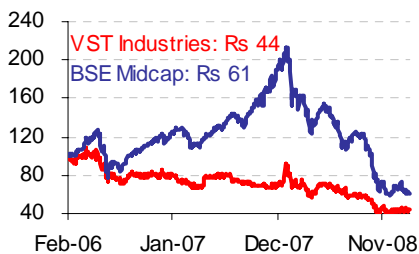


Market data

| | |
|---------------|--------------|
| Current price | Rs 213 (BSE) |
| Market cap | Rs 3,318 m |
| NSE symbol | VSTIND |
| BSE code | 509966 |
| No of shares | 15 m |
| Free float | 67.8% |
| Face value | Rs 10.0 |
| FY08 DPS (Rs) | Rs 20.0 |
| 52 week H/L | Rs 380/183 |

Rs 100 invested is now worth



Stock price performance

| | VST Industries | Index* |
|-------|----------------|--------|
| 6-Mth | -26.1% | -48.7% |
| 1-Yr | -41.5% | -62.7% |
| 3-Yr | -23.9% | -15.2% |

Returns over 1 year are compounded annual averages (CAGR)

* BSE Midcap index

Shareholding (Dec-08)

| Category | (%) |
|-------------------|--------|
| Promoters | 32.2% |
| FII's | 0.0% |
| Banks, MFs & FI's | 11.4% |
| Public | 14.3% |
| Others | 42.2% |
| Total | 100.0% |

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VST Industries

Buy

Target price: Rs 355

Investment Rationale

- **Even Graham would be proud:** VST Industries, our mid cap recommendation this fortnight, is one stock that even the father of value investing would be proud of. Although Benjamin Graham has talked of several techniques of zeroing in on a low priced stock, the one that fits VST Industries to the proverbial tee is the 'Debt Capacity Bargain' technique. As per this method, if the market cap of a debt free company is less than the amount of debt that the company can comfortably service, then the stock of the company makes for an attractive investment.

Does VST pass this test? Let us try and find out. Taking into account the company's average profit before tax (PBT) between FY06 and FY08 of Rs 942 m and an interest coverage ratio of 3 times, VST would be in a position to comfortably service debt to the tune of Rs 3.5 bn carrying an interest rate of 9%, which given the direction where interest rates are headed, makes for a decent enough yield. Furthermore, given the stability of the company's business model, the odds are high that the PBT would be sustained if not overtaken. Thus, taking into account the debt of Rs 3.5 bn that the company can service and its current market cap of Rs 3.3 bn, we can safely conclude that the risk reward ratio of investing in the company at the current juncture is in favour of the investor.

- **Strong portfolio of products:** VST has emerged as a strong number three of the organised cigarettes industry in India. Besides, the company has also been successful in reorienting its business model towards filter cigarettes so much so that more than 90% of the revenues now come from the filter cigarettes category as opposed to 45% in FY05 and 33% in 1998. In fact, the shift in filter cigarettes could not have come at a better time.

In the FY09 Union Budget, the government brought into effect an unprecedented increase in the excise duties on non-filter cigarettes, VST's revenues mainstay not many years back. Thus, had it not been for the company's increased focus towards filter cigarettes, the company might have had to incur huge losses in revenues on account of shift in consumer preferences towards filter cigarettes as the price gap between filter and non-filter would have narrowed considerably. But now with the company having a well entrenched position in filter cigarettes in select regions, the impact of large scale consumer shift towards filters is likely to be a lot less muted. We expect the company's net sales to grow at a CAGR of 7% between FY08 and FY11.

Get paid till the time value is unlocked: Income from equity investments accrues to an investor in two ways, in the form of dividends and through the appreciation of the company's share price. Since the company's share price can remain low for a long stretch of time and that too, for various reasons other than fundamental,

the greater the income that comes in the form of dividends, the better it is. This is because till the time the market comes to its senses and unlocks the value in a company's share price, one can atleast be assured of a steady stream of dividends. VST is one company where investors will not mind much even if it takes years for the share price of the company to advance meaningfully. In fact, very few people would indeed mind if one is getting a return of as high as 9% by way of dividends alone. Yes, this is the dividend yield the company's stock price is trading currently at. Thus, even if the company were to cut its dividends by 25%, yield would still be attractive, making the stock an attractive investment proposition.

- **Enough cash to keep litigators at bay:** At the end of FY08, the company had as much as Rs 2.3 bn worth of cash and investments sitting pretty on its balance sheet. While uninformed investors may balk at such a number, it should be noted that the company operates in an industry where the risk of litigation is on the higher side. Furthermore, the company also has a few tax dispute cases against it pending in the courts of law. Thus, the big cash cushion that the company has in its possession will enable it to fork out penalties if required without having any adverse impact on its day to day operations.
- **Management's renewed focus:** Having burned its fingers in unrelated businesses like foods and realty, the management is now firmly committed towards growing its cigarettes business. The new found seriousness can be gauged from its efforts at pulling the business out of troubled waters after the company lost market share in 2001-02 on account mass customer migration to filter cigarettes. It has never looked back since then and has in fact doled out pretty large dividends. Thus, the event does go a long way in ensuring that the management of the company is indeed serious this time around and will not indulge in acts of wealth destruction by going into uncharted waters.

Investment Concerns

- **Increasing competition:** Cigarettes business has high price inelasticity. VST has been able to pass on the burden of high taxes through price hikes in the past. However, in the recent Union budget, government increased the excise duty on non-filter cigarettes, thus making non-filter business an unviable business proposition.

However, the opportunity to convert the remaining 86% of the tobacco consumers (around 48% is in the form of chewing tobacco, 38% as bidis) into cigarette users will be difficult as the gap between bidi and filter cigarettes is substantial (about 10 times).

Further with non-filter cigarettes becoming unviable, smuggled and tax-evaded cigarettes, as per the company, are capturing its market. It claimed that consequent to the 30% equivalent increase in tax rates on cigarettes during the year the volume of these illegal products has doubled from around 150 m per month to nearly 300 m. Also over the last few months, several contraband low cost filter cigarette brands have witnessed a rapid volume growth and now account for around 5% of industry volumes. According to industry estimates, cigarette grey market has grown by over 25% to Rs 18 bn in the last six months alone as against Rs 14 bn last year. These contraband cigarettes could pose a significant threat to the company's market share and hence, its profitability in the coming years.

- **Government's favourite whipping boy:** The government has become very aggressive in targeting the tobacco consumption, specially smoking. It also raised the taxes on the non-filter cigarettes to bring it on par with the filter cigarettes. Post the price increases, non-viability of the non-filtered segment has forced major cigarettes manufacturers like VST to withdraw from non-filter segments. Increasing taxes, ban of smoking in public place and pictorial warnings would further hurt the long-term growth prospects of the company.
- **Higher tobacco prices:** The average price of the premier grade used for cigarette making, flue cured virginia (FCV), has risen to Rs 85 per kg from Rs 47 a year ago. The global shortfall in tobacco output has boosted demand for the Indian leaf, pushing up prices in the domestic market to new records, thus hurting Indian cigarette makers. Although we have factored in the impact of higher raw material prices by assuming lower operating margins, any further jump in prices could result in margins coming even lower than our estimates.

Management Team

Mr. Raymond Noronha, MD, is a BA (Hons) from St. Stephen's College Delhi and attended the

Wharton Advanced Management Program at Philadelphia, US. He has had over 34 years of varied experience in the cigarette business both international and domestic and has held several top level positions for over a decade.

Mr. Sai Sankar N, B.Com (Hons), ACA, AICWA and ACS, serves as the Finance Director and the Secretary of the company. He is 49 years old and has over 26 years of experience in the industry.

Background

VST, incorporated in 1930, is one of India's largest tobacco companies. The company began its operations under the name of Vazir Sultan and Sons, which was eventually changed to VST in 1984. British American Tobacco, popularly known as BAT owns a significant 32% stake in the company. With manufacturing facilities based in Hyderabad, the company's profitability in the past was significantly affected due to presence in non core industries. However, the management has got its act together in recent times and a renewed focus on its core business of tobacco has seen the company report impressive financials in the past few years.

Comparative valuation

| Parameter (FY10E) | VST Industries | I.T.C. Ltd |
|-------------------------|----------------|------------|
| EBDITA margin (%) | 22.0 | 30.9 |
| Net margin (%) | 16.3 | 20.0 |
| Return on equity (%) | 22.8 | 22.1 |
| Debt to Equity ratio | 0.0 | 0.2 |
| Valuation ratios | | |
| Price (Rs) | 213 | 180.0 |
| Price to earnings (x) | 5.0 | 18.0 |
| Price to book (x) | 1.1 | 4.0 |
| Price to cash flow (x) | 4.2 | 14.5 |

Industry Prospects

The Indian tobacco industry is unlike most other countries. In spite of being the second largest producer of tobacco in the world after China, India holds a meager 0.7% share of the US\$ 30 bn global trade in tobacco, with cigarettes accounting for 85% of the country's total tobacco exports.

Chewing tobacco has been a tradition in India for centuries. Of the total amount of tobacco produced in the country, around 48% is in the form of chewing tobacco, 38% as bidis, and only 14% as cigarettes.

Thus, bidis, snuff and chewing tobacco (such as gutka, khaini and zarda) form the bulk (86%) of India's total tobacco production. In the rest of the world, production of cigarettes is 90% of total production of tobacco related products.

Per capita consumption of cigarettes in India is merely a tenth of the world average. This unique tobacco consumption pattern is a combination of tradition and more importantly, the tax imposed on cigarettes over the last 2 decades. Cigarette smokers pay almost 85% of the total tax revenues generated from tobacco. In India, three major cigarette players dominate the market, ITC with 72% market share, Godfrey Phillips with 13% and VST with 8% share of the market.

Risk Analysis

Note: See the 'Risk Matrix' table on the page 5

Sector: Although the growth in industry volumes is on the lower side, pricing power and stability in revenues does exist on account of the stickiness of the consumer. Hence, we assign a medium risk to the stock on this parameter.

Company standing: With VST Industries having a strong market share in most of the segments that it is present in, we assign a 'strong' rating to the company on this parameter.

Sales: VST Industries generated revenues to the tune of nearly Rs 3.4 bn (US\$ 69 m) in FY08. Further, the company is expected to generate average revenues to the tune of Rs 4 bn over the next three years. We thus assign a medium risk rating of 5 to the stock on this parameter.

Operating margins: 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. VST Industries' average operating margins for the past five years has been 26%, which we expect to go down to 22% during the next three years. As such, we assign a low risk rating of 8 to the stock on this parameter.

Long-term EPS growth: We expect the company's net profit to grow at a CAGR of 5% between FY08 to FY11. In a normal scenario, we consider a compounded growth of over 20% in net profits over

a period of 3 to 5 years as healthy for a company. As such, the rating assigned to the stock on this factor is 1.

Return on invested capital: 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 the fact that VST Industries operates on a negative working capital cycle and has very low capex needs, the rating assigned to the company on this parameter is 10.

Dividend payout: VST Industries has had an average dividend payout of 44% over the last 5 years, which we expect to go up to 50% over the next three on account of its robust cash flows. The rating assigned on this parameter is 10.

Promoter holding: A larger share of promoter holding indicates the confidence of people who run the company. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of December 2008, the promoter holding in VST Industries stood at 32%. We have assigned a risk rating of 2 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. At the end of December 2008, there was no FII holding in the company and hence, the rating assigned is 10.

Liquidity: The past 52-week's average daily volume of the stock is in the range of 1,586 shares, which indicates that the stock has inadequate liquidity. The rating assigned is thus 1.

Current ratio: VST Industries average current ratio during the period FY09 to FY11 is estimated to be around 0.6 times. However, it should be noted that the company has significant liquid investments, which can take care of any short term liquidity problems. We thus assign a low-risk rating of 9 to the stock.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering VST Industries' debt free status, which we expect to continue in the future

as well, we have assigned it a risk rating of 10 on this parameter.

Interest coverage ratio: This ratio 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. VST Industries does not pay interest as it has no debt on its books. Thus, the rating assigned to the stock on this parameter is 10.

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. VST Industries' P/E on its earnings of the past four quarters currently stands at 6 times, which makes the stock highly attractive on a valuation basis. As such, we have assigned a low risk rating of 9 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 85 that, on a weighted basis, stands at 6.8. This makes the stock a medium-risk investment from a long-term perspective.

Valuations

At the current price of Rs 213, VST Industries is trading at a rather attractive multiple of 4.8 times our estimated FY11 earnings per share. VST operates in a concentrated industry. Furthermore, the industry has high entry barriers in the sense that it will take much longer for a new entrant to register its brand in the mind of consumers on account of severely restricted modes of advertising or publicities. This is indeed a boon for entrenched players like VST. Thus, taking into account these factors and also the company's strong balance sheet and its high return ratios, we believe that a company like VST should deserve a P/E multiple of at least 10 times.

However, in order to impart some margin of safety, we assign the company a multiple of 8 times. This gives us a target price of Rs 355, implying a compounded return of 26% from an FY11 perspective. On a point-to-point basis, the return translates into a healthy 65% over the current price. It should be noted that the expected returns do not take into account the strong dividend payout, which can easily add another 7% to 8% to the expected

returns if the company continues to reward shareholders. In light of these factors, we recommend a 'BUY' on the stock.

Valuations

| Standalone (Rs m) | FY08 | FY09E | FY10E | FY11E |
|------------------------|-------|-------|-------|-------|
| Revenue (Rs m) | 3,400 | 3,805 | 3,995 | 4,195 |
| PAT (Rs m) | 596 | 672 | 653 | 686 |
| EPS (Rs) | 38.6 | 43.5 | 42.3 | 44.4 |
| CEPS (Rs) | 47.5 | 51.0 | 50.6 | 53.7 |
| Price to earnings (x) | 5.5 | 4.9 | 5.0 | 4.8 |
| Price to cash flow (x) | 4.5 | 4.2 | 4.2 | 4.0 |

Risk Matrix

| Rating | Weightage* (A) | Rating accorded | |
|-------------------------------|----------------|-----------------|----------------|
| | | Rating# (B) | Weighted (A*B) |
| Sector Risk | - | Medium | NA |
| Company | - | Strong | NA |
| Performance parameters | | | |
| Sales | 5.0% | 5 | 0.3 |
| Operating margins | 5.0% | 8 | 0.4 |
| Long term EPS growth | 10.0% | 1 | 0.1 |
| Return on invested capital | 10.0% | 10 | 1.0 |
| Technical parameters | | | |
| Dividend payout | 5.0% | 10 | 0.5 |
| Promoter holding | 10.0% | 2 | 0.2 |
| FII holding | 5.0% | 10 | 0.5 |
| Liquidity | 10.0% | 1 | 0.1 |
| Safety parameters | | | |
| Current ratio | 5.0% | 9 | 0.5 |
| Debt to equity ratio | 10.0% | 10 | 1.0 |
| Interest coverage ratio | 5.0% | 10 | 0.5 |
| P/E ratio | 20.0% | 9 | 1.8 |
| Final Rating** | | 85 | 6.8 |

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 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

Financials at a glance

| Standalone (Rs m) | FY08 | FY09E | FY10E | FY11E |
|-----------------------------|--------------|--------------|--------------|--------------|
| Sales | 3,400 | 3,805 | 3,995 | 4,195 |
| Sales growth (%) | 1.1% | 11.9% | 5.0% | 5.0% |
| Operating profit | 840 | 837 | 879 | 923 |
| Operating profit margin (%) | 24.7% | 22.0% | 22.0% | 22.0% |
| Net profit | 596 | 672 | 653 | 686 |
| Net profit margin (%) | 17.5% | 17.7% | 16.3% | 16.4% |
| Balance Sheet | | | | |
| Current assets | 982 | 1,481 | 1,687 | 1,913 |
| Fixed assets | 1,217 | 1,407 | 1,598 | 1,789 |
| Investments | 2,233 | 2,233 | 2,233 | 2,233 |
| Total Assets | 4,433 | 5,121 | 5,518 | 5,935 |
| Current liabilities | 2,114 | 2,523 | 2,649 | 2,781 |
| Net worth | 2,319 | 2,598 | 2,869 | 3,154 |
| Total liabilities | 4,433 | 5,121 | 5,518 | 5,935 |

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