Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Heritage Foods Ltd

Value play in dairy sector

Consumer Goods	Sharekhan code: HERITGFOOD	
Reco/View: Positive	CMP: **Rs. 258**	Upside potential: **33%**

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- We initiate viewpoint on Heritage Foods Limited (HFL) with Positive View and expect an upside of 33% over the next 12 months. Stock trades at an attractive valuation of 17x/12x its FY2024E/25E EPS. HFL is a preferred pick in dairy space with large focus on increasing contribution of value-added products (VAP).
- VAP contribution is likely to go to 40% from current 29% in next four years. Gross margin of VAP is around 10-12% higher compared to base dairy products gross margins for the company.
- Market share gains, expansion in new markets and higher traction to value added products would help the company to grow at CAGR of 16% to Rs6,000crore over the next four years. It will be driven by mix of volume and value in the ratio of 50:50.
- Return profile to consistently improve with RoE/RoCE expected to improve to 21%/26% in FY26 from 10%/11.5% in FY23. Likely to generate cumulative free cash flow (FCF) of over Rs. 500 crore during FY24-26E.

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral – Negative

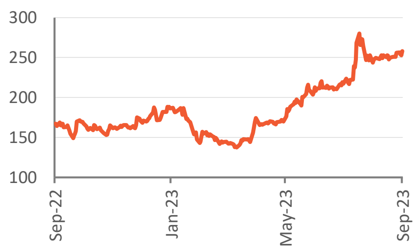
Company details

Market cap:	Rs. 2,394 cr
52-week high/low:	Rs. 287 / 136
NSE volume: (No of shares)	3.1 lakh
BSE code:	519552
NSE code:	HERITGFOOD
Free float: (No of shares)	5.4 cr

Shareholding (%)

Promoters	41.6
FII	3.5
DII	15.9
Others	39.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.3	22.3	81.7	54.5
Relative to Sensex	3.7	16.5	70.9	42.3

Sharekhan Research, Bloomberg

Heritage Foods Ltd (HFL) is one of the leading dairy companies in India with a diversified product portfolio, which includes milk and milk-based value-added products. It has created long-lasting relationships with 3,00,000+ dairy farmers for milk procurement across nine states in India. Leveraging on its strong distribution network of 1,30,000+ retail outlets and diversified portfolio, the company has maintained its leadership positioning in the core markets of Andhra Pradesh, Telangana, Karnataka and Tamil Nadu. Increasing share of value-added products (VAP), penetration into new geographies and expanding the product portfolio are some of the key growth drivers to achieve revenue of close to Rs. 6,000 crore (16% CAGR growth with volume/value growing by 8% each) and OPM close to ~8% over the next four years. VAP contribution is expected to increase to 40% from current 29% with product launches and distribution expansion in key markets. With stable working capital management and a consistent improvement in the profitability, the cash flows on books are expected to improve (to achieve cumulative FCF of over Rs. 500 crore during FY24-26E). Return ratios to consistently improve with RoE and RoCE likely to improve to 21.0%/25.7% in FY2026 from 9.6%/11.5% in FY2023.

- **Strong procurement, distribution reach and product portfolio to aid a 16% CAGR revenue growth:** HFL has created long lasting relationships with 3,00,000+ dairy farmers for milk procurement across nine states in India with capacity of 1.43 million litres per day (MLPD). It is focusing on investing prudently in village-level milk collection infrastructure, bulk coolers, and chilling centres to increase procurement capacity to 2.0-2.3 MLPD. Thus, leveraging on strong procurement capabilities along with distribution network of 1,30,000+ retail outlets and diversified product portfolio (including value added portfolio) the company is focusing on achieving industry leading revenue growth of ~16% over FY2023-26E. With focused strategies in place, the company targets to achieve revenues of Rs. 6,000 crore over the next 3-4 years.
- **Focus on increasing VAP contribution:** VAP revenues clocked an 11% CAGR over FY2019-23 and currently contributes ~29% of revenues. The VAP segment's margins are higher compared to the base business' margins. Gross margins are 10-12% higher than that of base milk products. Strong growth in VAP segment will aid a consistent improvement in the overall EBIDTA margins of the company in the coming years. The company is aiming at 40% contribution from VAP over the next four years.
- **Targets 25% RoCE; cash flows to consistently improve:** Higher contribution of VAP will help the OPM to consistently improve as VAP has higher margins than the base product portfolio. We expect HFL's OPM to be ~7.7% in FY2026 compared to 4.3% in FY2023. Mid-to-high teens revenue growth along with a consistent improvement in the OPM would help the PAT to grow at CAGR of 56% over FY2023-26E. This along with stable working capital management would help it to generate cumulative FCF of over Rs. 500 crore during FY2023-26. This will be utilized for future growth prospects and creating value for shareholders by optimizing operations and efficiencies across the value chain. Return profile to improve substantially with RoE/RoCE expected to stand at 21% and 26% in FY2026 versus 9.6% and 11.5% in FY2023.

Our Call

View – Initiate viewpoint with Positive view and an upside of 33%: HFL is transforming itself into a value play, focusing on its diversified product portfolio and leveraging on procurement and distribution efficiencies in the coming years. The company has a leadership position in its core markets (contributes 93% of revenues). Leveraging upon its leadership positioning and strong procurement capabilities in key regions, the company is focusing on scaling up its VAP business in the coming years. With strategies in place, the company is expected to achieve revenue and PAT growth of 16% and 56% respectively over FY2023-26E. The stock trades at an attractive valuation of 16.6x/12.1x its FY2024E and FY2025E earnings. We initiate viewpoint on the stock with a Positive view and potential upside of 33% over the next twelve months.

Key Risks

Any sharp rise in milk prices would act as a key risk to earnings in the coming years.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23	FY24E	FY25E	FY26E
Revenue	2,681	3,241	3,775	4,414	5,030
OPM (%)	7.1	4.3	6.6	7.2	7.7
Adjusted PAT	109	66	144	198	251
% YoY growth	-29.4	-39.2	117.1	36.9	26.9
Adjusted EPS (Rs.)	23.6	7.2	15.6	21.3	27.0
P/E (x)	10.9	36.0	16.6	12.1	9.5
P/B (x)	1.8	3.3	2.8	2.2	1.8
EV/EBIDTA (x)	6.1	18.3	9.8	7.5	5.6
RoNW (%)	17.4	9.6	18.1	20.4	21.0
RoCE (%)	21.4	11.5	20.5	24.3	25.7

Source: Company; Sharekhan estimates

Viewpoint

New Idea

We recently interacted with Mr. Srideep Nair Kesavan, CEO of HFL to understand the business strategies and future growth prospects. Some of the key highlights of the interaction are as follows:

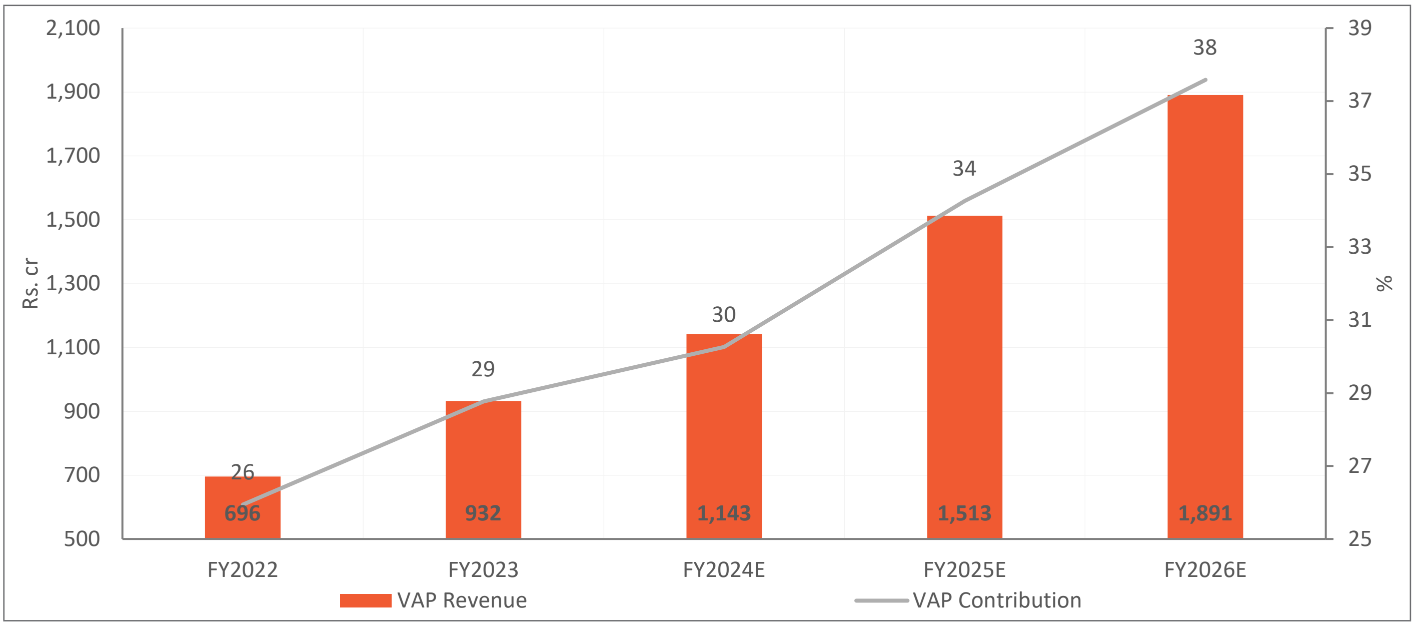
- **Shift in consumer spends to aid in growth of dairy sector:** In the past 4-5 years, consumer spends have undergone a change with share of savings reducing to 27-28% from 32-33% five years ago. Thus, consumers' spending capacity is rising. The management indicated that this is largely spent on wellbeing and better nutrition. Hence, management expects biggest growth to be seen in companies that provide better nutrition and is the major reason why dairy sector is growing.
- **Dairy sector growth to be driven by multiple factors:** India is largest producer of dairy in the world, producing ~230 million tonnes of milk and contributing ~24% to overall milk production. Per capita consumption is low in India at ~250-260 gm per person against world average of ~300-400 gm per person and 800-900 gm per person in the developed countries. India's per capita consumption is low compared to western world as the western world has more occasions of consuming dairy products with better consumption of cheese, milkshakes and other products, while India's consumption is mainly in the form of milk. Thus, the dairy sector will benefit as offtake of other dairy products rises. Further, India is not the most efficient producers of milk as the cost of the same is high. As per the management, 40-45% of world's animal population produces 23-24% world's milk. However, there has been a good improvement in milk procurement in the recent years and management expects the trend to continue in the coming years supported by improvement in the feed and breeding practices, which will contribute to the growth of the sector. Thus, with cost of production coming down, if dairy is able to beat inflation, consumers will increase their consumption.
- **Farmer & consumer - Two pillars of HFL:** The management has strong relationship with 3 lakh farmers. However, currently 1.6-1.7 farmers are providing milk as all animals don't lactate throughout the year. In terms of consumers, the company currently has a consumer base of 30-35 lakh consumers and is focused on growing its consumer base.
- **Procurement the most critical and strongest function:** The company is focusing on systematic farmer network expansion and plans to enter 150 new villages and add 3,000 farmers every month (1,600-1,800 new villages every year). The company has established a strong veterinary care team of 18 doctors and 40 assistants which provides free consultation to farmers. Moreover, HFL's accuracy of measurement is high and the payment to farmers is done on time so the company has achieved farmer's trust. Payment to farmers is 100% digital.
- **Good infrastructure:** HFL collects ~15.5-16 lakh litres of milk from farmers everyday from ~12,000 villages. Management stated that milk collection is franchisee operated, while HFL's investment is largely in the 204 chilling centres present across the country. The company has 18 factories, which produce ~20 products.
- **Balanced channel-wise revenue mix:** At present, 12% of the company's revenue is generated from e-commerce and modern trade channels, 23% from the company's own network (1,000 parlous and happiness points) and the balance from the retail channel.
- **Increase VAP contribution with focus on core markets:** As guided by the management, VAP contributes 10-12% higher gross margins. HFL is targeting 40-45% contribution from VAP with main focus on core markets. The company is aiming to be known as the 'curd people'. Thus, the company would continue to focus on curd, however, contribution of curd is expected to reduce with growth in other VAP.
- **Aiming for 15-16% revenue growth:** The company's core markets include Andhra Pradesh, Tamil Nadu, Karnataka and Telangana, which contribute 93% to revenues. In most of the core markets, the company has the leadership position. The company enjoys No. 1 position in Hyderabad with 25% market share. In Bangalore, the company is in very close competition to Nandini for flavoured milk. The company's frontier markets include Delhi, Haryana, Maharashtra (Pune & Vidarbha), and Orissa. As per the management, North is fastest growing market for HFL, and the company is growing in other markets as well. The company grew by 21% in FY23, with 50:50 volume:value mix. Going ahead, the company aims to achieve 15-16% revenue growth with 7-8% volume growth and balance from price -led growth or shift to VAP. The company is working on building people capability (investment in R&D), improving delivery (Zepto is HFL's key delivery partner) and marketing investments (to create consumer awareness) to achieve its revenue target of Rs. 6,000 crore in the next 3-4 years.

- **Margins likely to improve with cooling of milk prices:** Management stated that milk prices have cooled down and the company expects the prices to further cool down post Diwali, with the commencement of the flush season in October. The company reported an 11-12% increase in net realisation in the past one year. Management is of the opinion that rollback of prices is rare, so with cooling milk prices, margins are expected to improve in the coming months. HFL is eyeing a 7.5% OPM in medium term and increase it to 8.5% in long term.
- **Capacity expansion to continue:** The company plans to incur Rs. 120-130 crore capex every year, out of which largest part of investment would be for VAP and is expected to be spent on replacement of old machines or adding new machines. The company is currently co-packing milkshake, however, it is adding a line for own packaging.
- **Working capital to remain stable:** Management indicated that working capital cycle is expected to remain stable at the current level of ~30 days.
- **Target to achieve 25% RoCE:** HFL is targeting RoCE of 25% in the long term. The company expects return improvement to be mainly due to higher profitability, stable working capital and no major capex.

Focus on increasing VAP contribution

Value added products (VAP) contributed ~29% of the company's revenue in FY2023, registering a CAGR of 11% over FY2019-23. The VAP segment's margins are higher compared to the base business margins of the company. Gross margins are ~2x higher than that of base milk products. Strong growth in the VAP segment will help in consistent improvement in the overall OPMin the coming years. The company is aiming at 40% contribution from VAP over the next four years.

Trend in revenues of VAP; increase in contribution



Source: Sharekhan Research

Contribution of value-added products (VAP) to overall dairy products mix is less than 50% overall dairy products sales in the urban market. With an increase in consumers' spending power, demand for milk and other value-added dairy products is expected to increase in the coming years. In addition to greater buying power, consumers are also becoming increasingly health conscious. This is aggressively driving the increasing share of dairy and other nutritious products in the consumer basket. For example, many consumers are replacing sugar-laden beverages with more nutritious milk-based beverages. There is also marked geo-spatial shift that we are witnessing, in terms of urbanisation bringing more and more consumers to urban centres with limited access to unorganised dairy players and the consolidation of organized retail segment and their increasing share of the shopper basket.

HFL's VAP portfolio

Source: Company; Sharekhan Research

HFL has several value-added products especially in flavoured milk, ice cream and healthy variant categories. Curd contributes ~75% of the segment revenues. However, with expected strong traction to new product additions, the contribution of curd is expected to slowly decrease in the coming years.

Strong supply chain supported by a robust distribution network

The company's products are sold through the retail trade as well as through HFL's own network of Heritage Parlours and Heritage Happiness Points. In the retail trade, the company has a strong distribution network with availability of products in 0.13 million kirana stores (general trade retail outlets), 27 organised modern retain chains and a strong presence on 16 E-Commerce platforms. In terms of its own network, HFL has 159 Happiness Points and 859 Parlours across the country. Along with a focus on expanding its distribution network, the company is also focusing on strengthening brand-presence through omni channel platform and improvement in Heritage own network. The company is also planning to broaden its geographical footprint and penetrate deeper into metropolitan cities. At present, it has sales networks in 11 Indian states and is expanding into several towns and semi-urban areas.

HFL's distribution network

Source: Company, Sharekhan Research

Riding on digital capabilities

HFL is technology-enabled business that is equipped to handle varied task including sales, maintaining connections with distributors, delivering dairy products to customer's footsteps. With digital capabilities in place, the company aims to provide 24/7 service to consumers through its digital platforms.

HFL's digital infrastructure

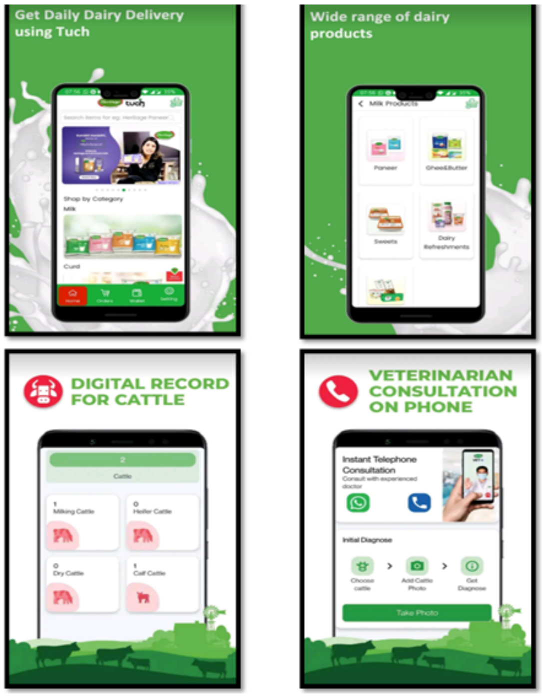
Clapp: Clapp (stands for Customer Live Application) was initiated as a digital transformation for growth and innovation to streamline the indenting process while improving transparency and efficiency. The key focus of Clapp was to aid in streamlining sales and costs attributable while creating a responsible and accountable support environment at Heritage DIGIT Centres.

DMS: DMS (stands for Distributor Management System) was developed to give an edge in terms of streamlining the primary and secondary sales process from Agent level up to the counter sales level in an authentic manner.

TUCH: The company has introduced Heritage TUCH app in Hyderabad so that consumer get hassle free delivery. The app is one-click solution for fulfilling all the dairy product needs of our consumers, which is delivered at their doorstep. The app has served 0.10 lakhs+ consumers and has 1.2 lakhs+ downloads till FY22.

VET+: Heritage VET+ is a one-stop solution for milch animal management that focuses on providing remote primary veterinary care, nutrition and best practices in dairy management to share knowledge with and empower dairy farmers. The app has led to the treatment of thousands of cattles and benefits farmers across all states.

HESS: Employee Portal lets employees view their self and his subordinate's attendance & leave information and initiate a number of activities like applying for leave, leave cancellation, etc.



Source: Company; Sharekhan Research

Capex of Rs. 100-125 crore planned over next three years

Heritage Foods plans to incur capex of Rs. 100-125 crore over the next three years. There will be a replacement capex wherever required depending upon the aging and inefficiency of machinery at chilling and processing level. The company has been investing in the village level for setting up milk collection infrastructure. In each village, the cost of setting up a milk collection center is ~Rs. 1 lakh and Rs. 60-70 lakhs for milk chilling facility. Secondly, in the existing geographies, wherever there is milk available, the company is planning to increase its milk procurement capacity to 27-29 lakh litres per day in the next five years to achieve its strong growth. Capex is largely to increase the procurement capacity, improving rural infrastructure for milk collection and adding bulk coolers and chilling capacities. It will also invest ~Rs. 50 crore for the capex of ice cream business.

Revenues and PAT to clock 16% and 56% CAGR, respectively over FY2023-26E

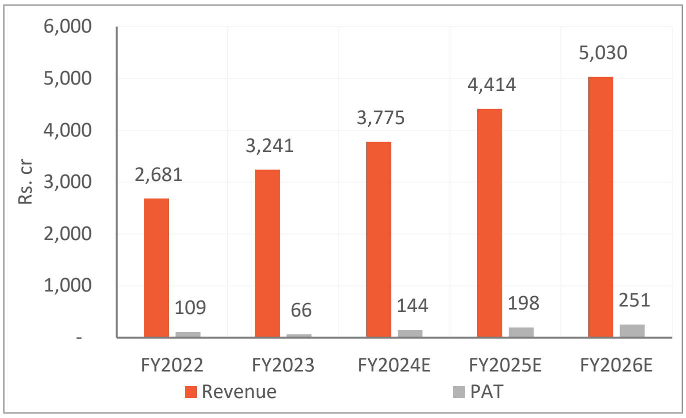
HFL's revenue and PAT are expected to grow at 16% and 56% CAGR over FY2023-26E with consistent improvement in the OPM due to increase in contribution from VAP and ice cream segments. VAP has 2x higher gross margins compared to based business while ice cream segment has gross margins of ~35%. Overall OPM is expected to increase to ~8% by FY2026 from 4.3% in FY2023. This is in-line with the company's aspiration of achieving OPM of 7-8% in the medium term. Double digit revenue growth and strong expansion in OPM would help the PAT to grow at CAGR of 56% over FY2023-26E.

Cash balance to increase; return profile to consistently improve in the near term

Higher contribution of VAP will help OPM to consistently improve as VAP has higher margins than the base product portfolio. We expect HFL's OPM to be ~7.7% in FY2026 compared to 4.3% in FY2023. Mid-to-high teens revenue growth along with consistent improvement in the OPM would help the PAT to grow at CAGR of 56% over FY2023-26E. This along with a stable working capital management would help it to generate cumulative FCF of over Rs. 500 crore during FY2023-26. This will be utilized for future growth prospects and creating value for shareholders by optimizing operations and efficiencies across value chain. Return profile to improve substantially with RoE/RoCE expected to be at 21% and 26% in FY2026 versus 9.6% and 11.5% in FY2023.

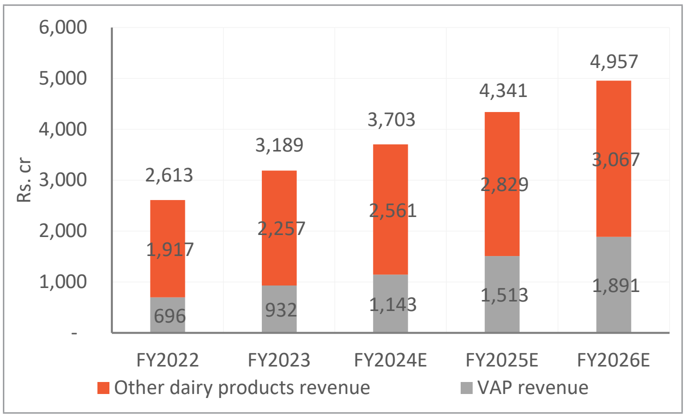
Financials in charts

Steady growth in revenue and PAT



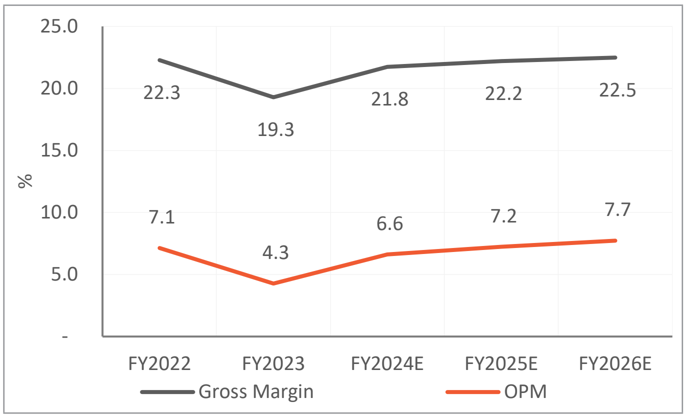
Source: Company, Sharekhan Research

Segment-wise revenue trend



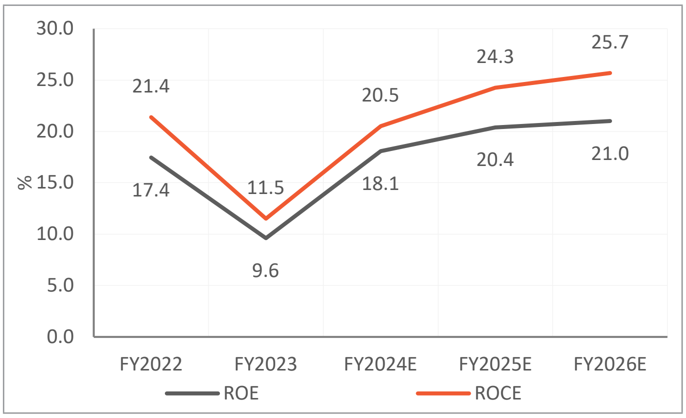
Source: Company, Sharekhan Research

Margins to improve from current level



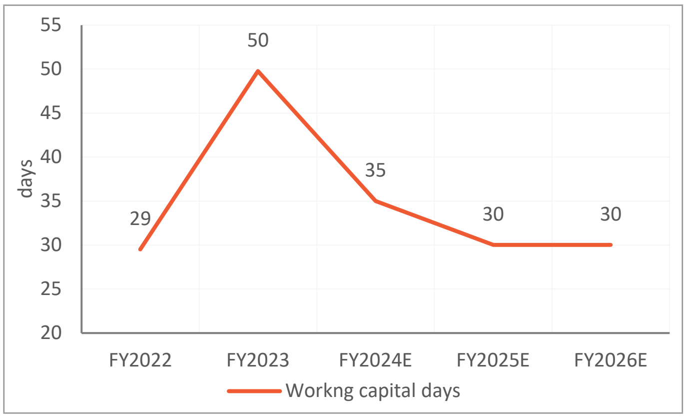
Source: Company, Sharekhan Research

Return ratios to sharply increase



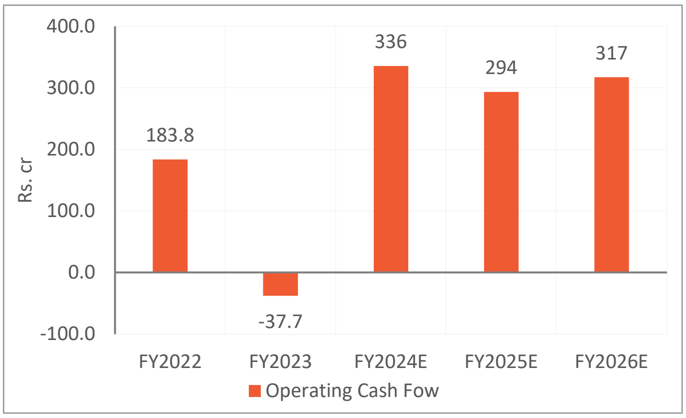
Source: Company, Sharekhan Research

Working capital days to remain stable



Source: Company, Sharekhan Research

Trend in operating cash flows



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector Outlook – Traction in value added products to drive growth ahead

India is the largest producer of dairy products in the world and ranks first in terms of milk production, contributing 23% of the global milk production. The Indian dairy industry is projected to achieve a market size of Rs. 31 billion by 2028, showcasing a CAGR of 13.2% during 2023 to 2028. Growth would be largely driven by increasing health awareness, pick-up in demand of value-added products (VAP), steady sales of liquid milk and rising retail rates. Continued innovation and adoption of advanced technologies to enhance productivity, quality and reduce cost would aid in improving the profitability in the coming years.

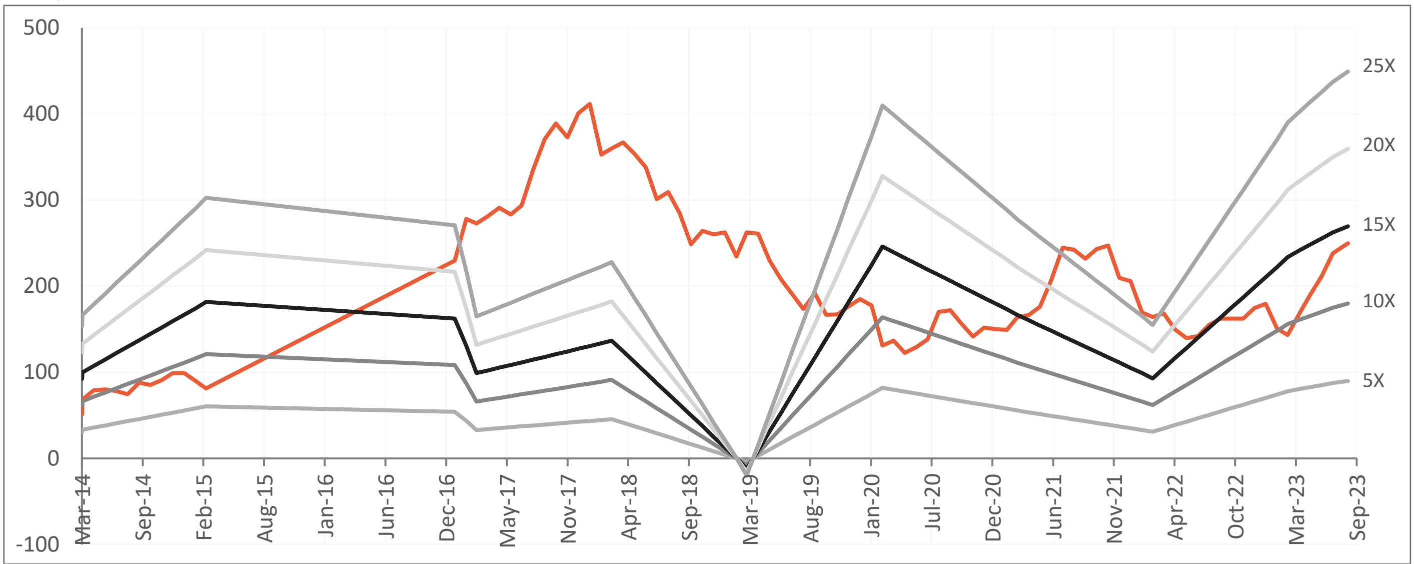
■ Company Outlook – Strategies in place to achieve strong earnings growth

HFL's FY2023 performance was mixed with revenues growing strongly by 21%yoy, driven by 23%yoy growth in value-added products. The growth was driven by mix of volume and value of 10% each. OPM was affected by a sharp increase in the milk prices due to lower availability of milk. However, the milk supply has improved in the recent past and prices have started softening from its pick. With milk prices expected to further fall post Diwali, the company expects good margin improvement in FY024. Going ahead, an increase in contribution from value-added-products and operating efficiencies would help the OPM to reach close to 8%. Overall, the company is well-poised to achieve strong double-digit earnings growth over the next three to four years.

■ Valuation – Initiate viewpoint with Positive view and an upside of 33%

HFL is transforming itself into a value play, focusing on its diversified product portfolio and leveraging on procurement and distribution efficiencies in the coming years. The company has a leadership position in its core markets (contributes 93% of revenues). Leveraging upon its leadership positioning and strong procurement capabilities in key regions, the company is focusing on scaling up its VAP business in the coming years. With strategies in place, the company is expected to achieve revenue and PAT growth of 16% and 56% respectively over FY2023-26E. The stock trades at an attractive valuation of 16.6x/12.1x its FY2024E and FY2025E earnings. We initiate viewpoint on the stock with a Positive view and potential upside of 33% over the next twelve months.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Dodla Dairy	36.0	24.1	19.4	21.3	14.0	11.1	11.2	14.9	15.4
Hatsun Agro Products	-	88.9	61.9	40.9	31.0	25.6	8.4	12.6	17.6
Heritage Foods	36.0	16.6	12.1	18.3	9.8	7.5	11.5	20.5	24.3

Source: Company, Sharekhan estimates

About company

Founded in 1992, Heritage Foods is a pivotal player in the Indian dairy sector, with a wide portfolio of dairy products comprising of milk, value added products (curd, buttermilk, flavoured milk, sweet lassi, milk shakes, cold coffee, paneer, cheese, etc), fat products (ghee, butter, cream), ice-cream and frozen desserts, yogurt and animal nutrition. The company has emerged as one of the largest private dairies in South India and its influence extends to select North Indian states as well. The company has a strong distribution network with omni-channel presence and serves 1.5+ million households daily. The company has 18 State-of-the-art milk processing facilities with a total processing capacity of 2.65 Mn litres per day (MLPD), and 204 Chilling Units with 2.23 MLPD milk chilling capacity. The company's portfolio not only encompasses dairy products but also extends to cattle feed and renewable energy.

Investment theme

Heritage Foods (HFL) is one of the leading dairy companies in India with a diversified product portfolio, which includes milk and milk-based value-added products. The company has leading position of no.1/no.2 in core markets of Telangana, Andhra Pradesh, Tamil Nadu and Karnataka. It is leveraging on strong leadership position in key markets, expanded distribution reach and diversified portfolio to achieve consistent revenue and PAT growth of 16% and 56% over FY2023-26E with OPM improving close to 8%. Return profile to consistently improve with RoE/RoCE improving to 21%/26% by FY2026. It is likely to generate cumulative free cash flow (FCF) of Rs. 500 crore over FY2023-26E.

Key Risks

- **Slowdown in the demand environment:** Any slowdown in demand would affect sales of key categories, resulting in moderation of sales volume growth.
- **Higher input prices:** Any significant increase in the prices of some key raw materials would affect profitability and earnings growth.

Additional Data

Key management personnel

N Bhuvaneswari	Chairman
A Prabhakara Naidu	Chief Financial Officer
Srideep Nair Kesavan	Chief Executive Officer
Umakanta Barik	Company Secretary & Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Nirvana KK	11.76
2	DSP Investment Managers Pvt Ltd	5.24
3	Kotak Mahindra AMC Ltd	4.96
4	UTI AMC Ltd	2.77
5	Aditya Birla Sun Life AMC Ltd	1.34
6	Mann Paramjit	1.22
7	Kedia Securities Pvt Ltd	1.20
8	IDFC Mutual Fund	0.88
9	Dimentional Fund Advisors	0.58
10	Sundaram AMC Ltd	0.12

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/ weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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