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Game Changer Stock Idea#1 - Gokaldas Exports

Date: 19th Sept 2019

Wtg% in portfolio = Max 10% [Initial 5% between 80-85 & final 5% between 60-65]

Price target = Around INR 800 by 2024 (Assuming 60% CAGR for next 5 years which is achievable)

Market Cap: 366 Cr	**Current Price: 85**	52 weeks H/L: 119 / 65
Book Value: 56	Stock P/E: 9.24	Dividend Yield: 0 %
ROCE: 10.11 %	ROE: 16 %	Sales Growth (3Yrs): 1.48 %
Face Value: 5.00	Promoter Holding: 32.93	Dividend Payout: 0 %
Sales Growth (10Y): 0.72%	Profit Growth (10Y): 23.41%	ROE (10 Years): -16.93%

* Financial ratios, growth track record, dividend payouts are not good because it's turnaround case.

Dear Friends,

Have you ever tried **getting a 'feel' of the MD/CEO speech** or Management Discussion section in the annual report? You might not have, but I do because I believe more on **'gut feeling or intuition'** than the financial jargons which may not show the true picture/state of the company. I normally read 8 out of 10 annual reports published every year (except ultra micro caps or large caps), although I do not read it completely but a cursory glance for 5-10 minute will be enough to catch your attention if something new or something unique is happening in the company, some new slogan, new product, new management etc. I still remember reading AR 2009-10 of APL Apollo Tubes Ltd **(https://www.bseindia.com/bseplus/annualreport/533758/5337580310.pdf)** erstwhile Bihar Tubes Ltd during 2010, it was just 250-300 Cr company then and while reading their AR you can very much feel the clarity of thoughts, execution capability, achievements and vision.

In nutshell what I mean to say that, financial numbers are available for everyone to interpret; what you need to develop is to **get a "feel" of the changing environment in the company** and for that you need to read a lot, think a lot, discuss with like-minded people and focus more on reading history because end of the day, most of the success stories have similar pattern, what changes is the sector, theme, players but the ingredients required to become wealth creator remain same!

Gokaldas Exports was not a new company for me, I use to track it during 2007-10 period, in those days it was called **"Infosys of Textile Sector"** but after the change in management to Blackstone group it lost its charm. One of the article published in ET which got my attention again in May 2019. One advice, never go with face value about the articles published in ET because most of these are paid articles and published with some self interest. According to me the easy way to ruin your financial health is to blindly follow the articles or stories published in these pink papers, financials magazines' or stock discussed by TV anchors.

Here is the article on Gokaldas Exports in Economic Times - May 19th 2019.

https://economictimes.indiatimes.com/industry/cons-products/garments-/-textiles/how-sivaramakrishnan-ganapathi-knit-the-biggest-revival-story-of-indias-apparel-export-industry/articleshow/69389940.cms

Well, I decided to give it a thought and looked into their AR from 2010 till 2019, what I found in last 2 years of AR is there is something new happening, during 2018 they started a theme called **"NO LIMITS! - PHILOSOPHY IN ACTION",** I can feel the fresh energy injected in this company by new MD. The story goes like this, Gokaldas Exports who use to be India's largest textile exporter during 2005-06 period was bought by Blackstone PE in 2008. Promoters of Gokaldas Exports (3 brothers who use to run the business were in late 60s decided to exit and engage themselves into the business ventures owned by their siblings). For Blackstone PE it's a small investment out of their large portfolio. They were not able to manage this company and a decade later, they sold this to Mathew Cyriac, former Co-head Private Equity, Blackstone who started his own fund. Now, the company is in the hand of individual from institution. Mathew Cyriac first task was to hire a CEO, and the second, backing them up with necessary capital. When he looked around, he found that most apparel exports companies were led by their owners. He decided that he need to find a CEO who would think like an owner. Sivaramakrishnan Ganapathi (Mathew Cyriac friend & classmate at IIM-Bangalore) who was associated with Aditya Birla Group since last 2 decade & was responsible for turnaround of Idea Cellular, got the mandate to turn around the company, once India's largest apparel exporter.

Ganapathi visited the company's Bengaluru factory four times before he signed on. Since last 1 year, green shoots are visible for Gokaldas with revenue up 11%, 16% YoY in FY18, H1FY19, respectively. Mathew Cyriac bought shares from Blackstone @42 in March 2018 , QIP of 70 Cr happened @90 in May 2018 to L&T Mutual Fund and HSF Mauritius is a fund managed by Samir Arora, a high net-worth individual, who actively invests in domestic equities. Stock has shown strength even in the weak market and downside is limited from CMP of 85/share. Accumulation between Rs 65 to 80 over the period of next 6 months will provide exceptional returns. Just for the purpose of understanding, we have mentioned below **the chart showing movement of stock during last 10 years and expected movement of stock for the next 5 years.** One can expect upside of 50-75% during next 6-12 months but the real move will start in 2020-21.

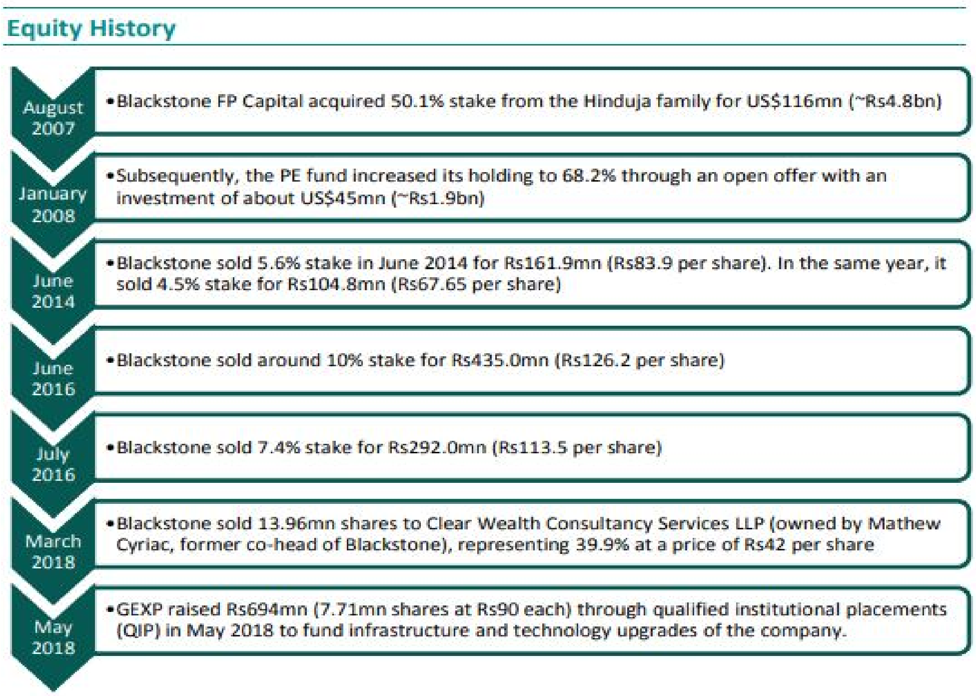
Following are the topics covered in this report....

1) **About Gokaldas Exports**
2) **What went wrong in last ten years?**
3) **What has changed in GEXP in the last twelve months?**
4) **Key Growth Drivers**
5) **Key Risks**
6) **Outlook & Valuations**

About Gokaldas Exports

Gokaldas Exports (GEXP) is a leading apparel exporter since 1979 with marquee clientele across USA, Canada, Europe, Japan, Russia, Middle East, South Africa and South America. It has 16 facilities with a capacity to manufacture 30m garments pa. Originally promoted by the Hindujas, it was later sold to Blackstone in 2008. During the Blackstone era, the management focus got diluted, operational efficiencies suffered; gross margins slipped and overall performance was adversely impacted.

In 2017, Blackstone exited and sold their 39.9% stake to Clear Wealth Consultancy Services LLP (owned by Mathew Cyriac, former Co-head Private Equity, Blackstone). **Mr. Siva Ganapathi was appointed as the MD in October 2017. Since then GEXP has witnessed significant improvement in its performance.** During FY19, topline grew by 13.8% to Rs 1174.5 crores on back of improvement in efficiencies, addition of new clients and increased wallet share from existing customers. It reported EBITDA of Rs 61.8 crores after reporting EBITDA losses for the past 2 years. EBITDAM improved from -3.4% in FY17 to 5.3% in FY19 due to reduction in wastages from 4% to 3% and improvement in efficiencies from 34% to 39%. The company has zero long term debt and has reduced its working capital requirement by Rs 93 crores from FY17-19 in spite of topline growth of 12.4%. Further, GEXP has successfully turned free cash positive in FY18 (Rs 18.2 crores). However in FY20 it will be marginally free cash negative due to capex of Rs 70 crores before turning positive once again in FY21.



What went wrong in last ten years?

The buy-out by Blackstone and the change in management brought about a sea change towards business execution. When the Hindujas were in the management each of the Hinduja brothers involved had a clear role to play in sourcing, operations and finance. **With the ownership shifting to Blackstone, we believe that the focus got diluted which impacted its all-round performance gross margins slipped and operational efficiencies got hit.** In a nutshell, we view this transformation as a result of a muddled leadership causing operational inefficiencies and losses.

What were the inefficiencies?

1. The business was divided into six SBUs, each SBU having end-to-end charge from procuring material to manufacturing. This led to diseconomies of scale for the company.

2. The management divided factories customer-wise and not product-wise (all types of products for a customer would be manufactured at a single unit). This led to two problems –firstly, not all factories had the expertise to produce all kinds of garments and secondly, no further orders could be taken from a customer if capacities at a particular factory were running at a peak utilization (as prior client certifications would be required to process the order at any other factory). Over a period of time, this led to business as well as financial losses.

3. Factory-wise P&L were prepared and instead of finding ways to improve operational efficiencies and thereby generate profits, the loss-making factories were subsequently sold or shut down. (2007: 54 factories, 2018: 22 factories).

4. As the state-of-the-art blazer manufacturing unit was loss-making, it was sold to Raymond. From having the ability to produce a bouquet of products, GEXP saw its manufacturing bandwidth curtailed, leading to sub-optimal operations.

5. Since garment manufacturing is a low-margin business, management needed to maintain focus on increasing efficiency and reducing wastages, which failed to happen.

6. Wastages in the form of rejected garments, style-specific unused fabric and trimmed raw material could have been reused. Also high input consumption were costs that undermined GEXP's profitability.

What has changed in GEXP in the last twelve months?

In 2017, Clear Wealth Consultancy Services LLP acquired GEXP from Blackstone for Rs 58.6 crore. Mr Siva Ganapathi was appointed as Managing Director of the company.

Under the new management and leadership, GEXP has witnessed the following changes:

1. They undertook data-driven initiatives like monthly data analysis from the factories to help understand reasons for low efficiency plus high wastages and simultaneously took measures to improve them. Effectively, the management was able to pin-point the problem areas which they fixed later. The low hanging fruits have been addressed.

2. Employee attrition and absenteeism has always been high in this industry which impacts efficiency and GEXP has started addressing this like paying 'Attendance bonus' to employees who worked all days in a month, leading to better attendance and productivity. The management also introduced programmes like 'Hello Sakhi' where

experienced employees mentored new employees for the first six months- more which gave a better working atmosphere.

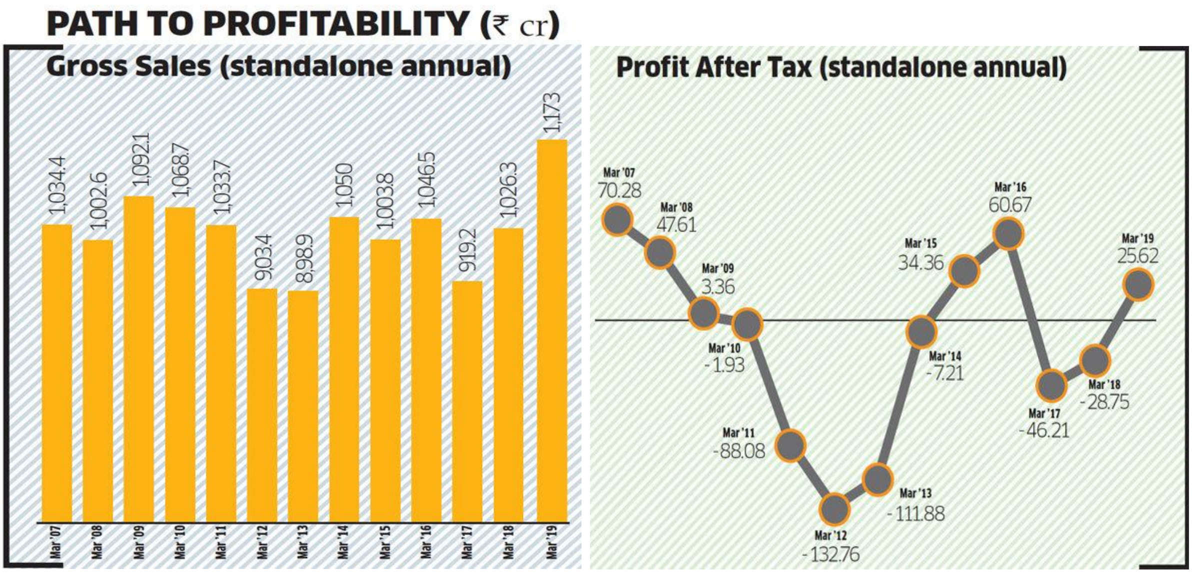
3. In the past, there was no single streamlined ERP system for requisition of raw materials and procurement which resulted in a quantities mismatch. This caused production delays and sometimes high inventories. GEXP has now moved its processes into a single ERP which has significantly helped to reduce these mismatches.

4. The new management was able to improve material-on-time performance on a monthly basis, sewing efficiency (34% in October 2017 to 39%) and reduce wastages to 3% from 4% in FY17. Overall, the operations got a complete overhaul leading to better efficiency.

5. Subsequently, GEXP has been reporting profits since Q4FY18 on back of improving efficiency. During FY19, it reported profits of Rs 25.6 crore Vs loss of Rs 31 crores in FY18.

Potential turnaround on the cards...

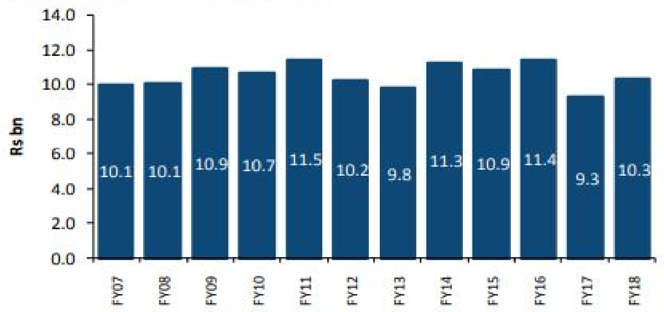
Gokaldas chiefly focuses on manufacturing complex garmenting products & designs that insulate it from other price based competition. It has an impressive clientele of leading international brands with 'GAP', 'H&M' being major contributor to revenues. Currently, top five customers contribute ~70% of revenues. It is adding several new customers to reduce client concentration risk. In FY18, Mathew Cyriac, non-executive director (former co-head, Blackstone's private equity business in India) acquired 39.96% stake in Gokaldas from Blackstone by way of a distressed buyout to script a turnaround. With a new management team in place, laying foundation for sustainable, profitable growth will be key focus area. **Despite headwinds (fall in duty drawback rates), green shoots are visible for Gokaldas with revenue up 11%, 16% YoY in FY18, H1FY19, respectively**



Revenues halved in USD terms during FY07-18 while reported losses in most years

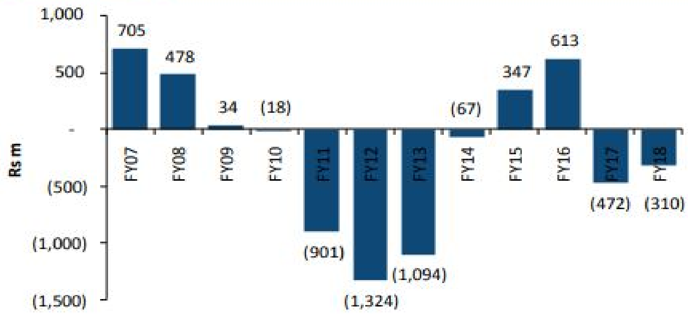
During the last ten years (FY07-18), the company had an all-round dismal performance with turnover almost halving in USD. In FY07, the company reported a turnover of Rs10.1bn and ended FY18 at Rs10.3bn. During the same period, INR depreciated against the USD from Rs39.98 to Rs65.07. The company also saw its EBITDA before other income crashing from Rs900mn in FY07 to a loss of Rs233mn in FY18. The operational performance nosedived during the ten years when Blackstone was in control.

Revenues halved in USD terms during FY07-18



Source: Company Data,

Profits hit between FY07-18

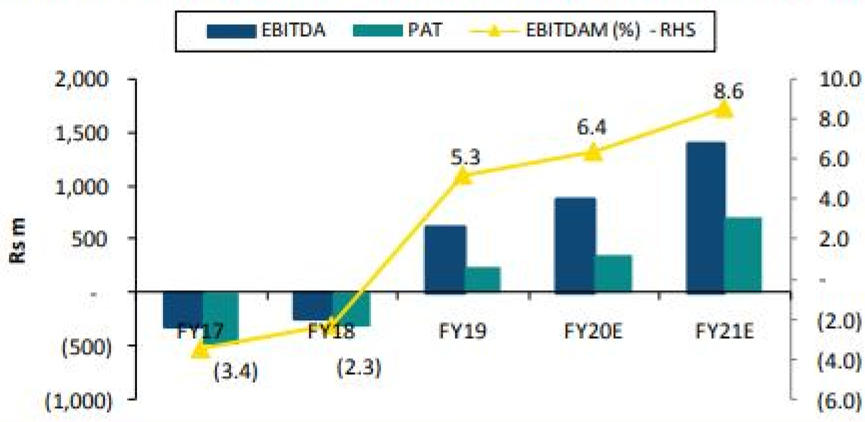


Source: Company Data,

The worse is behind – Revenue & PAT to grow at ~ 18-20% & 40-45% CAGR for next 2-3 years.

Over the coming 2 years, we expect revenues to grow at CAGR of 18-20% on back of ramping up of new capacities, increasing wallet share from old customers and revenue from new clients. Better operational efficiencies will aid margin expansion from 5.3% in FY19 to 8.6% in FY21E. EBITDA/PAT will grow at 40-45% CAGR.

Operational efficiencies will aid margin expansion from 5.3% in FY19 to 8.6% in FY21E



Source: Company Data,

Capex of Rs 100 crores will aid topline growth

The management plans to spend of Rs 100 crore over next two years for expanding capacities organically and inorganically. Capex will be funded by internal accruals and TUFF loan. A Greenfield capacity in Andhra Pradesh is planned which will add 15-18 lines at a cost of Rs 30-35 crores and is likely to be commissioned by Q2FY21E. At peak efficiency levels, each line can generate revenues of Rs 7-8 crore pa. The management focus is on cost-effective capacity expansion through de-bottlenecking which will add 20 lines. Additionally, the management plans to overhaul its old technology which will reduce lead time by 30% with improved workflows, reduce 25% of IT maintenance costs, lower waste generation and inventory, thus, increasing margins for GEXP.

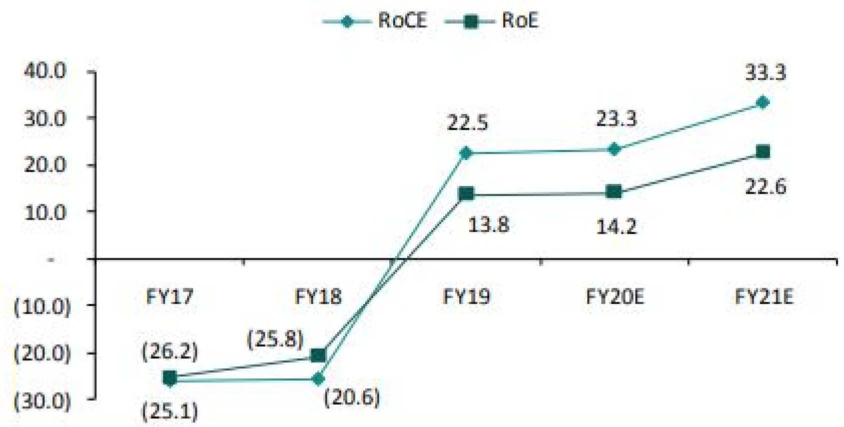
Comfortable debt levels

GEXP has no long term debt since 4 years. It has repaid working capital debt to the tune of Rs 93 crore over past 2 years (in spite of growing the topline at 12.4% from FY17-19) bringing the net DER down from 2.5x in FY17 to 1.5x in FY19. In coming 2 years, the company will borrow ~Rs 30-40 crore for their capex requirements while still maintaining the net DER at 1.2x in FY21E. GEXP has successfully turned free cash positive in FY18 (Rs 18.2 crore). However in FY20 it will be marginally free cash negative due to capex of Rs 70 crore before turning positive once again in FY21.

Improved return ratios led by operational efficiency

During FY19, the company turned EBITDA positive after 2 years of losses. EBITDA stood at Rs 61.8 crore vs loss of Rs23.3 crore in FY18. This indicates significant improvement in GEXP's operational performance. As on March 2019, RoE/RoCE was 13.8% / 22.5%. In FY21E, due to better resource utilisation along with improved operational efficiencies, we expect RoE and RoCE to inch up to 22.6% and 33.3% respectively.

We expect RoE/RoCE to increase to 22.6%/33.3% in FY21E from 13.8%/22.5% in FY19

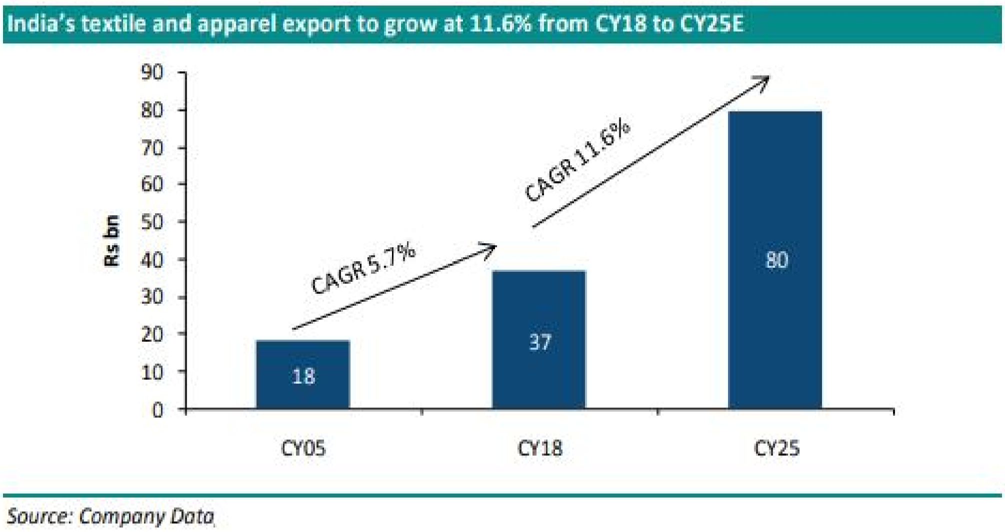


Source: Company Data,

Key Growth Drivers

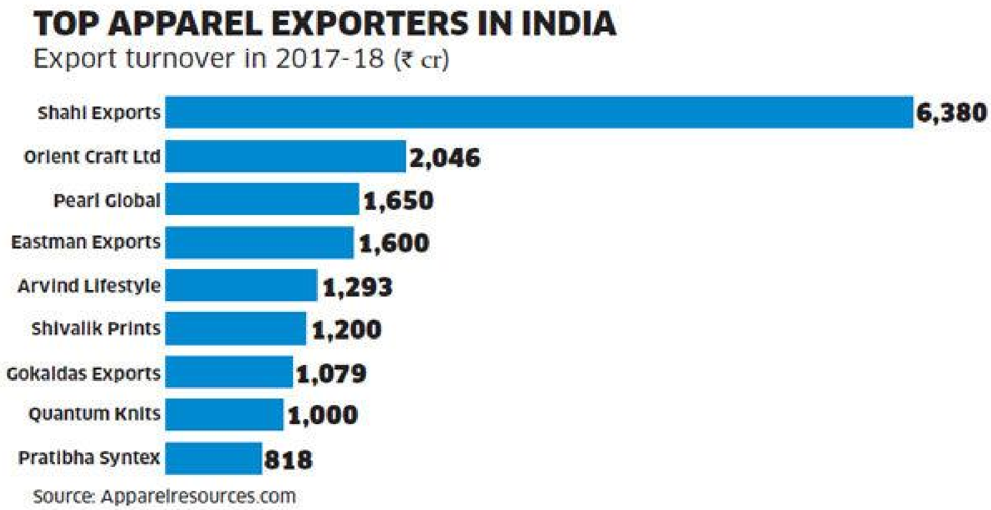
Increasing demand for Indian apparel exports will boost GEXP revenues

The size of the global apparel market was USD1.7tn in 2015 and is expected to increase to USD2.26tn by 2025 (reflecting a 3% CAGR) largely driven by the developing and emerging economies. Though the per capita expenditure on apparels in developed countries is far more than developing countries, China and India are expected to be the fastest growing apparel markets (both growing in double digits).



India's textile and apparel exports grew at 5.7% CAGR to USD37bn in CY18 and are expected to grow at 11.6% CAGR to USD80bn in CY25. This growth will be driven on back of availability of raw material, skilled manpower and favourable Central & State Government schemes (TUF and RoSL). GEXP is one of India's largest apparel exporters with exports accounting for 80% of its revenues. Thus, a robust demand scenario coupled with favourable government policies will augur well for GEXP.

China's loss – India's gain



In the mid-80s, India and China accounted for 1% and 8% of the global textile and apparel exports; which increased to 5% and 36% respectively in 2017. The Chinese textile and apparel exports which stood at USD210bn in 2017 are expected to come down to USD 180bn in 2019E due to trade war with the US. The plummeting Chinese exports will pave way for increasing exports from Bangladesh, Vietnam and India. While Bangladesh and Vietnam have expertise in manufacturing basic garments, India specialises in manufacturing niche garments based on trend analysis. Indian apparel and textile exports stood at USD17bn in 2016. With declining Chinese exports by end of 2019E, there arises a tremendous opportunity for Indian garment manufacturing companies. There are only a few apparel export companies with revenues exceeding Rs10bn, with the largest accounting for not more than 5% of the country's apparel exports. This indicates there is huge potential for organised players like GEXP and Shahi Exports to grow.

Big players such as Arvind Lifestyle were entering the field. Gokaldas had slipped to the seventh position on the export turnover league table. The top player, Shahi Exports, posted seven times as much revenue as Gokaldas, whose top line had stagnated at about Rs 1,000 crore for a decade.

Reorganisation of operational structure to improve capacity utilisation…

Gokaldas's subdued financial track record can be mainly attributed to underutilisation of assets (average a/t ratio: 2.3x) leading to EBITDA losses (employee expenses as percentage to sales significantly higher at 32%+ due to negative operating leverage). The new management has undertaken various initiatives to raise operational efficiency at every stage of value chain. The company is improving its on-time delivery performance leading to a steady flow of orders, effective capacity utilisation. Previously, it had a complex organisational structure with six to eight SBUs having control over its assigned manufacturing facilities. The management has now addressed the issue by centralising control at a main SBU level that would raise efficiency levels.

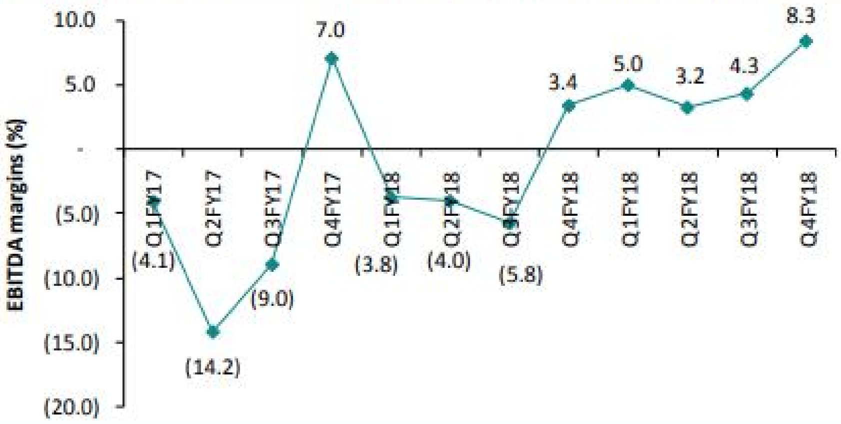
Newly appointed MD has a strong track record of turning around businesses

During Blackstone era GEXP turnover almost halved in USD terms and suffered losses while peers (Shahi Exports) grew. In 2017, Blackstone exited and sold their 39.9% stake to Clear Wealth Consultancy Services LLP (owned by Mathew Cyriac, former Co-head Private Equity, Blackstone) at Rs42 per share. Subsequently in October 2017, Mr Siva Ganapathi was appointed as MD of the company. Mr Siva Ganapathi (MD) is a PG Diploma in Management from IIM, Bangalore and a B.Tech from NIT. He has over 27 years of experience and has spent 21 years working for the Aditya Birla Group. **Before joining GEXP, Siva was the Chief Operating Officer of Idea Cellular, where he was responsible for turning around the business operations. His business strategy is typically data driven and he analyses every aspect of revenue and cost which helps to improve productivity and efficiency.** GEXP has successfully turned around operationally in FY19 with EBITDA increasing to Rs 61.8 crore from EBITDA loss of Rs 23.3 crore. Thus, we believe that under his leadership the company can achieve its revenue as well as margin targets.

Focus on process efficiencies to help improve the margin trajectory

Under the new leadership, monthly data analysis was used to comprehend reason for low efficiency plus high wastages and simultaneously implied measures to improve the same. GEXP has moved its processes into a single ERP for requisition and procured raw material to reduce production delays. GEXP is trying to curb employee attrition and absenteeism by offering incentives like 'Attendance bonus' to improve productivity. Programmes like 'Hello Sakhi' are introduced where experienced employees mentor new employees for first six months. Overall, the operations got a complete overhaul leading to better efficiency and enhanced EBITDA margins from -4.1% in Q1FY17 to 8.3% in Q4FY19 (Highest in last 12 quarters). For FY19, EBITDAM improved from -3.4% in FY17 to 5.3% in FY19 due to reduction in wastages from 4% to 3% and improvement in efficiencies from 34% to 39%.

EBITDA margins improved to 8.3% in Q4FY19 due to better operational efficiencies



Source: Company Data,

Robust revenue growth on back of better customer connect

Partnered with leading apparel brands

Source: Company Data,

GAP, Columbia, Carhartt, H&M and Puma are the top five clients for GEXP and account for 75% of revenues. From an export focussed producer, today 20% of their turnover comes from the domestic apparel market. Despite all the problems that the company underwent, the customers have stuck with GEXP as the company's business model is positioned around long-term relationships with marquee clients, thus, providing greater revenue visibility. GEXP will continue to enlarge its customer base while deepening its customer wallet share. However, the company continues to ensure that no single customer has a significant big share which could turn counterproductive if they lose him.

Subsequent to the change in management, efforts have been deployed into marketing strategies rather than waiting for the customers to approach. This has given a good traction to sales in form of increased wallet share from existing customers and addition of new customers. GEXP has added 7 new customers in FY19.

Scaling up capacity in a cost effective manner

GEXP has 16 factories and six value-adding service units with an annual capacity to manufacture 30mn garments. They have a total of ~200 lines of which 40% are in Tier 2 & 3 cities and remaining in Bengaluru. Due to favourable conditions like labour abundance, low cost of operations and Government incentives in Tier 2 & 3 cities, GEXP will expand and realign manufacturing footprints in these cities while optimising capacities at Bengaluru. The management plans to spend of Rs 100 crore over next two years for expanding capacities organically and inorganically. Capex will be funded by internal accruals and TUFF loan. A Greenfield capacity in Andhra Pradesh is planned which will add 15-18 lines at cost of Rs30-35 crore and is likely to be commissioned by Q2FY21E. The management focus is on cost-effective capacity expansion through debottlenecking (adding 20 lines in FY20E), acquiring assets on lease and increasing output in low cost geographies along with Greenfield expansion in Andhra Pradesh.

Key Risks

Change in Government Policies

Any changes in regulations or Government incentives could materially and adversely affect its operations and growth prospects. During FY18, export incentives such as duty drawback and rebate on state levies (ROSL) have been reduced, while duty drawback rate was lowered to 2% from 7.7% and ROSL was lowered to 0.97% from 3.9% in the post GST era. However, incentive under merchandise exports from India scheme (MEIS) was increased from 2% to 4%. This had resulted in to low other income for FY18. Recently, new RoSCL scheme will result into net benefit of 3% of export revenues and will flow straight to the PBT. The government might roll back MEIS scheme as it is not WTO compliant. This can impact the other income negatively. Thus any change in Government policy can impact the bottom-line of the company.

Availability of labour and increase in wage rates

Garment manufacturing business is labour intensive with employee costs accounting for ~30% of the revenues. Non availability of labour and high labour turnover impacts productivity. Any increase in the minimum wages for labour will dent margins of the company. Wage hike is expected in the state of Karnataka which will increase the cost for GEXP as 95% of the facilities are in Karnataka.

Export dependant revenues

GEXP business has been heavily dependent on export. Any reduction in business of international customers affects the company's business. GEXP has been diversifying its customer base in recent years to reduce revenue concentration.

Top 5 client concentration

Top 5 customers account for 75-80% of the revenues. A loss of order from any top customer will dent revenues. The largest customer accounts for 30% of the revenues which the management plans to bring it to 20% over the coming the years.

Fluctuation in foreign currency rates

Exports account for 80% of the company's revenues of which a significant portion of the revenue is in USD. Hence is exposed to risks of foreign exchange rate fluctuation. All the orders are hedged by forward covers to curb the effect of the fluctuating exchange rates.

Outlook & Valuations

GEXP has witnessed a massive turnaround since Mr Siva Ganapthi took charge. Over the last two years, he has improved process efficiencies, expanded capacities both effectively and efficiently, increased wallet share with existing clients as well as added new clients to the basket. The company has reduced working capital requirement by close to Rs 93 crore in spite of growing topline by 12.4% over the same period. It has zero long term debt, which in our opinion is a huge positive. Further, the company has successfully turned free cash positive FY18 (Rs 18.2 crore) onwards. However in FY20 we expect that it be marginally free cash negative due to capex of Rs 70 crore before turning positive once again in FY21. The management focus is to grow revenues by deepening the ties with the customers and adding of new clients, to increase capacities by expanding through organic and inorganic route, to reduce downtime by modernising plant and machinery and to expand margins by increasing efficiencies. We expect GEXP to benefit from trade war and wage hike issues in China. There is still no clarity on continuation of MEIS scheme after December 2019.

If we consider PE data of last 5 years (2014-19) we observe that 33% days this stock has traded below current Price to Earnings of 6.7 while Average Price to Earnings = 14.3 & Median Price to Earnings = 8.2. It means there is not much downside in this stock.

Regards

Binoy

Statutory Disclosure:

SEBI Research Analyst Registration No. : INH200006451

1. At the time of writing this article, the analyst does not have a position in the stock covered by this report.

2. The analyst has not traded in the recommended stock in the last 30 days.

3. The research analyst does not have any material conflict of interest at the time of publication of the research report.

4. The research analyst has not received any compensation from the subject company in the past twelve months.

5. The research analyst or its associates has not managed or co-managed public offering of securities, has not received any compensation for investment banking or merchant banking or brokerage services nor received any third party compensation. The subject company was not a client during twelve months preceding the date of distribution of the research report.

6. The research analyst has not served as an officer, director or employee of the subject company.

7. The research analyst or research entity has not been engaged in market making activity for the subject company.

8. The research analyst or research entity or its associates or relatives does not have actual/beneficial ownership of one per cent or more in the securities of the subject company, at the end of the month immediately preceding the date of publication of the research report or date of the public appearance.

9. The analyst does not own more than 1% equity in the said company.