

Bon Appetit

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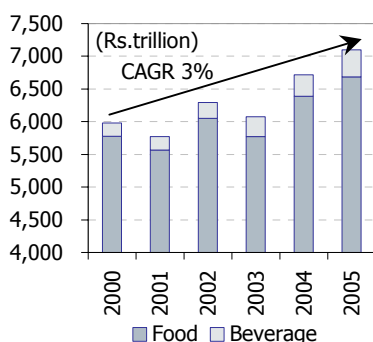
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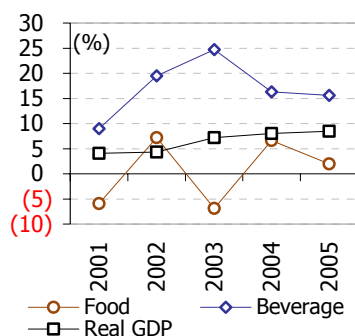
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F & B growth 2000-2005*



Source: CMIE. Note: *Nominal growth in private final consumption expenditure on foods and beverage at current price.

Real GDP vs. F&B growth*



Source: CMIE, World Economic Outlook;
 Note: *Food and Beverage PFCE growth at constant price.

The recent CII International Food & Beverage Summit held at Mumbai grappled with opportunities, challenges & possible solutions to organize the most unorganized market in India. A transparent & conducive regulatory environment, partnering organized retail, optimizing supply chain, branding & packaging innovations were some of the key discussion points for regenerating growth in the F&B sector. We believe that a coordinated and sustained initiative at the company, industry and government level could translate into real growth of ~10-15% p.a. till 2010 for branded F&B categories.

The assessment

- **Large but fragmented and under-penetrated markets:** The share of organized F&B in the overall F&B market is only 0.7%, with the penetration of branded products at an abysmally low 5%.
- **Changing consumer behavior is inevitable:** India's middle class will spearhead the change in consumer profile. Higher cost of domestic help and larger proportion of women joining the workforce will drive consumption of processed F&B.
- **Organized retail at an embryonic stage:** F&B share in overall retail in India is at a staggering 65%, but the relative share in organized retail is at a mere 17%.
- **Majors need to get the mega trends right:** In Asia pacific, health & pleasure has taken a pivotal role in the consumer decision-making process.
- **Tug-of-war for brands:** Branded primary foods are still at the nascent stage, but have immense potential, whereas large national brands need to compete with local brands for incremental growth.
- **Packaging innovation:** Packaging to be the key enabler for the first phase of growth.
- **Inadequate cold chain system:** 30% of fruits and vegetable produce do not reach the end consumer.
- **Food safety & standards:** The Food and Safety Bill, 2006 is expected to harmonize multiple food laws. Standards have been laid for all, but there seems to be a gap in implementing them in its entirety.

F&B peers

	Mkt Cap (Rs.mn)	Net sales (Rs.mn)		F & B		Adj. PAT (Rs.mn)		P/E (x)	
		FY07E	FY08E	% of Rev.	2yr CAGR	FY07E	FY08E	FY07E	FY08E
HLL	434,187	121,792	134,835	15	(5)	15,725	18,544	34.1	28.9
Nestle	99,342	27,730	30,642	100	8	3,400	4,204	29.2	23.6
Dabur	71,061	22,189	25,763	19	29	2,824	3,418	28.8	23.8
Tata Tea*	48,796	32,516	33,866	100	1	3,328	3,655	14.7	13.4
Marico	31,306	14,955	17,426	25	9	1,301	1,565	22.8	18.9

Source: Company, ENAM estimates; Note: *excludes EOC and Glaceau acquisition.

UNFOLDING OPPORTUNITIES IN THE 2ND LARGEST FOOD PRODUCER, GLOBALLY

A large and growing food basket

The food market: India is one of the biggest food markets in the world, with an ever-growing demand for food to satisfy about a billion people. It is today the 2nd largest food producer with food comprising ~50% of private consumption (F&B~Rs.7000 trillion rupees in FY05)

It is the largest producer of agri-products with

- Tea at 28.7% of world production
- Rice at 21.4% of world production
- Wheat at 11.3% of world production

The food processing market in India was pegged at Rs.70bn in 2004 and is expected to double by the end of 2006 to Rs.140bn. While the F&B consumption expenditure has gone up by 3% CAGR over the last 5 years, the branded foods segment has clocked 10%-15% growth in FY05. In fact, some of the key drivers (mentioned later) are expected to trigger an accelerated growth of over 15% p.a in the food and beverage sector.

Branded F&B is under-penetrated...

The share of organized F&B in the overall F&B market is only 0.7% with the branded products penetration at an abysmally low 5%. This represents a hugely untapped opportunity for the organized players.

...and a highly fragmented market

With a few dominant players in the small processed foods segment and virtually a large fragmented market in the primary foods segment, there is scope for local players, organized retailers and MNCs to make an aggressive entry into branding.

A fraction of available brands



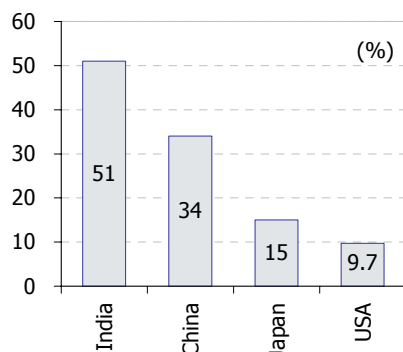
Contours of the food processing industry

Key processed categories	Mkt. Size* (Rs.bn)	Growth (%)		Key players
		FY05	FY06	
Choc. & Confectionary	20	7	8	Nestle, Cadbury, Amul, ITC, Parle, Perfetti
Bread & Biscuits	64	10	11	Brittannia, Modern, ITC, Parle, Priya gold
Tea	86	(2)	8	Tata Tea, HLL, Nestle
Coffee	25	15	(11)	Nestle, HLL, Tata Tea
Malted beverages	14	11	8	Nestle, Cadbury, Amul, GSK
Ready to eat	90	20	22	MTR, ITC
Milk & Milk products	2000	12	11	Nestle, Amul, Mother Diary, Britannia
Edible oil	250	-	20	Marico, Agro tech, NDDDB, Large unorg. Players
Branded flour	7	12	13	HLL, ITC, Pillsbury, Agro tech
Snack food	16	8	10	Local bakery, Pepsico, McCain, Haldiram
Fruit juices/pulp etc	32	18	18	Pepsi, Dabur, Parle, Godrej, Mother Diary

Source: FICCI, CMIE, ENAM Research; Note: *includes organized and unorganized market

The Indian consumer – Change is inevitable

Food consumption as % of PFCE



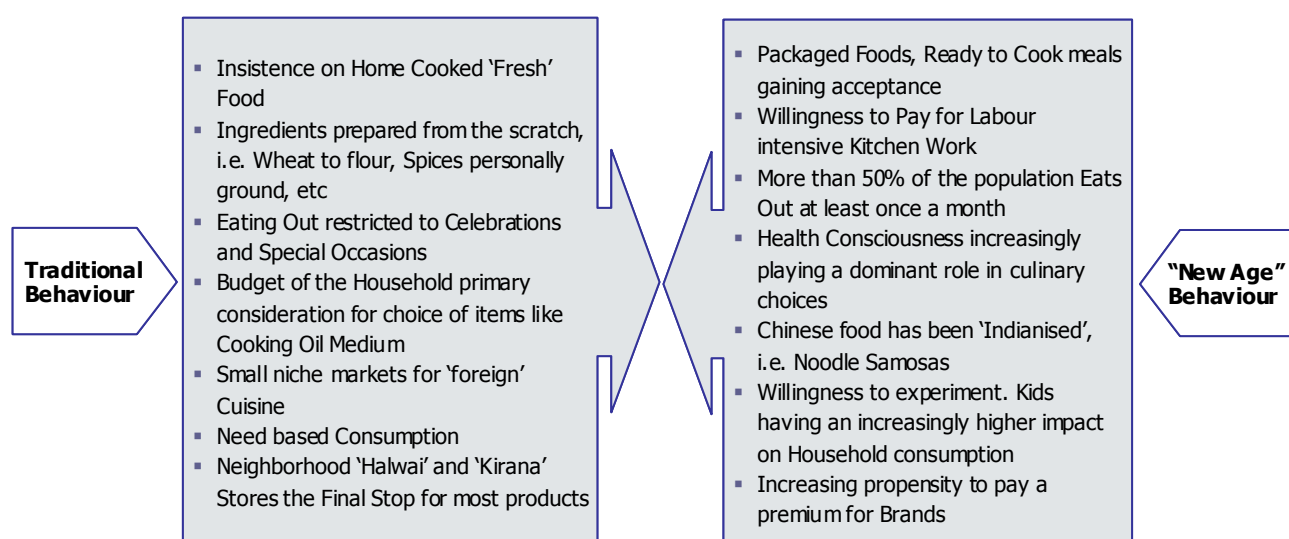
India's middle class to spearhead the change: Of the ~1bn population, the middle class segment accounts for about 350-370 million. The profile of the Indian middle class family is about to change. A vast majority of the families in this segment are either non-working housewives or those who cannot afford hired domestic help, thus preferring self-cooked meals that cater to their taste. As hired domestic help is becoming costlier and more women join the workforce, the demand for packed foods is only likely to move up. Due to changing consumer preferences and the increased affordability of the growing middle income group of the Indian population, the market for branded foods is growing at a healthy ~15%.

F&B highest share of wallet - Indian consumers' absolute spend on food and beverage is estimated at 51% of private final consumption expenditure. As real GDP per capita grows over time, we believe the consumption pattern will merge with that of other developing nations (ref graph). However, the absolute spend on F&B will continue to rise.

Consumer Insight – ITC, Aashirvaad

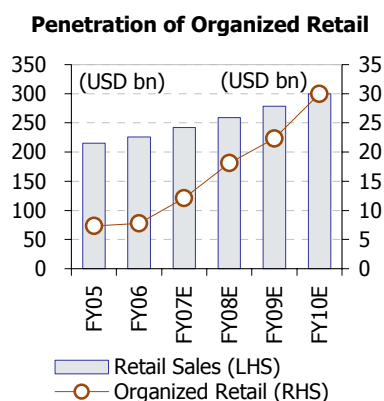
India produced 70 mn MT of wheat of which majority is consumer in atta form, with 95% unbranded market. Since the packaged flour market was explored first at a national level by the Mumbai based DCW group in 1994, with "Captain Cook" atta, some large players, like Hindustan Lever (with its Annapurna brand) and Godrej Pillsbury (Pillsbury), Agro Tech (Healthy World) and Nature Fresh entered the market. Changing life style has lead consumers to shift to packed atta from traditional milling (known for the impurities, inconvenience and un-assured quantity). ITC's sourcing advantage (e-choupal), consumer insight (changing role of an urban mother) and product differentiation (different texture of atta preferred in different regions) enabled it to gain 53% market share of branded atta in 4 yrs. The market for branded packed atta today is growing at 12% p.a.

Changing consumer preferences



Source: KPMG consumer behavior study

THE KEY GROWTH IMPETUS



Organised retail – At embryonic stage in India

- *Share of organized retail* is at 85% of total retail sales in USA, 55% in Malaysia, 40% in Thailand, 20% in China and a mere 3% in India. In fact globally, organized retail is an astounding USD7.8trillion industry with food retailing at 90% of all retail outlet sales. Of the total Indian retail sales of ~USD230bn (~37% of GDP), organized retail accounts for ~USD8bn in sales, which is expected to reach ~USD30bn in 2010 at a 40% CAGR.
- *F&B share in overall retail in India* is at a staggering 65%, while the relative share in organized retail is at a mere 17%. Introduction of private labels, especially for primary food products, will remain the key driver in the initial stage.
- *Provides a value proposition* - Organized retail has not only become an important component of the trade channel, it also provides consumers with a unique shopping experience, a wide range of products, at better quality and at affordable prices. The convenience aspect “All branded products under one roof” is driving away consumers from the local kirana stores. It was opined that organized retail will take away 60% of sales from local kirana stores in the 20 km radius.

Consumerism – Getting the mega trends right!

Consumers today want more for their money, and now actively seek quality; the attitude of compromise is a thing of the past. While disposable income is on the rise, the consumption pattern has undergone a rapid change due to urbanization and changing lifestyle. A study conducted by KPMG has shown that global mega trends in the F&B category are -

- *Pleasure*: Consumers demand sophistication, and an exotic variety of products/services to suit their needs
- *Convenience*: Easy to handle, time-saving formats etc.
- *Health benefits*: Consumers today demand natural products, vegetarianism, medical focus and functional products.
- *Wellness*: A key change in trend has led consumers to be more diet conscious; thus, demand for energy foods and well being are up.
- *Ethics & accountability*: Consumers are interested in environment friendly and social acceptable products.

In Asia pacific, health & pleasure has taken a pivotal role in the consumer decision-making process. While some of the Indian food majors (HLL, Nestle, Marico & Dabur) have focused on the health and wellness benefits, global majors (Pepsico & McCain) have focused on the pleasure attribute in the snack food segment. We believe a concerted effort by the domestic FMCG majors and organized retailers to spread the awareness and benefits of branded F&B will drive consumerism.

Branding – Some contradictory trends

While the market for branded foods is growing at a healthy pace of 15%-20%, the share of organized F&B in overall F&B sector is at an abysmal 0.7%.

Food products are divided into primary foods (retailed relatively in raw state e.g. wheat) and processed foods (prepared from processing primary foods eg. biscuits). Primary foods have largely remained unbranded and sold in loose form due to their price sensitive nature and un-differentiable attributes. On the other hand, processed foods (under 2% of the total fruits and vegetables produced in India is processed) have been the domain of organized players who have focused on the value-addition opportunity.

The generic value proposition a branded primary food offers is contamination-free, hygienic packing in convenient quantity. The driver of product branding in primary foods commodities (foodgrains, vegetables, fruits, cooking oil etc) has been the emergence of organized retail and changes in customer profile and technology. While branded primary foods are still at the nascent stage and have immense potential, the opportunity to enhance margins exists only if there is a convincing value proposition.

The situation is different for established national brands that have been losing out on incremental growth to local brands in select processed food categories. Some of the reasons highlighted were low entry barriers, limited product differentiation, diverse consumer preference and supply chain constraint. The need of the hour for national brands is to choose an appropriate positioning, provide a value-mix offering, improve supply chain integration and pay attention to the localized needs of consumers.

Packaging innovation

Packaging is now integrated as a part of branding and has assumed the role of a silent salesman. The last 3 seconds of the consumer decision making process are determined by packaging and what it communicates. The industry is of the view that there is no need to re-invent the wheel and innovate in products for now, but rather focus on packaging and distribution in the first phase of growth, as packaging will act as a key enabler in the success of food & beverage distribution. The following points illustrate the benefits of packaging and reiterate the importance of it in the overall gamut of key retail drivers:

- **Protection:** Packages protect the contents from microorganisms and harsh external environment. Considering our diverse environment/conditions, protection has become the need of the hour.
- **Preservation:** Good packages help preserve food and prolong its shelf life during storage, transport, retailing and consumption.
- **Communication:** Vital product information about ingredients, quantities, nutritional value, use, sell-by dates and much more to convince the customer about the hygiene and nutritional value.
- **Convenience:** Ease of transporting and usage while serving.

Packaging – A growth enabler



Evolution & benefits of packaging at India's largest co-operative – Amul



From loose milk to plastic packs



To milk variants in multiuse packs



To flavored milk in retail packs



To perishable milk product in retail packs

Source: ENAM Research

Supply-driven initiatives

The food supply chain in India is fragmented with the presence of various intermediaries and the lack of economies of scale. Thus, companies with investment into the ECR (Efficient Consumer Response) technique and working closely with channel partners could help consumers receive enhanced value and service. Some of the supply driven initiative have been highlighted below.

- Information transparency – Demand forecasting, data integration, supply-demand match and goods movement synchronization.
- Channel structure and incentive management
- Prevent duplication & grey market leakages
- Backward integration and strategic sourcing
- Fiscal benefit from plant location

CHALLENGES

Inadequate cold chain system

Probably the biggest challenge that the agri industry faces is that a staggering 30% of its produce does not reach the end consumer, but gets wasted annually due to gaps in the cold chain such as poor infrastructure, insufficient cold storage capacity, unavailability of cold storages in close proximity to farms, poor transportation infrastructure, etc. This results in instability in prices, farmers not getting remunerative prices and the end consumer bearing the cost.

Although private players like Reliance (Reliance fresh), Bharti, ITC (e-choupal) & HLL (project shakti) are investing large sums into supply chain infrastructure, there still remains a pressing need by the government and industry combine to seize the initiative and build a world-class cold supply chain. Provision should be made for sufficient accommodation in various modes of transport, particularly in trains for transport of perishable fruits and vegetables in cool condition on priority basis.

High added cost due to intermediaries

A direct fallout of an unchecked infrastructure is the additional cost of intermediaries that the consumers are burdened with. Today a farmer has no contact with the end consumer or even the retailer who sells his produce and, in turn, has no understanding of the pricing, consumer needs and preferences.

A typical supply chain, illustrated below, places 3 intermediaries who pass on the produce to each other adding hefty margins. A working by Reliance has shown that a consumer lands up paying ~ 45% commission cost over the price that a farmer sells in the auction market. F&B majors need to go in for a comprehensive overhaul of procurement system – farmgate procurement (ITC e-choupal), contract farming (Pepsico), importing intermediary raw materials and utilizing the commodity exchange to hedge prices.

Margin addition (without value addition) in supply chain



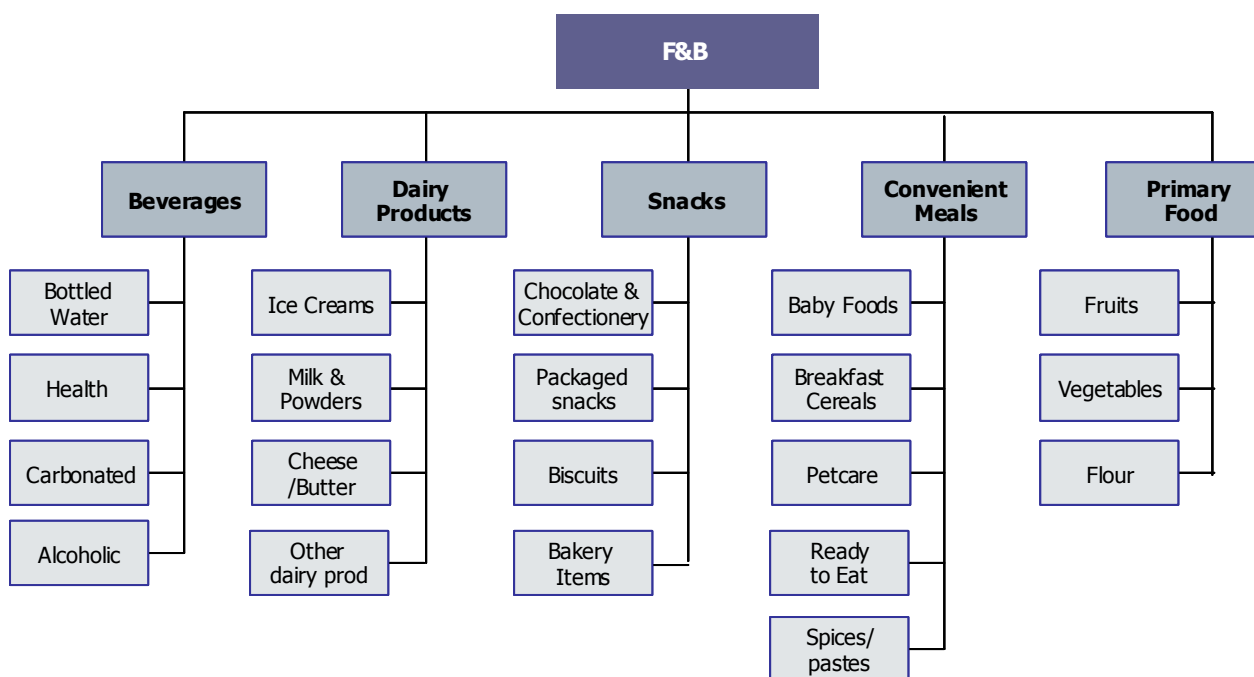
Source: ENAM Research

Differences in regulations

- *Harmonization of multiple laws* – The government has passed the Food and Safety Bill, 2006 that will unite 13 different laws enforced by 9 ministries under one body – Food Safety and Standards Authority of India. Food standards in Indian tend to be overlapping, contradictory and highly prescriptive. This needs to be made simple to be complied with.

- *The Prevention of Food Adulteration Act, 1954* aims at making provisions for the prevention of adulteration of food. Although it is a comprehensive act, it fails to provide a level playing field for all concerned. Recently it has come under heavy criticism from the industry on the following broad issues:
 - ▶ The PFA is more like a cookbook since it specifies the ingredients & the amount that should be used. This creates a lot of difficulty, as companies who want to deviate from it to create a unique product have to go through various clearances.
 - ▶ Standards have been laid for all, but there seems to be a gap in implementing them in its entirety. Although the government carries out stringent checks on companies, it fails to capture the failure of the same norms in for street vendors, fast food outlets etc.
- *The Agricultural Produce and Marketing Act* needs to be reviewed to ensure freedom to farmers to sell agricultural produce to sellers of their choice at remunerative prices rather than selling them through regulated market committees or authorized agents.
- *VAT regulation changes* – Denial of partial input VAT credit on stock transfer to depots/branches of other states.

Key F&B Categories



Source: ENAM Research

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