

Coverage Stocks: Heritage Foods Ltd.

South King: Moving PAN India
CMP INR: 1126
Target: INR 1460
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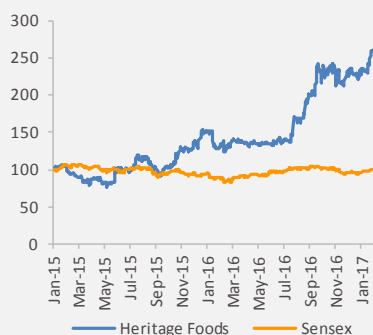
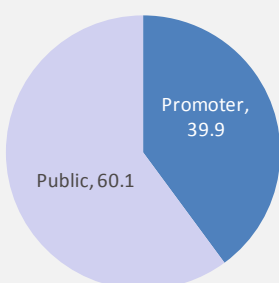
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Bloomberg:
HTFL:IN

52-week range (INR): 1,120 / 446

Share in issue (Cr): 2

M cap (INR Cr): 2,562

SHARE HOLDING PATTERN (%)

 Date: 14th February, 2017

Heritage Foods (Heritage) is a leading dairy player with strong presence in South market, wherein it has cornered ~10-12% of the organised market pie. Successful expansion of procurement and distribution reach from mere 2 states a decade ago to 8 currently has underpinned the company's soaring prospects over the years. Its endeavour to expand footprint in new geographies adds further legs to its growth narrative. Heritage, in pursuit of transitioning into a full-fledged dairy company, is aggressively transforming from a plain vanilla milk to value-added products' player, which further burnishes its prospects as the latter entails higher margins. Additionally, divestment of the loss-making retail business has freed up much required capital and management bandwidth, which can be fruitfully utilised to spur the dairy business. Expansion in non-South markets, improving share of high margin value-added products and exit from loss making retail business are envisaged to propel 20% and 30% EBITDA and EPS CAGR, respectively, and over 30% RoCE (ex retail) over FY16-20E. Initiate coverage with 'BUY' and target price of INR 1,460.

Deepening reach in existing markets, expansion in untapped geographies to spearhead spurt

Heritage is a leading private dairy player with 10-12% organised market share in South India. We estimate the company's dairy business to post 13.4% revenue CAGR to INR2,927cr over FY16-20E spearheaded by: (a) deepening penetration in current markets; (b) expanding reach in virgin geographies; and (c) robust 23% CAGR spurt in high-margin value-added products.

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.

Sale of loss-making retail business to free up capital and management bandwidth

The company's retail division was loss making at the EBITDA level since inception (2006). Over the past 10 years the business posted consolidated EBITDA loss of INR204cr and net loss of INR300cr, impacted by high rentals and surging overheads. Ergo, the retail business was a drag on Heritage's overall EBITDA and net level. However, now that the company has sold its retail business to the Future Group, Heritage has turned into a pure dairy play, freeing capital and management bandwidth to sharpen focus on the dairy business. Thus, we anticipate the divestment to be earnings as well as returns accretive (excluding investment).

Outlook and valuations: Strong brand, superior & efficient returns ratio; initiate with 'BUY'

Heritage is a strong brand in the 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 (30% value-added products), expanding reach in new markets and enhanced focus on the dairy segment will propel its earnings to clock 30% CAGR over FY16-20E. We value the company at 26x FY19E to arrive at a target price of INR1,460. We initiate coverage with 'BUY'.

Year to March (Standalone) (INR Cr)	FY15	FY16	FY17E	FY18E	FY19E
Income from operations	2073	2381	2660	2189	2530
YoY Grth%	20.4	14.8	11.7	-17.7	15.6
EBITDA	84	131	149	188	222
EBITDA Margin%	4.0	5.5	5.6	8.6	8.8
Profit after tax	28	56	70	110	131
YoY Grth%	(37.8)	96.5	27.1	55.8	19.2
EPS	12.2	23.9	30.4	47.3	56.4
ROAE (%)	15.2	25.6	26.0	21.9	17.3
ROACE (%)	14.0	25.6	28.9	27.2	22.2
ROACE (ex retail Investment)	14.0	25.6	32.6	55.0	34.6
P/E	92.7	47.2	37.1	23.8	20.0
EV/EBITDA (x)	32.6	20.6	17.9	13.3	11.0

Investment Rationale

Heritage Food is an integrated B2C dairy player with strong presence in the southern market. It is a leading private dairy player in A.P & Telangana with best RoCE in the listed private dairy space. With divestment of its loss making retail business, increasing focus towards value added dairy products along with increasing procurement and distribution reach, it is expected to post 20% and 30% CAGR in EBITDA and earnings from FY16-20E.

Divestment of Retail to enhance focus in Dairy. Retail was a loss making business, divestment to be margin and earnings accretive

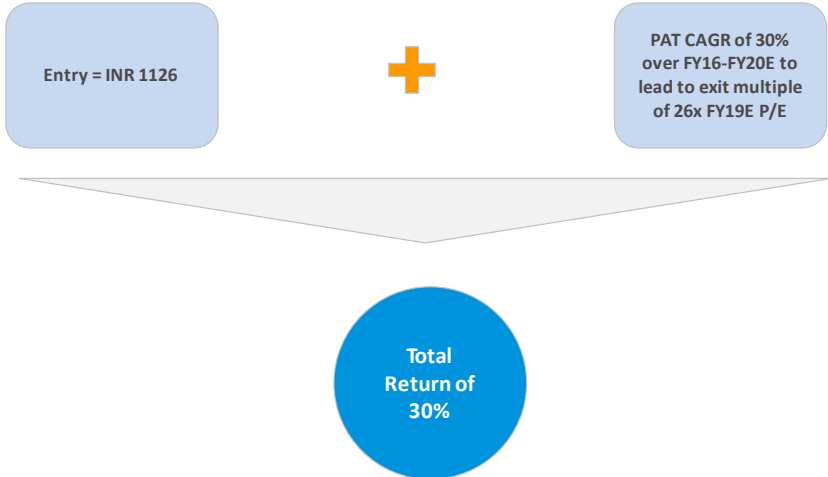
Increasing focus on expanding the reach and portfolio of value added products to aid in revenue growth and margin expansion

Increasing the procurement & distribution ecosystem via deepening and widening the reach through organic and inorganic ways- Acquisition of Reliance Dairy is a step in direction

	FY16	FY17E	FY18E	FY19E
Revenue	2,381	2,660	2,189	2,530
EBITDA	131	149	188	222
EBITDA Margin	5.5	5.6	8.6	8.8
PAT	56	70	110	131

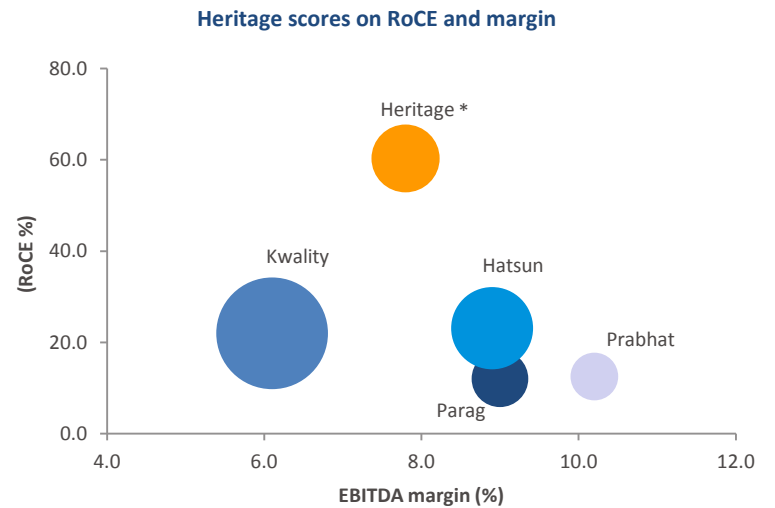
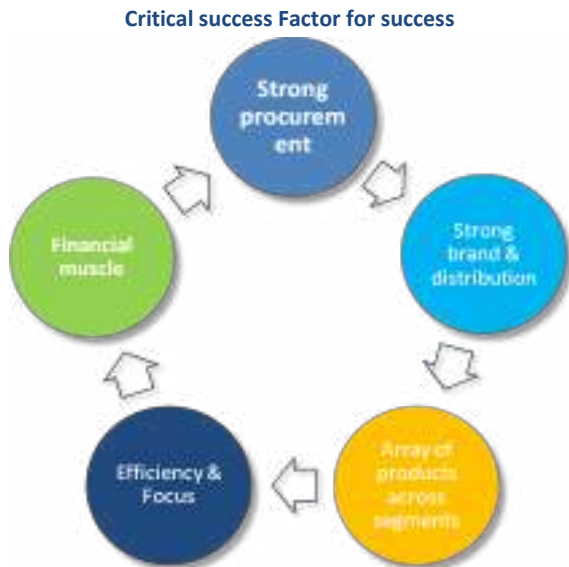
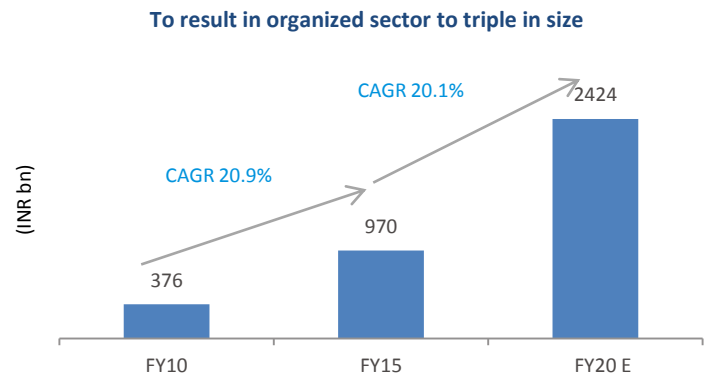
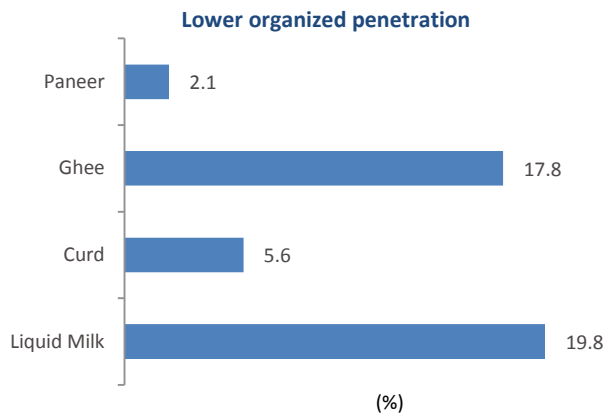
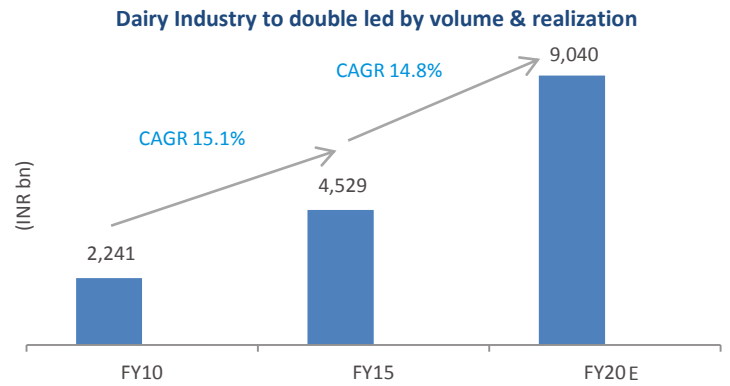
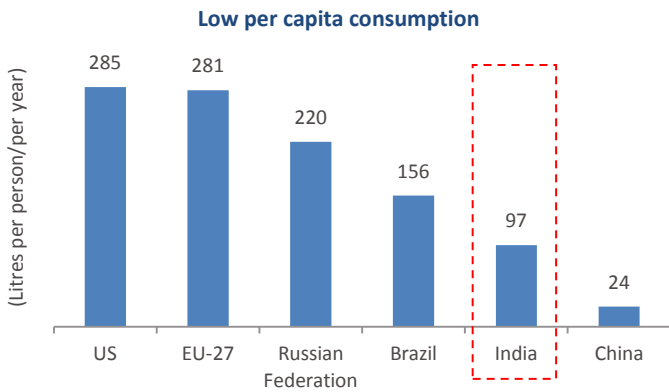
	FY16	FY17E	FY18E	FY19E
RoACE % (ex Retail)	25.6	31.8	52.4	32.9
Debt to Equity (x)	0.5	0.2	0.1	0.1

	Multiple	Price Target
Heritage	26x P/E	1465
	28x P/E	1578



Source: Company, Edel Invest Research

Focus Charts

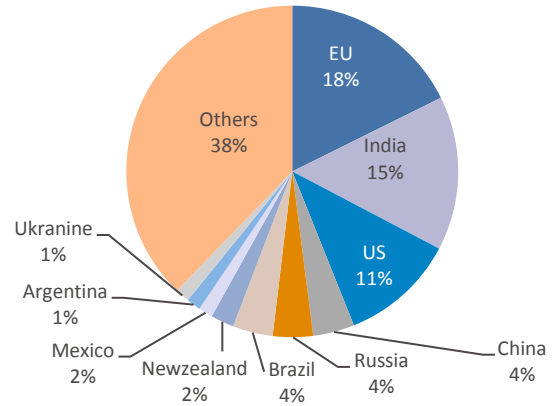
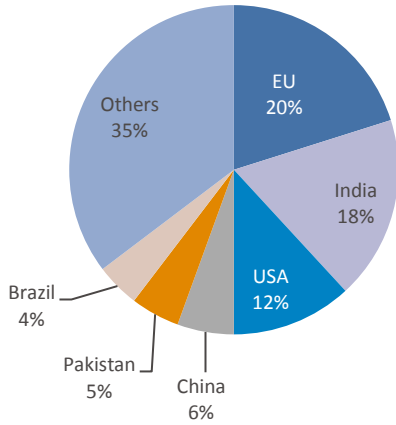


* Heritage's ROCE are only dairy segments ROCE

Source: Industry, Edel Invest Research.

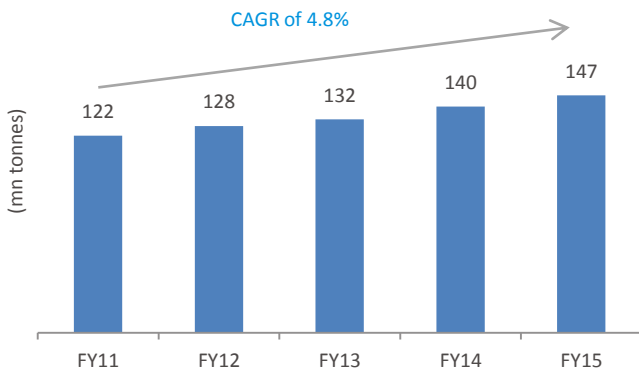
Dairy Industry- The Macro picture; Globally, India being the 2nd largest producer & consumer

Global production & consumption

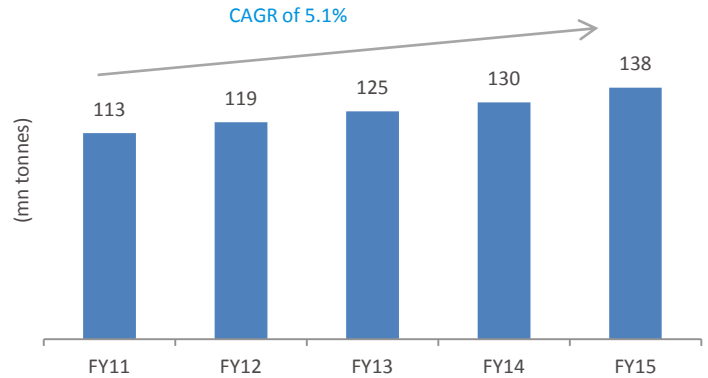


Source: Industry, Edel Invest Research

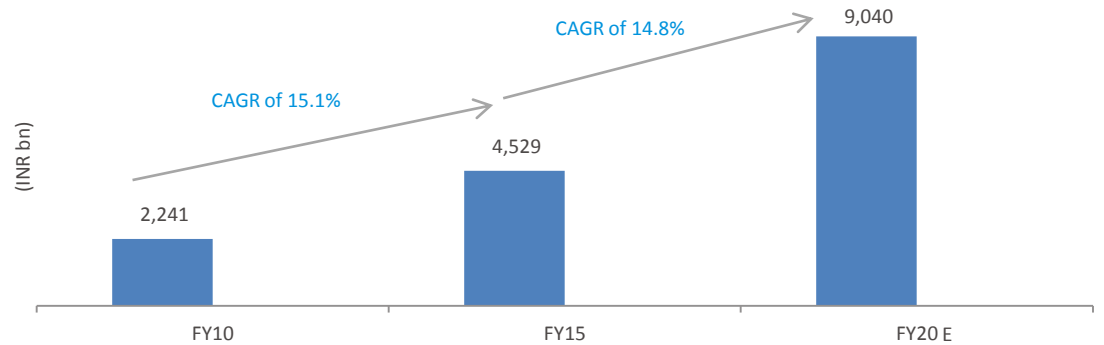
India Production



India Consumption



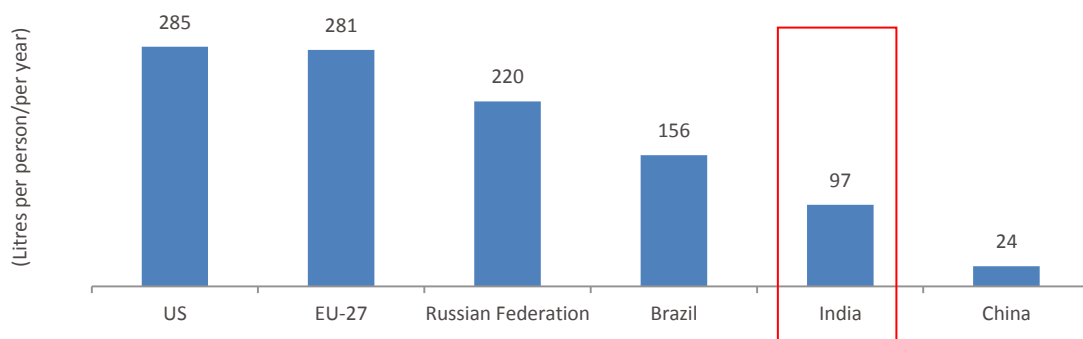
The Indian dairy industry has posted CAGR of 15.1% over FY10-15—from INR 2.2lac crore to INR 4.5 lakh cr



Source: Industry, Edel Invest Research.

The Indian Organized Dairy market – Opportunites galore

Despite robust spurt and 15% global consumption share, India’s per capita dairy consumption is way lower, offering humungous scope for structural growth.

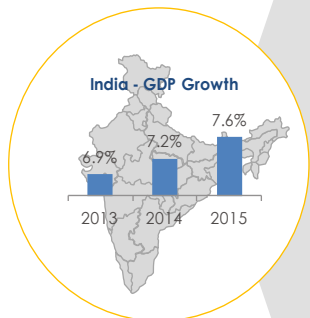


Source: Industry, Edel Invest Research.

Thus, the overall industry is estimated to post 19.1% CAGR over FY15-20 to INR 9 lac crore underpinned by volume (5-6%) and realisation (of 11-12%) spurt.

Led by improving demographics, increasing urbanization, change in the dietary patterns within milk and shift towards packaged food, the organized dairy is expected to catapulated almost 2.5x from a INR 97,000 crore to over INR 2,40,000 crore, providing humngous opportunity for the players to benefit from.

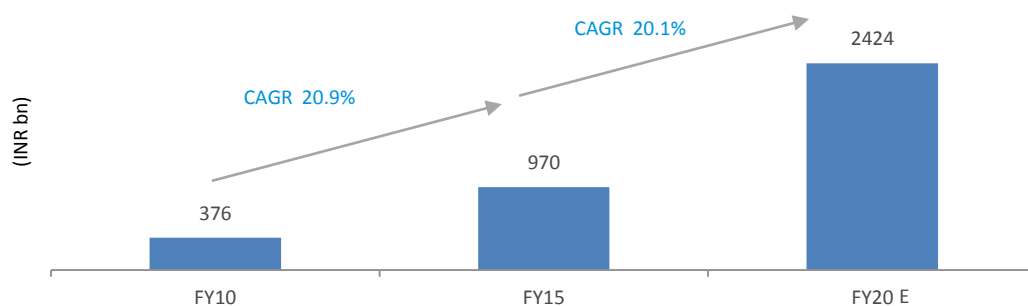
Indian Dairy Indstry- Opportunity galore; Organized dairy players to grow strong



Riding middle class population & income levels	<ul style="list-style-type: none"> • Middle class houdeholds to grow from 255 million in 2015 to 586 million in 2025 at a CAGR of 8.7% • Rising income & disposable income to drive consumption of milk & dairy products
Urbanisation	<ul style="list-style-type: none"> • Urban population expected to increase from 3.2% in 2011 to 34.5% in 2021 • Preference for clean, hygienic & ready-to-eat milk & dairy products to boost organised dairy industry
Changing Dietary patterns with focus on milk	<ul style="list-style-type: none"> • Milk being important source of vital nutrients especially for vegetarians, consumers are shifting away from cereals to milk & dairy products • 31% Indian population is vegetarian, ensuring continuous demand for milk & dairy products
Shifted to packaged food to drive organised market	<ul style="list-style-type: none"> • Increasing quality & safety concerns increasing demand for packaged food, in particular pasteurised packaged milk • Organised dairy market to grow at 19.5% CAGR over 2015-20 • Organised market share to also increase to 26%, in value terms, by 2020

In the organised pie, growth is envisaged to be broad based, with value-added segments headlining robust surge, penetration of which is still in single digits. Also, there are certain westernized categories like cheese, Whey protein, Yoghurt, Flavoured milk etc which were not present in the Indian cuisines are finding flavour in the youth's food segment and thus are expected to grow strong at 25-30% CAGR over the next three years time frame.

Indian Organized Dairy market to grow 2.5x the current levels



Source: Industry, Edel Invest Research.

Indian Dairy market to double in revenue in next three years time frame

(INR bn)	Industry Size			CAGR%		Penetration level (%)
	2010	2015	2020	2010-15	2015-20	
Liquid Milk	1501	3022	6,068	15	15	19.8
Curd	164	288	493	11.9	11.4	5.6
Ghee	345	708	1,367	15.5	14.1	17.8
Paneer	164	337	654	15.5	14.2	2.1
UHT Milk	10	33	104	27	25.8	100
Cheese	5	15	59	24.6	31.5	100
Flavoured Milk	5	16	48	26.2	24.6	100
Skimmed Milk Powder	28	57	113	15.3	14.7	100
Flavoured & frozen Yoghurt	1	3	12	24.6	32	100
Lassi	5	15	39	24.6	21.1	100
Whey		3,009	10		26.4	100
	2,241	4,529	9,040	15.1	14.8	20

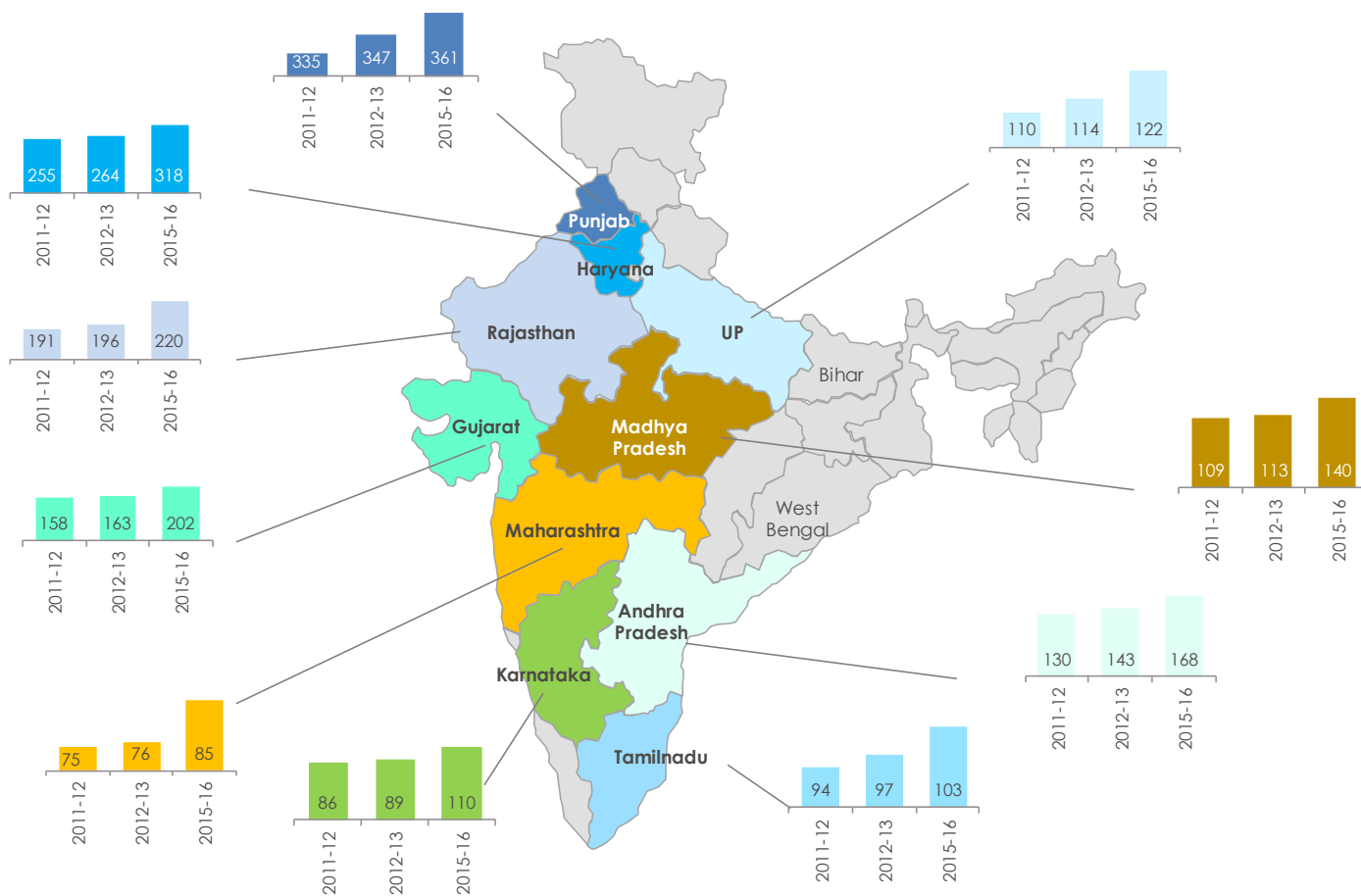
Source: Company, Edel Invest Research

The Indian organized dairy market to grow faster over 2.5x

ORGANIZED MARKET	Industry Size			CAGR%	
	2010	2015	2020	2010-15	2015-20
Liquid Milk	242	629	1593	21.1	20.4
Curd	6	14	35	18.5	20.1
Ghee	54	130	289	19.2	17.3
Paneer	3	14	23	36.1	10.4
UHT Milk	10	33	104	27	25.8
Cheese	5	15	59	24.6	31.5
Flavoured Milk	5	16	48	26.2	24.6
Butter Milk	6	17	43	23.2	20.4
Skimmed Milk Powder	28	57	113	15.3	14.7
Cream	7	15	30	16.5	14.9
Flavoured & frozen Yoghurt	5	15	48	24.6	26.2
Lassi	5	15	39	24.6	21.1
Overall	376	970	2424	20.9	20.1

Source: Company, Edel Invest Research

India's Map on key production and consumption states



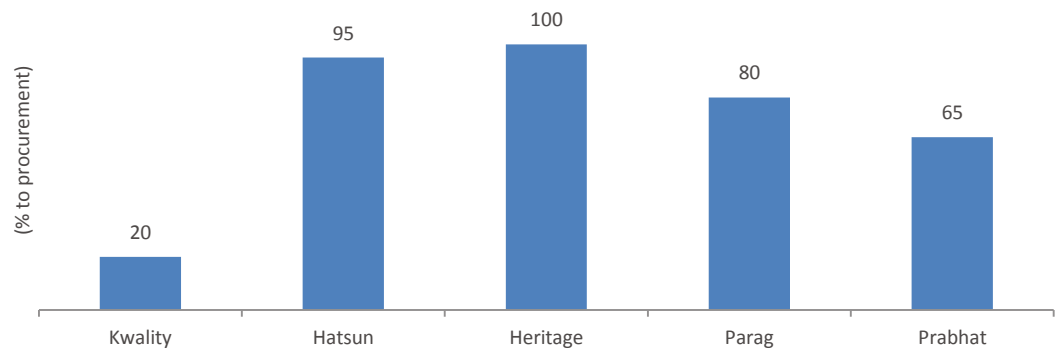
I. Focused B2C dairy player with robust procurement and distribution reach

Critical elements for success in the dairy segment are: (a) stable & consistent source of key raw material—milk—as it determines the end product quality, consistency and thereby brand credibility; and (b) robust distribution presence in the retail market. Heritage scores high on both these counts.

(A) Strong direct procurement reach

Heritage procures 100% of its milk requirement through the direct mode, whereby farmers sell milk directly to the company via Village Collection Centres (VLCC). This is a vital element as the scattered nature of producers i.e., farmers, along with competition from co-operatives, takes the maximum time and effort to build a credible ecosystem. Region-wise, co-operatives are well entrenched and also a few state governments provide subsidies to farmers, thereby distorting the procurement equation for private players. Despite these challenges, Heritage has commendably expanded its procurement base from mere 2 states a decade ago to 8 currently. **Among private dairy players, the company stands tall in terms of procurement, as it sources 100% of its requirement directly from farmers.**

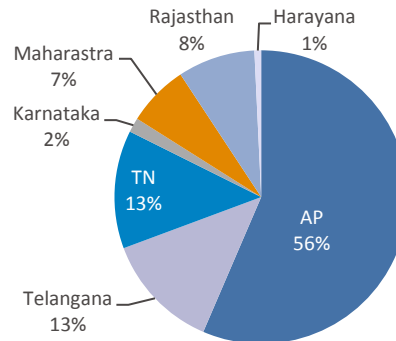
Direct procurement- Heritage scores high



Source: Industry, Edel Invest Research.

Heritage’s daily procurement has jumped from 8.5lac litres/ day in FY13 to ~10.5lakh litres/ day in FY17, CAGR of 6.5%. This was led by a mix of rising share from current regions along with deepening reach in new geographies and regions. Currently, of the total procurement, while 56.5% comes from Andhra Pradesh, second in league are Telangana and Tamil Nadu—contribute ~13% each. The company entered Maharashtra, Orissa and Harayana in FY12-13; these markets currently contribute ~10-11% to the procurement mix.

Heritage—Procurement break up (procures between 10.0 and 10.5lac litres daily)



Source: Industry, Edel Invest Research.

In its home market of Andhra Pradesh and Telangana, despite being in pole position in terms of procurement, Heritage has garnered less than 2% of the procurement pie. This presents huge opportunity to harness its existing reach to expand procurement.

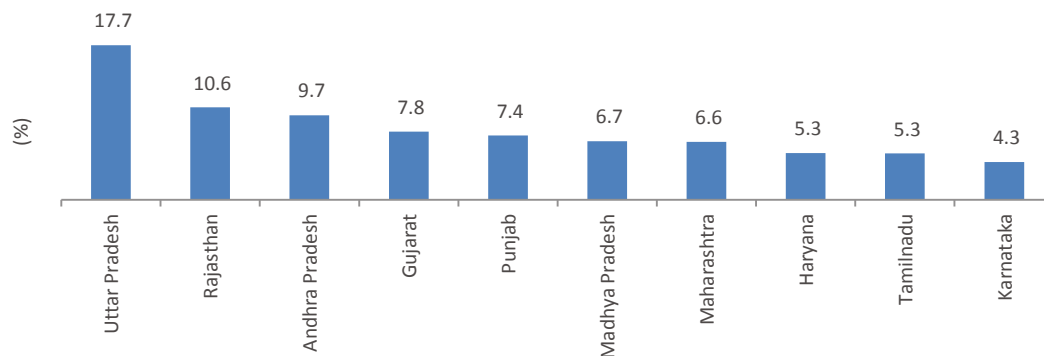
Procurement in key markets vis-a-vis potential—Humungous opportunity

	Overall market size (Lakh litres)	Heritage procurement	Procurement share (%)
Andhra	264	5.5	2.1%
Telanagana	115	1.6	1.4%
Tamil Nadu	195	1.3	0.7%
Karnataka	167	0.5	0.3%
Maharashtra	168	1.6	1.0%
Key Markets	909	10.5	1.2%

Focus on Tamil Nadu & Maharashtra to boost growth

Tamil Nadu and Maharashtra are high milk producing states, constituting around 12% of overall milk production. Heritage's presence in these markets is low currently. Thus, the company's endeavour going forward is to increase procurement from these regions.

Top 10 milk producing states in India contribute 80% to total production



Source: Industry, Edel Invest Research.

Milk being a perishable product, its freshness plays an important role in maintaining quality and taste. Hence, a robust procurement system entailing direct connect with farmers proves to be a moat for the business and brand. In this context, Heritage is expanding its procurement presence across key milk producing areas. Moreover, procurement and distribution distance should be minimal for the economies of profitability to play out for milk as: (a) 85% is water and hence transportation entails freight cost; and (b) freshness deteriorates with passage of time, thus entailing high cost in storing milk via refrigeration. Thus, for a player envisioning to be a pan-India player, it is vital to enhance procurement presence in key milk producing markets.

Reliance Dairy acquisition: Gives foothold in virgin sourcing regions, bolsters presence in weak markets

Heritage acquired Reliance Retail's (Reliance) dairy business in a slump sale in September 2017 (The final formalities are yet to be done, and is expected to get complete in next 4 weeks). Reliance operates a pan-India dairy procurement, processing and distribution platform under 2 brands *Dairy Life* and *Dairy Pure* with a wide variety of products—packaged & flavoured milk, butter, ghee, curd, dairy whitener, sweets and skimmed milk powder. It currently procures 2.25lac liters of milk per day from 2,400 villages across 10 states. It generated INR550 cr revenue in FY16. We believe, this acquisition augurs well for Heritage as it opens up new opportunities in Punjab, Uttarakhand and Rajasthan, where the company is not present, and offers strong synergies in markets like Mumbai and Delhi-NCR, wherein its presence is not strong.

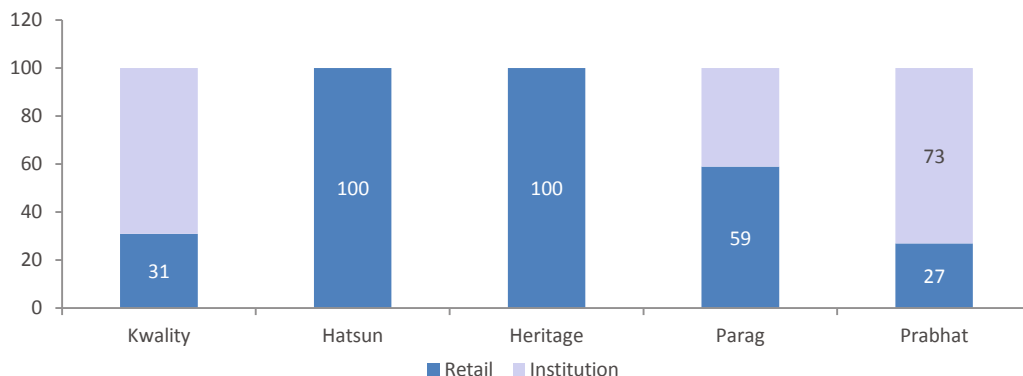
Milk procurement capacity estimated to jump 2x over next 5 years

We anticipate Heritage’s milk procurement to almost double from ~1.1mt/ day currently to around 2mt/ day over the next 5 years. The spurt will be spearheaded by: (a) **inorganic expansion**: acquisition of Reliance’s dairy business, which has direct procurement and processing capacity of 2.25lac litres spread across 10 states; (b) **entry in new markets**: It has entered Maharashtra, Delhi and Haryana to enhance procurement & distribution; and (c) **burgeoning milk procurement per collection centre** in its leadership regions of Andhra and Telangana.

(B) Deepening distribution reach entrenches brand

Along with procurement, another vital cog in the success of a dairy player is the reach of its products and the pull that the company’s brand enjoys. This brand building and distribution reach aids a company introduce other value-added products, wherein margins are 1.8-3.0x higher than the liquid pouch milk segment. Heritage sells pouch milk under the *Heritage* brand. Retailing milk under its own brand has enabled the company enjoy strong brand recall and create a pull from the customers’ end. *Heritage* is the leading dairy brand in Andhra Pradesh & Telangana, with substantial shares in other southern states as well. 84% of the company’s distribution is directly via own agents/parlours.

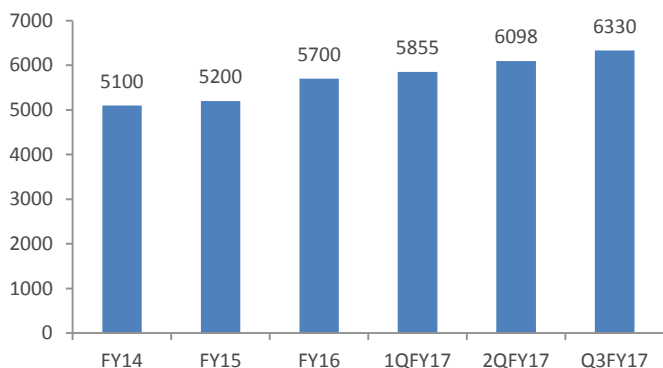
Heritage products are sold 100% through retail (B2C) enabling higher brand recall



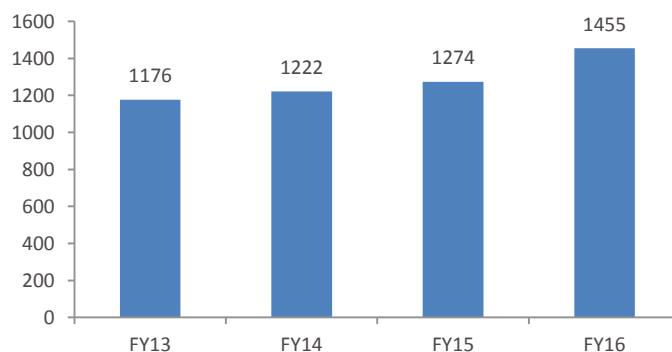
Source: Industry, Edel Invest Research.

Robust distribution mix—Over 6,000 distributors and 1,445 Heritage Parlours

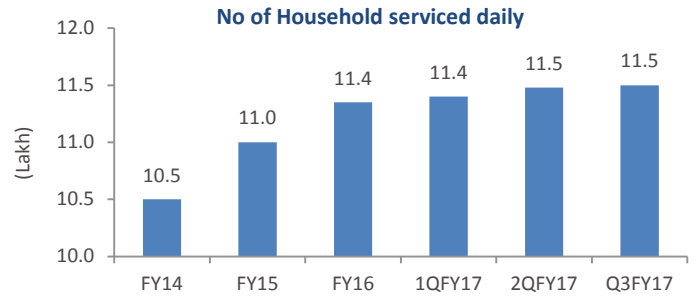
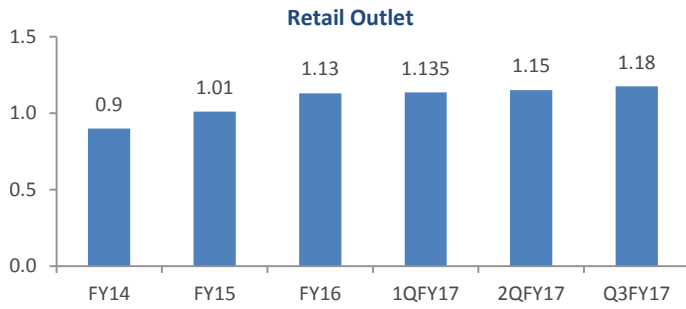
No of distributors/agents



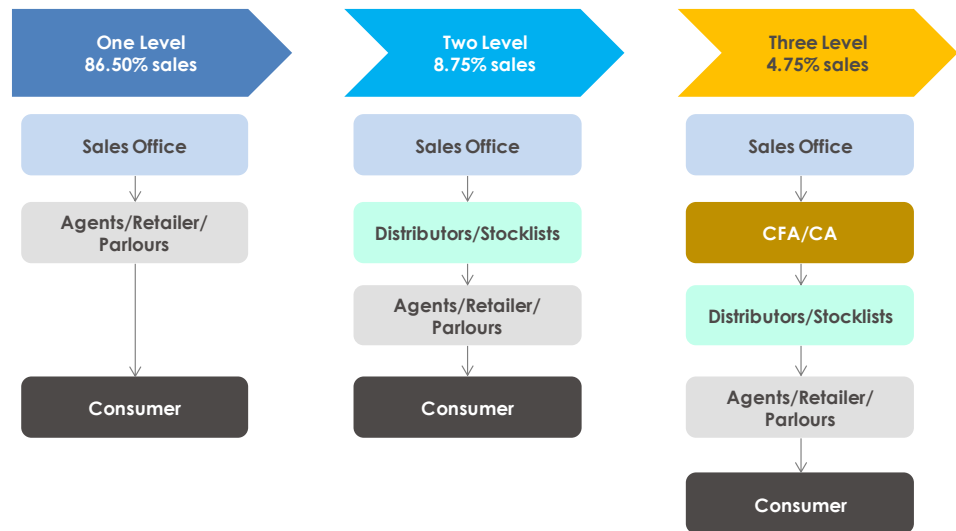
Franchisee operated Heritage parlours



Source: Industry, Edel Invest Research.



Distribution Mix



- No of sales offices: 31
- No of distributors/Agents: 6330
- No of Outlets: 117500
- No of Households serviced on daily basis: 1150000
- No of vehicles (trucks/tankers/puff vehicles) servicing Heritage everyday: 1723

Product range

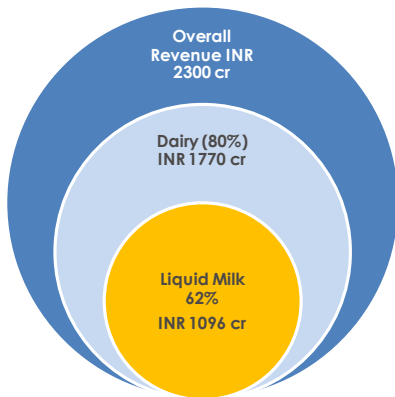


II. Prudent combination of milk and high-margin value-added products to drive earnings spurt

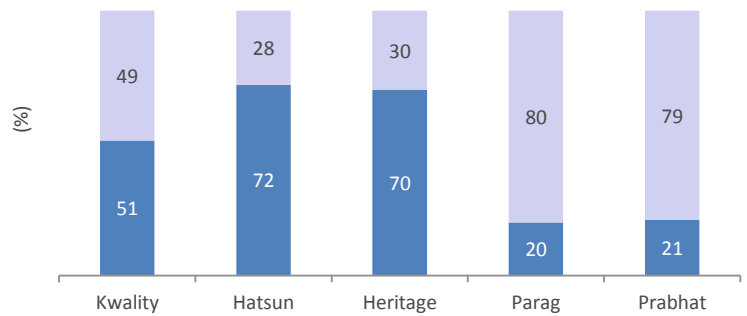
In the Dairy business, for Heritage 62% comes from Milk while rest 34% is nonmilk segment that includes value added products (Curd, Ice cream and Butter Milk), and Fat (Ghee, Butter)

By virtue of procurement as well as distribution presence in key geographical segments served and proximity to processing plants (14 plants spread across procurement and distribution regions), Heritage’s asset turn for milk is high, while working capital requirement is low, resulting in the segment clocking superior RoCE.

Liquid Milk is 62% to revenue

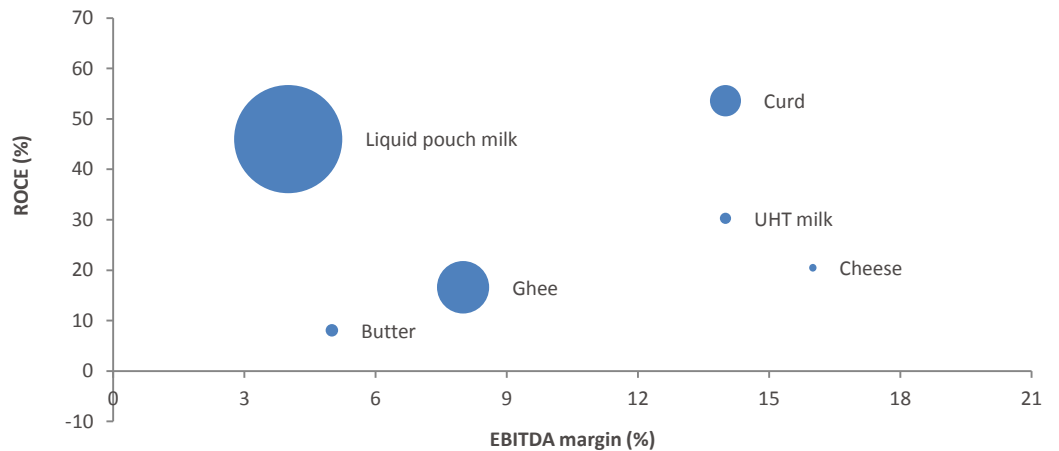


Pouch Milk share amongst higher side for Heritage



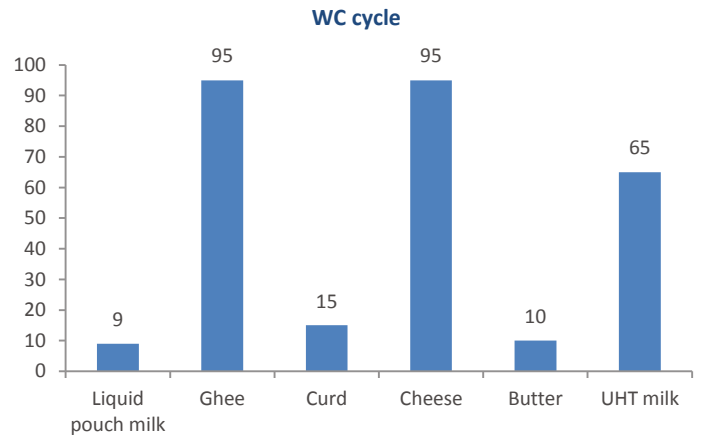
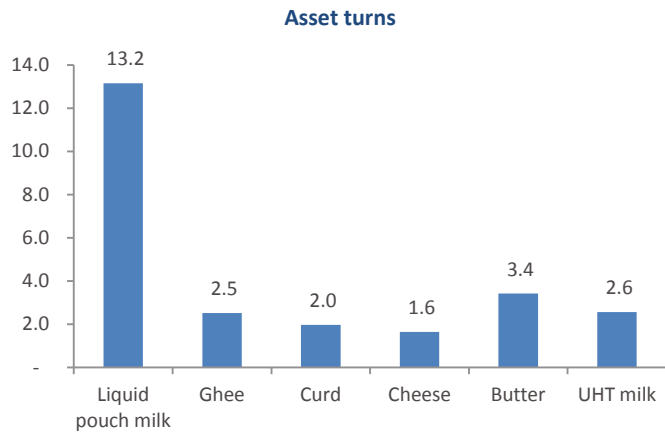
Source: Industry, Edel Invest Research.

EBITDA margin and returns profiling for dairy products; Milk scores on RoCE



Source: Industry, Edel Invest Research.

The asset turn in liquid milk category is huge (12-14x range). This, coupled with high fixed asset turn, leads to B2C category’s working capital cycle of around 8-10 days, which yields robust RoCE.

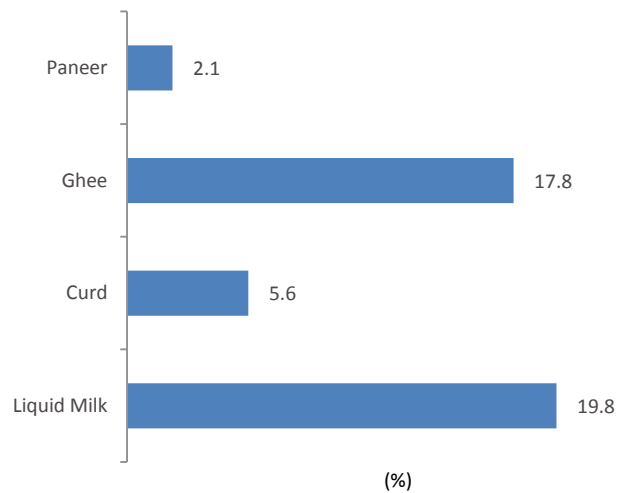
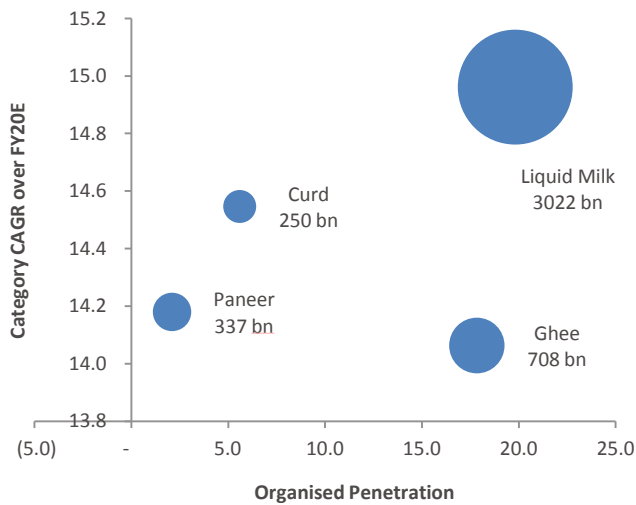


Source: Industry, Edel Invest Research.

The pouch liquid milk business, despite entailing robust RoCE, is not highly scalable and hinges on enhancing procurement reach, which takes time to develop. Hence, in order to succeed, it is imperative for a player to leverage its procurement and brand image to extend into other value-added dairy categories. Further, organised penetration in value-added categories is still lower than in liquid milk, with many categories in low-single digit. Led by rising income levels, increasing urbanization, improving dietary habits, the Organised value-added categories are estimated to post 25% CAGR over the next 3 years

Heritage presciently entered the value-added category in 2006 with the launch of curd and ice cream under the *Heritage* brand.

Low penetration in value-added categories provides huge growth opportunity; focusing on curd



Source: Industry, Edel Invest Research.

On the segment front, while curd is the third largest category at INR2,50,000 cr, penetration stands at a paltry 5.6%. Sensing opportunity in this segment and by virtue of traditional high consumption in its key southern market, Heritage identified this category and entered it in FY07. Within a span of 9 years, the company has made strong inroads therein—registered CAGR of 44% over FY08-16. Its share in the overall dairy segment has jumped to 21.6% in FY16 from 10.4% in FY11. 80% of Heritage’s value-added products comes from curd.

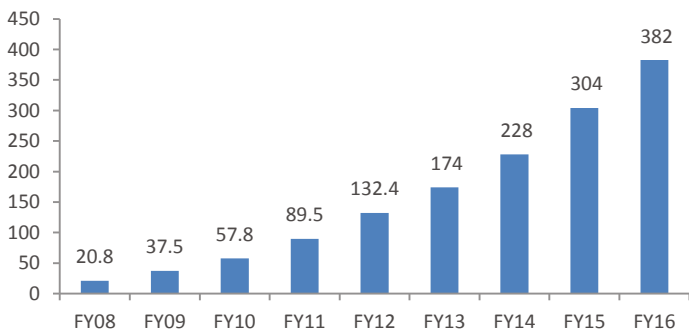
Smartly straddling high-returns pouch milk segment and high-growth & margin accretive curd and yogurt segment

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 FY20 and to this end Heritage is deepening reach in the category via introduction of new varieties of curd and ice cream. Along with organic growth potential, the company 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. We believe, Heritage 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—1.7-2.0x liquid milk—but do not involve high working capital and hence returns are much better.

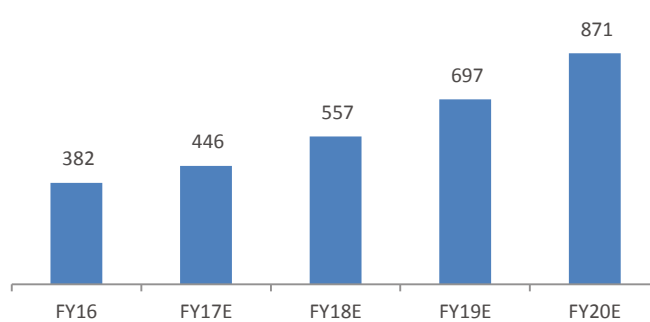
With a plethora of players entering high shelf life value-added products, the capex intensity has catapulted manifold on account of higher fixed capex as well as enhanced working capital requirement.

We believe, the Reliance acquisition augurs well for Heritage as it offers the latter new opportunities in virgin states like Punjab, Uttarakhand and Rajasthan, and strong synergies in markets like Mumbai and Delhi-NCR, where Heritage’s presence is not strong.

Value added grown at a CAGR of 44% over FY08-16

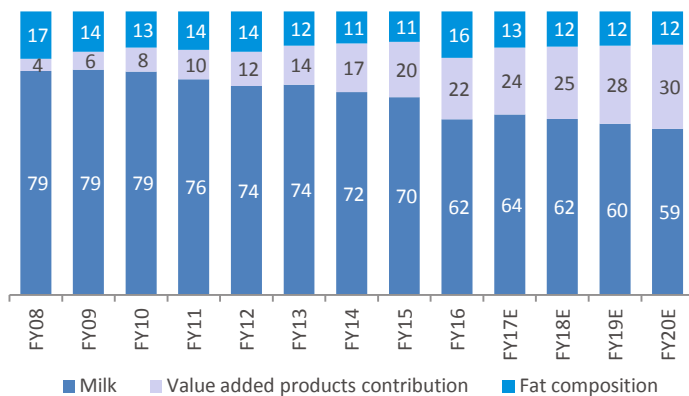


Value added likely to grow at a CAGR 23% over FY16-20E

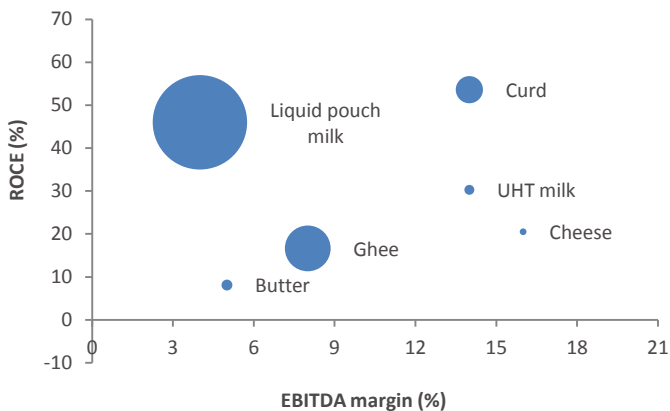


Source: Industry, Edel Invest Research.

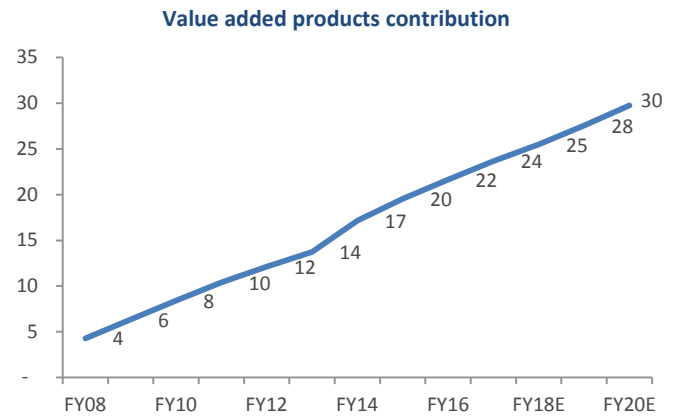
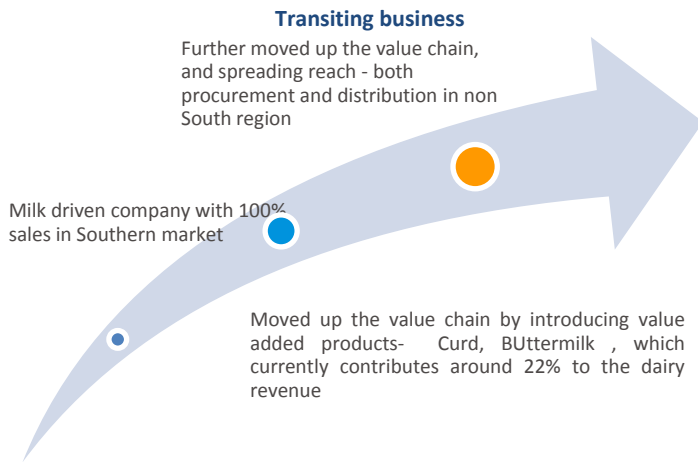
Increasing mix of value added products



Value added margins 1.7-2x milk margins



Source: Industry, Edel Invest Research.



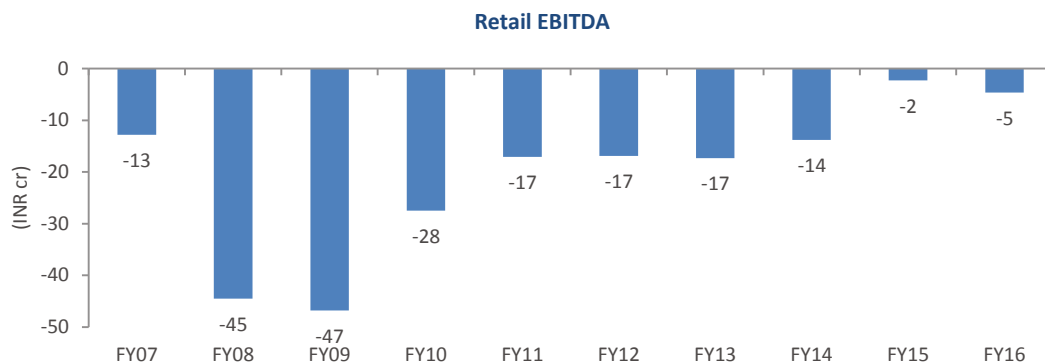
Source: Industry, Edel Invest Research.

Burgeoning value-added products' share to spur 130bps margin expansion to 9% in FY20E

Dairy EBITDA margin is estimated to jump 130bps to 9% in FY20E from 7.8% in FY16 driven by rising share of value-added business. As the value-added portfolio earns 1.7-2.0x higher margin, its burgeoning share is envisaged to drive overall margin.

III. Sale of loss-making retail business to free up capital and management bandwidth

Heritage's retail division was loss making at the EBITDA level since inception in 2006. Over the past 10 years the business posted consolidated EBITDA loss of INR204cr and net loss of INR300cr, impacted by high rentals and surging overheads. Ergo, the retail business was a drag on Heritage's overall EBITDA and net level. However, now that the company has sold its retail business to the Future Group, the company has turned into a pure dairy play, freeing management bandwidth to sharpen focus on the same.



Source: Industry, Edel Invest Research.

The event: Heritage sells its retail, agri and bakery businesses to Future Group in an all stock deal.

The deal: Heritage has approved sale of its retail business to Future Retail in an all share deal wherein the latter will pay the consideration via issuance of 1.78cr Future Retail shares.

Step 1: Heritage's retail, agri, Vet Care and bakery divisions will be transferred to Heritage Foods Retail (HFRL), a wholly owned subsidiary. This transfer of business will take place as a going concern on slump sale basis, which values these businesses at INR135 cr (which we believe is the current capital employed in these businesses). In consideration for this business transfer, HFRL will issue INR 1.44 cr shares of HFRL to Heritage Foods @ INR96.43/ share (FY-10, Premium-86.43) and HFRL will remain Heritage's 100% subsidiary.

Step 2: HFRL will then demerge retail, agri and bakery verticals in favour of Future Retail and the latter will issue INR1.78 cr fresh equity of Future Retail to Heritage as consideration towards the deal at INR152/ share comes at INR270 crore. These freshly issued shares are understood to be subject to lock-in of 3 years from the allotment date.

Step 3: As a result of this demerger, HFRL's issued, subscribed and paid-up capital will reduce.

Deal outcome

Post deal completion, standalone Heritage (listed company) will become a pure dairy play.

Loss-making retail business (FY16 sales INR570cr and EBITDA loss INR4.3cr), agri business (FY16 sales INR38cr, EBIT loss INR3.1cr) and insignificant bakery business will be out, while Heritage will hold profitable and scalable Veterinary Care business (FY16 sales INR56.9cr, EBIT INR1.76 cr) which entails humungous growth potential. Now the earlier planned capex of INR20cr per annum on retail will be available to seed growth of the dairy business.

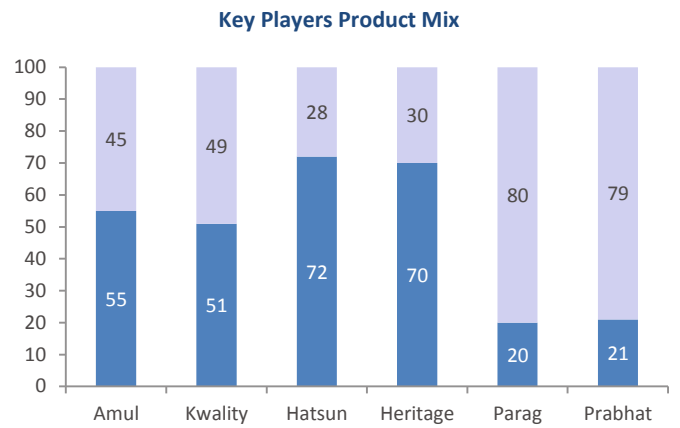
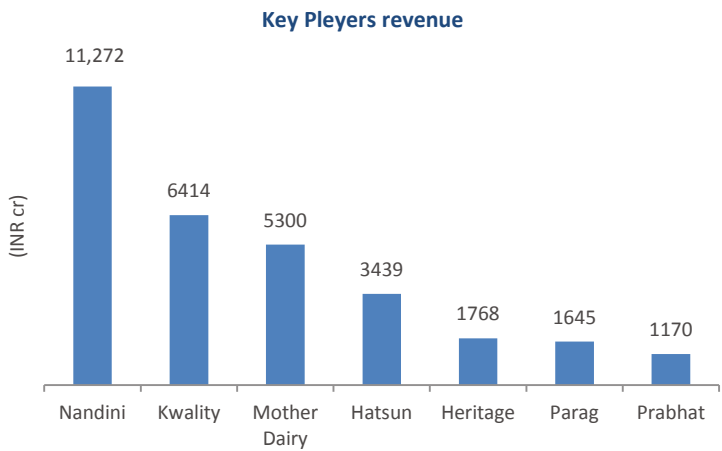
Heritage's branded dairy products will get access to Future Retail's outlets across India.

Competitive landscape

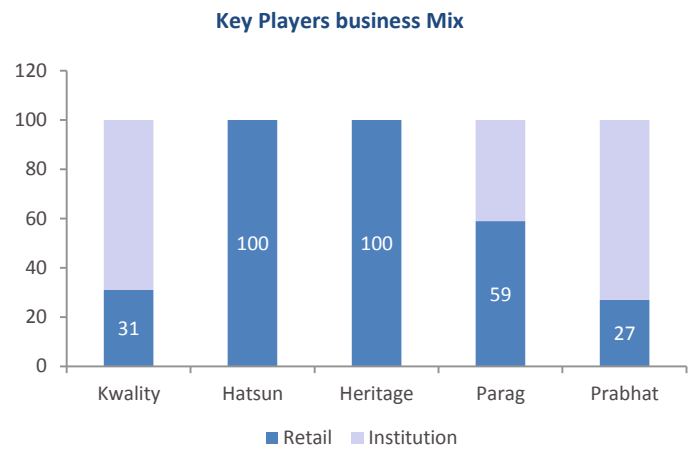
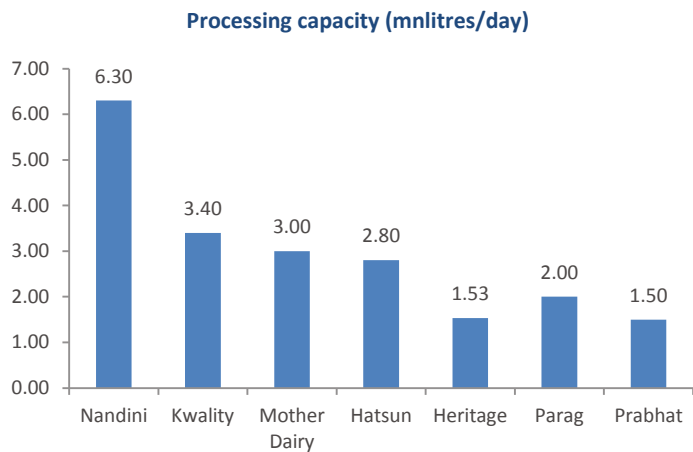
Particulars	Hatsun	Heritage*	Parag	Prabhat	Kwality
Processing capacity (Mn litres perday)	3.0	1.5	2.0	1.5	3.4
Milk Procurement	100%	100%	80%	65%	22%
Brand presence in retail market	100%	100%	70%	20%	30%
Brands	Arun Icecream Arokaya Milk Hatsun Milk	Heritage	Govardhan, Go, Top upp	Prabhat, Flava	KDIL's Kwality, Dairy Best
Markets present	In South India, largely TN	In South India largely AP, Telangana	Pan India reach largely West	Concentrated in Maharashtra	Concentrated in North
Revenue growth CAGR FY16-19E	17.7%	13%	12%	16.5%	10%
EBITDA growth CAGR FY16-19E	18.5%	17.5%	16.7%	17.3%	25%
PAT growth CAGR FY16-19E	25.6%	25%	33%	54%	35%
RoCE	17%	30%	12	12.5	22

* Heritage numbers are ex retail

Competitive landscape – FY16

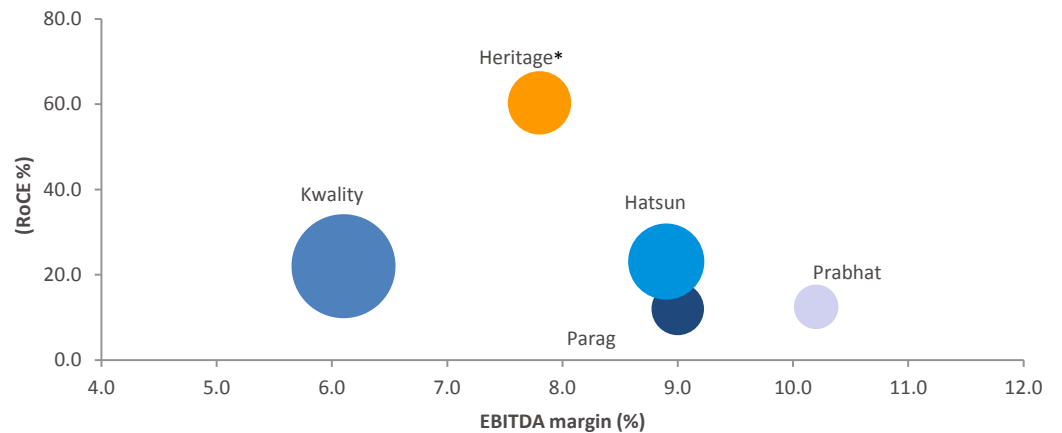


Source: Industry, Edel Invest Research.



Source: Industry, Edel Invest Research.

Heritage scores on ROCE and margin



* Heritage's ROCE are only dairy segments ROCE
Source: Industry, Edel Invest Research.

Outlook and Valuations

Amongst the listed dairy players, Heritage scores high on the key pillars of procurement and distribution with almost entire sales being branded and B2C in nature. Further owing to its high mix towards liquid milk, its working capital cycle is low resulting in it enjoying the highest RoCE (exRetail) in the sector.

We believe that with the divestment of the loss making retail, the management's bandwidth is now free to focus on the core dairy business. The company's continuous effort towards expanding its procurement reach, prudently increasing the share of medium shelf time value added products to enhance margins is likely to result in strong earnings momentum. Also these developments would lead to further improvement in its overall company level returns (ex Retail).

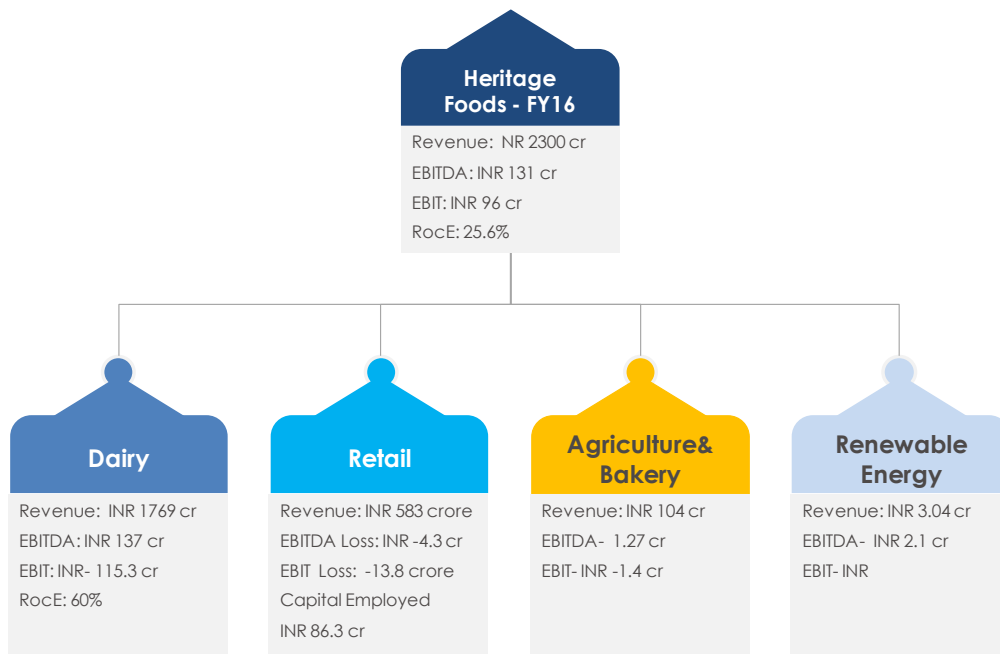
Despite, Heritage's strong presence in the high growth organized milk and milk product market, along with its transition from a pure milk play to a combination of milk and product company without sacrificing on the margins and returns, the stock is available at a reasonable valuation at a PER of 24x and 20x its FY18 and FY19E EPS of Rs 47.3 and Rs 56.4 respectively. We believe that given the strong sector tailwinds along with increasing momentum in the company, the stock is likely to trade in line with mid cap FMCG plays, and hence value it at 26x FY19E EPS to arrive at our exit level price target of INR 1460, providing 30% upside from the current levels.

Peer Comparison

	Basic Details (INR cr)				CAGR FY13-16 (%)			CAGR FY16-19E (%)			FY16 (%)	Ratios (%)		Valuations (x)				
	CMP (INR)	M-cap	Debt	Enterprise Value	Sales	EBITDA	PAT	Sales	EBITDA	PAT	EBITDA margin	RoCE	RoE	PER FY16	PER FY18E	EV/ EBITDA	Mcap/ Sales	EV/sales
Parag	271	2,270	280	2,550	21	21	31	12	17	33	9.0	12	20	48.3	25	12.7	1.4	1.6
Prabhat	108	1,430	140	1,570	22	19	18	17	17	54	10.2	13	5	58.4	25.5	10.3	1.2	1.3
Kwality	142	3,423	1400	4,823	18	21	17	12	15	29	6.1	22	27	19.7	12.3	9.3	0.5	0.8
Heritage	900	2,708	47	2,755	14	9	2	2	19	30	7.8	19	25	49.2	28.8	14.5	1.1	1.2
Hatsun	440	6,791	650	7,441	17	27	32	18	25	36	8.9	11	27	69.7	34.3	15.1	2	2.2

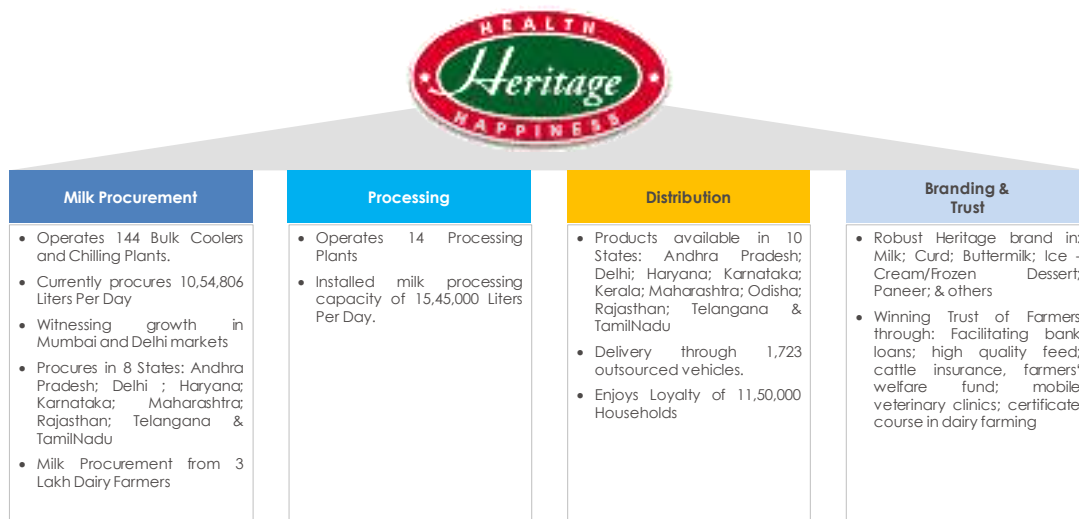
Company Description

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.

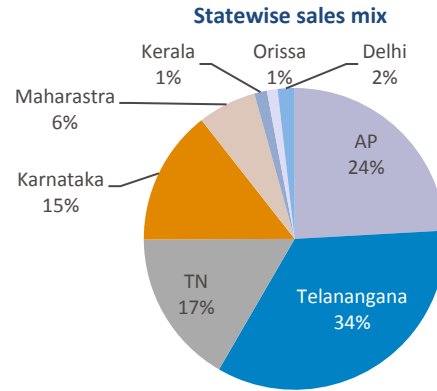
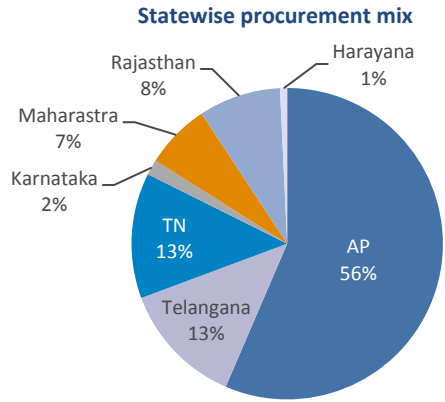


Source: Industry, Edel Invest Research.

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.



Source: Industry, Edel Invest Research.



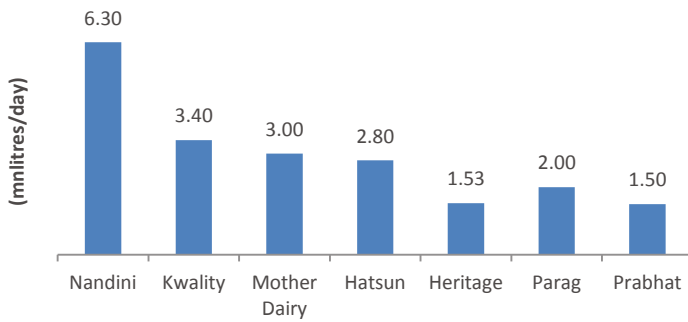
Source: Industry, Edel Invest Research.

Heritage has a daily procurement capacity of 10.5-11.0 lakh litres, of which 56.5% comes from Andhra Pradesh, while second in league are Telangana and Tamil Nadu—contribute around 13% each to the overall procurement pie.

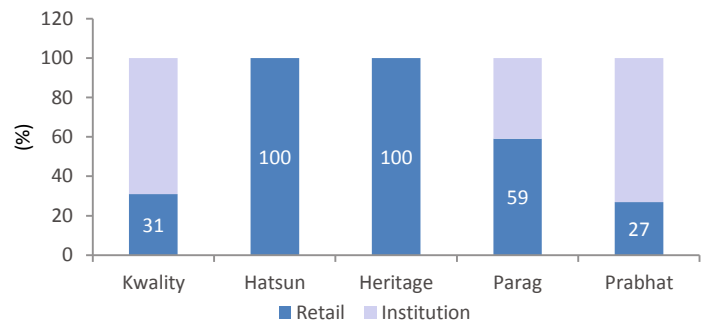
The company has a daily average sales volume of 8.5lac litres, of which the largest market is Telangana (contributes around 34% to overall revenue), followed by 24% share in Andhra Pradesh. Karnataka and Tamil Nadu contributed around 17% and 15%, respectively, to FY17 sales. New markets like Maharashtra, Delhi, Orissa and Kerala collectively contribute around 10% to overall revenue.

Reach of the company

Processing capacity

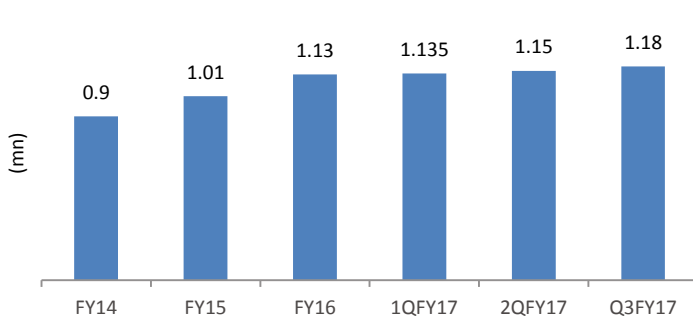


Key Players business Mix

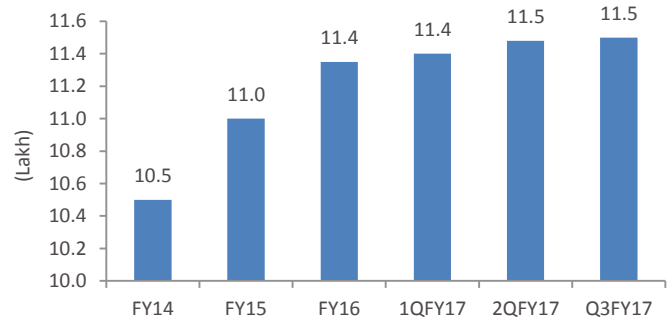


Source: Industry, Edel Invest Research.

Retail Outlet



No of Household serviced daily



Source: Industry, Edel Invest Research.

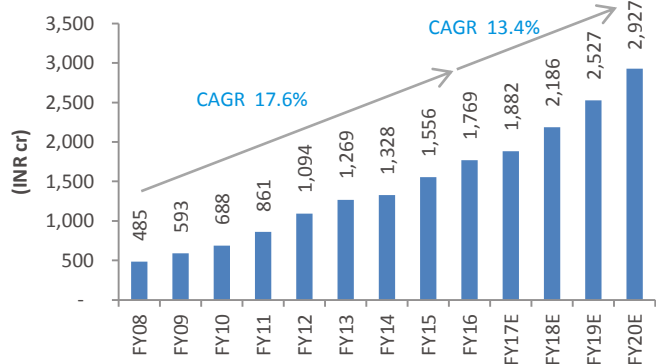
Financial Outlook

Revenue to clock 5.3% CAGR over FY16-20E; exRetail, dairy to grow at 12.6%

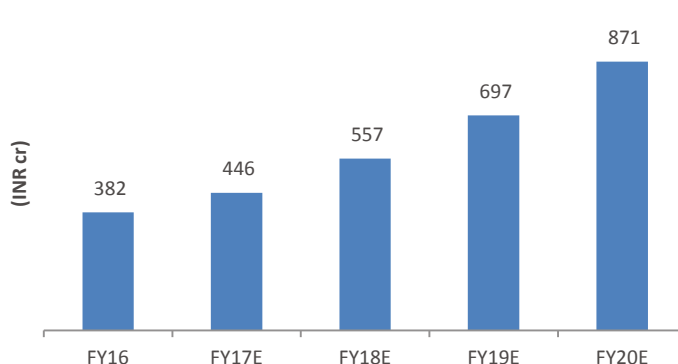
We estimate Heritage to post revenue CAGR of 2% over FY16-19E. As the company has exited the loss-making retail business, the base is impacted. Excluding the divested retail and bakery businesses, core dairy revenue is estimated to post 12.6% CAGR over FY16-19E. The growth in the dairy business is likely to be backed by (a) milk volume and value growth by penetration in the newer geographies (b) Increasing share of the value added products in the overall portfolio

Led by growing focus, introduction of new variants in the value added category, its value-added portfolio is estimated to clock 22% CAGR over FY16-19E and contribute around 30% to overall dairy revenue by FY20E.

Dairy Business Revenue



Value added likely to grow at a CAGR of 23% over FY16-20E

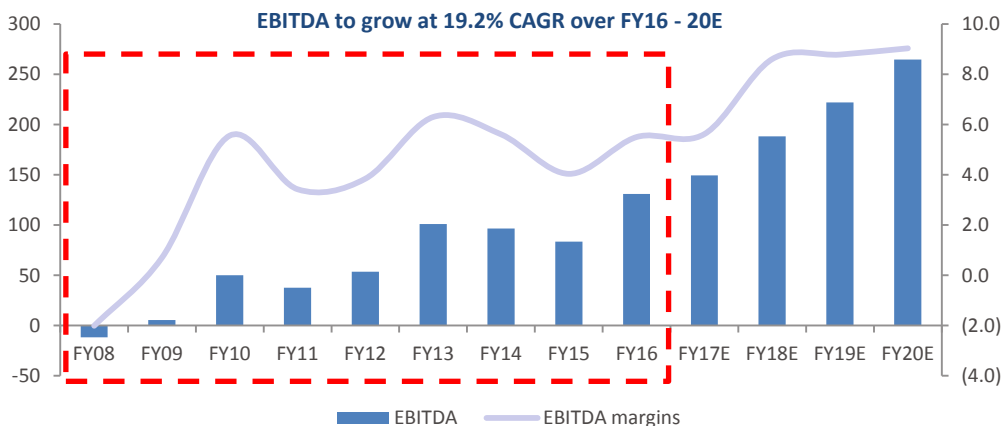


Source: Industry, Edel Invest Research.

EBITDA to post 19.2% CAGR over FY16-20E spurred by rising contribution of value-added products

Driven by healthy spurt in the dairy vertical underpinned by high double digit growth in the value-added portfolio, the latter's contribution will jump to around 30% by FY20E from 22% currently. Over FY16-20E, while we estimate the dairy vertical's EBITDA to post 17.8% CAGR, overall EBITDA is expected to clock 19% CAGR spurred by divestment of the loss-making retail business. Heritage's margin is estimated to catapult 350bps to 9% in FY20E from 5.5% in FY16 (suppressed by loss making retail). We forecast dairy's EBITDA margin to expand 130bps to 9.0% in FY20E from 7.8% in FY16 driven by value-added business. As the value-added portfolio entails 1.7-2.0x higher margin, its rising revenue proportion is bound to spur margin.

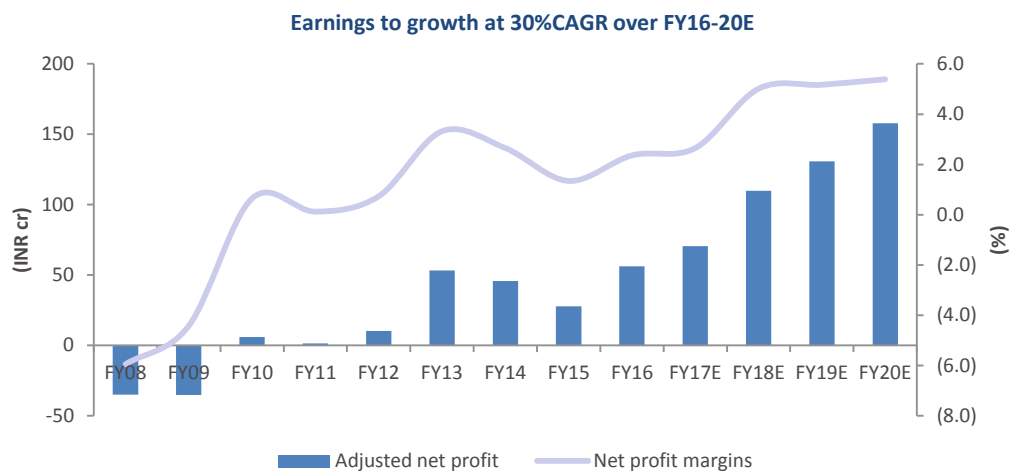
EBITDA to grow at 19.2% CAGR over FY16 - 20E



Source: Industry, Edel Invest Research.

Earnings to register healthy 30% CAGR over FY16-20E

With healthy surge in the base dairy business, improving profitability and divestment of the loss-making retail business, we estimate Heritage to post robust 30% earnings CAGR over FY16-20E.



Source: Industry, Edel Invest Research.

Shortest working capital cycle, owing to exposure in fresh segment

Year to March	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E	FY20E
Debtors (days)	5	5	3	3	4	4	4	4	5	5	5
Inventory (days)	31	22	24	19	23	25	22	22	15	15	15
Payable (days)	32	26	28	24	27	23	24	24	10	10	10
Cash conversion cycle (days)	4	1	(1)	(2)	(0)	6	2	2	10	10	10

Board of Directors

Mr. Seetharamaiah Devineni Chairperson, -Commerce graduate from Andhra University and a fellow member of the Institute of Chartered Accountants of India. Senior partner of Brahmayya & Co., a leading Chartered Accountancy firm and has been practicing for the last five decades. Has held various coveted posts, which include Membership of the Southern Regional Board of Reserve Bank of India, and Federation of Andhra Pradesh Chamber of Commerce and Industry, Chairpersonship of the Tirumala Tirupati Devasthanams Trust Board and Trusteeship of the NTR Memorial Trust. Is also on the Board of several other companies

Mr. Srivishnu Raju Nandyala Director, - Holds a bachelors degree in Chemical Engineering from Osmania University, Andhra Pradesh. Founder Chairperson and CEO of EXCIGA group, which consists of five non banking finance companies. Founder and Past President of Entrepreneurs Organization, Hyderabad. Past President of CII's (Confederation of Indian Industries) Young Indians, Hyderabad Chapter and a past member on the state council of CII. Is a Director in several Public and Private Companies

Mr. Rajesh Thakur Ahuja Director -Graduate in Production Engineering from Pune University Engineering College. Started Silver line Wire Products in 1993 as a manufacturer of plastic coated wire products for household applications. In 1998, started marketing under the brand name of Sleek. Presently he is Managing Director at M/s. Sleek International Private Limited, which is a subsidiary company of M/s. Asian Paints Limited, Mumbai. Currently pursuing Owner President Management Programme at Harvard University, USA.

Dr. Nagaraja Naidu Vadlamudi Director, -M. Com, M. Litt and a PhD. (Financial Management), Began his career from the Administrative Staff College of India, Hyderabad in 1972. Has held various positions in reputed Universities, like Professor, Dean, Director etc., and has taught in the fields of Finance and Business Economics at Post Graduate and Doctorate levels for about 25 years. Has been the Registrar (Administrative Head) of the Dr B R Ambedkar Open University for about 10 years. Has been associated with the company since it's inception and has been able to utilize his intimate understanding of the rural socio-economic scenario to strengthen milk procurement systems and strategies of Heritage, which has contributed to the current status of Heritage as a leading player in South India.

Mr. Lokesh Nara Director, -Master's Degree in Business Administration from Stanford University, Bachelor of Science degree in Management Information Systems from Carnegie Mellon University. Worked with the World Bank as a Junior Professional Associate where he completed various projects including an e-Governance Capacity Building program for the government of Ethiopia, and e- Governance Capacity Building program for the governments of South Sudan and Kenya. Before joining the Board of Heritage Foods, he was associated with the Company as a Vice-President.

Mrs. Bhuvaneshwari Nara Vice-Chairperson & Managing Director, B.A Graduate, Is a Director in several other Companies. Is a dynamic leader who has extensive experience in business and has been successfully steering Heritage towards growth and better prospects.

Mrs. Brahmani Nara Executive Director, Master's Degree in Business Administration from Stanford University, Bachelor of Science degree in Electrical Engineering from Santa Clara University USA and Bachelor of Engineering with specialization of Electronics and Communications from Chaitanya Bharathi Institute of Technology. Investment Associate in Vertex Venture Management Pvt Ltd between 2009-2011 in Singapore and was associated with the Company as a Vice-President (Business Development).

Key Management

Dr. M. Sambasiva Rao President-Post Graduate and Doctorate in Zoology. Served the state and central governments for about two decades as a member of the Indian Administrative Services(IAS). Dr Rao was the Joint Secretary in the Department of Commerce under the Ministry of Commerce and Industry, Government of India

Mr. CA A Prabhakara Naidu Vice President - Finance & Accounts,--Fellow Member of the Institute of Chartered Accountants of India and Graduated from Sri Venkateswara University with a University rank in Science. Has 23 years of experience in Finance and Accounts. Has been associated with the Heritage group since It's inception.

Mr. Umakanta Barik Company Secretary-Has Masters in Economics, LLB, FCS, LIII. Is a Fellow Member of the Institute of Company Secretaries of India, New Delhi and a Licentiate from Insurance Institute of India, Mumbai. Has over 14 years of experience in the domains of Secretarial, Legal, Insurance & Intellectual Property Rights.

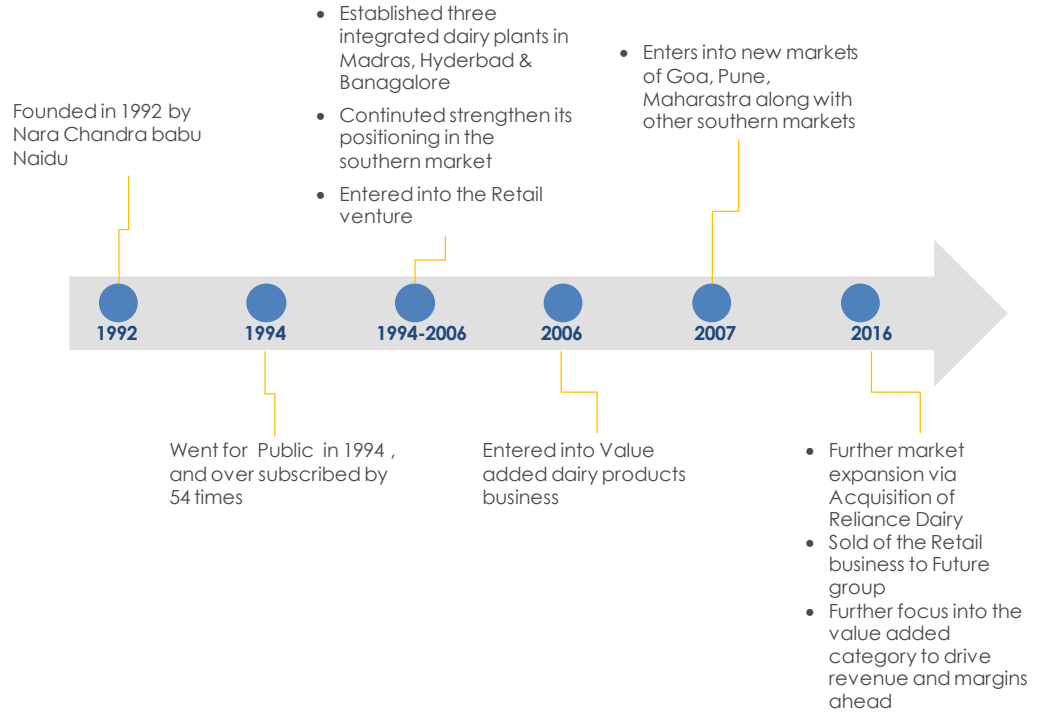
Mr. J Samba Murthy Head - Dairy Division,-Holds an MBA in Marketing and a Bachelors of Science degree. Is the Senior Vice President at Heritage and has been associated with the Company since 2007. Has worked previously in APDDCF Limited, Visakha Dairy NDDDB, and Reliance in various positions in the field of Sales & Marketing.

Mr. Dharmender K Matai Chief Operating Officer - Retail & Bakery-Has B.Com, MBA (Technology Management) from Osmania University and has around 25 years of experience with – Metro Cash & Carry India Pvt. Ltd., Reliance Retail Limited, Spencer Hyper, Foodworld Supermarkets India, Hindustan Unilever Limited and Eureka Forbes Limited. His last assignment is working as a Head - Space Management and Merchandise Management, Stationed at Bangalore

Mr. Anil Kumar Srivastava Chief Operating Officer - Agri Business Division,-Holds an MBA and a Post Graduate Diploma in Foreign Trade and also Fruit & Vegetables Technology. Has around 29 years of rich experience in different reputed Food Processing Industries

Mr. C V S Kaleshwar Rao Head - VetCa Division,-Has B.Sc, MA (Social Work) from Andhra University is the Vice President at Heritage and has been associated with the Company since 2005. Previously worked in four large Manufacturing & Processing Industries, viz. The Lanco Group, The Thapar Group and The International Paper Group.

Timeline



Key Risk

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)					(INR cr)
Year to March	FY15	FY16	FY17E	FY18E	FY19E
Income from operations	2,073	2,381	2,660	2,189	2,530
EBITDA	84	131	149	188	222
Depreciation and amortisation	34	35	39	29	32
EBIT	50	96	111	160	190
Interest expenses	18	17	7	9	9
Other income	7	7	7	7	7
Profit before tax	39	86	110	157	187
Provision for tax	11	31	40	47	56
Core profit	28	55	70	110	131
Extraordinary items	-0	1	0	0	0
Profit after tax	28	56	70	110	131
Minority Interest	0	0	0	0	0
Share from associates	0	0	0	0	0
Adjusted net profit	28	56	70	110	131
Equity shares outstanding (mn)	2	2	2	2	2
EPS (INR) basic	12.2	23.9	30.4	47.3	56.4
Diluted shares (Cr)	2.3	2.3	2.3	2.3	2.3
EPS (INR) fully diluted	12.2	23.9	30.4	47.3	56.4
Dividend per share	3.0	3.0	3.6	5.7	6.8
Dividend payout (%)	24.7	12.6	12.0	12.0	12.0

Common size metrics- as % of net revenues					(INR cr)
Year to March	FY15	FY16	FY17E	FY18E	FY19E
Operating expenses	96.0	94.5	94.4	91.4	91.2
Depreciation	1.6	1.4	1.5	1.3	1.3
Interest expenditure	0.8	0.7	0.3	0.4	0.4
EBITDA margins	4.0	5.5	5.6	8.6	8.8
Net profit margins	1.3	2.4	2.6	5.0	5.2

Growth metrics (%)					
Year to March	FY15	FY16	FY17E	FY18E	FY19E
Revenues	20.4	14.8	11.7	(17.7)	15.6
EBITDA	(13.4)	56.5	14.1	26.0	17.9
PBT	(36.1)	119.7	28.0	42.4	19.2
Net profit	(37.8)	96.5	27.1	55.8	19.2
EPS	(37.8)	96.5	27.1	55.8	19.2

Balance sheet (Standalone)					(INR cr)
As on 31st March	FY15	FY16	FY17E	FY18E	FY19E
Equity share capital	23	23	23	23	23
Preference Share Capital	0	0	0	0	0
Reserves & surplus	170	217	279	675	790
Shareholders funds	193	240	302	699	814
Secured loans	157	125	58	78	78
Unsecured loans	0	1	1	1	1
Borrowings	157	126	59	79	79
Minority interest	0	0	0	0	0
Sources of funds	350	366	361	778	893
Gross block	462	518	598	424	499
Depreciation	182	206	245	151	184
Net block	281	312	353	273	316
Capital work in progress	9	10	10	10	10
Total fixed assets	290	322	363	283	325
Unrealised profit	0	0	0	0	0
Investments	1	1	1	268	268
Inventories	139	145	160	90	104
Sundry debtors	24	29	29	30	35
Cash and equivalents	41	45	-0	184	247
Loans and advances	9	9	9	9	9
Other current assets	0	0	0	0	0
Total current assets	214	228	198	313	395
Sundry creditors and others	130	158	175	60	69
Provisions	15	16	16	16	16
Total CL & provisions	145	174	191	76	85
Net current assets	69	54	8	237	310
Net Deferred tax	-19	-19	-19	-19	-19
Misc expenditure	10	8	8	8	8
Uses of funds	350	366	361	778	893
Book value per share (INR)	83	103	130	301	351
	0	0	0	0	0

Cash flow statement					
Year to March	FY15	FY16	FY17E	FY18E	FY19E
Net profit	29	55	70	110	131
Add: Depreciation	34	35	39	29	32
Add: Misc expenses written off	1	2	0	0	0
Add: Deferred tax	-4	-0	0	0	0
Add: Others	0	0	0	0	0
Gross cash flow	60	91	109	138	163
Less: Changes in W. C.	24	-19	-1	45	9
Operating cash flow	36	110	110	93	154
Less: Capex	41	66	80	-51	75
Free cash flow	-5	44	30	144	79

Ratios

Year to March	FY15	FY16	FY17E	FY18E	FY19E
ROAE (%)	15.2	25.6	26.0	21.9	17.3
ROACE (%)	14.0	25.6	28.9	27.2	22.2
Current ratio	1.5	1.3	1.0	4.1	4.6
Debt/Equity	0.8	0.5	0.2	0.1	0.1
Debtors (days)	4	4	4	5	5
Inventory (days)	25	22	22	15	15
Payable (days)	23	24	24	10	10
Cash conversion cycle (days)	6	2	2	10	10
Debt/EBITDA	1.9	1.0	0.4	0.4	0.4
Adjusted debt/Equity	0.6	0.3	0.2	-0.2	-0.2

Valuation parameters

Year to March	FY15	FY16	FY17E	FY18E	FY19E
Diluted EPS (INR)	12.2	23.9	30.4	47.3	56.4
Y-o-Y growth (%)	(37.8)	96.5	27.1	55.8	19.2
CEPS (INR)	26.8	38.8	47.1	59.6	70.3
Diluted P/E (x)	92.7	47.2	37.1	23.8	20.0
Price/BV(x)	13.5	10.9	8.7	3.7	3.2
EV/Sales (x)	1.3	1.1	1.0	1.1	1.0
EV/EBITDA (x)	32.6	20.6	17.9	13.3	11.0
Diluted shares O/S	2.3	2.3	2.3	2.3	2.3
Basic EPS	12.2	23.9	30.4	47.3	56.4
Basic PE (x)	92.7	47.2	37.1	23.8	20.0
Dividend yield (%)	0.3	0.3	0.3	0.5	0.6

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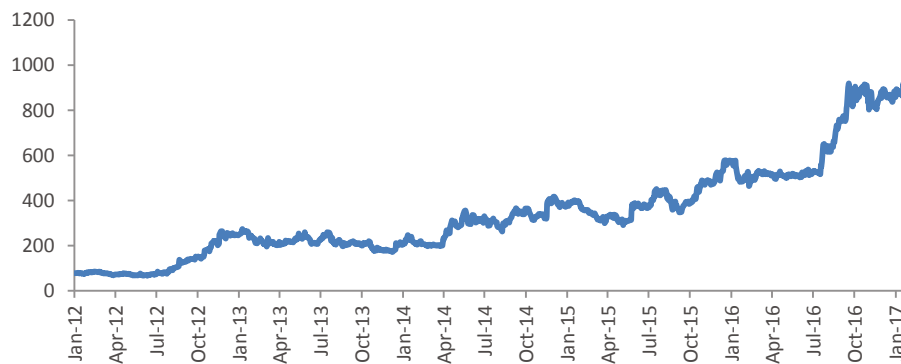
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Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period

Heritage Foods 5 years price chart



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