

# Heritage Foods (India) Limited

Better times ahead

November 13, 2006

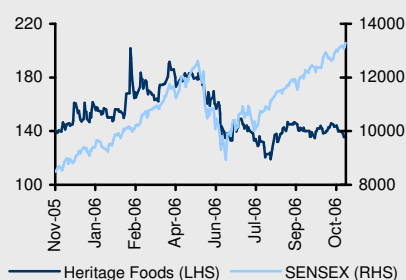
## Industry-Dairy

Recommendation	Buy
Current Price (Rs)	134
Target Price (Rs)	172

## Market Data

Bloomberg / Reuters Code	HFTI.IN
Share Outstanding (mn)	10
52 week High / Low	210/111
Market Capitalisation ( Rs mn )	1337.7

## Share price Vs Sensex



## Shareholding Pattern (%)

Promoters	47
Banks/FI / Mutual Fund	8.9
FII	9.4
Public & Others	34.7

## Recent News:

The company has declared a dividend of Rs 3 per share for the year ended 31<sup>st</sup> March 2006

## Analyst

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Heritage Foods is one of the largest private sector dairies in the country and has a major presence in southern India. It has undertaken expansion of its dairy capacity, which will be completed by February 2007 and will be revenue accretive from FY08. We believe that the dairy business offers a good investment opportunity due to the growing urbanization in the country as well as rising per capita income that has led to higher demand for milk and milk products from the organized dairy sector. We recommend a **BUY** on the company with a price target of Rs 172.

- Changing demographics to boost sales:** The Indian GDP is growing at a rate of 8% per annum and is expected to sustain the growth momentum going forward. The main contributors to the high GDP growth are the services and manufacturing sectors. The growth in these sectors has led to a growth in urbanization in the country along with an increase in disposable income of people. The rising income level has resulted in higher demand for milk and milk products and greater quality consciousness among the consumers. The growing quality consciousness along with easy availability of milk through the day has led to a shift in demand in favour of the organized dairy sector.
- Capacity addition to fuel growth:** Heritage Foods is expanding its milk chilling capacity from 8.5 lac litres per day to 10 lac litres per day, and its packing capacity from 6 lac litres per day to 7.5 lac litres per day. This expansion will be completed by February 2007 and will start yielding its benefits from FY08. The total cost of this expansion will be Rs 250 million, which will be met by internal accruals as well as borrowings. In view of the expansion drive, we expect the top line of the company to grow at a CAGR of 18% during FY06-08E to Rs 4050 million.
- Operating margins to stabilize:** Heritage Foods is expected to witness a decline in operating margins in FY07E to 6% due to higher milk procurement prices as well as skimmed milk prices. However, in FY08 we expect the operating margins to improve by 100 bps to 7% due to an increase in selling prices coupled with a fall in skimmed milk prices. We expect the company to witness an operating profit growth of 36.2% to Rs 283.5 million in FY08.
- Valuations:** Heritage Foods is trading at 13.1 x FY07E and 9.3x FY08E and at an EV/EBITDA of 6.8x FY07E and 5x FY08E. It is trading at 0.33x P/Sales and at 6.3 x CEPS FY08E which is attractive. Its return ratios are also going to improve significantly in FY08E, when it is expected to have a ROIC of 24% and an ROE of 17%. Heritage Foods has a strong presence in southern India where urbanization is growing fast along with rising income levels leading to a growth in the demand for milk and milk products. The company stands to gain from this demand growth and with its additional capacity coming on-stream in FY08, we are positive on the company and recommend a **BUY** with a price target of Rs 172.

Rs Mn	FY2005	FY2006	FY2007E	FY2008E
Net sales	2661.3	2920.7	3470.0	4050.0
EBITDA	201.3	239.6	208.2	283.5
Net Profit	101.0	131.7	101.8	143.6
EPS(Rs)	10.1	13.2	10.2	14.4
EPS growth (%)	(29.7)	30.4	(22.7)	41.1
Operating Profit margin (%)	7.6	8.2	6.0	7.0
PER(x)	13.2	10.2	13.1	9.3
EV/EBITDA (x)	6.5	5.4	6.8	5.0
P/S (x)	0.5	0.5	0.4	0.3
RoIC(%)	25%	31%	19%	24%
RoE(%)	17%	19%	13%	17%

Source: Company, DDAV Research

## Company

- Heritage Foods (India) Limited is one of the largest private dairies in the country. It was founded in 1992 by Sri Chandra Babu Naidu and went public in November 1994.
- The company supplies milk and milk products in the states of Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and the Union Territory of Pondicherry.
- The company plans to enter the organized retail sector by opening a chain of retail stores in Hyderabad, Chennai and Bangalore. Through its retail chain, the company will sell household items like fruits & vegetables, staples, dairy products, bakery items and FMCG products with special emphasis on fresh food produce.
- It plans to open 45 stores by April 2007 and another 43 stores by April 2008. The total cost of this expansion will be about Rs 2000 million, which would be funded through internal accruals as well as debt.

## Key investment arguments

- Changing demographics to boost sales:** The Indian GDP is growing at a rate of 8% per annum and is expected to sustain the growth momentum going forward. The main contributors to the high GDP growth are the services and manufacturing sectors. The growth in these sectors has led to a growth in urbanization in the country along with an increase in disposable income of people. The rising income level has resulted in higher demand for milk and milk products and greater quality consciousness among the consumers. The growing quality consciousness along with easy availability of milk through the day has led to a shift in demand in favour of the organized dairy sector.
- Operating margins to stabilize:** Heritage Foods is expected to witness a decline in operating margins in FY07E to 6% due to higher milk procurement prices as well as skimmed milk prices. However, in FY08 we expect the operating margins to improve by 100 bps to 7% due to an increase in selling prices coupled with a fall in skimmed milk prices. We expect the company to witness an operating profit growth of 36.2% to Rs 283.5 million in FY08.
- Capacity addition to fuel growth:** Heritage Foods is expanding its milk chilling capacity from 8.5 lac litres per day to 10 lac litres per day, and its packing capacity from 6 lac litres per day to 7.5 lac litres per day. This expansion will be completed by February 2007 and will start yielding its benefits from FY08. The total cost of this expansion will be Rs 250 million, which will be met by internal accruals as well as borrowings. In view of the expansion drive, we expect the top line of the company to grow at a CAGR of 18% during FY06-08E to Rs 4050 million.

## Key investment risks

- Dependent on vagaries of nature:** The quantity of milk produced by the milch animals largely depends on the quality and quantity of their fodder intake. In drought or flood situations, availability of fodder is affected and therefore milk production gets significantly reduced. This leads to escalation of milk procurement prices affecting the profitability of the players engaged in this sector.
- Lack of proper execution of the retail strategy:** The company plans to enter the organized retail sector, incurring a capital expenditure of about Rs 2000 million spread over two years. Failure to properly execute its retail plans will hamper the future prospects of the company.
- Rise in milk procurement prices:** The cooperatives are the dominant players in the dairy industry and any decision on their part to raise milk procurement prices without a simultaneous increase in selling prices will affect the profitability of the players operating in this segment.

## Sector view

- The organized dairy industry will witness a high demand growth for milk and milk products due to the rapid growth in urbanization as well as rising income level in the country.
- With the growth of the working middle class population in the country, conveniences of shopping and easy availability of products have become very crucial factors influencing purchase decisions. As the organized dairy sector meets both these requirements along with high quality, it is witnessing a shift in demand in its favour, aiding growth of the sector.
- Organized retail in India is in a nascent stage and is expected to grow by over 400% to USD 30 billion by 2010. This industry thus offers a lot of opportunities.
- It is estimated that food and grocery segment constitutes about 65% of the total retails sales in the country. This segment has not been catered to properly as of now and offers a big opportunity to organized players.

## Valuation

Heritage Foods is trading at 13.1 x FY07E and 9.3x FY08E and at an EV/EBIDTA of 6.8x FY07E and 5x FY08E. It is trading at 0.33x P/Sales and at 6.3 x CEPS FY08E which is attractive. Its return ratios are also going to improve significantly in FY08E, when it is expected to have a ROIC of 24% and an ROE of 17%. Heritage Foods has a strong presence in southern India where urbanization is growing fast along with rising income levels leading to a growth in the demand for milk and milk products. The company stands to gain from this demand growth and with its additional capacity coming on-stream in FY08, we are positive on the company and recommend a **BUY** with a price target of Rs 172.

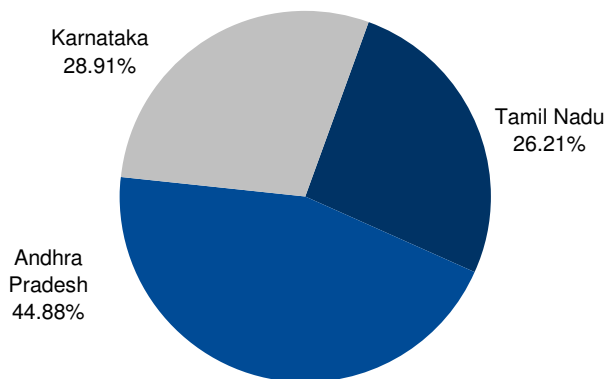
## Company background

Heritage Foods has been in the dairy business since 1992 and went public in November 1994. The company was founded by Sri Chandra Babu Naidu, the former Chief Minister of Andhra Pradesh.

*Heritage Foods is one of the largest private sector dairies in the country*

Heritage Foods is one of the largest private sector dairies in the country. It supplies milk and milk products in the states of Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and the Union Territory of Pondicherry.

**Exhibit 1: Revenue distribution across markets**



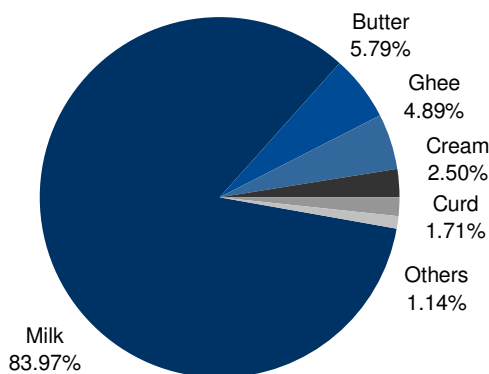
Source: Company

*It procures milk from the rural areas of Andhra Pradesh, Tamil Nadu and Karnataka*

Heritage Foods procures milk from the rural areas of Andhra Pradesh, Tamil Nadu and Karnataka and processes it at its processing plants located in various regions. Its main plant is located at Kasipentla, about 25 kms from Tirupati in Andhra Pradesh, and has a capacity of processing 1,50,000 litres per day.

Heritage Foods has been rapidly expanding its product profile and currently offers most of the dairy items like butter, ghee, curd, cream, doodh peda, khoa, flavored milk, paneer, lassi, etc.

**Exhibit 2: Revenues from different segment**



Source: Company

The company, which currently has a milk chilling capacity of about 8.5 lac litres per day, plans to expand it to 10 lac litres per day. It also plans to expand its packing capacity from 6 lac litres per day to 7.5 lac litres per day.

These capacity expansions are expected to be completed by February 2007 and its full benefits will be seen in FY08. The company has also acquired Indian Dairy Specialties Limited located at Uppal, Hyderabad, with a packing capacity of 1 lac litres. The total cost of this expansion will be about Rs 250 million which the company plans to meet through internal accruals and debt.

*The company plans to enter the organized retail industry*

Heritage Foods is in the expansion mode and plans a foray into the retail industry. It is going to set up a chain of retail stores in Chennai, Bangalore and Hyderabad. Through these retail stores, the company plans to sell household items like staples, dairy products, fruits, vegetables, consumer goods, etc.

*It plans to have 88 retail stores by the end of April 2008*

The company plans to open 88 stores by April 2008 in two phases. In the first phase, it would open 45 stores by April 2007 while the rest 43 would come up by April 2008.

The total estimated cost of opening these stores and setting up the required infrastructure would be about 2000 million. The company plans to meet this capital expenditure by internal accruals as well as by borrowings.

Heritage Foods has also created an infrastructure and construction company, Heritage Infra Developers Limited, which will be 51% owned by the company. This new entity will develop the surplus land that the company has in its possession. However, the required approval for this purpose has not yet been given by the concerned government and local authorities.

## Management

Heritage Foods is managed by a team of professionals. It is headed by Mr M.S.S. Rao, who is the President of the company.

Its dairy division is looked after by Mr. K Durga Prasad Rao, Senior VP (Operations); Mr. N Venkat Rao, VP (Procurement & Inputs); and Mr. T Venkateswara Rao, VP (Plant & Engineering) and the team working under their leadership.

Its retail venture is headed by Mr. N Lokesh, VP retail division, and his team which includes Mr. G P Subramanya Sama, head of Logistics & Warehousing division, Mr. Santosh Unni, head of Marketing & Operations, and Mr. P Harish Kumar, head of Merchandising.

## Business model

Heritage Foods procures milk from the rural areas of Andhra Pradesh, Tamil Nadu and Karnataka. It collects milk from local agents/farmers and sends the procured quantity to its mini chilling plants where it is stored at a temperature of about 4°C-5°C.

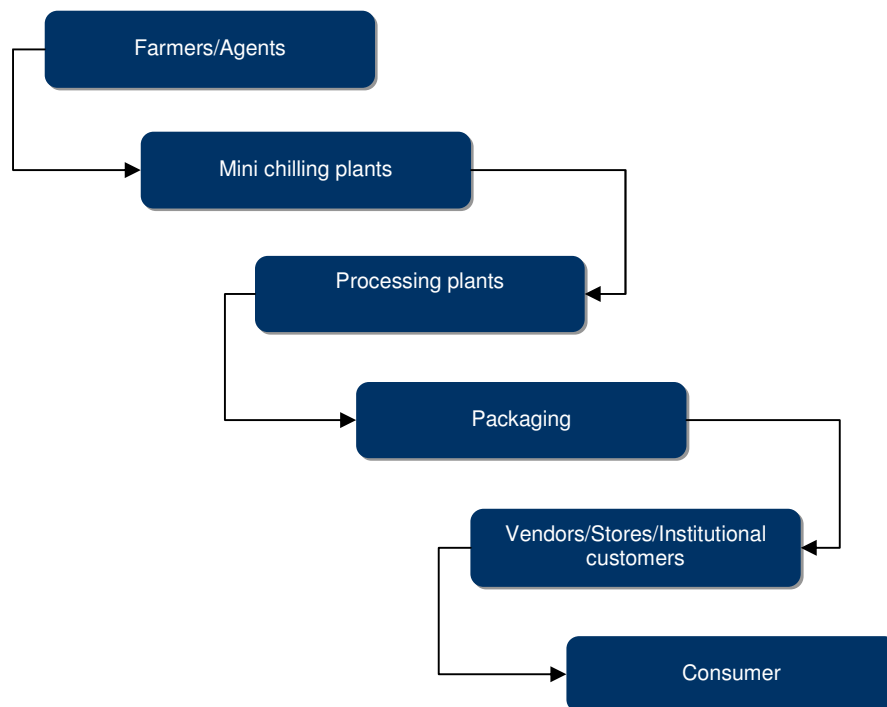
The low temperature at the mini chilling plants ensures that the produce is not affected by bacterial formation and gets a longer life with preserved quality. The milk is then transported from these mini chilling plants to the processing and packaging plants via tankers. In the processing plant, milk is pasteurized, harmonized and standardized as per the fat content requirement before being packed in plastic packets.

*In order to preserve the milk quality it has to be kept under control temperature till it is consumed*

The milk packets are then distributed to vendors/stores across different locations in insulated vans. The vendors/stores keep these milk packets in refrigerators under controlled temperatures and sell it to the customers as per their requirement.

As milk and milk products are highly perishable commodities, they have to be kept under controlled temperature from the time they are procured till the time they are consumed. It is estimated that if milk is kept under a controlled temperature of 4.4°C, then the bacteria standard plate count per 1000 ml after 72 hours is as low as 8 as against a bacteria standard plate count of 3,26,000 if kept at a temperature of 15°C. Thus the cold chain plays a vital role in this industry.

### Exhibit 3: Process flow



Source: Company, DDAV Research

Heritage Foods has a strong rural presence which helps it to procure milk easily from these areas and meet the growing demand for milk in urban areas.

*The company plans to set up retail stores in the cities of Hyderabad, Chennai and Bangalore*

Heritage Foods is now planning to enter the retail market by opening a chain of retail stores through which it will sell household items. The company plans to open 45 retail outlets by April 2007 and another 43 stores by April 2008. These stores will be opened in Bangalore, Chennai and Hyderabad with each of the cities having 15 stores in the first phase.

Each store will encompass an area of about 3000 square feet and have around 3500 SKU's. The company will sell bakery products, dairy products, staples, horticultural goods, FMCG products, etc. through these stores.

Though the company plans to keep various types of household items, it will focus on fresh produce items like fruits and vegetables, bakery products and dairy products.

The company, in its endeavour to foray into organized retail, enjoys the advantages of having its own cold chain in place and a thorough understanding of the logistics requirement of the business. It also has a strong rural presence wherefrom it plans to source fresh fruits and vegetables for selling in the urban markets.

Heritage Foods has entered into agreements with farmers under which they will procure fruits and vegetables at prevalent market prices from them. This agreement is a win-win situation for both the parties as the farmer will get ready a buyer whereas the company will get regular supplies of fresh produce.

The company has also contracted 5000 acres of land at Chittoor, Andhra Pradesh, where all types of fruits and vegetables will be grown under contract farming. This in turn will help to meet a major portion of demand for fresh produce by its stores.

The company plans to have a warehouse in each of the cities of Chennai, Bangalore and Hyderabad which will meet the stocking requirements of each of the stores in those cities. It is also putting up the requisite IT infrastructure for the retail venture.

Heritage Foods plans to have an in house bakery too, so as to meet the requirements of its stores. By having an in house bakery, an existing dairy as well as ready source of supply for vegetables and fruits, the company expects to enjoy better price realization.

It has also set up a core team for its retail venture, to be headed by Mr. N. Lokesh. The company is expecting revenues of about Rs 100,000 per day from each store. The total cost of setting up the stores along with the requisite infrastructure, bakery and agricultural production facilities is estimated to be about Rs 2000 million. The company plans to part finance this expansion cost through debt and has already tied up with banks for the purpose.

The company also plans to sell FMCG products in the rural areas to farmers/agents from whom it procures milk. Heritage Foods plans to use its existing infrastructure to deliver goods/products required by the farmers through its agents who procure milk for the company. This model looks quite feasible for Heritage Foods as currently the company's vehicles go empty on their way to the rural areas to collect milk and can be used to deliver the products demanded at no additional cost.

Also, the working capital required for this business is going to be low as the company will be selling it to agents who procure milk for it, thus doing away with credit.

## Industry

India is the largest producer of milk and accounts for nearly 15% of the total milk production in the world. The country produced about 90.7 million tones of milk in 2004 as against the global production of 625.7 million tones.

### Exhibit 4: Some of the major milk producing nations

Milk Production ( million tones)	2005
EU	146.9
India	95.1
USA	80.2
China	32.4
Russia	31
Pakistan	29.5

Source: FAO

The major milk producing regions in the world are Europe and Asia with each accounting for about 215 million tones. However, going ahead it is expected that Asia will become the largest producer of milk due to the high growth of milk production that this region is experiencing. It is expected that milk production in Asia will grow by 5% as compared to 2.5% growth estimated for Europe in 2006.

*The company plans to have a bakery to meet the requirements of its stores*

*Heritage Foods will use its existing rural network to sell FMCG products*

*India is the largest producer of milk*

*Milk production in India is growing at a CAGR of 4%*

The global milk production is estimated to be growing at a CAGR of 1.1% whereas the total milk production in India is growing at a CAGR of 4%. The total milk production in the country has grown from 55.7 million tones in 1991-92 to 90.7 million tones in 2004-05.

**Exhibit 5: Milk Production and Per Capita milk Availability in the country**

Year	Production ( Mn tones)	Per Capita Availability (gms/day)
1991-92	55.7	178
1992-93	58	182
1993-94	60.6	187
1994-95	63.8	194
1995-96	66.2	197
1996-97	69.1	202
1997-98	72.1	207
1998-99	75.4	213
1999-00	78.3	217
2000-01	80.6	220
2001-02	84.4	225
2002-03	86.2	230
2003-04	88.1	231
2004-05	90.7	229

Source :NDDB

India, despite being the largest milk producing nation and having a high growth, has a low per capita availability of milk. The per capita availability of milk in India is about 229 grams per day as compared to the world average of about 285 grams per day.

In India, about 60% of the population is engaged in agricultural activity and a significant portion of it also engages in milk production as it supplements their income. It is estimated that over 70 million rural households (primarily small and marginal farmers and landless labourers) are engaged in milk production in the country.

India has the world's largest livestock population, accounting for over 55% of the world's buffalo population and 16% of the cattle population. In spite of this, the country has not been able to exploit its potential due to reasons like low productivity of milch animals, lack of quality control and monitoring mechanism, lack of infrastructure facilities, etc.

The productivity of Indian cows is one of the lowest in the world whereas that of buffaloes is amongst the highest globally. Due to this high productivity as well as large buffalo population, buffalo milk accounts for 57% of the total milk production in the country.

**Exhibit 6: Average yield of cows in India**

Country	Average Yield (Kg per year)
India	800
World Average	3100
Australia	4800
EU	5700
USA	8400

Source: FAO

Indian milk production has grown substantially over the years. From being a milk deficit country in the 1950's and 1960's, when about 40% of milk solids in the total throughput of the dairy industry had to be imported, India today stands as a milk self sufficient country.

This transformation occurred due to the setting up of National Development Dairy Board (NDDB) in 1965 to oversee dairy development in the country. NDDB launched

*India has the largest livestock population in the world*

*Operation Flood resulted in the modernization of the Indian dairy sector*

“Operation flood“ in 1970, with a thrust to organize farmers’ cooperatives in rural areas and link them with urban customers.

Operation Flood, which lasted for over 26 years, has been the world’s largest and the most successful dairy development programme. It has led to the modernization of India’s dairy sector and created a strong network for procurement, processing and distribution of milk by the cooperative sector. It also eliminated the middlemen from the procurement process, helping the milk producers realize a better price.

Organized dairy industry in India has been dominated by the cooperative societies post operation flood till the onset of liberalization in 1991. As part of the government’s policies for economic liberalization, the dairy sector was opened to private players, though a few restrictions remained. However, the private sector got a major boost following an amendment in the Milk and Milk Products Order (MMPO) in 2002, whereby all restrictions with regard to setting up milk processing and milk manufacturing plants were removed. The delicensing of this industry and removal of restrictions have made this industry attractive to a lot of private players, many of whom have already entered the sector.

*The Indian dairy market is catered to both by the organized as well as by the unorganized sector*

The Indian dairy market is catered to by both the organized and the unorganized sector. The organized sector comprises of large scale dairies, whereas the unorganized sector consists of halwais and vends. In the organized sector, there are 676 dairy plants in the cooperative, private and government sectors registered with the government of India and state governments.

In India, about 35% of milk produced is processed, while the rest is retained by the rural consumer /sold to rural non-producers or sold as loose milk in urban areas. It is estimated that about 39 million tones of milk is retained by rural consumer/sold to rural non-producers whereas about 17 million tones is sold as unprocessed milk in the urban areas.

In the processed milk segment, the unorganized sector dominates the organized sector. Of the 35 million tones milk processed, 22 million tones is done by the unorganized sector whereas 13 million tones is done by the organized sector. The estimated market size of the processed products (as per 2003-04 prices) is about Rs 1161 billion.

In India, the quantity of milk processed is low and this offers tremendous scope for players in this industry.

### Types of milk

The milk and milk products industry is regulated by the Prevention of Food Adulteration Rules, 1955. The government has classified various types of milk based on the percentage of milk fat and milk solid non fat contents.

#### Exhibit 7: Various types of milk

	Minimum %	
	Milk Fat	Milk solids non fat
<b>Buffalo milk</b>		
Skimmed Milk	<0.5	8.7
Double toned milk	1.5	9
Toned Milk	3	8.5
Standardized Milk	4.5	8.5
Full Cream Milk	6	9
<b>Cow milk</b>	3.5/4	9

Source: Prevention of Food Adulteration Rules, 1955

*Dairy industry is regulated by the Prevention of Food Adulteration Rules, 1955*



*The price of milk depends on the fat content in it*

The prices of each category of milk vary depending on the fat content. The category having lower fat content is cheaper as compared to the one having higher fat content. The selling price of milk varies between Rs 16 and Rs 20 per litre. Toned milk and double toned milk are the highest selling milk category in the country.

Buffalo whole milk has about 6-8% of fat as compared to 3-4% fat found in cow whole milk. As the buffalo whole milk has higher fat content, the extra quantity of fat is removed at the processing plant and is used to make products like cream, butter, ghee, etc. The demand for these products is stable throughout the year though it goes up during festive seasons.

The demand for milk too is stable throughout the year but the supply is not, the reason for this being that the animal does not give milk in the same quantity all through the year. The animal gives a higher quantity of milk during a particular period which is called the 'flush' season and lower quantity during the other period called the 'lean' season.

*Milk demand is similar across the year but the supply is not so*

As the supply is erratic but the demand is steady, the dairies during flush season convert milk into milk powder and store it. This milk powder is later converted into milk by mixing it with water during lean seasons. The conversion of milk into milk powder and later again into milk helps dairies to smoothen the supply of milk and keep prices stable across the year.

In India, the unorganized sector dominates the dairy industry and thus availability of milk to the organized players is low. Also the organized players are present mostly in the urban areas as their selling price of milk is higher than the unorganized sector. Due to low availability of milk and limited markets, the capacity utilization of private dairies are in the range of 40% to 50%.

The existence of a significant number of players in the organized industry and limited markets has resulted in uniform prices which are similar across the board for various players.

### **Distribution of milk and milk products**

In the dairy industry there are both the organized as well as unorganized players. In the organized sector, the dairies distribute milk packets across the markets to wholesalers/retailers/stores, etc. who in turn sell it to the customers.

As milk and milk products are highly perishable products, they have to be kept under controlled temperature from the time they are procured till the time they are consumed. Thus the cold chain becomes very critical for this industry. In order to keep the milk fresh, dairies maintain controlled temperature throughout the value chain. This cold chain is also maintained by the wholesalers/retailers/stores, etc. in order to ensure that the milk does not get stale.

The organized players mostly sell milk as well as other milk products as compared to the unorganized sector which primarily sells milk only.

*As against the organized sector which has a cold chain throughout the value chain the unorganized sector has no presence of the cold chain*

As against the organized sector, the unorganized sector has no presence of cold chain in their distribution process. The milkman, who normally has his own animal, sells the milk directly to the consumer. This milk is sold directly as whole milk, in the raw form, to the consumer. Due to the non-existence of the cold chain and the perishable nature of the product, the seller and the buyer are normally closely situated, unlike the organized sector where they are spread far and wide.

Milk is a highly perishable product and so the global trade in it is very limited. It is estimated that only 7% of world milk production is traded (excluding intra-EU trade). Dairy products which are traded in the world market include cheese, butter, condensed milk, milk fats, caseins, etc.

India, despite being the largest producer of milk, has an insignificant share in global trade (less than 1%). The reason for it being low quality and hygiene conditions, lack of expertise in marketing dairy products in the international markets and availability of limited surplus milk for exports.

## Industry Outlook

### Dairy Industry

The demand for milk is stable throughout the year and goes up during specific festive occasion. Milk demand is linked to the population in the country and the purchasing power of people.

*The increasing purchasing power of the people will result in a higher demand for milk*

As India has a high population and the purchasing power of the people is going up, demand for milk is expected to keep growing. The consumption of milk and milk products is expected to grow by 8.4% in the urban areas and in the rural areas by 7% in the years ahead.

The growth in the milk market will be primarily driven by increase in per capita expenditure. The per capita expenditure on milk and milk products in India has grown at a CAGR of 5.9% to Rs 659 during 1996-2002 and is expected to have similar growth going ahead.

The organized dairy industry in India is primarily catering to the urban areas. The reason for it being that the milk prices in the organized sector are higher than the unorganized sector because of the processing and cold chain costs that the organized players have to incur.

*The increasing urbanization in the country will lead to a demand shift towards organized dairy industry*

We believe that going ahead the country will experience faster growth of urbanization, which will result in a bigger market for the organized dairy industry. Also, due to growing urbanization, the real estate prices of property in towns/cities are going up. This compels the unorganized sector to move out of the urban centers, leaving the market open for the organized players.

The service industry in India has been growing at the rate of 12% in the country and this is expected to continue going forward too. As a result of continued growth in this sector, a lot of new cities/towns have emerged of late, resulting in higher demand for milk from the organized sector which ensures quality and easy availability of the product.

The GDP growth in India is currently pegged at about 8% and is expected to sustain the momentum going ahead. This growth is primarily driven by the growth in manufacturing and service sectors. Due to the high growth in these sectors, a huge number of new offices are coming up in urban centers. Most of such offices have facilities like vending machines that serve beverages like tea, coffee, etc. for its employees. The milk requirement for these vending machines is primarily going to be met from the organized sector, thus aiding its growth further.

*Higher quality standards followed by the organized dairy sector will attract the growing health conscious middle class population in the country*

In India, though the dairy industry is regulated by the Prevention of Food Adulteration Act, 1955, adulteration of milk has been a common practice. This is more prevalent in the unorganized sector whereas in the organized sector, milk adulteration is limited/ non-existent. We believe that with rising income levels and growing health consciousness, more and more people will prefer to source their consumption requirements from the organized sector, thus aiding its growth.

The organized sector makes milk easily available at all times during the day, unlike the unorganized sector which makes it available only during a particular time. We believe that due to the growth in the middle class population in the country and the younger

*The coming up of organized retail chain in the country will aid further growth of organized dairy sector*

profile of the working population, this convenience in availability at all times during the day will ensure a permanent shift in demand in favour of the organized sector.

Another area wherefrom a huge growth impetus will come for the organized milk sector is the coming up of the retail food chains. These food chains will help further shift the market from unorganized market to the organized market.

Also, the coming up of tea/coffee shops like Café Day, Barista, etc. across the country will help the organized dairy see significant growth.

We believe that the organized dairy industry will see a significant growth both due to shift of demand from the unorganized sector as well as due to growth in the market. We also see a significant shift in demand to tetra pack milk in the next decade or so from the current plastic packing.

India has a location advantage geographically as it is situated close to milk deficit countries. For instance, countries like Bangladesh, Indonesia import about 40% of their total milk requirement, whereas Malaysia, Philippines and South Korea import about 95% of their milk requirement. We believe that export market offers a good opportunity to the organized sector which can be tapped in due course of time.

*Organized retail is expected to grow by 400% to USD 30 billion by 2010*

### **Retail Industry**

The retail industry in the country is in a nascent stage. Organized retail is expected to grow by over 400% to USD 30 billion by 2010. This offers a huge opportunity for existing players as well as potential players in this sector.

It is estimated that of the total retail sales in the country, about 65% constitutes of food and grocery. This segment thus presents good opportunity for the organized retail players.

We believe that the organized retail sector presents a good opportunity for players who can source the requisite products as the demand is very high and has not been catered to till date.

# Investment Argument

## Demographic changes to boost sales

Heritage Foods sells about 5 lac litres a day with about 70% sales coming from three cities Chennai, Bangalore and Hyderabad. These cities are witnessing rapid growth for being the preferred destinations for the service sector.

*The growth in the services sector in the southern cities has resulted in spiraling property prices resulting in unorganized milk sector moving out from these areas*

As a result of this high growth in the service sector, which created huge demand for office spaces, a large portion of the population has shifted to these cities whereby creating demand for residential accommodation. This combined demand for both office space and residential accommodation has led to a spiraling of property prices in these cities. The rising property prices have compelled a lot of small players to sell out their properties and move out of these cities. So has been the case with the unorganized milk sector.

These unorganized players have sold out their property and shifted to outskirts of the big cities. They are now catering to a select segment of the customer base but have lost a major market due to their lack of proximity to the customers and their inability to provide milk all through the day.

Such marginalization of the unorganized sector has acted as a great demand booster for the players in the organized sector in the dairy industry.

*The growth in services sector in these areas has resulted in migration to these cities, creating additional demand for milk*

The growth in the services industry in these cities has resulted in migration of population to these areas from across the country. This shift of population has created a massive demand for milk and milk products which will be catered to mostly by the organized sector.

These South Indian cities are seeing a lot of young population coming due to the growth in the service industry in these cities. These young people require convenience in availability of goods used for daily needs as they have odd hours of working. As organized players in the dairy industry make milk easily available at all times and at convenient locations they are preferred to the unorganized players in the dairy industry.

The growth of the service industry in these cities has resulted in an increased purchasing power of the people which in turn has raised demand for milk and milk products.

*Rising income level has also resulted in additional demand for milk*

Also, due to a rise in the income levels of the people, they have become quality conscious. The growing quality consciousness has led to a shift in demand in favour of the organized dairy sector, where the adulteration issue is much lower as compared to the unorganized sector.

The south Indian cities are witnessing a significant growth in office spaces. These new offices are being built with latest infrastructure one such thing being vending machines. These vending machines require milk and most of this demand is met by the organized dairy sector.

Also with a lot of young population being present in these cities and business growing, a lot of restaurants, hotels, coffee shops etc have come up, further adding to the demand for milk, from the organized sector.

Heritage Foods is present across south India and has a major presence in these three cities. As demand for milk from the organized sector grows we believe that Heritage Foods will be a major beneficiary. The company has the required distribution network and sourcing avenues for milk which will help it meet this demand explosion in the years to come.

### Capacity addition to fuel further growth

Heritage Foods is expanding its milk chilling and packing facility in order to meet the growing demand for milk. The company has also acquired Indian Dairy Specialties Limited (in liquidation) situated at Uppal, Hyderabad in April 2006. The acquired firm has a capacity of 100,000 litres per day.

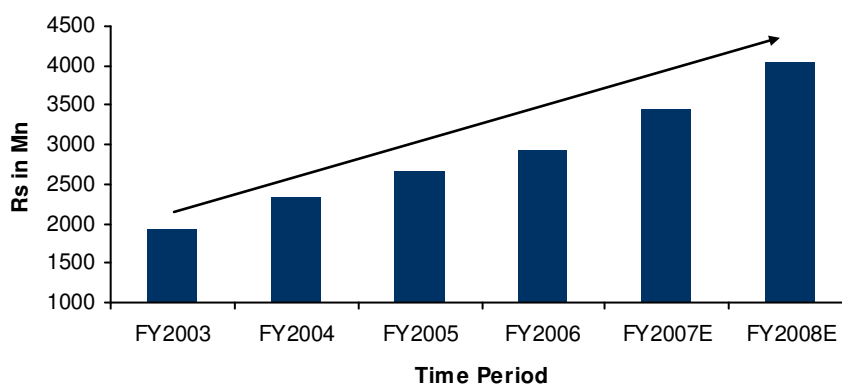
*The total cost of capacity addition is going to be about Rs 250 million and is expected to be completed by February 2007*

It is also setting up two procurement, processing and packaging plants; four procurement and processing plants, 10 mini chilling plants and three bulk cooling units. The total cost of this expansion is about Rs 250 million and the enhanced capacity is expected to be operational by February 2007. The company plans to meet this capital expenditure through internal accruals as well as debt.

After the acquisition of Indian Dairy Specialties Limited and completion of its expansion plans, the chilling capacity of the company will go up from 8.5 lac litres per day to 10 lac litres per day. The packing capacity of the company will also go up from 6 lac liters per day to 7.5 lac liters per day.

As these expansions will come by February 2007, the total benefit of it will be seen in FY08. We expect that the revenues of the company to grow at a CAGR of 18% during the period FY06-08E.

### Exhibit 8: Revenue growth



Source: Company, DDAV Research

### Deep rural penetration to help volume growth

Heritage Foods has a strong presence in the rural areas of Andhra Pradesh, Karnataka and Tamil Nadu. The deep penetration of the company in these regions will help it to procure milk for the growing demand in the cities of Hyderabad (Andhra Pradesh), Chennai (Tamil Nadu) and Bangalore (Karnataka).

Heritage Foods has built a strong procurement base in the rural areas by maintaining high ethical standards with regards to measurement of milk, paying the appropriate price for the milk based on milk fat content, payment to farmers on the specified dates etc.

*The company has a strong rural presence due to the high ethical practices it follows as well as due to social activities it undertakes*

Besides this the company also engages in social activities in these regions where by it has built in strong relationship with the farmers. The company engages in activities like providing animal fodder at no profit no loss basis and availability of animal medicines on a no profit no loss basis etc. Heritage Foods procures animal medicines on wholesale basis through annual contracts with pharmaceutical companies whereby it gets a discount of about 30%-40% on the MRP, which thus benefits the farmers as the company supplies it to them on a no profit no loss basis.

The company also organizes free medical camps for animals from time to time which helps the farmer to take proper care of their animals.

Heritage Foods also helps farmers to get loans for buying animals through a tri-party agreement where by the bank gives loan to the farmers and it collects installments from the farmers for the bank. Heritage Foods collects the installments from the farmers in the form of buying milk from them and giving a part of the purchase price to the bank. In this tri-party agreement Heritage Foods is not liable for any payment default by the farmer.

*Heritage Foods also lends money to farmers to buy animals*

Heritage Foods itself also lends money to small farmers to buy animals. In FY06 the company gave direct loans of about Rs 60 million to farmers. As the company has a strong rural presence it has witnessed minimal bad debts due to direct loans it has given to the farmers.

All these steps taken by the company have helped it come closer to the farming community and thus ensure regular supply of milk. Also its presence for more than a decade in these areas and ethical practices followed by it has helped it to establish itself in the rural areas.

We believe that the company will be able to get the additional milk required for the growing demand in the urban areas due to its strong rural base. Also the decision by the company to reach deeper pockets of these states which have still not been properly tapped will help it to get more quantity of milk.

### **Strong Distribution Network**

Heritage Foods has over the past decade set up a wide distribution network in urban areas. It has a strong network in the major markets like Hyderabad, Chennai and Bangalore.

*Heritage Foods has a strong distribution network in the growing cities of Hyderabad, Chennai and Bangalore*

As the demand in these cities is growing significantly and as Heritage Foods has a strong distribution network there, it should be a significant beneficiary of this growth. Also, the presence of Heritage Foods in these areas for over a decade will help it to garner a significant share of this growing market.

### **Stable business**

Heritage Foods is into a business which has a stable demand throughout the year except during some festive occasions when demand goes up. This stability in demand ensures a ready market for the company and gives visibility of revenues over a period of time.

The demand for milk is expected to go up in the years ahead due to the high growth the regions in which the company is operating is witnessing and also due to increase in the per capita income of the people leading to higher demand for milk. We believe that this stability in demand makes the business of Heritage Foods very attractive.

### **Operating margins to improve**

The operating margins of Heritage Foods have been in the range of 7-8% from FY05. However in FY07 the operating margins of the company is expected to come down to 6%. The reason for this decline in operating margins is the higher milk procurement prices during the first half of FY07.

*Operating margins to decline in FY07 due to higher procurement prices of milk and skimmed milk powder*

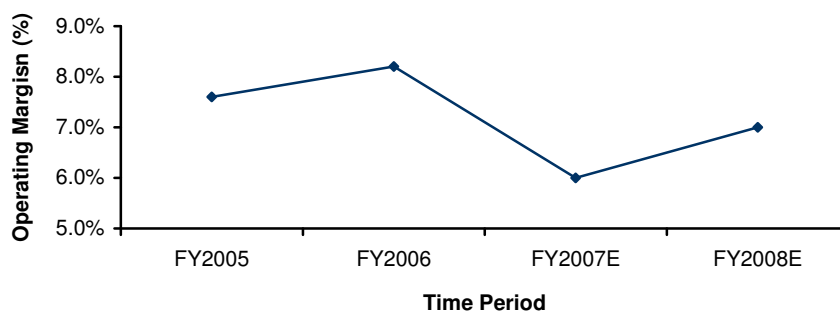
The cooperatives operating in these areas had raised the procurement prices of milk without raising its selling prices. As cooperatives veil more power due to them being market leaders, Heritage Foods have to follow the prices they set. Also the prices of skimmed milk powder during H1FY07 went to Rs 130-Rs 135/Kg as against Rs 110-Rs 120/Kg during H1FY06. This increase in purchase price and higher skimmed milk powder prices without a subsequent increase in selling prices resulted in the operating margins seeing a fall to 5% during H1FY07.

However from the second half of FY07 the company has hiked the selling prices of milk. This resulted in an initial drop in sales but due to the growing demand in the areas where it sells, it has been able to regain its sales.

Another reason for the increase in milk procurement prices was the scarcity in supply of milk due to drought conditions in the areas from where it procures, followed by floods. Now the situation has improved and milk supply has become normal.

We expect the company to be able to operate at 7% operating margins for the H2FY07 and so also for the full year FY08.

#### Exhibit 9: Operating Margins



Source: Company, DDAV Research

#### Return ratios to improve

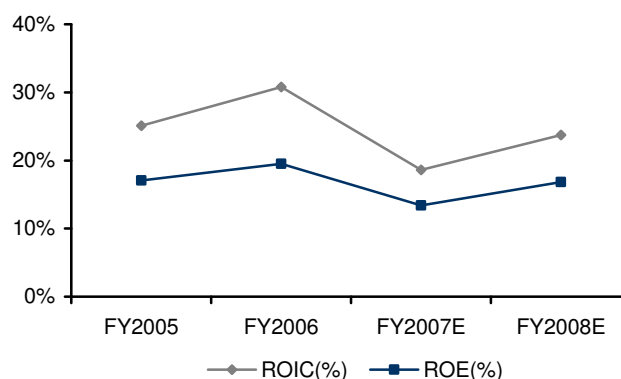
Heritage Foods has had healthy return ratios in FY06. The company had an ROIC of 31% and an ROE of 19% in FY06. However, in FY07 we expect the ROIC and ROE to be 19% and 13%, respectively.

*Return ratios to improve going further due to improvement in operating margins*

The reason for this decline in profitability ratios is the lower operating margins the company is going to witness due to rise in raw material prices. However going ahead we expect the operating margins to improve due to reduction in procurement prices of milk and increase in selling prices.

The increase in operating margins will result in the profitability ratios to improve and we expect the ROIC and ROE of the company to be 24% and 17% respectively in FY08E.

#### Exhibit 10: ROIC vs ROE



Source: Company, DDAV Research

#### Entry into an untapped market- organized retail

Heritage Foods is entering into organized retail by opening a chain of retail stores across Chennai, Hyderabad and Bangalore. The company plans to launch these stores under a different brand name which has not yet been disclosed. Through these stores the

*The company plans to enter the organized retail industry with special focus on fresh produce*

company plans to sell all household items, while special attention will be paid towards sale of fresh produce items like dairy products, bakery items, fruits and vegetables.

The company plans to give special emphasis on fresh produce as the company has the required expertise in cold chain which is critical in case of fresh produce business. Also the fresh produce business has a lot of potential as the demand is high and has been not addressed till date.

It is estimated that about 65% of the total retail market in India constitutes of Food and grocery. This segment has been mainly catered to by the local shops or *kirana* shops as they are called.

The company in order to meet the needs of the customers is setting up its own bakery and has also entered into agreements with farmers for buying fresh fruits and vegetables.

Heritage Foods has also contracted 5000 acres of land at Chittor, Andhra Pradesh where all types of fruits & vegetables will be grown by the farmers and the company will buy from them at prevalent market price. The sourcing from these farms will help meet a major portion of demand of its stores. Besides this the company has also tied up with other farmers to procure fruits & vegetables at market prices which will help meet the remaining demand for fresh produce from the stores.

For the dairy products the company plans to meet the requirements of its stores through the existing facilities.

The company plans to open 15 stores each in Hyderabad, Chennai and Bangalore by April 2007 and another 43 stores by April 2008. These stores will be about 3000 square meter in size and would stock about 3500 SKU's. It also plans to make free home delivery within a radius of 2 km.

The company expects revenues of 1,00,000 per store per day and an operating margin of 7-8% from it. The total cost of the setting up of stores and requisite infrastructure like bakery, interiors of the stores etc is estimated to be about 2000 million. Heritage Foods plans to meet this expansion cost through debt and internal accrual.

The company also plans to use its strong rural network to sell FMCG products in these areas to the farmers. For distribution of products in these regions Heritage Foods will use its existing transportation infrastructure and agent network and will not incur any additional cost.

We believe that the retail business model of the company is feasible and a proper execution will create a lot of value for the company. The decision to open retail stores with special focus on fresh produce which has a huge untapped market will help it to establish itself.

Heritage Foods decision to open stores in the growing cities of Chennai, Hyderabad and Bangalore and its strong presence in these areas will help the company to make its foray in the burgeoning organized retail industry.

We are positive on the foray of the company into organized retail but have not incorporated the numbers from this business in our estimates as there is lack of availability of data. We would wait for the execution of the company's plans into organized retail before factoring in the numbers from this business.

*The company plans to have each store of 3000 square feet and stock 3500 SKU's in it*



## Financial Performance

*The top line of the company is expected to grow at a CAGR of 18% during FY06-08E*

Heritage Foods top line is expected to grow at a CAGR of 18% during the period FY06-08E from the dairy business. This top line growth of the company is going to come from the expansion in the dairy business.

The operating margins of the company will witness a rise of 100 basis points to 7% in FY08E due to lower milk procurement prices as well as increase in selling price of milk by the company.

In FY07, however the operating margins will see a dip of 220 basis points to 6%. The company will see this fall in margins due to higher milk procurement prices and skimmed milk prices in H1FY07. However, from Q3FY07 the company has raised the selling price of milk and also the prices of skimmed milk have come down which will thus result in the company seeing operating margins of 7% during H2FY07.

As the company will have lower operating margins in FY07 we expect the company to see a drop of 22.7% in net profits to Rs 101.8 million. However, we believe that the worst is over and with the company being able to increase its selling price and a fall in skimmed milk powder prices the company will witness a growth of 41.1% in its bottom line in FY08E.

*Heritage Foods has a debt free balance sheet*

Heritage Foods has a debt free balance sheet (after adjusting for cash) and can easily meet its expansion requirements for the dairy business as well as for the organized retail business.

In doing our projection for the company we have not considered the revenues as well as the financing modes from the retail business and have only considered the dairy business.

## Valuations

Heritage Foods is trading at 13.1x FY07E and 9.3x FY08E and at an EV/EBIDTA of 6.8x FY07E and 5x FY08E. We believe that the organized dairy business is a stable business and a scalable one. With growing urbanization in the country, it offers a good investment opportunity.

Heritage Foods has seen some tough times in FY07 due to rising raw material prices. We, however, expect the company to see better days ahead with decline in raw material prices, and are thus positive on the company.

We have valued the milk business at Rs 172 (12x FY08E) only for our estimates and have not considered the organized retail business due to lack of availability of data.

Heritage Foods is currently trading at 0.33x P/Sales FY08E and at 6.3x P/CEPS FY08E which is attractive. Also, the return ratios of the company are going to improve significantly going ahead and the company is expected to have a ROIC of 24% and ROE of 17%.

*We recommend a **BUY** on the stock with a price target of Rs 172*

We believe that the milk business of the company offers significant value at the current price and thus recommend a **BUY** on the stock with a price target of Rs 172. Besides, a successful execution of the organized retail business of the company will result in a re-rating of the stock, which will offer a further upside to the stock.

Income Statement (Rs mn)	FY2005	FY2006	FY2007E	FY2008E
Net Sales	2661.3	2920.7	3470.0	4050.0
% growth	13.5	9.7	18.8	16.7
Raw Material	2075.2	2253.4	2776.0	3209.6
Staff	68.9	81.9	100.6	113.4
Others	316.0	345.8	385.2	443.5
Total Expenditure	2460.0	2681.1	3261.8	3766.5
EBITDA	201.3	239.6	208.2	283.5
% growth	(33.5)	19.0	(13.1)	36.2
EBITDA margin (%)	7.6	8.2	6.0	7.0
Other income	7.8	12.7	14.0	14.0
Interest	6.0	4.0	10.0	12.0
Gross Profit	203.1	248.2	212.2	285.5
% growth	(35.1)	22.2	(14.5)	34.5
Depreciation	40.1	48.0	58.0	68.0
Profit Before Tax	163.0	200.2	154.2	217.5
% growth	(40.5)	22.9	(23.0)	41.1
Tax	61.4	63.9	52.4	74.0
Effective tax rate (%)	37.7	31.9	34.0	34.0
Net Profit	101.6	136.4	101.8	143.6
% growth	(42.4)	34.2	(25.4)	41.1
Extraordinaries	0.6	4.7	0.0	0.0
Reported Net Profit	101.0	131.7	101.8	143.6
% growth	(29.7)	30.4	(22.7)	41.1
EPS (Rs)	10.1	13.2	10.2	14.4
% growth	(29.7)	30.4	(22.7)	41.1
DPS (Rs)	3.0	3.0	3.0	3.0
Payout (%)	29.7	22.8	29.4	20.9

Balance sheet (Rs mn)	FY2005	FY2006	FY2007E	FY2008E
Equity	99.9	99.9	99.9	99.9
Reserves	526.5	625.0	696.8	810.4
Net worth	626.4	724.9	796.7	910.3
Loans	121.4	187.3	237.3	287.3
Deferred tax liability	62.9	60.2	60.2	60.2
Liabilities	810.7	972.5	1094.3	1257.8
Gross Block	726.9	801.5	1051.5	1201.5
Depreciation	223.2	268.2	326.2	394.2
Net Block	503.8	533.3	725.3	807.3
Capital work-in-progress	11.6	26.4	0.0	0.0
Long-term Investments	7.0	2.1	2.1	2.1
Inventories	236.0	257.3	290.3	348.8
Debtors	16.6	23.3	29.9	34.4
Cash	152.5	227.9	161.8	205.3
Other Current assets	115.0	192.5	216.3	249.7
Total Current assets	520.1	701.0	698.4	838.3
Creditors	73.7	100.4	112.5	131.6
Other current liabilities	158.1	189.8	219.0	258.2
Total current liabilities	231.8	290.3	331.5	389.8
Net current assets	288.3	410.7	366.9	448.5
Total Assets	810.7	972.5	1094.3	1257.8

Cash Flow Statement (Rs mn)	FY2005	FY2006	FY2007E	FY2008E
EBIT	161.15	191.56	150.20	215.50
(Inc.)/Dec in working capital	81.27	(47.01)	(22.28)	(38.12)
Cash flow from operations	242.42	144.55	127.92	177.38
Other income	7.81	12.69	14.00	14.00
Depreciation	40.15	48.00	58.00	68.00
Interest paid (-)	(5.99)	(4.01)	(10.00)	(12.00)
Tax paid (-)	(61.39)	(63.86)	(52.43)	(73.95)
Dividends paid (-)	(34.17)	(34.17)	(29.97)	(29.97)
Net cash from operations	188.83	103.19	107.52	143.46
Capital Expenditure (-)	(71.96)	(89.37)	(223.60)	(150.00)
Net cash after capex	116.87	13.82	(116.08)	(6.54)
Inc./(Dec.) in short-term borrowing	(108.77)	65.92	50.00	50.00
Inc./(dec.) in long-term borrowing	0.00	0.00	0.00	0.00
Inc./(dec.) in borrowings	(108.77)	65.92	50.00	50.00
(Inc.)/Dec in Investments	(4.11)	4.89	0.02	0.00
Cash from Financial Activities	(112.88)	70.80	50.02	50.00
Others	9.89	(2.69)	(0.01)	0.00
Opening cash	138.66	152.51	227.90	161.83
Closing cash	152.51	227.90	161.83	205.29
Change in Cash	13.85	75.38	(66.07)	43.46

Valuation ratios	FY2005	FY2006	FY2007E	FY2008E
EPS(Rs)	10.1	13.2	10.2	14.4
CEPS(Rs)	14.1	18.0	16.0	21.2
PER(x)	13.2	10.2	13.1	9.3
P/CEPS(x)	9.5	7.4	8.4	6.3
Mcap/Sales(x)	0.5	0.5	0.4	0.3
EV/EBIDTA(x)	6.5	5.4	6.8	5.0
ROIC(%)	25%	31%	19%	24%
ROE(%)	17%	19%	13%	17%

Growth(%)	FY2005	FY2006	FY2007E	FY2008E
Net Sales	13.5	9.7	18.8	16.7
Operating profit	(33.5)	19.0	(13.1)	36.2
PBT	(40.5)	22.9	(23.0)	41.1
PAT	(29.7)	30.4	(22.7)	41.1

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