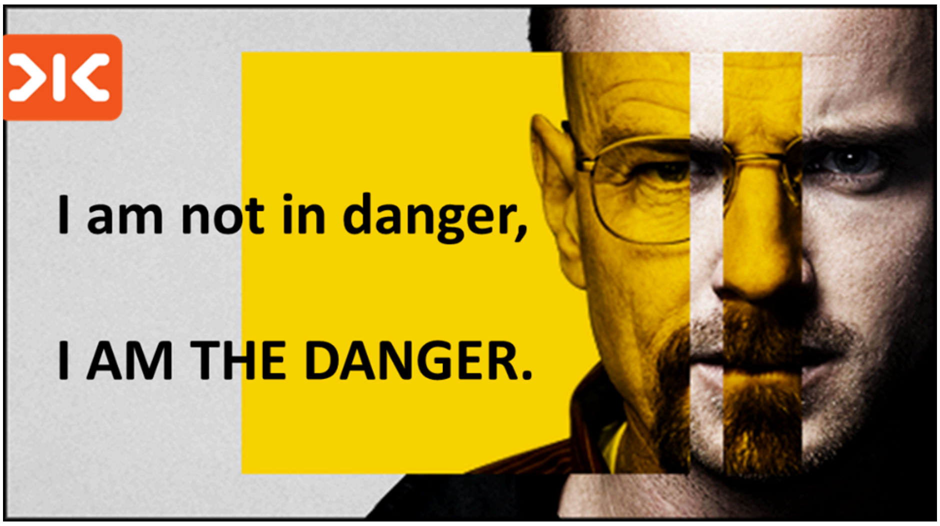


Taking a page from the popular US TV serial *Breaking Bad*, Kewal Kiran Clothing, a low-profile Indian listed company with a high-profile *Killer Jeans* brand (and a few other ones as well), announced on its Facebook page a week ago: I am not in danger, I AM THE DANGER.

Sounds like an empty threat no?

But hey look what this company's balance sheet look like.

A Killer Balance Sheet With Loads of Ammo

Look Ma! No Net Debt!!!

KEWAL KIRAN CLOTHING LTD. / Annual Report 2012-13

FASHION WITH CONSCIENCE

BALANCE SHEET as at 31st March 2013

(Amount in ₹)

Particulars	Note	As At 31st March 2013	As At 31st March 2012
EQUITY & LIABILITIES			
Shareholders' Funds			
Share Capital	2.1	123,250,370	123,250,370
Reserves and Surplus	2.2	2,415,321,866	2,132,208,120
		2,538,572,236	**2,255,458,490**
Non-Current Liabilities			
Other Long-Term Liabilities	2.3	54,340,491	38,661,577
Long-Term Provisions	2.4	5,542,023	6,946,819
		59,882,514	**45,608,396**
Current Liabilities			
Short-Term Borrowings	2.5	140,907,135	148,903,166
Trade Payables	2.6	227,411,678	157,817,077
Other Current Liabilities	2.7	111,607,402	77,967,781
Short-Term Provisions	2.8	165,909,178	144,211,328
		645,835,393	**528,899,352**
TOTAL		**3,244,290,143**	**2,829,966,238**
ASSETS			
Non-Current Assets			
Fixed Assets	2.9		
Tangible Assets		431,720,105	432,509,351
Intangible Assets		3,706,679	1,830,800
Tangible Capital Work in Progress		7,034,040	8,860,793
Non Current Investments	2.10	34,828,044	35,077,783
Deferred Tax Assets(Net)	2.11	20,294,011	17,275,564
Long-Term Loans and Advances	2.12	96,810,146	106,516,218
Other Non-Current Assets	2.13	9,638,815	10,945,938
		604,031,840	**613,016,447**
Current Assets			
Current Investments	2.14	1,181,337,724	280,692,911
Inventories	2.15	336,691,933	320,931,825
Trade Receivables	2.16	478,695,845	482,166,067
Cash & Bank Balances	2.17	607,653,104	1,013,224,549
Short-Term Loans & Advances	2.18	18,148,995	45,569,103
Other Current Assets	2.19	17,730,702	74,365,336
		2,640,258,303	**2,216,949,791**
TOTAL		**3,244,290,143**	**2,829,966,238**
Significant accounting policies and notes on accounts	1 & 2		

Investments: Rs 118 cr.
Cash: Rs 61 cr.
Therefore, Total Treasury: Rs 179 cr.
Debt: Rs 14 cr.
Therefore, Net Cash: Rs 165 cr.

Net Operating Assets = Net worth - Net Cash
Or, Rs 254 cr. - Rs 165 cr. = Rs 89 cr.

What a sexy balance sheet! No net debt. And net operating assets (invested capital *less* treasury assets) of only Rs 89 cr. at the end of FY 13 and Rs 112 cr. at the end of FY 12. So, average net operating assets employed was *only* Rs 101 cr. Why *"only Rs 101 cr.?"*

That's because that such a *low* amount in relation to what the company *earns*.

Killer Return on Net Operating Assets

See P&L below.

STATEMENT OF PROFIT AND LOSS for the year ended 31st March 2013

(Amount in ₹)

Particulars	Note	For the Year Ended 31st March 2013	For the Year Ended 31st March 2012
INCOME			
Revenue from Operations (Gross)	2.20	3,203,945,130	3,260,553,582
Less: Excise Duty		174,020,238	241,834,885
Revenue from Operations (Net)		3,029,924,892	3,018,718,697
Other Income	2.21	121,738,721	117,587,822
		3,151,663,613	**3,136,306,519**
EXPENDITURE			
(Increase) / Decrease in Stocks	2.22	5,838,710	(16,684,481)
Cost of Material Consumed	2.23	1,178,562,883	1,185,020,994
Purchase of Trading Items: Lifestyle Accessories/ Products		78,530,140	140,168,631
Personnel Cost	2.24	340,751,505	292,362,746
Manufacturing and Operating Expenses	2.25	238,284,442	235,896,741
Administrative and Other Expenses	2.26	167,474,950	155,459,616
Selling and Distribution Expenses	2.27	283,921,768	292,674,108
Finance Expenses	2.28	26,211,196	25,952,080
Depreciation/ Amortisation	2.9	59,375,659	62,309,584
		2,378,951,253	**2,373,160,018**
Net Profit Before Tax		**772,712,360**	**763,146,500**
Provisions for Taxation			
Current Tax		241,000,000	242,588,032
Deferred Tax		(3,018,447)	(849,541)
Short Provision for taxes of earlier years		558,059	-
Net Profit for the Year		**534,172,748**	**521,408,009**
Earnings Per Share - Basic and Diluted (Face Value of ₹ 10 each fully paid up)		43.34	42.30
Weighted average number of shares used in computing earnings per share -Basic and Diluted		12,325,037	12,325,037

In FY 13, the company earned a profit before taxes and other (mostly treasury) income of Rs 65 cr. Why did I reduce other income? Because I want to compare what the company earned from the *business* with the average net assets employed by that *business* which we earlier estimated at *"only Rs 101 cr."*

If this was a mediocre business earning only a pretax 10% return a year on net operating assets, the quantum of those assets needed by the business to deliver earnings of Rs 65 cr. would have been Rs 650 cr., right?

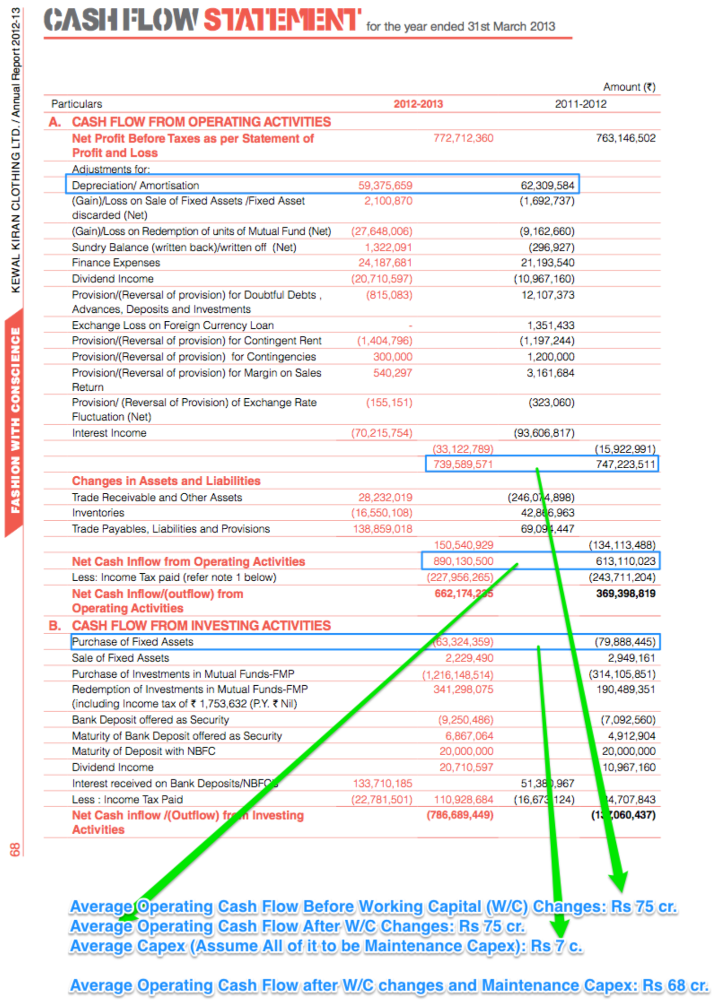
But this company's killer balance sheet shows that the company employed net operating assets *only Rs 101 cr.!*

That *translates* into a pre-tax return on net operating assets of 65/101 or 64%, which when compared to AAA bond yields of 11% or so, looks stunningly good, no?

But, are these earnings *real* or just an illusion?

Killer Cash Flow Statement

Let's find out by checking out the cash flow statement.



KEWAL KIRAN CLOTHING LTD. / Annual Report 2012-13

FASHION WITH CONSCIENCE

CASH FLOW STATEMENT for the year ended 31st March 2013

Amount (₹)

Particulars	2012-2013		2011-2012	
A. CASH FLOW FROM OPERATING ACTIVITIES				
Net Profit Before Taxes as per Statement of Profit and Loss		772,712,360		763,146,502
Adjustments for:				
Depreciation/ Amortisation	59,375,659		62,309,584	
(Gain)/Loss on Sale of Fixed Assets /Fixed Asset discarded (Net)	2,100,870		(1,692,737)	
(Gain)/Loss on Redemption of units of Mutual Fund (Net)	(27,648,006)		(9,162,660)	
Sundry Balance (written back)/written off (Net)	1,322,091		(296,927)	
Finance Expenses	24,187,681		21,193,540	
Dividend Income	(20,710,597)		(10,967,160)	
Provision/(Reversal of provision) for Doubtful Debts , Advances, Deposits and Investments	(815,083)		12,107,373	
Exchange Loss on Foreign Currency Loan	-		1,351,433	
Provision/(Reversal of provision) for Contingent Rent	(1,404,796)		(1,197,244)	
Provision/(Reversal of provision) for Contingencies	300,000		1,200,000	
Provision/(Reversal of provision) for Margin on Sales Return	540,297		3,161,684	
Provision/ (Reversal of Provision) of Exchange Rate Fluctuation (Net)	(155,151)		(323,060)	
Interest Income	(70,215,754)		(93,606,817)	
		(33,122,789)		(15,922,991)
		739,589,571		747,223,511
Changes in Assets and Liabilities				
Trade Receivable and Other Assets	28,232,019		(246,0[illegible]4,898)	
Inventories	(16,550,108)		42,8[illegible]6,963	
Trade Payables, Liabilities and Provisions	138,859,018		69,09[illegible],447	
		150,540,929		(134,113,488)
Net Cash Inflow from Operating Activities		890,130,500		613,110,023
Less: Income Tax paid (refer note 1 below)		(227,956,265)		(243,711,204)
Net Cash Inflow/(outflow) from Operating Activities		**662,174,2[illegible]5**		**369,398,819**
B. CASH FLOW FROM INVESTING ACTIVITIES				
Purchase of Fixed Assets		(63,324,359)		(79,888,445)
Sale of Fixed Assets		2,229,490		2,949,161
Purchase of Investments in Mutual Funds-FMP		(1,216,148,514)		(314,105,851)
Redemption of Investments in Mutual Funds-FMP (including Income tax of ₹ 1,753,632 (P.Y. ₹ Nil)		341,298,075		190,489,351
Bank Deposit offered as Security		(9,250,486)		(7,092,560)
Maturity of Bank Deposit offered as Security		6,867,064		4,912,904
Maturity of Deposit with NBFC		20,000,000		20,000,000
Dividend Income		20,710,597		10,967,160
Interest received on Bank Deposits/NBFC's	133,710,185		51,3[illegible]0,967	
Less : Income Tax Paid	(22,781,501)	110,928,684	(16,673,124)	[illegible]4,707,843
Net Cash inflow /(Outflow) from Investing Activities		**(786,689,449)**		**(1[illegible],060,437)**

68

Average Operating Cash Flow Before Working Capital (W/C) Changes: Rs 75 cr.
Average Operating Cash Flow After W/C Changes: Rs 75 cr.
Average Capex (Assume All of it to be Maintenance Capex): Rs 7 c.

Average Operating Cash Flow after W/C changes and Maintenance Capex: Rs 68 cr.

Earlier, we had estimated average pre-tax operating earrings of Rs 65 cr. Over FY12 and FY13. Now, the above cash flow statement confirms that those earnings were *real.*

Let's do another check.

Killer Dividends

Since the company went public in 2006, it has *paid* its shareholders dividends totalling to Rs 92 cr. See table below for the company's dividend paying track record:

	Mar-13	Mar-12	Mar-11	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06
Earnings Per Share (Rs)	43.34	42.30	37.51	26.38	11.57	17.23	15.13	12.94
Dividend Per Share (Rs)	17.50	17.00	16.50	6.00	3.00	4.00	2.50	1.50
Dividend Payout Ratio	40.4%	40.2%	44.0%	22.7%	25.9%	23.2%	16.5%	11.6%

Where did the money to pay dividends come from?

1. Did it come from assets sales? No, because since the company went public it has *spent* Rs 70 cr. on net capex (asset purchases less asset sales).
2. Did it come from debt issuance? No, because we know the company has no net debt, and indeed hasn't had net debt since it went public.
3. Did it come from issuance of new shares for cash? Yes, the company did raise Rs 49 cr. in FY06 in its IPO but cash on the balance sheet has only accumulated over the years, so IPO proceeds were not the source of dividends.

That means the only possible source left for financing those dividends was operating cash flow.

But, we need more assurance, so let's do *our* thing by creating a reconciliation statement.

Killer Reconciliation Between Reported Earnings and Cash Flows

Here is a reconciliation of aggregate P&L account and Cash Flow Statement from FY06 to FY13

FY06 to FY13 Aggregates	Rs. Cr.
Earnings before taxes, depreciation, interest expense, and other income as per P&L	323.37
Pretax operating cash flow after working capital changes as per Cash Flow Statement	330.48

The reported earnings and cash flows get along quite well.

Earnings Quality Control ☑

Killing Them Softly

Step into a mall and you see jeans all over. There are foreign brands like Levis, Wrangler, Pepe, Diesel etc.

Then there are local brands like Flying Machine and Spykar.

Spykar, says this in its Ads: Bring it On.

Spykar is privately held and backed by private equity. In June 2010, CARE Ratings had this to say about Spykar

CARE Ratings

Press Release

June 18, 2010

CARE REAFFIRMS THE RATINGS ASSIGNED TO THE BANK FACILITIES OF SPYKAR LIFESTYLE PVT LTD.

Ratings Assigned

Facilities/Instruments	Amount (Rs. crore)	Ratings[1]	Remarks
Long-term Bank Facilities	97.85	'CARE BBB-' (Triple B Minus)	Reaffirmed
Short-term Bank Facilities	22.00	'PR3' (PR Three)	Reaffirmed
Total Facilities	**119.85**		

Rating Rationale

The ratings continue to derive strength from SLPL's experienced promoters, established brand name, wide spread distribution network, equity infusion by private equity fund during FY09 and growth in operations.

The ratings are, however, constrained by high gearing levels, working capital intensive nature of operations, long working capital cycle and increasing competition in branded apparel segment.
Ability of SLPL to maintain healthy profitability in a competitive environment accompanied with changing fashion trends is the key rating sensitivity.

Company Profile
Incorporated in 1992, Spykar Lifestyle Pvt. Ltd. launched the 'Spykar' brand with product profile ranging from cotton casual wear, jeans, fashionable denims, belts, caps, cargos, shirts and t-shirts for men as well as shorts for women.
SLPL recorded net sales of Rs.236.97 crore and PAT of Rs.8.74 crore in FY09 as compared to net sales of Rs.146.91 crore and PAT of Rs.12.44 crore in FY08. For the nine months ended December 31, 2009, SLPL posted net sales of Rs.181.43 crore and PBT of Rs.16.09 crore.

High gearing levels in Spykar? Kewal Kiran is actually debt free. Just saying…

And then in Feb 2011, when it came to debt levels of Spykar, and its quality, CARE stopped caring.

CARE Ratings

Press Release

February 2, 2011

CARE SUSPENDS THE RATINGS ASSIGNED TO THE BANK FACILITIES OF SPYKAR LIFESTYLE PRIVATE LTD

CARE has suspended, with immediate effect, the **'CARE BBB-' [Triple B Minus] and 'PR3' [PR Three]** ratings assigned to the Long-term bank facilities aggregating to Rs.88.62 crore and Short-term Bank Facilities of Rs.17 crore of Spykar Lifestyle Private Ltd (SLPL) as the company has not furnished the information required by CARE for monitoring the rating.

Bring on what, Spykar?

In its 2010 annual report, Levi Strauss & Co announced the launch of a brand called denizen™ meant to take on Killer Jeans (and other similar brands in emerging markets). Here is what the annual report said:

> *"Introduced in 2010 and headquartered in asia, denizen is the company's first brand launched out- side of the united states. The denizen collection is designed with the standards of construction and craftsmanship that have made Levi Strauss & Co. famous around the world. It's outfitting a new generation of upwardly mobile youth with great fitting, quality jeanswear and other fashion essentials at **affordable prices**."* (Emphasis mine)

The logic of launching denizen was to sell *lower priced* jeans than the ones Levi Strauss was selling under its original brands. The company explained:

> *"The biggest challenge for any business today is how to tap into the phenomenal growth in china and india, as well as emerging markets worldwide. Instead of thinking "product" first, we began by thinking about the customer."*

By 2012, Levi Strauss had a change of heart and *killed* the Denizen brand. In its annual report for that year, the company wrote:

> *"In Asia, revenues declined due to stiff economic headwinds in the key markets of China and India, and the exit of the Denizen® brand."*

Hmmmmm…

Killer Margins

While it's competitors were, let's say, struggling, Kewal Kiran, since its IPO has delivered killer margins. See table below.

	Mar-13	Mar-12	Mar-11	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06
Inc / Exp Performance								
Revenues (Rs Cr.)	320.39	326.06	237.32	175.94	145.49	159.60	133.62	85.96
EBIDTA (Rs Cr.)	85.83	85.14	77.05	56.92	28.47	39.15	32.72	20.67
EBITDA Margin	26.8%	26.1%	32.5%	32.3%	19.6%	24.5%	24.5%	24.0%
PAT (Rs Cr.)	53.42	52.14	46.23	32.52	14.26	21.24	18.65	11.94
PAT Margin	16.7%	16.0%	19.5%	18.5%	9.8%	13.3%	14.0%	13.9%

Now, compare Kewal Kiran's Killer PAT margins with those of other Indian listed apparel retail companies.

	Revenues	Net Profit	Net Profit Margin
	Rs Cr.	Rs Cr.	%
Digjam	133	-13	-9.8%
Lovable Loungrie	151	16	10.6%
Page Industries	876	113	12.9%
Provogue	525	2.3	0.4%
Rupa	812	64	7.9%
Shoppers Stop	2517	39	1.5%
Trent	991	44	4.4%
Zodiac	307	10.4	3.4%
Source: Capital Market			

When it comes to PAT Margins, even the most profitable company in the above list— the highly recognised Page Industries— is less profitable than Kewal Kiran.

Killer Value Creation

Since the FY07, Kewal Kiran has created more than Rs 4 in incremental market value for every rupee it has earned and retained (i.e. not paid out as dividend).

	Mar-13	Mar-12	Mar-11	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06
Market Cap (Rs Cr.)	893.07	819.55	672.82	301.96	122.57	400.50	219.88	-
PAT (Rs Cr.)	53.42	52.14	46.23	32.52	14.26	21.24	18.65	11.94
Dividend (Rs Cr.)	21.57	20.95	20.34	7.40	3.70	4.93	3.08	1.38
Earnings Retained (Rs Cr.)	31.85	31.19	25.90	25.12	10.56	16.31	15.57	10.55
From FY07 to FY13								
Incremental Market Cap (Rs Cr.)	673.19							
Total Earnings Retention (Rs Cr.)	156.49							
Multiplier	4.30	times						

Kewal Kiran's stock price has also beaten Sensex by a wide margin since the company's IPO. See chart below, keeping in mind that the stock price performance ignores substantial dividends paid by the company over the last seven years.

The Killer Puzzle

Now that I have hopefully aroused your curiosity, I will pose a few questions.

1. Why is Kewal Kiran so profitable as compared to any other listed apparel company in India? Is it branding? Is it low cost advantage? Is there something else? Substantiate your answer.
2. What's the growth potential of the business of Kewal Kiran over the next decade or two? How scalable is this business?
3. Who does Kewal Kiran compete with?
4. Has Kewal Kiran been moving up the value chain? Substantiate your answer with evidence.
5. What is Kewal Kiran's competitive strategy?
6. What are the entry barriers, if any, in Kewal Kiran's business, which will protect its margins and profitability over the next decade or two.
7. As an investor, what's there to *like* about the denim jeans business? What's there to *dislike* about the denim jeans business?
8. Compare Kewal Kiran's balance sheet with that of Relaxo. Which one do you like more, and why?
9. Compare Kewal Kiran's business model with that of Relaxo's business model. What are the similarities? What are the differences?
10. How would you value the shares of Kewal Kiran?

Disclosure: I own shares in Kewal Kiran Clothing Limited so you should know I may be biased here.
Acknowledgement: I would like to thank Viraj Mehta, an ex student, in helping me in developing this project.

A Few Links:

1. http://www.youtube.com/watch?v=6b72tCPcRcs (Pepe Jeans was started by three brothers from Indian origin)
2. Private Equity and Indian Retail: https://db.tt/9XAAo8dd
3. Emergence of an Indian Levi's or Gap: https://db.tt/i6dCAt5L
4. The Smart Way: https://db.tt/vdMxgx9p
5. http://www.youtube.com/watch?v=IKgtxh1mqew (Kewal Kiran Production Process)
6. http://www.youtube.com/watch?v=1ibfEAudfkE (Kewal Kiran's Sales Training Film)
7. http://www.youtube.com/watch?v=4hvJ7obXrZE

8. http://www.youtube.com/watch?v=Ch7x0cVVljM
9. http://www.youtube.com/watch?v=x0znf-aOMz4
10. http://www.youtube.com/watch?v=Y4sJQpMUJh4
11. http://www.youtube.com/watch?v=17EN-EAJqb4
12. http://www.youtube.com/watch?v=XvMoXcFnE2Y

ENDS