Faysal AssetManagement

NISHAT MILLS LIMITED (NML)

<u>Date</u>: **28th August 2012**

KSE – 15,234.48
NML – PKR56.52

<u>KSE-100 52-week:</u>

High –15,234.48
Low – 10,909.12

<u>NML 52 week:</u>

High – PKR 58.91
Low – PKR 40.09

Shares Outstanding: 351.6mn
Market Capitalization: PKR 19,872.4mn
Average Volume: 2,024,124.5
Book Value: PKR 134.34/Sh
Last Full Year EPS: PKR 25.62
2QFY12 EPS; PKR 5.1
Price Target: PKR 64

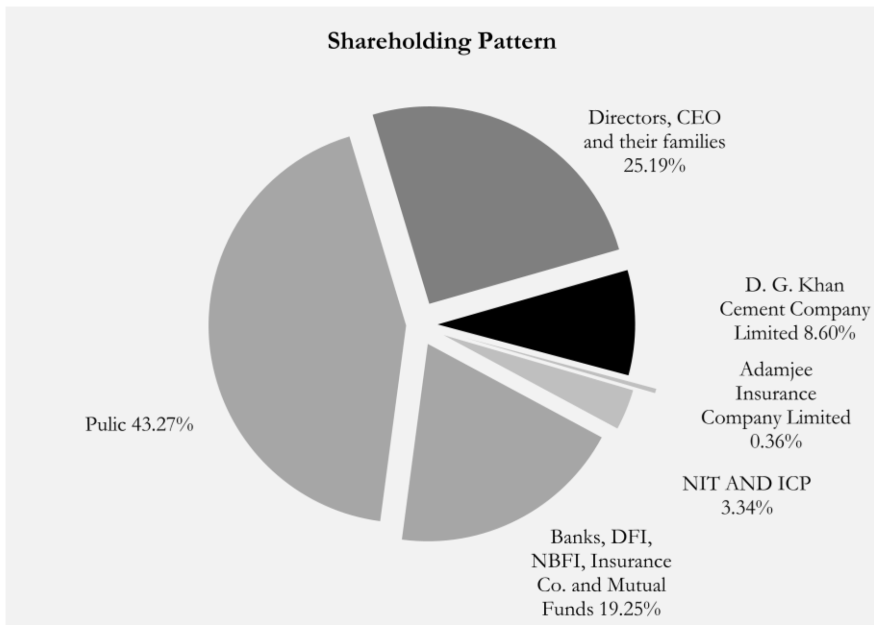
<u>Board of Directors:</u>

Mian Umer Mansha
Mian Hassan Mansha
Mr. Khalid Qadeer
Mr. Muhammad Azam
Syed Zahid Hussain
Ms. Nabiha Shahnawaz Cheema
Mr. Maqsood Ahmad

Company Background

Nishat Mills Limited is the flagship company of Nishat Group. It was established in 1951. It is one of the most modern, largest vertically integrated textile company in Pakistan. Nishat Mills Limited has 198,120 spindles, 655 Toyota air jet looms. The Company also has the most modern textile dyeing and processing units, 2 stitching units for home textile, one stitching unit for garments and Power Generation facilities with a capacity of 89 MW. The Company's total export for the year 2011 was Rs. 36.015 billion (US$ 416 million). Due to the application of prudent management policies, consolidation of operations, a strong balance sheet and an effective marketing strategy, the growth trend is expected to continue in the years to come. The Company's production facilities comprise of spinning, weaving, processing, stitching and power generation.

Shareholding Pattern



Operational Performance

Company's profit after tax in this period has been on a lower side compared to the corresponding periods. The primary reason for decrease in profit is fall in profitability of spinning division and increase in power generation cost and finance cost of the company.

Profitability of spinning division has declined in the current period as compared to the corresponding period owing to reduction in gross margins on yarn sales. Yarn sale prices were sky high in the third quarter of corresponding period due to the highest ever cotton prices in that quarter. Nishat spinning division reaped the benefit of timely buying of cotton at low prices which resulted in low cotton consumption rates as against high yarn sale rates and hence yielded high gross margins for spinning division in the third quarter of corresponding period.

Power generation cost has increased mainly due to increase in usage of diesel and furnace oil during the gas load shedding for generating electricity. Furnace oil and diesel consumption has increased by Rs. 432 million (March 2012 Rs. 1,175 million, March 2011 Rs. 743 million).

Finance cost of the company increased in the current period due to increase in average borrowing costs. Long term loans had been obtained to finance fixed capital expenditure, major portion of which related to establishment of power generation facilities using cheap alternative fuels. This strategic initiative will ease the financial pressure which is being caused by the use of expensive traditional fuels i.e. furnace oil and diesel for power generation and affecting the company's profitability.

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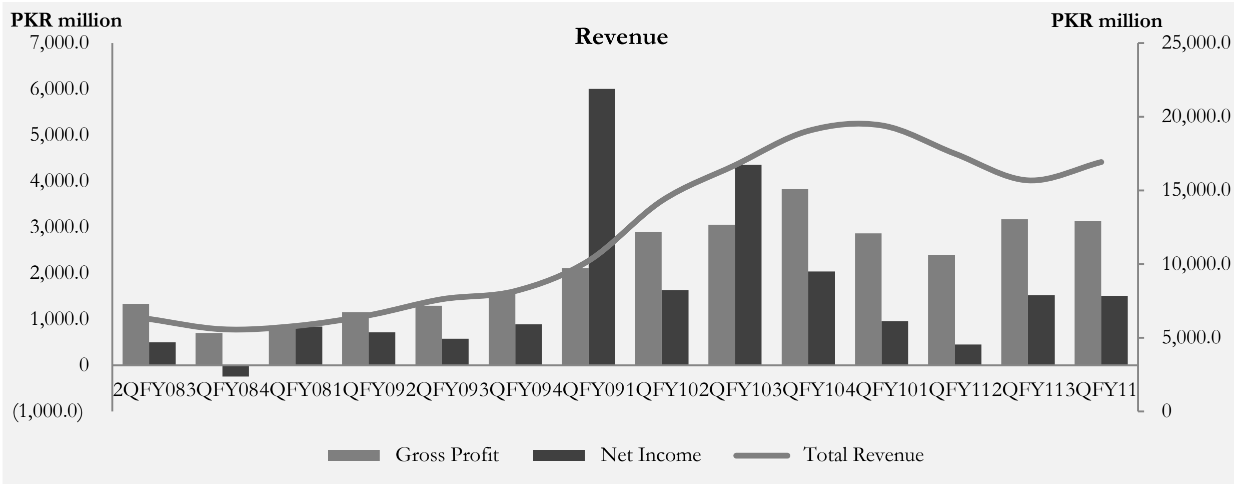

Improving outlook of core operations and margin environment as the management focuses its energies on lifting product mix towards higher margin garments segment. Relative stability in cotton prices post 37% correction in 12M and Pak Rupee depreciation of 9.9% (FY12) will improve the margin environment for export-heavy textile revenues. NML is finely poised to explore better margins the estimated gross margins to creep up from 18.0% in FY12E to 20.6% by FY16E.

The upside risk to the conservative volume estimates for NML in key export segments from (1) EU duty waiver on textile export from Pakistan (decision likely by Sep 2012) and (2) Pakistan's accession to GSP Plus status.

Near-term cost cutting measures to aid in margin accretion via innovative solution to lingering power supply issues in Pakistan. A coal biomass power plant with 6MW capacity (likely to come online by Sep 2012) may provide PRs250-300mn/year (PRs0.7-0.8/sh) in fuel cost savings (where energy costs account for 11% of COGS) via substitution of expensive power fuels. Further capex in power cost efficiency at three other facilities (total installed capacity of 89MW) may deliver significant upside to our margin and earnings estimates.

Growing dividend income from associate companies given business turnaround in a cement associate, and shift in dividend profile towards power sector companies, as fresh investment in the past few years (acquisition and setting up of a new IPP) has started bearing fruits. The estimated dividend contribution to rise to PRs2.2bn (PRs6.23/sh) in FY13, up from PRs1.8bn (PRs5.2/sh) in FY12.

Undemanding valuations with FY13E P/E 4.3x and EV/EBITDA 3.4x. On historical basis, NML's current spot P/E (5.6x) is at 7% discount to its 3-year average. Furthermore, NML's market cap/equity portfolio ratio suggests an unjustified 19% discount versus 4-year average premium of 17%. With stable core operations outlook, margin accretion and growth in dividend income, the NML stock is ripe for re-rating. NML's current discount to market P/E stands at ~18%.

Investment in associates bearing fruits

Growing dividend income from associate companies given business turnaround in a cement associate, and shift in dividend profile towards power sector companies as fresh investment in the past few years (acquisition and setting up of a new IPP) has started bearing fruits. MCB has historically remained the highest contributor with 70%-90% share in dividend income. This would dilute in the future as power sector portfolio takes on a more prominent role.

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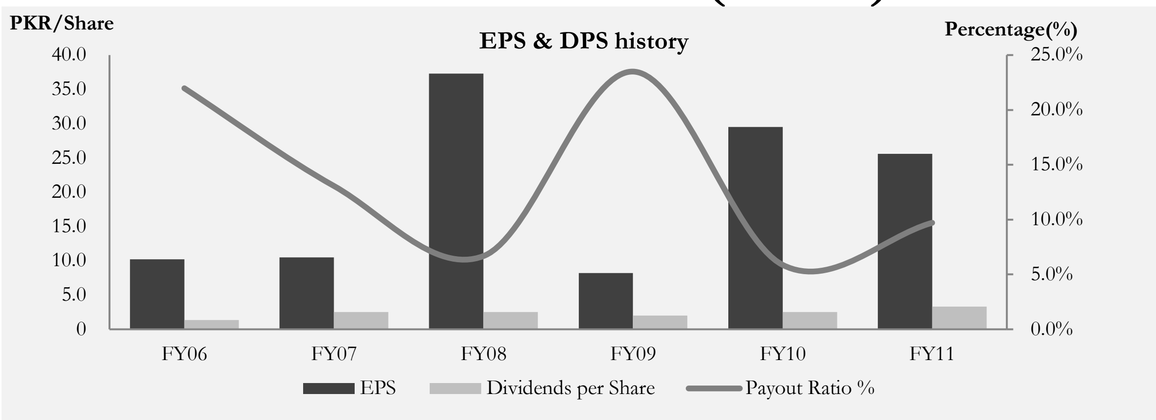

Pakistan ranks 4th in terms of trading partners of the EU for imports of textiles and 8th for imports of clothing

The expected near-term positives emerging from duty waiver from the EU will provide a key outlet for volume growth. The EU remains one of Pakistan's largest trading partner with share in total exports approx. 28% in FY12. As per Eurostat, EU imports from Pakistan stood at €4.5bn in 2011 where textiles and clothing constituted 74% of the total. There might be a final approval by the European Parliament (due in Sep-12) as the last requirement for Pakistan to achieve a duty waiver on export of 75 products, provided no further objections are raised. The waiver is intended for a period of two years however has the provision to be extended for an additional year. Recall that the trade concession package pertains to a one-off case which involves granting preferential treatment and was devised with an aim to assist Pakistan recover from the 2010 floods.

Triggers

1. **Improving backdrop for core operations and margins** on the back of management initiatives to shift Product mix, stable cotton prices and Pak Rupee depreciation for export-oriented textile company. The upside risk to the conservative volume estimates from (1) EU duty waiver on textile export from Pakistan and (2) Pakistan's accession to GSP Plus status.
2. **Near-term cost cutting measures** via innovative solution to lingering power supply issues in Pakistan. Combined Heat and Power Plant (6MW) should provide PRs250mn-300mn (PRs0.7-0.8/sh) in fuel cost savings. Further capex in power cost efficiency at three other facilities (total installed capacity of 89MW) promises to deliver significant future upside to margin and earnings.
3. **Growing dividend income from associate companies** with business turnaround, and shift in dividend profile towards power sector companies. The estimate dividend contribution to rise to PRs2.2bn in FY13E, up from PRs1.8bn in FY12 which should provide an effective cushion to core earnings.
4. **Undemanding valuations** (FY13E P/E 4.3x, EV/EBITDA 3.4x). Interestingly, NML's market cap is at an unjustified 19% discount to its equity portfolio value versus 4-year average premium of 17%. With stable core operations outlook and growth in dividend income, research believes NML stock is ripe for re-rating.