C Mahendra Exports Ltd. (CMEL) - IPO Note

Issue Details	Particulars
Issue Date	December 31, 2010 – January 06, 2011
Issue Size	Rs. 1,425 mn - Rs.1,650 mn
Price Band	Rs. 95-110
FV	Rs.10
Fresh Issue	15 mn equity shares
- QIBs	50% (7.5 mn equity shares)
- Non institutional	15% (2.25 mn equity shares)
- Retail	35% (5.25 mn equity shares)
Equity shares prior to issue	45 mn equity shares
Equity shares post issue	60 mn equity shares
Post issue market capitalization	Rs.5,700 mn- Rs.6,600mn
IPO Rating	Grade 2 by ICRA
Lot size	60 shares
Issue Manager	Yes Bank Ltd. and Anand Rathi Advisors Ltd.

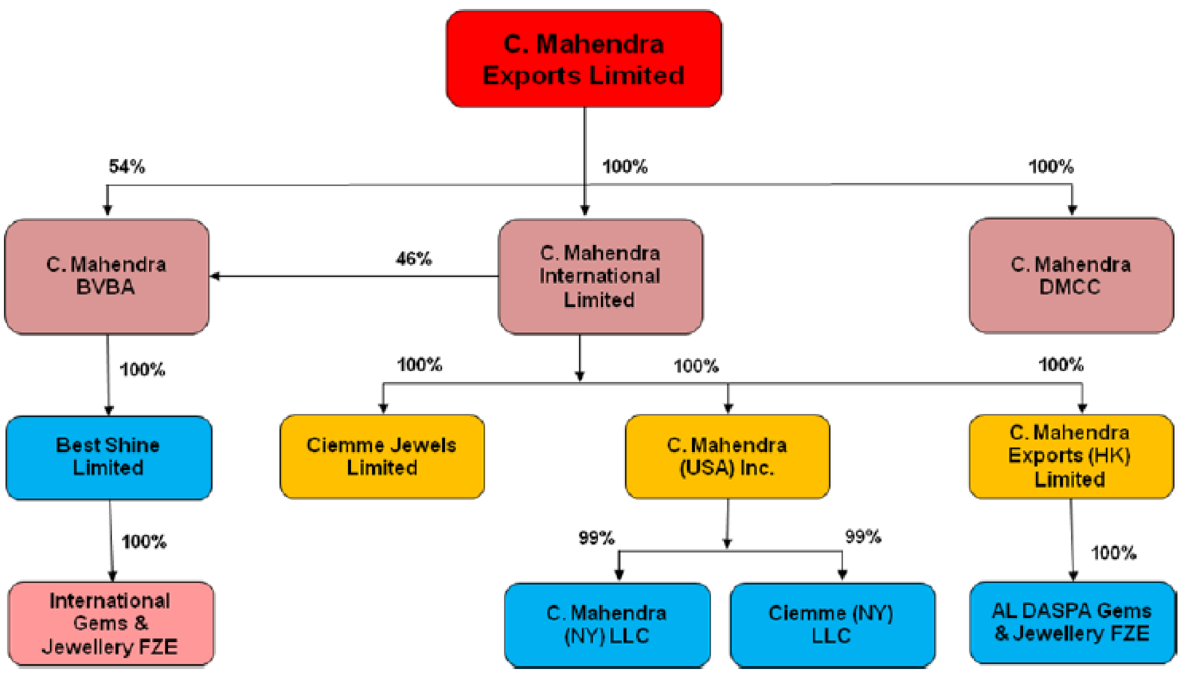
Shareholding Pattern (%)

Particulars	Pre IPO (%)	Post IPO(%)
Promoters	57.2	42.9
Promoter group (other than promoters)	42.8	32.1
Public	-	25

About the company

The group was promoted in 1974 by Mr. Mahendra C Shah and Mr. Champaklal K. Mehta. It was initially formed to undertake trading activity in diamonds, precious stones. The company was recognized as a DTC Sight holder in 1991 and is one of the first Surat based entities to receive this recognition. In 1993, the first manufacturing facility for processing rough diamonds was setup at Surat with an installed capacity of 120,000 carats per annum. For sourcing of raw diamonds, it setup its subsidiary C. Mahendra BVBA in Antwerp, in Belgium. To enter in international markets, it established marketing entities in Hong Kong and USA to sell cut, polished diamonds and jewellery. Currently the company has around eight marketing offices spread across Surat, Mumbai, Delhi, Kolkata, Hong Kong, New York, Los Angeles and Antwerp.

Group Structure



Manufacturing facilities

Currently, the company has two manufacturing facilities for cutting and polishing of diamonds at Varachha and Udhana in Surat. Further, Ciemme Jewels Ltd. and C Mahendra Infojewels own jewellery manufacturing facilities in MIDC, Andheri, Mumbai.

Objects of the issue

Particulars	Amount (Rs in mn)
Setting up of a diamond processing unit at Gujarat Hira Bourse,SEZ, Ichchhapore	361
To set up a jewellery manufacturing unit at Mumbai	236
Setting up retail outlets	300
Financing brand development expenses	200
Investment in capital of C. Mahendra BVBA (Diamond procuring subsidiary)	800
General Corporate Expenses	-
Total	**1,897**

Source: RHP

About the Business

CMEL is an integrated diamond and diamond jewellery player having presence across the value chain. It undertakes every activity from sourcing of rough diamonds, trading of rough and polished diamonds, processing of diamonds and manufacture of diamond jewellery. The company has established itself as one of the leading exporters of Cut and Polished Diamonds (CPDs) from India with exports accounting for 78% of total income in FY10.

Its product range is dominated by low – value diamonds, with 61% of its sales contributed by the under US$600 price range. The company is also concentrating on increasing the share of high value diamonds (above US$600) in its product range. Over the last three years the share of high value diamonds has increased from ~34% in FY09 to 39% in Q1FY11.

Key strengths

1) An integrated diamond and diamond jewellery player

CMEL is an integrated diamond and jewellery manufacturing player with presence across the value chain. The group's ability to source rough diamonds is consistent thereby eliminating any supply bottlenecks. Its business operations supported by advanced manufacturing setup, strong marketing and distribution network across the globe, elegant and exquisite designer jewellery for domestic and export jewellery market, exquisite retail outlets, shop-in-shop operations in India coupled with strong corporate brand enables the company to gain competitive advantage in the domestic market. CMEL is a leading exporter of cut and polished diamonds with a proven track record.

2) Strong marketing and distribution network, global reach

The group has established strong marketing network through its offices located in various locations like Surat, Mumbai, Delhi, Kolkata, Hong Kong, New York, Los Angeles and Antwerp to market cut and polished diamonds to domestic and international markets. For domestic sales of its cut and polished diamonds locally, it has a well-knit distribution and sales channel network. The company follows a strategy of selling its diamond jewellery through exclusive retail stores and franchisee stores in India and shop-inshop set-up for domestic and international markets. As on the date of filing the Draft Red Herring Prospectus, the company has eight exclusive retail stores and one franchisee store in India.

3) Experienced Promoters

The promoters of the company have more than three decades of experience in diamond market, which has enabled the company to successfully implement its growth strategies.

4) Direct sourcing of rough diamonds from primary source suppliers

One of the critical success factors in its business is the ability to source considerable portion of the rough diamond requirement. Around 18-20% requirement of rough diamonds is sourced from primary source suppliers viz., DTC and ALROSA Company Ltd. and the balance is sourced from secondary market. These primary source suppliers select their customers based on various criteria like financial strength, distribution reach, marketing abilities, manufacturing capacity, future development plan, BPP, etc.

It is one of the first DTC Sightholders based in Surat. As on January 31, 2010, there were only 115 sightholders worldwide and CMEL is one of them (Source: www.dtcsightholderdirectory.com). CEML also procures rough diamonds from leading diamond mining companies like ALROSA Company Limited, Russia and its subsidiaries; Harry Winston Diamonds International N.V. and various other companies in Russia, Canada and Africa ensuring consistent supply of rough diamonds at competitive rates.

5) Well defined business strategy

a) Setting up units strategically to continue availing fiscal incentives

Currently the company's operations are in Surat and are subject to tax exemption u/s 10B of the Income Tax Act, 1961 and the company is eligible to avail this benefit till AY2011-2012. The company intends to set up a new diamond processing facility in Gujarat Hira Bourse, SEZ, Ichchhapore, Surat which will be exempt U/s. 10AA of the Income Tax Act, 1961, subject to the receipt of the necessary approvals. It has also earmarked Rs. 361 million for setting up this new facility. As per the extant policy, 100% of the export income from the SEZ facility will be exempted for the first five years, 50%

for the next five years thereafter and 50% of the ploughed back export profit for the next five years. The new facility will also be entitled to some other benefits like exemption from Central Sales Tax, exemption from Minimum Alternative Tax.

b) Strengthening its rough diamond sourcing capability

It is currently in discussions with various primary source suppliers. Any materialization in talks to relationships would help the company to scale up its operations and reduce its dependence on the existing primary and secondary sources. The company intends to infuse equity capital in its subsidiary C. Mahendra BVBA in order to enable it to further leverage their expertise and source diamonds directly from the diamond mining companies at the most competitive rate.

Risks and Concerns

1) Heavy Dependence on near-luxury markets like USA, Hongkong etc.

Demand for diamonds directly correlate with the purchasing power of its end-consumers. In boom times, demand for luxury products tends to grow and slowdowns cause sales to retreat rapidly. Some of the key markets for cut and polished diamonds are USA, Hong Kong, Middle East and Belgium which constituted around 82.8% and 80.5% of its export sales of cut and polished diamonds in FY10 and period ended June 30, 2010 respectively. Any slowdown in these markets would force the company to enter into alternative markets for its products which would result in pricing pressures for the company.

Export income as a % of total income

Countries	FY08	FY09	FY10	Q1FY10
Hong Kong	50%	49.2%	41.2%	43.6%
USA	23%	19.1%	8.3%	6.6%
Belgium	3%	0.4%	0.1%	0.2%
Dubai	21%	19%	33.2%	30.1%
Others	3%	12.3%	17.2%	19.5%

Source: RHP

2) Higher working capital requirement

The company faced negative cash flows at the operational level since FY05 except for FY07 and FY10. To ensure efficient management working capital cycle, the company needs to has a tighter control on debtors, or else it poses a threat to the company.

3) Vulnerability to foreign exchange fluctuations

The company is significantly exposed to foreign exchange fluctuations. It suffered losses of Rs.503mn on account of foreign exchange fluctuations which affected the profitability of the company.

Financial Analysis

CMEL has witnessed revenue CAGR of 15.3% over FY06-10 whereas Pre exceptional PAT clocked a CAGR 24% over the same period. OPM of the company has improved from 6% in FY10 to 7.9% in FY10. PAT margin have also shown an uptick from 2.3% in FY06 to 3% in FY10.

On the working capital cycle front, the company has improved its efficiency. Working capital cycle has improved from 315 days in FY06 to 167 days in Q1FY11 owing to reduction in inventory and debtors cycle. Inventory cycle registered significant improvement from 198 days in FY06 to 72 days in Q1FY11. Debtor days have reduced from 189 days in FY06 to 146 days in Q1FY11.

The company's net debt equity ratio has also improved from 3.4x in FY06 to 2.6x in FY10.

Significant improvement has been witnessed by the company in terms of Return on equity from 6% in FY06 to 17.9% in FY10.

Outlook

The company has transformed itself from being a rough diamond trader to an integrated diamond player present across the value chain. It has gradually diversified into larger size diamond, where competition is relatively lower which is a competitive advantage. In the fragmented market of diamond, CMEL has long-standing relationships with the major diamond mining company, De Beers, as DTC Sightholder since 1991.

We expect improvement in its operating income and margins because its diversification into retail through its subsidiary. CMEL through its expansion in retail outlets to sell its diamond jewellery and polished diamonds would be a major beneficiary on account of India's private consumption story. The company plans to open 15 new exclusive retail outlets by 2011. In the past, the company has opened nine exclusive retail stores and one franchisee store.

Opening of Retail Stores

Zone	FY11E	FY12E	FY13E	Total
East	-	2	1	3
West	1	4	1	6
North	1	2	-	3
South	1	1	1	3
Total	**3**	**9**	**3**	**9**

Source: RHP

Peer Analysis

Particulars	CMEL	Suashish Diamonds	Shrenuj and company	Gitanjali Gems	Rajesh Exports	Ganesh Jewellery
CMP	Rs.95-110	Rs.167	Rs. 43	Rs. 212	Rs. 123	Rs.195
FV (Rs.)	10	10	2	10	1	10
Mkt Cap/Sales (x)	0.36	0.28	0.3	0.5	1.9	0.4
OPM (%)	7.9	7.3	10	7.6	1.6	7.0
NPM (%)	3	5.5	1.5	4.2	1.0	5.7
EPS(TTM)	13**	39.7	2.8	20.9	9.3	38.5
P/E (x)	7.3 - 8.4	4	15.3	10.1	13.3	5.1
Book Value(Rs.)	85	286	33	242	40	90
P/BV (x)	1.11 – 1.3	0.6	1.3	0.9	3.0	2.2

*Source: RHP, Ajcon Research, ** indicates FY10 EPS calculated on Pre-exceptional PAT*

Valuation and Recommendation

At the upper end of the price band of Rs.110 per share, the sock is valued at 8.8x at FY10 Pre Exceptional EPS and at a PE of 4.07x at Q1FY11 annualized EPS of Rs.27 on post issue equity. With due consideration to factors like a) strong brand name, b) elegant and exquisite designer jewellery for domestic and export jewellery market, c) well established worldwide sales and distribution network, d) proposed expansion in exquisite retail outlets, e) improving working capital cycle, we recommend investors with a higher risk appetite to **"SUBSCRIBE'** the issue.

Financials

Income Statement (Rs. in mn.)

Particulars	FY05	FY06	FY07	FY08	FY09	FY10	Q1FY11
Total Income	**8,391**	**10,478**	**16,580**	**17,320**	**15,337**	**18,528**	**7,364**
EBITDA	**502**	**649**	**1,451**	**1,131**	**1,572**	**1,463**	**681**
Depreciation	38	69	120	109	107	95	22
Interest	144	270	509	716	791	769	154
PBT	**436**	**323**	**835**	**343**	**760**	**618**	**513**
Tax	66	84	96	17	42	55	27
PAT	**370**	**239**	**739**	**326**	**718**	**563**	**485**
EO Gains/(Loss)	-	-	-	-	-	(503)	(82)
Minority Interest	(149)	(105)	(118)	-	(7)	-	-
Reported PAT	**221**	**134**	**621**	**326**	**711**	**60**	**403**

Source: RHP, Ajcon Research

Balance Sheet (Rs. in mn.)

Particulars	FY06	FY07	FY08	FY09	FY10	Q1FY11
Sources of Funds						
Equity Capital	2,240	300	300	300	450	450
Preference Capital	-	-	-	-	125	125
Reserves	(66)	1,220	1,837	2,171	3,383	3,774
Minority Interest	575	677	476	36	27	19
Def. Tax Liab.	73	134	136	155	150	141
Borrowings	7,609	8,621	10,592	12,189	10,291	10,498
Total	**10,431**	**10,952**	**13,340**	**14,851**	**14,426**	**15,007**
Application of Funds						
Net Block	1,055	1,100	1,222	1,109	1,027	1,009
CWIP	78	17	39	23	38	39
Intangible assets	18	12	-	-	-	-
Def. Tax Assets	2	2	5	17	13	12
Net Current Assets (excl. cash)	**9,028**	**9,641**	**11,814**	**13,514**	**12,883**	**13,478**
Cash	**249**	**179**	**260**	**188**	**465**	**470**
Misc. Exp	**-**	**-**	**-**	**-**	**-**	**-**
Total	**10,431**	**10,952**	**13,340**	**14,851**	**14,426**	**15,007**

Cash Flow Statement (Rs. in mn.)

Particulars	FY06	FY07	FY08	FY09	FY10	Q1 FY11
Profit before Tax and after MI	220	715	359	704	116	431
Operating Cash flow	(1,988)	609	(885)	(500)	1,722	(39)
Investing Cash flow	(749)	(85)	(99)	8	(24)	5
Financing Cash Flow	2,855	(594)	1,066	435	(1,419)	41
Net Increase in Cash	118	(70)	82	(72)	279	7
Opening Cash balance	131	249	179	261	189	468
Closing Cash balance	249	179	261	189	468	475

Ratio Analysis

Particulars	FY06	FY07	FY08	FY09	FY10
EPS	1	21	11	22	13
OPM (%)	6.2	8.8	6.5	9.9	7.9
NPM (%)	2.3	4.5	1.9	4.4	3
ROE (%)	6	33.6	17.8	28.7	17.9
ROCE (%)	6.7	12.6	8.7	10.7	9.5
Debt/Equity(x)	3.5	5.7	5	4.9	2.7
Debtor days	189	137	174	248	213
Inventory days	198	148	139	161	130
Creditor days	83	80	75	116	108

Source: RHP, Ajcon Research

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