



impetus advisors

research@impetusadvisors.com

08 Sep 2003

For Private Circulation Only
Please read important
disclosure on last page

Ester Industries Ltd

Jacta Alea Est

Ester Industries recovered from sickness with a major turn around. Debt has been restructured, interest costs have been brought down, other costs are being reduced, assets are being sweated, and curtain on bleeding business segments. In nutshell, Rubicon has been crossed and the die is cast.

Fair Value Rs.45

Price Rs.15

+200%

The stock currently trades at 1.6 times estimated FY04 EPS (Rs.9.14). We expect its earnings to grow at 38% this year and 20% next year driven largely by cost reductions and efficiency gains. A business with Rs.2.8bn in sales and post-tax RoCE of 20% plus is going dirt-cheap. It trades at less than 2 times trailing EPS as compared to 8-9 times trailing EPS at which its competitors (Polyplex and Jindal Polyester) trade at present. We estimate DCF fair value at Rs.45.

Key Data

Market Cap	Rs.610mn
Shares Outstanding	40.8mn
52 week High-Low	Rs.23 – Rs.3
Average Daily Volume	No. of shares
BSE 365 days	42,962
BSE 30 days	183,786

Shareholding %

Promoters	49.50
Institutional Investors	15.88
Others	34.62

Major Shareholders

UTI	4.91
LIC	2.81
ICICI TSL	2.21
IFCI	2.19

Stock Performance

3 months	+117%
6 months	+199%
12 months	+179%

Multiple Valuation

	FY03
EV/EBIT	3.9
Market Cap/Sales	0.2
P/E	2.3
P/BV	0.9

Key Investment Points

- Polyester films, used mainly for packaging, have a number of other applications. Demand for polyester films is rising worldwide and there has been no capacity addition globally after 1998.
- Cost reduction measures are yielding results and there is scope for further cost reductions.
- Working capital requirement, especially inventories, to go down with implementation of ERP.
- Low effective tax rate till FY06 due to large unabsorbed depreciation
- Sale of polyester yarn capacity to lead to cash inflow to be used for repaying debt.

Value Kickers

- Globally some of the capacities may have to be shut as they become uncompetitive.
- Ester's foray into value added polyester films.

Party Poopers

- An expansion project is under consideration. The industry may again go into global overcapacity situation, if unbridled capacity expansion takes place.
- Spike in prices of key raw material (PTA, MEG) may temporarily lead to lower profitability.





Executive Summary

Ester Industries Ltd, a polyester film manufacturer with revenues of Rs.2.8bn in FY03, turned around in FY03 after making losses for four years in a row. A rehabilitation package contributed significantly to this turnaround. However, there have been other factors as well. Improved demand-supply balance in global polyester films industry and cost reductions are two of the other factors that have led to improved performance of the company.

We expect the company to further improve its performance over the next three years. The improved performance will be driven largely by cost reductions, workforce rationalization, lower inventories, significantly lower interest costs, minimum alternate tax for two years due to large unabsorbed depreciation, and closure of unremunerative business of polyester yarn.

Ester is working on multiple fronts to improve its performance. We estimate that these efforts will lead to net profit growth of 38%, 20%, and 13% in each of the next three years (FY04-FY06). The company is operating at full capacity and we have not assumed any rise in revenues.

For the long-term growth, the company is currently considering an expansion project for polyester films with capacity of 24,000 tonnes per annum at a cost of Rs.1.5bn. Ester's polyester film production in FY03 was 23,000 tonnes. As a final decision on expansion project is not yet taken, we have not considered this in our estimates and valuation. We, however, think that it will be sagacious to go for higher value addition rather than expand further into plain films.

The key risk to watch out for will be demand-supply balance for polyester films. Additional production facilities are coming up and these may put pressure on price realizations if demand does not rise commensurately.

Business Profile

Ester Industries is in the business of manufacturing and selling polyester films and engineering plastics. Till FY03, it was also making polyester yarn. It also makes polyester chips, which is raw material for making polyester film, yarn, and engineering plastics. It sells small quantity of surplus polyester chips in the market. It used to generate small quantities of methanol as by-product when it was using DMT as one of the raw materials. Going forward, Polyester films and engineering plastics will be focus areas.

Sales mix

Rs.mn	FY00	FY01	FY02	FY03E	FY04E
Polyester Films	1225	1549	1547	2172	2520
Engineering Plastics	172	216	303	267	299
Polyester chips	476	214	110	73	62
Polyester yarn	428	360	405	315	0
Methanol	66	74	27	0	0
Others	104	198	2	0	0
Total	2471	2611	2395	2826	2880



Polyester Films

Ester makes thin polyester films (PET films) of 10 to 23 microns. These films find applications mainly for packaging. However, these films are versatile and have large number of other applications as well.

Polyester film is mainly used for flexible packaging. Food and personal care products account for a large share of films used for packaging. There are electrical applications like motor insulation, cable wrap, flexible printed circuit board, and power capacitors. It is used is magnetic media as base film for audio/video cassettes & computer tapes, and floppy discs. It also finds applications in labelling, holography, hot stamping foils, and adhesive tapes.

Demand for polyester films has been growing at 15% per annum in India and 4-6% per annum globally. Key demand drivers are new application development for the film and growth in user industries. As polyester film is a fairly mature product, there is hardly any switch from other packaging material to polyester film. While the polyester film producers have one growth driver (new application development) in their control, the other growth driver (growth in user industries) is not in their control. As the polyester film finds applications in a diverse set of industries, the demand is immune from low or negative growth in a few of the user industries.

There are very few applications where polyester film has substitute. Therefore, it's immune from substitution risk.

Polyester films industry is global and highly competitive. It is dominated by Japanese and Korean companies. These companies have production units world over. Indian companies have lately been growing their presence in international market, as they are globally competitive. Mitsubishi, Toray, and Teigan are top Japanese companies in polyester films. In India, key polyester film producers are Flex Industries, Jindal Polyester, Polyplex, Garware Polyester, and Ester Industries. Ester is today number two in thin films after Flex Industries. SRF Polymer has small capacity and is planning expansion.

Ester exports polyester films to 40 countries world over. It does not export to the US now after it imposed anti-dumping and anti-subsidy duties. The US was a large market for Ester earlier. Even export to Europe has been curtailed due to imposition of anti-dumping duties. Small amount of export is happening to Europe under MIP undertaking.

Key raw materials for making polyester film are MEG (Mono Ethylene Glycol) and PTA (Polyethylene Terephthalate Acid) /DMT (Di-Methyl Terephthalate). Ester was using MEG and DMT earlier. In FY02, it shifted from DMT to PTA. DMT and PTA are substitutes. These raw materials are easily available in international and domestic market. Reliance Industries is the largest manufacturer and supplier of both the raw materials in India. India Glycols is also a large manufacturer of MEG in India. Prices of these materials move in tandem with landed cost. Import duties on these materials have been falling and are expected to fall further. This will bring down the landed cost of these materials.

In the domestic market, its customers are converters and metalisers. They include companies like Paper Products and Rollainers. In the international markets, it sells largely for packaging and cable insulation applications.



Engineering Plastics

Engineering plastics are high value added products and find applications in a diverse set of industries. These are PBT polymer and compounds and nylon compounds for sophisticated engineering applications. Ester has been selling it largely for use in optical fibre. As optical fibre industry faced the worst of times, Ester's sales of engineering plastics were adversely impacted in FY03. Other user industries are injection mouldings for telecom & electronics, auto components, components for household appliances, and electrical machinery parts.

Polyester chips

Polyester chips (PET Chips – Poly Ethylene Terephthalate chips) are intermediate used for making polyester films and engineering plastics. Polyester chips are made of PTA/DMT and MEG. All polyester film and yarn makers make polyester chips in house and therefore, the market for polyester chips itself is very small. Ester sells small quantities of surplus chips in the market.

Key Investment Points

Debt Restructuring led to turnaround

After making losses for four years in a row, the company turned around in FY03 largely on the back of debt restructuring. The debt restructuring took place as part of a rehabilitation package.

Interest bearing debt came down from Rs.2.3bn at the end of FY02 to Rs.877mn at the end of FY03. Under the debt restructuring, the company got total capital waiver of Rs.570mn and total interest waiver of Rs.403mn. This has led to an addition of Rs.973mn to the company's eroded network.

The company has fully repaid debt from foreign lenders – DEG and CDC. UTI has also been paid in full. Out of total repayment of Rs.780mn required under the package, the company has so far repaid Rs.560mn.

This has brought down interest costs substantially. Interest cost in FY03 was Rs.151mn only as against Rs.406mn in FY02. We expect net interest cost to go down further in FY04.

Preference shares of Rs.83mn, which were overdue for redemption, will now be repaid in 2012 and will carry coupon of mere 0.1% as compared to earlier 10%.

Cost Reductions

Ester has cut costs in many areas. Staff rationalization through VRS, power cost reduction, and outward freight are major areas where cost reduction has been evident. There is still scope for cost reduction.

Workforce and inventory rationalization

Ester is implementing ERP (complete suit of SAP R3) across the company. It plans to go live with SAP on October 1st, 2003. The use of SAP is expected to lead to faster & better decision-making, further workforce rationalization and reduction in inventory.



Large unabsorbed depreciation to keep tax outgo at minimum

Four years of losses has left Ester with unabsorbed depreciation for Income Tax purpose of Rs.1.2bn. There are no unabsorbed carry forward losses. We estimate that due to the unabsorbed depreciation, the company will be paying only MAT till FY05. We estimate effective tax rate of 10% for FY06 and full tax thereafter. For FY03, there is deferred tax asset of Rs.120mn. However, the company has acted conservatively and not accounted for the deferred tax asset.

The company has sales tax exemption till 2012 on its second film line of 12,000 TPA capacity.

Exiting unremunerative business of polyester yarn

Polyester yarn business was making losses at EBIT level. As this business has been unremunerative for the company, it discontinued the business from April-03. This will not only improve operating profits (as losses of this business cease to exist), there will be cash inflow from liquidation of assets of polyester yarn business. As at the end of Jun-03, this business segment had capital employed of Rs.102mn. We have estimated cash inflow of Rs.80mn from sale of this segment's net assets.

Shift from DMT to PTA is beneficial

In FY02, Ester switched from DMT to PTA. This switch has a number of advantages. While there is not much difference in prices of the two raw materials, input-output ratio for PTA is 0.87 as compared to 1.03 for DMT. Use of PTA leads to superior quality and better efficiency. The use of PTA requires marginally lower quantity of MEG. Moreover, there are more suppliers of PTA than there are for DMT. The company now has dual feed plant. This implies that if in future use of DMT becomes beneficial, then the company can switch to DMT.

Improved demand-supply balance in polyester films business

There has been no capacity addition in the global polyester film industry after 1998. The demand continued to grow steadily. This has brought about a balance in demand-supply worldwide. The global polyester film capacity is around 1.5 million MT at present. Of this, around 150,000 MT is in India. In India, there is still overcapacity, which is being used for exports. Global polyester film demand is growing at 4-6%. In India, it is currently growing at 15%. This improved balance has been chiefly responsible for improved performance of companies in this industry.

Looking at the continued growth, new capacity additions are being planned. It takes about 14 months to put up a polyester film plant. Therefore, over the next 1-2 years, we will see additional production capacity. This may lead to lower price realizations for polyester films till the demand catches up with the increased supply, or some uncompetitive plants close down.

Concerns

Additional Polyester Films capacity is coming up

Additional Polyester Films capacity is coming up and this may put pressure on price realizations. After 1998, there has been no capacity addition worldwide while demand rose steadily. This led to a balance in global demand-supply for polyester films. Additional capacities are expected over next couple of years and these will temporarily put price realization for polyester films under pressure till the time demand catches up.



To combat the risk of falling price realizations, Ester is adopting a two-pronged strategy – cost reduction and higher value added products. Significant progress has been made on cost cutting front and more is expected. Development of higher value added products, however, will be a gradual process and will take time to reflect on financials. Garware Polyester has a lot of value added polyester films like solar films, OHP films, TRDR films, and metallised films in its product portfolio. As a result, its average realization is 70% higher than that of other players. This shows the kind of scope there is in value addition.

We are of the opinion that it will be sagacious for Ester to go for higher value addition rather than expand further into plain polyester films. The amount of capacities that are being planned will definitely reduce margins in plain polyester films going forward. Capacity expansion will make sense once the company creates sustainable cost advantage over competitors, so that it can gain market share at the cost of competition. Each company in the industry wants to raise capacity to be cost competitive. They will all achieve lower costs but realizations will fall faster due to over capacity. Polyplex commissioned 15,000 TPA capacity at Thailand in Apr-03 and will commission another 15,000 TPA capacity by Apr-04. Jindal Polyester has scheduled commissioning of 29000 TPA capacity at Nasik in Nov-03. This will be followed by another 20,000 TPA capacity. SRF Polymers has also been planning 18,000-20,000 TPA capacity, which may come up by mid-2004. Certainly, market cannot absorb so much of capacity.

Higher value addition will lead to profitable growth. Horizontal expansion may lead to growth but it is unlikely to be profitable at the margin. The gains from cost reductions due to scale economies will be more than eclipsed by fall in prices, as producers will attempt to keep their capacity utilizations rate up.

Uptrend in key raw material prices

An uptrend in key raw material prices causes short-term fluctuations in profitability. Over the long term, however, profitability depends on global demand-supply balance in polyester films. As long as polyester film demand keeps growing, higher raw material prices can be passed on to customers, as is the case now. However, if there is large unutilised capacity, it will be hard to pass on price increase to customers.

Ownership & Management

Promoters and key owners of Ester Industries are Sitaram Singhanian, family and associates. After the split of LML group, Ester Industries came into Sitaram Singhanian's fold and is the only company in his fold. Sitaram Singhanian, chairman of Ester Industries, was instrumental in founding JK Synthetics and LML. His son -- Arvind Singhanian is managing director of the company. Arvind Singhanian has over 20 years experience in business. He has been with the company ever since its inception in 1985.

Promoters hold 49.5% and domestic institutions hold 15.88% of the company's equity.

Pricing / Valuation

We estimate fair value of Ester Industries' stock at around Rs.45 using discounted cash flow method. Our fair value estimate is mere 5 times FY04 expected EPS (Rs.9.14). Two of Ester's competitors Jindal Polyester and Polyplex currently trades at 8-9 times trailing EPS.

At the current price of Rs.15, the stock trades at mere 2.3 times FY03 EPS (Rs.6.62) and 1.4x expected EPS for FY05 (Rs.10.94). The stock is a three-bagger from here.



Income Statement

<i>Rs. Mn.</i>	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
Revenues	2,842	2,896	2,896
EBIT	584	631	678
PBT	270	404	484
Adj. PAT	270	373	447
Fully Diluted EPS (Rs.)	6.62	9.15	10.96

Ratios

<i>No. of months:</i>	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>12</i>	<i>12</i>	<i>12</i>	<i>12</i>
Revenue Growth %	19.9	-0.5	0.1
EPS Growth %	Loss to Profit	38.1	19.8
RoE %	259.4	40.9	33.8
D/E x	1.3	0.5	0.1
Receivables (days)	40	40	40
Inventory (days)	64	57	47
Payables (days)	84	84	84

Balance Sheets

<i>Rs. Mn.</i>	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
Assets			
Net Block	1,766	1,686	1,686
Investments	0	0	0
Net Current Assets	222	197	150
Liabilities			
Equity Capital	408	408	408
Reserves	562	881	1273
Preference Capital	83	83	83
Debt	877	437	54
Non-Current Liab.	67	83	27

Quarterly

<i>Rs. Mn.</i>	<i>Jun-02</i>	<i>Jun-03</i>	<i>Var</i>
<i>No. of months:</i>	<i>3</i>	<i>3</i>	<i>%</i>
Net Revenues	653	726	11.2
EBITDA	82	147	79.7
Depreciation	38	40	6.4
EBIT	44	106	143.7
Interest	81	34	-58.0
Other Income	1	3	226.8
PBT	(37)	75	
Tax	0	5	
PAT	(37)	70	
Equity Capital	408	408	
EPS –annualised (Rs.)	(3.61)	6.87	

Quarterly Ratios

<i>%</i>	<i>Jun-02</i>	<i>Jun-03</i>	<i>Bps</i>
<i>No. of months:</i>	<i>3</i>	<i>3</i>	<i>Chg.</i>
EBITDA / Sales	12.5	20.3	+772
EBIT / Sales	6.7	14.7	+797
Other income/PBT	-2.4	3.9	
Tax/PBT	0.0	6.7	
Material cost/sales	62.7	55.2	-748
Staff cost/sales	3.8	4.1	+32
Sales & Distn / Sales	4.6	5.8	+119
Admin exp / sales	3.8	3.8	-1

Multiple Valuation

	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
EV/EBITDA x	2.8	2.6	2.4
EV/EBIT x	3.9	3.5	3.2
Mkt. Cap/Sales x	0.21	0.21	0.21
P/E x	2.3	1.6	1.4
Price/Book x	0.9	0.6	0.4

Free Cash Flow

<i>Rs. Mn.</i>	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>No. of months</i>	<i>12</i>	<i>12</i>	<i>12</i>
NOPLAT	421	431	468
Change in Net Working Capital	(62)	(25)	(47)
Operating Cash Flows	483	456	515
Capex & others	(117)	(42)	110
Free Cash Flow	600	497	406
Non-opr. Cash flow	403	0	0
Cash Flow to Investors	1,003	497	406

Financing Cash Flow

<i>Rs. Mn</i>	<i>Mar-03E</i>	<i>Mar-04P</i>	<i>Mar-05P</i>
<i>No. of months:</i>	<i>12</i>	<i>12</i>	<i>12</i>
Post-tax Interest	151	58	22
Repayment/ (issue) of Debt	852	439	384
Equity Share	0	0	0
Dividend			
Buyback/Redn/ (issue) of equity shares	0	0	0
Increase in non-opr assets	0	0	0
Financing Cash Flow	1,003	497	406

DCF Valuation

	<i>Rs. Mn.</i>	<i>%</i>
Key Assumptions		
Terminal Growth Rate		1.0
WACC		14.6
Cost of Equity		18.0
DCF Valuation		
NPV FY2004E-2008E	1,534	
NPV Terminal Cash Flows	1,355	
PV of non-operating assets	12	
Contingent Liabilities @ 100%	0	
Enterprise Value	2,902	
Debt, Pref. Cap, PV of NCL	1,043	
Equity Value	1,859	
Fair Value Range (Rs.)	35 - 55	
Per share Value (Rs.)	45	
Stress Value per share (Rs.)	30	



Important Disclosure

This material has been prepared by Impetus Advisors, Mumbai, India (www.impetusadvisors.com).

The views expressed herein correctly reflect Impetus Advisors' views. Owners, analysts, and/or employees of Impetus Advisors hold long position in the stock of Ester Industries Ltd.

This document is not for public distribution and has been furnished to you solely for your information and may not be reproduced or redistributed to any other person. Persons into whose possession this document may come are required to inform themselves of, and to observe such restrictions.

This material is for the personal information of the authorised recipient, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. No person associated with Impetus Advisors is authorised to call or initiate contact with you for the purposes of elaborating or following up on the information contained in this document. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Neither Impetus Advisors, nor any person connected with it, accepts any liability arising from the use of this document. The recipient of this material should rely on their own investigations and take their own professional advice. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavour to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. Prospective investors and others are cautioned that any forward-looking statements are not predictions and may be subject to change without notice.

We and our affiliates, officers, directors, and employees world wide, including persons involved in the preparation or issuance of this material may; (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company(ies) mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the company(ies) discussed herein or act as advisor or lender / borrower to such company(ies) or have other potential conflict of interest with respect to any recommendation and related information and opinions. The same persons may have acted upon the information contained here.

No part of this material may be duplicated in any form and/or redistributed without Impetus Advisor's prior written consent.

Be the first to receive Impetus Advisors' multi-bagger research ideas

Impetus Advisors is an equity research boutique, which specialises in identifying multi-bagger stock ideas among Indian equities. It caters mainly to high networth individuals & entities. It also counts among its clients a few discerning institutional investors.

Please visit www.impetusadvisors.com for details. Write to research@impetusadvisors.com if you wish to be among the first ones to receive our research ideas.