# Welspun India Limited

## Putting numbers to the Welspun scandal

**Capital Surge**

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## Executive Summary

- Welspun India Limited ("Welspun" or "Welspun India" or "the Company") is a supplier of home products like terry towels and bed sheets to major US retailers such as Target, Walmart and Bed, Bath & Beyond.

- In August 2016, one of Welspun's customers, Target, claimed that the Company had been selling fake Egyptian cotton bed sheets to it for two years. This statement was not refuted by the Company and Target decided to sever its entire relation with Welspun.

- Given the above developments, other customers like Walmart also started their investigations regarding the concerned bed sheets supplied by Welspun.

- On 19 August 2016, i.e. before the news of the scandal, the shares of the company were trading at Rs. 102.85 per share. Over the last month, the shares of the company have tumbled more than 40% and are now trading at Rs. 55.75 per share as of 20 September 2016.

- The valuation report attempts to incorporate the effects of the scandal on various aspects of the company's business in order to come up with a value of the company based on the discounted cash flow method ("DCF"). We value the company twice - once on a pre-scandal basis and then on a post-scandal basis.

- The scandal costs are analysed in three separate categories:
  - One-time penalties;
  - Legal and administrative costs; and
  - Revenue effects/ drop in operating income - value of lost opportunities and potential drop in operating margins.

- In our base case scenario, we value the equity in the company before the scandal broke out at Rs. 10,200 cr. or Rs. 102 per share (approx.). On a post-scandal basis, we estimate a value of Rs. 4,800 cr. or Rs. 48 per share (approx.).

- The valuation is most sensitive to assumption regarding the operating margins, as every 1% change in operating margin causes a change of about Rs. 7.50 in value on a per share.

## Introduction

Welspun India is a one of the world's leading suppliers of home textile products like terry towels, cotton bed sheets to retailers in the US and elsewhere. The Company is among the top three home textile manufacturers in the world and is a vendor to 14 of top 30 global retailers, including marquee names such as Bed, Bath and Beyond, Target, Macey's, Walmart and JC Penny.

In August 2016, one of the Company's customers, Target, announced that Welspun had been supplying fake Egyptian cotton bed sheets to it since 2014. These accounted for about 10% of the total business that Welspun did with Target. These claims were not refuted by the Company and accordingly, Target decided to sever all business ties with Welspun.

Given this development, other customers like Walmart also started their own investigations on similar products supplied by the company to them. In a recent development, Walmart has also decided to discontinue sourcing bed sheets from Welspun, although, it has categorically stated that it will not cancel orders for other products. The cotton bed sheets constituted about 20% of the total business with Walmart (i.e. roughly Rs. 98 cr.).

As a consequence of these actions, Welspun claims to have appointed a Big 4 audit firm in order to investigate its supply chain processes and suggest improvements in the same.

A snapshot of the company's trailing twelve month financial results[1] before the scandal broke out is provided below:

| Particulars | Amt. (in Rs. cr.) |
|---|---|
| Revenue | 6,184.65 |
| EBIT | 1,222.76 |
| Operating profit margin | 19.77% |

A list of the Company's major customers including its share of revenue from these customers is as under:

| Customer | Share of Revenue (in %) | Share of Revenue (in Rs. cr.) |
|---|---|---|
| Bed, Bath and Beyond | 11% | 680 |
| Target | 10% | 618 |
| Walmart | 8% | 495 |
| Macey's | 8% | 495 |
| JC Penny | 7% | 433 |

[1] Source - screener.in

| | | |
|---|---:|---:|
| Others | 56% | 3,463 |
| **Total** | **100%** | **6,185** |

On 19 August 2016, i.e. before the news of the scandal, the shares of the company were trading at Rs. 102.85 per share. Over the last month, the shares of the company have tumbled more than 40% and are now trading at Rs. 55.75 per share as of 20 September 2016.



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# Our approach

In order to value Welspun, we divide our valuation into two stages:

- First, we are going to go back a month before the scandal broke out and value it as if nothing had happened. We are going to consider that the market price prevailing at the time was correct and back out the operating income that the market was expecting it to deliver based on the expectations incorporated in that price.
- Next, we are going to consider the consequences of the scandal on Welspun's revenues and operating margins.

## Pre-scandal valuation of Welspun

Our pre-scandal story for Welspun is that it is a leading player in the home textile products with its competitive edge being strong relationships with leading US retailers. Given the nature of its product and the diverse base of its customers, we felt that the business risk was low reflecting in the 10.79% cost of capital we used for the company.

We assumed a high growth period of 5 years with a growth rate of 11.85% (based on a reinvestment rate of 81.79% and return on capital of 14.48%). Thereafter, we assumed that the company would reach a steady state with a growth rate of 4.81% (equal to the risk free rate for the Indian economy). We also assumed that the company's cost of capital would drop to about 9.84% during steady state and it would end up making a return on capital of 11% forever. Reproduced below is a summary of inputs used and our DCF:



| Input Summary | Particulars | |
|---|---|---|
| Normalized EBIT | 1,222.76 | |
| Adjusted EBIT | 1,222.76 | |
| Adjusted Interest Expense | 212.72 | |
| Adjusted Capital Spending | 801.25 | |
| Adjusted Depreciation | 407.14 | |
| Current Revenues | 6,184.65 | |
| Current Non-cash WC | 949.18 | |
| Change in WC | 101.63 | |
| Adjusted BV of Debt | 3,085.09 | |
| Adjusted BV of Equity | 1,431.85 | |
| Length of High Growth | 5 | Forever |
| Growth Rate | 11.84% | 4.81% |
| Debt Ratio in CoC | 19.01% | 20.00% |
| Beta | 1.00 | 1.00 |
| Risk-free Rate | 4.81% | 4.81% |
| Risk Premium | | 6.00% |
| Cost of Debt | 9.20% | 8.00% |
| Effective Tax Rate | 30.00% | 25.00% |
| Marginal Tax Rate | 33.00% | 25.00% |
| Return on Capital | 20.44% | 11.00% |
| Reinvestment Rate | 57.92% | 43.69% |

| Particulars | Current | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Terminal |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Expected Growth Rate | - | 11.84% | 11.84% | 11.84% | 11.84% | 11.84% | | | | | | 4.81% |
| Cumulative Growth Rate | - | 111.84% | 125.07% | 139.88% | 156.44% | 174.95% | | | | | | |
| Reinvestment Rate | - | 57.92% | 57.92% | 57.92% | 57.92% | 57.92% | | | | | | 43.69% |
| EBIT | 1,223 | 1,367 | 1,529 | 1,710 | 1,913 | 2,139 | | | | | | 2,242 |
| Tax Rate (for CF) | 30.00% | 29.00% | 28.00% | 27.00% | 26.00% | 25.00% | | | | | | 25.00% |
| EBIT*(1 - t) | 856 | 971 | 1,101 | 1,249 | 1,415 | 1,604 | | | | | | 1,682 |
| Less: Capex- Dep | 394 | 394 | 449 | 513 | 584 | 666 | | | | | | 615 |
| Less: Change in WC | 102 | 168 | 188 | 211 | 236 | 263 | | | | | | 120 |
| FCFF | 360 | 409 | 463 | 525 | 596 | 675 | | | | | | 947 |
| Cost of Capital | - | 10.79% | 10.79% | 10.79% | 10.79% | 10.79% | | | | | | 9.84% |
| Cumulative Cost of Capital | - | 1.1079 | 1.2275 | 1.3600 | 1.5068 | 1.6695 | | | | | | 19.8460 |
| Present Value | - | 369 | 377 | 386 | 395 | 404 | | | | | | 11,256 |

Based on these assumptions, we obtained a value of about Rs. 13,200 cr. for the operating assets of the company. Adding the cash (Rs. 124 cr.) and reducing the market value of the debt (Rs. 2,594 cr.) and minority interest (Rs. 503 cr.), gives us a value of Rs. 10,200 cr. for the equity in the company or Rs. 101.68 per share. Since this value is extremely close to the share price prevailing before the scandal (the share was trading at Rs. 102.85 on 19 August 2016), we can take the trailing-twelve-month EBIT of Rs. 1,223 cr. as largely what the market was pricing in its current price. This EBIT will form the basis of our valuation post the scandal breakout.

| Valuation | Results |
|---|---|
| PV in high growth phase | 1,932.35 |
| PV of Terminal Value | 11,255.78 |
| **Value of operating assets** | **13,188.13** |
| Value of Cash, etc. | 124.31 |
| **Value of Firm** | **13,312.44** |
| Makret Value of Debt | 2,593.86 |
| Minority Interests | 502.92 |
| Market value of equity | 10,215.65 |
| Value of equity in options | - |
| **Value of Equity** | **10,215.65** |
| Less: Scandal effect | - |
| **Value of Equity** | **10,215.65** |
| **Value per Share** | **101.68** |

## Post scandal valuation of Welspun

One thing is for sure, Welspun has lost trust of its most important customers and there will be consequences for the Company. We divide these in the following three categories:

- **One time penalties:** These are the financial costs that Welspun might have to incur for falsely labelling its products. These would include potential lawsuits by Target and others over misrepresentation, customer refunds and any other contractual penalties that the parties might have agreed to. We believe that these one-time penalties should not exceed the value of the total product that was faulty. The company has represented that the total Egyptian cotton business was 6% of total sales of the company, which comes to about 370 cr. Accordingly, we estimate these costs at around Rs. 500 cr. in a conservative basis. We consider that 50% of these costs will be tax deductible for the company.

- **Legal and administrative costs:** These are the costs of hiring outside consultants to mitigate the damage caused by this scandal. We attach a cost of Rs. 50 cr. in increased legal and other fees. We consider that all of these costs will be tax deductible for the company.

- **Revenue effect and loss of operating profits:** Given that Target has already cancelled all of its business with Welspun and Walmart has cancelled the bed sheets business, we can expect other customers to follow suit. However, we do not believe that other customers will sever all ties with Welspun and are more likely to follow the Walmart route. Accordingly, we assume the following cost of lost opportunities for the Company.

  a. A 20% cut in revenues from all other customers for the next 2 years before the business gets back on its feet and the scandal blows over (Egyptian cotton sales accounted for about 20% of the total business that Welspun did with Walmart). These assumptions give us a total revenue drop of about 28%. from current levels.

| Particulars | Total Sales | Bed Bath and Beyond | Target | Walmart | Macey's | JC Penny | Others |
|---|---|---|---|---|---|---|---|
| % sales | 100.00% | 11% | 10% | 8% | 8% | 7% | 56% |
| Sales (TTM) | 6,185 | 680 | 618 | 495 | 495 | 433 | 3,463 |
| Loss estimation | | 20% | 100% | 20% | 20% | 20% | 20% |
| | | | | | | | |
| Revenue loss | 1,731.70 | 136.06 | 618.47 | 98.95 | 98.95 | 86.59 | 692.68 |
| % of revenue loss | 28.00% | | | | | | |

  b. **Loss in operating margin:** One of the consequences of the scandal will be the increased concessions that Welspun might have to offer to save business with existing customers. Also, given Welspun's history, we believe the company will be hard pressed to maintain such operating margins going forward. It's premium Egyptian cotton business, which was a high margin product, is ruined for all practical purposes. Accordingly, operating margins can be expected to drop going forward and we assume these to be 14% instead of the current 19.70% forever.

The loss in margin gives us an updated EBIT of Rs. 866 cr. (14% of Rs. 6,185 cr.) as our starting point. Due to the fall in market capitalisation of the company and consequent increase of debt ratio, there is an increase in the cost of equity of the company. This in turn leads to a slightly higher cost of capital of 10.93%. Other assumptions regarding reinvestment rates, growth rates, etc. do not change.

Given these updated assumptions, the value of the operating assets now drops to about Rs. 8,500 cr. Adding the value of the cash and reducing the value of the debt and minority interests gives us a value before scandal costs of about Rs. 5,600 cr.

| Particulars | Current | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Terminal |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Expected Growth Rate | - | 11.84% | 11.84% | 11.84% | 11.84% | 11.84% | | | | | | 4.81% |
| Cumulative Growth Rate | - | 111.84% | 125.08% | 139.89% | 156.46% | 174.98% | | | | | | |
| Reinvestment Rate | - | 81.79% | 81.79% | 81.79% | 81.79% | 81.79% | | | | | | 43.69% |
| EBIT | 866 | 968 | 1,083 | 1,211 | 1,355 | 1,515 | | | | | | 1,588 |
| Tax Rate (for CF) | 30.00% | 29.00% | 28.00% | 27.00% | 26.00% | 25.00% | | | | | | 25.00% |
| EBIT*(1 - t) | 606 | 688 | 780 | 884 | 1,002 | 1,136 | | | | | | 1,191 |
| Less: Capex- Dep | 394 | 394 | 449 | 513 | 584 | 666 | | | | | | 401 |
| Less: Change in WC | 102 | 168 | 188 | 211 | 236 | 264 | | | | | | 120 |
| FCFF | 110 | 125 | 142 | 161 | 183 | 207 | | | | | | 671 |
| Cost of Capital | - | 10.93% | 10.93% | 10.93% | 10.93% | 10.93% | | | | | | 9.84% |
| Cumulative Cost of Capital | - | 1.1093 | 1.2305 | 1.3650 | 1.5141 | 1.6796 | | | | | | 19.8460 |
| Present Value | - | 113 | 115 | 118 | 121 | 123 | | | | | | 7,924 |

We value the other costs of the scandal - one time penalties, legal costs and loss in revenues - separately and come up with a present value of lost opportunities at about Rs. 800 cr.

| Scandal effect | Current | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Terminal |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Expected growth rate | - | 11.84% | 11.84% | | | | | | | | | |
| Lost profits | - | 189.80 | 212.28 | | | | | | | | | |
| Cost of Capital | - | 10.93% | 10.93% | | | | | | | | | |
| Cumulative Cost of Capital | - | 1.1093 | 1.2305 | | | | | | | | | |
| Present Value | - | 171 | 173 | | | | | | | | | |
| One time penalties | 417.50 | | | | | | | | | | | |
| Legal costs | 33.50 | | | | | | | | | | | |
| Loss of operating income | 343.62 | | | | | | | | | | | |
| **Scandal effect** | **794.62** | | | | | | | | | | | |

When deducted from Rs. 5,600 cr. derived above, it gives us a value of Rs. 4,800 cr. or Rs. 48 per share for the equity in the company.

| Valuation | Results |
|---|---|
| PV in high growth phase | 589.95 |
| PV of Terminal Value | 7,923.94 |
| **Value of operating assets** | **8,513.89** |
| *Add:* Value of Cash, etc. | 124.31 |
| **Value of Firm** | **8,638.20** |
| *Less:* Value of Debt | 2,535.72 |
| *Less:* Minority Interests | 502.92 |
| *Less:* Value of options | - |
| Value of Equity (w/o scandal) | **5,599.56** |
| Less: Scandal effect | 794.62 |
| **Value of Equity** | **4,804.94** |
| **Value per Share** | **47.82** |

## Conclusion

Based on our base case valuation, we arrive at a value of Rs. 48 per share when the current price is Rs. 55.75 per share, thereby indicating an overvaluation of about 14%. One of the key drivers in our valuation is the potential loss in operating margins, eroding more than 4,000 cr. in value at a 14% assumption. This gives us a direction as to where our energies should be focused going forward - assessing the impact of the scandal on the operating margins of the company.

Investing is a game of odds, and there is no one correct value for a company. Reproduced below is a scenario analysis which comes up with the value of the company at different assumptions regarding operating margins and drop in revenues.

**Value per share at various assumptions**

| Drop in Revenues/ Operating Margin | 35% | 28% | 20% | 10% |
|---|---|---|---|---|
| **12%** | 32.20 | 32.93 | 33.76 | 34.80 |
| **13%** | 39.53 | 40.32 | 41.22 | 42.36 |
| **14%** | 46.97 | 47.82 | 48.80 | 50.02 |
| **15%** | 54.60 | 55.51 | 56.56 | 57.87 |
| **16%** | 62.22 | 63.20 | 64.32 | 65.72 |
| **17%** | 69.89 | 70.93 | 72.12 | 73.60 |
| **18%** | 77.56 | 78.66 | 79.92 | 81.49 |

As you can see, the valuation is most sensitive to operating margins since every 1% change causes a change of about Rs. 7.50 in value on a per share basis. The cell highlighted in green reflects our base case scenario. It is mainly at the 16% operating margin that the shares appear to be undervalued and these cases have been highlighted in blue.

It may be interesting to keep a watch on the share in the coming months for the possibility of an investment opportunity.

## Disclaimer

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