

Kwality Ltd- Q1FY18 Result Update

Mixed results; transiting towards B2C

CMP INR 136

Target INR 200

Rating: BUY

Upside: 47%

Kwality Ltd posted mixed set of results, with operational performance and the margins improving for the quarter, while earnings marred by low other income and higher depreciation. The company is progressing towards its stated strategic intent of focusing on B2C branded segment, that entails high margins and low working capital. We are positive on the transition and believe that these are likely to reflect on EBITDA margins in a staggered manner with impact on earnings and RoCE visible from FY19 onwards. We envisage that these improving visibility relating to these financial parameters will likely trigger re-rating, upholding our positive stance on the company. We re-iterate our Buy rating on the stock with a revised price target of INR 200

Q1FY18 – Mixed performance; operating margin expands; while net earnings decline – Kwality posted mixed result with topline growth of 6.7% yoy, led by healthy 11.5% yoy growth in the B2C category. Improving share from B2C segment (from 31% in Q1FY17 to 42% in Q1FY18) resulted in gross margin (+60 bps yoy) as well as EBITDA margin (+40 bps yoy) expansion at the company level. The operating profit grew by 13.5% yoy. Despite strong operating performance, increase in depreciation (from INR 3 crore to INR 24 crore) & higher interest cost (+30% yoy), coupled with lower other income (down 87% yoy) resulted in 34% yoy decline in the net earnings.

In line with its strategic intent moving towards B2C segment with new launches – Kwality in line with its strategic intent is moving towards B2C segment with launch of new products and categories. Over the last 9 months the company has launched (a) fresh products ; viz- Pouch milk, dahi and Chaaaah (b) UHT milk and Milk cream (c) Flavoured milk, all under the brand KDIL's "Kwality". These new products along with increasing penetration in the distribution setup across general, modern and ecommerce route is likely to result in shift in the revenue mix from 30% retail to 50-55% retail leading to margin, and earnings expansion, along with improvement in the cash conversion cycle.

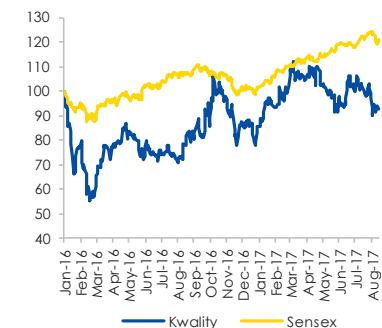
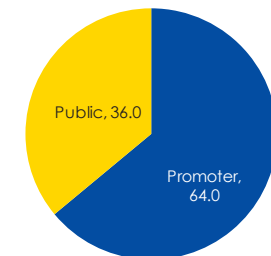
Key management comments - The company aims to continue its launch of new products for the next 2-3 quarters, post which it would witness stabilization and monetization. Further in the immediate future; owing to change in the business mix and employment of combination of push and pull method of branding and distribution, the expense would witness elevation hence though margin expansion would be visible but the quantum would be low, post FY18, it expects strong momentum in margins, and has guided to reach 9% EBITDA margin in FY19. Incorporating higher than expected depreciation and interest, we have revised our earnings downwards for the company, our revised EPS for FY18 and FY19 is INR 8.8 and INR 12 respectively

Outlook and valuations: Attractive; Re-iterate – BUY and a price target of INR 200 -Kwality is in the process of changing its business from a largely institutional-led to a consumer-facing model. With the transition in the business mix from a B2B commodity play towards a B2C branded player, whereby the business moves from the vagaries of limited margins, higher working capital days towards a consumer brand with stable to growing margins and relatively lower working capital cycle, we expect the earnings growth to be healthy along with expansion in the PER multiple to poise the stock for healthy returns ahead. We re-iterate our Buy call on the stock with a price target of INR 200.

(INR cr)	Q1FY18	Q1FY17	% change	Q4FY17	% change	FY17	FY18E	FY19E
Net sales	1,572	1,474	6.7	1,534	2.5	6,872	7,566	8,259
EBITDA	109	96	13.5	105	3.0	454	586	695
PAT	28	42	- 34.0	35	- 20.0	194	210	286
EPS	1	2	- 34.0	1	- 20.0	8	9	12
PER						17	15	11
EV/EBITDA						11	8	7
ROACE (%)						16	17	20

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Bloomberg:	KLD:IN
52-week range (INR):	169 / 111
Share in issue (cr):	2
M cap (INR cr):	3,253
Avg. Daily Vol.	1560
BSE/NSE :('000):	

Date: 16th August 2017

Q1FY18 Result Highlights

INR cr	Q1FY18	Q1FY17	% yoy	Q4FY17	% qoq	FY16	FY17
Net Revenues	1,572	1,474	6.7	1,534	2.5	6,414	6,872
Operating Expenses	1,463	1,378	6.2	1,429	2.4	6,023	6,418
EBITDA	109	96	13.5	105	3.0	391	454
Depreciation	24	3	703.7	13	86.7	23	22
EBIT	85	93	-8.5	93	-8.5	368	431
Interest expenses	50	38	30.7	53	-5.2	160	181
Other income	1	9	-86.5	-2	-148.4	30	14
PBT	36	64	-43.0	38	-3.7	238	264
Provision for tax	8	21	-60.8	3	201.7	64	69
PAT Before Minority & Associate Share	28	42	-34.0	35	-20.0	174	194
Share of Associates							
Reported PAT	28	42	-34.0	35	-20.0	174	194
Equity Capital	238	238		238	-	238	238
No of Shares	24	24		24		24	24
EPS	1	2	-34	1	-20.0	7	8
EBITDA Margin	7	6	0.41	7		6	7
PAT Margin	2	3		2		3	3
Tax Rate	23	34		7		27	26

Business Overview

Kwality is the largest manufacturer and processor of dairy products in the private sector in India. The company was established in 1992 as the backward integration unit of Kwality Ice-cream and was acquired by current promoters in 2002

Business Model	Largely a B2B player, with an aggregate milk processing capacity of 4.3 million litres per day, spread across 6 processing plants Entered B2C business with brand "Dairy best" in 2012, For FY16, around 30% of the standalone turnover comes from Dairy best Registered "Kwality" brand in FY16. It is building this brand for fresh and value added products. Dairy best continues to operate as usual
Strategic Positioning	A B2B player, now is taking various steps to become a B2C player Production and distribution nestled in the production surplus and consumption heavy north, UP and Rajasthan region Increased focus on B2C business,.
Competitive Edge	Processing capacity of 4.3 mn litres per day; largest amongst the private dairy players <ul style="list-style-type: none"> • Strong focus in the NCR, Rajasthan and UP belt on both procurement as well as distribution • First of its kind arrangement with PSU bank- Bank of Baroda to provide financial assistance to farmers to improve procurement • Series of on ground efforts and steps undertaken by the company to change the DNA from B2B to B2C company. Entire company geared towards the transformation • Prominent Private equity player – KKR has supported the company via structured debt
Financial Structure	The company's debt equity position is stretched owing to its weighty B2B, as B2B business is largely working capital intensive in nature
Key Competitors	Mother Dairy, Amul and regional brands
Industry Revenue Drivers	INR 6 lac crore industry, of which only 20% is organized The organized sector is likely to grow at a CAGR of 20%+ over the next five years time frame <ul style="list-style-type: none"> • Milk product based categories like Paneer, Cheese, Flavoured milk, Yoghurt are growing at 25%+ rate and expected to grow at similar levels ahead
Shareholder Value Proposition	With the changing business proposition towards B2C business, we expect the company to post a EPS of Rs 13.6n FY19. At 16x valuation one can have a price target of Rs 220 for the company, giving an upside of 47% from the current levels.

Investment Theme

Dominant presence in largest milk producing and consuming markets burnishes prospects

Kwality Ltd is India's third largest dairy player (behind Amul and Nandini, which are co-operatives) and a largest private dairy player with a daily processing capacity of 4.3 million litres. The company's processing facilities are located in Uttar Pradesh (UP), Haryana and Rajasthan —key milk producing regions — the three states that cumulatively contribute 34% to all-India production. Kwality's key consumption markets include these states and the NCR region, together constituting around 50% of India's overall milk consumption. By virtue of its presence in the key procurement and superior consumption markets, Kwality is in a sweet spot and is likely one of the best play to to encash the transition from an unorganized to an organized play

Changing track: From a B2B commodity to a high-margin, low-working capital B2C brand player

Until 2012, Kwality was largely a B2B player. However, this business model resulted in ;low margins of 6.0-6.5% and also entailed a higher working capital cycle. The company is now prudently focusing on the B2C segment, which primarily includes selling the products directly to the end consumers under the brand "Kwality. In the pursuit of this strategy the company has undertaken various measures- Direct procurement from the farmers, *(Also entered into a unique first of its kind tie-up with Bank of Baroda to provide loan to its farmers)* , launched new products , launched new brand campaign with leading bollywood star- Akshay Kumar as a brand ambassador, strengthened its mid- management team . Thus fructification of its various efforts is likely to reflect in higher margins, and improved earnings quality in terms of lean working capital cycle and healthy operating cash flows

Outlook and valuation: Rating imminent; initiate with Buy and a*price target of INR 200- Kwality is in the process of changing its business from a largely institutional-led to a consumer-facing model. With the transition in the business mix from a B2B commodity play towards a B2C branded player, whereby the business moves from the vagaries of limited margins, higher working capital days towards a consumer brand with stable to growing margins and relatively lower working capital cycle, we expect the earnings growth to be healthy along with expansion in the PER multiple to pose the stock for healthy returns ahead. We value the company at 16.5x FY19E EPS to arrive at a target price of INR 200

Key Risks

- High leverage
- Execution risk
- Availability and price volatility of raw milk

Financials

Income statement (Consol)						Balance sheet (Consol)						Ratios					
Year to March	FY15	FY16	FY17	FY18E	FY19E	As on 31st March	FY15	FY16	FY17	FY18E	FY19E	Year to March	FY15	FY16	FY17	FY18E	FY19E
Income from operations	5,878	6,414	6,872	7,566	8,259	Equity share capital	22	22	24	24	24	ROAE (%)	30.5	22.7	19.4	17.1	19.4
Direct costs	5,388	5,823	6,205	6,704	7,254	Reserves & surplus	643	842	1,094	1,303	1,588	ROACE (%)	19.0	17.2	16.5	17.4	19.9
Employee costs	24	34	40	57	66	Shareholders funds	665	864	1,117	1,327	1,612	Debtors (days)	82	94	84	80	80
Other expenses	139	200	214	276	310	Secured loans	1,235	1,279	1,196	1,002	1,094	Current ratio	11.9	12.8	14.3	11.8	12.1
Total operating expenses	5,526	6,023	6,418	6,980	7,564	Unsecured loans	14	242	593	593	443	Debt/Equity	1.9	1.8	1.6	1.2	1.0
EBITDA	352	391	454	586	695	Borrowings	1,249	1,521	1,789	1,596	1,538	Inventory (days)	18	10	19	15	15
Depreciation and amortisation	25	23	22	88	97	Sources of funds	1,914	2,385	2,906	2,922	3,149	Payable (days)	5	7	9	9	9
EBIT	327	368	431	498	598	Gross block	126	154	544	624	674	Cash conversion cycle (days)	95	97	93	86	86
Interest expenses	143	160	181	186	172	Depreciation	59	82	104	192	289	Debt/EBITDA	3.5	3.9	3.9	2.7	2.2
Other income	12	30	14	1	1	Net block	67	72	439	432	385	Adjusted debt/Equity	1.8	1.7	1.5	1.1	0.8
Profit before tax	196	238	264	313	426	Capital work in progress	118	195	7	50	41	Valuation parameters					
Provision for tax	30	64	69	103	140	Total fixed assets	186	267	446	482	426	Year to March	FY15	FY16	FY17	FY18E	FY19E
Core profit	167	174	194	210	286	Investments	90	180	272	272	272	Diluted EPS (INR)	7.6	7.8	8.1	8.8	12.0
Profit after tax	167	174	194	210	286	Inventories	291	171	351	311	339	Y-o-Y growth (%)	6.8	1.8	4.6	8.7	36.2
Adjusted net profit	167	174	193	210	286	Sundry debtors	1,325	1,655	1,579	1,700	1,856	CEPS (INR)	8.8	8.8	9.1	12.5	16.1
Equity shares outstanding (mn)	22	22	24	24	24	Cash and equivalents	52	86	107	116	182	Diluted P/E (x)	17.9	17.5	16.8	15.4	11.3
EPS (INR) basic	7.6	7.8	8.1	8.8	12.0	Loans and advances	122	179	264	189	239	Price/BV (x)	4.5	3.5	2.9	2.4	2.0
Diluted shares (Cr)	21.9	22.4	23.7	23.7	23.7	Total current assets	1,789	2,092	2,301	2,316	2,617	EV/Sales (x)	0.7	0.7	0.7	0.6	0.6
EPS (INR) fully diluted	7.6	7.8	8.1	8.8	12.0	Sundry creditors and others	80	115	156	190	208	EV/EBITDA (x)	11.8	11.5	10.8	8.0	6.6
Common size metrics- as % of net revenues						Provisions	70	48	5	5	5	Diluted shares O/S	21.9	22.4	23.7	23.7	23.7
Year to March	FY15	FY16	FY17	FY18E	FY19E	Total CL & provisions	150	163	161	196	213	Basic EPS	7.6	7.8	8.1	8.8	12.0
Gross profit margin	8.3	9.2	9.7	11.4	12.2	Net current assets	1,638	1,928	2,140	2,120	2,404	Basic PE (x)	17.9	17.5	16.8	15.4	11.3
Operating expenses	94.0	93.9	93.4	92.3	91.6	Net Deferred tax	1	12	51	51	51						
Depreciation	0.4	0.4	0.3	1.2	1.2	Misc expenditure	-1	-2	-3	-3	-3						
Interest expenditure	2.4	2.5	2.6	2.5	2.1	Uses of funds	1,914	2,385	2,906	2,922	3,150						
EBITDA margins	6.0	6.1	6.6	7.7	8.4	Book value per share (INR)	30	39	47	56	68						
Net profit margins	2.8	2.7	2.8	2.8	3.5	Cash flow statement											
Growth metrics (%)						Year to March	FY15	FY16	FY17	FY18E	FY19E						
Year to March	FY15	FY16	FY17	FY18E	FY19E	Net profit	167	174	194	209	285						
Revenues	17.3	9.1	7.1	10.1	9.2	Add: Depreciation	25	23	22	88	97						
EBITDA	19.6	11.0	16.0	29.2	18.6	Gross cash flow	192	187	177	297	382						
PBT	16.1	21.2	10.9	18.8	36.1	Less: Changes in W. C.	263	255	192	-29	184						
Net profit	14.9	4.2	11.8	8.2	36.1	Operating cash flow	-71	-68	-15	325	198						
EPS	6.8	1.8	4.6	8.7	36.2	Less: Capex	83	105	201	123	97						
						Free cash flow	-154	-173	-216	202	101						

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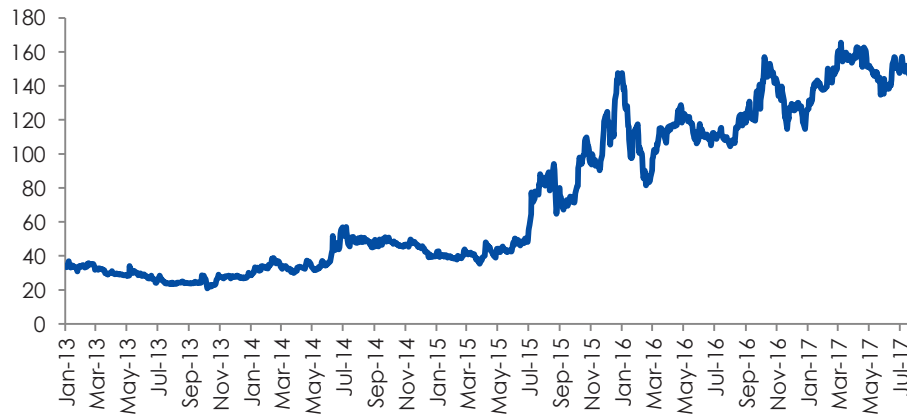
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Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period

Kwality 5 years price chart



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