Arvind Fashions Ltd (ARVFAS)

ICICI direct Research

CMP: ₹ 963 Target: ₹ 1290 (⬆ 34%) Target Period: 12-14 months **BUY**

March 22, 2019

'Power'ful brand portfolio...

Arvind Fashions (Arvind's hived-off brand & retail business) possesses the key ingredients that would enable it to capture the high trajectory growth opportunity in the discretionary consumption segment. The company has a presence in premium apparel and accessories through power/emerging brands, premium beauty products and value retail through its speciality retail formats. It has built a robust distribution network where products are sold through 1300 brand stores, 1400+ large format store outlets (LFS) and 1800 multi branded outlets (MBO). Over the years, the company has witnessed healthy revenue trajectory (20%+), with EBITDA margins improving significantly from 4.5% in FY16 to 5.8% as on 9MFY19.

Power brands: Cash Cow for Arvind Fashions

AFL's brand portfolio consists of a balanced mix, with power brands (brands that have crossed ₹ 200 crore in revenues) and emerging brands. Power brands of AFL include Arrow, Tommy Hilfiger, US Polo Association (USPA), and Flying Machine. USPA has turned out to be one of the most profitable brand for AFL, with turnover of over ₹ 1000 crore. Predominantly in casual menswear category, over the years, USPA has successfully leveraged its brand in newer product categories. On profitability front, the entire EBITDA is contributed by Power brands as other brands/formats are currently loss making. We model 15% revenue growth in FY18-21E for power brands driven by foray into newer categories like innerwear, kidswear.

Specialty retail to power next phase of growth

AFL's specialty retail format includes; a) 'Unlimited' (strong play on value fashion market) b) Sephora (leading player in premium beauty market) and c) 'GAP' stores. Unlimited has been successful in transforming itself from a discount store to a value fashion family store. Improved gross margin profile (up to 45% from 38%) and store rationalisation measures (closed stores from ~190 in FY14 to ~90 stores in FY19E) has led Unlimited to break-even at the store level (higher marketing spends to impact profitability in FY19E). Going forward, management aims to achieve 6-7% EBITDA margin by FY22.

Focus on profitable growth to enhance return ratios…

We anticipate overall revenues will grow at a CAGR of 15% YoY in FY18-21E, driven by healthy growth in the Power brands (15%) and specialty retail formats (24%). Revamping of business model in 'Unlimited format', asset light store expansion for 'GAP' and curtailment of losses for emerging brands are key levers to result in margin expansion of 200 bps to 7.4% by FY21E. Enhanced profitability, with steady improvement in working capital cycle are expected to improve RoCE from current 5.5% to 15.0% by FY21E. We arrive at a valuation of ₹ 1290 based on 17x FY21E EV/EBITDA.

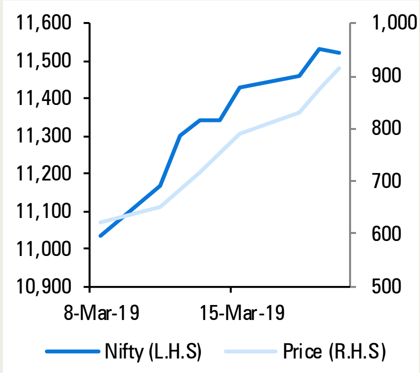
Company Update

ICICI Securities – Retail Equity Research

Particulars

Particulars	Amount
Market Capitalisation (₹ crore)	5,585.4
Total Debt (FY18) (₹ crore)	590.0
Cash (FY18) (₹ crore)	28.0
EV (₹ crore)	6,147.4
52 Week H / L	963 / 591
Equity Capital (₹ crore)	23.2
Face Value (₹)	4.0

Price Chart: *AFL listed on 8/3/2019



Key Highlights

- AFL has a unique brand Portfolio with presence across fashion apparel, accessories and beauty segment
- Power brands & Specialty Retail are expected to be the key growth drivers over the next few years
- Divesting of non-core Emerging brands would aid in reducing EBITDA losses & improve overall profitability

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Key Financial Summary

₹ crore	FY17	FY18	FY19E	FY20E	FY21E
Net Sales	3,336.0	4,219.0	4,818.4	5,552.7	6,445.3
EBITDA	157.0	229.0	279.5	360.9	477.0
PAT	-20.0	13.0	20.3	75.0	146.1
P/E (x)	NA	429.6	274.5	74.5	38.2
EV/Sales (x)	1.8	1.5	1.3	1.1	1.0
EV/EBITDA (x)	38.9	26.8	22.7	17.5	13.1
RoCE (%)	3.6	5.5	7.0	10.4	14.9
RoE (%)	-2.9	1.2	1.9	6.5	11.2

Source: ICICI Direct Research, Company

Company Overview

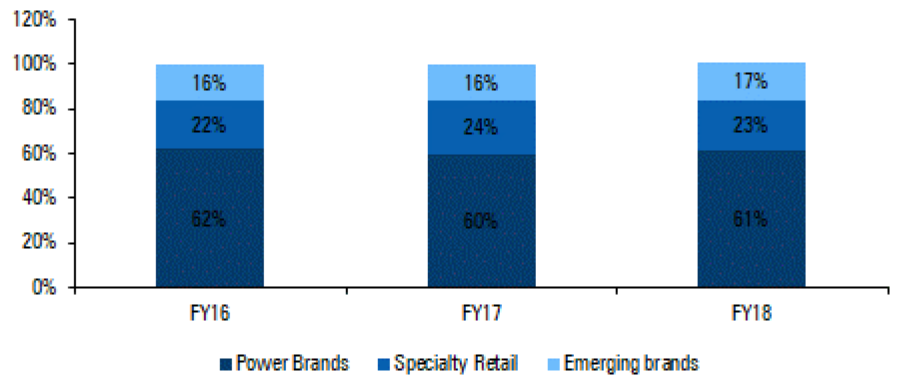
Arvind Fashions (AFL) is the pioneer in the branded apparel space and has several firsts to its name in India. It recently got demerged from its Parent company, Arvind Ltd. AFL entered the branded apparel segment as early as 1980 with the launch of the 'Flying Machine' brand (second largest denim brand in India). From 1993 onwards, AFL has been regularly adding brands to its portfolio and has created a strong bouquet of brands (owned & licensed) across different apparel categories with a presence at all price points varying from value to bridge to luxury.

AFL's brand portfolio consists of a balanced mix, with power brands (brands that have crossed ₹ 200 crore in revenues), emerging brands and speciality format stores. According to the management, as soon as a brand attains a turnover of ₹ 100-150 crore, it stops bleeding at the EBITDA level. Further, as it attains a turnover of ₹ 250 crore, the RoCE becomes attractive. By the time it reaches ₹ 350 crore it becomes a cash cow. Currently, the four power brands [Arrow, Tommy Hilfiger, US Polo Association (USPA) and Flying Machine] contribute 60% of the brand & retail revenues with ₹ 2566 crore with EBTIDA of 11.0%. The management's focus is on increasing the conversion rate of an emerging brand to a power brand.

Exhibit 1: Diversified brand portfolio

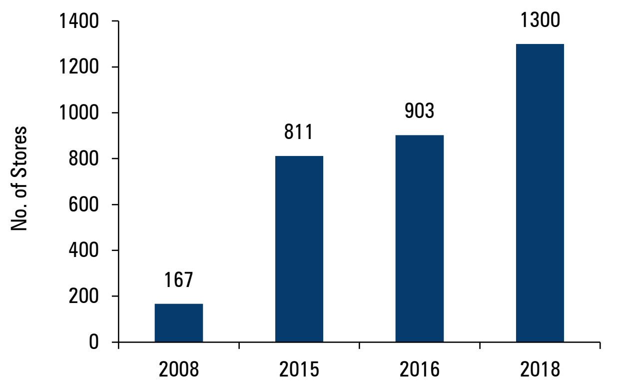
Source: Company, ICICI Direct Research

Exhibit 2: Revenue portfolio dominated by Power brands



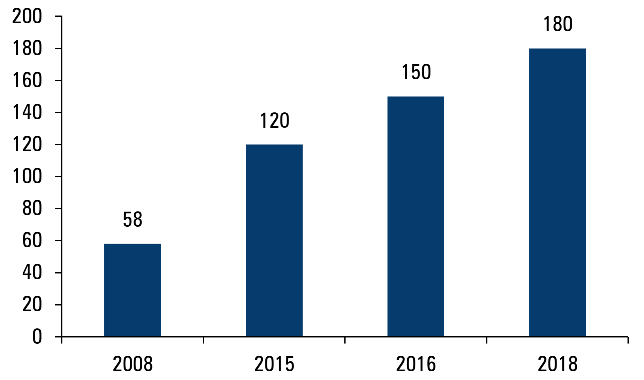
Source: Company, ICICI Direct Research

Exhibit 3: Number of branded stores



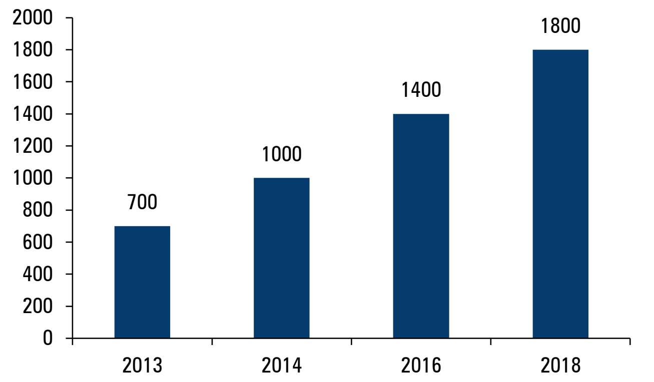
Source: Company, ICICI Direct Research

Exhibit 4: Number of towns covered



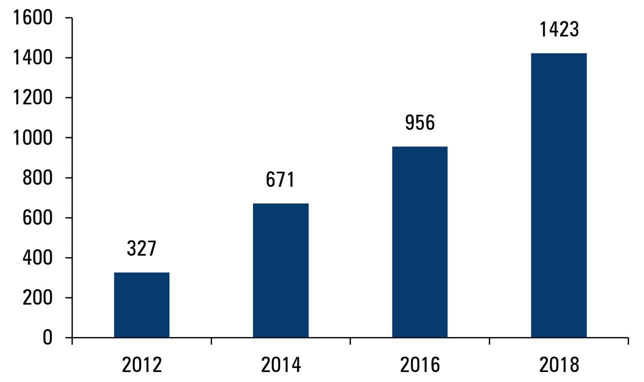
Source: Company, ICICI Direct Research

Exhibit 5: Available in 1800 MBOs……



Source: Company, ICICI Direct Research

Exhibit 6: ….and in more than 1400+ LFS



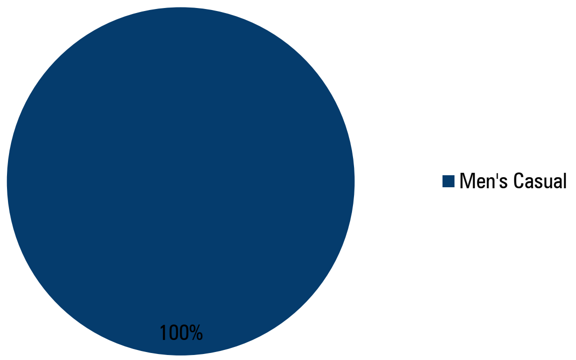
Source: Company, ICICI Direct Research

Power brands: Achieving steady profitable growth

The power brands of the company include Arrow, Tommy Hilfiger, US Polo Association (USPA) and Flying Machine. These brands contribute 60% of total revenues with ₹ 2566 crore and EBTIDA margin of 11.0%.

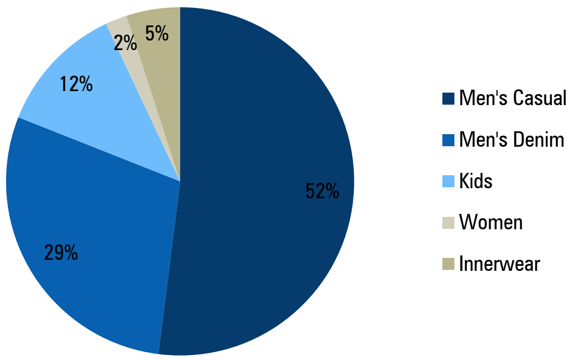
Of power brands, **USPA** has turned out to be one of the most profitable brands for AFL, with a turnover of ~₹ 1100 crore. The brand has a healthy margin profile in the high teens (most profitable brand among others) and generates robust return ratio of 35%+. Predominately in the casual menswear brand, over the years, USPA has successfully leveraged its brand in the newer consumer segments and product categories. The category expansion has powered USPA to record revenue growth trajectory of 25% over FY14-18. Going forward, the management has charted out three categories i.e. innerwear, kidswear and footwear under USPA brand, which has a potential to generate ₹ 1000 crore revenues by 2022. A foray into innerwear segment has witnessed healthy traction in a short span of time by capitalising on the brand recall of USPA. Currently, it has ~12000 point of sales and expects to reach ~20000 by FY20E, which would aid in maintaining the revenue growth momentum.

Exhibit 7: Started as men's casual wear brand… (FY10)



Source: Company, ICICI Direct Research

Exhibit 8: ….gradually diversified in other categories (FY18)



Source: Company, ICICI Direct Research

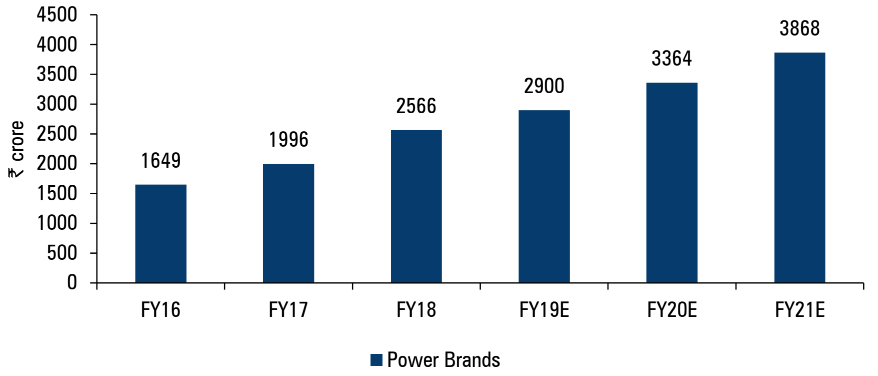
Flying machine is the second largest denim brand in India growing at a swift pace of 35% CAGR, having a turnover of ~₹ 500 crore. The company has introduced different sub-brands to cater to varied price points. For instance, a) 'FM Blue Label' for departmental stores and EBOs, b) 'FMX' for value channel and c) Flying machine for the e-commerce space. These initiatives are anticipated to provide growth impetus for the brand.

Predominately in the men's formal wear, the **Arrow** brand has reinvented itself as youth centric brand with Arrow sports now contributing ~34% of the business. Furthermore, it has introduced 'Arrow New York', mainly targeting the youth. It has also introduced new suits and blazer for special occasion. Arrow generates turnover of ~₹ 700 crore. The management expects to reach ₹ 1000 crore by FY22E.

For its super premium brand, **Tommy Hilfiger**, the management has extended its product categories into kids, footwear and accessories. It has also forayed into tailored apparels and jeans.

Going forward, we expect Power brands to report revenue CAGR of 15% in FY18-21E, driven by its foray into new categories like innerwear, kidswear and steady store expansion.

Exhibit 9: Revenues expected to grow at CAGR of 15% in FY18-21E



Source: Company, ICICI Direct Research

Specialty retail gaining scale rapidly…

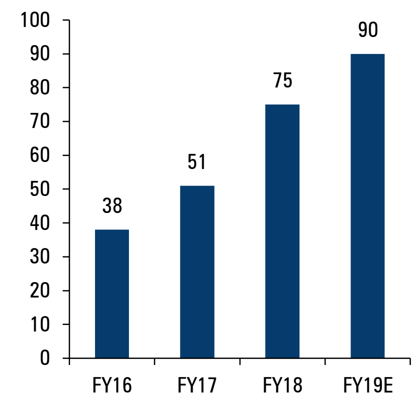
AFL is strategically enhancing its presence in specialty retail through varied retail formats like **Unlimited** (value fashion), **Sephora** (premium beauty products) and **GAP** retail stores.

Unlimited: Shift to value store format aiding improvement in margins…

The value fashion segment is one of the fastest growing segments and is expected to grow at a CAGR of 24% till FY22

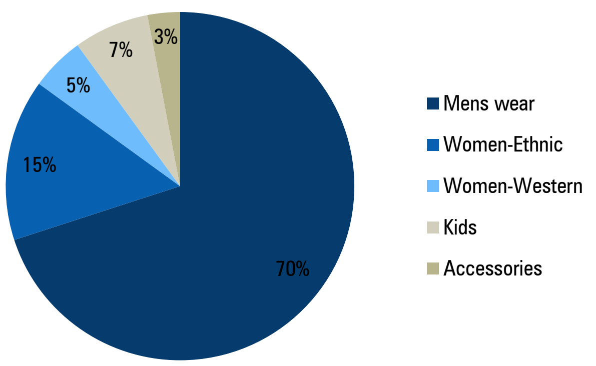
The management has restructured its speciality retail store, 'Unlimited' from a 'discount store' (earlier called Megamart) to 'value retail' with a higher proportion of private labels. The company now sells mainly private label brands (~90% of revenues). This has resulted in significant enhancement in gross margins from 38% to 45%. Also, several stores had been shut or re-branded (from Megamart to Unlimited), resulting in slower revenue trajectory of 5% CAGR in FY14-18 to ₹ 700 crore. Currently, the company has ~90 stores. The management expects to open 20-25 stores every year mainly in Tier II/III cities. Over the years, Arvind Fashions has positioned Unlimited as a family fashion store with a well-diversified product category across each segment (see exhibit 10-11). Unlimited had achieved break-even in FY18 itself. However, higher ad-spends are expected to drag the profitability in FY19E. We expect Unlimited to achieve break-even by FY20E with revenues growing at a CAGR of 18% in FY18-21E.

Shoring up store expansion for Unlimited



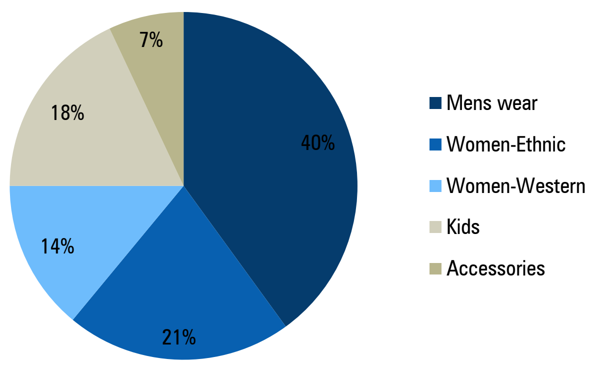
Source: Company, ICICI Direct Research

Exhibit 10: Transformed from men's wear store (FY15)…..



Source: Company, ICICI Direct Research

Exhibit 11: …to one store shop for family (FY18)

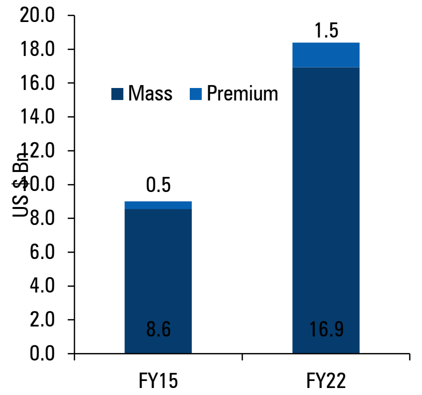


Source: Company, ICICI Direct Research

Nascent premium beauty segment to aid strong growth for Sephora

Sephora is one of India's leading premium beauty segment retail format with a range of exclusive brands. Since the acquisition from DLF brands in 2016, Sephora has already become profitable from its second year of operations with revenue growing at a robust trajectory albeit on a small base. Sephora has scaled up its store openings from four stores in FY14 to ~20 stores in FY19E. India's premium beauty and personal care product is expected to grow at a faster clip of 25% CAGR in FY15-22. Sephora is expected to exit FY19E with revenue growth of ~45% YoY with mid-single digit EBITDA margin. Currently, the stores are predominately located in metro cities. Going forward, the management intends to add six to seven stores each year with key focus in cities like Indore, Jaipur, Lucknow. The management believes there is immense opportunity in non-metro cities to scale up the business. It is also focusing on enhancing share of revenue contribution from online channel by replicating successful Sephora global online model in India. The management expects to double its revenues by FY22E.

Premium beauty segment to outpace mass segment



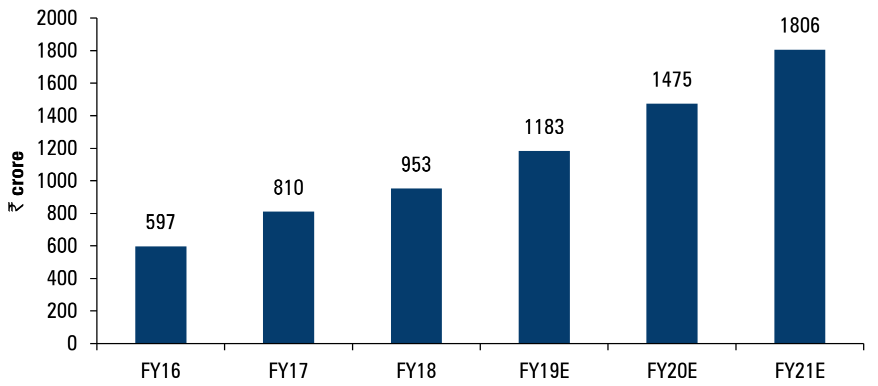
Company, ICICI direct Research

Addition of new categories/channels to drive growth for GAP

GAP is a leading global specialty retailer offering clothing, accessories and personal care products for men, women and Kids. Over the years, Arvind Fashions has gradually shifted to local sourcing, (with ~60% now manufactured in India) leading to an improvement in its gross margin profile. The management expects to further reduce the share of imported products to <20% over the next two to three years with AFL having better pricing control. Apart from its 15 standalone stores, it has secured the rights to sell GAP products through e-commerce platforms and shop in shop (SIS) formats in departmental stores, which can be a huge opportunity over the long term. GAP India has also sought permission to open exclusive 'GAP Kids' store on a franchise model, which would enable the company to expand its presence on an asset light basis. Opening up of new distribution channels is expected to accelerate the revenue growth, going ahead. For FY19E, we expect GAP to report robust revenue growth of 50% YoY. The management expects healthy revenue trajectory to sustain, going forward.

We expect strong growth momentum to sustain for the specialty retail portfolio, owing to swift pace of store additions in Unlimited format, revamping its distribution channel of sales for GAP and growing opportunity in the premiumised beauty segment format in Sephora. We pencil in 24% revenue CAGR and expect revenues to reach ₹ 1800 crore in FY21E.

Exhibit 12: We expect Specialty retail to post revenue CAGR of 24% in FY18-21E

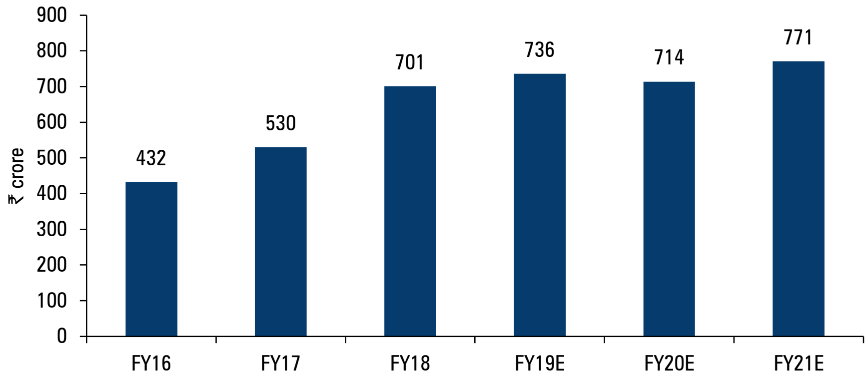


Source: Company, ICICI Direct Research

Focusing on profitability for emerging brands

For emerging brands, the management's main priority is to restrict losses with an exit from non-core brands and focus only on four core emerging brands i.e., Calvin Klein, Aeropostale, Ed Hardy and The Children's Place. Recently, the company divested two brands, 'Izod' and 'Elle', with further divestment expected in the near future. Exit from non-core brands is likely to keep revenue growth subdued in the near term. However, enhanced focus on profitability would curtail EBITDA losses. The efforts were visible with Emerging brands turning marginally profitable in Q3FY19 (excluding the brand closure cost of ₹ 6 crore). The management's key focus is to increase the conversion rate of an emerging brand to a power brand (CK, Aeropostale are already ₹ 100 crore brands each, and expect to become power brands in three to five years).

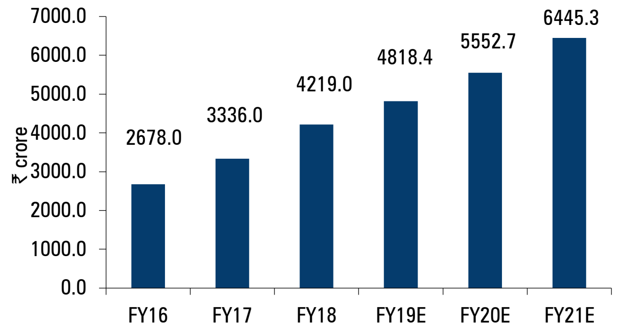
Exhibit 13: Revenue trajectory to remain muted amid exit from non-core brands



Source: Company, ICICI Direct Research

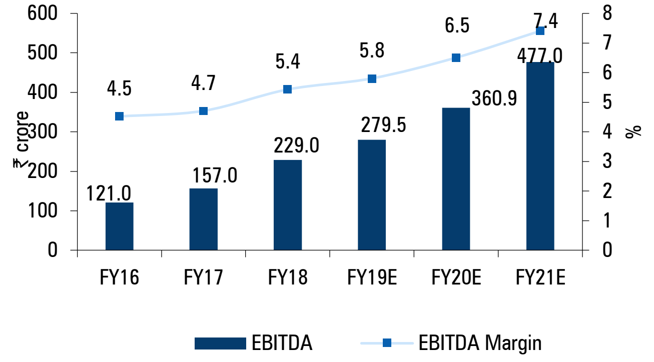
Financial Story in charts….

Exhibit 14: Overall revenue to grow at 15% CAGR in FY18-21E



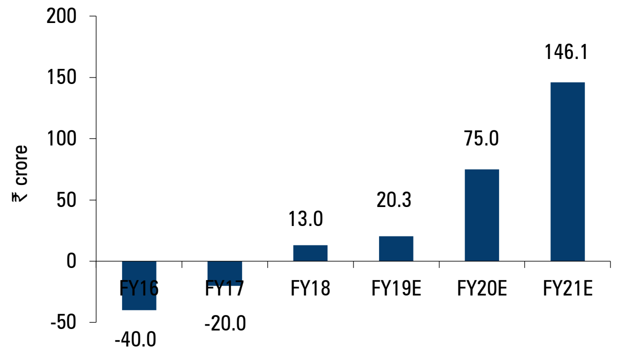
Source: Company, ICICI Direct Research

Exhibit 15: EBITDA margins to improve 200 bps YoY from FY18-21E



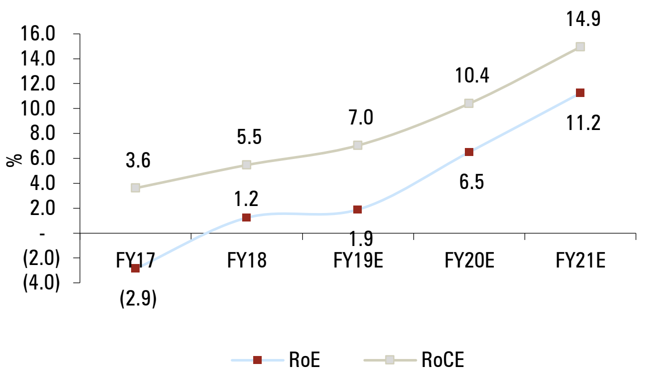
Source: Company, ICICI Direct Research

Exhibit 16: Net profit trend



Source: Company, ICICI Direct Research

Exhibit 17: Sharp improvement in return ratios



Source: Company, ICICI Direct Research

Exhibit 18: Profit & Loss Statement

(Year-end March)	FY18	FY19E	FY20E	FY21E
Net Sales	4,219.0	4,818.4	5,552.7	6,445.3
Growth (%)	26.5	14.2	15.2	16.1
Total Raw Material Cost	1,979.0	2,409.2	2,776.3	3,222.7
Gross Margins (%)	53.1	50.0	50.0	50.0
Employee Expenses	367.0	433.7	499.7	547.9
Other Expenses	1,644.0	1,696.1	1,915.7	2,197.8
Total Operating Expenditure	3,990.0	4,538.9	5,191.8	5,968.3
EBITDA	229.0	279.5	360.9	477.0
EBITDA Margin	5.4	5.8	6.5	7.4
Interest	91.0	112.0	106.4	98.0
Depreciation	139.0	147.3	162.1	178.3
Other Income	13.0	7.0	7.5	8.0
PBT	12.0	27.1	100.0	208.7
Total Tax	(1.0)	6.8	25.0	62.6
Profit After Tax	13.0	20.3	75.0	146.1

Source: Company, ICICI Direct Research

Exhibit 19: Cash Flow Statement

(Year-end March)	FY18	FY19E	FY20E	FY21E
Profit/(Loss) after taxation	13.0	20.3	75.0	146.1
Add: Depreciation	139.0	147.3	162.1	178.3
Net Increase in Current Assets	-484.2	-319.5	-241.0	-296.4
Net Increase in Current Liabilities	229.0	168.1	221.3	269.0
CF from operating activities	-103.2	16.3	217.4	297.0
(Inc)/dec in Investments	0.0	0.0	0.0	0.0
(Inc)/dec in Fixed Assets	-274.0	-200.0	-200.0	-200.0
Others	-28.0	-12.0	0.0	0.0
CF from investing activities	-302.0	-212.0	-200.0	-200.0
Inc / (Dec) in Equity Capital	1.2	0.0	0.0	0.0
Inc / (Dec) in Loan	39.0	210.0	-40.0	-60.0
Others	366.0	0.0	0.0	0.0
CF from financing activities	406.2	210.0	-40.0	-60.0
Net Cash flow	1.0	14.3	-22.6	37.0
Opening Cash	27.0	28.0	42.3	19.6
Closing Cash	28.0	42.3	19.6	56.6

Source: Company, ICICI Direct Research

Exhibit 20: Balance Sheet

(Year-end March)	FY18	FY19E	FY20E	FY21E
Equity Capital	23.2	23.2	23.2	23.2
Reserve and Surplus	1,036.0	1,056.3	1,131.3	1,277.4
Total Shareholders funds	1,059.2	1,079.5	1,154.5	1,300.6
Total Debt	590.0	800.0	760.0	700.0
Non Current Liabilties	244.0	244.0	244.0	244.0
Source of Funds	1,893.2	2,123.5	2,158.5	2,244.6
Net Block	532.0	584.7	622.6	644.3
Capital WIP	-	-	-	-
Net Fixed Assets	532.0	584.7	622.6	644.3
Investments	-	-	-	-
Inventory	727.0	884.5	1,004.0	1,147.8
Cash	28.0	42.3	19.6	56.6
Debtors	784.0	924.1	1,034.5	1,183.1
Loans & Advances & Other CA	868.2	890.2	901.2	905.2
Total Current Assets	2,407.2	2,741.0	2,959.3	3,292.7
Creditors	1,284.0	1,452.1	1,673.4	1,942.4
Provisions & Other CL	-	-	-	-
Total Current Liabilities	1,284.0	1,452.1	1,673.4	1,942.4
Net Current Assets	1,123.2	1,288.9	1,285.9	1,350.3
LT L& A, Other Assets	238.0	250.0	250.0	250.0
Other Assets	0.0	0.0	0.0	0.0
Application of Funds	1,893.2	2,123.5	2,158.5	2,244.6

Source: Company, ICICI Direct Research

Exhibit 21: Key Ratios

(Year-end March)	FY18	FY19E	FY20E	FY21E
Per share data (₹)				
EPS	2.2	3.5	12.9	25.2
Cash EPS	26.2	28.9	40.9	55.9
BV	182.6	186.1	199.1	224.2
Cash Per Share	4.8	7.3	3.4	9.8
Operating Ratios (%)				
EBITDA margins	5.4	5.8	6.5	7.4
PBT margins	0.3	0.6	1.8	3.2
Net Profit margins	0.3	0.4	1.4	2.3
Inventory days	63	67	66	65
Debtor days	68	70	68	67
Creditor days	111	110	110	110
Return Ratios (%)				
RoE	1.2	1.9	6.5	11.2
RoCE	5.5	7.0	10.4	14.9
Valuation Ratios (x)				
P/E	429.6	274.5	74.5	38.2
EV / EBITDA	26.8	22.7	17.5	13.1
EV / Sales	1.5	1.3	1.1	1.0
Market Cap / Revenues	1.3	1.2	1.0	0.9
Price to Book Value	5.3	5.2	4.8	4.3
Solvency Ratios				
Debt / Equity	0.6	0.7	0.7	0.5
Debt/EBITDA	2.6	2.9	2.1	1.5
Current Ratio	1.9	1.9	1.8	1.7
Quick Ratio	1.3	1.3	1.2	1.1

Source: Company, ICICI Direct Research

RATING RATIONALE

ICICI Direct endeavours to provide objective opinions and recommendations. ICICI Direct assigns ratings to its stocks according to their notional target price vs. current market price and then categorises them as Strong Buy, Buy, Hold and Sell. The performance horizon is two years unless specified and the notional target price is defined as the analysts' valuation for a stock

Strong Buy: >15%/20% for large caps/midcaps, respectively, with high conviction;

Buy: >10%/15% for large caps/midcaps, respectively;

Hold: Up to +/-10%;

Sell: -10% or more;

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