Nishat Chunian Limited (NCL PA)

Gateway to Pakistan's Textile Export Potential

Initiating Coverage: BUY

Target Price: Rs21

Textile

March 2010

JS Global Capital Limited

We initiate our coverage on Nishat Chunian Limited (NCL) with a 'Buy' stance and a target price of Rs21 per share. The company's fundamentals appear to be strong as the government's focus has shifted towards increasing textile exports, reflective from the latest textile policy and continued efforts in acquiring Generalised System of Preference (GSP) plus status from the EU. Therefore, we expect NCL to achieve a 3-year (FY10-13) revenue CAGR of 11.7%. Resultantly, the stock outperformed the market by 79% since July 2009. Interestingly, even after the price surge, NCL is available at FY11F PBV of 0.6x which is at a deep discount of 55% to the market. Our optimism for NCL is also driven by the company's 57.8% equity investment in Nishat Chunian Power (NCPL) which is expected to provide a stable dividend stream post FY11. The key risks to our thesis are: (1) Delay in the commissioning of 200MW power plant & (2) Slowdown in the EU's economy, post economic fallout of Greece.

Recent initiatives reflect GoP's renewed focus on textiles

Since Pakistan's export meltdown in 2008, the government renewed its interest in the textile sector evident from its efforts to acquire greater market access in EU and the textile policy (Aug 2009). In the past six months, the government has made serious efforts to acquire a GSP plus status from the EU. The probability of achieving this status is very high as Pakistan was successful in negotiating a removal of anti dumping duty last year. The government also resumed drawbacks of 1%, 2%, and 3% on fabrics, home textiles and garments, respectively. These initiatives will augur well for export oriented entities like NCL.

NCPL to bolster earnings via steady dividend payouts

A major addition to NCL's business profile is the addition of a 200MW power plant (RFO) which is due to come online in June 2010. According to our estimates, this investment would contribute dividend income worth of Rs213mn (EPS impact of 1.54 per share) in FY13, ultimately reducing the company's earnings volatility, as 24% of the total income would comprise these dividends in FY13.

Focus on the value added segment to boost revenues

We expect NCL's top line to register a 3-year (FY10-13) CAGR of 11.7%, predominantly on the back of higher proportion of home textile exports. Given the hike in cotton prices, NCPL's sales were skewed towards yarn exports in 1HFY10, a trend which is likely to continue in the second half of FY10 as well. However, amid expectations of improved international cotton supplies and in turn comparatively low cotton prices in FY11, NCL is likely to focus more on the value added segment. This will also help contain pressure on margins.

Valuation: attractive upside of 14%

Using the FCFE methodology with a cost of equity (Ke) of 15.8% and terminal growth of 3%, our sum of the parts (SoTP) target price of NCL arrives at Rs21 per share. NCL's valuation share from core operations stands at Rs13 per share, whereas Rs8 per share is contributed by the power arm. Hence, we recommend 'Buy' on the scrip which currently trades at FY12F PE and FY11F PBV of 4.4x and 0.6x respectively, which is at a 30-55% discount to the market.

KATS Code:
NCL

Bloomberg Code:
NCL PA

Reuters Code:
NCHU.KA

Market Price:
Rs18.36

Market Cap:
Rs2.3bn
US$26.9mn

1-yr Avg. Daily Volume:
1.6mn shares
Rs30.7mn
US$0.4mn

1-yr High/Low:
Rs25.56/7.87

Estimated free float:
55.8mn shares (45%)

NCL - Key Statistics

	FY10E	FY11F	FY12F
EPS (Rs)	1.5	2.4	4.1
PE (x)	12.5	7.5	4.4
Div. yield (%)	5.4%	5.4%	6.8%
PBV (x)	0.6	0.6	0.6
ROE (%)	5%	9%	14%

Source: JS Research

Rabia Tariq
rabia.tariq@js.com
Analyst
92 (21) 111-574-111
(ext. 3119)

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Export meltdown & Government's rekindled focus

Since Pakistan's export meltdown in 2008, the government regenerated its interest in the textile sector; reflected through its initiatives to acquire further market access in the EU & releasing the first ever textile policy in Aug 2009.

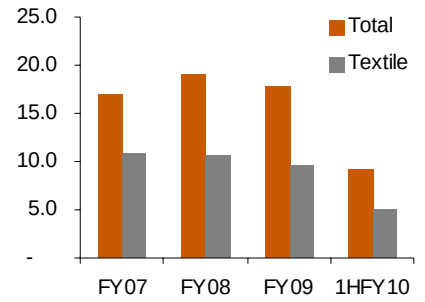
Textile Policy promises export growth

The textile industry in Pakistan has not been able to fully reap all the benefits of post the quota regime unlike other regional competitors like China, India and Bangladesh. Its share in exports significantly deteriorated from 66% in FY04 to 53.7% in FY09. Pakistan's maiden 5-year (2009-14) textile policy approved by the cabinet on August 12, 2009, was thus hailed enthusiastically by the stakeholders. It aims at addressing global challenges faced by the industry on a sustainable basis. The textile policy aspires to augment Pakistan's textile exports to US$25bn by 2014 through various incentives. Some of the key incentives are:

- Zero rating of textile exports and machinery imports
- Allocation of Rs5.4bn by the government to settle the past R&D claims
- Reduction in the refinance rate to 5% (previously 6%)
- Exemption from power load shedding and priority in gas allocation (similar to the fertilizer sector)
- A new insurance scheme to protect the exporters against any unforeseen losses
- Creation of textile investment support and up gradation fund (TUF)
- Government will bear 20% of the capital as a grant for new technology acquisition
- Duty drawback of 1%,2%,3% on fabrics, home textiles and garments, respectively
- 1% supplementary duty drawback on increase in exports by 15%
- Local sales of yarn and fabrics to large exporters to be termed as 'deemed exports' and 1% drawback on levies and unadjusted tax on sales from the export houses to be given to the small producers

As NCL is an export oriented entity and around 60% of its total sales comprise of export sales, the significance of this textile policy cannot be undermined.

Graph: Pakistan exports (US$bn)



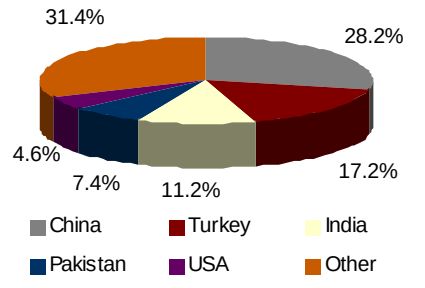
Source: FBS

Trade talks with EU

After a series of discussions, the EU at last broadly agreed to place Pakistan on the Generalised System of Preferences (GSP) plus category, which will enable it to export to the EU at preferential rates. According to the latest statistics available, Pakistan's textile has a 7.4% share in EU's total textile imports as compared to India with an 11.2% share (2008).

Our conviction regarding the GSP plus status is also driven by Pakistan's successful negotiation with EU in removing the anti dumping duty on bed linen exports in 2009. Pakistan's bed linen has a 29% market share (volume wise) in the EU market, which is substantially lower than pre removal of the WTO quota regime of 2004. We believe, the abolition of the anti dumping duty and Pakistan's likely entry in the GSP plus category will boost exports and help the country regain its lost world market share.

Graph: EU import partners

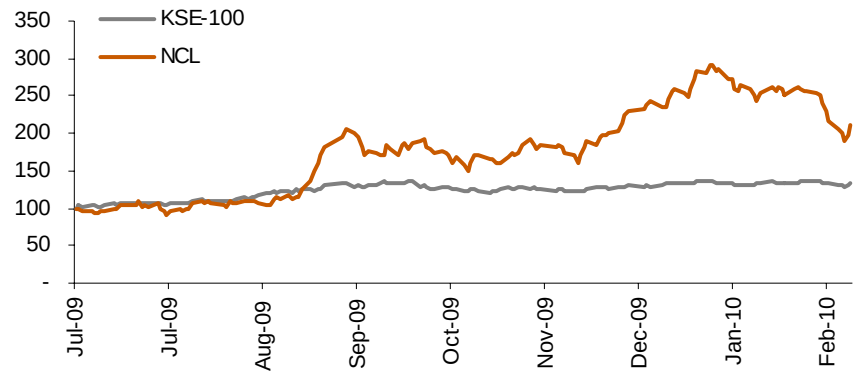


Source: Europa

Global cotton shortage boosts NCL profitability in 1HFY10

Due to the global cotton shortage, local cotton prices have surged 69% since July 2009 which has triggered prices for yarn. Being a major yarn producer, NCL has re-profiled its production chain and further bent towards yarn production. As a result, the company's topline rose by 33%YoY in 1HFY10. The improved outlook is also reflected from the company's share price, up 113% since July 2009. This along with the company's diversification into the power business will enhance its ability to generate stable income stream, going forward. Despite the above average price performance of NCL, we believe the stock offers a blanketed exposure to Pakistan's textile export potential. The scrip is available at FY11F PBV of 0.6x which is at a deep discount of 55% to the market.

Graph: Relative performance of NCL to KSE-100 index

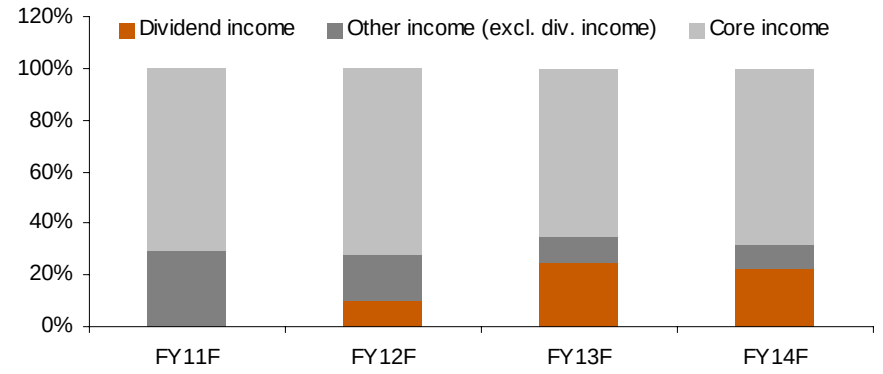


Source: KSE

NCPL's steady dividend payout to bolster earnings

One major addition to NCL's business profile is the addition of its power plant (NCPL) which is expected to come online in June 2010. NCL has a 58.7% equity stake in NCPL which is an RFO (Residual Furnace Oil) based IPP (Independent Power Producer) with a name plate capacity of 200MW and an estimated project cost of Rs18.4bn. 80% of the project is funded through debt and has an estimated project life of 25 years, while offering a 15% real IRR to the investors. According to our estimates, the project would commence dividend payment from the latter half of FY12, resultantly increasing NCL's other income by Rs52mn in FY12 (EPS impact of 0.37 per share). Going forward, we estimate the project to contribute Rs213mn and Rs233mn as other income to NCL in FY13 and FY14, which will ultimately improved the company's risk profile. The investment is likely to add Rs8 per share to NCL's valuation.

Graph: Share of Dividend & core income in NCL's profitability



Source: JS Research

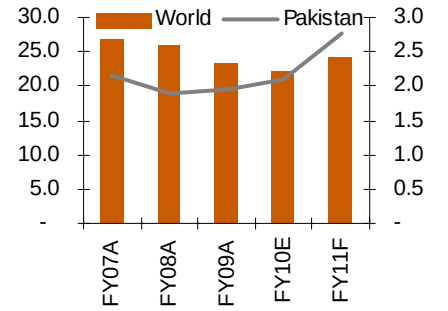
Focus on the value added segment to augment revenue

A hike in cotton prices and global production shortfall allowed local yarn and cotton manufacturers in Pakistan to achieve better prices in the international markets. Yarn exports have increased by 46%YoY to 425k MT during the first seven months of FY10. NCPL's sales were also skewed towards yarn exports in 1HFY10, a trend which is likely to continue in the second half of the year as well. However, amid improved international cotton supply and in turn low cotton prices in FY11, NCL is likely to focus more on the value added segment. This will also help contain the pressure on margins as competition escalates from Chinese exports. According to the ICAC (International Cotton Advisory Committee), world cotton production is expected to increase by 10% to 24.2mn tons in FY11.

Monetary easing to reduce financial burden

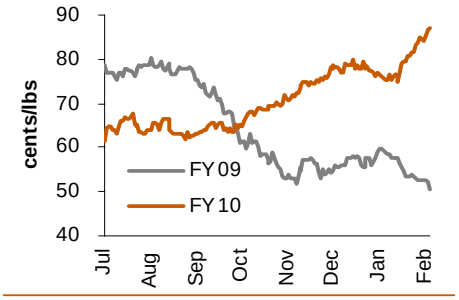
Our economist believes, interest rates have peaked out and are likely to come down, once liquidity from external sources starts flowing in the country. This should help ease the financial burden on NCL's books. The company incurred Rs1.1bn in interest cost last year. A 100bps decline in interest rates will save NCL Rs97mn (Refer to the sensitivity table). Additionally, Rupee depreciation of 6% has also helped the company to maintain its margins. We further expect Rupee to shed 2-3% on an annualized basis, going forward.

Graph: Cotton production(mn tons)



Source: ICAC

Graph: Cotlook 'A' Index



Source: Reuters, JS Research

Financial cost sensitivity

(New EPS)	FY11F	FY12F
Down 50bps	2.59	4.45
Down 100bps	2.75	4.42

Source: JS Research

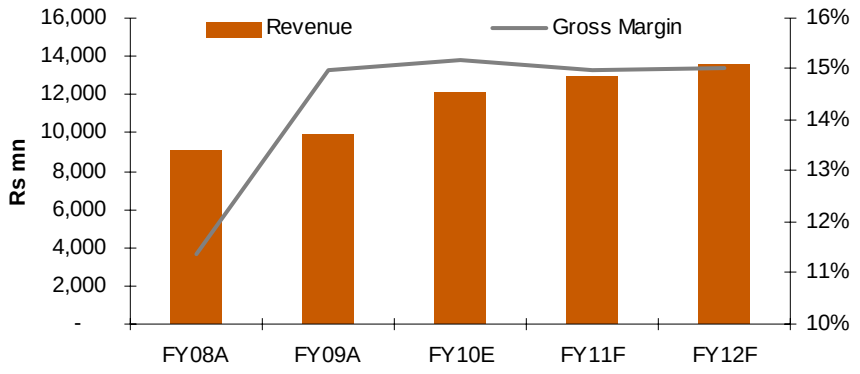
US$-PKR sensitivity on gross margins

US$-PKR parity	FY11F
90	15.7%
89	15.3%
Base case 88	**14.8%**
87	14.6%
86	14.2%

Source: JS Research

Compared to previous years, oil prices are likely to remain range bound on account of global recessionary woes. Therefore, we do not anticipate any substantial escalation in energy prices.

Graph: Revenues vs Gross margins



Source: JS Research & Company accounts

Valuation: attractive upside of 14%

Our SoTP based target price of Rs21 per share comprises of Rs13 from core operations and Rs8 contributed by company's investment in NCPL. We have valued company's core business on Free Cash Flow to Equity (FCFE) assuming 15.8% discount rate and 3% terminal growth rate. Whereas the investment in power business is being valued based on Dividend Discount Model (DDM) methodology as power generation companies tend to maintain healthy dividend stream throughout the project life. To arrive at this valuation, we have forecasted NCL's share in dividend income for the entire project life of 25 years with zero terminal value.

On the basis of PE multiple, the stock slightly expensive as it is trading at FY11F PE 7.5x. However, we believe this is not truly reflective of company's long term earnings potential as earnings from Nishat Power would start flowing in to NCL post FY11. Company's PBV seems attractive as the NCL is currently trading below its FY11F PBV of 0.6x.

SoTP valuation (Rs/share)

Core Business	13
NCPL	8
Total Value	21

Source: JS Research

Table: NCL Core Business FCFE

(Rs mn)	FY10E	FY11F	FY12F	FY13F	FY14F
PAT (Ex. NCPL Div.)	182	302	461	658	796
Depreciation	558	572	586	600	614
Working Cap	(20)	(142)	(95)	(95)	(90)
CAPEX	(953)	(18)	(268)	(268)	(268)
Debt repayment	(920)	(1,351)	(1,217)	(611)	(274)
Pref. Dividend	(62)	(62)	(62)	-	-
FCFE	(1,215)	(699)	(596)	285	779
Discounted Cashflow	(1,130)	(561)	(413)	170	402
Valuation					
PV of Cash Flows	(1,530)				
Terminal Value	3,102				
Total Present Value	1,571				
No of shares	124				
Core Business Value	13				

Source: JS Research

Assumptions

Risk Free Rate	11%
Premium	6%
Beta	0.8
Ke	15.8%

Source: JS Research, Bloomberg

Risks to our thesis

- **Delays in commissioning of Nishat Chunian power plant –** Our valuation & earnings projections for NCL is heavily dependent upon assumption that there will no be major delays in the commissioning of the 220 MW RFO based power plant. Any delays in commissioning of the plant significantly dilute earnings & in turn valuation of the company.
- **Slowdown in the EU post economic fallout out of Greece –** EU remains one of the key export markets for Pakistan (constitutes 27% of Pakistan's total exports out of which more than 60% are textile exports). Hence, any major fallout of the Greece debacle on the Economic Union could hamper future export orders for NCL.
- **Disruption in gas supply –** NCL relies on a gas based captive power plant to meet energy needs for the textile plants. Recent gas load shedding particularly during the winter season could pose risks for the company, though load management has now seized as demand has normalized in the Northern Areas.

About the Company

Nishat Group

Nishat Group is one of the most affluent and diversified group in South East Asia. It has fixed/current assets of over Rs300bn and it ranks amongst the top five business houses of Pakistan. The group has spread its operations in key sectors like textile, cement and financial services. Under its umbrella comes Adamjee and Security General, Nishat Mills, DG Khan cement, MCB bank, Phoneix Aviation and many more. It has a strong market share in each of the sector it operates in and is led by a highly experienced and professional management.

Nishat Chunian Limited (NCL)

NCL is a composite textile unit with expertise in spinning, weaving and home textiles. It has also diversified into the power business with a 57.8% equity stake in Nishat Chunian Power Limited (NCPL).Nishat Chunian Limited was incorporated in 1990 as a public limited company with an equity investment of Rs100mn. It started off as a spinning unit but now the company has expanded into a diversified composite unit comprising of spinning, weaving, dyeing, finishing and a printing unit which will be operational by next year. Presently; NCL operates with 150,000 spindles, 293 wider width looms, a dyeing and stitching plant and captive power plants with 41MW capacity. It has a monthly production capacity of 7.5mn lbs of yarn, 4.0mn yarns of greige fabric and 3.5mn yards/month of dying and finishing capacity with an equivalent stitching capacity.

Nishat Chunian Power Limited (NCPL)

NCL has also ventured into the power business by setting up Nishat Chunian Power Limited (NCPL) which has a gross capacity of 200MW. NCPL is a RFO (Residual Furnace Oil) based IPP (Independent Power Producer) with a negotiated project life of 25 years. NCL holds 55% equity take in NCPL and the total cost of the project is US$235mn.The expected commissioning date of NCPL is June 2010.

Appendix I: Income statement & Balance sheet

Year ended June (Rs mn)	FY08A	FY09A	FY10E	FY11F	FY12F
Income Statement					
Net sales	9,138	9,965	12,111	12,904	13,611
COGS	8,097	8,473	10,271	10,988	11,582
Gross profit	1,041	1,491	1,840	1,916	2,029
Operating profit	782	1,250	1,489	1,481	1,582
Other income	57	173	113	89	143
Financial charges	706	1,082	1,202	1,086	968
PBT	76	168	287	395	614
Tax	58	65	105	93	102
PAT	18	103	182	302	513
Balance Sheet					
Issued, subscribed and paid-up capital	752	1,241	1,654	1,654	1,654
Reserves	1,848	1,862	1,858	1,854	1,970
Shareholder's Equity	2,600	3,102	3,512	3,508	3,625
Non current liabilities	2,591	3,183	2,128	993	168
Current liabilities	5,647	5,731	6,833	7,402	7,731
Total Liabilities & Equity	10,838	12,017	12,473	11,903	11,524
Total Fixed Assets	6,480	7,370	7,516	7,213	6,896
Total Current Assets	4,358	4,647	4,991	4,895	5,020
Total Assets	10,838	12,016	12,506	12,107	11,915

Source: JS Research & Company accounts

Appendix II: Ratio Analysis

	FY08A	FY09A	FY10E	FY11F	FY12F
Valuation					
Diluted EPS (Rs)	0.15	0.83	1.47	2.44	4.13
Dilution with Preference shares (Rs)	0.11	0.62	1.10	1.83	3.10
Dividend yield (%)	0.0%	0.0%	5.4%	5.4%	6.8%
Book value per share (Rs)	21.0	25.0	28.3	28.3	29.2
Price to earning ratio (x)	NM	8.6	12.5	7.5	4.4
Price to book value (x)	1.0	0.3	0.6	0.6	0.6
Profitbility					
Gross margin	11%	15%	15%	15%	15%
Operated margin	9%	13%	12%	11%	12%
Pretax margin	1%	2%	2%	3%	5%
Net margin	0%	1%	2%	2%	4%
Return on assets	0%	1%	1%	2%	4%
Return on equity	1%	3%	5%	9%	14%
Momentum					
Sales growth	19%	9%	22%	7%	5%
Net profit growth	79%	468%	76%	66%	70%

Source: JS Research & Company accounts

Research Team

Muzzammil Aslam	Economy & Politics	(92-21) 111574111 (ext. 3035)	muzzammil.aslam@js.com
Farhan Rizvi, CFA	Banks, Strategy & Insurance	(92-21) 111574111 (ext. 3096)	farhan.rizvi@js.com
Umer Bin Ayaz	E&P, Refinery & Power	(92-21) 111574111 (ext. 3103)	umer.ayaz@js.com
Syed Atif Zafar	OMCs, Cement, Autos & Chemicals	(92-21) 111574111 (ext. 3118)	atif.zafar@js.com
Mustufa Bilwani	Banks, Telecom & Paper&Board	(92-21) 111574111 (ext. 3100)	mustufa.bilwani@js.com
Bilal Qamar	Fertilizer & Textile	(92-21) 111574111 (ext. 3099)	bilal.qamar@js.com
Sana Hanif	Chemicals	(92-21) 111574111 (ext. 3102)	sana.hanif@js.com
Rabia Tariq	Textile	(92-21) 111574111 (ext. 3119)	rabia.tariq@js.com
Raheel Ashraf	Technical Analyst	(92-21) 111574111 (ext. 3098)	raheel.ashraf@js.com
Adeel Jafri	Database Manager	(92-21) 111574111 (ext. 3098)	adeel.jafri@js.com
Angela Yousuf	Research Trainee	(92-21) 111574111 (ext. 3097)	angela.memon@js.com
Muhammad Furqan	Librarian	(92-21) 111574111 (ext. 3105)	muhammad.furqan@js.com

Equity Sales

Junaid Iqbal	(92-21) 32799511	junaid.iqbal@js.com
Atif Malik	(92-21) 32799513	atif.malik@js.com
Raza Abbas	(92-21) 32799563	raza.abbas@js.com
Faiza Naz	(92-21) 32799505	faiza.naz@js.com
Muzammil Mussani	(92-21) 32799508	muzammil.mussani@js.com
Sameer Danawala	(92-21) 32799569	sameer.danawala@js.com
Asim Ali	(92-21) 32799509	asim.ali@js.com
Samar Iqbal	(92-21) 32800152	samar.iqbal@js.com
Irfan Iqbal	(92-21) 32799502	irfan.iqbal@js.com
Ahmed Abdul Rauf	(92-21) 32799518	ahmed.rauf@js.com
Abdul Aziz	(92-21) 32799507	abdul.aziz@js.com
Irfan Ali	(92-21) 32462567	irfan.ali@js.com

Main Office

6th Floor, Faysal House,
Main Shahrah-e-Faisal
Karachi. Pakistan
Tele: 92-21-111-574-111
Fax: 92-21-32800163-66
Website: www.js.com

KSE Office

2nd Floor, Room No. 75,
Karachi Stock Exchange Building,
Stock Exchange Road, Karachi.
Tele: 92-21-32425692 (2427458)
Fax: 92-21-32418106

Lahore Office

307 – Upper Mall,
Lahore – 54000
Pakistan
Tele: 92-42-111-574-111
Fax: 92-42- 5789109

Islamabad Office

Chaudhary Plaza, 65 West,
Fazal-e-Haq Road, Blue Area
Islamabad, Pakistan.
Tele: 92-51-111-574-111
Fax: 92-51-2806328

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ANALYST CERTIFICATION

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

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