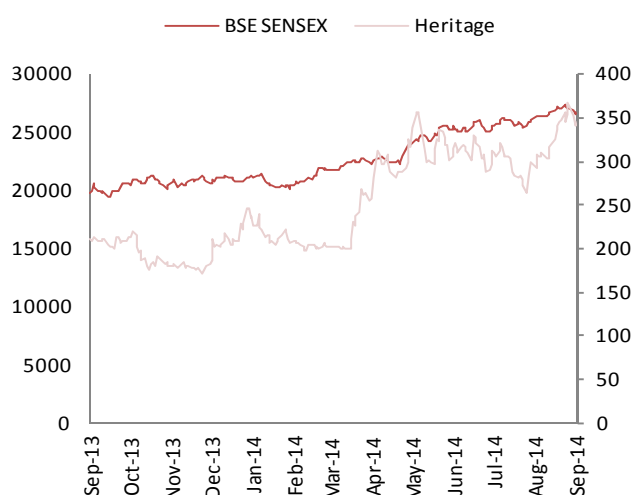




CMP	342	Rating	BUY
Target	591	Upside	73%

STOCK DETAILS

BSE Code	519552
NSE Code	HERITGFOOD
Market Cap (Rs mn)	7934
Sector	DAIRY
Year End	March
52 w.High/Low	375/169
Avg. Daily Turnover (Rs mn)	38.01
Listed on	BSE/NSE
Shares in Issue (mn)	23.20
BSE Sensex	26745
NSE Nifty	8002



SHAREHOLDING PATTERN

%	June 2014	March 2014
Promoter	40.03	40.03
FII	2.83	2.66
DII	0.94	0.69
Others	56.20	56.62

CONSOLIDATED FINANCIALS

Rs in bn	FY13	FY14	FY15E	FY16E
Revenue	16.02	17.22	19.97	23.63
EBIDTA	1.01	0.95	1.08	1.65
EBIDTA(%)	6.30	5.50	5.40	7.00
PAT	0.53	0.46	0.47	0.87
EPS (Adj)	21.5	19.5	20.4	37.7
P/E (x)	15.9	17.5	16.8	9.1

Source: Company, Indsec Research

Incorporated in 1992 in Hyderabad by the name of Heritage Foods (India) Ltd, Heritage Foods is the flagship company of Heritage group. Company operates 5 business divisions namely Dairy, Retail, Agri, Bakery and Renewable Energy. Dairy is the largest contributor to topline followed by Retail division.

Investment Rationale:

Proxy play on Indian dairy growth story: India is the largest producer of milk with total production of 132 Mn Tonnes in CY13. National Dairy Development Board (NDDB) projects Indian milk demand to go to 200 Mn Tonnes by 2021-2022 which means milk demand is expected to grow at 4.56% CAGR over next 9 years or 6 mn Tonnes incremental Milk demand every year. At Av Milk price of Rs 35/ kg, this offers incremental business opportunity of Rs 266bn every year over next 9 years.

Capacity expansion will lead to sustained topline growth: Heritage Foods has two drivers of Top line growth- Dairy and Retail and the company has been constantly investing money to enhance the capacity in both these lines of business. To keep the growth momentum going, company is in the process of investing approx Rs 500-525 mn over next 2 years. The capital expenditure should help Dairy division grow its topline by 39% (to Rs 18.49bn) and Retail division by 38% (to Rs 5.22bn) by FY16E. This is expected to lead to consolidated Top line growth of 37% (to Rs 23.64bn) by FY16E.

Increasing proportion of Value added Products to improve margin: Valued Added dairy products (VADP) command EBITDA margin (13-16%) which is almost double of what is fetched by liquid milk (6-7%). Company is actively striving to enhance the contribution of VADP to total Dairy sales to 22% by FY16E from 18% in FY14. Increasing Proportion of VADP in total dairy sales should lead to improvement in Operating margin of dairy division by 50 bps by FY16E to 9% from 8.5% in FY14.

Turnaround in Retail business ,trigger for re -Rating: Loss in the Retail division has eclipsed the profit of company's dairy division. If losses of retail division are removed, consolidated PBDIT for FY13 and FY14 would have been better by minimum 12-13%. The scenario is expected to change with Retail Division all set to become profitable at EBITDA level from FY16E . We expect Retail division to clock EBITDA profit of Rs 78.27mn in FY16E from EBITDA loss of Rs 133.2mn in FY14. This will lead to consolidated EBITDA margin of the company improving by 150 bps over FY14 to 7.00% by FY16E. 150bps improvement in EBITDA margin will enhance the Net profit by almost 90% between FY14 and FY16E. This will lead to massive rerating of the stock over next 12-18 months.

Outlook & Valuation :

Based on SOTP method, where we value Dairy business at 6x FY16 EV/EBITDA (50% discount to Hatsun Agro) and Retail business at 0.5x FY16 EV/Sales (more than 50% discount to Shoppers Stop), we get March'16 Fair value of Company's equity as Rs 13.72bn. This translates into per share fair price of Rs 591. At the fair price of Rs 591, company's stock is valued at 28.97x FY15E EPS and 15.67x FY16E EPS which is at comfortable level compared to peers.

We Recommend BUY on Heritage Foods with March'16 price target of Rs 591 and upside potential of 73%.

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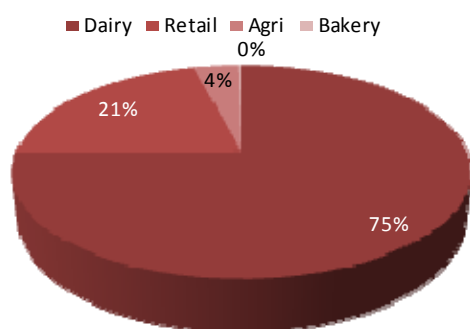
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Company Background

- Incorporated in 1992 in Hyderabad by the name of Heritage Foods (India) Ltd, Heritage Foods is the flagship company of Heritage group.
- Company operates 5 business divisions namely Dairy, Retail, Agri, Bakery and Renewable Energy. Dairy is the largest contributor to topline followed by Retail division.
- Dairy products are sold under brand name of “Heritage” while Retail stores operate under brand name “Heritage Fresh” and its Non Food FMCG products are sold under the brand name “Blossom”.
- Company’s dairy division has operations in 8 states (Including 5 southern states, Maharashtra, Odisha and Delhi) with daily milk procurement of 0.89 mn litres of liquid milk from 0.3 mn farmers.
- Company has 129 Chilling plants and 13 Processing & Packaging plants with capacity of 1.56 Mn Litres and 1.38 mn Litres per day.
- Company’s dairy products are sold to 1.1 mn households daily through 101000 outlets who are supplied by 5,200 distributors / Agents.
- Retail division under “Heritage Fresh” brand has 0.256 mn Sq Ft of carpet area under 74 stores where private and popular FMCG Labels are sold.
- Company engages 3656 people across different divisions as on March 31, 2014.

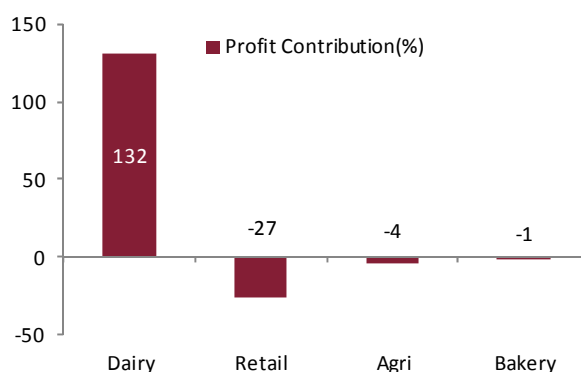
Business Segment: Dairy segment is the mainstay of company’s business in terms of both Topline and profitability with contribution of 75% to consolidated turnover while contributing 132% of Consolidated Operating profit for FY14.

Segment-wise Sales Contribution—FY14



Source: Company, Indsec Research

Segment-wise Profit Contribution—FY14



Source: Company, Indsec Research

Infrastructure: Dairy Segment

Processing Related: Heritage Foods Ltd has got chilling capacity of 1.56 mn LPD and packaging capacity of 1.38 mn LPD via 129 chilling plants and 13 processing & packaging plants respectively. State wise plant Number of plants and their combined capacity is as given below.

State	AP & Telangana	Tamil Nadu	Karnataka	Maharashtra	Total
No. of Chilling Plants	112	12	-	5	129
Chilling Capacity (LLPD)	11.80	2.47	0.50	0.87	15.64
No of Processing & Packaging Plant	10	1	1	1	13
Packaging Capacity (LLPD)	11.30	0.50	1.50	0.50	13.80

Source: Company, Indsec Research

Sales and Distribution Related

No. of Sales Offices	Distributors	Outlets	No of Vehicles	Household Reach
26	5200	101000	1073	1100000

Source: Company, Indsec Research

Business Model

Dairy

Sourcing: Heritage's dairy business is retail centric business where the company sources almost 70% of Milk (of approx 9 lac litres/day) directly from 3 lac farmers in 5 states while remaining 30% is sourced from Secondary Sources (15% from Milk Co-Operatives and remaining 15% from Private Players/Aggregators/Competitors).

Sales & Distribution: Raw milk sourced is sent to 129 chilling plants of the company and then it is processes and packed at 13 packaging units of the company. Almost 83% of Raw milk sourced is sold within 24 hours in liquid form as packaged milk while remaining milk is sold after converting it into various value added Milk Products like Curd, Lassi, Ice Cream, Ghee, Sweets etc .

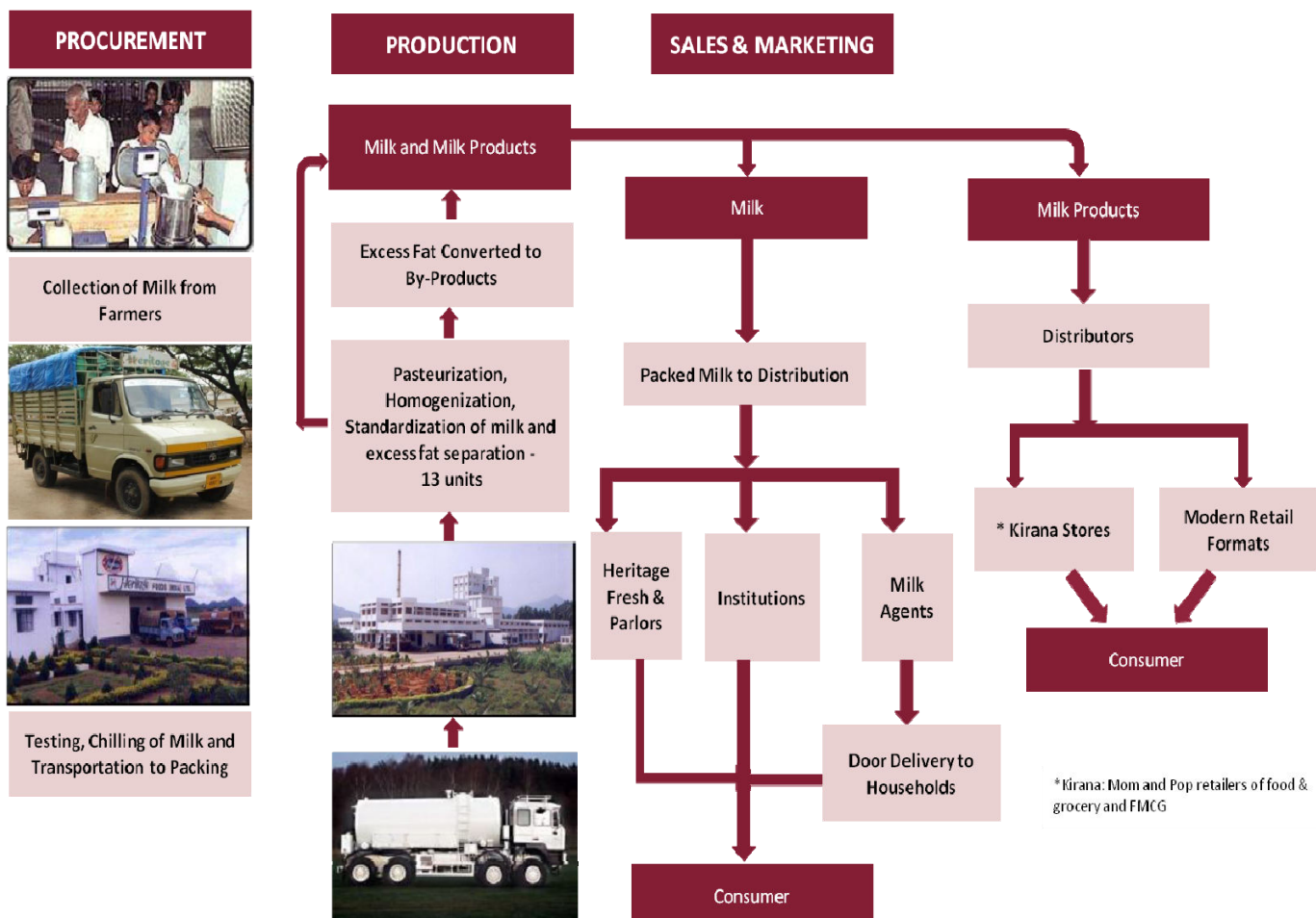
95% of liquid Milk is sold to almost 1.1mn retail household daily via 5200 Agents/Distributors and 101000 outlets while remaining 5% is sold to institutional clients like local coffee chain, Organized retail Chain etc..

Payment: Dairy is a negative working capital business for the company where the company pays milk suppliers/farmers between 1-4 weeks time (subject to negotiation) while it sells the milk to distributors/ Agents/ retail Outlets on cash & carry basis. Institutional clients get 30 days of credit from the company.

Retail

- Company Operates 74 No of Heritage Fresh Stores under brand name of "Heritage Fresh" with total carpet area of 0.256 mn sq ft.
- The stores are spread across three cities of Hyderabad, Chennai and Bangalore.
- Heritage Fresh stores are focused towards Food and Grocery items along with day to day use FMCG items .
- Besides regular FMCG brands company also sells private labels through these stores. Private labels contribute approx 20% to Retail Division Turnover.
- Some of the key private labels are " Farmers Pride– Grains & Staples", Blossom– Toilet papers, Spic– Utensil Cleaners, Sanistar– Toilet Cleaner, Cleanex– Phenyl, Cozy– detergent Bar etc. Company markets food FMCG products under Heritage brand name only.

Activity Flow Chart



Source: Company, Indsec Research

Management Profile

Name	Profile
Sri D Seetharamiah Chairman, 88	B Com, FCA, is the senior partner of Brahmayya & Co., a leading Chartered Accountants firm. He had occupied several coveted positions, which include, Membership of the Southern Regional Board of Reserve Bank of India, Federation of Andhra Pradesh Chamber of Commerce and Industry, Chairmanship of Tirumala Tirupati Devasthanams Trust Board etc. He is also on Board of several Companies.
Smt N. Bhuvaneswari Vice-Chair-Person & Managing Director, 52	B.A, is a dynamic leader who has extensive experience in business and has been successfully steering Heritage towards growth and better prospects. She was named as one of the most powerful business women in India and placed 45th rank in the list of " Fortune 50" for the year 2013. She is also a Director in several other Companies.
Dr V Nagaraja Naidu Director, 67	M Com, M Litt, PhD (FM), starting from Administrative Staff College of India, Hyderabad in 1972 held various positions in reputed Universities for about 25 years. He has been associated with the Company since inception and has been able to utilize his intimate understanding of the rural socio economic scenario to strengthen the milk procurement systems and strategies of Heritage.
Sri M Siva Rama Prasad Addl. Director, 66	BE (Met), Mr. Prasad with his rich and successful background of reviving and rehabilitating sick industries and starting new industries was awarded" The Most Successful and Innovative Entrepreneur" for the African Region in the year 1996 by UNIDO.
Sri N P Ramakrishnan Director, 67	He has substantial experience in the transport business, has a thorough understanding of the systems of milk procurement and transportation and has enabled Heritage to strengthen its main milk procurement base at Chittoor, Bangalore and nearby areas.
Sri Srivishnu Raju Nandyala Director, 41	B.E (Chem), He is the founder Chairman and CEO of EXCIGA group, which consists of five non banking finance companies. Past President of CII's Young Indians, Hyderabad Chapter and a past member on the state council of CII. He is a Director in several Public and Private Companies.
Sri Lokesh Nara Director, 31	B.Sc (MIS), MBA (Stanford), Before joining the Board of Heritage Foods, he was associated with the Company as a Vice-President of the Retail division. He has also worked with the World Bank as a Junior Professional Associate.
Smt N.Brahmani Executive Director, 27	B.E (Electronics), MBA (Stanford), Before joining the Board of Heritage Foods, she worked as Investment Associate in Vertex Venture Management Pvt Ltd between 2009 to 2011 in Singapore and associated with the Company as a Vice-President (Business Development).
K Durga Prasada Rao Whole Time Director, 72	DE (Mech), D.E (Dairy), D Tech (Dairy), He worked 3 years in Amul Dairy, 24 years in AP Dairy Development Co-operative Federation Limited and 22 Years in Heritage Foods Ltd in various positions.

Corporate Management Team

Name	Profile
Dr. M. SambaSiva Rao President	M.Sc, PhD (Zoology), He served the state and central governments for about two decades as a member of Indian Administrative Services(IAS). Before joining Heritage Foods Ltd, Dr Rao was Joint Secretary in Department of Commerce under Ministry of Commerce and Industry, Government of India.
A Prabhakara Naidu Chief Financial Officer	FCA, He has 21 years of experience in Finance and Accounts. He is associated with the Organization since inception.
Umakanta Barik Company Secretary	MA (Eco), LLB, FCS, has over 12 years of experience in the areas of Secretarial, Legal and Insurance.
Sri J Samba Murthy, Head - Dairy Division	B.Sc, MBA , has around 26 years of Experience in Dairy industry. Presently working in the Company as Sr. Vice President and associated with the Company since 2007. Before Heritage Foods Limited, He worked in APDDCF Limited, Visakha Dairy NDDDB, and Reliance in various positions in the field of Sales & Marketing.
S Jagdish Krishnan, Chief Operating Officer - Retail and Bakery Divisions	MS, MBA, has over 16 years of experience in the areas of Brand Management, Consulting, Corporate Communications and Retailing with leading Indian and Multinational Organizations. His last assignment was with the CavinKare Group at Chennai where he was the Head of the Retail Organization.
Anil Kumar Srivastava, Chief Operating Officer— Agri Business Division	MBA, PG Diploma (Foreign Trade & Fruit and vegetable Technology), He has around 29 years of rich experience to his credit with various reputed Food Processing Industries.

Investment Rationale:

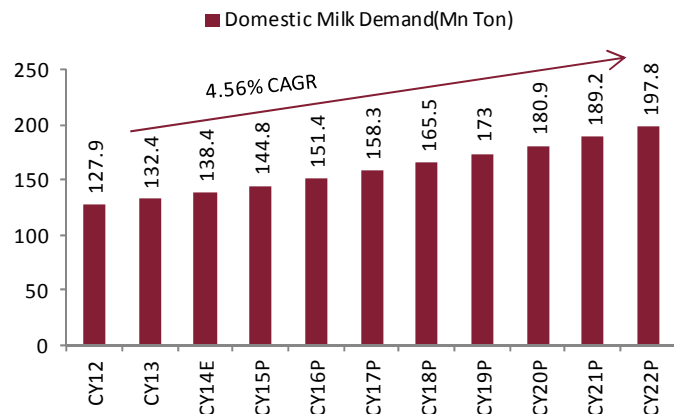
- **NDDB projects India's Milk demand to grow to 200 Mn Tonnes by CY 22 from 138 Mn Tonnes in CY 14.**

1. Proxy play on Indian Dairy growth story :

India is the largest producer of milk with total production of 132 Mn Tonnes in CY13. National Dairy Development Board (NDDB) projects Indian milk demand to grow to 200 Mn Tonnes by 2021-2022 which means milk demand is expected to grow at 4.56% CAGR over next 9 years or 7.6 mn Tonnes incremental Milk demand every year. At Avg Milk price of Rs 35/ kg , this offers incremental business opportunity of Rs 266Bn every year over next 9 years. Heritage Foods Ltd being a prominent player in Dairy space in India is all set to benefit from this secular demand growth.

- **Changing Food habits and increase in disposable income are the key drivers of growth in Milk Demand.**

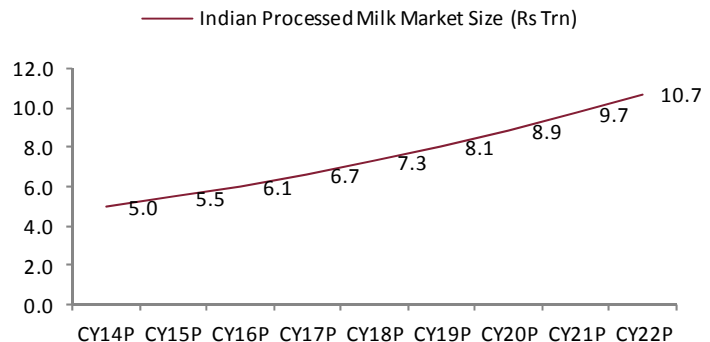
Domestic Milk Demand (Mn Ton)



Source: NDDB, Indsec Research

- **In order to meet the projected milk demand, India needs incremental milk of 7.6 Mn Tonnes per annum over next 9 years.**

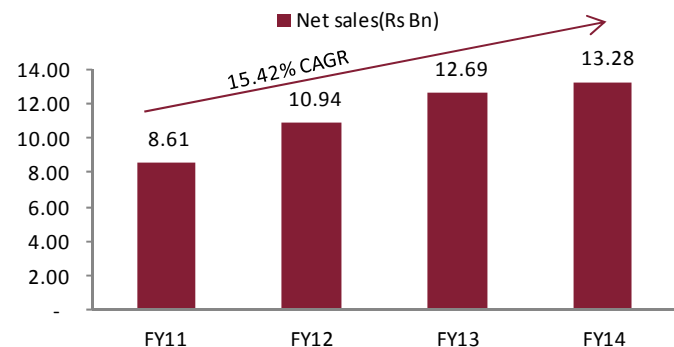
Indian Processed Milk Market Size (Rs. Trn.)



Source: Industry, Indsec Research

- **At Average Rate of Rs 35/kg, this presents incremental business opportunity of Rs 266 Bn Per annum.**

Heritage Dairy Turnover (Rs. Bn)



Source: Company, Indsec Research

- **Heritage Foods with its leadership Position In South Indian market is an excellent vehicle to ride the expected boom in Dairy demand.**

- In order to Capture the huge business opportunity in Dairy Business segment company is required to invest in back end infrastructure which includes Chilling Plants , Processing & Packaging plants etc.

- Company intends to invest around Rs 375– 400 mn over next 2 years in the dairy business to strengthen back end infrastructure.

- Further Retail segment is expected to break even once area under Retail reaches 0.4 mn Sq Ft from current 0.275 mn Sq Ft.

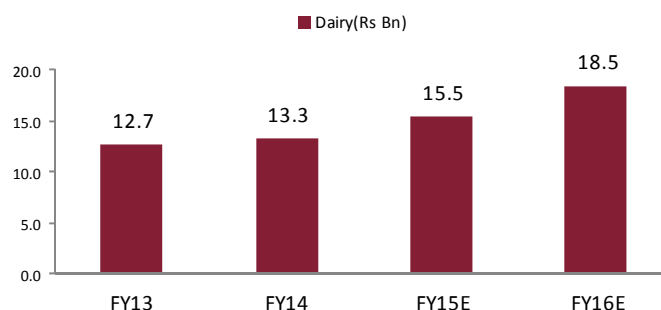
- Company intends to invest close to Rs 100-125 mn to achieve the targeted retail space.

- These investments are expected to help the company increase the dairy segment turnover by 39% by FY16E to Rs 18.5 Bn while Retail Segment turnover is expected to clock 37% growth during the same period (Rs 5.2 Bn).

2. Capacity expansion will lead to sustained topline growth:

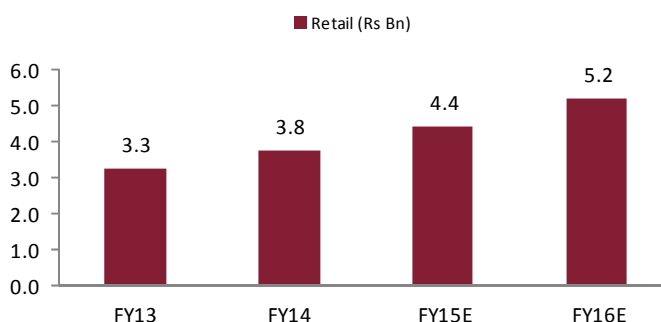
Heritage Foods has two drivers of top line growth- Dairy and Retail and the company has been constantly investing money to enhance the capacity in both these lines of business. In Dairy division, company has enhanced its Milk chilling capacity by 15% (from 1.35 Mn Litre per day to 1.56 mn Litre per day) and Milk packaging capacity by 20% (from 1.15 MLPD to 1.38 MLPD) in last 2 years while in the Retail segment, Total carpet area of retail space has gone up from 0.2 mn Sq Ft to 0.22 mn Sq Ft. The capex has resulted into Dairy and Retail division Top line growing by 21% (Rs 13.28 Bn Vs Rs 10.94 Bn) and 26% (Rs 3.78 bn Vs Rs 2.99 Bn) respectively. To keep the growth momentum going, company is in the process of investing approx Rs 450-500mn over next 2 years. This involves approx Rs 350-375mn investment in dairy segment and Rs 100-125 mn in Retail segment. The capital expenditure should help Dairy division grow its topline by 39% (to Rs 18.49 Bn) and Retail division by 38% (to Rs 5.22Bn) by FY16E. This is expected to lead to consolidated Top line growth of 37% (to Rs 23.64 Bn) by FY16E.

Segment wise Turnover Growth—Dairy (Rs. Bn)



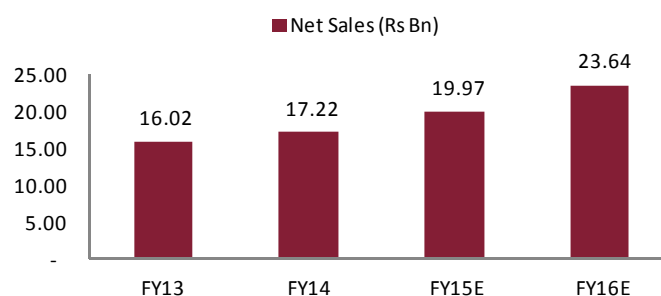
Source: Company, Indsec Research

Segment wise Turnover Growth—Retail (Rs. Bn)



Source: Company, Indsec Research

Consolidated Turnover Growth— Net Sales (Rs. Bn)



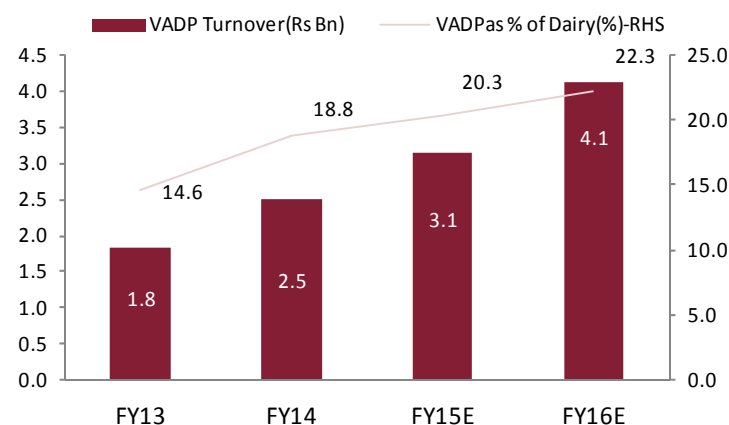
Source: Company, Indsec Research

3. Increasing proportion of Value added Products to improve margin :

- Value Added Dairy products (VADP) have been the fastest growing segment of Dairy Industry with Av growth of 25% P.a (vs 10-11% growth in liquid milk segment) and command margins between 13-16% compared to 6-7% margin in Liquid Milk Business.

Valued Added Dairy products (VADP) command EBITDA margin (13-16%) which is almost double of what is fetched by liquid milk (6-7%). Of the total sales of Rs 13.28 bn registered by Dairy division of the company in FY 14, Value added dairy products (VADP) has contributed Rs 2.50 Bn or 18.8%. Company is actively striving to enhance the contribution of VADP to total Dairy sales to 22% by FY16E (Rs 4.12 bn). Increasing Proportion of VADP in total dairy sales should lead to improvement in operating margin of dairy division by 50 bps by FY16E to 9%.

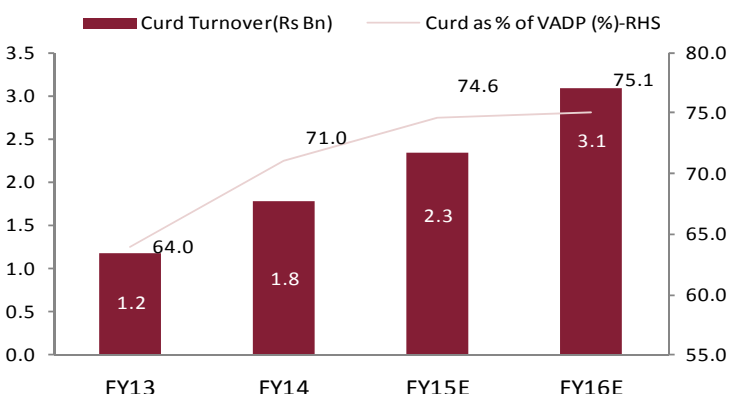
Value Added Dairy Product Revenue (Rs. Bn)



Source: Company, Indsec Research

Curd Segment Revenue (Rs. Bn)

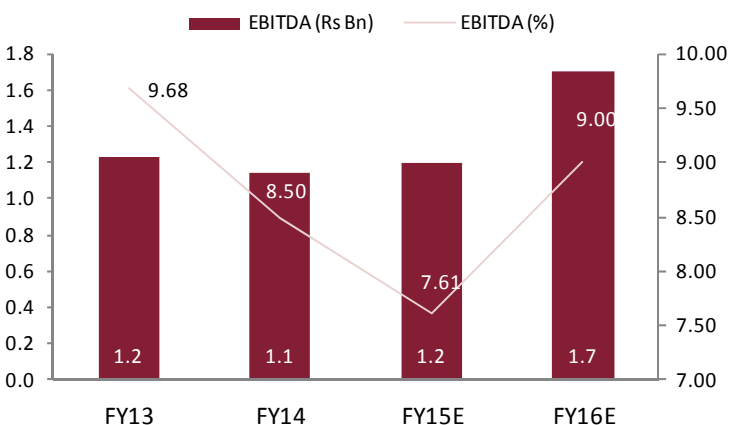
- Curd sales has been the key driver of growth in VADP and it has grown at CAGR of 52.5% during the same period (FY 09-14).



Source: Company, Indsec Research

Trend in Dairy Segment EBITDA

- Higher proportion of VADP is expected to enhance Dairy segment EBITDA by 50 bps between FY 14-16.



Source: Company, Indsec Research

4. Turnaround in Retail business will provide trigger for Re -Rating:

- **Retail division which accounted for 21% of consolidated turnover in FY14 has made losses which ate almost 27% of operating profit made by Dairy division.**

- **This led to consolidated operating profit subdued to the tune of 12-13% of its potential operating profit.**

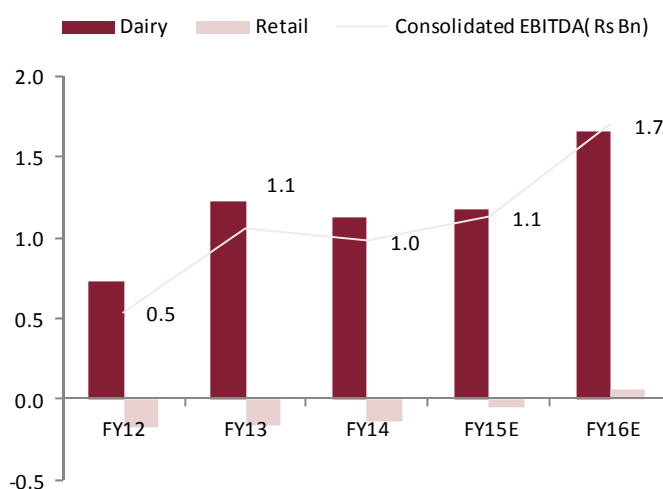
- **Retail division is expected to register its first profit at EBITDA level in FY16e (Rs 62 Mn) due to increased area under retail and cost cutting .**

- **Turnaround of Retail division will have very positive impact on Company's PAT which is expected to double in next two years (FY16e) to Rs 0.87 Bn.**

- **The stock could get re Rated due to expected performance over next 12-18 months.**

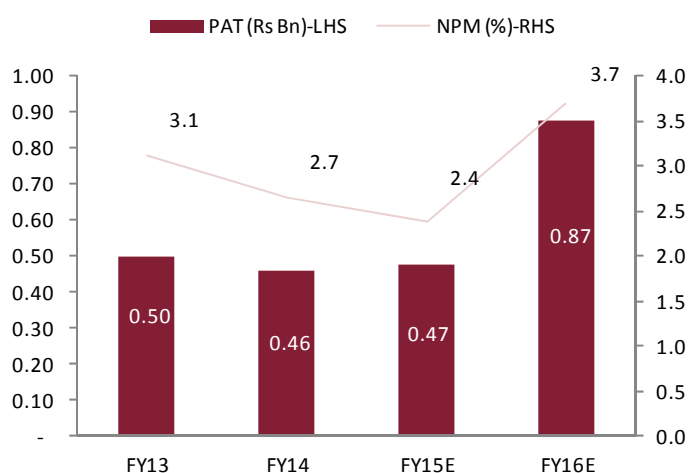
Heritage Fresh, the Retail Division of the company has been the Achilles Heel for last 5 years. Loss in the Retail division has eclipsed the profit of the Dairy division. If losses of retail division are removed, consolidated PBDIT for FY13 and FY14 would have been higher by minimum 12-13%. This has forced the company to keep investing out of pocket to maintain the growth momentum. The scenario is expected to change with Retail Division all set to become profitable at EBITDA level from FY16E on the back of economy of scale and improvement in same store sales. We expect Retail division to clock EBITDA of Rs 62 mn in FY16E from EBITDA loss of Rs 133.2mn in FY14. This will lead to consolidated EBITDA margin of the company improving by 150 bps over FY14 to 7.00% by FY16E. 150bps improvement in EBITDA margin is expected to increase in Net profit by almost 90% to Rs 0.87Bn between FY14 and FY16E. This will lead to a Re -Rating of the company over next 12-18 months.

Trend in Operating Profit



Source: Company, Indsec Research

Trend in PAT and Net Profit Margin



Source: Company, Indsec Research

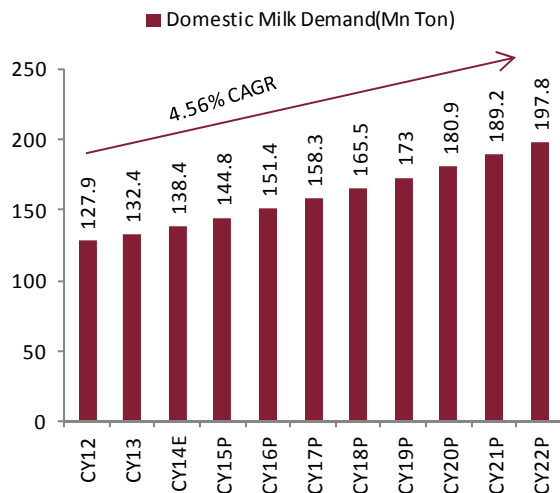
SWOT Analysis



Source: Company, Indsec Research

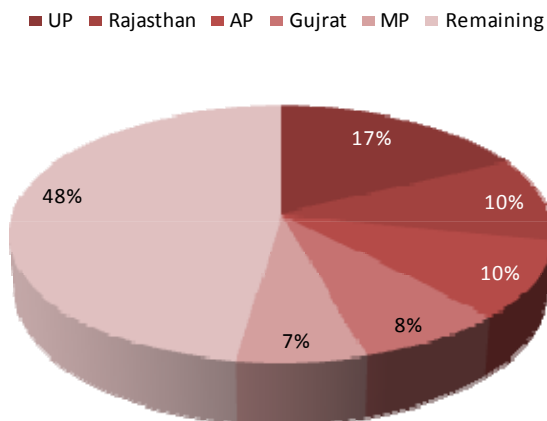
Dairy Sector: Sector View

Domestic Milk Demand (Mn Ton)



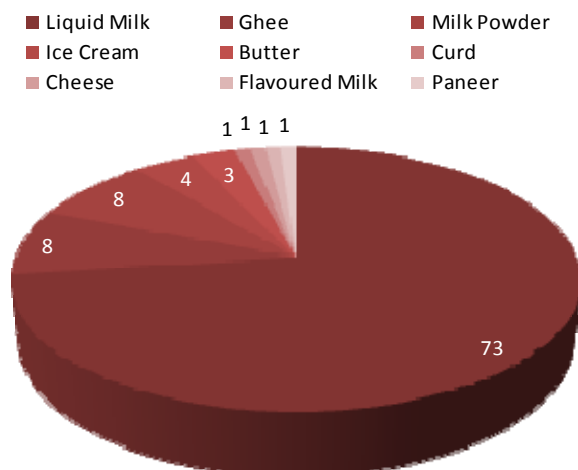
Source: NDDDB, Indsec Research

State Wise Milk Production CY13 (Mn Ton)



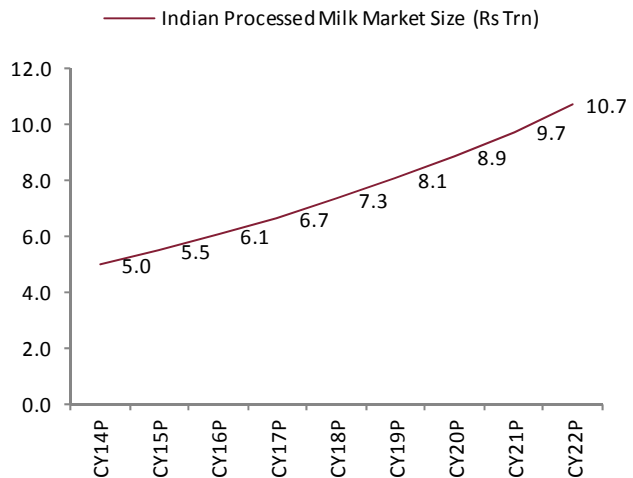
Source: NDDDB, Indsec Research

Dairy Product Sales Composition (%)



Source: NDDDB, Indsec Research

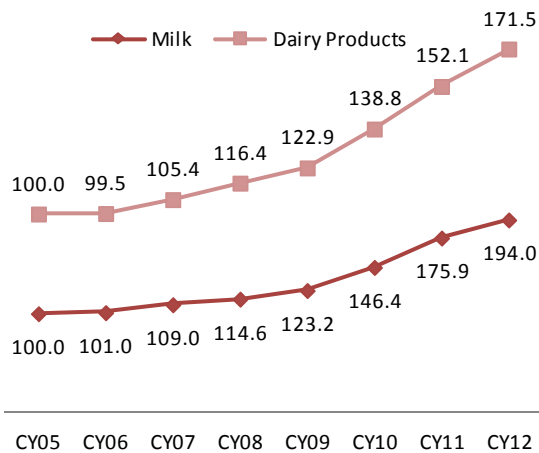
Indian Processed Milk Market Size (Rs. Trn.)



Source: Industry, Indsec Research

- India is the largest producer of Milk globally and produced 132.4 Mn Tons of milk in CY 13 accounting for 17% of Global Milk production .
- Only 50% of milk produced in India is used for trading domestically .
- National Dairy Development Board expects domestic milk demand to grow at 4.56% CAGR in volume terms over next 8-9 years to 200 Mn Tons by CY 21-22 which means annual incremental milk demand of 6 Mn Tons .
- Processed milk market size is estimated at Rs 5 trn for CY 14 (FY15) and expected to grow at 10% P.a.
- Top 5 states account for almost 50% of total milk production.
- Total value of Dairy product sold in India in CY 13 stood at approx Rs 4.5 Trn and 73% of it comprises of Liquid Milk while remaining 27% is sold in the form of Milk derivatives . Out of this 27% space approx 11% is sold in the form of Value added dairy products .
- Currently only 30% of domestic milk trade share held by Organized sector (16%-Dairy Co-Operatives and 14%-private dairy companies) while rest comes from Unorganized sector.
- Industry estimates suggest VADP (Value Added derivative products) segment is growing at 25% p.a and will maintain the growth momentum for next 5-6 years. Changing life-style, growing per capita income and consistent product quality is the key reason behind faster growth in VADP.

Inflation Trend in Dairy Products—WPI Trend—Milk Vs Dairy Products

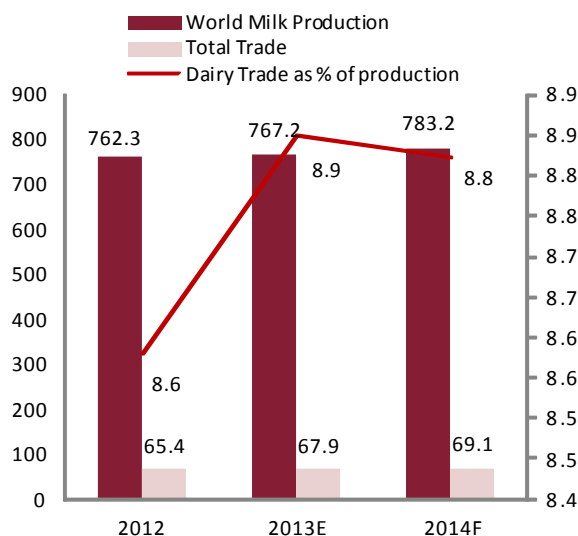


Source: Ministry of Commerce, Gol, Indsec Research

- Inflation in Dairy products is in double digits since CY09.

Global Dairy

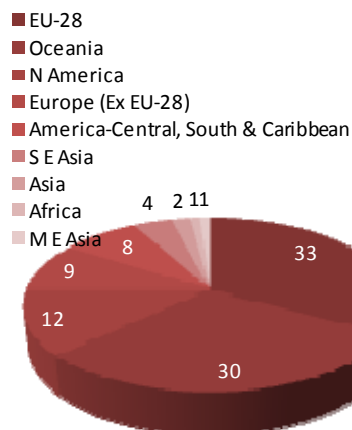
Global Milk Production & Trade (Mn Tonnes)



Source: USDA, Indsec Research

Global Dairy Trade—Key Highlights

2013—Global Dairy Trade Share (%)



Source: Industry, Indsec Research

- Profit margin in liquid Milk is barely 5-6% while same for VADP segment stands between 13-16%. Lure of Higher profit margin along with faster growth (25% vs 12%) has prompted many private dairies to aggressively venture into VADP space which also help them ward off competition from unorganized players.
- Though inflation in Dairy products can be easily passed on to the end consumer due to staple nature of Milk, Government (Both state & centre) do interfere in pricing of Liquid milk by using state Co-operatives and policy instruments. Higher exposure to VADP also provides hedge against vagaries of Government Policies.
- Milk being a perishable commodity, processing plants have to be close to market as well as centre of procurement so that milk can be processed and consumed within limited time. This is the main reason why Milk Brands are regional in Nature and Market leader Amul has got only limited presence in India in spite of being in existence for more than 5 decades.
- Further back end Infrastructure like chilling plants and refrigerated vehicles along with continuous power availability is very important for Dairy business to grow.

Top 5 Global Producers of Milk

Countries	Milk Production (Mn Tons) CY 2013	10 Yr CAGR (%)
India	141	4.3
USA	91	1.7
China	39	11.4
Pakistan	39	3.4
Brazil	30	4.2

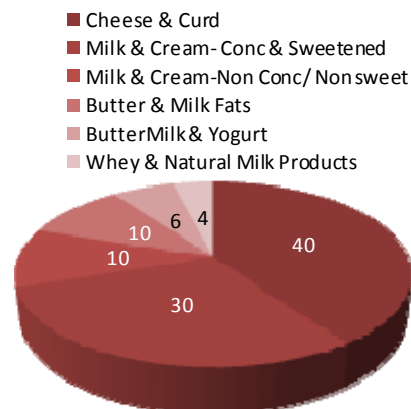
Source: OECD-FAO, Indsec Research

Top 5 Exporters and Importers of Dairy Products

Top Importers	% of Total Imports	Top Exporters	% of Total Exports
China	44.0	New Zealand	55.0
Algeria	24.0	EU 27	21.0
Indonesia	6.7	US	
Brazil	6.0	Australia	7.3
Russia	5.3	Argentina	13.0
Total	86.0	Total	

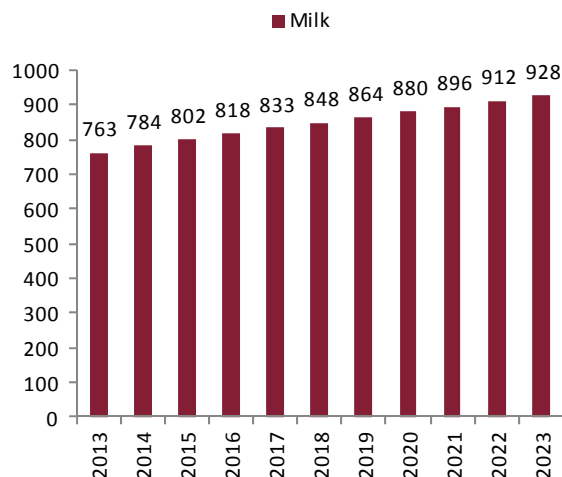
Source: Industry, Indsec Research

Productwise Contribution (%)—Global Dairy Trade—CY10



Source: Industry, Indsec Research

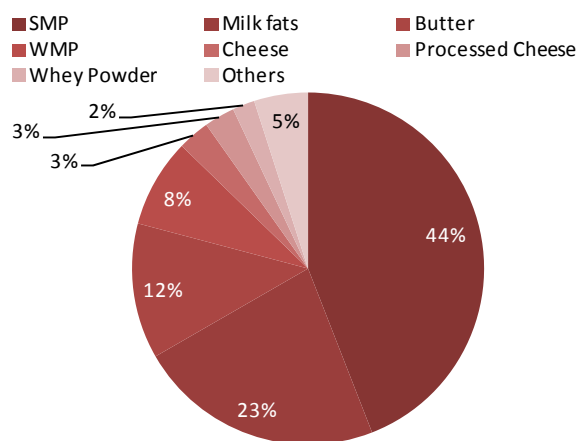
Global Milk Production Projection (Mn Tonnes)



Source: OECD-FAO Forecast, Indsec Research

India and Global dairy Trade

Composition of India's Dairy Export CY10



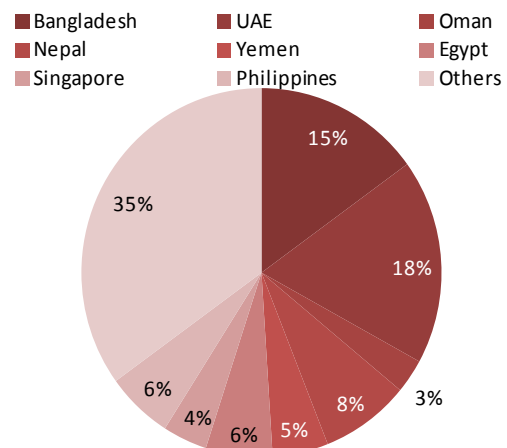
Source: Industry, Indsec Research

Key Issues with India's Dairy Sector

- In spite of being the largest global producer of Milk, India's growing domestic demand leaves very little surplus milk for export.
- Productivity of Milch animals in India is miserably low (1 ton/ Milch Animal/ Year vs 9.4 for US, 6.2 for EU and 5.9 for Australia) among prominent producer countries and is expected to remain so for next 6-7 years.
- Indian Dairy Industry suffers with perception of Poor quality among global consumers which makes it challenging to export products to global consumers.
- Cow Milk is the only popular milk in most developed countries and buffalo milk is unheard of. India produces substantial quantity of buffalo milk. Foreign buyers are not very sure of suitability of buffalo milk for human consumption.

- Total value of Global dairy Trade of USD 47Bn in CY13 where EU- 28 and Oceania (New Zealand & Australia) combined together account for almost two third of Global Export.
- Global Milk production projected to increase by 162 Mn tonnes over next 10 years out of which close to 40% additional production to come from India and China itself. Estimates suggest India's Milk production will overtake combined production of EU-28 by 2020.
- Because of large population and increasing per capita Income these countries will witness higher milk demand.
- Since cost of milk production in India and China is among the lowest in the world, production growth to cater to incremental demand will be coming to these countries.
- Due to mandatory phase out of Subsidy under WTO regime, EU and US will lose out on competitiveness in Global Dairy market and thus are looking to set production bases in low cost countries like India.

Key Markets for India's Dairy Export CY10



Source: Industry, Indsec Research

- Developed countries like EU, USA, Japan etc offer heavy subsidy to domestic dairy producers in the form of subsidized feed grains, irrigation, interest on loans and insurance. They further provide export incentive to their farmers to sell dairy produce in international market. For example, EU gives subsidy of more than USD 550/ Ton on SMP, USD 850/ Ton of Full Cream Powder, USD 1200/Ton of Butter and Butter Oil. The heavy subsidy along with Higher tariff barrier (Canada- 126.6%, Japan- 93.3%, EU-48.3%) create heavy obstacle in way of Indian dairy export to these countries.

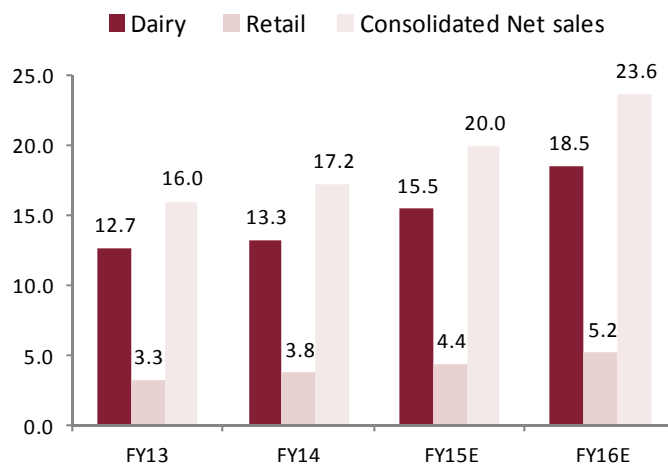
The Way Forward:

With the WTO regime banning subsidy of Agriculture Export by countries to come in force, Indian Milk producers have real chance of growing their presence in Global Market if they are able to address quality and productivity issue. Since, India's domestic demand growth is set to outgrow global Dairy demand growth, many more global players will be inclined to buy stake in Domestic Dairy companies and use their superior technology to gain market share. Strong Brand and Back End infrastructure will be key to capturing this market.

Financial Performance Analysis

Sales Projection—Yearly

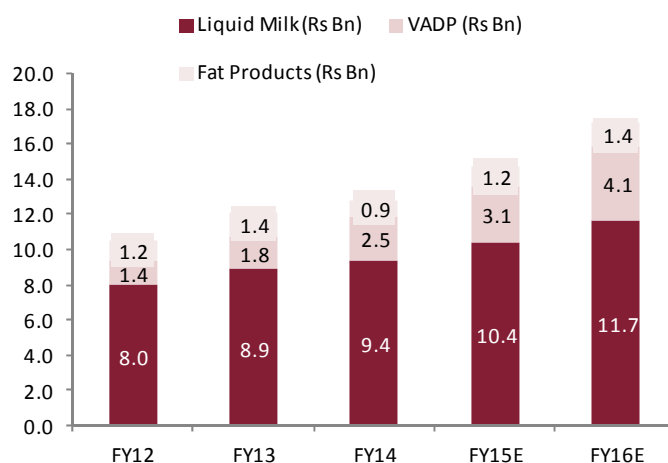
- *Topline is expected to grow by 37% between FY14-16 to Rs 23.63 bn on the back of 39% growth in Dairy segment (Rs 18.49 bn) and 38% growth in Retail division sales (Rs 5.21Bn).*



Source: Company, Indsec Research

Trend in Dairy Segment Turnover

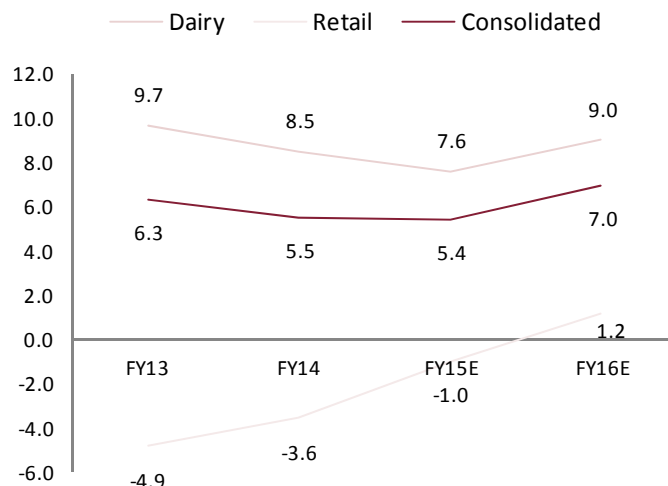
- *Value Added Dairy Product (VADP) is the key growth driver in the Dairy segment . This division is expected to register growth of 64% between FY14-16 compared to 24.5% growth registered by Liquid Milk Division during the same period.*
- *Curd sales is expected to lead VADP growth by clocking sales growth of 74% between FY14-16.*



Source: Company, Indsec Research

Trend in Operating Margin

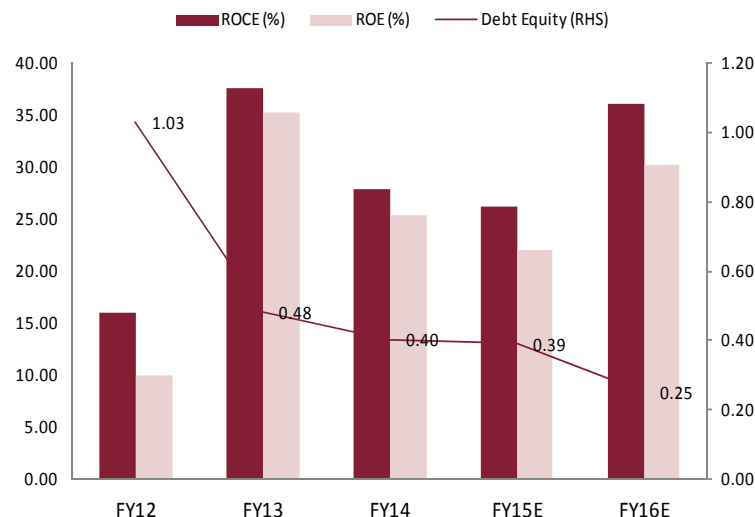
- *Consolidated Operating Margin (PBDIT%) is all set to improve by 150 bps between FY14 and FY16E on the back of turnaround in Retail segment margin which is turning positive in FY16E from -3.59% in FY14.*



Source: Company, Indsec Research

Trend in Leverage and Return Ratios

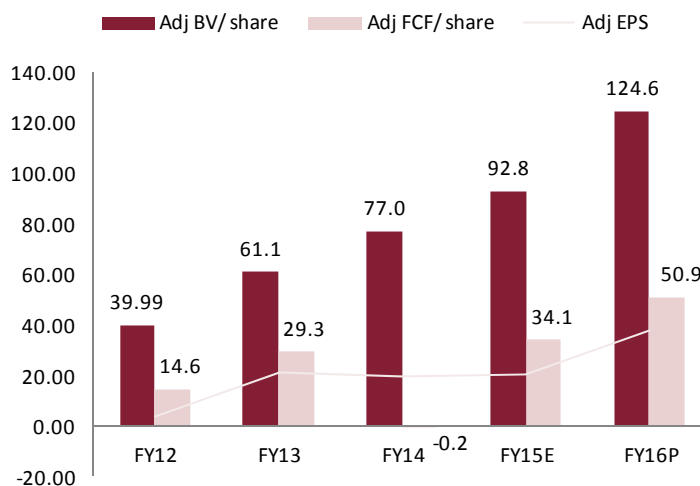
- Debt Equity ratio has consistently improved, ROCE and ROE too have enhanced by 686 bps and 392 bps respectively between FY14 and FY16E mainly due to turnaround in retail Segment and improving profitability in Dairy Segment.



Source: Company, Indsec Research

Movement in FCF

- There is tremendous improvement in free cash flow per share from FY15 onwards after blip in FY14 due to improvement in Inventory days and normalization of Capex in FY15E and FY16E.



Source: Company, Indsec Research

Peer comparison

Company	Heritage	Kwality	Hatsun Agro	Fontera NZ	Danone
Sales (Rs.bn)	17.22	45.69	24.81	18.63*	21.29\$
EBITDA(%)	5.50	5.95	7.45	7.62	16.53
NPM(%)	2.70	2.75	3.30	3.70	7.70
Net-Worth (Rs.bn)	1.79	4.28	1.79	6.75	10.73
Debt-Equity	0.40	2.52	2.21	0.69	1.12
ROCE(%)	27.91	16.99	22.12	10.21	9.17
ROE(%)	25.34	33.87	45.63	10.91	14.49
Div Yield (%)	0.87	0.20	0.87	3.33	NA
PAT CAGR(%)-(FY14-16E)	39.92	14.89	7.24	-12.00	10.90
FY16 PE	8.87	6.07	34.57	19.75	17.95
FY16 PB	2.59	1.42	8.98	2.11	2.51
FY16 EV/EBITDA	4.16	5.43	14.64	10.07	11.66

* The number is into New Zealand Dollar. \$ The number is denoted in Euro.

Sales number and return ratio for Fontera are for 12 months ending 31st, July 2013 and Danone are for 12 months ending 31st, December 2013 while for remaining companies they are for FY14, i.e. 12 month period ending 31st, March 2014.

Valuation and Recommendation :

We are using SOTP method to value the company where Dairy business is being valued on EV/EBITDA basis while Retail business (along with Agri & Bakery) is valued using EV/sales methodology.

A) Dairy business EV at 6x FY 16E EBITDA (Rs Mn)	$6 \times 1646.75 = 9880.48$
B) Retail business EV @ 0.5x FY16 sales (Rs Mn)	$0.5 \times 6163.42 = 3081.71$
C) Consolidated EV Rs Mn (A +B) FY 16	12962.2
D) Consolidated FY16 Market Cap	= EV - (Long Term Debt+ Short term Borrowing) +(Cash) all for FY16
	= $12962.2 - (318.48 + 350.00) + (1425.09)$
	= 13718.81
E) Per share FY 16 Fair Value of Heritage Foods	= $13718.81 / 23.2$
	= 591

We advise BUY on Heritage Foods with March 16 price target of Rs 591 which gives upside potential of 72% from current level. At the target price, stock is valued at 15.67x FY16E EPS which is quite comfortable.

Risk to Call :

We have been prudent in our projection about segment revenue and margin of the company. In spite of that there might be some inherent risks associated with our call which could derail the projected revenue and profitability . Some of the key risks are outlined below.

Downside Risk :

- We have assumed 9% average realization growth for liquid milk over next couple of years which we believe reasonable looking at past trend and inflation expectation. In case company is not able to increase prices for liquid milk, it might impact top line growth as well as profitability.
- We have assumed 27% average sales growth for Value added Dairy Product (VADP) over next couple of years which is in line with the past growth recorded by the company. In case, the company is not able to maintain the growth momentum in VADP space, it can have negative impact on profitability of the company.
- We have projected Retail division (along with Agri and Bakery) to turn profitable at EBITDA level in FY16E. In case, the Retail division does not perform as expected, profitability projection for FY16 might not materialize as projected.

Upside Risk:

- Better than anticipated sales growth, margin growth in any segment/ across segments can cause upside risk to profitability and hence stock price. We have been very conservative about margin improvement in dairy segment. There is high probability it may surprise on the upside.
- Any news on stake sale/JV in Retail operation can lead to value unlocking, which again may cause upward risk to target price.

Summary Income Statement For the fiscal year ending					
Amt. in Rs. millions	FY12	FY13	FY14	FY15E	FY16E
Net Revenues	13,934.1	16,018.1	17,220.4	19,971.3	23,635.4
Cost Of Revenues	11,190.6	12,369.0	13,438.1	15,654.1	18,207.0
Gross Profit	2,743	3,649	3,782	4,317	5,428
Power and fuel	308.6	364.1	396.1	459.3	543.6
Other Operating Expenses	1,923.1	2,274.3	2,436.5	2,776.0	3,238.0
EBITDA	511.8	1,010.8	949.8	1,081.8	1,646.7
Other Income	32.1	41.0	49.5	51.5	99.8
EBITDA, including OI	544	1,052	999	1,133	1,747
Depreciation	211.9	220.2	250.0	299.6	342.7
Net Interest Exp.	197.7	167.0	132.2	116.6	80.2
EBT	134	665	617	717	1,324
Taxes	42.4	136.9	160.2	243.9	450.0
Tax Rate	32%	21%	26%	34%	34%
Net Income	92	528	457	473	874
Adj EPS (INR)	4.0	21.5	19.5	20.4	37.7
Shares Outstanding	11.5	11.6	23.2	23.2	23.2

Summary Balance sheet For the fiscal year ending					
Amt. in Rs. millions	FY12	FY13	FY14E	FY15E	FY16E
SOURCES OF FUNDS					
Share Capital	115.3	116.0	232.0	232.0	232.0
Reserves	812.4	1,300.6	1,555.5	1,920.4	2,658.3
Total Shareholders Funds	928	1,417	1,788	2,152	2,890
Warrant application money	-	-	-	-	-
Minority Interest	0.6	0.2	0.2	0.2	0.2
Long term borrowing	699.3	405.6	391.7	471.3	318.5
Net Deferred Tax liability	181.5	195.3	225.2	245.0	265.0
Other long term liabilities	66.5	75.5	93.4	112.0	132.0
Long term provisions	7.5	7.7	9.3	10.7	11.5
Current Liabilities and Provisions					
Current Liabilities	652.4	568.2	689.8	766.0	906.6
Provisions	63.7	84.2	128.8	164.1	194.3
Short term borrowings	705.8	576.2	882.5	500.0	350.0
Other Current Liabilities	761.4	776.6	709.8	820.7	971.3
Total Current Liabilities	2,183.3	2,005.1	2,410.9	2,250.9	2,422.1
Total Liabilities	4,066.4	4,106.0	4,918.3	5,242.6	6,039.6
APPLICATION OF FUNDS :					
Net Block	2,302.6	2,367.9	2,714.8	2,765.2	2,622.5
Capital Work in Progress	92.4	82.7	111.2	110.0	80.0
Long term loans and advances	191.0	174.7	205.2	115.0	135.0
Non Current Assets	10.4	4.4	6.9	5.0	5.9
Investment	1.6	8.1	6.6	6.6	6.6
Current Assets, Loans & Advances					
Inventories	934.5	820.9	1,085.5	1,258.5	1,489.4
Sundry Debtors	112.0	150.7	166.1	191.5	210.5
Cash and Bank	301.2	330.7	445.4	736.1	1,425.1
Loans and Advances	120.7	165.8	176.6	54.7	64.8
Other Current assets	-	-	-	-	-
Total Current Assets	1,468	1,468	1,874	2,241	3,190
Miscellaneous Expenditure	-	-	-	-	-
Total Assets	4,066.4	4,106.0	4,918.3	5,242.6	6,039.6

Summary Cash Flow Statement For the fiscal year ending					
Amt. in Rs. millions	FY12	FY13	FY14E	FY15E	FY16E
PBT & Extraordinary	134.3	636.4	617.1	717.2	1323.6
Depreciation	211.9	220.2	250.0	299.6	342.7
After other adjustments					
(Inc) / Dec in Working Capital	113.6	56.1	-204.8	258.2	61.2
Taxes	(29.8)	(124.5)	-160.2	-243.9	-450.0
Others	174.5	184.6	116.7	109.2	73.1
Cash from Ops.	605	973	618.8	1140.3	1350.6
Purchase of Fixed Assets	(288.1)	(296.0)	-625.3	-348.8	-170.0
Others	22.8	3.7	1.5	0.0	0.0
Cash from Investing	(265)	(292)	-623.8	-348.8	-170.0
Issue of share capital	1.0	-	0.0	0.0	0.0
Borrowings	(119.7)	(476.7)	292.4	-302.9	-302.9
Others	(194.0)	(175.0)	-172.7	-197.9	-188.7
Cash from Financing	(313)	(652)	119.7	-500.8	-491.6
Net Change in Cash	27	29	114.7	290.7	689.0
BF Cash	262.0	288.5	330.7	445.4	736.1
Bank Balances	12.7	13.3	0.0	0.0	0.0
END Cash	301.2	330.7	445.4	736.1	1425.1

Summary Ratios For the fiscal year ending					
	FY12	FY13	FY14E	FY15E	FY16E
<u>Profitability</u>	-	-	-	-	-
Return on Assets (%)	2.3	12.2	10.0	9.3	15.5
Return on Capital (%)	15.9	37.6	27.9	26.1	36.0
Return on Equity (%)	9.9	35.2	25.3	22.0	30.2
<u>Margin Trend</u>	-	-	-	-	-
Gross Margin (%)	19.7	22.8	22.0	21.6	23.0
EBITDA Margin (%)	3.7	6.3	5.5	5.4	7.0
Net Margin (%)	0.7	3.1	2.7	2.4	3.7
<u>Liquidity</u>					
Current Ratio	0.7	0.7	0.8	1.0	1.3
Quick Ratio	0.2	0.3	0.3	0.4	0.7
Debtor Days	2.9	3.4	3.5	3.5	3.3
Inventory Days	24.5	18.7	23.0	23.0	23.0
Creditor Days	17.1	12.9	14.6	14.0	14.0
Working Capital Days	-26.6	-19.8	-20.8	-13.6	-10.2
<u>Solvency</u>	-	-	-	-	-
Total Debt / Equity	1.0	0.5	0.4	0.4	0.3
Interest Coverage	2.6	6.1	7.2	9.3	20.5
<u>Valuation Ratios</u>	-	-	-	-	-
EV/EBITDA	17.7	8.5	9.2	7.6	4.4
P/E	86.3	15.9	17.5	16.8	9.1
P/B	8.6	5.6	4.4	3.7	2.7

Annexure
Heritage Foods—Key Brands

Product/Brand	
Dairy	
Milk	   
Ice Cream	  
Ghee	 
Curd	  
Buttermilk/ Sweets	 
Butter	

Product/Brand	
Retail/FMCG (Non Food)	
Drinking Water	
Utensils Cleaner	
Toilet Cleaner	
Floor Cleaner	
Toilet Tissue Roll	
Bar Detergents	

Product/Brand	
FMCG (Food)	
Namkeens	
Honey / Corn Flakes	
Pickles	
Instant Noodles/ Instant Mixes	
Wheat Flour / Salt	
Turmeric /Chilli Powder	
Papads	

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BUY : Expected total return of over 25% within the next 12 months.

ACCUMULATE : Expected total return between 10 to 25% within the next 12 months.

REDUCE : Expected total return below 10% within the next 12 months.

SELL : Expected total return is below the market return within the next 12 months.

NEUTRAL: No investment opinion on the stock under review.

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CONTACT DETAILS

Management	Designation	Email ID	Direct No. (+91-22)
Nandkishore Gupta	Managing Director	ngupta@indsec.com	6114 6101/02
Research Team	Designation [Sectors Covered]	Email ID	Direct No. (+91-22)
Milan Wadkar	Vice President-Research [Cement, Auto & Mid Caps]	milanw@indsec.co.in	6114 6105
Shailesh Kumar	Research Analyst [Banking, FMCG & Mid Caps]	shaileshk@indsec.co.in	6114 6139
Divya Sankaranarayanan	Research Associate	divyas@indsec.co.in	6114 6115
Rahul Dani	Research Associate	rahuld@indsec.co.in	6114 6116
Chandrakant Maske	Technical Analyst	chandrakantm@indsec.co.in	6114 6136
Institutional Sales Team	Designation	Email ID	Direct No. (+91-22)
Nilesh Mistry	Head – Sales	nileshm@indsec.co.in	6114 6125
Parag Shah	Sales Trader	parags@indsec.co.in	6114 6133
Pradnya Potdar	Executive—Dealing	pradnyap@indsec.co.in	6114 6134

For additional information please contact: research@indsec.co.in, or visit us at www.indsec.co.in

Indsec Securities & Finance Ltd, 301/302, "215 Atrium", "A" Wing, Andheri-Kurla Road, Chakala, Andheri (East), Mumbai - 400 093
Telephone: +91 22 6114 6114 / 6114 6100, Fax: +91 22 6114 6180 / 86