

Target Price: Rs65

Textile Policy? NML has got more to offer

Our liking for Nishat Mills Limited (NML) could not have come at a better time than this. The first ever Textile Policy of Pakistan was finally approved by the Cabinet on August 12, 2009. Secondly, Nishat Power Limited (NPL) a subsidiary of NML is due to come online in Sept. 2009. Textile Policy with an export target of US\$25bn by the end of the policy period (five years), no doubt, can act as a focal point for the contracting industry but addition of NPL into NML's equity portfolio is a major trigger for the company, we believe. What market has failed to recognize is Rs9 per share value of NPL into NML's portfolio. The aforementioned impact itself proves to have an upside of 20% on current NML price. Add this to our Sum-of-Parts target price, the scrip is trading at a discount of 33% to the market. NML's share from its core earnings on its target price stands at Rs38, whereas Rs27 per share is contributed by its strong equity portfolio. Moreover, the new Textile Policy looks set to shore up NML's top line by giving it an opportunity to increase its margins by cutting back on their local sales. Moreover, reduction in export financing (down 100bps) and relaxation in long term loans facility is likely to bring down the finance costs. Hence, we are upgrading our stance to 'Buy' on current levels.

Valuation: 33% discount to market on FY10 PE

NML has already posted a more than decent return year-to-date (98%) on the back of strong earnings reported in 9MFY09, owing to devaluation in rupee. However, we believe there still remains a huge upside potential of 34% to our revised SoP based target price of Rs65. Our revision in our fair value is mainly based on the fact that NPL is set to come online in September 2009, which adds an attractive Rs9 per share upside at current levels. Moreover, textile policy would be another growth trigger for NML.

At current levels, the stock is trading at a respective PE of 5.1x and 4.1x on FY10F and FY11F, at a discount of 33-36% to the market's FY10F and FY11F PE of 7.5x and 6.5x, respectively. Hence, the addition of NPL into its already strong investment portfolio, consisting MCB Bank (53%) and DG Khan Cement (20%) is another compelling case to take exposure in NML.

KATS Code: NML

Bloomberg Code: NML PA

Reuters Code: NISM.KA

Market Price:

Rs44.70

Market Cap:

Rs10.8bn

US\$131mn

1-yr Avg. Daily Volume:

3.1mn shares

Rs109.6mn

US\$1.3mn

1-yr High/Low:

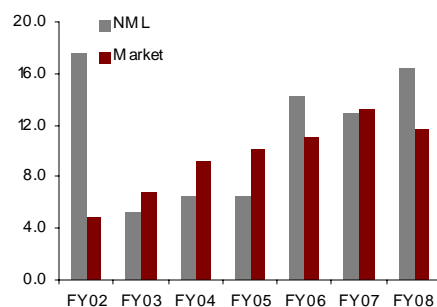
Rs51.46/21.71

Estimated free float:

121.2mn shares (50.0%)

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Graph 1(a): PE (x)



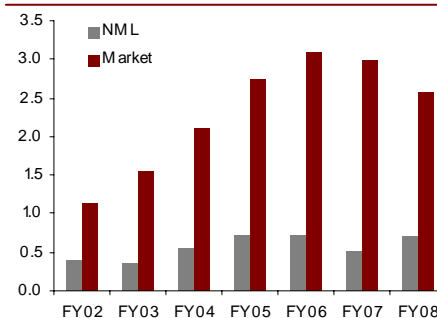
Source: JS Research

Table: NML's Equity Portfolio

	Shares (mn)	Market Value (Rs mn)
MCB	47	8,310
Nishat Power	224	3,583
DG Khan Cement	96	3,262
Nishat Chunian	38	353
Others	41	317
Total		15,825

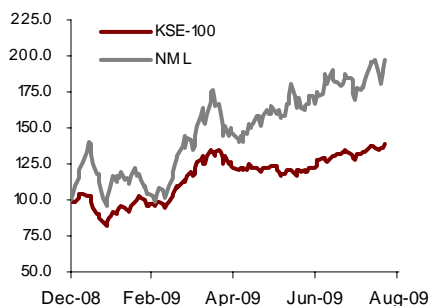
Source: Company accounts

Graph 1(b): PBV (x)



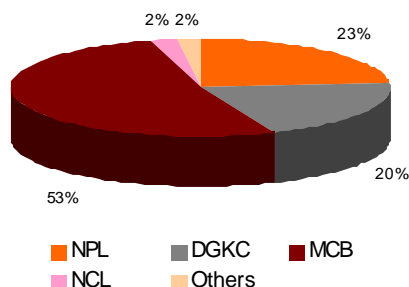
Source: JS Research

Graph 1(c): NML vs KSE



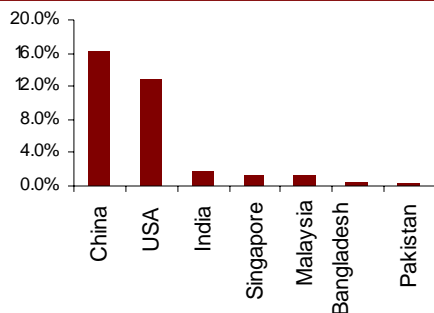
Source: JS Research

Graph 2: Equity Portfolio (Value)



Source: Company Announcement
As of Aug 24, 2009

Graph 3: EU Import partners



Source: Europa

Graph 4: Exports under GSP



Source: FBS

Nishat Power

Nishat Power Limited, a wholly owned subsidiary of NML, is an RFO (Residual Furnace Oil) based IPP (Independent Power Producer) with a nameplate generation capacity of 200MW, based on reciprocating engine technology. The total cost of this project is US\$204mn, with debt to equity structure of 80:20. Nishat Power has a negotiated project life of 25 years offering a US\$ IRR of 17.5%.

As per company's management, the project is expected to commence its commercial operation by Sep 2009.

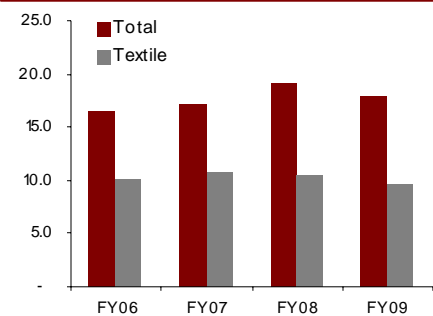
ROE of IPP investment in Pakistan is determined under pre-negotiated tariff structure and Power Purchase Agreement (PPA). The ROE component of the power tariff is paid out to the shareholders. So we believe that the dividend stream of NPL would be reflected in NML's profit & loss account, as it owns 63.2% holding of the company. As per our estimates, NML would start receiving dividend income from NPL by FY10, which would increase NML's FY10 bottom line by Rs1.7 per share. Going forward, in FY11 and FY12, income contribution from NPL is likely to stand at Rs1.32 and Rs1.4 per share, respectively. Net present value of the project for NML stands at Rs9 per share which, we believe, the market has failed to account for.

Trade Agreements – Another trigger for the top line

The recent talks between Pakistan and EU, with regards to a Free Trade Agreement (FTA) are another positive prospect for NML. According to the Finance Minister Shaukat Tarin, EU has given Pakistan a GSP plus (Generalized system of Preferences) status through which Pakistan's export will be available at preferential rates in the EU. Similarly, the US has also agreed to give market access to Pakistan's textile products with deliberations expected to be held soon to transform this understanding into a formal agreement.

According to the latest statistics available, EU accounts for approx. 27% of Pakistan's total exports, out of which more than 60% is contributed by the textile sector. We understand that present duties imposed on Pakistan's export to EU would immediately be zero rated once a formal agreement is reached, giving Pakistan an opportunity to compete against its regional rivals. Pakistan when compared to regional countries does not enjoy any preferential access to EU Market at the moment.

As a case study, we compare Bangladesh as a regional rival to Pakistan in international textile market. Bangladesh enjoys a special 'Everything but Arms' arrangement with EU under the GSP program. Since its addition to GSP, Bangladesh's total exports have risen significantly by US\$17bn, which only stood at US\$718mn in 1995. Keeping in mind how Bangladesh has risen as one of the biggest exporters of textile products to EU, Pakistan's inclusion into the program cannot be overemphasized. Currently, Bangladesh contributes 0.4% to the total imports by EU, compared to 0.2% from Pakistan. During the first cycle of GSP (1995-2004), where Pakistan enjoyed the preferential rates in the EU between 2001-2004, its exports increased by a 3 year CAGR of 16%. Hence, a GSP plus status would definitely bode well for the country as well as for NML given its export share of 85% in total revenue.

Graph 5: Pak Exports (US\$bn)

Source: FBS

Top line – Exports to stem up revenues

Despite deteriorating economic conditions in 3QFY09, NML posted net profits of Rs1.2bn (up 61%YoY) in its core operations owing primarily to company's export earnings in rupee terms. Resultantly, gross margins went up by 6% from 14% in the corresponding period last year. However, amid promising global economic recovery and approval of the Textile Policy (salient features to follow), we believe NML's export revenue to gain momentum going forward.

According to the policy framework, total textile exports of Pakistan are likely to increase by a CAGR of 21% by the end of FY14 giving an opportunity to big export houses like NML to increase their margins. As per our talks with the management, increasing export revenue would not be a major issue as they can cut back on their local sales to boost their export revenues. Pakistan's likely entry into the GSP plus club would support this move. If we look at NML's revenue stream, yarn contributes 25% to the local sales. We understand that the yarn, which NML sells in the local market at current price of between Rs60-70, could be sold in the international market at higher price (Rs135-140). During FY08, a total of 15.9mn kg of yarn was sold locally which at current prices (Rs70 as our base case) translate into revenues of Rs1.1bn. As a base case, we have taken the average price of yarn in the international market to be Rs130 per kg, compared to Rs158 per kg in FY08. If the whole amount of yarn is exported in the international market at Rs130 per kg it could augment NML's top line by an additional Rs954mn in revenues. This will have an earnings impact of Rs0.4-0.5 par share going forward.

However, NML can also make use of the zero ratings on machinery import to their advantage as well in order to increase their capacity, if required.

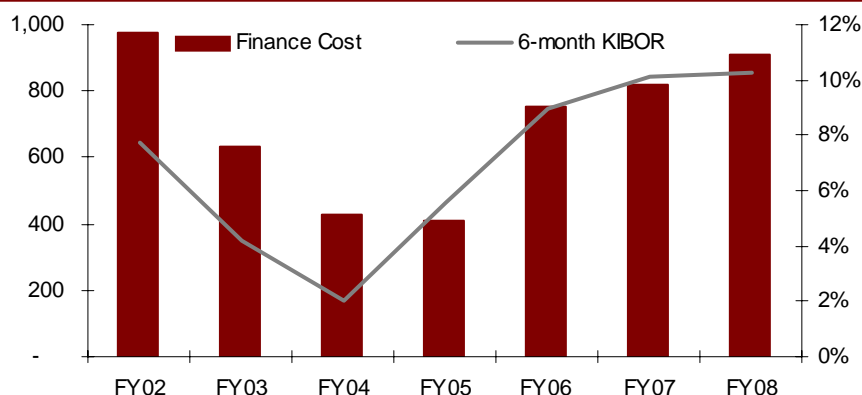
Table: Financial cost sensitivity

(EPS)	FY10F	FY11F
Down 100bps	0.31	0.32
Down 200bps	0.62	0.63

Source: JS Research

Declining interest rates

With debt to equity ratio of 63% (as of Mar 31, 2009), declining interest rates are set to rekindle the company's bottom line. 6-Month KIBOR has come down significantly to 12.4% from 15.7% since the start of the year. This declining trend, due to improved liquidity in the interbank bank, is set to improve NML's profits going forward. NML's reliance on short-term borrowings means that the company can benefit from a cut in interest rates. We have already witnessed a 200bps reduction in interest rate since the beginning of 2009 and are of the view that interest rates could come down by an additional 100bps by the year end. We believe, the improved liquidity is likely to bode well for the company.

Graph 6: Finance cost (Rs mn) versus 6-month KIBOR

Source: Company Accounts, JS Research

Textile Policy: What's on offer?

Amid ailing economic conditions in the international market coupled with intense competition from regional countries, Pakistan's textile exports dwindled in the last year, down 9.5% YoY. Hence, to boost textile exports, the first ever Textile Policy of Pakistan was finally approved by the cabinet on August 12, 2009. The new textile policy pledges on stemming Pakistan's exports by setting a US\$25bn export target in the next five years. In order to meet the targets set by the Ministry, the policy framework addressed some major issues - power & gas, finance costs, cost of production and providing the textile sector with modern technology and skills. Some of the major propellers for the textile sector are as follows:

- The export refinance would be available to 5% (previously 6%), for a period of 6 months.
- Textile sector would be exempted from power load shedding and will also enjoy priority in gas allocation as is given to the fertilizer sector.
- Long term loans will be converted on the same pricing as applicable to LTF scheme together with a grace period of one year on both existing and converted facilities, without the facility of refinancing.
- Value added textile exports have been compensated for a period of two years through provision of drawbacks to offset the costs imposed on the companies. Fabrics, home textiles and garments would be entitled to 1%, 2% and 3% drawback, respectively. Additionally, those who will achieve an incremental 15% exports, relative to last year would be given 1% additional drawback.
- Rs5.4bn has been allocated by the government in order to settle the past R&D claims.
- A new insurance scheme would be introduced in order to protect exporters against unforeseen losses, which may arise due to failure of the buyers, bank or problems faced by the buyer of the country.
- Local sales of yarn and fabrics to large exporters would be termed as deemed exports - 1% drawback on levies and unadjusted taxes on sales to the export houses would be given to small producers.
- Machinery imports will be zero rated to support new investments.
- A Technology Up-gradation Fund (TUF) would be set up in order to facilitate new investment and up-gradation of technology. Under this scheme, government will pick up 50% of interest cost of new investment in plant and machinery with a maximum of 5%. As for small investments, government will contribute up to 20% of the total capital cost.

As an export oriented business, the importance of this Textile Policy cannot be overemphasized for NML. Reduction in export refinancing by 100bps and conversion of long term loans into LTF scheme is likely reduce NML's finance costs and support its bottom line going forward.

Nishat Mills Limited

Year ended June (Rs mn)	FY07A	FY08A	FY09F	FY10F	FY11F
Income Statement					
Net sales	17,180	19,268	21,317	23,008	24,069
COGS	14,335	16,299	17,252	17,883	18,274
Gross profit	2,845	2,969	4,064	5,125	5,679
Operating Profit	1,596	1,608	2,393	3,299	3,668
Other income	671	5,807	599	905	1,046
Financial charges	819	907	1,246	1,685	1,630
PBT	1,356	6,397	1,624	2,357	2,550
Tax	145	258	217	235	246
PAT	1,211	6,139	1,406	2,122	2,645
Balance Sheet					
Issued, subscribed and paid-up capital	1,598	1,598	2,425	2,425	2,425
Reserves	28,566	23,549	20,680	21,880	23,080
Shareholder's Equity	30,164	25,147	23,104	24,304	25,504
Non current liabilities	1,774	1,048	1,403	1,322	1,100
Current Liabilities	7,649	11,722	13,320	14,330	14,069
Total Liabilities & Equity	39,587	37,917	37,830	39,958	40,675
Operating Fixed Assets	10,310	10,365	10,279	10,179	10,043
Other Assets	15,968	13,622	13,608	13,599	13,591
Total Current Assets	13,309	13,930	13,943	16,180	17,041
Total Assets	39,587	37,917	37,830	39,958	40,675
Ratio Analysis					
Valuation					
Earning per share	5.0	25.3	5.8	8.8	10.9
Dividend per share	2.5	2.5	1.0	1.3	2.0
Book value per share	163.3	156.4	156.0	164.8	167.7
Price to earning ratio (x)	12.8	16.4	7.7	5.1	4.1
Dividend yield (%)	5.6%	5.6%	2.2%	2.8%	4.4%
Price to book value (x)	0.5	0.7	0.5	0.4	0.4
Profitability					
Gross margin	16.6%	15.4%	19.1%	22.3%	23.6%
Operating margin	9.3%	8.3%	11.2%	14.3%	15.2%
Net margin	7.1%	5.6%	6.6%	9.2%	11.0%
Return on assets	3.1%	16.2%	3.7%	5.3%	6.5%
Return on equity	4.0%	24.4%	6.1%	8.7%	10.4%
Momentum					
Sales growth	4.6%	12.2%	10.6%	7.9%	4.6%
Net profit growth	11.1%	-10.9%	30.3%	50.9%	24.6%

Source: JS Research & Company Accounts

Company background

NML was established in 1951 under the umbrella of Nishat Group with five listed companies having concentration on four core businesses namely textile, cement, banking and power generation.

It is engaged mainly in the business of textile manufacturing and of spinning, weaving, processing, stitching and otherwise dealing of yarn, linen, cloth and other goods and fabric made from raw cotton, synthetic fiber and cloth.

NML today has 173,000 spindles, 284 Sulzer shuttle-less looms and 244 TSUDAKOMA air jet looms. NML also has the most modern textile-processing unit, 2 stitching units and Power Generating plant with a capacity of 33.6 MW. NML total export for the year 2000 was Rs. 9.1 billion (US\$143 million).

Key Management Personnel

Mr. Mian Mohammad Mansha - Group Chairman

Mian Mohammad Mansha is on the board of numerous companies in Pakistan and is one of the most powerful and influential persons in the country. He is the Chairman of the Nishat Group and was awarded the Sitara-e-Imtiaz civil award by President Musharraf in 2004.

Under Mr Mansha's guidance, Nishat group has demonstrated sound execution, stupendous growth and has turned into one of the premier business groups of Pakistan.

Mr. Mian Umer Mansha - CEO

He completed his education from Babson College, Boston, USA. Mr Umer Mansha is on the board of numerous big companies in Pakistan which include MCB Bank Adamjee Insurance and MCB Assent Management Company Limited. Moreover, he is also a member of the Business Council of Pakistan.

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ANALYST CERTIFICATION

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