Liberty Shoes Ltd. (LSL) – Q3FY14 Result Update

HDFC sec Scrip code	Industry	CMP (Rs.)	Recommended Action	Averaging Price Band (Rs.)	Target (Rs.)	Time Horizon
LIBSHOEQNR	Footwear	126	Buy at CMP and add on dips	109-114	156	1 quarter

LSL is engaged in manufacturing & selling leather & non-leather footwear. It is the only Indian company which is amongst the world's top 5 manufacturers of leather footwear, producing over 50,000 pairs of footwear a day (in peak season). Its products are marketed across the globe through ~150 distributors, ~543 exclusive showrooms (franchisee and company owned) & over 6000 multi-brand outlets.

LSL's Q3FY14 results were impressive and above our estimates on all parameters. We present an update on the stock.

Q3FY14 Results Review

Standalone

Y-o-Y

- The net sales grew by 22.7% to Rs. 1145.5 mn [Q3FY13: Rs. 931.7 mn], driven by a mix of volume growth (9.6%) and price hikes (12.2%).
- Exports grew by 35.3% Y-o-Y, led by 26.1% growth in volumes. Domestic growth stood at 21.8% Y-o-Y, driven by 12% price hikes. Region-wise, the domestic growth was driven by North & South (up 25.1% & 27.9% respectively). West grew by 15.1%. However, growth in East was marginal at 1.3%. On a segmental basis, institutional sales grew by 44.8% (healthy growth in premium warrior brand safety shoes sold), while growth in wholesales & exclusive stores stood at 19% & 16.7% Y-o-Y respectively. Company owned showrooms (Liberty Retail Revolutions - LRR) grew at a slower rate by 8.8%, as LRR decided to lower its inventory level (LRR store sales were up by 30%, hence demand was not an issue).
- Operating profit grew by 37.1% Y-o-Y, while OPM improved by 88 bps Y-o-Y to 8.4%, led by lower growth in other expenses (up 8.7% Y-o-Y). However, higher material & employee cost restricted further expansion in margin.
- PAT grew by 86.4% Y-o-Y to Rs. 32.8 mn [Q3FY13: Rs. 17.6 mn], aided by marginal growth in depreciation cost (up 5.1% Y-o-Y) and sharp fall in effective tax rate (down from 7.8% in Q3FY13 to -0.6% in Q3FY14). PAT margins improved by 102 bps Y-o-Y to 3%. However, interest cost remained higher (up 36.6% Y-o-Y), which restricted further margin expansion. EPS for the quarter stood at Rs. 1.9 vs Rs. 1 in Q3FY13.

Q-o-Q

- Sequentially, the results were decent. Net sales grew by 5.3% Q-o-Q, while the operating profit grew by 7% Q-o-Q, led by marginal growth in the employee cost (up 0.3%). OPM rose 13 bps Q-o-Q.
- PAT grew by 9.7%, better than the performance at operating level, aided by lower depreciation cost (up 3.5% Q-o-Q). PAT margins improved by 12 bps Q-o-Q.

Consolidated

Y-o-Y

- The gross sales grew by 24% to Rs. 1243.7 mn [Q3FY13: Rs. 1002.9 mn], led by 112.3% growth in subsidiaries' sales.
- PAT grew by 55.5% Y-o-Y, while PAT margins improved by 59 bps Y-o-Y to 2.9%.

Q-o-Q

- The gross sales grew by 10.1%. The subsidiaries sales grew at a faster rate by 37.9% Y-o-Y, led by robust growth from LRR.
- PAT grew by 79% Y-o-Y, while PAT margins improved by 112 bps Q-o-Q.

Quarterly Financials: Standalone

(Rs. in Million)

Particulars	Q3FY14	Q3FY13	VAR [%]	Q2FY14	VAR [%]	Remarks
Gross Sales	1145.5	931.7	23.0	1083.9	5.7	Y-o-Y growth was driven by a mix of volume growth (9.6%) and price hikes (12.2%). Exports grew at a faster rate by 35.3%. Region-wise, the domestic growth was led by North & South, while Segment-wise, the growth was driven by institutional segment (22.4% of the total sales)
Excise Duty	45.6	35.1	30.1	39.7	14.8	
Net Sales	1099.9	896.6	22.7	1044.2	5.3	
Other Operating Income	4.7	4.5	5.9	4.0	18.5	
Total Income	1104.6	901.0	22.6	1048.2	5.4	
Total Expenditure	1012.7	834.0	21.4	962.3	5.2	
Raw Material Consumed	441.7	278.2	58.7	506.5	-12.8	Material Cost / Net Sales increased by 192 bps Y-o-Y & 42 bps Q-o-Q to 55%.
Stock Adjustment	88.4	72.4	22.1	-94.3	-193.8	
Purchase of Finished Goods	74.9	125.3	-40.2	157.9	-52.5	
Employee Expenses	127.2	100.1	27.1	126.8	0.3	
Other Expenses	280.5	258.0	8.7	265.5	5.7	Other expenses were lower on Y-o-Y basis on the back of decline in the royalty / franchisee fees (paid to the group companies for use of facilities, network and Liberty trademark) as a % to net sales from 4.78% in Q3FY13 to 4.33% in Q3FY14.
Operating Profit	91.9	67.0	37.1	85.9	7.0	
Other Income	-0.3	0.5	-	0.1	-	
PBIDT	91.6	67.5	35.6	85.9	6.5	
Interest	37.7	27.6	36.6	35.6	5.9	Higher interest cost on Y-o-Y basis was due to higher utilisation of working capital limits and increase in the cost of borrowing.
PBDT	53.9	39.9	35.0	50.4	7.0	
Depreciation	21.7	20.7	5.1	21.0	3.5	
PBT	32.2	19.3	67.0	29.4	9.5	
Tax (including DT & FBT)	-0.2	1.5	-	-1.0	-	Negative tax expense was due to MAT credit entitlement.
Reported Profit After Tax	32.4	17.8	82.1	30.4	6.6	
Extra-ordinary Items	-0.4	0.2	-	0.5	-	
Adjusted PAT	32.8	17.6	86.4	29.9	9.7	Marginal growth in the depreciation cost & sharp fall in the effective tax rate boosted the PAT

						growth on Y-o-Y basis
EPS (Rs.)	1.9	1.0	86.4	1.8	9.7	
Equity	170.4	170.4	0.0	170.4	0.0	
FV	10	10	0.0	10	0.0	
OPM (%)	8.4	7.5	11.8	8.2	1.6	Y-o-Y OPM expansion was led by lower growth in other expenses (due to lower growth in royalty / franchisee fees)
PATM (%)	3.0	2.0	52.0	2.9	4.2	

(Source: Company, HDFC sec)

Other highlights / developments:

- The company has projection Rs. 480-500 mn of export sales in FY14 and expects the healthy growth momentum to continue in FY15 (~30% growth expected) on the back of expansion into new geographies.
- The total number of franchisees has increased from 390 in 9MFY13 to 445 in 9MFY14, while the company owned showrooms stood at 98 as on Dec 31, 2013, compared to 85 as on Dec 31, 2012. The company plans to increase the number of franchisee stores to 455 by the end of FY14 and to 495 by FY15. It plans to increase the company owned stores to 105 by FY14 and to 180 by FY15 (addition of 75 new stores). Along with continuing focus on North & South, the company plans to expand its presence in Western region.
- The management stated that the amount of royalty / franchisee fees paid to the group companies as a % to sales would reduce further in Q4FY14 and in FY15 as the entities have agreed to a cap on these fees.
- As regards the restructuring of some or all of the group companies (Liberty Enterprise, Liberty Group Marketing Division & Liberty Footwear Company), the company indicated that the same is likely to be completed by March 31, 2015.
- LRR will merge LSL from Q4FY14 as it expects to receive final orders by end of March.
- The company incurred a total CAPEX of Rs. 58 mn at the standalone level in 9MFY14.
- The company expects the working capital cycle to improve going forward. The inventory days are expected to reduce from 94 days in FY13 to 80 days in FY14, while the receivable days are likely to come down from 100 days in FY13 to 85 days in FY14.

Conclusion & Recommendation:

After reviewing LSL's 9MFY14 results we feel the company could surpass our projections for FY14 & FY15. Hence we are enhancing our net sales, operating profit & PAT estimates by 8.2%, 6.1% & 28.6% respectively for FY14 and by 8.1%, 6.7% & 25% for FY15.

Sales growth is likely to be driven by distribution expansion, penetration into low presence / untapped markets, new launches, incremental revenues from new stores and robust industry outlook. We expect the organised footwear market to grow at a robust pace over the next two years, as economic growth is expected to improve in FY15, which would improve the spending power and increase the demand for LSL's products. Low per capita consumption of footwear in India provides immense growth opportunity going forward. Being an established branded player with strong domestic presence, LSL is likely to benefit immensely. Timely ramp up of the new stores could enable LSL to expand its reach and boost its revenues & profits going forward. TOC approach would continue to help LSL to attract more channel partners and expand its reach and range in its key markets as well as in areas which are untapped or where it has low presence. LSL also expects its export business to do well going forward, which would further boost the growth.

LSL's OPM is likely to improve over next two years on the back of stability in the input prices (as majority inputs are crude based and crude oil prices are expected to fall or remain stable) and cost rationalisation (lower marketing expenses). Consolidation of retail operations (in the form of lower service tax & CST) and a cap on fees to related parties could also aid in margin improvement. Higher OPM, relatively lower growth in depreciation & interest cost & NIL tax could boost the PAT & PAT margins over the next two years

Minority shareholder friendly restructuring of financial arrangements with group companies and subsidiary (if proposed and extensive) could result in value unlocking, add value to brand, better credit rating, valuation re-rating and boost profits. Timely implementation could enable LSL to rope in a PE investor to fund its expansion plans. Restructuring would ensure that the company will own the brand/sub-brands and the facilities and hence it would not be required to pay the licence / franchise fees which would boost the net profits significantly. Shareholder friendly initiatives (like successful and comprehensive restructuring, dividend payments) and sustained growth in turnover & profits could narrow down the discount in valuations to its nearest peers Bata India & Relaxo Footwear.

In our Management Interaction Note dated Dec 17, 2013, we recommended investors to buy LSL at the then CMP of Rs. 95 and to average it further on dips in the price band of Rs. 83-87 for a price target of Rs. 125 over the next 1-2 quarters. The stock met our price target on Dec 24, 2013. At CMP, the stock is trading at 12.1xFY15E Revised EPS. Based on earnings upgrade, we are revising our price target to Rs. 156 (15xFY15RE EPS). We feel investors could buy the stock at CMP and add it on dips to Rs. 109-114 (10.5-11xFY15E Revised EPS) for our price target over the next quarter. Faster progress on restructuring and improved financials could result in re-rating in the stock prices going forward.

Financial Estimations: (Consolidated)

(Rs. in Million)

Particulars	FY11	FY12	FY13	FY14 (OE)*	FY14 (RE)*	FY15 (OE)*	FY15 (RE)*
Net Sales	3099.0	3563.9	3628.6	4492.8	4860.9	5285.1	5711.6
Operating Profit	242.0	308.3	301.1	382.2	405.6	460.5	491.2
Adjusted PAT	61.8	79.4	57.9	104.4	134.3	141.7	177.1
EPS	3.6	4.7	3.4	6.1	7.9	8.3	10.4
OPM (%)	7.8	8.7	8.3	8.5	8.3	8.7	8.6
NPM (%)	2.0	2.2	1.6	2.3	2.8	2.7	3.1
PE	34.7	27.0	37.1	20.6	16.0	15.2	12.1

*OE = Original Estimates; RE = Revised Estimates (Source: Company, HDFC sec Estimates)

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