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Aditya Birla Nuvo

Company at tipping point of generating superior return on capital employed in its diversified businesses

CY13 RETURN
9%

STOCK PRICE
₹1,189

P/E (FY15)
11X

MARKET CAP
₹15,463 cr

NET SALES
₹25,490 cr

NET PROFIT
₹1,184 cr

ROE
14.23%

ROCE
13.12%

A prolonged economic downturn is a testing time for many businesses and their promoters. Many giants fall and make way for newer leaders with better capital structure, impeccable management bandwidth and operating structure. One such company is Aditya Birla Nuvo (ABN). The company has an interesting mix of value-creating businesses that represent domestic consumption (telecom, fashion and garments), import substitution (fertiliser, viscose fibre yarn) and financial services (insurance, NBFC lending, asset management) among several others. These business lines give it a unique competitive advantage in allocating funds across varied businesses and lower cost of capital. It can finance longer gestation businesses and withstand short-term earnings volatility while keeping in sight long-term goals and value creation.

ABN was predominantly a manufacturing house till a few years ago. It has embarked on a programme to build a new economy services sector business backed by cash flows from the manufacturing business and captured that transition successfully. During FY05-13, the share of manufacturing in revenue dropped from 67% to 28%. Services and consumption revenues now constitute the bigger part and reflect future opportunities. The company has painstakingly gained leadership position across business lines and widened the moat on the back of disciplined execution.

COMING OF AGE

Take a look at the key milestones that have defined the entrepreneurial spirit of the company and laid the foundation for robust growth in future. ABN has successfully built a pan-India telecommunications powerhouse, Idea Cellular. The telecom business has crossed the regulatory minefield and increased market share to the current 16%, while competition intensity has reduced considerably. The company is the sole investment vehicle of the Aditya Birla group in telecom and has 26% investment in Idea Cellular. The sector was marked with high capital investments (₹9,000 crore by ABN) and poor return. However, with the reduction in competitive intensity the return on capital employed (RoCE) will improve for the company.

Then, ABN has built a high-growth fashion and branded garment business, Madura Lifestyle, that generates revenue of ₹2,200 crore and RoCE in excess of 20% a year. The business was a loss-making acquisition for a long time, but the unique operating structure and stable earnings of the group have led to business creation over the last eight years while most competitors have floundered in the downturn.

Also, ABN has built insurance (8% market share) and asset management (9.4% market share) businesses with JV partners and is among the top five players in terms of market share and profitability. It is one of the prime candidates among 26 applicants for new banking licences to be issued by the Reserve Bank in 2014. ABN also has presence in retail broking, wealth management, distribution of financial products and general insurance advisory and has forayed into private equity as well.

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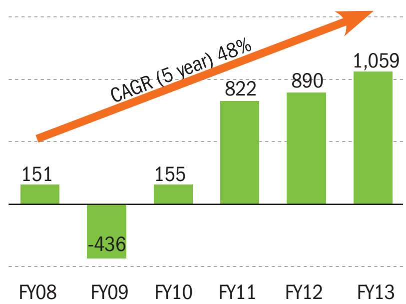
Profits have shown a robust 48% CAGR over the past five years

Net profit (₹ cr)



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HARVEST SEASON BEGINS

While ABN transformed its portfolio and grew new businesses, its market cap has grown only marginally. Shareholders have for long complained about focus, low RoE/RoCE generated by the operating businesses and investment structures with long payoffs. During 2007-2013, ABN seeded new businesses. Its key businesses are attaining critical mass within their industry segments. Now it is positioned to deploy sizeable capital and realise attractive returns. The company has switched from investment mode to harvest mode now, and has a three-pronged strategy to achieve this.

The first part is to consolidate segment leadership with bolt-on acquisitions. In 2012, ABN acquired the retail format business of Pantaloon for ₹1,200 crore, employing its management bandwidth to harness synergy and turn around this business. This creates a combined fashion enterprise of about ₹4,000 crore (sales) with revenue growing in excess of 15% a year, synergies of scale and a tight control over working capital. Given that most competitors operate in niches or lack the financial capability to drive consolidation in the industry, the company is well placed to lead the rapid transition from unorganised to organised markets. It is also eagerly waiting for policy guidelines for the fertiliser business and is geared up to make significant investments in this business, which has a good RoCE.

Second, ABN is realigning its business portfolio. It has divested the low-margin carbon black business and redeployed capital in the NBFC lending business, which is generating higher RoCE over an economic cycle. It has also marked out the ₹2,400-crore IT-ITES business, which generates an RoCE of less than 9%, for divestment. This will release capital of ₹2,000 crore that can be deployed in other businesses.

The third part of the strategy relates to value unlocking. ABN has considerable experience in financial services through its activities in NBFC lending, life insurance and asset management. With its impeccable track record, the group is a strong contender for a banking licence. If that happens, the financial services businesses will be spun off into a separate structure, thereby unlocking the value of the investments and reducing the holding company discount attributed to the listed company.

I believe that market participants are overlooking the last decade's journey of capital-intensive business with competitive advantages. Sales, profit after tax and book value at ABN have grown at a CAGR 30% over the past eight years. The company has achieved this with minimal dilution of equity. It generated cumulative operating cash flow of over ₹15,500 crore, which has been deployed in various growth businesses as well as to reduce debt. Overall, the total debt level is close to 1.0X, much less if we remove the leverage by NBFC. Most of the new businesses have attained a reasonable size and market leadership in their respective industry. I foresee improvement of 100 basis points a year in consolidated RoCE from the current 11% for the next three years. This tipping point — superior RoCE in these businesses — will be the most powerful re-rating trigger for the company, a fact missed by market participants. More importantly, the stock is currently trading at an attractive valuation: estimated FY15 earnings multiple of 11 times. OB

THE WRITER AND HIS CLIENTS HAVE INVESTMENTS IN AB NUVO

ABN's key businesses are attaining critical mass within the industry segments and are poised to generate attractive return

Return on capital employed has been quite robust in key businesses

BUSINESS	%
Textile	97
Life insurance	42
Viscose Filament Yarn	26
Garments	21
Fin. services	16
Fertiliser	12
IT/ITES	11
Insulators	10
Telecom	10
Carbon black	7

Note: Data for FY13