Initiating Coverage

Faze Three Ltd.

August 16, 2022

RETAILRESEARCH

Faze Three Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Textile Products	Rs.397	Buy between Rs.393-405 & add more on dips to Rs.350	Rs.437	Rs.466	2-3 quarters

HDFC Scrip Code	FAZTHREQNR
BSE Code	530079
NSE Code	N.A.
Bloomberg	FZT:IN
CMP Aug 12, 2022	397
Equity Capital (Rs Cr)	24.3
Face Value (Rs)	10
Equity Share O/S (Cr)	2.4
Market Cap (Rs Cr)	966
Book Value (Rs)	114
Avg. 52 Wk Volumes	30160
52 Week High	413
52 Week Low	155

Share holding Pattern % (Jun, 2022)	
Promoters	51.5
Institutions	0.0
Non Institutions	48.5
Total	100.0

* Refer at the end for explanation on Risk Ratings

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Our Take:

Faze Three ltd (FTL) is engaged in the business of manufacturing and export of technical and home textiles products supplying to top retailers across the globe. Majority of FTL's revenue (90%) is derived from Exports to USA, UK and Europe region. The product ranges includes technical & home textiles as well as handloom Home textiles products. It has strong relations with its top 15 customers, evident from consistent business of over 2 decades. Promoters has more than three decades of experience as well as track record of turning around the company. The company has laid down capacity expansion plan with Rs. 80 Cr and targeted asset turnover of ~8 to 10x of new capex. This is in line of the company's plan to each up to Rs.1500 Cr annual revenue run rate in next five to six years. China plus one strategy adopted by major global retailers along with work from home culture has resulted in unprecedented demand for the company's products. Government's support in terms of PLI and other benefits have boosted the textiles exports industry scenario. Rupee depreciation will also help.

Rinsing raw material prices, high client concentration as well as lingering fear of US and Europe recession are the key risks for the company.

Valuation & Recommendation:

FY22 was a remarkable year for the company as it was able to add significant capacities, management bandwidth, new products, customers & substantial value across all stakeholders. Even after sharp rise prices of raw material, Coal/Fuel costs, shipping costs, etc., the company was able to report highest ever revenue. Margins also improved resulting in strong net profit growth. The company is currently running at peak capacity level. It has zero long term debt in the balance sheet since FY18, however recently the short term debt has risen due to inflated raw material and transportation cost as well as due to ongoing capex. Management has indicated that there is huge unfulfilled demand within the existing customers and this could be met with the increased capacity.

We have envisaged 16% and 18% CAGR in top line and bottom line between FY22P-24E. We will remain watchful on the margin front as select raw material as well as crude prices are at elevated levels. The return ratios are estimated to remain north of 19% level at least for next two years. The company is currently trading at 13.6x FY24E earnings.

We arrive at base case fair value of Rs.437 (15x FY24E EPS) and bull case fair value of Rs.466 (16x FY24E EPS). We feel that investors can buy the stock on between Rs. 393-405 (13.7x FY24E EPS) band and add further on dips to Rs.350 (12x FY24E EPS) band.

Financial Summary (Rs.Cr)

	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)	FY21	FY22P	FY23E	FY24E
Revenue	146.5	99.7	46.9	155.3	-5.7	324.6	504.5	577.6	674.1
EBITDA	24.5	16.4	49.3	24.1	1.6	45.8	79.6	92.0	110.7
APAT	14.5	9.1	60.5	15.8	-7.8	24.9	51.1	58.1	70.8
EPS						10.3	21.0	23.9	29.1
RoE						11.7	20.3	19.0	19.3
RoCE						15.6	23.8	23.3	23.7
P/E						38.7	18.9	16.6	13.6
P/BV						4.3	3.5	2.9	2.4

(Source: Company, HDFC sec)

Q1FY23 Result Update

The company has reported strong earnings growth in Q1FY23 results. Revenue reported was highest ever Q1 revenue at Rs.146.5 Cr up 47% YoY and down 5.7% QoQ. EBITDA margin improved sequentially at 16.7% vs 15.5% in last quarter as the raw material prices are cooling off. However, Polyester prices are yet to cool off given the crude rise & currency depreciation impact. Due to higher depreciation and interest cost the net profit declined by ~8% QoQ, while it was still up by ~60.5% YoY due to lower base. Further, management has informed that the capex spends are going as per plan and the order visibility has settled from euphoric levels last fiscal to positive / realistic this year across all legacy products.

Investment Rationales

Changing industry dynamics

In last two three years the tide has turned well in favor of India's textiles exporters. Earlier US-China trade war and recently the covid pandemic induced extended lockdown in China has triggered 'China Plus One' supply chain diversification strategy adopted by major global players. This has created opportunity for Indian players who has low cost labour as well as favorable government policies. India is the second largest exporter of Textile and Apparel Exporters ("T&A") after China. On the organized retail front under Home Textiles category, India is already a leading exporter of sheets and towels to USA, UK & Europe region whereas in other products like Technical textiles, floor coverings, etc., China is estimated to be at least 10x of India's share until recently. There is a tangible shift in demand in this sector similar to sheets and towels in the previous decade. Existing manufacturing set-ups in India with ongoing business with organized retail will greatly benefit from this movement. The government has approved the Production-Linked Incentive (PLI) Scheme for Textiles – focusing on manmade fiber (MMF) apparel, MMF fabrics, and products of technical textiles to enhance India's manufacturing capabilities and exports.

Moreover, the work from home culture has further accentuated the demand for products of FTL. Now that people are spending more time at home the desire to improve and beautify home has increased. As per the management the pipeline of opportunities in all of the core business categories has never been better in last 32 years of his experience.

Diversified product basket and strong cliental base

FTL has been in the business of Home & Technical Textiles manufacturing since 1985. It has seven factory locations including captive process houses. It has built a complete in-house business model from Design to Delivery : Yarn to Finished Product. Further, another distinctive factor is that the designing capability and efficient turnaround cycle for the handloom, where there is presence of huge unorganised players who lack adherence to compliance standards required by large brands.

The company is uniquely placed to have Handloom, Technical & Rubber backed floorcoverings under one umbrella. The products includes:

A) **Technical & Home Textiles Products:** Floor coverings (Bathmats / Rugs – Rubber backed), Performance & Outdoor Home Textiles, Cushions, Top of the Bed Products, Blankets, Accessories, etc.
B) **Handloom Home Textiles Products:** Bathmats, Accent Rugs, Cushions, Power loom rugs, Accessories, etc.

Product Category:

(Source: Company, HDFC sec)

The company has direct exposure with clients and does business via order backed manufacturing only. The clients includes very large retail chains in USA, UK, Europe etc. The company has strong relations with its top 15 customers, evident from consistent business of over 2 decades. Top 10 customers contribute around 80% of revenue. Any single Customer revenue is not more than 15% of total revenue of the company. As per management, the company is currently in the state where there is huge un-fulfilled demand within existing customer base / product mix offered by the company and that is one of the reason that they have laid down aggressive capex plan. This Customer appetite is at-least 10x across all product lines given their global sourcing including in India.

Long standing relations with large retailers:

(Source: Company, HDFC sec)

Experienced Promoters could navigate well during rough patches

Mr. Ajay Anand, Chairman & Managing Director, promoted the company in 1985. Mr Sanjay Anand (Brother) is also part of the promoter group. Promoters have good experience and sound knowledge in of the textiles business. In 2017, Mr Vishnu Ajay Anand also joined the business by getting involved in Operations and Management segments. This also ensures the succession planning.

FTL faced most challenging time during FY13-17, when the wholly owned German subsidiary (Pana Textile) went into insolvency. In FY17, the company settled its corporate guarantee liability arising out of its PANA subsidiary and entered into an agreement with its FCCB bondholders to settle the entire liability, which resulted in heavy debt burden on balance sheet of FTL. At that time promoters as well as investors infused money in the company to improve the capital structure. After this, the management implemented new policies and strategies to do the turnaround of the company; efforts started to fructify from FY21 onwards. This turnaround shows that the promoters/ top management has the ability to navigate the ship in to rough weathers. We feel that the company is well placed and has sufficient experience to grow in the cyclical business such as textiles.

Capacity Expansion plans

The company had drawn a plan to reach up to Rs.1500 Cr annual revenue run rate in next five to six years and for that it has budgeted to spend Rs.80 Cr on the capacity expansion with a targeted asset turnover of ~8 to 10x of new capex. Out of this Rs.40 Cr from the internal accruals was spent across units for new machinery, new technologies & de-bottlenecking from 2017-2020. Further, the company is under process of evaluating / exploring relevant / ready to use for manufacturing (brownfield opportunities) from time to time. Currently, it has commenced expansion at Panipat, Handloom Home Textiles division for 3x capacity by May-23 with overall Investment Rs.35 Cr. Expansion for Top of Bed / Blankets segment was done in Nov-21 to increase capacity to 3x of existing capacity. This was done after analyzing the commitments from various customers. Already Rs.12 Cr investment has been incurred and additional Rs.8 Cr is lined up. Concluded expansions includes expansion at Silvassa in Jun-22, to have 3x capacity on existing spare land, under Floor coverings / Rugs segment with Rs.35 Cr investment. Currently, the company is running at a full capacity. Further, the company has invested in subsidiary Mats and More Pvt Limited (Aurangabad) to cater to a new category under floor coverings to cater to the existing. Investment will be Rs. 12 Crs over July 2022-June 2023, building a revenue potential of at-least USD 10 mn in phase 1 within 3-4 years. We are very optimistic about the growth plans that the company has laid out. The company has guided that they are looking forward for some of the new product categories in pipeline to fruition in next 12-18 months which adds parallel engine to growth.

Tailwinds for exports from India

China plus one sentiment continues to improve in India's favour overall and especially in value added Textile merchandises pertaining to manmade fibres. As a company, FTL is using this temporary pause in high growth momentum to build capacities / capabilities. Economic challenges faced by neighboring countries and their cotton textile sector are also helping Indian exporters. Ban on cotton from China is now fully implemented globally, benefits of this are yet to fully accrue to Indian textile exporters.

Risks & Concerns:

Commodity and currency fluctuation

The raw materials that the company is using are cotton, polyester yarn and latex. Raw material cost contributes almost half of the total cost. The company now has lower fixed cost as percentage of total cost so any increase in variable cost such as raw material could impact the profitability. Raw materials are commoditized products and prices are dependent on global demand-supply dynamics, environment, area under cultivation and yield during that year etc. Polyester yarn is crude derivative which again is highly volatile commodity. The company's ability to pass on the price hike to customers remains the key here. FTL's 90% of the total revenue is derived from Exports to USA, UK and Europe region, which brings forex risks for the unhedged part.

Operating margins for the company have fallen in Q4FY22 and Q1FY23 from the previous two quarters despite rising topline.

Long working capital cycle

Stretched working capital cycle is due to working capital intensive nature of operations such as specific skill and limitation of capacity involved in the value added home textiles. Some of the sales are done via made to order with a specific time lines and for that the company has to keep high inventory levels. However, with the focussed efforts of management the inventory days has come down in last couple of quarters.

Client concentration

As noted earlier, the company's clients includes giant retail chains in US and Europe as well as some reputed OEMs in the automotive segment. These tend to be sticky to their suppliers, however this client concentration is still a risk for the company. Top 15 customers contribute around 80% of revenue. The company has more than two decades of relationships with these clients.

Lingering fear of US and Europe recession

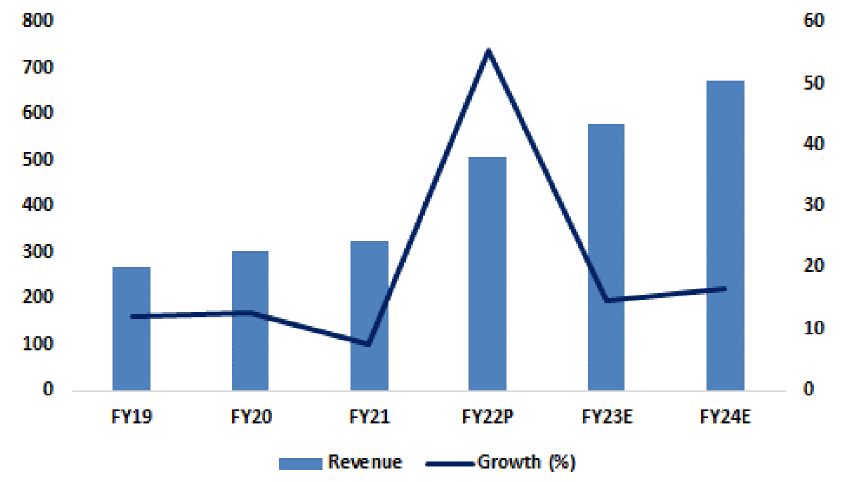
Global central banks are pulling liquidity out of the system by raising interest rates to fight against the inflation. By doing so there are chances that they push growth rate down. Many economists are fearing onset of recession in the US and Europe. In fact, the headwinds are already being felt; expectation of tighter monetary policy has lowered the consumer sentiments. The company generates majority of its sales from US and Europe market; any slowdown in these regions could affect the company's business. As per management, the company's products are largely positioned in the band at $10-25$ per piece / per set band for sale by retailers which empirically have not seen significant reduction in demand in tough times given its budget friendly nature.

Company Background:

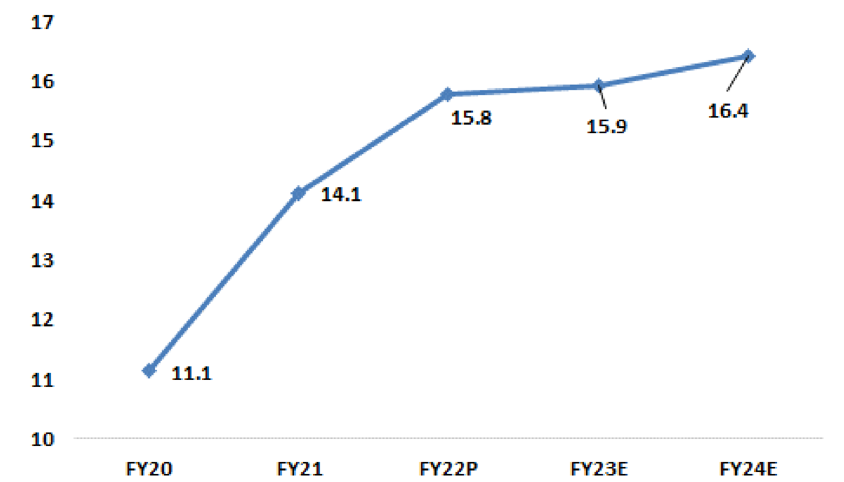
Faze Three Limited (FTL), promoted by Mr. Ajay Anand in 1985, is engaged in manufacturing and export of superior quality high-end Home Textile products supplying to top retailers across the globe. It has a diversified product line, main products include Bathmats, Bath Rugs, Chair pads, Blankets, Rugs, Throws, Floor covering, Bed spreads, etc. FTL has capability to offer every product other than sheets and towels under Home Textile segment. Currently floor covering segment is the dominant product category. The Company is known for its sheer pursuit for innovation, ideas and designs which reflects in its products and has enjoyed being a preferred vendor to most of its customers. Majority of FTL's revenue (90%) is derived from Exports to USA (60%), UK and Europe region (30%). The company has eight facilities to manufacture home textiles situated at Dadra and Nagar Haveli, Vapi (Gujarat), Panipat (Haryana) and Aurangabad (Maharashtra) in India.

FTL has a wholly owned subsidiary Faze Three US LLC in the US for marketing purposes. The group carries out Automotive Technical Textiles (Passenger Car Fabrics) under a separate company Faze Three Autofab Limited.

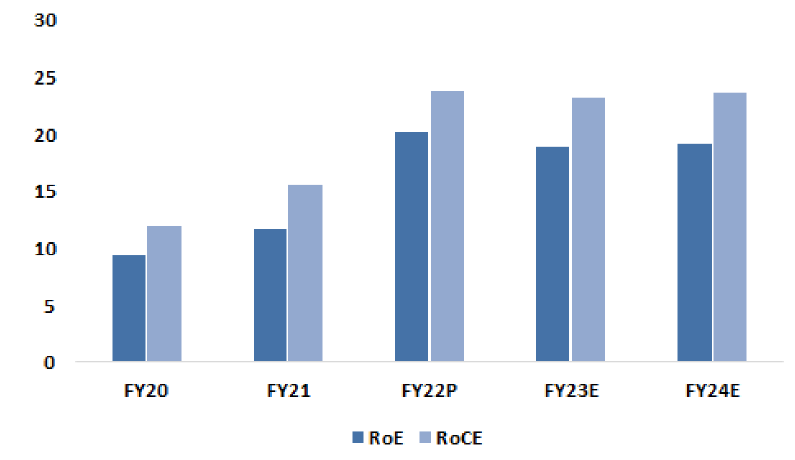
Revenue to grow at 16% CAGR between FY22P-FY24E



EBITDA Margin (%)



Return Ratios (%)



Financials

Income Statement

(Rs Cr)	FY20	FY21	FY22P	FY23E	FY24E
Revenue	302.2	324.6	504.5	577.6	674.1
Growth (%)	12.5	7.4	55.4	14.5	16.7
Operating Expenses	268.5	278.8	424.9	485.6	563.3
EBITDA	**33.6**	**45.8**	**79.6**	**92.0**	**110.7**
Growth (%)	**20.1**	**36.3**	**73.7**	**15.6**	**20.4**
EBITDA Margin (%)	**11.1**	**14.1**	**15.8**	**15.9**	**16.4**
Depreciation	8.0	8.8	10.2	11.2	12.3
EBIT	**25.7**	**37.0**	**69.4**	**80.8**	**98.4**
Interest	8.6	3.8	5.0	8.3	9.8
Other Income	4.1	2.1	7.0	7.7	8.4
PBT	**21.2**	**35.3**	**71.4**	**80.2**	**97.0**
Tax	3.0	10.4	20.3	22.1	26.2
APAT	**18.1**	**24.9**	**51.1**	**58.1**	**70.8**
EPS	7.5	10.3	21.0	23.9	29.1

Balance Sheet

(Rs Cr)	FY20	FY21	FY22P	FY23E	FY24E
SOURCE OF FUNDS					
Share Capital	**24.3**	**24.3**	**24.3**	**24.3**	**24.3**
Reserves	177.1	201.8	254.0	309.7	376.9
Shareholders' Funds	**201.5**	**226.1**	**278.3**	**334.0**	**401.2**
Long-Term Borrowings	1.2	0.3	0.3	0.3	0.3
Other non-Current Liab & Provisions	12.0	10.4	12.7	12.9	13.0
Total Source of Funds	**214.6**	**236.8**	**291.3**	**347.2**	**414.5**
APPLICATION OF FUNDS					
Net Block	124.6	130.9	160.8	147.6	153.3
Capital Work-in-Progress	0.8	1.0	4.0	4.3	4.7
Non-Current Investments	0.2	0.2	0.2	0.2	0.2
Intangible assets under development	0.0	0.0	0.0	0.0	0.0
Long Term Loans & Advances	22.7	17.1	15.3	34.1	33.0
Total Non-Current Assets	**148.3**	**149.2**	**180.3**	**186.2**	**191.2**
Current Investments	0.0	0.0	10.2	10.2	10.2
Inventory	60.8	69.8	115.1	132.9	152.8
Trade Receivables	44.0	69.7	81.8	94.9	110.8
Cash & Equivalents	16.3	42.5	56.4	72.8	94.8
Short-Term Loans and Advances	0.1	1.2	2.3	2.6	2.8
Other Current Assets	15.3	24.2	41.5	56.0	78.4
Total Current Assets	**136.4**	**207.3**	**307.3**	**369.4**	**449.8**
Short-Term Borrowings	53.5	91.4	157.6	165.5	178.8
Trade Payables	6.7	13.3	21.7	24.5	27.6
Other Current Liab & Provisions	10.0	15.1	17.0	18.4	20.2
Total Current Liabilities	**70.2**	**119.8**	**196.3**	**208.4**	**226.6**
Net Current Assets	66.3	87.6	111.0	161.0	223.3
Total Application of Funds	**214.6**	**236.8**	**291.3**	**347.2**	**414.5**

Faze Three Ltd.

Cash Flow

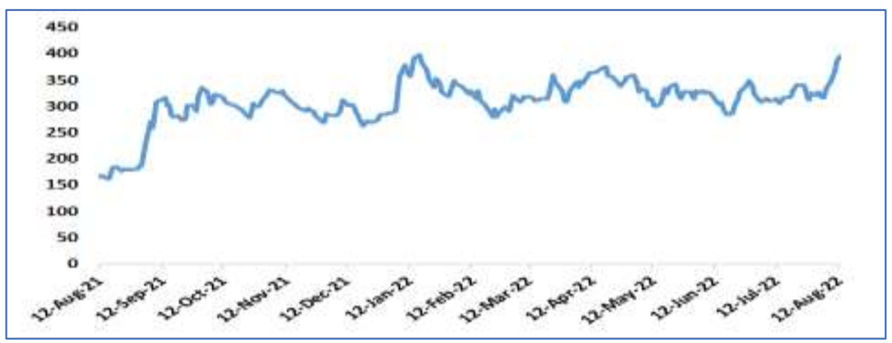
(Rs Cr)	FY20	FY21	FY22P	FY23E	FY24E
Reported PBT	21.2	35.3	71.4	80.2	97.0
Non-operating & EO items	-1.0	0.7	0.0	48.2	24.5
Interest Expenses	5.9	4.1	1.6	8.3	9.8
Depreciation	8.0	8.8	10.2	11.2	12.3
Working Capital Change	2.0	-34.4	-76.4	-67.9	-78.3
Tax Paid	-5.0	-5.7	-13.3	-22.1	-26.2
OPERATING CASH FLOW (a)	**31.1**	**8.9**	**-6.5**	**57.9**	**39.2**
Capex	-10.5	-13.9	-32.5	-20.0	-18.0
Free Cash Flow	20.6	-5.0	-39.0	37.9	21.2
Investments	0.0	0.0	-10.1	-18.7	1.1
Non-operating income	5.3	-38.7	-8.2	0.0	0.0
INVESTING CASH FLOW (b)	**-5.2**	**-52.6**	**-50.8**	**-38.7**	**-16.9**
Debt Issuance / (Repaid)	-14.9	35.3	64.8	7.9	13.2
Interest Expenses	-5.4	-4.5	-4.0	-8.3	-9.8
FCFE	0.3	25.9	21.8	37.5	24.6
Share Capital Issuance	0.0	0.0	0.0	0.0	0.0
Dividend & Other	-1.5	0.0	0.0	-2.4	-3.6
FINANCING CASH FLOW (c)	**-21.8**	**30.9**	**60.8**	**-2.8**	**-0.3**
NET CASH FLOW (a+b+c)	**4.1**	**-12.8**	**3.5**	**16.3**	**22.0**

Key Ratios

	FY20	FY21	FY22P	FY23E	FY24E
Profitability (%)					
EBITDA Margin	11.1	14.1	15.8	15.9	16.4
EBIT Margin	8.5	11.4	13.8	14.0	14.6
APAT Margin	6.0	7.7	10.1	10.1	10.5
RoE	9.4	11.7	20.3	19.0	19.3
RoCE	12.0	15.6	23.8	23.3	23.7
Solvency Ratio					
D/E	0.3	0.4	0.6	0.5	0.4
Net D/E	0.2	0.2	0.3	0.2	0.2
PER SHARE DATA					
EPS	7.5	10.3	21.0	23.9	29.1
BV	83	93	114	137	165
DPS	0.5	0.0	0.5	1.0	1.5
Turnover Ratios (days)					
Debtor days	53.1	78.3	59.2	60.0	60.0
Inventory days	73.4	78.5	83.3	84.0	82.8
Creditors days	11.3	21.4	22.0	21.6	21.0
VALUATION					
P/E	53.2	38.7	18.9	16.6	13.6
Dividend Yield	0.1	0.0	0.1	0.3	0.4
P/BV	4.8	4.3	3.5	2.9	2.4
EV/EBITDA	31.7	23.3	13.4	11.6	9.6

(Source: Company, HDFC sec)

One Year Price Chart



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HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

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