

## **Cosmo Films Limited**

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**Not Rated**  
**Rs105**

We met *S K Mittal, CEO*, Cosmo Films Limited (CFL) to understand the company's business dynamics. In this visit note, we have covered the company's expansion plans and future strategies. CFL has done well to bring down its costs over a period of time and this should reap good benefits in the long term. However, in the short to medium term we expect the margins to be under pressure.

### **Background**

CFL is a pioneer in the manufacture of bi-axially oriented polypropylene (BOPP), which is used as a packaging material in the consumer product industry. Incorporated in 1976, the company started with an installed capacity of 800mta. However, over the years the company has increased its capacity along with becoming a cost efficient player. In FY02, the company acquired Gujarat Propack Limited and increased its capacity by 10000mta. Current capacity of CFL stands at 46000mta.

### **Key Takeaways**

#### **Capacity Expansion – Among the Top-15 players in the world**

CFL is further increasing its capacity by 14000mta to take its total capacity of BOPP to 60000mta. Capacity expansion is expected to be over by March 2004 and CFL will then become among the Top-15 players of BOPP in the world. Capacity expansion undertaken will cost CFL Rs500mn, part of which is funded by external commercial borrowings (ECBs).

#### *Worldwide Industry*

Worldwide BOPP is a 3.8mn mta market. The BOPP market is growing strongly at 15% p.a. BOPP capacities are scattered around the world with a presence in the US, Europe and South East Asian countries. Exxon is the largest player with a capacity of 0.17mn mta. BOPP is among the preferred packaging material due to its excellent moisture barrier, high stiffness and good optical properties. Its usage ranges from packaging material for snacks, confectionaries, baked goods, dried foods and tobacco, to name a few.

#### *Domestic market*

The domestic market for BOPP was 56,500mt in 2002-03 and is growing at 12-13%. Recently, there has been a capacity expansion by a few domestic players including Cosmo, Flex Industries and Jindal Polyester. This should create a demand-supply mismatch in the short term. However, in the medium term excessive capacity will start catering to the export market. We expect CFL's sales in the domestic market to slow down, which should however be compensated by growth in exports.

#### **Substantial savings in Power and Fuel cost**

Power and Fuel (P&F) is the second highest cost among the operating costs for CFL. P&F expenses constituted 7.2% of sales (Rs253mn). P&F cost is as high as Rs8.3 per kg of output. To reduce the P&F cost, the company is setting up an 8 MW captive power plant (CPP) at a cost of Rs200mn. This CPP will be operational by September 2003, which should lead to substantial savings in P&F cost. The company expects the power cost to reduce to Rs6 per kg of output.

**Significant reduction in interest cost**

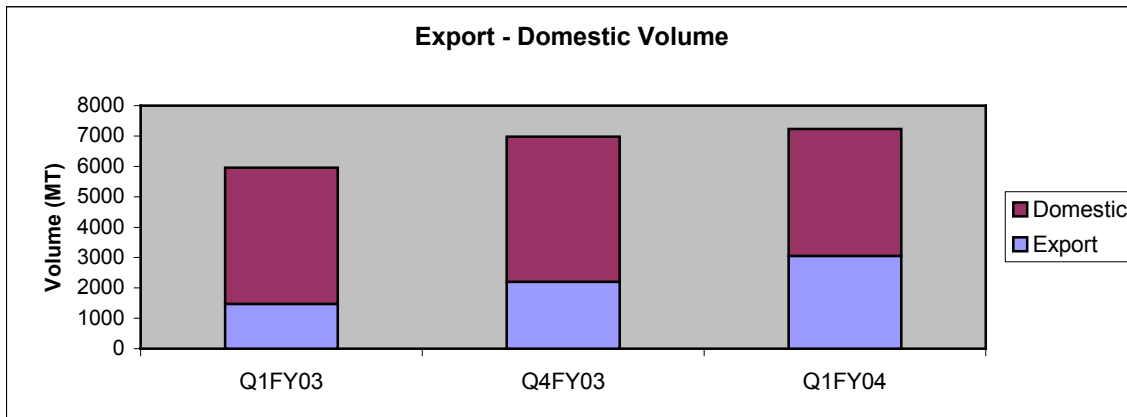
CFL has done well to reduce its interest cost. The company has converted its loans into ECBs, which has led to substantial savings in interest expense. The average interest cost is at around 4.5%, down from 11% in FY03. In Q1FY04, interest expense stood at Rs28.8mn as compared to Rs36.0mn in the previous corresponding quarter. However, interest expense of Rs28.8mn included Rs9.5mn on account of pre-payment of loans. If this is excluded, interest expense will be down by 46% YoY.

**Domestic Realisation could be under pressure**

We believe that domestic realisation for CFL could be under pressure as more BOPP capacities are being added. Flex Industries and Jindal Polyester have also increased their capacity in the last year, which could lead to a demand-supply mismatch in the short term.

**Exports to be growth driver**

CFL’s future growth will clearly come from exports. In FY03, exports constituted 25% of sales. In Q1FY04, exports rose by a whopping 156% (Y-o-Y) to Rs320.3mn. In terms of volume, exports grew from 2199 tonnes in Q4FY03 to 3057 tonnes in Q1FY04, a sequential growth of 39%. The company is exploring new markets including Russia, Africa and the European countries to drive future growth. However, we believe export realisation would be under pressure due to the depreciating Dollar.



Source: Company

**Margins under pressure in first quarter**

CFL’s EBITDA margins declined substantially to 21% in Q1FY04 from 29% in Q1FY03. Fall in margins is attributed to the following two reasons:

- Firstly, CFL completed its capacity expansion of 10000 mta in March 2003. To utilise its enhanced capacity and not keep it idle, the company sold low margin products with realisations below average. We believe that it would take CFL another quarter to stabilise its new plant.
- Secondly, polypropylene (PP), the raw material for BOPP also saw a sharp run up in the prices due to a rise in crude oil during January-March 2003. PP prices increased from Rs40 per kg to Rs50 per kg during the period. The company maintains a 50 days raw material inventory and this impacted its raw material cost in Q1FY04. However, PP prices have now stabilised and are back to Rs42 per kg levels. We believe that this should lead to some improvement in operating margins in Q2FY04 as compared to Q1FY04.

### New facility commences production

CFL commissioned its new production line of 10000mta in March 2003. The company produced 1463mt during Q1FY04 from this facility. We believe, capacity utilisation will increase once the production line stabilises.

### Financials: Quarterly Review

#### *Strong topline growth*

CFL reported strong topline growth of 22% to Rs867.7mn during Q1FY04. This growth was primarily driven by export sales, which grew by 156% to Rs320.3mn. However, domestic sales were down by 7%. We believe that the domestic slowdown was due to the fact that a number of capacities have been added in the domestic market, which has led to temporary demand-supply mismatch. However, exports growth has more than compensated for decline in the domestic sales. We expect export would be the growth driver for CFL going forward.

#### *Rising raw material prices and lower realisation resulted in lower margins*

CFL's operating margins declined from 29% in Q1FY03 to 21% in Q1FY04 due to lower realisations and rise in raw material cost. However, we believe that realisations should stabilise in another quarter. On the raw material front, price of PP has declined considerably which should also lead to improvement in operating profit going forward. Moreover, Power and Fuel cost increased substantially by 60% due to commencement of the new production line. Power and fuel cost per kg of output increased by Rs7.4 to Rs8.6.

### View and Valuation

We expect CFL's sales to grow 18% in FY04. Though we believe, in volume terms the growth would be more, but realisation will decline in the short term. We expect operating margins to decline as well from 30% in FY03 to 24% in FY04. However, we expect the operating margins to improve once the new production line stabilises and new CPP is in place. Net profit is expected to grow from Rs402mn in FY03 to Rs472mn in FY04, representing a growth of 17.5%. At current levels (Rs100), the stock is trading at 3.5x FY04 earnings. Though we believe that the valuations are pretty cheap, concerns over the operating margin will remain in the short term.

Financials	Rs Million			
YE March 31	FY01	FY02	FY03	FY04E
<b>Revenues</b>	1293.6	1593.9	3501.8	4140.0
<i>% chng</i>		23.2	119.7	18.2
Less: Excise	121.4	141.2	348.8	414.0
Net Sales	1172.2	1452.7	3153.0	3726.0
EBITDA	198.6	367.3	934.0	885.5
<i>% chng</i>		84.9	154.3	-5.2
EBITDA %	16.9	25.3	29.6	23.8
Other Income	21.3	31.9	41.4	80.0
Depreciation	60.3	113.8	220.7	268.9
PBIT	159.6	285.4	754.7	696.6
Interest	56.4	41.0	139.5	83.3
PBT	103.2	244.4	615.2	613.3
Tax	7.9	71.9	213.2	141.1
% PBT	7.7	29.4	34.7	23.0
<b>PAT</b>	95.3	172.5	402.0	472.3
<i>% chng</i>		81.0	133.0	17.5
Shares Outstanding	8.2	8.2	17.0	17.0
EPS(Rs)	11.6	20.9	23.7	27.8



17 July 2003  
Visit Note

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