

Nishat Mills Limited (NML PA)

AES; another feather in the cap

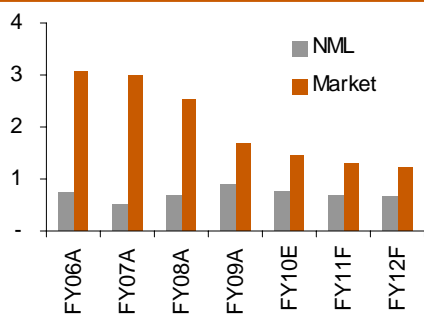
NML, these days is not short on positive news flow. After the recent commissioning of Nishat Power Limited (NPL) and announcement of the maiden Textile Policy by the government, the decision to invest in AES Lalpir (Pvt.) Limited and AES Pak Gen (Pvt.) Limited would be another ace in the pack for NML. The two projects with a cumulative capacity of 727MW would take the total capacity for the Group in excess of 1000MW, and provide NML with a more stable earnings stream, going forward. According to our estimates, investment in AES projects will have an incremental valuation impact of Rs13 per share after taking account of the cost of investment. Hence, we have revised our target price to Rs83 (Rs70 earlier) and upgraded our stance to 'Buy'. Rising cotton prices, a slowdown in export orders, any regulatory bottlenecks in the acquisition process and delays in the resolution of circular debt issue remain key risks to our thesis.

Valuation: 18% upside to target price of Rs83

The revision in our Sum-of-Parts target price is mainly premised on the fact, that the new acquisitions would add Rs13 per share to NML's valuation (taking account of cost of capital), translating into an 18% upside at current levels. The valuation share from NML's core business, stands at Rs40 whereas Rs30 per share is contributed by its already strong equity portfolio, comprising MCB and DG Khan. Though the scrip has performed admirably during the year (210% return year to date), the AES trigger is set to allow NML to continue posting healthy returns in the future.

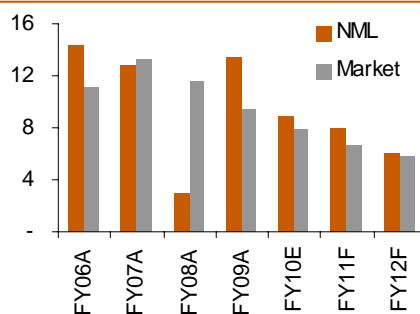
The stock is presently trading at a respective FY11F PE and PBV of 5.9x and 0.7x. Given our revised target price of Rs83 and a significant discount of 47% on PBV to the market, we upgrade our stance on the scrip to 'Buy'.

Graph: PBV (x)



Source: JS Research

Graph: PE (x)



Source: JS Research

Company Update: **BUY**

Target Price: **Rs83**

Textile Composite

December 2009



JS Global Capital Limited

KATS Code:
NML

Bloomberg Code:
NML PA

Reuters Code:
NISM.KA

Market Price:
Rs70.09

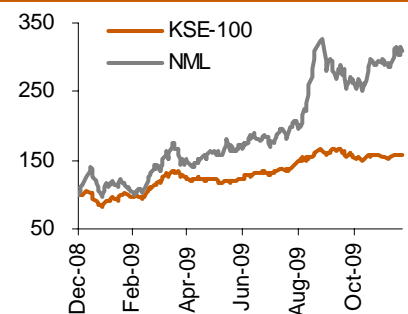
Market Cap:
Rs17.0bn
US\$201.4mn

1-yr Avg. Daily Volume:
4.1mn shares
Rs188mn
US\$2.2mn

1-yr High/Low:
Rs73.65/21.71

Estimated free float:
121.2mn shares (50%)

Graph: NML vs KSE



Source: JS Research

Acquisition to boost valuation by Rs13; Investment IRR of 25%

NML has announced plans to acquire shares of up to US\$60mn in AES Lalpir (Pvt.) Limited and AES Pak Gen (Pvt.) Ltd, as part of its diversification strategy in the power sector. AES Lalpir and AES Pak Gen are RFO based oil fired power plants with name-plate capacities of 362MW and 365MW, respectively.

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The two projects are governed by the Power Policy of 1994 and were set up with an investment of US\$700mn; 25% of the equity contributed by the sponsors.

Assuming equal investment in both projects, a US\$60mn (Rs5bn) equity stake implies approximately 46% share in each company. However, as per our discussions with the management, NML's share in the acquisition is likely to stand in the vicinity of 35%, translating into an acquisition cost of US\$45mn (Rs3.8bn). Based on the remaining project life of 18 years and indexation with the US CPI & Rupee/US\$ parity (2.5% & 3% annually, respectively), the investment is expected to offer an attractive IRR of ~25%. The Present Value (PV) of the cumulative dividend stream from the two projects is expected to stand slightly above Rs6.4bn

Using the sum-of-part valuation methodology, and valuing AES based on the PV of future cash flows, the investment is likely to add another Rs13 to our current fair value of Rs70. Thus, at the revised target price of Rs83, NML offers an attractive 18% upside to investors.

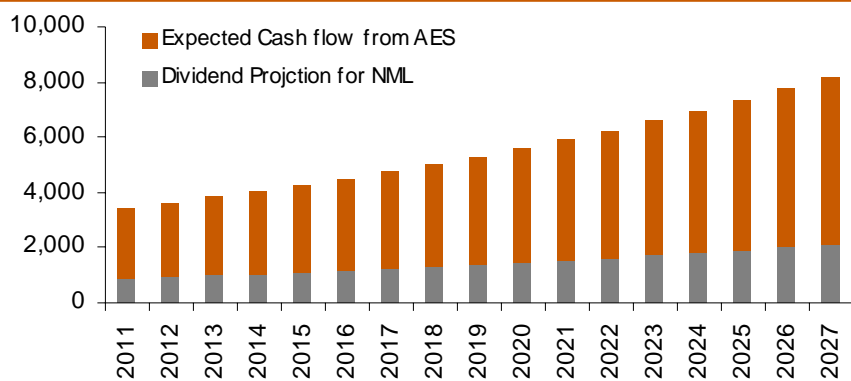
Project Funding: The key question

There has been some speculation in the market over the possible funding sources for NML to undertake this acquisition. Alternatives include leverage, partial disposal of investment portfolio & new equity. However, after yesterday's (December 23, 2009) notice at the exchange & our subsequent discussions with management, we rule out leveraging as an option for the proposed funding. Moreover, given the strategic nature of the investment portfolio, rights issuance in a combination with internally generated funds seems to be the most probable outcome. We expect the company to raise around Rs3.0-3.2bn via a rights issue, while Rs600-800mn is expected to be generated internally. Though, the possibility may not be appreciated by the day-traders, given the impressive investment IRR of 25% (versus required return of 17%), we believe the acquisition would add value to long term share holders.

Right shares: Base case at Rs45 per share

Taking cue from the recent rights issues and accounting for a positive long term outlook for NML, we opine that the company can comfortably announce a right issue in the range of Rs40-45 per share. Assuming Rs45 per share as our base case the company would issue 72mn right shares with a theoretical ex-right price of Rs65 (based on yesterday's price). In comparison, the rights adjusted target price of NML arrives at Rs76.

Graph: Cash flow projections from AES (Rs mn)

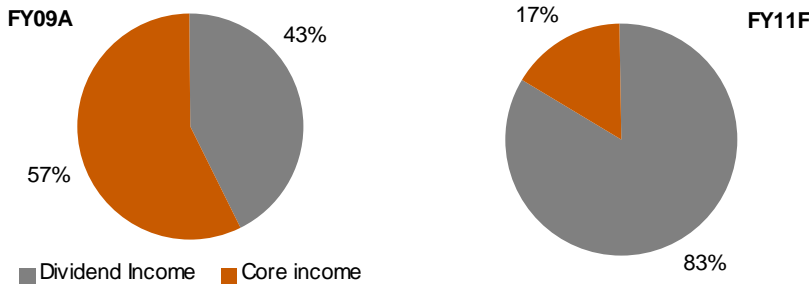


Source: JS Research

Dividend income to swell to Rs1.9bn in FY11

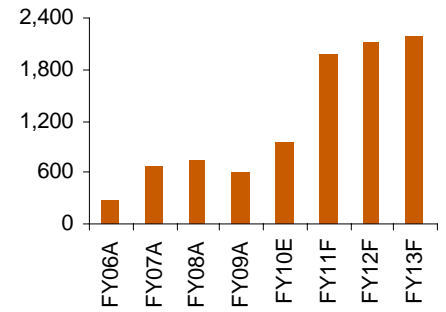
While dividend income has always occupied an important share in NML's earnings profile, the earnings' mix is expected to witness a massive change starting FY11, amid dividend flows from NPL and AES. According to our estimates, the dividend income will increase to Rs1.9bn in FY11 from Rs599mn in FY09, taking the share in the total earnings to 83% (refer to the pie chart). The swelling dividend stream will certainly reduce volatility in NML's earnings, going forward and will help NML to post a 3 year (2009-12) earnings CAGR of 42%.

Graph: Core vs dividend income



Source: JS Research

Graph: Dividend income (Rs mn)



Source: JS Research, FY08 excluding one time gain of MCB

Risks to our thesis

- As oppose to a shortage in the world cotton production, demand for local cotton and yarn in the international market is on the rise; hence, local cotton prices have shown an ascent (up 30% since July 09) during the current season. Since, local prices have a positive correlation with international prices, they have started to converge with the latter and we expect this trend to continue in the future.
- An improved global economic state of affairs have allowed textile exports to pick up pace in recent times, however, any slowdown in the process and/or increased regional competition, can prove to be hurdles for the growing top line of the company.
- Bottlenecks in the form of delays in the financing of the acquisition and regulatory issues can prove to be a hindrance. However, we rule out any such possibilities from materializing.
- The circular debt issue can hamper expected dividend payouts from Nishat Power and AES, post acquisition.

Year ended June (Rs mn)	FY08A	FY09A	FY10E	FY11F	FY12F
Income Statement					
Net sales	19,590	23,870	27,065	28,301	29,783
COGS	16,778	19,519	22,155	22,774	23,397
Gross profit	2,812	4,352	4,910	5,527	6,385
Operating Profit	1,372	2,601	2,981	3,405	4,061
Other income	5,808	599	947	1,885	2,026
Financial charges	951	1,447	1,598	1,900	1,915
PBT	6,119	1,562	2,176	3,181	3,922
Tax	261	294	276	289	304
PAT	5,858	1,268	1,900	2,893	3,618
Balance Sheet					
Issued, subscribed & paid-up capital	1,598	2,425	2,425	2,425	2,425
Reserves	24,894	16,906	26,906	28,606	30,306
Shareholder's Equity	26,492	19,331	29,331	31,031	32,731
Non current liabilities	1,731	2,580	2,269	1,958	1,647
Current Liabilities	12,054	9,602	11,751	11,090	11,293
Total Liabilities & Equity	40,277	31,513	43,351	44,078	45,670
Operating Fixed Assets	11,471	11,200	11,246	11,320	11,331
Other Assets	19,988	12,018	22,252	22,656	23,935
Total Current Assets	8,818	8,295	9,852	10,103	10,404
Total Assets	40,277	31,513	43,351	44,078	45,670
Ratio Analysis					
Valuation					
Eaming per share	24.2	5.2	7.8	11.9	14.9
Adjusted EPS	24.2	5.2	6.1	9.2	11.5
Dividend per share	2.5	2.0	2.5	3.8	4.8
Book value per share	109.3	79.7	121.0	128.0	135.0
Adjusted Book value	109.3	79.7	93.4	98.8	104.2
Price to earning ratio (x)	2.3	13.4	8.9	5.9	4.7
Dividend yield (%)	2.9%	2.9%	3.6%	5.4%	6.8%
Adj. Price to book value (x)	0.6	0.9	0.8	0.7	0.7
Profitability					
Gross margin	14.4%	18.2%	18.1%	19.5%	21.4%
Operating margin	7.0%	10.9%	11.0%	12.0%	13.6%
Net margin	4.1%	5.3%	7.0%	10.2%	12.1%
Return on assets	14.5%	4.0%	4.4%	6.6%	7.9%
Return on equity	22.1%	6.6%	6.5%	9.3%	11.1%
Momentum					
Sales growth	14.0%	21.9%	13.4%	4.6%	5.2%
Net profit growth	-35.8%	59.0%	49.9%	52.2%	25.1%

Source: JS Research & Company Accounts

*FY08 margins exclusive of other gain

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ANALYST CERTIFICATION

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