LKP Bytes

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S.P. Apparels

Industry: Textiles

S.P. Apparels (SPAL) is a leading manufacturer & exporter of knitted garments for infants & children in India with an extensive product range of body suits, sleep suits, tops & bottoms. It generates more than 80 % of its top-line through export of knitted garments to big brand retailers of repute such as TESCO, Primark, ASDA & Mothercare. The company also manufactures & retails menswear garments in India under the brand *Crocodile*. Both childrenswear & menswear are manufactured at its 21 integrated facilities, allowing it to undertake end-to-end garment manufacturing from greige fabric to finished products. These facilities are all located within a 125 km radius of its registered office near Tirupur, an Indian hub for knitted garments for children & exports. SPAL is looking to foray in women's essential wear as well with its *Natalia* brand.

Investment Argument

SPAL is one of India's largest exporters in the global infant & childrenswear industry which was estimated to be a US$ 228 bn market as on 2014 and is expected to grow at a 5.6 % CAGR to $ 300 bn by 2019. The U.S. is the largest market for childrenswear with a market size of US$ 58 bn followed by China (US$ 44 bn) while European countries like Germany, U.K., France, & Italy lead in per child spending on apparel. The growth of childrenswear market in developing countries like China, India, Russia, Brazil etc. has been higher with CAGR in the range of 8 % to 12 %, between 2009 & 2014 owing to their low base. This is also competitive market as evident by the presence of a large number of international & local brands, private labels etc.

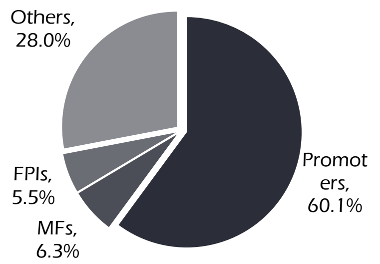
The global infant & childrenswear market is marked by its resilience to pressures on economic conditions & disposable incomes. Generally, parents across the globe tend to cut down their own discretionary spending rather than cutting down spending on children's clothing. While adults can delay purchase of new apparel, children quickly outgrow clothes making purchase of new apparel an absolute necessity. There is also a high level of safety standards required to be adhered to on account of laws enacted by the governments in these developed countries and are more stringent compared to that of general apparel. Most of the brands & retailers have a zero tolerance policy for non-compliance of standards for both chemical & physical safety of children's apparel, especially those which are intended for children of 0 - 3 years of age.

The textiles value chain globally extends across boundaries of countries. While developed economies like the U.S., E.U. & Japan are among the major consumption markets, most of the production in this labor intensive industry takes place in developing & least developed countries due to low labor costs. Although China has a lion's share in apparel exports, it has started to lose manufacturing competitiveness owing to rising labor & energy costs. Additionally, growing domestic demand has forced many local manufacturers to shift focus away from exports. This has opened up opportunities for other key exporting countries, especially India, which has the distinct advantage of abundant cotton supply, government support for apparel manufacturing and a strong reputation of meeting stringent quality, environmental & social norms of international buyers. India also possesses expertise with embroideries, trims & patchworks and can meet design & product development requirements of the western market, making it a sourcing destination of choice for buyers & buying offices that prefer to outsource designs from suppliers.

Stock Data

Current Market Price (₹)	421
12 month Target (₹)	530
Potential upside (%)	25.9
Market Cap (₹ bn)	10.5
52-Week Range (₹)	276.0 / 478.8
Reuters	SPAP.NS
Bloomberg	SPAL:IN
BSE / NSE Code	540048 / SPAL

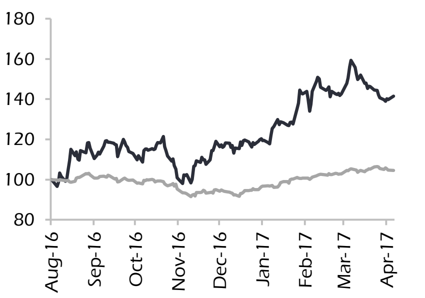
Shareholding Pattern



Financial Performance

Particulars	FY14	FY15	FY16	FY17E
Op. Rev (₹ mn)	4,509	4,726	5,328	6,531
EBITDA (₹ mn)	639	689	853	1,122
EBITDA Margins	14.2%	14.6%	16.0%	17.2%
Adj PAT (₹ mn)	67	86	357	613
Adj PAT Margins	1.5%	1.8%	6.6%	9.2%
Adj. EPS (₹)	3.9	4.6	17.7	26.6
P/E (X)	108.0	92.0	53.3	15.8
P/B (X)	10.7	7.8	6.4	2.5
ROCE	23.3%	22.3%	27.6%	19.9%
ROE	9.9%	9.4%	16.7%	16.3%

Relative Price Performance



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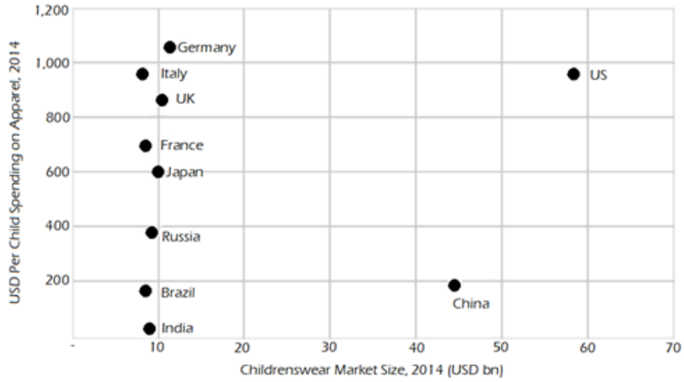
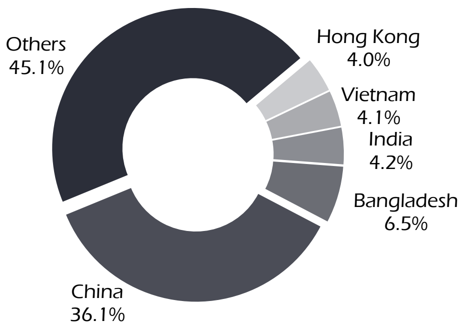
Global childrenwear industry - an overview

Major Childrenswear Markets



Major Childrenswear Exporters



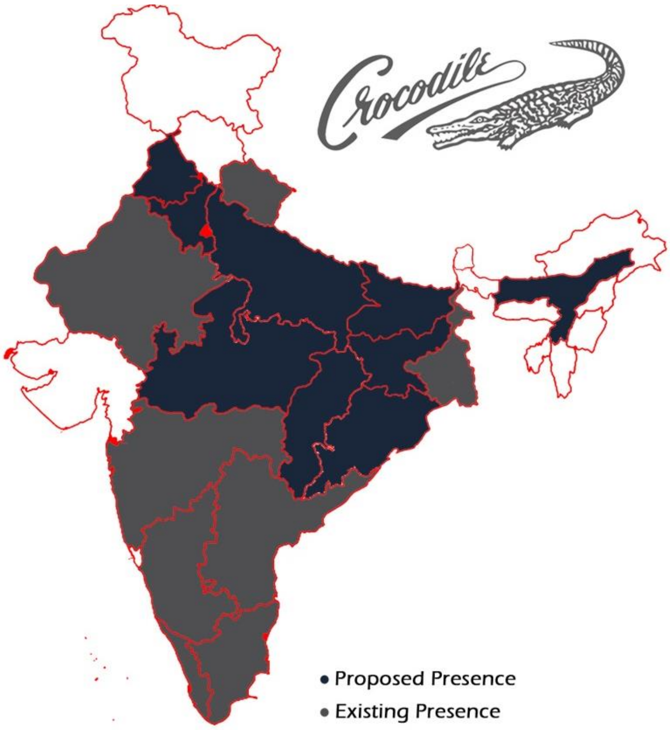
Source: Company, LKP Research

SPAL is one of the leading exporters of childrenswear from India with over 36.0 mn & 36.6 mn pieces of knitted garments for infants & children exported in FY16 & 9MFY17 respectively. Its long-standing relationship with its major customers such as TESCO, ASDA, Primark, Mothercare & Dunnes Stores has been one of the most significant factors contributing to its growth as it leverages its understanding of buying preferences of its customers, enabling the company to secure repeat orders despite not having any long term supply agreements. These orders are typically booked for a period of 3 - 6 months in advance which help SPAL to adapt to changing fashion trends. It has a subsidiary in the U.K. (SPUK) to explore possible marketing opportunities & engage in trading activities with new customers in the U.K., Ireland & other European countries. SPUK has a design studio and hires experienced designer consultants that provide design support services to customers.

The company faces concentration risk both in terms of geography & customer profile as all of its export revenues currently come from over 4 - 5 customers in the U.K. This was because of its initial focus on customers in Europe which prefer suppliers that are able to offer end-to-end garments manufacturing services from design to delivery. This helped SPAL to earn better price realizations in a scenario of constrained capacities which saw utilization levels hitting 88 - 89 % in FY16.

SPAL is now looking to de-risk its business by ramping up its sewing capacities with over 200 sewing machines added in 9MFY17 & another 300 expected to be added in Q4FY17. This will enable the company to grow its customer base from 4 - 5 customers currently to 8 - 10 customers, including some non - U.K. clients, while catering to larger orders from existing clientele such as Primark. It has also embarked on backward integration of its manufacturing facilities with the help of the funds raised from its IPO in August 2016, enabling it to expand EBITDA margins by 200 - 300 basis points thereby offering a potential upside to its bottom-line.

Crocodile - SPAL's Indian retail play



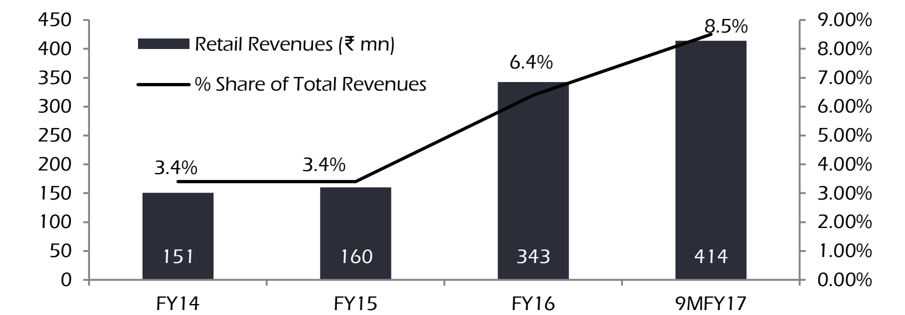
Presence across large format stores

Retail Network	Dec- 16
EBOs- COCO	41
EBOs- FOFO	3
MBOs	4,000
LFS	145
No.of States	9
Outlet Size (Sq.ft)	400-1,500

Source: Company, LKP Research

SPAL also manufactures & retails menswear garments like shirts, polo shirts, t-shirts, trousers, jeans, sweaters, jackets and innerwear products like vests, briefs, boxer shorts in India under the brand *Crocodile*. The company has an exclusive license of the *Crocodile* brand until July 31, 2021 owned through its subsidiary Crocodile Products Private Limited (CPPL) where it holds a 70 % stake. The balance 30 % stake of this joint venture is held by Crocodile International Pte. Ltd which also earns royalties on the sale of *Crocodile* brand garments & essential wear.

Crocodile retail operations on a gradual path of growth



Source: Company, LKP Research:

SPAL is well on its way to turn around its loss-making retail operations with the management expecting this business to break even in the next two quarters. Even as the company looks to set up 70 new stores with the funds raised through the IPO, it is exploring the franchisee model as well where it aims to have 10 - 20 franchisees by FY18. It is also working on a BOT model whereby it transfers existing stores which are performing well to franchisees.

The success of its retail business offers a potential trigger as it might encourage SPAL to offer childrenswear and make a foray in women's essential wear with its *Natalia* brand in the domestic markets. An important risk to consider here though is the trademark infringement case by Lacoste against CPPL pending before the Delhi high court, one of many legal battles being fought worldwide between the two brands.

Utilization of IPO Proceeds

Particulars	Plan	Utilized	Outstanding
Expansion & Modernization of manufacturing facility	701.6	75.3	626.3
Repayment / Prepayment of debt	630.0	630.0	0.0
Opening of new Crocodile brand stores	278.5	6.7	271.8
Addition of balancing machineries for dyeing unit	49.1	43.3	5.8
General Corporate Purpose & Issue Expenses	490.8	490.8	0.0
Total	**2150.0**	**1246.1**	**903.9**

SPAL came out with a ₹ 2.4 bn IPO on August 2016 out of which ₹ 2.2 bn was a fresh issue to be utilized by the company for repayment of debt, expansion of its manufacturing facilities and addition of more *Crocodile* stores to ramp up its retail business. The IPO helped prune down the company's debt from the highs of 5.3 X Debt to Equity experienced in FY12 to 0.4 X Debt to Equity as on 9MFY17. The immediate impact of a lower debt burden is evident by ~ 300 basis point yoy jump in PAT margins from 6.2 % in 9MFY16 to 9.3 % in 9MFY17.

Easing of this financial burden also freed up resources for the addition of 500 sewing machines at a capex of ₹ 200 mn in FY17, with another ₹ 200 mn budgeted for the current fiscal. The ramp up of capacities has equipped SPAL to accept more orders from both existing as well as new clientele, helping the company to take its first steps towards geographical de-risking. The capex of ₹ 750 mn from the IPO proceeds toward expansion & backward integration is expected to improve margins by 200 - 300 basis points through de-bottlenecking, higher operational efficiencies and better quality control while providing headroom for further expansion. The tailwinds from the expansion & backward integration can already be seen in the 24.6 % yoy top-line growth clocked in 9MFY17 as against ~ 7.4 % CAGR growth between FY12 - FY16.

A key risk to consider for SPAL's revenues & profitability is the ability of forex fluctuations to materially distort its financial performance, considering the fact that it bills its customers in dollars, pounds & euro, all experiencing significant swings due to political & economic uncertainties that have gripped the global economy.

Quarterly Performance

Particulars	Q3FY17	Q2FY17	qoq growth	Q3FY16	yoy growth	9MFY17	9MFY16	yoy growth	FY16
Operational Revenues	**1,481.8**	**1,669.6**	**-11.2%**	**1,359.6**	**9.0%**	**4,775.6**	**3,831.7**	**24.6%**	**5,328.3**
Material Cost	577.1	705.7	-18.2%	498.7	15.7%	1,894.2	1,443.0	31.3%	2,042.2
Employee Benefits	347.4	376.9	-7.8%	290.9	19.4%	1,096.9	883.0	24.2%	1,211.4
Other Expenses	319.6	333.6	-4.2%	281.7	13.5%	971.2	838.2	15.9%	1,221.6
Operational Expenses	**1,244.2**	**1,416.2**	**-12.2%**	**1,071.3**	**16.1%**	**3,962.3**	**3,164.2**	**25.2%**	**4,475.2**
EBITDA	**237.7**	**253.3**	**-6.2%**	**288.3**	**-17.6%**	**813.3**	**667.5**	**21.8%**	**853.1**
EBITDA Margins	*16.0%*	*15.2%*		*21.2%*		*17.0%*	*17.4%*		*16.0%*
Depreciation & Amortization	53.5	51.3	4.4%	48.6	10.1%	153.5	149.6	2.6%	201.0
EBIT	**184.1**	**202.0**	**-8.9%**	**239.7**	**-23.2%**	**659.7**	**518.0**	**27.4%**	**652.1**
EBIT Margins	*12.4%*	*12.1%*		*17.6%*		*13.8%*	*13.5%*		*12.2%*
Finance Costs	31.4	36.1	-12.8%	48.7	-35.5%	134.5	186.4	-27.9%	252.7
Other Income	76.9	57.1	34.6%	0.6	13883.6%	153.9	23.8	547.7%	49.3
Exceptional Items	-	-		-		-	-		(168.7)
PBT	**229.6**	**223.1**	**2.9%**	**191.5**	**19.9%**	**679.2**	**355.3**	**91.1%**	**279.9**
Tax Expenses	87.8	75.0	17.1%	65.0	35.2%	233.6	116.3	100.8%	93.4
PAT	**141.8**	**148.1**	**-4.3%**	**126.5**	**12.1%**	**445.6**	**239.0**	**86.4%**	**186.5**
MI	(1.4)	(0.8)	77.2%	(0.8)	81.8%	(10.9)	(0.3)	4080.8%	(1.7)
PAT after MI	**143.2**	**148.9**	**-3.8%**	**127.3**	**12.5%**	**456.4**	**239.3**	**90.8%**	**188.2**
PAT Margins	*9.2%*	*8.6%*		*9.4%*		*9.3%*	*6.2%*		*3.5%*
EPS	**6.4**	**7.4**	**-12.9%**	**7.4**	**-13.3%**	**20.6**	**14.0**	**47.6%**	**7.9**

Competitive Landscape for Childrenswear Exports

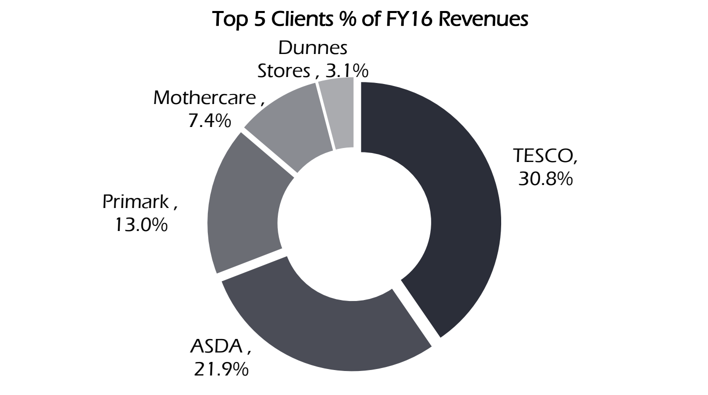
Company	FY14 Exports (USD)	Annual Capacities	Key Markets
Kitex Garments	87	165 mn	US, Europe
S.P. Apparels	62	50 mn	Europe
Jay Mills	52	15 mn (Infant Garments) 3 mn (Basic T-Shirts)	UK, US, Brazil, France Sweden
KPR Mills	50	63 mn (Pieces), 90,000 metres (Yarn) 27,000 metres (Fabric)	Europe, US
Eastman Exports	NA	72 mn (T Shirts) 36 mn (Underwear)	US, Europe, Canada, Mexico, Brazil, Hong Kong, Korea, Japan, South Africa, Australia
SCM Garments Pvt Ltd	35	2.1 mn (T Shirts) 1.6 mn (Underwear)	US, Europe, Canada

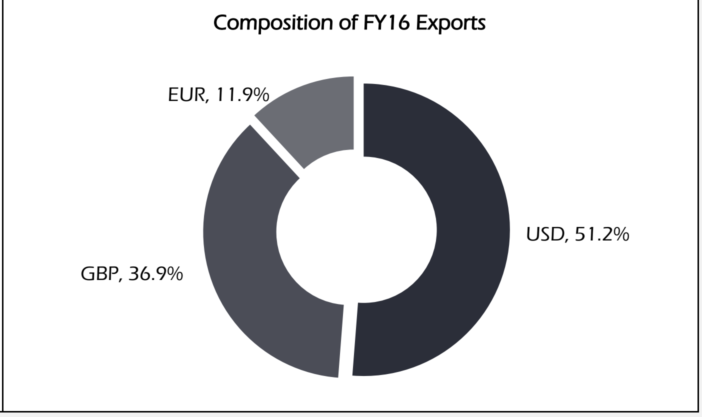
Valuation & Outlook

We believe SPAL is truly at an inflection point as it looks to leverage its healthier financial position, strong customer relationships & end-to-end manufacturing capabilities to foray into U.S. markets as well as grow its business with existing clientele. The close proximity of its manufacturing facilities to an international port along with convenient access to skilled labor, raw materials, machinery supplies & replacement parts offer potential for significant savings in production, labor & transportation costs. This puts SPAL in a unique position to take advantage of the structural tailwinds in the form of policy push by the Centre to promote apparel manufacturing & exports and the gradual shift of sourcing preferences from Chinese manufacturers to other major apparel exporters, especially India. Its reputation as a quality conscious & responsible manufacturer would help SPAL to continue to make inroads with newer customers & geographies in the specialized & demand inelastic industry of childrenswear. Capacity additions & backward integration would enable it to fulfill orders from customers that it would previously refuse on account of capacity constraints while supplying to new customers as well.

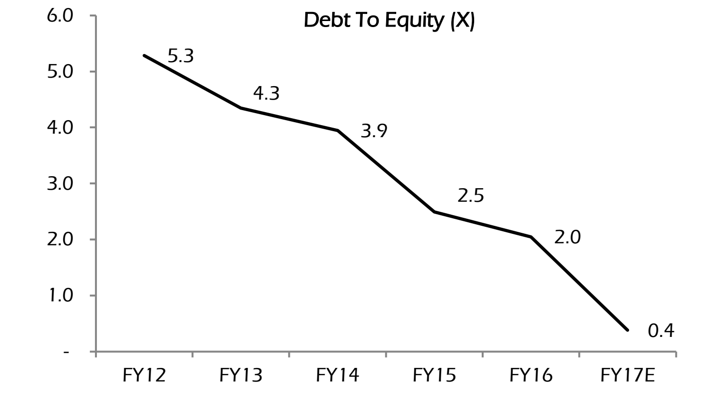
We expect SPAL to continue on its growth trajectory seen over the last 2 quarters both on the volume & margin front on the back of its strong balance sheet as well as economies of scales kicking in from its added capacities & backward integration. Considering the inelasticity of demand for childrenswear, strong customer relationships, end-to-end manufacturing capabilities, comfortable debt position, healthy margins and strong free cash flows & return ratios, we recommend a **BUY** on SPAL with a **12 month price objective of ₹ 530 (25.9 % upside)** where the scrip would trade at a **20 X FY17E earnings**.

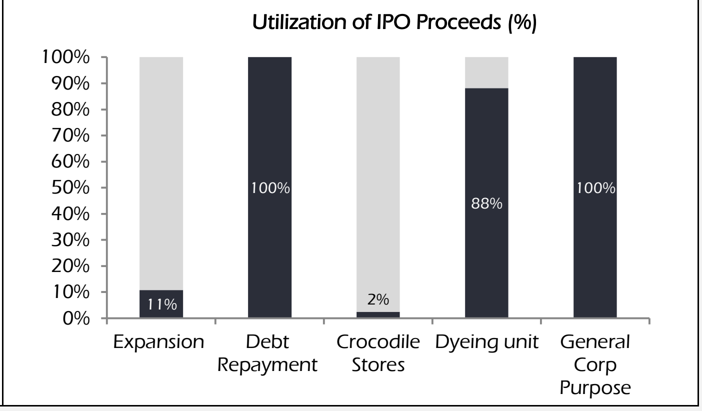
Looking to mitigate concentration risk & augment growth...



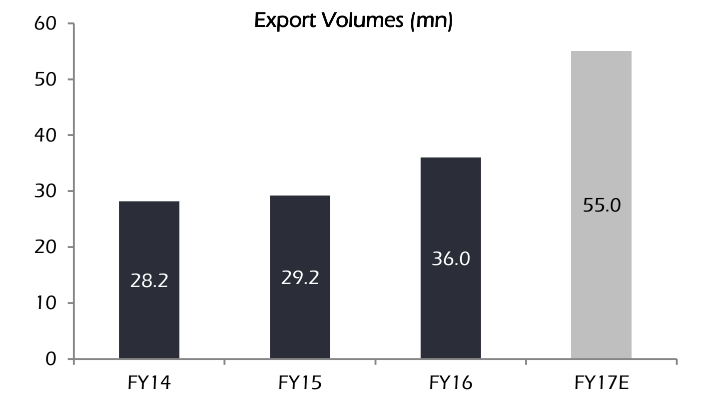


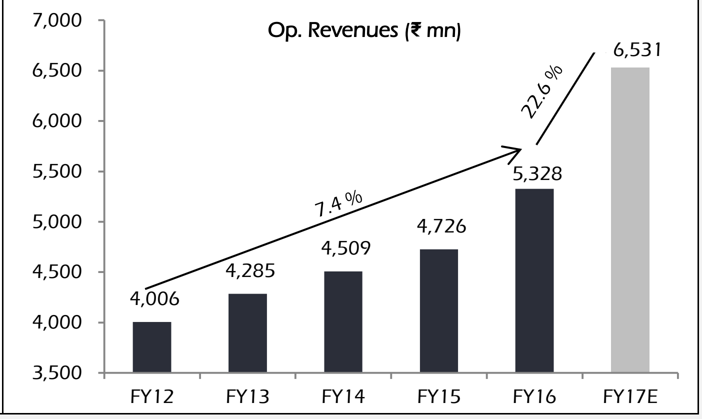
...SPAL came up with its IPO in FY17 for funding expansion & debt repayments ...



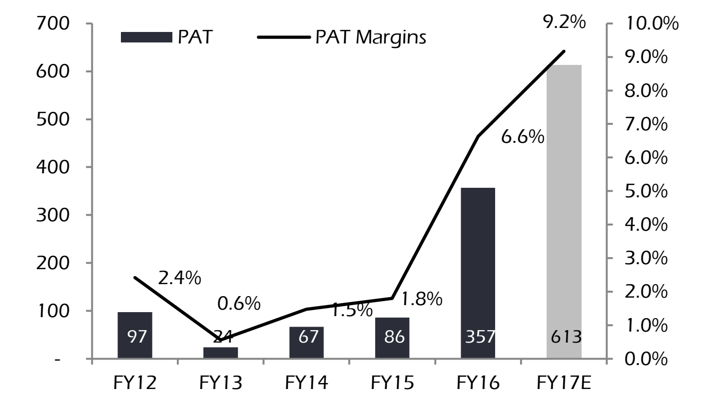


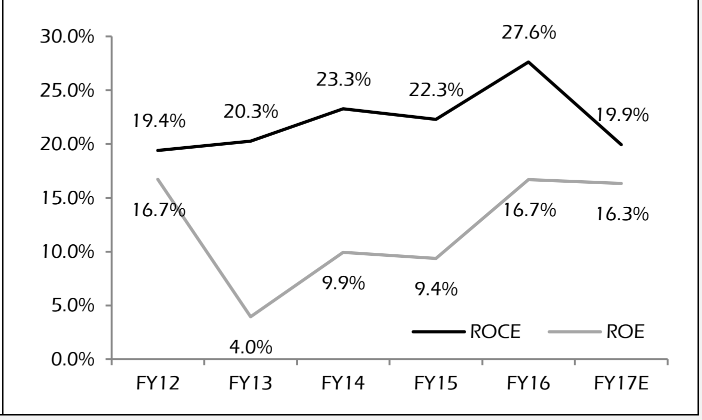
... Thereby boosting exports volumes & revenues...





... While augmenting PAT & delivering healthy returns.





Financials

Income statement

Particulars	FY14	FY15	FY16	FY17E
Operational Revenues	**4,509**	**4,726**	**5,328**	**6,531**
Material Cost	2,069	2,062	2,042	2,557
Employee Benefits	761	1,000	1,211	1,500
Other Expenses	1,040	974	1,222	1,352
Operational Expenses	**3,870**	**4,037**	**4,475**	**5,409**
EBITDA	**639**	**689**	**853**	**1,122**
EBITDA Margins	*14.2%*	*14.6%*	*16.0%*	*17.2%*
Depreciation & Amortization	176	200	201	219
EBIT	**462**	**489**	**652**	**903**
EBIT Margins	*10.3%*	*10.4%*	*12.2%*	*13.8%*
Finance Costs	356	312	253	171
Other Income	12	67	49	163
Exceptional Items	-	-	(169)	-
PBT	**119**	**244**	**280**	**895**
Tax	54	166	93	295
Minority Interest	2	8	2	14
PAT	**67**	**86**	**188**	**613**
PAT Margins	*1.5%*	*1.8%*	*3.5%*	*9.2%*
Adj PAT	**67**	**86**	**357**	**613**
Adj PAT Margins	*1.5%*	*1.8%*	*6.6%*	*9.2%*

Key Ratios

Particulars	FY14	FY15	FY16	FY17E
Per Share Data (₹)				
EPS	3.9	4.6	7.9	26.6
Adj. EPS	3.9	4.6	17.7	26.6
CEPS	14.2	16.2	19.6	36.5
BVPS	39.2	53.6	65.7	169.6
DPS	-	-	-	4.2
Growth Ratios (%)				
Revenues	5.2%	4.8%	12.8%	22.6%
EBITDA	16.1%	7.9%	23.8%	31.5%
PAT	179.0%	29.1%	118.6%	226.0%
Valuation Ratios (X)				
P/E	108.0	92.0	53.3	15.8
P/CEPS	29.7	25.9	21.4	11.5
P/B	10.7	7.8	6.4	2.5
EV/ Revenues	1.8	1.7	1.5	1.5
EV/EBITDA	12.8	11.6	9.4	8.6
FCF/EBITDA	0.70	0.63	0.47	(0.36)
Debt / Equity	3.94	2.50	2.05	0.38
Profitability Ratios (%)				
ROCE	23.3%	22.3%	27.6%	19.9%
ROE	9.9%	9.4%	16.7%	16.3%
Dividend Yield	0.0%	0.0%	0.0%	1.0%

Source: Company, LKP Research

Balance sheet

Particulars	FY14	FY15	FY16	FY17E
Equity Share Capital	168	168	171	252
Preference Share Capital	272	272	200	200
Reserves & Surplus	503	751	956	3,505
Net Worth	**944**	**1,192**	**1,327**	**3,957**
Minority Interest	(50)	(58)	(59)	(73)
Long Term Debt	920	728	679	221
Other Non Curr. Liab. & Provn.	172	332	413	422
Sources of Funds	**1,987**	**2,194**	**2,359**	**4,527**
Fixed Assets	2,789	2,695	2,746	3,188
GW on Consolidation	59	59	59	59
Other Non Curr. Assets	158	390	294	315
Current Assets				
Cash & CE	144	68	111	1,094
Current Investments	7	3	2	1
Inventories	1,253	1,073	1,275	1,478
Trade Receivables	542	743	816	984
Non Curr. Loans & Advances	293	315	307	371
Other Current Assets	8	4	3	3
Current Liabilities & Provisions				
Curr. Borrowings	1,728	1,566	1,627	1,219
Trade Payables	1,075	1,215	1,168	1,401
Other Curr Liabilities	422	287	355	126
Curr. Provisions	41	88	104	220
Net Curr. Assets	**(1,019)**	**(950)**	**(740)**	**966**
Application of Funds	**1,987**	**2,194**	**2,359**	**4,527**

Cash Flow

Particulars	FY14	FY15	FY16	FY17E
PBT	119	244	280	895
Depreciation & Amortization	176	200	201	219
Finance Cost	356	312	253	171
Other income	(12)	(67)	(49)	(163)
(Inc) / Dec in Working Capital	(124)	(149)	(169)	(723)
Other Operating Activities	4	(73)	177	(11)
Tax Paid	(54)	(166)	(93)	(295)
CF from Operating Activities (a)	**465**	**301**	**599**	**92**
(Inc) / Dec in Fixed Assets	(32)	(109)	(252)	(661)
(Inc) / Dec in Consol Adjustments	-	173	-	-
(Inc) / Dec in Investments	2	4	2	0
Other income	12	67	49	163
CF from Investing Activities (b)	**(18)**	**134**	**(201)**	**(497)**
Free Cash Flows (a+b)	**447**	**436**	**398**	**(405)**
Inc / (Dec) in LT Debt	(81)	(192)	(49)	(458)
Finance Cost	(356)	(312)	(253)	(171)
Inc / (Dec) in Pref Share Capital	72	-	(0)	-
Inc / (Dec) in Equity Share Capital	-	-	-	2,150
Preference Dividend Paid	-	(7)	(44)	(20)
Equity Dividend	-	-	-	(92)
Taxes on Dividend paid	-	(1)	(9)	(21)
CF from Financing Activities (b)	**(364)**	**(511)**	**(355)**	**1,388**
Inc / (Dec) in Cash & CE	83	(76)	43	983
Closing Cash & CE	**144**	**68**	**111**	**1,094**

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