SSKI

INDIA RESEARCH

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BSE Sensex: 13091

Sector report

# Wine

## *On cloud nine*

**The wine god *Bacchus* is smiling upon India. Wine, a poor cousin of "hard" drinks here, is slowly but surely finding its feet. The industry grew at 25%+ per annum over the last three years to Rs2.6bn currently. Interestingly, growth rates will be stronger going forward; with young, *loaded* Indians aspiring to "arrive" in the society as also favorable regulations encouraging viticulture, the industry is estimated to record a strong 60% CAGR over FY06-10 and 24% over FY10-15, to Rs20bn and Rs60bn respectively. The credit for seeding India with a wine culture goes to Champagne Indage (CIL), the market leader with a 70% share and the only listed play in the space. We believe CIL is at the vantage point to reap the rewards of its perseverance, and is set to witness exponential growth (90% EPS CAGR over FY06-09E).**

**Indian wine industry – finding its feet:** With growing consumerism in India, aspirational products like wine are finding favour among the cash-rich younger population. Associated health benefits enhance the attractiveness of wine vis-à-vis other alcoholic drinks. In this backdrop, the Indian wine industry has grown at 25%+ per annum over the last three years to Rs2.6bn currently.

**Potential unlimited – an Rs20bn market estimated by FY10:** At per capita consumption of 0.07 litres per annum, the Indian wine market offers an exponential growth opportunity for producers. The industry is estimated to log in 60% CAGR for the industry over FY06-10 and 24% CAGR over FY10-15, to Rs20bn and Rs60bn respectively. Our interaction with the industry suggests that supply constraints would also be overcome with the Centre and state governments starting to realize the benefits offered by the industry from both agriculture and the exchequer perspectives.

**We have a bullish stance on the sector:** With unprecedented growth anticipated in the industry, producers have enough room to grow exponentially. However, as winemaking is a time consuming process (gestation period of around five years) and calls for deep pockets, not many players are operational in the space. Champagne Indage, the only listed play, is a proxy to the sector and provides an opportunity to play the growth story. We expect the company, the leader with a 70% share, to grow at above industry rates (revenue CAGR of 75% and earnings CAGR of 90% over FY06-09E). Initiating coverage on Champagne Indage with an Outperformer rating.

**Summary valuations**

| FY08E | Reco | CMP (Rs) | Price Target (Rs) | Mkt. Cap (Rs m) | Sales (Rs m) | EPS (Rs) | PE (x) | Mkt Cap/Sales (x) | RoCE (%) |
|---|---|---|---|---|---|---|---|---|---|
| Champagne Indage | Outperformer | 370 | 500 | 5,661 | 2,627 | 32.2 | 11.5 | 2.02 | 22.2 |
| Sula Vineyards | Unrated | | | | | | | | |
| Grover vineyards | Unrated | | | | | | | | |

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# INVESTMENT ARGUMENT

**The Rs2.6bn (estimated) Indian wine industry has grown at 25%+ for the last three years. With demand impetus from strong economic growth and a structural shift in the underlying demographics, the industry is estimated to register 60% CAGR over FY06-10 and 24% CAGR over FY10-15. Also, given wine's associated health benefits and that it provides a fillip to the agri-economy of states practicing viticulture, wine production is gaining recognition in India. Alcoholic beverages being on the state list, a plethora of rules, levies and regulations across states have impeded the emergence of a robust domestic market. Going forward, we expect the policymakers to emulate progressive states like Maharashtra in order to pave the way for emergence of a strong industry functioning with lesser administrative and legislative hurdles.**

## INDIAN WINE INDUSTRY: ACQUIRING THE 'RIGHT TEMPERATURE'

*God in His goodness sent the grapes, to cheer both great and small; little fools will drink too much, and great fools not at all.*

Anonymous

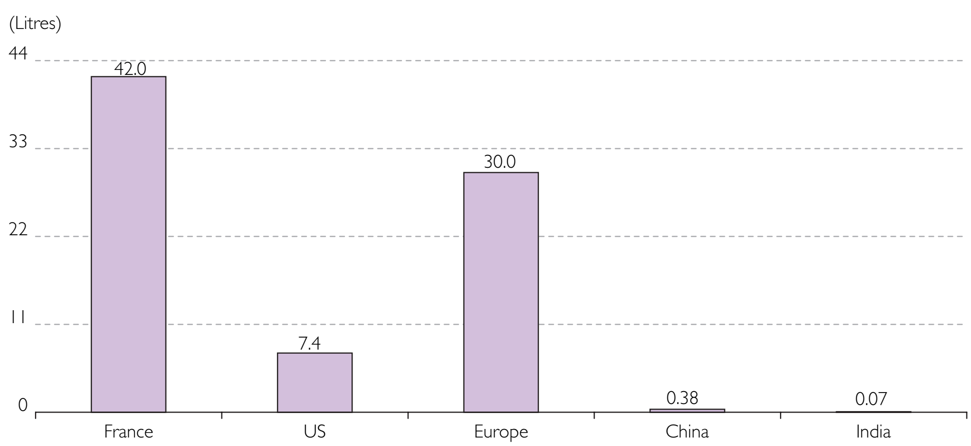
### ❑ An insipid past

*India's per capita wine consumption at just 0.07 litres per annum…*

India's annual per capita consumption of wine stands at a dismal 0.07 litres, i.e. half a tablespoon (source: indianwine.com). In contrast, the per capita consumption is 42 litres in France, 7.4 litres in USA and 30 litres for the European region. The figure for China is 0.375 litres per annum (estimated to touch 0.6 litres in the next three years).

*…vis-à-vis 42 litres for France, 7.4 litres for USA, 30 litres for Europe and 0.375 litres for China*

**Exhibit 1: Per capita consumption of wine in India – half a tablespoon**




*Source: www.indianwine.com*

## ❑ A bubbly present

*Exorbitant retail prices have kept wine out of reach of average Indians*

Wine has been a lifestyle drink and an aspirational product in India. Given its "elegant" and "sophisticated' connotation in the past, wine consumption was essentially limited to connoisseurs and oenophiles, who typically have high disposable incomes and belong to the top layer of the society. Exorbitantly high levies imposed by the government have ensured that a retailed bottle stays out of the reach of the average Indian (therefore, the tag "white collar drink"). Combined with the preference of the average Indian consumer for hard spirits (whisky, rum, gin, vodka and brandy) and beer, the wine industry was virtually insignificant till recently.

*However, growing wealth making wine more popular*

However, the last three years have seen a marked change in the industry dynamics. With the Indian economy registering 7% growth for three successive years, the demographic profile skewing towards the youth (>50% of the population <25 years of age) and high disposable incomes as also a willingness to spend, aspirational products are experiencing strong demand. The wine industry has grown at 25%+ over FY02-05 with higher growth estimated in the current year.

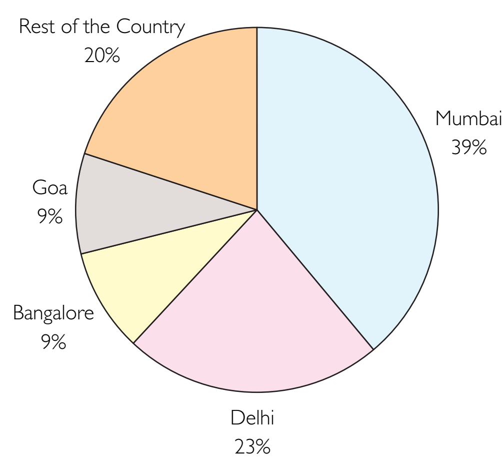
*Growing at 25%+ per annum, Indian wine industry is Rs2.6bn now…*

Despite the stupendous growth, the domestic wine industry is very small compared to the global market (refer to '*The international wine market*', page 4). Current production capacity stands at 6.2m litres per annum (0.7m cases per annum), i.e. ~Rs2.6bn in value terms (*source: www.indianwine.com*). Of this, 85% is table wine with the remaining 15% comprising the expensive varieties (sparkling, fortified, etc).

*…with consumption pattern skewed in favour of bigger cities*

In India, the total number of wineries stands at 38, of which 36 are in Maharashtra. The state accounts for over 85% of India's wine production. In terms of consumption pattern, around 80% of wine consumption in India is confined to the cities, as is brought out by the following exhibit.

**Exhibit 2: Cities – the main consumers of wine**




*Source: www.indianwine.com*

India has 75,000 acres of vineyards, of which less than 10% (only 7,000 acres) are used for growing wine-grade grapes.

**Exhibit 3: Segment-wise size of the Indian wine market**

| Segment | Production ('000 cases) | | Imports ('000 cases) | | Total ('000 cases) | | Retail Value (Rs m) | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| Sparkling wines | 35 | 35 | 5 | 11 | 40 | 46 | 258 | 297 |
| Still wines - premium | 117 | 143 | 53 | 63 | 170 | 206 | 779 | 944 |
| Still wines - cheap | 234 | 240 | - | - | 234 | 240 | 281 | 288 |
| Fortified wines/ others | 4 | 5 | 1 | 1 | 5 | 6 | 13 | 16 |
| **TOTAL** | **390** | **423** | **59** | **75** | **449** | **498** | **1,331** | **1,545** |

*Source:www. indianwine.com; Note: 1 case = 9 litres/ 12 bottles, total production in 2005: 6.2m litres (source: www.indianwine.com)*

## THE INTERNATIONAL WINE MARKET

The international wine market has been estimated at US $7bn (in 2001), having grown rapidly to this level from US $1bn in 1977 (*source: CRS Report for Congress, August 2003)*.

The competitive landscape being filled with many small, privately held wineries owned and operated by families for years/ centuries, the "Old World"/ EU (the traditional source of wine) market is highly fragmented. The prime example of this is France, which has 230,000 wineries, none of them having a significant market share. On the other hand, the "New World" (comprising wine growing countries that have emerged on the wine map in the past quarter of a century or so – Australia, Chile, New Zealand and South Africa) is characterized by a limited number of large, publicly held corporations, which are beginning to play a key role in the market.

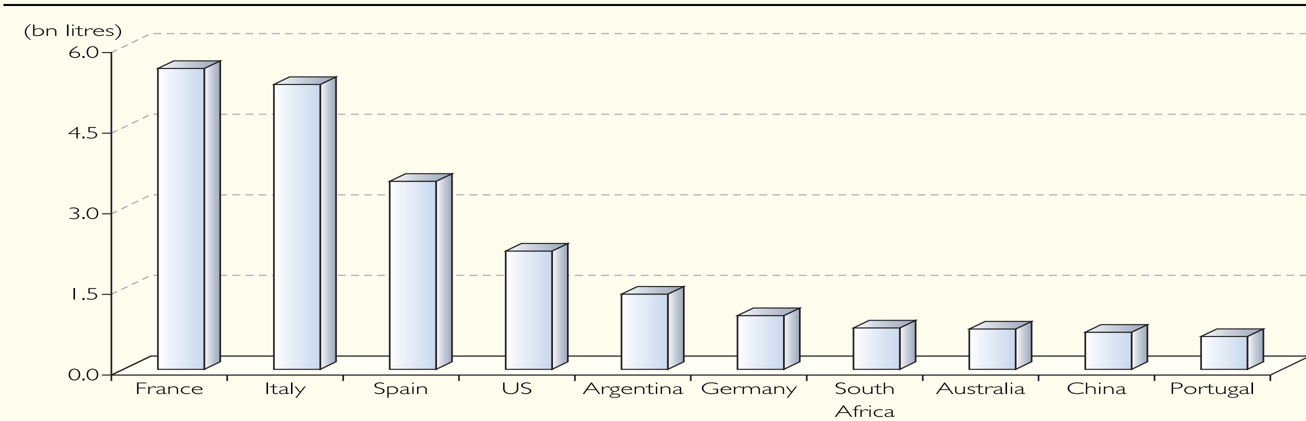
Buyer power is more pronounced in the "Old World" (on account of the fragmented market there) than in the "New World". More sales occur through supermarkets and other off-premise locations in Europe. In addition, supermarkets offer private label wines in Europe, while they generally do not in the United States (the exception being Wal Mart, which has introduced a private label wine through an alliance with E & J Gallo).

### ❑ Key wine markets of the world

Total world production of wine stands at 32bn litres per annum (approximately 32m metric tonnes; *source: www.indianwine.com*), valued at US $192bn (EU 150bn). The EU dominates the production with a 60% share. Given the fact that it has been the traditional source of wine, it is also known as the "Old World". On the other hand, USA, Australia, Chile, South Africa and New Zealand constitute the "New World" on account of the fact that they have emerged as prominent wine producing markets in the last 20 odd years.

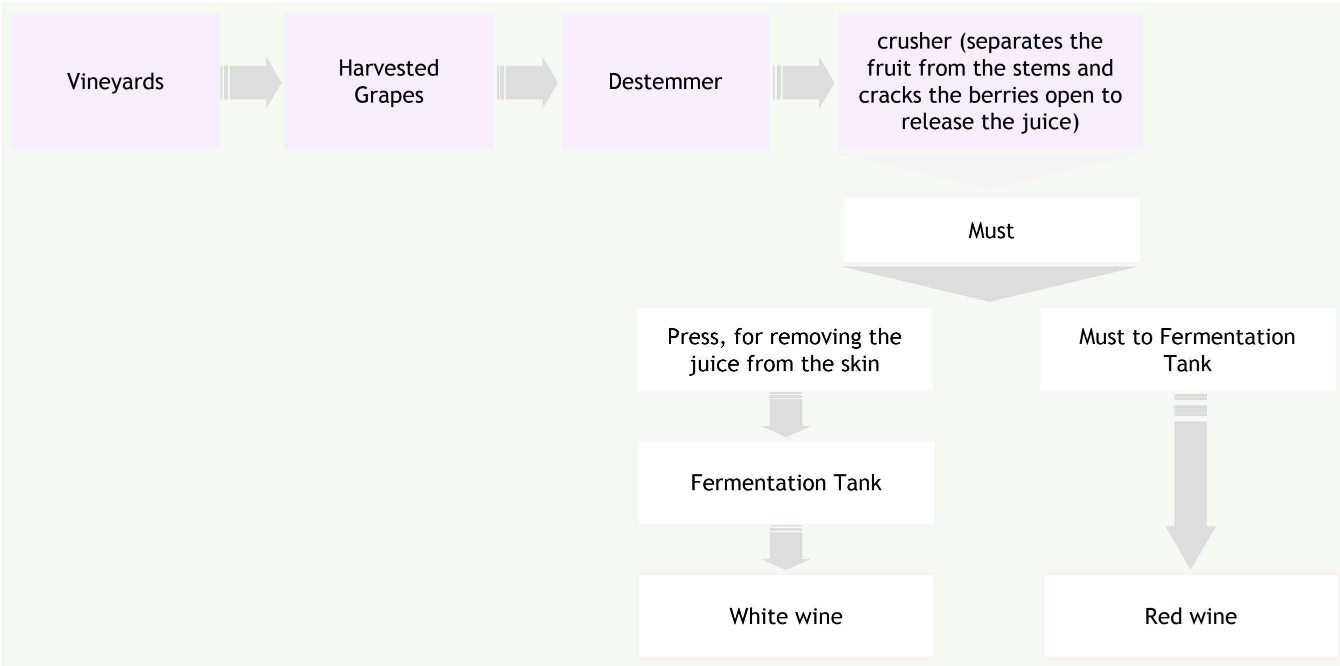
In Europe, wine has been a traditional staple in the household diet for many families. As a result, per capita wine consumption (30 litres per annum) is the highest in the region.

**Exhibit 4: Key wine markets of the world**




*Source: www.indianwine.com*

**Exhibit 5: Wine making process**




## THE WINE MAKING PROCESS

Wine is the product of fermentation by yeast of grape juice or grape must (grape that still contains the fruit skins and seeds). To get sparkling wines, another round of fermentation is carried out in the bottles.

### ❑ Terroir

Terroir refers to the basic identity of the wine owing to soil, climate and the winemaking process. The grape used is the single most important factor contributing to wine's character. Grapes influence the wine's flavour, alcohol content, acidity and colour.

### ❑ Types of wines

Wines are categorized using a number of different methods, such as grape variety, region of origin, colour, name of the winemaker (viticulturist) and production technique.

There are three basic groups of wines most easily distinguishable for the consumer – table wines, sparkling wines and fortified wines. Traditionally consumed as part of a meal, table wines constitute 85% of the market. These wines contain 10-14% of alcohol and are further classified by their colour, sugar content and variety and origin of the grapes used. The remaining 15% of the market is constituted by the expensive varieties/ vintage wines.

Depending on the grape variety and the winemaking technique, wines can be white, red or pink in colour.

## A SPARKLING FUTURE

*We expect 60% CAGR for the wine industry over FY06-10 and 24% CAGR over FY10-15*

The Indian wine industry is estimated to touch Rs20bn by 2010 and Rs60bn by 2015. This entails a CAGR of 60% for FY06-10 and 24% for the remaining five years – a great prospect for the industry going forward, albeit on a small base. Going forward, even if we conservatively estimate wine consumption in India to catch up with China's current consumption in the next five years, the Indian market would attain a size of 375m litres, i.e. 40m cases.

The extent of the gearshift that is possible in the industry is indicated by the fact that if per capita consumption were to rise to 1 litre per annum, we would have a billion litre market – comparable to the German and Argentine markets!

*A multifarious tax structure has so far constricted growth*

In order to develop the industry to its full potential, the regulatory environment needs to be streamlined for creating a growth-conducive environment. India has so far lacked a uniform duty structure on wines with duties varying from state to state. Various levies imposed on the industry include excise, sales tax, import tax (levied by the government of the destination state), export tax (levied by the government of the state where the wine is produced), central sales tax imposed by the Centre (pegged at 4%) and a basic customs duty of 100% on wines. The state governments impose a number of other levies such as vendor fees, special fees, etc. Depending upon the CIF price per case, an additional import duty is imposed in lieu of excise, as follows:

**Exhibit 6: Import duty structure**

| Price per case | Basic customs duty (%) | Additional Customs Duty |
|---|---|---|
| < US $ 25 | 100 | 75% |
| > US $25, < US $ 40 | 100 | 50% or minimum of US $ 37 |
| > US $ 40 | 100 | 20% or minimum of US $ 40 |

*Source: Model Policy/ Taxation/ Act/ Rules for Alcoholic Beverages & Alcohol, Ministry of Food Processing Industries*

### ❑ Wine industry getting preferential treatment in a few states

Regulatory circles are increasingly realizing the need to distinguish hard spirits from wine and beer within the alcoholic beverages industry. In fact, a case has been made out for meting out preferential treatment to wine and beer from the agri-economy perspective.

*Immense scope for commercialization of grape cultivation prompting Centre to formulate positive policies*

The Model Policy for Taxation/ Act/ Rules for Alcohol and Alcoholic Beverages issued by the Ministry of Food Processing Industries (December 2005) acknowledges that, given the range of agro-climatic zones in the country, the wine industry provides immense scope for substantial commercialization of agriculture (grape cultivation). This document explicitly states that imports could swamp the market in case the domestic capacities are not provided adequate protection and incentives at this stage. Examples of the wine industry providing impetus for growth in the local economy in countries like USA (California), Chile, South Africa and Australia have been cited in the policy, thus outlining the salutary effect of wine industry on local areas where viticulture is practiced and encouraged.

**Exhibit 7: Comparative benefits of spirits, beer and wine**

| Item | Spirits | Beer | Wine |
|---|---|---|---|
| %age alcohol content | 42.8% | 8% | 12% |
| Normal consumption in a sitting (volume) | 120 - 180 ml | 300 - 600 ml | 100 - 300 ml |
| Alcohol consumed | 51.36 - 77.04 ml | 24 - 48 ml | 12 - 36 ml |
| Impact on pollution | Generally molasses based & has harsh effluents to treat | Medium quality effluent, not so difficult to treat | Mild, only bottling related effluent |
| Impact on economy | Generally molasses used: molasses being a by - product, no direct impact on the economy. | Hops and barley used; beer directly benefits farmers growing barley and hops. | Generally grapes used; better price to farmer, inferior fruits get utilized. |
| Employment generation | Limited | Substantial | Large: Grape growing is labour intensive |
| Impact on health | Harmful | Much less harmful, some health benefits | Less harmful, some health benefits |

*Source: Model Policy/ Taxation/ Act/ Rules for Alcoholic Beverages & Alcohol, Ministry of Food Processing Industries*

## BENEFITS OF VITICULTURE GAINING RECOGNITION

In India, alcoholic beverages fall under the jurisdiction of state governments – the multifarious taxation system has shackled the industry in a plethora of rules, regulations and levies. However, the experience of progressive state governments (like Maharashtra) in encouraging the wine industry has made the Centre and state governments take notice of the advantages of providing incentives to the industry from an agri-economy perspective. The Maharashtra State Government has declared the grape wine industry as a small-scale industry, with food processing industry status for wine producers. It has completely exempted the industry from excise levy for a period of 10 years from 2001. Other primary wine producing states like Karnataka are expected to follow suit in the short run.

***Centre and state governments providing incentives and special status to wine industry***

We expect the structural issues affecting the domestic industry to be streamlined in the medium term, with joint efforts of the central and state governments, as spelt out in the Model Policy/ Taxation/ Act Rules for Alcoholic Beverages & Alcohol dated December 2005 by the Ministry of Food Processing Industries. This bodes well for the industry in the coming times. With a view to encourage the domestic industry, a conscious effort is being made to provide incentives to the same. At the forefront are those states where viticulture has an existing base and wine production holds the potential to become a good revenue earner.

**Exhibit 8: Regulatory policy turning growth-conducive**

### Excise Duty

- Duty structure determined by state governments as alcoholic beverages fall under the state list. This results in a non-uniform excise duty structure across states
- The Government of Maharashtra has completely exempted wine from excise duty for a period of 10 years from 2001
- Karnataka, which ranks next to Maharashtra in terms of viticulture, is expected to follow suit soon

### Distribution

- State governments increasingly endorsing free market policy. Uttar Pradesh and Madhya Pradesh, which have switched over to the free market system in the last five years
- In September 2006, the Maharashtra government has allowed sale of wines through the retail route. As per the E2 licence, which earlier allowed supermarkets and modern retail formats with requisite permits/ licences to sell only beer, these outlets would now be allowed to sell wines also.
- Even in the Union Territory of Chandigarh, departmental stores are allowed to sell wines for a very nominal annual fee.

**Distribution policy varies from state to state**

| Prohibition States | Free Markets | Auction Markets | Government |
|---|---|---|---|
| Gujarat | U.P. | Punjab | T.N. |
| Mizoram | Maharashtra | Bihar | A.P, Rajasthan |
| Manipur | Goa | H.P. | Kerala |
| Nagaland | J & K | Haryana | Delhi |
| | M.P. | | Karnataka |
| | Assam | | Orissa |
| | West Bengal | | Chandigarh |

** Some states are likely to move from the Auction system to Government*

*Source: Model Policy/ Taxation/ Act/ Rules For Alcoholic Beverages & Alcohol, Ministry of Food Processing Industries*

### Financial assistance

The Ministry of Food Processing Industries offers the following Financial assistance to the wine industry:

- Grants to individual wine making units to the extent of 25% of the cost of technical civil works and plant & machinery subject to a cap of Rs5m in general areas and 33% subject to a cap of Rs7.5m in difficult areas
- Reimbursement of 10% of the value of raw material purchased from farmers (as per prior contract) subject to a ceiling of Rs1m per year for three years, under the Backward Linkages Scheme
- Grant of Rs40m for creation of common facilities and infrastructure as part of a Food Park based on wine industry

Maharashtra, the leading state in this business, came out with a Grape Processing Policy in 2001. The salient features of this policy are:

- Declaration of grape wine industry as a small scale industry;
- Simplification of the licensing procedure for new units;
- Food Processing Industry status for production units;
- 100% excise exemption for a period of 10 years;
- Single window clearance facility for new units;
- Decision to establish Maharashtra Grape Board to ensure coordination among various activities related to the industry (production, quality control and marketing).

Maharashtra Industrial Development Corporation (MIDC) has set up two Wine Parks – one at Vinchur (near Nashik) and the other at Paus (near Sangli). These parks offer top class facilities and infrastructure to help small and start-up wineries to set up base. The Model Policy/ Taxation/ Act/ Rules for Alcoholic Beverages & Alcohol (December 2005) has recommended the setting up of a **National Wine Board** in order to centralize the effort to promote the Indian wine industry in the global market.

### ❑ Supply constraints would ease going forward

*Grape cultivation being promoted aggressively; easing supply to support industry growth*

Wine production involves a long gestation period. Any crop of wine-grade crop takes over three years to produce the fruit. Additionally, processing/ maturing of the wine produced requires between six months (for young wines) to three years (sparkling wines). Therefore, at any point in time, the inventory of wines under processing/ maturing is very high in the industry (time required of over five years) and thus calls for deep pockets. This is why that despite increasing attractiveness, only a few players operate in the industry.

In light of the benefits expected to be extended to the sector by the authorities and the anticipated growth in demand for wine going forward, India should gradually catch up with the international trend of cultivating more than 70% of the grapes for wine production (~10% currently) in the long term.

## "TROPICAL WINES" FROM INDIA: A LONG-TERM OPPORTUNITY

*Sunshine factor imparts unique flavour to Indian wines; gives India chance to position tropical wines*

Besides a huge latent domestic market, there is a window of opportunity for domestic wine producers to create a unique niche or "position" for Indian wines in the international market. Given India's tropical climate, the sunshine factor imparts a unique flavour to the grape grown and wines produced here vis-à-vis those by the world's two principal wine producing blocks – the "Old World" and the "New World". Other than India, only Brazil – which has recently started wine production – boasts of a tropical climate. This offers an opportunity to the domestic producers to create a separate niche or "position" for Indian wines in the international market – that of "Tropical Wines". However, given that the domestic market is big enough to absorb even the ramped up supplies in the coming period, we see this as a long-term story for the domestic industry with a perspective of 5-7 years.

## INDUSTRY GENERATING A LOT OF INTEREST AMONG INVESTORS

*Investor interest testimony to the industry's immense growth potential*

The Indian wine industry is generating a lot of interest in the investment circles – Champagne Indage, the only listed player from the industry, is in the portfolio of quite a few institutional investors. The other two key private players also have sold minority stakes to investors – Sula to GIA and Grover Vineyards to Veuve Clicquot Ponsardin. This development is yet another indicator of the industry beginning to make its mark in the alcoholic beverages space. The UB Group – market leader in the hard drinks and beer segments – is reportedly looking to enter the business in the near future. To that end, its group company McDowell & Co has acquired Bouvet Ladubay, a winery in France. Before setting up a local winery in France, the company would initially ship the wine in bulk and bottle it in India till a strong franchise has been created for its brands.

## CHAMPAGNE INDAGE: PROXY FOR THE INDIAN WINE INDUSTRY

*Champagne Indage controls 70% of the Indian wine market*

With 70% of the market under its belt, Champagne Indage is the largest and only listed player in the Indian wine industry. The company is vertically integrated with ~5,600 acres of vineyards under cultivation – both owned by the group and on contract farming basis. Its robust portfolio of 35 brands (28 of which are owned) straddles the entire price spectrum in the market place – from Rs99/ bottle to Rs600+/ bottle (detailed report starting page 13).

Besides Champagne Indage, there are two other key players, as enunciated in the table below:

**Exhibit 9: Players in the Indian wine industry**

| Player | Market share (%) | Status | Comment |
|---|---|---|---|
| Champagne Indage | 70 | Listed Player | Growing at above industry rates |
| Sula Vineyards | 20 | Private | |
| Grover Vineyards | ~7 | Private | |

*Sula Vineyardsand Grover Vineyards – the other key players*

After Champagne Indage, Sula Vineyards is the second largest player in the Indian wine industry with a 20% market share. Set up in 1998 at Nashik in Maharshtra, this new entrant into the industry has notched up an impressive performance in a short span to garner this market share. The company has three wineries with a total capacity of nearly 2m litres per annum and access to vineyards with an expanse of about 400 acres. Besides selling its own products, Sula also imports and distributes wines from leading worldwide players in the domestic market. Given that it is a privately held company, details about its financials are not available. The interesting development is that in 2005, GEM India Advisors (GIA), a private equity fund, has invested US $3.5 m for a minority stake in the company.

Grover Vineyards is another well-known player in India with ~7% market share. The company owns over 200 acres for growing wine grade grapes near Bangalore and uses 35 varieties of French wine grade grapes in its production process. Grover Vineyards too is a private company with 14% stake held by Veuve Clicquot Ponsardin, a leading champagne house of France.

## SULA VINEYARDS UNRATED

Established in 1998, Sula Vineyards is the second largest player in the Indian wine industry, after Champagne Indage. The company has three wineries at Nashik (Maharashtra) – a region with climatic and soil conditions amenable to viticulture. In fact, according to the management, the region is suitable for production of wine grapes of the same quality as in California, Australia and Spain. Mr. Rajeev Samant, who discovered this fact, then roped in Kerry Damskey, an eminent Californian wine maker to help start a winery at the 30 acre land owned by the Samant family.

Sula has to its credit the planting of French Sauvignon Blanc and Californian Chenin Blanc varieties of grapes for the first time in the country in 1997. Since the launch of its wines in 2000, the company has notched up an impressive performance and garnered 20% of the market share in a short span of time. It has three wineries with a total capacity of 2m litres, the latest with a 1m litres capacity having come up recently. Today, Sula has access to 400 acres of vineyards. These vineyards extend beyond Nashik into the adjacent upcoming wine region of Dindori. The portfolio includes varieties of Red, White, Sparkling, Rose and Dessert wines.

Besides Maharashtra, Sula sells its products in Andhra Pradesh, Karnataka, Uttar Pradesh, Rajasthan, Chandigarh, Delhi, Chennai, Pondicherry, Goa and Madhya Pradesh. It has set up distributors in the international markets also with presence in California, New York, UK, Italy, France, Canada and Singapore. In addition, Sula imports wines from leading worldwide players in France, Italy, Australia, Japan (Sake), New Zealand and South Africa, and then distributes them in India.

Details of financials are not available as Sula is a privately held company. However, the expansion in capacity from 0.5 m litres at the time of inception of the company to the current 2m litres in eight years indicates its pace of growth. With the Maharashtra state government having allowed sale of wines by grocers and supermarkets from September 2006, presence in the state would be an additional positive going forward. Sula has generated interest among the investor community, as is evident from the US $3.5m investment made by GEM India Advisors (GIA), a private equity fund, for a minority stake.

## GROVER VINEYARDS UNRATED

Grover Vineyards, another well-known player in the Indian wine market, has its vineyards and crushing capacities located outside Maharashtra. The vineyards are located at Dodballabpur, 40 km north of Bangalore at the foot of Nandi hills. The company was set up by the Grover family along with Mr. George Vessele, the erstwhile Technical Director of the vineyards of Champagne Mumm, with vineyard acreage of 40 acres in 1988. The aim was to grow French varieties of wine grapes for the first time in India. As many as 35 varieties of French grade wine grapes were planted, of which nine responded positively and were planted on an industrial scale.

In 1996, the world's leading champagne house, Veuve Cliquot Ponsardin of France, took a 14% stake in Grover Vineyards. The investor also extends technical support to Grover Vineyards through its wineries in Australia and New Zealand.

Grover Vineyards' distribution system pans the prime wine consuming markets of Mumbai, Goa, Delhi, Pune, Kolkata and Chandigarh in the domestic market and France, UK, Russia, USA and Luxembourg in the international arena. The company also has on board Michell Roland, a world-renowned oenologist as an exclusive advisor for the Indian market.

Grover Vineyards today has over 200 acres of vineyards under plantation of French grapes for wine making and has notched up a 7% share of the Indian market. The portfolio covers Red, White and Rose wines which are popular with the oenophiles.

# Champagne Indage

Rs370

**OUTPERFORMER**

*Time to toast*

Mkt Cap: Rs4.5bn; US$97.3m

Initiating coverage

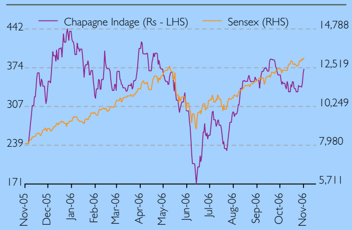
**2 November 2006**

**BSE Sensex: 13091**

**Stock data**

| | |
|---|---|
| Bloomberg | INDG IN |
| 1-yr high/low (Rs) | 455 / 158 |
| 1-yr avg daily volumes (m) | 0.023 |
| Free Float (%) | 74.2 |

**Price performance**




**Performance (%)**

| | 3-mth | 6-mth | 1-yr |
|---|---|---|---|
| Champagne India | 1.1 | 59.9 | 174.1 |
| Sensex | 20.1 | 54.2 | 88.6 |

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**Champagne Indage (CIL), the pioneer and leader in the Indian wine industry with a 70% market share, is set to ride the unprecedented boom in the domestic market. With a robust economy and structural changes in demographics, the Indian wine industry is estimated to grow from Rs2.6bn currently to Rs20bn by 2010 (60% CAGR over 2006-10) and Rs60bn by 2015 (25% CAGR over 2010-15). To capitalize on the opportunity, CIL is expanding its capacity from 3.5m litres in FY06 to 15m litres by FY10 – a 300% increase. Sustained leadership would enable CIL to clock higher-than-average growth; we expect 75% CAGR in CIL's revenues and 90% CAGR in earnings over FY06-09. Initiating coverage with Outperformer rating.**

**Fully integrated operations:** CIL, with ~5,600 acres of vineyards (group owned as well as on contract farming basis), has set the tone for generating 15m litres of wine at full operations by FY10. Access to grapes being the critical factor in capitalizing on the strong demand growth, CIL is way ahead of competition in terms of capacity ramp up. The company is set to reap the rewards of its toils with 75% revenue CAGR estimated over FY06-09.

**A wide product basket straddling the entire price spectrum:** CIL has a portfolio of 35 brands (28 of them owned), covering the entire price spectrum from Rs99 per bottle to price in excess of Rs600 per bottle. We believe CIL is sitting on a remarkable opportunity to tap the strong growth in the Indian wine market. The company is setting up bottling plants in eight new states in order to deal with the high levies imposed on intra-country movement of wines.

**Strong growth ahead – initiating coverage with Outperformer:** Rapid capacity expansion from 3.5m litres in FY06 to 15m litres by FY10 in a market growing at 60% would lead to a revenue CAGR of 75% and earnings CAGR of 90%+ for CIL over FY06-09E. With exciting growth prospects and FY07E EV/EBIDTA of 12.8x, valuations are attractive vis-à-vis peers in the alcoholic beverages sector (both domestic and international). Initiating coverage with an Outperformer rating and a 12-month price target of Rs500 – an upside of 35%.

**Key valuation metrics**

| Year to 31 March | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| Net sales (Rs m) | 362 | 686 | 1,419 | 2,627 | 3,662 |
| Shares in issue (m) | 6.7 | 10.3 | 12.1 | 15.3 | 15 |
| Adj. EPS (Rs) | 8.2 | 10.5 | 18.6 | 32.2 | 52.3 |
| % growth | 86.3 | 27.2 | 78.2 | 72.8 | 62.6 |
| PER (x) | 45.0 | 35.4 | 19.9 | 11.5 | 7.1 |
| Price/Book (x) | 7.9 | 4.3 | 2.8 | 1.9 | 1.5 |
| EV/EBITDA (x) | 27.5 | 23.1 | 12.8 | 8.4 | 5.2 |
| RoE (%) | 18.3 | 17.9 | 18.0 | 21.4 | 23.9 |
| RoCE (%) | 14.6 | 15.7 | 19.7 | 21.6 | 25.9 |
| EV/CE (x) | 3.5 | 3.1 | 2.0 | 1.6 | 1.3 |

# INVESTMENT ARGUMENT

**CIL is the market leader in the Indian wine industry and the only listed player from this space. With consistently high economic growth and favourable changes in the underlying demographics creating strong demand for aspirational products, wine industry is expected to log in a CAGR of 60%+ over the next four years and 24% CAGR up to FY15 (to a size of Rs20bn and Rs60bn respectively from Rs2.6bn currently). With an expected improvement in raw material availability that would ease supply constraints, CIL is putting into place infrastructure to crush >25,000 MT of grapes in FY10 (5,500 MT currently). Besides providing concentric diversification, the expanded capacity would enable CIL to retain its leadership status.**

## CIL: RIGHT AROMA, RIGHT FLAVOUR

CIL is the pioneer and leading player in the domestic wine industry with a market share of 70%. The company was established as Champagne Vineyards by Mr. S. G. Chougule in 1982, as a 100% Export Oriented Unit, in technical collaboration with Champagne Technologie of France. For a decade, vineyards and wineries for the export business were run under the aegis of Champagne Vineyards, and the domestic wines and hotels businesses of the family by Champagne Indage. After a restructuring of operations in 1997, the viticulture business was brought under the banner of Champagne Vineyards, whereas the wine production and selling business fell into Champagne Indage's fold.

### ❑ Leadership status emanating from a sound supply base

*CIL has three wineries and a capacity of 5m litres*

1986 was the first year of commercial production of wine for CIL. Since then, the company has come a long way – it currently has three wineries and a capacity of 5m litres. The vineyards and wineries are located at Narayangaon in Maharashtra, at the foothill of the Sahyadris. The location is ideal for viticulture with optimum weather conditions (in terms of temperature and rainfall) and a lime rich chalky soil that facilitates production of best-quality grapes. At least 38 varieties of grapes are grown on a commercial basis on over 5,000 acres of vineyards. In addition, more than 100 varieties of grapes are cultivated and tested for production of wine of international quality and standards for R&D purposes.

*Contract farming agreements for 5,000 acres of grape crop with 600 acres owned*

Of the total acreage under CIL's management, 600 acres are owned by the group company Champagne Vineyards while 5,000 acres are owned by 1,600 farmers with whom CIL has forged contract-farming agreements. CIL has helped the contract farmers tie up with the State Bank of India and UCO Bank for their viticulture funding requirements. The offtake being assured at Rs16/ kg plus a bonus for meeting certain parameters (effective rate of ~Rs18/ kg), the contract agreement is quite remunerative for the farmers. Besides provision of planting material and inputs by CIL, its officials closely monitor the entire fruit growing cycle. A large number of raw material suppliers ensure that bargaining power stays with CIL.

*Sensing the immense potential ahead…*

## ❑ CIL expanding capacity to meet the growing demand

The domestic wine industry is currently on a roll. Having grown at over 25% per annum for the last three years (albeit on a small base), it is now set to clock a CAGR of over 60% till FY10, by when it is estimated to touch Rs20bn in size vis-à-vis Rs2.6bn. The industry is further estimated to expand at a CAGR of 24%+ up to FY15 to become Rs60bn in size. Therefore, a proportionate rise in supply is required to meet the galloping demand.

*…CIL has already tied up raw material supply*

Wine production is dependent on the availability of grapes for crushing. Commercial grade grapes are obtained with a time lag of over three years post sowing – therefore, the total acreage under viticulture for a wine company is distributed in terms of proportion of land under active cultivation (for crushing purposes) and the proportion under cultivation for yield with a sizeable time gap (12-18 months). Therefore, demand can only be met to the extent that raw material is available for crushing and blending at the right time.

The 5,000 acres+ of vineyards under CIL's management have been contracted to meet the encouraging demand scenario anticipated in the coming years. The tonnage crushed and estimates going forward (roughly 1 kg of grape yields 0.5 litre of wine when crushed) are a pointer to the scale of CIL's future plans.

*From 5,582 tonnes in FY06, crushing capacity being augmented to 25,000 tonnes by FY09*

**Exhibit 1: Increasing crushing capacity**

| | Quantity / Estimated quantity of grapes for crushing (tonnes) | Wine production/ Estimated wine production (ltrs) |
|---|---|---|
| FY04 | 1,639 | 0.85 m |
| FY05 | 3,258 | 1.73 m |
| FY06 | 5,582 | 3.07 m |
| FY07E | 10,500 | 5.25 m |
| FY08E | 18,000 | 9 m |
| FY09E | 25,000 | 12.5 m |

*Source: Company, SSKI Research; Note: Production figure in the table excludes the quantity produced from imported grape juice and wine*

By aggressively adding capacity, CIL is gearing itself up to meet the challenges ahead. With international players keenly eyeing the Indian market as a growth zone, the company can ill afford to let the early mover advantage (read 70% market share) slip by when the prospects are strong.

## ❑ Striving for pan-India footprint to minimize impact of taxes on MRP

*Bottling plants all over India would ensure the best MRP for CIL wines*

With wine being a state subject (just like hard liquor and beer), the Indian alcoholic beverages market is a complex maze of varying duties, rules and regulations across different states. Thus, in the context of the wine industry, the country functions as a conglomerate of as many different markets as there are states.

As movement of bottled wine from the state of production to other markets involves levy of steep duties, the only way of cushioning the effect of levies on the final MRP in target markets is to set up bottling plants in the respective markets/ states. To that end, CIL is already in the process of establishing its bottling units in eight states.

**Exhibit 2: Schedule for new crushing capacities**

| State | Estimated year of operation |
|---|---|
| Goa | FY07 |
| Punjab | FY08 |
| Andhra Pradesh | FY08 |
| Pondicherry | FY07 |
| Tamil Nadu | FY09 |
| Karnataka | FY07 |
| Assam | FY08 |
| West Bengal | FY07 |

*Source: Company, SSKI Research*

In addition, CIL is setting up two wineries in Himachal Pradesh – one with a 1m litre capacity and the other with 0.5m litre capacity, the latter also serving as a Tourist Spot close to Manali. Eventually, we expect CIL to set up crushing capacity in each of the locations where the bottling capacity is being erected.

***Processing and bottling capacity being increased to 15m litres per annum by FY10***

Overall, CIL is implementing a strategy to increase its processing as well as bottling capacity to 15m litres per annum by FY10, while simultaneously ensuring presence across the growth areas/ zones in the country. This will help CIL in terms of both logistics (time to market) and costs (lower levies with domiciled bottling units), thus helping it retain the competitive advantage post expansion.

## ❑ Product portfolio pans the entire price spectrum

***Of the 35 brands straddling a price range of Rs99-600 per bottle, 28 are owned***

CIL has in its portfolio 35 brands, 28 of which are owned. These brand offerings straddle the entire price spectrum from Rs99/ bottle for the *Vino* brand to Rs600+/ bottle for superior/ sparkling wines. In addition, CIL also produces and markets Breezers under the *Sinn* brand name at a price of Rs30/ bottle. The strategy is clear – to have a product for consumers of each economic strata. While at one end, CIL offers Sinn for the young, first time wine drinkers, sparkling wines like *Marquise De Pompador* cater to discerning oenophiles from the upper economic layer.

## ❑ "Tropical Wines" from India – a potential long-term growth kicker

***CIL to be the key beneficiary of the "Tropical Wines from India" opportunity***

Products from the "Old World" and the "New World" are made from grapes grown on the further side of 23 degrees North/ South of the Equator. Interestingly, India and Brazil are the only countries where wine is produced is from grapes grown in the tropical region – between 23 degrees North and 23 degrees South. Because of the sunshine factor, this wine tastes different from "Old World" and "New World" wines. In the long run, there exists an opportunity for domestic wine players to create a separate "position" for Indian Tropical Wines in the international market over the next 5-7 years. These wines are quite distinct in their terroire from the offerings of the "Old World" and the "New World".

***CIL eyeing global markets either through the JV or acquisition route***

Given its leadership status, we expect CIL to be the torchbearer in this exercise. A few of CIL's sparkling wines have been winning awards at various wine competitions, indicating its capability to finally create a market for Indian wines in the world market. We expect CIL to enter the international market either through joint ventures with international players or via acquisition of wineries and distribution companies. CIL has already carried out due diligence for acquiring a majority stake in Mckinley Vinters, the wine distribution business of Harvey Millers Wine Agencies of UK. The final decision on the matter is awaited. We expect similar moves by CIL in other international markets within the next two years.

## ❑ Retail foray in the domestic market

*Retail outlets planned to set up in key malls with the aim of getting closer to the retail market*

Given the strong growth in demand for wine in the domestic market, a retail foray is being planned, particularly with the aim of moving closer to the target market. With the slow but sure-footed proliferation of mall culture in the country, CIL is planning to set up a dedicated space for its products within the most frequented stores and malls across India. The implementation of this strategy would begin by Q2FY08 and it would take an estimated two years to be fully operational. The total cost of this initiative would be Rs700m.

## ❑ CIL on lookout for synergistic associations in the Indian market

*CIL planning to diversify into related areas by taking up majority stakes in struggling but promising businesses*

CIL is also talking to a number of companies in related businesses for acquiring a majority stake, thus striving to create additional selling routes for its wines besides adding to the bottomline. The idea is to take up majority stakes in promising business ventures which are currently struggling to remain afloat and require management inputs to realize their full potential. Such businesses mostly fall in the privately held/ family owned domain. However, CIL plans to do so without straining its balance sheet.

One such example is the recent acquisition of a 55% stake in the business and brands of the erstwhile Compact International under the aegis of Seabuckthorn Indage. This company markets the Leh Berry brand of fruit juices and other consumer products derived from Seabuckthorn, a wild fruit, which grows in the Himalayas and the Alps. The derivatives from this fruit (juices, OTC medicines, Chyavanprash, Biscuits and Cosmetics to name a few) are very beneficial from the health perspective, and CIL plans to tap the opportunity by leveraging its marketing expertise. As per our estimates, CIL has invested around 10% of 1x Sales of about Rs150m for the product basket. The margins in this business are in excess of 40% at the operating level.

## ❑ CIL adding other alcoholic beverages to its portfolio

*Foray into other alcoholic beverages business estimated to contribute Rs500m to sales by FY09*

Starting FY07, CIL is extending its presence to other alcoholic beverages. The company proposes to buy these hard drinks in bulk from domestic producers, bottle and label the same and use its distribution network for generating additional revenues. We expect this business stream to contribute Rs350m in FY08 and Rs500m in FY09 with margins of around 7.5%.

## ❑ An improving operational environment – a positive

*A positive regulatory environment to boost prospects*

As discussed, the wine industry is suddenly receiving a lot of positive attention from the central and state governments from the agri-economy and health perspectives. The state government of Maharashtra has taken the lead in improving the operating environment for the industry, and has recently allowed the sale of wines at the retail level by clubbing it with beer for E2 licence holders. We expect other state governments to follow suit in due course of time, thereby providing fillip to the industry as a whole.

## FINANCIALS & VALUATIONS

We expect CIL to register sales CAGR of 75%+ over FY06-09 on the back of capacity expansion and strong demand growth. With margins in the 28%+ region, RoCE of 19.5% and RoE of 18%+, the stock compares favourably with peers in the alcoholic beverages industry – both domestic and international. The stock trades at 12.8x FY07E EV/ EBIDTA vis-à-vis 14.0-17.5x for the peer group. With estimated CAGR of 90%+ over FY06-09 in earnings, we initiate coverage on the stock with an Outperformer rating and a 12-month price target of Rs500.

### ❑ Sales CAGR of 75%+ over FY06-09

*Sales growth to be driven by augmented capacity*

CIL is raising its capacity from 3.5m litres at the end of FY06 to 15m litres by FY10 by setting up bottling capacities in various states (to be followed by crushing capacities in the next phase) and new capacities at Himachal Pradesh. Aided by the expanded capacity, CIL is poised to see a sales CAGR of 75%+ over FY06-09.

### ❑ Expect 90%+ CAGR in earnings over FY06-09

*EPS projected to cross Rs52 by FY09*

We estimate CIL to log in net profit CAGR of >90% over FY06-09, with EPS projected to touch Rs52.3 in FY09. RoCE in the period is estimated to cross the 19% mark and RoE to be above 18%.

### ❑ Initiating coverage with Outperformer rating – price target of Rs500

Globally, most of the leading wine companies are privately owned. Therefore, we have chosen major international and Indian alcoholic beverage companies as a benchmark. The table below provides the valuation metrics for these companies:

**Exhibit 3: Valuation of comparable companies**

| US $ m | SALES | EBIDTA | PAT | OPM (%) | RoCE (%) | RoE (%) | EV | EV/ EBIDTA |
|---|---|---|---|---|---|---|---|---|
| Mcdowell & Co. (FY07) | 660.2 | 91.4 | 39.2 | 13.8 | 16.5 | 20.6 | 1,596.0 | 17.5 |
| Radico Khaitan (FY07) | 143.2 | 24.7 | 13.6 | 17.3 | 21.9 | 39.4 | 395.0 | 16.0 |
| United Breweries (FY07) | 212.8 | 43.3 | 23.3 | 20.4 | 20.6 | 42.9 | 605.0 | 14.0 |
| CIL (FY07) | 30.8 | 9.0 | 4.9 | 29.3 | 20.4 | 18.9 | 115.5 | 12.8 |
| | | | | | | | | |
| Diageo plc (FY06) | 12,580.0 | 3,634.0 | 2,571.0 | 28.9 | 20.9 | 37.5 | 56,528.0 | 15.6 |
| Pernod Ricard (FY06) | 6,729.0 | 1,293.0 | 826.0 | 19.2 | 14.2 | 22.5 | 22,380.0 | 17.3 |

*Buy with a price target of Rs500 per share*

As is evident from the table, comparable alcoholic beverage companies trade at EV/ EBITDA of 14.0-17.5x with RoCE of 14-20%. We believe CIL, with higher growth potential and expected 75% 3-year revenue CAGR, deserves to trade at higher valuations. Moreover, given the fact that wine occupies the highest position in terms of aspirational connotation in the industry, CIL's valuation should logically be higher than for other alcoholic beverage companies. However, taking an average EV/EBIDTA of 12x FY08E, we get a target price of Rs500 – a 35% upside from the current levels.

## Earnings model

| Year to Mar (Rs m) | FY05 | FY06E | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| **Net sales** | **362** | **686** | **1,419** | **2,627** | **3,662** |
| *% growth* | *54.0* | *89.5* | *106.8* | *85.2* | *39.4* |
| Operating expenses | 254 | 501 | 1,003 | 1,882 | 2,503 |
| **EBITDA** | **108** | **185** | **416** | **745** | **1,159** |
| *% growth* | *110.2* | *71.3* | *124.8* | *79.2* | *55.5* |
| Other income | 5 | 10 | 10 | 10 | 10 |
| Net interest | (45) | (30) | (96) | (87) | (85) |
| Depreciation | 7 | 10 | 24 | 38 | 46 |
| Pre-tax profit | 60 | 155 | 306 | 630 | 1,038 |
| Deferred Tax | 1 | 7 | 0 | 0 | 0 |
| Current Tax | 5 | 40 | 79 | 139 | 239 |
| **Profit after tax** | **55** | **108** | **226** | **491** | **799** |
| Preference dividend | 0 | 0 | 0 | 0 | 0 |
| Non-recurring items | 0 | 0 | 0 | 0 | 0 |
| Net profit after non-recurring items | 55 | 108 | 226 | 491 | 799 |
| *% growth* | *86.3* | *96.9* | *109.7* | *117.3* | *62.6* |

## Key ratios

| Year to Mar 31 | FY05 | FY06E | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| EBITDA margin (%) | 29.8 | 27.0 | 29.3 | 28.4 | 31.6 |
| EBIT margin (%) | 27.9 | 25.5 | 27.6 | 26.9 | 30.4 |
| PAT margin (%) | 15.1 | 15.7 | 15.9 | 18.7 | 21.8 |
| RoE (%) | 18.3 | 17.9 | 18.0 | 21.4 | 23.9 |
| RoCE (%) | 14.6 | 15.7 | 19.7 | 21.6 | 25.9 |
| RoCE - WACC (%) | 3.1 | 6.4 | 7.8 | 11.1 | 13.9 |
| Gearing (x) | 1.6 | 0.5 | 0.6 | 0.3 | 0.2 |

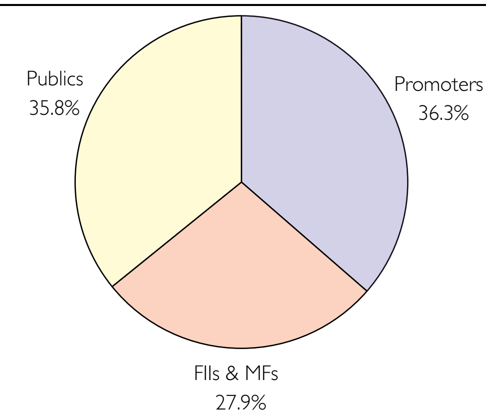
## Valuations

| Year to Mar 31 | FY05 | FY06E | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Reported EPS (Rs) | 8.2 | 10.5 | 18.6 | 32.2 | 52.3 |
| Adj. EPS (Rs) | 8.2 | 10.5 | 18.6 | 32.2 | 52.3 |
| PER (x) | 45.0 | 35.4 | 19.9 | 11.5 | 7.1 |
| Price/Book (x) | 7.9 | 4.3 | 2.8 | 1.9 | 1.5 |
| EV/Net sales (x) | 8.2 | 6.2 | 3.7 | 2.4 | 1.7 |
| EV/EBITDA (x) | 27.5 | 23.1 | 12.8 | 8.4 | 5.2 |
| EV/CE (x) | 3.5 | 3.1 | 2.0 | 1.6 | 1.3 |

## Balance sheet

| Year to Mar (Rs m) | FY05 | FY06E | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Paid-up capital | 67 | 103 | 121 | 153 | 153 |
| Preference share capital | 0 | 0 | 0 | 0 | 0 |
| Reserves & surplus | 247 | 791 | 1,492 | 2,834 | 3,555 |
| Total shareholders' equity | 314 | 894 | 1,613 | 2,986 | 3,708 |
| Total current liabilities | 122 | 190 | 284 | 495 | 617 |
| Total Debt | 511 | 460 | 967 | 942 | 913 |
| Deferred tax liabilities | 19 | 26 | 26 | 26 | 26 |
| Other non-current liabilities | 0 | 0 | 0 | 0 | 0 |
| Total liabilities | 652 | 676 | 1,277 | 1,463 | 1,556 |
| **Total equity & liabilities** | **966** | **1,570** | **2,890** | **4,449** | **5,264** |
| Net fixed assets | 338 | 426 | 687 | 999 | 1,203 |
| Investments | 69 | 70 | 85 | 110 | 135 |
| Total current assets | 559 | 1,074 | 2,118 | 3,341 | 3,926 |
| Deferred tax assets | 0 | 0 | 0 | 0 | 0 |
| Other non-current assets | 0 | 0 | 0 | 0 | 0 |
| Working capital | 437 | 884 | 1,834 | 2,845 | 3,309 |
| **Total assets** | **966** | **1,570** | **2,890** | **4,449** | **5,264** |

## Shareholding pattern




*As of September 2006*

## Cash flow statement

| Year to Mar (Rs m) | FY05 | FY06E | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Pre-tax profit | 60 | 155 | 306 | 630 | 1,038 |
| Depreciation | 7 | 10 | 24 | 38 | 46 |
| chg in Working capital | (93) | (447) | (818 | (844) | (258) |
| Total tax paid | (5) | (40) | (79) | (139) | (239) |
| Ext ord. Items | 0 | (1) | 0 | 0 | 0 |
| Operating cash Inflow | (31) | (322) | (568) | (315) | 587 |
| Capital expenditure | (163) | (98) | (285) | (350) | (250) |
| Free cash flow (a+b) | (193) | (420) | (853) | (665) | 337 |
| Chg in investments | (58) | (1) | (15) | (25) | (25) |
| Debt raised/(repaid) | 262 | (51) | 507 | (25) | (29) |
| Capital raised/(repaid) | 3 | 494 | 527 | 942 | 0 |
| Dividend (incl. tax) | (11) | (21) | (34) | (60) | (77) |
| Misc | 0 | 0 | 0 | 0 | 0 |
| Net chg in cash | 3 | 0 | 132 | 167 | 206 |

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**Explanation of Ratings:**

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

**Disclosure of interest:**

1. SSKI and its affiliates have not received compensation from the company covered herein in the past twelve months for Issue Management, Capital Structure, Mergers & Acquisitions, Buyback of shares and Other corporate advisory services.
2. Affiliates of SSKI are currently not having any mandate from the subject company.
3. SSKI and its affiliates do not hold paid up capital of the company.
4. The Equity Analyst and his/her relatives/dependents hold no shares of the company covered as on the date of publication of research on the subject company.