

Heritage Foods Ltd- Q1FY18 Result Update

Weak results; but bright outlook

CMP INR 1260 Target INR 1460

Rating: BUY Upside: 16%

Heritage Foods posted weak performance for Q1FY18 ; on account of intergration and consolidation of Reliance Dairy's performance into the business. The topline grew by 32% yoy; led by 22%yoy growth in milk volumes and 21% yoy growth in the value added segment largely curd. **Reliance Dairy's consolidation added 20% to the overall revenue.** Despite strong reveue performance, higher milk procurement price, weak margin profile of Reliance along with one time brand revamping expense dragged the operating performance , which was down 33% yoy. Incorporating Reliance Dairy into our estimates, would lead to upgrading the revenue , but reducing the margins and the net earnings. Going forward, despite weak earnings led by high milk prices and Reliance's impact for FY18; we believe margins should stablize ahead in 2HFY19 and FY20 onwards. Improving organized dairy dynamics coupled with Heritage's aggression on expanding its procurment and distribution reach and changing the DNA of the company from traditional milk player to a leading consumer brand makes us positive on the company. We reiterate our Buy rating on the stock with a price target of INR 1460.

Q1FY18 – Weak dairy operating performance; marred by Relaince consolidation and one time brand revamp

The consolidated reveue grew by 32% yoy led by stellar 32.2% yoy growth in the dairy vertica, on account of integration and consolidation of Reliance Dairy business into the financials (Reliance Dairy added 22% to the overall revenue). Despite strong revenue performance, the operational and the net earnings were down 33% and 58% yoy on account of (a) Weak earnings profile of Reliance Dairy, Reliance Dairy posted a loss of INR 6 crore for the quarter (b) Increase in the milk procurement prices (+10% yoy), without commensurate increase in the pouched milk realization(5% yoy) (c) One time brand building expenses of INR 4 crore. Adjusting to the Reliance's loss and one time brand revamp operating profit was down 8% on a yoy basis.

Inked JV with French company- Novandie SNC to manufacture & market Yoghurt – In line with its stated intent of expanding into fresh products without high capex and without compromise on returns, the company has entered into a 50:50 JV with french company- Novandie to manufacture and market yoghurt with an initial capacity of 20 tons/day and a capex of INR 16 crore in the first phase. The JV aims to reach INR 300 crore revenue in 5 years time frame with a peak capex of INR 75 crore, and a EBITDA margin of 15% at a steady state. We continue to like this strategy of the company to be asset light and churn high RoCE.

Strong focus on Dairy

The company has undertaken various strategic decision viz (a) Acquisition of the Reliance Retail's Dairy business – this has enhanced its procurement and distribution capability by around 20% (b) Sale of the loss making Retail business to Future Retail on a share swap deal- The retail business was loss making uptill 10 years, the divestment of retail frees up the managemnet bandwidth, improves distribution reach across future group stores, and has bought focus to the dairy business (c) Undertaken Joint venture agreement with French subsidiary for Yoghurt. We believe that focus on dairy, improvement in the distributionand procuremment leg, coupled with management's clear focus on high ROCE generating fresh dairy product segment – Yoghurt, Dahi will lead to better growth, higher margins and strong ROCE and this makes us positive on the stock.

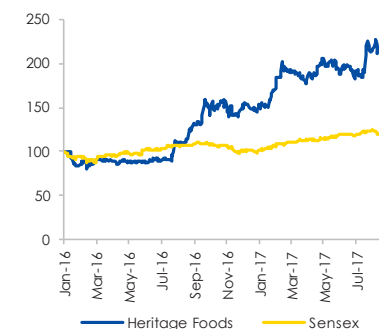
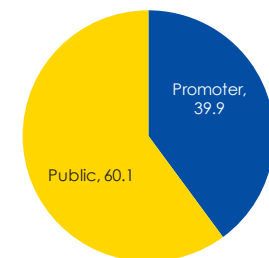
Outlook and valuations: Attractive; Re-iterate – BUY

Heritage is a strong brand in a high growth pouch milk segment, which is gaining salience and momentum with the shift of business from unorganised to organised players. We believe, improving product mix (targeting 40% value-added products), expanding reach in new markets and enhanced focus on the dairy segment will propel its earnings to clock 36% CAGR over FY17-19. We value the company at a target price of INR 1,460 and re-iterate our Buy call.

Year to March	Q1FY18	Q1FY17	% change	Q4FY17	% change	FY17	FY18E	FY19E
Net sales	617	467	31.9%	493	25.0%	2,643	2,385	2,769
EBITDA	27	40	-33.2%	29	-6.3%	141	169	225
PAT	10	17	-40.9%	10	-2.6%	67	88	124
PAT from continuing operations	10	25	-58.0%	15	-32.1%			
Dil. EPS (INR)						29	38	54
Diluted P/E (x)						43.7	33.2	23.5
EV/EBITDA (x)						21	17	12
ROACE (%)						24	21	20

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Bloomberg:	HTFL IN
52-week range (INR):	1,342 / 603
Share in issue (cr):	2
M cap (INR cr):	2,831
Avg. Daily Vol.	29
BSE/NSE :('000):	

Date: 14th August 2017

Q1FY18 Result Highlights

INR cr	Q1FY18	Q1FY17	% change	Q4FY17	% change	FY17	FY16	% change
Net Revenues	617	467	32%	493	25%	2,643	2,381	11%
Operating Expenses	590	427	38%	465	27%	2,502	2,250	11%
EBITDA	27	40	-33%	29	-6%	141	131	8%
Depreciation	9	6	53%	6	34%	38	35	10%
EBIT	18	35	-47%	22	-18%	104	96	7%
Interest expenses	4	2	96%	4	6%	11	17	-34%
Other income	1	1	62%	2	-16%	6	7	-8%
PBT	16	34	-53%	20	-23%	98	86	14%
Provision for tax	6	9	-39%	10	-44%	31	31	3%
PAT Before Minority & Associate Share	10	24	-58%	10	-3%	67	55	21%
Share of Associates	-	-		-	NA	-	-	NA
PAT from continuing operations	10	24	-58%	10	-3%	67	55	21%
Reported PAT	10	17	-41%	15	-33%			
Equity Capital	23	23		23		23	23	
No of Shares	2	2		2		2	2	
EPS	4	11		5		29	24	
EBITDA Margin	4%	9%		6%		5%	6%	
PAT Margin	2%	5%		2%		3%	2%	
Tax Rate	35%	27%		48%		32%	36%	

Segmental Performance

Revenue	Q1FY18	Q1FY17	% change	Q4FY17
Dairy	609	461	32.2	488
Retail	-	169	NM	212
Others	18	17	10.1	31

EBIT	Q1FY18	Q1FY17	% change	Q4FY17
Dairy	15.8	33.9	-53.4	26.2
Retail	-	- 6.2	NM	3.4
Others	0.5	0.0	1,277.4	0.1

EBIT margin	Q1FY18	Q1FY17	% change	Q4FY17
Dairy	2.6	7.4	(477)	5.4
Retail	-	- 3.7	-	1.6
Others	2.7	0.2	250	0.5

Company Description

Heritage was set up by Mr. Chandrababu Naidu as a dairy company in 1992 with a vision to provide remunerative prices to dairy farmers for milk. It was involved in dairy, retail, agri, and bakery businesses in India; however, with slump sale of loss-making retail, agri and bakery businesses, it is now a pure dairy play. The company's dairy division procures, manufactures, packs, and distributes milk & milk products. Heritage operates via 1,457 Heritage Parlours. Over the years, it has become a formidable private dairy player in South India with a dominant presence in Andhra Pradesh and Telangana.

The company's dairy products are sold under the *Heritage* brand across 10 states in India, wherein it enjoys leadership in Andhra Pradesh & Telangana and holds sizeable market shares in Tamil Nadu and Karnataka. 80% of the company's dairy revenue comes from South India and hereon growth in these markets will be spearheaded by Tier II & III towns. The company is trying to make inroads in North and West India markets by entering NCR Delhi & Maharashtra, wherein it is setting up milk procurement infrastructure and capacities.



Milk Procurement	Processing	Distribution	Branding & Trust
<ul style="list-style-type: none"> Operates 144 Bulk Coolers and Chilling Plants. Currently procures 10,54,806 Liters Per Day Witnessing growth in Mumbai and Delhi markets Procures in 8 States: Andhra Pradesh; Delhi ; Haryana; Karnataka; Maharashtra; Rajasthan; Telangana & TamilNadu Milk Procurement from 3 Lakh Dairy Farmers 	<ul style="list-style-type: none"> Operates 14 Processing Plants Installed milk processing capacity of 15,45,000 Liters Per Day. 	<ul style="list-style-type: none"> Products available in 10 States: Andhra Pradesh; Delhi; Haryana; Karnataka; Kerala; Maharashtra; Odisha; Rajasthan; Telangana & TamilNadu Delivery through 1,723 outsourced vehicles. Enjoys Loyalty of 11,50,000 Households 	<ul style="list-style-type: none"> Robust Heritage brand in: Milk; Curd; Buttermilk; Ice - Cream/Frozen Dessert; Paneer; & others Winning Trust of Farmers through: Facilitating bank loans; high quality feed; cattle insurance, farmers' welfare fund; mobile veterinary clinics; certificate course in dairy farming

Investment Theme

Key Investment arguments

- **Leading B2C milk player in Southern pouch milk segment; expanding presence in the non southern markets** - Heritage Food is a leading private dairy player with 11-12% organized market share in south. The company is the second largest player in the Andhra Pradesh Telangana market. Over the years the company's dairy revenue have grown at a CAGR of 17.6% over FY08-16, while the EBITDA has grown at a CAGR of 21.2% . Going forward (a) led by increasing penetration from the current region (b) Expanding reach from the newer geographies (c) and strong 20% CAGR growth in value added category, we expect Heritage's dairy business to grow at a CAGR of 13.4% over FY16-20 to reach Rs 2,927 crore revenue
- **Burgeoning share of value-added products to spur growth and margin** - Heritage, in its quest to become a full fledged dairy company, is aggressively transitioning from a plain vanilla milk to value-added products' player. We expect the company to enhance the share of value-added products from current 22% to 30% in FY20 and to this end it is deepening reach in the category via introduction of new varieties of curd and ice creams. Along with organic growth potential, Heritage is also scouting for partnerships in the value-added segment and is in discussions with international players for medium shelf life products like curd and yogurt. The company is smartly straddling the high-returns pouch milk segment and high-growth & margin accretive medium shelf life curd and yogurt segment. Unlike high shelf life products like cheese, branded ghee & flavoured milk, Curd and yogurt entail higher margins—1.7-2x liquid milk—but do not involve high working capital and hence returns are much better. Ergo, we estimate the value-added portfolio to post 23% CAGR over FY16-20—2.3x FY16 sales.
- **Divestment of loss making retail business to bring focus & improve company level profitability and returns ratio ahead** – The Retail business that was started in 2006, that been continuously reeling under losses and has accumulated a EBITDA loss of Rs 200 crore, and the net accumulated loss of Rs 300 crore in the balance sheet. Now the company has divested its stake in the retail business, which will free the management in terms of time and resources to focus on the core dairy business. We expect the sale of loss making retail to be earnings accretive and returns accretive (ex the investment)
- **Strong brand, superior and efficient returns ratio makes it a compelling buy**- Heritage Foods is a strong brand in the secular growing pouch milk segment that is gaining fast acceptance and growth via transition from unorganized to organized play. We believe Heritage's improving product portfolio (targeting 40% value added product), expanding reach into new markets and enhanced focus on dairy is expected to propel its earnings by 30% CAGR over FY16-20. We value the company at 25x FY19 (25% discount to FMCG) to arrive at a price target of Rs 1460.

Key Risks

Volatility in the milk prices to impact margins- Heritage has a sizeable milk contribution from the pouch milk business, wherein the spread is limited, ranging between 18-20%, thus any small increase in the procurement price without commensurate rise in the price of the end product, results in hit in the margins.

Increase in the competitive intensity – The increase in the competitive intensity by the co-operatives or the private players either in terms of procurement (by increasing prices to the farmers), or selling price (via lower prices) to impact the performance

Financials

Income statement (Standalone)						Balance sheet (Standalone)						Ratios					
(INR cr)						(INR cr)											
Year to March	FY15	FY16	FY17	FY18E	FY19E	As on 31st March	FY15	FY16	FY17	FY18E	FY19E	Year to March	FY15	FY16	FY17	FY18E	FY19E
Income from operations	2,073	2,381	2,643	2,385	2,769	Equity share capital	23	23	23	23	23	ROAE (%)	15.2	25.6	24.7	17.8	16.6
EBITDA	84	131	141	169	225	Reserves & surplus	170	217	277	666	790	ROACE (%)	14.0	25.6	24.2	20.8	20.4
Depreciation and amortisation	34	35	38	29	33	Shareholders funds	193	240	301	689	813	Current ratio	1.5	1.3	1.1	5.2	5.6
EBIT	50	96	104	140	192	Secured loans	157	125	74	94	94	Debt/Equity	0.8	0.5	0.5	0.2	0.2
Interest expenses	18	17	11	21	21	Unsecured loans	0	1	77	77	77	Debtors (days)	4	4	2	5	5
Other income	7	7	6	6	6	Borrowings	157	126	211	172	172	Inventory (days)	25	22	17	15	15
Profit before tax	39	86	98	126	178	Sources of funds	350	366	511	861	985	Payable (days)	23	24	24	10	10
Provision for tax	11	31	31	38	53	Gross block	462	518	598	429	509	Cash conversion cycle (days)	6	2	-5	10	10
Core profit	28	55	67	88	124	Depreciation	182	206	244	151	184	Debt/EBITDA	1.9	1.0	1.1	1.0	0.8
Profit after tax	28	56	67	88	124	Net block	281	312	354	278	326	Adjusted debt/Equity	0.6	0.3	0.3	(0.1)	(0.2)
Adjusted net profit	28	56	67	88	124	Capital work in progress	9	10	10	10	10	Valuation parameters					
Equity shares outstanding (mn)	2	2	2	2	2	Total fixed assets	290	322	364	288	335	Year to March	FY15	FY16	FY17	FY18E	FY19E
EPS (INR) basic	12.2	23.9	28.8	37.9	53.6	Investments	1	1	149	268	268	Diluted EPS (INR)	12.2	23.9	28.8	37.9	53.6
Diluted shares (Cr)	2.3	2.3	2.3	2.3	2.3	Inventories	139	145	123	98	114	Y-o-Y growth (%)	(37.8)	96.5	20.5	31.8	41.3
EPS (INR) fully diluted	12.2	23.9	28.8	37.9	53.6	Sundry debtors	24	29	16	33	38	CEPS (INR)	26.8	38.8	45.1	50.4	67.8
Common size metrics- as % of net revenues						(INR cr)											
Year to March	FY15	FY16	FY17	FY18E	FY19E	Loans and advances	9	9	16	16	16	Diluted P/E (x)	103.6	52.7	43.7	33.2	23.5
Gross profit margin (%)	19.7	21.8	21.9	100.0	100.0	Total current assets	214	228	203	402	490	Price/BV (x)	15.1	12.2	9.7	4.2	3.6
Operating expenses	96.0	94.5	16.6	92.9	91.9	Sundry creditors and others	130	158	173	65	76	EV/Sales (x)	1.5	1.3	1.1	1.2	1.0
Depreciation	1.6	1.4	1.4	1.2	1.2	Provisions	15	16	12	12	12	EV/EBITDA (x)	36.3	22.9	21.4	16.8	12.3
Interest expenditure	0.8	0.7	0.4	0.9	0.7	Total CL & provisions	145	174	185	77	88	Diluted shares O/S	2.3	2.3	2.3	2.3	2.3
EBITDA margins	4.0	5.5	5.3	7.1	8.1	Net current assets	69	54	18	325	402	Basic EPS	12.2	23.9	28.8	37.9	53.6
Net profit margins	1.3	2.4	2.5	3.7	4.5	Net Deferred tax	-19	-19	-20	-20	-20	Basic PE (x)	103.6	52.7	43.7	33.2	23.5
Growth metrics (%)						Uses of funds											
Year to March	FY15	FY16	FY17	FY18E	FY19E	Book value per share (INR)	83	103	130	297	350						
Revenues	20.4	14.8	11.0	(9.7)	16.1	Cash flow statement											
EBITDA	(13.4)	56.5	7.9	19.8	33.1	Year to March	FY15	FY16	FY17	FY18E	FY19E						
PBT	(36.1)	119.7	14.3	28.0	41.3	Net profit	29	55	67	88	124						
Net profit	(37.8)	96.5	20.5	31.8	41.3	Add: Depreciation	34	35	38	29	33						
EPS	(37.8)	96.5	20.5	31.8	41.3	Gross cash flow	60	91	114	117	157						
						Less: Changes in W. C.	24	-19	-39	100	11						
						Operating cash flow	36	110	153	17	147						
						Less: Capex	41	66	21	12	80						
						Free cash flow	-5	44	132	5	67						

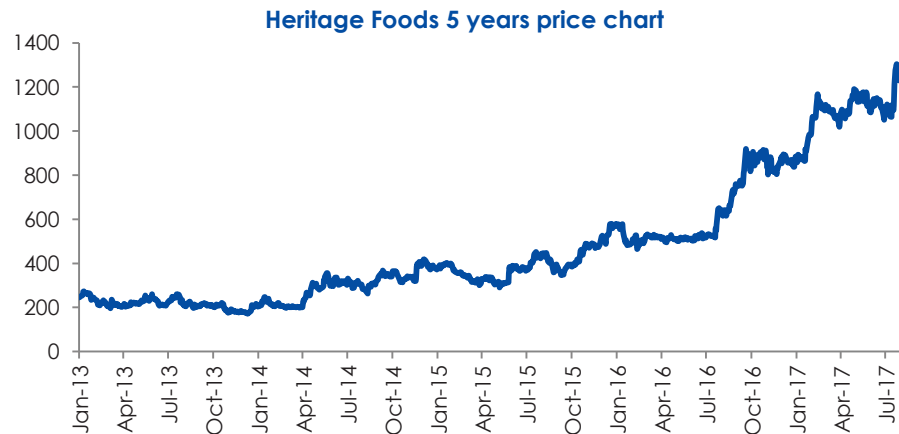
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Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period



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