UNRATED

Zydus Wellness

MANAGEMENT MEETING NOTE

Rs591

Mkt Cap: Rs23bn; US$508m

We recently interacted with the management of Zydus Wellness for an update on the business and future plans. We like the company for its impregnable brand franchise (three core brands, Sugar Free, EverYuth and Nutralite) in highly under-penetrated but rapidly growing niche categories and brand extension into others (Sugar Free Dlite, EverYuth Menz). While competition from bigger players is negligible, an increase in competitive activity would accelerate category growth and create a bigger opportunity for incumbents like Zydus. As the company gets into capex mode with an investment of Rs450m for its Sikkim plant, our take is that the additional capacity will deliver at least Rs3bn revenues over the next 3-4 years (more than overall revenues in FY10!) and the tax rate would come down from 34% to ~20% (MAT rate). We believe the company is brilliantly placed to leverage the emerging 'health and wellness' urban story and can deliver a 25% revenue CAGR over the next 3-4 years to become a Rs6bn-7bn business by FY14. The stock trades at 26x FY12 earnings on consensus estimates. We have a positive bias.

Key takeaways

- Impregnable brands in niche categories…

  Zydus Wellness operates in niche categories in the health and wellness market with strong brands like Sugarfree, EverYuth and Nutralite. These brands are dominant (70%+ market share each) in their respective categories, which in turn are highly under-penetrated but growing rapidly. While competition has been limited, we expect it to intensify as each of these categories grows to Rs5bn-10bn. However, an increase in competition would accelerate market development as the burden of consumer awareness (a key driver to market growth) will shift from a single player (Zydus, in this case) to multiple players (e.g., accelerated growth of the diaper market after P&Gs' entry). We expect these categories to grow in excess of 20-25% over the next couple of years and believe Zydus is well placed to capitalize on the growth momentum.

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Strong brand portfolio

Categories	Sugar substitute	Peel off, scrub & facewash	Butter substitute
Brands			
Market share	80%	Peel off: 96% Scrubs: 70%	70%
All brands growing 25%+			

Source: IDFC Securities research

- New product launches to add growth drivers…

Zydus is leveraging its strong brands to expand into new categories like sugar-free beverages (Sugar Free Dlite), skincare for men (EverYuth Menz) and new categories like Actilife, a nutritional health drink for adults. The company is continuing to invest in R&D to create a repertoire of new products (e.g., sugar-free ice cream, medicated shampoo) to be tested in the market. We believe this spirit of innovation will enable the company to create new growth drivers for the future.

However, the management has stated that it will continue to focus on niche segments and avoid mainstream categories like fairness creams, shampoos, etc, due to significant investments required to compete against large players. Our take here is that Zydus, equipped with brands like EverYuth, should be able to move into mainstream categories like fairness creams and shampoos quite easily. While the company will probably not become a market leader, grabbing a few points of market share should be possible with very little investment. *A mere 5% market share in the Rs30bn shampoo category would equate to almost 50% of Zydus' current revenues! By staying away from these categories, Zydus may be missing out on a significant growth opportunity.*

Leveraging brands into new segments

Source: IDFC Securities Research

- **Sikkim tax benefits: A boost to profits…**

  The company is setting up a new plant in Sikkim for an investment of ~Rs450m, with the potential to add ~Rs3bn in revenues over the next 3-4 years. All third-party manufacturing at Ahmedabad will move to the Sikkim plant and only value-added sugar-free products will continue to be outsourced. Given that the company currently pays tax at 33%, the plant at Sikkim will offer substantial tax savings to the company especially over the next five years (exempt from income tax). We expect the transition in manufacturing to commence in April 2011 and complete by Q2FY12 or early Q3FY12. After the transition, we expect the tax liability to fall to almost half (from 34% to 20% MAT), driving a significant improvement in profitability.

- **…ensuring sustenance of strong profitable growth**

  Zydus looks poised for strong growth given its dominance in under-penetrated core categories and extension into newer ones. We expect the company to record 20-25% revenue growth over the next 4-5 years. With Rs1bn cash and zero debt, Zydus has the ability to acquire smaller, relevant brands or invest in new activities to propel revenue growth.

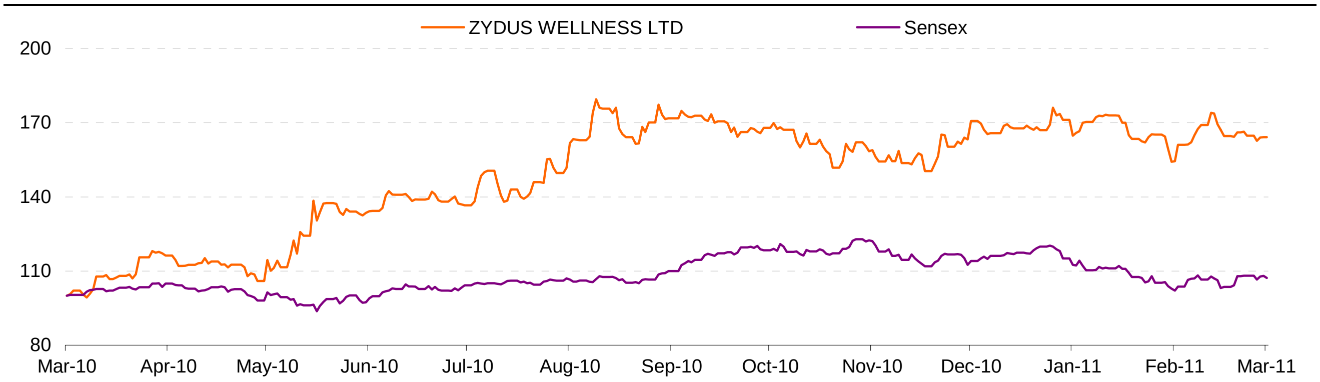
  The company also has a robust cost structure, with raw materials forming only 32% of revenues. As a result, its sensitivity to commodity prices is modest. While A&P spends are high at 35% of revenues, we expect it to significantly decline as categories grow and the need for investment in consumer education reduces. With tax rates reducing by almost half, our sense is that Zydus has the ability to double profits in the next three years. The stock trades at 26x FY12 (consensus estimates). We have a positive bias.

Key financial

As on 31 March	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E
Net sales (Rs m)	180	285	309	427	563	1,947	2,675	3,413	4,306
Adj. net profit (Rs m)	18	25	25	43	46	238	453	619	876
Shares in issue (m)	5.6	5.6	5.6	5.6	5.6	39.1	39.1	39	39
Adj. EPS (Rs)	4.0	5.3	4.4	7.7	8.2	6.1	11.6	15.8	22.4
% change	-	*34.0*	*(17.1)*	*73.2*	*6.6*	*(25.4)*	*90.2*	*36.7*	*41.5*
PE (x)	145.4	108.5	130.9	75.6	70.9	95.0	50.0	36.6	25.8
Price/ Book (x)	48.0	37.1	19.0	15.7	13.2	32.8	22.5	15.48	10.75
EV/ EBITDA (x)	116.8	79.9	64.1	76.1	50.6	57.1	31.9	25.17	19.88
RoE (%)	30.5	32.2	19.2	22.8	20.2	50.9	53.4	50.3	49.1
RoCE (%)	30.2	32.3	19.3	22.8	20.6	51.0	53.5		

Source: Bloomberg, IDFC Securities Research

Relative price performance



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