Orient Paper and Industries Ltd *13th March 2015*

About the Investment

Orient Paper and Industries Ltd (OPIL) is engaged in the business of manufacturing of fans, lighting products, home appliances and paper. Currently the company is witnessing a tough time across its divisions for number of reasons. Its fans segment is going through slowdown because of lacklustre residential real estate market. Paper is into losses because of oversupply in the industry and high cost of raw materials. OPIL launched its home appliances product range almost 3 years back; the category is currently in investment phase and is making losses. We believe it's a classic contrarian investment opportunity where nothing is going right for the company and market is ignoring franchise value of its ORIENT brand. Based on our homework, we find most of the issues to be temporary and to correct in next 12-18 months (*refer to section – 'growth drivers' for detailed reasoning*). At the current valuation, the business presents itself as a favourable risk-return opportunity.

Table below shows the current shareholding pattern of OPIL –

Shareholder category	% Shareholding	12m Change
Promoters	38.23%	0.00%
FII	1.36%	0.87%
DII	20.90%	-3.29%
Public	39.51%	-2.42%
Total	100.00%	

As of 12th Mar 2015, OPIL had a market cap of 408Cr and a book value of 399Cr. It recorded losses in last 12 months.

Why We Like this opportunity

- **Largest manufacturer of ceiling fans with a wide distribution network** – OPIL has a very strong brand recall for its ORIENT brand of ceiling fans. During 1990's it became famous with its classic ad campaign – 'Yeh PSPO nahin jaanta'. Ceiling fans account for ~72% of total fans demand in India and OPIL is the market leader with ~25% organized market share in this category. The company is the largest exporter of fans from India with ~100Cr of export sales. Its fans are available at ~50% (75,000 retailers touch points of OPIL) of all fans retailers in the country.

- **Opportunity in home appliances category** – OPIL launched an all new range of home appliances products such as air cooler, water heater, induction cooker, mixer juicer grinder, blender and kettle under the brand name of ORIENT. We find this a prudent move as this category will have network synergies with fans and lighting category. OPIL has an enviable distribution network of ~75,000 retailers in the country and products like air cooler and water heater can be sold leveraging the existing network. Our channel checks suggest that OPIL has priced its products in mid segment (lower than Havells/Symphony and higher than Singer/Usha). We also developed the understanding that company is not spending much on below the line sales promotion activities (not giving huge margins to dealers to push the products) instead it is trying to create a brand pull in its home appliances division as well leveraging the success of its ORIENT brand.

- **Renewed focus of management** – In CY 2014, OPIL's management came out with a new ad campaign for its electric division spending a total of ~25Cr on its branding and advertising. Company renewed its contract with Indian cricket team captain MS Dhoni for its entire product range. It is co-sponsoring some of the programs during the on-going ICC Cricket World Cup. OPIL is aggressively installing bill boards and hoardings outside its dealers' shops, this has significantly increased the visibility of 'orient electric' brand in the eyes of a customer. All this looks promising for the company. Management is also getting aggressive in terms of diversifying its revenue stream into related categories, 3 years back it launched home appliances products line and is soon planning to launch switchgears.

- **Strong performance of fans and lighting products –** OPIL's fans have grown at a CAGR of 8% in volume terms over last three years when the industry grew by ~3%. Lighting as a category grew by whopping 45% over last 3 years when the industry grew by ~12%. Over a 7 years horizon, electric division as a whole has grown by 25% CAGR and has generated ROCEs of 24%.

- **Favourable risk-return profile in the opportunity** – As per our (sum of the parts) SOTP valuation methodology, OPIL's electric division is trading at a discount of 55% from its intrinsic valuation calculated on our target price of INR 27/share (*please refer to valuation and return analysis for detailed workings*). We expect to make ~4x (IRR of 60%) from this opportunity over 3 years horizon. Returns will come from two sources - growth (mainly from electric division) and arbitrage (electrical business being undervalued currently).

We see following growth drivers for the business -

- **Launch of new products** – OPIL launched an all new range of home appliances products towards the end of FY12 under the brand name of ORIENT. Company has opted for outsourced manufacturing model to begin with. This segment is expected to clock revenues of ~200Cr in FY15 from almost scratch at the beginning of FY13. This industry is witnessing a shift in terms of changing consumer preferences towards organized/branded products on the back of increasing purchasing power of consumers. Overall, home appliances market is growing by ~10% annually and OPIL is expected to grow by 25% for next 2-3 years given the small base of this category.

- **Growth revival in fans** – Currently the fans market is facing lacklustre demand because of slowdown in residential real estate market. With the prospects of Indian economy improving and pick up in real estate market, fans product line should get back on a fast growth trajectory of 25%+ on the back of its strong brand name of ORIENT. We draw comfort from the fact that OPIL's fans sales have grown by annual growth rate of 13% in value terms over last 3 years amid the tepid real estate market.

- **Turnaround of paper division** – This division has been in losses since FY10. It had been profitable for 60 years in a row up until FY09 but because of a combination of internal and external factors it has been facing a tough time. Management has been able to resolve both the internal issues by setting up a captive power plant of 55MW at a capex of 175Cr and two water reservoirs of 250 Mn gallons to tackle power and water shortages respectively. Currently the company is facing profitability pressures because of increased raw material prices and demand-supply mismatch. During last 2 years, this division has started showing signs of improvement as visible through reported segmental margins. We believe the division will continue to improve on the back of 1) increased share (30% in FY14) of high margin tissue paper 2) secured sourcing of wood pulp to some extent from local farmers in tie up with the company 3) upcoming crop of wood (to hit the market in next 1-2 years) expected to ease supply issues and 4) improving prospects for economy expected to bring balance in demand-supply mismatch

Risks and challenges

- **Paper division does not improve from here on** – This is the biggest risk we envisage in this investment. Paper division is running into losses and is becoming a drag on overall profitability. Though this division is no more incurring cash losses, which is a big improvement over last 2 years.

- **Competition in home appliance market leading to price wars** – There are over 15 branded players in the home appliances market making it highly competitive resulting in lower profitability for these players. This coupled with weak demand scenario has put further pressure on growth and profitability of these players. If demand scenario does not get better from here it might lead to price wars in the industry leading to poor performance for OPIL's home appliance category which is already in investment phase and is not generating any profits.

- **Contingent liabilities on account of water tax liabilities** – There is an old tax dispute going on between OPIL and government of MP. Original amount of tax liabilities was less than 10Cr which has now grown to ~350Cr including penalty and interest costs over the last ~20 years. Any unfavourable outcome can greatly dent balance sheet strength of the company. We draw some comfort from the fact that original liability in this case is very small and secondly, though unrelated, there is some long term investment on the books of OPIL into shares of two group companies –HIL Ltd and Century Textiles, which has market value of over ~145Cr as on 13th Mar 2015 and there is also lying some idle land in Orrissa which can provide downside protection in the worst case scenario.

Valuation and returns analysis

We have valued OPIL using sum of the parts (SOTP) methodology. We have tried to calculate EV of both the businesses – paper and electric – separately. Long term debt has been divided in the ratio of gross block of two divisions and working capital debt net of cash has been divided in the ratio of revenues of two divisions. We have valued paper business at half time its capital employed to calculate its EV and have accordingly arrived at its equity value of 87Cr. Using this, we derived the market value of electric division at 457Cr. Next, we have valued electric division, on a certain set of conservative assumptions and have arrived at its intrinsic valuation. OPIL's electric business seems to be trading at a ~55% discount to its intrinsic valuation of 1,017Cr.

Paper

	INR CR	
Capital employed (CE)	408	As on Q3'15
Multiple of CE	0.5x	Conservative assumption
EV	204	
Net Debt	118	
Intrinsic equity value - A	87	

Mcap of OPIL - B	543	On target price of INR27/share
Derived market value of Electric- (B-A)	457	

Electric

TTM Sales	1,218	As on Q3'15
EBITDA margins %	8%	Based on peer set
EBITDA	97	
EV/EBITDA multiple	12x	5yr median multiple of peer set is 14.2
EV	1,169	
Net Debt	153	
Intrinsic equity value (IV)	1,017	
Discount to IV	55%	

Please see below for workings on returns analysis -

Assumptions

Growth in electric division	25%	growth in home appliances, launch of new products and recovery in fans division
EBITDA margins	8%	
EV/EBITDA multiple	12	
Investment horizon (yrs)	3	
Net Debt (Cr)	284	kept same as Sep 2014 as there should not be any further requirements of capital

Electric *INR Cr*

TTM revenues (Q3'15)	1,218
Revenues - FY18	2,379
EBITDA- FY18	190
EV -FY18	2,284

Paper

EV -FY18	204	same as assumed to be today

OPIL

EV -FY18	2,488
Equity value -FY18	2,205
Mcap at target price	543
MOIC	4.1
IRR	60%

Key metrics to track

- Breakeven of paper segment by Q4 2015
- Growth momentum to be continued in home appliance segment (growth of 25%)
- Breakeven in home appliances along with improved working capital (by FY17 - assuming 5 full years of operations is good enough a time to breakeven specially given the fact there are no capex attached)
- Reduction in debt
- Pick up of fans vertical - growth as well as margins

About the Company

- **Brief history and background** – OPIL is part of CK Birla group of companies. It was established as a paper company in 1939 and later on entered new products categories such as cement, fans, lighting products and home appliances. In 2012, management demerged its cement operations into a separate listed entity, Orient Cement, thereby unlocking value for its shareholders.

- **Segmental overview** –

	Electric Division	**Paper Division**
Products offerings	Fans, CFL, luminaires, home appliances	Writing and prinitng (W&P) paper, tissue paper
Revenues FY14	1,139 Cr	430 Cr
Revenue split	- Fans 73%, lighting 15%, home appliances 12% - Ceiling fans account for 80% of fans revenues - CFLs account for 82% of lighting revenues	- W&P paper 70%, tissue paper 30% - 50% of tissue paper is exported
Market position	Fans (domestic) - 2nd largest overall and largest in ceiling fans with 25% market share Fans (exports) - largest exporter from India	Tissue paper - amongst the leading exporter from India
Brands	Orient	1st Choice, Orient, Diamond Touch
Capacity	Fans - 90 lcas units CFLs - >10Mn units	W&P paper - 60k tons Tissue paper - 25k tons

- **Segmental performance** –

Revenues (INR Cr)

Segments	**FY07A**	**FY08A**	**FY09A**	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14A**	**7yr CAGR**
Paper	263	274	290	239	278	334	349	430	7%
Electrical	243	285	341	481	642	756	912	1139	25%

EBIT Margins

Segments	**FY08A**	**FY09A**	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14A**	**7yr avg**
Paper	10%	1%	-18%	-12%	-19%	-22%	-3%	-9%
Electrical	8%	10%	13%	9%	7%	6%	6%	8%

ROCE

Segments	**FY08A**	**FY09A**	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14A**	**7yr avg**
Paper	17%	1%	-14%	-10%	-15%	-17%	-3%	-6%
Electrical	25%	30%	43%	28%	21%	19%	18%	26%

Electric's revenue mix%

Products	**FY11A**	**FY12A**	**FY13A**	**FY14A**
Fans	91%	87%	81%	73%
Lighting	9%	12%	14%	15%
Appliances	0%	2%	6%	12%

Paper sales volume mix

Products	**FY07A**	**FY08A**	**FY09A**	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14A**
W&P paper	89%	90%	90%	85%	77%	74%	74%	69%
Tissue paper	11%	10%	10%	15%	23%	26%	26%	31%

Industry Overview

- **Size and growth rates -**

INR Cr	Fans	Lighting	Home Appliances	Tissue Paper	W&P Paper
Size (FY14)	4,750	9,500	6,000	NA	NA
3yr CAGR	3%	12%	10%	15%	6%

growth for tissue paper is available only for FY13

- **Brief on various industries OPIL caters to -**
  - **Fans** – It's a highly competitive market with presence of lot of branded players such as Crompton Greaves, Orient, Havells, Khaitan, Bajaj, Usha, Orpat, Luminous and VGuard etc. Organized sector accounts for 80% of total industry. Table below represents market share of organized segment and fans revenues for top 4 players.

Company name	Revenues from fans (Cr)	Market share %
Crompton Greaves	988	26%
Orient	859	23%
Havells	700	18%
Bajaj Electricals	620	16%

  - **Lighting** – Market consists of CFLs, halogen, LEDs and luminaires. Lighting industry is witnessing a fast change in technology. Few years back candescent bulbs were replaced by CFLs because of less power consumption and bright white light. This time, LEDs are replacing CFLs for being even more efficient in terms of consuming power and having a long life. Over next five years, CFL market is expected to shrink and LED market is expected to grow at a very fast rate of 40% from its small base of ~450Cr in FY13.

  - **Home Appliances** – It's a fast growing market and shift from unorganized to organized makes it even more attractive for branded players. Lot of new players have entered this lucrative market over last couple of years making it more competitive.

  - **Paper** – This industry is cyclical in nature as new capacity takes couple of years to come online. Recent capacity addition from FY09-FY14 has been at a CAGR of 11% as compared to 3.6% in the previous cycle (FY03-FY08). During FY09-FY14, demand grew only by a CAGR of ~6%, leading to oversupply situation in the market. In addition to this, industry is also facing raw material supply challenges in terms of shortage of raw material leading to high cost of wood pulp. Tissue paper is a better margin product and finds a good market in exports.

Corporate Governance Checklist

We have understood each highlighted issue and we will be cautious of the same.

Checklist Point	Comments
Quality of board	All independent directors are 70 years old
Related party transactions	Ok
Change in auditors over last 10 years	No, SR Batliboi since 1996
Pledged shareholding of promoters	No
Warrants issued to promoters	Issued prior to demerger of cement business, dilution of 5% - there was no requirement for fresh funds
Promoters’ salary as % of PAT	Company is in losses right now and there is no decline in managerial remuneration
Opinion of auditors	Qualified in respect of water tax contingent liabilities