues could see quantum jump

Over FY10-12, Delta has posted a CAGR jump of 53.6% in revenues, due to strong traction in real estate (CAGR 133.8%) as well as hospitality and gaming (CAGR 47.9%) businesses. However, the company plans to exit the real estate venture in the next couple of years, and focus exclusively on the hospitality and gaming business.

Over FY12-14E, we expect Delta to post a CAGR jump of 30.7% (in spite of declining revenues from the real estate segment) on the revenue front, thanks to its robust performance on the hospitality and gaming business (CAGR 80.3%). This boost would be led by new property additions (Horseshoe and Daman).

Hospitality and gaming division to drive future growth (%, yoy RHS)



Source: Company, Violet Arch Research

EBITDAM set to improve

Hospitality and gaming being a high operating leverage business, we expect Delta to benefit from the opening of Horseshoe in Goa and a casino in Daman. We estimate that more than 75% of the total operating expense for a casino has semi-fixed/variable costs, implying that a significant portion of incremental gaming revenues flow directly through to EBITDA. The largest ongoing cost components for a gaming operation are labour (around 31% of costs), licence fee (17% of costs), and administration (16% of costs).

The table below shows how revenue growth has a positive impact on EBITDA margins, due to the high operating leverage nature of the business. EBITDA margins have increased by 670bps on account of a 20% growth in revenues.

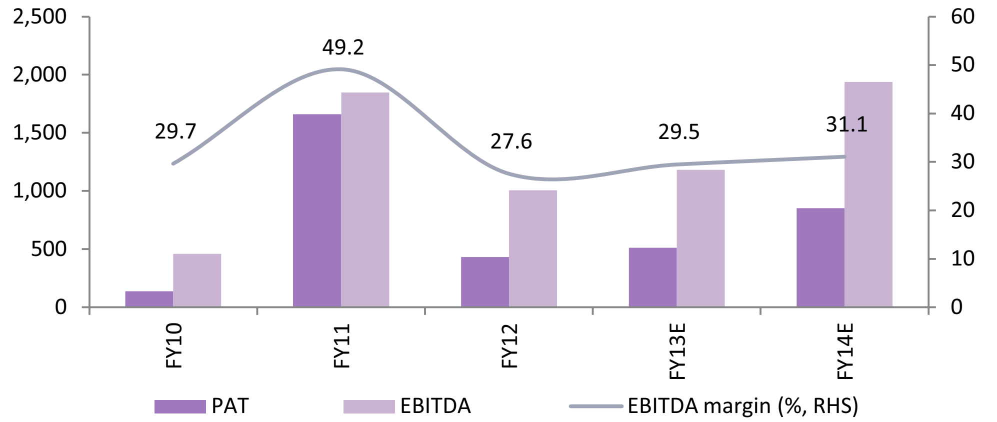
Typical P& L of a casino (Rs)	Current year	Next year	Remarks
Net revenues	100.0	120.0	20% growth
Employee/labour cost	23.0	25.3	10% growth
Fuel and power cost	6.0	6.3	5% growth
Administration cost	12.0	12.6	5% growth
License fee	13.0	13.0	Flat
Repair & maintenance	3.0	3.2	5% growth
Other expenses	0.3	0.3	5% growth
F&B cost	9.0	10.8	20% growth
Sales & marketing cost	9.0	10.8	20% growth
Total expenses	75.3	82.2	
EBITDA	24.8	37.8	
EBITDA margin (%)	24.8	31.5	670bps margin expansion

Source: Company, Violet Arch Research

Against this backdrop, we expect 590bps expansion on the EBITDA margin front for Delta's hospitality and gaming business, given the operating leverage benefits and setting up of new properties for which fixed overheads have already been incurred. To put things in perspective, we expect Delta to clock consolidated EBITDA margins of 31.1% in FY14 as against 27.6% in FY12.

On the profitability front, we expect Delta to post a CAGR of 40.2% over FY12-14 on account of: a) strong revenue growth, b) margin expansion, and 3) decrease in interest cost.

Financial and operating discipline growth boost PAT growth (Rs mn)



Source: Company, Violet Arch Research

Valuation

We have valued Delta on a SOTP basis, valuing its gaming business at 14x FY14, with a gaming EBITDA of Rs 1.4bn at an EV of Rs 16.8bn. Growth of the US market is stagnant, and other markets with comparable growth are Asian markets such as Macau and Singapore. Hence, we believe that Indian gaming operators can be compared to pure Asian gaming market operators in terms of growth potential. The average multiple enjoyed by pure Asian operators over the past three years (see charts below) is 12-16x EV/EBITDA on a one-year forward basis. However, we have valued Delta's gaming business at the middle (14x EV/EBITDA) of the band because of lower RoCE generated by Delta's gaming operations and uncertainty over regulatory norms in India vis-a-vis Asian peers.

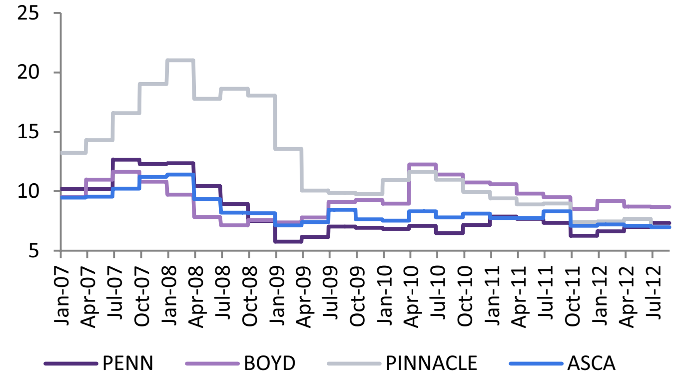
In addition, we have added value from the Daman venture, the hotel and the casino in Panjim as well as real estate on a P/BV basis separately (see Exhibit below). Our 12-month target price is Rs 86. We rate the stock a Buy.

Derivation of SOTP-based target price for DCL (FY2014E)

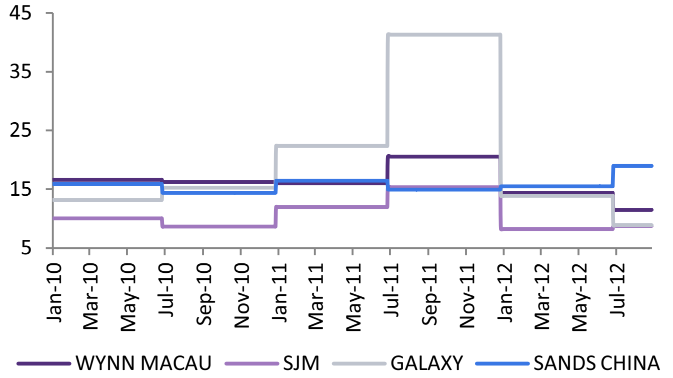
Business Segment	Methodology	Remarks	Rs mn	Rs/share	% to TP
Real estate (Kenya)	P/BV	1.5x land cost - Delta Corps 40% stake	1,350	6.0	7.0
Marvel Resorts	P/BV	1.5x land cost - Delta Corps 76% stake	540	2.4	2.8
Daman	EV/EBITDA	14.0x FY14E; Delta Corps 51% stake	1,379	6.2	7.1
Goa Gaming and Hospitality	EV/EBITDA	14.0x FY14E;	16,082	71.8	83.1
Total			**19,351**	**86**	**100.0**
CMP (Rs)				**71**	
Upside (%)				**22.2**	

Source: Company, Violet Arch Research

Historical one-year forward EV/EBITDA for regional US casinos

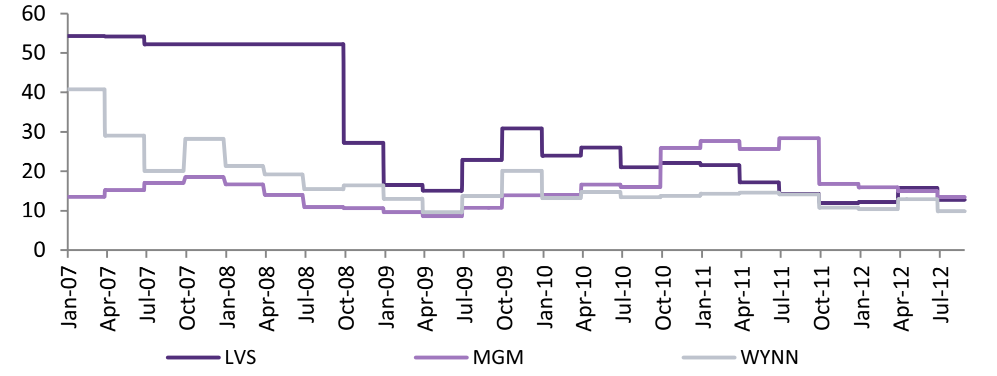


Historical one-year forward EV/EBITDA for Asian players



Source: Company, Violet Arch Research; Economic Intelligence Unit

Historical one-year forward EV/EBITDA for global casinos



Source: Company, Violet Arch Research

Company Background

Delta Corp Ltd. (Delta Corp) is a fast-growing Indian company operating primarily in three business segments: entertainment & gaming, hospitality, and real estate. Delta is the largest gaming company in the country (offering 800 gaming positions) and the only listed company in this space. The company has entered the hospitality segment, with the view to provide an international casino experience in India. Delta is also an emerging player in the real estate segment in East Africa, where it is operating through a 40:60 JV with a wholly owned subsidiary of Reliance Industries Ltd.

Gaming and Entertainment – Goa

Offshore live casinos: Of the six offshore live casino gaming licences issued by the Government of Goa, Delta owns and operates three licences, namely, Casino Royale, Caravela and Horseshoe (expected to come up soon). These casinos offer a variety of international games such as Baccarat, Poker, Roulette and Black Jack, among others.

Casino Royale is India's largest live offshore gaming casino, with 480 gaming positions (47 live gaming tables and 30 slot machines). Furnished with four decks and an amphitheatre, with live music on the sun deck, the casino has separate VIP and VVIP gaming areas for high-rollers. Serviced by a helipad, high-speed feeder boats and three jetties, the casino offerings also include a crèche, an Aquabar, three suites, which are usually occupied by high-rollers and their families, and a 6,000 sq ft live kitchens, which are managed by China Garden.

Caravela is India's first live casino that offers 190 gaming positions (20 live gaming tables and 10 slot machines). The casino has two operational decks, with level-1 being the gaming facility and level-2 the Food & Beverage (F&B) area.

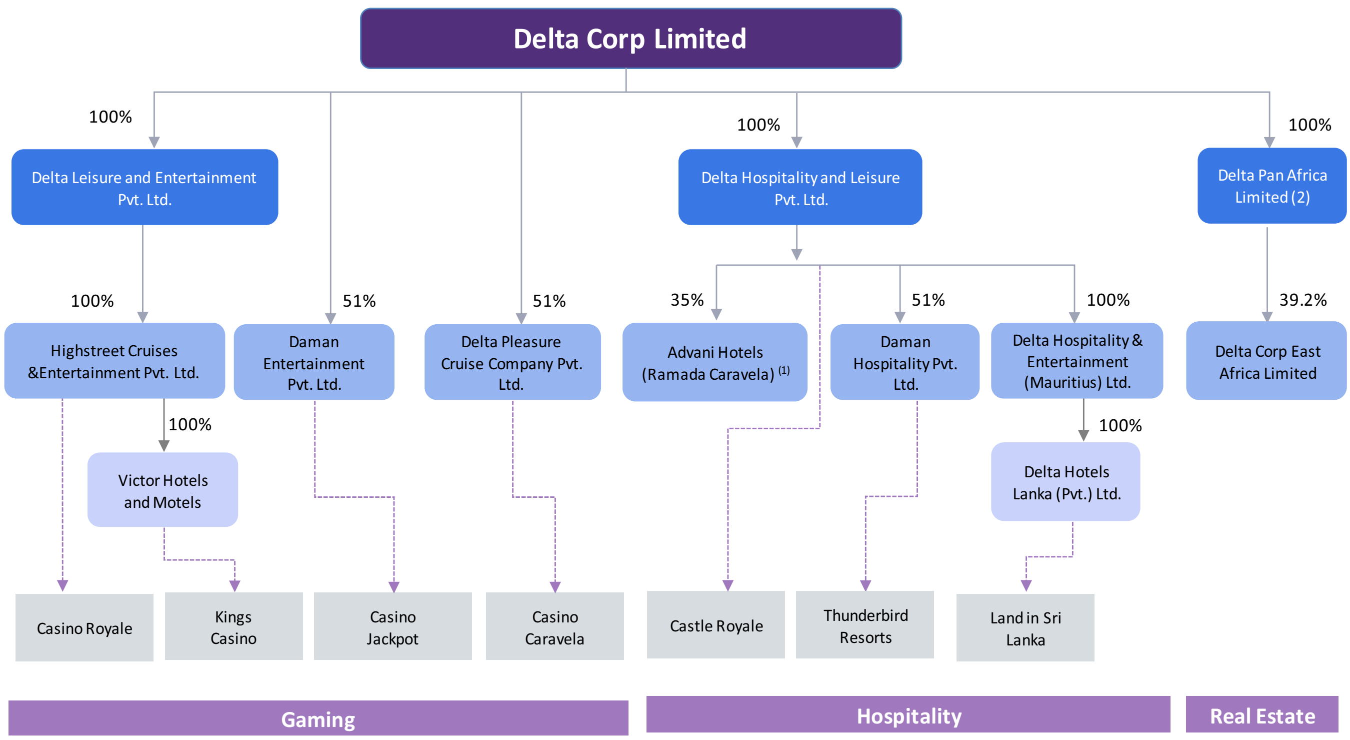
King's Casino is in the process of upgrading its vessel to a much larger boat, namely, M.V. Horseshoe. The boat, which has 1,500 gaming positions through 155 tables and 250 slot machines, is three times the size of Casino Royale. This, in turn, is two to three times the size of any other currently operational offshore casino in Goa. The casino is expected to start operations in 2013.

These casinos are serviced by four jetties and six fully air-conditioned feeder boats (Gulf Crafts), with luxurious interiors that can seat 19 passengers at a time.

Gaming and Entertainment – Daman

Delta has acquired a 51% stake in the existing 5-star Hotel and Casino in Daman, which will offer 1,000 gaming positions (100 gaming tables and 300 slot machines). In addition, the company also owns an in-principle licence for setting up a Casino in Daman

Organizational chart



(1)Delta owns 35% equity stake in Advani Hotels & Resorts India Limited. Not operated or controlled by DCL
(2) Delta Corp owns 39.2% in Delta Corp East Africa Limited. Delta Pan Africa Limited owns 30.3% stake and owns balance 8.9% through one of the Mauritius entity

Source: Company

Financial summary - Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**3,760**	**3,649**	**4,013**	**6,233**
growth (%)	142.9	(2.9)	10.0	55.3
Operating expenses	1,912	2,643	2,829	4,295
EBITDA	**1,849**	**1,007**	**1,184**	**1,938**
(% of Net Sales)	49.2	27.6	29.5	31.1
growth (%)	302.6	(45.5)	17.6	63.8
Depreciation & Amortisation	60	65	74	85
EBIT	**1,789**	**942**	**1,109**	**1,853**
Interest & Other charges	149	107	117	105
Other income	87	127	141	141
Pre-tax profit	**1,727**	**962**	**1,134**	**1,889**
Tax	71	296	349	582
Effective tax rate (%)	4.1	30.8	30.8	30.8
Net profit	**1,656**	**666**	**784**	**1,307**
PAT after Ass. & MI	**1,661**	**433**	**511**	**851**
growth (%)	-	(73.9)	17.8	66.8
Shares o/s (mn nos)	202	224	224	224
Reported EPS (Rs)	8.2	1.9	2.3	3.8
Fully Diluted Adj. EPS (Rs)	8.2	1.9	2.3	3.8
% chg	-	(76.8)	20.0	66.8

Cash flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit (adj to MI/Ass.)	1,723	962	860	1,433
Depreciation & Amortisation	60	65	74	85
Tax paid	273	296	349	582
Chg in working capital	1,098	1,354	(804)	(150)
Other income	101	127	141	141
Cash flow from operations (a)	**310**	**(750)**	**1,247**	**945**
(Inc.)/ Dec. in Fixed Assets	(1,146)	(2,715)	(655)	(428)
(Inc.)/ Dec. in Investments	(90)	(286)	-	-
Other income	101	127	141	141
Cash flow from investing (b)	**(1,136)**	**(2,874)**	**(514)**	**(287)**
Equity raised	2,039	816	-	-
Inc./(Dec.) in loans	(620)	2,377	(666)	(533)
Dividend (incl. tax)	60	61	61	61
Chg in minorities	3	-	-	-
Others	(346)	1,173	(74)	(85)
Cash flow from financing (c)	**1,010**	**4,305**	**(801)**	**(679)**
Net chg in cash (a+b+c)	184	680	(68)	(21)
Opening Cash balances	**460**	**644**	**1,324**	**1,256**
Closing Cash balances	**644**	**1,324**	**1,256**	**1,235**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net fixed assets	**1,921**	**5,462**	**6,118**	**6,546**
Capital Work-in-Progress	826	-	-	-
Investments	1,628	1,343	1,343	1,343
Current assets	**5,092**	**7,414**	**6,666**	**6,632**
Inventories	2,493	3,148	2,833	2,550
Sundry Debtors	29	647	53	71
Cash and Bank	644	1,324	1,256	1,235
Loans and advances	1,926	2,233	2,457	2,702
Others	-	61	67	74
Mis. Exp. not written off	-	-	-	-
Total assets	**9,467**	**14,219**	**14,126**	**14,520**
Shareholders' funds	**6,186**	**7,518**	**7,967**	**8,757**
Share capital	202	224	224	224
Preference Capital	122	122	122	122
Reserves & surplus	5,862	7,172	7,621	8,411
Minority Interest	593	1,074	1,074	1,074
Total Debt	**2,017**	**4,394**	**3,728**	**3,195**
Secured loans	1,329	3,329	2,663	2,131
Unsecured loans	688	1,065	1,065	1,065
Deferred Tax Liability	(0)	(11)	(11)	(11)
Curr Liab & prov	**671**	**1,243**	**1,368**	**1,505**
Current liabilities	537	824	907	998
Provisions	134	419	461	507
Total liabilities	**3,281**	**6,700**	**6,159**	**5,763**
Total equity & liabilities	**9,467**	**14,219**	**14,126**	**14,520**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Fully diluted Adj EPS (Rs)	8.2	1.9	2.3	3.8
Adj EPS growth (%)	0.0	(73.9)	17.8	66.8
EBITDA margin (%)	49.2	27.6	29.5	31.1
Pre-tax margin (%)	45.9	26.4	28.2	30.3
AROE (%)	37.8	6.3	6.6	10.2
AROCE (%)	31.8	9.4	9.4	15.7
Turnover & Leverage ratios (x)				
Total Asset turnover (x)	0.7	0.4	0.3	0.5
Gross block Asset turnover (x)	2.6	1.0	0.7	1.0
Net margin (%)	44.2	11.9	12.7	13.7
Net Debt/Equity (x)	0.2	0.4	0.3	0.2
Working Capital & Liquidity ratio				
Inventory days	212	282	272	158
Receivable days	4	34	32	4
Payable days	133	107	127	92
Working capital cycle (ex-cash) (days)	302	431	404	232
Valuations				
PER (x)	8.6	36.5	31.0	18.6
Price/Book value (x)	2.3	2.1	2.0	1.8
PCE (x)	8.3	31.8	27.1	16.9
EV/Net sales (x)	4.6	5.2	4.6	2.9
EV/EBITDA (x)	9.3	18.8	15.5	9.2
Dividend Yield (%)	0.4	0.4	0.4	0.4

VIOLET ARCH

COMPANY REPORT

Equity Research | Cement & Cement Products

21 September, 2012

HIL Ltd.

All Under One Roof

Absolute Rating	**BUY**
Target Price	**Rs 780**
Upside	**59%**

HIL Ltd., erstwhile Hyderabad Industries Ltd., is a leading player in the building products segment and a market leader in the fibre cement-roof manufacturing in India. HIL has two major business segments: building products and thermal insulation. Under building products, the company manufactures and sells fibre cement (FC) sheets, autoclaved aerated concrete blocks (AAC) and Aerocon panels. FC sheets contributed 82% of the company's revenue in FY12. We initiate coverage on HIL with a Buy rating.

Driven by rural households moving up the value chain

The fibre cement (FC) sheet industry is mainly driven by rural households moving up the value chain from kuccha to pucca housing, helped by an improving labour market and government welfare schemes. Pucca housing fares better over kuccha housing in terms of waterproofing, fire hazards, low-maintenance and security concerns. The sector remained relatively unaffected by the global slowdown, as it is driven by strong agri-income and government welfare schemes.

Market leader in FC sheets with strong brands

HIL is the market leader in the FC sheet industry, with its brand 'Charminar' accounting for a market share of 19%. The four major players account for roughly 60% of the market share, eliminating excessive fragmentation and competition in the sector. The freight-intensive nature of the business limits the companies to adjacent locations, which helps HIL that enjoys the highest number of manufacturing plants.

Fast-growing AAC blocks and Aerocon panels business

Demand for AAC blocks and Aerocon panels is growing at an encouraging pace helped by easy installation and environment-friendly nature (leading to better LEED ratings for real estate projects) of the products. AAC blocks grew at a CAGR of 29%, while the panels business grew at a 20% CAGR over the last six years.

Valuation

We initiate coverage on HIL with a buy rating and target price of Rs 780 valued at 7.0x FY14E EPS, an upside of 59% from CMP. Over the last eight years, the stock has traded in a wide P/E multiple band of 1.0x-26.0x with an average forward P/E of 7.0x. The stock outperformed BSE Sensex by 165% and the BSE Mid-cap index by 188% over the last five years. Despite outperformance over the benchmarks, strong earnings growth of 23% and average ROE of 22% (over the last five years), the stock traded in a low PE band, possibly owing to regulatory risk, and we value the stock accordingly at the long-term average PE at 7.0x. At the CMP, the stocks trades at an attractive dividend yield of 4.5% FY13E.

Standalone -Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Sales	7,245	8,578	10,259	11,697
EBITDA	900	1,100	1,327	1,510
EBITDA growth (% YoY)	(41.7)	22.2	20.6	13.8
EBITDA margin (%)	12.4	12.8	12.9	12.9
Net profit	506.0	606.0	732.1	833.7
EPS (Rs)	67.8	81.2	98.1	111.7
EPS growth (%YoY)	(43.6)	19.8	20.8	13.9
P/E	7.2	6.0	5.0	4.4
EV/EBITDA	4.9	4.2	3.5	3.1

Source: Company, Violet Arch Research

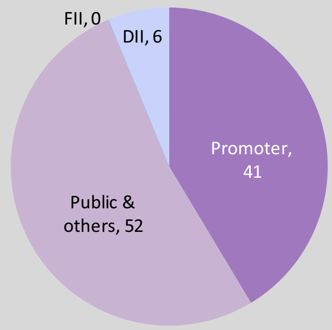
Stock data

CMP	**Rs 490**
Reuters Code	HYDI.BO
Bloomberg Code	HYI IN
Equity Shares o/s (mn)	7
Market Cap (Rs mn)	3,657
Market Cap (USD mn)	69
3m Avg daily t/o(US$ mn)	0.4

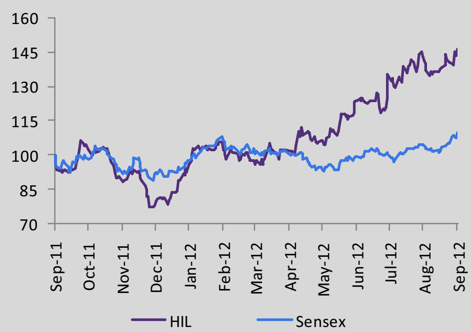
Stock performance (%)

52-week high / low			**Rs 498/255**
	1M	**3M**	**12M**
Absolute	2.4	18.3	56.0
Relative	(2.7)	7.9	40.0

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull	Base	Bear
FC sheet volume growth (%YoY)	10.0	7.0	3.0
FC sheet realisation growth (%YoY)	8.0	6.0	0.0
AAC blocks value growth (%YoY)	30.0	20.0	15.0
Aerocon panels value growth (%YoY)	20.0	20.0	10.0
Thermal insulation (%YoY)	15.0	10.0	0.0
Sales (Rs mn)	12,237	11,697	10,725
EBITDA margin (%)	13.9	12.9	11.9
EBITDA (Rs mn)	1,700	1,510	1,279
PAT (Rs mn)	957	834	691
PAT (%YoY)	30.7	13.9	(5.7)
EPS (Rs)	**128**	**112**	**93**
CMP (Rs)	490	490	490
Target P/E multiple (x)	10.0	7.0	5.0
Target price (Rs)	**1282**	**780**	**463**
Upside/Downside (%)	**161.7**	**59.2**	**(5.5)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY08	FY09	FY10	FY11	FY12	FY13E	FY14E
FC sheet volume growth (%YoY)	18.9	7.6	4.4	3.8	5.8	10.0	7.0
FC sheet realisation growth (%YoY)	(18.6)	22.0	11.3	(3.8)	7.2	8.0	6.0
AAC blocks value growth (%YoY)	33.4	31.7	(14.9)	24.1	100.0	50.0	20.0
Aerocon panels value growth (%YoY)	(2.1)	(0.2)	26.4	57.0	21.0	30.0	20.0
Thermal insulation (%YoY)	10.1	29.0	14.3	(18.4)	19.2	5.0	10.0
EBITDA margin (%)	7.3	14.8	21.9	12.4	12.8	12.9	12.9

Source: Company, Violet Arch Research

Base case

- For FC sheets, we estimate a volume and realization growth of volume growth of 10%/7% and 8%/6% for FY13/FY14 respectively; in line with the structural trend and slightly below the management guidance.
- We expect raw material costs, as % of sales, to remain at FY12 levels at 54% as reported in 1QFY13 results and also given the limited number of countries which use the major input i.e. chrysotile fibre (53% of input costs). A 100 bps increase in raw material cost to impact EPS by 10%.
- EBITDA margin at 12.9% to be maintained as operating leverage offsets input cost risks. This is supported by 1QFY13 results as operating margin maintained at previous year levels despite the currency depreciation. Valued at 7x FY14E EPS, it leads to a target price of Rs 780, an upside of 68%. A 100 bps drop in EBITDA margin to impact EPS by 10%.
- We expect agricultural GDP, the main driver for the rural economy, to grow at more than 2% helped by late recovery in monsoon.

Bull case

- Sales growth of 19%, EBITDA margin improvement by 100 bps and a P/E multiple of 10x FY14E gives a best case target price of 1282, an upside of 175%.

Bear case

- Sales growth of 4.5%, fall in EBITDA margin by 100 bps and a P/E multiple of 5x FY14E leads to a target price of 463, equal to the CMP.

SWOT Analysis

Strengths

1) Industry leader with established brands like Charminar and Aerocon. Better margins compared to other players in the segment helped by pricing power.

2) The fibre cement sheet industry remained relatively unaffected by GDP growth. In FY09, HIL achieved 7.6% volume growth (slightly higher than trend) even as GDP growth fell to 6.7%.

3) Higher growth segments like aerated concrete blocks and panels driving the growth story.

4) The industry being freight-intensive, catering to nearby geographies, HIL with the highest number of manufacturing plants is a beneficiary.

Threats

1) Regulatory action or ban of asbestos related products remains the biggest threat for the company.

2) Drastic fall in prices of other roofing materials like aluminium and steel sheets due to global economic slowdown, which makes them substitute products for pucca housing. The sector faced competition from GI corrugated sheets when steel prices fell to Rs 35,000/tonne in FY10/FY11 (30% below current levels).

3) Drastic rise in prices of key inputs - fibre, cement and fly-ash.

SWOT Analysis

Weaknesses

1)High concentration of revenues from the FC sheet segment.

2)Capacity expansion by competitors could bring down the pricing power and margins. The capacity of top 4 players (60% market share) increased by 11.4% (CAGR) between FY05 and FY11 versus demand growth of 7.2%.

3) Industry growth for fibre cement sheets, which constitutes 82% of revenues, eased in the second half of the last decade vis-a-vis the first.

Opportunities

1) The company's presence in aerated blocks and panels will continue to drive growth, and the company could leverage its presence to other building products.

2) Focus on logistics and warehousing to counter inflation a huge opportunity in the coming years.

3) Strong presence, distribution and brands in rural areas would help the company spread its operations to other products in rural economy relatively unaffected by the economic slowdown. The company enjoys a strong distribution network of 45 depots and 8000 sales points spread across the country.

Source: Violet Arch Research

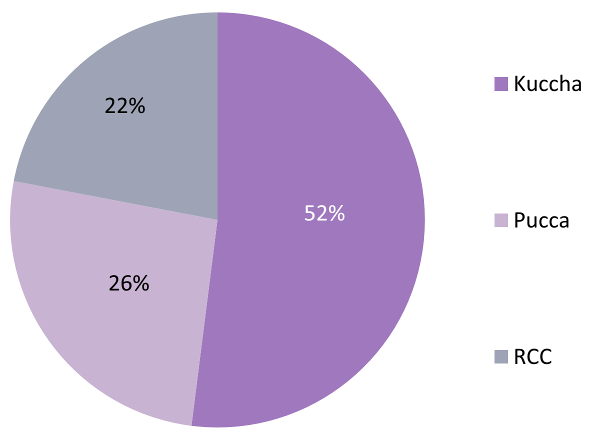
Investment Arguments

Segment driven by rural households moving up the value chain

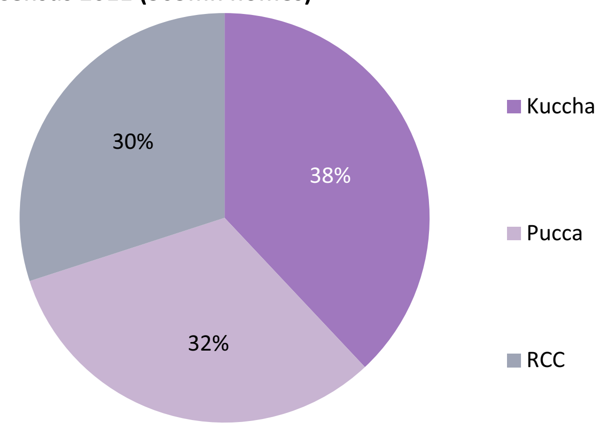
The fibre cement (FC) sheet industry is mainly driven by rural households moving up the value chain from kuccha to pucca housing, helped by an improving labour market and government welfare schemes. Pucca housing fares better over kuccha housing in terms of waterproofing, fire hazards, low maintenance and security concerns. Fibre cement sheets lead the market share in pucca housing, which is also served by corrugated galvanized iron sheets, aluminium sheets and red-mud plastic, driven by performance, low cost and minimum maintenance.

It is estimated that FC roofs can be installed at one-third the cost of reinforced cement concrete roofing. A 500 sq ft roof using FC sheets costs about Rs 15,000, including the installation cost. For the same, it takes around Rs 50,000 using reinforced cement concrete.

Census 2001 (249mn homes)



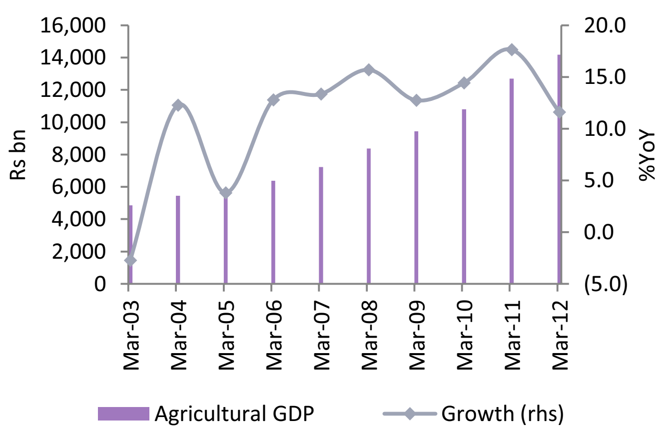
Census 2011 (305mn homes)



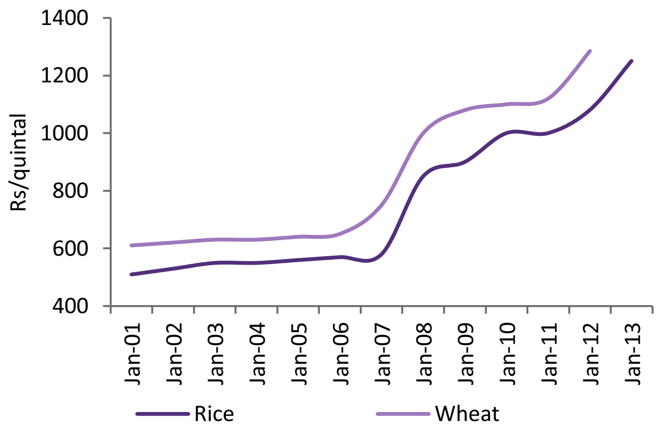
Source: Company, Violet Arch Research, Industry

Over the last four years, the sector remained unaffected by the economic slowdown and achieved 5.4% volume growth and 14.0% value growth. It is mainly driven by strong ongoing rural economy, largely led by strong agri-income and government welfare schemes. The government continues to support housing of poor households through schemes such as rural housing fund and Rajiv Aawas Yojana.

Strong agri-income growth in recent years



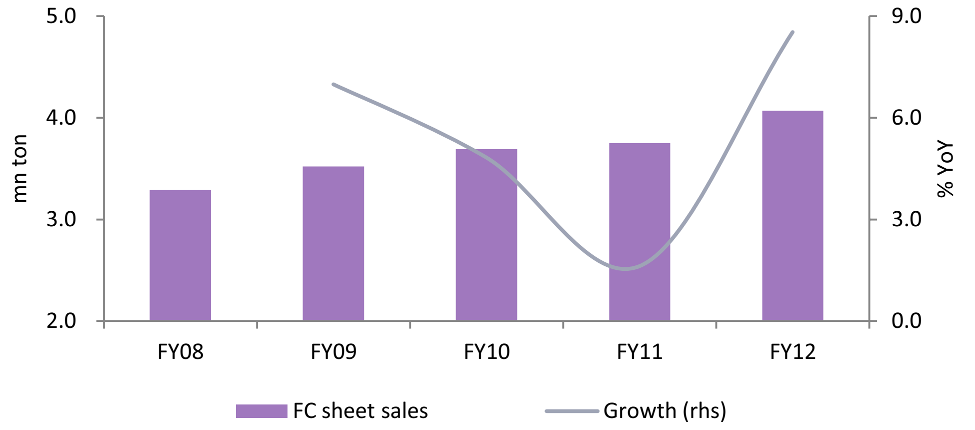
Increased support in the form of minimum support prices



Source: Company, Violet Arch Research

Evidently, the sector has remained unaffected by the economic slowdown, as it registered a volume CAGR of 5.4% over the last four years. HIL has achieved volume growth in line with the industry, and a value growth of 14.1% during the same period.

FC sheet sales in India



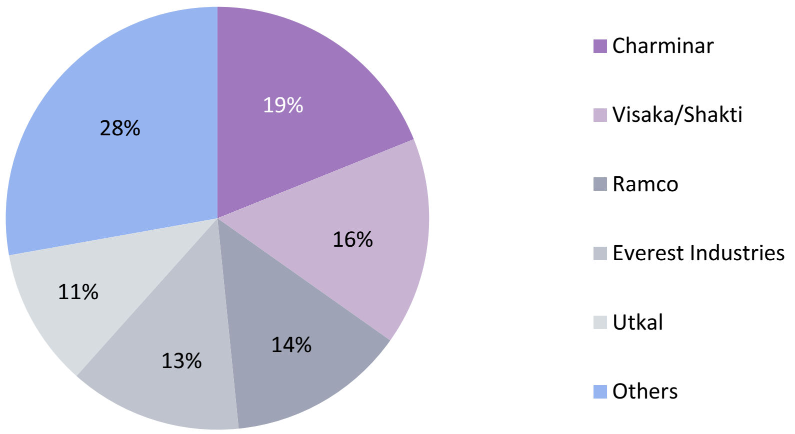
Source: Company, Violet Arch Research, Industry

Market leader in FC sheets with strong brands

HIL is the market leader in the FC sheet industry, with its brand 'Charminar' accounting for a market share of 19%. It helped the company to record better operating margins and strong asset turnover, leading to higher ROEs.

The four major players account for roughly 60% of the market share, eliminating excessive fragmentation in the sector. HIL is the largest player in the FC sheets segment, with a 19% market share.

Major players in FC sheet industry



Source: Company, Violet Arch Research

Fibre cement products being freight-intensive, most producers cater to the immediate geographic regions. Here again, HIL scores over its major peers, as it has more (10) FC sheet manufacturing plants across the country vis-à-vis Visaka Industries (8), Ramco (9) and Everest Industries (5).

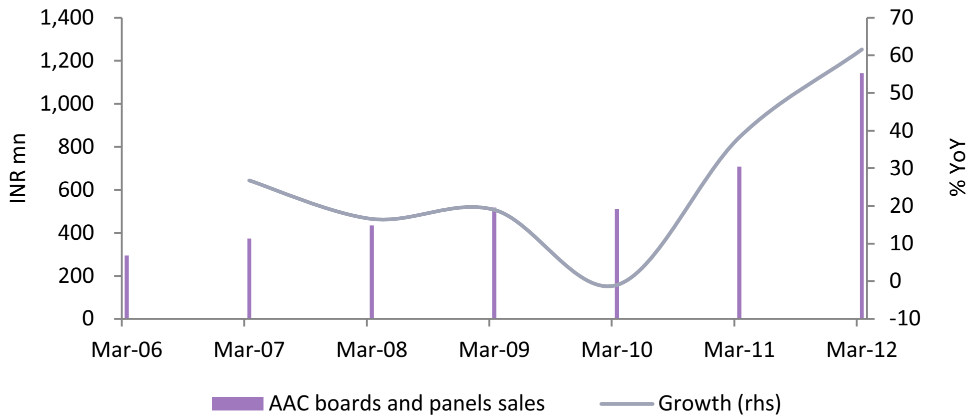
Fast-growing boards and Aerocon panels business

AAC blocks (light-weight large-sized bricks) witnessed a significant CAGR of 29% over last six years, as builders shift from conventional red clay bricks to save time and costs. In FY12, the company achieved a 100% growth in AAC blocks, thanks to a new unit.

Aerocon panels are used for construction of prefab structures and partition walls in the infrastructure sectors as well as for building malls, schools and colleges. The segment enjoyed a CAGR of 20% over last six years. The company has a domestic market share of 58% in the segment.

Demand for AAC blocks and Aerocon panels is growing at an encouraging pace helped by easy installation and environment-friendly nature (leading to better LEED ratings for real estate projects) of the products. Demand for AAC blocks and Aerocon panels is likely to remain strong, as labour costs continue to rise and labour availability becomes difficult.

Fast growing AAC boards and panels business



Source: Company, Violet Arch Research

Warehousing

Warehousing remains a huge potential opportunity for the FC sheet segment, as the government plans to increase the food grain storage capacity and private players catch up with the retail demand. According to a recent study released by CII Institute of Logistics, by 2012 around 110 logistics parks, spread over 3,500 acres, are expected to come up across India at an estimated cost of US$1bn. The logistics sector has been growing at a rate of 8-10 per cent per annum since 2002. It was estimated at over $100bn in 2009-10. Warehousing activities account for about 20 per cent of the total Indian logistics industry.

Key Risks and Concerns

Change in regulatory stance the major risk for the industry

According to sources, chrysotile asbestos used in fibre cement sheets is believed to cause tumours in animals and is a recognized cause of asbestosis and malignant mesothelioma (a form of cancer) in humans. Asbestos exposure becomes a health concern when high concentrations of asbestos fibres are inhaled over a long period of time. People who got sick from inhaling asbestos are often those who are exposed on a day-to-day basis in a job, where they worked directly with the material.

Asbestos has been banned in all European countries, Australia, Argentina, Chile, South Africa, Egypt and South Korea. Fibre cement sheets are widely used in China, Russia, Brazil and India.

Litigations have been filed from time to time to ban the use of asbestos in India. But a blanket ban was never imposed due to a lack of clear evidence of its negative effects. The Supreme Court issued directions and precautions to the asbestos industry in 1995. In January 2012, the Kerala high court directed the Union government and the Customs Department to reply to its proposal to prohibit asbestos fibre and manufacture of asbestos products.

Commodity nature of the business

Commoditized nature of the business could lead to excess capacity creation, competition and margin compression. However, freight intensive nature of the business saved it from excess competition as manufacturing plants catered only to nearby areas.

Significant rise in input costs

Input costs, which forms 54% of sales, determine the profitability of the company. The major constituents of fibre cement sheets are OPC cement, fibre, fly-ash, lime and water. Cement prices have moved up across the country in the last one year, despite the excess capacity. Any ban on asbestos in major producing countries remains a major risk, as fibre price forms 53% of input costs. A ban on asbestos mining in Canada (7% of global production), one of the few developed countries that allows asbestos operations, could significantly impact raw material prices. In recent years, the cost of fly-ash, which was earlier procured either free or at a low price from thermal power stations, has increased manifold. A weak currency is also a risk for the fibre input cost, which is completely imported.

Reversal in fortunes of rural economy

Weakness in rural economy, either due to reduced welfare spending, owing to stretched government balance sheet, or on account of the weakness in agri-based income either due to low productivity, prices or higher input costs, could impact demand for the industry.

Financial Outlook

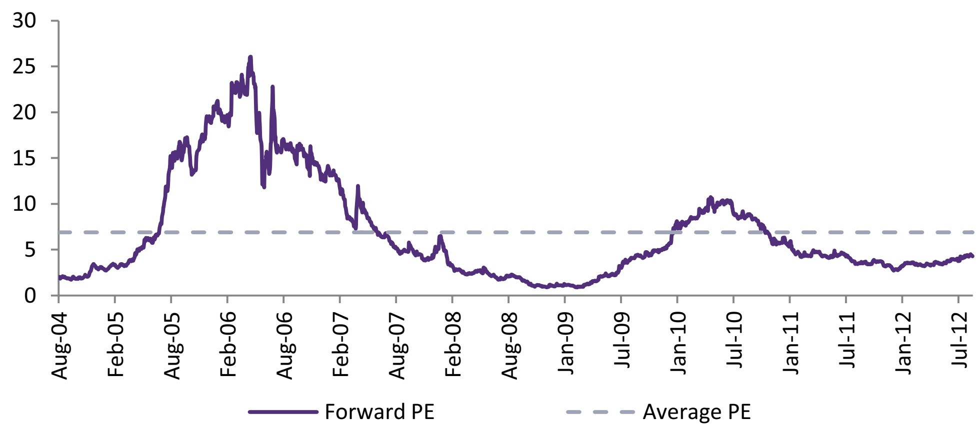
Sales increased at a CAGR of 14.3% over the last five years and EBITDA by 25.4% during the same period. Revenue growth was led by a CAGR of 11.2% (growth) in FC sheets, a CAGR of 30% in AAC blocks, a 18.6% growth in Aerocon panels and a 9.6% growth in thermal insulations.

We estimate 19.6% sales growth in FY13, driven by strong growth in AAC blocks and panels. The company reported a 33% revenue growth in 1QFY13, and it assumes a 13.5% growth for the remaining three quarters. We estimate operating margins to remain close to FY12 levels, as observed in 1QFY13 results, Rupee appreciation will also benefit the company going forward, as 53% of input costs (54% of sales) are denominated in foreign currency.

Valuation

We initiate coverage on HIL with a buy rating and target price of Rs 780 valued at 7.0x FY14E EPS, an upside of 59% from CMP. Over the last eight years, the stock traded in a wide valuation band of 1x and 26x forward P/E at an average of 7.0x. The stock outperformed BSE Sensex by 165% and the BSE Mid-cap index by 188% over the last five years. Despite outperformance over benchmarks, strong earnings growth of 23% and average ROE of 22% (over the last five years), the stock traded in a low PE band, possibly owing to regulatory risk, and we value the stock accordingly at the long-term average PE at 7x. At the CMP, the stocks trades at an attractive dividend yield of 4.5% FY13E.

Historical 1-year forward P/E



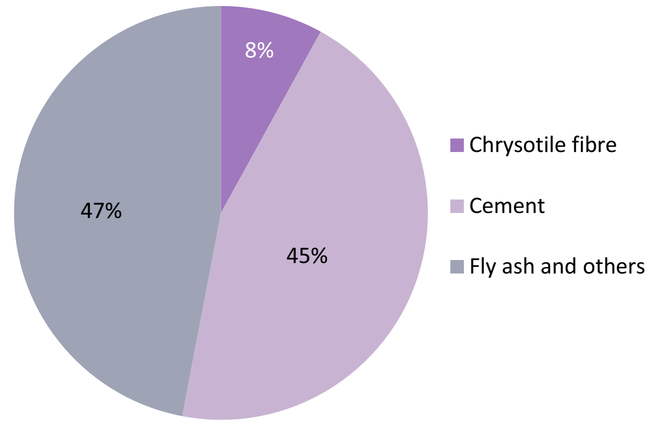
Source: Company, Violet Arch Research

Company Background

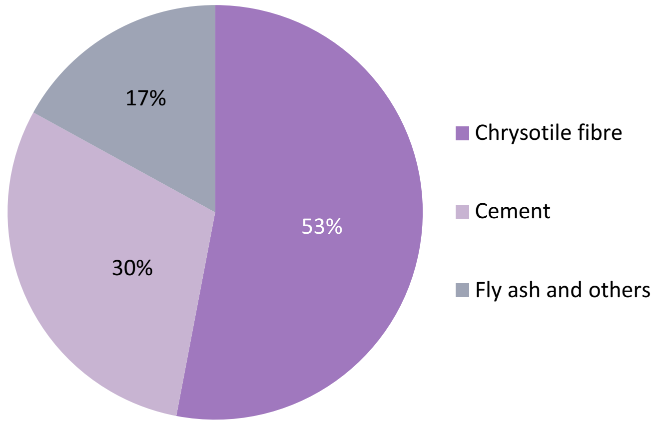
HIL Ltd., formerly Hyderabad Industries Ltd., is a leading player in the building products segment. It is the market leader in the fibre cement roof manufacturing in India. HIL has two major business segments: building products and thermal insulation. Under building products, the company manufactures and sells fibre cement (FC) sheets, autoclaved aerated concrete blocks (AAC) and Aerocon panels.

FC sheets have also proven to be the most cost-effective, easy-to-install, strong and durable roofing material for warehouses, factories and low-cost housing. The major raw materials for the roofing product are chrysotile fibre, cement and fly-ash. Fibre cement products are freight-intensive and hence most units cater to the immediate geographic regions. Russia, China and Brazil are the biggest producers of chrysotile, a form of asbestos.

Fibre cement sheet by volume

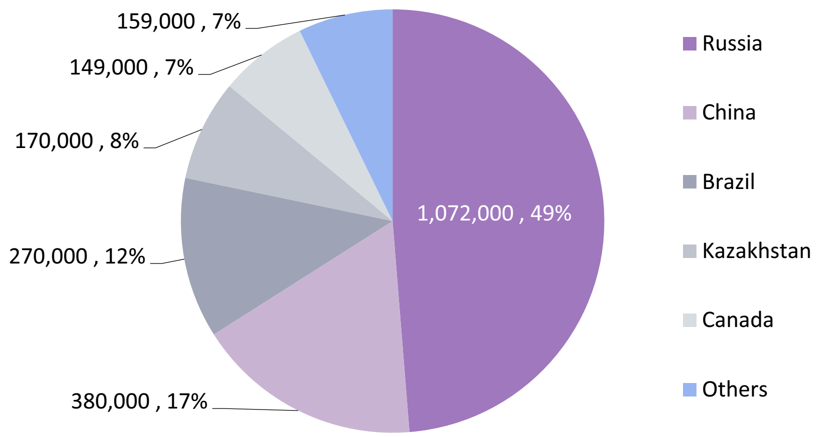


Fibre cement sheet by value



Source: Company, Violet Arch Research

Producers of chrysotile fibre



Source: Company, Violet Arch Research

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Thermal Insulation Product Group

The Group's calcium silicate-based insulating materials cater to industries such as cement, power, petrochemical and fertilizer plants. The sale of the thermal insulation segment in terms of quantity grew by 7% over the previous year, keeping pace with the industry growth. The company enjoys a market share of 65%.

With the commissioning of a 2.50MW wind power project in Jodhpur District of Rajasthan, the company's total installed wind power capacity would be 7.35MW.

Financial Summary - Standalone

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**7,245**	**8,578**	**10,259**	**11,697**
growth (%)	2.8	18.4	19.5	14.0
Raw material costs	3,901	4,630	5,540	6,316
EBITDA	**900**	**1,100**	**1,327**	**1,510**
growth (%)	(41.7)	22.2	20.6	13.8
Depreciation	180	212	256	292
EBIT	**797**	**948**	**1,131**	**1,278**
Interest paid	56.0	75.0	75.0	75.0
Pre-tax profit	**741**	**874**	**1,056**	**1,203**
Tax	235	268	324	369
Effective tax rate (%)	31.7	30.7	30.7	30.7
Net profit	**506**	**606**	**732**	**834**
growth (%)	7.0	7.1	7.1	7.1
Shares o/s (mn nos)	7.5	7.5	7.5	7.5
Standalone EPS	67.8	81.2	98.1	111.7

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net fixed assets	**2,671**	**3,095**	**3,439**	**3,746**
Investments	265	265	265	265
Current assets	**2,430**	**3,193**	**3,635**	**4,158**
Inventories	1,515	1,853	2,226	2,538
Sundry Debtors	626	846	975	1,111
Cash and Bank	105	94	35	109
Loans and advances	168.286	380.224	380.224	380.224
Total assets	**5,589**	**6,722**	**7,572**	**8,440**
Shareholders' funds	**2,983**	**3,426**	**3,977**	**4,603**
Share capital	75	75	75	75
Reserves & surplus	2,908	3,351	3,902	4,528
Total Debt	**850**	**1,036**	**1,036**	**1,036**
Curr Liab & prov	**1,602**	**2,097**	**2,397**	**2,639**
Current liabilities	1,458	1,894	2,194	2,436
Provisions	143	203	203	203
Total liabilities	**2,681**	**3,370**	**3,670**	**3,912**
Total equity & liabilities	**5,589**	**6,722**	**7,572**	**8,440**
Book Value (Rs)	**400**	**459**	**533**	**617**

Cash Flow

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Profit before Tax	741	874	1,056	1,203
Adjustments for:				
Depreciation	179	212	256	292
Interest	56	75	75	75
Operating Profit before Working Capital	**917**	**1,138**	**1,388**	**1,571**
Adjustments for:				
(Increase)/Decrease in Sundry Debtors	(261)	(461)	(291)	(273)
(Increase)/Decrease In Inventories	(130)	(338)	(373)	(312)
Cash generated from Operating Activities	**656**	**677**	**1,097**	**1,297**
Direct Taxes Paid	(139)	(129)	(324)	(369)
Net Cash from Operating Activities	**518**	**548**	**773**	**928**
Cash Flow From Investing Activities				
Purchase of Fixed Assets	(619)	(607)	(600)	(600)
Net Cash (used) in Investing Activities	**(540)**	**(537)**	**(600)**	**(600)**
Cash Flow From Financing Activities				
Dividends paid	(118)	(118)	(157)	(179)
Interests Paid	(56)	(75)	(75)	(75)
Net Cash from / (used in) Financing Activities	**22**	**(22)**	**(232)**	**(254)**
Net Cash Inflow / Outflow	**0.1**	**(10.5)**	**(59.0)**	**73.9**
Opening Cash & Cash Equivalents	**105**	**105**	**94**	**35**
Closing cash	**105**	**95**	**35**	**109**

Financial Ratio

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	67.8	81.2	98.1	111.7
Adj EPS growth (%)	(43.6)	19.8	20.8	13.9
EBITDA margin (%)	12.4	12.8	12.9	12.9
Pre-tax margin (%)	10.2	10.2	10.3	10.3
ROE (%)	18.1	18.9	19.8	19.4
ROCE (%)	15.3	15.8	16.6	16.6
Turnover & Leverage ratios (x)				
Asset turnover (x)	1.3	1.3	1.4	1.4
Leverage factor (x)	1.9	2.0	1.9	1.8
Net margin (%)	7.0	7.1	7.1	7.1
Net Debt/Equity (x)	0.2	0.3	0.3	0.2
Working Capital & Liquidity ratio				
Inventory days	4.8	4.6	4.6	4.6
Receivable days	11.6	10.2	10.6	10.5
Payable days	11.6	9.7	9.7	9.7
Valuations				
PER (x)	7.2	6.0	5.0	4.4
Price/Book value (x)	0.9	0.7	0.9	0.8
EV/EBITDA (x)	4.9	4.2	3.5	3.1

Indoco Remedies Ltd.

Salubrious Growth

Absolute Rating	**BUY**
Target Price	**Rs 87**
Upside	**23%**

Over the past five years, Indoco Remedies Ltd. (Indoco) has consolidated its position in the domestic formulations market, besides strengthening its exports footprint. We expect Indoco to maintain its growth momentum on the back of new product launches in the domestic market and enjoy healthy exports growth led by contract revenues and supply deals with Watson and Aspen. According to our estimation, the company's revenues and PAT would grow at a CAGR of 20.0% and 64.1%, respectively, over FY12-14E. At the CMP of Rs 71, the stock trades at a PER of 6.5x of our estimated FY14E earnings. We initiate coverage on Indoco with a Buy recommendation at target price of Rs 87 with a potential upside of 23%.

Domestic formulations to maintain the growth curve

Indoco's domestic formulations business contributes 60% of its total sales. It has a presence in 18 therapeutic segments, with a huge basket of products (135) and a strong field-force (2,200). Its 17 brands rank among top-5 in their respective segments, while other big brands have a sizeable market share in their respective segments. Going forward, the company will focus on high-margin and cash-flow sticky chronic therapies, besides aiming to increase its contribution from 10% to 20% over the next two years supported by new product launches (20-25 products annually). We estimate the company's domestic revenues to grow at a CAGR of 18.0% during FY12-14E.

Exports business continues on a high growth trajectory

Indoco's products (formulations and dossiers) are spread across as many as 80 countries. Until now, the company has filed 17 ANDAs and 15 DMFs in the US. Going forward, we expect robust growth in the US market, driven largely by the Watson deal (ophthalmic, total 19 ANDAs, filed 10). We expect revenues of Rs 300-400mn in FY14E from the Watson deal. The deal with Aspen (12 products) will boost its revenues in semi-regulated markets. We estimate revenues of Rs 200-250mn and Rs 400mn in FY13E and FY14E, respectively, from the Aspen deal. The company is also engaged in the tender-related business in Germany and the UK (for the supply of Metformin), which is expected to contribute around Rs 800mn over the next two years. We expect the overall exports business to grow at a CAGR of 25.8% during FY12-14E.

Valuation

We estimate revenues and earnings at a CAGR of 20.0% and 64.1%, respectively, over FY12-14E. The EBITDA margin is expected to improve by 422bps to 19.1% by FY14E. At the CMP of Rs 71, the stock is trading at 8.6x and 6.5x FY2013E and FY2014E earnings of Rs 8.2 and Rs 10.9, respectively. We recommend a Buy on the stock at a target price of Rs 87 (8x of FY14E EPS Rs 10.9), with a potential upside of 23%, which is based on: a) increased focus on chronic therapy, strong product portfolio, and new products launches in the domestic business, b) increased revenues from supply deals signed with MNCs such as Watson, Aspen and DSM, and c) incremental revenues from the CRAMS business.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	4,811	5,688	6,767	8,186
EBITDA	676	846	1,211	1,564
EBITDA margin (%)	14.1	14.9	17.9	19.1
EBITDA growth (%)	27.5	25.1	43.2	29.1
Adj. PAT	438	374	757	1,007
Adj. PAT margin (%)	9.1	6.6	11.2	12.3
Adj. PAT growth (%)	26.8	(14.6)	102.4	33.0
FDEPS (Rs)	4.8	4.1	8.2	10.9
FDEPS growth (%)	26.8	(14.6)	102.4	33.0
PE (x)	14.9	17.5	8.6	6.5

Source: Company, Violet Arch Research

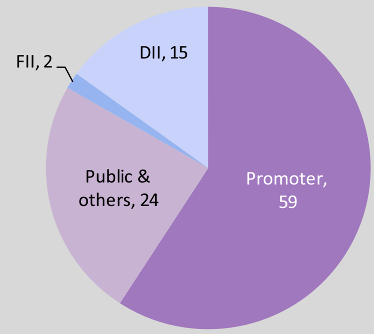
Stock data

CMP	**Rs 71**
Reuters Code	INRM.BO
Bloomberg Code	INDR IN
Equity Shares o/s (mn)	92
Market Cap (Rs mn)	6,543
Market Cap (USD mn)	122
3m Avg daily t/o(US$ mn)	0.2

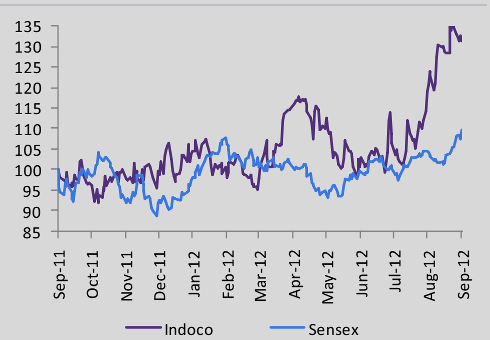
Stock performance (%)

52-week high/low			**Rs 77/48**
	1M	**3M**	**12M**
Absolute	17.1	32.8	33.8
Relative	3.4	15.6	15.6

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E (Rs mn)	Bull Case	Base Case	Bear Case
Sales	**8,490**	**8,186**	**7,888**
Domestic formulations- chronic therapy	1,218	942	774
Domestic formulations- Acute therapy	3,653	3,768	3,778
Export formulation (chronic and acute)	3,144	3,001	2,861
API	433	433	433
Other operating income	43	43	43
EBITDA	1,791	1,564	1,349
PAT	1,189	1,007	809
EPS (Rs)	**12.9**	**10.9**	**8.8**
PE(x)	9.0	8.0	7.0
CMP (Rs)	71	71	71
Target price (Rs)	**116**	**87**	**61**
Upside (%)	**63.6**	**23.1**	**(13.4)**

Source: Company, Violet Arch Research

Assumptions

Assumptions FY14E	FY11	FY12	FY13E	FY14E
Chronic therapy, % to domestic formulation	8.0	10.0	15.0	20.0
Acute therapy, % to domestic formulation	92.0	90.0	85.0	80.0
Export formulation (chronic and acute), % growth y-o-y	29.8	31.0	25.5	28.9
EBITDA margin (%)	14.1	14.9	17.9	19.1

Source: Company, Violet Arch Research

Base case

- Revenues to grow by 21%, y-o-y in FY14E, largely driven by strong growth in domestic formulations (18% growth, y-o-y) and export formulations (29% growth, y-o-y), and also on account of a deal signed with Watson and Aspen Pharma. It's pertinent to note that we have applied target PE multiple to adjusted earnings, considering the tax rate of 20% as against the company guidance of 10.0%.
- EBITDA margin to improve by 422bps to 19.1% over FY12-14E as a result of robust growth in the high-margin domestic formulations business and increased productivity through the recently added field-force (254 MRs in the high-margin chronic segment).

Bull case

- Revenues to grow by 23% y-o-y in FY14E, led by an improved market share of top brands, increased contributions from chronic therapy of 25% from 20% in FY14 to the domestic formulations business and greater revenues of 32% y-o-y in the export formulations business because of a deal inked with Watson and Aspen Pharma and increased revenue from the tender-related business in Europe.
- EBITDA margin to improve by 622bps to 21.1% over FY12-14E as a result of the high-margin chronic therapy and as per the management's guidance.

Bear case

- Revenues to grow by 19% in FY14E, led by muted growth in domestic (16% growth, y-o-y) and export formulations (26% growth, y-o-y). We assume intense price competition in the domestic market for Indoco's top brands.
- EBITDA margin to decline by 200bps to 17.1% over FY12-14E as result of lower contribution and subdued performance of the chronic segment (17% of domestic formulations).

SWOT Analysis

SWOT Analysis

Strengths

1) Strong manufacturing facilities (formulations - 5, API - 3), with approvals from USFDA, UKMHRA, Brazil, and MCC South Africa, which will help to leverage its sales in regulated export markets.

2) Widespread geographical reach in over 80 countries worldwide.

3) Less exposure to DPCO (10% of total revenue).

4) Market leader in the stomatological segment, with a market share of 95%.

Weaknesses

1) Dependence on C&F Agents to handle warehousing and back-office operations has led to inefficiencies in certain pockets.

2) Acute segment (considered a low margin segment) generates 90% of domestic formulations revenue.

3) Indoco's dependency on top-10 products. Currently, they contribute 60% of the domestic formulations business.

Opportunities

1) With India formulations expected to report a 15-16% growth over the next few years, Indoco will be one of the key beneficiaries, due its strong presence (63% of total revenues, field-force of 2200, and a presence in 18 therapeutic categories).

2) Indoco has a presence in as many as 80 countries through its own subsidiaries and distribution & marketing alliances. The company is a key beneficiary of the semi-regulated market.

3) A large number of pharmaceutical companies are losing their blockbuster drug patents, thereby increasing the scope for outsourcing to countries that offer a low-cost manufacturing base such as India.

4) CMO (contract manufacturing opportunities) with other large MNCs for patented drugs.

Threats

1) Regulatory issues, especially from the USFDA.

2) Rising competitive pressures in India from existing players, due to new product launches.

3) Delay in product approvals across geographies.

4) A new drug policy is being formulated by the government, with the objective of capping the prices of 348 drugs (60% of the domestic market). This will expose Indoco's many brands to the price capping threat.

Source: Violet Arch Research

Investment Arguments

Domestic formulations to maintain growth curve of 18.0% over FY12-14E

Indoco has a strong presence in domestic formulations market estimated at over 60% of its sales. It has been ranked 28th by CMARC in the Rx Ranking (June 2012). The Acute therapy represents the major portion (90% of sales, DPCO exposure - 10%) of its business, while Chronic contributes a mere 10% of domestic revenues.

Indoco has an extensive network of distributors, with a presence in 18 therapeutic segments comprising a huge basket of products (135) and a strong field-force (2,200). The company's eight marketing divisions cater to both acute and chronic therapies. Each division has its special filed-force, with a focused approach on doctor specialties through a particular product basket.

Indoco's 17 brands rank among the top-5 in their respective segments, while other big brands have garnered a sizeable market share in their respective segments. Last year, its domestic formulations business reported a 10% growth y-o-y, thanks to the restructuring undertaken in the distribution set-up. Going forward, the company will focus on high-margin and cash-flow sticky chronic therapies, besides increasing its contribution from 10% in FY12 to 15% and 20% in FY13E and FY14E, respectively. We estimate domestic revenues to grow at a CAGR of 18.0% over FY12-14E, driven largely by new product launches in newer and existing therapies (20-25 products annually), greater focus on tier-III and rural areas, and by increasing its pan-India coverage.

Performance of products showing positive trend in Q1FY13 (top-10 brands contribute 60% of domestic formulations revenues)

Brand Name (Rs mn)	Therapy	Q1FY12	Q1FY13	Growth
Cyclopam Tab	Gastro Intestinal	52	67	27.6%
Sensodent – K 100gms	Stomatologicals	40	52	30.9%
Cital Liquid - 100ml	Gynaec	28	37	31.6%
Febrex Plus Syrup	Respiratory	27	31	16.2%
Sensoform 100 Gms	Stomatologicals	23	29	24.9%
Cyclopam Suspension	Gastro Intestinal	25	28	11.4%
Febrex Plus Tab	Respiratory	22	26	16.2%
Cloben G - 15gms	Dermatology	23	26	11.7%
Sensodent KF 100gms	Stomatologicals	19	24	29.1%
Vepan -500 Tab	Anti Infectives	17	21	22.0%

Source: Company, Violet Arch Research

Performance of top therapies in Q1FY13

Therapy (Rs mn)	Q1FY12	Q1FY13	Growth
Stomatologicals	154	193	25.5%
Gastro intestinal	126	153	21.4%
Anti-infectives	122	134	10.1%
Respiratory	111	128	15.7%
Life style	105	112	7.0%

Source: Company, Violet Arch Research

Indoco's 17 brands rank among top-5 in respective segments

Brand Name	Therapy	Rank	Market share
Cyclopam	Antispasmodic	1	70%
Sensodent-K	Desensitizing Toothpaste	1	95%
Sensoform	Desensitizing Toothpaste	1	68%
Cital	Urinary Alkalizer	1	35%
Carmicide	Anti-Flatulant	1	76%
Homide	Ophthalmic	1	93%
Febrex Plus	Anti-Cold	2	24%
Sensodent-Kf	Desensitizing Toothpaste	2	25%
Scabex	Scabies Skin Cream	2	22%
Hemsyl	Gynaec	2	14%
Cloben G	Anti-Fungal Skin Cream	3	14%
Tuspel Px	Cough Syrup	3	12%
Vepan	Anti-Infective	3	16%
Cyclomeff	Antispasmodic/Analgesic	3	3%
Nosic	Anti-Emetic	4	6%
Triz	Anti-Allergic	4	6%
ATM	Anti-Infectives	5	5%

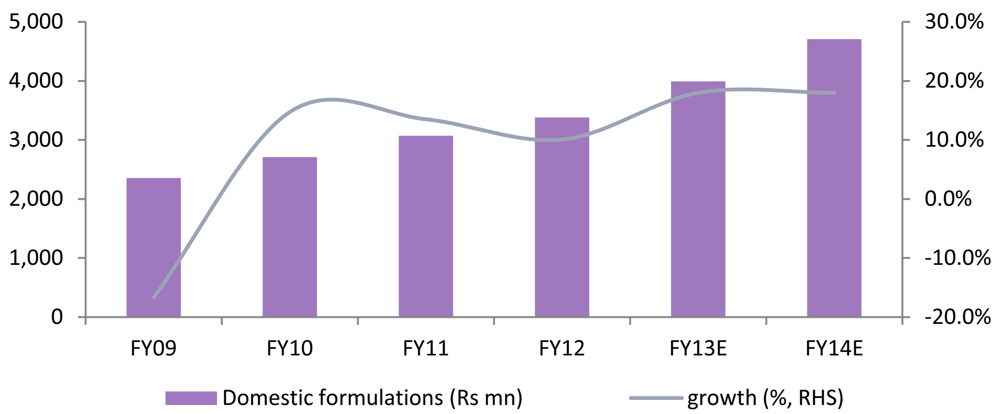
Source: Company, Violet Arch Research

Indoco has a presence in 18 therapeutic segments, with a huge basket of products, promoted by 8 marketing divisions

Division	Field force	% to domestic	Key brands	Key Therapies
Indoco	590	39%	Cyclopam, Cloben-G, Tuspel Plus, Hemsyl and Nosic	GI, Anti-infectives, Respiratory and Anti-diabetics
Spade	460	21%	Febrex Plus, ATM and Methycal	Anti-cold, Anti-Infectives, Vits, Haematinics, Calcium prep and Analgesics.
Warren	320	19%	Sensodent K, Sensoform and Senolin SF	Stomatologicals, Local Anaesthetics and Oral care
Spera	270	8%	Cital and Triz LM	Urinary Alkalizer, Anti allergic, Anti-flatulent and Scabicides
Excel	155	5%	Homide, Renolen, Macuchek, Irivisc, Mofloren, Alerchek, Irimist and AXL CV	Ophthalmics and Otological
Xtend	125	2%	VCef-O, Pepchek, Bactogard, Osteoflam, Tuspel, Dolochek and Proferrin	Anti-infectives, Analgesics, Cough preparations and Anti-Ulcerants (extra urban markets)
Eterna	150	1%	Osteochek, Lorchek and Atherochek	Orthopedics and GI
Indoco CND	190	2%	Amchek, Prichek, Telmichek, Cal-aid, G-Neuro and Febubest	CVS and Diabetic (super-specialty)

Source: Company, Violet Arch Research

Performance of domestic formulations



Source: Company, Violet Arch Research

Exports business continues on a high growth trajectory

Indoco's export business, both generic and branded formulations, generates 35% of its total sales. It has a large basket of products and a strong product pipeline. The company markets its products across the regulated market (80% of export sales) and the semi-regulated market (20% of export sales). Indoco has major tie-ups with generic companies for certain geographies and products. Until now, the company has filed 17 Abbreviated New Drug Applications (ANDAs) and 15 Drug Master Files (DMFs) in the US market.

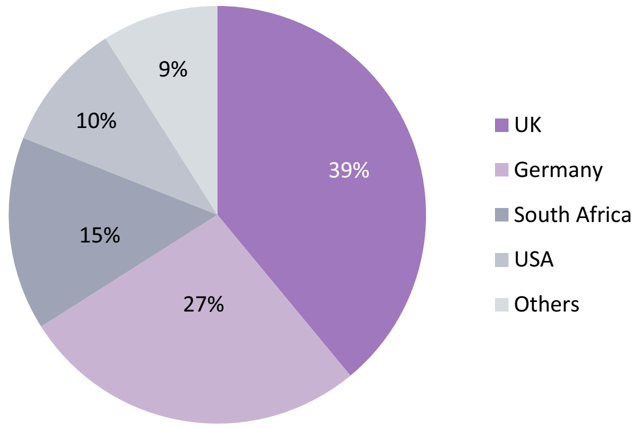
Indoco has forged a couple of deals with multi-national companies, which are expected to drive growth in the future. The deal with Watson is to develop and manufacture 19 ophthalmic products for marketing in the US. Indoco will also manufacture Active Pharmaceutical Ingredients (APIs) and develop formulations, while Watson files ANDAs in the USFDA. Till date, the company has filed 10 ANDAs and expects to file further two ANDAs in H2FY13E (FY14E - 4-5 ANDAs filings). We expect the Watson deal to accrue revenues of Rs 300-400mn.

Indoco has also signed a deal with Aspen for 12 ophthalmic products in Latin America and sub-Saharan African countries. While the company will manufacture APIs, the Aspen's role will confine to filing and marketing of products. In FY12, it contributed revenues of Rs 120mn. We estimate revenues of Rs 200-250mn and Rs 400mn in FY13E and FY14E, respectively, from the Aspen deal. The contract manufacturing deal, signed by the company with DSM, Austria, is for marketing its eight APIs across various geographies.

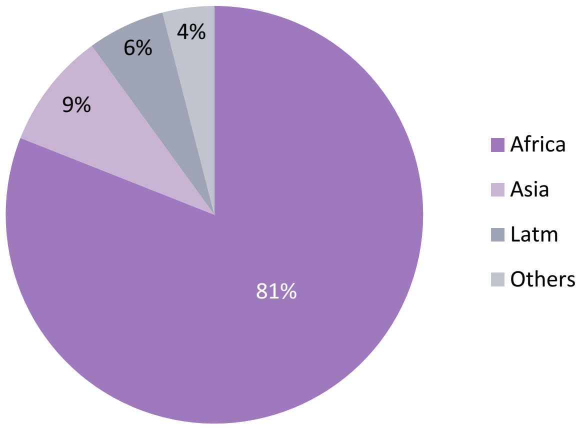
Indoco is in the process of developing some innovative New Drug Delivery Systems (NDDS), Para IV filings and 505(b) 2 applications. It is also engaged in the tender business in Germany and the UK (for the supply of Metformin), which will contribute around Rs 800mn over the next two years. We expect the company's overall exports business to grow at a CAGR of 25.8% during FY12-14E.

Revenue break-up (FY12)

Formulations – Regulated market (26% of total sales)

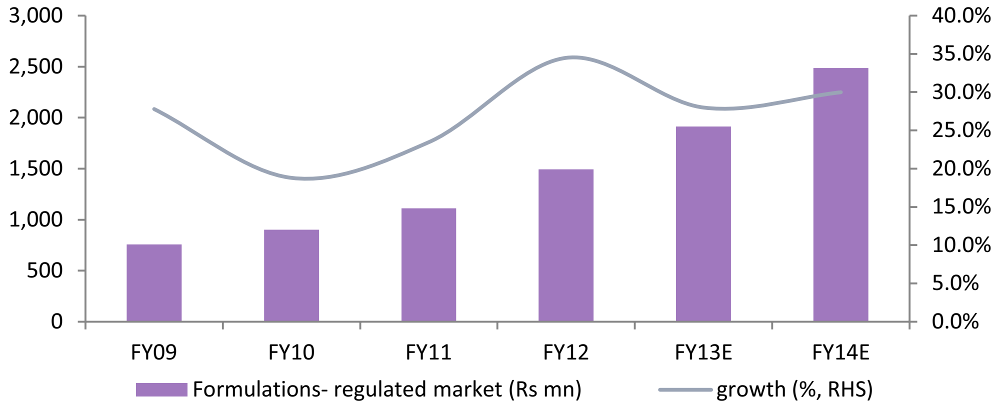


Formulations – Semi-regulated market (6% of total sales)



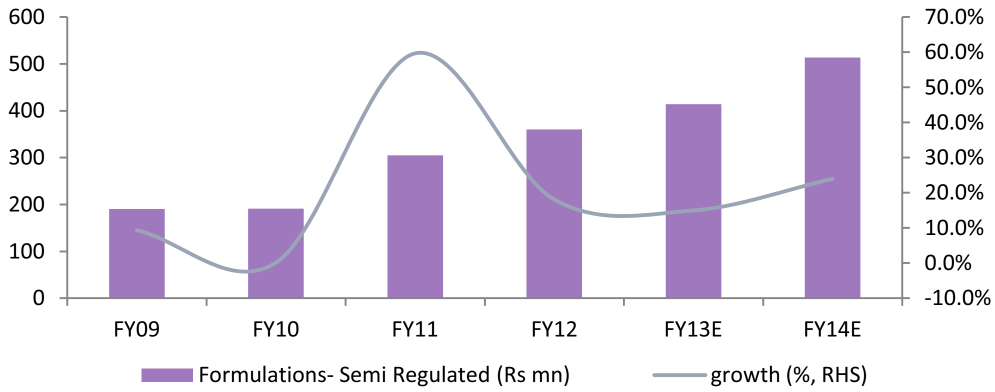
Source: Company, Violet Arch Research

Export formulation – Regulated market revenues performance



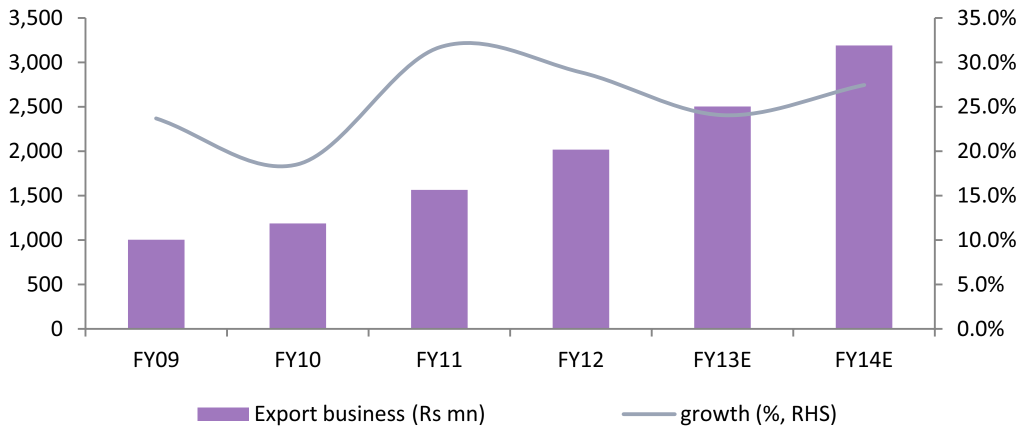
Source: Company, Violet Arch Research

Export formulations – Semi-regulated market (SRM) revenues performance



Source: Company, Violet Arch Research

Export business (formulations and APIs) revenues performance



Source: Company, Violet Arch Research

Key Risk and Concerns

Price control

Currently, 10% of Indoco's total revenue is under the Drug Price Control Order (DPCO), 1995 coverage. The DPCO regulates prices of drugs (currently 74 drugs, 20% of the domestic market). The order, *inter alia,* provides the list of price-controlled drugs, the procedures for fixing of prices of drugs, the method of implementation of prices fixed by the government and the penalties for contravention of provisions, among others. However, any further reduction in prices by the government may pose a potential risk of revenue loss and margin reduction. A new drug policy is being formulated by the government, with the objective of capping the prices of 348 drugs (60% of the domestic market).

Product lifecycle risks

Indoco secures 90% of its domestic revenues from acute therapy, which has a short product lifecycle because of the continuous innovations and NDDS (new drug delivery system). To counter the risks associated with the shortening of product lifecycles in some therapeutic segments, Indoco has embarked upon newer segments such as chronic and lifestyle (wherein patients are recommended medication for a prolonged period). In order to cater to product demands, it has set up a division called RADIUS.

Revenue dependency on top brands

Indoco's top-10 brands contribute 60% of its total domestic formulations revenue. Presumably, intense price competition in the market could pose a risk to top brands. To reduce dependency on its top brands, the company has already started focusing on other tier-II brands, besides launching brand extensions of top brands and engaging in aggressive marketing in the tier-III, IV cities.

Delay in approvals

Indoco's 35% of revenues accrue from exports. The company markets its products across regulated markets (80% of export sales) and semi-regulated markets (20% of export sales). Any undue delays in securing approval for its products in the exports market would have a negative impact on the company's sales growth.

Forex transactions

Indoco's exposure to forex has risen year-on-year and has kept pace with its growing global business. It plans to mitigate currency-associated risks through measures such as forward and derivative contracts.

Financial Outlook

Revenue to grow at a CAGR of 20.0% over FY12-14E

We expect Indoco's revenue to grow at a CAGR of 20.0% over FY12-14E, driven largely by strong growth in domestic and export formulations and on account of a deal inked with Watson and Aspen Pharma.

Indoco has been outperforming industry growth in the last two quarters, thanks to its strong growth in domestic formulations business. The company has a strong field-force of 2,200 and has a product basket of 135 across therapies. We expect domestic formulations to grow at a CAGR of 18.0% during FY12-14E.

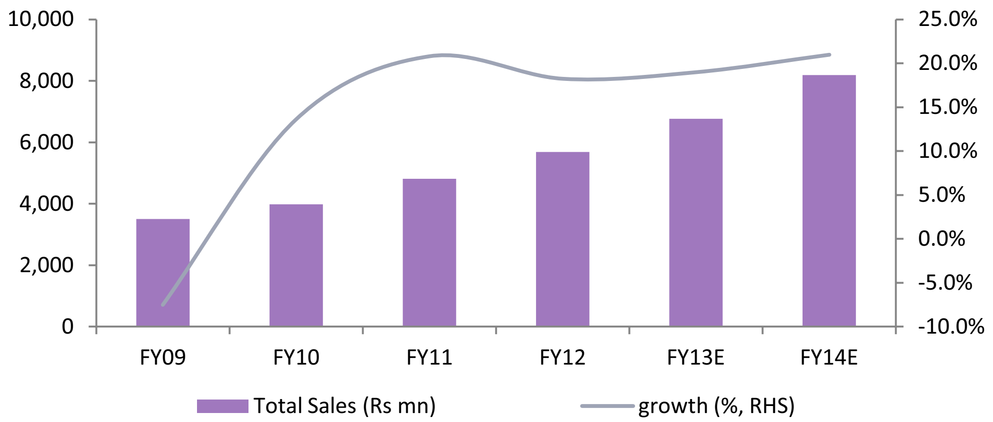
Indoco exports branded and generic formulations to regulated and emerging markets. The company has a large customer base of generic companies across geographies. Besides, it has recently signed three deals each with Watson, Aspen and DSM. We expect the deals and the presence across countries to provide the company the necessary boost to its exports business and help to achieve a CAGR of 25.8% over FY12-14E.

Revenue break-up – Segment-wise (Rs mn)

Particulars	FY09	FY10	FY11	FY12	FY13E	FY14E
Domestic	**2,468**	**2,795**	**3,220**	**3,575**	**4,213**	**4,953**
Formulation	2,359	2,707	3,073	3,382	3,991	4,710
API	109	88	147	193	222	244
Export	**1,003**	**1,188**	**1,565**	**2,017**	**2,503**	**3,190**
Formulation	**948**	**1,091**	**1,416**	**1,855**	**2,327**	**3,001**
Regulated	758	900	1,111	1,495	1,913	2,487
Semi-regulated	191	191	305	360	414	513
API	**54**	**98**	**149**	**163**	**176**	**190**
Total	**3,470**	**3,983**	**4,785**	**5,592**	**6,715**	**8,143**

Source: Company, Violet Arch Research

Sales performance

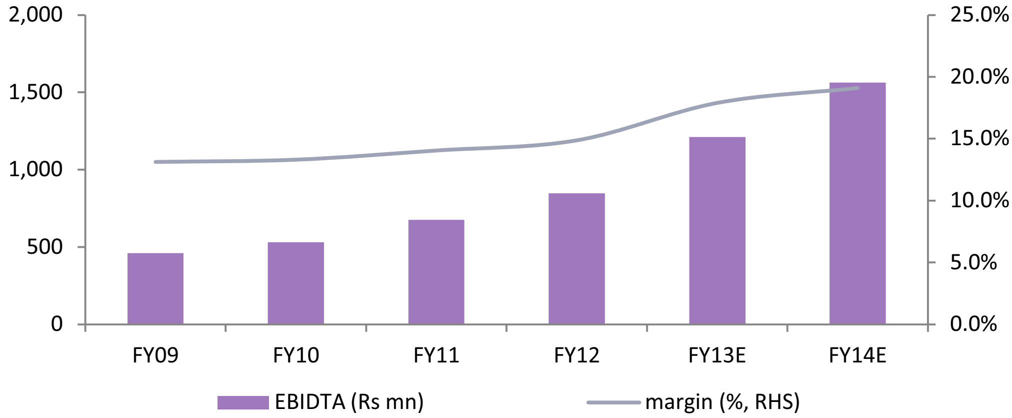


Source: Company, Violet Arch Research

EBITDA margin to improve by 422bps to 19.1% over FY12-14E

We expect Indoco's EBITDA margin to improve by 422bps to 19.1% over FY12-14E, led mostly by robust growth in the high-margin domestic formulations business and increased productivity through the recently added field-force (254 MRs in the high-margin chronic segment).

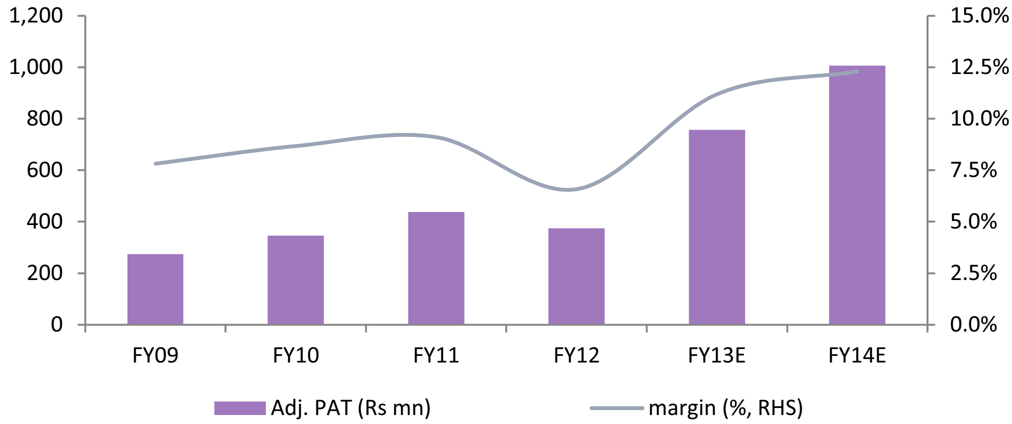
EBITDA margin to improve by 422bps over FY12-14E



Source: Company, Violet Arch Research

We expect the adj. PAT to clock a CAGR of 64.1% growth over FY12-14E on the back of higher operating margins and lower taxes. On the margins front, we expect 111bps expansion to 12.3% in FY14E from FY13E. The adj. EPS for FY12, FY13E and FY14E are estimated at Rs 6.1, Rs 8.2 and Rs 10.9, respectively.

Adj. PAT to grow at a CAGR of 64.1% over FY12-14E



Source: Company, Violet Arch Research

Valuation

We estimate revenues and earnings at a CAGR of 20.0% and 64.1%, respectively, over FY12-14E driven by strong growth in domestic formulations business. In the domestic market, Indoco enjoys a strong product portfolio, with a substantial field-force. Going forward, we will see increased focus on high-margin chronic therapy, where management plans to increase its contribution to 20% in FY14E from 10% in FY12. We expect robust growth in the export business on the back of supply deals with Watson, DSM and Aspen. We estimate revenues from the CRAMS business to be Rs 800mn in the next two years.

Going forward, EBITDA margins are slated to improve by 422bps to 19.1% on the back of robust growth in the high-margin domestic formulations business and increased productivity through the recently added field-force (254 MRs in the high-margin chronic segment).

The company is increasing its manufacturing capacities to cater to domestic formulations as well as its CRAMS business. Currently, Indoco has eight manufacturing facilities (formulations - 5, API - 3), which can cater to the large demand for low-cost generic drugs. The company also plans to scale up its exports business through increased focus on the regulated market such as the US and Europe.

At the CMP of Rs 71, the stock is trading at a PE of 8.6x and 6.5x earnings of Rs 8.2 and Rs 10.9 in FY13E and FY14E, respectively. We initiate coverage on Indoco Remedies with a strong Buy recommendation at target price of Rs 87 (8x of FY14E EPS of Rs 10.9) with a potential upside of 23%. It's pertinent to note that we have applied target PE multiple to adjusted earnings, considering the tax rate of 20% as against the company guidance of 10.0%.

Peer comparison

Company	CMP (Rs)	Market cap	EPS (Rs)		P/E (x)		ROE		ROCE		EV/EBITDA (x)		EV/Sales (x)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Unichem Labs	196	17,705	15.5	20.7	12.7	9.5	17.7%	21.1%	15.3%	18.4%	10.3	8.0	1.7	1.5
IPCA	427	53,866	30.2	33.8	14.1	12.6	23.3%	21.1%	23.0%	22.4%	9.8	8.5	2.1	1.9
Elder Pharma	305	6,264	48.4	62.6	6.3	4.9	12.5%	14.1%	11.8%	13.8%	3.7	3.2	0.6	0.5
Average					**11.0**	**9.0**	**17.8%**	**18.8%**	**16.7%**	**18.2%**	**7.9**	**6.6**	**1.5**	**1.3**
Indoco Remedies	**71**	**6,543**	**8.2**	**10.9**	**8.6**	**6.5**	**16.7%**	**18.6%**	**16.9%**	**19.4%**	**6.1**	**4.8**	**1.1**	**0.9**

Source: Company, Violet Arch Research

Company Background

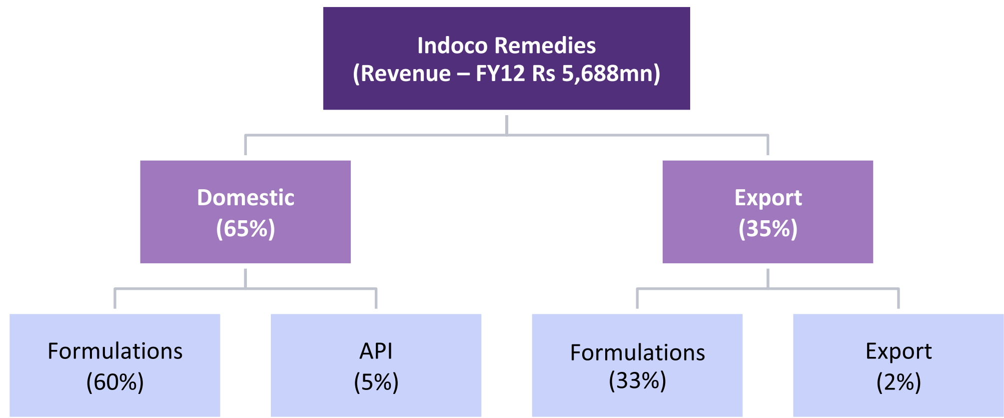
With a strong presence in formulations, Contract Research and Manufacturing Services (CRAMS), and APIs, Indoco Remedies (Indoco) operates in as many as 18 therapeutical segments, including anti-infective, anti-diabetic, cardiovascular (CVS), ophthalmic, dental care, pain management and respiratory areas. Indoco's working capital facilities are rated A1+, while its long-term borrowings A+ by ICRA. In the overall pharma industry, the company has been ranked 28th in terms of prescription generation (CMARC). Currently, it has eight manufacturing facilities: five formulations units and three API units. On the domestic business front, the company has a strong brand portfolio comprising 135 products, with a large base of 2,200 medical representatives. Indoco's 17 brands have ranked among top-5 in their respective segments. The prominent brands include Cyclopam, Sensodent-K, Cital, Febrex Plus, and Sensoform. The company's top-10 brands contribute more than half of its domestic sales.

Management profile

Ms. Aditi Kare Panandikar - Managing Director: A pharmacist by profession, she has a degree in Pharmaceutical Administration from Ohio State University, US. A third-generation entrepreneur, Ms. Panandikar joined the family business soon after returning to India in 1992.

Mr. Sundeep V. Bambolkar - Jt. Managing Director: He is a pharma professional, with over 25 years of experience in the industry and has worked in various capacities. A science graduate, with a Master's degree in Business Administration from Mumbai University, he has also undergone management training at the Indian School of Business, Hyderabad, and the Kellogg School of Business, US. Mr. Bambolkar has been associated with the group since 1982.

Business model



Source: Company, Violet Arch Research

Manufacturing facilities

	Location	Regulatory approvals
Formulations	Goa plant- I	UKMHRA, WHO, Canada, TGA, MCC
	Goa plant- II	USFDA, MCC, WHO-GMP, Canada
	Goa plant- III	TGA, Germany
	Baddi plant (Himachal Pradesh)	UKMHRA, Slovenia
	Waluj plant (Maharashtra)	Kenya, Yemen, Ukraine, Tanzania
API	Patalganga (Maharashtra)	USFDA, GMP and EDQM compliance
	Rabale (Maharashtra)	WHO-GMP
	Kilo lab (Maharashtra)	USFDA compliance

Source: Company, Violet Arch Research

Financial Summary- Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**4,811**	**5,688**	**6,767**	**8,186**
Growth (%)	*20.8%*	*18.2%*	*19.0%*	*21.0%*
Operating expenses	4,135	4,842	5,556	6,623
EBIDTA	**676**	**846**	**1,211**	**1,564**
EBITDA margin (%)	*14.1%*	*14.9%*	*17.9%*	*19.1%*
Depreciation	135	192	225	261
EBIT (core)	**542**	**654**	**987**	**1,303**
Other income	29	23	27	24
Interest	35	68	68	69
PBT	**535**	**609**	**946**	**1,258**
Tax	55	49	95	126
Tax rate (%)	*10.2%*	*8.1%*	*10.0%*	*10.0%*
Reported PAT	**511**	**464**	**851**	**1,133**
Forex (gain) / loss	(30)	96	-	-
Reported EPS (Rs)	5.5	5.0	9.2	12.3
Adjusted PAT	**438**	**374**	**757**	**1,007**
Adj. PAT margin (%)	*9.1%*	*6.6%*	*11.2%*	*12.3%*
Shares o/s (mn)	92	92	92	92
Adj. EPS (Rs)	4.8	4.1	8.2	10.9

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit	566	513	946	1,258
Depreciation	135	192	225	261
Tax paid	(118)	(100)	(95)	(126)
Chg in working capital	(180)	(100)	(180)	(361)
Other operating cash flow	(24)	85	192	24
Cash flow from operations (a)	**378**	**590**	**1,088**	**1,056**
(Inc.)/ Dec. in Fixed Assets	(807)	(660)	(800)	(800)
(Inc.)/ Dec. in Investments	-	(1)	-	-
Other investing cash flow	38	22	-	-
Cash flow from investing (b)	**(769)**	**(639)**	**(800)**	**(800)**
Equity raised	-	-	-	-
Inc./(Dec.) in loans	20	180	20	20
Dividend (incl. tax)	(100)	(114)	(215)	(215)
Chg in minorities	-	-	-	-
Other financing cash flow	324	(140)	(68)	(69)
Cash flow from financing (c)	**244**	**(73)**	**(263)**	**(264)**
Net chg in cash (a+b+c)	**(147)**	**(122)**	**24**	**(8)**
Opening Cash balances	**361**	**214**	**92**	**116**
Closing Cash balances	**214**	**92**	**116**	**108**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Shareholder's funds	**3,502**	**3,848**	**4,542**	**5,414**
Share capital	123	123	184	184
Reserves & Surplus	3,379	3,725	4,358	5,230
Total debt	**999**	**974**	**994**	**1,014**
Secured Loan	920	691	711	731
Unsecured Loan	80	283	283	283
Deferred tax liability	257	294	294	294
Total Liabilities	**4,759**	**5,116**	**5,830**	**6,722**
Net fixed asset	**2,948**	**3,342**	**3,917**	**4,457**
Investments	-	2	2	2
Net Current Assets	**1810**	**1771**	**1910**	**2263**
Current Assets	**2,684**	**3,220**	**3,697**	**4,439**
Inventories	804	1,019	1,212	1,466
Sundry Debtors	918	1,137	1,353	1,637
Cash And Bank Balances	271	105	116	108
Loans And Advances	692	959	1,015	1,228
Less: C L and Provisions	**874**	**1,449**	**1,787**	**2,177**
Current liabilities	710	1,260	1,446	1,724
Provisions	164	189	341	453
Total Assets	**4,759**	**5,116**	**5,830**	**6,722**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	4.8	4.1	8.2	10.9
Adj EPS growth (%)	26.8	(14.6)	102.4	33.0
EBITDA margin (%)	14.1	14.9	17.9	19.1
PBT margin (%)	11.1	10.7	14.0	15.4
PAT margin (%)	9.1	6.6	11.2	12.3
ROE (%)	12.5	9.7	16.7	18.6
ROCE (%)	10.2	11.7	15.2	17.4
Turnover ratios				
Asset turnover (x)	1.0	1.1	1.2	1.2
Net fixed asset turnover (x)	1.6	1.7	1.7	1.8
Net Debt/Equity (x)	0.3	0.3	0.2	0.2
Working Capital & Liquidity ratio				
Inventory days	61	65	65	65
Receivable days	70	73	73	73
Payable days	63	95	95	95
Valuations				
PE (x)	14.9	17.5	8.6	6.5
Price/Book value (x)	1.9	1.7	1.4	1.2
EV/EBITDA (x)	10.8	8.8	6.1	4.8
EV/Sales (x)	1.5	1.3	1.1	0.9

Jammu & Kashmir Bank

Growing Customer Focus

Absolute Rating	**BUY**
Target Price	**Rs 1,205**
Upside	**32%**

Jammu & Kashmir Bank (JKBK), the Kashmir-based state-owned bank, has a network of 603 branches. At the end of FY12, its business size was at Rs 864bn. The bank has a healthy CASA ratio, given the fact that around 82% of its branches are in Jammu & Kashmir alone, with the CASA ratio at 55% in the state. JKBK's margins have improved consistently on account of healthy growth in CASA and core income. We expect the same to continue. We initiate coverage on the stock with a Buy rating and at a target price of Rs 1,205, offering 32% upside from the CMP.

Liability franchise on the higher side

The virtual monopoly in Jammu & Kashmir has helped JKBK to enjoy a healthy CASA growth over the years, which has also aided the bank to sustain its cost of deposits on the lower side. JKBK's CASA share has improved from 37% in FY07 to 40.7% in FY12. We expect CASA to grow at a CAGR of around 17% between FY12 and FY14E, and the ratio to be sustained at around 39% till FY14E, due to branch expansion plans and government accounts.

Loan growth to be higher than industry

JKBK's business growth in FY12 was at 22%, led by a robust credit growth of 26.3% and a deposit growth of 19.4%, while the CD ratio improved to 62% in FY12 from 58.6% in FY11. We expect loan growth to be maintained at around 22% till FY14E on account of the improvement in the CD ratio and greater focus on SMEs, agricultural loans, short-term working capital loans and corporate loans outside Jammu & Kashmir.

J&K provides ample opportunity for healthy growth

Over the past few years, Jammu & Kashmir's GDP has been growing at an accelerated pace. It is poised for further growth in the future, with the government spending and private investment on the rise. The state's GDP growth has moved up from 4.6% in FY06 to 6.1% in FY12. While the state's fiscal deficit has declined from 6.7% in FY09 to 4.8% in FY12, it is estimated to come down to 3.4% by FY13E.

NIM improvement due to growth in CASA and CD ratios

With the healthy CASA growth, which has helped to maintain CoD, and considerable growth in advances, JKBK's NIM has improved from 3% in FY07 to 3.58% in FY12. We expect the loan book to grow at a CAGR of 22% between FY12 and FY14E. This, coupled with healthy growth in CASA and improvement in the CD ratio, will aid in NIM growth. We expect NIM to improve to 3.8% by FY14E.

Growth in return ratios to continue

JKBK's return ratios are on the healthier side vis-à-vis peers. Its RoA has improved from 1% in FY07 to 1.45% in FY12, and RoE has grown from 14.4% in FY07 to 21.2% in FY12. Going forward, we expect its profits to grow at a CAGR of 24% between FY12 and FY14E. Hence, we expect its return ratios to improve. Also, RoA and ROE are expected to increase to 1.54% and 22.7%, respectively, by FY14E.

Valuation

At the CMP of Rs 911, the stock is available at a price-to-adjusted book value (P/ABV) of 0.76x of FY14E. We value the bank's business at a P/ABV of 1x FY14E based on the historical average of 1x of JKBK on account of healthy growth in business, improvement in earnings, lower stressed assets and return ratios (i.e. RoE from 18% in FY10 to 23% in FY14E and RoA from 1.3% in FY10 to 1.5% in FY14E. We initiate coverage on the stock with Buy rating and at a target price of Rs 1,205, with an upside of around 32.4% from the CMP.

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Interest Income	15,437	18,384	22,798	28,298
Growth (%)	37.9	19.1	24.0	24.1
PPP*	11,495	13,703	17,069	21,239
Growth (%)	20.0	19.2	24.6	24.4
Profit After Tax	6,153	8,033	9,846	12,344
Growth (%)	20.1	30.6	22.6	25.4
NIM (%)	3.6	3.6	3.7	3.8
ROAA (%)	1.3	1.5	1.5	1.5
ROAE (%)	19.0	21.2	21.9	22.7
EPS (Rs)	105.7	126.9	165.7	203.1
ABV (Rs)	706.4	834.0	994.0	1205.4

*Source: Company, Violet Arch Research; *PPP – Pre-provisioning Profit*

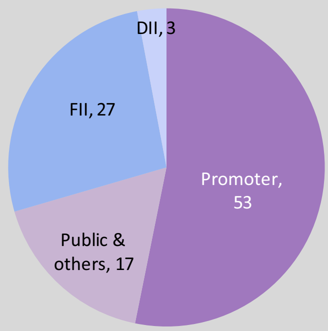
Stock data

CMP	**Rs 911**
Reuters Code	JKBK.BO
Bloomberg Code	JKBK IN
Equity Shares o/s (mn)	48
Market Cap (Rsmn)	44,169
Market Cap (USD mn)	829
3m Avg daily t/o(US$ mn)	0.9

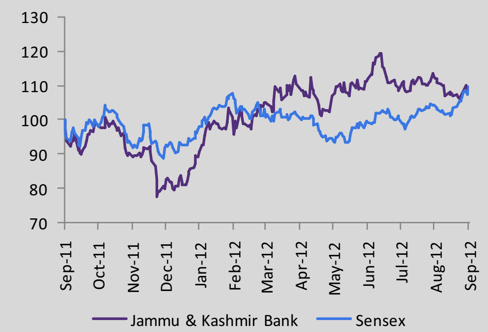
Stock performance (%)

52-week high / low			**Rs 1,033/645**
	1M	**3M**	**12M**
Absolute (%)	(2.5)	(1.1	12.5
Relative (%)	(6.7)	(11.2)	0.8

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

Particulars	FY14E		
	Bear	Base	Bull
Loan growth (%)	19.0	22.0	25.0
NIM (%)	3.3	3.8	4.0
Slippage ratio (%)	1.4	1.1	1.2
ABV (Rs.)	1,099	1,205	1,318
ROE (%)	16.0	22.7	24.6
P/ABV (x)	0.8	1.0	1.2
Target price (Rs)	873	1,205	1,531
CMP (Rs)	910.7	910.7	910.7
Upside / (Downside) (%)	(4.2)	32.4	68.1

Source: Company, Violet Arch Research

Key Assumptions

Particulars (%)	FY11	FY12	FY13E	FY14E
Deposit growth	20	19	20	20
Loan growth	14	26	22	22
CD ratio	59	62	63	64
NIM	3.6	3.6	3.6	3.7
RoA	1.3	1.5	1.5	1.5
RoE	19	21	22	23

Source: Company, Violet Arch Research

Base case

- We have factored in a 20% loan growth for FY14E. We have estimated deposit growth to be at 20%, thereby a credit-deposit ratio of 64.1% in FY14E as against 62% in FY12. The reason for our assumptions about business growth being slightly higher than the industry's is on account of the bank's expansion plans (which would lead to an improved CD ratio) and due to the monopoly the bank enjoys in Jammu & Kashmir (which would result in better CASA ratio).
- For FY14, we expect the bank's margins to improve on healthy credit growth as a result of its focus on SMEs and the agri-segment, healthy growth in the CASA ratio and improvement in the CD ratio. The bank's cost-to-income ratio has been one of the best among peers. We expect a further improvement in cost-efficiency on account of better income and control over costs. The bank has one of the best asset qualities in comparison to peers. We expect the same to be maintained. It has a healthy provision coverage ratio (PCR) of 91% (including the technical write-off).
- Given the improvement in NIM, better operating efficiency and lower credit cost, we expect profits of the bank to grow at a CAGR of 23.9% between FY12 and FY14E. This, in turn, would help the bank to improve its return ratios. Thus, we expect its RoA to improve to 1.5% by FY14E and RoE to increase to around 23% by FY14E.

Bear case

- We have factored in around 19% loan growth for FY14E. We expect slightly higher slippages at 1.4%. Hence, NIM is likely to decline to 3.3%, with a slight deterioration in CASA growth as against our base case assumption. The decline in business growth will take its toll on asset quality and NIMs. This would lead to lower income and higher provision, which would impact profit growth and thereby return ratios. Thus, we expect RoE to be at 16% in the bear case as against 22.7% in the base case in FY14E.

Bull case

- We have factored in around 25% loan growth for FY14E. We expect slightly lower slippages at 1%, but healthier recovery. Hence, NIM is likely to improve to 4%, with higher growth in CASA as against our base case assumption. The robust business growth and better margins, along with lower provisions, would help healthy profit growth. This, in turn, would improve return ratios. Thus, we expect RoE to be at 24.6% in the bull case as against 22.7% in the base case in FY14E.

SWOT Analysis

Strengths

1) Healthy CASA at ~41% has helped the bank in keeping its CoD on the lower side.

2) JKBK is the dominant player in Jammu & Kashmir.

3) CASA per branch is on the higher side in the industry at Rs.360 mn as against industry average of Rs.200-240mn due to a healthy customer base.

4) Being the only player in the state has helped the bank to gain market expertise and loyalty from customers.

5) No exposure to SEBs.

6) Stressed assets are on the lower side at 5.8% as against 10-12% in peers. The slippage ratio stood at 1.06% in FY12 as against 2.02% in FY09.

7) Consistent improvement in return ratios, RoA has improved from RoA from 1% in FY07 to 1.45% in FY12 and RoE improved from 14.4% in FY07 to 21.2% in FY12.

Threats

1) Further slowdown in the economy will affect business growth, and it may be lower than our estimates, thereby earnings of the bank.

2) Despite the bank being the predominant leader in the state, it has only 64% of its advances to the state. This has come down since the entry of new players in the region who have started capturing the market share in recent times. For this reason JKBK intends to strengthen its presence in the state.

SWOT Analysis

Weaknesses

1) The fee income of the bank has been on the lower side.

2) JKBK's provision on the slippages ratio has been declining over the last few years.

Opportunities

1) Adequate capital with the Tier-I ratio at 11.1% provides opportunity for the bank to grow its business.

2) Lower CD ratio at 62% provides ample room for the bank to grow its book at a healthy rate.

3) Entering new geographies like the western India where the bank lacks presence, will provide better opportunity to grow its book and decrease its dependency on a single state for growth.

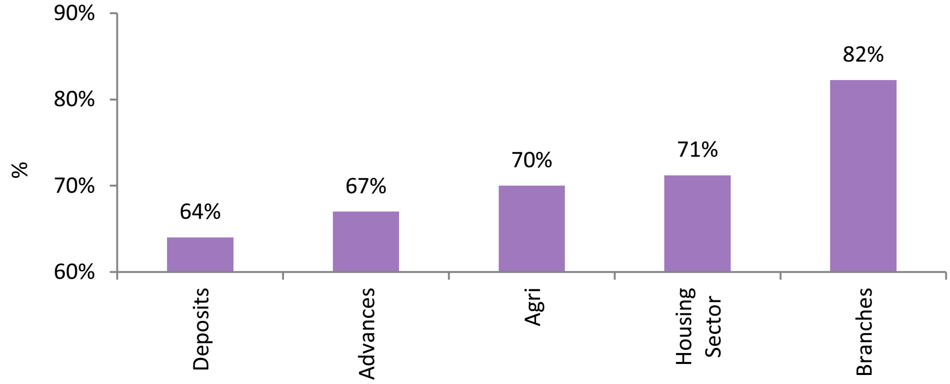
Source: Violet Arch Research

Investment Arguments

Predominantly focused in Jammu & Kashmir

JKBK is a predominant player in Jammu & Kashmir. As of March 2012, the bank had 64% of its deposits in Jammu & Kashmir, with the state forming 67% of the loan book. Around 82% of its branch network is spread across Jammu & Kashmir. The bank has 496 branches (out of 603 branches as on March 2012) located in Jammu & Kashmir alone. JKBK enjoys various other significant competitive advantages over other banks in the state, mainly due to its healthy branch network vis-a-vis peers, deep domain knowledge and legacy of banking relationships. Being an official banker to the Jammu & Kashmir government (promoters of the bank), JKBK collects tax and makes utility payments on behalf of the state government, which has helped the bank to maintain its CASA ratio at 56% in the state.

JKBK's exposure in Jammu & Kashmir (FY12, %)

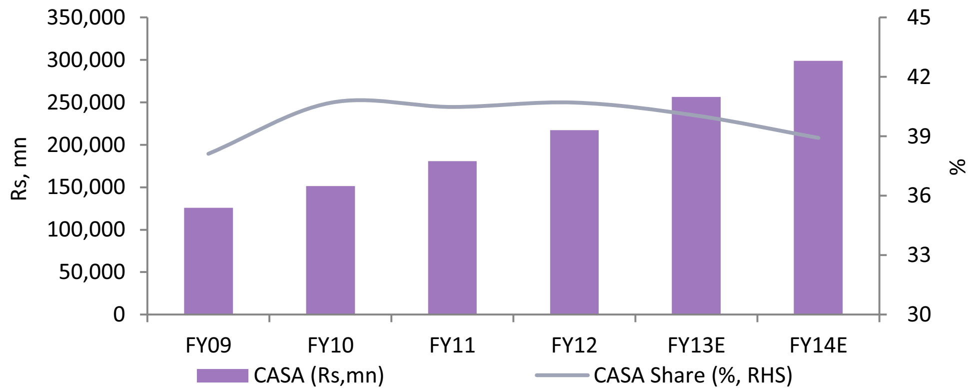


Source: Company, Violet Arch Research

Liability franchise on the higher side

The virtual monopoly in Jammu & Kashmir has helped JKBK to garner healthy CASA growth over the years, which has aided the bank to sustain its cost of deposits on the lower side. JKBK's CASA share has improved from 37% in FY07 to 40.7% in FY12. The share of savings deposits in total deposits has improved from 23% in FY07 to 30% in FY12, while that of current deposits has decreased from 13.8% in FY07 to 10.7% in FY12. While deposits of the bank have grown at a CAGR of 17.4% between FY07 and FY12, the CASA book has increased at a CAGR of around 20% between FY07 and FY12. We expect CASA to grow at a CAGR of about 17% between FY12 and FY14E, and the CASA ratio to be maintained at around 39% till FY14E, thanks to branch expansion plans and government accounts.

CASA details

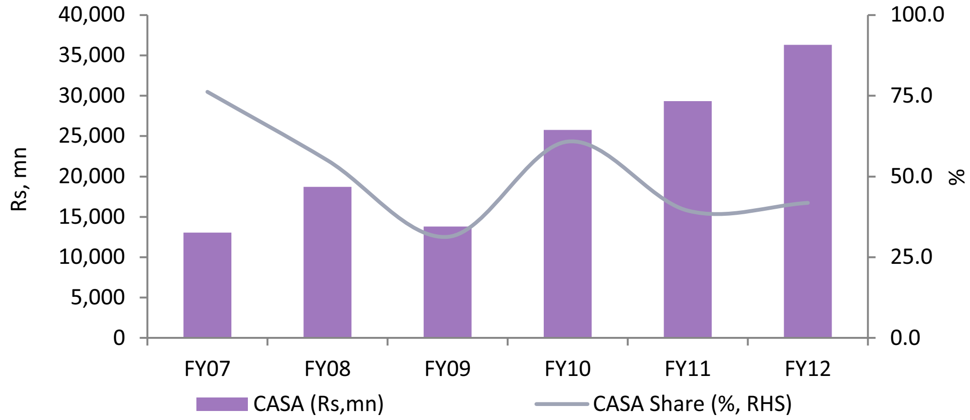


Source: Company, Violet Arch Research

Incremental CASA growth

JKBK intends to further strengthen its network in Jammu & Kashmir. It plans to implement three-fourth of its branch expansion plans in the state alone. Given the fact that branch expansion plans are mainly for Jammu & Kashmir, which is the stronghold of the bank, it is looking to strengthen its grip over productivity to maintain its hold over the state. The incremental CASA share has been at a healthy rate of 43.4% over the last four years.

Incremental CASA book and share

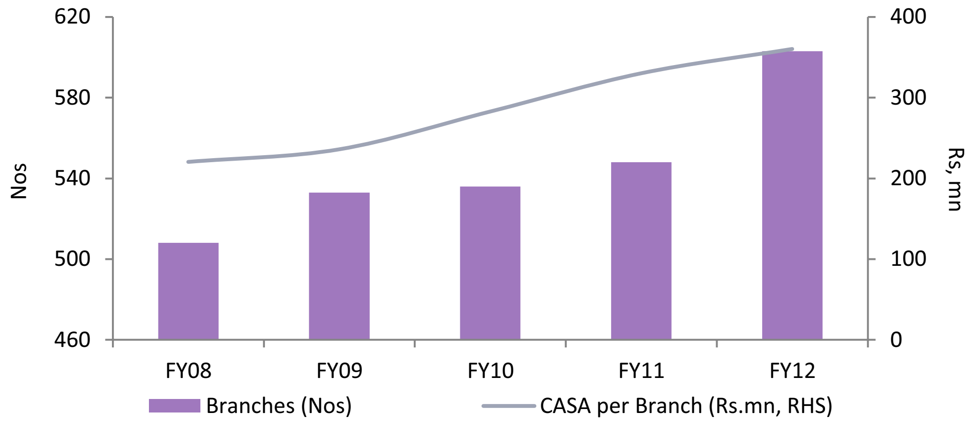


Source: Company, Violet Arch Research

Improvement in CASA per branch

JKBK has added 95 branches from FY08 to FY12, i.e., the bank's network has expanded from 508 branches in FY08 to 603 branches in FY12. The CASA per branch has increased from Rs 220mn in FY08 to Rs 360mn in FY12, which is on the higher side compared to the industry average of Rs 200mn to Rs 240mn.

Branches and CASA per branch

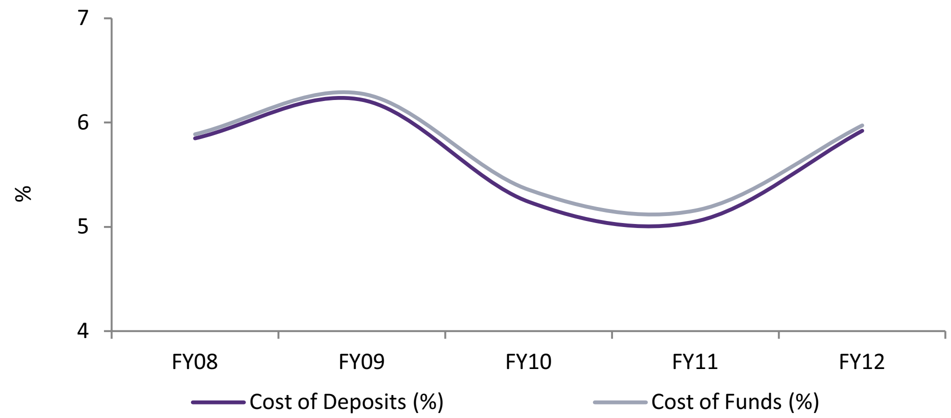


Source: Company, Violet Arch Research

Cost sustained due to healthy growth in low-cost deposits

Its healthy CASA growth has helped JKBK to maintain the cost of deposits on the lower side, which has improved from 5.8% in FY07 to 5.9% in FY12. Its cost of funds has grown from 5.9% in FY07 to 6% in FY12. This has enabled the bank to improve its NIM, which has also been aided by healthy loan growth and improvement in asset quality.

Costs (%)

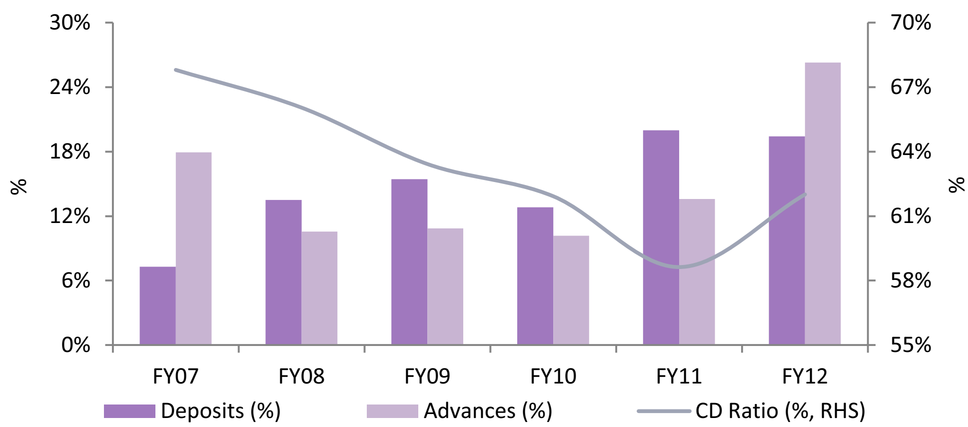


Source: Company, Violet Arch Research

Loan growth to be higher than industry average

JKBK's business growth clocked a CAGR of 17% between FY09 and FY12, while deposits grew at a CAGR of 17.4% during the same period. Its advances registered a CAGR of 16.5% during the period. However, business growth in FY12 has been at around 22%, led by a robust credit growth of 26.3% and a deposit growth of 19.4%, while the CD ratio improved to 62% in FY12 from 58.6% in FY11. In FY12, the loan book's robust growth was mainly led by a 75.6% loan growth in the corporate book, an agriculture portfolio growth of 14.8%, and a personal loan book growth of 1%. The SME loan book de-grew by 36.9%, while the trade book declined by 5.3%. However, we expect loan growth at around 22% till FY14E on account of the improvement in the CD ratio and greater focus on SME, agricultural loans, short-term working capital loans and corporate loans outside Jammu & Kashmir.

Business growth

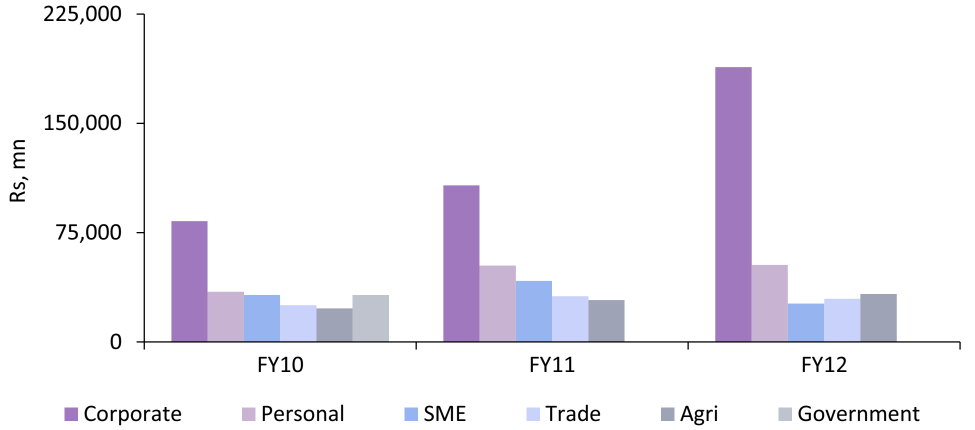


Source: Company, Violet Arch Research

Loan book fairly balanced

JKBK's loan book is fairly balanced, and the bank has been able to improve its corporate loan book share while reducing its personal loan portfolio, SME and trade book. In FY12, the bank's corporate loan portfolio formed around 57% of the loan book as against 41% in FY11 and 36% in FY10. The bank has reduced its share in the personal loan book from 20% in FY11 to 16% in FY12. The share of SME book came down from 16% in FY11 to 8% in FY12, while that of the trade book reduced from 12% in FY11 to 9% in FY12. The agriculture portfolio's share declined marginally from 11% in FY11 to 10% in FY12.

Advance break-up (Rs, mn)

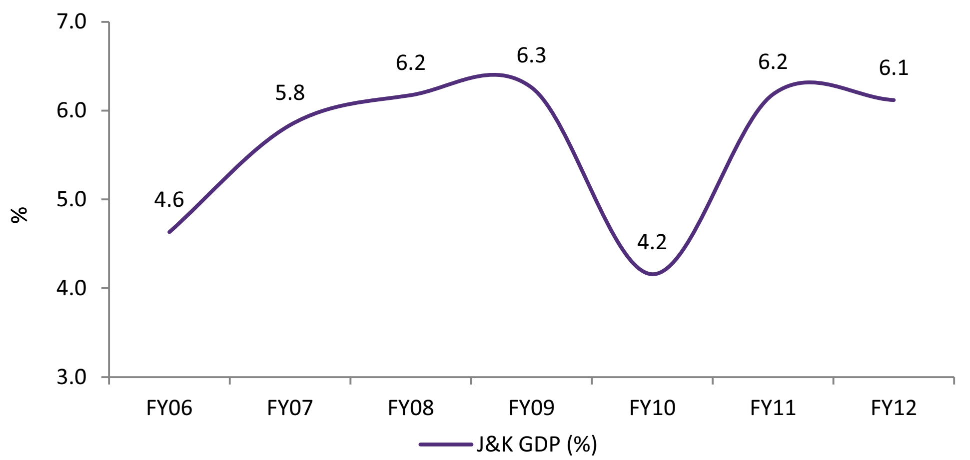


Source: Company, Violet Arch Research

J&K provides ample opportunity for healthy growth

Over the past few years, Jammu & Kashmir's GDP has been growing at an accelerated pace. It is poised for further growth in the future, with the government spending and private investment on the rise. The flourishing tourism industry is also pushing up credit demand from the state. Around 70% of the population is involved in agriculture and contributes to 23% of the state's GDP. Horticultural production, which involves around three million people, contributes about 45% to agricultural production. Around 80% of apple-growers avail of their financing from local moneylenders, which provides ample opportunity for JKBK to further capture the market. The state's GDP growth has moved up from 4.6% in FY06 to 6.1% in FY12.

Jammu & Kashmir's GDP growth rate (%)



Source: Company, Violet Arch Research

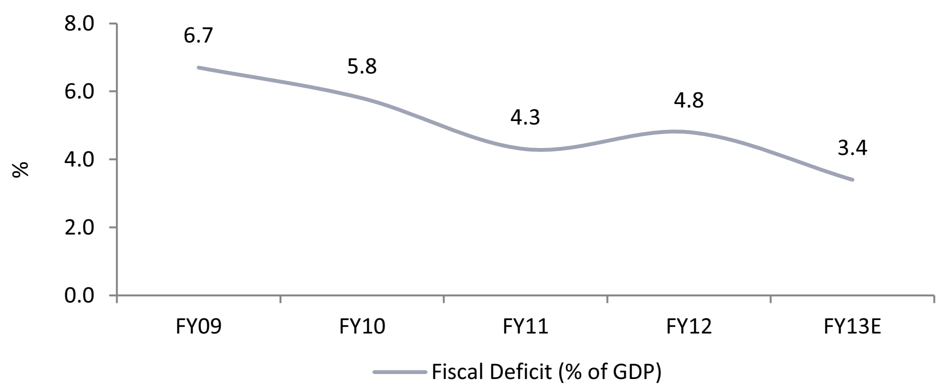
Improvement in fiscal deficit in the state

Jammu & Kashmir's fiscal deficit (as a percentage to GDP of the state) has improved over the years as a result of efforts being made in this direction. The average gross fiscal deficit from FY05 to FY08 has been at 6.4%, which increased to 6.7% in FY09. However, it has come down to 4.8% in FY12.

The state improved its fiscal position over the last five years. The fiscal deficit is estimated to fall from 4.8% in FY12 to 3.4% FY13E. This is led by 17% growth in revenue receipts, whereas expenditure is estimated to grow by only 9.1%.

For FY12, the state budgeted for a nil conventional deficit. Conventional deficit (an indicator for state budgets) represents the difference between aggregate disbursements and aggregate receipts. Aggregate receipts include: (i) revenue receipts; (ii) capital receipts, excluding Ways and Means Advances and Overdraft from the RBI, and (iii) net receipts under Public Account excluding withdrawals from Cash Balance Investment Account and deposit with the RBI. Aggregate disbursements include: (i) revenue expenditure and (ii) capital disbursements, excluding repayments of Ways and Means Advances and Overdraft from RBI.

Jammu & Kashmir's fiscal deficit (%)

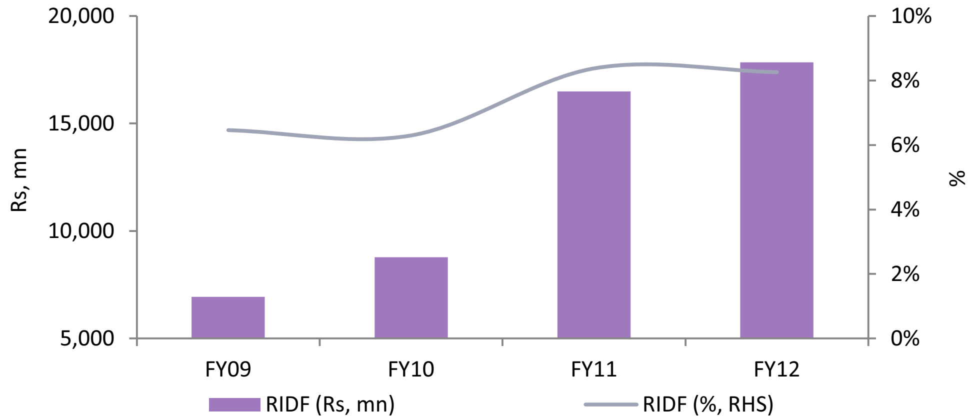


Source: Company, Violet Arch Research

While investment book remains healthy, RIDF portfolio a concern

The investment book of JKBK grew at a healthy CAGR of around 26.3% between FY09 and FY12. The investment-deposit ratio improved from 32.5% in FY09 to 40.5% in FY12. The G-sec-to-deposit ratio declined from 70.8% in FY09 to 53.4% in FY12. The Rural Infrastructure Development Fund (RIDF) portfolio is a cause for concern, since the bank has not been able to meet the PSL target. The RIDF-to-investment book ratio has increased from 6.5% in FY09 to 8.25% in FY12.

RIDF details

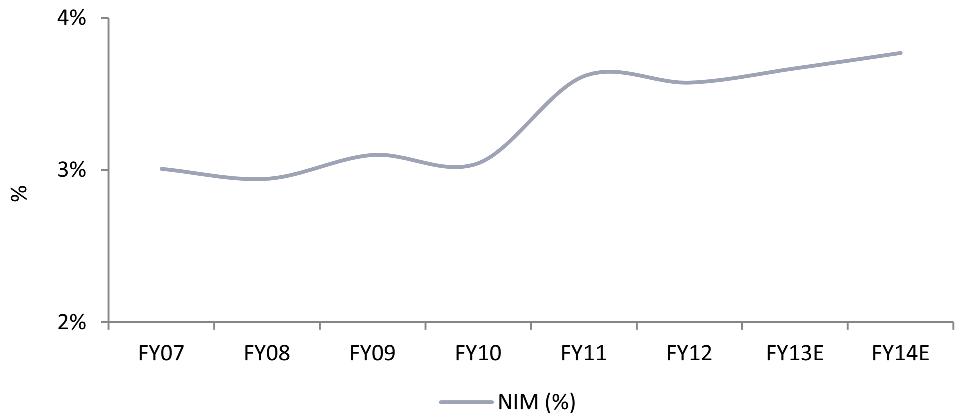


Source: Company, Violet Arch Research

Improvement in NIM to continue

Thanks to the healthy CASA growth (which has helped the bank to maintain CoD and healthy growth in advances), JKBK's NIM improved from 3% in FY07 to 3.58% in FY12. We expect the loan book to grow at a robust CAGR of 22% between FY12 and FY14E. This, along with healthy growth in CASA and improvement in the CD ratio, will aid in NIM growth. Thus, we expect NIM of the bank to be at 3.77% by FY14E.

Net interest margin (%)

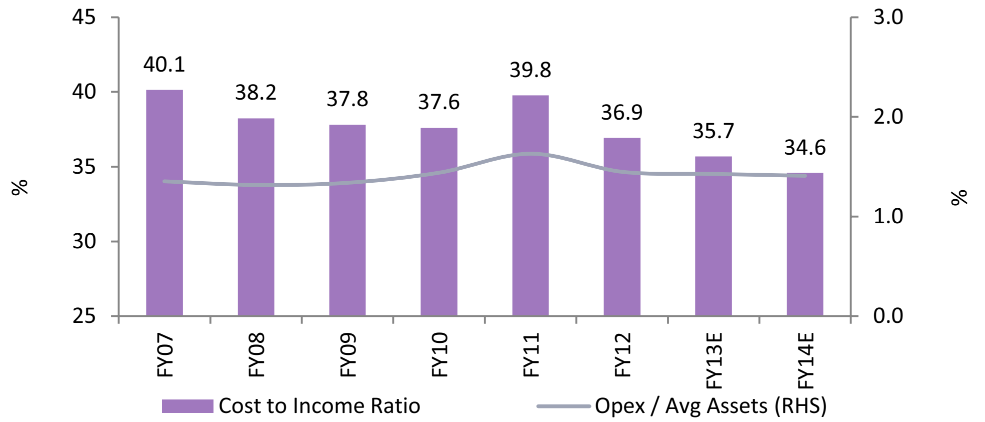


Source: Company, Violet Arch Research

Healthy improvement in cost-efficiency expected to continue

JKBK has been able to improve its operating efficiency by bringing down the cost-to-income ratio from 40.1% in FY07 to 36.9% in FY12. The operating-expenses-to-average-assets ratio has decreased from 1.6% in FY11 to 1.4% in FY12. The management has been highly cost-effective and has been able to grow the balance sheet with a low-cost model, despite increasing the network and strengthening the workforce. With the same expected to continue and on account of healthy growth in income and greater focus on productivity, we expect the cost-to-income ratio to decline to around 35% by FY14E.

Operating efficiency (%)



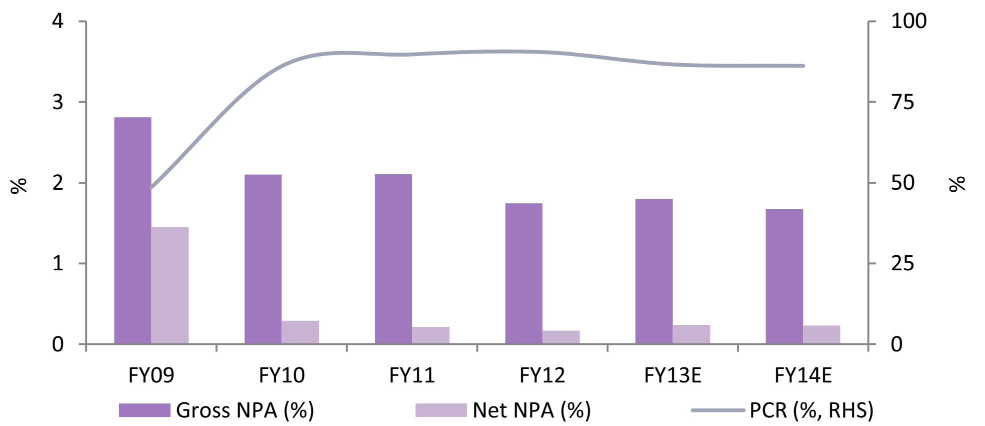
Source: Company, Violet Arch Research

Asset quality

JKBK's asset quality has improved over the last few years. While GNPAs declined from 2.8% in FY09 to 1.7% in FY12, NNPAs decreased from 1.5% in FY09 to 0.2% in FY12. During the same period, the slippage ratio reduced 2% in FY09 to 1.06% in FY12, while the provision on the slippages ratio declined from 79.5% in FY10 to 28.6% in FY12. But the provision coverage ratio (PCR), including the technical write-off, improved from 48.5% in FY09 to 90.4% in FY12. The PCR of the bank is on the higher side compared to the industry.

However, we have anticipated a slight deterioration in asset quality, given the lower GDP growth and stress seen in various sectors. Therefore, we have been conservative in our estimates on the bank's asset quality and expect the healthy PCR to continue.

Asset quality (%)



Source: Company, Violet Arch Research

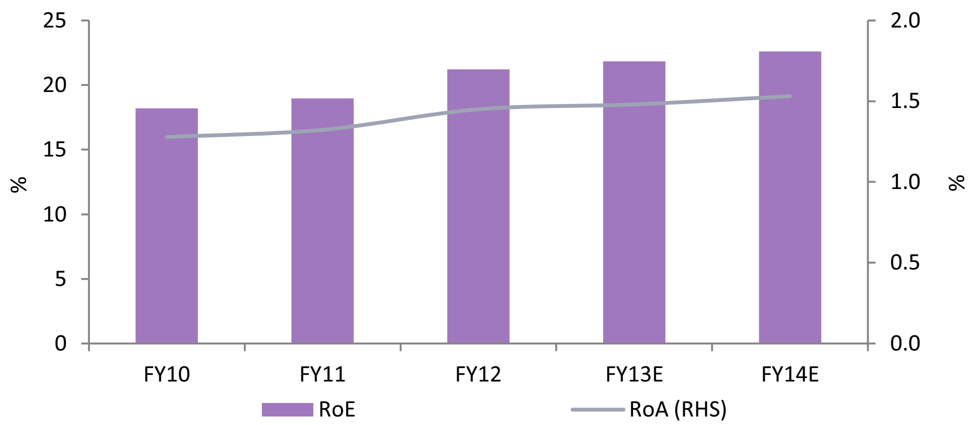
Restructured assets

JKBK's outstanding restructured book, which formed 4.1% of advances, stood at Rs 13.7bn at the end of Q1FY13. This is one of the lowest in the industry. The bank has no exposure to SEBs, which has helped it in sustaining the restructured account on the lower side. The NPAs from restructured accounts stood at 11.3% of the restructured book.

Return ratios to improve

JKBK has been very consistent in improving its return ratios over the last six years. The bank's profit has grown at a CAGR of 24% between FY07 to FY12, while its balance sheet has grown at a CAGR of 16%, which has led to an improvement in RoA from 1% in FY07 to 1.45% in FY12. The bank's RoE improved from 14.4% in FY07 to 21.2% in FY12. Going forward, we expect profits of the bank to grow at a CAGR of 24% between FY12 and FY14E. Hence, we expect return ratios to improve. Besides, we expect its RoA to improve to 1.54% by FY14E and its RoE to increase to 22.7% by FY14E.

Return ratios (%)

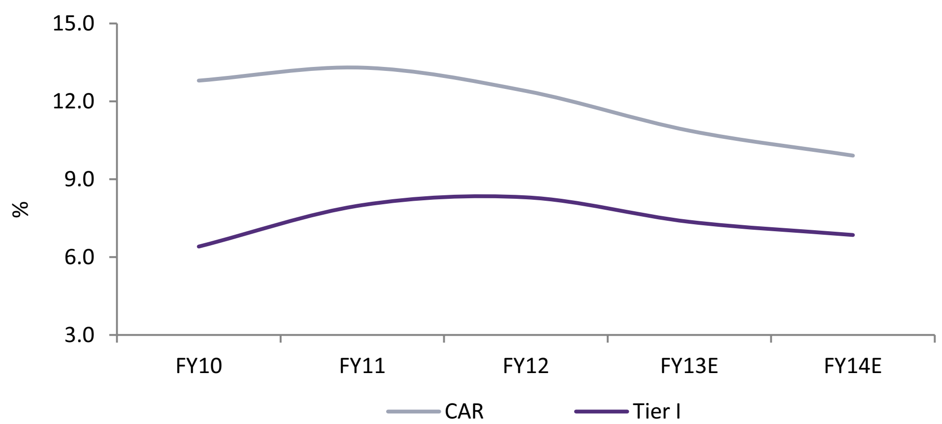


Source: Company, Violet Arch Research

Capital adequacy ratio

JKBK's capital adequacy ratio (CAR) stood at 12.4%, with tier-I at around 11.5% at the end of Q1FY13. Given the kind of growth that the bank envisages, we expect it to sustain the same at higher levels. The overall CAR stood at 13.75%, which leaves enough room in tier-II for the bank to raise capital when required.

Capital adequacy ratio (%)



Source: Company, Violet Arch Research

Key Risk and Concerns

Heavily concentrated in Jammu & Kashmir

JKBK is heavily concentrated in the region of Jammu & Kashmir alone. The state accounts for 82% of its branches and nearly two-third of its business, which make it vulnerable to the risk of regional concentration.

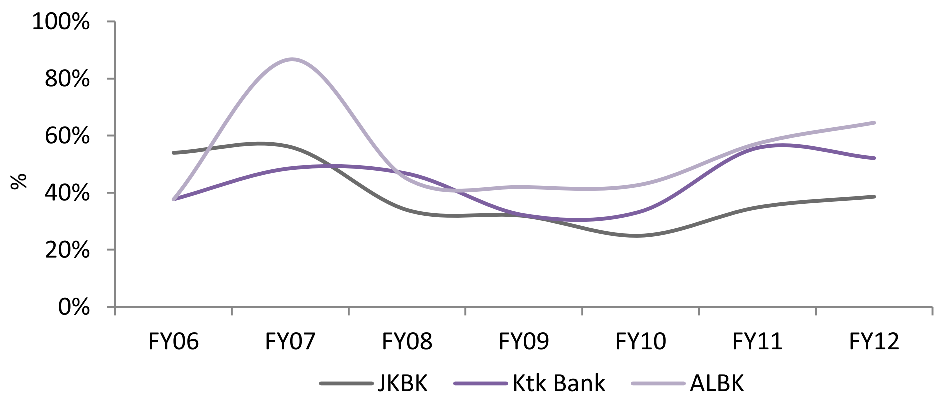
Further slowdown in economy may affect earnings

If the pace of economic growth decelerates even further, then it may have an adverse impact on the earnings of the bank on account of a decline in demand. It may also affect the payment schedule from its customers, leading to an increase in NPAs, thereby impacting our earnings estimates.

Fee income on the lower side

The bank's fee income has been on the lower side. This is a concern due to the fact that the corporate loan book has grown at a robust rate, but it has not translated into fee income. Also, the fact that the bank has a good customer base in the liability profile but it has not been able to generate fee income out of the customers by marketing third-party products such as insurance and credit cards, among others. We expect this to improve, as the bank has already begun to shift its focus towards bancassurance and various other third-party products, which are expected to contribute to growth. But the overall fee income growth would be lower than the balance sheet growth.

Fee income to other income share (%)



Source: Company, Violet Arch Research

Financial Outlook

JKBK had a healthy business growth of around 17% (CAGR) between FY09 and FY12. Advances of the bank grew by a healthy CAGR of 16.5% as against a deposit CAGR of 17.4% between FY09 and FY12. We expect the business of JKBK to grow at a CAGR of 20.8% till FY14E. The improvement in its CASA ratio over the last couple of years has contributed towards better margins as the cost of deposits has been on the lower side. The bank's investment book grew at a CAGR of 26.3% between FY09 and FY12.

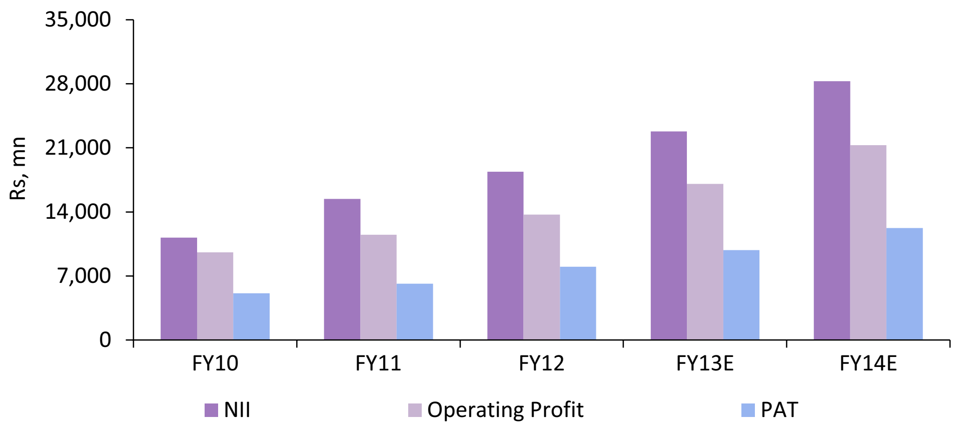
JKBK's interest income from advances grew at a CAGR of 13.9% from FY09 to FY12, while the interest income from investment grew at a CAGR of 29.5% during the same period. For the past three years, the management have shifted their focus on corporate loans. The share of the corporate loan book has increased from 36% in FY10 to 57% in FY12. The investment book has been driven by other investments, while G-sec book constituted 53.4% in FY12. The income from investments increased at a robust CAGR of around 20% between FY09 and FY12. Overall, the interest income grew at a healthy CAGR of around 17.6% between FY09 and FY12.

JKBK's net interest income (NII) grew at a healthy CAGR of 23.2% between FY09 and FY12. With sustainability of CASA at around 39%, we expect NII to register a CAGR of 24.1% from FY12 to FY14E. We expect NII to grow from Rs 18.4bn in FY12 to Rs 18.3bn in FY14E.

JKBK's operating efficiency being one of the best in the industry and among its peers, we expect it to sustain the same, despite the increase in the number of branches and employees, due to better healthy income. We expect the pre-provisioning profit (PPP) to grow at a CAGR of 24.5% between FY12 and FY14E. Moreover, we expect the cost-to-income ratio to come down from 37% in FY12 to around 35% in FY14E.

Going forward, we expect the credit cost to increase marginally from 0.3% in FY12 to 0.4% in FY14E. Despite the increase in the credit cost, on the back of healthy operating profit growth, we expect the bank's net profit to grow at a healthy CAGR of around 24% over FY12-14E, which will help in improving its return ratios.

Financial performance (Rs, mn)



Source: Company, Violet Arch Research

Valuation

Healthy CASA ratio to continue, leading to NIM improvement

Thanks to JKBK's virtual monopoly in Jammu & Kashmir and because of the government account that the bank has been entrusted with, we expect the bank's CASA ratio to continue to remain at healthy levels of around 39% till FY14E. The bank is planning to set up 100 more branches in FY13, of which 75 branches would be in opened in the state of Jammu & Kashmir alone, which would provide geographical strength. The sustainability of CASA at healthy levels should keep the cost of deposits in check. The improvement in the CD ratio, coupled with healthy CASA levels, should aid in growing the bank's margins.

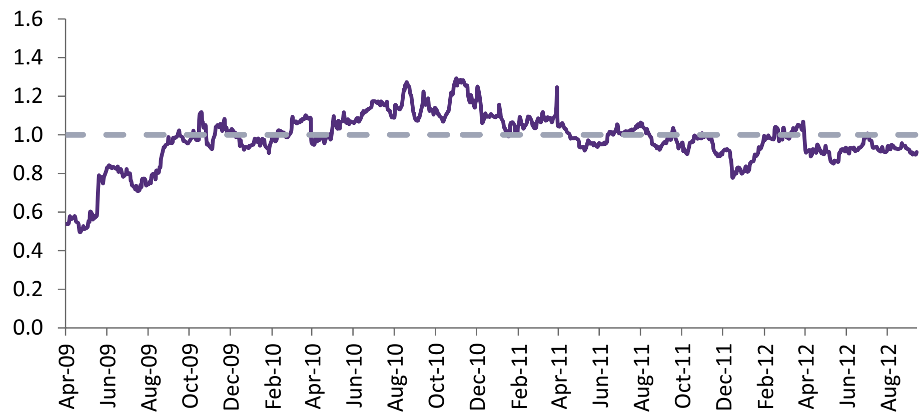
Improvement in NIM and operating efficiency to aid profit growth

We expect NII growth at a CAGR of 24.1%, leading to an improvement in NIM. We expect the cost-to-income ratio to come down, which should aid profit growth and improve return ratios. Despite a conservative stance on the asset quality of the bank, we still expect a CAGR of 24% between FY12 and FY14E profits.

Target price at 32% upside

At the CMP of Rs 911, the stock is available at a price-to-adjusted book value (P/ABV) of 0.76x of FY14E. We value the bank's business at a P/ABV of 1x FY14E based on the historical average of 1x of JKBK on account of healthy growth in business, improvement in earnings, lower stressed assets and return ratios (i.e., RoE from 18% in FY10 to 23% in FY14E and RoA from 1.3% in FY10 to 1.5% in FY14E). We initiate coverage on the stock with Buy rating and at a target price of Rs 1,205, with an upside of around 32% from the CMP.

Price to adj. book value (x)



Source: Company, Violet Arch Research

Company Background

Jammu & Kashmir Bank (JKBK) commenced operations in July 1939 in Kashmir (India). It was the first state-owned bank. It offers banking services under the three major divisions: support services, depository services, and third-party services.

JKBK acts as a corporate agent of MetLife India Insurance Company. It has entered into an alliance with Bajaj Allianz to distribute the latter's non-life products. Besides, it has entered into an arrangement with AMCs such as UTI, Kotak and Reliance Mutual Fund to distribute their current schemes and NFOs (new fund offers). It is the only bank in the private sector that has been designated an agent of the Reserve Bank of India for banking. At the end of FY12, the bank had 603 branches and a business size of Rs 864bn.

Key milestones

1939	**Commenced operations Kashmir**
1998	Introduced a new term-deposit scheme under the title of *Jana Priya Jamma Yojna*, which offers flexibility in the repayment schedule.
	Introduced housing loan and education loan schemes.
1999	Entered into agreement with American Express to launch a co-branded credit card.
2000	Diversified into non-life insurance and depository business, apart from life Insurance and asset management business.
2003	Launched Global Access Card (an international debit card) in association with Master Card International.
2004	Received the Asian Banking Award for its customer convenience programme.
	Agreement with ICICI Bank to share the ATM network.
	Signed an MoU with Bajaj Tempo.
2006	Set up branches in Chennai, Kanpur, Agra and Kolkata.
2007	Signed an MoU with TCS, signaling their intent to work together to create an IT blue-print for the bank.

Source: Company, Violet Arch Research

Financial Summary

Income Statement

Rs,mn	FY11	FY12	FY13E	FY14E
Interest Earned	37131	48356	58,376	70,400
Interest Expended	21695	29972.2	35,578	42,102
Net Interest Income	15,437	18,384	22,798	28,298
Other Income	3647.6	3341.2	3,742	4,303
Net Income	19,084	21,725	26,540	32,601
Operating Expenses	7,589	8,022	9,471	11,362
Operating Profit	11,495	13,703	17,069	21,239
Provisions	2,151	1,692	2,373	2,816
Profit Before Tax	9,344	12,011	14,696	18,423
Tax	3,191	3,978	4,850	6,080
Profit After Tax	6,153	8,033	9,846	12,344

Balance Sheet

Rs,mn	FY11	FY12	FY13E	FY14E
Equity Share Capital	485	485	485	485
Reserves & Surplus	34,302	40,447	48,596	59,000
Net Worth	34,787	40,932	49,081	59,485
Deposits	446,759	533,469	640,163	768,195
Borrowings	11,047	12,410	16,004	23,046
Other Liabilities	12,489	15,882	19,455	24,319
Total Liabilities	505,082	602,692	724,703	875,045
Investments	196,958	216,243	259,492	311,390
Advances	261,936	330,774	403,545	492,324
Other Assets	46,188	55,675	61,667	71,331
Total Assets	505,082	602,692	724,703	875,045

Key Ratios

Particulars (%)	FY11	FY12	FY13E	FY14E
Growth Matrix				
Deposits	20.0	19.4	20.0	20.0
Advances	13.6	26.3	22.0	22.0
Total Business	17.5	21.9	20.8	20.8
NII	37.9	19.1	24.0	24.1
Operating Expenses	31.4	5.7	18.1	20.0
Operating Profit	20.0	19.2	24.6	24.4
Provisions	29.1	(21.3)	40.2	18.7
Profit After Tax	20.1	30.6	22.6	25.4
Ratios (%)				
NIM	3.6%	3.6%	3.7%	3.8%
Cost to Income	39.8%	36.9%	35.7%	34.9%
ROAA	1.3%	1.5%	1.5%	1.5%
ROAE	19.0%	21.2%	21.9%	22.7%
Pre-Prov ROAA	2.5%	2.5%	2.6%	2.7%
Pre-Prov ROAE	35.4%	36.2%	37.9%	39.1%
Gross NPA (%)	2.1%	1.7%	1.8%	1.7%
Net NPA (%)	0.2%	0.2%	0.2%	0.2%
CAR (%)	13.7	13.4	12.6	12.3
Tier I (%)	11.3	11.1	10.6	10.5
BV (Rs.)	717	844	1,012	1,227
Adj BV (Rs.)	706	834	994	1,205
P/ABV (x)	1.3	1.1	0.9	0.8

COMPANY REPORT

Equity Research | Infrastructure

21 September, 2012

Arshiya International Ltd.

Unlocking Benefits

Absolute Rating	BUY
Target Price	Rs 179
Upside	32%

Arshiya International Ltd. (AIL) is the first Indian entity to successfully implement and operate an FTWZ (Free Trade & Warehousing Zone, which is governed by the SEZ Act, 2005), which provides integrated warehousing facilities. Further, AIL also provides logistics support to its clients complementing its warehousing business. With eight warehouses in the Panvel FTWZ and 7 warehouses set to be operational in Khurja by end-FY13, we expect a substantial jump (from 16.0% in FY12 to 37.6% in FY14E) in the company's revenues from this high-margin segment (around 53.9%). Therefore, we believe, AIL is set to continue on its growth path and post a revenue CAGR of 30.2% over FY12-14E. With an increase in share of revenues from the high-margin warehousing segment, we expect AIL to post a 764bps expansion in EBITDA margins over the same period, resulting in a 44.1% CAGR jump in profitability. We initiate coverage on the AIL stock with a Buy recommendation at a target price of Rs 179 (upside of 32%), largely on account of its increasing operational assets and growing business opportunities.

Growing Indian logistics business

Over the last decade, the Indian logistics sector has been growing at a robust pace of 8-10% annually. Several factors have favourably contributed to this growth, including: 1) the consistent rise in India's GDP, leading to growth across major consumer industries, 2) various government initiatives undertaken to boost the economy, and 3) the emergence of organized retail, etc. With large corporates keen to make India their distribution hub, thanks to the cost advantage over its Asian peers such as Singapore and Hong Kong, among others, we believe that the Indian logistics business will gather further growth momentum, creating opportunities for various market participants. The Government of India's plans to phase out CST and introduce GST could lead to consolidation in warehousing facilities for domestic companies.

AIL one-stop shop

To bridge the gap in services required by corporates and services provided by the traditional CBWs, the Government of India introduced the concept of FTWZ under the SEZ Act 2005. AIL is first company to successfully build and operate an FTWZ in the country, making it an end-to-end integrated logistics solutions provider.

Valuation

AIL currently trades at an EV/EBIDTA of 7.3x and 4.5x FY13E and FY14E basis, respectively. To capture the high financial leverage of the company, we have valued AIL on an EV/EBIDTA basis. Historically, the stock has traded between 4x-8x EV/EBIDTA on a one-year forward basis, in line with global/domestic peers, depending upon the stage of the economic cycle. Given the current slowdown and uncertainty, we believe that the stock would trade at the lower-end of the band, and hence we assign 5x one-year forward EV/EBIDTA to arrive at a target price of Rs 179.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	8,218	10,573	14,217	17,923
Growth (%)	56.3	28.7	34.5	26.1
EBITDA (%)	19.1	25.7	29.4	33.3
Adj. Net Profit	826	1,208	1,586	2,507
Adj. EPS (Rs)	14	21	27	43
EPS growth (%)	(16.7)	47.3	31.3	58.0
PER (x)	9.8	6.6	5.0	3.2
Price/Book value (x)	1.1	0.9	0.8	0.6
AROE (%)	11.0	13.9	15.7	20.0
AROCE (%)	6.6	7.9	9.9	12.6
EV/Net sales (x)	2.4	2.7	2.1	1.5
EV/EBITDA (x)	13.2	11.1	7.3	4.5

Source: Company, Violet Arch Research

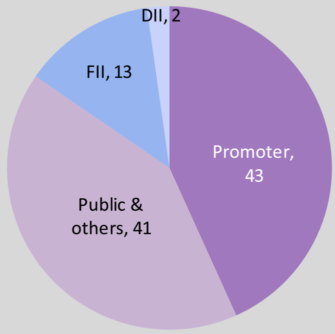
Stock data

CMP	**Rs 136**
Reuters Code	ARTC.BO
Bloomberg Code	ARST IN
Equity Shares o/s (mn)	59
Market Cap (Rs mn)	8,004
Market Cap (USD mn)	150
3m Avg daily t/o(US$ mn)	0.3

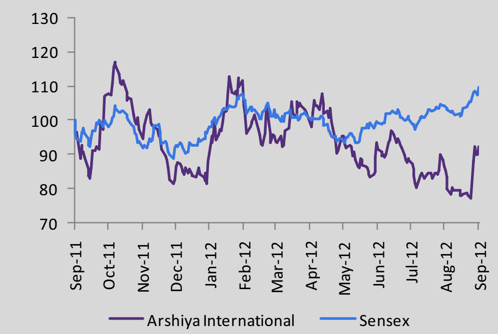
Stock performance (%)

52-week high / low			**Rs 179/111**
	1M	**3M**	**12M**
Absolute	17.1	32.8	33.8
Relative	3.4	15.6	15.6

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull Case	Base Case	Bear Case
Revenue from FTWZ/Distripark	6,990	6,749	6,602
Growth from FY13E (%)	80	74	70
EBIDTA Margin (%)	60	54	50
EBIDTA	4,194	3,637	3,301
Revenue from Railway freight	5,250	5,040	4,830
Growth from FY13E (%)	25	20	15
EBIDTA Margin (%)	26	22	18
EBIDTA	1,365	1,109	869
Revenue from Logistics	6257	6134	6011
EBIDTA Margin (%)	22	20	18
EBIDTA	1,376	1,227	1,082
TOTAL EBIDTA	6,935	5,972	5,252
Multiple (x)	6	5	4
EV	38,145	29,861	23,110
Net Debt	19,040	19,308	19,316
Market Capital	19,105	10,553	3,794
Price per share	325	179	64
CMP	**136**	**136**	**136**
Upside/(Downside)%	**139**	**32**	**(53)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY11	FY12	FY13E	FY14E
Number of warehouses by year end	3	5	15	29
Average number of palettes in each warehouse	13,000	13,000	13,000	13,000
Rentals per palette for general storage	1,000	1,000	1,000	1,000
Rentals per palette for VAS	800	800	800	800
Number of temperature controlled rooms	36	60	180	360
Number of container yards	1	1	2	2
Number of open yards	1	1	3	3
Number of railway rakes by year end	20	20	30	30

Source: Company, Violet Arch Research

Base case

- With gradual capacity expansion in FY13-14E, we have assumed that the share of contribution from the high-margin warehouse segment would increase from the current 16% to 38%, with new warehouses being added every quarter.
- We have assumed a total of 29 operational warehouses by the end of FY14E, with an average utilization rate of 70%. We have assumed a lower average utilization rate considering a gradual increase in warehouse occupancy. Rental revenues per VAS and general clients to be Rs 800 and Rs 1,000, respectively.
- With the increase in warehouses and VAS services, we have arrived at a blended EBIDTA margin of 54%.
- In the rail freight segment, we have assumed an addition of 10 rakes in FY14E, with *the* average revenue of Rs 42mn per rake *per* quarter and EBIDTA margins of 22%.

Bull case

- We have assumed a total of 30 operational warehouses by the end of FY14E with better execution by AIL.
- We have considered a higher utilization rate of 80% on the back of growth in the economy, leading to a higher movement of goods.
- With a better mix of VAS and general storage rentals, we expect a blended EBIDTA margin of 60% in FY14E.
- In the rail freight segment, we have considered an addition of 10 rakes in FY14E with EBIDTA margins of 26%.

Bear case

- We have assumed a delay in the upcoming operational warehouses, with 27 warehouses becoming operational by FY14E.
- We assume a lower utilization rate of 65%, due to operational delays and economic slowdown, leading to lower occupancy.
- With lower occupancy and higher fixed costs, we assume a blended EBIDTA margin of 50% for the warehousing segment.
- In the rail freight segment, we have considered an addition of 10 rakes in FY14E with EBIDTA margins of 18%.

SWOT Analysis

SWOT Analysis

Strengths

1) AIL is accredited with India' first FTWZ and has the first-mover advantage.

2) Integrated business model of AIL provides end-to-end solutions.

3) With only 5 active licensed players, AIL faces minimal competition in the rail frieght segment

Weaknesses

1) Asset-heavy nature of busines model has resulted in high debt levels (FY12 D/E increased to ratio 2.6x from 1.7x in FY11), making it susceptible to interest rate fluctuations.

2) Subdued return ratios of 11%, given the company is into invesment phase.

Threats

1) Low entry barriers in the sector.

2) Delay in government policy (GST) or retraction of tax sops in SEZs can hamper AIL business.

3) Prolonged sluggishness in the economy can hamper containerization and exim trade.

Opportunities

1) China, an emerging economic power, has clocked a robust CAGR of 19.6% in GDP over 2002-11, with its exim trade registering a healthy CAGR of 21.7% during the period. With India poised for GDP growth of 7% in the coming years, we expect a similar trend in exim trade.

2) India's current warehouse capacity stands at 108.75mmt, and as per the Planning Commission, it is expected to post a CAGR of 8.0% over next five years, driven largely by increasing exim trade.

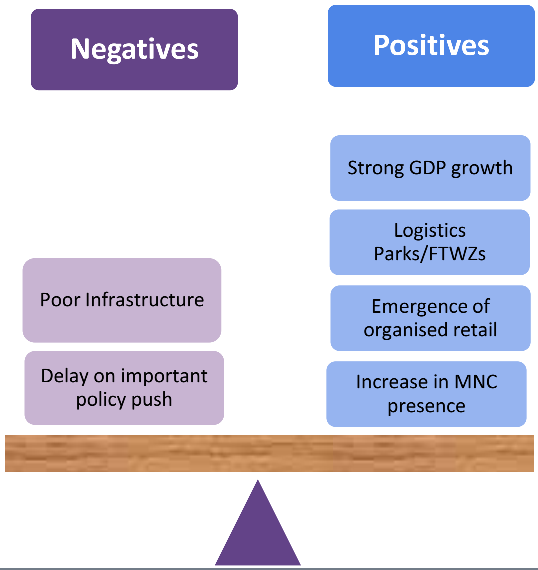
Source: Violet Arch Research

Investment Arguments

Growing Indian logistics business

Over the last decade, the Indian logistics sector has been growing at a robust pace of 8-10% annually. Several factors have favourably contributed to this growth, including: 1) the consistent rise in India's GDP, leading to growth across major consumer industries such as automobile, pharmaceutical, and fast-moving consumer goods (FMCG), 2) various government initiatives undertaken to boost the economy, and 3) the emergence of organized retail, etc. Notwithstanding this, the Indian logistics industry accounts for a mere 2% ($100bn) of the $5000-billion global logistics industry, restrained mainly by poor infrastructure and delays in required regulatory impetus, among others.

Advantage, Logistics Sector



Source: Company, Violet Arch Research

Indian FTWZs are better positioned over its global counterparts, namely, Singapore and Hong Kong, due to cost arbitrage opportunities, which lead to savings of 15-30% for companies using these services for Asia-Pacific. We believe, this would help promote the Indian logistics business and lead to a further growth momentum for the industry players (read AIL).

The growing presence of MNCs and greater exim trade in India call for efficient logistics and favourable government laws. However, the government-operated CBWs have been found inadequate to provide requisite services, which resulted in a loss of business for Indian ports.

To correct the anomaly, the concept of FTWZ was introduced, taking a cue from its success in boosting exim trade in international ports such as Singapore and Dubai, which would be operated by private companies, bringing in their expertise and tapping into their potential.

Therefore, an FTWZ is a much more comprehensive in terms of service offering compared to traditional CBWs. FTWZs provide value-added services (VAS) such as packaging, labeling, high-end inventory and distribution management. This customization of warehouses and VAS has proved to be critical in the overall scheme of things.

Rollout of GST – Medium-term catalyst

Currently, companies have set up small warehouses and distribution centres in every state to save on CST (central sales tax). Due to varying state level taxes applicable over central taxes, a manufacturer ends up getting taxed twice for the same set of goods. Thus, planning for distribution of goods are more driven by better tax structures, rather than better operational efficiencies. This has restricted companies from developing new-age modern warehouses with packaging and delivery systems. With the Government of India proposing to phase out CST and replace it with GST by the end of FY13, we expect companies to consolidate their warehousing facilities to save on costs by either realigning their smaller warehouses in the same region or outsourcing the logistics services. This, in turn, would provide business opportunities for large warehouse developers, which provide integrated services (read AIL).

AIL one-stop shop – Differentiating factor

Envisaging opportunities in the Indian logistics business, AIL has transformed itself from an asset-light logistics service provider to an asset-heavy model for providing integrated supply chain solutions and capture the upcoming opportunities. This transformation has led to AIL's emergence as one of the few companies to provide integrated end-to-end solutions in the logistics space (shown in the table below).

AIL presence across key verticals

	Transportation services			Warehouse facility		Other related services	
	Rail rakes	Road	Ship	Domestic	FTWZ	Software	Consultancy
All Cargo	×	✓	✓	✓	×	✓	✓
DHL	×	✓	✓	✓	✓	✓	✓
Northeastern Cargo	✓	✓	✓	✓	×	✓	✓
Arshiya	✓	✓	✓	✓	✓	✓	✓

Source: Company, Violet Arch Research

This quality stands out in AIL in comparison to its peers, besides giving the company a clear advantage in attracting clients. A few examples of preference for AIL over others by global clients are Cisco Systems, World Kitchen and Sandvik, who moved their distribution centres to India to support the Asia Pacific region.

Upcoming properties/rail rakes: Future growth drivers

In pursuit of growth in the logistics business, AIL has invested in warehousing facilities of Panvel and Khurja. We believe that the company is poised to reap benefits from its past investments, as the number of operational warehouses is set to increase from the current five to fifteen in the next few quarters.

Panvel facility

AIL initiated a 165-acre FTWZ, with a capacity for accommodating 18 warehouses at Panvel, providing integrated services. Its proximity and connectivity to JNPT (India's busiest and the largest port) is an added attraction to this facility. Currently, AIL has five operational warehouses, with three facilities being set up, which will take the number of facilities to eight by end-FY13.

Khurja facility

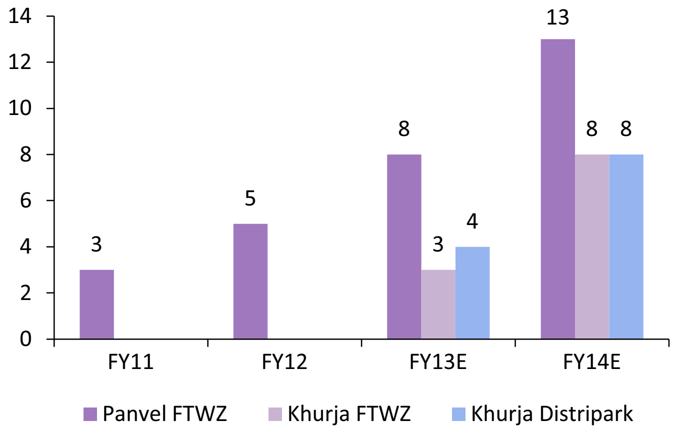
Recently, AIL initiated an FTWZ in Khurja, and three warehouses are expected to be operational by end-FY13. The company has also developed a 130-acre Distripark for domestic warehousing purposes. Further, this facility has the advantage of railway connectivity, and AIL has its own terminal. This provides the company benefits for the following reasons: a) railways are a cheaper and faster mode of transportation compared to roads, leading to cost-savings, and b) complements the warehousing and railway rake business.

Features across facilities of AIL – Capacity and connectivity

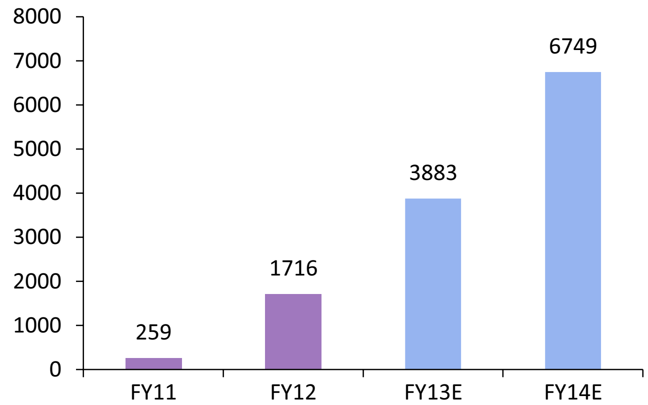
Particulars	Panvel FTWZ	Khurja FTWZ	Khurja Distripark
Area (acres)	165	135	130
Capacity (warehouses)	18	15	15
Operational warehouses	5	3	3
Cargo yard	Yes	Yes	Yes
Container yard	Yes	Yes	Yes
Railway network	No	Yes	Yes
Port	Yes	No	No

Source: Company, Violet Arch Research

Number of warehouses



Revenue from warehouses (Rs mn)



Source: Company, Violet Arch Research

Future upcoming facility – Long-term catalyst

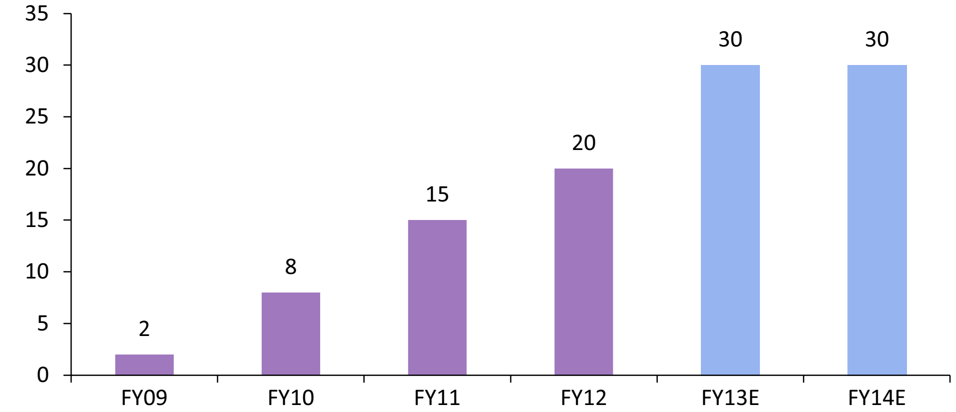
AIL plans to expand its presence across all regions in India by developing five similar FTWZs and Distriparks each in Central, East and South India, and connect the same with rail transportation logistics. The company has already received approval to develop its Nagpur FTWZ in Butibori village, spread across over 108 acres.

Increase in number of rail rakes to further enhances its offering

Currently, AIL owns and operates 20 rakes in the domestic segment, which have resulted in some capital allocation. However, though the business complements its core business, the returns generated has been low. Therefore, AIL has changed its business model on the rail rake business and has begun to enter into long-term leasing with US-based GATX Corp. It plans to lease 10 rakes from Q3FY13 onwards. In line with the expansion of their FTWZ/Distripark business, AIL developed a railway terminal at Khurja that complements its freight business by way of consolidating multiple commodities in a single route, increasing efficiency of the business. The railway freight segment is expected to witness further growth as and when AIL commences operations in its planned FTWZs and Distriparks across India and connects them with its rail transportation.

AIL's core business includes 3PL and 4PL services for logistics. The company undertook its first upward integration of its logistics services business in 2008 by entering the rail transportation business. Container Corporation of India's (Concor) monopoly in the space ended when the Government of India allowed private players into the arena by issuing licenses. AIL Rail Infrastructure Services has been operational since February 2009. Of the 15 private licensees, only five players are currently active, with AIL being the largest of them. Unlike its counterparts, AIL has always focused on the domestic segment, with virtually no presence in the export-import (exim) front.

Operational rakes FY14E



Source: Company, Violet Arch Research

Key Risks and Concerns

Change in government policies

The major risk to the business model of AIL is the change in government policies. In the past, we have witnessed changes in government policies, i.e., a change in haulage charges and a reduction in tax SOPs for SEZs, which have been detrimental to the industry. Any changes such as the imposition of more taxes on SEZs could be disadvantageous to AIL's business.

Increase in competition

With increase in exim trade in India, we have noted a growing number of companies applying for FTWZ permits. Chiplun Infrastructure is developing a 100-acre FTWZ, near Mumbai, to capture business opportunities arising from JNPT, which has been touted as India's busiest port. Due to the high sensitivity of rentals and utilization rates of warehouses, the only way AIL could retain the business is by competing with better and more efficient VAS.

Prolonged slowdown in economy

With the current slowdown in economy, exim trade has witnessed a lull. In case the slowdown is prolonged, the company could witness subdued cash-flows, which, in turn, could hamper AIL's capex plans and debt repayments.

Awareness in the industry

Although FTWZ has been in existence for a long time across the globe, it is comparatively a new concept in India. Even today CBWs enjoy greater popularity within the business community. Evidently, FTWZs may take some time to gain popularity in the country. A prolonged delay in gaining popularity could hamper revenue accretions and hence may result in a cash crunch for AIL.

Forex exposure

AIL's billing in the FTWZ business is in US dollars, which currently contributes 22.5% of the total revenue. With upcoming FTWZ warehouses in Panvel and Khurja, contributions from the FTWZ segment is expected to increase to 29.1% by FY14E, which increases its exposure to exchange rate movements. To hedge this stream of revenues and get benefits of lower costs of foreign capital, AIL has raised Rs 1,000mn, and plans to further increase its exposure to foreign capital.

High leverage

AIL's balance sheet is highly leveraged with a D/E ratio 2.6x, with a very small portion of debt in foreign currency. Any delay in operations or revenues could result in the company facing financial stress in operations, which could hamper the performance of the stock.

Financial Outlook

Revenues: Significant uptick in the warehousing segment

AIL revenues witnessed a significant jump of 28.7% in FY12 on account of: a) higher revenue growth coming in from the FTWZ/Distripark segment, led by an increase in operational warehouses, and b) higher revenues from the railway freight business.

With the addition of 16 warehouses in Khurja (8 in FTWZ and 8 in Distripark) and additional 8 warehouses in Panvel (taking the total warehouse count to 29 in FY14E), we expect revenues from warehousing and VAS services to increase substantially in FY13E and FY14E by 126% and 70%, respectively. We have considered lower utilization of 10% in the initial three months of operations and thereafter to grow gradually to 80%.

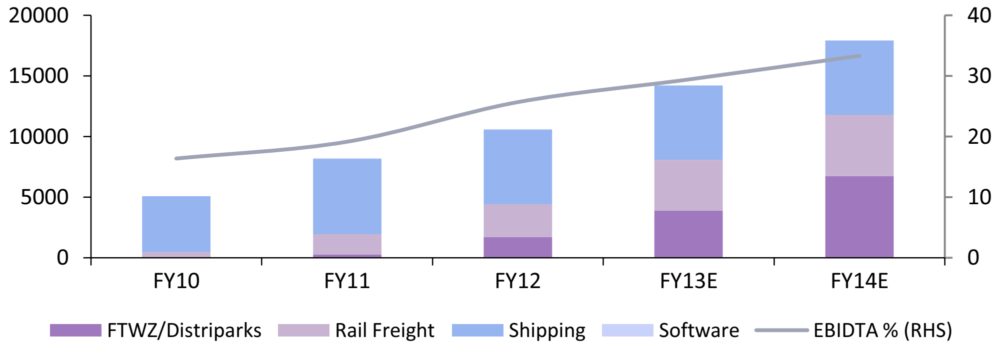
On the rail freight segment, we have assumed average revenues of Rs 168mn per rake, taking into consideration previous performance and management guidelines. With 10 additional rakes getting added to the current fleet of 20, we expect revenues from rail freight to increase by 54.5% and 20% in FY13E and FY14E, respectively.

Operating performance and return ratios to enhance with change in business mix

Growth of EBITDA margins in FY12 (up 650bps) was primarily due to incremental revenues, accruing largely from the high-margin FTWZ and Distripark segment. We expect contributions from this segment to increase from 22.5% in FY12 to 38% in FY14E, leading to an overall margins expansion by 764bps from FY12 levels.

Although overall margins in VAS services are lower than those in warehousing services, the management is working towards enhancing their VAS portfolio to ensure the retention of clientele in the price-based competition environment, and maintain a balance between VAS and rentals.

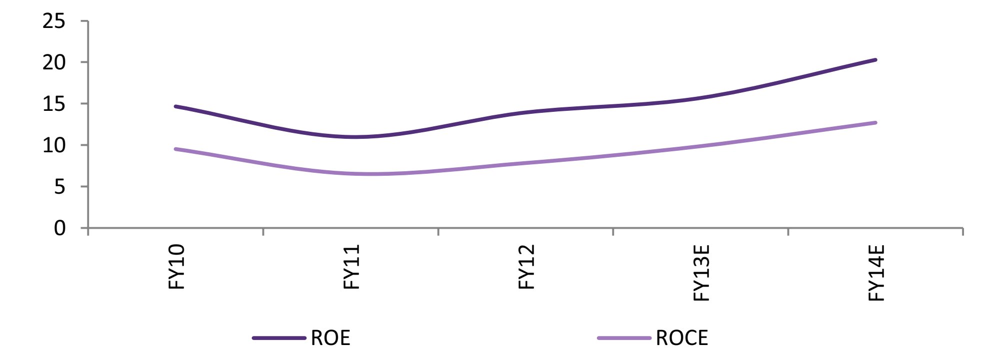
Revenue break-up and margins (Rs mn)



Source: Company, Violet Arch Research

Since the major part of growth during FY12-14E is coming in from the capital-intensive warehousing business, we expect ROE and ROCE to witness an uptick from FY13 onwards.

ROE and ROCE

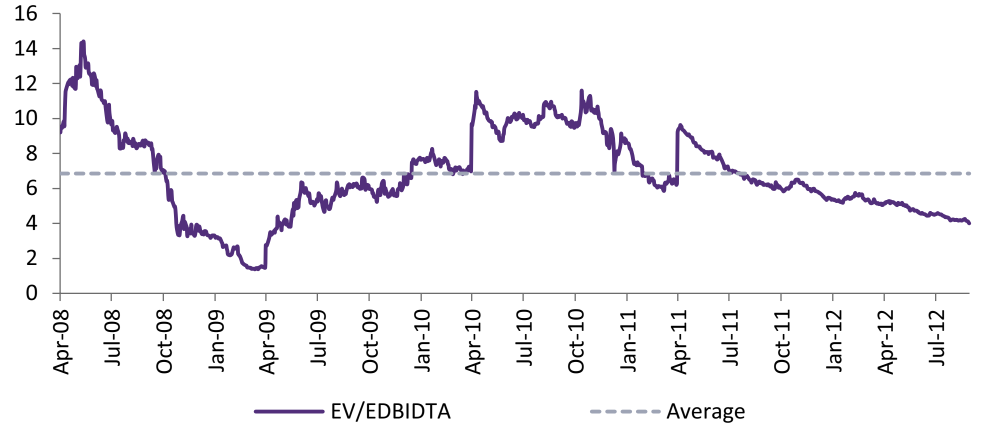


Source: Company, Violet Arch Research

Valuation

AIL currently trades at an EV/EBIDTA of 7.3x and 4.5x FY13E and FY14E basis, respectively. To capture the high financial leverage of the company, we have valued AIL on an EV/EBIDTA basis. Historically, the stock has traded between 4x-8x EV/EBIDTA on one-year forward basis, in line with global/domestic peers, depending upon the stage of the economic cycle. Given the current slowdown and uncertainty, we believe that the stock would trade at the lower end of the band, and hence we assign 5x one-year forward EV/EBIDTA to arrive at a target price of Rs 179.

Historical one-year forward EV/EBITDA



Source: Company, Violet Arch Research

Peer Comparison

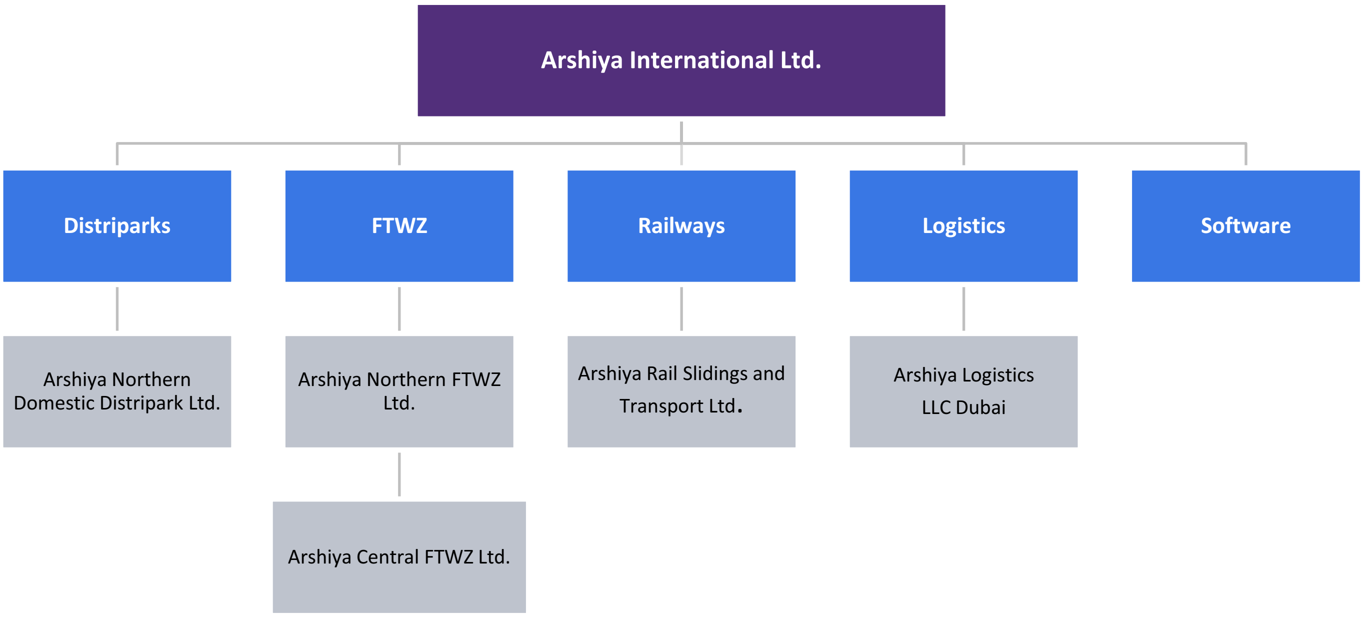
Name	Country	Mkt Cap (US$ mn)	ROE	PE	EV/EBIDTA
Hitachi Transport	Japan	1920.6	8.8	10.6	5.4
Far Eastern Shipping	Russia	965.1	7.5	8.2	5.5
Transcontainer	London	1670.2	7.8	17.9	6.1
Asciano Ltd.	Australia	4510.0	9.6	13.4	7.0
Arshiya International	**India**	**124.6**	**20.3**	**2.8**	**4.3**

Source: Company, Violet Arch Research

Company Background

Arshiya International Ltd. (AIL), a mid-sized asset light-logistics service provider, has been transformed into a full-fledged warehousing and logistics service provider. AIL is the first Indian entity to successfully implement and operate an FTWZ (governed by the SEZ Act, 2005), which comprises warehouses designed for storage of goods through palletization, or a special area such as open and covered yards, with temperature-controlled storage rooms, etc. Further, the company also provides logistics support to its clients complementing its warehousing business. While it has five operational warehouses in its Panvel FTWZ, 10 warehouses are set to become operational.

Arshiya International is promoted by Mr. Ajay Mittal and Mrs. Archana Mittal, both of whom take active interest in the operations of the company. Mr. Mittal has more than 20 years of entrepreneurial experience, with a focus on logistics and supply chain management.



Source: Company, Violet Arch Research

Annexure

Benefits of FTWZ

Import Benefits	Export Benefits	Re-export Benefits
FTWZ is deemed foreign territory; hence, goods imported and stored in an FTWZ do not draw custom duty until it is moved out of the premises. This helps in deferment of duty expenses, unlocking working capital for the importer.	Domestic goods entering the FTWZ are treated as an export, thereby providing immediate export benefits (duty drawback, DEPB credits, etc.) to suppliers/companies in DTA.	Income-tax exemption on re-export of imported goods.
Hassle-free business environment in terms of local laws regulatory compliance.	FTWZs provide companies infrastructure to consolidate, value-add and conduct quality control on its products before end distribution worldwide, increasing supply chain efficiencies (forward and reverse).	Service tax exemption on all activities conducted inside the FTWZ, including rentals and labour.
24/7 customs clearance, enhancing speed and efficiency of India distribution.	Local tax exemption (e.g., CST, sales tax, excise and VAT) on purchase of material from DTA for authorized operations.	Exemption from custom & stamp duty on imports into FTWZ, meant for re-export out of India.
Quality control capability prior to duty payment (will allow companies to have quality control on products before the duty payment).	Ability to conduct quality control before dispatch from India and flexibility of sending it back to DTA for repairs or replacement.	Hassle-free re-export of value-added products.
Enabling Implementation of the vendor-managed inventory (VMI) model.	Hassle-free business environment in terms of local laws and regulatory compliance.	Ability to leverage India as a regional/global distribution and value-addition hub.
Postponement of distribution capabilities.	Enhanced capital cash-flow and higher inventory visibility	-

Source: Company, Violet Arch Research

Financial summary (Consolidated)

Income statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	**8,218**	**10,573**	**14,217**	**17,923**
% chg	56.3	28.7	34.5	26.1
Total Expenditure	6,645	7,858	10,035	11,950
Operating profit	**1,574**	**2,716**	**4,183**	**5,972**
(% of Net Sales)	19.1	25.7	29.4	33.3
Other Income	45	76	76	76
Depreciation& Amortisation	180	314	788	1,108
Interest	474	1,060	1,605	1,991
PBT	**962**	**1,419**	**1,866**	**2,949**
(% of Net Sales)	11.7	13.4	13.1	16.5
Tax	140	211	280	442
(% of PBT)	14.5	14.9	15.0	15.0
PAT	**820**	**1,208**	**1,586**	**2,507**
Add/(Less): Extraordinary Items	(6.3)	-	-	-
Adj PAT	**826**	**1,208**	**1,586**	**2,507**

Cash flow statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
PAT	820	1,208	1,586	2,507
Depreciation	180	314	788	1,108
Chg in working capital	(918)	282	490	356
Other Current Assets	379	118	-	-
CF from operations	**1,539**	**1,121**	**1,884**	**3,259**
Capital expenses	9,368	10,466	2,400	-
Chg in investments	**145**	**50**	**-**	**-**
CF from investing	**(9,513)**	**(10,516)**	**(2,400)**	**-**
Free cash flow	(7,829)	(9,345)	(516)	3,259
Equity raised/(repaid)	0	-	-	-
Debt raised/(repaid)	**8,706**	**8,465**	**2,137**	**1,680**
Dividend(Incl tax)	**69**	**82**	**82**	**82**
CF from financing	**8,774**	**8,547**	**2,219**	**1,762**
Net change in cash	**800**	**(847)**	**1,703**	**5,021**
Opening cash bal	**718**	**1,518**	**671**	**2,374**
Closing cash bal	1,518	671	2,374	7,395

Balance sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
SOURCES OF FUNDS				
Equity Share Capital	118	118	118	118
Reserves& Surplus	7,456	8,662	10,110	12,535
Shareholders Funds	**7,456**	**8,662**	**10,110**	**12,535**
Total Loans	14,421	22,886	25,023	26,703
Total Liabilities	**21,877**	**31,549**	**35,133**	**39,238**
APPLICATION OF FUNDS				
Gross Block	6,757	15,693	23,693	31,693
Less: Acc. Depreciation	287	595	1,382	2,490
Net Block	**6,470**	**15,098**	**22,311**	**29,203**
Capital Work-in-Progress	12,560	14,090	8,490	490
Investments	**150**	**200**	**200**	**200**
Current Assets	4,519	4,895	7,384	13,420
Current liabilities	2,484	1,919	4,111	9,488
Net Current Assets	**2,035**	**2,977**	**3,273**	**3,933**
Miscellaneous Expenses	**213**	**242**	**21**	**(143)**
Total Assets	**21,877**	**31,549**	**35,133**	**39,238**

Financial ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Leverage				
Debt-Equity	1.7	2.6	2.2	1.5
Interest Coverage -on EBIT	2.0	1.3	1.2	1.5
Per Share Data (Rs)				
Diluted EPS	13.9	20.5	27.0	42.6
Diluted Cash EPS	17.0	25.9	40.3	61.4
DPS	1.2	1.2	1.2	1.2
Book Value	127	147	172	213
Returns %				
ROE	11.0	13.9	15.7	20.0
ROCE	6.6	7.9	9.9	12.6
Margin Ratios(%)				
EBITDA margin	19.1	25.7	29.4	33.3
PBT margin	11.7	13.4	13.1	16.5
PAT margin	10.0	11.4	11.2	14.0
Operating Cycle				
Debtors Days	102	107	100	100
Inventory Days	0	0	0	0
Creditors Days	105	131	110	110
Valuation				
P/E	9.8	6.6	5.0	3.2
P/BV	1.1	0.9	0.8	0.6
EV / Sales	2.5	2.8	2.1	1.5
EV / EBITDA	13.2	11.1	7.3	4.5
MCap/Sales	1.0	0.8	0.6	0.4

COMPANY REPORT

Equity Research | Auto

21 September, 2012

Balkrishna Industries Ltd.

On a Roll

Absolute Rating	**Buy**
Target Price	**Rs 329**
Upside	**21%**

We initiate coverage on Balkrishna Industries Ltd. (BIL) with a Buy rating. BIL is one of the few players specializing in the off-highway tyre (OHT) business with a global market share of 4.0%. With the Bhuj capacity expansion on track, we believe the company is well placed to garner incremental market share in the global OHT market. Declining natural rubber prices and increasing radialization would lead to BIL's margin expansion over the next couple of years. BIL stock is available at attractive valuations of 6.6x P/E on FY14 EPS of Rs 41.2. Hence, we believe, the company's stock is an attractive pick.

Replacement market and radialization to drive revenue growth

BIL has a presence in OHTs, a niche tyre segment. With around 62% of revenues accruing from agri-tyres, this is a low-volume and high-customization business. While the European OEM demand is witnessing a slowdown, the replacement market continues to grow at a healthy pace. Global players such as Michelin, Goodyear, and Continental are shifting their focus and are eyeing high-volume automotive tyres. Currently, BIL has a mere 4% market share in the global OHT market. But it still has considerable scope for increasing its share in the coming years. Further, with capacity expansions underway, the share of high realizations (10-15% higher than cross-ply tyres) of radial tyres is expected to go up from the current 25% to 35% by FY14E.

High-margin business with considerable cost advantage to global peers

BIL's OHT business fetches impressive EBITDA margins of 17-20%. This is significantly higher compared to its global peers, which have EBITDA margins in the range of 8-14%. On the other hand, domestic tyre companies have EBITDA margins of 6-10%. Besides, BIL enjoys a considerable labour cost advantage vis-à-vis its global peers. BIL's employee expenses/sales are at a mere 4-4.5% compared to its global peers at 20%. A weak INR vis-à-vis USD and EUR, along with the absence of excise duty up to 90% of its revenues (being export revenues), further aid margins. Prices of natural rubber, a key input raw material for OHTs, are expected to soften, adding to the company's profitability.

Capex on track, well positioned to garner market share

Recently, BIL has undertaken an exhaustive capex plan at its Bhuj plant. The current capacity of 144,000mt at Bhuj is expected to reach 276,000mt by FY15E. The company has already bagged an order of 51,000mt equivalent to sales for the next four months. Being present in the replacement market of OHTs in Europe, risks for the company from any significant slowdown in OEM sales would be minimal.

Valuation

The stock is currently trading at an attractive 6.6x P/E on FY14 EPS of Rs 41.2 lower than its historical average of 7.2x. With the company enjoying industry (tyre) best EBITDA margin (17.0-20.0%) and potential to gain incremental market share, we assign a P/E of 8x a premium of around 10% to historical average (FY12-FY14E PAT CAGR of 21.7% vs. FY10-FY12 PAT CAGR of 14%). We Initiate coverage on BIL with a Buy rating at a target price of Rs 329, implying an upside of 20.5% from current levels.

Standalone Y/E 31 Mar (Rs Mn)	FY11	FY12	FY13E	FY14E
Revenues	19,341	28,200	36,260	43,690
EBITDA	2,788	5,058	7,049	8,532
EBITDA margin (%)	14.4	17.9	19.4	19.5
EBITDA growth (%)	(24.6)	81.4	39.4	21
Adj. Net Profit	1,856	2,685	3,450	3,978
Adj. Profit growth (%)	(10.2)	44.7	28.5	15.3
Net profit margin (%)	9.6	9.5	9.5	9.1
FDEPS	19.2	27.8	35.7	41.2
FDEPS growth (%)	(10.2)	44.7	28.5	15.3
P/E (x)	14.2	9.8	7.6	6.6

Source: Company, Violet Arch Research

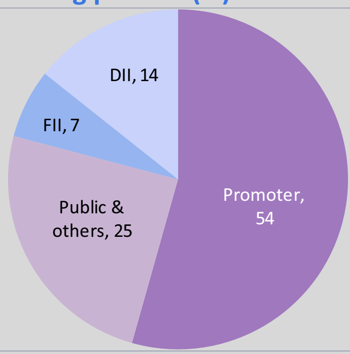
Stock data

CMP	**Rs 273**
Reuters Code	BLKI.BO
Bloomberg Code	BIL IN
Equity Shares o/s (mn)	97
Market Cap (Rs mn)	26,385
Market Cap (USD mn)	495
3m Avg daily t/o(US$ mn)	1.2

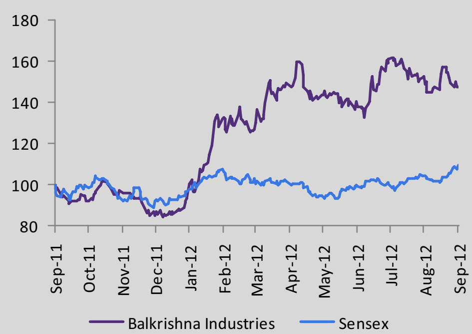
Stock performance (%)

52-week high / low			**Rs 308/146**
	1M	**3M**	**12M**
Absolute	(3.3)	7.1	50.0
Relative	(8.4)	(3.4)	34.0

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull case	Base case	Bear case
Volumes (MT)	201,444	185,328	157,932
Volume growth (%)	20.0	15.0	(2.0)
Realization (Rs)	244,469	237,678	230,887
Realization growth (%)	8.0	5.0	2.0
Natural rubber price (USD / kg)	2.4	2.6	3.0
EBITDA (Rs mn)	10,280	8,532	6,524
Inc/decrease from base case (%)	20.5		(23.5)
EBITDA margin (%)	21.0	19.5	15.0
PAT (Rs mn)	5,149	3,978	1,904
Inc/decrease from base case (%)	29.4		(52.1)
EPS (Rs)	**53.3**	**41.2**	**19.7**
CMP (Rs)	273	273	273
Target Multiple (x)	9.0	8.0	6.0
Target Price (Rs)	**479**	**329**	**118**
Upside / (Downside) (%)	**76.3**	**20.5**	**(56.5)**

Source: Company, Violet Arch Research

Particulars	FY11	FY12	FY13E	FY14E
Volumes (MT)	111,543	133,039	161,155	185,328
Net realisation / ton (Rs)	178,923	212,578	226,360	237,678
EBITDA margin (%)	14.4	17.9	19.4	19.5

Source: Company, Violet Arch Research

Base case

- We expect total volume growth at 21% / 15% in FY13E / FY14E to 161,155MT / 185,328MT driven by strong mining sector demand in U.S. at 30% / 20% in FY13E / FY14E. The company has guided for a total volume of 160,000-165,000MT in FY13 and 191,000-195,000MT in FY14. We note that the company has been able to meet its guidance in past. However, we have factored in lower volumes in FY14 predominantly due to a relatively lower growth assumption in European region at 8%.
- We expect blended realization growth of 6.5% / 5.0% in FY13E / FY14E to Rs 226,360 / Rs 237,678 – led by exchange benefit and product mix. We have assumed the INR:EUR (hedged)/INR:USD exchange rate at 71/53 in FY13E and FY14E.
- EBITDA margin assumption at 19.4% / 19.5% in FY13E / FY14E on the back of reduced natural rubber prices. Natural rubber price at USD 2.6 / kg in FY13E and FY14E.

Bull case

- Expectation of Europe to revive in FY14E and management to exceed its volume guidance of 191,000-195,000MT and thereby clocking volume of 201,444MT, 25.0% growth.

Bear case

- Europe and US go into a recession leading to lower demand, pricing pressure and fall in margins. In this scenario, our volumes would de-grow by 2% to 157,932MT in FY14E. If rubber prices rise to 3 USD/kg and fixed costs as a percent of sales increase to 10%, the EBITDA margin would drop to 15% and EPS would shrink to Rs 19.7.

SWOT Analysis

Strengths

1) Export-oriented (90% of revenues) business model acting as a natural hedge against imported raw material costs (rubber, carbon black, etc). Effective JIT like distribution model with near-zero inventory at the company level.

2) Significant cost advantage due to lower labour costs, resulting in industry-best EBITDA margins (17-20% vis-a-vis 8-14% of peers).

3) Increase in revenue share of high-margin radial segment (25%-35%) over FY12-14E.

Weaknesses

1) Exposure only to off-highway tyres and not autmotive tyres. Thus, misses out on the automotive boom cycle in India as well as abroad.

2) With 80% revenues accruing from Europe/US, the business faces a risk of prolonged slowdown in these countries.

3) Does not have market leadership in any major geography. Hence, low pricing power.

SWOT Analysis

Opportunities

1) Earth-moving tyres have good growth potential, where BIL can take advantage of the structural shift from cross-ply tyres to radial tyres.

2) With just a 4% global market share, BIL has significant scope to increase it in various geographies through capacity expansions.

3) New client acquisitions in the OEM space to counter any potential slowdown in the replacement market.

Threats

1) Volatile natural rubber prices and crude oil prices (>50% of total cost) pose a threat to margins.

2) Sustained slowdown in European and US markets can impact replacement demand in the future.

3) We expect a transformation of current automotive cross ply capacity to speciality tyres leading to higher competition for incumbents like BIL.

4) If exports taper off and domestic sales proportion increases substantially, it could lead to BIL paying import duty on natural rubber, which is currently nil.

Source: Violet Arch Research

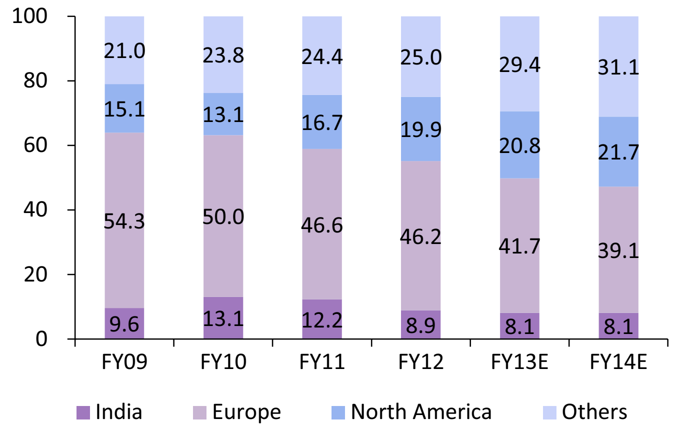
Investment Arguments

Replacement market, radialization and weak competitive positioning in global markets to drive revenue

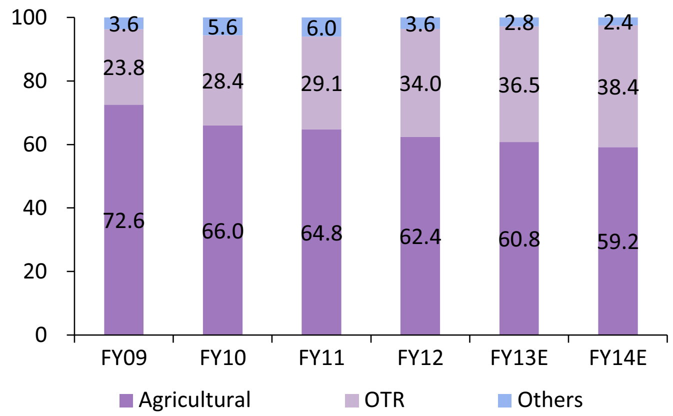
BIL has a presence in the off-highway tyres (OHT), a niche tyre segment. With around 62% of its revenues accruing from agri-tyres, this is a low-volume and high-customization business. The European OEM demand for OHTs has been subdued due to the macroeconomic scenario. However, BIL is relatively insulated from the current financial downturn, as it mostly serves the replacement market (80% of revenues), where demand continues to be steady. The replacement cycle for an agricultural tyre is 24-30 months, while that for Industrial tyres is around 18 months. Demand in the US for off-the-road (OTR) tyres is strong, with the industrial and construction segment witnessing robust growth. Mining tyre's supply in the US has shown a shortfall, providing growth potential in the American market. We expect the company's European and US revenues to log a CAGR of 15% and 30.5%, respectively, over FY12-14E.

While the current weak OEM demand is likely to negatively impact replacement demand in the next 24 months, BIL has been scouting for OEM clients to diversify its risk from excessive exposure to the replacement market. The company plans to increase its exposure to OEMs from around 15% currently to about 22% in the next couple of years as the Bhuj capacity comes on stream.

Geography-wise revenue share (%)



Category-wise volume contribution (%)



Source: Company, Violet Arch Research

Global players such as Michelin, Goodyear, and Continental are shifting their focus elsewhere from the business and are eyeing high-volume automotive tyres. Currently, BIL has a mere 4% market share in the global OHT market. But it still has considerable scope for increasing its share in the coming years. Further, with capacity expansions underway, the share of high realizations (10-15% higher than cross-ply tyres) of radial tyres are expected to go up from the current 25% to 35% FY14E.

High entry barriers, with a client customized model

Presumably, OHT manufacturing involves a high level of client customization. With exposure to different types of surfaces, OHTs require different levels of soil compaction for farm applications and surface-gripping requirements for industrial and mining applications. Thus, it is a high-customization low-volume business. Over the last 15 years, the company has developed 2,000 stock-keeping units (SKUs). It has consistently been adding 100-200 SKUs per annum, which is higher than the industry average of 50-60. Thus, the business model is distinct from what volume-focused automotive tyre makers have adopted globally. Besides, the business is fairly difficult for new players in terms of achieving substantial benefits in a short time.

Distribution model: A win-win situation

BIL's distribution model is unique unlike its global peers. The company sells its products to its distributors globally, and passes on risk and expenses involved in inventory management as well as sales and promotion expenses to dealers. BIL's production always matches the orders received from distributors. Dealers, in turn, receive a higher margin of around 15% from BIL compared to 5-6% for global peer's distributors. Thus, it is a win-win situation for both BIL and its dealers. Incidentally, global peers manufacture goods in advance, incurring significant sales and distribution expenses. The company boasts of over 200 distributors spread across as many as 120 countries.

Hedging policies in place for EUR-denominated revenues, USD-denominated exports provide natural hedge to imported raw materials

In FY13E, around 41% of BIL's revenues are expected to be EUR-denominated, while about 50% of revenues to be USD-denominated. Around 45% of total raw materials are expected to be USD-denominated. Thus, USD revenues provide a natural hedge against USD-denominated raw materials. The company also has USD exposure in terms of ECBs. Interest expenses of USD6mn in FY13E on an ECB of around USD180mn are naturally hedged by export revenues. However, the principal repayment is expected to commence only from FY16.

Currency	As % of total revenues	Hedging policy
EUR-denominated revenues (FY13E)	41.0	Hedged at the rate of EUR:INR of 70-71. Forward contracts rolled over every month. ~EUR217mn
USD-denominated revenues (FY13E)	50.0	Natural hedge to raw material imports. **~USD345mn**. Proportion of USD denominated export revenues to increase going forward.
USD-denominated raw material costs (FY13E).	45.0	Naturally hedged by dollar revenues. **~USD307mn** (predominantly natural rubber and synthetic rubber),
USD-denominated interest costs (FY13E)		Naturally hedged by dollar revenues. **~USD6mn**.
USD-denominated principal		Payments to start from FY16

Source: Company, Violet Arch Research

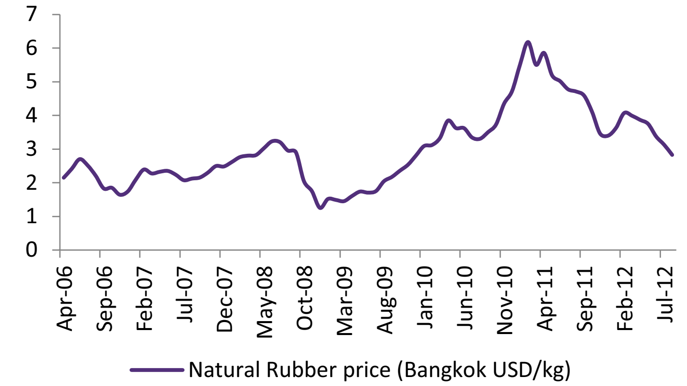
Industry-best EBITDA margin, softening natural rubber prices to provide further fillip

BIL's OHT business fetches impressive EBITDA margins of 17-20%. This is significantly higher compared to its global peers, which have EBITDA margins in the range of 8-14%. On the other hand, domestic tyre companies have EBITDA margins of 6-10%. Besides, BIL enjoys a considerable labour cost advantage vis-à-vis its global peers. The company's employee expenses/sales are at a mere 4-4.5% compared to its global peers at 20%. A weak INR vis-à-vis USD and EUR, along with the absence of excise duty to 90% of its revenues (being export revenues), further aid margins. Prices of natural rubber, a key input raw material for off-highway tyres, are expected to soften, adding to the company's profitability.

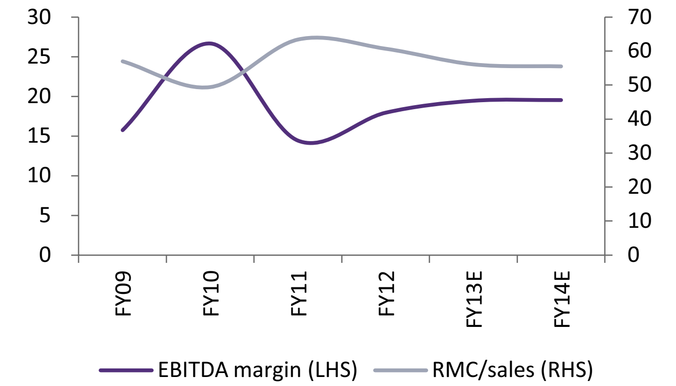
Domestic companies EBITDA margin (%)	FY09 / CY08	FY10 / CY09	FY11 / CY10	FY12 / CY11
Balrishna Industries Ltd.	15.7	26.7	14.4	17.9
Apollo Tyres Ltd.	8.2	14.4	10.9	9.6
JK Tyres	3.6	11.0	5.3	4.5
Ceat Ltd.	2.8	11.4	4.8	5.9
MRF Ltd. #	7.8	11.6	10.7	7.7
Goodyear Ltd. *	6.7	12.0	9.4	7.5
TVS Srichakra. *	6.5	6.5	9.4	8.7
Y/E - * - Dec ending; # - Sep ending				
Global companies	**CY08**	**CY09**	**CY10**	**CY11**
Michelin	11.3	12.2	15.1	13.9
Bridgestone	9.9	9.9	11.8	11.6
Titan	10.0	3.7	7.8	11.9

Source: Company, Violet Arch Research

Global natural rubber prices trending downwards…

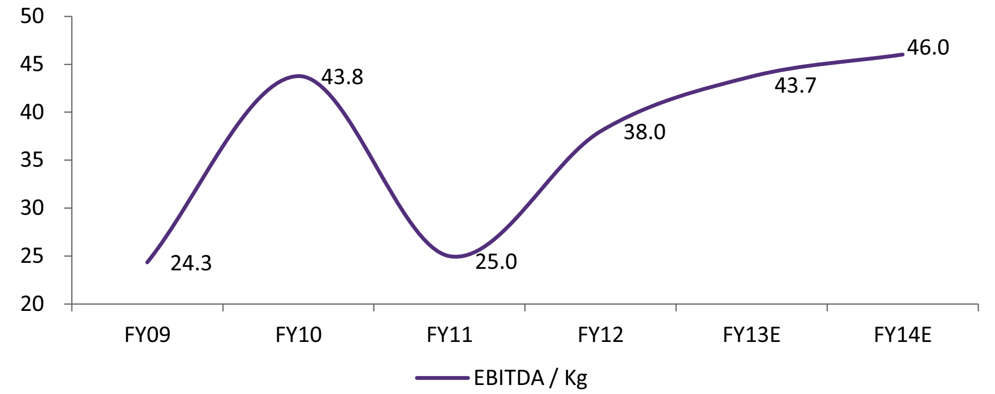


….giving expectations of margin expansions



Source: Company, Violet Arch Research

EBITDA/kg to get a fillip



Source: Company, Violet Arch Research

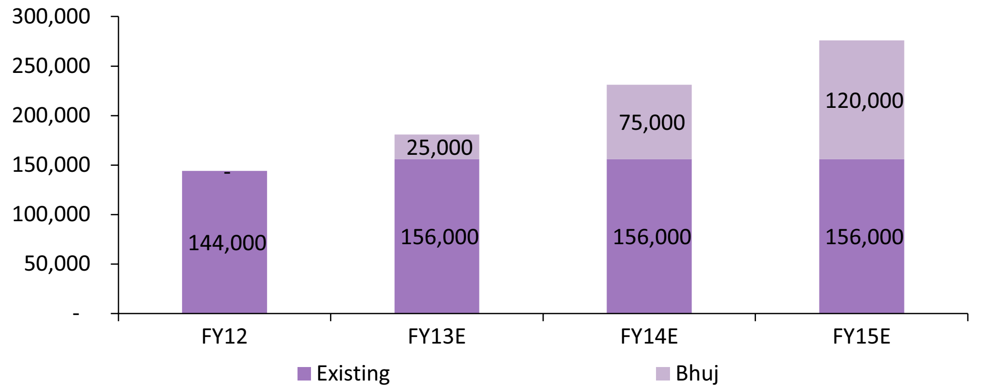
BIL's fixed cost as a percent of sales is estimated at around 8%. Thus, the company would not be a major victim of poor operating leverage, as it would be able to resist a margin impact in the event of lower-than-expected demand from global markets.

Thanks to its export-oriented business model, BIL is exempted from paying import duty on natural rubber. In fact, other Indian manufacturers have to pay import duty of 20% or Rs 20/kg, whichever is lower. We expect natural rubber prices to soften going forward. Currently, the company has 2-2.5 months of natural rubber inventory at a cost of USD2.8/kg. Going forward, we expect BIL to book inventory for a period of 2-2.5 months only in view of the declining trend of natural rubber prices. Thus, we expect its EBITDA margin to improve to 19.4% and 19.5% in FY13 and FY14, respectively.

Capex on track, well positioned to garner global market share

In the last 2-3 years, BIL has undertaken heavy capacity expansions, which are expected to commence operations in the next couple of years. The Bhuj facility is likely to touch the peak capacity of 276,000mt in FY15E. The company has already bagged an order of 51,000mt equivalent to sales over the next four months. Given the fact that BIL has its presence in the replacement OHT market in Europe, risks from a significant slowdown in OEM sales would be minimal.

Bhuj facility capacity expansions (MT)



Source: Company, Violet Arch Research

With its significant cost advantage vis-à-vis global peers, BIL is able to sell its products at a discount to them and still maintain healthy margins. In fact, the company's products sell at a 25-30% discount to global peers such as Michelin and Bridgestone. This, along with its presence in the replacement market in Europe, would aid BIL to gain a further market share in Europe and the US.

Key Risk and Concerns

Appreciation of INR vis-à-vis EUR

Around 41% of BIL's revenues are derived in EUR. Although the company has a hedging policy in place for its EUR-denominated revenues, a sustained appreciation of INR vis-à-vis EUR has the potential for unfavourable rates for hedging in the long term.

Lower-than-expected replacement demand in Europe

Although the replacement market for OHTs in Europe is more insulated than the OEM market from a slowdown, a prolonged downturn in the region may hamper replacement sales in the coming years. It derives 46% of revenues from Europe. With a significant capacity expansion expected to come up at Bhuj by then, lower capacity utilizations may hamper margins going forward.

Volatile natural rubber prices could wreak havoc

While natural rubber prices have been softening over the last six months, their volatile nature could play spoilsport in BIL's sustained margin expansions. Further, it could impede pricing power in the global market, which may consequently hamper the market share.

Redundant cross-ply capacities of domestic players could be diverted to speciality tyres

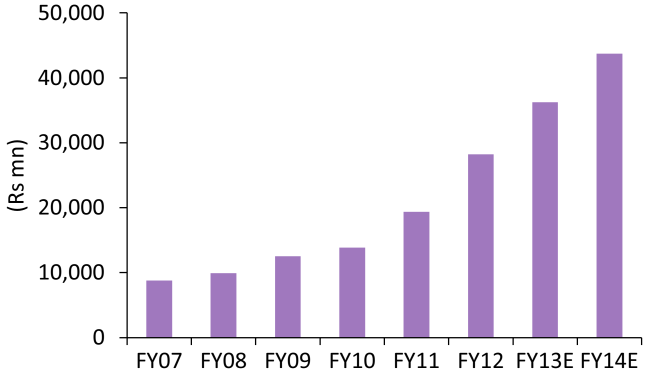
With increased radialization taking place in the automotive tyre segment, the cross-ply tyre capacities of domestic tyre makers are expected to become redundant over the next couple of years. Talks in industry circles indicate that the tyre capacities could be diverted towards production of industrial and speciality tyres, which may pose a threat to BIL's USP in the long-term.

Financial Outlook

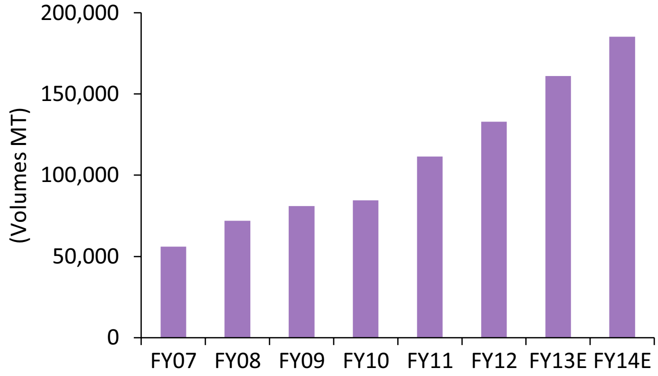
Revenue CAGR to be 24.5% over FY12-14E

BIL's standalone net revenues grew at a CAGR of 26.3% to Rs 28.2bn over FY07-12. We expect its net revenues to grow at a CAGR of 24.5% to Rs 43.7bn during FY12-14E. Its volumes are expected to log a CAGR of 18% to 185,328mt over FY12-14E. Its net realization is likely to log a CAGR of 5.7% to Rs 237,678 over FY12-14E. Its volume growth, expected to come predominantly from the US on the back of strong demand for industrial segment tyres, is likely to clock a CAGR of 24.9%. Over FY12-14E, Europe would relatively experience a lower growth of 8%.

Standalone net revenue trend



Standalone volume trend

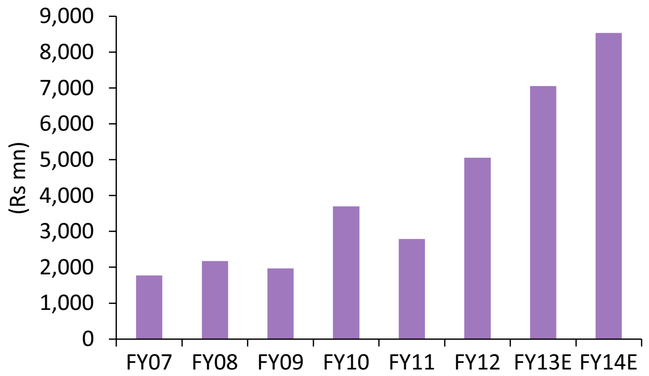


Source: Company, Violet Arch Research

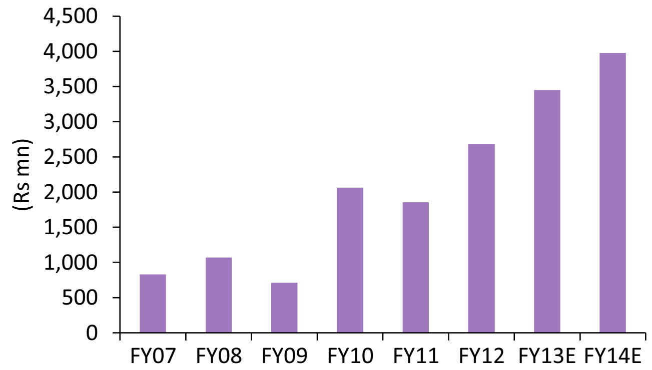
EBITDA CAGR to be 29.9% over FY12-14E

BIL's EBITDA grew at a CAGR of 23.3% to Rs 5.1bn over FY07-12. We expect its EBITDA to log a CAGR of 29.9% during FY12-14E. Softening of natural rubber prices and efficient hedging policies, coupled with increasing radialization of the OHT market, is expected to aid the EBITDA margin. We expect the EBITDA margin to improve to 19.4% and 19.5% in FY13 and FY14, respectively, from 17.9% in FY12.

Standalone EBITDA trend



Standalone PAT trend



Source: Company, Violet Arch Research

PAT CAGR to be 21.7% over FY12-14E

BIL's standalone PAT logged a CAGR of 26.4% to Rs 2.7bn over FY07-12. We expect its PAT to log a CAGR of 21.7% to Rs 3.9bn during FY12-14E. Its PAT is partially expected to be hampered by increasing interest costs and depreciation from FY13 post-partial commissioning of the Bhuj facility. While the PAT margin is expected to be at 9.5% and 9.1% in FY13 and FY14, respectively, EPS is expected to be at Rs 35.7 and Rs 41.2 in FY13E and FY14E, respectively.

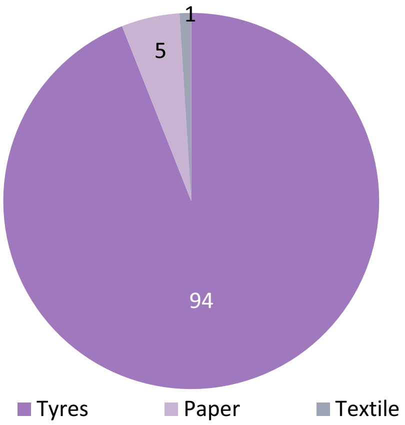
Valuation

BIL is currently trading at a P/E of 6.6x. We believe that raw material prices have peaked out, and hence BIL's EBITDA margin is expected to get a boost in the coming years. With the company enjoying industry-best EBITDA margin and expected to garner greater market share going forward, with capacity expansions on track, we believe BIL should command a P/E multiple of 8x. Thus, we value BIL at 8x P/E to its FY14E EPS of Rs 41.2 a premium of around 10% to historical average P/E of 7.2x (FY12-FY14E PAT CAGR of 21.7% vs. FY10-FY12 PAT CAGR of 14%) and arrive at a target price of Rs 329, implying a 20.5% upside from current levels.

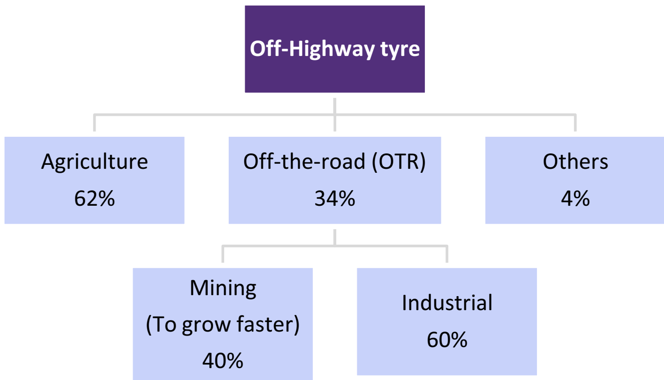
Company Background

Balkrishna Industries Ltd. (BIL) is the flagship company of the Siyaram Poddar Group. The tyre business (standalone) forms 94% of the company's consolidated revenues and 99% of consolidated EBITDA. The paper business constitutes 5% and textiles forms just 1% of consolidated revenues. The OHT business comprises agricultural tyres, OTRs and other tyres like sports and utility vehicles such as golf-cart, lawn and garden tyres.

Consol Net revenue break-up (FY12, %)



Off-highway tyre volume segment-wise break-up



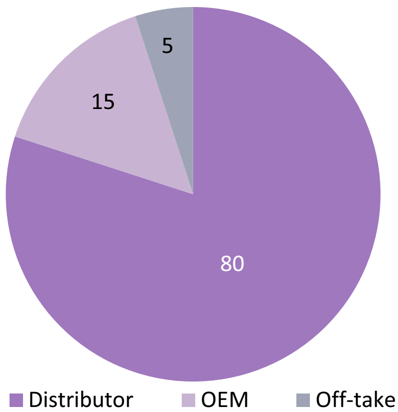
Source: Company, Violet Arch Research

Tyre types and applications

Tyre type	Application
Agricultural	Tyres for tractors, trailers, farm equipment and forestry.
	Tractor radial tyres under brand Agrimax.
OTR	Industrial, construction and earth-mover tyres.
	Steel radial OTR tyres under the brand, Earth Max.
Others	Tyres for sports and utility vehicles such as golf-cart, lawn and garden tyres.
	Tyres for all-terrain vehicles (ATV) with puncture resistance.

Source: Company, Violet Arch Research

Standalone channel-wise volume break-up (%)



Financial Summary -Standalone

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**19,341**	**28,200**	**36,260**	**43,690**
growth (%)	39.5	45.8	28.6	20.5
Operating expenses	16,553	23,141	29,211	35,158
EBITDA	**2,788**	**5,058**	**7,049**	**8,532**
growth (%)	(24.6)	81.4	39.4	21.0
Depreciation	744	831	1,340	1,748
EBIT	**2,044**	**4,227**	**5,709**	**6,784**
Interest paid	207	278	621	874
Other income	912	33	22	27
Exceptional items	-	-	-	-
Pre-tax profit	**2,749**	**3,982**	**5,111**	**5,937**
Tax	894	1,297	1,661	1,959
Effective tax rate (%)	32.5	32.6	32.5	33.0
Minority interest				
Income from JV/associates				
Net profit	**1,856**	**2,685**	**3,450**	**3,978**
Adjusted net profit	**1,856**	**2,685**	**3,450**	**3,978**
growth (%)	(10.2)	44.7	28.5	15.3
Shares o/s (mn nos)	96.7	96.7	96.7	96.7
EPS	19.2	27.8	35.7	41.2

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net fixed assets	7,297	12,766	16,927	20,680
Net Intangible assets	18	14	14	14
Investments	328	327	327	327
Current assets				
Inventories	4,104	4,811	5,293	6,311
Sundry Debtors	3,242	4,796	5,365	6,464
Cash and Bank	110	3,574	3,839	4,127
Other current assets	374	248	1	1
Loans and advances	5,503	5,879	7,977	9,612
Total assets	**20,975**	**32,416**	**39,743**	**47,536**
Shareholders' funds				
Share capital	193	193	193	193
Reserves & surplus	8,124	10,608	13,855	18,240
Minority interest				
Total Debt	6,210	16,970	20,470	22,970
Deferred Tax Liability	570	626	626	626
Curr Liab & prov				
Current liabilities	2,254	2,565	3,511	4,195
Provisions	3,624	1,454	1,088	1,311
Total liabilities	**12,658**	**21,615**	**25,695**	**29,102**
Total equity & liabilities	**20,975**	**32,416**	**39,743**	**47,536**

Cash Flow

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Profit before Tax	2,749	3,982	5,111	5,937
Adjustments for:				
Depreciation	744	831	1,340	1,748
Other operating cashflow	107	248	599	847
Operating Profit before Working Cap Changes	**3,601**	**5,062**	**7,049**	**8,532**
Adjustments for:				
(Increase)/Decrease in Sundry Debtors	(1180)	(2436)	(568)	(735)
(Increase)/Decrease in Loans and Advances	-	-	(1851)	(1189)
(Increase)/Decrease In Inventories	(2073)	(707)	(482)	(879)
Increase/(Decrease) in Current Liabilities and Provisions	1084	322	580	599
Cash generated from Operating Activities	**1432**	**2241**	**4728**	**6327**
Direct Taxes Paid	(837)	(1505)	(1661)	(1959)
Net Cash from Operating Activities	**594**	**736**	**3067**	**4367**
Cash Flow From Investing Activities				
Capital expenditure	(2162)	(6751)	(5501)	(5500)
Change in investments	485	0	0	0
Other investing cash flow	97	(20)	22	27
Net Cash (used) in Investing Activities	**(1580)**	**(6771)**	**(5479)**	**(5473)**
Cash Flow From Financing Activities				
Issue of equity	0	0	0.0	0.0
Issue/(repay) debt	1,433	9,856	3,500	2,500
Dividends paid	(158)	(157)	(202)	(233)
Interests Paid	(222)	(201)	(621)	(874)
Other financing cash flow	-	-	-	-
Net Cash from / (used in) Financing Activities	**1,053**	**9,497**	**2,677**	**1,394**
Opening cash	**42**	**112**	**3,574**	**3,839**
Closing cash	**110**	**3,574**	**3,839**	**4,127**

Financial Ratio

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	19.2	27.8	35.7	41.2
Adj EPS growth (%)	(10.2)	44.7	28.5	15.3
EBITDA margin (%)	14.4	17.9	19.4	19.5
Pre-tax margin (%)	14.2	14.1	14.1	13.6
ROE (%)	24.9	28.1	27.8	24.5
ROCE (%)	10.7	13.5	12.4	12.0
Turnover & Leverage ratios (x)				
Asset turnover (x)	1.1	1.1	1.0	1.0
Leverage factor (x)	2.5	2.8	2.9	2.7
Net margin (%)	9.6	9.5	9.5	9.1
Net Debt/Equity (x)	0.7	1.2	1.2	1.0
Working Capital & Liquidity ratio				
Inventory days	92	95	95	95
Receivable days	52	52	54	54
Payable days	51	51	50	50
Valuations				
PER (x)	14.2	9.8	7.6	6.6
Price/Book value (x)	3.2	2.4	1.9	1.4
EV/EBITDA (x)	11.6	7.8	6.1	5.3

COMPANY REPORT

Equity Research I IT

21 September, 2012

KPIT Cummins Infosystems Ltd.

Unmatched Expertise

Absolute Rating	**BUY**
Target Price	**Rs 163**
Upside	**27%**

KPIT Cummins Infosystems Ltd. (KPIT), a niche solutions provider to the automotive and manufacturing verticals, has been witnessing strong demand for its solutions. With significant momentum across client buckets, including its top client, Cummins, the company has recorded strong performance in recent quarters. The company is expected to grow by 33% in FY13E and 16% in FY14E on the back of increasing adoption of SAP and Oracle technologies by the automotive and manufacturing industry. Further, a shift in projects to offshore mode, coupled with employee pyramid rationalization, is likely to drive the company's EBITDA margins to 15.9% in FY14E compared with 14.5% in FY12. We initiate coverage on KPIT with a Buy rating and a target price of Rs 163.

FY13E revenue growth at 35% achievable

The US market, which accounts for 76% of KPIT's revenues, is witnessing good demand traction. Cummins has registered a strong 11% sequential growth in Q1FY13. Deals recently won in key geographies and aggressive client mining used across revenue buckets are more likely to drive KPIT towards a 33% YoY revenue growth.

Strong presence in automotive, manufacturing and utilities

KPIT derives a major part of its revenues from automotive and manufacturing verticals, which collectively contribute over 70% of its revenues. Four to five large deals won by the company over the last six months are likely to bode well.

Margins expansion of 100bps in FY13

KPIT's EBITDA margins are likely to expand by 50-100bps, led largely by SAP vertical clocking a strong rise in margins to 11-12% in FY13E. Recent ramp-up in deals has led to projects starting with more onsite work. The same is likely to move offshore, which will contribute to improved profitability. Further, an improvement in the employee pyramid is likely to aid margin growth in FY13E and FY14E.

Aggressive client mining to drive growth

KPIT has added 14 clients in FY12. Aggressive client mining would be the key for achieving higher revenues for the company. Excluding the top client, lower client buckets from 2-10 have grown at an average of over 11% during Q1FY11-Q1FY13 leading to a solid performance in recent quarters.

Valuation

We initiate coverage with a Buy rating on the stock, by assigning an 11x P/E multiple, in line with its eight year historical average to our FY14E EPS of 14.8 and arrive at a target price of Rs 163. We believe our target multiple is backed by: 1) winning substantial deals across SAP, 2) automotive and utilities space, 3) robust traction across client revenue buckets, and 4) aggressive client mining are likely to drive a dollar revenue growth of 33% and 16% for FY13E and FY14E, respectively.

Consolidated Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenue	10,120	15,000	21,719	25,088
EBITDA	1,522	2,181	3,366	3,998
EBITDA margin (%)	15.0	14.5	15.5	15.9
EBITDA growth (%)	(5.7)	43.3	54.3	18.8
Net Profit	946	1,454	2,147	2,708
Net profit margin (%)	9.3	9.7	9.9	10.8
Net profit growth (%)	10.3	53.7	47.7	26.1
EPS (Rs)	5.2	8.0	11.8	14.8
EPS growth (%)	10.3	53.7	47.7	26.1
PE (x)	24.8	16.1	10.9	8.6

Source: Company, Violet Arch Research

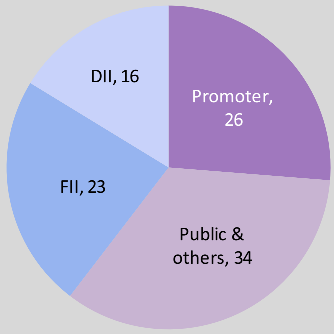
Stock data

CMP	**Rs 128**
Reuters Code	KPIT.BO
Bloomberg Code	KPIT IN
Equity Shares o/s (mn)	182
Market Cap (Rs mn)	23,413
Market Cap (USD mn)	428
3m Avg daily t/o(US$ mn)	1.4

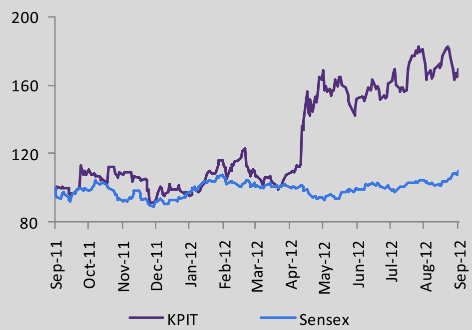
Stock performance (%)

52-week high / low			**Rs 142/68**
	1M	**3M**	**12M**
Absolute	(3.8)	11.3	68.0
Relative	(8.8)	0.8	52.0

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E (Rs Mn)	Bull case	Base case	Bear case
INR:USD Exchange rate	55	53	51
Net employee additions (Nos.)	2,100	1,200	1,000
Revenue (USD)	502	473	461
Revenue	27,619	25,088	23,534
EBITDA	5,149	3,998	3,062
Inc/dec from base case (%)	28.8	-	(23.4)
EBITDA margin (%)	18.6	15.9	13.0
PAT	3,534	2,708	2,031
EPS (Rs)	**19.4**	**14.8**	**11.1**
Inc/dec from base case (%)	30.9	-	(24.8)
CMP (Rs)	128.3	128.3	128.3
P/E(x)	12.0	11.0	10.0
Target price (Rs)	**232**	**163**	**111**
Upside (%)	**80.8**	**27.0**	**(13.5)**

Source: Company, Violet Arch Research

Key Assumptions

	FY11	FY12	FY13E	FY14E
INR:USD Exchange Rate	45	49	53	53
Net employee additions	1,596	1,205	1,200	1,200
Net utilization (%)	71.0	75.1	76.5	76.9
Tax rate (%)	14.0	24.5	26.0	26.0

Source: Company, Violet Arch Research

Base case

- The strong traction in deal wins across the Automotive & Engineering (24% of revenues) and the SAP SBU (32% of revenues) is likely to drive a 15.5% YoY dollar revenue growth for FY14E. Hence we expect KPIT to record revenue (Rs) CAGR of 29% over FY12-14E.
- Focused efforts in improving the employee pyramid by hiring more freshers (500-600 freshers to be hired of the 1200 in FY13E) coupled with an offshore shift in projects will lead to EBITDA margins expanding from 14.5% in FY12 to 15.9% in FY14E. We have assumed a net addition of 1,200 people in FY14E and net utilization of 76.9% for FY14E with freshers becoming ready for deployment.
- We have factored in a 26% Tax rate for FY14E.
- Our Base case scenario factors in an exchange rate of INR:USD at 53 in FY14E.

Bull case

- We have factored in a 22.5% YoY dollar revenue growth in FY14E driven by the improvement in demand environment in key geographies (US & Europe) and an increase in demand for SAP and Oracle implementation across key verticals like Automotive, Manufacturing and Utilities.
- EBITDA margins are likely to improve to 18.6% lead by solid deal flow, operational efficiencies driven by the improvement in employee pyramid and rupee depreciation.

Bear case

- Further escalation in the global economic crisis will lead to a contraction in IT spend across the manufacturing space leading to dollar revenues growing by 12.6% YoY in FY14E.
- EBITDA margins are likely to drop to 13% in FY14E driven by the slowdown in demand and an appreciation in the rupee. Further, the contraction in demand for IT projects from Cummins, the company's top client (21% of revenues), could hamper KPIT's growth prospects.

SWOT Analysis

SWOT Analysis

Strengths

1) Leadership position in niche automotive and engineering SBU.

2) Strong client profile, garners business from nine of the top-12 global auto OEMs.

3) Strong revenue visibility on the back of 4-5 large deals won in America and the Asia-Pacific region.

4) Aggressive client mining across revenue buckets to drive growth.

Weaknesses

1) Low vertical diversification with +70% revenues accruing from automotive and manufacturing verticals.

2) Higher proportion of laterals in workforce (70%) denting margins.

3) The delayed launch of Revolo is likely to happen only after FY13.

Opportunities

1) Employee pyramid rationalization to lead to an imporvement in margins (1,200 people to be hired, of which 500-600 will be freshers in FY13E).

2) The Onsite heavy mix (53% of revenues) is likely to reduce with more projects being shifted offshore, thus leading to operational efficicencies.

3) Strong client mining to drive revenues.

4) The launch of Revolo could significantly boost growth prospects.

Threats

1) Any further slowdown in Europe, which has been in contraction (PMI below 50) mode for the last 12 months, is likely to hamper demand from the region.

2) Slowdown in top client, which contributes 21% of revenues, could severly dent growth prospects.

3) Slowdown in discretionary spending could dent revenues from SAP SBU (85% work is implementation).

Source: Violet Arch Research

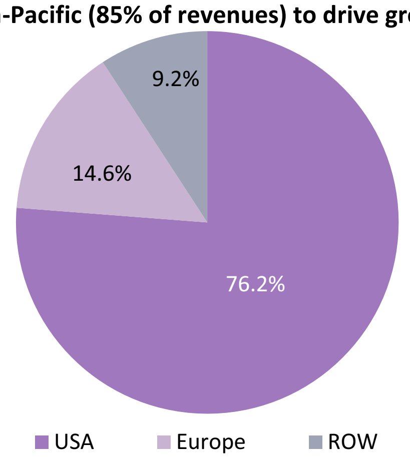
US and Asia-Pacific to lead 35% growth

KPIT has won 4-5 substantial deals, the largest being PACCAR, which is providing them strong revenue visibility. With US contributing 76% of revenues, the company continues to see good traction with strong deal wins. KPIT has recorded a strong sequential performance, growing at an average of 15% over the last six quarters. Europe is likely to see slow growth compared to USA and Asia Pacific which are likely to drive growth for FY13. The management believes that growth will be evenly spread across the year, as the company remains confident of achieving the growth guidance of 32-35%.

Cummins, KPIT's top client, which accounts for 21% of revenues, has clocked a strong sequential growth of 18% in Q1FY13 while maintaining an average of 12% sequentially growth over the last one year. KPIT works with Cummins on IT transformational as well as on engineering projects with embedded solutions. The company is confident of the deal-flow from Cummins and believes that the momentum would be sustainable for the remaining part of the year.

For OEMs across the world investments in research and development (R&D) are crucial, and during downturns if R&D spends are curtailed, it would result in incompetence and technological lag. We believe this approach of OEMs and their commitment to focus on the future will drive growth in automotive and manufacturing verticals across the US, India, China and Japan.

US and Asia-Pacific (85% of revenues) to drive growth



US contributed to 90% of incremental revenues

Incremental revenue	Q1 FY13	Contribution to revenue
USA	525	**90%**
Europe	119	**20%**
ROW	(62)	(11%)
Total	**582**	**100%**

Source: Company, Violet Arch Research

Growth QoQ.	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Contribution to Revenue
US	(2%)	15%	21%	12%	0%	9%	21%	34%	15%	76%
Europe	1%	3%	23%	0%	18%	(2%)	10%	(8%)	18%	15%
ROW	26%	13%	(6%)	39%	24%	(18%)	4%	41%	(11%)	9%

Source: Company, Violet Arch Research

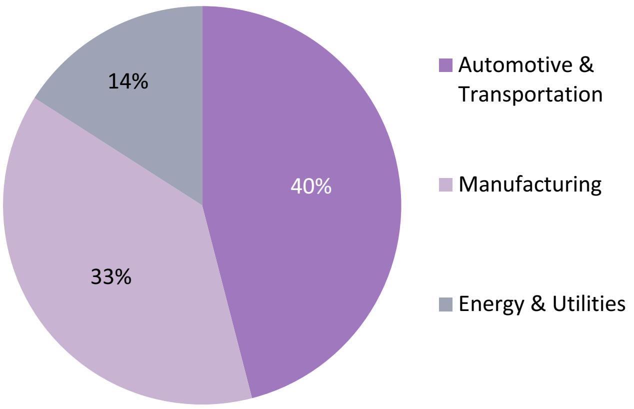
Automotive and engineering to drive growth

KPIT's key focus areas are automotive and manufacturing verticals. The automotive vertical contributes 40% of revenues. The company works with nine of the top-12 global auto OEMs and is the largest third party vendors for automotive electronics in India. Recently, the company won 4-5 large deals, of which the largest deal was with PACCAR, a global leader in medium and heavyweight trucks. The deal involves setting up of a technical centre for PACCAR in Pune, India, with around 200 employees focusing on engineering, IT and component sourcing for worldwide production and after-market operations. Another deal that the company has won is with a larger automotive customer from North America for SAP implementation.

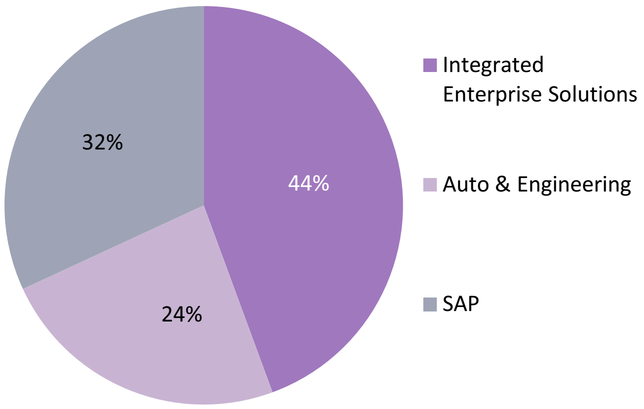
The automotive and engineering SBU caters to 40% of revenues. Around 90% of the work is undertaken for the automotive vertical on embedded solutions, while the remaining 10% for manufacturing. KPIT's EBITDA margins for this SBU are likely to improve from 16-17% in FY12 to 19-20% in FY13E. The SAP SBU is likely to see its EBITDA margins improve from 6-7% in FY12 to 11-12% in FY13E.

KPIT acquired a 57.5% stake in SYSTIME, the world's largest JD Edwards solutions provider. This acquisition has significantly strengthened KPIT's position in catering to the manufacturing and utilities space, as Oracle's JD Edwards has been a business leader. Strong demand in this segment is likely to drive IES revenues, with EBITDA margins being maintained at 16-17% for FY13E.

Automotive and energy and utilities verticals to drive growth



Automotive and SAP SBU to lead growth



Well-rounded contribution to growth

Incremental Revenue	Q1 FY13	Contribution to Revenue
Automotive & Transportation	391	67%
Manufacturing	77	13%
Energy & Utilities	173	30%
Others	(58)	(10%)
Total	**583**	**100%**

Strong demand for IES and auto & engineering solutions

Incremental Revenue	Q1 FY13	Contribution to Revenue
Integrated Enterprise Solutions(IES)	346	59%
Auto & Engineering	176	30%
SAP	163	28%
SSG	(103)	(18%)
Total	**583**	**100%**

Source: Company, Violet Arch Research

Margin expansion of 50-100bps in FY13

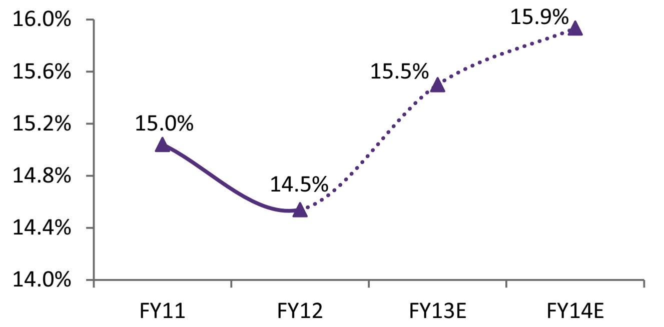
The recent winning of deals across key sectors provides KPIT good revenue visibility. Similarly, its EBITDA margins are likely to expand by 50-100bps to 15.5% in FY13E, driven largely by rationalization of the employee pyramid, which is heavy on laterals. Currently, the company has 70% of its workforce as laterals and 30% as freshers. It plans to correct this by hiring more freshers in FY13E, with a target to add 1000-1200 employees (net), of which 500-600 would freshers. This is likely to help KPIT rationalize its cost structure, leading to an improvement in its EBITDA margins.

Further, the SAP and automotive SBUs are likely to improve their margin profiles. The management has indicated that investments in the SAP SBU are over, and a margin improvement is expected, led by strong revenue momentum and a boost from the offshore shift. Most projects, which are being implemented onsite, are likely to move offshore for maintenance work, which will drive operating efficiencies. Thus, the deals won in FY12 would be shifted offshore for implementation in H1FY14E and would contribute to greater efficiency in FY14E.

Strong improvement in SBU margins…

SBU	Q1 FY13 contribution to Revenue	EBITDA Margins	
		FY12	FY13E
IES	44%	16-17%	16-17%
Automotive	24%	16-17%	19-20%
SAP	32%	6-7%	11-12%

…leading to EBITDA margin improvement



Source: Company, Violet Arch Research

Aggressive client mining to drive growth

In FY12, KPIT added 14 new clients, and at the end of Q1FY13 has 172 active clients. Thanks to its sharper focus on aggressive client mining, it has won 4-5 large deals, including the PACCAR deal. Top client revenues have grown at an average of 10% sequentially from Q1FY11-Q1FY13, and are likely to continue its strong performance. Similarly, strong client mining has led to top 2-4 client bucket growing at an average of 10% sequentially from Q1FY11 to Q1FY13. The continued focus on client mining is likely to drive growth further in FY13E.

Growth QoQ	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Contribution to Revenue
Top client	3%	7%	22%	8%	(8%)	12%	23%	3%	18%	21%
Top-5 clients	16%	14%	7%	1%	8%	5%	12%	12%	23%	36%
Top-10 clients	17%	10%	10%	3%	12%	1%	13%	14%	17%	44%

Source: Company, Violet Arch Research

Rs mn	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13
Top client	503	539	655	711	653	734	906	936	1,108
Growth QoQ	3%	7%	22%	8%	(8%)	12%	23%	3%	18%
Top 2-4 clients	400	491	448	400	550	529	510	649	843
Growth QoQ	39%	23%	(9%)	(11%)	37%	(4%)	(4%)	27%	30%
Top 5-10 clients	215	203	248	285	354	310	363	442	418
Growth QoQ	21%	(6%)	22%	15%	24%	(13%)	17%	22%	(5%)

Source: Company, Violet Arch Research

Key Risks and Concerns

Global economic slowdown

KPIT derives over 90% of its revenues from the US and Europe. With the euro zone struggling to revive its flagging economy and the US is yet to find a firm footing, any further deterioration would put pressure on companies, which, in turn, could exert pressure on their IT budgets.

In the US, non-farm payrolls improved to 163,000 in Jul'12, which is an improvement from the average of 73,000 in the preceding three months. The house price index rose, on a YoY basis, for the first time in 21 months. On the other hand, unemployment remained high at 8.3%, and the ISM manufacturing index remained in contraction mode for the last three months. US GDP is expected to remain below 2% for the third consecutive quarter in 3QCY12. Thus, the US economic data has remained mixed and the outlook remains uncertain along with added concerns of the fiscal cliff at the start of the next year.

In contrast, Europe data remained clearly weak for the last one year. The economy contracted sequentially for the last three quarters and unemployment has been on the rise. The composite PMI for the region has been in contraction mode in the last 12 months. The unemployment rate rose from 9.9% in Jun'11 to 11.2% in Jun'12. Thus, there are no signs of recovery in the near term with the economy reeling under pressure.

Revolo launch delayed

The company's hybrid kit, Revolo, is in testing mode, involving 150-200 vehicles. It has tied up with fleet operators to conduct on-road tests. The launch of the kit has been delayed for technical issues involving the battery life. Any further delay in the launch of Revolo may impact the company, as it could prove to be a future growth catalyst.

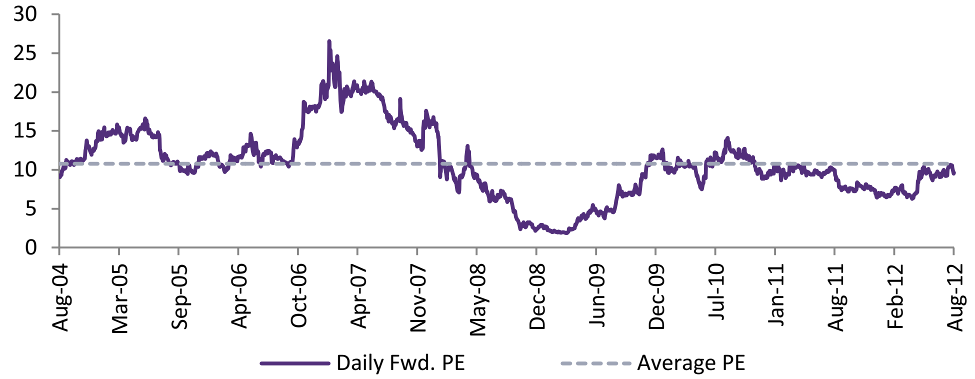
Currency volatility

Since March 2012, the Rupee has depreciated around 10% till date against the US dollar. A 1% change in the INR:USD can lead to EBITDA margins being impacted by 0.28%-0.30%. Hence, any form of volatility in the currency could impact the margin performance in the future.

Valuation

We initiate coverage with a Buy rating on the stock, by assigning a 11x P/E multiple, in line with its eight year historical average to our FY14E EPS of 14.8 and arrive at a target price of Rs 163. We believe our target multiple is backed by: 1) winning substantial deals across the SAP, 2) automotive and utilities space, 3) robust traction across client revenue buckets, and 4) aggressive client mining which are likely to drive a dollar revenue growth of 33% and 16% for FY13E and FY14E, respectively.

Historical 1-yr forward P/E



Source: Company, Violet Arch Research

Company Background

Founded in 1990, KPIT Cummins Infosystems is a leading technology solutions partner for global manufacturing companies, with a focus on automotive, energy & utilities, and industrial equipment industries. The company derives 76% of its revenues from the US, followed by Europe at 15%. The service offerings are focused across three SBUs in the form of SAP, Integrated Enterprise Solutions (IES), and auto and engineering. With its strong knowledge base of over 7,700 employees, the company has grown its revenues at a CAGR of 24% over FY09-12. Similarly, profits have grown at a CAGR of 30% over the same period.

With a strong client base of 172, KPIT derives 21% of its revenues from its top client, Cummins, which has seen strong growth over the year. Aggressive client mining has aided the company to expand its revenues, with clients contributing more than $1mn in revenues moving from 32 in Q1FY11 to 65 in Q1FY13. In June 2010, KPIT entered into a 50:50 JV with Bharat Forge to manufacture and market a hybrid technology solution for automobiles called Revolo. This is likely to increase the efficiency of existing and new cars by at least 40%, while helping to reduce emissions. Keeping in mind the key focus areas, KPIT has made several strategic acquisitions, which have given rich dividends.

KPIT Cummins – The journey

Name	Year	Size at time of Acquisition	Rationale
Cummins Infotech	2002	$ 1.0mn	Anchor Customer – Cummins, with focus on manufacturing
Panex Consulting	2003	$ 7.2mn	SAP Practice; Anchor Customer
SolvCentral.com	2005	$ 3.5mn	BI Practice; Anchor Customer
Pivolis	2005	$ 1.5mn	Direct Presence in France Geography
CG Smith Software	2006	$ 6.25mn	Auto Electronics Domain, Auto OEM & Tier I Customers
Harita TVS	2008	$ 1.0mn	MEDS Practice
Sparta Consulting	2009	$ 25mn	SAP Practice, US Geography presence in SAP
In2Soft	2010	$ 4mn	Vehicle Diagnostic & Telematics, German Frontline
CPG	2010	$11mn	Oracle Consulting
SYSTIME	2011	$ 50 Mn	Oracle Consulting, JDE Specialist

Source: Company, Violet Arch Research

Financial Summary - Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenues	**10,120**	**15,000**	**21,719**	**25,088**
Growth (%)	38.3	48.2	44.8	15.5
Cost of Revenue	8,598	12,819	18,353	21,091
EBITDA	**1,522**	**2,181**	**3,366**	**3,998**
Growth (%)	(5.7)	43.3	54.3	18.8
EBITDA Margin (%)	15.0	14.5	15.5	15.9
Other income	18	128	112	251
Depreciation	411	445	457	477
Interest	26	78	125	113
Pre-tax profit	**1,103**	**1,786**	**2,896**	**3,659**
Taxes	155	437	753	951
Effective Tax Rate (%)	14.0	24.5	26.0	26.0
Minority interest	2	31	12	0
Exceptional Items	0	100	27	0
Share of profit from associates	0	35	(10)	0
Net profit	**946**	**1,454**	**2,147**	**2,708**
Growth (%)	10.3	53.7	47.7	26.1
Net Profit Margin (%)	9.3	9.7	9.9	10.8
Shares o/s (mn nos.)	182	182	182	182
EPS	5.2	8.0	11.8	14.8

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Gross Block	2,836	3,711	4,580	5,584
Less: Acc. Depreciation	1,632	2,054	2,511	2,988
Net fixed assets	1,203	1,657	2,069	2,596
Capital Work-in-Progress	316	185	185	185
Investments	477	582	728	910
Sundry Debtors	2,538	4,544	6,587	7,609
Cash & Bank	2,080	1,473	2,687	4,304
Loans and Advances	1,111	1,253	1,253	1,253
Intangible Assets	1,360	3,633	3,633	3,633
Total Asset	**9,085**	**13,328**	**17,142**	**20,490**
Share capital	173	354	354	354
Share application money and ESOP	6	3	3	3
Reserves & surplus	5,854	6,768	8,715	11,169
Total Debt	1,038	2,486	2,486	2,486
Provisions	251	598	1,189	1,472
Other liabilities	1,701	2,820	4,096	4,708
Minority Interest	9	326	326	326
Deferred tax Liability	55	(27)	(27)	(27)
Total Equity & Liabilities	**9,085**	**13,328**	**17,142**	**20,490**

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Profit before Tax	**1,103**	**1,886**	**2,900**	**3,659**
Depreciation & Amortization	411	445	457	477
Interest	38	73	125	113
Other Income	(66)	(54)	(112)	(251)
Others	(20)	(208)	0	0
Change in working capital	(574)	(870)	(175)	(128)
Tax paid	249	268	753	951
Cash flow from operations (a)	**643**	**1,005**	**2,442**	**2,918**
(Inc.)/ Dec. in Fixed Assets	(419)	(603)	(869)	(1,004)
(Inc.)/ Dec. in Investments	(192)	(2,353)	(146)	(182)
(Inc.)/ Dec. in loans	(118)	62	0	0
Dividend and Interest income	55	66	112	251
Cash flow from investing (b)	**(675)**	**(2,828)**	**(902)**	**(935)**
Equity Raised	1,243	22	0	0
Inc./(Dec.) in debt	(97)	1,203	0	0
Dividend (incl. tax)	(64)	(72)	(201)	(253)
Interest	(38)	(69)	(125)	(113)
Cash flow from financing (c)	**1,043**	**1,084**	**(326)**	**(366)**
Net chg in cash (a+b+c)	**1,011**	**(739)**	**1,214**	**1,617**
Opening Cash balances	**1,001**	**2,080**	**1,473**	**2,687**
others	68	132	0	0
Closing Cash balances	**2,080**	**1,473**	**2,687**	**4,304**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Fully diluted Adj EPS (Rs)	5.2	8.0	11.8	14.8
Adj EPS growth (%)	10.3	53.7	47.7	26.1
EBITDA margin (%)	15.0	14.5	15.5	15.9
PAT margin (%)	9.3	9.7	9.9	10.8
ROCE	15.8	15.7	20.3	20.4
ROIC	21.4	20.0	25.3	28.0
ROE	19.1	22.1	26.5	26.3
Turnover Ratios				
Total Asset turnover (x)	1.1	1.1	1.3	1.2
Debtor days	91.5	110.6	111.0	111.0
Creditor days	40.0	50.0	50.0	50.0
Working capital days	61.2	57.9	42.9	39.0
Valuation				
P/E	24.8	16.1	10.9	8.6
P/BV	3.9	3.3	2.6	2.0
EV/EBITDA	14.7	11.2	6.9	5.4
EV/Sales	2.2	1.6	1.1	0.9

COMPANY REPORT

Equity Research l Mining

21 September, 2012

MOIL Ltd.

Mining a Fortune

Absolute Rating	BUY
Target Price	Rs 321
Downside	24%

We initiate coverage on MOIL Ltd. (MOIL) with a Buy rating. Following the company's IPO in December 2010, the stock has corrected by around 45% on the back of a similar fall in global manganese prices from US$7/mtu to US$4.63/mtu (49-50% grade). However, with the depreciation of the rupee and the increase in global manganese prices by about 12%, MOIL recently hiked its selling price of ore by 12-15%, which in our view is sustainable. The company is expected to clock a CAGR of 4.9% in sales volume and a CAGR of 15.6% in EBITDA growth over FY12-14E, with consistent free cash-flow generation. MOIL's net cash balance is expected to reach Rs 166/share (64% of the CMP) by end-FY14E. At the CMP, the stock trades at an attractive 2.7x EV/EBITDA and 8.2x P/E FY14E Valuations.

Manganese prices at their worst presumably over

Manganese ore prices declined by around 26% from US$7/mtu in December 2010 to US$5.2/mtu till date, resulting in the stock price correcting by around 45% over the same period. However, MOIL increased prices by 12-15% in July 2012. As per our understanding, manganese prices seems to have bottomed out and current prices are close to the marginal cost of production globally and hence unlikely to fall further.

Indirect steel play in import-dependent market

MOIL is India's largest producer of manganese ore in terms of volumes, with its FY12 production at around 1.1mn tonnes. The country's FY12 manganese ore demand of about 4.3mt was met through domestic production of around 2.9mn tonnes and about 1.4mn tonnes of imports. Further, a CAGR of around 8% in domestic steel production during FY12-15E provides good consumption visibility for manganese ore. Incidentally, around 33kg of manganese ore is required for production of one tonne of steel. MOIL is expected to exhibit a stable CAGR of 5% in sales volume growth over FY12-14E and post sales of 1.18mn in FY14E.

Strategic locations of mines provide competitive edge

Most of MOIL's mines are situated in Central India in Maharashtra (border) and Madhya Pradesh, which have well-developed road and rail infrastructure. This offers the company an edge over others in terms of lower transportation costs and faster delivery to customers.

FY14E cash forms around 65% of current market cap

We believe MOIL's production cost will be around Rs 4,075/tonne in FY13e and about Rs 4,150/tonne in FY14e. This, coupled with a low capex of Rs 8bn spread over the next five years, will result in the company continuing to generate free cash-flows even in a distress cycle. According to our estimate, the company's net cash per share would reach Rs 166 by FY14e (around 64% of the CMP) from Rs 124 in FY12.

Valuation

At the end FY14E, MOIL is likely to have cash and cash equivalents of Rs 28bn, translating to Rs166/share and accounting for about 65% of the current market capitalization. This we believe restricts the downside in terms of valuations. Further, the company operates at an EBITDA margin of around 50%, with around 45% share in India's manganese ore market, which augers well for the company. We value the stock at 4.5x EV/EBITDA (25%/34% discount to its average EV/EBITDA/P/E multiple at the time of its IPO) and arrive at a target price of Rs 321. As per our understanding, manganese prices seems to have bottomed out and current prices are close to the marginal cost of production globally and hence unlikely to fall further. However, they are not expected to reach levels seen in prior years and hence the discount. Initiate with a Buy.

Y/E Mar 31 (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	11,400	8,996	9,710	10,719
EBITDA	7,672	4,332	5,146	5,788
EBITDA margins (%)	67.3	48.2	53.0	54.0
EBITDA growth (%)	28.8	(43.5)	18.8	12.5
Net profit	5,881	4,108	4,742	5,321
Net profit growth (%)	26.1	(30.1)	15.4	12.2
Net profit margin (%)	51.6	45.7	48.8	49.6
FDEPS (Rs)	35.0	24.5	28.2	31.7
FDEPS growth (%)	26.1	(30.1)	15.4	12.2
P/E(x)	7.4	10.6	9.2	8.2

Source: Company, Violet Arch Research

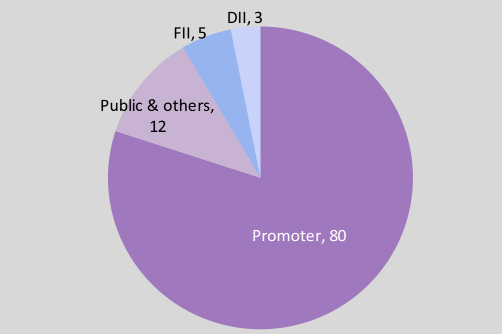
Stock data

CMP	**Rs 259**
Reuters Code	MOIL.BO
Bloomberg Code	MOIL IN
Equity Shares o/s (mn)	168
Market Cap (Rs mn)	43,478
Market Cap (USD mn)	816
3m Avg daily t/o(US$ mn)	0.5

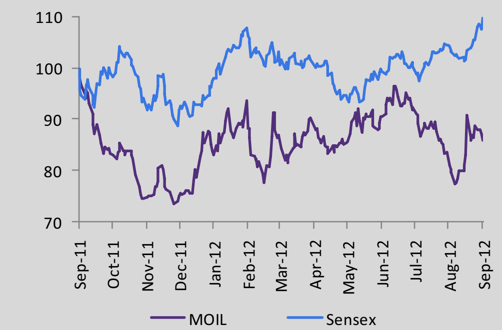
Stock performance (%)

52-week high / low			**Rs 315/216**
	1M	**3M**	**12M**
Absolute	4.5	(4.9)	11.2
Relative	(0.6)	(15.4)	(27.2)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

(FY14E)	Bull Case	Base Case	Bear Case
Manganese realization (Rs/tonne)	9,013	8,194	7,374
Manganese sales volumes (mn Tonnes)	1.31	1.19	1.07
EBITDA (Rs mn)	7,134	5,788	4,084
Inc/dec from base case (%)	23.3	-	(29.4)
EPS (Rs.)	37.3	31.7	24.5
Inc/dec from base case (%)	17.8	-	(22.7)
CMP (Rs.)	259	259	259
Target price (Rs.)	**363**	**321**	**255**
Upside (%)	**40.2**	**23.9**	**(1.5)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY11	FY12	FY13E	FY14E
Manganese ore sales volumes (tonnes)	999,249	1,078,263	1,120,000	1,187,200
Manganese ore realization/tonne (Rs)	10,701	7,516	7,840	8,194
Ferro manganese sales volumes (tonnes)	6,903	13,239	13,901	14,596
Ferro manganese realisation per tonne (Rs)	65,631	55,219	56,000	57,500

Source: Company, Violet Arch Research

Base case

- We have factored in a 3.9% YoY growth in FY13 sales volumes to 1.12mn tonnes and a further 6% YoY increase to 1.187mn tonnes in FY14. Incremental volume in FY13 is likely to come from the company's Gumgaon mine where production is expected to go up from 0.06mn tonnes to 0.1mn tonnes. Further, the company is in the process of deepening the production shaft at the Balaghat mine which will support the incremental volumes in FY14.
- Realisation per tonne is expected to increase by 4.3% YoY to Rs 7,840/tonne in FY13E, and further by 4.5% YoY in FY14E to Rs 8,194/tonne. This is on the back of increase in international manganese prices coupled with a weaker rupee.
- Ferro manganese sales volumes are expected to increase 5% each in FY13E to 13,900 tonnes, and further to 14,596 tonnes in FY14E, with realisations at Rs 56,000/tonne and Rs 57,500/tonne in FY13E and FY14E, respectively. The company has beneficiation plants at its Balaghat and Dongri Buzurg mines, with a processing capacity of 0.5mn tonnes and 0.4mn tonnes respectively. Beneficiation of ore helps the company upgrade manganese ore of below 44% grade to above 46% grade. This high-grade ore is commercially sold and consumed internally for production of value-added products such as High Carbon Ferro Manganese (HFCM) and Electrolytic Manganese Di-oxide (EMD).

Bull case

- We factor in higher manganese ore realization of Rs 9,013/tonne and sales volumes of 1.31mn tonnes in FY14E, assuming high amount of inventory liquidation, leading to an EBITDA growth of 23.3% from our base case and PAT to grow at 17.8% YoY in FY14E.

Bear case

- We factor in manganese realization of Rs7,374/tonne assuming prices were to fall below FY12 average realization of Rs7,516/tonne and sales volumes of 1.07mn tonnes assuming no incremental production or inventory liquidation, which could lead to EBITDA falling by 29.4% YoY and PAT to fall 22.7% from our base case scenario in FY14E.

SWOT Analysis

Strengths

1) MOIL is the largest producer of high grade manganese ore in India, and supplies around 45% of manganese dioxide ore in India.

2) The company owns 10 mines, which constitute about 60% of the total demonstrated reserves of ferro grade manganese ore in India.

3) Joint ventures with SAIL as well as Rashtriya Ispat Nigam Ltd. (RINL) to set up plants for production of ferro alloys.

4) Balaghat mine operated by MOIL has one of the best quality manganese ore in India, with 40% grade and 21.3mn tonnes of reserves.

5) MOIL has zero debt on the balance sheet, with cash reserves of Rs 20.8bn at the end of FY12.

Weaknesses

1) Performance of MOIL is dependent on the steel industry, as the market for manganese ore is linked to fortunes of the steel industry.

2) The operations of MOIL are labour-intensive, thus making the company highly sensitive to labour laws. Employee costs accounted for 26% of sales and 51% of total costs in FY12.

SWOT Analysis

Opportunities

1) Demand for MOIL's products are expected to go up, as its largest client, SAIL, is expanding capacity from 13.8mn tonnes to 14.6mn tonnes by FY15E.

2) Government of India's spending on infrastructure development is expected to keep the demand for steel high.

3) India's manganese reserve deposits are the world's second-largest in the world, totaling 240mn tonnes.

Threats

1) Changes in policy of the Government of India for manganese ore may affect the performance of the company.

2) Hike in the cost of transportation, labour and power may also affect the performance of the company.

3) While royalty is borne by the buyer, any increase in these rates and implementation of local development funding norms equal to the royalty paid could affect volumes. Currently, royalty on manganese ore stands at 4.2% of sale price.

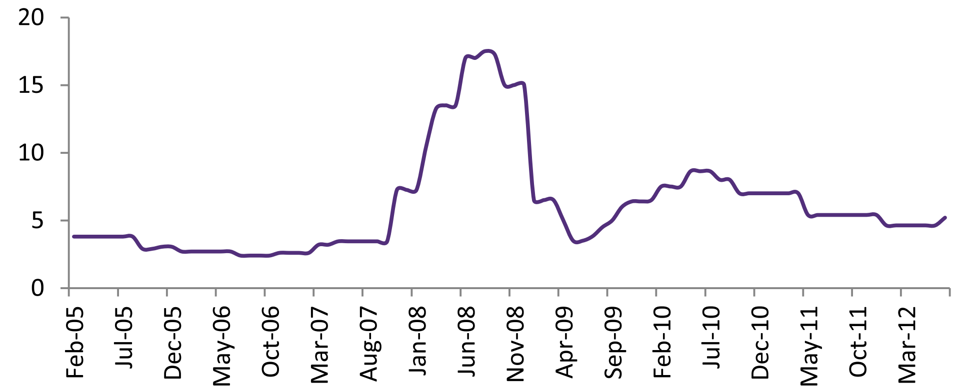
Source: Violet Arch Research

Investment Arguments

Manganese prices at their worst presumably over

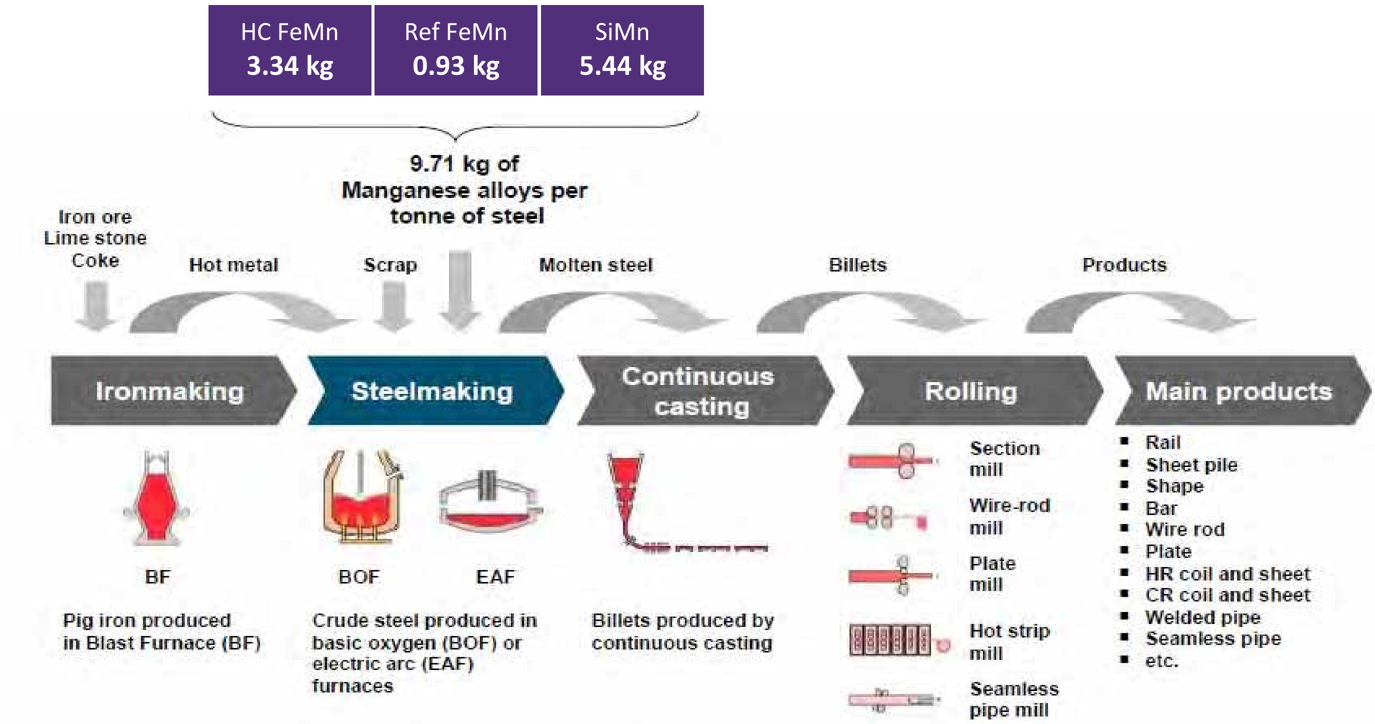
In the light of the steel growth forecast, we expect MOIL's blended realization to improve in FY13E by 4.3% to Rs 7,840/tonne, and further grow by 4.5% to Rs 8,194/tonne. Moreover, according to the management, the recent fall in prices helped the company to re-align the marginal cost of production. If the prices had remained unsustainable for long, they would have resulted in production curtailments. However, prices are not expected to reach levels seen during FY09 and FY11 of around Rs 11,000/tonne over the next two years, due to the surplus in the manganese ore market and also because of the overall economic environment. Hence, since the current prices are close to the marginal cost of production globally, the same is unlikely to fall further.

Mn ore 48-50% Europe spot price (USD/mtu)



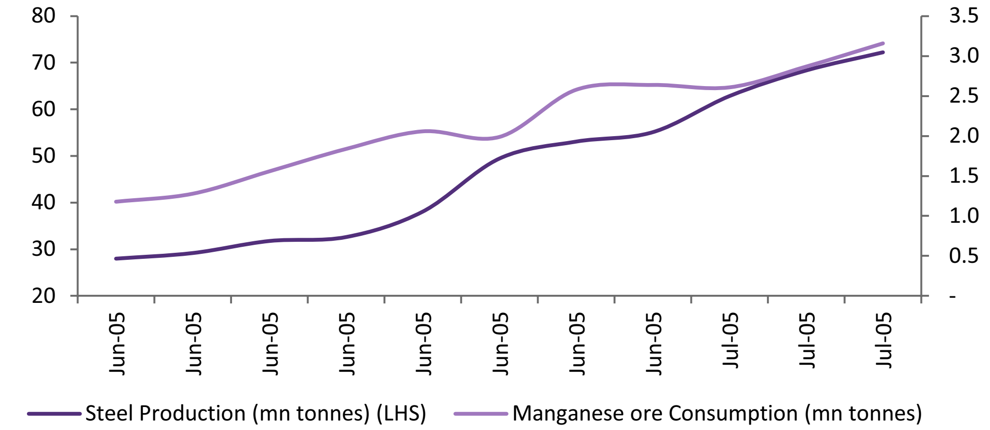
Source: Company, Violet Arch Research

Indirect steel play in import dependent market



Source: Company, Violet Arch Research

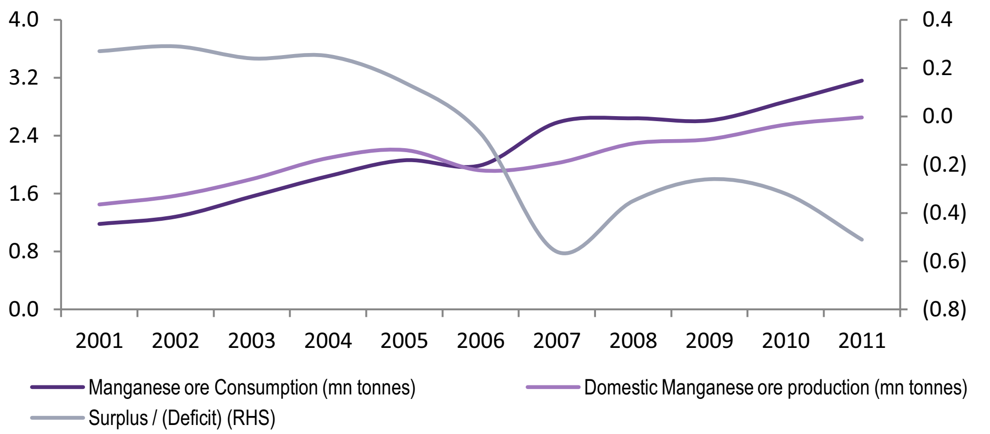
Manganese consumption has direct correlation with steel production



Source: Company, Violet Arch Research

Demand for manganese is directly correlated with growth of steel production, as 90% of the output is used in an alloy form as high carbon manganese (HCMn and SiMn) in steel making. While manganese used per tonne of steel varies depending upon the type of steel produced, on an average, about 8kg of manganese is required to produce a tonne of steel. Domestically, consumption of manganese ore grew at a CAGR of10.4% over CY01-11 compared to domestic steel production at a CAGR of 9.9% during the same period.

Domestic production continues to lag consumption

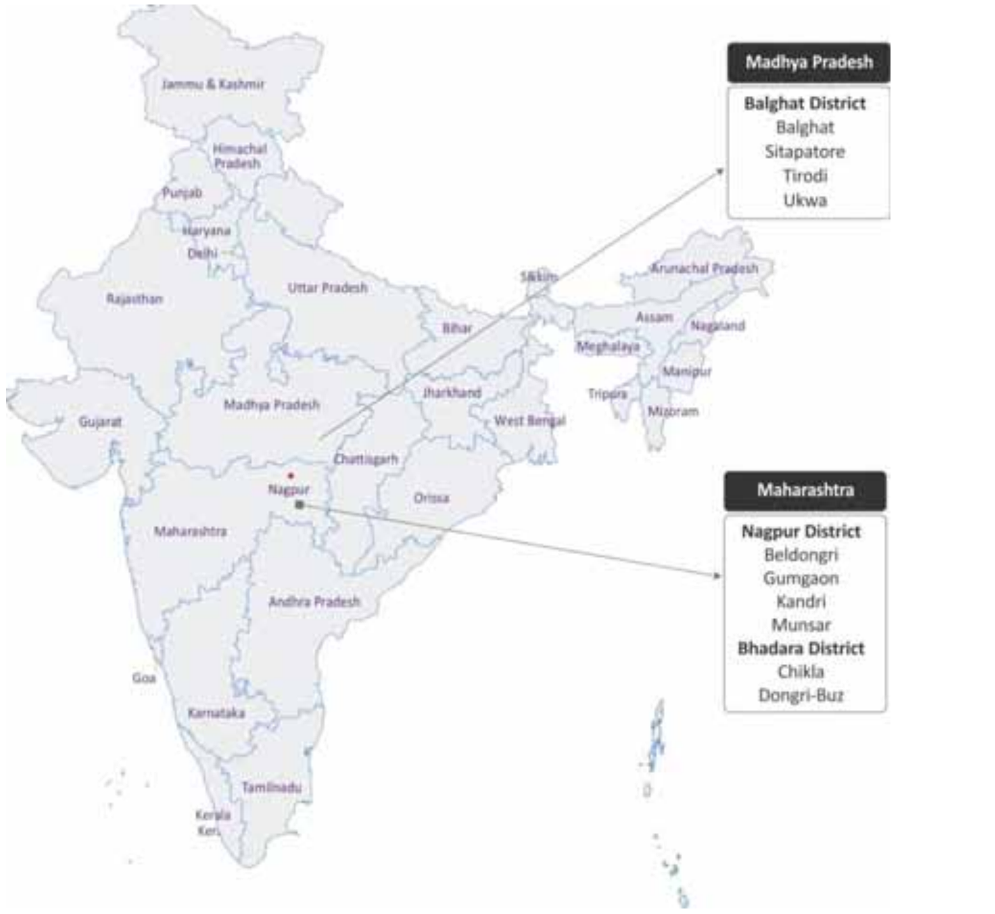


Source: Company, Violet Arch Research

As domestic manganese production continues to lag demand, the industry has been importing ore since 2007. Domestic manganese ore production has grown at a CAGR of 6.2% from 2001 to 2011 compared to domestic steel production growth of 10.4%. Further, with domestic steel production poised for growth due to outlays in projects that are underway or completed, additional capacities of nearly 20mn are expected over the next three years.

Strategic location of mines provides competitive edge and pricing power

Most of MOIL's mines are situated in Central India away from ports, thereby giving the company protection against imports. Further, the company has access to the best quality manganese ore in the country, with an average grade of around 40% compared to about 34% of domestic players. This has resulted in its products commanding a premium over competitors. MOIL sells its ore through a quarterly pricing mechanism, resulting in a faster alignment on the import parity basis. Currently, the import duty on manganese ore stands at 2.5%.



Source: Company, Violet Arch Research

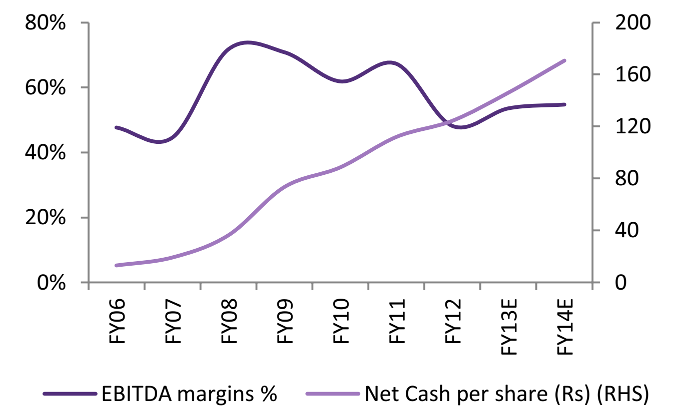
SAIL and RINL JVs for value-added products to help enhance margins

MOIL has entered into two JVs, with SAIL and RINL, to set up ferro alloy plants in Chhattisgarh and Andhra Pradesh, respectively. These plants are expected to produce ferro manganese and silico manganese to secure further potential sources of demand for manganese ore and capture a larger part of the value chain from the sale of these value-added products. This move is in line with the company's aim to maintain its leadership position in the Indian manganese ore market by increasing production capacity to keep pace with demand growth, expanding the value-added product line to capture industry trends, controlling costs, and strengthening relationships with customers. Besides, the company has set up beneficiation plants at its Balaghat and Dongri Buzurg mines, with a processing capacity of 500,000 tonnes and 400,000 tonnes, respectively. Beneficiation of ore helps the company upgrade manganese ore of below 44% grade to above 46% grade. This high-grade ore is commercially sold and consumed internally for production of value-added products such as high-carbon ferro manganese (HFCM) and electrolytic manganese dioxide (EMD).

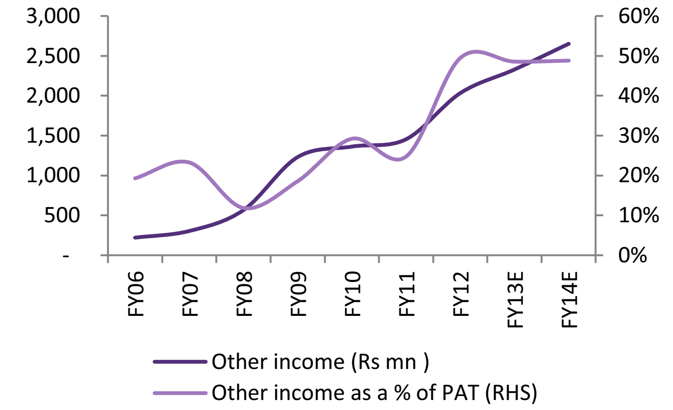
Strong cash generation to continue

MOIL has planned a relatively low weighing (intensity) capex of around Rs 8bn over the next 5 years. This, coupled with healthy EBITDA margins even in a depressed manganese cycle, has resulted in net cash per share increasing from Rs 13 in FY06 to Rs 124 in FY12. We expect the same to further increase to Rs 166/share in FY14E, representing about 65% of the current market capitalization.

Net cash/share expected to increase to Rs166/share



Other income to account for 48.5% of PAT in FY14E



Source: Company, Violet Arch Research

Key Risks and Concerns

Inability to increase production could lead to lower-than-estimated earnings

While FY12 production at 1.07mn tonnes was below MOIL's target of 1.2mt, sales volumes rose 8% to 1.08mn tonnes. The company expects FY13 volumes to rise to 1.15mn tonnes, but we have estimated a slightly lower number at 1.12mn tonnes. However, if it is unable to meet the expectations, earnings could be lower than our estimates.

Weak manganese ore prices

MOIL sets prices every quarter based on global price trends and demand-supply in India. The company's average realizations fell from Rs 11,600/tonne in FY09 to Rs 7,516/tonne in FY12, a drop of 35%, with a part of the drop due to a higher share of fines in the sales mix. Although the company has raised prices recently after six consecutive quarters of price cuts, its realizations could be adversely affected if global prices continue to remain weak going forward.

Prices of manganese ore have a direct co-relation with supply-demand dynamics of the global ferro alloys market. Hence, the fall in prices was largely due to increase in supply and stable demand. Hence, if supply continues to grow at a rapid pace and demand at a moderate one, then prices could fall.

Regulatory overhang and delays in capex implementation

Currently, MOIL is in midst of a capex programme to increase its capacity to 2mn tonnes per annum by CY20. Production is expected to ramp-up to 1.6mtpa starting FY15. However, the Indian mining sector could face higher expenses in the form of increased royalty rates and implementation of local development funding requirement equal to the royalty paid. This could lead to the company moderating its capex plans and inturn impact long-term volume visibility.

Valuation

At the end FY14E, MOIL is likely to have cash and cash equivalents of Rs 28bn, translating to Rs166/share and accounting for about 64% of the current market capitalization. This we believe restricts the downside in terms of valuations. Further, the company operates at an EBITDA margin of around 50%, with around 45% share in India's manganese ore market, which augers well for the company. As per our understanding, manganese prices seems to have bottomed out and current prices are close to the marginal cost of production globally and hence unlikely to fall further.

We initiate coverage on MOIL with a Buy rating and a target price of Rs 321. At our target price, the stock will trade at an EV/EBITDA of 4.5x FY14E. We value MOIL at a discount to its international peers as their revenue stream is diversified unlike MOIL, which is dependent on a single commodity. Further, our DCF values the stock at Rs 429/share, assuming a mine-life of 30 years.

EV/EBITDA	FY14E
EBITDA (Rs mn)	5,788
Multiple applied	4.5
EV (Rs mn)	26,047
Less:- Net debt	(27,917)
Target M.Cap (Rs mn)	53,964
Total Shares O/S (mn)	168
Target Price	**321**
CMP	**260**
Upside (%)	**23.6**

Source: Company, Violet Arch Research

Company	Revenue (Rs.bn)			EBITDA (Rs. bn)			PAT (Rs. bn)			EPS (RS)			ROE (%)			P/E (x)			EV/EBITDA (x)		
	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E	CY11E / FY12	CY12E / FY13E	CY13E / FY14E
Eramet	236	246	265	54	37	49	17	8	14	652.8	317.0	533.5	8.4	3.1	7.1	9.6	19.9	11.8	3.7	5.5	4.1
Assore Ltd	84	93	98	41	46	48	25	29	31	231.4	258.0	271.7	34.3	33.9	29.5	8.8	7.9	7.5	6.8	6.1	5.8
Vale SA	3,044	2,763	3,048	1,800	1,324	1,597	1,216	790	872	228.8	155.7	180.3	30.1	18.9	18.2	4.0	5.8	5.0	3.5	4.7	3.9
Eurasian Resources	389	378	429	178	126	147	104	55	66	80.4	44.5	52.6	18.9	8.5	9.4	3.3	5.9	5.0	4.9	6.9	5.9
BHP Billiton Ltd	3,964	4,055	4,349	1,848	1,890	2,061	934	905	1,013	176.4	168.6	190.7	26.3	21.3	21.2	10.2	10.7	9.4	5.9	5.7	5.3
Rio Tinto PLC	3,005	3,068	3,429	1,355	1,181	1,399	760	616	693	398.9	336.0	384.8	24.8	19.3	18.6	6.1	7.2	6.3	7.0	8.0	6.8
AVERAGE																**7.0**	**9.6**	**7.5**	**5.3**	**6.2**	**5.3**
MOIL Ltd	**9.0**	**9.7**	**10.7**	**4.3**	**5.1**	**5.8**	**4.1**	**4.7**	**5.3**	**24.5**	**28.2**	**31.7**	**16.8**	**16.8**	**16.3**	**10.6**	**9.2**	**8.2**	**5.2**	**3.7**	**2.7**

Source: Company, Violet Arch Research

Company Background

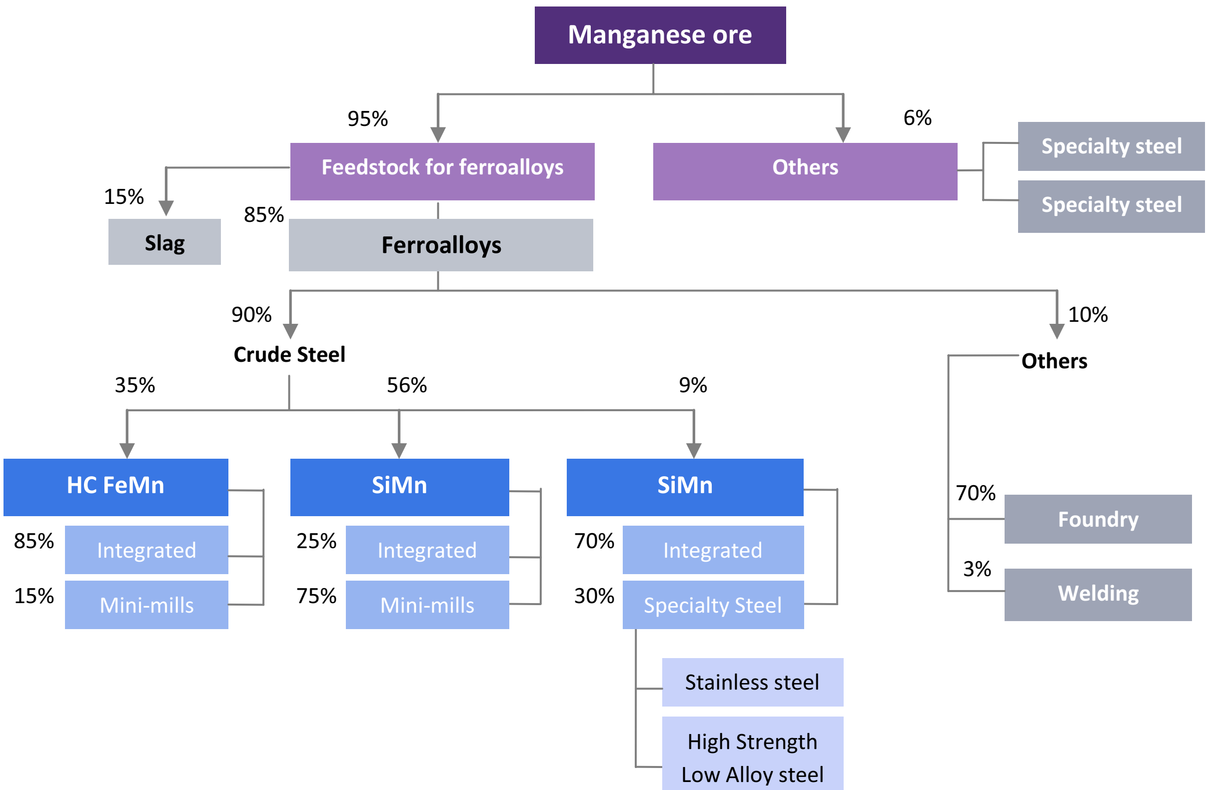
MOIL Ltd., erstwhile Manganese Ore (India) Ltd., is the largest manganese ore producer in India. In FY12, the company produced around 1.1mn tonnes of manganese ore. It has about 22mn tonnes of reserves, representing around 16% of the country's reserve base. Around 50% of MOIL's reserves have an average manganese content of over 40% and 27.5% an average manganese content ranging from 36-39.9%. None of its mines produce low-grade manganese (below 30% of the manganese content). Established in 1962, MOIL currently has 71.6% of its shares held by the Central government, 4.6% by the Maharashtra government and 3.8% by the Madhya Pradesh government. The company operates 10 mines: four in Madhya Pradesh and six in Maharashtra.

Centrally located mines leading to transportation savings

Mine Name	State	Method	Ore	Grade	Proved	Probable	Total	Measured	Indicated	Inferred	Total
Balaghat	Madhya Pradesh	UG	Oxide	40.0%	6.9	2.1	9	12.7	7.1	1.5	21.3
Dongri Buzurg	Maharashtra	OC	Dioxide	42.0%	3	0	3	3.3	7.5	0.2	11
Chikla	Maharashtra	UG	Oxide	36.0%	0.5	0.6	1.1	1.2	2.4	0.6	4.2
Tirodi	Madhya Pradesh	OC	Oxide	32.0%	0.1	0.8	0.9	1.2	0	0.5	1.7
Kandri	Maharashtra	UG	Oxide	38.0%	0.4	0	0.4	0.6	2.7	0	3.3
Beldongri	Maharashtra	UG	Oxide	30.0%	0.2	0	0.2	0.4	0.1	0	0.5
Ukwa	Madhya Pradesh	UG	Oxide	38.0%	1.4	1.4	2.8	4.4	1.4	3	8.8
Munsar	Maharashtra	UG	Oxide	32.0%	0.1	1.2	1.3	0.7	2.5	1.5	4.7
Gumgaon	Maharashtra	UG	Oxide	36.0%	1.6	0	1.6	2.6	0.6	0.7	3.9
Sitapatore/Sukli	Madhya Pradesh	OC	Oxide	31.0%	0	0	0	0	0.2	0.2	0.4
Dumps					1.4	0	1.4	9.7	0	0	9.7
Total					**15.6**	**6.1**	**21.7**	**36.8**	**24.5**	**8.2**	**69.5**

Source: Company, Violet Arch Research

Manganese consumption



Source: Company, Violet Arch Research

Financial Summary

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**11,400**	**8,996**	**9,710**	**10,719**
growth (%)	18.4	(21.1)	7.9	10.4
Operating expenses	3,728	4,664	4,564	4,931
EBITDA	**7,672**	**4,332**	**5,146**	**5,788**
growth (%)	28.8	(43.5)	18.8	12.5
Depreciation	325	299	323	370
EBIT	**7,347**	**4,033**	**4,823**	**5,419**
Interest paid	-	-	-	-
Other income	1,455	2,033	2,307	2,582
Pre-tax profit	8,801	6,066	7,131	8,001
Tax	2,921	1,959	2,389	2,680
Effective tax rate (%)	33.2	32.3	33.5	33.5
Net profit	5,881	4,108	4,742	5,321
Adjusted net profit	5,881	4,108	4,742	5,321
growth (%)	26.1	(30.1)	15.4	12.2
Shares o/s (mn nos)	168	168	168	168

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Gross Block	**3,965**	**4,226**	**4,616**	**5,280**
Less:- Accumulated depreciation	1,905	2,155	2,478	2,848
Net fixed assets	**2,060**	**2,070**	**2,138**	**2,432**
C.WIP	**288**	**390**	**664**	**995**
Investments	22	42	42	42
Other non-curr assets	748	1,187	1,299	1,398
Current assets				
Inventories	974	813	894	972
Sundry Debtors	680	993	1,093	1,180
Cash and cash equivalents	18,797	20,884	24,289	27,917
Loans and advances	828	993	1,052	1,105
Total assets	**24,397**	**27,374**	**31,471**	**36,042**
Shareholders' funds				
Share capital	1,680	1,680	1,680	1,680
Reserves & surplus	19,603	22,733	26,619	31,031
Total Debt				
Secured loans	-	-	-	-
Unsecured loans	-	-	-	-
Other liabilities				
Curr Liab & prov				
Current liabilities	1,544	1,689	1,774	1,863
Provisions	1,570	1,271	1,398	1,468
Total liabilities	**3,114**	**2,960**	**3,172**	**3,331**
Total equity & liabilities	**24,397**	**27,374**	**31,471**	**36,042**

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit	**8,801**	**6,066**	**7,131**	**8,001**
Depreciation	325	299	323	370
Other Income	1,455	2,033	2,307	2,582
Tax paid	2,921	1,959	2,389	2,680
Chg in working capital	**604**	**529**	**268**	**228**
Other operating activities				
Cash flow from operations (a)	**5,354**	**2,902**	**3,025**	**3,336**
Capital expenditure	(460)	(364)	(664)	(995)
Chg in investments	(20)	(20)	-	-
Other investing activities	(344)	(495)		
Cash flow from investing (b)	**(824)**	**(879)**	**(664)**	**(995)**
Equity raised/(repaid)	-	-	-	-
Debt raised/(repaid)	-	-	-	-
Dividend (incl. tax)	(1,371)	(978)	(1,179)	(1,278)
Chg in minorities				
Other financing activities	(688)	(991)	(85)	(17)
Other Income	1,455	2,033	2,307	2,582
Cash flow from financing (c)	**(604)**	**65**	**1,043**	**1,288**
Net chg in cash (a+b+c)	**3,926**	**2,088**	**3,405**	**3,628**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	35.0	24.5	28.2	31.7
Adj EPS growth (%)	26.1	(30.1)	15.4	12.2
EBITDA margin (%)	67.3	48.2	53.0	54.0
Pre-tax margin (%)	77.2	67.4	73.4	74.6
ROE (%)	27.6	16.8	16.8	16.3
ROCE (%)	**32.3**	**19.1**	**18.9**	**18.1**
Turnover & Leverage ratios (x)				
Asset turnover (x)	0.5	0.4	0.3	0.3
Leverage factor (x)	-	-	-	-
Net margin (%)	51.6	45.7	48.8	49.6
Net Debt/Equity (x)	-	-	-	-
Working Capital & Liquidity ratio				
Inventory days	126	64	72	72
Receivable days	22	40	41	40
Payable days	27	40	40	38
Valuations				
PER (x)	7.4	10.6	9.2	8.2
Price/Book value (x)	2.1	1.8	1.5	1.3
EV/EBITDA (x)	3.2	5.3	3.8	2.7

COMPANY REPORT

Equity Research | Oil & Gas

21 September, 2012

Mangalore Refinery and Petrochemicals Ltd.

Surging Ahead

Absolute Rating	BUY
Target Price	Rs 83
Upside	38%

Mangalore Refinery and Petrochemicals Ltd. (MRPL), a pure refinery with an installed capacity of 11.8mtpa and a Nelson complexity factor of 5.5, is all set to benefit from its capacity expansion/upgradation initiative. This initiative, we believe, would lead to a significant improvement in GRMs over FY12-14, where the company would be operating at enhanced capacity levels of 15.4mtpa, with a Nelson complexity factor of 9.0. We expect the company to post a robust CAGR of 25% on the profitability front over FY12-14 on the back of revenue growth (CAGR 12.0%) and a GRM improvement ($2.5/barrel). We initiate coverage on the MRPL stock with a Buy recommendation and at a target price of Rs 83, with a potential upside of around 38% from current levels by assigning 5.5x EV/EBITDA multiple to FY14E.

Expansion and upgradation to catapult MRPL into league of complex refiners

MRPL is undergoing Phase-III refinery expansion and upgradation, which will increase its refinery capacity from the current 11.8mtpa to 15.4mtpa, with the Nelson complexity factor increasing from 5.5 to 9.0 by end-FY13. The expansion/upgradation will help to: a) process more low-cost high sulphur/high-acid heavy crude oil, b) increase the distillate yield by upgrading low-value black oil, c) produce value-added products such as propylene, and d) upgrade its total diesel pool to the superior (Euro III/IV/V) grade. The MRPL management has guided towards Phase-III refinery expansion/upgradation completion by November 2012.

GRM to improve significantly post-expansion/upgradation

MRPL's product slate before expansion/upgradation was 20% light distillate, 52% middle distillate and 27% heavy distillate. After upgradation, with the Nelson complexity factor at 9.0, the product slate would improve to 30% light distillate, 54% middle distillate and 16% heavy distillate, which will result in improved margins. Also, the company will be able to refine heavier and sour grades of crude, which will help improve GRMs. With Single Point Mooring becoming operational, the company will also be able to save freight costs of $0.5/bbl to $1/bbl. As per the management guidance, GRMs will rise by $5/bbl from current levels.

Valuations

While earnings remained subdued over the last three years led by the lack of improvement in GRMs, the absence of capacity expansion, high interest costs and volatility in crude prices, we believe that MRPL has taken considerable strides on the business front, which would yield results in FY14 (capacity expansion by 30.0% and an improved Nelson Complexity factor, leading to higher GRMs). We expect GRMs to improve to $7.5/bbl in FY14 compared with the average of $5.3/bbl during FY10-12. MRPL stock has traded at an EV/EBITDA of 6.7x during this period. An increased capacity, coupled with a better complexity factor, will restore the firm to the earnings growth trend in FY14. We value MRPL at Rs 83 based on 5.5x FY14E EV/EBITDA, notably at a discount to historical multiple enjoyed by the stock.

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	389,567	537,703	593,319	674,158
EBITDA	20,157	16,134	12,306	37,586
Margins (%)	5.2	3.0	2.1	5.6
Growth (%)	5.2	(20.0)	(23.7)	205.4
Adj. Net Profit	11,766	9,086	2,042	14,282
Adj. EPS (Rs)	6.2	4.9	1.1	7.8
EPS growth (%)	5.8	(20.4)	(77.5)	599.5
PER (x)	9.7	12.1	54.0	7.7
PBV (x)	1.7	1.5	1.5	1.3
EV/EBITDA (x)	4.9	7.9	14.8	4.4
AROE (%)	18.0	12.6	2.8	17.1
AROCE (%)	21.3	10.6	3.8	17.2

Source: Company, Violet Arch Research

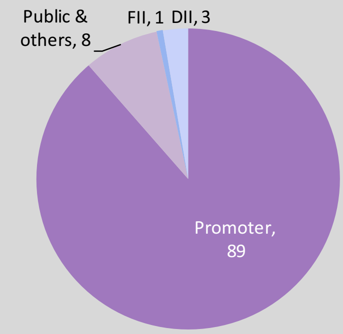
Stock data

CMP	**Rs 60**
Reuters Code	MRPL.BO
Bloomberg Code	MRPL IN
Equity Shares o/s (mn)	1,753
Market Cap (Rs mn)	108,068
Market Cap (USD mn)	1,973
3m Avg daily t/o(US$ mn)	0.8

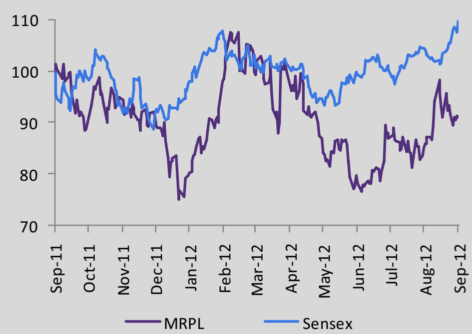
Stock performance (%)

52-week high / low			**Rs 75/49**
	1M	**3M**	**12M**
Absolute	(4.6)	10.2	(5.8)
Relative	(9.7)	(0.3)	(21.8)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull Case	Base case	Bear Case
GRM (USD/bbl)	8.5	7.5	6.5
Capacity utilization (%)	100	100	90
EBITDA (Rs mn)	43,552	37,586	28,458
Inc/(Dec) from base case (%)	15.9		(24.3)
EV/EBITDA multiple (x)	5.5	5.5	5.5
EV (Rs mn)	239,535	206,722	156,518
Inc/(Dec) from base case(%)	15.9		(24.3)
Net Debt (Rs mn)	51,798	54,868	62,717
Inc/(Dec) from base case (%)	(5.6)		14.3
Mcap target (Rs mn)	187,737	151,854	93,801
No of shares (mn)	1,838	1,838	1,838
Target share price (Rs)	102	83	51
Inc/(Dec) from base case(%)	23.6		(38.2)
CMP (Rs)	**60**	**60**	**60**
Upside (%)	**70.2**	**37.7**	**(14.9)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY11	FY12	FY13E	FY14E
Capacity (mt)	11.8	11.8	15.4	15.4
Capacity Utilization (%)	107	108	90	100
GRM ($/bbl)	6.0	5.6	5.0	7.5

Source: Company, Violet Arch Research

Base case

- We expect the company to operate at 90% and 100% capacity utilization in FY13 and FY14, respectively, at enhanced capacity of 15.4mtpa (The refinery has been running at above 100% capacity utilization for last five years and management has given guidance of 100% capacity utilization for FY13 and FY14).
- The management expects the expansion/upgradation to complete by Nov'12 which will result into improved distillate, superior product quality, sourcing of cheaper crude and consequently GRMs to improve by $5/bbl. We expect benefits of this to accrue in FY14 and estimate GRMs of $5/bbl and $7.5/bbl in FY13 and FY14, respectively (vis-à-vis average of $5.3/bbl over last three years).
- MRPL incurred a forex loss of Rs 6.5bn in Q1FY13. For the remaining three quarters of FY13, we do not expect MRPL to report any large forex losses as we expect rupee to remain stable at these levels or appreciate slightly. We maintain the same exchange rate assumption for FY14 and hence no losses.
- MRPL has incurred inventory loss of Rs 7.3bn in Q1FY13. Over the last three years, the company has not accrued any inventory losses, as losses in few quarters were more than offset by gains in other quarters. Over full year the company has never recorded any inventory losses as losses in one quarter had been offset over next few quarters. The recovery in crude prices after June 2012 will offset the losses in Q1FY13, and we have not factored in further inventory losses in FY13 and FY14 in line with the past trend.
- We estimate debt to increase by Rs 20,871mn by FY14 to fund the remaining capex (total of Rs 63,000 mn). Net debt/equity will stand at 0.6x/0.5x in FY13/FY14.

Bull case

- Led by strong global economic recovery, the global refining sector could bounce to post high margins as observed in FY08. In such a scenario, MRPL could achieve GRMs of $8.5/bbl which will lead to an EBITDA (FY14) growth of 83% over FY12. Based on our EV/EBITDA multiple of 6x, it will lead to a target price of Rs 96.

Bear case

- If the global economy and refining deteriorate from the current scenario, we expect MRPL to record GRMs of $6.5/bbl and a capacity utilization of 90%, leading to an EBITDA (FY14) growth of 76%. An EV/EBITDA multiple of 5x will lead to a target price of 49.

SWOT Analysis

Strengths

1) Capacity to increase from around 12mtpa to about1 5mtpa.

2) Nelson complexity factor to improve from the current 5.5 to 9.0.

3) Strong promoter with ONGC holding an 71.63% stake and HPCL holding 16.96% stake.

4) Strong balance sheet with D/E at 0.5x and cash at Rs 22347mn as of FY12.

Threats

1) Globally, growth in refinery capacity additions is expected to outpace demand over next few years, putting pressure on operating volumes and margins.

2) The US and the EU imposing sanctions to curb imports from Iran.

3) Once outages and maintenance shutdowns are over, then from Dec'12, its expected Chinese players will commence new capacities/increase production, bringing down global product spreads.

SWOT Analysis

Weaknesses

1) The expansion/upgradation project has suffered numerous delays in the past, and the commissioning of PFCCU and DCU is dependent on BHEL's implementation of CPP on time.

2) The company does not have a strong presence in the retail marketing segment.

Opportunities

1) Middle distillate sector will continue to remain the driver for Asian refining margins.

2) The company embarking in the petchem segment with a polypropylene unit.

3) Setting up of linear alkyl benzene plant, a raw material for manufacturing detergents, and a further expansion of the refinery to 21mtpa as per the MoU signed with the Government of Karnataka.

Source: Violet Arch Research

Investment Arguments

Expansion and upgradation to catapult MRPL into league of complex refineries

Phase-III refinery expansion and upgradation

MRPL has undertaken Phase-III refinery expansion and upgradation, with the objective to step up its refinery capacity from the current 11.820mtpa to 15.420mtpa and scale up the Nelson complexity factor from the present 5.5 to 9. The expansion/upgradation is expected to help the company to process more low-price high-sulphur/high-acid and heavy crude oil, increase distillate yields by upgrading low-value black oil, produce value-added products such as propylene, and upgrade its total diesel pool to the superior (Euro III/IV/V) grade.

MRPL's expansion and upgradation includes a crude distillation unit (CDU)/vacuum distillation unit (VDU) of 3mmtpa, a petro fluidized catalytic cracking unit (PFCCU) of 2.2mmtpa, a coker heavy gas and oil treating unit (CHT) of 0.65mmtpa, a delayed coker unit (DCU) of 3.0mmtpa, a hydrogen generation unit (HGU), a diesel hydro treater unit (DHDT), a sulphur recovery unit (SRU), and a captive power plant (CPP).

Single Point Mooring (SPM)

MRPL is also setting up an offshore SPM facility at an investment of Rs 10bn in the vicinity of Mangalore Port, with a view to receive crude oil in very large crude carrier (VLCC) tankers at substantial savings in freight charges. Currently, MRPL is sourcing crude through Aframax tankers, which have a capacity of 100,000 tonnes, while VLCC tankers have a capacity of 250,000 tonnes. The SPM will also enable MRPL to source Venezuelan and West African crude, which can be processed economically. De-congestion of existing jetties at New Mangalore Port Trust (NMPT) will result in handling of more petroleum products. According to company sources, the SPM would result in savings of $0.5-1.0/bbl at gross levels. The SPM is expected to begin trial operations by the end of September 2012.

Polypropylene plant

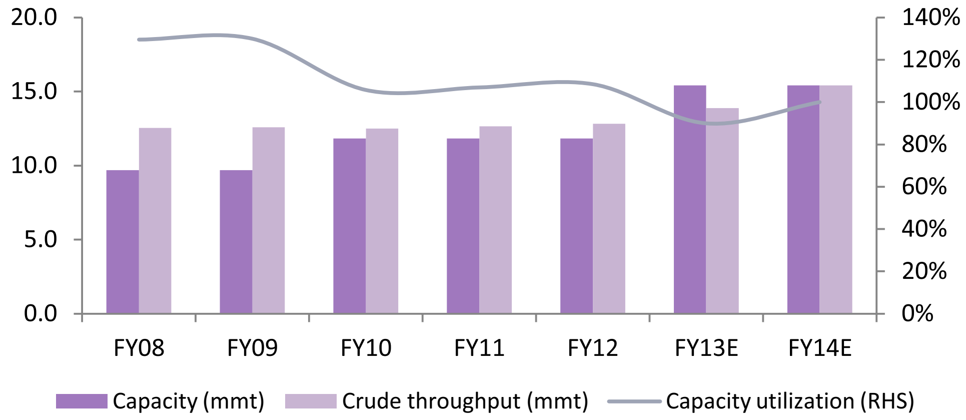
MRPL is setting up a polypropylene unit (PPU), with a capacity of 440ktpa, which would be integrated with the Phase-III expansion of the refinery complex at an outlay of Rs 18bn, for supplying polypropylene to the downstream processing industry. The PFCCU can produce 440ktpa of polymer grade propylene which will be the feedstock to PPU. The project has faced some delay, due to the re-location of the plant. However, the PPU plant is expected to be commissioned by December 2012.

Project progress report

Project	Project cost (Rs bn)	Progress as of 15th June'11	Progress as of 15th June'12	Likely commencement of project
Phase-III refinery	122	84.4%	95.4%	Nov'12
Polypropylene unit	18	64.2%	81.6%	Dec'12
SPM	10	15.7%	94.6%	Sept'12

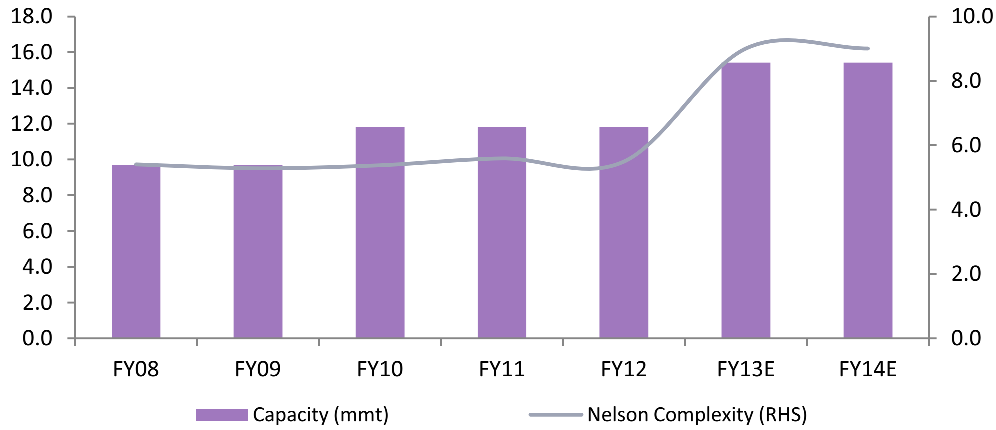
Source: Company, Violet Arch Research

Crude throughput and capacity



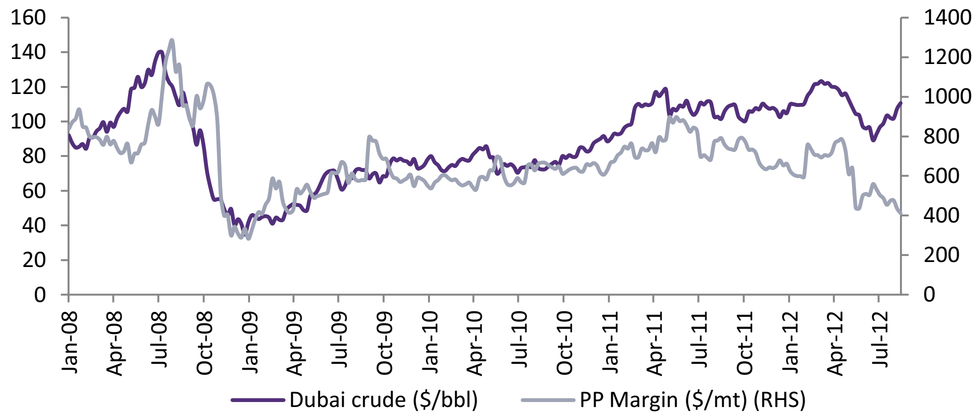
Source: Company, Violet Arch Research

MRPL capacity and Nelson complexity



Source: Company, Violet Arch Research

Polypropylene margin



Source: Bloomberg, Violet Arch Research

GRMs to improve significantly post-expansion and upgradation

Prior to expansion and upgradation, MRPL's product slate comprised 20% light distillate, 52% middle distillate and 28% heavy distillate. Post-expansion and upgradation, the Nelson complexity factor of the refinery is expected to increase from the current 5.5 to 9.0.

Essentially, a high Nelson complexity factor points to the following characteristics:

- Ability to process inferior quality crude or heavy sour crudes.
- Ability to have a superior refinery product slate comprising high percentage of LPG, light distillates and middle distillates, and a low percentage of heavy distillate and fuel oil.
- Ability to make high-quality refinery products such as Bharat 3 gasoline or diesel or Euro-III/Euro-IV grade diesel.

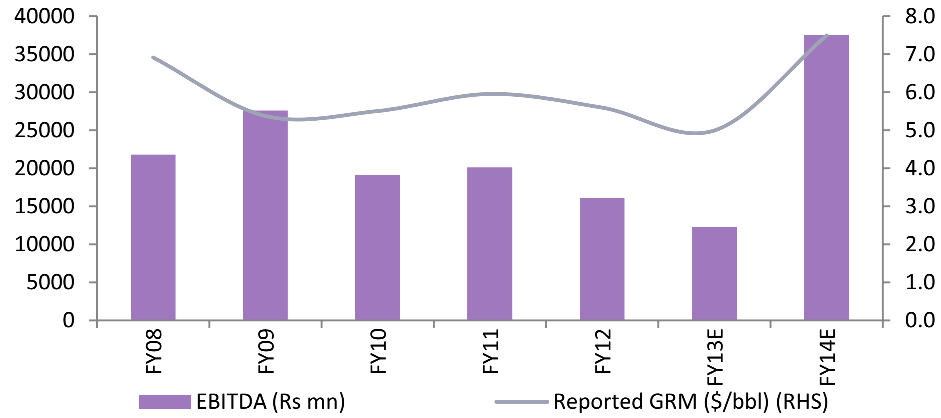
Consequently, the company's product slate would improve to 30% light distillate, 54% middle distillate and 16% heavy distillate. After the new units are commissioned, HSD distillate is likely to improve from 42% currently to 45-47%. MRPL will be best-positioned amongst all domestic refiners to capitalize on the strong Asian diesel spreads expected in the medium term. The expansion and upgradation project will help the company to produce value-added products such as propylene from the low-value black oil, producing Euro-III/Euro-IV/Euro-V grade of HSD. Moreover, the fuel oil distillate will decrease from 15%-plus currently to almost nil (2-3%). Heavy distillates trade at a discount to crude, and a reduction in their proportion would result in improved margins. However, MRPL would have the flexibility to produce fuel oil if the fuel oil crack spreads are favourable. Also, it would be able to refine heavier and sour grades of crude, which would help improve its gross refining margins (GRMs).

In last three years, GRMs of MRPL have been hovering around $5/bbl. Post-expansion/upgradation, the company expects GRMs to improve by further $5/bbl for the following reasons:

- Sourcing of cheaper crude (heavy-sour crude) + improved distillate + superior product quality = $2.5/bbl.
- PFCCU (petro fluidized catalytic cracking unit) + Delayed coker unit (DCU) = $1.5/bbl.
- Single Point Mooring = $0.5/bbl to $1.0/bbl savings in freight costs.

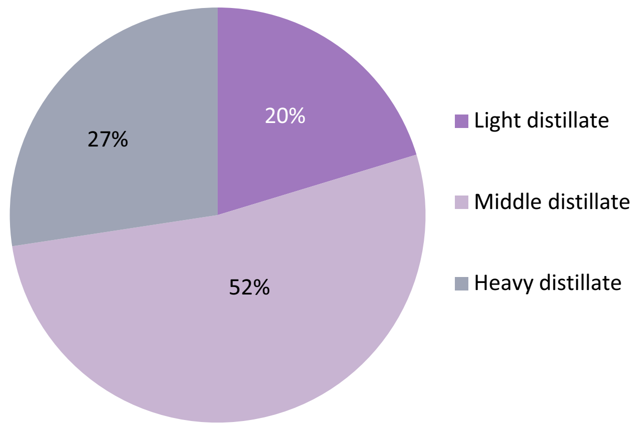
We expect GRMs for MRPL to remain at $5.0/bbl in FY13 and increase to $7.5/bbl in FY14. However, crude throughput would increase to 13.9mt and 15.4mt in FY13 and FY14, respectively. Consequently, EBITDA would improve significantly at a CAGR of 53% over FY12-14 to Rs 37,586mn in FY14.

EBITDA and GRM trend over the years

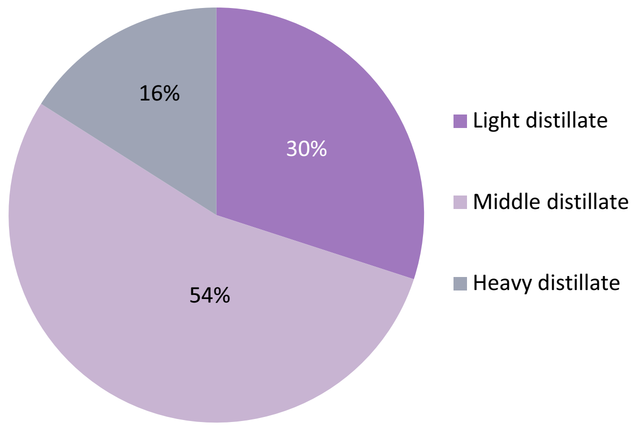


Source: Company, Violet Arch Research

Product slate before expansion/upgradation

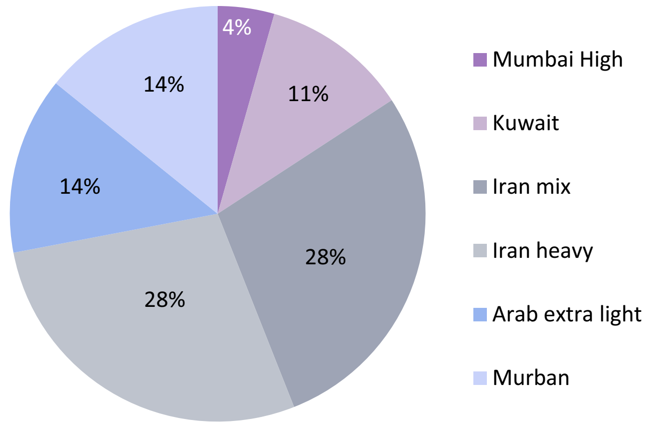


Product slate after expansion/upgradation

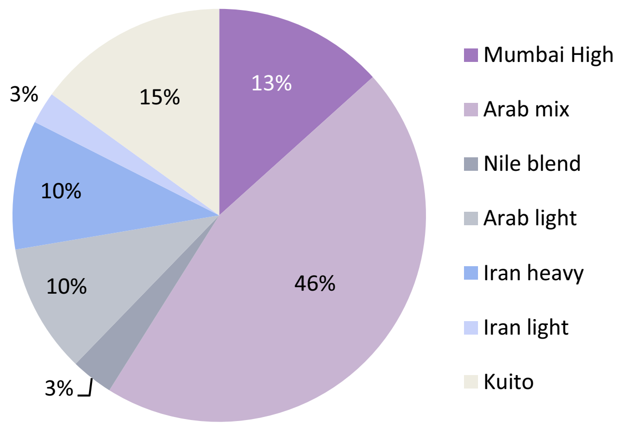


Source: Company, Violet Arch Research

Crude mix before expansion/upgradation



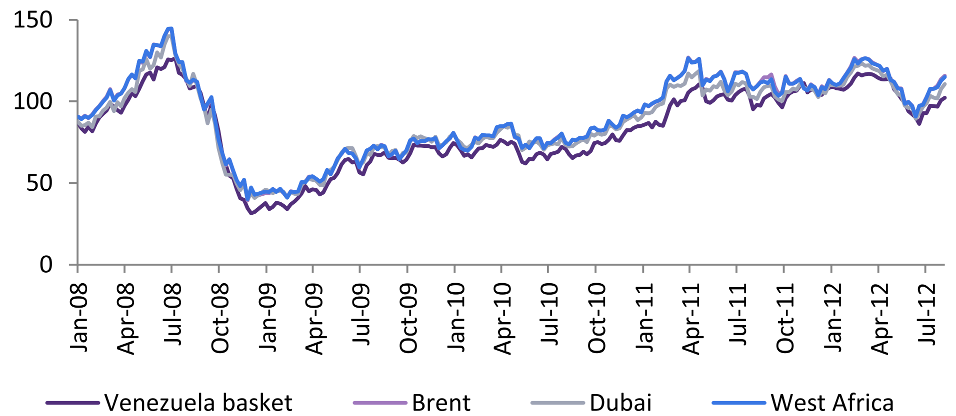
Crude after expansion/upgradation



Source: Company, Violet Arch Research

The Venezuelan crude basket is currently trading at around 105/bbl, while Brent crude is trading at $110/bbl. Post commissioning of SPM facility, MRPL will also be able to source crude from Venezuela using VLCC tankers.

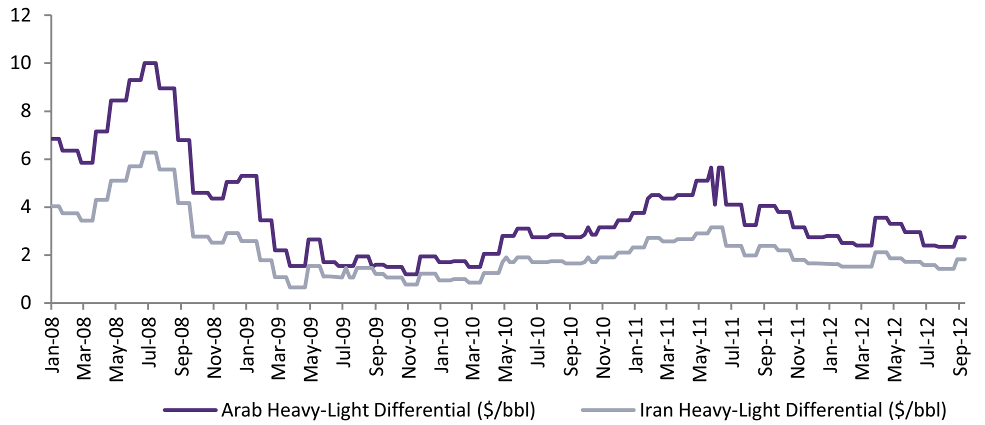
Performance of different crude grades over the years



Source: Bloomberg, Violet Arch Research

In last four years, the Arab heavy-light differential has averaged $3.8/bbl, while Iran heavy-light differential has averaged $2.3/bbl.

Arab and Iran Heavy-Light differential



Source: Bloomberg, Violet Arch Research

Karnataka government incentives

The Government of Karnataka has given an attractive incentive package consisting of the following fiscal benefits for Phase-III project of MRPL:

- Exemption from payment of Entry Tax on the plant and machinery, and capital goods during the initial period of four years from the date of commencement of project implementation.
- Exemption from payment of Entry Tax on crude oil throughput in Phase-III for 15 years from the start of commercial production of Phase-III. This will result in savings of Rs 1000mn per annum for MRPL.
- Exemption from Central Sale Tax for 15 years from the date of commencement of commercial production for all interstate sales. This will result in savings of Rs 1500mn per annum for MRPL.
- Interest-free soft loan at the rate of 100% of the eligible gross VAT for the initial three years, and 60% of the eligible gross VAT on the sale of PP, petroleum coke, LSHS, naphtha, LPG (incremental production), mixed xylenes and reformate to non-SEZ units for the next 12 years to be repaid after 15 years by 15 equal annual installments limited to Rs 5000mn per annum.

Besides, since MRPL has successfully commissioned CDU and VDU of the Phase-III project before the sunset deadline of March 31, 2012, it is now eligible for Income Tax benefit under Section 80(IB). This will place the company in a better position for competing with its peers in the market.

Globally refining capacity to increase however middle distillate demand to remain strong

Particulars	2010	2011	2012	2013	2014	2015	2016
OECD North America	21.5	21.4	21.9	22.0	22.0	22.0	22.0
OECD Europe	15.9	15.7	15.7	15.7	15.7	15.9	15.9
OECD Pacific	8.6	8.5	8.6	8.6	8.6	8.6	8.6
FSU	8.1	8.2	8.5	8.6	8.6	8.7	8.8
China	9.9	10.0	10.6	11.0	11.4	12.3	13.2
Other Asia	10.7	11.1	11.5	11.8	11.9	11.9	12.0
Middle-East	7.8	8.0	8.1	8.6	9.0	9.8	10.1
Other Non-OECD	10.6	10.7	11.0	11.3	11.7	12.0	12.2
World	**93.1**	**93.5**	**95.9**	**97.5**	**98.8**	**101.3**	**102.7**

Source: Company, Violet Arch Research; OPEC

The global refining capacity is expected to reach 102.7mbpd in 2016 from 93.5mbpd in 2011. The OECD countries will witness refinery closures on account of lower refinery utilization rates. However, the planned capacity addition will keep the refinery capacity in the OECD countries at the same levels as of now. Most additions are planned in the non-OECD countries, particularly in Asia. China and India have been expanding their refining capacities to cater to domestic demand as well as to establish themselves as key players in export markets.

The middle distillate sector will remain the driver for Asian refining margins. Any subsidy on diesel in emerging economies in Asia will shield retail consumers from high and volatile oil prices, supporting strong demand growth. Overall, the outlook for Asian refining industries continues to remain positive.

The light and middle distillate category continues to show improvement in Asia-Pacific and the Middle East, with the product demand expected to increase to 29.3mbpd in 2015 from 25.2mbpd in 2010. Following refinery expansion/upgradation, the light and middle distillate yield of MRPL is expected to increase from 78% to 84%, which augurs well for MRPL.

Petroleum product demand in 2010

Particulars	World	US & Canada	Latin America	Africa	Europe	FSU	Middle East	Asia-Pacific
Ethane/LPG	9.0	2.5	1.1	0.4	1.2	0.4	1.0	2.5
Naphtha	5.7	0.4	0.3	0.0	1.2	0.3	0.2	3.4
Gasoline	21.4	9.3	1.9	0.9	2.3	1.1	1.2	4.7
Jet/Kerosene	6.5	2.0	0.3	0.3	1.2	0.3	0.4	2.0
Diesel/Gasoil	25.2	4.4	2.4	1.4	6.2	1.0	1.8	8.0
Residual fuel	9.2	0.7	1.0	0.7	1.5	0.4	1.5	3.3
Other products	9.9	2.6	1.3	0.1	1.8	0.4	0.7	3.0
Total	**86.8**	**21.8**	**8.3**	**3.8**	**15.4**	**3.9**	**6.7**	**27.0**

Source: Company, Violet Arch Research; IEA

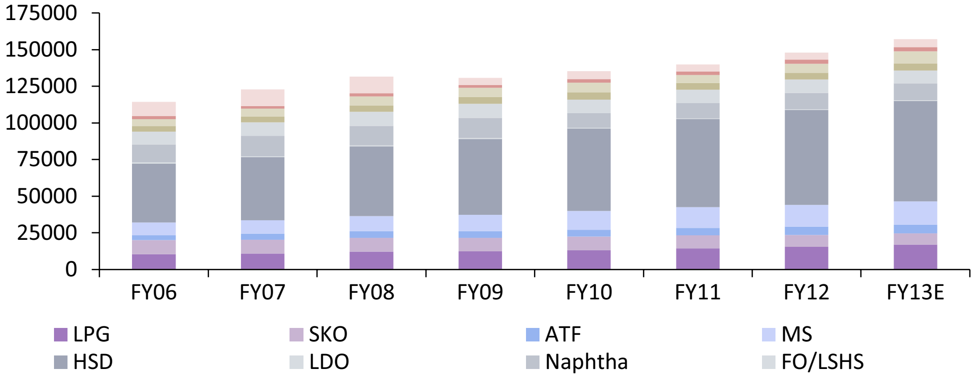
Petroleum product demand in 2015

Particulars	World	US & Canada	Latin America	Africa	Europe	FSU	Middle East	Asia-Pacific
Ethane/LPG	9.5	2.5	1.1	0.4	1.2	0.5	1.1	2.7
Naphtha	6.4	0.3	0.4	0.0	1.2	0.3	0.2	4.0
Gasoline	22.5	9.2	2.2	1.0	2.2	1.1	1.4	5.4
Jet/Kerosene	7.0	2.0	0.3	0.3	1.2	0.3	0.5	2.3
Diesel/Gasoil	28.7	4.8	2.7	1.6	6.8	1.1	2.0	9.7
Residual fuel	8.6	0.6	0.9	0.7	1.1	0.3	1.6	3.4
Other products	10.2	2.5	1.3	0.2	1.5	0.5	0.8	3.3
Total	**92.9**	**21.9**	**9.0**	**4.3**	**15.2**	**4.1**	**7.5**	**30.9**

Source: Company, Violet Arch Research; IEA

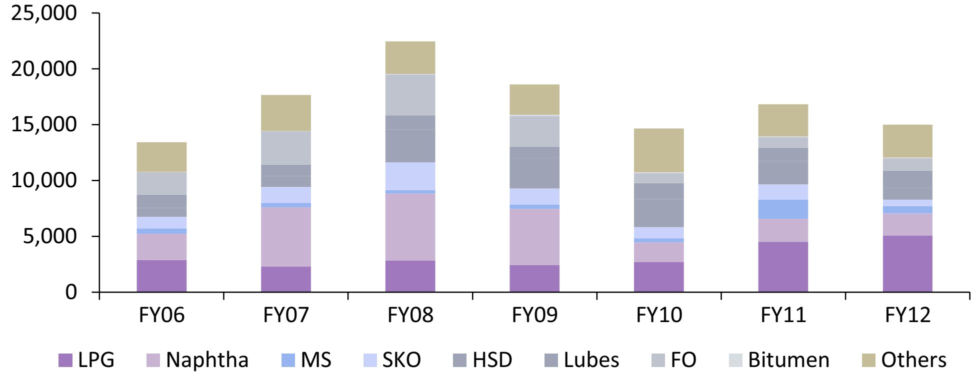
In India, demand for petroleum products has been on the rise and has clocked a CAGR of 4.4% over FY06-12, with LPG, ATF, MS and HSD registering a CAGR of 6.6%, 9.9%, 9.6% and 8.3%, respectively. Consumption of petroleum products is expected to increase by 6.1% in FY13, with LPG, ATF, MS and HSD expected to increase by 10.3%, 6.9%, 5.8% and 5.9%, respectively. MRPL's product slate will increase to 84% for light and middle distillates from the current 78%.

Petroleum product consumption in India ('000 tonnes)



Source: Company, Violet Arch Research; PPAC

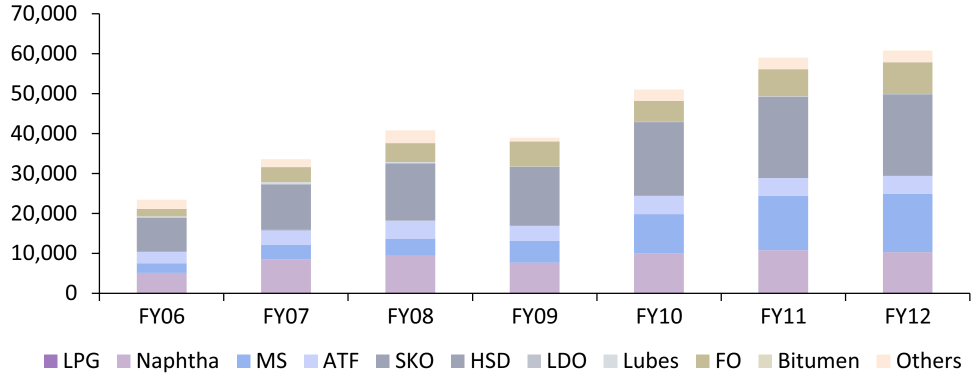
Import of petroleum product in India ('000 tonnes)



Source: Company, Violet Arch Research; PPAC

The import of petroleum products has registered a CAGR of 8.8% over FY06-12, with LPG, MS and HSD, registering a CAGR of 9.9%, 5.1% and 4.6%, respectively, over the same period.

Export of petroleum product from India ('000 tonnes)



Source: Company, Violet Arch Research; PPAC

The export of petroleum products has registered a robust CAGR of 28.8% over FY06-FY12, with LPG, Naphtha, MS, ATF and HSD registering a CAGR of 21.9%, 12.3%, 34.8%, 8.3% and 15.7% over the same period.

Key Risks and Concerns

Delay in implementation of project

MRPL has faced delays in the past in project executions. Phase-III refinery expansion/upgradation was initially expected to complete in Q3FY12. However, as per the latest guidance, the project is likely to be commissioned in Q3FY13. The project progress as per latest information is given below. Any further delays could impact cash-flows of the company.

Project Progress Report

Project	Progress as of 15th June'11	Progress as of 15th June'12	Likely commencement of project
Phase-III refinery	84.4%	95.4%	Nov'12
Polypropylene unit	64.2%	81.6%	Dec'12
SPM	15.7%	94.6%	Sept'12

Sourcing of crude could pose a problem

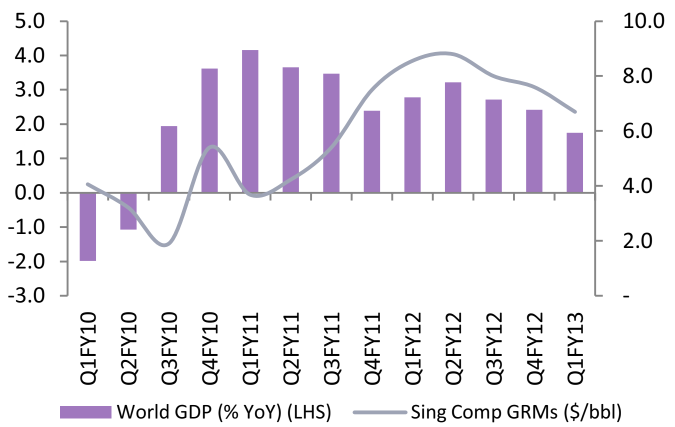
In the past, MRPL sourced 7mtpa crude from Iran, which is expected to come down to 5mtpa in FY13, as the company is facing difficulty in remitting payments due to sanctions imposed on the country by the US/EU. Indian refiners are also struggling to find insurance and shipping for their Iranian oil imports since the EU has banned most of the world's insurance firms from covering shipments from Iran. However, MRPL is already gearing up to deal with this situation and diversify its crude sources. It has bought 1.15mmbbl of crude oil through tenders (0.55mmbbl of Dubai crude oil from BP for lifting in second half of October and 0.6mmbbl of Oman crude oil from Trafigura for lifting in first half of November).

MRPL receives 90 days credit period from NIOC (National Iranian Oil Company) for its imports as against 30 days from other companies. With the decrease in crude imports from Iran the creditor days will decrease going forward.

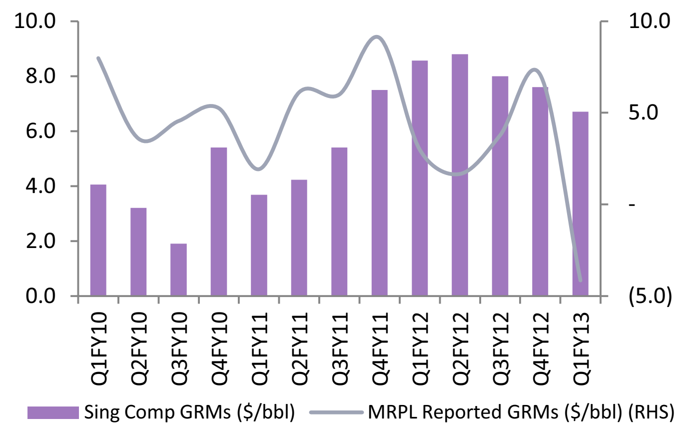
Global economy

GRMs worldwide depend upon how the world economy is doing. As seen from the chart below GRMs remained lower when global economy started faltering through FY08-10 and improved when global growth revived post-financial crisis. In recent times, with concerns over EU resurfacing, GRMs have again shown a dip. Uncertainty in the global economy could affect MRPL's GRMs, which have a direct impact on its margins.

World GDP and Singapore Complex GRMs



Singapore GRMs and MRPL GRMs over the years

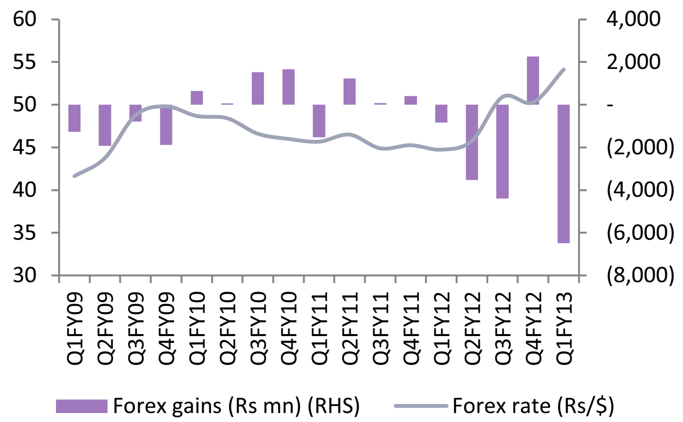


Source: Company, Violet Arch Research

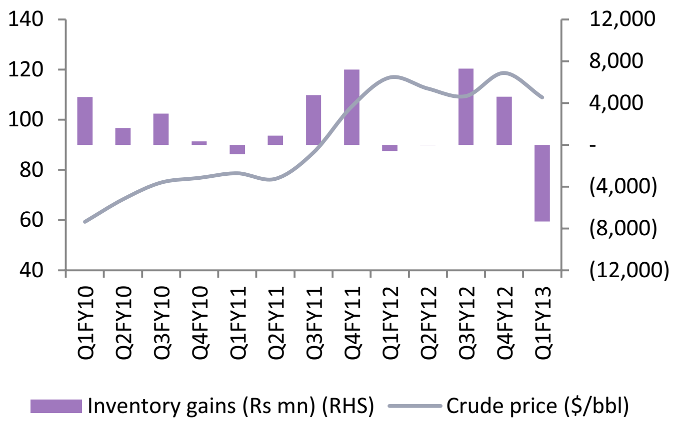
Volatility in crude, product prices and forex

Fluctuations in crude and product prices could result in inventory losses, while the currency fluctuation, resulting in forex losses, could dent MRPL's profitability. As seen from the chart below, the company makes forex gains/losses when rupee appreciates/depreciates. Any wild swings in currency will lead to forex gains/losses. Similarly, when there is fluctuation in crude prices and product prices, the company reports inventory gains/losses. However, over the full year, the company has never recorded any inventory losses, as losses in one quarter had been offset over the next few quarters.

Forex gains and losses over last few quarters



Inventory gains and losses over last few quarters



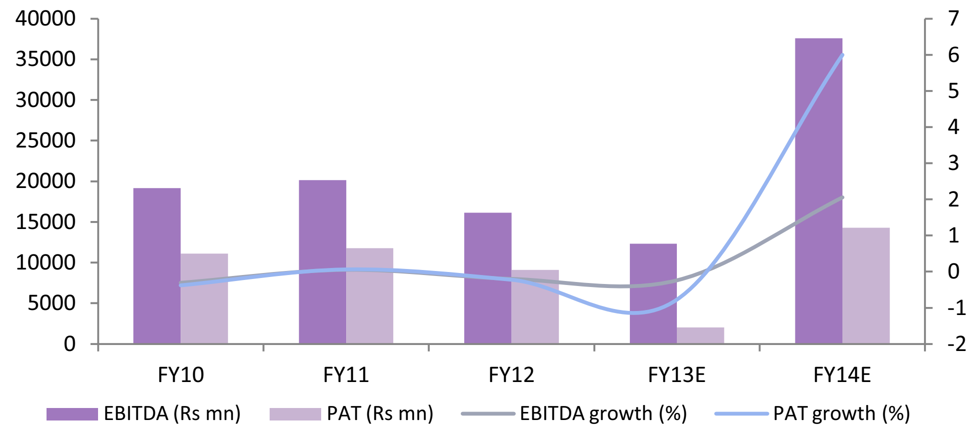
Source: Company, Violet Arch Research

Financial Outlook

EBITDA and PAT

The reported EBITDA has declined at a CAGR of 8% over FY10-12, as MRPL had to incur a forex loss to the tune of Rs 6.5bn in FY12. We expect EBITDA to decline 24% in FY13 due to forex losses (the company had forex losses of Rs 6.5mn in Q1FY13). However, post Phase-III refinery expansion/upgradation EBITDA in FY14 will increase by 205% over that of FY13. We expect PAT to decline sharply by 78% in FY13 on account of increased depreciation and higher interest costs and forex losses. In FY14, we expect PAT to improve by 600% over that of FY13.

EBITDA and PAT trend

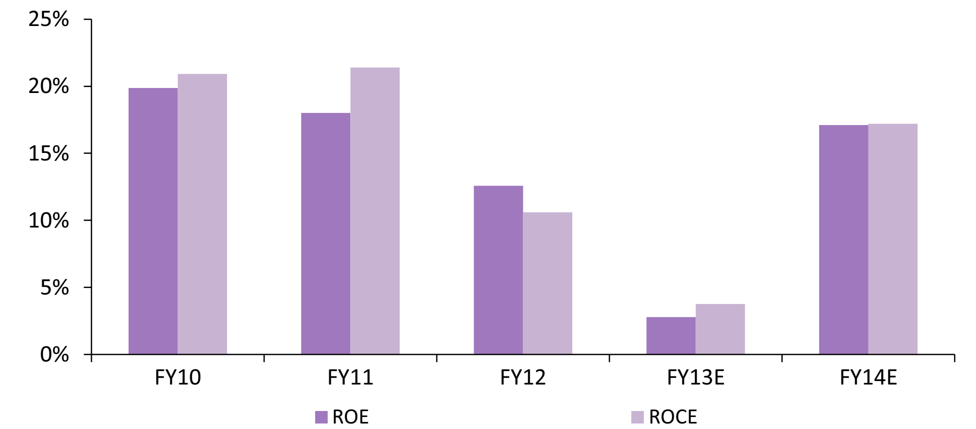


Source: Company, Violet Arch Research

ROE and ROCE

MRPL has consistently maintained ROE in the range of 18%-20% over last few years. MRPL has incurred a forex loss of Rs 6.5bn and inventory loss of Rs 7.3bn in Q1FY13. For the remaining three quarters of FY13, we do not expect MRPL to report any large forex losses as we expect rupee to remain stable at these levels. According to management, over the full year inventory losses in Q1FY13 would be more than made up for. Hence we assume zero inventory losses in FY13. We expect ROE to decline to 3% in FY13 due to decreased profitability (forex losses) in FY13. However, ROE will rebound in FY14 to 17% on account of improved profitability (due to commencement of Phase III expansion/upgradation projects by end of FY13). We expect ROCE to decline to 4% in FY13, and thereafter improve to 17% in FY14.

ROE and EOCE trend



Source: Company, Violet Arch Research

Peer comparison

	PE (x)		P/B (x)		EV/EBITDA (x)		RoE (%)	
	2012	2013	2012	2013	2012	2013	2012	2013
North America	11.0	10.9	2.7	2.6	4.4	5.8	37.5	21.1
Europe	11.2	12.7	1.1	1.1	6.5	5.8	9.3	10.5
Asia – ex-Japan	11.1	9.3	1.5	1.4	7.8	6.6	13.6	15.2
Japan	17.4	13.4	0.7	0.6	10.6	7.6	1.5	7.2
India downstream	11.6	9.5	1.0	1.0	8.4	7.8	9.2	10.5
Average	**12.5**	**11.2**	**1.4**	**1.3**	**7.6**	**6.7**	**14.2**	**12.9**
MRPL	54.0	7.7	1.5	1.3	14.8	4.4	2.8	17.1

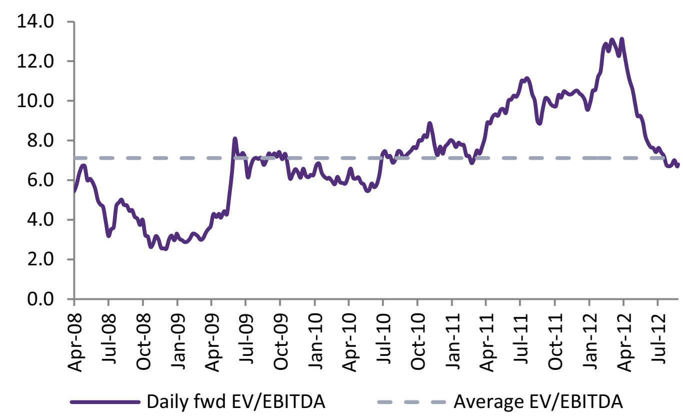
Source: Company, Violet Arch Research; Bloomberg

The stock is currently trading at FY14e EV/EBITDA of 4.4x, which is at a discount to refineries across regions. Asia ex-Japan trades at FY14e EV/EBITDA of 6.6x, while Indian downstream majors, on an average, trade at FY14e EV/EBITDA of 7.8x, which gives an attractive investment opportunity in MRPL.

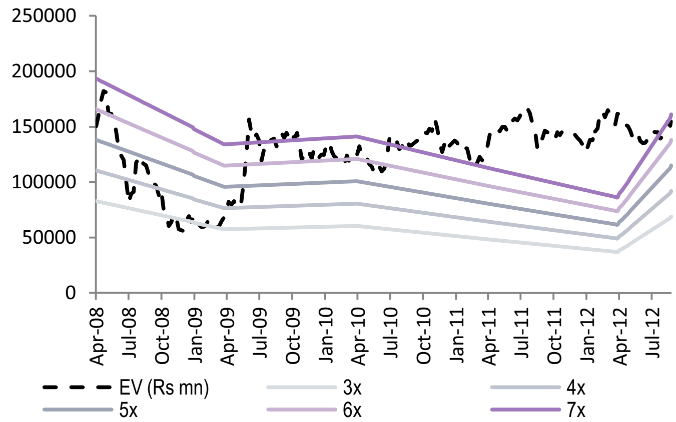
Valuation

While earnings remained subdued over the last three years led by the lack of improvement in GRMs, the absence of capacity expansion, high interest costs and volatility in crude prices, we believe that MRPL has taken considerable strides on the business front, which would yield results in FY14 (capacity expansion by 30.0% and an improved Nelson Complexity factor, leading to higher GRMs). According to MRPL management, Phase-III refinery expansion/upgradation is expected to be complete by November 2012. However, taking a conservative stance, we assume the project would be operational by the end of FY13 and, consequently, benefits of the expansion/upgradation would accrue in FY14. We expect GRMs to improve to $7.5/bbl in FY14 compared with the average of $5.3/bbl during FY10-12. MRPL stock has traded at an EV/EBITDA of 6.7x during this period. Increased capacity, coupled with better complexity, will restore the firm to earnings growth trend in FY14. We value MRPL at Rs 83 based on 5.5x FY14E EV/EBITDA, notably at a discount to historical multiple enjoyed by the stock. We initiate coverage on MRPL with a Buy recommendation.

Daily forward EV/EBITDA chart



Historical 1 year forward EV/EBITDA chart

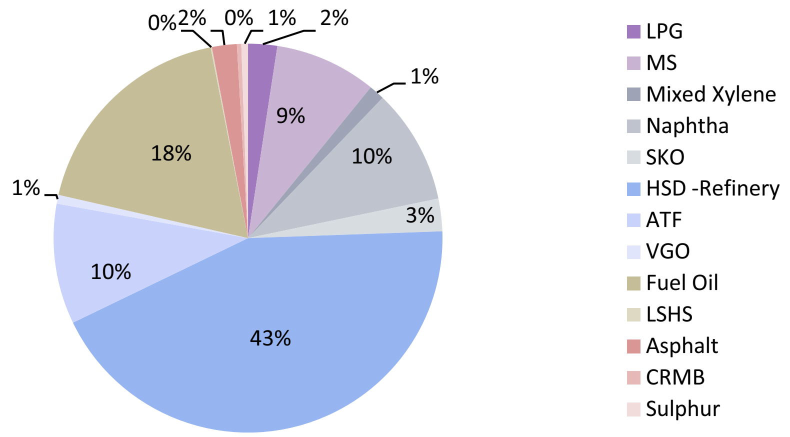


Source: Company, Violet Arch Research

Company Background

MRPL was incorporated in 1988 as a joint venture oil refinery promoted by HPCL and Indian Rayon & Industries and Associates (AV Birla Group), with an initial refining capacity of 3mtpa. The refinery project was set up in two phases: in Phase-1 3.69mtpa was commissioned in 1996, while Phase-II took the capacity to 9.69mtpa in 1999. Since the refinery was set up during a period of administered pricing, the regulatory framework provided assured returns on the capital employed. However, the partial deregulation of the refining sector in the late 90's exposed the company to volatile international refining margins, which affected its operating profitability significantly. This, coupled with high debt service commitments, resulted in MRPL posting substantial losses. In 2003, ONGC acquired a 51% stake in MRPL and, subsequently, increased its stake to 72%. Since then, the company had a turnaround in its operations with considerable financial and operational support from ONGC. In 2011, MRPL scaled up its nameplate capacity to 11.82mtpa through debottlenecking. The Nelson complexity factor of MRPL currently stands at 5.5.

MRPL's product slate in FY12



Source: Company, Violet Arch Research

Financial Summary - Standalone

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	**389,567**	**537,703**	**593,319**	**674,158**
Growth (%)	*21.9*	*38.0*	*10.3*	*13.6*
Total Expenditure	**369,410**	**521,569**	**581,013**	**636,572**
EBITDA	**20,157**	**16,134**	**12,306**	**37,586**
Margins (%)	*5.2*	*3.0*	*2.1*	*5.6*
Growth (%)	*5.2*	*(20.0)*	*(23.7)*	*205.4*
Depreciation & amortisation	3,914	4,339	6,713	11,223
EBIT	16,243	11,795	5,593	26,363
Margins (%)	*4.2*	*2.2*	*0.9*	*3.9*
Interest	1,044	2,067	3,450	6,530
Other income	2,176	3,474	816	866
PBT	**17,375**	**13,202**	**2,959**	**20,699**
Tax provision	5,609	4,116	917	6,417
PAT	**11,766**	**9,086**	**2,042**	**14,282**
PAT Margins(%)	*3.0*	*1.7*	*0.3*	*2.1*
Growth (%)	*5.8*	*(22.8)*	*(77.5)*	*599.5*
Diluted EPS	6.2	4.9	1.1	7.8

Cash flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
PBT	17,371	13,202	2,959	20,699
Adjustments	3,052	3,173	8,343	16,887
Changes in WC	7,233	(18,610)	2,845	(7,622)
Direct taxes	(8,212)	(4,323)	(917)	(6,417)
Cash flow from operations	**19,424**	**(6,591)**	**13,229**	**23,547**
Capital expenditure	(35,623)	(32,649)	(63,712)	0
Changes in investments	15,814	0	0	0
Other income	2,411	3,006	816	866
Cash flow from investing	**(17,398)**	**(29,643)**	**(62,896)**	**866**
Equity raised	0	(46)	0	0
Debt raised	(1,394)	46,261	36,400	(5,529)
Dividends paid	(2,452)	(2,444)	(2,042)	(1,021)
Interest paid	(1,047)	(2,066)	(3,450)	(6,530)
Cashflow from financing	**(4,893)**	**41,705**	**30,909**	**(13,079)**
Net Change in Cash	**(2,867)**	**5,472**	**(18,758)**	**11,334**
Opening Cash & Cash Eq	27,544	16,875	22,347	3,588
Closing Cash & Cash Eq	**24,677**	**22,347**	**3,588**	**14,922**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Sources of Funds				
Share Capital	17,619	17,573	17,573	17,573
Reserves & Surplus	47,671	54,719	55,740	65,939
Shareholder's Funds	**65,289**	**72,292**	**73,313**	**83,511**
Debt	10,657	38,919	75,319	69,791
Other Liabilities	268	309	309	309
Total Liabilities	**76,214**	**111,520**	**148,941**	**153,611**
Application of Funds				
Gross Block	76,198	90,243	206,807	224,847
Accumulated Depreciation	45,301	49,644	56,357	67,580
Net Assets	**30,896**	**40,599**	**150,449**	**157,266**
CWIP	39,953	70,892	18,040	0
Investments	423	423	423	423
Current Assets Loans & Advances				
Inventory	40,974	78,176	65,021	73,880
Debtors	25,301	34,593	39,013	44,328
Cash & Bank	24,677	22,347	3,588	14,922
Loans & advances and others	7,162	6,981	6,981	6,981
Current Liabilities & Provisions				
Creditors	100,533	142,464	136,574	143,127
Other liabilities & provisions	4,792	3,046	1,021	4,084
Net Current Assets	**(7,213)**	**(3,413)**	**(22,992)**	**(7,099)**
Deferred tax assets/(liabilities)	(3,472)	(4,531)	(4,531)	(4,531)
Total Assets	**76,214**	**111,520**	**148,941**	**153,611**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Leverage Ratio (x)				
Net Debt/Equity	(0.2)	0.2	1.0	0.7
Interest coverage ratio	15.6	5.7	1.6	4.0
Per Share Data (Rs)				
Diluted EPS	6.2	4.9	1.1	7.8
Cash EPS	8.3	7.3	4.8	13.9
DPS	1.2	1.0	0.5	2.0
BVPS	34.4	39.3	39.9	45.4
Valuation Ratios (x)				
PE (x)	9.7	12.1	54.0	7.7
P/BV (x)	1.7	1.5	1.5	1.3
EV/EBITDA (x)	4.9	7.9	14.8	4.4
EV/Sales (x)	0.3	0.2	0.3	0.2
Profitability Ratios (%)				
EBITDA Margins	5.2	3.0	2.1	5.6
PAT Margins	3.0	1.7	0.3	2.1
ROE	18.0	12.6	2.8	17.1
ROCE	21.3	10.6	3.8	17.2
Growth Ratios (%)				
Revenue	21.9	38.0	10.3	13.6
EBITDA	5.2	(20.0)	(23.7)	205.4
PAT	5.8	(22.8)	(77.5)	599.5

Equity Research I Breweries & Distilleries

21 September, 2012

Radico Khaitan Ltd.

Equity in the Brand

Absolute Rating	BUY
Target Price	Rs 143
Upside	21%

Radico Khaitan Ltd. is a successful brand creator. This has been evident from its very first branded offering, 8PM Whisky. The product became a 'millionaire' (Millionaire = 1mn cases = 9mn litres liquor) brand in the first year of its launch. Further, the company currently has four millionaire brands under its fold, and plans to offer new premium whiskies. This, along with strong macro demand, better access to key markets, the revival of flagship brands and premiumisation, will drive Radico's earnings growth going forward. Strong operational levers and strategic value (as a potential target for acquisition by global spirit players), thanks to the company's pan-India distribution strength, makes it an attractive consumption play in the FMCG space. At the CMP, the stock trades at 7.7x EV/EBITDA and 12.4x P/E on FY14E basis. We value the company at 15x FY14E EPS and arrive at a target price of Rs 143. We initiate coverage on Radico with a Buy rating.

Margin expansion on the back of focus on premium brands

Since FY02, Radico has evolved into an economy and regular segment IMFL (Indian Made Foreign Liquor) participant entity in the semi-premium and premium category, with a series of successful launches. However, Radico is now focusing on strengthening its position in the premium category, which we believe will aid margin expansions. Recent brand launches in the premium category are in line with the company's premiumisation strategy.

8PM Whisky, back on track

8PM has been the forerunner for the company, with its record sales of 1mn cases in the first year of launch. However, a change in its formulation led to some moderation in volumes. Further, higher growth in the premium segment (up-trading) and the molasses price spike impacted the regular segment, where 8PM is a dominant brand. However, the company changed the blend to a complete grain-based whisky and offered it in an innovative packaging, which resulted in volume growth picking from FY10 onwards.

Magic Moments Vodka growing at magical speed

Radico successfully fulfilled its quest to create space in the fast-growing premium vodka segment with the launch of Magic Moments Vodka in 2006. The brand now has a market share of around 65% in the semi-premium vodka segment and has grown at a CAGR of 49.3% over the past five years to reach sales of 2.22mn cases in FY12. Going forward, this, along with other premium launches, will lead to higher realizations and better product mix, aiding the company's top-line and, in turn, its profitability.

Valuations

The revival in flagship brands, premiumisation, and strong macro demand in tier-2 and tier-3 cities, along with expected stable molasses prices, will drive Radico's earnings growth over FY12-14E. Over the last three years, the stock of Radico, on an average, has traded at premium P/E multiples of 20.0x on one-year forward earnings, owing to stupendous earnings growth clocked during the period (CAGR of around 127%). Therefore, our multiple of 15.0x on FY14E EPS, to arrive at a target price of Rs 143, factors in: 1) lower earnings CAGR (FY12-14 – 28.8%), 2) volatility in molasses prices, 3) overall slowdown in economy, and 4) de-rating of mid-cap stocks in such uncertain times. We note that even at a lower P/E multiple, the stock offers an upside of 21.2% from current levels, and hence we recommend a Buy.

Y/E Mar 31 (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	9,464	11,439	13,793	16,158
EBITDA	1,507	1,720	2,277	2,675
EBITDA margins (%)	15.9	15.0	16.5	16.6
EBITDA growth (%)	15.8	14.1	32.4	17.5
Adjusted Net profit	728	762	972	1,264
Adj.Net profit growth (%)	127.2	4.6	27.6	30.1
Adj.Net profit margin (%)	7.7	6.7	7.0	7.8
FDEPS (Rs)	5.5	5.7	7.3	9.5
FDEPS growth (%)	126.0	4.6	27.6	30.1
P/E(x)	21.4	24.6	16.1	12.4

Source: Company, Violet Arch Research

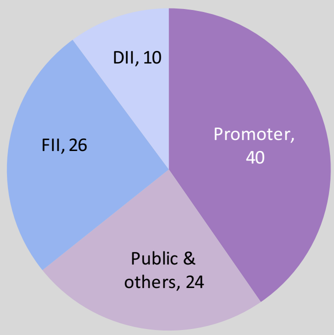
Stock data

CMP	Rs 118
Reuters Code	RADC.BO
Bloomberg Code	RDCK IN
Equity Shares o/s (mn)	133
Market Cap (Rs mn)	15,617
Market Cap (USD mn)	293
3m Avg daily t/o(US$ mn)	1.0

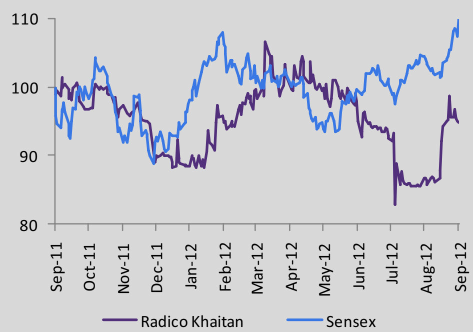
Stock performance (%)

52-week high / low			Rs 144/92
	1M	3M	12M
Absolute	9.4	(0.2)	(4.5)
Relative	4.4	(10.7)	(20.6)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

(FY14E)	Bull Case	Base Case	Bear Case
Net sales (Rs mn)	16,757	16,158	15,756
IMFL Volume growth (%)	14.0	8.0	5.0
Country Liquor Volume growth (%)	20.0	15.0	10.0
EBITDA (Rs mn)	3,404	2,675	2,606
Inc/Dec from Base Case (%)	27.3	-	(2.6)
EPS (Rs.)	**10.1**	**9.5**	**9.1**
Inc/Dec from Base Case (%)	5.9	-	(4.5)
CMP (Rs.)	118	118	118
P/E Multiple (x)	16	15	12
Target Price (Rs.)	**161**	**143**	**109**
Upside (%)	**36.4**	**21.2**	**(7.6)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY11	FY12	FY13E	FY14E
IMFL Quantity ('000) KL/AL	23,246	26,036	28,639	30,931
IMFL Realisation (Rs/AL)	365	383	394	406
Country Liquor Quantity ('000) KL/AL	9,242	10,628	12,222	14,056
Molasses (Rs/kg)	3,303	2,752	3,165	3,387
Packaging Material Consumed (Rs mn)	1,489	1,602	1,862	2,181

Source: Company, Violet Arch Research

Base case

- We expect net sales to grow by 20.6% to Rs13.79bn in FY13E and further by 17.1% in FY14E to Rs16.15bn. Growth in FY13E to be backed by a 10% volume growth in IMFL coupled with a 3% realisation growth, while that in FY14E backed by volume growth of 8% and realisation growth at a similar level to that in FY13E. Historically, IMFL volumes have grown by a CAGR of 10.1% from FY04-FY11, while realisations have grown by 20.5% over the same period. Further, country liquor volumes are expected to grow by 15% each in FY13E and FY14E respectively while realisations expected to grow by 10% each year.
- Molasses prices expected to average at Rs 3,165/kg in FY13E and Rs3,387/kg in FY14E, a growth of 15% & 7% respectively. Molasses prices have grown at a CAGR of 1.6% over FY04-FY11, however going forward since sugar demand is expected to lag production, prices of molasses a by-product of sugar-cane is expected to rise.

Bull case

- We assume IMFL volume growth to be 14% YoY and realization growth to be higher than our base case at 5% YoY in FY14E. Further, Country liquor growth to be 20%YoY leading to a stronger top line growth. As far as margins are concerned, the same is expected to increase to 20.3% up 380bps from our base case in FY14E, leading to a 5.9% increase in PAT.

Bear case

- We assume IMFL volume growth to be a mere 5% YoY and country liquor sales to be 10% YoY in FY14E, factoring in higher level of competition. This along with lower realisation to result in revenues and EBITDA falling marginally from our base case.

SWOT Analysis

Strengths

1) Since people drink brands and not alcohol, it is very important for a company to establish brands well. Radico has successfully created its own brands like 8PM and Magic Moments.

2) Well-entrenched brands in canteen stores/government.

3) Strong distribution network. Radico has a vast network of 450 wholesalers, who, in turn, sell the products to around 36,000 retail outlets as well as through over 5,000 on-premises outlets

4) Good incumbency advantage due to high entry barriers.

Threats

1) Molasses, a by-product derived by beating suagrcane, has high correlation with sugar demand-supply. As per estimates , sugarcane production in Maharashtra (second largest producer in India) is expected to decline by 16%YoY in SY2012. While we have asumed a higher molasses price, any increase more than our estimate could affect margins adversly.

2) Threat from foreign players in the form of withdrawal of additional customs duty (ACD) on foreign liquor and decrease in import duty. Currently, total duty on imported liquor is 150%.

SWOT Analysis

Weaknesses

1) Moderate market share of around 9% in IMFL.

2) Does not have a significant share in important markets like Maharashtra. As per estimates, ~40% of the states 125mn population comsumes liquor in some form, and in volume terms ~12mn cases annualy.

3) Negligible presence in wine and beer segments.

4) High regulatory risk exposed to government policies. Increase in taxes, changes in distribution structure, and prohibition of liquor.

Opportunities

1) Visible shift in urban Indian women consumers.

2) Rising social acceptability of alcoholic beverages.

3) Further regulatory easing will propel the IMFL industry.

4) Volumes of the alcoholic beverages industry are expected to grow at a CAGR of 10% from CY12 to CY16.

5) Scale advantage as advertising of alcoholic beverages is restricted.

Source: Violet Arch Research

Investment Arguments

Margin expansions on the back of focus on premium brands

Radico has had three successful brand launches in the past decade, which reflect well on the company's ability to create successful brands. Seagram has been the only other major brand creator in this space. We believe this is a positive sign for a young company like Radico, because building brands is investment-intensive. However, once a brand is created, the company can reap long-term benefits. Further, Radico has a wide portfolio of brands, covering most segments and price points (largely mid and regular price points). Over the past few years, it also has successfully ventured into semi-premium and premium segments. Radico has to its credit the highest number of successful new launches in the last decade.

Major Millionaire spirit brands launched since 1995.

Brand	Company	Cases sold in FY12 (mn)
Royal Stag Whisky	Seagram	12.3
8 PM Whisky	Radico Khaitan	4.57
Old Admiral VSOP Brandy	Radico Khaitan	3.32
Blenders Pride whisky	Seagram	3.5
White Mischief Vodka	United Spirits	1.7
Magic Moments Vodka	Radico Khaitan	2.22

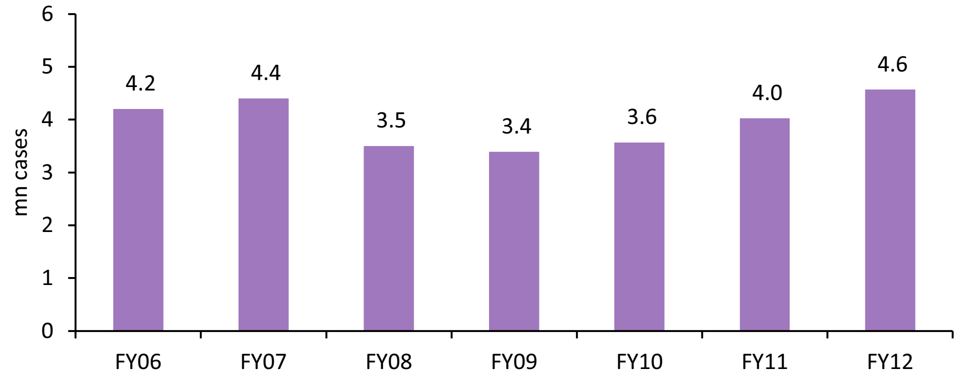
Source: Company, Violet Arch Research

On the distribution front, Radico has a vast network of 450 wholesalers, who, in turn, sell the products to around 36,000 retail outlets as well as through over 5,000 on-premises outlets. Additionally, the company has 200 sales and distribution personnel across its four regional centre's, which are extensively being leveraged to reach the maximum number of retail points, clubs and bars in the country. Radico is also focusing more on tier-2 and tier-3 cities, and point of sale (POS) promotions by co-branding event promotions to drive sales. A strong and aggressive POS promotion and association with celebrities should improve the brand recall and growth. The company has 33 bottling plants spread across the country, which limit inter-state taxes and transport costs.

8PM Whisky, back on track

8PM has been the forerunner for the company, with its record sales of 1mn cases in the first year of launch. However, a change in its formulation led to some moderation in volumes. Further, higher growth in the premium segment (up-trading) and the molasses price spike impacted the regular segment, where 8PM is a dominant brand. However, the company changed the blend to a complete grain-based whisky, with an attractive packaging, which resulted in a pick-up of volume growth from FY10 onwards. This, coupled with an innovative packaging strategy and the effective use of celebrity endorsements, resulted in volumes growing at a CAGR of 10.5% from FY09 to FY12. Going forward, we expect this brand to gather further momentum.

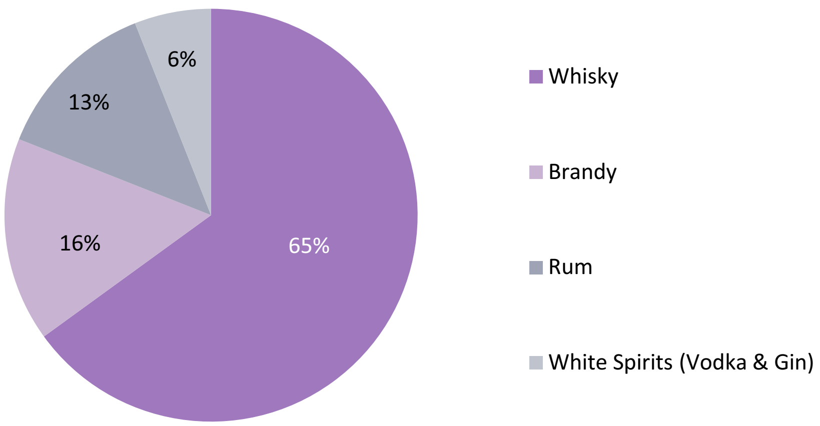
8pm sales back on track



Source: Company, Violet Arch Research

In India, whisky dominates the IMFL segment, with a market share of around 65%. It is derived from molasses, a byproduct of sugar. Whiskies are available in various flavours and blends at broad price points. North India has a higher preference for whisky, with 80% of IMFLs consumed being whisky. United Spirits leads the whisky market with a market share of over 45%, followed by Pernod Ricard, Jagatjit Industries, Radico Khaitan and others. Over the past few years, Pernod Ricard has gained a handsome volume share, with its major brands, Royal Stag and Blender's Pride, doing well.

Whisky dominates the IMFL segment in India



Source: Company, Violet Arch Research

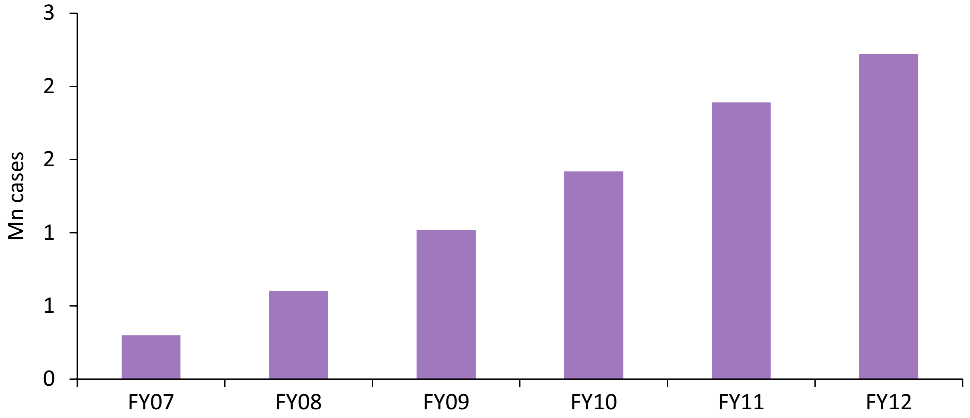
Magic Moments Vodka growing at magical speed

Radico successfully fulfilled its quest to create space in the fast-growing premium vodka segment with the launch of Magic Moments Vodka in 2006. The brand now has a market share of around 65% in the semi-premium vodka segment and has grown at a CAGR of 49.3% over the past five years to reach sales of 2.22mn cases in FY12. Going forward, we believe, this along, with other premium launches, will lead to higher realizations and better product mix, aiding the company's top-line and, in turn, its profitability.

Radico's quest to create space in the fast-growing vodka segment and establish its presence in the premium segment was fulfilled with the launch of the Magic Moments Vodka brand. Magic Moments has already crossed 1mn cases since its launch in 2006 and has a market share of 70% in the semi-premium vodka segment. The brand has been further re- energized through the launch of several flavours such as raspberry, chocolate, orange and ginger, among others, with a higher mark-up price (Rs 50/bottle higher). Magic moments volumes have grown at a CAGR of 49.3% over FY07-12. It must be noted that Magic Moments is the 23rd largest selling brand in terms of volumes globally and the 8th fastest-growing Vodka in the world.

Magic Moments not only added another feather to Radico's cap, but has also spurred more launches from the company in the premium segment. Radico has launched its premium brandy, Morpheus, priced at Rs 700 for a bottle. The 25-million-case brandy segment has not so far charted the premium segment above Rs 600/bottle, where Radico has carved out a niche with the Morpheus brandy.

Magic Moments

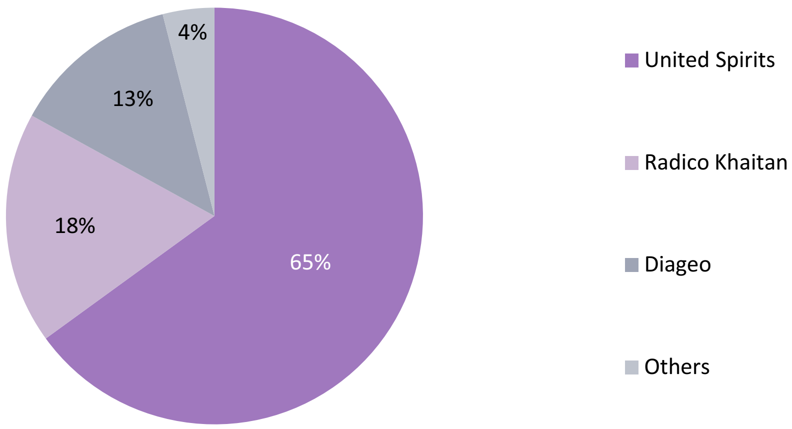


Source: Company, Violet Arch Research

Vodka, a white-spirit variant, has witnessed the fastest growth in the spirits segment from 0.35mn cases in CY00 to 7.3mn cases in CY11. Currently, vodka forms over 3% of the spirits and is expected to grow at a healthy pace of around 30% over the next few years. Major vodka brands include White Mischief, Romanov and Magic Moments. United Spirits leads the regular vodkas. Radico leads in semi-premium, while Diageo (Smirnoff) has a dominant share in the premium vodka segment.

Company	Brand
Imperial Spirits	Black Magic, Imperial Iceberg Premium
Radico Khaitan	Magic Moments
Tilaknagar Industries	Castle Club
United Spirits	Romanov, White Mischief

Radico has the second-highest share in the Vodka segment



Source: Company, Violet Arch Research

CSD sales to continue providing steady revenue

After United Spirits, Radico has the second-largest distribution network in India. It sells through around 36,000 retail outlets, catering to almost 80% of liquor consumers in India. Radico is one of the largest suppliers of branded IMFLs to the Canteen Stores Department (CSD). The CSD for defense forces accounts for about 15% of liquor consumption in India. Enrolling a brand with the CSD is a tedious process. It takes roughly 9-10 months to register brands with the CSD. Hiking prices, launching variants and newer designs of bottles also require myriad approvals. Interestingly, Radico has been successful in registering all its brands with the CSD. Its strong ties with the CSD allow it to register variants as well as fresh launches. The company has 18 products registered with CSDs across categories, which have high entry barriers due to stringent qualification and registration requirements. Going forward, CSD is expected to continue to grow in volumes at a modest growth rate of 5-10% and drive a steady stream of revenue, albeit at a higher margin.

Well-positioned to meet future demand

Over the past few years, Radico has focused on creating assets to meet its future needs, leading to substantial investments in distilleries and new bottling units (the gross block increased by around Rs 37bn between FY05 and FY11.) Today, the company has five distilleries (three in Uttar Pradesh and two in Maharashtra), with a capacity of 150.5mn litres, which is sufficient to meet its requirements over the next few years.

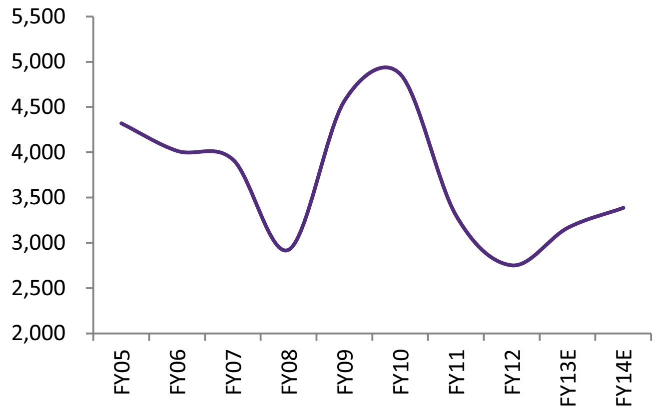
Radico has further enhanced its distillation capacity in Aurangabad (under a 36:64 JV between Radico and two other partners), with the construction of a new grain-based distillery of 12mn litres. Also, the company has 33 bottling units (five self-owned and 28 on contracts), giving it a strong and wide distribution reach. It has also built a new state-of-the-art, owned-bottle printing plant at Bahadurgarh, Haryana, and a PET bottle manufacturing plant in Uttaranchal, a tax-exempt zone, which will help in backward-integration and sourcing efficiency for the company.

Key Risks and Concerns

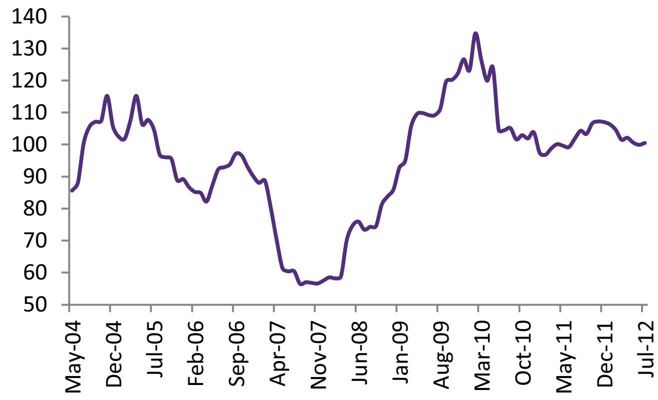
Inflation in raw material prices

Prices of major raw materials, glass (for bottling) and molasses, are volatile. Molasses follow a yearly cyclical pattern in sync with sugarcane crops. While grain-based Extra Neutral Alcohol (ENA) is increasing in India, it is still at an infant stage and hence not likely to make any impact. The price of glass is also volatile due to price fluctuations as well as availability of silica. These changes in raw material prices make margins volatile for liquor companies. While we have factored in higher molasses prices in our estimates, lower-than-anticipated sugarcane production and/or any sharp rise in prices of molasses higher than our assumption will have an impact on the company's margins and earnings. Additionally, inflation in glass and a significant increase in packing costs will also impact the company's margin.

Molasses (Rs/Kg)

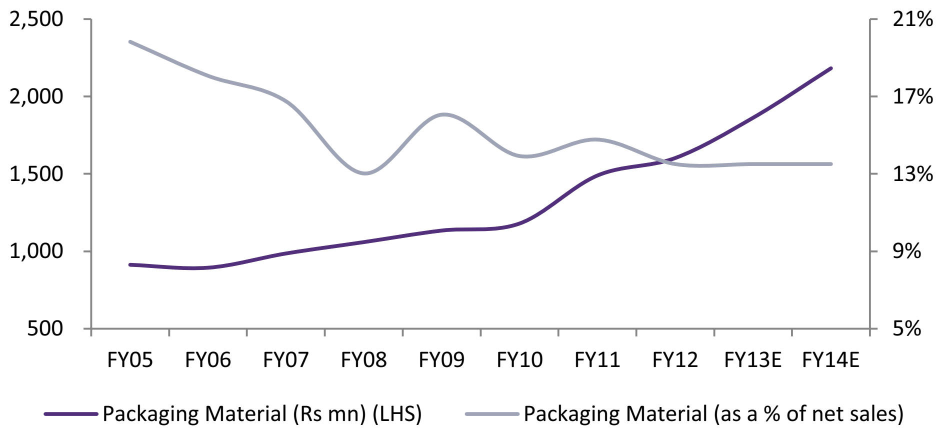


Indian wholesale price index molasses



Source: Company, Violet Arch Research

Packaging material costs have increased at a CAGR of 8.4% over FY05-12



Source: Company, Violet Arch Research

Regulatory risk

Alcohol, being subject to state laws, involves a high degree of government regulation. Unlike other consumer companies, liquor companies do not enjoy the advantage of correcting product prices based on raw material prices, media inflation, new launches, probable re-launches and competitive pressure. Liquor prices are decided by most state governments once every year. Once liquor companies decide the prices, they cannot be altered in the course of the year. Hence, any failure to take a price rise, despite adverse factors, will have a bearing on Radico's earnings. Further, alcohol advertising on television and billboard has been banned in India since September 2000, forcing players to spend on surrogate advertising. Also, tax in the form of excise on alcohol is a progressive exercise and is calculated on proof litre basis. (1 case of 750ml alcohol has 6.75 proof liters, here 9 is the bulk litre quantity of 1 CASE OF 750ML Liquor which contains 12 bottles).

Entry of foreign liquor brands could lead to higher competition

While there are a lot of entry barriers for new companies and brands largely due to ban on liquor advertising and import duties, international companies with deep pockets have been eyeing India considering the population demographics (over 65% of population below the age of 35). However, barring Seagram's a Pernod Ricard group company the world's second largest wine and spirits conglomerate; there has not been any significant presence of global liquor majors in India. Going forward, this could change leading to increased competition for incumbents.

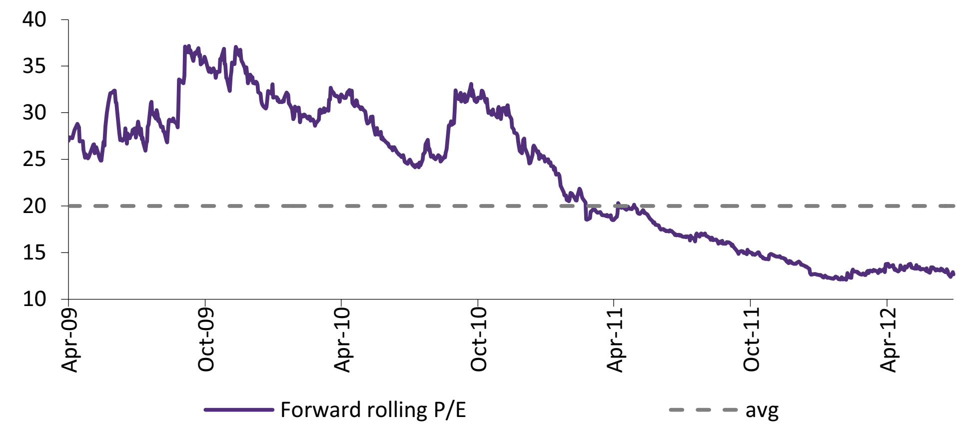
Valuation

Revival in flagship brands, premiumisation, and strong macro demand in tier-2 and tier-3 cities along with expected stable molasses prices will drive Radico's earnings growth over FY12-14E. Over the last three years, the stock of Radico has on an average traded at premium P/E multiples of 20.0x on one year forward earnings, owing to stupendous earnings growth clocked during the period (CAGR around 127%). Therefore, our multiple of 15.0x on FY14E EPS, to arrive at a target price of Rs 143, factors in: 1) lower earnings CAGR (FY12-14 – 28.8%), 2) volatility in molasses prices, 3) overall slowdown in economy, and 4) de-rating of mid-cap stocks in such uncertain times. We note that even at a lower P/E multiple, the stock offers an upside of around 21% from current levels, and hence we recommend a Buy.

Particulars (FY14E)	
EPS	9.5
Multiple applied	15
Target Price	143
CMP	118
Upside (%)	21.2

Source: Company, Violet Arch Research

Historical one-year forward P/E chart



Source: Company, Violet Arch Research

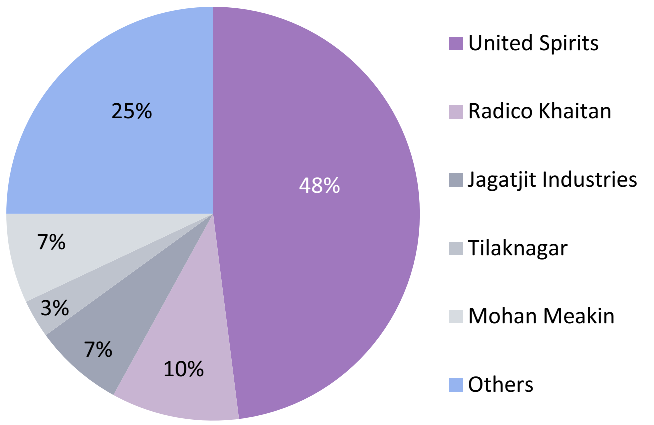
Company Background

Radico Khaitan, formerly known as Rampur Distillery, is one of the oldest and largest liquor manufacturers in India. The company entered the branded IMFL market only in 1999 by marketing its own brands. Launched in 1999, 8PM Whisky sold 1mn cases within the first year of its launch. Today, the company has grown to be the second-largest liquor manufacturer and has brands that straddle almost every market segment: whisky, rum, brandy, vodka and gin, and most price categories. The company has a market share of around 9% in the IMFL segment, making it the second-biggest IMFL player.

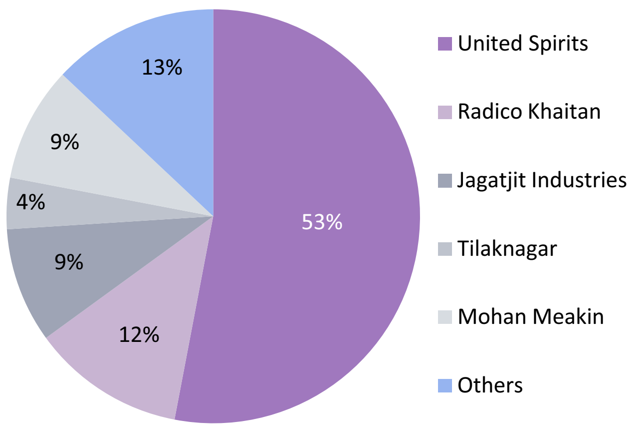
The company has a total distillery capacity of 150mn litres, with a 100mn litres capacity distillery, one of the largest distilleries of its kind, at Rampur (75mn litres molasses-based distillery and 25mn litres dual-feed-based distillery). It also has five self-owned bottling units and 27 contract bottling units, with a pan-India presence. The company is vertically integrated with PET bottle manufacturing in Uttaranchal and a new state-of-the-art bottle printing unit at Bahadurgarh, Haryana. Additionally, the company has a JV (Radico, 36:64 partners) for distillery, with a capacity of 48mn litres in Maharashtra.

Radico has four 'millionaire' (selling more than 1mn cases annually) brands: 8PM Whisky, Contessa Rum, Old Admiral Brandy and Magic Moments Vodka in its portfolio. Geographically, about 80% of its revenues accrue from North and South India. The company obtains around 75% of its revenue from IMFL, while the remaining from non-IMFL streams.

CY08



CY11



Source: Company, Violet Arch Research

Product	Brand	Segment
Whisky	8PM	Regular
	Whytehall	Premium
	After Dark	Premium
Vodka	Magic Moments	Premium
Brandy	Old Admiral	Regular
	Morpheus	Premium
Rum	Contessa	Regular

Source: Company, Violet Arch Research

Financial Summary

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY2014E
Net Sales	**9,464**	**11,439**	**13,793**	**16,158**
Raw Materials	4,309	5,461	6,362	7,453
Employee Cost	620	706	839	983
Other Expenses	3,028	3,551	4,314	5,047
Total Expenditure	**7,957**	**9,718**	**11,516**	**13,483**
EBITDA	**1,507**	**1,720**	**2,277**	**2,675**
Other Income	111	214	230	253
Interest	353	611	823	801
Depreciation	271	328	371	418
PBT	**995**	**995**	**1,313**	**1,708**
Total tax	267	233	341	444
Less: Extraordinary	0	125	0	0
Reported PAT	**728**	**637**	**972**	**1,264**
Adjusted PAT	**728**	**887**	**972**	**1,264**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY2014E
Equity capital	265	265	265	265
Reserves & Surplus	6,240	6,687	7,611	8,697
Net worth	**6,505**	**6,953**	**7,877**	**8,962**
Minority interest	0	0	0	0
Total debt	**4,912**	**6,161**	**5,686**	**5,870**
Total	**11,426**	**13,163**	**13,619**	**14,860**
Net block	4,189	5,022	5,253	5,755
Capital WIP	715	48	48	48
Total fixed assets	**4,904**	**5,071**	**5,302**	**5,803**
Investments	709	1,113	1,113	1,113
Net Working capital				
Current Assets	**8,063**	**9,252**	**10,038**	**11,085**
Inventories	1,275	1,774	2,002	2,345
Debtors	3,191	3,478	3,833	4,245
Cash & bank	94	210	879	798
Other Current Assets	3,503	3,789	3,324	3,697
Current Liabilities & Provisions	**1,752**	**1,709**	**2,271**	**2,578**
Creditors	1,093	1,385	1,613	1,890
Other liabilities	61	131	178	209
Provisions	598	193	479	479
Net Deferred Tax Assets	(498)	(563)	(563)	(563)
Miscellaneous Exp	0	0	0	0
Total	**11,426**	**13,163**	**13,619**	**14,860**

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY2014E
PAT	728	637	972	1,264
Add: Depreciation	271	328	371	418
Add: Interest expense	353	611	823	801
Less: Other income	(111)	(214)	(230)	(253)
Change in working capital	(1,252)	(1,074)	450	(848)
Others	0	0	0	0
Cash flow from operations	**(11)**	**288**	**2,386**	**1,382**
Change in fixed assets	(507)	(495)	(602)	(920)
Change in investments	185	(405)	0	0
Other income	111	214	230	253
Others	0	0	0	0
Cash flow from investing activities	**(210)**	**(686)**	**(372)**	**(667)**
Change in debt	450	1,249	(475)	184
Dividend & dividend tax	(108)	(124)	(155)	(179)
Change in equity & share premium	1	0	0	0
Interest paid	(353)	(611)	(823)	(801)
Other Adjustments	4	1	108	0
Cash flow from financing activities	**(5)**	**514**	**(1,345)**	**(796)**
Change in cash & cash equivalents	(239)	116	669	(81)
Opening cash and cash equivalents	**332**	**94**	**210**	**879**
Closing cash and cash equivalents	**94**	**210**	**879**	**798**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY2014E
Asset based ratios (%)				
ROCE	9.0	10.0	11.8	13.0
ROE	11.7	9.5	13.1	15.0
Turnover ratios (days)				
Debtor days	60	61	55	52
Inventory days	48	49	50	49
Creditors days	83	83	86	86
Working capital days	224	221	203	184
Growth ratios (%)				
Net Sales	11.6	20.9	20.6	17.1
EBITDA	15.8	14.1	32.4	17.5
EPS	126.0	(12.7)	52.6	30.1
CEPS	72.4	8.9	23.2	25.3
Per share (Rs)				
EPS	5.5	4.8	7.3	9.5
CEPS	7.5	8.2	10.1	12.7
BV	49.1	52.4	59.4	67.5
DPS	0.7	0.8	1.0	1.2
Valuations (x)				
P/E	21.4	24.6	16.1	12.4
P/CEPS	15.6	14.3	11.6	9.3
P/BV	2.4	2.2	2.0	1.7
Yield (%)	0.6	0.7	0.8	1.0
EV/EBITDA	13.6	12.5	9.0	7.7
EV/sales	2.2	1.9	1.5	1.3

COMPANY REPORT

Equity Research | Oil & Gas

21 September, 2012

Rallis India

Spurring Crop Revolution

Absolute Rating	BUY
Target Price	Rs 167
Upside	21%

Rallis India is one of the leading players in the agro-chem industry. The company, with its major focus on the pesticide segment, is the second-largest firm in the Indian crop protection industry. Over the past few years, it has embarked upon the growth path by extending its global footprint and has taken major steps towards faster growth through the inorganic route. Against this backdrop, it has clocked revenues at a CAGR of 15.1% over FY09-12. Going forward, we believe, the company would hit the growth trajectory on the back of: a) the expected growth of the Indian pesticide industry, which is estimated to grow at a faster pace of 12-13% over FY12-17 compared to 8-9% over FY07-12, b) the comprehensive portfolio of products and the extensive distribution network, and c) the returns on past investments. Hence, Rallis is expected to post a CAGR of 17.5%, 23.3% and 28.0% in revenues, EBITDA and earnings, respectively, over FY12-14E. We initiate coverage on the Rallis stock with a Buy recommendation at a target price of Rs 167, with an upside of around 21% from current levels.

Huge demand in crop protection market in India

India's pesticide consumption is one of the lowest in the world at 0.6kg/ha compared to the global average of 3.0kg/ha. Even when compared to its Asian peers, India fares poorly (1.3kg/ha in Pakistan and 2.0kg/ha in China), implying latent demand potential. We believe, Rallis is well poised to take advantage of this opportunity, with a comprehensive portfolio of products, many of which are ranked among top brands; a vast distribution network (2,500 dealers and 37,000 retailers) across India, covering 80% districts; and strong rapport the company has established with farmers with initiatives such as *Rallis Kisan Kutumba, Grow More Pulses,* and *Samrudhi Krishi.* We expect Rallis to post a CAGR of 12% in revenue over FY12-14E in the domestic pesticide segment.

Global pesticide business to witness strong growth

Rallis' pesticide business growth has been 34.0% and 50.3% in FY11 and FY12, respectively, thanks to strong demand for pesticides in key markets. With the commencement of the Dahej facility, the business will receive a further boost, with a third of the capacity being reserved for contract manufacturing. We expect a CAGR of 27.5% in revenue over FY12-14E.

Seeds business, the next growth-driver

With the acquisition of Metahelix, Rallis will be able to garner a substantial share of the growing pie of the Indian seed industry, whose current estimated size is Rs 70bn. It is expected to reach Rs 120bn over the next five years, growing at a CAGR of 11.4%. We expect a CAGR of 30% from this segment in the coming two years.

Valuations

Historically, the stock has traded at an average P/E multiple of 18x over past three years (FY09-FY12), at a time when adjusted earnings grew at a CAGR of 15.4%. Going forward (FY12-FY14E), we expect the company to post a CAGR of 28.0% in adjusted earnings, led by pesticide and seeds business segments. Hence, we believe that Rallis should continue to enjoy this high trading multiple backed by superior earnings growth story. We value the stock at 18.0x FY14E EPS and arrive at a target price of Rs 167.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	10,862	12,749	14,949	17,611
Growth (%)	23.6	17.4	17.3	17.8
EBITDA	1,862	2,027	2,541	3,082
Margins (%)	17.1	15.9	17.0	17.5
Net Profit	1,260	992	1,457	1,805
Margins (%)	11.6	7.8	9.7	10.3
EPS (Rs)	6.5	5.1	7.5	9.3
Growth (%)	24.2	(21.3)	46.9	24.0
PER (x)	21.4	27.3	18.6	15.0
ROE (%)	25.0	17.9	23.1	24.8

Source: Company, Violet Arch Research

Stock data

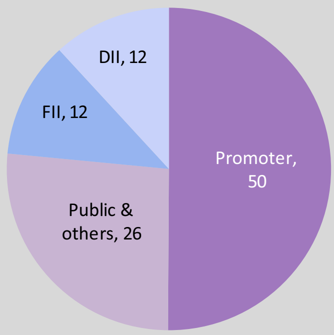
CMP	**Rs 138**
Reuters Code	RALL.BO
Bloomberg Code	RALI IN
Equity Shares o/s (mn)	194
Market Cap (Rs mn)	26,895
Market Cap (USD mn)	505
3m Avg daily t/o(US$ mn)	0.7

Stock performance (%)

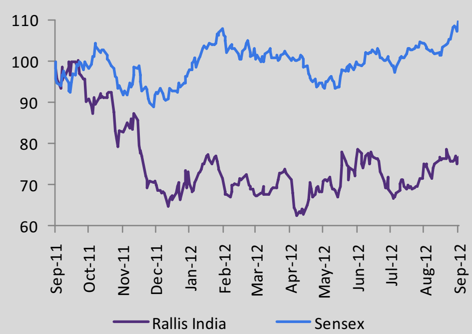
52-week high / low **Rs 187/111**

	1M	3M	12M
Absolute	2.3	(2.1)	(19.8)
Relative	(2.8)	(12.6)	(35.8)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

Rallis India's FY14 target price

	Bull Case	Base case	Bear Case
Domestic pesticide revenue growth (%)	15.0	12.0	10.0
International pesticide revenue growth (%)	30.0	25.0	20.0
Seed + subsidiary revenue growth (%)	40.0	30.0	20.0
Revenue (Rs mn)	18,498	17,611	16,905
Inc/(Dec) from base case (%)	5.0		(4.0)
RM as % of sales (%)	53.0	53.5	56.0
EBITDA (Rs mn)	3,330	3,082	2,536
Inc/(Dec) from base case (%)	8.0		(17.7)
EPS (Rs)	**10.1**	**9.3**	**7.4**
P/E multiple (x)	18	18	16
Target price) from core business (Rs)	182	167	118
Inc/(Dec) from base case (%)	9.2		(29.1)
NAV per share for land in Navi Mumbai and Hyderabad	20.0	-	-
Target price including land value (Rs)	202	167	118
Inc/(Dec) from base case (%)	21.2		(29.1)
CMP (Rs)	**138**	**138**	**138**
Upside (%)	**46.2**	**20.7**	**(14.5)**

Source: Company, Violet Arch Research

Key Assumptions

Segment revenue growth rates	FY11	FY12	FY13E	FY14E
Domestic pesticide (%)	16.5	(3.6)	12.0	12.0
International pesticide (%)	34.0	50.3	30.0	25.0
Seed + subsidiary including Metahelix (%)*	1050.3	73.7	30.0	30.0

*Source: Company, Violet Arch Research; * due to Metahelix acquisition the seed business has shown a big jump in FY11*

Base case

- Rallis' management guided for a 12-15% CAGR growth for the domestic pesticide business over the next five years. We expect a 12% revenue growth over the next two years in line with lower end of management guidance. Although the monsoon started on a negative note and continued to be below average for the initial two months, it showed a significant recovery in the last one month. As a result, the deficit in rainfall has declined from the peak of 22% to 5% currently, which we believe should arrest concerns on demand for pesticides.
- The global pesticide business has grown at 50% and 30% in FY11 and FY12, respectively, thanks to the demand pick-up and the rupee depreciation. We assume that the global business would continue to grow at 30% and 25% over the next two years, mainly due to demand from export markets, the commissioning of the Dahej plant in Q1FY12 and the rupee depreciation.
- We expect seeds business to continue to grow at 30% for the next two years on account of the Metahelix acquisition. Metahelix posted revenues of Rs 814mn in FY12 compared with Rs 424mn in FY11, a growth of 92%.
- Higher contribution from seeds segment (including that of Metahelix) will lead to EBITDA margin expansion from 15.9% in FY12 to 17.0% in FY13E. Input costs (as a percentage of sales) are expected to be around 54% in FY14 compared with around 55% in FY11/FY12.

Bull case

- In the past, domestic pesticide segment of Rallis has grown at much higher pace whenever there has been subdued performance. As the performance of domestic pesticide segment was subdued in FY12, we believe that in the best case (with rainfall deficit decreasing with pick-up in monsoon since last week of Aug'12 and normal rainfall situation in FY14), the pesticide segment can grow at 15% each for FY13 and FY14.
- We expect international pesticide segment to grow at 30% each in FY13 and FY14 on the back of improved global economy.
- Seeds business continues to grow at an even higher pace of 40% in FY14 led by Metahelix.
- We also consider the NAV of Rs 20/share for the land bank that Rallis has at Navi Mumbai (25 acres at Rs 7/share) and Hyderabad (85 acres at Rs 13/share).

Bear case

- In case of an adverse impact on pesticide demand in the country due to erratic rainfall, we expect domestic pesticide segment to grow at 10% in FY13 and FY14 each.
- In case the raw material costs spike driven by global commodities, we expect EBITDA margins to be lower by 200 bps.
- Seeds business does not pick up as expected and grow at subdued pace of 20% in FY14.

SWOT Analysis

Strengths

1) Strong presence in terms of product offerings and service capabilities (pesticides, seeds, PGN, farm retailing, agri-services, etc).

2) Seven out of the top-12 pesticide brands in terms of customer recall belong to Rallis.

3) Strong promoter with Tata Chemicals holding a 50% stake. Rallis can leverage 700 exclusive outlets of Tata Chemicals.

4) Strong balance sheet with net D/E at 0.2x, which can provide an opportunity to go for inorganic expansion as seen in the past with Metahelix acquisition.

5) Metahelix acquisition will strengthen Rallis' presence in the entire seeds value chain that comprises breeding, production and marketing of seeds, with the Indian seed industry being pegged at Rs 70bn.

Threats

1) Highly competitive industry, with more than 100 manufacturers in the market.

2) Market for pesticides is highly price-sensitive, as it caters largely to farmers.

3) The spurious pesticides market, selling counterfeit products, has a negative impact on the organized sector's revenues and farmers.

SWOT Analysis

Weaknesses

1) Since the level of irrigation is low in India, the dependence of farmers on the monsoon is high, which can affect revenues in the agro-chem business.

2) Demand for pesticide is seasonal in nature, with the demand being maximum during the Kharif season.

3) Currently, Rallis has high dependence on the pesticide business, with ~90% of revenues accruing from it.

Opportunities

1) New manufacturing facility at Dahej to cater to the exports market via contract manufacturing.

2) Metahelix also has a proprietary Bt trait, Cry1C in cotton, with a market estimated at Rs 40bn.

3) Rallis also has a land bank of 85 acres in Hyderabad (Andhra Pradesh) and 25 acres in Navi Mumbai (Maharashtra). In the past, Rallis monetized its 31 acres land bank in Mumbai for a consideration of Rs 900mn.

Source: Violet Arch Research

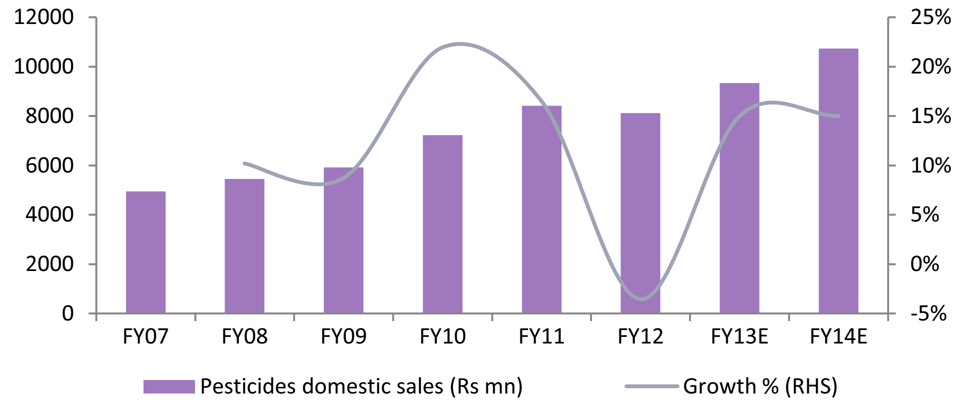
Investment Arguments

Huge opportunity in crop protection market in India

Pesticide consumption in India

Rallis' domestic pesticide sales has increased at a CAGR of 10.4% over FY07-12, thanks to a comprehensive product portfolio, a large distribution network across India, covering 80% of districts, with a distribution network of 2,500 dealers and 37,000 retailers and, a continued focus on farmers. According to the management, the domestic pesticide sales will further increase at a CAGR of 12-15% over the next five years. According to the Planning Commission, the Indian pesticide industry has grown at 8-9% over FY07-12, while Rallis has clocked a 25% growth. Further, going forward, the industry is expected to post a higher growth rate of 12-13% during FY12-17, which augers well for Rallis. We expect domestic pesticide sales to increase at the rate of 12% in the next two years on lower base, due to subdued pesticide sales growth in FY12 and on account of under-penetration of pesticide usage in India. Incidentally, India's pesticide usage has been pegged at 0.58kg/ha vis-à-vis the global average of 3.0kg/ha. Even Asian peers have much higher pesticide usage with Pakistan at 1.3kg/ha and China at 2.0kg/ha.

Rallis' domestic pesticide sales



Source: Company, Violet Arch Research

As seen in the table below, Rallis' products enjoy huge endorsement and brand recall from farmers on account of strong Tata-Rallis brand (farmers often refer to Rallis' products as Tata-Rallis) and continued rapport with farmers. According to a Gallup survey, Rallis has seven brands among India's top-12 brands.

Domestic formulation: Top brands

Brands	Company	2010	2011
Confidor	Bayer	54%	51%
Contaf	Rallis	30%	41%
Rogor	Rallis	29%	37%
Asataf	Rallis	28%	38%
Tata Mida	Rallis	24%	15%
Contaf Plus	Rallis	19%	30%
Fame	Bayer	17%	26%
Antracol	Bayer	15%	29%
Tata Mono	Rallis	13%	31%
Applaud	Rallis	13%	16%
Proclaim	Syngenta	13%	17%
Hostathion	Bayer	12%	14%

Sources: Unaided recall, Gallup Customer Engagement Survey

With initiatives such as *Rallis Kisan Kutumba* (RKK), *Samrudh Krishi* and *Grow More Pulses* (MoPu), Rallis is trying to build a strong relationship with farmers.

RKK was an initiative started in FY08, aiming to bring about a difference in terms of farmer relationship and farmer understanding by providing farmers information on improving productivity across major crops. The RKK initiative is to enable farmers to imbibe and use knowledge and share the same with the farmer community to increase productivity. The key activities with the RKK farmers are regular contact throughout the crop cycle, organizing crop seminars, product demonstrations, Farmer exchange programmes (Prerna), Focused Group Discussions (FGDs) and advisory services. In addition, going forward, the company has added more value-added services such as SMS alerts on crop prices, weather and possible disease outbreak through Samrudh Krishi.

Through the MoPu programme, the company is actively engaging with farmers to increase the productivity of pulses, as also helping them in marketing the produce, aims at embracing the entire value chain of products and services to the farming community.

Samrudh Krishi reaches out to farmers with holistic agro-advisory through multiple touch-points. The physical connect with farmers is provided by knowledgeable crop-advisors who visit every farmer's plot and provide him with customized recommendations. This is supplemented by electronic connect – daily SMSs (text and/or voice), which provide village-specific weather information and advisory. Samrudh Krishi combines the benefit of technology with the personal touch of crop advisors to meet productivity requirements of farmers.

Rallis has a digitized database of 0.7mn under RKK and expects the same to reach 1.0mn by the end of FY13 and 5mn members over next few years. This compilation of database lends critical inputs for the following end-purposes: 1) understand the pulse of farmer requirements (which are essential to create new offerings), and 2) create brand for its product offerings.

As seen from the table below, Rallis has consistently launched new products every year to cater to the evolving need of the market. New product launches are the key to growth of the company, as pests become tolerant to pesticides and efficacy of products goes down over a period of time.

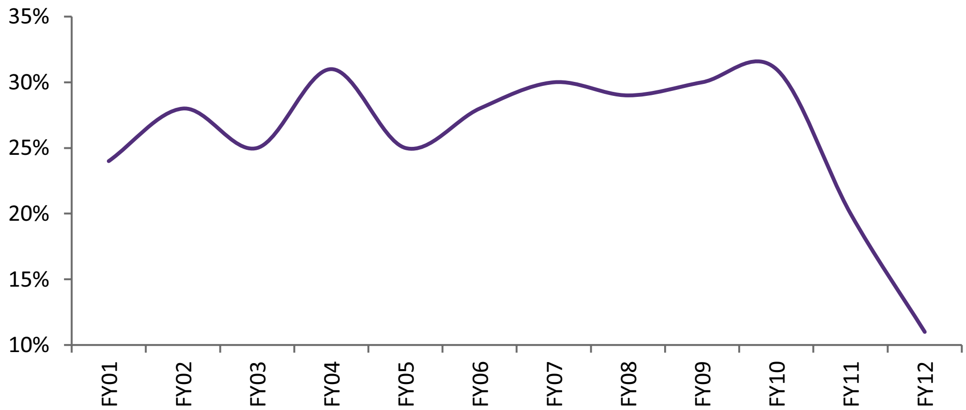
Products launched

Year	Insecticide	Fungicide	Herbicide	Other
FY07	Nova, Applaud	Taqat	-	-
FY08	Takomi, Sedna, Royal	Ishaan, Tebuconazole	-	-
FY09	-	-	-	Mantis*
FY10	Ergon	-	-	-
FY11	Toran	-	Tarak	-
FY12	Taffin, Sonic, Neon,	Saras	Cylo, Vaar, Honcho, Fycol, Ditaf	Bahaar#

*Source: Company, Violet Arch Research - *Mantis is a blasticide; #Bahaar is a Plant Growth Promoter*

Rallis has consistently maintained the Innovation Turnover Index (revenues from products newly introduced in the last four years to the total turnover) at around 25%. In FY12, the index fell to around 11% because of subdued performance in the pesticide business due to low pest infestation in paddy and cotton, poor yield in pulses, low price realization of farm produce for farmers which resulted into reduced usage of Rallis' branded and premium products. Also Applaud and Takumi were removed from the innovation turnover index as these products are now more than 4 years old. However, we expect the Innovation Turnover Index to rebound to 20% on the back of 10 new product launches in FY12, which are expected to yield results in the coming years. Also notably, out of 10 products launched in FY12 five are herbicides, which is the move in the right direction as manual labour has become costly for removal of weeds.

Innovation turnover index

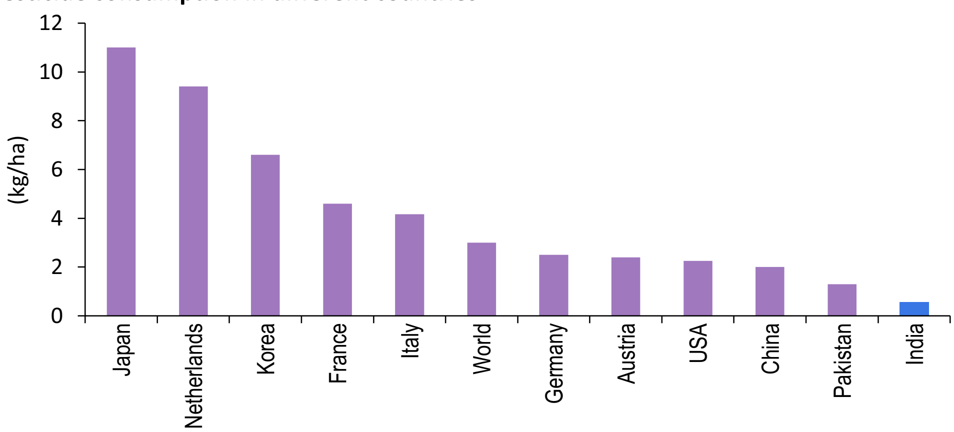


Source: Company, Violet Arch Research

Structural factors in favour of domestic pesticide business

The usage of pesticides in India is 0.58kg/ha compared to 2.0kg/ha in China. To meet the country's food requirements, which has been spurred by the increasing population, rising income, and limited availability of arable land, the yield per hectare will have to be stepped up (for example, crop productivity in India is at 2.0mt/ha compared to China at 5.0mt/ha). This can be achieved through multiple means (for example, larger fields, better automation, improved irrigation infrastructure), along with increased use of agrochemicals. According to estimates, Rs 700-800bn worth of crop is lost due to insufficient usage of pesticide in India.

Pesticide consumption in different countries

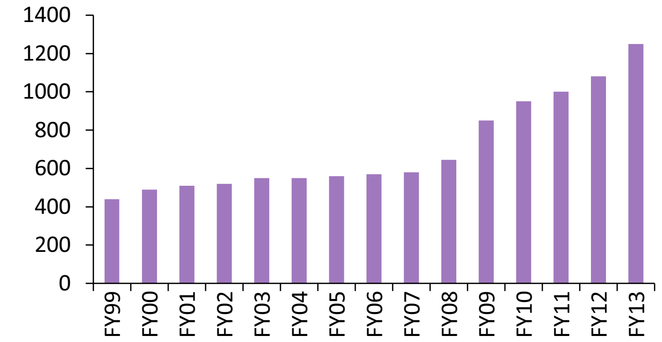


Source: Violet Arch Research; Industry sources

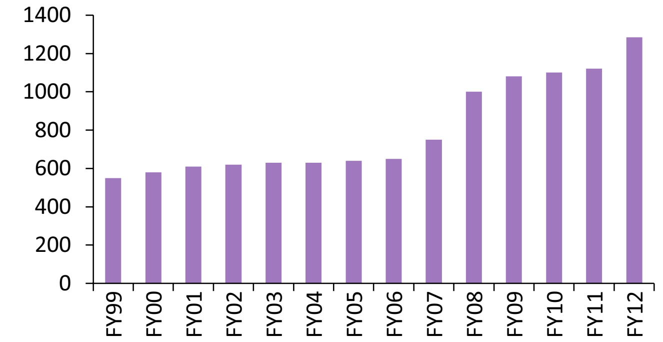
Farmers' willingness and ability to spend is an important driver for demand in the pesticide business. Strong support prices for crops and better availability of credit will ease pressure on the farming community. Higher MSPs for key crops (as seen since FY07) bodes well for the agro-chem industry, as farmers will be able to use more pesticides, fertilizers, PGN, better seeds, etc. to improve yield/production and reduce crop losses.

Higher MSPs for key crops

Rice (Rs per quintal)



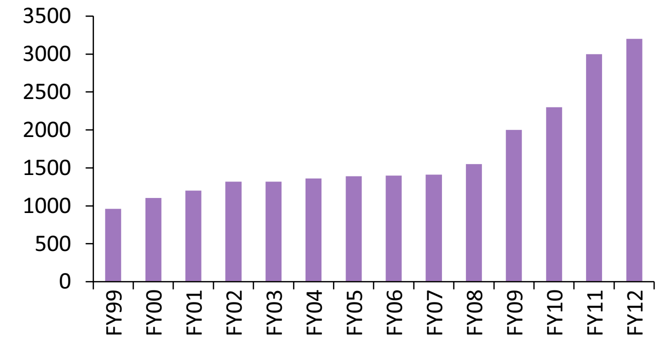
Wheat (Rs per quintal)



Source: Company, Violet Arch Research

Cotton (Rs per quintal)

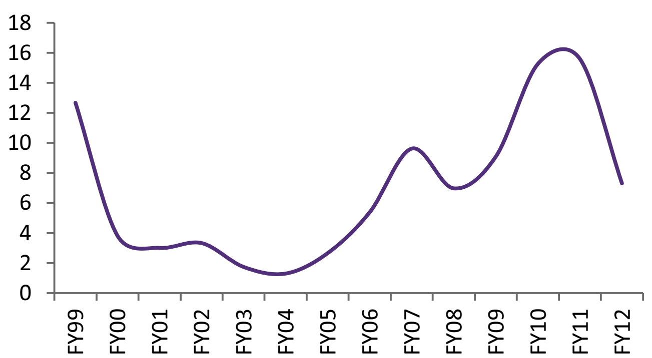
Tur (Rs per quintal)



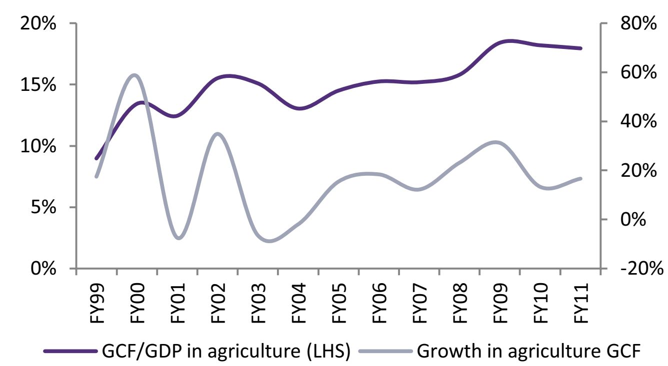
Source: Company, Violet Arch Research

Food inflation has averaged above 10% in last 5-6 years which bodes well for farmers as higher realization for farm produce results in higher farm incomes and hence farmer willingness to spend on Agro-chem products. Also the growth in gross capital formation growth has been above 15% since FY05 when food inflation has been high benefiting the agriculture sector.

Food Inflation (% YoY) remaining high for last few years



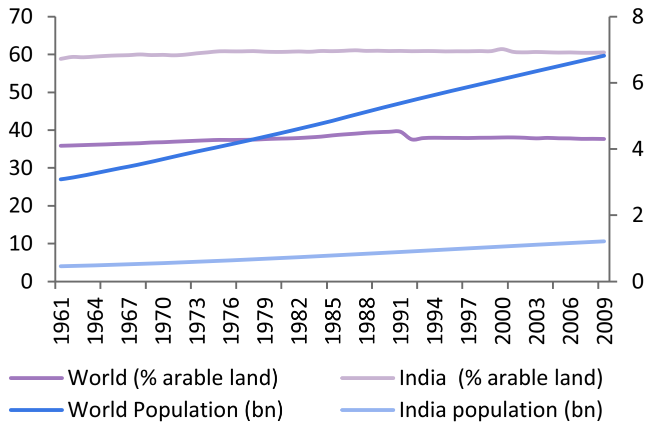
Agriculture GCF/GDP and GCF growth



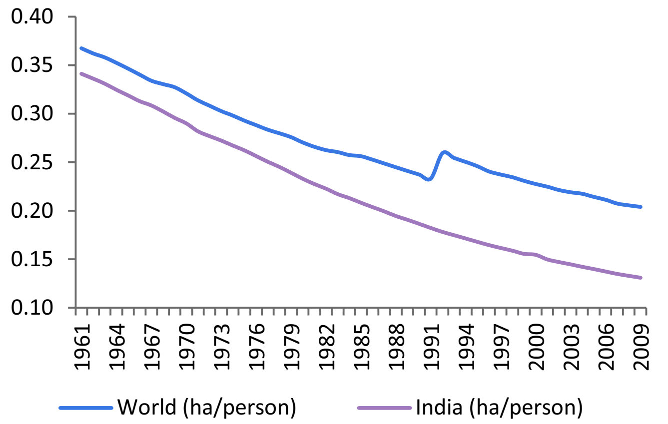
Source: Company, Violet Arch Research

The arable land in India and the world over has remained stagnant over the years with rising population. Consequently, arable land available per capita has been declining over the years and has dropped from at 0.34ha/person in 1961 to 0.13ha/person currently. Globally, the ratio has declined from 0.37ha/person to 0.20ha/person currently.

Arable land and Population



Per capita arable land declining over the years



Source: Company, Violet Arch Research

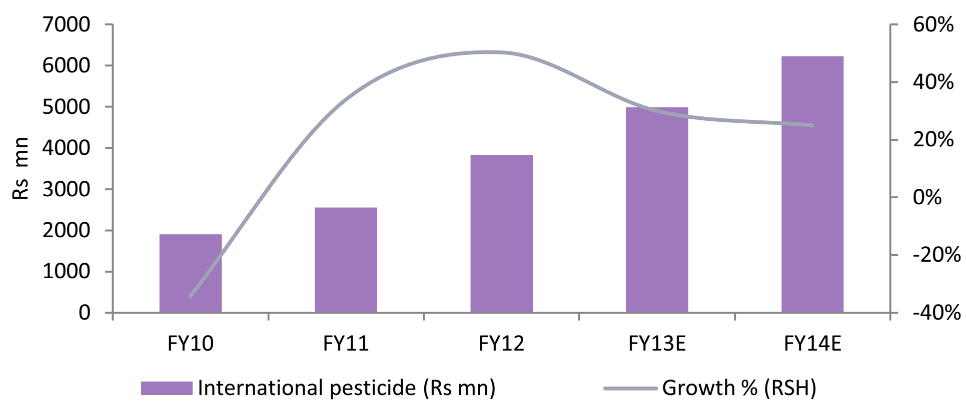
International business witnessing strong growth

Over the last few years, Rallis' global business has witnessed an increasing share in overall scheme of things, led mainly by strong demand witnessed in key export markets and increase in realizations. Also, the company has strategically extended its presence in newer geographies, given better realizations in the international market and growing opportunities on offer.

To put things in perspective, FY12 witnessed considerable volume growth in key manufactured products exported to Latin America and the US under contract manufacturing. Sales in Southeast Asia also improved, due to higher sales of fungicides. Africa reported stable sales in spite of forgoing certain business because of political instability.

Rallis has set up a new manufacturing facility at Dahej in Gujarat at an outlay of Rs 1.5bn. A third of the capacity is expected to cater to contract manufacturing. Phase-I of this facility, which became operational in June 2011, will enhance the competitive edge of Rallis to handle different types of chemistries, increasing its potential to attract contract manufacturing from suitable alliance partners. The management has guided cumulative revenues of Rs 5bn from the Dahej facility over FY12-17. The company's international pesticide business has grown at 34-50% in last two years. We expect a growth of 30% and 25% in FY13 and FY14, respectively.

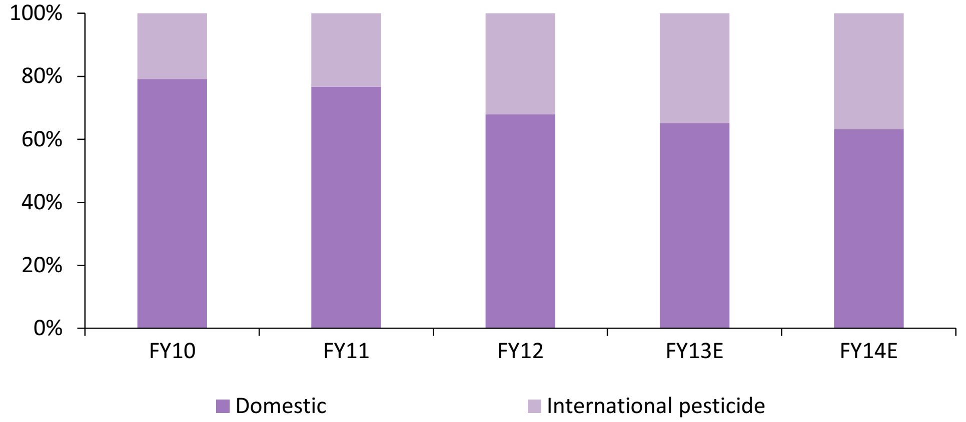
International pesticide business



Source: Company, Violet Arch Research

Currently, 30% of revenues from the pesticide segment accrue from the international business, which we expect to reach 37% in FY14.

Growing share of global segment in pesticide business



Source: Company, Violet Arch Research

Seed business to grow at robust pace

Metahelix acquisition and turnaround to drive Ralllis' seed business

In December 2010, Rallis acquired a 53.5% stake in Metahelix Life Sciences. It increased its stake further to 75.6% by FY12. The total consideration paid for a 75.6% stake was around Rs 15.8bn. Rallis has plans to increase its stake to 100% over the next five years.

Metahelix, a Bangalore-based agricultural biotechnology enterprise, is focused on crop improvement and greater productivity, with well-developed expertise in crop genetics and high-performance hybrid seeds of rice, maize, cotton, millets, tomato, hot pepper, okra, etc.

Rallis launched close to 10 hybrid seeds in FY12 through Metahelix, thereby helping the company to diversify its portfolio and generate a robust income. Rallis plans to roll out several new hybrid seeds in FY13 and market them through its 2,500-strong retail network and 700 exclusive outlets of Tata Chemicals. The company will also be able to leverage its strong rapport with farmers established over several years, which will give a fillip to its seeds business.

Metahelix's turnaround is already evident from the fact that it clocked revenues of Rs 814mn compared with Rs 424mn in FY11, and a profit of Rs 6mn as against a loss of Rs 143mn in the previous year.

Metahelix consolidated financials

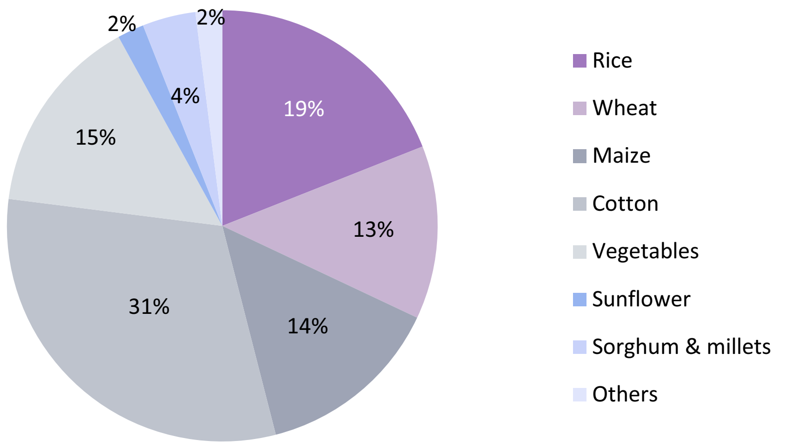
Rs mn	FY11*	FY11	FY12
Net sales	148	424	814
Net profit	17	(143)	6

*Source: Company, Violet Arch Research, *FY11 contains figures for Metahelix after Rallis Acquisition, i.e., from the fourth quarter onwards.*

According to official data, India, the world's second-largest grain grower, produced 35.34mn quintals of seeds in FY12, compared with the requisite 33.02mn quintals. Although seed supplies have remained smooth for most crops, the availability of quality seeds had been a problem until recent times. The private sector accounts for 40% of the country's seed production, while state-run companies still continue to play a dominant role. With land resources remaining limited and the population rising, quality inputs such as seeds are the key to raising production. A considerable chunk of the seed production is still in the unorganised sector, which offers inputs, albeit low-quality and often spurious seeds at cheaper rates.

The seeds business in India is growing at 12-15% annually compared to the global growth of 6-7%. Currently, the seeds industry is pegged at Rs 70bn, which was Rs 50bn two years ago. It could reach Rs 120bn in the coming five years. With the acquisition of Metahelix, Rallis looks poised for growth at a robust pace in seeds business. At present, Metahelix commands only 11% of the total pie of the Rs 70-bn seeds industry. In our model, we have assumed a 30% growth in the seeds business for FY13 and FY14 each.

Indian seed industry estimated at Rs 70bn

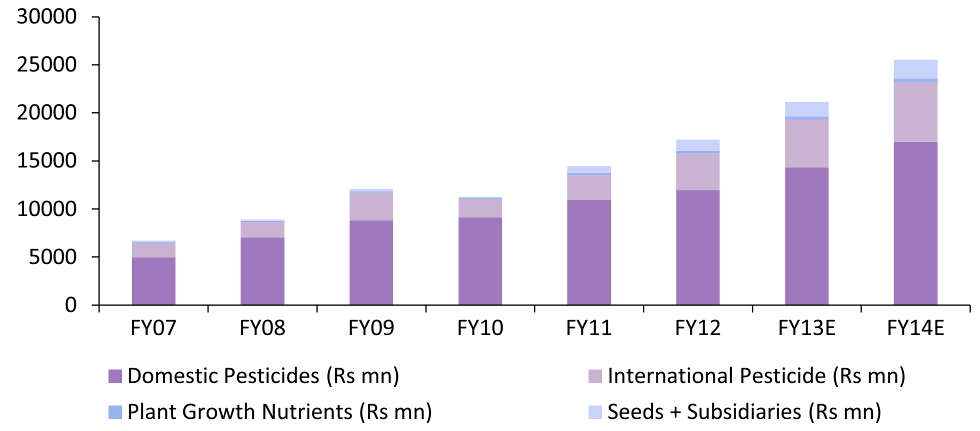


Source: Violet Arch Research, Industry

Metahelix also has a proprietary Bt trait Cry1C in cotton. Some estimates peg the market for the Bt cotton seed in India at Rs 40bn. Currently, Monsanto, multinational agricultural biotechnology giant is the only company in India with patent for Bt Cotton seed production technology and it markets its sales through local seed company Mahyco-Monsanto. Other seed companies like Raasi Seeds Pvt Ltd, Nuzveedu Seeds Pvt Ltd, Bioseeds Pvt Ltd, Pioneer Seeds and Leed Better Seeds Pvt Ltd have bought the technology from Monsanto and pay it a royalty of Rs 225 per packet on Bt-II variety. Metahelix plans to garner a 10% share of the total market in the initial 3-5 years after the launch of Bt trait Cry1C.

With robust growth expected in the international pesticide business and the seeds business in the coming years, the dependence of Rallis on the domestic pesticide business will reduce. By FY14, we expect the international pesticide and the seeds business to contribute 25% and 8%, respectively, towards the total revenues, while the domestic pesticide business will be 66% of the total revenues.

Rallis' business segment



Source: Company, Violet Arch Research

Key Risks and Concerns

Dependence on the monsoon

Performance of the crop protection industry is largely dependent on the monsoons. Any major fluctuations in the total rainfall and its distribution may affect crop acreages, increase pest incidences and impact the overall productivity. Besides, they have a direct correlation with sales. Although the monsoon has been erratic for the year so far, sowing has been healthy for major kharif crops as evident from the data given below.

Crop	Area as on 21/09/2012	Normal area for this time of the year	Deviation (%)
Rice	363.8	358.7	1.4
Coarse cereals	175.9	208.5	(15.6)
Pulses	99.8	103.2	-3.2
Oilseeds	174.4	174.4	0.0
Sugarcane	52.9	47.2	12.0
Cotton	114.9	108.6	5.8
Jute and mesta	8.8	9.0	(2.4)
Total	**990.5**	**1,009.6**	**(1.9)**

Source: Company, Violet Arch Research

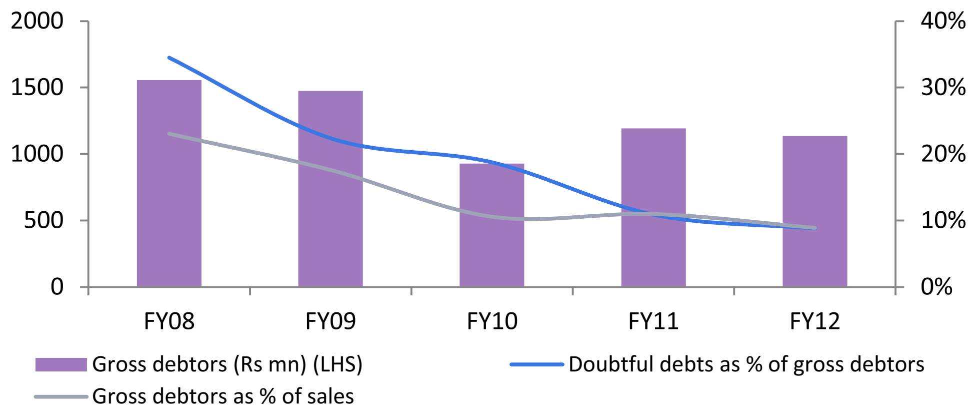
Metahelix growth not as per expectation

Robust growth in the seeds segment of Rallis is expected on the back of consistent higher revenues from Metahelix as well as on account of its ability to garner a higher market share of the growing pie of the seeds industry. We have assumed a 30% growth in Metahelix revenues for the next two years. Metahelix's lower-than-expected revenue growth could affect the company's profitability.

Working capital-intensive nature of the business

The pesticide industry is working capital-intensive, as the seasonal nature of demand for pesticides persuades companies to maintain large inventory levels. Moreover, farmers require long credit periods, as they have little surplus money for purchasing pesticides. However, as evident from the graph below, Rallis has managed to bridle its bad debts.

Bad debts declining over the years



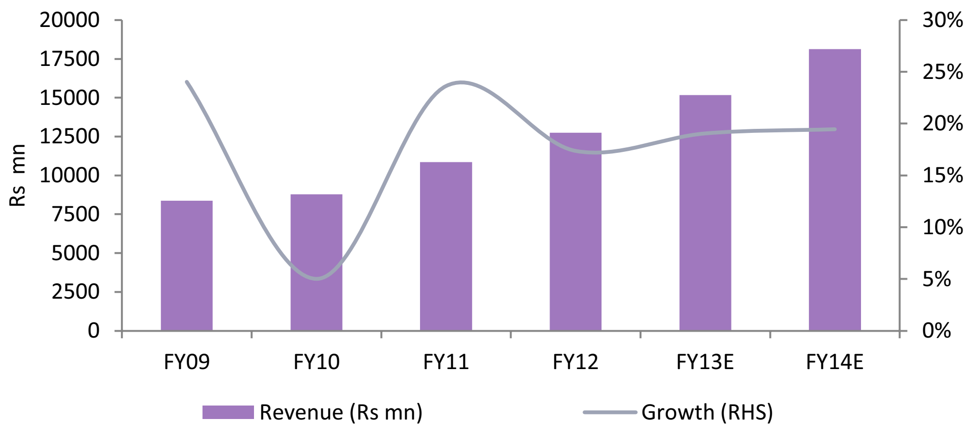
Source: Company, Violet Arch Research

Financial Outlook

Revenue

Rallis' revenues have grown at a CAGR of 15% over FY09-12 on the back of an 11% (CAGR) growth in the domestic pesticide segment, a CAGR of 10% in the international pesticide segment, a CAGR of 30% in the PGN segment, a CAGR of 72% in the seeds and subsidiary business. Going forward, we expect, Rallis to clock a CAGR of 18% in revenues over FY12-14 due to a 12% growth (CAGR) in the domestic pesticide revenues, a CAGR of 27% in the international pesticide revenues, and a CAGR of 30% in the seeds and subsidiary revenues.

Revenue trend

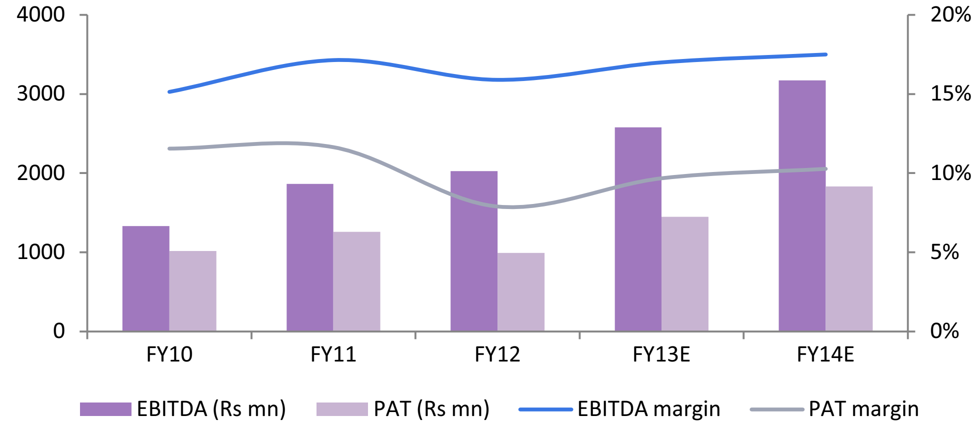


Source: Company, Violet Arch Research

EBITDA and PAT

We expect EBITDA margins to improve marginally in FY13 and FY14 to around 17% from about 16% in FY12, due to increasing contributions from the high EBITDA margin seeds business. In FY12, PAT margins were lower in FY12 on account of the exceptional item (cessation costs) and higher interest costs (debt raised for the Dahej plant) and higher depreciation charges (due to the commissioning of the Dahej plant). In FY13 and FY14, we expect PAT margins to be improve to 10% because of lower interest costs on account of paring of debt.

EBITDA and PAT trend

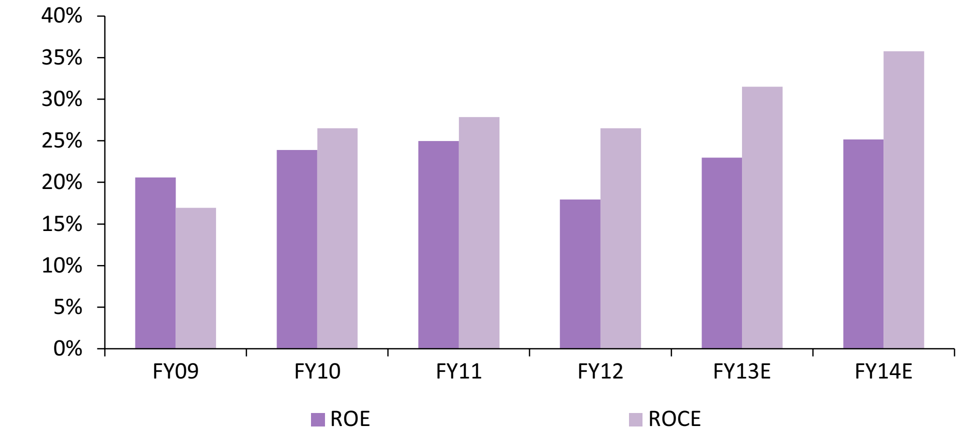


Source: Company, Violet Arch Research

ROE and ROCE

Over the last few years, Rallis has consistently maintained ROE above of 20%. We expect ROE to improve to 23% and 25% in FY13 and FY14, respectively, due to greater profitability led by robust performance in the pesticide and seeds business. We expect ROCE to improve to 31% and 35% in FY13 and FY14, respectively, on account of paring of debt.

ROE and ROCE trend

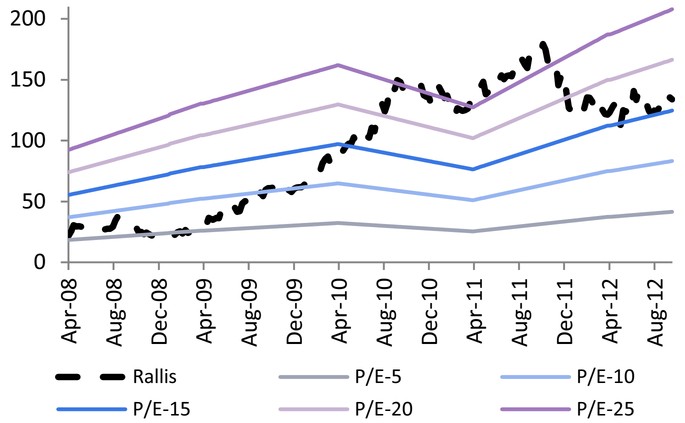


Source: Company, Violet Arch Research

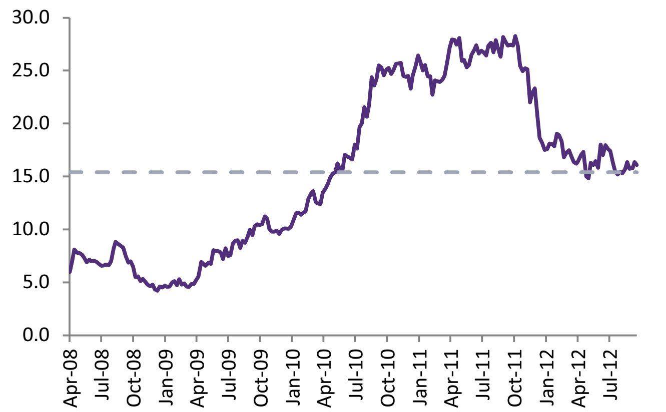
Valuation

Historically, the stock has traded at an average P/E multiple of 18x over past three years (FY09-FY12), at a time when adjusted earnings grew at a CAGR of 15.4%. Going forward (FY12-14E), we expect the company to post a CAGR of 28.0% in earnings, led by pesticide and seeds business segments. Hence, we believe that Rallis should continue to enjoy this high trading multiple backed by superior earnings growth story. We value the stock at 18.0x FY14E EPS and arrive at a target price of Rs 167. At the CMP, the stock trades at 18.6x and 15.0x its FY13E and FY14 EPS, respectively. We note that Rallis has a land bank of 85 acres and 25 acres in Hyderabad and Navi Mumbai, respectively. In the past, Rallis monetized its land bank in Mumbai and generated cash (sold 31 acres land for consideration of Rs 900mn). But we have not assigned any value for the same. It remains a potential upside to our target price. We initiate coverage on the stock with a Buy recommendation.

Historical one-year forward PE



Daily forward P/E



Source: Company, Violet Arch Research

Company Background

Incorporated in 1948, Rallis Ltd. is a subsidiary of Tata Chemicals, which holds a 50.8% stake in Rallis India. Rallis is the second-largest company in India in the pesticide industry, with top brands such as Contaf, Rogor, and Asataf, among others. In the domestic pesticide market, it has a presence through formulations and institutional business. Rallis also caters to export markets through contract manufacturing, registered product sales and alliance/bulk sales. The other business segments of Rallis include the plant growth nutrient (PGN) segment and the seeds segment. Rallis also has a 75.6% stake in Metahelix life sciences, a research-led seeds company, which is expected to help Rallis to increase its presence in the seeds industry in India.

In FY12, Rallis derived 89% of its total revenues from the pesticide segment, with the domestic segment contributing 61%, the international segment 28%, subsidiaries 8% (which includes Metahelix) and the rest coming from PGN and seeds segments.

Financial summary - Consolidated

Income statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	10,862	12,749	14,949	17,611
Growth (%)	23.6	17.4	17.3	17.8
Total Expenditure	**9,000**	**10,722**	**12,407**	**14,529**
EBIDTA	**1,862**	**2,027**	**2,541**	**3,082**
EBIDTA Margins(%)	17.1	15.9	17.0	17.5
Depreciation	171	287	347	377
EBIT	1,692	1,740	2,195	2,705
EBIT Margins (%)	15.6	13.6	14.7	15.4
Interest	69	175	91	66
Other Income	222	101	100	100
PBT	**1,845**	**1,666**	**2,204**	**2,739**
Exceptional items	0	(172)	0	0
Tax Provisions	580	487	727	904
Minority Interest	4	15	20	30
PAT	**1,260**	**992**	**1,457**	**1,805**
PAT Margins (%)	11.6	7.8	9.7	10.3

Cash flow statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
PBT	1,845	1,494	2,204	2,739
Adjustments	58	366	337	342
Changes in WC	(314)	(507)	(378)	(576)
Direct Taxes	(706)	(407)	(727)	(904)
Cash Flow from Operations	**883**	**946**	**1,436**	**1,602**
Capital Expenditure	(1,278)	(531)	(500)	(500)
Changes in Investments & other items	(116)	(289)	-	-
Cash Flow from Investing	**(1,338)**	**(740)**	**(400)**	**(400)**
Equity Raised	-	-	-	-
Debt Raised	849	369	(250)	(250)
Dividend Paid	(353)	(473)	(498)	(679)
Cash Flow from Financing	**458**	**(242)**	**(839)**	**(995)**
Net Change in Cash	2	(37)	197	207
Opening Cash & Cash Eq	**120**	**122**	**85**	**282**
Closing Cash & Cash Eq	**146**	**112**	**309**	**516**

Balance sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Sources of Funds				
Equity Share Capital	194	194	194	194
Reseves & Surplus	4,855	5,336	6,113	7,078
Shareholder's Funds	5,049	5,530	6,308	7,272
Minority Interest	21	14	14	14
Total Debt	1,028	1,033	783	533
Total Liabilities	**6,099**	**6,578**	**7,106**	**7,820**
Application of Funds				
Net Block	3,484	5,171	5,333	5,440
Capital WIP	1,586	599	599	599
Investments	1,302	1,138	1,138	1,138
Current Assets	3,794	4,319	5,268	6,519
Current Liabilities	4,035	4,518	5,102	5,746
Net Current Assets	(241)	(199)	166	773
Deferred Tax Assets / Liabilities	(32)	(131)	(131)	(131)
Total Assets	**6,099**	**6,578**	**7,106**	**7,820**

Financial ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Leverage Ratio				
Net Debt/Equity	0.2	0.2	0.2	0.1
Interest Coverage Ratio	24.5	9.9	24.2	41.1
Per Share Data				
Diluted EPS	6.5	5.1	7.5	9.3
Cash EPS	7.4	6.6	9.3	11.2
DPS	2.0	2.2	3.0	3.7
BVPS	26.0	28.4	32.4	37.4
Valuation Ratios (x)				
P/E	21.4	27.3	18.6	15.0
P/BV	5.4	4.9	4.3	3.7
EV/EBIDTA	14.5	13.3	10.6	8.8
EV/Sales	2.5	2.1	1.8	1.5
Profitability Ratios (%)				
EBIDTA Margins	17.1	15.9	17.0	17.5
PAT Margins	11.6	7.8	9.7	10.3
RoCE	27.8	26.5	30.9	34.7
RoE	25.0	17.9	23.1	24.8
Growth Ratios (%)				
Sales	23.6	17.4	17.3	17.8
EBITDA	40.0	8.8	25.4	21.3
PAT	24.2	(21.3)	46.9	24.0

COMPANY REPORT

Equity Research | Finance

21 September, 2012

Shriram Transport Finance Company

Broadening Horizon

Absolute Rating	**BUY**
Target Price	**Rs 752**
Upside	**20%**

Shriram Transport Finance Company (STFC), the flagship company of the Shriram group, is the largest asset financing NBFC in India. STFC set up 200 centres in rural areas in Q1FY13, with the objective of acquiring new customers and promoting disbursement growth. It added 12,000 to its customer base in Q1FY13 itself. The disbursements, which were in the range of Rs 47-49bn in the last few quarters, have increased to Rs 53.7bn in Q1FY13. The firm intends to set up another 200 centres in the coming couple of quarters and also acquire 60,000-65,000 more customers over the next few quarters. We expect the momentum in disbursements to continue, as the bank now focuses on rural markets.

Unique business model

STFC is the only organized player in the pre-owned CV financing business, with a market share of around 25%. The company has been operating in the market for 30 years. Its strength lies in customer credit evaluation, valuation of pre-owned CVs, collection of payments from customers, a strong customer base and an extensive branch network.

Shift in focus towards LCVs

STFC has shifted its focus from financing MHCVs to LCVs (which help in reaching the last-mile in consumer business). Over the last eight months, growth in LCVs has been estimated at 22.5% as against a de-growth of 2.5% in MHCVs. We expect LCVs to grow at 15-18% in FY13E vis-à-vis a 5-6% de-growth in MHCVs in FY13E.

New securitization norms not to impact earnings

In Aug'12, the RBI securitization guidelines specified a minimum retention requirement (MRR) for securitization. NBFCs selling loans will have to retain 5% of the amount if the loan is for a period less than two years and 10% if it is for over two years. But this will not have a significant impact on the securitization portfolio of STFC, mainly because it has its loan book tenured to the maximum period of 38-40 months. It may lead to securitization being spread out evenly. The other guideline on securitization stipulates conversion of all assignments into pass-through certificates (PTC). However, STFC being the largest securitization player in the market, we do not expect a material impact on the portfolio.

Superior return ratios to continue

Historically, STFC has had superior return ratios. We expect this trend to continue. We expect the company's RoA (on AUM) to improve to 3.4% by FY14E, driven largely by healthy growth in AUM, due to better disbursement as mentioned above. Also, we expect it to focus on high-yielding older vehicles in the rural market, and its funding costs to decline as bank-lending rates come down.

Valuations

At Rs 625, the stock is available at price-to-adjusted book value (P/ABV) of around 1.6x of FY14E. We expect return ratios to improve on account of healthy growth in profits at a CAGR of 18.7% between FY12 and FY14E. Thus, we value the NBFC's business at 1.9x FY14E P/ABV based a slight discount to the historical average of 2.5x due to a fall in AUM growth rate, fall in profit growth and decrease in return ratios (i.e. RoE from 28% in FY10 to 21.7% in FY14E and RoA at ~3.4%). We initiate coverage on the stock with a Buy rating at a target price of Rs 752, with an upside of ~ 20% from current levels.

Particulars (Rs mn)	FY11	FY12	FY13E	FY14E
Net Interest Income	29,582	32,261	36,262	41,998
Growth (%)	37.4	9.1	12.4	15.8
PPP*	24,037	26,431	30,575	35,713
Growth (%)	38.8	10.0	15.7	16.8
Profit After Tax	12,299	12,575	14,993	17,723
Growth (%)	40.9	2.2	19.2	18.2
NIM (%, on AUM)	8.1	8.0	7.9	8.0
ROAA (%, on AUM)	3.4	3.1	3.3	3.4
ROAE (%)	28.1	23.1	22.5	21.7
EPS (Rs)	54.4	55.6	66.2	78.3
ABV (Rs.)	216.8	264.8	324.4	387.8

*Source: Company, Violet Arch Research; *PPP – Pre-provisioning Profit*

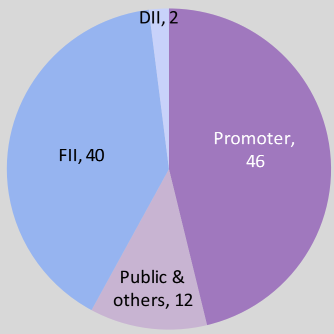
Stock data

CMP	**Rs 625**
Reuters Code	SRTR.BO
Bloomberg Code	SHTF IN
Equity Shares o/s (mn)	226
Market Cap (Rsmn)	141,507
Market Cap (USD mn)	2,657
3m Avg daily t/o(US$ mn)	2.5

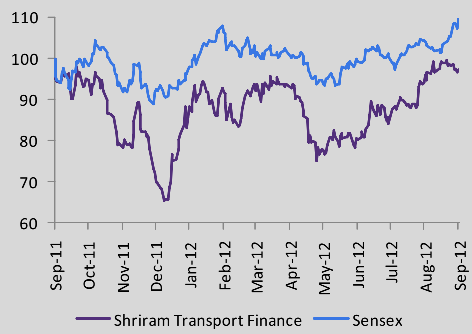
Stock performance (%)

52-week high/low			**Rs 680/416**
	1M	**3M**	**12M**
Absolute (%)	3.1	20.7	(1.3)
Relative (%)	(3.6)	10.0	(10.8)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

Particulars	FY14E		
	Bear	Base	Bull
AUM growth (%)	11.5	14.1	16.2
NIM (%)	7.1	8.0	8.4
GNPA (%)	3.2	2.9	2.5
EPS (Rs.)	58.2	72.9	86.8
ABV (Rs.)	353.6	387.8	406.0
ROE (%)	17.3	21.7	24.3
P/ABV (x)	1.6	1.9	2.3
Target Price (Rs.)	565.8	752.3	913.5
CMP (Rs.)	**625.3**	**625.3**	**625.3**
Upside / (Downside) (%)	**(9.5)**	**20.3**	**46.1**

Source: Company, Violet Arch Research

Key Assumptions

Particulars (%)	FY11	FY12	FY13E	FY14E
Borrowing Growth	7.7	16.3	25.0	20.0
AUM Growth	26.0	9.6	14.0	14.1
Core Interest Spread	6.6	6.2	6.9	7.1
NIM	8.1	8.0	7.9	8.0
RoA (on AUM)	3.4	3.1	3.3	3.4
RoE	28.1	23.1	22.5	21.7

Source: Company, Violet Arch Research

Base case

- We have factored in around 14% AUM growth in FY14E. The reason for such an assumption is the increase in disbursement to about Rs 60bn per quarter on account of demand for LCVs and the company's shift in focus towards the rural market. We expect the securitization book to shrink slightly, but we expect an improvement in yield on account of STFC's focus on financing older vehicles (above 12 years of age), where the yield ranges between 22% and 24%.
- The current economic downturn has led to lower growth in truck sales. However, we expect the growth to be mainly led by used CV financing. We expect some slowdown in heavy CV financing and hence the growth to be chiefly led by LCV financing, which has grown at 22.5% in the last eight months.
- For FY14, we expect margins to remain healthy on account of the improvement in yield, healthy disbursement and decrease in cost of borrowings, as banks (which formed 76% of total borrowings in Q1FY13). We believe that the worst in terms of asset quality is presumably over, as the company faced asset quality stress during FY12 on account of the slowdown in the economy and the mining ban in Goa and Karnataka. But STFC has been maintaining a healthy provision coverage ratio at and above 80%. Some of the concerns, such as the removal of mining ban in Karnataka (for category A mines), have been taken care of. We expect the improvement in freight rates to help the timely repayment to the company from customers. The healthy recovery, coupled with higher provisions, should help the bank control asset quality by FY14E.
- Given the growth in disbursement aiding AUM growth, healthy margins, healthy operating efficiency and lower credit costs, we expect profits of the bank to grow at a CAGR of 18.7% between FY12 and FY14E. This, in turn, would help the bank to improve its return ratios. Thus, we expect RoA (on AUM) to improve to 3.4% by FY14E, respectively.

Bear case

- For FY14E, in the bear-case scenario, we have assumed a loan AUM growth of 11.5%, NIM of 7.1%, GNPA of 3.2% and the adjusted book value (ABV) of Rs 354. The decline in business growth will take its toll on asset quality and NIMs. This would lead to lower income and higher provision, which would impact profit growth and thereby return ratios. Thus, we expect RoE at 17.3% in the bear case as against 21.7% in the base case in FY14E.

Bull case

- For FY14E, in the bull-case scenario, we have assumed a loan AUM growth of 16.2%, NIM of 8.4%, GNPA of 2.5% and the adjusted book value (ABV) of Rs 406. The increase in business growth will take its toll on asset quality and NIMs. This would lead to higher income and lower provision, which would aid in profit growth and thereby return ratios. Thus, we expect RoE at 23.6% in the bull case as against 21.7% in the base case in FY14E.

SWOT Analysis

SWOT Analysis

Strengths

1) Largest NBFC in India.
2) Strong and unique business model.
3) Only organized player in used CV financing.
4) Valuation of used CV financing, which forms a huge entry barrier for peers.
5) Credit appraisal and collection process.
6) NIMs have been sustained at a healthy level of above 7% over the last few years.
7) Superior return ratios.
8) Provision coverage levels are at healthy levels.
9) Strong capital adequacy ratio, which provides sufficient fund for healthy growth.
10) Well-matched asset liability profile.

Weaknesses

1) Over the last few quarters, asset quality has been a cause of concern for the company.
2) Decline in GDP growth has affected AUM growth.
3) GNPA was at 3% in Q1FY13.
4) Competition from other players in the market has been impacting growth in new CV financing.
5) RoA has declined from 4.3% in Q1FY12 to 3.7% in Q1FY13 and RoE has declined from 27.4% in Q1FY12 to 20.9% in Q1FY13.

Opportunities

1) Growth in the construction equipment business.
2) Government thrust on infrastructure to provide opportunity for CV financing.
3) Automall to boost other income in the future.
4) In the guidelines of securitization, interest cap was relaxed to 8%, which is a positive for STFC, as major part of the loans is in the bracket of 18% yield. The RBI increased the PSL target for foreign banks (with more than 20 branches) to 40% from 32%, which could lead to increased demand for securitized assets, and STFC would seek to benefit from it.
5) STFC has initiated a new format for building centres in rural markets, which has helped gain access to new customers.

Threats

1) Regulatory challenges as the RBI has been very harsh with NBFCs on various aspects like higher capital adequacy ratio and securitization, among others.
2) Heavy dependency on the CV business for growth.
3) AUM growth is dependent on GDP growth. A slowdown in economic growth results in lower volume of trade, fewer purchases of commercial vehicles to transport goods across the country and lesser business for companies like STFC. While GDP growth witnessed a slowdown from 8.6% in FY11 to 6.3% in FY12, the M&HCV growth rate fell from 37.6% in FY11 to 7.9% in FY12.

Source: Violet Arch Research

Investment Arguments

Strong and unique business model

STFC's business model is unique, mainly due to the segment of its operations. The company is especially focused on the pre-owned and new CV financing business to small truck-owners or first-time users. The company has been in the industry for more than three decades. It is the largest player in India, with a major focus on the commercial vehicle financing business, particularly in the pre-owned CV financing segment, where it is a market leader, with a 25% market share. Besides, the company is the only organized player in this segment. In the new CV financing business, the firm has a market share of 6-8%. The new CV financing market is dominated by banks and other financial institutions.

STFC has a strong management team. The strength of STFC lies in credit evaluation of customers and effective cash collection (door-to-door cash collection on a regular basis); extensive branch network, enabling it to have a pan-India presence; and expertise in evaluation of pre-owned vehicles gained over three decades. Incidentally, these have been a major deterrent to other financial institutions.

STFC mainly finances CVs in the 5-12-year bracket, with a loan to value (LTV) of around 60%. The yield on pre-owned CV financing is between 18% and 24%. In the new CV financing, the yield ranges between 14% and 16%.

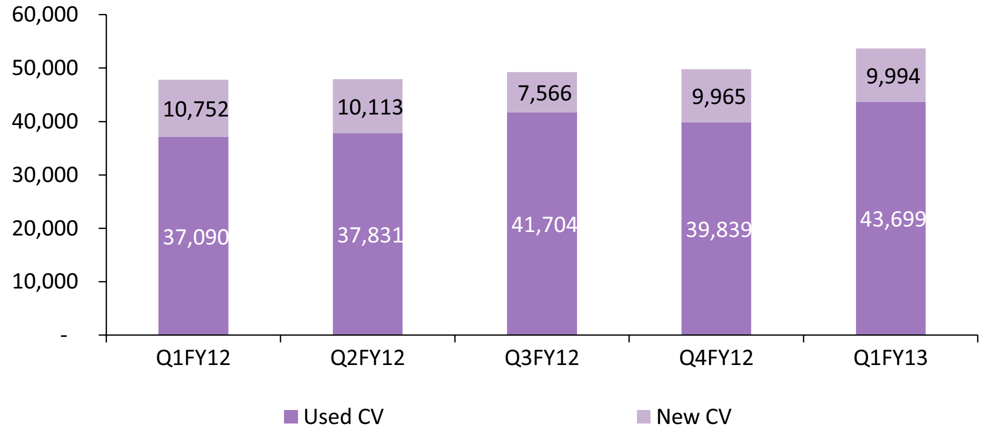
Apart from the CV financing business, as a value addition, STFC has also introduced other products such as tyre financing, engine financing and working capital requirement, among others, albeit by keeping in mind LTV restrictions.

STFC mainly caters to small truck-owners with 2-4 CVs and first-time users, who generally look for vehicles from the pre-owned market, mainly because they cannot buy them with cash upfront.

New format to aid growth

In Q1FY13, STFC opened 200 centres in rural areas to acquire new customers and aid in disbursement growth. In Q1FY13 itself STFC acquired 12,000 customers. The disbursements, which were in the range of Rs 47-49bn in the last few quarters, have increased to Rs 53.7bn in Q1FY13. The firm intends to set up another 200 centres in the coming couple of quarters and also acquire 60,000-65,000 more customers over the next few quarters. We expect the momentum in disbursements to continue, as the bank focuses more on rural markets.

Disbursement mix (Rs, mn)



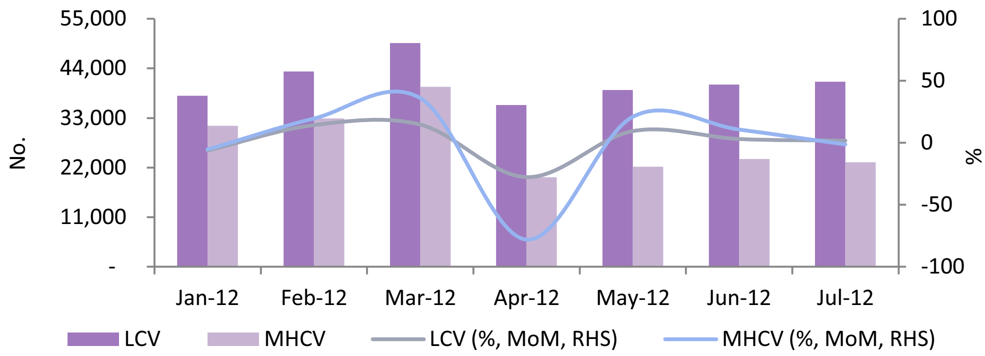
Source: Company, Violet Arch Research

New focus on CVs

Earlier, STFC was predominantly present in the 5-10 years age group of CV financing. Currently, the management has shifted its focus onto the high-yielding segment of above 10 to 12-year-old vehicles. Generally, the company generates yields in the range of 18-21% on 5 to 10-year-old vehicles, while yields on those above 10-12 years are 22-24%. As vehicles become older, they start moving into rural markets, and STFC intends to tap into this market, which has not been serviced by any other organized player so far. STFC is ideally positioned to do so, given the fact that it has the expertise for valuing pre-owned CV financing, besides it enjoys the requisite reach to such markets. This segment is generally not catered to by banks or other organized players, mainly due to non-banking habits of customers. This makes customer credit assessment an arduous task, besides rendering the portfolio a risky business, given the general absence of necessary documents.

STFC has also shifted its focus from financing MHCVs onto LCVs (which will help in reaching the last-mile in consumer business). Over the last eight months, LCVs have clocked a growth of 22.5% as against a de-growth of 2.5% in MHCVs. We expect LCVs to grow at 15-18% in FY13E compared to a 5-6% de-growth in MHCVs in FY13E.

CV sales

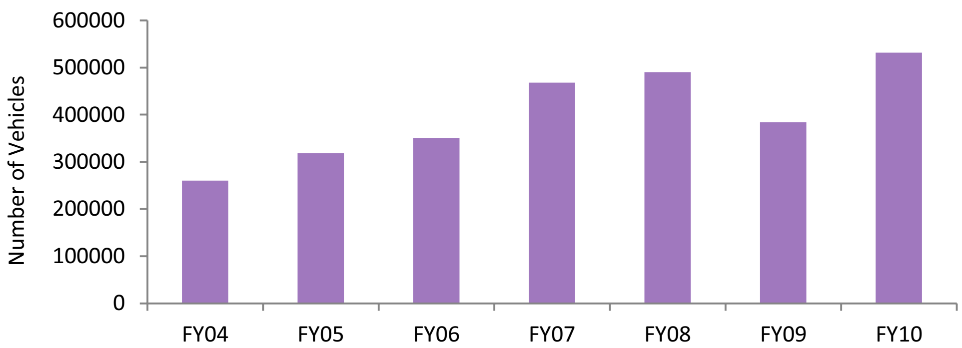


Source: Company, Violet Arch Research

New CV sales over FY04-08 to impact the resale market

New CV sales during FY04-08 will impact the resale market in the near term. Around 1.4mn CVs were sold during the above-mentioned period, which will return to the resale market. Generally, a CV changes hands 3-4 times in its lifetime, besides every four out of five resale vehicles are purchased on loans. We expect STFC's business over the next couple of years to be aided by new CVs sold during FY04-08. This is largely due to the fact that STFC mainly caters to the 5 to 10-year-old segment, and the majority of new CVs are sold during the said period would come for re-finance.

Sales Trend of Commercial Vehicles



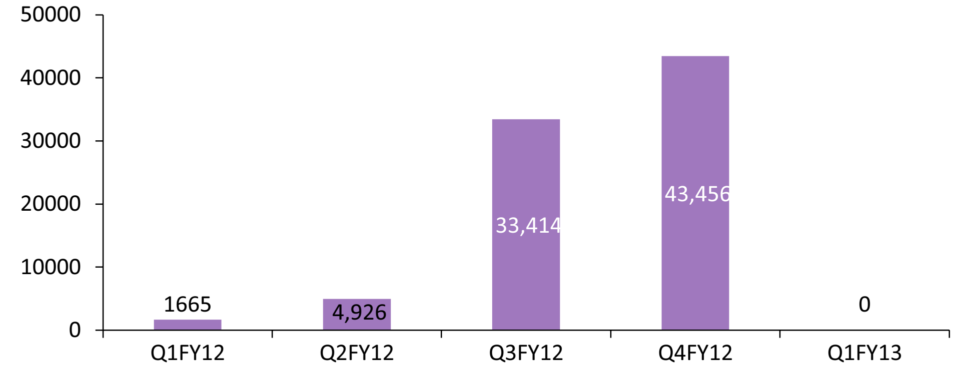
Source: Company, Violet Arch Research

We expect lower growth in new CV financing by STFC, largely on account of falling growth and intensifying competition. The company has already been under growing stress over the last few quarters. We expect it to be under stress over the next few months until growth returns to normal industry levels.

New securitization norms not to impact earnings

The Reserve Bank of India (RBI) has tightened NBFC securitization norms. The minimum retention requirement (MRR) stipulates in the guidelines on securitization that NBFCs selling loans would have to retain 5% of the amount if the loan is for less than a two-year period and 10% if the loan tenure is over two years. But this will not have a significant impact on the securitization portfolio of STFC, mainly because it has its loan-book tenured to the maximum period of 38-40 months. It may lead to securitization being spread out evenly. The other guideline on securitization is for conversion of all assignments into pass-through certificates (PTC). However, STFC being the largest securitization player in the market, we do not expect a material impact on the portfolio.

Securitization in the quarter (Rs, mn)

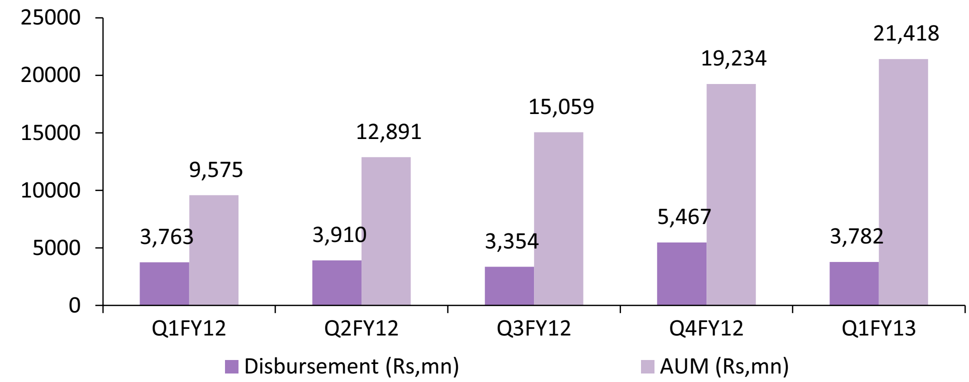


Source: Company, Violet Arch Research

Construction equipment business picking up momentum

In the last couple of quarters, the construction equipment business has picked up momentum. STFC has been funding small contractors, especially 'B' grade contractors. We expect this to gather further momentum going forward. We expect growth in the construction equipment financing business to be higher than in CV financing, given the low base and also the growth plan that the management has chalked out. Given the pick-up in growth expected in the infrastructure space in terms of road projects, etc., this development would also aid growth of this segment.

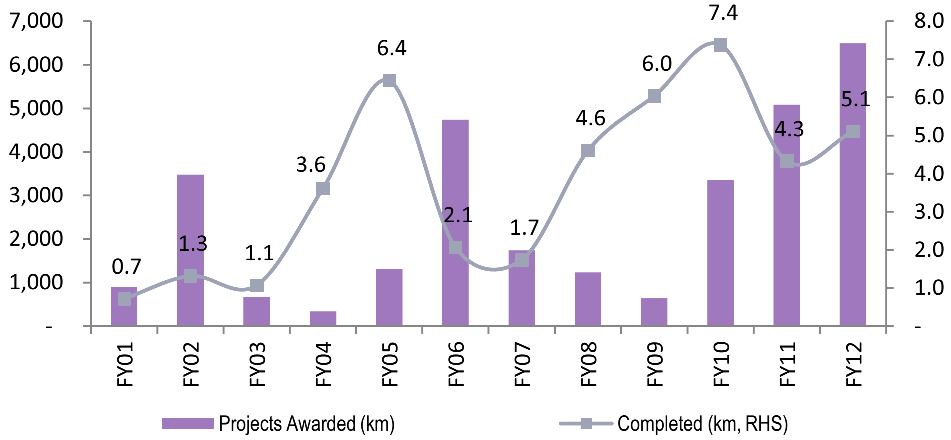
Construction equipment business



Source: Company, Violet Arch Research

The pace of awarding projects has definitely picked up considerably compared with the past. For FY12, NHAI has awarded around 6,491km, which is by far the best year for NHAI. This indicates a major jump in activity after a three-year lull from FY07 to FY09. NHAI has set itself an aggressive target of awarding about 7,300km (8,800km of the budget target includes around 1,500km of awards from state depart`ments and PWDs) of road projects in FY13 as against about 6,491km awarded in FY12.

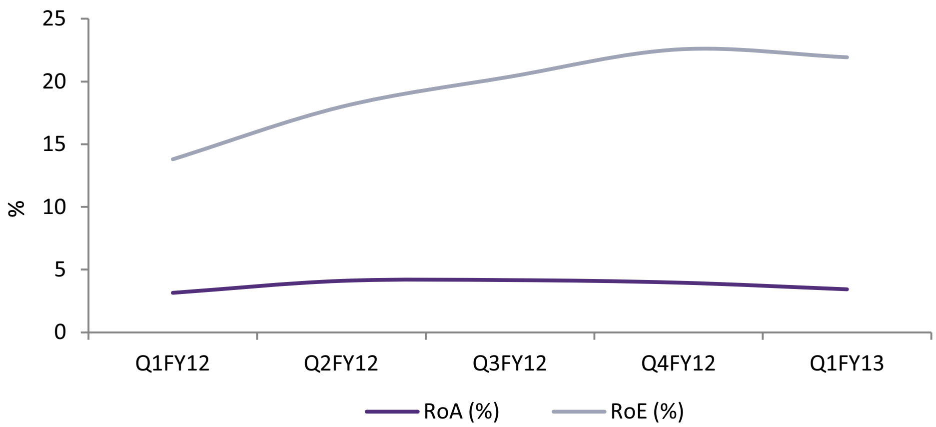
Pickup in road award activity



Source: Company, Violet Arch Research

The return ratios in this segment have phenomenally been strong and are expected to remain healthy in the future. While ROA of the construction equipment business has improved from 3.16% in Q1FY12 to 3.44% in Q1FY13, it was at 3.97% in Q4FY12. RoE of the same business has improved from 13.8% in Q1FY12 to 21.9% in Q1FY13, while the same was at 22.6% in Q4FY12.

Return ratios



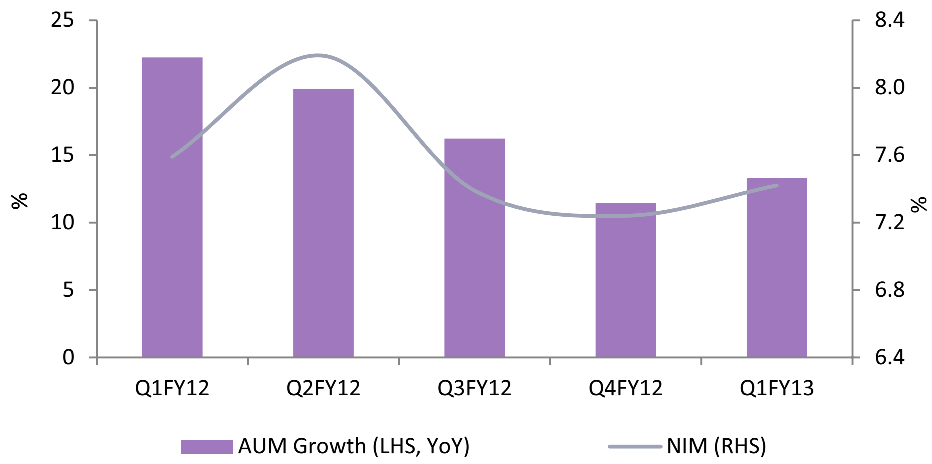
Source: Company, Violet Arch Research

We believe growth and margins have bottomed out

STFC's new format has boosted growth in disbursements, which have been subdued at Rs 47-49bn over the last few quarters. We expect disbursements to be above Rs 52bn over the next couple of quarters, which will aid in healthy growth in AUM in the near future.

With majority of banks witnessing interest rate cuts in the recent past and the softening in rates in the bond market, we expect the overall cost of funds for STFC to come down in the future. This, coupled with healthy disbursement growth, should improve margins of the company. The margins would also be aided by the increase in spreads on the securitization portfolio, which has been on the lower side in the last couple of quarters.

Asset under management growth and Net interest margin



Source: Company, Violet Arch Research

We expect AUM to grow to Rs 523bn by FY14E

STFC's AUM growth has phenomenally been on the higher side, led by high growth in GDP. However, with the slowdown in GDP and the base effect, the growth rate has taken a beating. We expect AUM to grow to Rs 523bn by FY14E as against Rs 402bn in FY12. We expect the average disbursement of Rs 52bn per quarter in FY13E and Rs 60bn per quarter in FY14E.

Asset under managemenet (Rs, mn)

Source: Company, Violet Arch Research

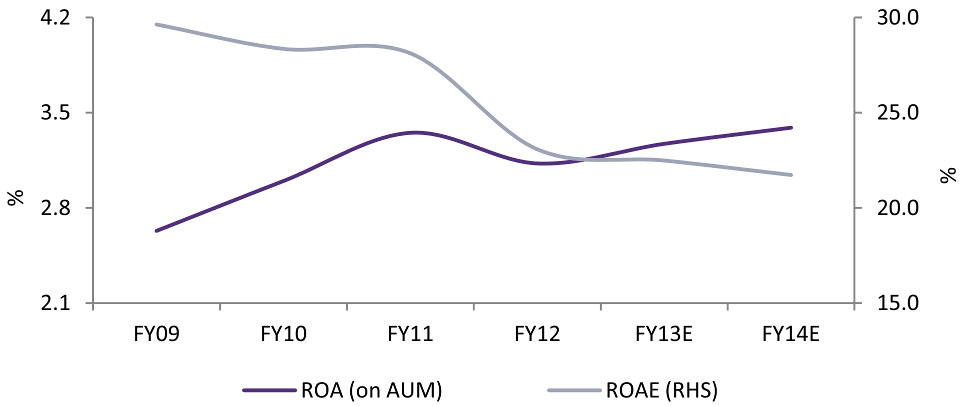
Sustainable superior return ratios

Historically, STFC's NIM, on an average, has been in the range of 6-8%. Arguably, this is on the higher side for the financial services sector. For FY12, NIM (on AUM) stood at 8%; we expect margins to remain at elevated levels. The slowdown in the growth rate and slight hiccups in asset quality will affect margins in FY13E marginally as against FY12. But it is still expected to be above 7.5%.

STFC has recorded a return on average equity (RoAE) of 20-30% in the last couple of years on the back of strong loan growth, improvement in fee income and control over operating costs. The company's RoAE in FY12 was 23.1% compared with 28.1% in FY11. We expect this ratio to stay at a sustainable level of around 22% till FY14E.

In the last few years, STFC has consistently been improving its return on assets (RoA) on AUM, i.e., from 2% in FY08 to 3.1% in FY12. We expect RoA (on AUM) to improve to 3.4% by FY14E, driven by a healthy growth in AUM, due to better disbursement as mentioned above. Also, we expect it to focus on high-yielding older vehicles in rural markets, and funding costs to decline as bank-lending rates come down.

Return ratios (%)



Source: Company, Violet Arch Research

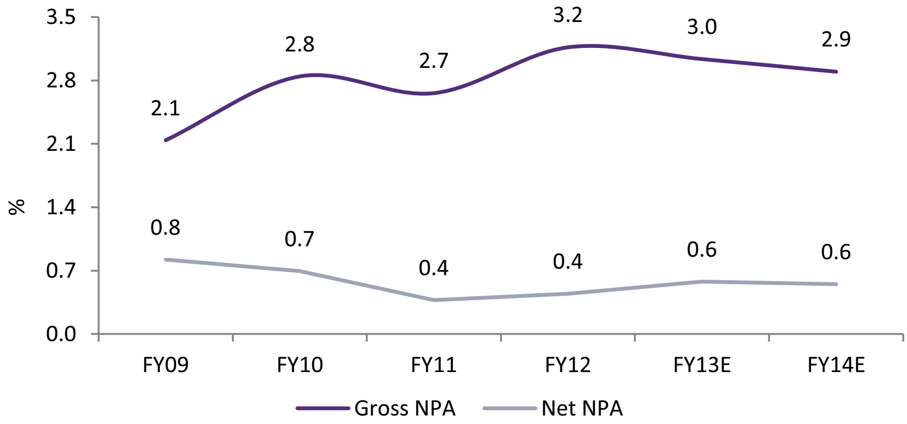
Asset – Liability well matched

STFC's average duration of assets is between 38 and 40 weeks. On the liability front, it has fixed and floating rates of 50% each. The company raises around 39% of its funding through securitization. The funding profile of borrowings through banks contribute about 76% and through retail around 24%.

Higher provisioning ensures lower NNPA

The provision coverage ratio of STFC has remained, on an average, above 80%. This has ensured that the company's net NPAs would remain under control. GNPAs have moved up from 2.1% in FY09 to 3.2% in FY12, while NNPAs have moved from 0.8% in FY09 to 0.4% in FY12. The company's provision coverage ratio has improved from 43.2% in FY08 to 85.9% in FY12. We expect GNPAs to come down to 2.9%, as growth picks up and certain government policy reforms help bring back the momentum. We expect NNPAs to be under control, as we expect PCR to remain above 80% in the next couple of years.

Asset quality



Source: Company, Violet Arch Research

Key Risks and Concerns

High dependency on CV business

A major portion of STFC's revenues accrues from CV financing and hence it is highly dependent on the segment. Although the company has been expanding its product basket, its dependency on CV financing will still weigh heavily on it, while other products and services will gain a substantial market share.

Further slowdown in economy may affect earnings

If the pace of the economic growth decelerates even further, then there might be an adverse impact on STFC's earnings due to a decline in demand. It may also affect the payment schedule of its customers, leading to a rise in NPAs.

Human resource retention

STFC follows a bottom-up approach towards its employees, though the method is not entirely flawless. Many incapable employees may be promoted to higher posts, which may have an adverse effect on the efficiency of certain operations of the company, leading to inefficiency in evaluations of vehicles. In other cases, many capable employees might not get their due share of promotion for certain other reasons, which may increase the attrition rate. The retention of field officers is also crucial, because the company is dependent on them for credit evaluation, cash collection of from customers and market feedback.

Regulatory challenges

The RBI has always maintained a hawkish stance on NBFCs in India. In fact, it has always maintained a conservative stance on them with directives such as a higher capital requirement (which is 9% for banks, but 15% for NBFCs), a cap on margins on securitization at 8%, a curb on financing to specific NBFCs, especially gold-financing NBFCs (where banks have been asked to reduce exposure from 10% of their capital fund to 7.5%), and stringent norms on securitization such as a 35% cap. Further measures by the RBI on NBFCs may take its toll on the business growth of STFC.

Financial Outlook

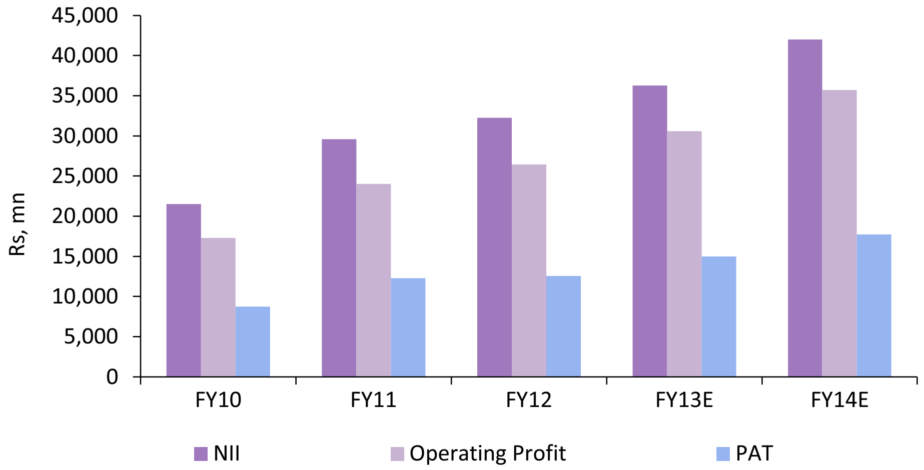
We expect STFC's top-line to grow at a CAGR of 15% between FY12 and FY14E on account of healthy growth in AUM at a CAGR of 14% between FY12 and FY14E. The numbers are on a standalone basis, and the STFC's construction equipment business has not been taken into the account for the top-line or bottom-line. We expect margins to improve as the spread on securitization income improves, and the cost of funds starts to decline. Thus, we expect the net interest income (NII) to grow at a CAGR of 14.1% between FY12 and FY14E.

STFC is targeting better growth in fee income from various sources such as auto malls, touch screens and Shriram new look.

STFC has taken steps to provide a one-stop hub for pre-owned CVs across India called 'auto malls' through its subsidiary, Shriram Automall India. The services offered under the subsidiary will be sale of pre-owned CVs and re-conditioning of pre-owned CVs of various makers and repossessed vehicles under 'Shriram new look'. We expect the momentum in other income to pick up, as the company has been utilizing its auto mall not only for STFC-financed vehicles, but also for other banks and their customers.

We expect the operating expense of the bank to grow at a CAGR of 16.2% between FY12 and FY14E. We believe that the worst of asset quality is over. Thus, we expect provision expenses to grow at a CAGR of 9% between FY12 and FY14E. Hence, we expect PAT to grow at a CAGR of around 18.7% from FY12 to FY14E, i.e., from Rs 12.6bn in FY12 to Rs 17.7bn in FY14E.

Financial performance (Rs, mn)

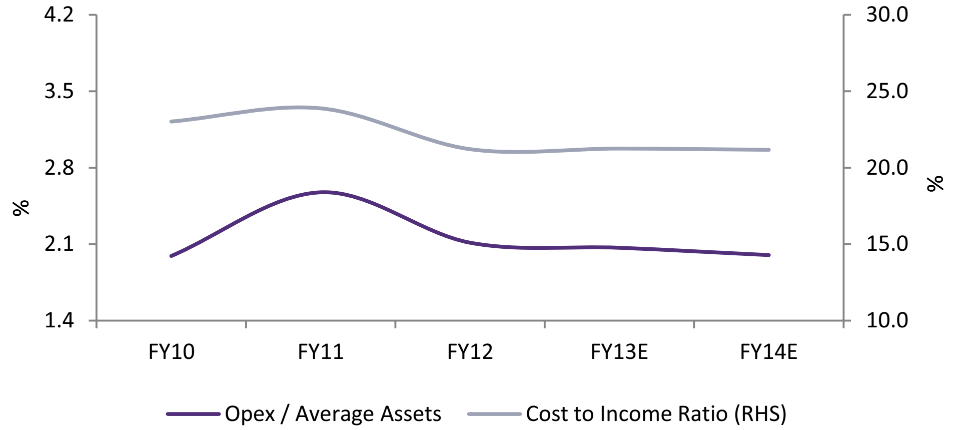


Source: Company, Violet Arch Research

Operating efficiency

STFC's cost-to-income ratio has decreased from around 33% in FY07 to about 21.2% in FY12. The company has been able to curtail its cost-to-income ratio due to robust growth in revenue, while bridling operating costs. We expect the cost-to-income ratio to stay at around 21% levels in FY13E and FY14E.

Operating Efficiency (%)

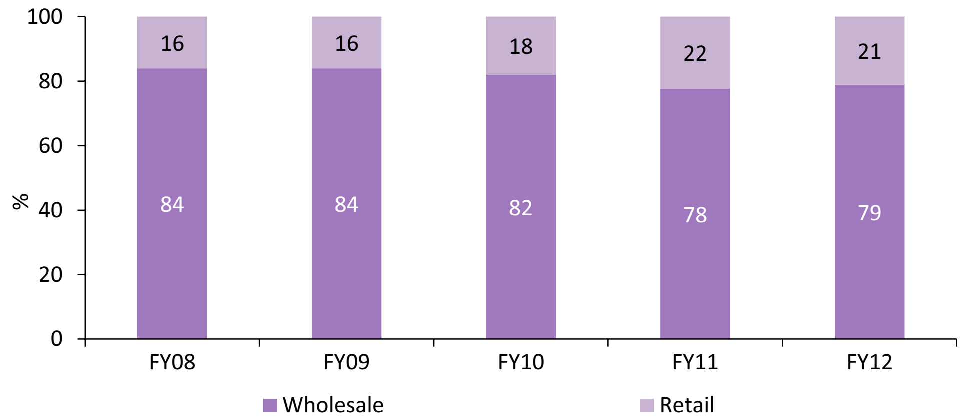


Source: Company, Violet Arch Research

Borrowing mix

STFC has begun to make efforts to increase the proportion of the wholesale (banks or financial institutions) deposits to total deposits. The wholesale deposits constituted around 51% of deposits in FY06, which was at about 79% in FY12. This has not only helped the firm in decreasing its cost of deposits, but has also helped to enjoy easy and quick access to money when required.

Borrowing Mix (%)

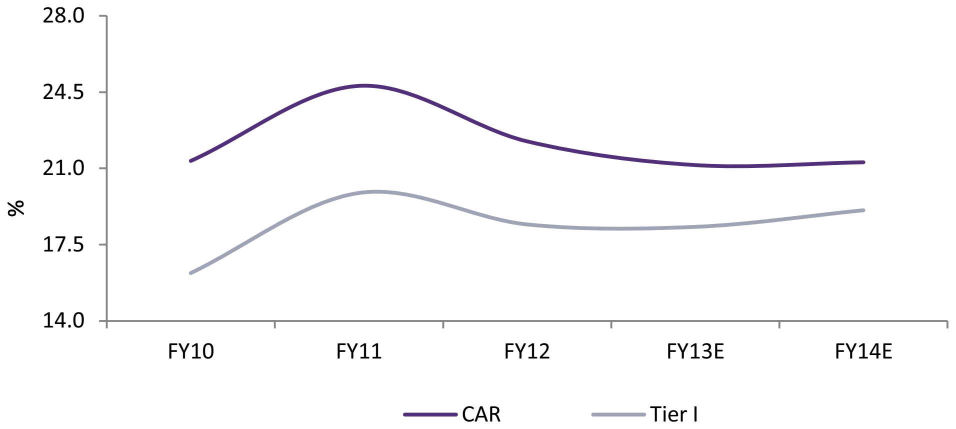


Source: Company, Violet Arch Research

Well capitalized

STFC has always maintained a higher-than-required capital adequacy ratio. It has also been able to access the capital market for raising funds. Its issues have received good response from investors.

Capital Adequacy Ratio (%)



Source: Company, Violet Arch Research

Valuation

Business growth due to rural market penetration and change in CV mix

We expect the momentum in disbursements to continue, as the bank's focus on rural areas and financing of old vehicles becomes sharper, which will lead to healthy yields on its portfolio, thereby helping margins to grow. The company has now started shifting its focus more towards the last-mile by reaching out to the LCV segment, which is expected to grow at a healthy 15-18%. STFC's construction equipment business will aid its earning capacity as infrastructure growth picks up.

Improvement in NIM and other income to aid profit growth

Generally, the company generates yields in the range of 18-21% on 5 to 10-year-old vehicles, while yields on those above 10 to 12 years are 22-24%. As vehicles become older, they start moving into rural markets and STFC intends to tap into this market, which has not been serviced by any other organized player so far. The firm has been increasing its portfolio in this segment which should aid in healthy yields. STFC has 76% of its funding from banks. Recently, banks have started reducing their base rates, which should help in curtailing the cost of funds for STFC going forward. In the fixed income market, interest rates have also softened up. Hence, the incremental retail cost of funding will come down over the next couple of years. Thus, we expect an improvement in NIM on account of better yields and a decrease in the cost of funds. We expect contributions from automall to aid growth in other income growth. We believe that the worst of asset quality is over and hence expect profits to grow at a CAGR of around 19% between FY12 and FY14E.

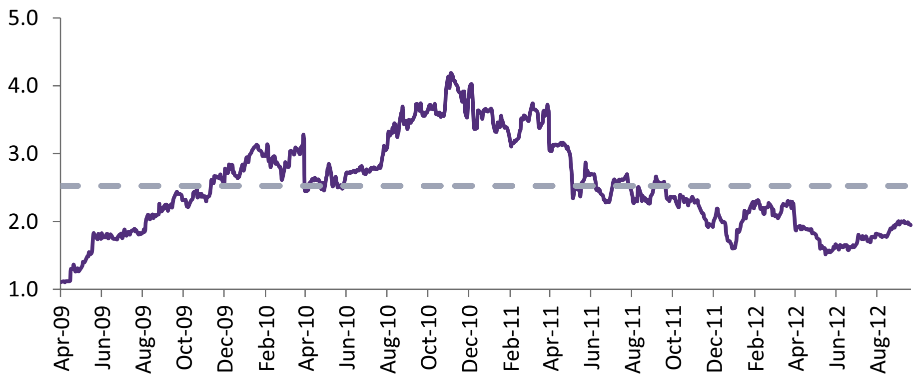
Superior return ratios to continue

STFC has always enjoyed superior return ratios. We expect this to continue. With a healthy profit growth at a CAGR of 19% between FY12 and FY14E, we expect its RoE to stay at a sustain at ~22% till FY14E, while RoA (on AUM) to improve to 3.3% by FY13E and 3.4% by FY14E.

Target price – 20% upside

Currently trading at Rs 625, the stock is available at price-to-adjusted book value (P/ABV) of around 1.6x of FY14E. We expect return ratios to improve on account of healthy growth in profits at a CAGR of 18.7% between FY12 and FY14E. Thus, we value the NBFC's business at 1.9x FY14E P/ABV based a slight discount to the historical average of 2.5x due to a fall in AUM growth rate, fall in profit growth and decrease in return ratios (i.e. RoE from 28% in FY10 to 21.7% in FY14E and RoA at ~3.4% in FY14E as against 4% a few quarters back). We initiate coverage on the stock with a Buy rating at a target price of Rs 752, with an upside of ~ 20% from current levels.

Price to adj. book value (x)



Source: Company, Violet Arch Research

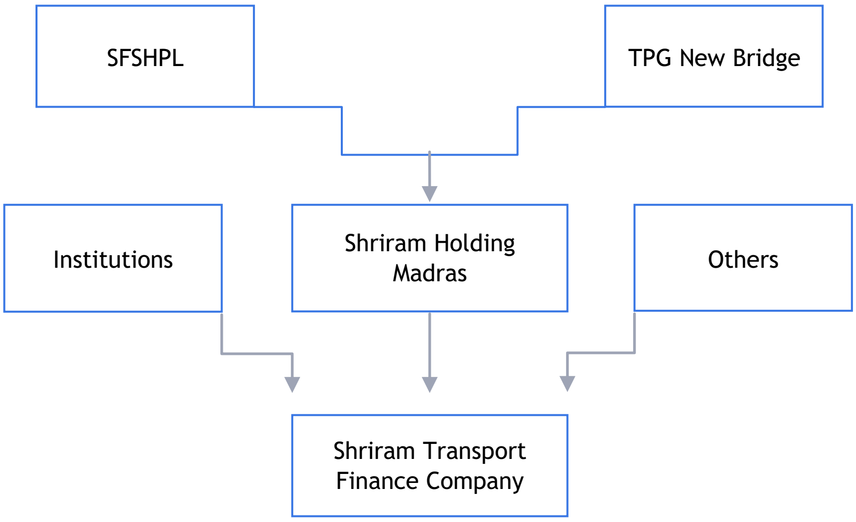
Company Background

The Group

Established in 1979, STFC is India's largest NBFC in the pre-owned truck financing. It is the flagship company of the Shriram Group, which has business interests in chit funds, insurance (different types), consumer durables, property development and wind energy, among others. As a group, the various units cater to over 3mn customers in India.

Shriram Holding (Madras) Ltd. (SHML) is an exclusive holding company, wherein Shriram Financial Services Holding Pvt. Ltd. (SFSHPL) and TPG Newbridge hold a stake of 51:49, respectively. Shriram Holding (Madras) Ltd. has a stake of around 41% in STFC. TPG is a global private investment firm. It manages a family of funds, including private equity, venture capital, and public equity and debt investing. It provides creative capital, structured for each investment opportunity.

Shareholding pattern in STFC



Strategic investors

STFC went public in 1984. In 2005, Chryscap entered as a private equity investor through UNO Investments (the investment vehicle). With the objective of transforming STFC into a highly integrated entity and giving it a pan-India presence, the NBFC was merged in FY06 with Shriram Investments Ltd. and Shriram Overseas Finance. In December 2007, Blue Ridge Ltd., Tiger Global Management Ltd. and Kampani Finance Ltd. bought a stake in STFC aggregating Rs 3,600mn. During the same period, the company had issued 0.8mn optional convertible warrants to SHML. STFC made a QIP in January 2010, raising US$125mn. The top buyers were Genesis and Eton Park, both from the UK, Wellington from the US, Credit Agricole from Hong Kong, and Reliance Mutual Fund from India.

The business

STFC is predominantly engaged in truck (pre-owned and new) financing. It also has the unique distinction of having a vast fund base under the lease portfolio management scheme, in which several corporate entities, including other finance companies invest funds. About 75% of the market share in the pre-owned commercial vehicle financing belongs to private/unorganized players. The company has a market share of around 25% in this segment. Basically, the company caters to 5 to 12-year-old pre-owned trucks financing. Today, the company is a leader in its market, with virtually no other equally competent companies in the pre-owned truck financing business. STFC is also into the business of new CV financing, with a current market share of 6-8% in the segment. Incidentally, the new CV financing industry is dominated by banks and financial institutions such as ICICI.

Financial Summary

Income Statement

Rs,mn	FY11	FY12	FY13E	FY14E
Interest Earned	52,301	56,735	64,568	74,999
Interest Expended	22,720	24,473	28,306	33,001
Net Interest Income	29,582	32,261	36,262	41,998
Other Income	1,995	1,284	2,564	3,304
Net Income	31,577	33,545	38,825	45,303
Operating Expenses	7,540	7,114	8,250	9,590
Operating Profit	24,037	26,431	30,575	35,713
Provisions	5,548	7,622	8,029	9,062
Profit Before Tax	18,489	18,809	22,545	26,651
Tax	6,190	6,235	7,553	8,928
Profit After Tax	12,299	12,575	14,993	17,723

Balance Sheet

Rs,mn	FY11	FY12	FY13E	FY14E
Equity Share Capital	2,262	2,263	2,263	2,263
Reserves & Surplus	46,747	57,637	71,159	87,411
Net Worth	49,044	59,923	73,422	89,674
Deposits	198,817	231,219	289,023	346,828
Borrowings	68,223	66,051	78,601	81,338
Other Liabilities	2,262	2,263	2,263	2,263
Total Liabilities	**316,084**	**357,193**	**441,046**	**517,840**
Investments	36,507	39,646	44,404	51,065
Advances	198,656	219,019	293,311	345,245
Other Assets	80,921	98,528	103,331	121,530
Total Assets	**316,084**	**357,193**	**441,046**	**517,840**

Key Ratios

Particulars (%)	FY11	FY12	FY13E	FY14E
Growth Matrix				
Borrowings (%)	7.7	16.3	25.0	20.0
Advances (%)	10.6	10.3	33.9	17.7
NII (%)	37.4	9.1	12.4	15.8
Operating Expenses (%)	45.7	(5.6)	16.0	16.2
Operating Profit (%)	38.8	10.0	15.7	16.8
Provisions (%)	36.3	37.4	5.4	12.9
Profit After Tax (%)	40.9	2.2	19.2	18.2
Ratios (%)				
NIM (on AUM) (%)	8.1	8.0	7.9	8.0
Cost to Income (%)	23.9	21.2	21.2	21.2
ROAA (on AUM) (%)	3.4	3.1	3.3	3.4
ROAE (%)	28.1	23.1	22.5	21.7
Pre-Prov ROAA (%)	7.3	6.9	7.1	7.3
Pre-Prov ROAE (%)	55.0	48.5	45.9	43.8
Gross NPA (%)	2.7	3.2	3.0	2.9
Net NPA (%)	0.4	0.4	0.6	0.6
CAR (%)	24.8	22.2	21.2	21.3
Tier I (%)	19.9	18.4	18.3	19.1
Adj BV (Rs.)	213.5	260.4	316.9	387.8
P/ABV (x)	2.9	2.4	1.9	1.6

COMPANY REPORT

Equity Research | Infrastructure

21 September, 2012

Titagarh Wagons Ltd.

On the Right Track

Absolute Rating	**BUY**
Target Price	**Rs 433**
Upside	**35%**

Titagarh Wagons Ltd. (TWL) is a leading manufacturer of railway wagons for the Indian Railways. It has been a beneficiary of the Indian Railways in terms of wagon procurement, which has grown at a CAGR of 16.8% over FY06-12. The Indian Railways' Vision 2020 has indicated a pick-up in the growth momentum for the railways, which should augur well for TWL. We believe that the YTD decline of around 26% in the stock price of TWL on account of uncertainty over the Indian Railway Budget is presumably overdone, and at 5.9x P/E and 2.4x EV/EBIDTA FY14E valuations, the stock seems attractive. We initiate coverage on TWL with a Buy rating.

Railways growth momentum to continue

The Indian Railways envisages its revenues to grow from 1.2% of GDP to 3.0% of GDP by FY20 through the introduction more services and the ramp-up in production of wagons from its current capacity of 220,000 wagons. This implies that the revenue of the Indian Railways would grow at a CAGR of 22.5% during the same period. Over the past six years, the Indian Railways' budgetary outlays have increased at a healthy CAGR of 30.3%, while wagon procurements have grown at a CAGR of 16.8%, leading to a revenue growth of 12%. Since the industry has witnessed a healthy order rollout for wagons by the Indian Railways over the years (i.e., replacement orders and fresh orders), we expect the same to continue and clock a CAGR of 16.0% over FY12-14E, which would provide ample opportunities for incumbents (read TWL).

TWL – Market leader

TWL enjoys a market share of 18-20% of the Indian Railways' wagon division, with a current outstanding order-book of 1,800 wagons (Rs 4.7bn). Historically, the company has been receiving diversion and supplementary orders, thanks to its efficiency and huge manufacturing capacity. Apart from production of freight wagons, TWL also manufactures custom-built wagons for private players. With the Government of India sharpening its focus on the railway budgetary expenditure, we expect order inflows to grow even further in the coming years.

Order-book to swell further with favourable verdict for CIMMCO

Due to regulatory issues over qualification, CIMMCO, a subsidiary of TWL, could not secure any orders from the Indian Railways during FY12. However, on filing a petition in the Delhi High Court against the verdict of the Indian Railways, TWL received favourable response. Hence, going forward, we expect CIMMCO to bag at least a few orders from the railways. We assume nil order inflow for FY13 and 800 wagons for FY14E.

Valuations

The stock currently trades at 6.1x/5.9x FY13E/FY14E earnings. In recent times, we have seen an increase in the number of players in the Indian wagon manufacturing segment. Further, given the Indian Railways' bidding mechanism, we believe, it would lead to a reduction in market share of TWL. To factor in the same, we have assigned a 10% lower PE multiple than its four-year historical average. We value the stock at 8.0x FY14E earnings and arrive at a target price of Rs 433, giving an upside of 35%. We initiate with a Buy rating.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	7,244	8,909	10,747	11,713
Growth (%)	30.7	23.0	20.6	9.0
EBITDA (%)	9.8	15.8	14.8	14.3
Adj. Net Profit	745	832	1,045	1,086
Adj. EPS (Rs)	40	41	52	54
EPS growth (%)	23.8	4.7	25.6	4.0
PER (x)	8.1	7.7	6.1	5.9
Price/Book value (x)	1.0	1.0	0.8	0.7
AROE (%)	12.9	12.5	13.6	12.3
AROCE (%)	16.6	18.5	17.6	16.4
EV/Net sales (x)	0.8	0.6	0.5	0.4
EV/EBITDA (x)	8.5	4.0	3.2	2.4

Source: Company, Violet Arch Research

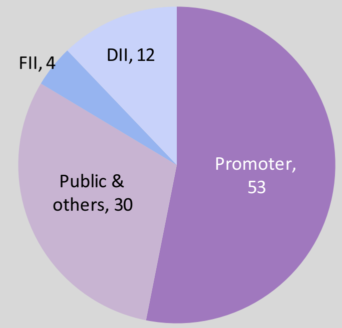
Stock data

CMP	**Rs 320**
Reuters Code	TITW.BO
Bloomberg Code	TWL IN
Equity Shares o/s (mn)	20
Market Cap (Rs mn)	6,426
Market Cap (USD mn)	121
3m Avg daily t/o(US$ mn)	0.1

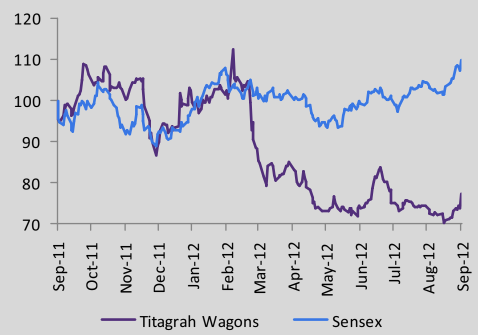
Stock performance (%)

52-week high / low			**Rs 485/276**
	1M	**3M**	**12M**
Absolute	6.5	6.9	(20.5)
Relative	1.5	(3.4)	(28.3)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull Case	Base Case	Bear Case
Total Wagon Sales	5,400	4,626	3,500
Passenger Coach Sales	100	90	80
Segmental Revenue			
Wagons	13,710	10,589	7,348
Steel Foundry	2,183	1,819	1,273
Heavy Earth Moving Machinery (HEMM)	191	174	156
Total Revenue	**14,556**	**11,713**	**7,971**
Expenses	12,459	10,039	6,982
EBIDTA	2,097	1,675	989
EBIDTA Margin (%)	15.3	14.3	13.3
PAT	1,382	1,086	606
PAT Margin (%)	9.5	9.3	7.6
EPS	**69**	**54**	**30**
P/E	9	8	7
Price Target	620	433	212
CMP	**320**	**320**	**320**
Upside/(Downside) (%)	**93.8**	**35.4**	**(33.9)**

Source: Company, Violet Arch Research

Key assumptions

Particulars	FY11	FY12	FY13E	FY14E
Number of Wagon Sales	3,461	4,100	4,200	4,626
Passenger Coach Sales	0	72	90	90
Segmental Revenue				
- Wagons	6,694	8,265	9,730	10,589
- HEMM	141	111	139	174
-Steel foundry	1,205	1,384	1,620	1,819
EBIDTA Margins (%)	**9.8**	**15.8**	**14.8**	**14.3**

Source: Company, Violet Arch Research

Base case

- With the increase in market participants, we expect the company's market share in the wagons segment (which contributes 80% of revenues) to decline from the current 19% to 14% in FY14E. However, with the increase in overall market size, we expect the company to post a CAGR of 14.7% over FY12-14E. Hence, we have assumed a total freight wagons procurement of 25,500 from the Indian Railways, of which TWL is likely to receive orders for 3,226 wagons in FY14E. Among other revenues, 400 wagon sale from AFR, and private wagons sales of 1,000 units, leading to total wagon sales of 4,626 units.
- With the current order-book of passenger coaches to be delivered over the next two years, we expect passenger coach sales of 90 units in FY14E.
- For TWL's steel foundry division, which accounts for around 14% of total revenues, we have assumed Rs 0.2mn realization per bogie (in line with the current market scenario) for the domestic business and additional revenue of Rs 500mn from the outstanding order-book.
- To factor in the increase in competition, we expect a decline in EBIDTA margins for FY14E by 150bps to 14.3% compared to 15.8% in FY12.

Bull case

- We expect wagon procurement by the Indian Railways to increase at a CAGR of 20% with total wagon orders of 27,000 units, and TWL to receive orders worth 3,500 from the same.
- With an increase in private and customized wagon orders, we assume a total of 1,500 from private and customized wagon segments and passenger coach sales of 100 units. This would lead to revenue (CAGR) of 27.8% over FY12-14E.
- Expecting an increase in revenues from the private sector and custom wagons, we have assumed an EBIDTA margin expansion of 100bps from our base case scenario.

Bear case

- We expect wagon procurements by the Indian Railways to dip, with wagon procurements of 17,000 units, and TWL to receive orders worth 2,100 units from the same.
- We have considered sales of 1,000 wagons from private and customized wagon segments, and passenger coach sales of 80 units.
- We have assumed that an economic slowdown and limited orders would lead to aggressive bidding and contraction of TWL's EBIDTA margins by 100 bps.

SWOT Analysis

Strengths

1) India's largest wagon manufacturing company, with a consolidated capacity of 10,000 wagons per annum.

2) Qualified manufacturer in the low-competition passenger coach segment.

3) Strong balance sheet, with a net cash balance of Rs 809mn, lends scope for future expansions.

SWOT Analysis

Weaknesses

1) Indian Railways being the biggest client , future propects depend on the financial stability and spending paterns of Indian Railways.

2) Private players require custom-designed wagons for captive purposes. These designs require approval of the Research Designs & Standards Organization (RDSO), which reviews the progess on a periodic basis. Thus, constant changes and delays by the RDSO may hamper the performance of TWL.

Opportunities

1) Indian Railways' budgetary expenses have grown at a CAGR of 30.3% over the past six years. As per Vision 2020, we expect this momentum to sustain going forward.

2) Demand from the private segment to increase with custom-designs for different goods like automobiles, coal, iron ore, etc.

3) TWL manufactures passenger coaches, which can be a Rs 600-bn opportunity in the coming years.

Threats

1) Indian Railways' bidding mechanism enforces the lowest bid price as the price of manufacturing for all bidders. Thus, any increase in competition can hamper margins of TWL.

2) Slowdown in the overall economy could delay the Indian Railways' growth plans.

3) Deterioration in financials of the Indian Railways can lead to paymet delays or derail capex plans.

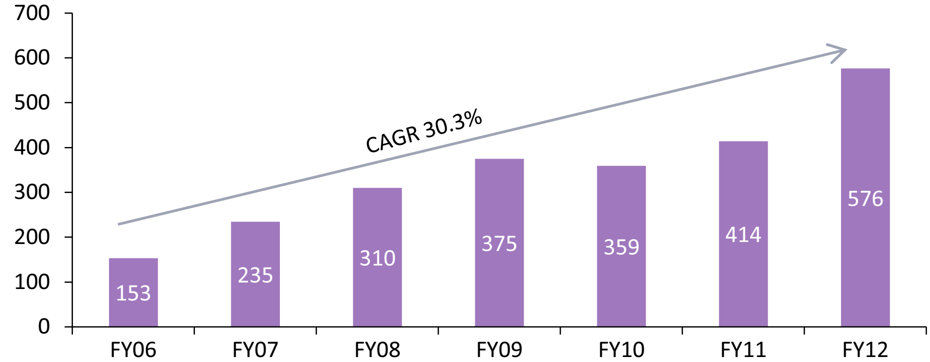
Source: Violet Arch Research

Investment Arguments

Railways growth momentum to continue

The Indian Railways envisages its revenues to grow from 1.2% of GDP to 3.0% of GDP by FY20 through the introduction more services and the ramp-up in production of wagons from its current capacity of 220,000 wagons. This implies that the revenue of the Indian Railways would grow at a CAGR of 22.5% during the same period. Over the past six years, the Indian Railways' budgetary outlays have increased at a healthy CAGR of 30.3%, while wagon procurements have grown at a CAGR of 16.8%, leading to a revenue growth of 12%. Since the industry has witnessed a healthy order rollout for wagons by the Indian Railways over the years (i.e., replacement orders and fresh orders), we expect the same to continue and clock a growth of 16% over FY12-14E, which would provide ample opportunities for incumbents (read TWL).

Indian Railways' budgetary expenditure

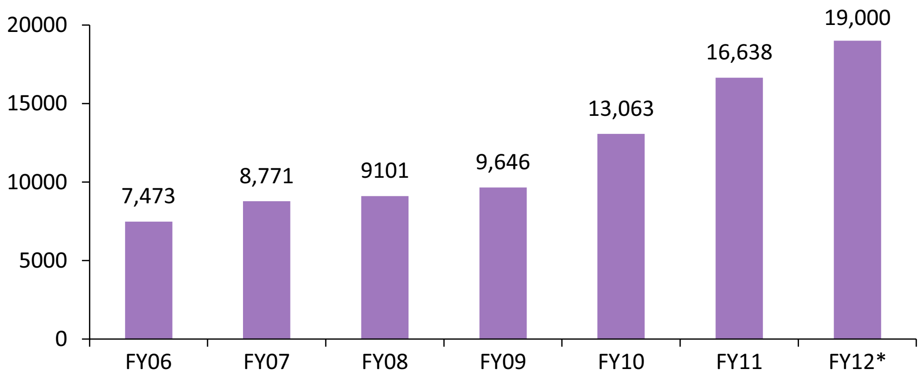


Source: Company, Violet Arch Research

Demand for wagons

At present, the Indian Railways has a total fleet size of 220,000 wagons in the freight segment, which contributes around 70% of its revenues. In order to achieve its Vision 2020 target, it needs to scale up its fleet-size substantially, while at the same time replacing old wagons. Industry data suggests that 40% of the 220,000 wagons have become obsolete and would require replacement. The fleet-size is expected to keep pace with the country's GDP at 7%. This indicates an addition of 15,400 and 15,862 wagons in FY13E and FY14E, respectively. Over the past six years, wagon procurements by the Indian Railways have witnessed a CAGR of 16.8%. Based on the industry expectations and our observation of the historical data, we expect the growth momentum to continue with CAGR of 16.0%, and the Indian railways to procure 22,040 and 25,500 wagons in FY13E and FY14E, respectively.

Indian Railways' wagon procurement (in units)



Source: Company, Violet Arch Research (- Provisional)*

With India's trade emerging stronger and the deficit in the Indian Railways' freight transport capacity, private players have started investing in rakes for their captive usage. This has led to a spurt in demand for wagons from the private sector. While the companies such as NTPC and Arshiya International procure wagons for their captive purposes, GATX and Tata Capital obtain wagons for leasing. With India poised for a GDP growth of 7% in the coming years and the railway network increasingly connecting major ports, we expect demand for wagons in the private sector to grow further going forward.

DFC calls for increase in wagons

The ambitious Dedicated Freight Corridor (DFC) project, targeted at high-capacity and high-speed railway network for freight movement, is expected to be India's largest-ever infrastructure project. With an estimated completion cost at around Rs 900bn, the Delhi-Mumbai and Delhi-Kolkata corridors are expected to revolutionize freight transport in India. With the DFC project scheduled to be completed by FY18, we expect the Indian Railways to roll out orders to increase its fleet size of high-speed wagons to support its freight transport business, thereby creating opportunities for domestic manufacturers (read TWL).

Greater focus on passenger coach segment

Currently, the India Railways has a fleet-size of 63,000 passenger coaches. According to the Indian Railways' Vision 2020 document, a total of around 50,000 coaches are expected to be added to the existing fleet by FY20, which would be a Rs 600-bn market opportunity. New products such as Electric Multiple Units (EMUs) and passenger coaches would be key growth-drivers, as the wagons business increasingly metamorphoses into an annuity business. Growing urbanization has led to strong demand from the metro railway segment. Apart from Chennai, Delhi and Mumbai, new projects have been planned in several cities, including Chennai, Hyderabad, Ludhiana, Lucknow, Ahmadabad and Kanpur. A number of new products such as hybrid stainless steel coaches, air-conditioned metro coaches, high-speed self-propelled accident relief trains, double-decker air-conditioned coaches, and DMUs with heating arrangements have been identified by market incumbents for future business. About 300 EMUs worth Rs 5bn are added every year to the Indian Railways' fleet, which can emerge as a sizeable market, as the existing rolling stock is renewed.

TWL in a sweet spot

Being one of the oldest and biggest players in wagon production, TWL enjoys a market share of 18-20% in the freight wagon segment. Although the company faces intense competition from new entrants, it has been in a favourable position, thanks to its capacity and efficiency compared to others.

Why?

The Indian Railways places wagon orders once a year. It conducts a mid-term review to scrutinize performance of manufacturers. In case, a manufacturer is unable to execute 25% of its outstanding order-book, it diverts remaining orders to other players who have achieved the set target. With the largest production capacity in India, TWL is favourably placed to bag diversion and supplementary orders as in the past.

Apart from freight wagons, TWL had bagged two EMU orders worth Rs 2.5bn in the face of intense competition from heavyweights such as BEML and Jessop. With these two orders, TWL garnered the lion's share in the Indian EMU space. Another key advantage that TWL enjoys in this segment is low competition, as very few players are qualified to manufacture passenger coaches for the Indian Railways. A company wishing to make a foray into coach manufacturing, besides the stipulated qualification, must build a proto-type, as per the specifications of the Indian Railways, and test the same over a period of 18-24 months to qualify as an authorized manufacturer. Thus, for two years, we expect no major entrants in this segment.

TWL, well qualified for receiving orders from both segments of the Indian Railways, is in a sweet spot to seize the opportunities arising from their expansion plans.

Wagon sales of TWL (in units)

Segment	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13E	FY14E
Wagons IR	878	964	694	928	1,204	1,293	1,400	1,800	1,926
- Diversion Orders			380	540	800	860	900	500	500
Wagons other than IR	276	1,252	2,514	2,129	722	718	500	800	1,000
Standalone sales (Wagons)	**1,154**	**2,216**	**3,588**	**3,597**	**2,726**	**2,871**	**2,800**	**3,100**	**3,426**
AFR						18	NA	400	400
CIMMCO					123	572	1,300	700	800
Passenger Coaches							72	90	90

Source: Company, Violet Arch Research

Order-book to swell further with favourable verdict for CIMMCO

In 2007, TWL acquired CIMMCO, a wagon manufacturing company. CIMMCO's operations, which had been suspended for eight years, were restarted after TWL acquired it. In FY10, CIMMCO qualified for orders from the Indian Railways and has since maintained a market share of 7-10%. However, due to some regulatory problems, it did not qualify for any orders during FY12. After the matter was referred to the High Court, TWL received a favourable verdict declaring CIMMCO as a qualified manufacturer of wagons for the Indian Railways. Currently, CIMMCO has an outstanding order-book of 700 wagons, which is expected to grow considerably on implementation of the court order by the Indian Railways.

French acquisition to enhance product bouquet

Beside its Indian acquisition, TWL has bought Arbel Fauvet Rail (AFR), a French wagon manufacturer with operations in Europe. AFR has pioneered custom-built wagons for different types of goods, including coal, iron ore, automotives and heavy machinery. As per the Liberalized Wagon Investment Scheme, introduced by the Indian Railways in 2008, the Government of India allowed investments from private players in special-purpose and high-capacity wagons. With the technology acquired from its French subsidiary, AFR, TWL is favourably placed to attain growth expected in special purpose wagons. Besides, AFR has an outstanding order-book of 800 wagons, which it expects to deliver over the next two years.

Key Risks and Concerns

Delay in order awarding – Inherent business risks

Historically, Indian Railways has accounted for around 70% of the total order book of TWL. Hence, the company is heavily dependent on the railways. Any slowdown in the rollout of orders from the Indian Railways could affect the company's order book. However, given the Indian Railways' focus on fleet-size expansion and Vision 2020, we expect a timely and efficient execution.

Raw material delay by Indian Railways

As a business practice, Indian Railways supplies raw material for the wagon orders placed by it. Since its contribution to TWL's current order-book is the highest, any scarcity of raw materials or delays by the Indian Railways could hamper the company's execution of orders.

Business slowdown

A slowdown in the economy could put the capex plans of Indian Railways on the back-burner, and only replacement orders would be rolled out. It would also affect the movement of goods in the country, which would restrict order flows from the private segment. In case the industry growth is at a CAGR of 10% (against our assumption of 17%) over FY12-14E, then EPS for TWL would be impacted by 4.5%.

Competition – The prime concern

Although the wagon sector in India has historically witnessed low competition due to high entry barriers, the sector has seen increased competition from new players such as Jupiter, CEBBCO and Jindal Rail, among others, over the last couple of years, with an aggregate production capacity of around 2000 wagons. The Indian Railways distributes orders based on bidding and qualification. This ensures the lowest production cost, besides price uniformity across bidders. Incidentally, the aggressive pricing strategy adopted by new entrants to capture a market share has exerted margin pressure.

Delays in rolling of new wagons

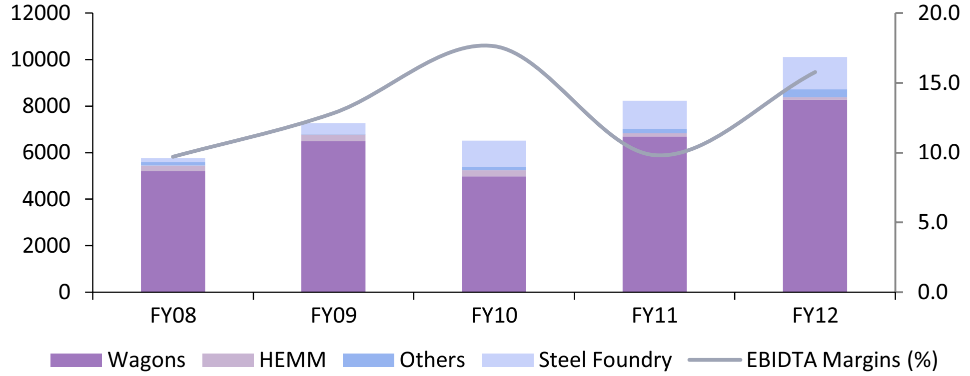
TWL plans to introduce new innovatively designed freight wagons in the market, which have high realizations and margins. Since the RDSO undertakes periodic reviews and constant design changes, TWL may incur a substantial loss of time on designing single proto-types.

Financial Outlook – Consolidated

Revenues: Steady growth in wagon procurement by Indian Railways

Over FY12-14E, we expect TWL to clock a CAGR of 14.7% in revenue on the back of a stable order inflow from the Indian Railways and increased orders from the private segment. With India's GDP poised to grow at 7% and given the current order book of the company, we expect a total freight wagon sale of 4,200 and 4,626 units in FY13E and FY14E, respectively. In the passenger coach segment, TWL has an order book of 23 rakes (207 wagons), which would be delivered over the next two years.

Revenue and margin



Source: Company, Violet Arch Research

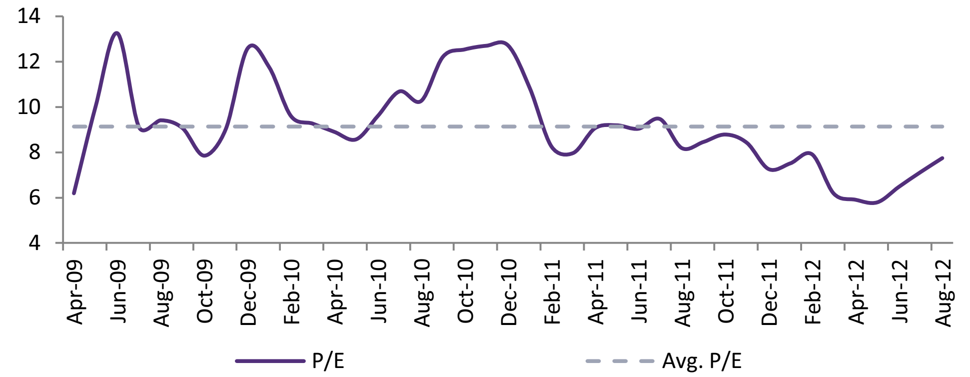
Operating performance - Margins to remain under pressure

For the past two years, TWL has witnessed pressure on its margins on account of: a) increased competition in the Indian Railways' freight wagon segment, and b) increase in raw material prices (i.e. brakes, clutches, etc.). Since new entrants in the freight wagon segment have been aggressive in enhancing their market shares, we expect EBIDTA margins to remain under pressure and stabilize at 14.3% in FY14E.

Valuation

The stock currently trades at 6.1x/5.9x FY13E/FY14E earnings. In recent times, we have seen an increase in the number of players in the Indian wagon manufacturing segment. Further, given the Indian Railways' bidding mechanism, we believe, it would lead to a reduction in market share of TWL. To factor in the same, we have assigned a 10% lower PE multiple than its four-year historical average. We value the stock at 8.0x FY14E earnings and arrive at a target price of Rs 433, giving an upside of 35%. We initiate with a Buy rating.

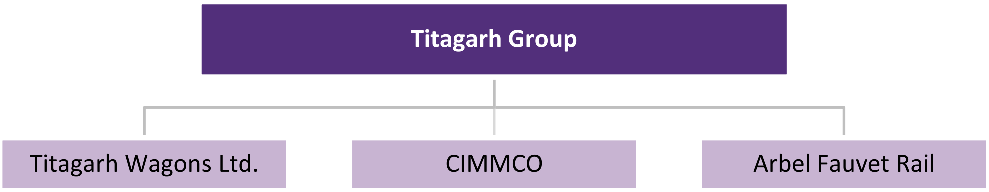
One-year forward P/E Chart



Source: Company, Violet Arch Research

Company Background

Titagarh Wagons Ltd. (TWL) is one of the leading private sector wagon manufacturers in India. It is primarily engaged in the manufacture of wagons, bailey bridges, heavy earth-moving & mining equipment, steel and SG iron casting of moderate to complex configuration, etc. The company also manufactures wagons, shelters and other engineering equipment for the Defence Research Development Organization (DRDO). TWL took over CIMMCO in 2007 and Arbel Fauvet Rail (AFR), France, in 2010. Headquartered in Kolkata, it has production facilities at Titagarh and Uttarpara in West Bengal, with a wagon manufacturing capacity of 10,000 wagons per annum.



Source: Company, Violet Arch Research

Financial summary (Consolidated)

Income statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	**7,244**	**8,909**	**10,747**	**11,713**
% chg	30.7	23.0	20.6	9.0
Total Expenditure	6,532	7,504	9,161	10,039
Operating profit	**712**	**1,406**	**1,586**	**1,675**
(% of Net Sales)	9.8	15.8	14.8	14.3
Other Income	186	245	245	245
Depreciation& Amortization	83	108	121	122
Interest	92	176	196	224
PBT	**1,117**	**1,367**	**1,514**	**1,573**
(% of Net Sales)	15.4	15.3	14.1	13.4
Tax	808	401	454	472
(% of PBT)	72.3	29.4	30.0	30.0
PAT	**725**	**966**	**1,060**	**1,101**
Add/(Less): Extraordinary Items	(19.7)	133.9	15.0	15.0
Adj PAT	**745**	**832**	**1,045**	**1,086**

Cash flow statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
PAT	745	832	1,045	1,086
Depreciation	83	108	121	122
Chg in working capital	(51)	(381)	583	181
Other Current Assets	(570)	110	-	-
CF from operations	**1,449**	**1,210**	**582**	**1,028**
Capital expenses	1,268	450	50	50
Chg in investments	(34)	61	-	-
CF from investing	(1,234)	(511)	(50)	(50)
Free cash flow	181	760	532	978
Equity raised/(repaid)	-	12	-	-
Debt raised/(repaid)	**(239)**	**79**	**293**	**154**
Dividend(Incl tax)	**150**	**160**	**-**	**-**
CF from financing	(89)	252	293	154
Net change in cash	**127**	**951**	**825**	**1,132**
Opening cash bal	**1,151**	**1,278**	**2,229**	**3,053**
Closing cash bal	**1,278**	**2,229**	**3,053**	**4,185**

Balance sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Sources of Funds				
Equity Share Capital	188	201	201	201
Reserves& Surplus	5,576	6,441	7,500	8,602
Shareholders Funds	**5,764**	**6,641**	**7,701**	**8,802**
Total Loans	1,341	1,420	1,713	1,867
Total Liabilities	**7,299**	**8,351**	**9,703**	**10,959**
Application of Funds				
Gross Block	3,179	3,629	3,679	3,729
Less: Acc. Depreciation	819	926	1,047	1,169
Net Block	**2,361**	**2,703**	**2,632**	**2,560**
Capital Work-in-Progress	210	332	332	332
Investments	**26**	**87**	**87**	**87**
Current Assets	6,799	7,322	9,176	10,704
Current liabilities	2,141	2,094	2,539	2,756
Net Current Assets	**4,658**	**5,228**	**6,636**	**7,949**
Miscellaneous Expenses	-	-	-	-
Total Assets	**7,299**	**8,351**	**9,703**	**10,959**

Financial ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Leverage Ratio				
Net Debt-Equity	0.0	(0.1)	(0.2)	(0.3)
Interest Coverage -on EBIT	13.1	8.8	8.7	8.0
Per Share Data (Rs)				
Diluted EPS	39.6	41.5	52.1	54.2
Diluted Cash EPS	44.0	46.8	58.1	60.2
DPS	8.0	8.0	-	-
Book Value	306	331	384	439
Returns %				
ROE	12.9	12.5	13.6	12.3
ROCE	16.6	18.5	17.6	16.4
Margin Ratios (%)				
EBITDA margin	9.8	15.8	14.8	14.3
PBT margin	15.4	15.3	14.1	13.4
PAT margin	10.3	9.3	9.7	9.3
Growth Ratios (%)				
Net Sales	30.7	23.0	20.6	9.0
EBITDA	(27.2)	97.5	12.8	5.6
EBIT	16.1	27.5	10.8	5.1
PAT	20.5	33.1	9.8	3.9
Valuations				
P/E	8.1	7.7	6.1	5.9
P/BV	1.0	1.0	0.8	0.7
EV / Sales	0.8	0.6	0.5	0.4
EV / EBITDA	8.5	4.0	3.2	2.4
MCap/Sales	0.8	0.7	0.6	0.5

COMPANY REPORT

Equity Research | Pharma

21 September, 2012

Dishman Pharmaceuticals & Chemicals Ltd.

A Leap Forward to Health

Absolute Rating	**BUY**
Target Price	**Rs 132**
Upside	**32%**

Dishman Pharma is a major player with a sizable business in the Indian contract research and manufacturing services (CRAMS) industry. The majority of the company's business revenue comes from CRAMS (64% of sales) and marketable molecules (36% of sales). Besides, it also offers a range of antiseptics and disinfectants through its disinfectant division. With expected growth in CRAMS, Carbogen Amcis (CA) and vitamin D3, we expect revenues to grow at a CAGR of 11.8% over FY12-14E. EBITDA margins are expected to improve by 110bps between FY12-14E, which will be largely driven by high business margins in vitamin D3 and CA. We initiate coverage on Dishman Pharma with a Buy recommendation and a target price of Rs 132, with a potential upside of 32%.

CRAMS business to gather further growth momentum

During FY10-11, Dishman's performance was far from satisfactory, mainly due to de-growth in CA, subdued performance by Solvay and inventory de-stocking by MNCs. However, the company has been showing an improvement in CRAMS over the past two quarters. Further, we believe, Solvay's contract will be on track beginning Q2FY13E, led by the completion of the Abbott-Solvay merger. Also, we expect to see a strong performance in CA as a result of the completion of restructuring undertaken by the company and on account of the recently secured euro 18-mn order (Jan'13) for oncology products from Astellas. We expect the CRAMS segment to grow at a CAGR of 17.6% over FY12-14E.

Vitamin D3 business back on track

Dishman Pharma has commissioned its new vitamin D3 manufacturing plant (Unit-13) in India. Revenues from this business are set to see a substantial growth. Moreover, the company has vitamin D3 manufacturing facility in the Netherlands, which will complement the Indian facility. Recently, prices of vitamin D3 have risen sharply due the global shortage. Hence, going forward, we see strong demand for the product. With only two prominent players in the market, we believe, Dishman Pharma will be a key beneficiary. We expect high revenue margins in vitamin D3 revenues, which will grow at a CAGR of 24.0% over FY12-14E.

Expect major turnaround in FY13E, driven by HiPO facilities, new orders

Dishman Pharma has developed two state-of-the-art facilities at Bavla in Ahmedabad and China. The two facilities, touted to be the largest in India, have commenced production. Further, we believe, these HiPo (high potent) facilities will maintain the growth momentum going forward. Currently, the company is in talks with different MNCs for securing fresh orders. The company, we believe, is likely to bag 2-3 new large orders in FY13E and FY14E.

Valuation

We expect a major turnaround in FY13E and FY14E on the back of new orders and full commercialization of HiPo facilities in Bavla (India) and China, a turnaround in revenues of Carbogen Amcis and the Abbott-Solvay contract [Dishman, the sole supplier, has a 3-year ongoing contract for eprosartan mesylate (USD100mn); other products such as fenofibrate will be included in the near term] and an improvement in the marketable molecule business. We believe that the medium to long-term prospects of Dishman Pharma are encouraging because of its world-class facilities, completion of asset expansions and attractive valuations. At the CMP of Rs 100, the stock trades at PE of 8.3x and 6.8x of FY13E and FY14E earnings of Rs 12.0 and Rs 14.7, respectively. Our target price is (9x of FY14E EPS of Rs 14.7) Rs 132, with an upside of 32%.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	10,315	11,241	12,630	14,062
EBITDA	2,030	2,245	2,694	2,971
EBITDA margin (%)	19.7	20.0	21.3	21.1
EBITDA growth (%)	(0.4)	10.6	20.0	10.3
Adj. PAT	814	569	972	1,182
Adj. PAT margin (%)	7.9	5.1	7.7	8.4
Adj. PAT growth (%)	(30.8)	(30.2)	70.9	21.6
FDEPS (Rs)	10.1	7.0	12.0	14.7
FDEPS growth (%)	(30.8)	(30.2)	70.9	21.6
PE (x)	9.9	14.2	8.3	6.8

Source: Company, Violet Arch Research

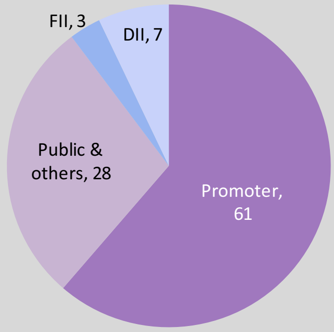
Stock data

CMP	**Rs 100**
Reuters Code	DISH.BO
Bloomberg Code	DISH IN
Equity Shares o/s (mn)	81
Market Cap (Rs mn)	8,054
Market Cap (USD mn)	151
3m Avg daily t/o(US$ mn)	2.6

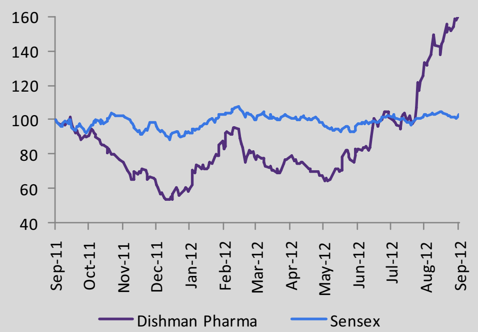
Stock performance (%)

52-week high/low			**Rs 107/33**
	1M	**3M**	**12M**
Absolute	8.7	63.3	52.8
Relative	(0.3)	36.8	38.3

Shareholding pattern (%)



Relative stock movement



Krishnanath Munde
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Scenario Analysis

FY14E (Rs mn)	Bull Case	Base Case	Bear Case
Sales	**15,195**	**14,062**	**12,976**
India CRAMS	4,756	4,382	4,023
Carbogen Amcis	6,010	5,523	5,057
Quats	853	853	853
Vit D	3,576	3,304	3,043
EBITDA	3,515	2,971	2,482
PAT	1,601	1,182	806
EPS (Rs)	**19.8**	**14.7**	**10.0**
PE(x)	10.0	9.0	8.0
CMP (Rs)	100	100	100
Target price (Rs)	**198**	**132**	**80**
Upside (%)	**98.7**	**32.1**	**(20.0)**

Source: Company, Violet Arch Research

Key Assumptions	FY11	FY12	FY13E	FY14E
India CRAMS (%)	(2.0)	5.5	27.8	12.4
Carbogen Amcis (%)	(0.7)	12.5	17.7	14.1
Quats (%)	(3.1)	57.8	(36.8)	(29.1)
Vitamin D3 (%)	68.4	(0.3)	25.0	23.0
EBITDA margin (%)	19.7	20.0	21.3	21.1

Source: Company, Violet Arch Research

Base case

- Revenues to grow by 11.3% y-o-y in FY14E, driven largely by the Indian CRAMS (at a CAGR 19.8% over FY12-14E) and Carbogen Amcis businesses (at a CAGR 15.9% during FY12-14E). Also, the contribution from Unit-9 (HiPo API, and anti-cancer) through the supply contract with the generic companies. We expect revenue of Rs 1,850mn from the Solvay contract Dishman, the sole supplier, has a 3-year ongoing contract for eprosartan mesylate (USD100mn). Other products such as fenofibrate will be included in the near term; the contract period can be extended up to five years.
- EBITDA margin to improve by 110bps to 21.1% over FY12-14E, led mostly by the high-margin business of Carbogen Amcis, Unit-9 (anti-cancer) and vitamin D3. With production being a major driver for the EBITDA expansion, we expect a ramp-up in capacity utilization.

Bull case

- Revenues to grow by 16.0% y-o-y in FY14E led by a strong improvement in the Carbogen Amcis business, due to the high margin contract and the completion of restructuring. We also expect the growth momentum in the Indian CRAMS (courtesy the Solvay contract) and vitamin D3 (due to the global shortage) business.
- EBITDA margin to improve by 310bps to 23.1% over FY12-14E on account of high-margin revenues from vitamin D3 and the Carbogen Amcis contract.

Bear case

- Revenues to grow by 6.7% y-o-y in FY14E as a result of muted growth in the overall Indian CRAMS business, a delay in securing a high-margin Carbogen Amcis contract and an improvement in vitamin D3 supply globally.
- EBITDA margin to decline by 90bps to 19.1% over FY12-14E, due to a muted performance in the Carbogen Amcis and vitamin D3 business.

SWOT Analysis

Strengths

1) Management's experience and ability to maintain client relationships have ensured repeated orders.

2) R&D capabilities to develop an efficient and cost-effective process at a short notice.

3) IPR (Intellectual Property Rights) adhering status.

4) Multi-purpose and multi-product production facilities in place. The company has plants in India, China, the Netherlands, Switzerland and the UK for manufacturing highly potent API, intermediates, vitamin D3, disinfectants, cholesterol and lanolin.

Threats

1) Competition from other Indian companies (Divis, Jubilant Healthcare and Piramal Healthcare) operating in similar segments.

2) Competition from countries that offer a low-cost manufacturing base such as China, Korea and Taiwan.

3) The patent/licence holder may abandon the NCE at any stage for various reasons.

SWOT Analysis

Weaknesses

1) Given the small balance sheet size of Dishman (total capital employed as on FY12 stands at Rs 20bn compared to its peers' avg of Rs 70bn), bagging large orders become difficult. Also, theh company finds it difficult to attract talent in comparison to large MNCs.

2) High dependence on a small number of clients deprives the company of large-ticket orders.

Opportunities

1) MNCs losing their blockbuster drug patents (> USD 100bn) in the next few years, thereby increasing the scope for outsourcing to countries that offer a low-cost manufacturing base such as India, China, Korea and Taiwan. The company is a leading CRAMS player in India.

2) Growth of generics market in the US and Europe (>USD 120bn patent expiries in the next 3-4 years) will lead to contract manufacturing opportunities (CMO) for Indian CRAMS companies due to low cost (1/4th of the US and Euorpe).

3) Globall shortage of vitamin D3. The company has a separate plant for vitamin D3. It will benefit through a recent price rise and a new order-book.

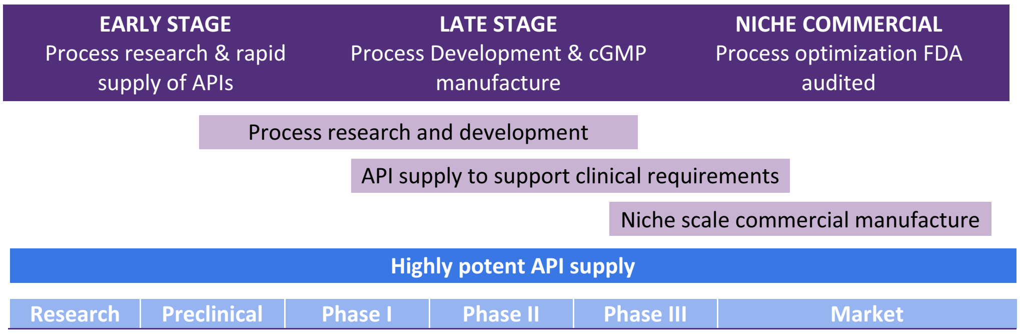
Source: Violet Arch Research

Investment Arguments

CRAMS growth momentum to continue, driven by Carbogen Amcis' turnaround and Eposartan Mesylate's supply resumption to Solvay

Carbogen Amcis (CA) is a 100% subsidiary of Dishman Pharma engaged in the process R&D of active pharmaceutical ingredients (API) for clinical trials and niche-scale commercial production. These highly potent API services are offered under the CA business. The company has five dedicated manufacturing facilities under this business: four of them in Europe and one in India, catering to varied requirements. They offer services from the laboratory scale for process research and development purposes to large-scale manufacturing on the 1600L scale, including category-IV compounds. CA is a major segment of Dishman'a CRAMS business, which contributes around 37% to total revenues.

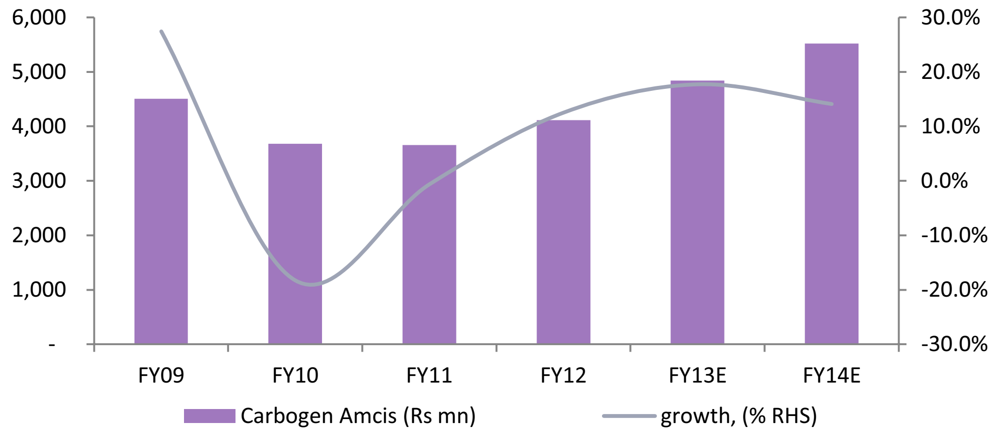
Value chain across Carbogen Amcis



Source: Company, Violet Arch Research

CA has been witnessing a major downturn in business due to its contract research business (>50% of CA). Globally, innovator firms have reduced R&D costs by outsourcing on the back of consolidation happening in the pharmaceutical industry. For the past two year, the company's business has consistently been poor. However, the CRAMS segment has shown an improvement over the last two quarters, mainly driven by robust performance in CA in terms of both top-line and bottom-line. We expect the CA segment to grow at a CAGR of 15.9% over FY12-14E on the back of the completion of business restructuring (for focusing on the high-margin contract and new geographical location, namely, Japan, a reduction of manpower and new top management) and the recently secured euro 18-mn order from Astellas for the supply of oncology products, which are slated to commence from January 2013 onwards.

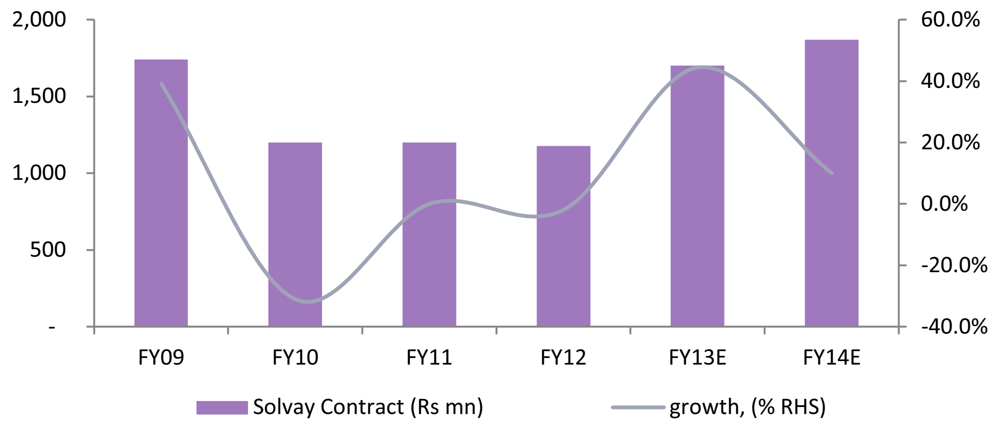
Carbogen Amcis (CA) performance



Source: Company, Violet Arch Research

Solvay, a key client of Dishman, contributed 10% to its top-line in FY12. Revenues from Solvay have been subdued over the last three years, due to Abbott announcing the acquisition of Solvay in 2QFY2010. Going forward Solvay's contract will be on track beginning Q2FY13E, which will be driven largely by the completion of the Abbott-Solvay merger. We expect Solvay's contract to contribute Rs 1,700mn & Rs 1,870mn (13% of revenue) in FY13E & FY14E, respectively.

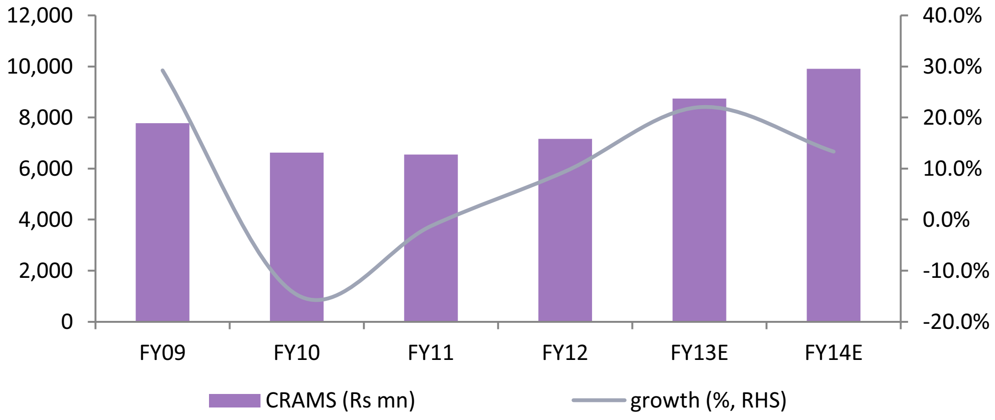
Solvay's contract (Eprosartan Mesylate) performance



Source: Company, Violet Arch Research

Dishman Pharma also has a euro 20-mn deal with Celegene and AstraZeneca, besides a contract with Abbott, estimated at euro 100mn. We expect the overall CRAMS business revenues to grow at a CAGR of 17.6% between FY12 and FY14E as a result of Solvay and other CRAMS businesses.

CRAMS business performance



Source: Company, Violet Arch Research

Vitamin D3 business back on track

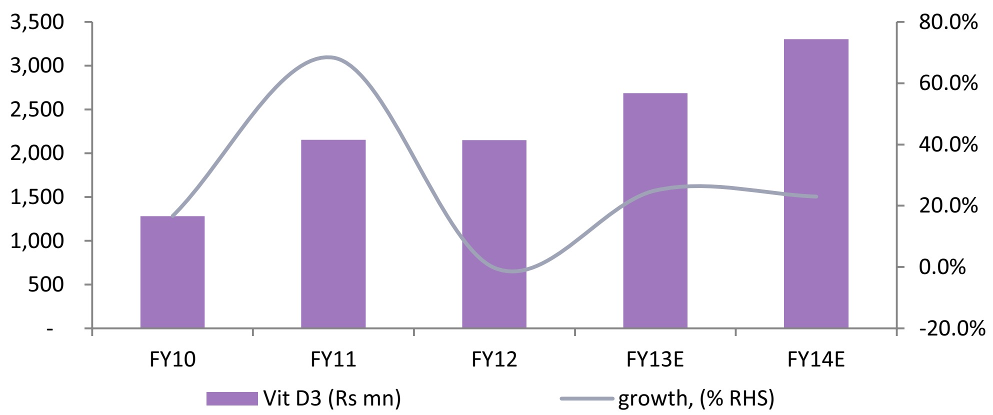
Vitamin D3 contributes around 19% to Dishman Pharma's total revenues. The company has ventured further into this segment by acquiring fine chemicals, vitamin D and vitamin D analogues of Solvay Pharmaceuticals in FY08. Cholesterol is used in pharmaceutical, cosmetic and crustacean feed applications. Vitamin D analogues, categorized under high-potency products, find applications in food and pharmaceuticals. The company retained production of cholesterol and vitamin D analogues at Veenendaal, while it transferred vitamin D3 production to Indian plants. Its production sites are ISO-9001 and 14001-certified and USFDA accepted.

Dishman Pharma has commissioned its new vitamin D3 manufacturing plant (Unit-13) in India. Revenues from this business are set to see a substantial growth. Moreover, the company has vitamin D3 manufacturing facility in the Netherlands, which will complement to the Indian facility. Recently, prices of vitamin D3 have risen sharply due the global shortage of the product. Hence, going forward, we see strong demand for the product. With only two prominent players in the market, Dishman Pharma, we believe, will be a key beneficiary. We expect high margins in vitamin D3 revenues, which will grow at a CAGR of 24.0% over FY12-14E.

No	Intended Use	Vitamin products
1	Pharmaceuticals	Ergocalciferol (vitamin D2)
		Cholecalciferol (vitamin D3)
		Dohyfral (vitamin D3 in oil)
		DHT2
		Calcitriol
		Calcifediol
		Alfacalcidol
		Cholesterol HP
2	Cosmetics	Cholesterol NF and HP (emulsifier)
		Dusoran MD (hair care)
		Dusogel (gelifier for cosmetics)
3	Food/Feed	Cholecalciferol
		Dohyfral
		Cholesterol SF and XG
4	Technical use	Cholesterol NF (liquid crystals)
		Lanolin Alcohol

Source: Company, Violet Arch Research

Vitamin D3 business performance



Source: Company, Violet Arch Research

Expect major turnaround in FY13E, led by HiPo facilities, new orders

Dishman Pharma has developed two state-of-the-art facilities at Bavla in Ahmedabad (India) and China, which manufacture Class-IV (reduce toxicity to negligible levels and side-effects of the drug will also be reduced accordingly) and Class-II and II (reduce toxicity to a moderate level) oncology APIs, respectively, which attracts high EBITDA margins. It has undertaken capex of Rs 1,500mn and Rs 1,250mn in Bavla (India) and China HiPo facilities, respectively. Dishman Pharma is poised to strengthen its ties with Global Innovators, which would lead to a stable revenue flow in the long term.

Of the USD106-bn high-potency therapy global market, oncology alone has a market-size of USD60bn. Dishman Pharma will target cytotoxics (market-size of USD12.5bn) and cytostatics (market-size of USD 24bn). The company's addressable oncology market will be USD20bn. These HiPo facilities will produce 5-7mt annually, which has the potential to be augmented to 30-50mt. The global market rate ranges from USD5,000 to USD10,000 per kg.

The two facilities have commenced production. We expect incremental revenue contributions of USD10mn in FY13E. Further, we believe, the HiPo facilities will help maintain the growth momentum going forward. Currently, the company has been in talks with different MNCs for fresh orders. . The company, we believe, is likely to bag 2-3 new large orders in FY13E and FY14E. Dishman Pharma has an extensive customer base, which includes top MNCs such as Abbott, J&J, Novartis, AstraZeneca, Merck, Pfizer and Eli Lilly, among others.

The management has guided revenues from the Unit-9 facility (HiPo, oncology) of USD5mn and USD15-20mn in FY13E and FY14E, respectively. At present, the company is supplying a small quantity to Merck for one of its experimental oncology drug from this facility.

Key Risk and Concerns

Lowest return ratios

Dishman Pharma's gross debt stood at Rs 9510mn in FY12. Its current RoCE (5.0%), RoE (6.1%), interest coverage (2.0x) and D/E ratios (1.0x) are amongst the lowest in the industry and hence are a cause for concern. The management plans to reduce the company debt by Rs 1000mn and Rs 500mn in FY13E and FY14E, respectively. Besides, no major capex is expected for the next two years. Denotification of its SEZ is already underway. The company expects to receive Rs 1000mn in cash during FY13 post-denotification and strata sale of land, which will be used for funding the capex or for reducing debt. Going forward, return ratios are expected to improve on account of robust top-line growth, which will be led largely by a high margin vitamin D3 products and HYPO facilities.

Competition from Indian and Chinese players in CRAMS

The India CRAMS segment has 5-6 large players, including Divis, Jubilant, Piramal Healthcare, Shasun and Biocon. These players have been aggressive and successfully established strong rapport with MNCs. Hence, Dishman Pharma has to face intense competition while bidding for new contracts. Also, the Indian CRAMS segment has been facing fierce competition from China, mainly because of its low cost and scale of operations. However, India has the edge over Chinese pharma companies in terms of the number of USFDA-approved plants (more than 120), strong ANDAs (over 30% of the total global filings) and DMFs (around 50% of the total global filings) and English language.

Consolidation in global pharma industry

Major instances of consolidation in the global pharma industry such as acquisitions of Fougera Pharma by Sandoz for USD 1,525mn, Actavis by Watson for euro 4,250mn, and Wyeth by Pfizer for USD 68,000mn, among others, pose a significant risk to the Indian CRAMS segment. Large MNCs have been acquiring companies for enhancing their scale of operations, enlarging their customer base and strengthening their R&D product pipeline. This development, we believe, may lead to a loss of business for Indian CRAMS players.

Huge investment in high-end production facilities

Over the last few years, Dishman Pharma has made huge investments in facilities such as an oncology plant (Unit-9) estimated at Rs 1,750mn, while plans are afoot for an additional capex of Rs 2,500mn in FY14E. Hence, any delay in procuring CRO (contract research) and CMO (contract manufacturing) contracts may lead to under-utilization of assets and a loss of revenue due to depreciation and maintenance costs.

Financial Outlook

Revenues to grow at a CAGR of 11.8% over FY12-14E

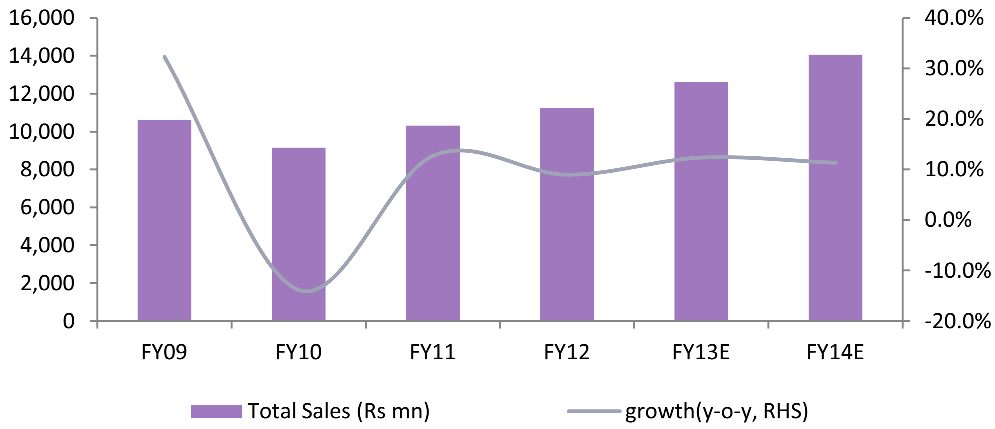
Dishman Pharma's revenues are expected to grow at a CAGR of 11.8% to Rs 14,062mn during FY12-14E on the back of growth from its CRAMS (CAGR 17.6%, FY12-14E) and Vitamin D3 business (CAGR 24.0%, FY12-14E). Going forward, we expect revenue growth to come from Unit-9 (high-potency API, anti-cancer) through supply contracts with generic companies and new contracts. The management has guided USD15-20mn revenues from Unit-9 in FY14E. In Q1FY13, Carbogen Amcis grew by 78% y-o-y to Rs 1,330mn, registering an EBITDA margin of 16%. Carbogen Amcis is expected to generate CHF85mn & CHF95mn in sales in FY13E & FY14E, respectively. Major revenue visibility will be seen from H2FY13E, which will be largely led by a ramp-up of Unit-13, Unit-10 and Unit-9.

Revenues break-up - Segment-wise (Rs mn)

Particulars	FY09	FY10	FY11	FY12	FY13E	FY14E
CRAMS	**7,774**	**6,631**	**6,547**	**7,164**	**8,741**	**9,905**
India CRAMS (Solvay & other)	3,270	2,951	2,891	3,051	3,900	4,382
Carbogen Amcis	4,504	3,680	3,656	4,113	4,841	5,523
Marketable molecules	**2,850**	**2,524**	**3,361**	**4,052**	**3,889**	**4,157**
Quats	1,753	1,244	1,206	1,903	1,203	853
Vit D	1,097	1,280	2,155	2,149	2,686	3,304
Total	**10,624**	**9,155**	**9,908**	**11,216**	**12,630**	**14,062**

Source: Company, Violet Arch Research

Sales performance

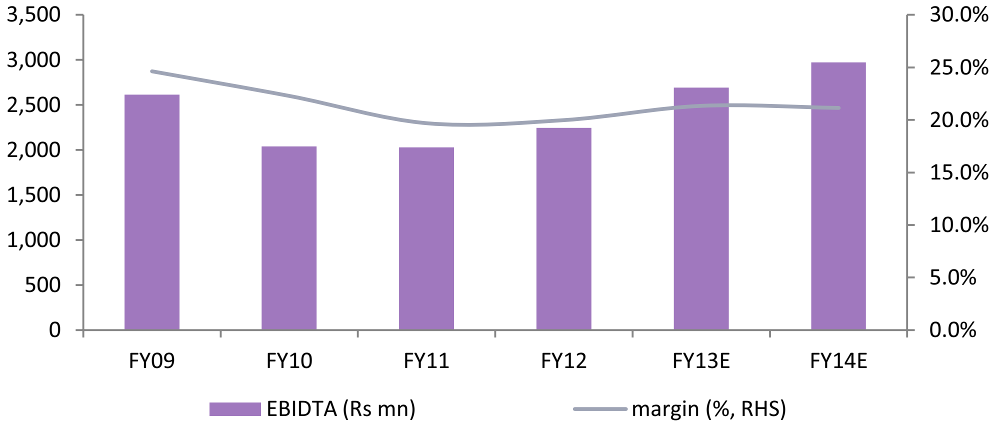


Source: Company, Violet Arch Research

EBITDA margin to improve by 110bps to 21.1% over FY12-14E

We expect EBITDA margins to improve by 110bps to 21.1% over FY12-14E, mainly driven by the higher margin business of Carbogen Amcis, Unit-9 (anti-cancer) and Vitamin D3. While we expect a ramp-up in capacity utilization, commercial production is likely to be a major driver for the EBITDA expansion.

EBITDA margin performance

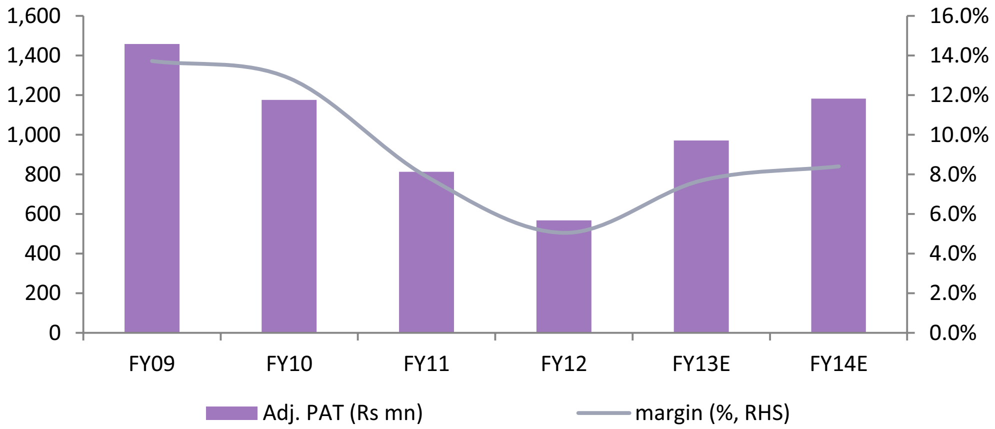


Source: Company, Violet Arch Research

PAT to grow at 44.2% (CAGR) between FY12 and 14E

We expect PAT to clock at a CAGR of 44.2% during FY12-14E on the back a robust performance from Carbogen Amcis and marketable molecules. Tax rates are expected to remain higher in the range of 22-25%, since the Bavla plant is being relocated, and hence may lead to the loss of the EoU status. We expect a margin improvement of 330bps to 8.4% over FY12-14E.

Adj. PAT performance



Source: Company, Violet Arch Research

Valuation

Being a leading CRAMS company, we believe, Dishman has a superior chemistry skill and vast infrastructure, which have been well recognized by most regulatory bodies. This will help the company to take advantage of the growing pharma outsourcing opportunities. With commercialization Unit-9 (oncology), Unit-10 (disinfectants) and Unit-13 (vitamin D3) in place, we expect an improvement in Carbogen Amcis' sales and margins, besides new manufacturing contracts going forward. We also expect the CRAMS and Vitamin D3 business to grow at a CAGR of 17.6% and 24.0%, respectively, over FY12-13E.

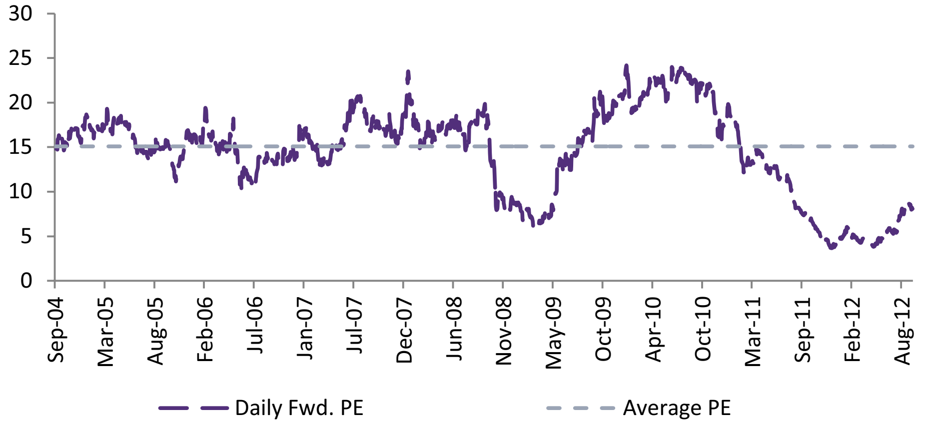
On the marketable molecules front, Dishman Pharma has sharpened its focus on value-added products. A price hike and better margins are expected from this segment. We expect revenues and PAT to grow at a CAGR of 11.8% and 44.2%, respectively, over FY12-14E. At the current market price of Rs 100, the stock trades at PE of 8.3x and 6.8x of FY13E and FY14E earnings of Rs 12.0 and Rs 14.7, respectively. Our target price would be (9x of FY14E EPS of Rs 14.7) Rs 132 with a potential upside of 32%.

Peer comparison (Rs mn)

Company	CMP	Market cap	EPS (Rs)		P/E (x)		ROE		ROCE		CAGR		EV/EBITDA (x)		EV/Sales (x)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	Sales (FY12-14E)	PAT (FY12-14E)	FY13E	FY14E	FY13E	FY14E
Divis	1,075	142,975	45.9	56.4	23.4	19.1	23.0%	22.7%	26.0%	26.4%	22.5%	17.2%	17.9	14.2	6.2	5.1
Jubilant	204	32,436	22.5	25.2	9.1	8.1	14.3%	14.1%	10.4%	10.9%	15.6%	8.8%	7.4	6.3	1.4	1.1
Piramal Ent.	471	81,277	5.4	7.7	87.2	61.2	1.6%	1.9%	0.0%	0.3%	25.9%	57.4%	26.2	21.0	3.4	2.9
Average					**39.9**	**29.4**	**13.0%**	**12.9%**	**12.1%**	**12.5%**	**21.4%**	**27.8%**	**17.2**	**13.8**	**3.7**	**3.1**
Dishman	**100**	**8,054**	**12.0**	**14.7**	**8.3**	**6.8**	**9.0%**	**9.7%**	**7.6%**	**8.1%**	**11.8%**	**44.2%**	**5.6**	**4.6**	**1.2**	**1.0**

Source: Company, Violet Arch Research

Forward PE (x) chart



Source: Company, Violet Arch Research

Company Background

Established in 1983, Dishman Pharma is a preferred and reliable CRAMS player offering a portfolio of development, scale-up and manufacturing services. Products and services offered by the company span customer requirements from chemical development to commercial manufacture and supply of active pharmaceutical ingredients. Headquartered in Ahmedabad, the company has a global presence, with manufacturing sites located in Europe, China, Saudi Arabia and India. Its production facilities are ISO-certified and FDA-approved. Initially, the company began by manufacturing of quats (specialty chemicals). Since 1997, it diversified its interest to CRAMS, which contributes majority of its revenues. Its marketable molecules division comprises vitamin D, quats and disinfectants.

Management profile

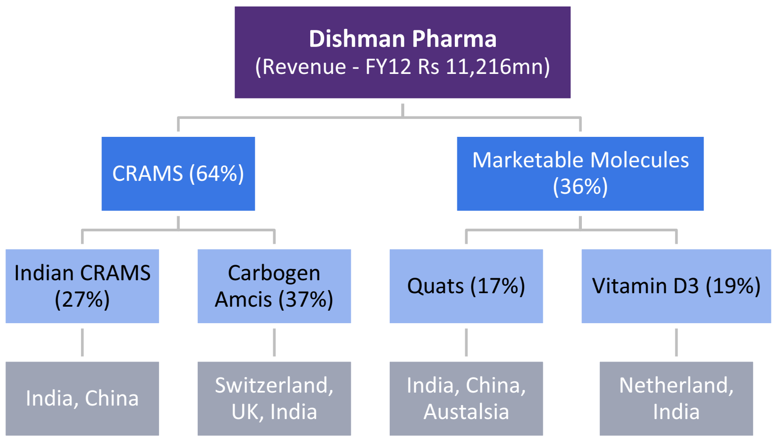
Name	Designation
Janmejay Vyas	Chairman & MD
Sanjay Majmudar	Director (Finance)

Business breakup

Business unit	Manufacturing locations	Business focus
Dishman Contract Research and Manufacturing Services (CRAMS)	India, China	High-value, cost-competitive contract services. Process development, process optimization, manufacture for late stage clinical and commercial supply.
Carbogen Amcis	Switzerland, UK, India	High-quality process research and development. API supply to support clinical trial requirements. Niche scale commercial manufacture. Highly potent API supply.
Specialty Chemicals	India, China, Australasia, Saudi Arabia	World leading manufacturer of Phase Transfer Catalysts. High-quality supply of intermediates, fine chemicals, and products for pharmaceutical, cosmetic and related industries. Next generation innovative antiseptic and disinfectant formulations.
Vitamins and Chemicals	Netherlands, India	Vitamin D2, Vitamin D3, Vitamin D analogues, cholesterol and lanolin related products for pharmaceutical, cosmetic and related markets.

Source: Company, Violet Arch Research

Revenue break-up



Source: Company, Violet Arch Research

Financial Summary- Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**10,315**	**11,241**	**12,630**	**14,062**
Growth (%)	12.7	9.0	12.4	11.3
Operating expenses	8,285	8,996	9,936	11,091
EBIDTA	**2,030**	**2,245**	**2,694**	**2,971**
EBITDA margin (%)	19.7	20.0	21.3	21.1
Depreciation	688	765	767	814
EBIT (core)	**1,342**	**1,480**	**1,927**	**2,158**
Other income	138	130	146	163
Interest	559	729	811	785
PBT	**922**	**880**	**1,262**	**1,536**
Tax	108	312	290	353
Tax rate (%)	11.7	35.4	23.0	23.0
Reported PAT	**828**	**569**	**972**	**1,182**
Forex (gain) / loss	-	-	-	-
Extraordinary items	(14)	(1)	-	-
Adjusted PAT	**814**	**569**	**972**	**1,182**
Adj. PAT margin (%)	7.9	5.1	7.7	8.4
Shares o/s (mn)	81	81	81	81
EPS (Rs)	10.1	7.0	12.0	14.7

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit	921	880	1,262	1,536
Depreciation & Amortisation	688	765	767	814
Tax paid	(136)	(312)	(290)	(353)
Chg in working capital	513	(472)	(538)	(496)
Other operating cash flow	69	597	1,660	1,169
Cash flow from operations (a)	**2,055**	**1,459**	**2,861**	**2,669**
(Inc.)/ Dec. in Fixed Assets	(2,433)	(700)	(500)	(600)
(Inc.)/ Dec. in Investments	-	-	-	-
Other investing cash flow	94	-	-	-
Cash flow from investing (b)	**(2,339)**	**(700)**	**(500)**	**(600)**
Proceeding from borrowing	(35)	-	-	-
Proceeding from equity issues	630	822	(1,000)	(500)
Dividend (incl. tax)	(113)	(113)	(113)	(113)
Interest paid	(547)	(729)	(811)	(785)
Other financing cash flow	319	-	-	-
Cash flow from financing (c)	255	(21)	(1,924)	(1,398)
Net change in cash (a+b+c)	**(30)**	**739**	**437**	**671**
Opening Cash balances	**455**	**425**	**1,164**	**1,601**
Closing Cash balances	**425**	**1,164**	**1,601**	**2,272**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Shareholder's funds	**8,791**	**9,248**	**10,793**	**12,175**
Share capital	161	161	161	161
Reserves & Surplus	8,630	9,087	10,632	12,014
Total debt	**8,688**	**9,510**	**8,510**	**8,010**
Secured Loan	8,080	8,480	7,980	7,730
Unsecured Loan	608	1,030	530	280
Deferred tax liability	320	320	320	320
Total Liabilities	**17,799**	**19,078**	**19,623**	**20,505**
Net fixed asset	**14,231**	**14,204**	**13,937**	**13,724**
Investments	14	14	14	14
Net Current Assets	**3,554**	**4,860**	**5,671**	**6,767**
Current Assets	**6,567**	**7,910**	**9,181**	**10,711**
Inventories	2,702	2,956	3,322	3,699
Sundry Debtors	1,737	1,879	2,111	2,350
Cash And Bank Balances	425	1,164	1,601	2,272
Loans And Advances	1,703	1,911	2,147	2,391
Less: CL & Provisions	**3,013**	**3,050**	**3,510**	**3,944**
Current liabilities	2,702	2,834	3,131	3,494
Provisions	311	216	379	449
Total Assets	**17,799**	**19,078**	**19,623**	**20,505**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	10.1	7.0	12.0	14.7
Adj EPS growth (%)	(30.8)	(30.2)	70.9	21.6
EBITDA margin (%)	19.7	20.0	21.3	21.1
PBT margin (%)	8.9	7.8	10.0	10.9
PAT margin (%)	7.9	5.1	7.7	8.4
ROE (%)	9.3	6.1	9.0	9.7
ROCE (%)	6.7	5.0	7.6	8.1
Turnover ratios				
Asset turnover (x)	0.6	0.6	0.6	0.7
Net fixed asset turnover (x)	0.7	0.8	0.9	1.0
Net Debt/Equity (x)	1.0	1.0	0.8	0.7
Working Capital & Liquidity ratio				
Inventory days	96	96	96	96
Receivable days	61	61	61	61
Payable days	119	115	115	115
Valuations				
PE (x)	9.9	14.2	8.3	6.8
Price/Book value (x)	0.9	0.9	0.7	0.7
EV/EBITDA (x)	8.0	7.3	5.6	4.6
EV/Sales (x)	1.6	1.5	1.2	1.0

COMPANY REPORT

Equity Research | Infrastructure

21 September, 2012

IL&FS Transportation Networks

Up on the Road

Absolute Rating	BUY
Target Price	Rs 218
Upside	20%

IL&FS Transportation Networks (ITNL), an established surface transportation player, is a pure play in the emerging business opportunities in the road segment. ITNL has the largest and most diversified BOT road asset portfolio in terms of geographical spread and revenue streams. A strong management setup, rich parentage and abundant opportunities, with a descending curve of competition and a reversal in the interest rate cycle, are the key positives for ITNL. We expect ITNL to post a CAGR of 13.3%/9.4% in consolidated revenues/profits over FY12-14E due to its recent order-winning spree. We have valued ITNL on an SOTP basis, wherein we have assigned 4.5x EV/EBITDA to its standalone business, while its investments on asset-owning front have been valued on a DCF/Mcap/BV basis. Our target price works out to Rs 218, implying an upside of 20.1% from current levels. We initiate coverage on the ITNL stock with a Buy recommendation.

Diversified portfolio – Segment-wise and region-wise

With a pan-India presence, ITNL has projects across 16 states in India, with exposure to both annuity and toll road projects. Moreover, the company has ongoing metro rail, bus system and border entry-point projects. We believe that this makes ITNL business model more resilient to slowdown in any particular arena and makes it comparatively more sustainable.

Opportunities galore as competition subsides

The National Highway Authority of India (NHAI) has set itself an aggressive target of awarding about 8,800km of road projects during FY13 as against around 6,491km awarded in FY12. Besides, plans are afoot to build 18,367km of expressways by 2022 in three phases. Justifiably, these initiatives would provide immense opportunities to road infrastructure development companies.

High debt – Blessing in disguise, with interest rates expected to soften

Given the scarcity of affordable debt capital in India and with consistent rate hikes in the past by the RBI leading to an increase in interest rates from Indian banks, infrastructure assets owners (read ITNL) have taken a hit on their profitability. We expect the RBI to start easing its monetary stance in 2HFY13, as the economy bottoms out. Policy interest rates could start coming down, spurring infrastructure investments and benefitting asset owners with debt on the balance sheet (read ITNL).

Valuations

We value ITNL on an SOTP basis to arrive at a target price of Rs 218. The standalone business is assigned a low target multiple of 4.5x EV/EBITDA on FY14E, given its high dependence on captive projects and contributes Rs 36.8/share. For the asset development business, we use the DCF/Mcap/BV method. As regards the revenue and margin profile, we have used the base-case-scenario assumptions. Therefore, a consistent revenue-generating asset portfolio, coupled with better growth opportunities and potential for garnering a greater share of operational projects, would support our value of Rs 181.4/share, also valuing its other subsidiaries/ventures.

Consolidated- Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	40,489	56,056	66,985	72,015
growth (%)	68.5	38.4	19.5	7.5
EBITDA (%)	28.5	26.1	27.3	29.0
Adj. Net Profit	4,335	4,969	4,928	5,950
Adj. EPS (Rs)	21.7	25.5	25.4	30.6
EPS growth (%)	25.9	17.5	(0.4)	20.7
PER (x)	8.4	7.1	7.2	5.9
Price/Book value (x)	1.6	1.3	1.1	1.0
AROE (%)	22.0	19.9	16.6	17.3
AROCE (%)	17.1	13.3	10.7	9.4
EV/Net sales (x)	2.1	2.4	2.8	3.1
EV/EBITDA (x)	7.4	9.3	10.1	10.5

Source: Company, Violet Arch Research

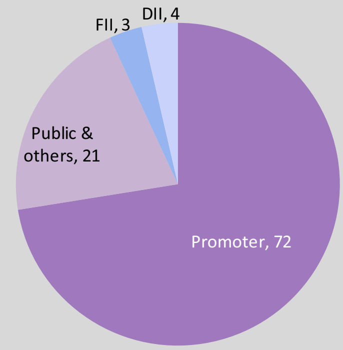
Stock data

CMP	**Rs 182**
Reuters Code	ILFT.BO
Bloomberg Code	ILFT IN
Equity Shares o/s (mn)	194
Market Cap (Rs mn)	35,668
Market Cap (USD mn)	670
3m Avg daily t/o(US$ mn)	0.2

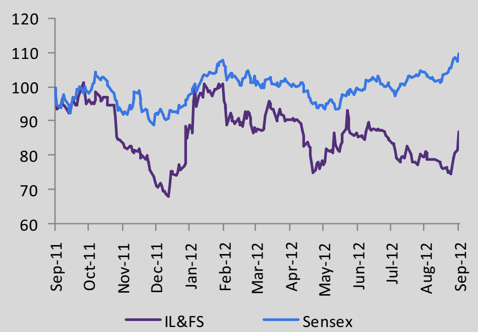
Stock performance (%)

52-week high / low			**Rs 231/142**
	1M	**3M**	**12M**
Absolute	7.5	(0.8)	(13.3)
Relative	2.7	(10.2)	(23.2)

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Method	Bull Case	Base case	Bear Case
BOT Segment				
Under operation - Rs/share	DCFE	104.3	70.5	39.4
Under construction - Rs/share	DCFE	141.1	77.6	29.1
Wins in FY13 and FY14		-	-	-
Subtotal - Rs/share		245.4	148.1	68.5
Holding Co Discount (%)		10	10	15
Subtotal - Rs/share (a)		**220.9**	**133.3**	**58.2**
Standalone - E&C Segment				
EBITDAM (%)		20.2	19.2	17.7
Target multiple (x)	EV/EBITDA	5.5	4.5	3.5
EV/EBITDA (Rs mn)		15,434	7,145	(1,144)
Subtotal - Rs/share (b)		**79.4**	**36.8**	**(5.9)**
Other investments (c)		**48.1**	**48.1**	**48.1**
Total - SOTP target price (Rs/share) (a+b+c)		**348**	**218**	**100**
CMP (Rs)		**182**	**182**	**182**
Upside (%)		**91.7**	**20.1**	**(44.7)**

Key Assumptions

Particulars	Bull Case	Base case	Bear Case
For BOT Segment			
Under operation			
Traffic growth (%)	7.0	6.0	4.0
Toll hike (%)	7.0	6.0	4.0
EBITDAM (%)	88.0	85.0	85.0
COE (%)	14.2	15.2	16.2
Under construction			
Traffic growth (%)	7.0	6.0	4.0
Toll hike (%)	7.0	6.0	4.0
EBITDAM (%)	88.0	85.0	85.0
COE (%)	14.9	16.4	17.4
For E&C Segment			
CAGR order inflow over FY12-14 (%)	20.0	10.0	10.0
FY14 Average execution period (months)	30	30	36

Source: Company, Violet Arch Research

Base case

- We have factored in a 6.0% traffic growth for BOT assets considering that India has witnessed CAGR of 8.4% in M&HCV over the last seven years (FY05-12) and long term growth prospects, except in the case of annuity projects, Western Gujarat Expressway (3.0%) and Beawar Gomati (4.0%).
- We have factored in a 6% toll hike for BOT assets which are normally linked to WPI, except in the case of annuity projects, Western Gujarat Expressway (4.0%).
- We have estimated 85.0% EBITDA margins for BOT assets, except in the case of annuity projects, as interest and depreciation are major expenses once projects are operational.
- We have valued road assets on the DCFE basis, wherein the discounting rate (COE) is considered 15.2%, 14.6% and 16.4% for operational, annuity and under-construction projects, respectively, factoring the status and type of project.
- For E&C segment, we expect revenue CAGR of 10.0% and EBITDA margin at 19.2% on the back of recent order winnings and revenue mix.

Bull case

- We have factored in higher traffic growth and toll hike (7.0% each) for BOT assets to factor in enhanced activity and overall buoyancy in the economy.
- We have estimated 88.0% EBITDA margins for BOT assets led by operating benefits.
- We have valued road assets on the DCFE basis, wherein the discounting rate (COE) is considered 14.2%, 13.6% and 14.9% for operational, annuity and under-construction projects, respectively, factoring the status and type of project.
- For E&C segment, we expect revenue CAGR of 20.0% and EBITDA margin at 20.2% on the back of robust order winnings and revenue mix.

Bear case

- We have factored in lower traffic growth and toll hike (4.0% each) for BOT assets to factor in reduced amount of activity and overall slowdown in the economy.
- We have estimated 85.0% EBITDA margins for BOT assets.
- We have valued road assets on the DCFE basis, wherein the discounting rate (COE) is considered 16.7%, 16.1% and 17.9% for operational, annuity and under-construction projects, respectively, factoring the status and type of project.
- For E&C segment, we expect revenue CAGR of 10.0% and EBITDA margin at 17.7%.

SWOT Analysis

Strengths

1) Being one the first-movers in the road development space, with the largest BOT road asset portfolio in terms of lane kilometre (11,860) in India, ITNL has established a pan-India presence, with projects across 16 states in India.

2) Professionlal management at the helm of affairs.

3) Strong parentage which helps ITNL better and efficient acess to capital.

Threats

1) Intense competition, given low entry barriers, in the industry can impact project IRRs.

2) Slowdown of awarding activity from the government can impact visibility.

3) Delay in commissioning of projects.

SWOT Analysis

Weaknesses

1) Segmental dependence (road contributes 90% of the order book).

2) ITNL's current net debt equity ratio at 3.7x limits its growth potential.

3) Higher percentage of projects under construction exposes ITNL to risk associated with construction.

Opportunities

1) Increased focus on roads and highways by NHAI and state governments. To boost interest of the privare sector participation, government has adopted several recomendations from the B.K.Chaturvedi Committee.

2) Diversifying into urban infrastructure could be next catalyst.

3) Inorganic growth given the number of road projects on block for monetisation.

Source: Violet Arch Research

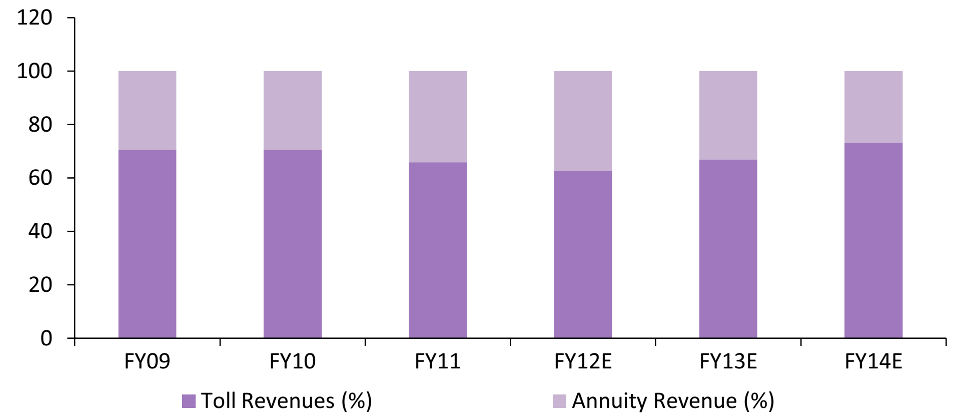
Investment Arguments

Diversified portfolio – Segment-wise and region-wise

ITNL is one of the first-movers in the road development space, with the largest BOT road asset portfolio in terms of lane kilometre (11,860) in India, ITNL has established a pan-India presence, with projects across 16 states in India. The company is one of the road players that have sizeable exposure to NHAI projects (annuity and toll road projects) and state projects (annuity and toll road projects). Also, the company has been experimenting with and attempting to diversify further with metro rail, bus system and border entry-point projects, though these ventures are currently insignificant compared to its road operations. But the management strategy is to tap the potential from the next sun-rise sector in the surface transportation space, as they have done with roads, and gain the first-mover advantage. We believe that this makes ITNL business model more resilient to slowdown in any particular arena and makes it comparatively more sustainable.

To put things in perspective, ITNL has nearly equal percentage of its portfolio (on the basis of TPC) coming from toll and annuity basis. Also on clientele terms, ITNL has decent exposure to NHAI projects and state projects.

BOT Revenue Mix



Source: Company, Violet Arch Research

Opportunities galore...

Road-focused players such as ITNL continue to benefit from structural opportunities in the road segment. NHAI has set itself an aggressive target of awarding about 8,800km (7,300km of NHAI projects, around 1,500km from state departments and PWDs) of road projects during FY13 as against about 6,491km awarded in FY12. Also, plans are afoot to build 18,367km of expressways by FY22 in three phases.

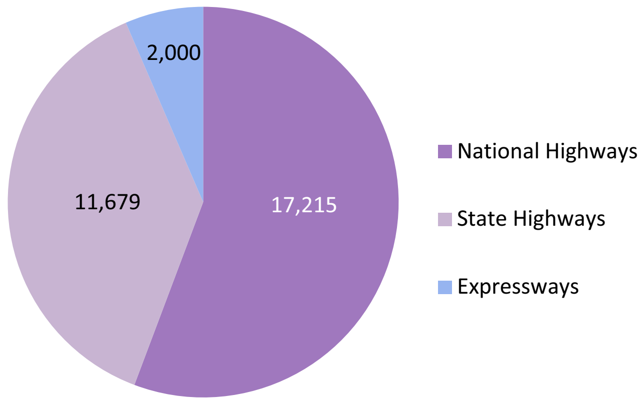
Around 1,000km of the expressway is expected to be completed over the next five years, representing an opportunity of around Rs 203bn (the average capex per km is about Rs 200mn). The government has also identified nine mega projects, with the length ranging from 390km to 700km. Over the next five years, an investment of around Rs 423bn is likely to flow into mega projects. Justifiably, these initiatives would provide immense opportunities. This, as per industry sources, would be about Rs 6.1trillion over FY12-16E towards road infrastructure development companies such as ITNL, IRB Infrastructure Developers Ltd. (IRB), and Sadbhav Engineering (SEL), among others, which have a proven track record and ability to manage large projects.

NHAI opportunities road map

As on 31st March, 2012	Total (km)	4/6-laned (km)	Under implementation		Balance (km)
			(km)	Contracts (No)	
Golden Quadrilateral	5,846	5,842	4	8	-
NS and EW corridors	7,142	6,011	711	69	420
Port connectivity	380	359	1	3	-
Other NHs	1,390	961	409	5	20
SARDP-NE	388	40	72	2	276
NHDP phase					
III	12,109	4,071	6,198	56	1,840
IV	14,799	2	3,316	1	11,481
V	6,500	1,052	3,028	16	2,420
VII	700	16	25	2	659
Total	**49,254**	**18,354**	**13,764**	**162**	**17,136**

Source: Company, Violet Arch Research, NHAI

Upcoming opportunity in India roads (km)



... As competition subsides

Over the last 12-18 months, the road sector has witnessed an unprecedented intensification of competition, preceded by drying up of orders and a big lull in all segments, including the road segment, leading to enhanced participation from serious as well as indifferent players. Our interactions with a cross-section of industry players have provided a mixed response, including views that competition is headed southwards. Evidently, there are signs of competition tapering off in some bids. However, we believe, the precursor of a clear trend would be an uptick in investments from other segments and/or a revival in private capex. Further, with more than 50 assets on the block currently, as per industry players, stress on contractors is palpable, which is either due to their inability to infuse equity or execution challenges. Given the uncertainty looming large over capital markets and the current risk aversion of banks, we believe, more and more small players would find it difficult to tie up project funds. This would ensure that the curve of intense competition is headed southwards and larger players (read ITNL) would be benefited.

High debt on books – Blessing in disguise, with interest rates expected to soften

Given the scarcity of affordable debt capital in India and with consistent rate hikes resorted to by the RBI that has led to an increase in interest rates of Indian banks, which enjoy almost an impregnable position as main suppliers of capital to the infrastructure sector, infrastructure assets owners (read ITNL) have taken a hit on their profitability. We as a house believe that RBI would start easing its monetary stance from 2HFY13 as the economy is poised to bottom out during that period. Policy interest rates could start coming down, spurring infrastructure investments and benefitting asset owners with debt on their balance sheet (read ITNL).

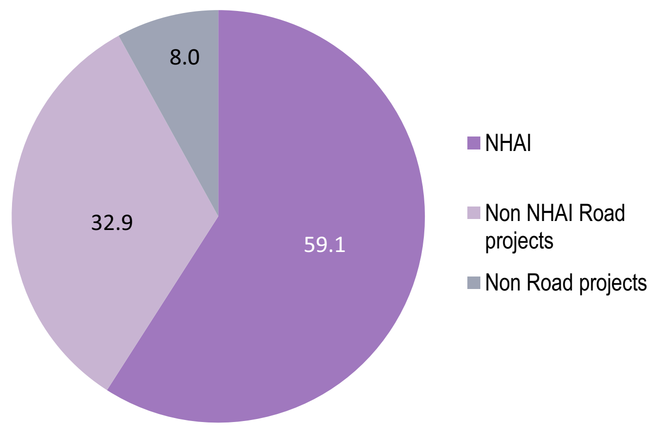
Further, given its strong parentage, ITNL has been able to implement innovative techniques for raising capital at effective rates compared to its peers. During FY11, the company listed Separately Transferable Principal Parts (STRPPS) for its subsidiary project, North Karnataka Expressway Ltd., a first for an Indian road developer, enabling it to cut borrowing costs by 125bp on the same loan. We expect ITNL to exercise similar refinancing options across some of its other profitable assets. Also, ITNL has been able to raise funds via Dim Sum bonds in 4QFY12. **We note that a 100bps lower interest rate would raise ITNL's asset valuation by 10%.**

Robust order book – Order inflow plays a 'key role'

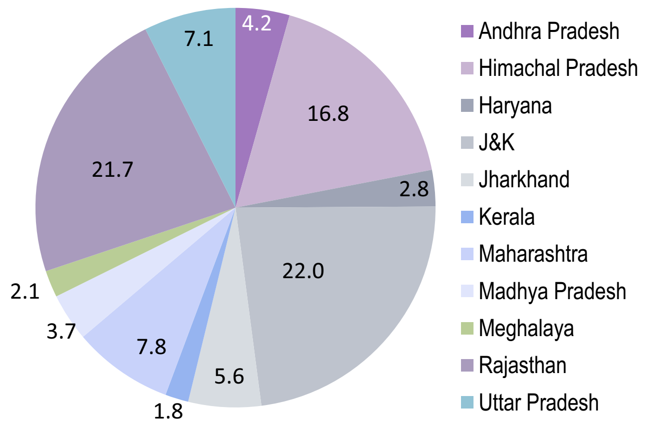
Essentially, an EPC contract is executed between ITNL and the respective SPV engaged in developing the road project for the completion of a turnkey project – from design to commissioning to operation and maintenance. The company has an in-house design and engineering team for project evaluation, bid process management, project development and implementation. In return, ITNL is entitled for upfront advisory fees (around 3% of the project cost) on achieving financial closure, which makes the order inflow critical for fee-based income booking. On the E&C front, the company outsources the contract to third-party contractors (mainly local contractors) and earns EBITDA margins (about 10% of the project cost) during the construction period.

ITNL has a robust order book of Rs 107.4bn, 5.0x FY12 E&C revenues, which ensures revenue visibility for the next few years. The order book mix is highly skewed in favour of road projects [NHAI (59.1%) and Non-NHAI (33.0%)] – 92.2%, while the balance is contributed by non-road projects.

Order book break-up segment-wise



Order book break-up region-wise (%)



Source: Company, Violet Arch Research

Strong parentage and professional management at the helm

ITNL has a strong parent in Infrastructure Leasing & Financial Services (IL&FS), which has rich experience in project advisory, project development and debt syndication. We believe that ITNL, thanks to its strong parentage, would have an edge in competition, and hence leverage the same while bidding and qualifying for new projects or approaching lenders for financing its projects. The company board comprises experienced and professional management, who have vast experience in the surface transportation segment. Some of the top personnel had also been associated with NHAI in the past, which would benefit the company during the upcoming bidding process.

Key Risks and Concerns

Monetary policy plays a crucial role in overall scheme of things

ITNL, in line with its peers, has taken high exposure to debt capital – net debt to equity has risen from 1.6x in FY10 to 3.7x in FY12 – to build its portfolio. Consistent rate hikes resorted by the RBI that has led to an increase in interest rates leading to infrastructure assets owners (read ITNL) taking a hit on their profitability. Further, given the current commitment towards its project we expect the leverage to increase further by FY14 (5.0x). Therefore, any further monetary tightening could negatively impact ITNL's financials. It's pertinent to note that we have factored in interest to soften from 2HFY13 and any delay would pose risk to our estimates.

Delay in order awarding – Inherent business risks

Being a road-focused player, ITNL is dependent on NHAI/State bodies for road-awarding activity. Thus, any slowdown on their part would affect the company's order inflow. We believe land acquisition could be the biggest hurdle faced by the government. The revised norms, 80% acquisition of land being mandatory for the NHAI prior to project award, can cause further delay. However, with the strong traction on order inflow front by ITNL (won projects worth Rs 74bn consecutively in the last couple of years), we believe the company is insulated from any temporary slowdown on order awarding front.

Competition – The unpredictable factor

Although ITNL has shown excellent capital and financial discipline, and restrained itself from competitive biddings, we believe that any change in this strategy might impact valuation. It should be noted that the company management has discounted such possibilities and highlighted its focus on equity returns and value creation.

Management bandwidth

ITNL's push towards different geographies or segments may constrain the management bandwidth, leading to slippage on the core business.

Input cost

As a road player ITNL consumes cement, steel and bitumen. But it has little control over the prices of these materials. Any unusual price increase, higher than the management's expectations, may result in margin pressure. However, we have noticed that ITNL has been engaging itself in back-to-back contracts to safeguard margins.

Financial Outlook

Standalone business

Revenues: Order winnings provide visibility

ITNL derives its standalone revenue from the E&C and fee-income business. The company has won projects worth Rs 74bn consecutively in the last couple of years, lending revenue visibility to its E&C and fee-income business. The company's robust order book ensures visibility for the next couple of years. Hence, over FY12-14, we expect the standalone business to post a CAGR of 25.0% to Rs 43.3bn from Rs 27.7bn. We note that there has been a consistent increase in the share of E&C revenues in the overall revenue from 62.5% in FY11 to 77.2% in FY12 on account of the ongoing projects. Going forward, we expect the share to increase even further to 80.9% by FY14.

EBITDAM: Function of revenue mix

In the past, ITNL's standalone business enjoyed EBITDAM as high as 65%, mainly on account of higher revenue bookings from fee income. The fee income business has only nominal allocation for overheads and no direct cost related to its services, and hence it leads to margins in the range of 60-75%. The fee income is charged at around 5% of TPC upfront for the period between the signing of concession and the financial closure of the project. Before the financial closure is executed, a fee income entry is made in the books. Hence, wining new projects becomes critical for the business. We note that the recent order awarding (Kiratpur-Ner Chowk, Kharagpur-Baleshwar, Sikar-Bikaner, the Beawer-Gomti and the two new roads in RIDCOR) gives visibility for FY13. We expect ITNL to bag more projects going forward, leading to a higher fee income. However, given the rising share of E&C revenues, which enjoys lower margins, say 8-10%, we expect blended margins to be around 19.0% over the next couple of years, which is marginally lower than about 20.0% in FY12.

Implied segmental break-up (FY11-14E)	FY2011	FY2012	FY2013E	FY2014E
Revenues (Rs mn)	**16,158**	**27,726**	**35,338**	**43,301**
Operation & Maintenance (O&M)	497	596	686	789
Project mgmt. & Supervision - FEE income	5,566	5,729	6,704	7,494
E&C income	10,095	21,401	27,949	35,018
EBITDA (Rs mn)	**5,419**	**5,632**	**6,825**	**8,297**
Operation & Maintenance (O&M)	199	239	274	316
Project mgmt. & Supervision - FEE income	4,175	3,666	4,225	4,959
E&C income	1,045	1,727	2,326	3,022
EBITDAM (%)	**33.5**	**20.3**	**19.3**	**19.2**
Operation & Maintenance (O&M)	40.0	40.0	40.0	40.0
Project mgmt. & Supervision - FEE income	75.0	64.0	63.0	66.2
E&C income	10.4	8.1	8.3	8.6
Blended margins on Fee and E&C	33.3	19.9	18.9	18.8
Revenues mix (%)				
Operation & Maintenance (O&M)	3.1	2.2	1.9	1.8
Project mgmt. & Supervision - FEE income	34.4	20.7	19.0	17.3
E&C income	62.5	77.2	79.1	80.9
EBITDA mix (%)				
Operation & Maintenance (O&M)	3.7	4.2	4.0	3.8
Project mgmt. & Supervision - FEE income	77.0	65.1	61.9	59.8
E&C income	19.3	30.7	34.1	36.4

Source: Company, Violet Arch Research

Profitability a mirror reflection

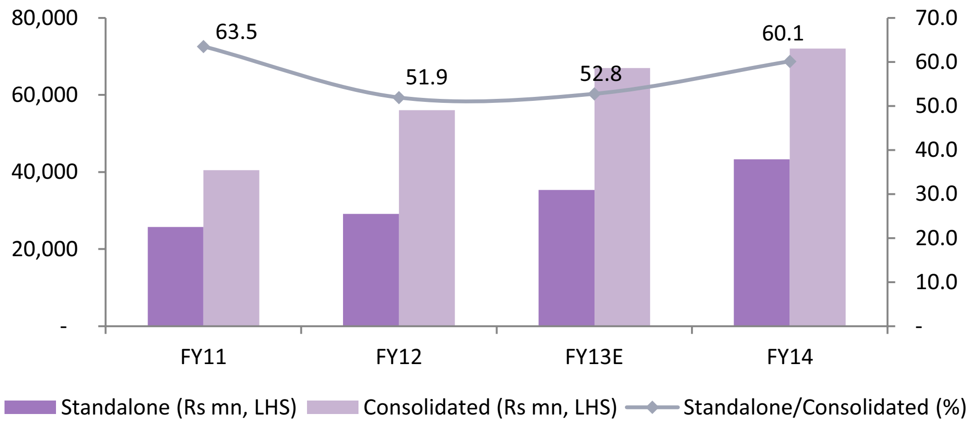
We expect ITNL to post a CAGR of 24.0% on the profitability front due to: a) strong revenue growth, and b) stable EBITDA margins.

Consolidated business

Revenues: Boosted by standalone performance

We expect ITNL to post a CAGR of 13.3% in consolidated revenues, primarily driven by the standalone numbers. Elsamex is estimated to record modest revenue growth during the period, while revenues from BOT projects, though growing, constitute an insignificant proportion of consolidated revenues. Going forward, we expect the company's overall performance, on a consolidated basis, to be further driven primarily by its standalone business.

Robust performance on revenue front led by standalone business

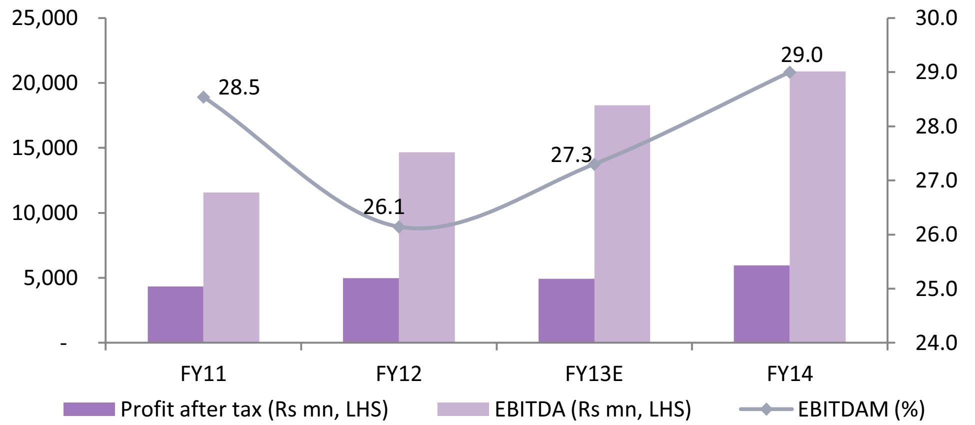


Source: Company, Violet Arch Research

Profitability to grow at lower pace

On the profitability front, we expect a subdued performance, mainly on account of an increase in interest costs with rising debt levels. Hence, we expect ITNL to post a CAGR of a mere 9.4% to Rs 5.9bn over FY12-14E.

Consolidated margins are expected to see an uptick



Source: Company, Violet Arch Research

Valuation

Given ITNL's diverse nature of business and expected multi-year growth, we believe that a simple multiples-based valuation may not entirely capture its long-term business potential. Hence, we value the company on an SOTP basis, and recommend a Buy at a target price of Rs 217. The target price is arrived at by valuing its standalone business (E&C plus fee-based income) on an EV/EBITDA basis, and its asset-owning business is valued on a DCF/Mcap/BV basis.

The standalone business is assigned a low target multiple of 4.5x EV/EBITDA on FY14E, given its high dependence on captive projects. Therefore, it contributes Rs 36.8/share to the overall target price. We note that valuations are depressed, given the high debt on standalone books.

For the asset development business, we use the DCF/Mcap/BV method. In this, discount rates are computed using CAPM, with an 8.6% risk-free rate and 6.0% as a risk premium. Betas are chosen at 1.0 for the annuity project (given the assured stream of revenues), 1.1 for the operational toll projects (given that the execution risk has subsided), and 1.3 for the non-operational toll projects (given the associated inherent risk during the execution period). Pertinently, it should be noted that the recently won projects have not been added to our target price. As regards the revenue and margin profile, we have used the above-given base-case-scenario assumptions. Therefore, a consistent revenue-generating asset portfolio, coupled with better growth opportunities and potential for garnering a greater share of operational projects, would support our value of Rs 181.4/share, also valuing its other subsidiaries/ventures.

DCFE value for BOT road projects

Project	DCF Value (Rs mn)	ITNL's Stake (%)	ITNL's Share (Rs mn)	Value/Share (Rs)	Implied P/BV (x)
North Karnataka Exp.	398.9	94.0	375.0	1.9	0.7
Thiruvanathapuram Road Develop. Phase 1 & 2	635.2	50.0	317.6	1.6	0.4
Andhra Pradesh Exp	324.6	100.0	324.6	1.7	1.4
Gujarat Toll Roads	10,550	84.0	8,862	45.6	8.3
RIDCOR, Rajasthan Phase 1 & 2	9,465	50.0	4,732	24.4	3.3
West Gujarat Exp	760.6	100.0	760.6	3.9	1.9
Hyderabad Ring Road	700.9	26.0	182.2	0.9	1.6
Beawar-Gomti	(2,311)	100.0	(2,311)	(11.9)	-
Jharkhand Road Dev. Phase 1 & 2	3,257	100.0	3,257	16.8	1.4
East Hyderabad Exp.	620.8	74.0	459.4	2.4	2.1
Hazaribaug Ranchi Exp.	711.1	74.0	526.3	2.7	0.6
Warora Chandrapur	3,462	35.0	1,212	6.2	5.6
Pune Sholapur	(638)	100.0	(638)	(3.3)	(0.4)
Moradabad Bareilly	8,570	100.0	8,570	44.1	3.9
Narketpalli Addanki	4,726	50.0	2,363	12.2	8.1
Jorbat Shillong	994	50.0	496.9	2.6	1.2
Chenani Nashri	(719.2)	100.0	(719.2)	(3.7)	(2.8)
Total Value	**41,508**		**28,771**	**148.1**	

Source: Company, Violet Arch Research

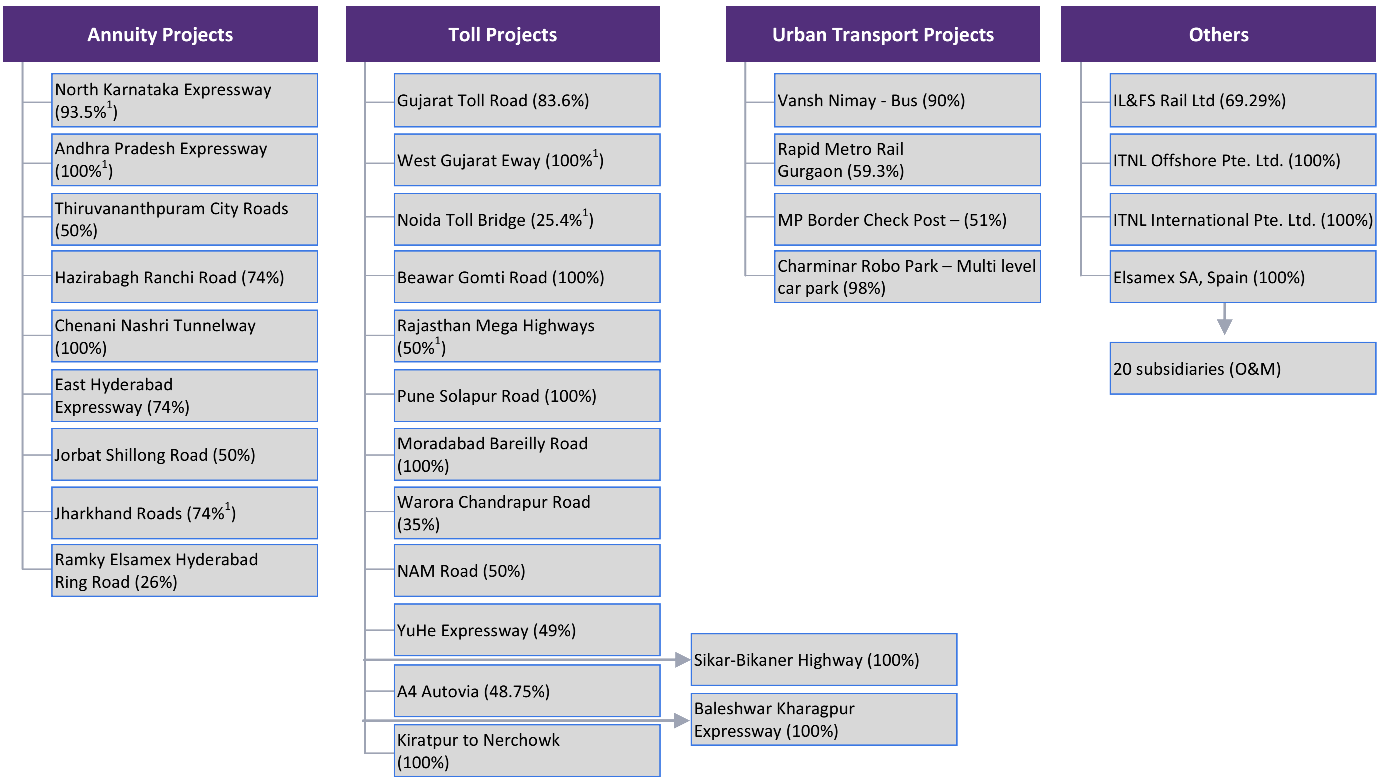
Derivation of SOTP-based target price for ITNL (FY14E) - Buy for a 28% upside

SOTP	Method	Multiple	Value (Rs mn)	Value/ Share
Road BOT Projects	DCFE@ 10% discount	-	25,894	133.3
Vansh Nimay	Investment	1.0	140	1.1
Gurgaon Metro	Investment	1.0	3,264	16.8
Noida Toll Bridge	10% Disc. to Mkt. Cap.	-	1,040	5.4
Elsamex	Investment	1.0	3,225	16.6
MP Check Post	P/BV	1.0	1,033	0.5
Yuhe project	P/BV	1.0	1,500	7.7
Parent	EV/EBITDA	4.5	37,299	192.0
Net Debt at parent level			(30,154)	(155.2)
			Fair Value	**218**
			CMP	**182**
			Upside (%)	**20.1**

Source: Company, Violet Arch Research

Company Background

ITNL is a surface infrastructure company, with a primary focus on roads. Incorporated in 2000, IL&FS Transportation Networks Ltd. (ITNL) is India's largest developer in the road sector. ITNL, a 78%-owned subsidiary of Infrastructure Leasing & Financial Services Ltd. (IL&FS), is one of India's leading infrastructure financing companies, besides being the promoter of the former. Apart from roads, the company has also extended its footprint to other transportation segments such as bus transport, metro rail, border entry-points and regional airports.



Source: Company, Violet Arch Research

International presence

In March 2008, ITNL acquired Elsamex SA, a Spanish company engaged in construction and maintenance of roads and buildings, for a consideration of €52.2mn. This acquisition not only complemented the company's O&M capabilities, but also provided a global presence.

Through its 100% subsidiary, ITNL International Pte. Ltd. (IIPL), ITNL has acquired a 49% stake in the operational YuHe Expressway in Chongquing district of China for USD160m. The entire investment was funded in the form of USD20m as equity and the balance USD140m by way of debt. The equity portion has been infused by ITNL, while IIPL raised the debt portion from offshore banks at an average interest rate of 5%, which was later partly refinanced by USD100m RMB-denominated bonds. The project, awarded in mid-CY02, has been operational for around 7 years. The total concession period for the project is 30 years, which ends in CY32 (a residual period of 20.5 years).

The expressway is a mix of toll and annuity revenues. In CY11, revenues from toll formed around 58% of total revenues, annuity about 42% and the balance was contributed by lease income. Of the total length of 58.7km, toll is charged on 27.1km, while the balance 31.6km is based on annuities. The project enjoys various benefits such as a lower tax rate at 15% for the next 10 years and a 5% annual increase in annuity income for the duration of the concession agreement, with the floor-to-toll rate set at CY11 levels.

Financial Summary - Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**40,489**	**56,056**	**66,985**	**72,015**
growth (%)	68.5	38.4	19.5	7.5
Operating expenses	28,933	41,401	48,698	51,131
EBITDA	**11,556**	**14,655**	**18,287**	**20,884**
(% of Net Sales)	28.5	26.1	27.3	29.0
growth (%)	45.5	26.8	24.8	14.2
Depreciation & Amortisation	614	766	1,297	1,532
EBIT	**10,942**	**13,889**	**16,990**	**19,352**
Interest & Other charges	4,981	7,282	10,865	11,876
Other income/Others	738	1,277	1,449	1,595
Pre-tax profit	**6,699**	**7,884**	**7,574**	**9,072**
Tax	2,242	2,457	2,457	2,943
Effective tax rate (%)	33.5	31.2	32.4	32.4
Net profit	**4,456**	**5,426**	**5,117**	**6,129**
Net profit after MI	**4,335**	**4,969**	**4,928**	**5,950**
growth (%)	25.9	14.6	(0.8)	20.7
Shares o/s (mn nos)	194	194	194	194
Reported EPS (Rs)	21.7	25.5	25.4	30.6
Fully Diluted Adj. EPS (Rs)	21.7	25.5	25.4	30.6
% chg	25.9	17.5	(0.4)	20.7

Cash flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit	6,626	7,426	7,386	8,893
Depreciation & Amortisation	614	766	1,297	1,532
Tax paid	2,242	2,457	2,457	2,943
Chg in working capital	257	(4,566)	(56)	398
Other income	791	1,238	1,449	1,595
Cash flow from operations (a)	**3,949**	**9,062**	**4,832**	**5,489**
(Inc.)/ Dec. in Fixed Assets	(27,461)	(57,980)	(51,290)	(40,481)
(Inc.)/ Dec. in Investments	2,535	(1,945)	(1,582)	(1,661)
Other income	791	1,238	1,449	1,595
Cash flow from investing (b)	**(24,135)**	**(58,687)**	**(51,422)**	**(40,547)**
Equity raised	-	-	-	-
Inc./(Dec.) in loans	20,733	48,311	48,914	37,619
Dividend (incl. tax)	794	796	796	796
Chg in monorities	-	-	-	-
Others	21	(328)	-	-
Cash flow from financing (c)	**19,960**	**47,187**	**48,119**	**36,823**
Net chg in cash (a+b+c)	**(226)**	**(2,438)**	**1,528**	**1,766**
Opening Cash balances	**5,502**	**5,276**	**2,838**	**4,366**
Closing Cash balances	**5,276**	**2,838**	**4,366**	**6,132**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Gross Block	33,421	68,460	119,750	160,231
Less: Acc. Depreciation	3,646	4,783	6,079	7,612
Net fixed assets	**29,775**	**63,677**	**113,670**	**152,620**
Capital Work-in-Progress	10	195	195	195
Goodwill on Consolidation	2,796	5,266	5,266	5,266
Investments	2,009	3,954	5,536	7,197
Other non current asset	31,857	56,635	56,635	56,635
Current assets	**27,658**	**22,747**	**27,058**	**30,528**
Inventories	262	210	251	270
Sundry Debtors	7,489	8,820	10,540	11,331
Cash and Bank	5,275	2,838	4,366	6,132
Loans and advances	10,927	9,198	9,893	10,636
Others	3,704	1,681	2,009	2,159
Mis. Exp. not written off	4	-	-	-
Total assets	**94,109**	**152,475**	**208,360**	**252,440**
Shareholders' funds	**22,392**	**27,638**	**31,771**	**36,925**
Share capital	1,943	1,943	1,943	1,943
Preference Capital	-	-	-	-
Reserves & surplus	20,450	25,695	29,828	34,982
Minority Interest	**2,175**	**2,935**	**2,935**	**2,935**
Adv - capital of Subsidiary				
Total Debt	55,062	104,550	153,465	191,084
Long term provision	692	751	751	751
Deferred Tax Liability	1,322	2,041	2,041	2,041
Curr Liab & prov	**12,466**	**14,560**	**17,398**	**18,705**
Current liabilities	12,466	14,560	17,398	18,705
Total equity & liabilities	**94,109**	**152,475**	**208,360**	**252,440**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Fully diluted Adj EPS (Rs)	21.7	25.5	25.4	30.6
Adj EPS growth (%)	25.9	14.6	(0.8)	20.7
EBITDA margin (%)	28.5	26.1	27.3	29.0
Pre-tax margin (%)	16.5	14.1	11.3	12.6
AROE (%)	22.0	19.9	16.6	17.3
AROCE (%)	14.2	11.3	9.4	8.4
Turnover & Leverage ratios (x)				
Total Asset turnover (x)	0.6	0.5	0.4	0.3
Gross block Asset turnover (x)	1.5	1.1	0.7	0.5
Net margin (%)	10.7	8.9	7.4	8.3
Net Debt/Equity (x)	2.2	3.7	4.7	5.0
Working capital & liquidity ratio				
Inventory days	2	2	1	1
Receivable days	63	53	53	55
Payable days	11	9	9	4
Working capital cycle (ex-cash) (days)	88	50	29	28
Valuations				
PER (x)	8.4	7.1	7.2	5.9
Price/Book value (x)	1.6	1.3	1.1	1.0
PCE (x)	8.4	6.2	5.7	4.7
EV/Net sales (x)	2.1	2.4	2.8	3.1
EV/EBITDA (x)	7.4	9.3	10.1	10.5
Dividend Yield (%)	1.9	1.9	1.9	1.9

VIOLET ARCH

COMPANY REPORT

Equity Research I IT

22 September, 2012

MindTree Ltd.

Back on Track

Absolute Rating	**Buy**
Target Price	**Rs 880**
Upside	**28%**

Aggressive client mining adopted by MindTree (MTL) has led to a substantial ramp-up in business from its top-10 clients, which, we believe, has put the company back on the growth trajectory. Over the past two years, the company has been able to mine its clients effectively and sharpen its focus on high-potential newer service lines such as Infrastructure Management & Testing. As a result, it has been able to strategically position itself for long-term growth. We believe that the improving client metrics, led by its greater focus on client mining, will lead to a 12% and 15% YoY growth in dollar revenues in FY13E and 14E, respectively. MTL's operating efficiencies, aided by an improvement in the employee pyramid, are likely to result in operating margins expanding from 15% in FY12 to 17% in F14E. We initiate coverage on MTL with a Buy rating and a target price of Rs 880.

'Back to Basics' yielding results

After a disappointing performance in FY10-11, MTL has reorganized its businesses into two segments: IT Services (ITS) and Product Engineering Services (PES). The ITS segment, which contributes 69% to revenues, has seen an average growth of over 5% QoQ from Q1FY11-Q1FY13. This segment is likely to be the primary growth-driver for the company in meeting the NASSCOM guidance. The PES segment, which contributes 31% to revenues, has been prone to volatility. Hence, it is likely to post a muted performance.

Improving utilization and pyramid benefits to boost margins

MTL has been successful in bringing about cost-efficiencies through employee pyramid rationalization (hiring of 3,000 people through campus recruitments during FY13). As fresh recruits become project-ready, utilization levels are likely to inch upwards. All these factors, in turn, are likely to lead to an expansion in EBITDA margins to 17% in FY14E. Further, the depreciation in the INR is likely to provide a cushion to margins.

Likely to meet Nasscom guidance

Despite the global economic environment continues to be challenging with extended decision-making cycles, MTL is not witnessing any budget cuts from clients. The ITS segment is expected to be the primary growth-driver, as the PES business is likely to be volatile. As MTL has initiated a large number of projects over the past several quarters, the project ramp-up would help the company achieve the Nasscom guidance.

Valuations

We initiate coverage with an outperform rating on the stock, by assigning an 11x P/E multiple to our FY14E EPS of Rs 80 and arrive at a target price of Rs 880. We believe our target multiple is backed by: 1) the increased focus on ITS backed by a strong deal pipeline, 2) improving client metrics driven by the increased focus on account mining, which is expected to drive a 12%/15% YoY growth in dollar revenues in FY13E/14E, and 3) the improvement in operating efficiencies, driven by rationalization in the employee pyramid, which is likely to lead to the EBITDA margin expanding from 15% in FY12 to 17% in F14E.

Consolidated Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenue	15,091	19,152	23,783	27,453
EBITDA	1,777	2,930	4,303	4,699
EBITDA margin (%)	11.8	15.3	18.1	17.1
EBITDA growth (%)	(27.7)	64.9	46.8	9.2
Net Profit	1,015	2,185	3,094	3,296
Net profit margin (%)	6.7	11.4	13.0	12.0
Net profit growth (%)	(52.8)	115.3	41.6	6.5
EPS (Rs)	24.6	53.1	75.1	80.0
EPS growth (%)	(52.8)	115.3	41.6	6.5
PE (x)	27.9	13.0	9.2	8.6

Source: Company, Violet Arch Research

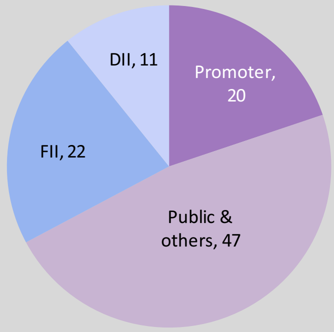
Stock data

CMP	**Rs 687**
Reuters Code	MINT.BO
Bloomberg Code	MTCL IN
Equity Shares o/s (mn)	41
Market Cap (Rs mn)	28,308
Market Cap (USD mn)	529
3m Avg daily t/o(US$ mn)	1.7

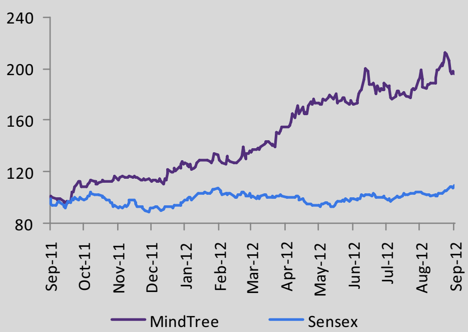
Stock performance (%)

52-week high / low			**Rs 733 /287**
	1M	**3M**	**12M**
Absolute	1.4	13.9	94.9
Relative	(3.7)	3.5	78.9

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E	Bull Case	Base Case	Bear Case
INR:USD Exchange rate	55	53	51
Employee Additions (Nos.)	4,500	3,500	2,500
Revenue (USD)	546	518	503
Revenue	30,044	27,453	25,672
EBITDA	5,806	4,699	3,979
Inc/dec. from base case (%)	23.6	-	(15.3)
EBITDA margin (%)	19.3	17.1	15.5
PAT	4,112	3,296	2,758
EPS (Rs)	**99.8**	**80.0**	**67.0**
Inc/dec. from base case (%)	24.8	-	(16.3)
CMP (Rs)	687.4	687.4	687.4
P/E(X)	12.0	11.0	9.0
Target price (Rs)	**1,198**	**880**	**603**
Upside (%)	**74.3**	**28.0**	**(12.3)**

Source: Company, Violet Arch Research

Key assumptions

Particulars	FY11	FY12	FY13E	FY14E
INR:USD Exchange rate	45.6	47.5	53.0	53.0
Gross Employee Additions	4,153	3,456	4,500	3,500
Net Utilization (Incl. Trainees) (%)	70.2	69.9	70.0	69.3
Tax Rate (%)	22.1	16.4	22.6	23.0

Source: Company, Violet Arch Research

Base case

- MTL has strengthened its focus on ITS from 53% of revenues in Q4FY10 to 69% in Q1FY13. The strong traction in US (58% of revenues), BFSI vertical (22% of revenues) likely to continue on its strong performance and aggressive client mining will drive a 15%YoY dollar growth for FY14E. Hence we expect MTL to record revenue (Rs) CAGR of 20% over FY12-14E.
- Focused efforts on improving the employee pyramid (3,000 freshers to be hired in FY13E) coupled with operational efficiencies in SG&A spends will lead to EBITDA margins expanding from 15% in FY12 to 17% in FY14E.
- We have factored in a 23% Tax rate for FY14E.
- Our Base case scenario factors in an exchange rate of INR:USD at 53 in FY14E.

Bull case

- We have factored in a 22% YoY dollar revenue growth in FY14E driven by the improvement in demand environment in key geographies (US & Europe) and an improvement in demand for PES.
- EBITDA margins are likely to improve to 19.3% lead by strong growth in revenues, operational efficiencies driven by the improvement in employee pyramid and rupee depreciation.

Bear case

- Further deepening of the global economic crisis will lead to a contraction in IT spends across key verticals with PES being under pressure leading to dollar revenues growing by 12% YoY in FY14E.
- EBITDA margins are likely to drop to 15.5% in FY14E driven by the slowdown in demand and an appreciation in the rupee.

SWOT Analysis

Strengths

1) Focus on client mining to lead to a higher wallet share.

2) Increasing share of IT Services likely to drive growth for the company (53% in Q4FY10 - 69% in Q1FY13).

3) Key verticals such as BFSI (22%) and manufacturing (19%) to lead growth.

4) Employee pyramid rationalization is likely to improve the margin profile.

SWOT Analysis

Weaknesses

1) The Product Engineering Services (PES) business is likely to lag company growth.

2) High Eurpoean client exposure(29%) could affect growth due to economic pressure.

3) Higher component of development work could take a hit, as clients squeeze budgets.

Opportunities

1) Operational efficiences are likely to improve the margin profile. EBITDA margins to expand from 15% in FY12 to 17% in FY14E.

2) The Product Engineering Services (PES) business is likely to lag company growth.

3) Improved focus on services such as IMS to boost long-term growth prospects.

4) Strong client additions (19 additions in Q1FY13) to drive growth.

Threats

1) Growing concerns over protectionism could lead to hiring of more onsite resources at higher costs.

2) Any further slowdown in Europe, which has been in contraction (PMI below 50) mode for the last 12 months, is likely to hamper demand from the region.

3) The volatility in currency could lead to foreign exchange losses, impacting earnings.

Source: Violet Arch Research

Investment Arguments

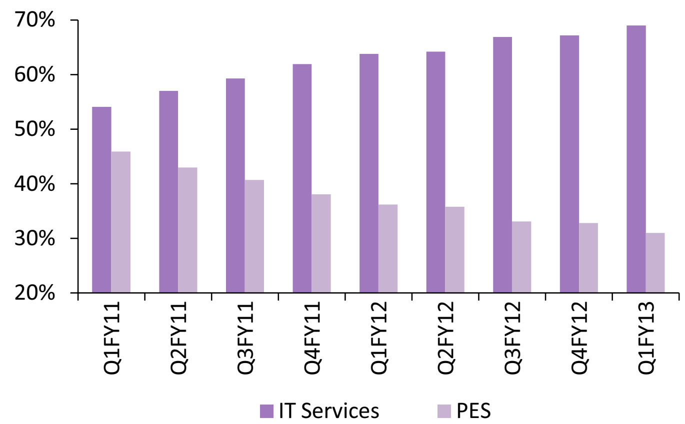
'Back to Basics' yielding results

In 2009, MTL acquired Kyocera Wireless India Pvt. Ltd. with the objective of developing mobile handsets. The company's strategy was to have a non-linear growth model to drive growth. However, deterred by higher-than-expected capital requirements and changing customer preferences, MTL exited the business in October 2010.

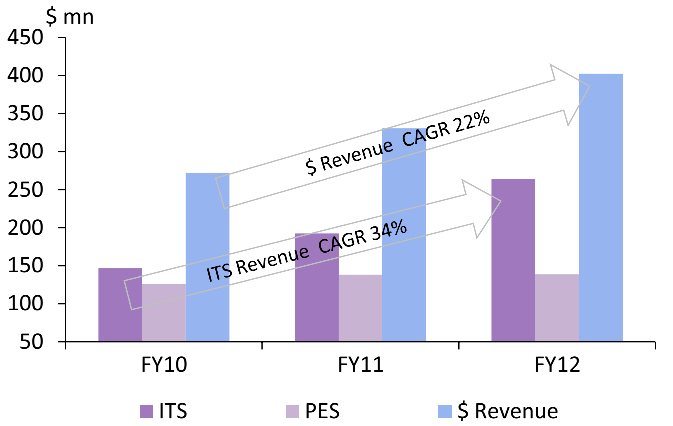
After exiting the mobile business, MTL regained its focus on key verticals and services. Since then, the company has steadily sharpened its focus on IT services. The ITS business accounted for 53% of its total revenues in Q4FY10, which has since been scaled up to 69% in Q1FY13, clocking an average 7% sequential growth. However, the PES business has seen a steady decline over the past two years, due to the challenging global economic environment, prompting clients to restrict investments in new products.

While we expect a more stable business contribution from the ITS segment, the PES business is likely to lag company growth on account of the volatile nature of the business. The management is confident of a pick-up in demand in both ITS and PES businesses on the back of recent winning of deals and ramping up of existing accounts.

Increasing focus on IT services…



…driving company growth



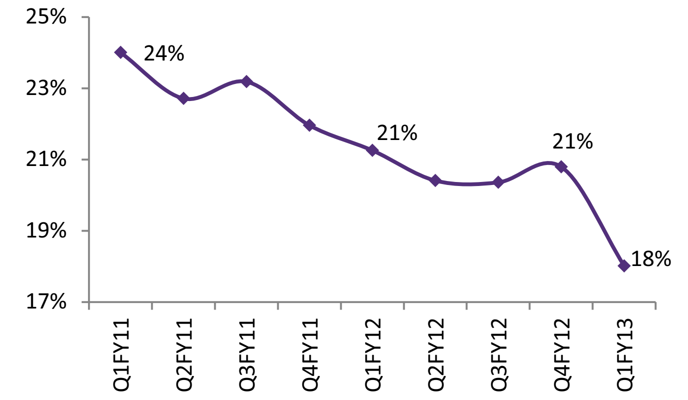
Source: Company, Violet Arch Research

Improving utilization and pyramid benefits to boost margins

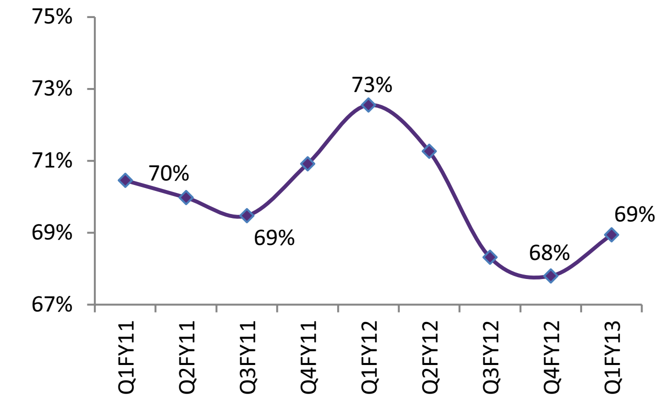
In 2010, MTL in a strategic move acquired Kyocera Wireless India Pvt. Ltd. to kick start the non-linear business. But the strategy did not have the desired effect on the company's performance. As a result of the cost incurred on the venture, the company posted a 717bps decline in EBITDA margins to 12% in FY11 compared with 19% in FY10.

At the beginning of FY12, employees with experience less than three years constituted 30% of the total strength of the company, which has gone up to 36% at the end of FY12. Further, the rationalization of the employee pyramid is likely on the back of fresher hiring, with 3,000 campus offers in FY13E. The management's renewed focus on client mining and ramp-up in recently won deals are likely to be the key drivers for revenue growth in FY13E and FY14E. An improvement in employee utilization levels, along with a reduction in SG&A (% of sales), is likely to be the key driver for EBITDA margin expansions.

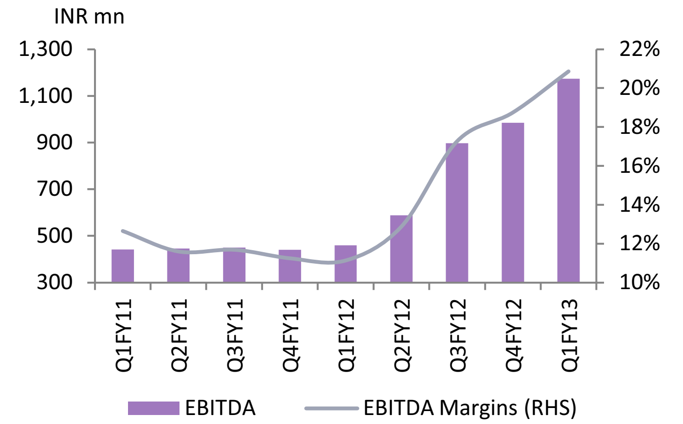
Declining SG&A (% of sales)…



… and improving utilization…



…leading to margin improvement



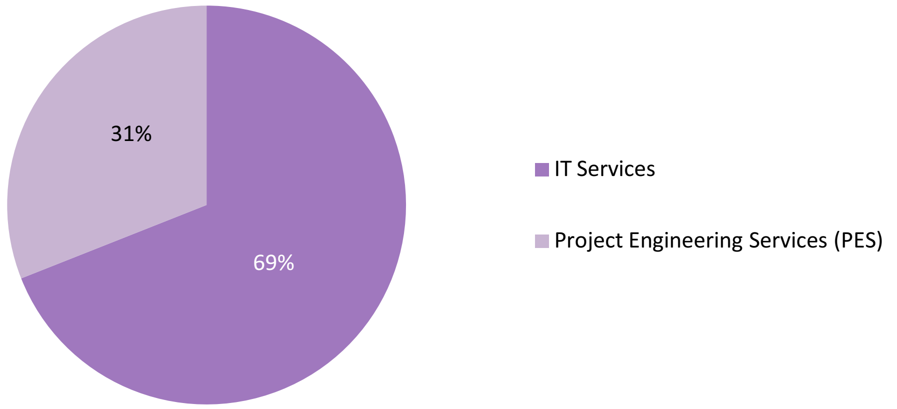
Source: Company, Violet Arch Research

To meet Nasscom guidance

The global economic environment continues to be challenging, with extended decision-making cycles. However, the demand environment for MTL has not deteriorated. Hence, the company has not witnessed any signs of cancellations or budget cuts from clients. Deals won by MTL recently, coupled with the ramp-up of existing accounts, should help the company achieve Nasscom's average industry growth guidance of 11-14% growth. We expect the company to post a dollar revenue growth of 12%/15% YoY in FY13E/14E. While the ITS business is expected to lead the growth, the PES segment is likely to see a muted performance. Despite PES declining sequentially 5% in Q1FY13, two deals recently won in the sub-$10mn range are likely to see growth in the coming quarters.

In Q1FY13, the key verticals such as BFSI and manufacturing contributed chiefly to the company's growth. BFSI, constituting 22% of the total revenue as on Q1FY13, saw a healthy growth of 4% sequentially. Hence, it is likely to continue to grow at the same pace for the rest of the year. The manufacturing segment, forming 19% of the total revenue as on Q1FY13, also saw good momentum, registering a sequential growth of 4%.

Higher component of IT services to bode well



Source: Company, Violet Arch Research

The management's strategy has been to increase the share of ITS and reduce the exposure to PES. The ITS business accounted for 53% of the company's total revenue in Q4FY10, which has since grown to 69% in Q1FY13, clocking an average 7% sequential growth. However, the PES business has seen a steady decline over the past two years on account of the challenging global economic environment, which has prompted clients to restrict investments in new products. A strong performance in the ITS segment is likely to drive MTL's growth.

ITS to drive growth; PES to grow in lower single digits

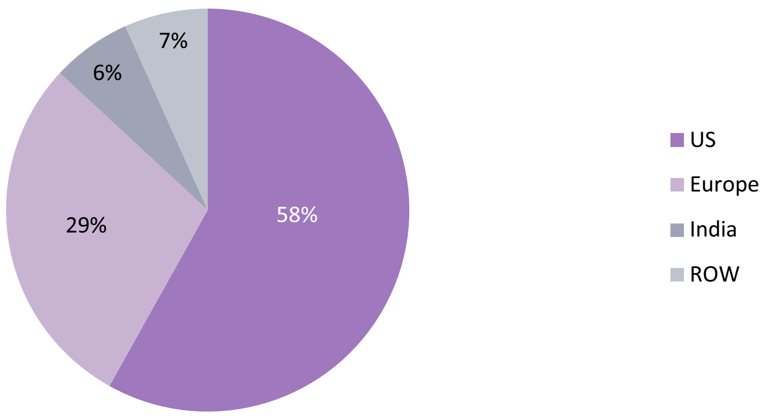
Growth QoQ.	Q1 FY11	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12	Q4 FY12	Q1 FY13	Contribution to revenue
IT Services	5%	13%	8%	6%	11%	10%	7%	2%	3%	69%
PES	2%	0%	(2%)	(5%)	2%	8%	(5%)	0%	(5%)	31%

Source: Company, Violet Arch Research

Strong geographic performance amidst gloomy demand environment

MTL has a well-diversified set of clients across geographies. The company's key markets are the US and Europe, which contribute over 85% of its revenues. With the global environment continuing to reel under pressure, MTL has not witnessed any instances of clients cutting back on their budgets or cancellations of projects. This, in turn, has led to a solid performance across geographies, with the US contributing to 58% of revenues, growing at an average 3% in the past two years. Europe, which contributes to 29% of revenues, has also grown at a similar pace. We believe that the recently won deals across geographies are likely to drive growth for the company.

Significant exposure to US and Europe



Source: Company, Violet Arch Research

MTL's US and European clients have not been adversely affected by the global economic downturn compared to its larger peers, who have witnessed a significant slowdown recently in business from top clients. The deals recently won in the US and Europe, along with no budget cuts or cancellations of projects, are likely to drive growth for the ITS business.

Strong performance led by the US and Europe

Growth QoQ.	Q1 FY11	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12	Q4 FY12	Q1 FY13	Contribution to Revenue
US	4%	5%	(1%)	1%	8%	6%	(2%)	3%	2%	58%
Europe	1%	14%	12%	14%	12%	23%	12%	0%	4%	29%
India	18%	14%	2%	8%	2%	1%	(7%)	6%	(14%)	6%
ROW	(6%)	6%	17%	(22%)	(2%)	6%	9%	(11%)	(10%)	7%

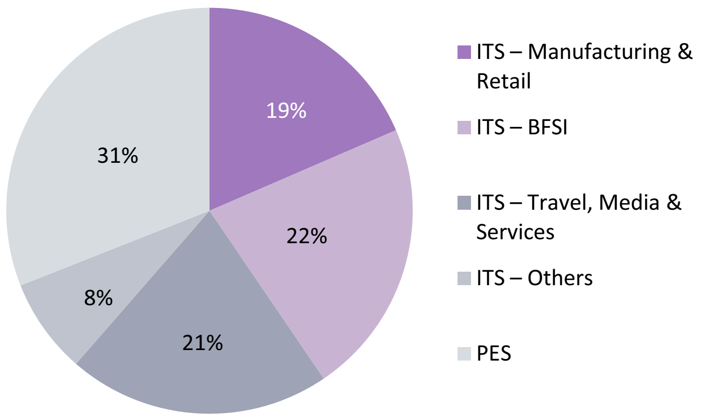
Source: Company, Violet Arch Research

Focus on key verticals and services to drive growth

MTL's focused approach on verticals such as BFSI, manufacturing and travel & media has led to a strong performance. BFSI (22% of revenues) saw a good performance, logging a 4% sequential growth. Similarly, manufacturing (19% of revenues), recorded a 3.8% sequential growth, followed by travel & media (21% of revenues), growing 2% sequentially.

The deals MTL has won recently in key verticals across the US and Europe, along with the robust traction seen in onsite volume growth of 7% QoQ, indicate strong project starts , which should drive the company's growth in the coming quarters. However, the PES business saw a sequential decline of 5% due to ramp-downs by two clients. The management has indicated that they expect the PES business to remain volatile. But the recently won deals will see the segment grow further in the coming quarters.

BFSI to continue growing at fast clip



BFSI recorded strong show in Q1FY13; PES business is likely to lag

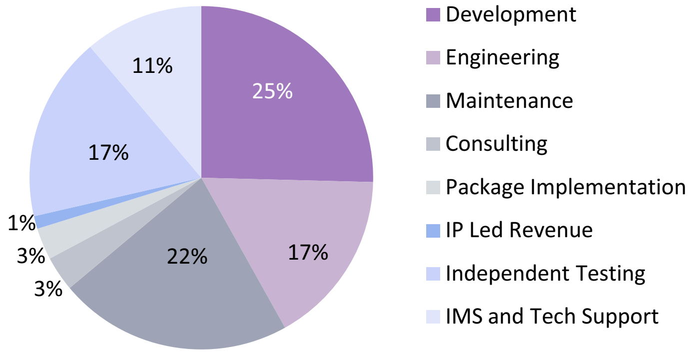
Vertical Mix	Q1FY13 QoQ Growth
Manufacturing	4%
BFSI	4%
Travel and Media	2%
Others	2%
PES	(5%

Source: Company, Violet Arch Research

IMS, the next growth-driver

The MTL management has indentified Infrastructure Management Services (IMS) to be the next growth-driver for the company. Recently, it bagged two large deals worth $70mn spread over five years for a large European customer and leading US bank. Over the last two years, the contribution has steadily increased from 5% in Q1FY11 to 11% at the end of Q1FY13. The PES business is likely to grow slower, with the cap on discretionary spends. We expect strong traction in IMS revenues on the back of recent deal wins to drive growth.

Service Offering

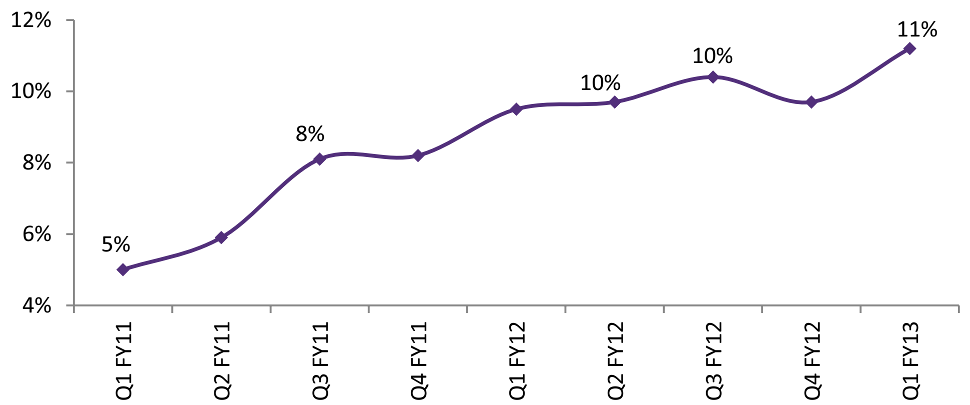


Application maintenance & IMS seeing strong traction

	Q1FY13 QoQ Growth
Development	**4%**
Engineering	(9%)
Maintenance	**3%**
Consulting	(3%)
Package Implementation	(16%)
IP Led Revenue	0%
Independent Testing	(2%)
IMS and Tech Support	**16%**

Source: Company, Violet Arch Research

IMS, the next growth-driver (% of revenues)



Source: Company, Violet Arch Research

Client-mining strategy paying dividends

MTL's strategy to focus on existing clients and increase the wallet-share has lead to a strong performance. The company's aggressive client mining has resulted in the top 2-4 client bucket growing at an average 8% sequentially over Q1FY11-Q1FY13. Its top client revenues, after declining during Q4FY12, have bounced back, recording a 2% sequential growth in Q1FY13.

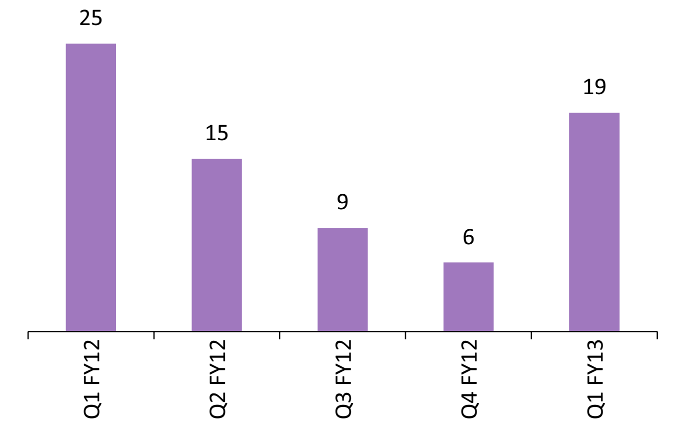
The management has indicated that despite clients becoming cautious about budget spends, there have been no cancellations of projects or budget cuts.

$mn	Q1 FY11	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12	Q4 FY12	Q1 FY13
Top Client	5	6	6	6	6	7	9	8	8
Growth QoQ	-	4%	5%	3%	7%	10%	20%	(7%)	2%
Top 2-4 Clients	**15**	**16**	**16**	**15**	**17**	**21**	**23**	**25**	**27**
Growth QoQ	**-**	**4%**	**0%**	**(4%)**	**8%**	**28%**	**10%**	**8%**	**9%**
Top 6-10 Clients	10	11	12	12	13	14	14	15	14
Growth QoQ	-	10%	10%	(4%)	13%	6%	(3%)	8%	(4%)

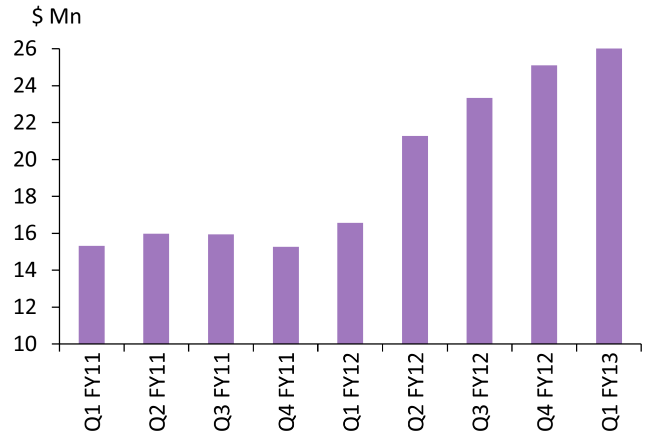
Source: Company, Violet Arch Research

An addition of 19 new clients, along with project ramp-ups, during Q1FY13 is likely to bode well for the company in the near future. Ramp-ups across the client metrics are seen in the $1-mn client category, which has witnessed strong momentum, moving up to 78 clients in Q1FY13 compared with 67 in Q1FY12. At the higher end of the metrics, the $20-mn category has seen strong momentum in the client base, with an addition of four clients in Q1FY13 from just one client in Q1FY12. MTL's top clients include Unilever, Microsoft and Volvo, among others.

Strong client additions and aggressive client mining to drive growth



Strong ramp-up in top 2-4 client revenue bucket



Source: Company, Violet Arch Research

Key Risks and Concerns

Around 42% of revenue is derived from development and engineering work

During an economic slowdown, discretionary projects such as Application Development and Enterprise Application Services would be the first one to take a hit, as clients would cut back on the "change the business" spends, and concentrate more on the "Run the Business" spends. Although MTL has not experienced any project cancellations or budget cuts, such events could impact the company's growth prospects.

Economic slowdown

As the global economy continues to remain weak with an uncertain outlook, IT clients may come under pressure if the economic environment deteriorates further leading to cuts in IT spends. This, in turn, could impact the growth of the company, as 87% of its revenues accrue from US and Europe.

In the US, non-farm payrolls improved to 163,000 in Jul'12, which is an improvement from the average of 73,000 in the preceding three months. The house price index rose, on a YoY basis, for the first time in 21 months. On the other hand, unemployment remained high at 8.3%, and the ISM manufacturing index remained in contraction mode for the last three months. US GDP is expected to remain below 2% for the third consecutive quarter in 3QCY12. Thus, the US economic data remained mixed, and the outlook remains uncertain along with added concerns of the fiscal cliff at the start of the next year.

In contrast, the Europe data has remained clearly weak for the last one year. The economy contracted sequentially for the last three quarters and unemployment has been on the rise. The composite PMI for the region has been in contraction mode in the last 12 months. The unemployment rate rose from 9.9% in Jun'11 to 11.2% in Jun'12. Thus, there are no signs of recovery in the near term with the economy reeling under pressure.

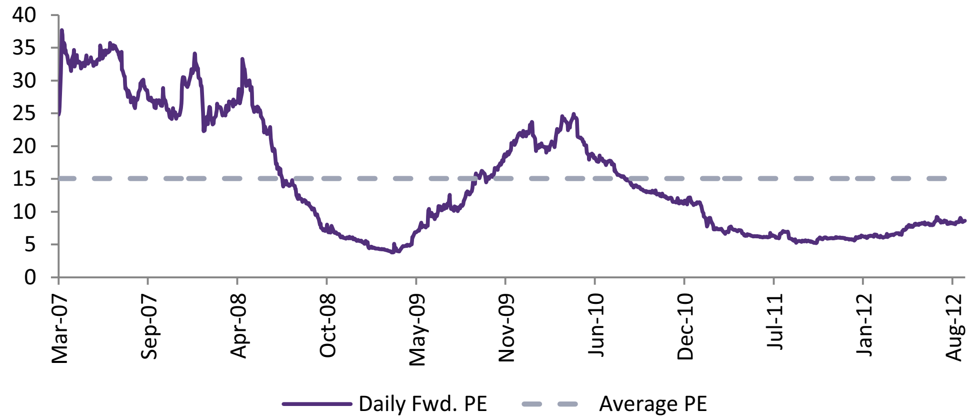
Currency volatility

Since March 2012, the rupee has depreciated around 10% against the US dollar. The MTL management has indicated that a 1% change in the INR:USD could impact the EBITDA margin by 0.4-0.5%. Hence, any fluctuation in the currency could impact the margin performance in the future.

Valuation

We initiate coverage with an outperform rating on the stock, by assigning a 11x P/E multiple to our FY14E EPS of Rs 80 and arrive at a target price of Rs 880. We believe our target multiple is backed by: 1) the increased focus on ITS backed by a strong deal pipeline, 2) improving client metrics driven by the increased focus on account mining, which is expected to drive a 12%/15% YoY growth in dollar revenues for FY13E/14E, and 3) the improvement in operating efficiencies, driven by rationalization in the employee pyramid, is likely to lead to EBITDA margin expanding from 15% in FY12 to 17% in F14E.

Historical 1-yr forward P/E



Source: Company, Violet Arch Research

Company Background

MindTree, a mid-sized IT services company with employee strength of 10,380 in end-Q1FY13, reported revenues of $403mn in FY12. The company offers a range of IT services such as application development and maintenance (ADM), consulting, package implementation, infrastructure management and independent testing services to banking, financial services and insurance (BFSI), manufacturing and travel/transportation verticals. MindTree's business is divided into two segments: IT Services (ITS) and Product Engineering Services (PES). The ITS segment offers solutions such as ADM, testing, enterprise services, infrastructure services and consulting. The PES segment works with software companies to launch new products, besides supporting them to achieve faster-time-to-market. In FY12, MindTree earned 65.6% of the total revenue, amounting to $264mn, from the ITS business, while its PES business posted revenue of $139mn (34.4% of the total revenue). The company is geographically focused on the US and Europe. In FY12, its estimated revenue from the US market was 58%, while Europe forming the second-largest chunk at 26.2%. The company has achieved consolidated revenues at a CAGR of 26.5% over FY07-12.

Financial Summary - Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenues	**15,091**	**19,152**	**23,783**	**27,453**
Growth (%)	16.4	26.9	24.2	15.4
Cost of Revenue	13,314	16,222	19,481	22,754
EBITDA	**1,777**	**2,930**	**4,303**	**4,699**
Growth (%)	(27.7)	64.9	46.8	9.2
EBITDA Margin (%)	11.8	15.3	18.1	17.1
Other income	242	385	320	282
Depreciation	712	695	613	686
Interest	4	5	12	14
Pre-tax profit	**1,303**	**2,615**	**3,997**	**4,281**
Taxes	289	430	903	985
Effective Tax Rate (%)	22.1	16.4	22.6	23.0
Minority interest	0	0	0	0
Net profit	**1,015**	**2,185**	**3,094**	**3,296**
Growth (%)	(52.8)	115.3	41.6	6.5
Net Profit Margin (%)	6.7	11.4	13.0	12.0
Shares o/s (mn nos.)	41	41	41	41
EPS	24.6	53.1	75.1	80.0

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Profit after Tax	**1,015**	**2,185**	**3,094**	**3,296**
Depreciation & Amortization	712	695	613	686
Exp deferred/written off	(66)	(140)	0	0
Other Income	(140)	(31)	(320)	(282)
Others	289	430	0	0
Change in working capital	(1,377)	(1,076)	(1,500)	(1,883)
Cash flow from operations (a)	**432**	**2063**	**1887**	**1818**
(Inc.)/ Dec. in Fixed Assets	(836)	(482)	(255)	(198)
(Inc.)/ Dec. in Investments	453	(1824)	(766)	(718)
Cash flow from investing (b)	**(383)**	**(2306)**	**(1022)**	**(917)**
Equity Raised	139	144	0	0
Inc./(Dec.) in Debt	13	397	0	0
Dividend (incl. tax)	(150)	(176)	(217)	(231)
others	5	21	86	0
Cash flow from financing (c)	**7**	**386**	**(131)**	**(231)**
Net chg in cash (a+b+c)	**56**	**143**	**734**	**670**
Opening Cash balances	**403**	**459**	**602**	**1,336**
Closing Cash balances	**459**	**602**	**1,336**	**2,005**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Gross Block	5,624	5,820	6,075	6,274
Less: Acc. Depreciation	2,618	3,229	3,842	4,528
Net fixed assets	3,006	2,591	2,233	1,746
Capital Work-in-Progress	1	85	85	85
Investments	1,112	3,082	4,082	5,082
Sundry Debtors	2,825	4,078	5,060	5,841
Cash & Bank	459	602	1,336	2,005
Loans and Advances	751	763	763	763
Other current assets	1,775	1,825	2,798	4,576
Deferred tax	216	320	320	320
Total Asset	**10,145**	**13,346**	**16,677**	**20,418**
Share capital	400	405	405	405
Reserves & surplus	7,362	9,167	12,075	15,173
Total Debt	41	37	37	37
Provisions	530	724	713	824
Other liabilities	1,812	3,013	3,447	3,979
Total Equity & Liabilities	**10,145**	**13,346**	**16,677**	**20,418**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Fully diluted Adj EPS (Rs)	24.6	53.1	75.1	80.0
Adj EPS growth (%)	(52.6)	115.3	41.6	6.5
EBITDA margin (%)	11.8	15.3	18.1	17.1
PAT margin (%)	6.7	11.4	13.0	12.0
ROCE	12.3	24.8	35.5	30.5
ROIC	14.9	30.7	56.7	51.4
ROE	14.0	25.2	28.1	23.5
Turnover Ratios				
Total Asset turnover (x)	1.9	2.0	1.9	1.8
Debtor days	68.3	77.7	77.7	77.7
Creditor days	43.8	57.4	52.9	52.9
Working capital days	72.8	55.8	68.5	84.8
Valuation				
P/E	27.9	13.0	9.2	8.6
P/BV	3.6	3.0	2.3	1.8
EV/EBITDA	15.1	8.4	5.3	4.5
EV/Sales	1.8	1.3	1.0	0.8

COMPANY REPORT

Equity Research l Pharma

21 September, 2012

Unichem Laboratories

Long-term Intact

Absolute Rating	**BUY**
Target Price	**Rs 236**
Upside	**21%**

Unichem Laboratories Ltd. (ULL) enjoys a leadership position in the Indian pharma space in therapeutic areas such as cardiac, anti-infective, CNS, gastro-intestinal, nutritional and diabetic, among others. The chronic segment accounts for 66% of ULL's domestic revenues. The company has superior return ratios and lower debt compared to its peers, which support a positive operating cash-flow. According to our estimation, the company is expected to clock a sales and a PAT CAGR of 15.3% and 32.4%, respectively, over FY12-14E. We initiate coverage on ULL with a strong Buy recommendation at a target price of Rs 236 (PE of 15x of FY14E EPS of Rs 15.8), with a potential upside of 21%.

Recovery in domestic formulations

ULL's domestic formulations business, comprising chronic (66%) and acute (34%), has shown slow growth over the past 5-6 quarters. However, the company reported a 21% y-o-y growth in Q1FY13, thanks to the completion of revamping and restructuring of its field-force and inventory rationalization at the distribution level. We expect domestic formulations business to grow at a CAGR of 13.5% to Rs 6,870mn during FY12-14E, which is expected to be largely driven by the company's entry into new therapeutic segments such as hospital products and women's healthcare as well as led by productivity from the newly added field-force.

Strong export growth led by contract revenues, greater traction in US business

ULL, which has a presence in as many as 35 countries through its own subsidiaries and distribution & marketing alliances, has submitted more than 500 regulatory filings such as DMFs and EDMFs. We expect its US contract business, estimated at around Rs 650mn, will drive strong growth in exports. Incidentally, the company has filed 25 ANDAs, of which 11 have been approved, and eight have already been launched. We expect positive returns on niche generics from Q1FY14E. According to our estimate, the export business would grow at a CAGR of 18.6% to Rs 4,825mn over FY12-14E.

EBITDA margin to improve and balance sheet to strengthen

We expect ULL's EBITDA margin to improve by 380bps to 18.8% over FY12-14E, mainly on account of its recent greater focus on distribution, which is a major shift from being a distributor to a C&F agent, and incremental revenues from high-margin chronic products. ULL has a healthy balance sheet, since it has a low D/E (0.1x), a shorter working capital cycle, a higher fixed asset turnover ratio and sustainable positive free cash-flow. The company can leverage its balance sheet comfortably for any investment decision in the future.

Valuations

We estimate revenues and earnings at a CAGR of 15.3% and 32.4%, respectively, over FY12-14E. The EBITDA margin is expected to improve by 380bps to 18.8% by FY14E. At the CMP of Rs 196, the stock is trading at 16.4x and 12.4x FY2013E and FY2014E earnings of Rs 11.9 and Rs 15.8, respectively. We recommend a Buy on the stock at a target price of Rs 236 (15x of FY14E EPS Rs 15.8), with a potential upside of 21%, which is based on: a) a recovery in the domestic formulations business due to the completion of restructuring of its field-force and inventory rationalization at the distribution level, b) aggressive new products launches in the export formulations, and c) an increased focus on the lucrative US market.

Consolidated - Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net Sales	8,240	9,025	10,396	12,006
EBITDA	1,501	1,358	1,744	2,255
EBITDA margin (%)	18.2	15.0	16.8	18.8
EBITDA growth (%)	(12.2)	(9.5)	28.4	29.2
Adj. PAT	952	811	1,078	1,422
Adj. PAT margin (%)	11.5	9.0	10.4	11.8
Adj. PAT growth (%)	(22.5)	(14.8)	32.9	32.0
FDEPS (Rs)	10.5	9.0	11.9	15.8
FDEPS growth (%)	(22.5)	(14.8)	32.9	32.0
PE (x)	18.6	21.8	16.4	12.4

Source: Company, Violet Arch Research

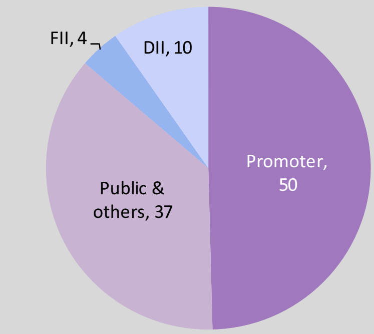
Stock data

CMP	**Rs 196**
Reuters Code	UNLB.BO
Bloomberg Code	UL IN
Equity Shares o/s (mn)	90
Market Cap (Rs mn)	17,689
Market Cap (USD mn)	333
3m Avg daily t/o(US$ mn)	0.4

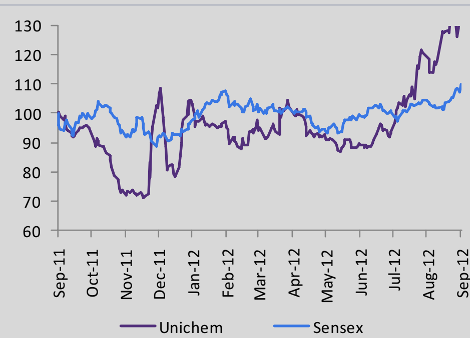
Stock performance (%)

52-week high / low			**Rs 199 /100**
	1M	**3M**	**12M**
Absolute	14.0	53.9	37.9
Relative	8.4	38.0	18.0

Shareholding pattern (%)



Relative stock movement



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Scenario Analysis

FY14E (Rs mn)	Bull Case	Base Case	Bear Case
Sales	**12,398**	**12,006**	**11,605**
Domestic formulations	7,114	6,870	6,630
Export formulation	2,904	2,818	2,733
Niche Generic	805	774	730
US Subsidiaries	365	333	302
EBITDA	2,576	2,255	1,947
PAT	1,667	1,422	1,188
EPS (Rs)	**18.5**	**15.8**	**13.2**
PE(x)	16.0	15.0	14.0
CMP (Rs)	**196**	**196**	**196**
Target price (Rs)	**295**	**236**	**184**
Upside (%)	**50.7**	**20.6**	**(5.9)**

Source: Company, Violet Arch Research

Key Assumptions

Particulars	FY11	FY12	FY13E	FY14E
Domestic formulations (growth % YoY)	7.5	(7.4)	12.5	14.5
Export formulation (growth % YoY)	33.7	44.8	36.0	28.0
EBITDA margin (%)	18.2	15.0	16.8	18.8

Source: Company, Violet Arch Research

Base case

- Revenues to grow 15% in FY14E, led by an improved market shares of top brands (top 10 brands contribute 60% of the domestic business), incremental revenue from the chronic segment (66% of domestic revenues), and growth of export formulations (28% y-o-y growth) through new product launches.
- EBITDA margin to improve by 380bps to 18.8% over FY12-14E, led mostly by an improvement in market shares of top brands (they contribute 60% of domestic formulations) and productivity from recently added field-force.

Bull case

- Revenues to grow 17% in FY14E, largely driven by strong growth in domestic formulations (17% y -o-y growth) and a robust performance in export formulations (30% y-o-y growth), led by an improved market share of top brands and incremental revenues from the chronic segment in domestic formulations (17% y-o-y growth), increased revenues in export formulations (30% y-o-y growth), an improvement in European (niche generic, 5% y-o-y) and US subsidiaries (10%, y-o-y).
- EBITDA margin to improve by 580bps to 20.8% over FY12-14E, led mostly by the high-margin chronic segment in domestic formulations.

Bear case

- Revenues to grow 14% in FY14E as a result of fierce competition and delays in new product launches in domestic (13% y-o-y) and export formulations (26% y-o-y), delay in securing product approvals from the USFDA, and pricing pressure on Niche Generic due to volatility in the European market.
- EBITDA margins to decline by 200bps to 16.8% over FY12-14E as a result of domestic and export formulations' muted performance.

SWOT Analysis

Strengths

1) Chronic (high-growth, sticky prescriptions) segment contributes 66% of the domestic formulation business.

2) Low contribution from volatile API (low-growth, less margin) business.

3) Aggressive in new product launches in India and other leading markets.

4) Less exposure to DPCO (10% of total revenues).

5) Has not faced any regulatory hurdles for its four USFDA-approved plants.

SWOT Analysis

Weaknesses

1) ULL's dependency on top-10 products. Currently, they contribute 60% of the domestic formulations business. Its leading product such as Ampoxin (8.5% of domestic formulations revenues) is under DPCO.

2) Late entrant into the US business (2HFY10). Till date, filed only 25 ANDAs at a slow pace.

3) Delayed turnaround in Niche Generic's (on the margin and sales front) business.

Opportunities

1) India formulations – expected to report a 15-16% growth over the next few years; ULL will be one of the key beneficiaries, due its increased focus on chronic therapies.

2) ULL has a presence in 35 countries through its own subsidiaries and distribution & marketing alliances; submitted more than 500 regulatory filings. ULL is a key beneficiary of semi-regulated markets.

Threats

1) Regulatory issues, especially from the USFDA.

2) Rising competitive pressures in India from existing players, due to new product launches.

3) A new drug policy is being formulated by the government, with the objective of capping the prices of 348 drugs (60% of the domestic market). This will expose ULL's many brands to the price capping threat.

4) Volatile business environment in Europe. ULL generates 10% of total revenues from Europe.

Source: Violet Arch Research

Investment Arguments

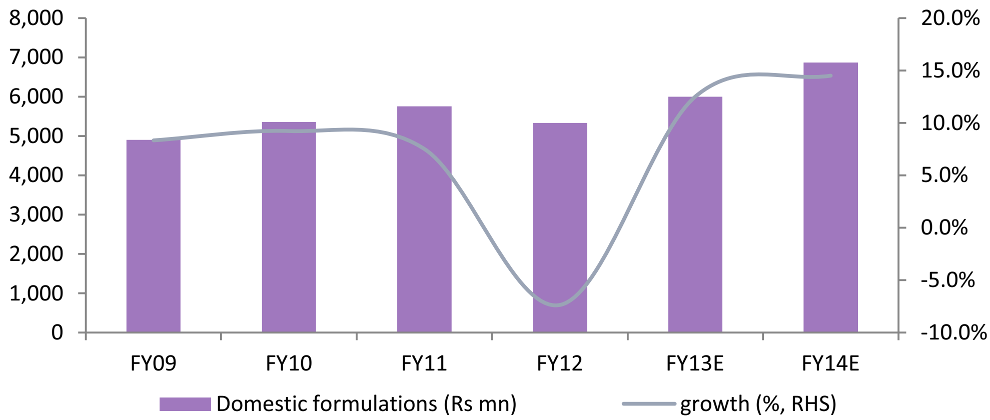
Recovery in domestic formulations

In FY12, the domestic formulations business contributed 60% of ULL's total consolidated revenues estimated at Rs 5,333mn. Out of this, 66% accrued from the high-margin chronic segment and the rest from the acute segment. With a strong brand position in the industry, ULL's top 10 brands contribute around 60% of its domestic revenues (*AIOCD AWACS, MAT – March 2012*). Its top brands include Losar, Ampoxin, Trika, Telsar, Unienzyme, TG-TOR, Olsar Group, Vizylac, etc.

In the past 5-6 quarters, ULL's domestic formulations business has been showing slow growth, due to inventory rationalization and a high rate of attrition of 30-35%. With revamping and restructuring of its field-force and inventory rationalization at the distribution level completed, it is expected to hit a high growth trajectory. During Q1FY13, the company reported a 21% y-o-y growth. We expect it to grow at a CAGR of 13.5% during FY12-14E, driven by its entry into the new therapeutic areas such as hospital products and women's health as well as by improved productivity due to the newly added field-force.

ULL is expected to launch line extensions of mature brands to drive growth. The new product launch campaign is expected to be less aggressive, involving 13-15 products annually, as the company is targeting prescription generation for scaling up productivity. Among several other initiatives undertaken by ULL include capping of the field-force and focusing on second-tier brands (11-25 brands) to reduce dependency on its top brands (10 primary brands - 60% and 15 secondary brands - 20% of domestic formulations revenues).

Performance of domestic formulations



Source: Company, Violet Arch Research

Telsar and Olsar offer long-term traction in second-tier power brands

As part of its marketing strategy, ULL has specifically been focusing on building power brands. It has been taking big strides to develop its brands in chronic segments by leveraging the brand equity that it has built through brands such as Losar and Ampoxin. The revenue growth is largely driven by appropriate product selection reinforced by a strong marketing team.

Top-10 brands (AWACS MAT, Mar'12)

Particulars (Rs mn)	Therapy	Category	% to total	Mar'12	Market Share
Losar	Cardiac	Chronic	23.0%	1,537	30.5%
Ampoxin	Anti-infectives	Acute	8.5%	567	29.0%
Trika	Psychiatrics	Chronic	5.3%	352	22.7%
Telsar	Cardiac	Chronic	5.2%	345	5.1%
Unienzyme	Digestive	Acute	4.6%	304	10.3%
Olsar- A	Cardiac	Chronic	3.7%	246	8.6%
TG-TOR	Cardiac	Chronic	2.7%	181	2.0%
Vizylac	Gastro	Acute	2.7%	181	40.3%
Metride	Diabetic	Chronic	2.6%	171	1.7%
Serta	Cardiac	Chronic	2.0%	131	28.1%
Unichem's top 10 brands			**60%**	**4,015**	
Unichem's formulations business			**6,670**		

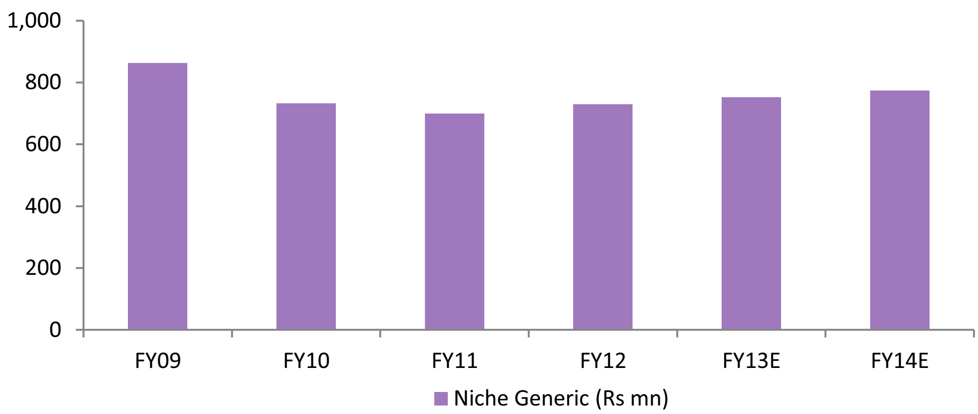
Source: Company, Violet Arch Research

Expect strong export growth led by contract revenue, greater traction in US business

We expect ULL's overseas business, which contributes around 40% of its total revenues, to grow at a CAGR of 18.6% over FY12-14E, driven by export formulations. According to our estimation, formulations export, which contributes 47% of its total overseas business, would clock a strong CAGR of 31.9% over FY12-14E, due to contract revenues (quarterly revenues are estimated at Rs 650mn) and strong product registrations across countries. ULL has a presence in the European market through its 100% subsidiary, Niche Generic, which contributes 21% of its overseas revenues, while the rest of the formulations export revenues come from Southeast Asia, Russia, CIS, Africa, the US and the rest of Europe.

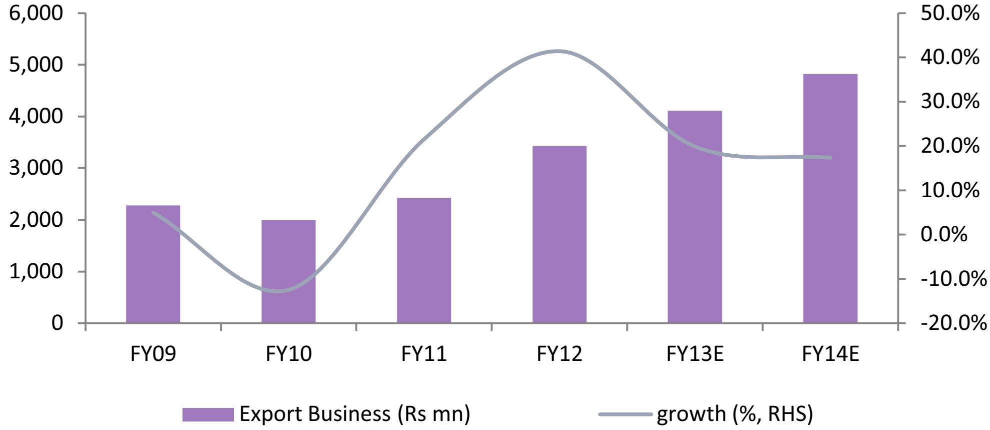
Niche Generic has reported revenues of Rs 730mn and a net loss of Rs 16mn in FY12. Going forward, we expect its sales turnover to be subdued at Rs 752mn and Rs 774mn in FY13E and FY14E, respectively, while its profitability to show high single-digit growth from FY14E.

Niche Generic performance



Source: Company, Violet Arch Research

Export business performance



Source: Company, Violet Arch Research

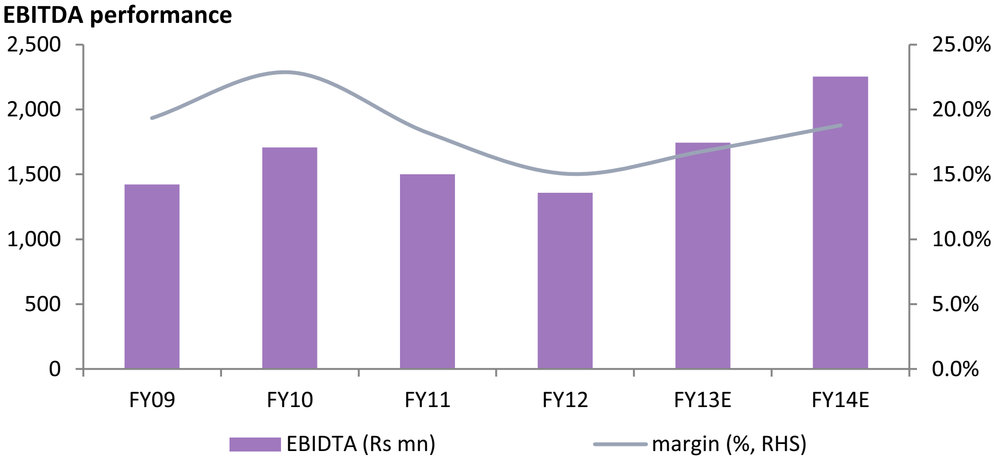
ULL has made a late entry into world's biggest US generic market in H2FY10. The performance of the US subsidiary has improved in a short span of time and has reported a top-line growth of Rs 302mn. Currently, the company has 25 Abbreviated New Drug Applications (ANDAs) filed (of which 11 have been approved, while seven have already been launched) in the US market. It plans to file 7-8 ANDAs annually; 25 products are in the pipeline. With tie-ups with large wholesalers and a retail chain now in place, product launches in the US are expected to be quicker.

Going forward, EBITDA margin to improve and balance sheet to strengthen

We expect ULL's EBITDA margin to improve by 380bps to 18.8% over FY12-14E, mainly on account of its greater focus on distribution (a shift from being a distributor to a C&F agent) and incremental revenues from high-margin chronic products. ULL has a healthy balance sheet, since it has a low D/E (0.1x), a shorter working capital cycle, a higher fixed asset turnover ratio and a sustainable positive free cash-flow generation. The company can leverage its balance sheet with comfort for any investment decision in the future.

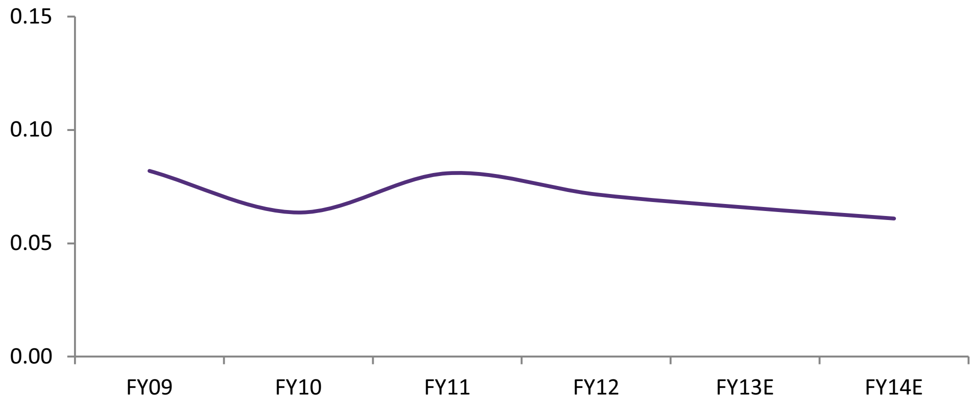
ULL's four USFDA-approved (API-2 and formulations-2) facilities, cater to the regulated market. Its Sikkim facility is eligible for 100% tax exemption. Its Indore SEZ plant is under development. We believe that the company will manage all cash expenses through internal accruals without opting for external debt.

EBITDA performance



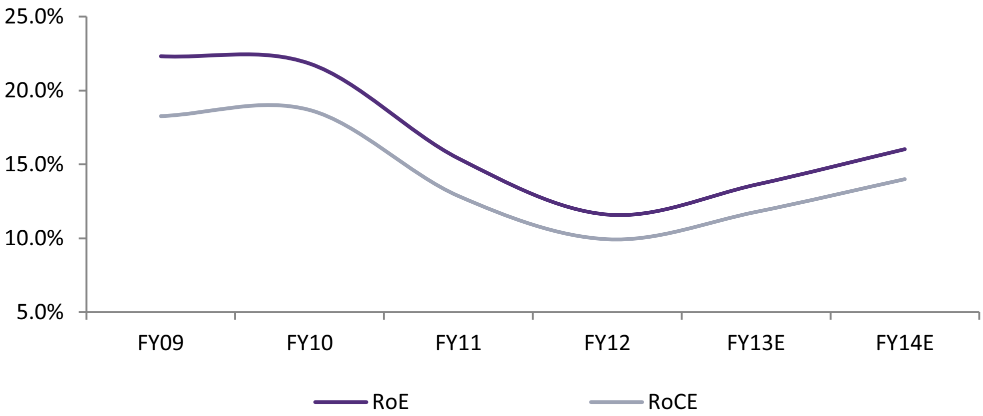
Source: Company, Violet Arch Research

D/E equity ratio (x)



Source: Company, Violet Arch Research

Return ratios, %



Source: Company, Violet Arch Research

Key Risk and Concerns

Revenue dependency on top brands

ULL's top-10 brands contribute 60% of its total domestic formulations revenues. The largest portion of domestic formulations revenues (23%) is generated by Losar (cardiac) [*MAT March 2012*]. In order to reduce dependency on its top brands, the company has already begun focusing on other tier-2 brands.

Pricing pressure in Europe

Niche Generic, UK, generates revenues of Rs 894mn (10% of revenues). However, pricing pressure in the European market has been impacting ULL's revenue growth and profitability. If the scenario continues to remain unchanged in the future, then it will negatively impact ULL's earnings. In our bear case scenario, we have not assumed any growth from this segment in the coming years.

DPCO threat

Currently, 20% of ULL's revenues are under the Drugs Price Control Order (DPCO) coverage. Ampoxin (anti-infective), which generates revenues of around Rs 567mn, has shown de-growth of -9.1% (*MAT March 2012*), due to the price capping undertaken by the DPCO. Going forward, a downward revision in prices or inclusion of new products under the DPCO by National Pharmaceutical Pricing Authority (NPPA) remains a downside risk to our target price, which will negatively impact our sales growth estimation. To reduce dependency on its top brands, the company has begun to focus on other 18 tier-2 brands.

Delay in approvals

Any delay in securing approvals for ULL's products in the export market will have a negative impact on its sales growth. Also, since a third of its revenues accrue from the global market, currency fluctuations are a concern.

Financial Outlook

Revenue to grow at a CAGR of 15.3% over FY12-14E

We expect ULL's revenue to grow at a CAGR of 15.3% between FY12 and FY14E on account of the addition to the field-force, de-risking of the domestic business by reducing dependence on top-5 brands and focusing on tier-2 brands. The company has consistently achieved higher growth in most of the therapeutic segments compared to market growth.

In the last 5-6 quarters, ULL's domestic business has witnessed sluggish growth. We expect an improvement from 1QFY13E on account of revamping and restructuring of its field-force and completion of inventory rationalization at the distribution level. We expect domestic formulations business to grow at a CAGR of 13.5% during FY12-14E. We expect ULL to enter new therapeutic areas such as hospital products, women's health, biological products and nephrology in the near future.

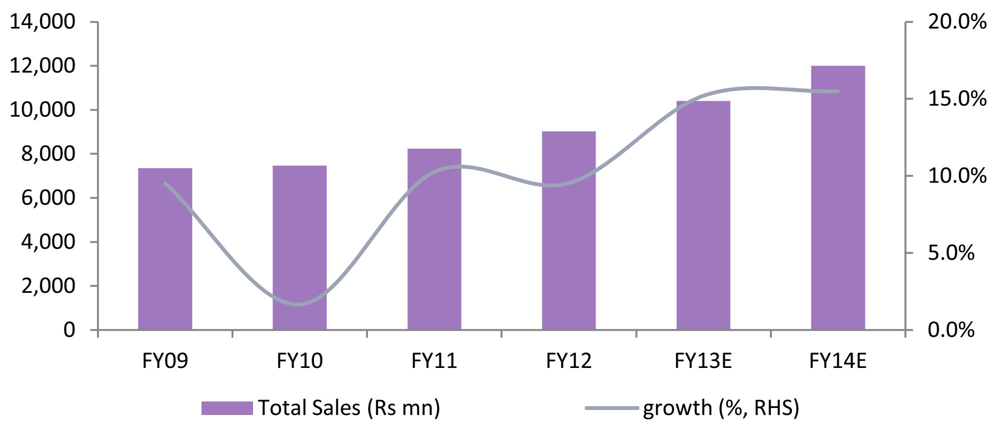
ULL has a presence in 20 countries through its own subsidiaries, and distribution and marketing alliances. It has submitted more than 416 regulatory filings such as DMFs and EDMFs, among others. We estimate that the US market will drive robust growth in the export business, as ULL has filed 22 ANDAs, out of which 11 have been approved and seven have already been launched in the US. ULL plans to file 7-8 ANDA in the US annually. According to our estimation, the company's export formulations business will report a CAGR of 31.9% over FY12-14E.

Revenue break-up – Segment-wise (Rs mn)

Particulars	FY09	FY10	FY11	FY12	FY13E	FY14E
Domestic	**5,074**	**5,576**	**5,978**	**5,542**	**6,225**	**7,111**
Domestic formulation	4,904	5,356	5,758	5,333	6,000	6,870
Domestic API	170	220	220	209	226	241
Export	**1,415**	**1,262**	**1,600**	**2,397**	**3,042**	**3,717**
Export formulation	831	836	1,118	1,619	2,202	2,818
Export API	584	426	483	778	840	899
Niche Generics	**863**	**733**	**700**	**730**	**752**	**774**
Unichem Pharmaceuticals, US	**-**	**-**	**124**	**302**	**317**	**333**
Total	**7,352**	**7,571**	**8,402**	**8,971**	**10,336**	**11,936**

Source: Company, Violet Arch Research

Sales performance

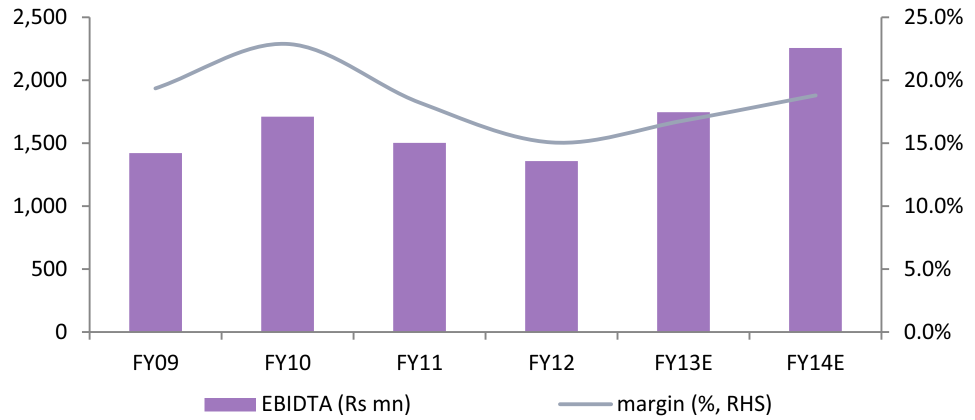


Source: Company, Violet Arch Research

EBITDA margin to improve by 380bps to 18.8% over FY12-14E

We expect ULL's EBITDA margin to improve by 380bps to 18.8% over FY12-14E, mainly on account of incremental revenue from chronic therapy (66% of domestic formulations), increased productivity through recently added field-force and completion of inventory rationalization at the distributor level, which would help bring down the cost and achieve higher margins.

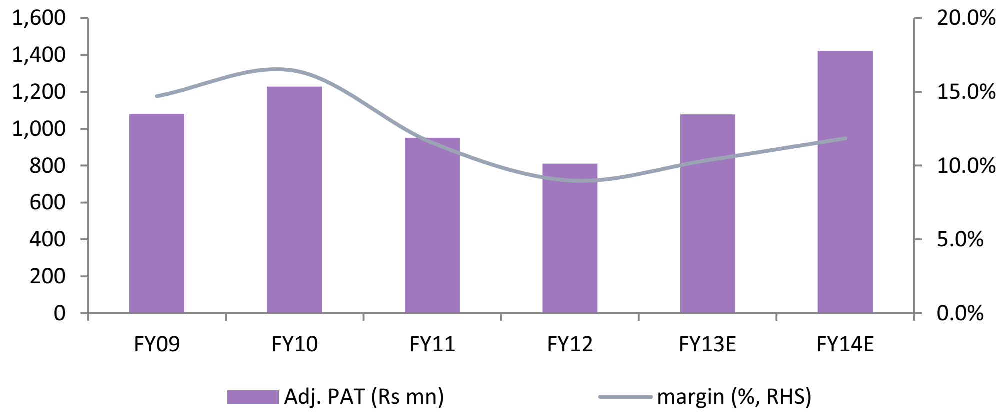
EBITDA margin performance



Source: Company, Violet Arch Research

We expect the adj. PAT to clock a CAGR of 32.4% over FY12-14E, driven by the high-profit margin chronic segment and negligible interest cost. Margins are expected to grow by 280bps to 11.8% in FY14E from FY12, driven largely by improved operating performance. The adj. EPS for FY12E, FY13E and FY14E are at Rs 9.0, Rs 11.9 and Rs 15.8, respectively.

Adj. PAT performance



Source: Company, Violet Arch Research

Valuation

In our view, consolidated revenues of ULL are expected to grow at a CAGR of 15.3% to Rs 12,006mn, while PAT to grow at a CAGR of 32.4% to Rs 1,422mn during FY12-14E. The company has a strong balance sheet, with insignificant debt. It has shown an improvement in fixed asset turnover to 1.9x in FY14E as against 1.7x in FY12. It is the highest dividend-paying company (100-200% in the fiscal), with a shorter working capital cycle (100 days).

We expect ULL's return ratios to be superior to its peers. Its RoE and RoCE are expected to improve from 11.6% and 9.9% in FY12 to 16.0% and 14.0% in FY14E, respectively.

Presumably, the company has taken several initiatives such as field-force addition and inventory rationalization at the distributor level for restructuring the domestic business. We expect both domestic and export segments to register robust growth going forward.

Historically, ULL has traded at a discount to peers, due to subdued performance in its domestic formulations business and on account of losses incurred by Niche Generics and the US business. At the CMP of Rs 196, the stock is trading at a PE of 16.4x & 12.4x earnings of Rs 11.9 and Rs 15.8 in FY13E and FY14E, respectively. We initiate coverage on Unichem with a strong Buy recommendation and at a target price of Rs 236 (15x of FY14E EPS of Rs 15.8), with a potential upside of 21%.

Peer comparison (Rs mn)

Company	CMP (Rs)	Market cap	EPS (Rs)		P/E (x)		ROE		ROCE		EV/EBITDA (x)		EV/Sales (x)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
IPCA	427	53,866	30.2	33.8	14.1	12.6	23.3%	21.1%	23.0%	22.4%	9.8	8.5	2.1	1.9
Elder Pharma	304	6,243	48.4	62.6	6.3	4.9	12.5%	14.1%	11.8%	13.8%	3.7	3.2	0.6	0.5
Indoco Remedies	71	6,133	8.2	10.9	8.6	6.5	16.7%	18.6%	16.9%	19.4%	5.8	4.5	1.0	0.9
Average					**9.7**	**8.0**	**17.5%**	**17.9%**	**17.2%**	**18.5%**	**6.4**	**5.4**	**1.2**	**1.1**
Unichem Labs	**196**	**17,689**	**11.9**	**15.7**	**16.4**	**12.5**	**13.6%**	**16.0%**	**15.3%**	**18.4%**	**10.3**	**8.0**	**1.7**	**1.5**

Source: Company, Violet Arch Research

Company Background

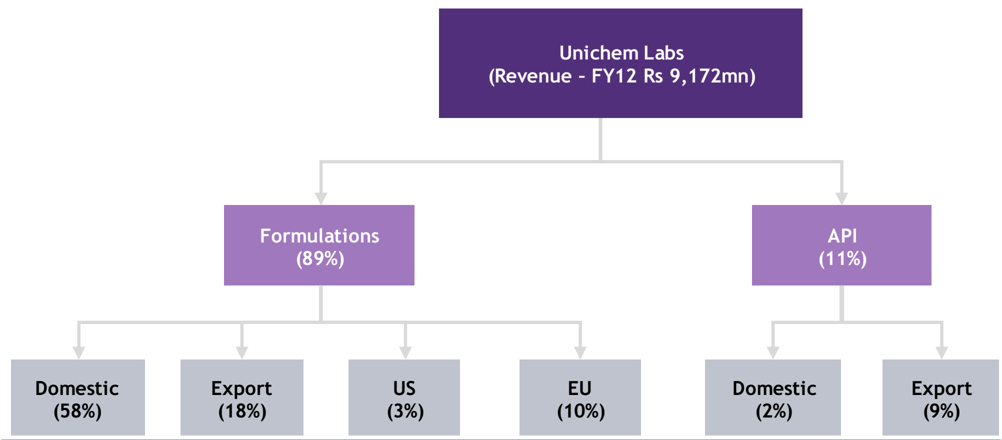
Unichem Laboratories Ltd. (ULL) is one of India's leading integrated pharmaceutical companies, with a strong presence in the domestic formulations market. ULL represents around 50% (Rs 229bn) of the total Indian pharma market (Rs 465bn). It covers around 18% of the total number of segments, with a presence in as many as 246 sub-segments. The company's superior brand-building capability has helped catapult its products into the No.1 position in 16 therapeutic groups, and three products have been featured in India's top-100 pharma brands. It is growing aggressively with a sharp focus on expanding a global presence for its generics, strategic alliances with global players for Contract Research and Contract Manufacturing Services (CRAMS) and development, and in-licensing of registered or under-development molecules or formulations in various therapeutic segments.

Management profile

Name	Designation
Dr. Prakash A. Mody	Chairman & MD
Mr. Rakesh Parikh	Vice-President - Finance

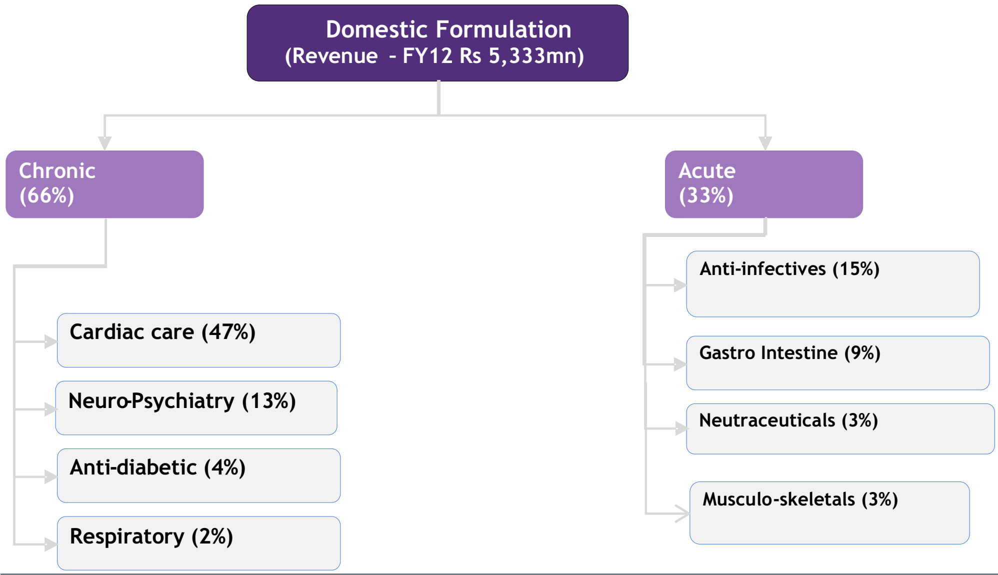
Source: Company, Violet Arch Research

Revenue break-up



Source: Company, Violet Arch Research

Domestic formulation revenue break-up



Source: Company, Violet Arch Research

Manufacturing facilities

Formulations

Facility (Location)	Utilization	Products manufactured	Markets	Approvals
Baddi I (Betalactam)	100%	Tabs, Capsule, Inj, Liq	Domestic	MHRA, MCC, WHO
Baddi II (Soft Gel –Non-Betalactam)	100%	Tabs, Capsule, Gel	Domestic	MHRA, MCC, WHO
Baddi III (Cephalosporin)	-	Tabs, Capsule, Inj, Liq	Domestic	MHRA, MCC, WHO
Goa	100%	Tabs, Capsule	Regulated, Developing	USFDA, MHRA, TGA, MCC, ANVISA, WHO
Ghaziabad	30%	Tabs, Inj, Capsule, Liq	Regulated, Developing	USFDA, MHRA, ANVISA, WHO
Sikkim	-	Tabs, Capsule	-	Under Development

Source: Company, Violet Arch Research

API

Facility	Utilization	Markets	Approvals
ROHA	-	Regulated, Developing	USFDA, EDQM, TGA, ISO 9001:2000
Pithampur	25%	Regulated, Developing	USFDA, EUGMP

Source: Company, Violet Arch Research

Financial Summary- Consolidated

Income Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Net sales	**8,240**	**9,025**	**10,396**	**12,006**
Growth (%)	10.2	9.5	15.2	15.5
Operating expenses	6,740	7,667	8,652	9,751
EBIDTA	**1,501**	**1,358**	**1,744**	**2,255**
EBITDA margin (%)	18.2	15.0	16.8	18.8
Depreciation	292	344	397	451
EBIT (core)	**1,208**	**1,014**	**1,347**	**1,803**
Other income	69	81	93	108
Interest	9	45	41	40
PBT	**1,268**	**1,050**	**1,399**	**1,871**
Tax	316	237	322	449
Tax rate (%)	24.9	22.6	23.0	24.0
Reported PAT	**952**	**811**	**1,078**	**1,422**
Forex (gain) / loss	-	2	-	-
Extraordinary items	-	-	-	-
Adjusted PAT	**952**	**811**	**1,078**	**1,422**
Adj. PAT margin (%)	11.5	9.0	10.4	11.8
Shares o/s (mn)	90	90	90	90
EPS (Rs)	10.5	9.0	11.9	15.8

Cash Flow Statement

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Pre-tax profit	1,268	1,050	1,399	1,871
Depreciation & Amortisation	292	344	397	451
Tax paid	(308)	(237)	(322)	(449)
Chg in working capital	(548)	(56)	(425)	(510)
Other operating cash flow	(18)	283	292	20
Cash flow from operations (a)	**686**	**1,384**	**1,342**	**1,383**
(Inc.)/ Dec. in Fixed Assets	(909)	(1,000)	(1,000)	(1,000)
(Inc.)/ Dec. in Investments	379	-	-	-
Other investing cash flow	54	-	-	-
Cash flow from investing (b)	**(476)**	**(1,000)**	**(1,000)**	**(1,000)**
Proceeding from borrowing	52	-	-	-
Proceeding from equity issues	3	-	-	-
Dividend (incl. tax)	(417)	(317)	(317)	(317)
Interest paid	(24)	(45)	(41)	(40)
Other financing cash flow	90	-	20	20
Cash flow from financing (c)	**(295)**	**(362)**	**(337)**	**(336)**
Net chg in cash (a+b+c)	**(85)**	**22**	**5**	**47**
Opening Cash balances	236	152	174	179
Closing Cash balances	**151**	**174**	**179**	**226**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Shareholder's funds	**6,177**	**6,987**	**7,905**	**8,871**
Share capital	181	181	181	181
Reserves & Surplus	5,997	6,806	7,725	8,690
Total debt	**500**	**500**	**520**	**540**
Secured Loan	273	253	263	273
Unsecured Loan	227	247	257	267
Deferred tax liability	378	378	378	378
Total Liabilities	**7,055**	**7,865**	**8,804**	**9,789**
Net fixed asset	**4,554**	**5,210**	**5,813**	**6,362**
Investments	213	213	213	213
Net Current Assets	**2288**	**2441**	**2777**	**3214**
Current Assets	**4,046**	**4,300**	**4,932**	**5,716**
Inventories	1,503	1,607	1,851	2,138
Sundry Debtors	1,857	1,978	2,279	2,631
Cash And Bank Balances	152	174	179	226
Loans And Advances	534	542	624	720
Less: CL & Provisions	**1,757**	**1,859**	**2,155**	**2,501**
Current liabilities	1,392	1,575	1,778	2,004
Provisions	366	284	377	498
Total Assets	**7,055**	**7,865**	**8,804**	**9,789**

Financial Ratio

Y/E 31 Mar	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	13.6	10.5	9.0	11.9
Adj EPS growth (%)	13.6	(22.5)	(14.8)	32.9
EBITDA margin (%)	22.9	18.2	15.0	16.8
PBT margin (%)	20.5	15.4	11.6	13.5
PAT margin (%)	16.4	11.5	9.0	10.4
ROE (%)	21.8	15.4	11.6	13.6
ROCE (%)	18.7	12.9	9.9	11.8
Turnover ratios				
Asset turnover (x)	1.2	1.2	1.1	1.2
Net fixed asset turnover (x)	1.9	1.8	1.7	1.8
Net Debt/Equity (x)	0.1	0.1	0.1	0.1
Working Capital & Liq. ratio				
Inventory days	53	67	65	65
Receivable days	82	82	80	80
Payable days	82	75	75	75
Valuations				
PE (x)	14.4	18.6	21.8	16.4
Price/Book value (x)	3.1	2.9	2.5	2.2
EV/EBITDA (x)	10.4	12.0	13.3	10.3
EV/Sales (x)	2.4	2.2	2.0	1.7

Upside >20%	Buy
Upside between 0% and 20%	Overweight
Downside up to 20%	Underweight
Downside >20%	Sell

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