Food Processing

Initiating Coverage

ADF Foods

BUY

Private Client Group

CMP : Rs.70

Target : Rs.120

ADF Foods (ADF) operates in the agro-based food industry, manufacturing and processing a wide range of canned, bottled and processed spices, vegetables and ready-to-eat foods for exports. Demand for ready-to-eat meals has captured a large amount of the food retail market in India and around the world. We like this segment, which is growing at CAGR of 35-40%. With well-entrenched brands and varied product profile, ADF is bound to ride the growing segment. We expect CAGR of 24% in sales and 31% in profits over FY07-FY09E. We are initiating coverage on the stock with BUY recommendation, giving a price target of Rs120 over one year period.

Key highlights

Diverse product & geography – The Company markets almost 300 variety of products under four major brands across four different geographical markets. Diverse product basket and presence in growing markets, provides sturdy and de-risked business model to the company.

Participating in growing market – Convenient and authentic ethnic food is driving the demand for ready-to-eat and frozen food globally. This demand for ready-to-eat meals has captured a large amount of the retail-food market in India and around the world. We feel ADF is well positioned to capitalize from the immense opportunity arising from the domestic and exports markets. There is a scope for the company to enter the fast growing domestic market where it does not have a presence.

On a spending spree – It has already incurred Rs40mn to expand its facility at Nadiad and plans to spend another Rs40mn at it Nasik plant. It also has plans to set up a green field facility for Rs200mn, this would increase its gross block by 60% and this would make it capable to grow its sales by more than 50% over next 2-3 years. It also has plans to grow inorganically for faster penetration in new geographies.

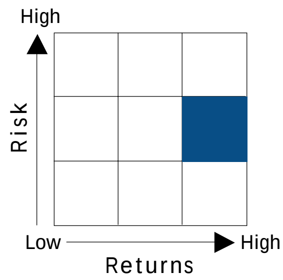
Valuations

As the company is participating in the fast growing business, we expect a CAGR of 31% in net profit over FY07-FY09. The consolidation in the industry is driving the valuations higher. There have been a couple of deals in the recent past in the domestic market at an average valuation of 2.5x sales and 15-20x EBIDTA. We have valued the company on weighted average basis, with 50% weightage assigned to market cap/sales, 30% to EV/EBIDTA and 20% to P/E multiple. We have arrived at a price target of Rs120 for the stock, which indicates 71% upside from current market price. Thus, we initiate coverage with **BUY** rating on the stock.

Valuation summary

Y/E, 31st March	FY06	FY07	FY08E	FY09E
Net sales (Rs mn)	**623**	**795**	**972**	**1,216**
Adj PAT (Rs mn)	27	66	84	114
Adj EPS (Rs)	**2.6**	**6.4**	**5.6**	**7.6**
EPS growth(%)	44.3	145.9	26.0	36.1
P/E (x)	**27.0**	**11.0**	**12.6**	**9.2**
Dividend yield (%)	1.5	2.9	2.9	2.9
RoCE (%)	**11.0**	**18.5**	**18.5**	**17.3**
RoNW (%)	8.8	19.8	17.5	17.7
P/BV (X)	**2.3**	**2.0**	**1.7**	**1.5**
EV/EBIDTA (x)	14.5	6.4	6.5	5.2
EV/Sales (x)	**1.4**	**1.0**	**1.1**	**0.9**

Risk Return Matrix



Indices

Sensex	16,846
Nifty	4,932

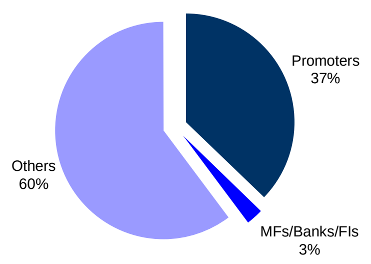
Stock Data

BSE Code	519183
NSE Code	AMERICADRY
Bloomberg	ADFL@IN
Reuters	AMRN.BO
Shares Issued (mn)	10
Market Cap (Rs mn)	700
52 Wk H/L (Rs)	77/25
Face Value (Rs)	10
Avg. daily vol. (12-mths)	28,016

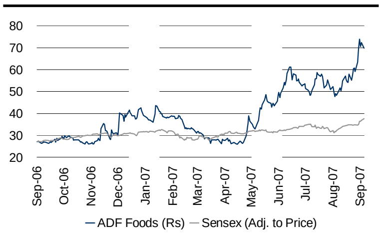
Absolute Returns (%)

	1 m	3 m	12 m
Absolute	37.8	35.1	165.4
Rel. to Sensex	24.3	19.0	127.0

Shareholding Pattern



ADF Foods Vs Sensex (Adj)



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September 25, 2007

Company background

ADF Foods (ADF) promoted by the Thakkar family from Mumbai way back in 1930. It was incorporated in 1990 and went public in 1991. The company manufactures a wide range of canned, bottled and processed spices, vegetables and ready-to-eat food for the exports market. Though, the company started as a retail store selling dry fruits, but over the years it has changed its business model. The company has established its marketing and sales network over two decades in the US, UK, Middle East, South East Asia and Australia, with strong brand recognition. Exports contribute 95% of revenues. The company has over the past two years ventured into fast growing frozen food and ready-to-eat segment. It manufactures over 300-product variety under four umbrella brands. It has two manufacturing facilities located at Nasik & Nadiad.

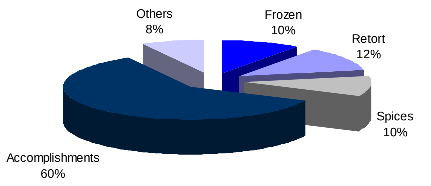
Diversified product & geographies – sturdy business model

ADF has four brands '**Ashoka**' is popular brand for US, UK and Australian markets, '**Classic Ashoka**' is pitched as a premium brand in the overseas market. It has enlisted one more brand in its portfolio - '**Truly Indian**' a new premium brand, which has successfully been test-marketed over the past one year in US and would be launched in the US markets and subsequently taken to UK markets. Its other two brands '**Camel**' and '**Aeroplane**' are positioned as value brands for the Middle East markets. The company markets almost 300 prodcut verities from pickles, spices to frozen vegetables and ready-to-eat food. Currently, ready-to-eat and frozen food segment together contributes only 22% to total revenues, but we expect the share of these two segments to go upto 40-45% by FY09. As the gross margins in frozen foods and ready-to-eat segment is higher at around 40-45% as compared to 30% margin in other products we expect the overall margins for the company would increase by 180bps to 17.6% by FY09 from 15.8% in FY07.

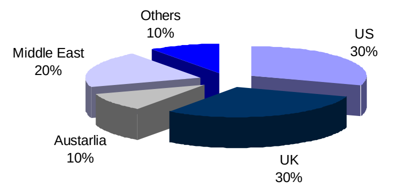
Currently, ready-to-eat and frozen food segment together contributes only 22% to total revenues, but we expect the share of these two segments to go upto 40-45% by FY09

De-risked business model (FY07)

Revenue (%)



Geographies (%)



Source: Company, MF Global PCG Research

Product basket – largest offering

						Ready to eat	
Pickles	**Pastes**	**Canned Products**	**Masala/Spices**	**Instant mixes**	**Frozen Vegetables**	**Curries**	**Snacks**
Mango	Tamarind Slab/Paste	Lotus Roots	Biryani Masala	Rava Idli	Goovar	Shahi Rajma	Aloo Paratha
Lime	Mango	Drumsticks	Chat Masala	Sada Dosa	Green Channa	Panjabi Chholey	Gobhi Paratha
Garlic	Green Masala Paste	Lady Finger	Chhole Masala	Mendu Vada	Suran	Pav Bhaji	Methi Paratha
Mix. Fruit	Panjabi Tandori Paste	Bean Seeds	Garam Masala	Idli	Drumsticks	Palak Paneer	Mixed Veg. Paratha
Chhundo	Mixed Fruit Relish	Tinda	Jalgira	Rava Dosa	Methi	Paneer Makhani	Paneer Paratha
Carrot	Chutney	Mango Pulp	Meat Masala	Sambhar	Tinda	Malai Kofta	Onion Paratha
Chilli		Mango Slices	Pani Puri Masala	Gulab Jamun	Bhindi	Dal Makhani	Paneer Paratha
Turmeric		Palak Paneer	Pav Bhaji Masala	Khatta Dhokla	Karela	Tadka Dal	Puran Poli
Brinjal		Patra	Kasuri Methi	Khaman Dhokla	Chicoo	Aloo Matar	Tandoori Roti
		Pav Bhaji	Sambhar Masala	Onion Bhujiya	Spinach	Surti Undhiu	Lachcha Paratha
		Sarson Ka Saag	Tandoori Masala	Shahi Kheer	Coconut Shreds	Navratan Korma	Kerala Paratha
		Panjabi Choley			Lotus Roots	Matar Paneer	Moong Halwa
		Surti Undhiu			Tindora	Chicken Achari	Dudhi Halwa
					Parval	Chicken Masala	Carrot Halwa
					Peas	Butter Chicken	Seera

Source: Company, MF Global PCG Research

As almost 95% of revenues come from exports there is risk of loss on currency appreciation. But the company is secured to larger extent as its revenues are denominated in three-four currencies, reducing the risk of exposure to single currency and any major negative impact of rupee appreciation.

Positive step on corporate governance

Out of the four existing brands under which the company markets its products, two of the well-established brands 'Ashoka' & 'Classic Ashoka' were earlier held through a group company Luster Investment. These two brands collectively contribute approximately 25% of the total revenues for the company. ADF is in the process to amalgamate Luster Investment, privately held by the promoters earlier, into the company. As a result of which it will hold 99% stake in Power Brands, which owns the two brands and the corporate office. The transaction has been valued at Rs200mn, Rs180mn for the intangible assets (two brands) and another Rs20mn for the fixed assets, existing corporate office. ADF would be issuing 5mn shares in lieu of the transaction this will increase the equity capital from Rs100mn to Rs150mn as a result of which the promoters stake in the company would also go up from 37% to 58%. We see this as a positive step on corporate governance front, as two of the foremost brands are being brought under the company's fold and at the same time it would save on the lease rent of Rs2mn being paid to the group company earlier, for the corporate office. Increase in promoters stake gives confidence of greater focus and seriousness of the promoters to take the company forward on the growth path.

We see this as a positive step on corporate governance front, as two of the foremost brands are being brought under the company's fold

Two sides of the coin – export & domestic markets

❖ **Exports – Demand growth at 35-40%**

Changing consumer preferences and increasing per capita income has made the consumers obsessed to seek convenience. Authentic ethnic food is driving the demand for ready-to-eat and frozen food globally. Ready-to-eat products exported from India are mostly consumed in UK, Europe, USA, and Arab countries. With the advanced food preservation technology, the shelf life for these products is increasing day by day. However, to maintain the product quality and to commit investment in brands and distribution it would be possible only for organized players. Globally, the organic foods industry is estimated at $56 billion and growing rapidly at CAGR of 35%. This demand for ready-to-eat meals has captured a large amount of the retail-food market around the world and is fast catching up in India and other Asian countries also. Indian manufacturers have good potential to export its products to countries dominated by NRI population as these products provide convenience and at the same time benefit from ethnic flavour of Indian palate.

Demand for ready-to-eat meals growing at CAGR of 35%, has captured a large amount of the retail-food market around the world

❖ **Domestic markets – on threshold of exponential growth**

Processed food market is the most important segment of the food industry, accounting for over 32% of the total food market. While India has an abundant supply of food, the food processing industry is still nascent only two per cent of fruit and vegetables; and 15% of milk produced are processed. Despite this, the processed food industry ranks fifth in size in the country, representing 6.3% of GDP. It accounts for 13% of the country's exports and 6% of total industrial investment. In a bid to boost the food processing sector, the Government is working on the concept of agri-zones and mega food parks, which would cover the entire food processing cycle "from the farm gate to the retail outlet", 30 locations have already been identified for mega-food parks, the government would also provide grants of up to $18.9 mn each for these kinds of parks.

The food processing industry is still nascent only two per cent of fruit and vegetables; and 15% of milk produced are processed in India

Also, the Union Cabinet has given its in-principle approval to an action plan for the food-processing sector, that aims to help the industry increasing the level of processing of perishable items to 20 per cent, and increasing value addition from 20% to 35% and share in global food trade from about 1.5% to 3%. This sector has also been attracting FDI across different segments. As per study by Confederation of Indian Industry the Indian food industry is estimated to be worth over $ 200 billion is expected to grow to $ 310 billion by 2015. There is enough potential for the segment to grow on the back of retail boom in the domestic market and humongous potential for exports to NRI populated countries.

Taking advantage of the opportunity

We feel ADF Foods is well positioned to capitalize from the immense opportunity in the frozen food and ready to eat segment. These two segments are fast growing and the company has ventured into these only over last 2-3 years. We expect sales from these two segments to account for 43% of total sales. The company's production of processed & preserved food during the last year increased by 20%. To participate in the growing market the company has spent Rs40mn to expand its frozen food capacity at Nadiad to 1000mt. It also plans to spend another Rs40mn at its Nasik facility during FY08 to expand its retort (ready-to-eat) facility. The funding for these two brown field expansions was done through internal accruals. Further there are plans on drawing board to set up a green field facility with cost outlay of Rs200mn. Thus, the company would be spending approximately Rs280mn over next two years. This would increase their gross block by almost 60% in FY09 to Rs732mn from Rs455mn in FY07. In this kind of business we have seen the average asset turnover ratio for the industry is 2x, thus the company would have built up capacity to add another Rs560mn top-line. Which implies that increased capacity would enable the company with assets that can sustain more than 50% growth in turnover over next two years.

ADF Foods is well positioned to capitalize from the immense opportunity in the frozen food and ready to eat segment

Booming organized retail to open another forte for ADF

Indian retailing has gathered exceptional pace in the last five-six years due to a growing consumer class, demographic changes, and fundamental shifts in attitude towards spending and trying new products. It is now positioned at an inflection point, with organized retail expected to grow at CAGR of 30% accounting for 6% of total retail sales. But, one important thing to notice is that Food and Grocery would account for 60% of consumer spending and the margins are also higher in this segment as compared to apparels and consumer durables. As the penetration of the organized retailing increases and reaches 2nd and 3rd tier of cities, the mass and base for the companies targeting to participate in the domestic retail boom would also become very attractive.

The management has intend to enter the fast growing domestic market over next one year

Opportunities to enter domestic market – Over the past two-three years, the ready-to-eat packed food market in India has grown from an almost insignificant number to become a $20-30 million-revenue industry. Considering the current 35-40% growth rate, revenues in this sector can easily touch $80-90 million over the next two-three years. The management of ADF also has intent to enter the domestic market over the next one year, by when the initial euphoria would have settled down and some decency in the retail market would have also prevailed. ADF already has four-five good brands and could be launched in the domestic market as and when the opportunity and market timing seems appropriate. This may add a new stream of revenue for the company which we have not factored in our projections.

Financial performance

ADF reported net profit of Rs74mn on sales of Rs795mn. During the first quarter it reported net profit of Rs22.7mn on sales of Rs179.10mn. The margins were at all time high of 21.1% and the net profit was highest among past eight consecutive quarters. We expect sales of Rs972mn and profit of Rs84mn in FY08 a growth of 22% and 26% respectively. Due to increase in revenues from frozen foods and ready-to-eat segment, we expect margin expansion of 180bps to 17.6% by FY09 from 15.8% in FY07. However due to amalgamation of Luster Investment, there would be equity dilution as a result of which the EPS growth would be lower in FY08. Also as the company would be in capex phase during FY08, as a result of which its return ratios would be subdued. However, we expect that by FY10 the RoCE and RoNW would increase to 21.8% and 23.7% respectively, as compared to 18.4% and 17.3% in FY08E.

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Its facility at Nasik has EOU status, while the frozen foods capacity at Nadiad, which is two years old, also has EOU status, thus it enjoys tax benefits. The new greenfield facility is expected to come in SEZ or with an EOU status and would thus also qualify for economic incentives. Thus we expect the overall tax liability to remain low at 22%.

Concerns

❖ **Competition**

MNC and large organized players are eyeing to enter the fast growing business of ready-to-eat and frozen food segment. Companies with well established brands & distribution network would only be able to succeed. Deep pockets would be required for brand promotions.

❖ **SCM & Distribution network**

In this kind of industry a very good supply chain management system and excellent distribution network is required to have an appropriate reach and penetration. The company would have to set up the same from scratch while entering the domestic market.

❖ **Dominated by fragmented and regional players**

The food processing business is still dominated by smaller players in the unorganized segment. But with growing quality concerns only organized players would be able to adopt new & expensive technology.

❖ **Exchange rate risk**

As the company derives 95% revenues from exports it has risk of loss due to fluctuation in exchange rate.

Consolidation in the Industry to drive valuations higher

Many players are eyeing the fast growing segment and consolidation in the industry has already started, with MNC and larger players like ITC, Dabur & Godrej vying to take a larger pie. The couple of past deals that have happened: Norway based Orkla had acquired MTR Foods for $80mn (Rs3200mn). MTR had revenues of Rs1351mn with net profit of Rs58mn for FY06. The deal was 2.5x sales and approximately 20x EBIDTA. Similarly, Tata Group announced its foray into processed foods business with acquisition of 70% stake in south based Innovative Foods from the Amalgam Group for Rs200mn. Innovative was a loss making company with sales of Rs160mn and its net worth completely eroded The acquisition was done through Residency Foods and Beverages Limited (RFBL), a subsidiary of Indian Hotels Company (IHCL). With consolidation already started in the domestic market, we expect the segment, which was largely dominated by the unorganized segment to move into the hands of larger and organized players, which would enable faster and sustained growth.

With consilidation in the industry underway we expect the valuations for existing players with establish brands to go up

Valuations

As the company is participating in the fast growing business, we expect a CAGR of 24% in sales and 31% growth in net profit over FY07-FY09. It also has potential to enter the fast growing domestic market. Most of the MNC and large FMCG players are targeting to enter this fast growing segment, thus the consolidation in the industry is driving the valuations higher. There has been couple of deals in the domestic market at average valuations of 2.5x sales. Likewise, if we compare the deals with valuations of ADF, with estimated sales of Rs972mn in FY08 it should be valued at more than market capitalization of Rs1.9bn at 2x its sales. At 12x EBIDTA also we arrive at the similar valuation of Rs1.9bn market cap, currently its market cap is only Rs700mn.

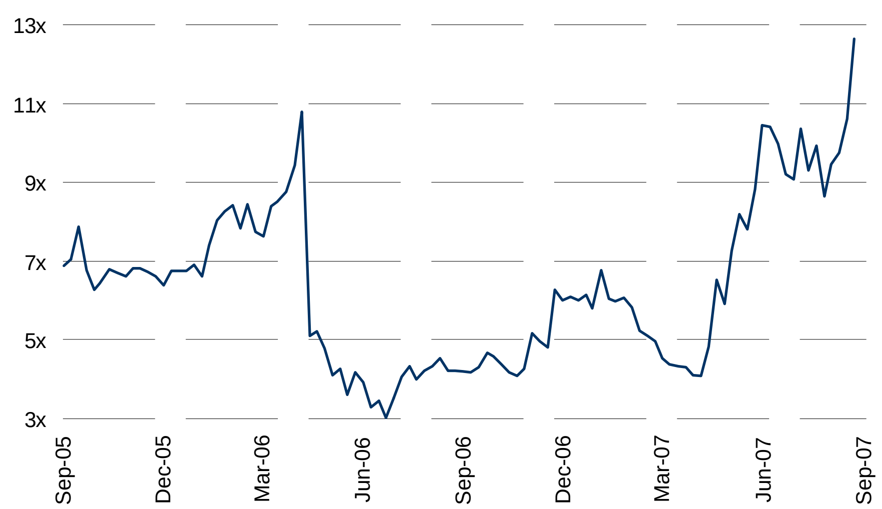
There has been couple of deals in the domestic market at average valuations of 2.5x sales and more than 15x EBIDTA

We have valued the company on weighted average of three valuation models, with 50% assigned to market cap/sales, 30% assigned to EV/EBIDTA and 20% to P/E multiple. We thus arrive at price target of Rs120 for 12 months. The stock offers potential upside of 71% from current price. We thus initiate coverage on the stock with **BUY** rating on the stock.

Valuation methodology

	Multiple	1-Year Price (Rs)	Weightage (%)
Marketcap/Sales	2x	130	50
EV/DBIDTA	12x	131	30
P/E	12x	80	20
Weighted average	–	**120**	–

1-year forward P/E multiple



Source: MF Global PCG Research

Financials

Income statement (Rs mn)	FY06	FY07	FY08E	FY09E
Net sales	**623**	**795**	**972**	**1,216**
Raw material	311	119	466	574
Employee expenses	24	30	39	49
Other exp	228	520	302	379
Op profit	**61**	**126**	**164**	**214**
OPM (%)	*9.7*	*15.8*	*16.9*	*17.6*
Other income	12	19	10	12
Depreciation	14	40	41	51
Interest	17	26	25	29
PBT	**42**	**78**	**108**	**146**
Tax	15	12	24	32
PAT	27	66	84	114
Extraordinary item	–	–	–	–
Adj PAT	**27**	**66**	**84**	**114**
NPM (%)	*4.4*	*8.4*	*8.6*	*9.4*

Balance sheet (Rs mn)	FY06	FY07	FY08E	FY09E
Equity capital	**104**	**104**	**150**	**150**
Reserves	210	252	452	531
Networth	**314**	**356**	**602**	**681**
Total debt	159	92	278	323
Deferred tax	34	33	47	65
Total liabilities	**507**	**481**	**927**	**1,070**
Gross fixed assets	451	455	688	732
Less: Cum depreciation	110	144	185	236
Net fixed assets	341	312	503	496
Capital WIP	6	29	36	2
Investments	1	1	201	251
Net current assets	159	140	187	321
Total assets	**507**	**481**	**927**	**1,070**

Cash flow (Rs mn)	FY06	FY07	FY08E	FY09E
PBT & extra ord. items	42	79	108	146
Add: Int, dep & other exp.	14	46	66	80
Cash flow from op.	**56**	**125**	**174**	**226**
Net change in wc, tax, int.	12	(6)	(46)	(102)
Net cash from op.	**68**	**119**	**128**	**124**
Capital expenditure	(163)	(39)	(240)	(10)
Sale/Purchase of investments	45	–	(200)	(50)
Net cash from inv.	**(118)**	**(39)**	**(440)**	**(60)**
Equity/Debt funds	61	(91)	323	(18)
Dividend & interest	–	–	–	–
Net cash frm fin	**11**	**(11)**	**11**	**46**
Net change in cash	11	(11)	11	46
Opening cash bal.	9	20	9	20
Closing cash bal.	20	9	20	66

Ratios	FY06	FY07	FY08E	FY09E
Growth (%)				
Net sales	1.2	27.6	22.3	25.1
Adj PAT	44.3	145.9	26.0	36.1
Adj EPS	44.3	145.9	(12.6)	36.1
Per Share Data (Rs)				
Adj EPS	2.6	6.4	5.6	7.6
Book value	30.1	34.3	40.1	45.4
DPS	1.0	2.0	2.0	2.0
Valuation (x)				
P/E	27.0	11.0	12.6	9.2
P/BV	2.3	2.0	1.7	1.5
EV/EBIDTA	14.5	6.4	6.5	5.2
Performance (%)				
RoCE	11.0	18.5	18.5	17.3
RoNW	8.8	19.8	17.5	17.7

BUY : > 20%	HOLD : > 5-20%	SELL : < 5%

Note: Ratings based on expected returns from current market price (on absolute basis).

Analyst Holding in the recommended stock: **NIL**

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