

## VARUN BEVERAGES

FMCG

# BUY

Target Price: Rs 765

### Inorganic prospects continue to spice up

PepsiCo India has transferred five new territories and its entire juice portfolio to Varun Beverages (VBL) over past few months. This is in line with our expectations and a testimony to VBL's proven ability over time. VBL now controls ~51% of PepsiCo volume in India. While organic business is poised to grow in high-single digit with 7-8% volume growth given multiple tailwinds, we see **inorganic prospects to be a kicker**. Capturing the stated inorganic additions, we see sales CAGR of 16% over CY17-20E. We maintain **BUY** with revised **TP of Rs 765** based on forward EV/E of 13x (Rs 590 earlier).

**Q4CY17:** Consolidated volume grew 13.8% YoY with 21.6% YoY volume growth in India. EBITDA at Rs 225 mn declined 14% YoY on OPM contraction of 177 bps YoY to 4.3% (given high other expenses).

CMP : Rs 652  
Potential Upside : 17%

#### MARKET DATA

No. of Shares : 183 mn  
Free Float : 26%  
Market Cap : Rs 119 bn  
52-week High / Low : Rs 762 / Rs 341  
Avg. Daily vol. (6mth) : 189,895 shares  
Bloomberg Code : VBL IB Equity  
Promoters Holding : 74%  
FII / DII : 13% / 1%

**New territories to aid 12% incremental volume growth for India business in CY18:** VBL's volumes in CY17 were marred by implementation of GST effective July-17 (June is the key month generating ~20% of annual volume, but has seen destocking, influencing 1% YoY volume growth in CY17). However, we remain confident of its structural play in the soft drinks and expect high single-digit organic volume growth over medium term. New territory acquisitions will aid ~12% volume growth, as we expect territory addition of Odisha and Madhya Pradesh to aid 5% growth, Jharkhand and Chhattisgarh ~3% and Bihar ~1%. Distribution rights for juices to aid ~3% volumes. New territories provide additional consumer base of ~21% of India's population, where under-penetration holds significant growth opportunities.

**Our view:** While June quarter remains a key quarter for the company from performance perspective given 40% volume and 60% of EBITDA concentration, Dec and Mar quarters (non-seasonal and maintenance quarters for VBL) are key in terms of structural initiatives. With proven capabilities, we continue to believe VBL is the apt partner for Pepsi Co, which continues to be validated by transfer of territories. Capturing new developments, we raise our EBITDA estimates for CY18-19 by 12-14%. We now estimate sales and earnings CAGR of 16% and 40% over CY17-20E.

#### Financial summary (Consolidated)

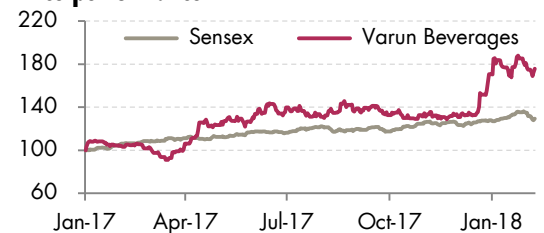
Y/E December	CY16	CY17E	CY18E	CY19E
Sales (Rs mn)	38,520	39,013	48,599	54,210
Adj PAT (Rs mn)	1,513	2,134	3,547	4,518
Con. EPS* (Rs)	-	-	-	-
EPS (Rs)	8.9	11.7	19.5	24.8
Change YOY (%)	6.5	30.8	66.3	27.4
P/E (x)	72.9	55.7	33.5	26.3
RoE (%)	11.8	10.8	16.2	17.9
RoCE (%)	11.0	10.3	13.9	16.1
EV/E (x)	17.7	16.7	13.0	11.2
DPS (Rs)	-	2.5	3.3	3.8

Source: \*Consensus broker estimates, Company, Axis Capital, CMP as on 16 Feb 2018

#### Key drivers

	CY17E	CY18E	CY19E
Domestic volume	224	267	285
International volume	54	67	75
Gross margin	54.9%	54.9%	54.8%
EBITDA margin	21.7%	22.1%	22.1%

#### Price performance



**Note:** Our model has not been updated for the latest IndAS changes

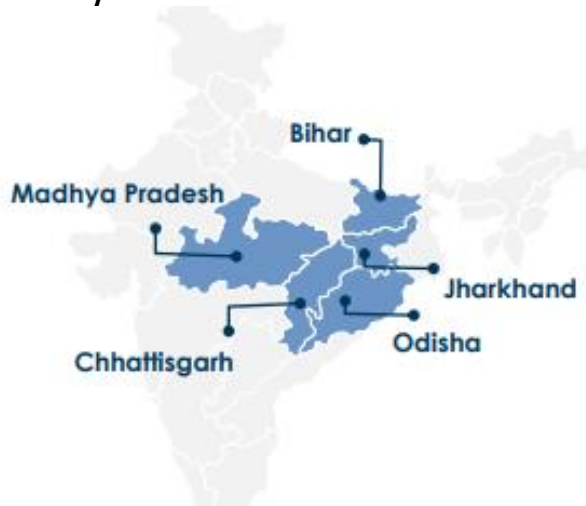
## Conference call highlights

- ◆ **Five new territory acquisitions:** Company highlighted the acquired territories have combined volume of ~30 mn cases with value sales of Rs 4.2 bn. Management is confident on driving the business in the acquired territories, given current market share at 10-15%. It would look to expand market share to existing 40-42% in the VBL territories. Total consideration for the acquired territories is ~ Rs 2.55 bn, of which Rs 1.39 bn already spend in CY17.
- ◆ **Update on Odisha and part of Madhya Pradesh territory transfer:** During CY17, Company concluded (w.e.f 27<sup>th</sup> Sep 2017) acquisition of PepsiCo India's previously franchised territory in Odisha and parts of Madhya Pradesh along with two manufacturing units at Bargarh and Bhopal from other franchisees. On a slump sale basis, the acquisition has derived enterprise value of Rs 1,302 mn based upon independent valuation reports. Company in Q1CY18 (w.e.f 19<sup>th</sup> Jan 2018) acquired manufacturing facility in Cuttack, Odisha, along with specific assets for total consideration of Rs 438 mn. We estimate these acquisitions will contribute ~5% to company's volume
- ◆ **Update on Jharkhand and Chhattisgarh territory acquisition:** VBL has entered into a binding agreement to acquire Pepsi Co India's previously franchised sub-territory in Jharkhand (20 districts) along with manufacturing facilities and franchisee rights for Chhattisgarh. We estimate these acquisitions will contribute 3% to company's volume
  - Chhattisgarh acquisition is complete (w.e.f 11<sup>th</sup> Jan 2018) in Q1CY18 at a consideration of Rs 150 mn, where it has obtained franchisee rights and other assets in the territory
  - Jharkhand acquisition is still in process (due diligence process on, transfer of land is taking time), where total consideration of Rs 654 mn to be paid for franchisee rights, certain manufacturing facilities and other assets on slump sale basis
- ◆ **Update on Bihar territory acquisition:** In Q1CY18, the company has acquired (w.e.f 17<sup>th</sup> Jan 2018) franchisee rights of PepsiCo India's previously franchised territory of Bihar. We estimate this acquisition will contribute 1% to company's volume

"Internationally, when we find a very good bottler and we believe that they can run the business better than us, we will rebrand the business, and that's what we did in Jordan, that's what we did in Thailand. And we look across our portfolio internationally to see where it makes sense. And I'd say internationally, we're pretty much rebrand in the bulk of the markets or franchised, I should say, in bulk of the markets"

- Indra Nooyi, CEO, Pepsi Co

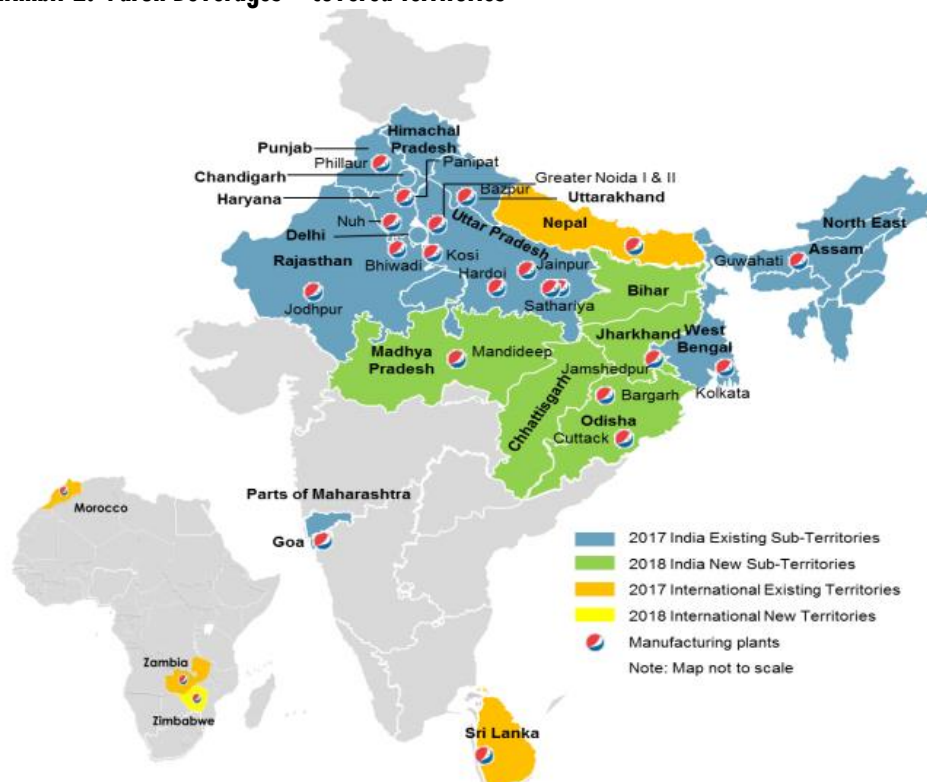
## Exhibit 1: Recent territory additions



Source: Company, Axis Capital

- ◆ **Update on beverage portfolio transfer:** Separately, VBL has entered into strategic partnership for selling and distribution of the larger *Tropicana* portfolio. This includes *Tropicana Juices (100%, Delight, Essentials)*, *Gatorade* in Sports drink category and *Quaker Value-Added Dairy* in territories across North and East India. *Tropicana's* volume in VBL territory is ~8 mn cases with value sales at Rs 5 bn. It is interesting to note that globally, Pepsi Co has kept the entire juice and snacks portfolio with itself
- ◆ **Overall coverage:** After aforementioned acquisitions, VBL controls ~51% (up 600 bps YoY) of Pepsi Co's India volume. In India, VBL is present in 21 states and 2 union territories with 23 manufacturing plants and 72 owned depots. (refer Annexure 1 for detailed evolution of the company)

## Exhibit 2: Varun Beverages – covered territories



Source: Company, Axis Capital

- ◆ **New product launches in India:** Q4 has seen launch of *Sting*, energy drink, pan-India. Before India launch, PepsiCo has test-marketed the offering in Vietnam and then Pakistan, and both worked well. Interestingly, under GST, energy drink attracts 18% GST vs. ~40% (28% GST + 12% additional cess) for other cola beverages (for sweetened aerated water). (refer Annexure 2 for detailed updated on new launches)
- ◆ **International expansion into Zimbabwe:** Company has established a greenfield production facility in Zimbabwe (30 mn case market) as sole franchisee. Zimbabwe is an untapped market with huge potential
- ◆ **Capex plans:** (1) **Nepal:** Given current utilization at 110% and market share stagnant at ~42% over past few years, VBL is looking to have greenfield capacity with capital outlay of Rs 1.5 bn. With the new capacity, the company aims for market share of ~50% in Nepal. (2) **Zimbabwe:** Company highlighted currently it imports to the country from Zambia, but a plant in Zimbabwe will

help improve market share and aid profitability. For Zimbabwe, the company has allocated capex of ~Rs 1.65 bn. (3) **India:** Management highlighted that current capacity can address 30% incremental volumes; hence, no expansionary capex needed. India maintenance capex will be ~ Rs 1.5 bn.

- ◆ **Capex spending (annual outflow):** Capex outflow for CY17 stood at Rs 6.61 bn, of which ~ Rs 3.9 bn was towards spend for CY17 and remaining Rs 2.7 bn was towards CY18 (of this ~ Rs 1.4 bn was spent on Odisha and Madhya Pradesh, Rs 950 mn in Zimbabwe and remaining Rs 360 mn in Nepal). In CY18, capex outflow will be Rs 4.85 bn, of which Rs 1.5 bn will be maintenance capex in India, Rs 1.14 bn as capex for Nepal, Rs 700 mn as capex for Zimbabwe, Rs 350 mn for upgradation of plant and machinery and marketing assets in acquired five territories and Rs 1.15 bn on new territories (of the acquisition cost of Rs 2.55 bn, Rs 1.4 bn spent in CY17).

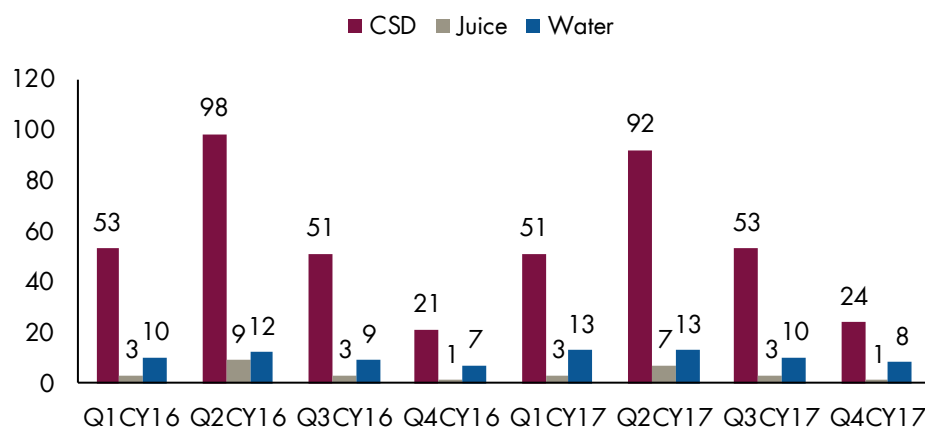
## Quarterly update

### Exhibit 3: Result update

(Rs. mn)	Dec-17	Dec-16	% Chg
<b>Net Sales</b>	<b>5,274</b>	<b>4,342</b>	<b>21.4</b>
Raw Material Cost	1,918	1,755	9.3
(% of Net Sales)	36.4	40.4	-405 bps
Staff Expenditure	1,158	1,035	11.9
(% of Net Sales)	22.0	23.8	-188 bps
Other Expenses	1,973	1,291	52.9
(% of Net Sales)	37.4	29.7	770 bps
<b>EBITDA</b>	<b>225</b>	<b>262</b>	<b>(14.2)</b>
EBITDA margin (%)	4.3	6.0	-177 bps
Other income	17	17	(0.1)
<b>PBIDT</b>	<b>242</b>	<b>279</b>	<b>(13.4)</b>
Depreciation	880	800	10.0
Interest	526	1,009	(48)
<b>PBT</b>	<b>(1,165)</b>	<b>(1,530)</b>	<b>(23.9)</b>
Tax	(439)	(408)	7.6
Minority interest	3	70	(96.3)
<b>Adjusted PAT</b>	<b>(728)</b>	<b>(1,192)</b>	<b>(38.9)</b>
<b>Reported PAT</b>	<b>(728)</b>	<b>(1,192)</b>	<b>(38.9)</b>

Source: Company, Axis Capital

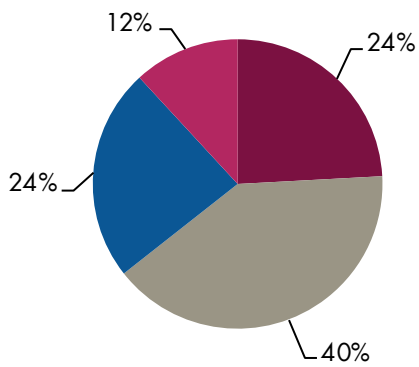
### Exhibit 4: Category-wise sales volume (mn cases)



Source: Company, Axis Capital

**Exhibit 5: Quarterly volume mix – CY17**

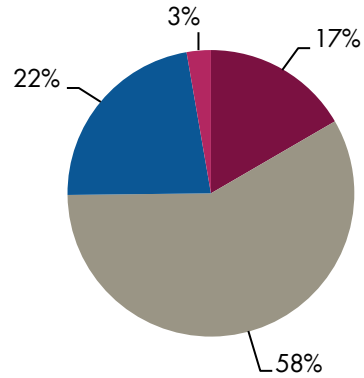
■ 1QCY17 ■ 2QCY17 ■ 3QCY17 ■ 4QCY17



Source: Company, Axis Capital

**Exhibit 6: Quarterly EBITDA mix – CY17**

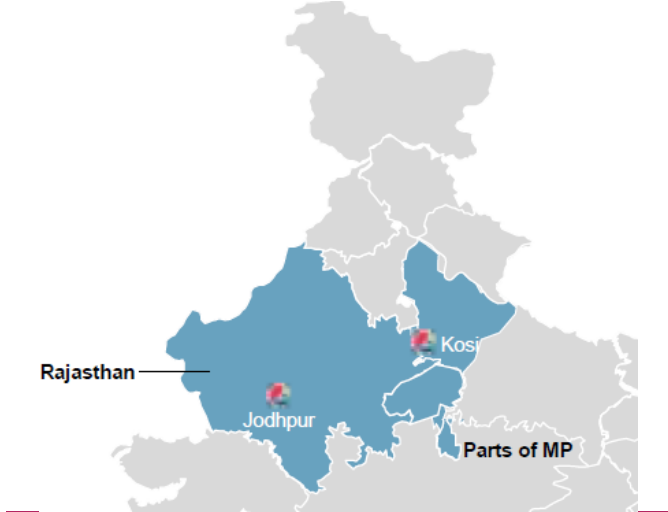
■ 1QCY17 ■ 2QCY17 ■ 3QCY17 ■ 4QCY17



Source: Company, Axis Capital

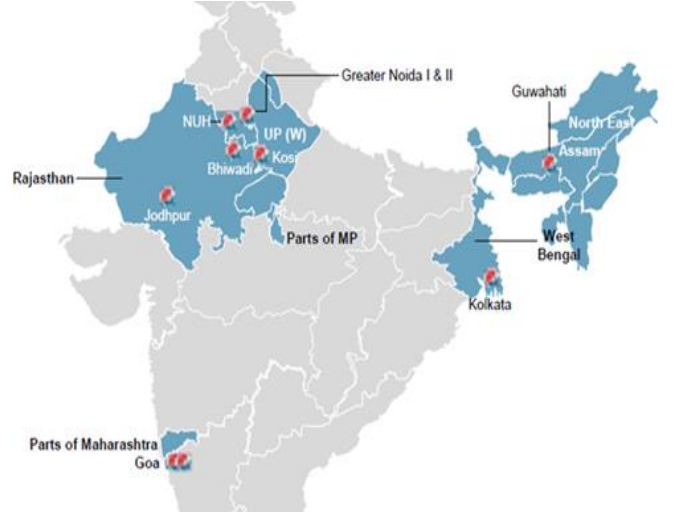
**Annexure 1: Domestic business evolution**

**Exhibit 7: Territories in mid-1990's**



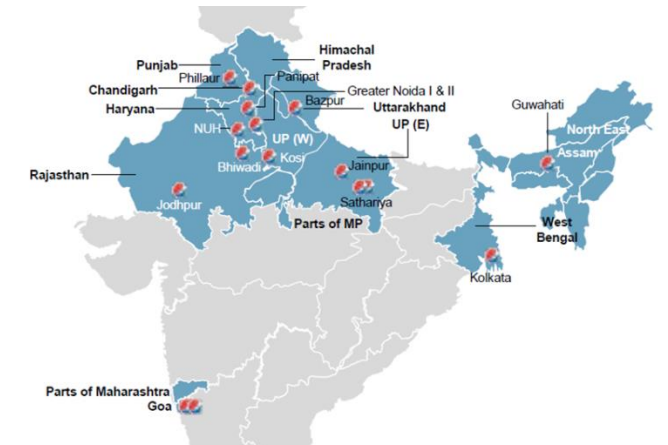
Source: Company, Axis Capital

**Exhibit 8: Territories in CY12**



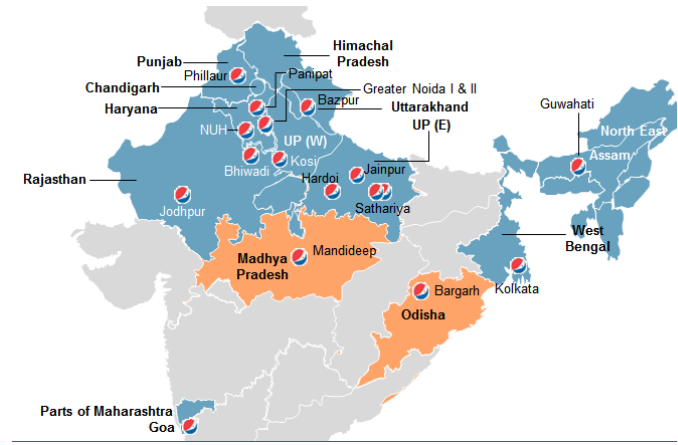
Source: Company, Axis Capital

**Exhibit 9: Territories in CY16**



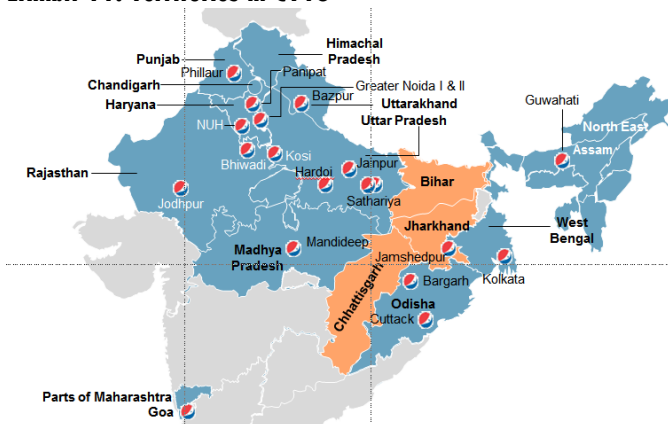
Source: Company, Axis Capital

**Exhibit 10: Territories in CY17**



Source: Company, Axis Capital

**Exhibit 11: Territories in CY18**



Source: Company, Axis Capital

**Exhibit 12: Global footprint**



Source: Company, Axis Capital

## Annexure 2: Innovation/new product launches

### 7up Nimbooz

Vouching local palate opportunity (where in many markets, consumer prefer adding masala with CSD for better experience), the company had rolled out Neembu Masala Soda (NMS) under 7 Up (with 5% lemon juice) in 2016, which has received excellent response. NMS is now 1.5% of VBL's volume.

#### Exhibit 13: 7up Nimbooz masala soda offering



Source: Company, Axis Capital

### Pepsi Black

Pepsi Black is a zero calorie cola flavor CSD product available in 250 ml cans (Rs 25; priced at par with base offering) and 250 ml non-returnable glass bottles (priced at par with can). This launch is part of PepsiCo's plan to intensify focus on health and nutrition, reduce sugar content in beverages. Within six month of launch, Pepsi Black is 0.5% of volume mix for VBL.

#### Exhibit 14: Pepsi Black offering



Source: Company, Axis Capital

**Sting**

Sting is a carbonated energy drink (category sized at ~2 mn cases) available in 250 ml cans and 250 ml PET bottles with a highly competitive price point (50% discount to competition Red Bull). It contains ~50% less sugar than the regular CSD products and 70 calories per 250 ml serving.

**Exhibit 15: Sting offering**

Source: Company, Axis Capital

### Annexure 3: Likely product introductions

#### 7up revive

Pepsi Co has introduced India's first Hydrotonic Drink that helps to replenish fluids and important electrolytes you lose when you sweat in summer 2017. Product is available in select states like Tamil Nadu, Andhra Pradesh, Kerala, Maharashtra, Goa, Telangana and West Bengal.

#### Exhibit 16: 7up Revive offering



Source: Company, Axis Capital

#### Aquafina Vitamin Splash

Pepsi Co has launched its vitamin-fortified water product, Aquafina Vitamin Splash, to tap into the fast growing value-added hydration and functional beverages segment, as consumers are lapping up health and wellness products. It will be available in Kiwi Lime and Raspberry Mint flavors in 20 cities and on e-commerce platforms at Rs 30 for 300 ml and Rs 50 for 500 ml. The company also said that it is the lowest-calorie vitamin water to be introduced in India.

#### Exhibit 17: Aquafina Vitamin Splash offering



Source: Company, Axis Capital

"Hydration is a critical portfolio for PepsiCo, and 7UP Revive is one of our first innovations in this space. It is a perfect solution to the warm and largely humid Indian climatic conditions. The product aims to address an existing need-gap in the market."

- Vipul Prakash, SVP, Beverage, PepsiCo India

"We plan to launch a new platform (sub-brand or product) every six to nine months in the value-added hydration category under brand Aquafina, for the next three years. Through these launches, we will look at meeting different health and wellness needs of Indian consumers."

- Vipul Prakash, SVP, Beverage, PepsiCo India

### Mirinda Joosy

Pepsi Co is currently test marketing its new offering under Mirinda (now Rs 10 bn brand for Pepsi Co) franchise – Mirinda Joosy in Tamil Nadu (biggest market for Mirinda). In this offering the company has reduced sugar mix by 50% and has 5% more orange juice (vs. normal Mirinda). A plant-based sweetener Stevia compensates sweetness for the low sugar content. PepsiCo India has partnered with the Maharashtra government for developing citrus ecosystem in the state.

#### Exhibit 18: Mirinda Joosy offering

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The launch of Mirinda Joosy is a reiteration of PepsiCo India's commitment to partnering the government's effort of catalyzing the carbonated fruit drinks category to benefit Indian farmers by adding 5% natural juice to carbonated beverages - Pepsi Co India

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Source: Company, Axis Capital

**Annexure 4: New product licenses**

**Tropicana juices**

Amid heated competition from category-leader Dabur India, with host of new offerings in response to new entrant ITC under 'B Naturals' range, Tropicana is likely to have lagged in terms of market share, as per media news flow.

Dabur under *Real* and *Real Active* brands lead the category with ~57% value and ~55% volume market share, while Pepsi Co's *Tropicana* follow with 28% value and volume market share. *B Natural* is likely to have clocked 7% value and 8% volume market share in the segment.

Recent new product introductions, primarily on health platform, are largely focused to gain back share and drive growth. With ~80% of the volume generation from VBL's covered territories, we see licensing of *Tropicana* a positive step.

"The goal is to double the Tropicana juice business by 2020 and to grow to be India's No 1 fruit and veggies brand in the next decade"  
 - Deepika Warriar, Vice President-Nutrition Category, PepsiCo India

**Exhibit 19: Tropicana offering**



Source: Company, Axis Capital

**Gatorade and Quaker milk**

**Exhibit 20: Gatorade offerings**



Source: Company, Axis Capital

**Exhibit 21: Quake beverage offerings**



Source: Company, Axis Capital

**Profit & loss (Rs mn)**

Y/E December	CY16	CY17E	CY18E	CY19E
Net sales	38,520	39,013	48,599	54,210
Other operating income	-	-	-	-
<b>Total operating income</b>	<b>38,520</b>	<b>39,013</b>	<b>48,599</b>	<b>54,210</b>
Cost of goods sold	(17,363)	(17,591)	(21,910)	(24,529)
Gross profit	21,157	21,422	26,689	29,681
<i>Gross margin (%)</i>	<i>54.9</i>	<i>54.9</i>	<i>54.9</i>	<i>54.8</i>
Total operating expenses	(13,205)	(12,965)	(15,937)	(17,709)
<b>EBITDA</b>	<b>7,952</b>	<b>8,457</b>	<b>10,752</b>	<b>11,972</b>
<i>EBITDA margin (%)</i>	<i>20.6</i>	<i>21.7</i>	<i>22.1</i>	<i>22.1</i>
Depreciation	(3,724)	(3,967)	(4,395)	(4,678)
<b>EBIT</b>	<b>4,228</b>	<b>4,490</b>	<b>6,357</b>	<b>7,294</b>
Net interest	(2,148)	(1,745)	(1,875)	(1,575)
Other income	348	283	403	420
<b>Profit before tax</b>	<b>2,428</b>	<b>3,028</b>	<b>4,885</b>	<b>6,140</b>
Total taxation	(829)	(894)	(1,338)	(1,622)
<i>Tax rate (%)</i>	<i>34.1</i>	<i>29.5</i>	<i>27.4</i>	<i>26.4</i>
Profit after tax	1,600	2,134	3,547	4,518
Minorities	(111)	-	-	-
Profit/ Loss associate co(s)	23	-	-	-
<b>Adjusted net profit</b>	<b>1,513</b>	<b>2,134</b>	<b>3,547</b>	<b>4,518</b>
<i>Adj. PAT margin (%)</i>	<i>3.9</i>	<i>5.5</i>	<i>7.3</i>	<i>8.3</i>
Net non-recurring items	-	-	-	-
<b>Reported net profit</b>	<b>1,513</b>	<b>2,134</b>	<b>3,547</b>	<b>4,518</b>

**Balance sheet (Rs mn)**

Y/E December	CY16	CY17E	CY18E	CY19E
Paid-up capital	1,823	1,823	1,823	1,823
Reserves & surplus	17,116	18,700	21,534	25,229
Net worth	18,939	20,523	23,357	27,052
Borrowing	22,482	24,621	22,121	16,621
Other non-current liabilities	3,237	3,268	3,301	3,335
<b>Total liabilities</b>	<b>44,657</b>	<b>48,412</b>	<b>48,779</b>	<b>47,008</b>
Gross fixed assets	52,437	59,047	64,397	67,297
Less: Depreciation	(14,936)	(18,903)	(23,298)	(27,975)
Net fixed assets	37,501	40,144	41,100	39,322
Add: Capital WIP	3,088	2,821	2,821	2,821
Total fixed assets	40,589	42,966	43,921	42,143
Total Investment	56	56	56	56
Inventory	4,899	4,700	5,748	6,313
Debtors	1,303	1,300	1,570	1,784
Cash & bank	657	2,125	1,793	2,144
Loans & advances	4,577	4,569	4,560	4,551
Current liabilities	7,566	7,445	9,012	10,124
Net current assets	3,969	5,347	4,759	4,765
Other non-current assets	43	43	43	43
<b>Total assets</b>	<b>44,657</b>	<b>48,412</b>	<b>48,779</b>	<b>47,008</b>

Source: Company, Axis Capital

**Cash flow (Rs mn)**

Y/E December	CY16	CY17E	CY18E	CY19E
Profit before tax	2,428	3,028	4,885	6,140
Depreciation & Amortisation	3,724	3,967	4,395	4,678
<i>Chg in working capital</i>	<i>820</i>	<i>90</i>	<i>257</i>	<i>344</i>
<b>Cash flow from operations</b>	<b>8,303</b>	<b>7,966</b>	<b>10,106</b>	<b>11,148</b>
<i>Capital expenditure</i>	<i>(7,999)</i>	<i>(6,344)</i>	<i>(5,350)</i>	<i>(2,900)</i>
<b>Cash flow from investing</b>	<b>(10,680)</b>	<b>(6,344)</b>	<b>(5,350)</b>	<b>(2,900)</b>
<i>Equity raised/ (repaid)</i>	<i>7,014</i>	-	-	-
<i>Debt raised/ (repaid)</i>	<i>1,025</i>	<i>2,139</i>	<i>(2,500)</i>	<i>(5,500)</i>
<i>Dividend paid</i>	-	<i>(549)</i>	<i>(713)</i>	<i>(823)</i>
<b>Cash flow from financing</b>	<b>2,459</b>	<b>(155)</b>	<b>(5,088)</b>	<b>(7,898)</b>
Net chg in cash	82	1,468	(332)	350

**Key ratios**

Y/E December	CY16	CY17E	CY18E	CY19E
<b>OPERATIONAL</b>				
FDEPS (Rs)	8.9	11.7	19.5	24.8
CEPS (Rs)	31.0	33.5	43.6	50.4
DPS (Rs)	-	2.5	3.3	3.8
Dividend payout ratio (%)	-	21.4	16.7	15.1
<b>GROWTH</b>				
Net sales (%)	13.5	1.3	24.6	11.5
EBITDA (%)	24.8	6.3	27.1	11.3
Adj net profit (%)	33.8	41.1	66.3	27.4
FDEPS (%)	6.5	30.8	66.3	27.4
<b>PERFORMANCE</b>				
RoE (%)	11.8	10.8	16.2	17.9
RoCE (%)	11.0	10.3	13.9	16.1
<b>EFFICIENCY</b>				
Asset turnover (x)	1.0	0.9	1.1	1.3
Sales/ total assets (x)	0.8	0.7	0.9	0.9
Working capital/ sales (x)	0.1	0.1	0.1	0.1
Receivable days	12.3	12.2	11.8	12.0
Inventory days	58.5	56.1	55.4	54.6
Payable days	32.8	34.3	32.9	34.0
<b>FINANCIAL STABILITY</b>				
Total debt/ equity (x)	1.8	1.2	1.0	0.7
Net debt/ equity (x)	1.7	1.1	0.9	0.6
Current ratio (x)	1.5	1.7	1.5	1.5
Interest cover (x)	2.0	2.6	3.4	4.6
<b>VALUATION</b>				
PE (x)	72.9	55.7	33.5	26.3
EV/ EBITDA (x)	17.7	16.7	13.0	11.2
EV/ Net sales (x)	3.7	3.6	2.9	2.5
PB (x)	5.8	5.8	5.1	4.4
Dividend yield (%)	-	0.4	0.5	0.6
Free cash flow yield (%)	-	-	-	0.1

Source: Company, Axis Capital

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