

Visit Note

Heritage Foods Ltd.

Gearing towards being Future Ready....

We met the management of Heritage Foods and also visited the plant and Heritage parlour to get an update on the market, and insights on the company's efforts towards achieving its stated target on growth and profitability. Our interaction with management, operational personnel reinstated our confidence in the ability of the management to drive growth and earnings ahead. We maintain our Buy rating with a price target of INR 750. The following are the key takeaways of our meeting.

Gearing the organizational structure for growth ahead- Being future ready

Heritage has geared itself for higher growth and increased penetration across geographies. The company remains committed to grow at a CAGR of 20% + to reach the revenue of INR 6000 crore with 40% share of added products over the next 4-5 years. To achieve growth at this staggering pace, the company has internally created groundwork in terms of (a) Increased capital outlay- To double the capex from INR 50-60 crore to INR 100-120 crore (b) Inducting new talent, reorganizing and empowering the existing talent (c) Embracing technology at the faster rates. We remain constructive on the developments.

Targeting key markets to double volumes

Heritage has successfully expanded its procurement and distribution reach from mere 2 states a decade back to now being present in 15 states (via organic growth and acquisition of Reliance Dairy), aggregating daily procurement and sales of around 14-15 lac litres. Going forward, it has embarked to double its procurement and sales volume to 30 lac litres in the next 4-5 years, with clear focus in the key markets – (a) Southern states aims to have additional 5 lac litres (b) Maharashtra, MP and Mumbai aims to bring additional 5 lac litres (c) From the new regions of north- NCR, Haryana, Delhi, aims to procure 5 lac litres daily from the current level of 1 lac litres.

Heritage to smartly straddle its portfolio between Milk and value added fresh products

Heritage, in its quest to become a full-fledged dairy company, is aggressively transitioning from a plain vanilla milk to value-added products' player. The company aims to enhance the share of value-added products from current 22% to 40% in next 4- 5 years and to achieve this, Heritage is deepening and widening reach in the category via introduction of new varieties of curd, butter milk, Lassi, Flavoured milk and ice cream. The latest JV with the French dairy company Nova dine to enter into Fruit flavoured Yoghurt is a step in the direction to increase range in its value added portfolio. The company is further scouting for inorganic growth potential to achieve its desired growth and targets. We believe, Heritage is smartly straddling the high-returns pouch milk segment and high-growth & margin accretive medium shelf life curd and yogurt segment. We like Heritage's strategy to focus in the fresh segment that entails high margins and low working capital.

Outlook and Valuation; Re-iterate BUY

Heritage focused strategy of balancing aggression in growth with profitability and efficiency continues to keep us positive on the company. We expect its revenue to grow at a CAGR of 12% while earnings to grow at a CAGR of 48% over FY18-20. We maintain Buy with a price target of INR 750. (Valued at 25x FY20+ Investment value of Future Retail Shares)

Sangeeta Tripathi
Research Analyst
sangeeta.tripathi@edelweissfin.com

CMP INR: 510

RATING: BUY

TARGET PRICE INR 750

UPSIDE: 47%

Bloomberg:	HTFL:IN
52-week range (INR):	889/419
Share in issue (cr):	4.6
M cap (INR cr):	2,367
Avg. Daily Vol. BSE/NSE :('000):	58
Promoter Holding (%)	40.0

Year to March (Consolidated)	FY16	FY17	FY18	FY19E	FY20E
Revenues (INR Cr)	2,381	2,643	2,373	2,540	2,991
Rev growth (%)	14.8	11.0	(10.2)	7.0	17.8
EBITDA (INR Cr)	131	141	130	187	239
PAT (INR Cr)	56	67	55	89	120
EPS (INR)	11.9	14.4	11.8	19.2	25.9
EPS growth (%)	96.5	20.5	(17.9)	62.4	34.8
P/E (x)	42.7	35.4	43.1	26.6	19.7
EV/EBITDA (x)	18.7	17.5	19.3	13.4	10.2
RoACE (%)	25.6	24.6	12.2	13.6	16.4
RoAE (%)	25.6	24.6	10.1	10.8	13.0

Date: 26th November, 2018

Heritage on an aggressive drive- getting Future ready

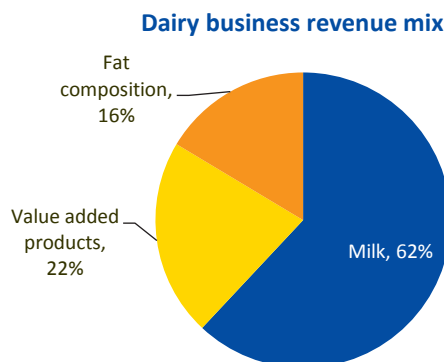
- **Strong aggression in the business-** The promoter and the executors are well aligned to grow the business aggressively. This drive was not that strong or not expressed in words before 2016. In 2016; with the engagement of KPMG to drive growth for the company a clear strategy and road map was thought of.
- **Focus on Dairy led to divestment of Retail business-** Clear path and focus towards the dairy business, resulted in divestment of the loss making retail business; even though valuation that the company fetched were not all that attractive
- **The Vision ahead** – (Engaged KPMG in FY16; which had given a timeline of FY22) Inorganic acquisition consolidation (It acquired Reliance Dairy in mid FY17; consolidation of the same required 18 months; further the external environment is also fluid and changes with vagaries of populism drive of Centre and State government) The present Vision for the company stands as follows being outlined by president
 - It is likely to end FY19 with an overall daily procurement of around 14-15 lac litres of milk in FY19; which has increased from around 9 lac litres in FY12 (CAGR of 7%).
 - The company aims to increase a daily procurement level of 15 lac litre procurement to 30 lac litres in the next 4-5 years' time frame (by FY23-24); implying a volume CAGR of 15%.
 - It aims to take the value added products share from current level of 23-24% to 40% over the same time frame
 - It has put itself to achieve an overall revenue turnover of INR 6000 crore in next 3-4 years

Strategies to drive the growth is as follows

- Increased capital outlay towards developing the back end Infra and new markets** – The growth up till FY17 for the company was at 12% CAGR; as the company was not investing into aggressive growth, it relied on organic growth. With the induction of young blood into the business (Brahmani Nara- the daughter in-law of Mr. Naidu; an electrical engineering graduate with Stanford management degree; having worked with Singapore based Venture Capital firm) the business got renewed focus and gained aggression. Having released that growth in dairy business needs to be built by building on the back end infrastructure (chilling centres, milk analysers, Bulk coolers, engagement with farmers, increasing the processing, packaging centres), the company has upped its ante on the capex. For FY18, it spent around INR 182 crore in capex (as against the last 10years average of INR 50-60 crore). Going forward the company has guided to incur a capex of INR 100-120 crore for the next 3 years' time frame to reach its growth objective. The company generates an annual cash flow of INR 80- 100 core. We believe that the company is adequately placed thereon for the growth, without getting too leveraged on the balance sheet front
- Redefining the eco-system of the organization with role re-organization, induction of new talent and empowering people via delegation** – Annually, Heritage sells around 4 mn tonnes of liquid milk (based on average of 11-12 lac litres sold on a daily basis). Of which 75-80% comes from the Southern market .Having had strong presence in the Southern market the company is now looking for growth in this market via (a) Focusing on the micro market (b) Empowering people with clear focus towards various segments – eg earlier the company had only one procurement and one distribution head, with centralized decision making authority; now with growth the company has decentralized the authority and delegated more powers to its personnel (c) Inducted talent from FMCG companies to drive sales and fresh learnings and thoughts, this we found very progressive for the steady player like Heritage
- Strengthening the Process-** It has strengthened its process via adopting newer technologies. All its procurement is on fast technology; enables have ready access to smart information at record time. This becomes all the more prominent for a dairy player as the no of human interface is quite high. Both in terms of supply (from large base of farmers) to demand (Consumer; a B2C business)
- Laying out a smart strategy for growth by studying micro markets and potential thereon** – Milk and fresh dairy is a local business, wherein the point of production and distribution should be between 100 kms of radius, which aids in retaining the freshness and the taste of the products. Having had a decent share in the Southern market, in its quest to be a PAN India player, it has studied the various regional markets and has zeroed into following regions for its growth on the procurement front (a) North market – that includes Delhi, NCR , Chandigarh and the nearby regions – It aims to procure around 5 lac litres from these markets (Currently with Reliance acquisition it has garnered a 1 lac litres procurement from these regions) (b) From the current 5 southern states – that includes – Andhra Pradesh, Telangana, Kerala, Karnataka and Tamil Nadu it aims to have an incremental 5 lac litres of sales and procurement. (c) Mumbai and Maharashtra market along with some belt of Central India is likely to fetch another 5 lac litres of sales for the company (Currently it has a sales volume of 2 lac litres from these regions). We believe that the growth aspirations are strong and the company is gearing towards the same

Brief background of the company

Heritage is Chandrababu Naidu promoted dairy company based out of Andhra Pradesh. The company commands a leadership position in its maiden market of Andhra Pradesh and Telanagana. It has moved from a one state company to five states in Southern market (AP, Telangana, Tamil Nadu, Karnataka, Kerala) garnering around 10% organized market share in these markets (all this despite high competition). It has also entered into adjacent market like Maharashtra wherein it sells around 2 lac litres per day.

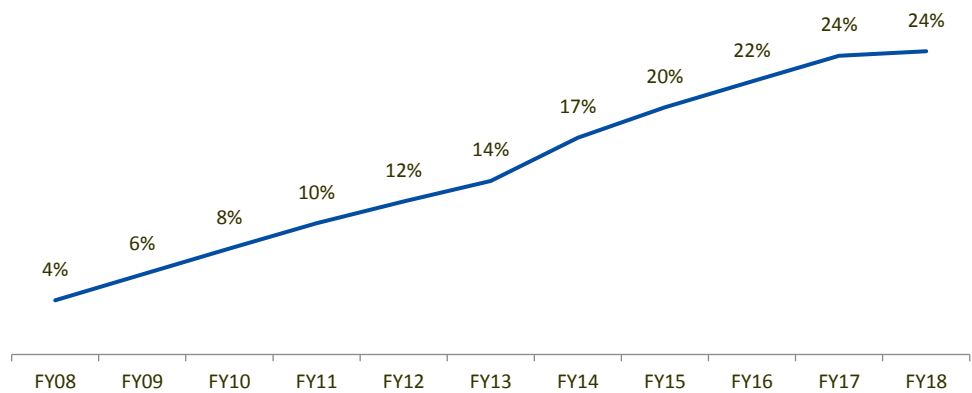


- The company had started off with Dairy, and had expanded in Retail business in 2006. The Retail business being highly competitive with wafer thin margins was never able to take off for the company. The company conducted the business for 10 years and it still was loss making at the net level
- In 2016; Heritage exited the business by selling it to Future group. The entire business was sold at an INR of 295 crore; with a revenue of INR 800 crore (valued at 0.4x Equity/Sales), while the consideration was received in the form of shares of Future Retail Ltd (FRL)
- The company has 1.8 crore share of Future Retail in its investment, which had a lock in for 3 years, and the lock in would come to end in mid FY2020. The company aims to exercise the lock in. As per the deal structure, at the current price of Future Retail shares, the value of the investment for the company is around INR 600 + crore

Key achievements in the past

- Overall revenue has grown at a CAGR of 17% over FY08-18
- Milk revenue (packaged milk which is called the fresh category) has grown at a CAGR of 14.6% over FY08-18
- Value added segment has grown at a CAGR of 38.2% over FY08-18 (Value added 80-85% comprises of curd; while 15% constitutes, buttermilk, lassi, flavoured milk and others)
- The share of value added segment in last one decade has grown from 4% in FY08 to 24% in FY18

Value added products contribution



- Has garnered presence in 9 states for procurement as well as 15 states for Sales and distribution
- Created a commendable INR 2500+ crore revenue business in last 25 years; with a consistent profitable track record and efficient capital allocation strategy

Heritage Foods Ltd.

Income statement (Consolidated)						(INR cr)				
Year to March	FY16	FY17	FY18	FY19E	FY20E					
Income from operations	2,381	2,643	2,373	2,540	2,991					
EBITDA	131	141	130	187	239					
Depreciation and amortisation	35	38	38	38	43					
EBIT	96	104	93	149	197					
Interest expenses	17	11	18	24	25					
Other income	7	6	8	8	8					
Profit before tax	86	98	82	133	179					
Provision for tax	31	31	27	44	59					
Core profit	55	67	55	89	120					
Extraordinary items	1	0	0	0	0					
Profit after tax	56	67	55	89	120					
Minority Interest	0	0	0	0	0					
Share from associates	0	0	0	0	0					
Adjusted net profit	56	67	55	89	120					
Equity shares outstanding (mn)	5	5	5	5	5					
EPS (INR) basic	11.9	14.4	11.8	19.2	25.9					
Diluted shares (Cr)	4.6	4.6	4.6	4.6	4.6					
EPS (INR) fully diluted	11.9	14.4	11.8	19.2	25.9					
Dividend per share	0.0	0.0	0.0	0.0	0.0					
Dividend payout (%)	0.0	0.0	0.0	0.0	0.0					

Common size metrics- as % of net revenue (INR crs)					
Year to March	FY16	FY17	FY18	FY19E	FY20E
Operating expenses	94.5	94.7	94.5	0.0	0.0
Depreciation	1.4	1.4	1.6	1.5	1.4
Interest expenditure	0.7	0.4	0.8	0.9	0.8
EBITDA margins	5.5	5.3	5.5	7.4	8.0
Net profit margins	2.4	2.5	2.3	3.5	4.0

Growth metrics (%)					
Year to March	FY16	FY17	FY18	FY19E	FY20E
Revenues	14.8	11.0	(10.2)	7.0	17.8
EBITDA	56.5	7.9	(7.7)	43.4	28.1
PBT	119.7	14.3	(16.6)	62.2	34.8
Net profit	96.5	20.5	(17.9)	62.4	34.8
EPS	96.5	20.5	(17.9)	62.4	34.8

Ratios					
Year to March	FY16	FY17	FY18	FY19E	FY20E
ROAE (%)	25.6	24.6	10.1	10.8	13.0
ROACE (%)	25.6	24.6	12.2	13.6	16.4
Current ratio	1.3	1.0	1.2	1.3	1.5
Debt/Equity	0.5	0.4	0.3	0.3	0.3
Debtors (days)	4	2	2	2	2
Inventory (days)	22	17	24	21	21
Payable (days)	24	24	34	30	30
Cash conversion cycle (days)	2	-5	-8	-7	-7
Debt/EBITDA	1.0	1.0	1.9	1.3	1.0
Adjusted debt/Equity	0.3	0.3	0.2	0.2	0.1

Valuation parameters					
Year to March	FY16	FY17	FY18	FY19E	FY20E
Diluted EPS (INR)	11.9	14.4	11.8	19.2	25.9
Y-o-Y growth (%)	96.5	20.5	(17.9)	62.4	34.8
CEPS (INR)	19.4	22.5	20.0	27.4	35.1
Diluted P/E (x)	42.7	35.4	43.1	26.6	19.7
Price/BV(x)	9.9	7.8	3.0	2.7	2.4
EV/Sales (x)	1.0	0.9	1.1	1.0	0.8
EV/EBITDA (x)	18.7	17.5	19.3	13.4	10.2
Diluted shares O/S	4.6	4.6	4.6	4.6	4.6
Basic EPS	11.9	14.4	11.8	19.2	25.9
Basic PE (x)	42.7	35.4	43.1	26.6	19.7
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0

Balance sheet (Consolidated)						(INR cr)				
As on 31st March	FY16	FY17	FY18	FY19E	FY20E					
Equity share capital	23	23	23	23	23					
Reserves & surplus	217	280	754	844	964					
Shareholders funds	240	303	778	867	987					
Secured loans	125	69	109	109	109					
Unsecured loans	1	66	142	142	142					
Borrowings	126	194	251	251	251					
Sources of funds	366	498	1,028	1,118	1,238					
Gross block	518	524	715	815	915					
Depreciation	206	244	282	320	363					
Net block	312	280	433	495	552					
Capital work in progress	10	10	9	9	9					
Total fixed assets	322	290	442	504	561					
Investments	1	149	576	576	576					
Inventories	145	123	155	146	172					
Sundry debtors	29	16	13	14	16					
Cash and equivalents	45	35	99	114	186					
Loans and advances	9	16	4	4	4					
Total current assets	228	189	271	279	379					
Sundry creditors and others	158	173	220	209	246					
Provisions	16	12	13	13	13					
Total CL & provisions	174	185	233	222	259					
Net current assets	54	4	38	57	120					
Net Deferred tax	-19	-19	-19	-19	-19					
Misc expenditure	8	0	0	0	0					
Uses of funds	366	424	1,037	1,118	1,238					
Book value per share (INR)	52	65	168	187	213					

Cash flow statement					
Year to March	FY16	FY17	FY18	FY19E	FY20E
Net profit	55	67	55	89	120
Add: Depreciation	35	38	38	38	43
Add: Misc expenses written off	2	8	0	0	0
Gross cash flow	91	113	92	127	163
Less: Changes in W. C.	-19	-39	-31	3	-9
Operating cash flow	110	152	123	123	172
Less: Capex	66	21	166	109	100
Free cash flow	44	131	-43	15	72

Heritage Foods Ltd.

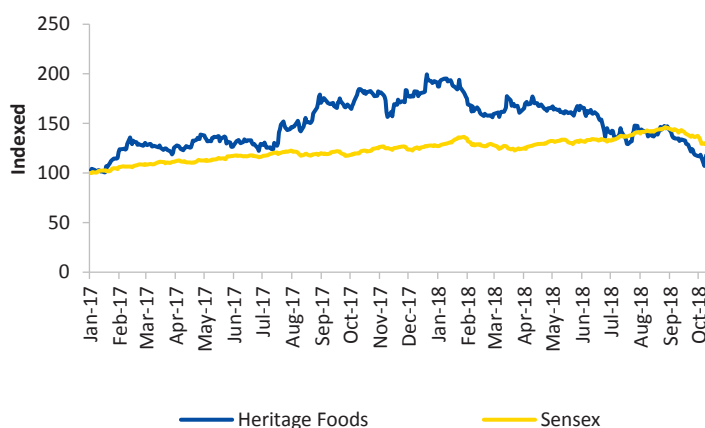
Heritage Plant- Uppal Plant



Edelweiss Broking Limited, 1st Floor, Tower 3, Wing B, Kohinoor City Mall, Kohinoor City, Kirool Road, Kurla(W)
 Board: (91-22) 4272 2200

Vinay Khattar
 Head Research
 vinay.khattar@edelweissfin.com

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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