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12 Nov 2004

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Aro Granite Industries Ltd

Aro Granite Industries, maker & exporter of granite slabs & tiles, is capitalising on high growth in the US residential construction market. It's expanding its granite slab capacity by three-fold. The first phase of expansion kicks in next month with 1.5 times rise in production. This will be followed by doubling of production in the middle of next year. Longer term plans include entering value added granite products.

Fair Value Rs.171

Price Rs.48

+256%

The stock currently trades at 2.1 times estimated EPS for FY05 and 1.2x estimated EPS for FY06. We expect its net profit to grow at 75% and 32% in FY06 & FY07 respectively. We estimate DCF fair value at around Rs.171. Present value of Free Cash Flows till FY2011 reduced by all debt is more than current market cap – implying substantial margin of safety.

Key Data

Market Cap	Rs.337 mn
Market Cap at fair value	Rs.1.2 bn
Shares Outstanding	7.02 mn
52 week High-Low	Rs.49/Rs.21
Average Daily Volume	No. of shares
BSE 365 days	8,704
BSE 30 days	20,876
BSE Scrip Code	513729

Shareholding %

Promoters – Mar-04	50.07
Jun-04	50.19
Sep-04	51.05
Institutions – Sep-04	Nil
Others	48.95

Stock Performance

3 months	76%
6 months	126%
12 months	103%

Multiple Valuation

YE Mar-05E

EV/EBITDA	2.3x
EV/EBIT	2.6x
Market Cap/Sales	0.43x
P/E	2.1x
P/BV	0.5x

Near Term Likely Triggers

- 50% rise in capacity effective Dec-04
- Further doubling of capacity in Sep-05
- Orders-in-hand for next 6 months

Key Investment Points

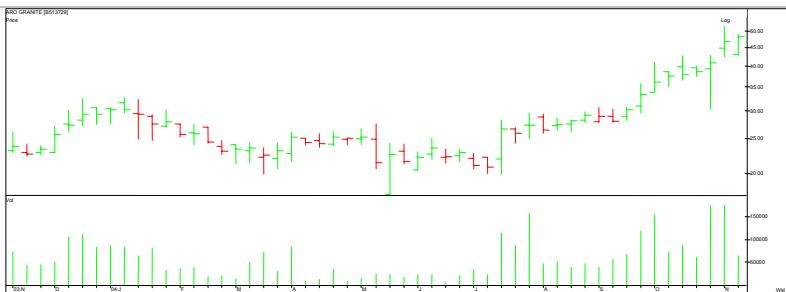
- Strong demand for granite from the US residential construction market
- Granite demand is expected to pick up from some European residential markets, non-residential & infrastructure markets going forward
- Three-fold capacity expansion to meet rising demand and strong order flow
- Growth in realisations kick in from the current year, input and other costs under check
- Tax exemption till March 2011 on substantial portion of profits
- Closure of granite tiles plants in Italy revived tiles business
- Company has been growing faster than the industry and is likely to keep it up
- Respect towards minority shareholders

Value Kickers

- Capacity expansion in granite tiles not factored in the valuations
- Forward integration into value added products to further add value

Party Poopers

- Decline or substantial slowdown in the US residential market
- Substantial weakening of US\$ and strengthening of Euro
- Capacity expansions in the industry beyond the currently envisaged ones may put pressure on realisations





Introduction

Aro Granite Industries Limited, a company with annual sales of Rs.675mn and annual net profit of Rs.113mn, processes and exports granite slabs and tiles. The Hosur based company has two manufacturing units near Bangalore. Its first unit for making granite tiles was commenced in 1991-92 as 100% EOU. It commenced another 100% EOU for granite slabs in FY02. ARO exports almost the entire production except about 5% rejects, which are sold in the domestic market.

Other major players in the granite industry are Pokarna Ltd, Madhav Marble & Granites Ltd, Crystal Granites, Gem Granites, GTP, etc. Among the international players, Chinese and Italian players offer tough competition.

Granite slabs find main application in kitchen tops and granite tiles are used for flooring. Granite is a hard coarse-grained rock that makes up a large part of every continent. Granite is one of the strongest of all dimension building stones. Most granite can withstand weathering for centuries. However, it is difficult to cut and handle because it is extremely hard. It is used extensively in the construction of public buildings. Granite can be polished to a glossy finish, and is an excellent background for carvings and lettering. Other dimension building stones are limestone, sandstone, marble, and slate.

Key Investment Arguments

Rising granite demand from US residential market

Half of the company's sales come from the US and half from many other countries in the world including Europe. Growth in recent years has been driven by granite slabs supplies to the US. The US residential construction market has been showing strong growth on the back of falling and low interest rates, among others. The company's slabs are mainly used for kitchen tops. The demand has been so strong that the company has been regularly expanding the capacity for slabs. It commenced the slab unit in FY02 with 3 Gangsaws (Gangsaw is the main machine that cuts rough granite blocks into slabs) and added the 4th one in FY03. It is putting up two more gangsaws currently and these are likely to commence production in Dec-04.

The most ambitious of all expansion is addition of six additional gangsaws for which civil work and fund raising has started. These six gangsaws will double its capacity and are likely to commence production from Sep-05. The company has adequate orders in hand for the next six months.

We expect the US residential market to remain strong in calendar 2005 as well. The growth rate may come down thereafter, as interest rates have started rising in the US. We foresee only a decline in growth rate and not decline in demand for home units.

Granite scores over competing products

Granite slabs are mainly used as Kitchen Top. Marble has long been edged out by Granite. Marble is now a poor cousin of Granite. There is no other natural substitute to Granite in Kitchen Top application. Dupont has come out with a Kitchen Top branded as 'Korean', which is made of synthetic stone-like material. This is however very expensive compared to Granite Kitchen Tops. Granite is increasingly being preferred over other stones due to its resistance to wear and tear as well as weathering which makes granite ever lasting stone. In flooring application, there are other substitutes like ceramics and wood. These, however, score poor on wear & tear and durability. Wooden flooring is significantly expensive too.

Aro Granite has been growing faster than the industry

It can be seen from the table below that the company has been growing much faster than the Industry in the past and looking at its ambitious expansion plans, it is likely to outgrow the Industry going forward as well.



Granite Exports

Rs.mn	FY02	FY03	FY04
India	20,470	24,300	25,000
Growth %		18.7	2.9
ARO Granite	297	534	612
Growth %		79.8	14.6

Three-fold capacity expansion underway to meet rising demand

Aro Granite currently has capacity to make 180,000 square meter of Granite Tiles and 197,000 square meters of Granite Slabs. It is expanding its slab capacity three-fold to 591,000 square meter by Sep-05. It may go for expansion of tiles capacity thereafter as it is operating at 99% capacity utilization in tiles plant.

Granite Slabs: Growth in capacity and production

YE Mar 31,	2003	2004	2005E	2006E	2007E
Capacity	197,000	197,000	295,500	591,000	591,000
Growth %	33%	-	50%	100%	-
Production	127,586	167,548	203,895	390,060	543,720
Growth %	65%	85%	69%	66%	92%

The company currently has four gangsaws of identical capacity. It plans to add eight more similar gangsaws to multiply its capacity three-fold. The task of setting up two of these gangsaws is in full swing and these are likely to begin production from next month. The company has spent Rs.150mn on these two gangsaws and the civil work for additional six gangsaws. It will incur additional capital expenditure of Rs.265mn next year to install the six gangsaws, which are expected to commission production in Sep-05. The company plans to finance this expansion with debt of Rs.225mn and rights issue of equity shares to the extent of Rs.100mn and the balance from internal accruals.

Realizations Growth – first time in three years

The company commenced production of slabs in FY02. In FY03 and FY04, it could not raise slab realization despite an annual 20% rise in rough block costs. This year for the first time, it has seen rise in realizations despite marginal increase in rough block costs. Granite slab realizations have grown around 9% as against 3% rise in rough block costs in the first half of FY05. This is a significant improvement over the last two years and points at the strength of demand for granite slabs. As many players in the industry are undertaking the capacity expansion, realizations growth is likely to be muted going forward. We expect most of the growth to come from volume growth and market share gain.

Tax exemption to granite slab unit till March 2011

Aro's granite tile plant, which was commissioned in 1991-92 completed 10 year tax holiday at the end of FY01. Profit from the tiles business is now fully taxable. Granite slab plant, which was commissioned in FY02, will continue to enjoy 100% tax holiday till March-2011. As it's a 100% EOU and exports its entire production, it does not have to pay any excise duty, nor does it have to pay any import duty on inputs. Going forward, slab plant will contribute maximum profits and growth. Therefore, the company will not have to pay any tax on its incremental profits. Even the expansions being undertaken currently will enjoy tax holiday till FY2011.

Closure of granite tiles plants in Italy

Over the last three years, granite tiles market has seen many changes. Chinese tiles and vitrified tiles, which cost only one third of granite tiles, chipped away a large pie of the tiles market. A number of units with Chinese machines for granite tiles have come up and these units further reduced the market share of players like Aro Granites, which uses Italian machines. There has also been a shift in demand from granite tiles to granite slabs.



Sales volume of granite tiles have picked up again in the current year, as a few tiles plant in Italy have closed down due to high labor cost. Despite rise in volumes, realizations have not improved yet. After the current expansion in slabs, the company may also go for expansion in granite tiles. The company is currently operating at 99% capacity in tiles. Moreover, cost of rough granite blocks for tiles has been falling and this has made it more profitable than what it was in the past couple of years.

India uniquely placed among granite producers in the world

India has large granite reserves of wide variety. Its granite has unique colors & grains and is of good quality. Most of the Indian granites are not available in other parts of the world. This combined with low labor cost for quarrying and processing gives India a competitive edge over other granite producing countries like China, Brazil, South Africa, and Norway.

Rough block costs showing sign of sanity now

After witnessing 20% annual rise in the cost of rough block (for slabs) in FY03 and FY04, rough block costs have increased by only about 3% this year. Though quality variation impacts costs, we see some sign of sanity in pricing of rough blocks this year.

Spiraling costs of rough block forced the company to look for cost reduction in other area. Costs of consumable & packing material (mostly imported from Italy and South Africa) have been brought down over the last two years despite strengthening Euro. There does not appear any more scope to cut costs here. However, we observe that other costs across the board have been very well controlled this year.

Longer term plans include value added granite products

After the current expansion in slab capacity, the company also intends to raise the capacity of tiles. It is currently operating at full capacity in tiles. Based on the demand for granite slabs and availability of rough blocks, the company is willing to further expand in granite slabs.

Longer term, the company intends to grow in this line of business itself and has no plans to diversify into unrelated areas unlike some of the other industry players like Pokarna Ltd, which has ventured into readymade garments. Going forward, the company may add further value to its granite slabs. For example, it can convert slabs into kitchen tops. Some of the granite companies have gone into making monuments, but we understand this business requires a totally different skill sets.

Respect towards minority shareholders

While we do not consider it sagacious for the company to raise equity at this point in time (more on this later), the choice of rights issue mode to raise equity wins our hearts. Rights issue is the fairest and most equitable mode of raising equity for existing companies. At a time when there are spates of preferential issues and private placements including issue of convertible warrants, which are highly inequitable and unfair to minority shareholders, the decision to go for the rights issue shows respect towards minority shareholders.

Risks / Concerns

Rising interest rates may slowdown growth in US residential market

While the US residential market is expected to be strong in calendar 2005, rising interest rate may cause slowdown in growth rate after 2005.

There is a need to target customers in non-residential and infrastructure segments, as these sectors are expected to witness accelerated growth rate going forward. However, Indian players have structural difficulties in breaking into these segments, particularly large projects. These structural difficulties include use of outdated technology at quarry sites, road & port infrastructure.

The company may do well to lay special emphasis on pockets of strength in Europe like France. France is expected to see accelerated growth in residential as well as non-residential construction in 2005 and possibly beyond.



Weakening US\$ and strengthening Euro

Half of the company's sales is to the US and invoiced in US\$. Most of its imports (consumables, spares) are from Italy and invoiced in Euro. This may prove double whammy for the company as the trend in both these currencies is against the company at present. The company needs a way to guard itself against this adverse trend in US\$/Euro. One possibility is to take US\$ denominated debt instead of rupee debt and convert as much rupee debt into US\$ debt as possible. This can partially set off risk to realizations due to weakening US\$.

Weak bargaining position vis-à-vis suppliers and customers

Granite processors have a weak bargaining position vis-à-vis suppliers. It is not easy to backward integrate into granite quarrying. We understand the key problems are hold of local strongmen over quarries and involvement of cash transactions. For companies like Aro Granite, where promoters come from the north; there is a language barrier as well in the south. Rough blocks are normally paid for in advance. During FY03 & FY04, granite slab realizations remained unchanged but rough block prices were raised by 20% per annum.

Cost of quarrying rough granite blocks have been increasing due to rise in royalty rates and cost of petroleum products. The increased cost is being passed on to slab and tiles makers. Export of rough blocks has also been growing due to demand from other countries for rough blocks. This has reduced the availability of rough blocks for Indian processors.

Consumables (diamond tools, abrasives, etc), machineries, spares are imported from Italy, which is the best source for these inputs. Even here, the bargaining power does not exist.

The company does not seem to have a good bargaining position vis-à-vis customers too. Aro Granite exports almost half of its production to the US. Most of the supplies to US distributors are without letter of credit. Though bad debts have not been significant in the past, the practice carries risk. This practice is common in the industry. The company gets payment almost after four months. Even in the face of 20% annual rise in cost of rough blocks, the company could not raise the price of granite slabs in FY03 and FY04.

For the first time ever since the company started granite slab production, it has witnessed rise in rupee realization for slabs in the first half of the current year. Average growth in rupee realization was around 9% in the first half of FY05. As rupee appreciated in the first half of FY05 compared to the average of FY05, USD realization were higher than 9%. This indicates that the strong demand from the US has given it some leeway in its bargaining position vis-à-vis customers and this is a good omen.

Other players in India also expanding capacity

Other Granite slab makers in India are also expanding capacity or considering expanding capacity. Among the listed companies, Madhav Marble & Granites (MMG) is mulling capacity expansion by adding two Gangsaws. It's also planning backward integration into granite quarrying. The large scale capacity expansion, which is a sign of improved confidence in the sector, will exert pressure on realizations once these capacities become operational.

Ability to procure rough blocks is a key limitation

Procurement of rough granite blocks is a key function in this business. Yield of final products depends a great deal on proper choice of blocks. A few bad blocks can alter the average yields significantly. Skill in block selection is a key success factor. What we understand from our interaction with the management of granite companies is that owners' involvement in procurement is a must, as employees, though trained & skilled, can not be relied on to act in good faith in procurement. This puts a lid on business scalability. The business can be scaled up only to the extent of owner managers' capacity to procure good quality blocks. An incentive & disincentive system with owner-like payoffs should be explored to overcome this key constraint.



Planned rights issue shows lack of financial sagacity

Aro Granite has very low operating leverage. It had very stable operating margins in the past. Such a company should use high financial leverage to create greater shareholder value. The company has been maintaining a sub-optimal financial leverage at around 33% (33% of capital employed came from debt). Our analysis shows that an optimum financial leverage (debt to capital employed) would be 65-70% for Aro Granite. This will be shareholder value accretive even if it meant lower credit rating and a little higher rate of interest. Over the last five years, debt has never been more than 40% of Capital Employed at year ends. If promoters want to invest more funds into the company, they can do it better by creeping acquisition than by rights issue. As shares are highly undervalued, it's the best option.

The company plans to raise around Rs.100mn from the rights issue. We have assumed an increase in equity from the present Rs.70mn to Rs.105mn taking 1:2 ratio for rights.

Ownership and Management

Major ownership of the company is with two Arora Families of Delhi. These families together hold 51.05% of the company. Mr. Sunil Arora, managing director and Mr. Prem Arora, whole time director are key management personnel. Mr. Sunil Arora's family has been in the business of building material supplies in Delhi and Mr. Prem Arora's family has been in construction business. Granite was thus a related filed for both of them. Mr. Sunil Arora is a chemistry graduate from St Stephens, Delhi and Mr. Prem Arora is from IIT-Delhi.

Valuation and key underlying assumptions

We estimate discounted cash flow value per stock at around Rs.171 at 18% cost of equity (Rs.210 at 15% CoE). At the current price of Rs.48, the stock offers significant appreciation potential. Present value of the company's likely free cashflows over the next six years reduced by all debt is greater than its current market capitalization. This implies that you are not paying for some uncertain cashflows in distant future but relatively certain cashflows over the next six years -- tremendous margin of safety.

Key assumptions are (a) debt/equity of at least 0.5 times, 5% annual growth in rough block cost, 2% annual growth in slab realizations, no growth in tiles realizations and optimum capacity utilization.

At the current price of Rs.48, the stock trades at 2.1x estimated EPS for FY05, 1.2x estimated EPS for FY06 and just 53% of estimated book value at the end of Mar-05.



Income Statement

<i>Rs. Mn.</i>	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
Revenues	776	1,281	1,718
EBIT	182	315	413
PBT	168	287	376
Adj. PAT	157	276	366
EPS (Rs.) (cum-right)	22.43	39.35	52.07

Ratios

<i>No. of months:</i>	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
<i>12</i>	<i>12</i>	<i>12</i>	<i>12</i>
Revenue Growth %	26.8	66.7	33.0
EPS Growth %	16.6	75.4	32.3
RoE %	30.5	35.9	34.4
D/E x	0.2	0.5	0.3
Receivables days	110	110	110
Inventory days - FG	38	33	32
-- RM	49	49	49
Advance to suppliers days	17	17	17

Balance Sheets

<i>Rs. Mn.</i>	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
Assets			
Net Block	391	656	656
Investments	0	0	0
Net Current Assets	411	672	904
Liabilities			
Equity Capital (post right)	105	105	105
Reserves	527	776	1,105
Preference Capital	0	0	0
Debt	137	414	318
Non-Current Liab.	33	33	33

Quarterly

<i>Rs. Mn.</i>	<i>Sep-04</i>	<i>Sep-03</i>	<i>Var</i>
<i>No. of months:</i>	<i>6</i>	<i>6</i>	<i>%</i>
Net Revenues	363	300	21.2
EBITDA	97	75	29.3
Depreciation	9	9	-6.6
EBIT	88	66	34.3
Interest	10	7	34.7
Other Income	6	1	
PBT	85	59	42.7
Tax	5	7	-32.4
PAT	80	52	53.0
Equity Capital	70	47	50.0
EPS –annualised (Rs.)	22.71	14.84	53.0

Quarterly Ratios

<i>%</i>	<i>Sep-04</i>	<i>Sep-03</i>	<i>Bps</i>
<i>No. of months:</i>	<i>6</i>	<i>6</i>	<i>Chg.</i>
EBITDA / Sales	26.4	24.5	+198
EBIT / Sales	24.1	21.5	+263
Tax/PBT	5.7	12.0	
Material cost/sales	56.1	53.8	+234
Staff cost/sales	3.9	4.2	-25
Other cost/sales	13.5	17.6	-406

Multiple Valuation

	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
EV/EBITDA x	2.3	1.3	1.0
EV/EBIT x	2.6	1.5	1.1
Mkt. Cap/Sales x	0.43	0.26	0.19
P/E x	2.1	1.2	0.9
Price/Book x	0.5	0.4	0.3

Free Cash Flow

<i>Rs. Mn.</i>	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
<i>No. of months</i>	<i>12</i>	<i>12</i>	<i>12</i>
NOPLAT	171	303	401
Change in Net Working Capital	95	273	242
Operating Cash Flows	75	29	159
Net Capex & others	151	265	0
Free Cash Flow	(76)	(235)	160
Non-opr. Cash flow	0	0	0
Cash Flow to Investors	(76)	(235)	160

Financing Cash Flow

<i>Rs. Mn</i>	<i>Mar-05E</i>	<i>Mar-06P</i>	<i>Mar-07P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
Post-tax Interest	13	27	36
Repayment/ (issue) of Debt	9	(277)	96
Equity Share	7	16	28
Dividend			
Buyback/Redn/ (issue) of equity shares	(105)	0	0
Increase in excess cash	0	0	0
Financing Cash Flow	(76)	(235)	160

DCF Valuation

	<i>Rs. Mn.</i>	<i>%</i>
<i>Key Assumptions</i>		
Terminal Growth Rate		2.0
WACC		15.9
Cost of Equity		18.0
<i>DCF Valuation</i>		
NPV FY05 to FY12	625	
NPV Terminal Cash Flows	704	
PV of non-operating assets	21	
Contingent Liabilities @ 100%	0	
Enterprise Value	1,350	
Debt, Pref. Cap, PV of NCL	151	
Equity Value	1,200	
<i>Fair Value Range (Rs.)</i>	150-197	
Per share Value (Rs.)	171	
Stress Value per share (Rs.)	89	



Important Disclosure

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