

Nitco Limited

Buy

Target price: Rs 70

Market data

Current price	Rs 29 (BSE)
Market cap	Rs 944 m
Face value	Rs 10.0
FY08 div./share	Rs 2.0
NSE symbol	NITCO
No of shares	32.1
Avg. 52-w liquidity	24,766
Free float	54.9%
52 week H/L	Rs 303/ 28

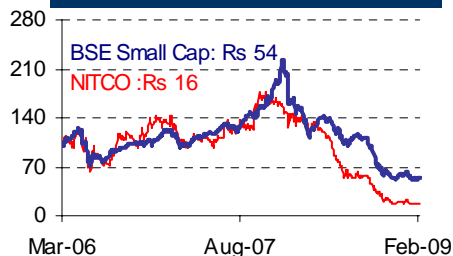
Stock Price Performance

	Nitco	Index*
6-Mths	-72.4%	-52.2%
1-Yr	-88.5%	-63.9%
2-Yr	-64.4%	-30.7%

Returns over 1 year are compounded annual averages (CAGR)

* BSE Smallcap

Rs 100 invested is worth



Shareholding (Dec-08)

Category	(%)
Promoters	45.2
Banks, FIs & MFs	6.7
FIIIs	27.9
Public	20.2
Total	100.0

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Buy tiles, get land free

At first glance you'd be surprised that we are recommending a company that is highly dependent on the real estate sector. But as you read on, you'll be even more surprised to see what hidden value the stock has.

If Benjamin Graham were alive today, he would have approved of this week's recommendation. He was very fond of stocks that were selling below their liquidation value (net current assets), could reasonably be expected not to squander these assets away and had shown a strong earning power in the past. Nitco is one such stock.

We can value the company in 2 segments: the tiles business and the real estate business.

The tile business: The standalone tile business can be valued conservatively on the basis of its trailing 12 months earnings at a multiple of 2x. The value of the segment on this basis comes to Rs 24 per share. Alternatively, it can be valued on a liquidation basis. We take the net current assets, subtract the land included under loans & advances and the debt on the books. By this method, the value of the segment comes to Rs 26 per share.

Value of the standalone tiles business: Alternative 1

Earnings basis	FY06	FY07	FY08	TTM
PAT (Rs m)	200	380	510	382
No. of shares (m)				32
EPS (Rs)	6	12	16	12
P/E multiple				2
Value per share (Rs)				24

Value of the standalone tiles business : Alternative 2

Net current assets basis (Rs m)	FY08
Net current assets	3,508
Less: Land incld in loans and advances	1,400
Less: Debt	1,281
Liquidation value	827
No. of shares (m)	32
Value per share (Rs)	26

The real estate business: The company has a substantial land bank on its books. Despite the current sluggishness in real estate activity, we believe that Mr. Market has given an ultra pessimistic value to the company's land bank, which is based in and around Mumbai. To be on the conservative side, we can value the land at its historical cost (as

opposed to fair market value). The value of the segment on this basis comes to Rs 44 per share.

Value of the real estate business

Value of the land	FY08
Land at historical cost (Rs m)	1,400
No. of shares (m)	32
Land per share (Rs)	44

The company's stock is currently quoting at Rs 29. The intrinsic worth of the business should be around Rs 26 + Rs 44 = Rs 70. Hence, the investor is paying only for the tile business and literally getting the real estate for free.

Investment Rationale

- **Replacement demand to act as the savior:** In our interaction with the management, we learnt that there is a time lag of around six months between a slowdown in construction activity and its impact on the demand for tiles. This is based on the fact that the demand for tiles comes towards the completion of a project. As realty projects have either slowed down or have been put on hold for quite some time, Nitco is feeling the heat. However, if we look at the company's 9mFY09 performance, the revenues from its tiles business have grown by almost 8% YoY as compared to the 9mFY08 numbers. At the bottom line level however, the company has taken a hit.

The company has been able to grow its revenues in the year till date, mainly on account of replacement demand. This is where the company's strong distribution chain comes in play. The company has over 5,000 distributors (including retailing outlets), out of which 700 are main distributors and the remaining are sub-distributors. The company also has over 130 sales and display counters in shops that offer tiles and other products. The company also sells its products through exclusive showrooms called 'Le Studio', which are either owned or run on a franchisee model. Nitco currently has setup nearly 20 such studios. In addition, another 20 stores are under implementation. It may be noted that the company sells nearly 50% of its products through distributors.

The company also caters to the institutional segment. These include large & small

commercial and residential builders. The company's clientele includes major construction businesses such as Hiranandani, Raheja, Pantaloon Retail, Godrej Properties, Oberoi Constructions, Keystone, Piyramals, Nirmal Lifestyle, Shruti, Runwal, RNA, DLF, Sobha Developers, Unitech etc.

- **Banking on land bank:** To participate in the 'booming' realty space, Nitco forayed into the sector during 2006. As we all are aware, the scenario has changed completely. However, the fact that Nitco entered late into the realty space gives it an advantage. The company has scaled down the number of projects from its initial plans, and is presently focusing on two projects, an industrial park at Thane and a residential tower (through an SPV in which it has a 20% stake) at Worli in Mumbai. The total area of these projects under development is about 0.5 million square feet (msqft). These projects are likely to be completed by 2010.

Nitco has acquired a substantial amount of land over the past few years. As of August 2007, the company had a land bank of about 35 acres with saleable area of around 1 msqft. This land bank includes properties in Kanjurmarg, Worli (both located in Mumbai), Thane and Alibaug (a coastal town 35 km south of Mumbai).

As per the company's balance sheet, the cost of land stands at about Rs 1.4 bn. You may be interested in knowing that in August 2007, Knight Frank, a leading estate agent, valued the company's properties at over Rs 4 bn. However, for valuation purpose, we have taken the historical cost of land, which is lower by 65% than the above-mentioned market value.

The real estate sector may not see signs of revival any time soon. However, on restoration it would only be a positive for the company.

Investment Concerns

- **Lack of recent information:** The balance sheet figures used for valuation are as of March 31, 2008. Ideally, latest balance sheet figures should be used as they are more reliable for assessing the current assets position. Due to the lack of information, we have relied on the last available balance sheet.
- **Realty effect:** Given the current slump in real estate activity and the grim outlook for the sector

in the immediate future, the earnings for the tiles business are likely to remain sluggish. To be on the safer side, we have been careful in not using peak historical earnings. We have also used a very conservative earnings multiple of 2X.

Key management personnel

- **Mr. Pran Nath Talwar, Chairman** started his industrial venture in 1956 by setting up a partnership firm Northern India Tiles Corporation (Delhi) for manufacturing mosaic tiles. He is a founder of Nitco Limited and has over 52 years of experience in the tile industry. In the year 1999 and 2000, he received an award from Institute of Trade and Industrial Development for excellence in Industrial performance.
- **Mr. Vivek Talwar, Managing Director** has over 28 years of experience in the tile industry. He joined the company as a director in 1980. He was involved in setting up the ceramic tiles facility at Alibaug and also in diversifying the company's business by foraying into new activities such as marketing of imported marble and vitrified tiles in India.

Background

Nitco Limited is one of the leading providers of flooring solutions in India. The company provides a diverse range of flooring solutions such as vitrified tiles (mainly used in commercial complexes), ceramic tiles (residential applications) and marble, amongst others. During the year 2006, the company made its foray into the real estate sector by setting up a 100% subsidiary named Nitco Realities Pvt. Ltd. (NRPL). The company also trades and distributes cement.

Nitco manufactures ceramic tiles at its facilities in Alibaug and Thane. The company currently has an annual production capacity of 6.3 m square meters. However, it outsources vitrified tiles from two tile producers in China. In addition, the company imports unprocessed marble from suppliers located in Italy, Spain, Greece, Portugal, Egypt, Oman and Turkey and processes it at facilities in Kanjurmarg and Silvassa.

During 9mFY09, the company earned nearly 21% of its revenues by selling ceramic tiles, 53% from the sales of vitrified tiles, about 18% from the marble segment and the balance from its cement and mosaic tiles business.

Like most real estate companies, NRPL's business model consists of special purpose vehicles (SPVs), in which it holds a 20% to 100% stake. An SPV is an entity created to execute single projects. This model allows the holding company to easily sell or transfer projects as a whole, if needed. In addition, there are certain tax benefits for the SPV which are lost if all projects are executed at the holding company level.

Land should appear as inventory in the financial statements of real estate companies. In Nitco's case, it appears under loans and advances. Nitco, the ultimate holding company has provided loans to NRPL. NRPL in turn holds stakes lower than 50% in several SPVs. It may be noted if a company holds less than 50% stake in a SPV, it will not be consolidated with its financial statement. Hence in Nitco's consolidated financial statement, the land bank appears under loans and advances. As and when the properties get developed, the value of the land will move out of loans and advances to inventories.

Industry Prospects

The size of the Indian ceramic tiles industry is around Rs 60 bn (about 4% of the global ceramic tile market) and consists of floor, wall and vitrified tiles. The industry has been growing at a pace of around 15% per annum in the past few years. However, growth is likely to slow down over the next few years. The key driver for the ceramic tiles business in India is the buoyancy in housing sector. With a slowdown in realty activities, the demand for flooring products will also slow down. As such, the sector largely depends on replacement demand as a backup option.

The industry enjoys the unique distinction of being highly indigenous with an abundance of raw materials, technical skills and infrastructure facilities, despite being fairly capital intensive. The per capita consumption of ceramic tiles in India currently stands at 0.30 sq m per person, much lower in comparison to over 2 to 2.5 sq m per person for countries like China, Brazil and Malaysia. The ceramic tiles industry in India has followed international trends, which have been characterised by increasing competition, pressure on realisations and consequently, falling margins. China has emerged as a major competitor, especially in the vitrified tile segment. In addition, nearly 55% of the industry sales are contributed by the unorganised players, which provide ample scope for large, organised players such as Nitco.

Risk Analysis

Please refer to the Risk Matrix on page 7 of this report

Sector: On account of the downturn in the realty sector, the incremental demand for ceramic tiles has declined considerably. With new property developments taking place on a slow pace, the industry has to bank on replacement demand to drive its growth. In addition, companies are following international trends, as seen from increasing competition, pressure on realisations and consequently falling margins. In addition, the fact that China has emerged as a major competitor, especially in the vitrified tile segment, is a cause for concern. Based on these factors, we have assigned a 'high' risk rating to the sector.

Company standing: Revenue wise, Nitco is the second largest organised tile player in India. With a strong presence in high end products and strong focus on product innovation the company enjoys higher margins as compared to its peers. While Nitco is likely to retain its advantage going forward, competition can be expected from the well established domestic players, the unorganised segment and emerging international players. Keeping this in mind we assign a 'medium' risk rating to the company.

Sales: Nitco's has earned average revenues of US\$ 84 m during the past four years (FY05 to FY08). The company's sales in FY08 stood at nearly US\$ 133 m. However, going forward we expect the company's revenues to remain flat over the next four years. However, based on the size of sales, we assign a low-risk rating of 9 to the stock on this parameter.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. Nitco's average operating margins for the past five years has been 13.6%. However, we expect the same to decline to levels of 10.2% on an average over the next few years. We assign a medium risk rating of 5 to the stock on this parameter.

Long term EPS growth: Nitco has grown its net profits at a compounded annual growth rate (CAGR) of 75.8% over the past four years. This has mainly been due to robust topline growth and a steady expansion in operating margins. However, going forward we expect the company's profits to decline by around 9% per year on an average. The rating assigned to the stock on this parameter is 1.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering Nitco's last five years' average ROIC of 8.8%, we have assigned a high-risk rating of 1 to the stock on this parameter.

Dividend payout: Stable dividend history inspires confidence in the management's intentions of rewarding shareholders. However, small companies who are in constant requirement of capital to fund growth generally pay out less as dividend. Nitco's average payout over the past three years has been around 14%. Given this, we assign a high risk rating of 3 to the stock on this parameter.

Promoter holding: A larger share of promoter holding indicates the confidence of people who run it, especially in case of small companies that lie low in terms of visibility. We believe that more than 50% promoter holding indicates safety for investors. At the end of December 2008, the promoter holding in Nitco stood at 45%. We have assigned a rating of 5 to the stock on this parameter.

FII holding: We believe that FII holding of greater than 20% can lead to high volatility in the stock price. At the end of December 2008, FII holding in Nitco stood at around 27.9%. We have assigned a high risk rating of 1 to the stock on this parameter.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. Considering PIL's five year average interest coverage ratio of 10.1, we have assigned a rating of 8 to the stock on this parameter.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share

relative to the per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. The stock of Nitco is currently trading at a multiple of about 2.2 times its trailing twelve months earnings. We have assigned a low risk rating of 10 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 63 that, on a weighted basis, stands at 5.7. This makes the stock a medium-risk investment among its small cap peers from a long-term perspective.

Valuations

The stock of Nitco has been beaten black and blue over the past year, declining by 90% from its 52-week high price. For the standalone tile business, whose prospects are tied to the real estate sector, the pessimism is understandable. Still, the stock is attractively valued at a multiple of just over two times, given that the company is among the leading players in its industry.

What comes in as the bonus is the company's landbank. We have valued the company in two portions – the tile business and the real estate development business. The value of the standalone tile business, on a net liquidation basis (net current assets minus the cost of land included under loans & advances minus debt), comes to Rs 26 per share. Further, we can value the real estate business by taking the land at its historical cost (as opposed to fair market value) to be on the conservative side. The value per share on this basis comes to Rs 44 per share. Thus by adding the two figures, we get a price of Rs 70 per share. Hence, we recommend a 'BUY' on the stock with a target of Rs 70 based on its intrinsic value. It may be noted that we have not included the value of investments and fixed assets on the company's books.

Standalone valuations at a glance

(Rs m)	FY08	FY09E	FY10E	FY11E	FY12E
Net sales (Rs m)	6,375	6,056	5,753	5,753	6,041
Net profit (Rs m)	516	304	192	280	355
No. of shares (m)	32.1	32.1	32.1	32.1	32.1
Diluted EPS (Rs)	16.1	9.5	6.0	8.7	11.1
Price to earnings (x)	1.8	3.1	4.9	3.4	2.7
Price to sales (x)	0.1	0.2	0.2	0.2	0.2
Price to book value (x)	0.2	0.1	0.1	0.1	0.1

Risk Matrix

Rating	Weightage* (A)	Ratings accorded	
		Rating# (B)	Weighted (A*B)
Sector risk		Low	
Company's standing		Medium	
Performance parameters			
Sales	5.0%	9	0.5
Operating margins	5.0%	5	0.3
Long term EPS growth	10.0%	1	0.1
Return on invested capital	10.0%	1	0.1
Technical parameters			
Dividend payout	5.0%	3	0.2
Promoter holding	10.0%	5	0.5
FII holding	5.0%	1	0.1
Liquidity	10.0%	5	0.5
Safety parameters			
Current ratio	5.0%	10	0.5
Debt to equity ratio	10.0%	8	0.8
Interest coverage ratio	5.0%	5	0.3
P/E ratio	20.0%	10	2.0
Final Rating**		63	5.7

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk. * 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be one of the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Standalone financials at a Glance

(Rs m)	FY08	FY09E	FY10E	FY11E	FY12E
Sales	6,375	6,056	5,753	5,753	6,041
Sales growth (%)	38.8	(5.0)	(5.0)	0.0	5.0
Operating profit	829	677	482	587	668
Operating profit margin (%)	13.0	11.2	8.4	10.2	11.1
Net profit	516	304	192	280	355
Net profit margin (%)	8.1	5.0	3.3	4.9	5.9
No. of shares (m)	32.1	32.1	32.1	32.1	32.1
Diluted EPS (Rs)	16.1	9.5	6.0	8.7	11.1

Balance Sheet

Net fixed assets	2,529	2,510	2,483	2,447	2,402
Current assets	5,168	6,481	7,954	9,757	11,955
Investments	321	321	321	321	321
Total assets	8,017	9,312	10,758	12,525	14,678
Current liabilities	1,767	1,693	1,620	1,629	1,714
Net worth	4,969	6,337	7,857	9,615	11,682
Total debt	1,281	1,281	1,281	1,281	1,281
Total liabilities	8,017	9,312	10,758	12,525	14,678

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