Dated: 21st May 2002

KARVY STOCK BROKING LIMITED
Private Client Group

Adlabs Films Limited

Company visit report: Initial Opinion

Person Met: **Mr. Manmohan Shetty**
Designation: Managing Director

Person Met: **Mr. NN Shah**
Designation: Company Secretary

Analyst: Amol Dhariya

We met up with Adlabs Films to ascertain its growth prospects. The company had recently announced that it would enter the activity of theatre management and film production. While negotiations with theatre owners in Mumbai are on, the company's finalised plans to launch four medium budget movies with an investment of Rs20 to Rs25 cr. These movies would be released in FY04.

Adlabs Films: Background

Adlabs is a motion picture processing house. It has facilities for processing raw exposed films, color correction, editing and making multiple copies of final print for the distributor. Adlabs has processed over 1,000 movies since inception and has a 70% market share of films in western India. Manmohan Shetty (54) and Vasanji Mamania (64) are its main promoters. They own close to 80% of the company's equity.

For FY02, the company had revenues of Rs56.7 cr, of which film processing accounted for 48.7%. Over 34% of the company's revenue came from supply of raw cinematographic film to producers on credit. This trading activity is integral to the company's core film processing business, since the raw film is stored and subsequently processed at its film-processing facility. Money is recovered from the producers after the film is shot and processed. In FY02, the company also commissioned its IMAX theatre (520 seats) and a multiplex (4 screens, 1225 seats). The IMAX dome theatre screens 15/70-mm large format films in the dome theatre & the multiplex would be screening the conventional 35mm movies. Revenues from film exhibition thus accounted for the balance 16.7% of its total revenues. It is for this exhibition business, that the company had made an IPO for Rs53 cr in December 2000.

Highlights of our meet:

- For FY02, the IMAX theatre achieved ticket sales of Rs5.12 cr at an occupancy of less than 35%, while the multiplex achieved sales of Rs2.45 cr at occupancy of 42%. Income from food and beverages stood at Rs1.55cr. It had to pay entertainment tax of Rs1.17 cr for FY02 since the state government's tax exemption for multiplexes was effective only from January 25, 2002. Going ahead, Adlabs would benefit from 100% exemption on entertainment tax for three years and 75% exemption thereafter for the next two years.

- For FY03, the company's planned a marketing campaign aimed at both promoting the IMAX experience as well as boosting occpancy at all its theatres. The company's has also negotiated for latest IMAX releases such as Ultimate X (produced by ESPN and Touchstone Pictures), Beauty & the Beast and Fantasia 2000 (both from Walt Disney). With more Hollywood production houses taking up production of movies in the IMAX (large film) fomat, occupancy at its IMAX (so far the only one in India) could improve substantially in the coming years. The company's marketing plan is also aimed at securing bulk bookings for school-going children at IMAX.

- Weekend collections at the box-office have today become more crucial. And unlike before where films were expected to run for several weeks, shelf life of most new films has been restricted to three to four weeks. As a result, there is a good churn of films at theatres. Pre-film publicity has also taken new proportions. This is driving occupany for Hindi movies.

- The company expects the film processing business to grow at a steady pace of 7% to 8%. The general buoyancy in the film production business has benefitted the company. The need for simultaneous releases across the country has led to an increase in the number of prints. With an annual capital expenditure of about Rs1 cr, the processing business is thus expected to generate surplus cash for the company's new ventures.

- Its film production strategy is aimed at making medium budget movies within schedule, with proper planning and execution. The movies are lined for release in FY04. The initial round of four movies would be internally financed. The company expects to finalise directors and scripts for its movies and would make an announcement in this regard in the next 2-3 months.

- Regarding theatre management too, the company expects to make a concrete announcement in the next month or so. The idea behind theatre management is to create a brand out of Adlabs, which the consumers can associate with. It is also to create bargaining power for itself as an exhibitor while negotiating movies with distributors. Currently, there are no plans to merge, Fame Adlabs, a multiplex at Lokhandwala, Andheri, with Adlabs. Fame Adlabs is partly owned by the company's managing director, Manmohan Shetty.

Financials

Adlabs financial performance has been quite impressive and given its strong position in the film processing business, it's not a surprise. For FY01, growth in print volumes led to a 30.7% growth in revenues to Rs46 cr. While for FY02, the new line of business, namely exhibition led the 22.3% growth in revenues to Rs56 cr. Operating profit margins improved sharply in FY01 to over 32% on the back of volume growth in the processing business. However, for FY02 OPM was marginally lower given lower profitability of the exhibition business in its first year of operations. Inclusive of the entertainment tax, the exhibition business had an OPM of just 14.4%. However, we expect overall OPM to improve at 34.5% for FY03 on revenues of Rs73.5 cr, of which exhibition revenues are estimated at Rs23.6cr.

Exhibit 1: Financial Performance and Projections **(Rs in crore)**

Year ending March 31st	FY01	FY02	FY03 (P)	FY04 (P)
Net revenues	**46.36**	**56.69**	**73.50**	**80.01**
Total expenditure	**31.23**	**40.15**	**48.13**	**52.21**
Operating Profit	15.12	16.54	25.37	27.79
OPM (%)	*32.63*	*29.18*	*34.52*	*34.74*
EBIT	13.97	12.83	20.13	22.45
Interest	0.23	0.97	0.80	0.20
Other Income	2.80	4.09	4.50	5.00
PBT	16.54	15.95	23.83	27.25
Taxes	5.00	5.70	6.67	7.63
PAT	11.54	10.25	17.16	19.62
Equity Capital (Face Value: Rs5)	10.75	10.75	10.75	10.75
EPS (Rs)	5.37	4.77	7.98	9.13

Valuation

The current market price of Rs60 discounts Adlabs' FY02 earnings at 12.5x. Price-to-sales ratio (PSR) is roughly 2.4x. Comparative valuation in its line of business is not available. However, we would use Mukta Arts for a forward relative valuation, especially since Adlabs is moving into film production and we believe that Adlabs has the strengths to emerge as a quality film production house just like Mukta Arts.

As a pure production house, Mukta Arts trades at a forward (CY02 estimated) PE of 10x and at a PSR of 2.9x. While Adlabs, based on its existing lines of business, trades at a FY03 PE of 8x and a PSR of 1.9x. Though film revenues will only accrue in FY04, we believe that clarity on the company's execution skills in the movie business (over the next few months) will drive a re-rating for the stock ahead of actual revenue visibility. Excluding these movie revenues, Adlabs currently trades 7x FY04 earnings.

Investors would also find Adlabs worth the wait for the following fundamental reasons:

1. One of the main promoters of Adlabs, Manmohan Shetty enjoys trememdous amount of goodwill in the film industry and it is not known to many that he has been closely associated with several successful film projects: *Ardh Satya, Akrosh, Chakra, Hip Hip Hurray, Kabhi Haan Kabhi Naa* and *Sarfarosh.*
2. Adlabs is using cash surpluses (Rs30 to Rs35 cr) from existing business to move up the value chain. Unlike Mukta Arts, Adlabs is thus also expected to emerge as a more diversified media play. However, unlike annuity-like cash flows from its current business, film revenues are seasonal and unpredictable. But given the management's track record and understanding of the film business, we see the unpredictability of the film business as a risk that the company can manage.

We rate Adlabs a **"Market Outperformer"** and would recommend buying with a 12-month price target of Rs100.

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