HERITAGE FOODS

RESULT UPDATE

KEY DATA

Rating	BUY
Sector relative	Outperformer
Price (INR)	281
12 month price target (INR)	445
Market cap (INR bn/USD bn)	13/0.2
Free float/Foreign ownership (%)	60.1/4.6

What's Changed

Target Price	–
Rating/Risk Rating	–

QUICK TAKE

	Above	In line	Below
Profit			•
Margins	•		
Revenue Growth			•
Overall	•		

Strong spreads sustain

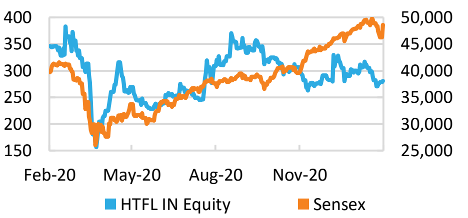
Heritage Foods (HTFL) reported another quarter of strong EBITDA (up 2.3x YoY), 20% ahead of our estimate. This was led by gross margin expansion of ~952bps YoY to 28.3% as higher spreads sustained, procurement cost declined and realisation remained high. Sales, however, decreased 10% YoY (4% below estimate) due to weather-related disruptions in primary geographies.

With the Future Retail (FRL) stake sale completed and the impact of delayed flush season yet to set in, we anticipate better days ahead, and are increasing FY21/22/23E EPS by 13/7/11%. However, as earnings are close to a cyclical high, we are moderating the multiple by 13% to 13x Jun-22E EPS; maintain 'BUY' with a TP of INR445.

FINANCIALS (INR mn)

Year to March	FY20A	FY21E	FY22E	FY23E
Revenue	27,259	25,093	27,679	30,284
EBITDA	1,293	2,605	2,683	2,985
Adjusted profit	2,096	1,399	1,519	1,742
Diluted EPS (INR)	45.2	30.2	32.7	37.6
EPS growth (%)	156.2	(33.2)	8.6	14.7
RoAE (%)	(1.2)	26.7	23.6	22.9
P/E (x)	6.2	9.3	8.6	7.5
EV/EBITDA (x)	11.6	4.7	4.4	3.5
Dividend yield (%)	0.9	2.7	3.5	4.0

PRICE PERFORMANCE



Sales under the weather; margin improvement led by spreads

Q3FY21 sales were impacted by inclement weather in October and November, and lower winter temperature in December. VADP contracted ~13% YoY (versus -28% YoY in H1FY21) as out-of-home consumption started showing signs of revival towards the end of Q3FY21. Spreads rose with procurement prices declining 5% YoY while realisations sustained at higher levels. Consequently, gross margin rose 952bps YoY (though down 80bps QoQ) while EBITDA margin improved 790bps YoY (but down 150bps QoQ) to 12.9%. Other expenses were regulated too, down 12% YoY.

Delayed flush season to improve margins further

Procurement dipped 14% YoY and 3% QoQ in Q3FY21, after a decline of 17% QoQ in Q2FY21 owing to floods in Andhra Pradesh. Furthermore, management is matching sales with procurement. The company is sitting on inventory of skimmed milk powder, which should be sufficient for the next seven–eight months. While prices have tightened somewhat, the setting in of the flush season should moderate them.

Management expects procurement prices to remain subdued going ahead with onset of the flush season and due to better monsoons. Furthermore, with better traction from HORECA, management expects sales to pick up.

Outlook and valuation: Strong B2C; maintain 'BUY'

HTFL is well placed owing to the B2C nature of its business (90%-plus), strong realisation despite lower procurement price and strong return ratios (30% pre-tax RoCE). We are raising FY21/22/23E EPS by 13/7/11%. Maintain **'BUY'** with TP of INR445 (13x Jun-22E EPS).

Financials

Year to March	Q3FY21	Q3FY20	% Change	Q2FY21	% Change
Net Revenue	6,049	6,724	(10.0)	6,100	(0.8)
EBITDA	778	334	133.1	876	(11.2)
Adjusted Profit	264	146	NM	31	NM
Diluted EPS (INR)	5.7	2.6	NM	0.6	NM

Explore:

Financial model | Podcast | Corporate access | Video

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Financial Statements

Income Statement (INR mn)

Year to March	FY20A	FY21E	FY22E	FY23E
Total operating income	27,259	25,093	27,679	30,284
Gross profit	5,013	6,270	6,637	7,283
Employee costs	1,564	1,757	1,827	1,953
Other expenses	2,157	1,909	2,127	2,345
EBITDA	1,293	2,605	2,683	2,985
Depreciation	509	522	611	659
Less: Interest expense	226	207	102	85
Add: Other income	89	53	62	89
Profit before tax	(1,525)	1,930	2,031	2,330
Prov for tax	153	531	512	587
Less: Other adjustment	0	0	0	0
Reported profit	(75)	1,399	1,519	1,742
Less: Excp.item (net)	2,171	0	0	0
Adjusted profit	2,096	1,399	1,519	1,742
Diluted shares o/s	46	46	46	46
Adjusted diluted EPS	45	30	33	38
DPS (INR)	2.5	7.5	9.8	11.3
Tax rate (%)	10.1	27.5	25.2	25.2

Balance Sheet (INR mn)

Year to March	FY20A	FY21E	FY22E	FY23E
Share capital	232	232	232	232
Reserves	4,364	5,635	6,769	8,009
Shareholders funds	4,596	5,867	7,001	8,241
Minority interest	22	22	22	22
Borrowings	2,607	1,150	1,000	1,000
Trade payables	599	464	519	567
Other liabs & prov	1,937	1,800	1,963	2,127
Total liabilities	9,882	9,431	10,639	12,098
Net block	4,750	4,878	5,467	5,408
Intangible assets	77	77	77	77
Capital WIP	757	757	757	757
Total fixed assets	5,584	5,712	6,301	6,242
Non current inv	1,523	126	126	126
Cash/cash equivalent	582	1,864	2,298	3,646
Sundry debtors	219	206	227	249
Loans & advances	82	80	83	85
Other assets	1,857	1,409	1,570	1,716
Total assets	9,882	9,431	10,639	12,098

Important Ratios (%)

Year to March	FY20A	FY21E	FY22E	FY23E
Milk (% of revenue)	66.9	70.3	69.3	69.1
VAP (% of revenue)	27.6	25.0	25.8	26.1
Gross margin (%)	18.4	25.0	24.0	24.1
EBITDA margin (%)	4.7	10.4	9.7	9.9
Net profit margin (%)	7.7	5.6	5.5	5.8
Revenue growth (% YoY)	8.4	(8.1)	10.3	9.6
EBITDA growth (% YoY)	(31.5)	101.5	3.0	11.3
Adj. profit growth (%)	156.2	(33.2)	8.6	14.7

Free Cash Flow (INR mn)

Year to March	FY20A	FY21E	FY22E	FY23E
Reported profit	(75)	1,399	1,519	1,742
Add: Depreciation	509	522	611	659
Interest (net of tax)	249	150	76	64
Others	459	57	26	21
Less: Changes in WC	26	198	39	48
Operating cash flow	1,167	2,325	2,272	2,535
Less: Capex	(1,120)	(650)	(1,200)	(600)
Free cash flow	47	1,675	1,072	1,935

Assumptions (%)

Year to March	FY20A	FY21E	FY22E	FY23E
GDP (YoY %)	4.8	(6.0)	7.0	6.0
Repo rate (%)	4.4	3.5	3.5	4.0
USD/INR (average)	70.7	75.0	73.0	72.0
Procurement (INR/l)	35.8	34.2	34.6	34.9
Procurement (mn l/day)	1.5	1.2	1.4	2.8
Milk Vols (mn l/day)	1.1	1.0	1.1	1.2
Milk Realisation (INR/l)	41.9	46.3	45.4	45.5
VAP Sales (% YoY)	16.8	(20.8)	14.1	10.6
Ad Spends (% of sales)	0.7	0.4	0.6	0.6

Key Ratios

Year to March	FY20A	FY21E	FY22E	FY23E
RoE (%)	(1.2)	26.7	23.6	22.9
RoCE (%)	9.7	30.0	28.3	27.9
Inventory days	23	24	19	19
Receivable days	4	3	3	3
Payable days	11	10	9	9
Working cap (% sales)	(0.6)	(1.4)	(1.4)	(1.4)
Gross debt/equity (x)	56.5	19.5	14.2	12.1
Net debt/equity (x)	43.8	(12.1)	(18.5)	(32.0)
Interest coverage (x)	3.5	10.1	20.3	27.4

Valuation Metrics

Year to March	FY20A	FY21E	FY22E	FY23E
Diluted P/E (x)	6.2	9.3	8.6	7.5
Price/BV (x)	2.8	2.2	1.9	1.6
EV/EBITDA (x)	11.6	4.7	4.4	3.5
Dividend yield (%)	0.9	2.7	3.5	4.0

Source: Company and Edelweiss estimates

Valuation Drivers

Year to March	FY20A	FY21E	FY22E	FY23E
EPS growth (%)	156.2	(33.2)	8.6	14.7
RoE (%)	(1.2)	26.7	23.6	22.9
EBITDA growth (%)	(31.5)	101.5	3.0	11.3
Payout ratio (%)	nm	25.0	30.0	30.0

Q3FY21 conference call: Key highlights

Operating and Financial

- Revenue declined 10% YoY primarily led by a volume decline of 14% YoY, mitigated by a 9% YoY increase in realisation. Volumes were primarily hit due to the floods in Andhra Pradesh.
- VADP sales lower: The VADP portfolio momentum declined 13% YoY in Q3FY21, after declining 28%YoY in H1FY21. The slowdown was led by 23% YoY dip in curd volumes. VADP contribution stands at ~22.5% in Q3FY21 (Q3FY20: 23% of sales).
- EBITDA margin improved 790bps YoY to 12.9%, a moderation (150bps down QoQ) vis-à-vis the last quarter as procurement prices picked up. This was led by growth of 952bps YoY in gross margin, primarily on account of spreads, which expanded 1.9x YoY to INR11.5/l. Furthermore, other expenses were well controlled, down 12% YoY.
- Heritage Nutrivet, the feeds subsidiary, reported 2.2x and 7.2x growth in EBITDA and PBT, respectively. It reported EBITDA margin of 9.8% versus 11% in Q2FY21 and 5.3% in Q3FY20.
- The company recorded a fair value loss on its FRL stake at INR0.2bn and should report a loss in Q4FY21 as well, after which there should not be any impact on profitability.
- Covid-19 had led to increase in supply of milk in Q1FY21, which the company converted to milk powder. The company continues to have a surplus inventory of SMP, which will be utilised for captive consumption over the next 7–8 months to improve protein content along with some conversion to liquid.
- During the quarter, HTFL matched procurement to sales subsequent to which procurement dipped 3% QoQ, 14% YoY. This should pick up as the flush season sets in. The procurement dipped on a YoY basis as the company procured in bulk in Q3FY20 to fulfil demand in the end-user markets.
- Procurement prices picked up slightly sequentially (up 7% QoQ); however, prices remained on a downward trajectory on a YoY basis (5% YoY) in Q3FY21.
- Sales were impacted by the decline in volumes owing to monsoon and lower OOH sales for agents of HTFL. The company is seeing some pickup in the OOH consumption as markets open up.

Others

- Capex: In H1FY21, HTFL incurred capex of INR471mn. However, capex will be planned to cater to demand for next summer season. The company believes capex in FY22 should also be at normal levels (~INR1bn), after which capex would taper off (~INR0.5bn).
- Debt: Long-term debt has been pared to INR1.15bn from INR1.85bn last quarter, driven by the FRL stake sale.
- Cash & cash equivalents stand at INR599mn, which may be utilised for rewarding shareholders.
- The company scaled down its operations in certain geographies in FY20, as logistics cost and packaging costs were unviable. HTFL continues to operate in Haryana and the NCR region.

- The regional mix is dominated by AP and Telangana with 60–62% of sales, and Maharashtra, Karnataka and Tamil Nadu each contributing 10% to revenue.
- The company discontinued its investments in the Farmers Welfare Trust and Employee Welfare Trust, and conducted the same via the parent entity.
- Capacity stands currently at 2.5mn litres of chilling capacity, 2.37mn litres of processing capacity and 1.55mn litres of packing capacity, and 600ktpd curd packaging capacity. HFL expects to cross 3–3.5mn litres over the next five years, which will be funded through a mix of debt and internal accruals.
- HTFL exited its stake in FRL of 17.8mn shares, for a value of INR1.36bn. The same was used to retire debt.

Exhibit 1: Quarterly financial snapshot

Year to March	Q3FY21	Q3FY20	% change	Q2FY21	% change	YTDFY21	FY21E	FY22E
Revenues	6,049	6,724	-10.0	6,100	(0.8)	18,538	25,093	27,679
Raw material	4,340	5,465	-20.6	4,328	0.3	13,618	18,823	21,042
Staff costs	468	399	17.2	450	4.0	1,334	1,757	1,827
Others	463	526	-12.0	447	3.6	1,352	1,909	2,127
Total expenditure	5,271	6,391	-17.5	5,224	0.9	16,304	22,488	24,996
EBITDA	778	334	133.1	876	(11.2)	2,233	2,605	2,683
Depreciation	113	128	-11.9	111	2.4	362	522	611
EBIT	665	205	223.9	765	(13.1)	1,872	2,083	2,071
Interest	51	54	-5.6	48		161	207	102
Other income	11	13	-15.3	18	(37.6)	45	53	62
Add: Prior period items								
Add: Exceptional items	-204	0		-512		-716	0	0
Profit Before Tax	421	164	156.1	223	88.8	1,039	1,930	2,031
Less: Provision for Tax	155	45	246.1	193	(19.5)	449	531	512
Less: Minority Interest	-4	-29		-4		-11	0	0
Add: Share of profit from associates	-5	-3		-3		-10	0	0
Less: Profit from Discontined Operations								
Reported Profit	264	146	180.6	31	839.3	591	1,399	1,519
Adjusted Profit	468	146	220.3	544	(14.0)	1,307	1,399	1,519
Equity capital (FV INR 5)	232	232		232		232	232	232
No. of Diluted shares outstanding (mn)	46	46		46		46	46	46
Adjusted Diluted EPS	10.1	3.1	220.3	11.7	(14.0)	28.2	30.2	32.7
P/E (x)							9.3	8.6
EV/EBITDA (x)							4.7	4.4
ROAE(%)							26.6	23.5
As % of net revenues								
Raw material	71.7	81.3		70.9		73.5	75.0	76.0
Staff expenses	7.7	5.9		7.4		7.2	7.0	6.6
Other expenses	7.7	7.8		7.3		7.3	7.6	7.7
EBITDA	12.86	5.0		14.4		12.0	10.4	9.7
Net profit	7.7	2.2		8.9		7.1	5.6	5.5

Source: Company, Edelweiss Research

Exhibit 2: We have revised our FY21/22/23E EPS by 13/7/11% respectively

(INR mn)	Old			New			% change		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Revenue	25,122	28,096	30,562	25,093	27,679	30,284	(0.1)	(1.5)	(0.9)
EBITDA	2,237	2,445	2,708	2,605	2,683	2,985	16.4	9.7	10.2
PAT	1,240	1,423	1,565	1,399	1,519	1,742	12.8	6.8	11.3

Source: Edelweiss Research

Company Description

Heritage was founded by Mr. Chandrababu Naidu in 1992 as a dairy company. Over the years, Heritage has operated in dairy, retail, agri, bakery and veterinary care. However, it has now demerged its loss making retail, agri and bakery businesses, selling them off to Future Retail for a consideration of 17.85mn shares (3.6% stake), rendering the company a pure dairy play. Heritage sells milk and milk products such as curd (largest share), ice cream, paneer, flavoured milk, ghee, butter and milk powders. Entire dairy sales are B2C and are sold under the Heritage brand. Of FY20 dairy revenues, milk constituted ~66%, VADP 24% and fat products 9% share. Curd's contribution within VADP is 77% and ~18% to Heritage's manufactured dairy sales.

Investment Theme

Heritage Foods (HFL), a strong private dairy player in south (AP) and a strong franchisee in liquid milk has set a strong target of INR60bn of sales with procurement of ~2.8 mn litres per day in 5 years, from current 1.4 mn liters per day and INR26.8bn of sales. It is focussing on deepening penetration in current markets and expanding reach in new geographies by inorganic acquisition. It is prudently straddling the high RoCE pouch milk segment and high-growth & margin curd, yogurt and ice-cream segments to attain its target. Targeting large categories like curd (INR288bn) with organised penetration at mere 6% and high margin segments like ice-cream are envisaged to spur Heritage's growth and margin.

HTFL is well placed led by B2C nature of its business (90% plus), strong realisation despite lower procurement price and strong return ratios (30% pre-tax ROCE). With improving procurement and milk prices expected to remain subdued, we expect strong margin for dairy players like HFL. Hence post margins bottoming out in FY20 we expect strong 44% EBIDTA CAGR over FY20-22E.

Key Risks

High dependency on low margin milk business

Pouch milk business, wherein margins are low, contributes a sizeable 65% to Heritage's sales. Hence, an increasing milk price scenario impacts the company's margin adversely as the increase in procurement price is passed on with a lag.

Increasing competition

Increase in competition from co-operatives (Amul having entered strongly in Andhra Pradesh with tie up with co-operatives) or private players, either in form of procurement (by increasing prices to farmers) or selling price (via lower prices), can impact Heritage's performance.

Additional Data

Management

Chairperson	D. Seetharamaiah
Vice-Chairperson & MD	Bhuvaneswari Nara
Executive Director	Brahmani Nara
CEO	Sambasiva Rao
Auditor	Walker Chandiok & Co

Holdings – Top 10*

	% Holding		% Holding
UTI AMC	5.76	Kedia Securities	1.04
Sundaram AMC	5.34	Union MF	0.78
Dorlic Asia Pacific	2.92	Invesco AMC	0.77
Kotak Mahindra MF	1.91	Dimensional Fund	0.47
IEPF	1.72	IndiaFirst Life	0.15

**Latest public data*

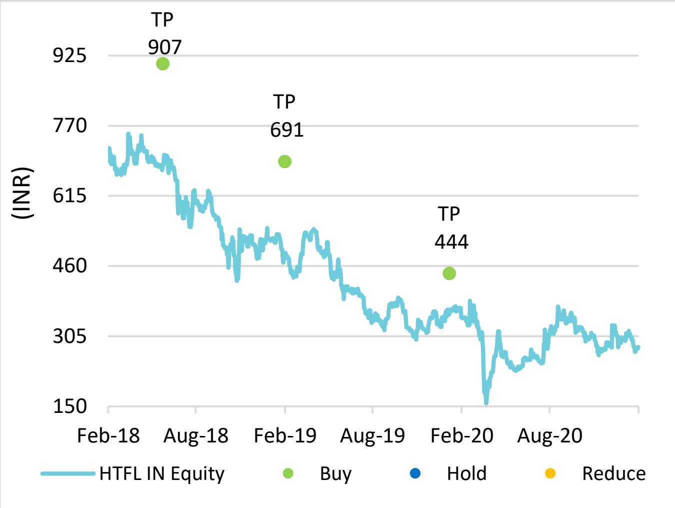
Recent Company Research

Date	Title	Price	Reco
10-Dec-20	Future stake sale: Overhang eliminated; *Company Update*	307.7	Buy
30-Oct-20	Core: Structurally and cyclically strong; *Result Update*	305.7	Buy
28-Oct-20	Stellar EBITDA performance; *Oven fresh*	305.7	Buy

Recent Sector Research

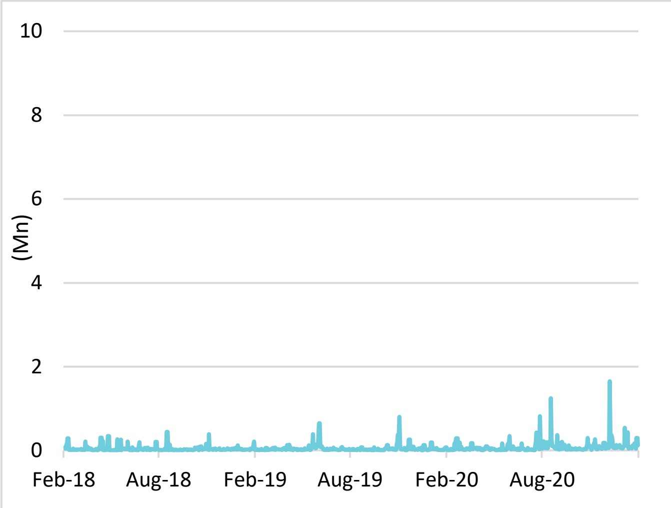
Date	Name of Co./Sector	Title
10-Nov-20	Parag Milk Foods	Modern trade, HORECA sour recovery; *Result Update*
08-Sep-20	Parag Milk Foods	Parag Milk Foods - Result Update Q1FY21 ; *Result Update*
30-Jun-20	Parag Milk Foods	Parag Milk Foods - Result Update Q4FY20 ; *Result Update*

Rating Interpretation



Source: Bloomberg, Edelweiss research

Daily Volume



Source: Bloomberg

Rating Distribution: Edelweiss Research Coverage

	Buy	Hold	Reduce	Total
Rating Distribution*	163	64	14	241
	>50bn	**>10bn and <50bn**	**<10bn**	**Total**
Market Cap (INR)	190	56	5	251

** stocks under review*

Rating Rationale

Rating	Expected absolute returns over 12 months
Buy:	>15%
Hold:	>15% and <-5%
Reduce:	<-5%

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