PhillipCapital

Titan Company (TTAN IN)

Losing lustre

INDIA | RETAIL | COMPANY UPDATE

7 May 2020

Downgrade to SELL: "When fishermen cannot go to sea, they repair nets". In our view, Tanishq is taking the best possible steps: (1) It focused on digital sales during Akshaya Tritya. (2) Allowing gold coin purchases digitally during the lockdown period to be set off against making charges of future purchases of gold jewellery. (3) Conducting comprehensive training programmes for sales staff/franchisee partners. (4) Organising design competitions for karigars (artisans) to help them get through these unprecedented times, when most of its stores are closed. However, headwinds (challenges later discussed in this report) are likely to be very strong in the medium term for Titan, making things difficult. Jewellery demand drivers are likely to worsen in the medium term, before earnings growth visibility starts emerging with store expansion and base-led recovery kicking in; historically, we have seen Titan make multiple nosedives to trade at as low as 35x. **We cut EPS estimates by 63%/25% for FY21/22 and downgrade to SELL with a target of Rs 560 (35x FY22 EPS).**

Demand destruction at its peak: COVID-19 has weakened already tepid jewellery demand. The following unfavourable trends will significantly weigh on jewellery sales: (1) Sharp spike in gold prices (up 20% yoy vs. FY20 average). (2) Deadly combo of *Adik maas* (a period considered inauspicious by Hindus; occurs every 32 months) and *Shraddh* (a period considered inauspicious for purchases in which rituals are performed to appease the souls of ancestors) in FY21. (3) Increased contribution from the margin-dilutive 'Gold Exchange Scheme' which was 42% of 3QFY20 sales; under this, most customers are likely to procure gold bars/coins available in physical markets at a 8-10% discount to Tanishq's rates, and exchange these for making jewellery, depriving Titan of the profit earned on gold spreads. (4) Many of the highly profitable and large-format L1 stores (company owned and operated) are located in malls and high-streets; so, adherence to social distancing norms will make matters worse for Tanishq. (5) Postponement/cancellation of weddings, festival celebrations and social gatherings.

Family-run jewellers to get their mojo back: We have been highlighting that the shift from unorganized jewellers to organized ones is already under way, but stringent implementation of COVID-19 guidelines could reverse this trend. We believe family-run jewellers are in a more comfortable position, as they operate on self-funded unhedged inventory (gold prices have risen 12-13% since the imposition of the lockdown), and limited overhead costs since they work with minimal employees. Our ground checks suggest that it is not viable for these jewellers to run business (ethically) via borrowed funds because of wafer thin margins and lower inventory turns (average 1.0-1.5x) in the jewellery business. These jewellers now have a golden chance to offload their non-hallmarked jewellery inventory ahead of implementation of hallmarking norms (likely from January 2021) by offering significant discounts and promotions, as most of their inventory was procured at lower costs, to boost sales in weak demand. Our discussion with a former president of the Hallmarking Association of India suggests that the 15 Jan 2021 deadline for the implementation of hallmarking might get pushed back (also been the case in the past), as jewellers associations at local/regional levels have not yet taken adequate measures to create awareness among its members and jewellery businesses will take at least a year to return to normalcy. We believe money-lending businesses (30-40% of the profit pool for family-owned jewellers) will flourish in coming days because their core customers would be in dire need of funds, higher gold rate would increase ticket sizes, and competition from NBFCs/SFBs would be lower.

Increased support to channel partners in an otherwise weak demand environment: We believe Tanishq might have to increase margins / offer favourable terms and conditions to its franchisee partners, so that they are able to maintain desired ROIs in this dire demand situation. Store addition guidance will be significantly curtailed in the near term despite major expansion proposed through the L2 route, as prospective franchisee partners are likely to show resistance in taking up business opportunities, given weak demand outlook.

SELL (Downgrade)

CMP RS 849

TARGET RS 560 (-32%)

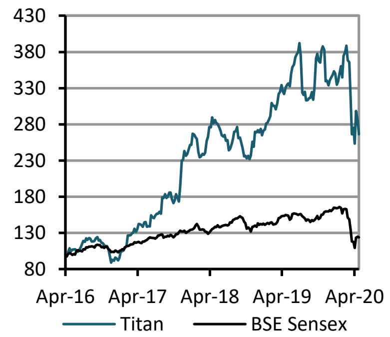
COMPANY DATA

O/S SHARES (MN) :	888
MARKET CAP (RSBN) :	780
MARKET CAP (USDBN) :	10.4
52 - WK HI/LO (RS) :	1341 / 720
LIQUIDITY 3M (USDMN) :	49.7
PAR VALUE (RS) :	1

SHARE HOLDING PATTERN, %

	Dec 19	Sep 19	Jun 19
PROMOTERS :	52.9	52.9	52.9
FII / NRI :	18.8	19.3	20.1
FI / MF :	8.8	8.3	6.4
NON PRO :	9.4	9.6	9.5
PUBLIC & OTHERS :	10.1	9.9	11.1

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY20E	FY21E	FY22E
Net Sales	2,01,835	1,44,572	2,00,751
EBIDTA	21,748	10,554	22,525
Net Profit	13,925	5,439	14,218
EPS, Rs	15.7	6.1	16.0
PER, x	54.1	138.6	53.0
EV/EBIDTA, x	33.6	68.5	32.0
PBV, x	10.9	11.2	10.3
ROE, %	20.1	8.1	19.5

Source: Phillip Capital India Research

CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY21E	FY22E	FY21E	FY22E
Revenue	1,44,572	2,00,751	-35%	-23%
EBITDA	10,554	22,525	-55%	-23%
Core PAT	5,439	14,218	-63%	-25%
EPS (Rs)	6.1	16.0	-63%	-25%

Vishal Gutka & Preeyam Tolia

Key risks to our SELL call

1) Stability in gold prices. We believe meaningful correction in gold prices could significantly help in raising jewellery segment volumes.
2) Relaxation of any regulatory restrictions for e.g., reduction in custom duty, liberal terms offered for Titan's Golden Harvest Scheme.
3) Allowing consumer finance for purchasing Jewellery (So far RBI has been averse to this idea).
4) Renegotiation (reduction) of rentals for L1-type stores, given that most stores are located in malls and high-street.
5) Announcement of mega stimulus package, which leads to broad-based recovery across key industries.

Titan – not a stranger to storms

We believe Titan has been able to navigate crises and has come out stronger and more agile after, but its valuation multiple nosedives during regulatory / macro crises and eventually starts inching up (re-rating), once clarity about its recovery and earnings growth visibility reappears.

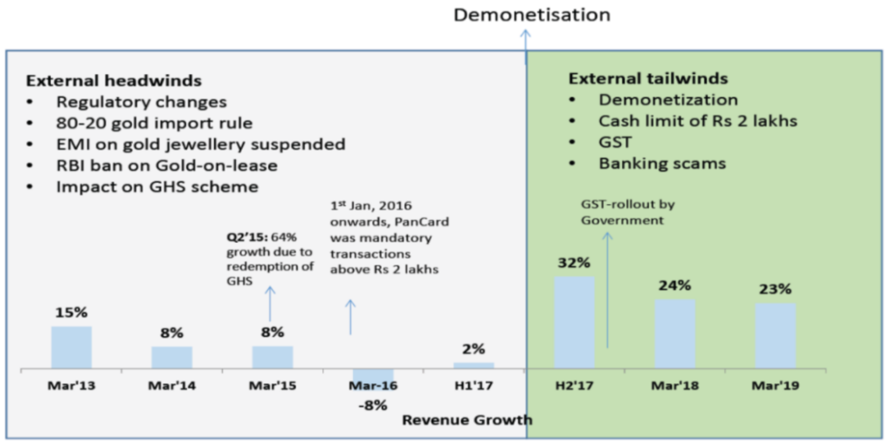
Titan's revenue CAGR was 12% over FY11-17 (as highlighted in figure 2) as multiple regulatory interventions kept growth under check. However, revenue CAGR of 22% over FY17-19 was quite healthy, as macro tailwinds such as demonetization, stringent implementation of GST regulations, inadequate availability of finance to non-compliant jewellers after the Nirav Modi scam, and cash purchases being disallowed above Rs 200,000 aided the growth of organized jewellers such as Tanishq.

Figure 1: Major regulatory / macro events over the past decade have crippled growth of the jewellery industry

Year	Event
FY11	Introduction of excise duty at 1% on branded jewellery
FY12	PAN Card for transactions above Rs 500,000 becomes mandatory. Increase in customs duty on gold to 2%, then to 4%, from 1%.
FY13	Increase in customs duty on gold to 6% from 4%.
FY14	Abolition of low-cost gold on lease. Introduction of 80: 20 rule (20% gold to be exported for every 80% imported). Increase in customs duty to 10% from 6%.
FY15	Regulatory measures introduced to reduce the lure of gold deposit schemes. Capping it to 25% of networth and interest rate to 12% per annum.
FY16	PAN card disclosure for all transactions above Rs 200,000 vs Rs 500,000 earlier.
FY17	Imposition of excise duty at 1% on all types of jewellery, which later was withdrawn
FY18	No cash purchases allowed above Rs 200,000.
FY20	Increase in customs duty to 12.5% from 10%.

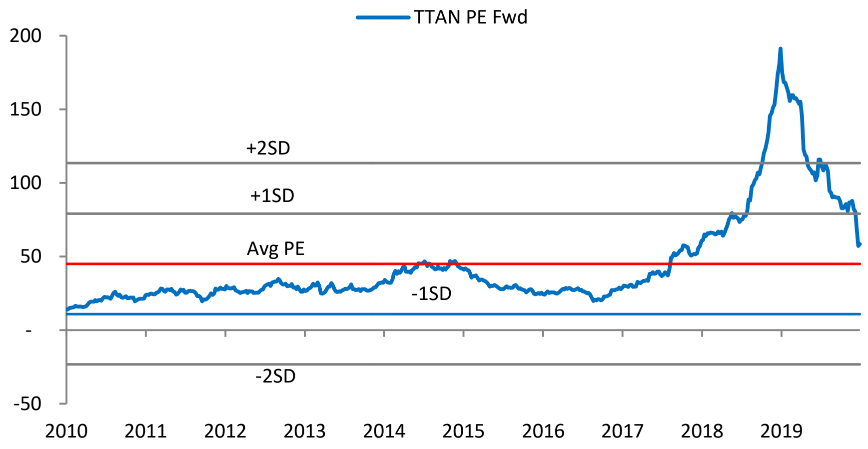
Source: Company, PhillipCapital India Research

Figure 2: Impact of regulatory environment in the past



Source: Company, PhillipCapital India Research

Figure 3: Titan is trading at 20% premium to its decadal average PE of 45x, despite no earnings CAGR over FY20-22

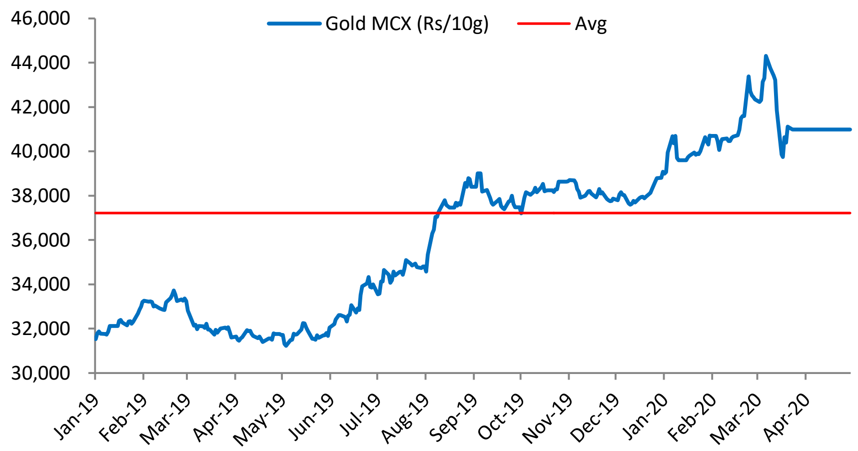


Source: Company, PhillipCapital India Research

Demand destruction at its peak

Sharp spike in gold prices (up 20% yoy vs. FY20 average): We believe higher gold price will put significant pressure on fashion-led discretionary jewellery sales (65-70% of Tanishq's sales), but sales of wedding jewellery might continue despite higher prices, given that it is more of a compulsion / custom driven purchase. Historically, gradually increasing prices is the best possible scenario for jewellery sales to pick-up, but a sharp spike in gold prices with a lot of volatility and uncertainty (job losses, salary cuts, etc.) drives away customers from purchasing gold.

Figure 4: Gold prices are up 20% vs. FY20 average, which could further defer demand



Source: Company, PhillipCapital India Research

Deadly troika of Adik maas + Shradh + muted consumer sentiment

Tanishq is unlikely to see meaningful recovery in consumer demand on a sequential basis until 2QFY21. Our checks suggest that consumers refrain from purchasing during Adik maas (18th Sept to 16th Oct 2020) + Shradh (1-17 Sept), given that these periods are considered inauspicious as per the Hindu calendar.

Adik mass (an additional month as per the Hindu calendar) appears once in every 32 months. (it last appeared in 2018 -16th May to 13th June) when Titan's jewellery business saw an 8% revenue growth and 2% like-to-like sales growth –much lower than its jewellery growth of 23% in FY19.

Malls / high-street-based jewellery stores to face unique challenges: We believe with Tanishq's most profitable L1 stores (company owned and operated) located either in malls or high-street with high density of customers, it is going to take considerable amount of time before businesses comes back to normalcy. In our view, it is next to impossible to sell high-ticket value jewellery through digital means; adherence to social distancing norms will make it more difficult. Appointment-led purchases might help to an extent, but one is always unsure of how much time it is likely to take while purchasing high-ticket value jewellery. Our ground checks suggest landlords and mall owners are unlikely to waive rentals for tenants, as landlords are also leveraged, and in the best-possible case, they are willing to defer rent with the assurance that they would be paid at a later date.

Figure 5: Tanishq store mix – 80% are franchised with L1 being company owned and company operated

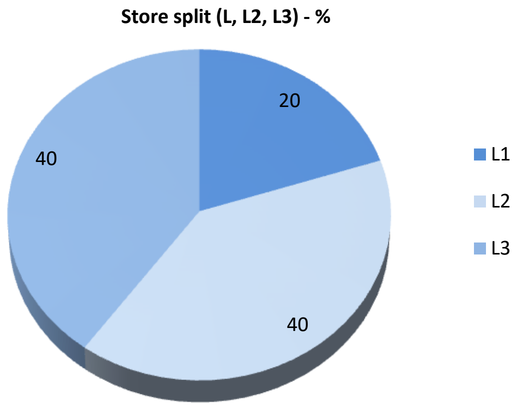
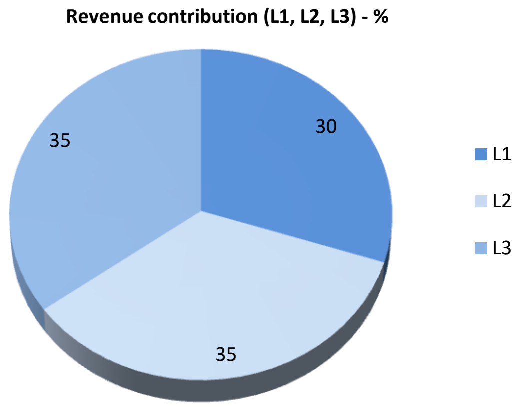


Figure 6: L1 stores, being large format stores have higher revenue salience



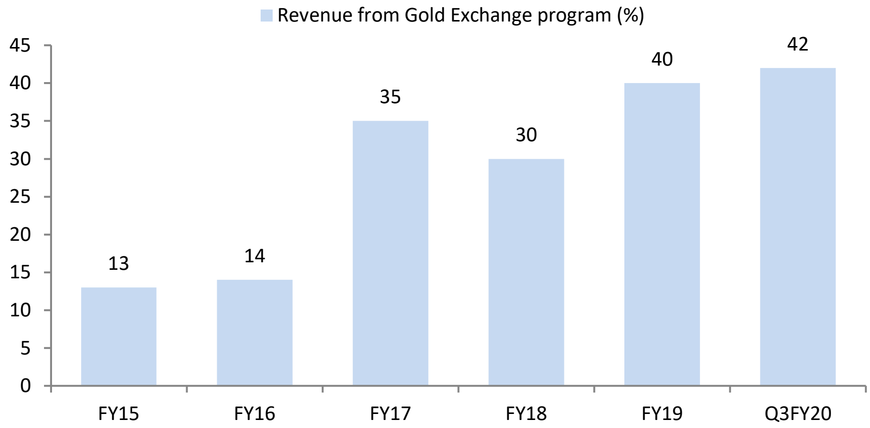
Source: Company, PhillipCapital India Research

Store additions to come to a grinding halt: Titan usually tries to achieve one-third of its growth in the jewellery segment from network expansion, (most of which are expansions via franchisee stores), and the rest through SSSG growth from existing stores. Store addition guidance would be significantly curtailed in the near term, despite major expansion proposed through the L2 route, as prospective franchisee partners are likely to show resistance in taking up business opportunities, given weak demand outlook. *We do not expect Titan to add any Tanishq stores in FY21.*

Increased salience of margin dilutive gold exchange programmes

Jewellers have two sources of income – mark-up (premium charged) on gold and diamond prices, and making charges. For most organized jewellers, ornaments sold under the gold-exchange programme earn lower margins, since they are not in a position to earn a mark-up on gold price, if jewellery exchanged under the programme also has been purchased from the same jeweller

Figure 7: Gold exchange programme has been a key driver of the jewellery segment growth over the past four years



Source: Company, PhillipCapital India Research

We believe customers are likely to procure gold bars and coins available in physical markets at a discount of 8-10% vs. rates quoted by Tanishq (which are higher) and exchange these for making jewellery, thus depriving Titan on profit earned via gold spreads. This trend has been visible throughout FY20 as gold bars and coins are available at a significant discount due to the oversupply situation.

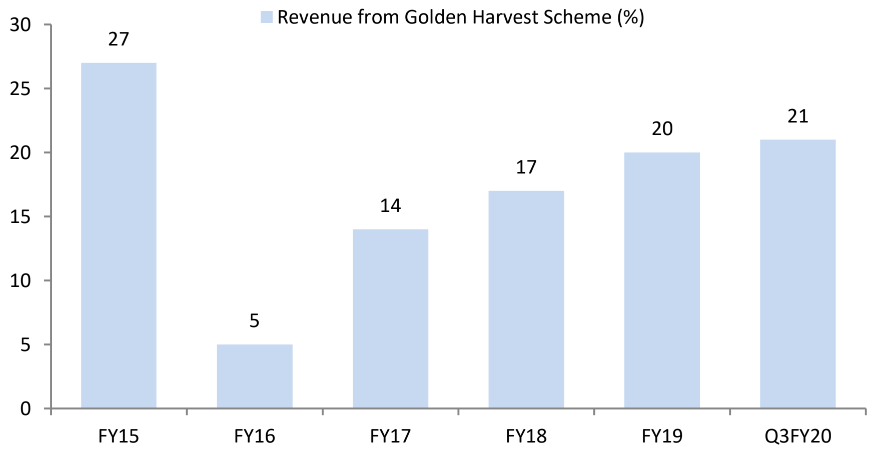
Our discussion with IBJA and GJEPC committee members suggests that significant amount of customers are likely to offer physical gold in exchange for cash due to sharp increases in gold prices and the dire need for funds due to the weak macro-economic environment that is worsening the oversupply situation. This could also lead to working capital issues for small and unorganized jewellers that have given guarantees on buybacks.

Reduction of rate of deduction to zero under the gold exchange programme could strain margins further: To lure customers under its Golden Exchange Scheme, Tanishq could reduce rates of deduction on gold rates to zero from about 4-8% earlier, putting more pressure on its margins.

Discontinuation of gold deposits schemes by customers

With nothing being deducted as surrender charges, customers that are facing income stress are likely to withdraw from Titan's Golden Harvest scheme.

Figure 8: Contribution of GHS has significantly improved – from 5% in FY16 to 21% in 3QFY20



Source: Company, PhillipCapital India Research

In the event of any premature closure of the account by the account holder, such an account holder may purchase jewellery at the Tanishq stores equal to the value of the instalments accumulated in his/her account as on that day. However, no discount on purchase of jewellery would be given in case of premature closure of the account where the number of instalments paid is less than 6 and below 180 days, under any circumstances.

Flat diamond prices over the past decade would turn off customers, despite becoming relatively affordable: We believe customers are likely to seek more value in whatever they purchase in a post-pandemic world, as the notion that diamond jewellery becomes more affordable to the gold jewellery may not give the required momentum to sales, as diamonds (in terms of value) have not appreciated much but gold price have almost seen 60% inflation.

Figure 9: Prices have remained stable since the last 3-4 years

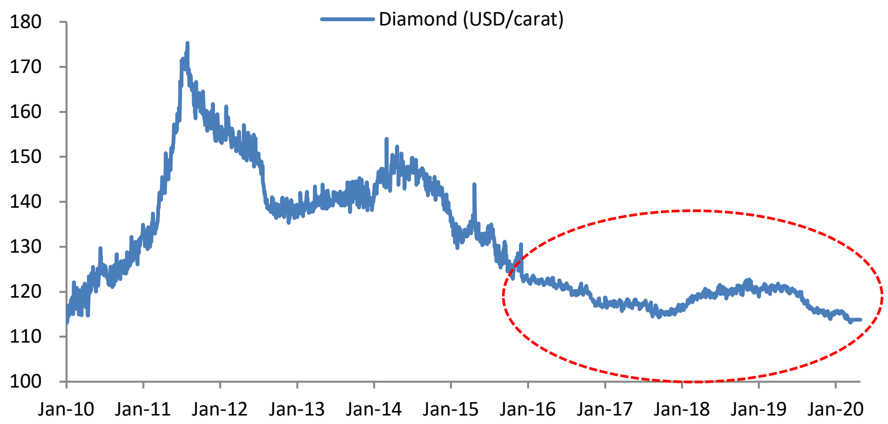
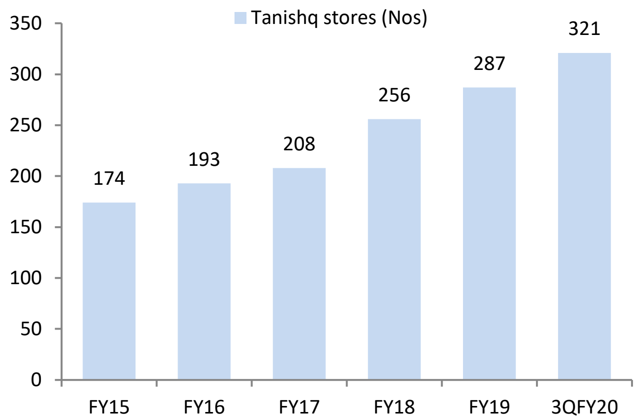
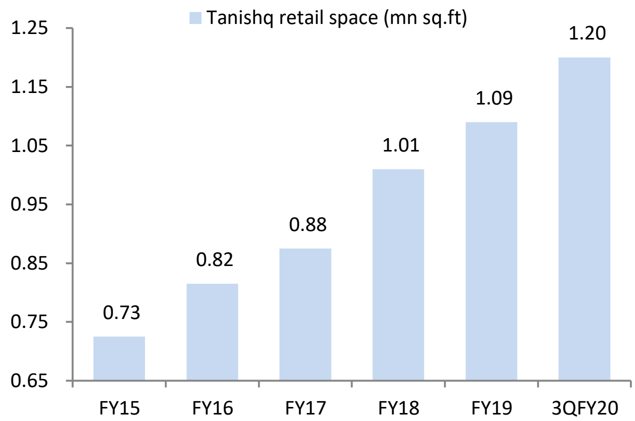


Figure 10: Titan jewellery segment growth in the past couple of years has been driven by network expansion through the franchisee route

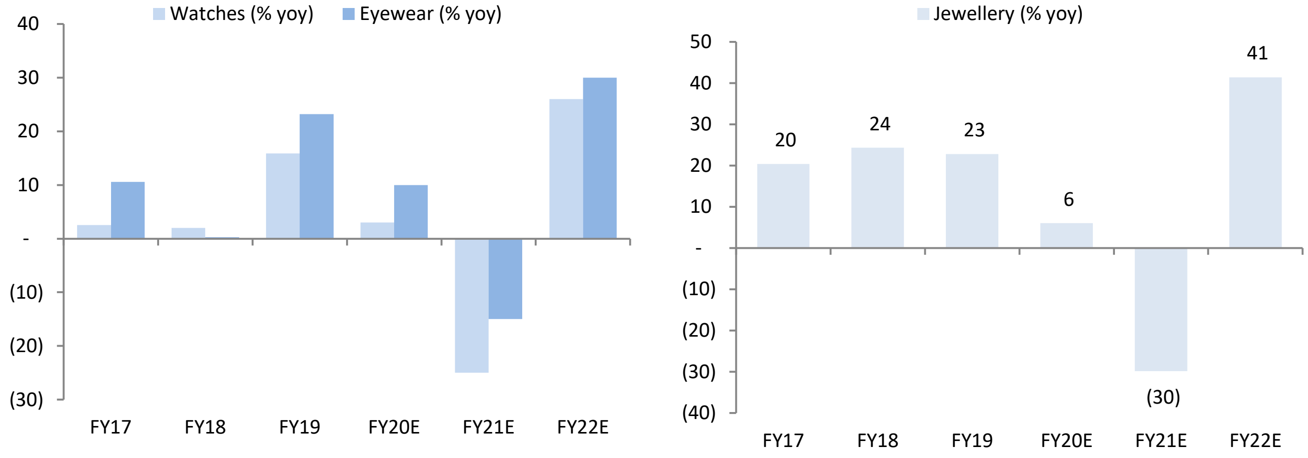




Source: Company, PhillipCapital India Research

Watches, eyewear to also face the axe of muted consumer sentiment: Titan's non-jewellery businesses – including watches (13% of sales), eyewear (3% of sales), Taneira, and Skinn – in the lifestyle discretionary categories are also likely to be dented by the overall slowdown in discretionary consumption. While some sales in these segments could be recouped through digital means, network expansion plans across these businesses are likely to be delayed.

Figure 11: We expect all the key segments to report similar revenue in FY22 (as seen in FY20) after seeing a massive dip



Source: Company, PhillipCapital India Research Estimates

Financials

Income Statement

Y/E Mar, Rs mn	FY19	FY20e	FY21e	FY22e
Net sales	**1,90,700**	**2,01,835**	**1,44,572**	**2,00,751**
Growth, %	22	6	-28	39
Other income	1,785	1,339	1,406	1,687
Total income	1,92,485	2,03,173	1,45,977	2,02,438
Raw material expenses	-1,39,872	-1,47,339	-1,06,983	-1,45,745
Employee expenses	-8,788	-10,545	-8,964	-10,398
Other Operating expenses	-22,018	-22,202	-18,071	-22,083
EBITDA (Core)	**20,022**	**21,748**	**10,554**	**22,525**
Growth, %	15.5	8.6	(51.5)	113.4
Margin, %	10.5	10.8	7.3	11.2
Depreciation	-1,389	-2,976	-3,111	-3,636
EBIT	**18,633**	**18,772**	**7,442**	**18,889**
Growth, %	14.8	0.7	(60.4)	153.8
Margin, %	9.8	9.3	5.1	9.4
Interest paid	-445	-1,503	-1,579	-1,575
Other Non-Operating Income	1,785	1,339	1,406	1,687
Non-recurring Items	-700	0	0	0
Pre-tax profit	**19,274**	**18,609**	**7,269**	**19,001**
Tax provided	-5,530	-4,684	-1,830	-4,782
Profit after tax	**13,744**	**13,925**	**5,439**	**14,218**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**13,744**	**13,925**	**5,439**	**14,218**
Growth, %	15.1	(3.6)	(60.9)	161.4
Net Profit (adjusted)	**14,243**	**13,925**	**5,439**	**14,218**
Unadj. shares (m)	888	888	888	888
Wtd avg shares (m)	888	888	888	888

Balance Sheet

Y/E Mar, Rs mn	FY19	FY20e	FY21e	FY22e
Cash & bank	10,947	22,391	30,997	33,278
Debtors	3,582	3,791	2,716	3,771
Inventory	67,192	71,886	51,491	71,500
Other current assets	13,358	14,137	10,126	14,062
Total current assets	95,078	1,12,206	95,331	1,22,611
Investments	8,063	8,063	8,063	8,063
Gross fixed assets	13,778	16,278	19,278	22,278
Less: Depreciation	-3,069	-6,044	-9,156	-12,792
Net fixed assets	10,710	10,234	10,123	9,487
Total assets	**1,13,851**	**1,30,503**	**1,13,516**	**1,40,161**
Current liabilities	52,796	61,915	46,947	67,896
Total current liabilities	52,796	61,915	46,947	67,896
Non-current liabilities	-763	-763	-763	-763
Total liabilities	52,033	61,153	46,184	67,133
Paid-up capital	888	888	888	888
Reserves & surplus	60,929	68,462	66,444	72,140
Shareholders' equity	61,817	69,350	67,332	73,027
Total equity & liabilities	**1,13,851**	**1,30,503**	**1,13,516**	**1,40,161**

Source: Company, PhillipCapital India Research Estimates

** All nos. In IGAAP format

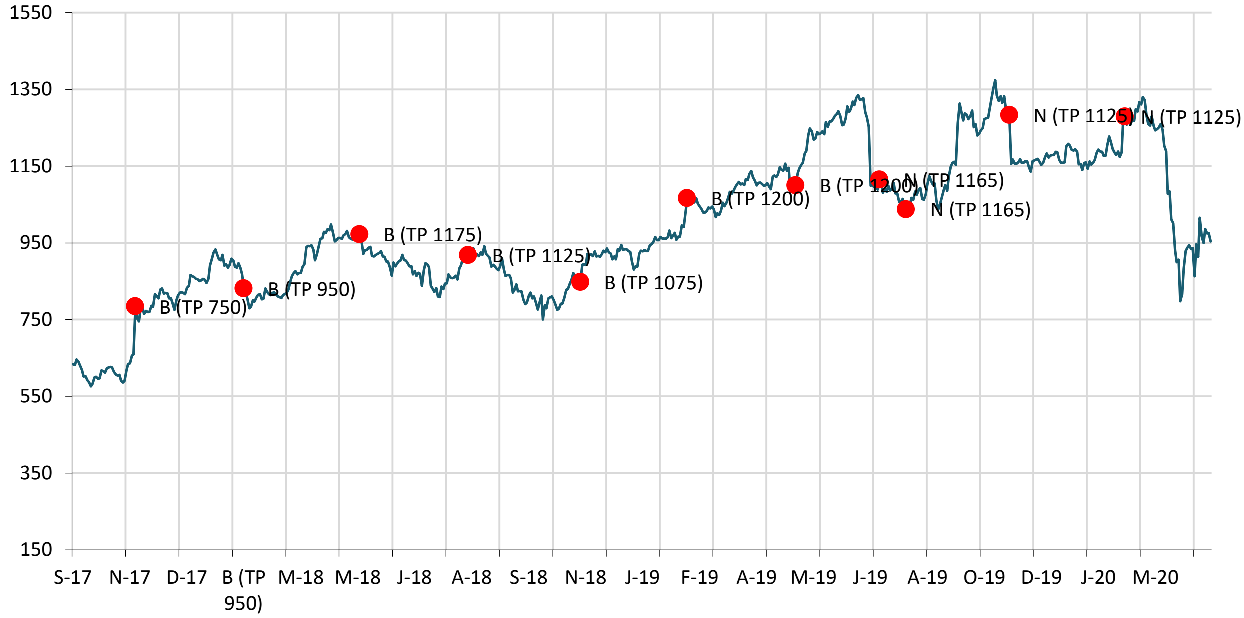
Cash Flow

Y/E Mar, Rs mn	FY19	FY20e	FY21e	FY22e
Pre-tax profit	19,274	18,609	7,269	19,001
Depreciation	1,389	2,976	3,111	3,636
Chg in working capital	-3,769	3,436	10,513	-4,051
Total tax paid	-5,530	-4,684	-1,830	-4,782
Other operating activities	0	0	0	0
Cash flow from operating activities	**11,364**	**20,336**	**19,064**	**13,804**
Capital expenditure	-2,175	-2,500	-3,000	-3,000
Chg in investments	-730	0	0	0
Cash flow from investing activities	**-2,905**	**-2,500**	**-3,000**	**-3,000**
Free cash flow	8,459	17,836	16,064	10,804
Dividend (incl. tax)	-5,327	-6,392	-7,457	-8,523
Other financing activities	0	0	0	0
Cash flow from financing activities	**-5,327**	**-6,392**	**-7,457**	**-8,523**
Net chg in cash	3,132	11,444	8,606	2,281
Opening cash balance	6,354	10,947	22,391	30,997
Closing cash balance	10,947	22,391	30,997	33,278

Valuation Ratios

	FY19	FY20e	FY21e	FY22e
Per Share data				
EPS (INR)	16.0	15.7	6.1	16.0
Growth, %	15.1	(3.6)	(60.9)	161.4
Book NAV/share (INR)	69.6	78.1	75.8	82.3
CEPS (INR)	18.6	19.0	9.6	20.1
CFPS (INR)	10.8	21.4	19.9	13.6
DPS (INR)	5.0	6.0	7.0	8.0
Return ratios				
Return on assets (%)	13.7	12.6	5.7	12.4
Return on equity (%)	23.4	20.1	8.1	19.5
Return on capital employed (%)	25.2	23.8	10.4	22.7
Turnover ratios				
Asset turnover (x)	4.7	4.9	4.3	6.7
Sales/Total assets (x)	1.8	1.7	1.2	1.6
Sales/Net FA (x)	18.5	19.3	14.2	20.5
Working capital/Sales (x)	0.2	0.1	0.1	0.1
Receivable days	6.9	6.9	6.9	6.9
Inventory days	128.6	130.0	130.0	130.0
Payable days	16.5	16.7	16.1	16.8
Working capital days	60.0	50.5	43.9	39.0
Liquidity ratios				
Current ratio (x)	1.8	1.8	2.0	1.8
Quick ratio (x)	0.5	0.7	0.9	0.8
Interest cover (x)	41.9	12.5	4.7	12.0
Net debt/Equity (%)	(17.7)	(32.3)	(46.0)	(45.6)
Valuation				
PER (x)	52.2	54.1	138.6	53.0
PEG (x) - y-o-y growth	3.4	(15.1)	(2.3)	0.3
Price/Book (x)	12.2	10.9	11.2	10.3
EV/Net sales (x)	3.9	3.6	5.0	3.6
EV/EBITDA (x)	37.1	33.6	68.5	32.0
EV/EBIT (x)	39.9	39.0	97.1	38.1

Stock Price, Price Target and Rating History



Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year. We have different threshold for large market capitalisation stock and Mid/small market capitalisation stock. The categorisation of stock based on market capitalisation is as per the SEBI requirement.

Large cap stocks

Rating	Criteria	Definition
BUY	>= +10%	Target price is equal to or more than 10% of current market price
NEUTRAL	-10% > to < +10%	Target price is less than +10% but more than -10%
SELL	<= -10%	Target price is less than or equal to -10%.

Mid cap and Small cap stocks

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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