stock idea

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December 31, 2012

Speciality Restaurants

Reco: Buy

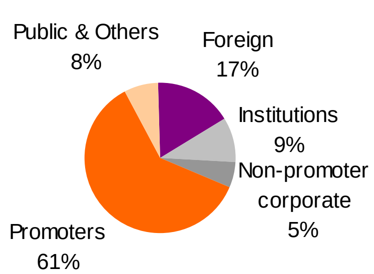
Dig into it

CMP: Rs171

Company details

Price target:	Rs243
Market cap:	Rs803 cr
52-week high/low:	Rs227/153
NSE volume: (no. of shares)	1.35 lakh
BSE code:	534425
NSE code:	SPECIALITY
Sharekhan code:	SPECIALITY
Free float: (no. of shares)	1.8 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-5.6	-4.3	-19.8	-
Relative to Sensex	-8.6	-7.9	-30.4	-

Key points

- **Secular high-growth opportunity in the Indian restaurant industry:** With growing disposable incomes and rising consumer aspiration for quality foods, ambience and services in the country, the organised players in the domestic food services industry have a unique opportunity to grow at a healthy rate of 28-30% annually over the next many years. Along with an exponential growth in the quick service restaurants (QSR; eg KFC, Domino's and McDonald's) within the organised segment, the fine dining (full service restaurants) are also expected register a healthy high double-digit growth rate for several years.

- **Speciality—a reputed player with leading and established brands:** With a portfolio of well established brands (including core brands *Mainland China*, *Sigree* and *Oh! Calcutta*), Speciality Restaurants Ltd (Speciality) is a leading player in the fine dining space. Its value-for-money proposition to offer five-star quality food, ambience and services at affordable rates has enabled it to successfully expand its chain of restaurants to over 80 restaurants spread across 22 cities in India. The management aims to open around 15 restaurants annually over the next three years and is well funded to achieve the target. Consequently, we expect Speciality's revenues to grow at a compounded annual growth rate (CAGR) of 31.5% over the next three years.

- **Focus on improving margin expansion:** In addition to its expansion-driven growth strategy, the company's management is focusing on increasing the share of its flagship brand, *Mainland China*, which has a 30-35% operating profit margin (OPM) as compared with a blended margin of close to 20% at the consolidated level in FY2012. The company is also taking initiatives through the use of technology and centralisation of processes to improve its efficiency. Consequently, the management expects to improve the blended margin by 200-300 basis points over the next few years.

- **Strong balance sheet with little threat of further equity dilution in the near term:** Speciality has an asset-light business model as all its properties are leased and this aids optimal utilisation of capital for efficiently managing the restaurants

Valuations

Particulars	FY2011	FY2012	FY2013E	FY2014E	FY2015E
Net sales (Rs cr)	173.1	196.2	256.4	347.0	445.2
Operating profit (Rs cr)	37.9	37.5	44.5	70.5	98.6
Adjusted PAT (Rs cr)	16.0	17.2	23.4	39.4	57.0
Diluted EPS (Rs)	3.4	3.7	5.0	8.4	12.1
OPM (%)	21.9	19.1	17.3	20.3	22.1
PE (x)	50.1	46.6	34.3	20.4	14.1
Market cap/sales (x)	3.5	3.1	3.1	2.3	1.8
EV/EBIDTA (x)	16.2	16.7	18.3	11.1	7.7
RoE (%)	19.5	16.2	10.9	11.8	14.9
RoCE (%)	24.3	21.5	15.9	17.4	22.1

at various locations. Its business entails services for cash and thus the business has excellent operating cash flows. With more and more of its restaurants attaining maturity, we expect Speciality's free cash generation ability to improve substantially in the coming years. This will not only take care of the future expansion plans, but also help in rewarding the investors with good dividend pay-outs.

- **Unique secular growth opportunity; recommend Buy with price target of Rs243:** Speciality is a unique investment play on the domestic consumption-driven secular growth story. In view of its expansion plans, portfolio of established brands and well capitalised balance sheet, we expect the company's revenues and earnings to grow at a CAGR of about 31% and 49% respectively over the next three years. Consequently, we recommend a Buy on the stock with a price target of Rs243 (20x its FY2015E earnings per share [EPS] of Rs12.1).

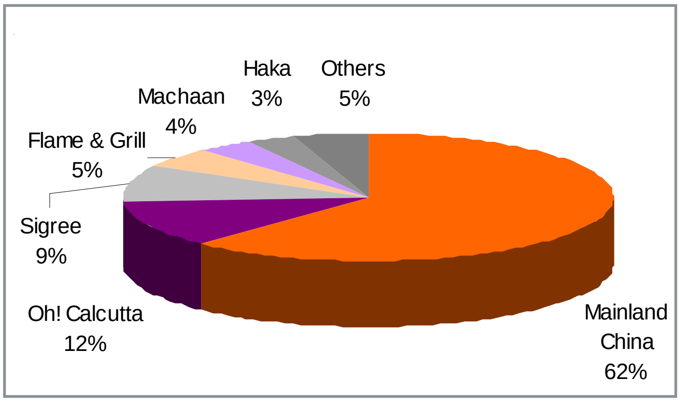
Company background

Incorporated in 1999, Speciality has established itself as a formidable name in the fine dinning space in a span of 14 years on the back of a portfolio of strong brands. It has several established brands across the country including *Mainland China*, *Oh! Calcutta*, *Sigree*, *Machaan*, *Haka* and *Sweet Bengal*. All its brands are well recognised for quality food and great service in India. As of June 2012, the company operated 55 company-owned and operated restaurants, 19 franchisees and 12 confectionery outlets spread across India and one city (Dhaka) in Bangladesh. *Mainland China* is its core brand, which contributes close to 60% of the company's revenue. The company leases all its properties, thereby keeping itself "asset light" and focusing on capital generation for expansion and growth. With an increase of two times in the number of outlets over FY2008-12, Speciality's revenues and profit after tax (PAT) grew at a CAGR of about 24% and 36% respectively over the same period.

The restaurant brands of the company

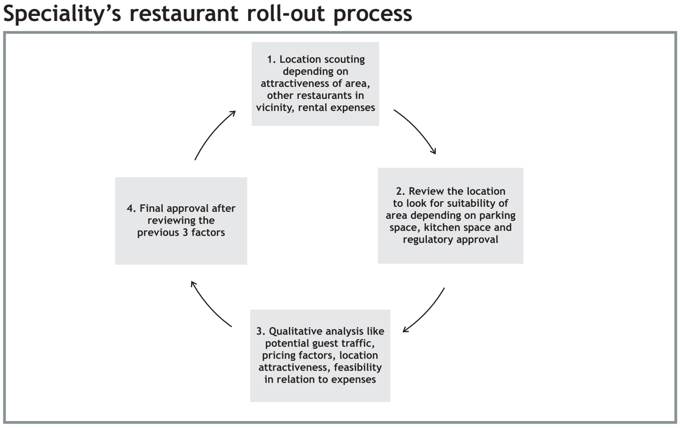
Main brands	Mainland China	• The company's flagship brand, commenced operations in 1994 • Serves authentic Chinese cuisine • Operates at higher margins (Operating profit margins of 32-35%)
Main brands	Oh! Calcutta	• Commenced operations as *Oh! Fish* in 1993 and was later renamed *Oh! Calcutta* • Menu features east Indian cuisine
Main brands	Sigree	• Another important focus area for the company after *Mainland China* • Menu features north-west Indian cuisine
	Flame & Grill	• Menu features a wide variety of kebabs • The company is exploring the option of combining *Flame & Grill* with *Sigree*
	Kibbeh	• A Lebanese bar lounge targeted at young professionals
	Sweet Bengal	• A chain of sweets and confectioneries in Mumbai
	Machaan	• Menu features both dishes for children and dishes that embrace traditional Indian methods of cooking to retain nutrition
	Haka	• Serves modern cuisine for guests on the go
	Shack	• A bar lounge with a beach theme

Revenue contribution from various formats (FY2012)



Source: Company

Speciality's restaurant roll-out process



Source: Company

The company follows the process depicted in the chart before finalising the roll-out of any outlet. After finalising a particular location, the company normally enters into a lease agreement and applies for regulatory permits. On securing the same the company starts the interiors. Typically the time between entering into a lease agreement and rolling out a restaurant is around 120 days. The break-even period for any particular restaurant at the EBITDA level ranges from six months to eight months. Location is a critical component for the success of any outlet.

Key drivers of Speciality's revenue growth

- **Focus on improving frequency of existing customers:** The company plans to increase the frequency of the visit of its existing guests through loyalty programmes, new menu offerings and quality food. The company has a guest relation team, which takes feedbacks from guests and takes corrective actions (if required) within 24 hours. This leads to high customer satisfaction and brand loyalty.

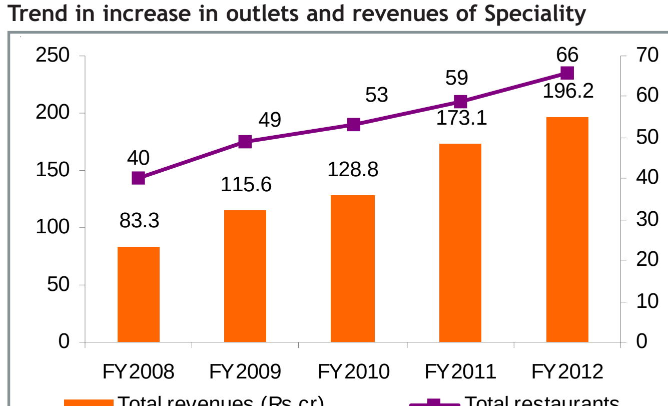
- **Launch of new formats:** The company has also consistently launched new formats to cater to the different strata of population. It has launched Mizuna in the third quarter of FY2013, a restaurant offering Italian cuisine along with a bar. The format targets the youth using innovative strategies. Mizuna would have a higher margin because a higher percentage of revenues would come from liquor sales. Hence, we believe the new formats and combo models (two brands at one location) would drive the growth of the company in the long run.

- **Emphasis on increasing delivery volumes:** The company intends to increase the contribution from the home delivery/take-away model from 5% to 7% of the overall sales. Home delivery is a fast growing segment and the company wants to derive substantial sales from this segment over the long run. The delivery model would also incur lower capital expenditure, thereby enhancing the profitability.

Investment arguments

- **Leveraging on recognised brands to expand into new markets:** The organised fine dinning segment in India is at a nascent stage (a Rs3,000-crore market) and is largely present in the metro and tier-I cities. The rising per capita income and the growing urbanisation have resulted in a strong demand for fine dining options in India. Sensing the opportunity and leveraging on the strong brand equity of some of its recognised brands, Speciality is planning to grab a large pie of the fine dinning market. It already has a strong presence in 22 cities (with 83 restaurants, and 13 confectionery and sweet outlets) in FY2012. Going ahead, it plans to open 45 new restaurants over the next three years. Of the planned expansion eight restaurants commenced operations in the first half of FY2013. The company will open these restaurants under the COCO (company owned and company operated) and FOCO (franchisee owned and company operated) models. The funding of the restaurants would largely be done through the proceeds of its initial public offering and internal accruals. The addition of new restaurants will fuel the revenue growth of the company and help in enhancing

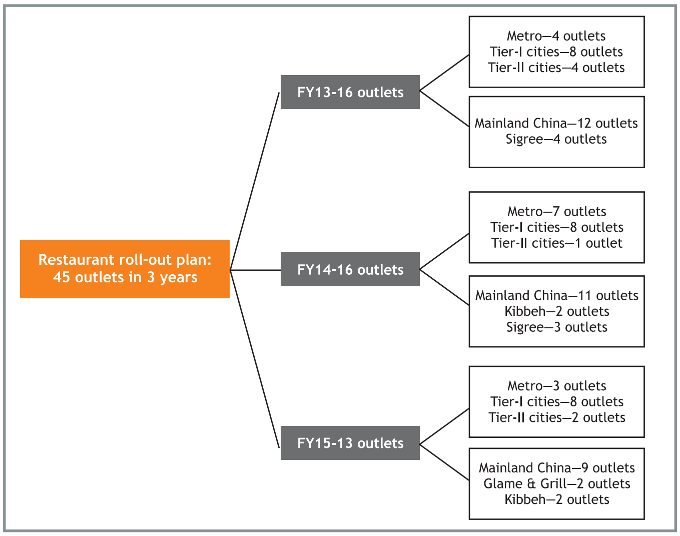
Trend in increase in outlets and revenues of Speciality



Source: Sharekhan Research, Company

its base in the key cities of the country. Hence, with a close to 20% increase in the company-operated restaurants, we expect Speciality's revenues to grow at a CAGR of 31.4% over FY2012-15.

Restaurant roll-out plans



Source: Company

- **Innovative promotional strategies and ideas to drive growth:** The company is consistently innovating its menu offerings and has come out with new promotional offerings to attract new customers and target a new set of audience (enhanced focus on the young generation). It has started including snacks in its menus and keeps restaurants in malls open during the afternoon hours. The snack menu would attract customers in malls during the non-peak afternoon hours when the restaurants are usually vacant. The company has introduced promotional offers like "Dine by Nine" where customers get a flat 25% discount on the bill if they dine before 9pm (only on week days). The Dine by Nine scheme again seeks to attract patrons before the busy hours, thereby reducing the idle time of tables. All these actions are undertaken to improve the turn-around ratio during the muted hour of operations.

- **Focus on margin improvement:** The company has maintained its thrust on improving its profitability and targets an OPM of close to 23% in the next four to five years. It is focusing on the following areas to improve its profitability in the coming years.

  - **Central manufacturing of non-perishable inputs:** The company plans to increase its gross profit margins (GPMs) by emphasising the use of regional commissaries to supply the key bulk items including soups and sauces to its restaurants. This would lead to a decrease in the kitchen space, which can be utilised to enhance the table space in the restaurant.

  - **Increase combos and multi-brand formats:** The company is focusing on introducing more and more combos and multi-brand formats which will reduce the operational cost (centralised kitchen) and employee cost. Also, the need for a larger space would allow the company to negotiate the lease rentals.

  - **Optimise logistics:** Along with introducing more restaurants in the existing and new cities, the company is planning to optimise its logistics to streamline its supply chain, increase the inventory turnover and reduce the waste. The company is planning to enhance the supplier base which will result in economies of scale and streamline the quality assurance mechanisms. The company also intends to go for bulk buying which will help in rationalising the raw material cost.

With these initiatives and the company's focus on improving the turn-around at the restaurants of various formats in different locations, the OPM of the company is expected to improve to 22-23% in the coming years.

- **Strong fundamentals and balance sheet:** With an increase of two times in the number of outlets over FY2008-12, Speciality's revenues and PAT grew at a CAGR of about 24% and 36% respectively over the same period. Its business entails services for cash and thus the business has excellent operating cash flows. The return ratios have also remained strong for the company with the return on capital employed standing at 21.5% in FY2012 (as against 24.3% in FY2011). With more and more restaurants attaining maturity, we expect Speciality's free cash generation ability to improve substantially in the coming years. This will not only take care of the future expansion plans, but also reward the investors with a good dividend pay-out.

- **Experienced management team and dedicated staff:** The company has an experienced top management with strong expertise in the field of restaurant industry in India. The founder promoter, Anjan Chaterjee, has over 30 years of experience in the Indian hospitality industry and is responsible for the overall strategic decisions of the company. Speciality has a dedicated staff of close to 3,500 employees across the chain of restaurants. The company's core values are instilled in all the recruited staff through rigorous training at the company's training centre in Kolkata. This helps in maintaining the quality and taste of the menu at various locations and providing superior services to guest. This, in turn, helps in building the brand and improving the turn-around of the restaurants.

Top management profile of Speciality

Anjan Chaterjee	• Anjan Chaterjee holds the post of managing director in the company and has been the director of the company since December 1, 1999. • He has a diploma in hotel management and over 30 years of experience in the hospitality industry.
Suchchanda Chaterjee	• Suchchanda Chaterjee is a whole-time director of the company. She has been the director of the company since December 1, 1999. • She holds a bachelor's degree in arts from the University of Calcutta and has over 11 years of experience in the hospitality industry.
Indranil Ananda Chaterjee	• Indranil Ananda Chaterjee has been a whole-time director of the company since August 18, 2005. • He holds a bachelor's degree in commerce from the University of Calcutta and a post-graduate degree in business from the Institute of Modern Management, Calcutta. • He has over 28 years of experience in finance and marketing.

Key concerns

- **A challenging economic environment:** With the Indian economy facing headwinds in the recent times, a curtailment of discretionary spending is likely. We believe that the fine dining segment would be affected more as people are likely to downgrade to cheaper alternatives or reduce the frequency of dining out.
- **International and domestic players eye India for growth:** With the growth in the western economies stagnating, a lot of international players (Yum, Domino's, and McDonald's) are eyeing India as an attractive expansion opportunity. The entry of the other players is likely lead to an increased competition.
- **Over dependence on *Mainland China*, other brands yet to prove themselves:** *Mainland China*, the company's flagship brand, contributed more than 60% of the company's revenues for the year ended March 31, 2012. The other brands have yet to scale up and contribute meaningfully to the revenues and profitability of Speciality. Besides, the company does not intend to increase the presence of the other brands in India.
- **India a diversified market with differing tastes:** India, though an attractive opportunity, is also a tough market with the consumers' taste preferences varying according to regions. Adapting to the widely differing preferences is likely to be a challenge for the company.

Outlook and valuation

Speciality is planning to add 13-15 restaurants every year. This along with a stable turn-around in the existing restaurants will help the revenues to grow at a CAGR of 31% over FY2012-15. With an enhanced focus on improving its profitability through cost optimisation measures and the benefits of an improved scale, we expect the company's OPM to grow to 21-22% going ahead. Overall, we expect Speciality's bottom line to grow at a CAGR of about 50% over FY2012-15. However, any moderation in the turn-around ratio due to macro uncertainties and any significant increase in the operating cost remain the key risks to our earnings estimates.

At the current market price the stock is trading at 34.3x its FY2013E EPS of Rs5.0 and 20.4x its FY2014E EPS of Rs8.4. In view of the improving business dynamics, strong earnings visibility and asset-light business model, we initiate coverage on Speciality with a price target of Rs243 (valuing the stock at 20x its FY2015E earnings).

Financials

Profit & Loss statement

Rs cr

Particulars	FY11	FY12	FY13E	FY14E	FY15E
Total revenues	**173.1**	**196.2**	**256.4**	**347.0**	**445.2**
Raw material cost	44.5	51.0	67.7	85.5	102.7
Employee cost	33.0	42.3	55.0	72.7	91.7
Rent	23.8	28.7	41.9	53.9	67.5
Other expenditure	33.9	36.7	47.3	64.5	84.8
Total expenditure	**135.2**	**158.7**	**211.9**	**276.5**	**346.6**
Operating profit	**37.9**	**37.5**	**44.5**	**70.5**	**98.6**
Other income	1.8	2.7	9.5	11.8	14.1
Interest expense	1.3	2.7	2.7	2.2	1.7
Depreciation	14.3	12.9	16.2	21.2	25.6
Profit before tax	**24.1**	**24.7**	**35.1**	**59.0**	**85.4**
Total tax	8.1	7.4	11.7	19.7	28.4
Reported PAT	**16.0**	**17.2**	**23.4**	**39.4**	**57.0**

Balance sheet

Rs cr

Particulars	FY11	FY12	FY13E	FY14E	FY15E
Equity capital	34.9	35.2	47.0	47.0	47.0
Reserves and surplus	62.7	79.6	267.4	306.8	363.8
Net worth	**97.6**	**114.9**	**314.4**	**353.8**	**410.7**
Deferred Tax liabilities (net)	-2.4	-4.3	-4.3	-4.3	-4.3
Total loans	19.6	29.1	24.1	19.1	14.1
Capital employed	**114.9**	**139.6**	**334.2**	**368.5**	**420.5**
Gross block	103.5	123.8	185.0	215.0	250.8
Depreciation	41.0	51.0	67.1	88.3	113.9
Net block	87.6	87.8	117.9	126.7	136.9
Investments	25.1	15.0	175.0	180.0	200.0
Current assets	**51.1**	**65.1**	**89.1**	**128.6**	**171.1**
Inventories	2.0	2.0	2.7	3.4	4.1
Sundry debtors	5.0	7.4	9.6	13.0	16.7
Cash and bank balance	**4.8**	**4.7**	**14.9**	**36.8**	**59.0**
Loans and advances	35.5	45.3	54.4	65.2	78.3
Other current assets	3.9	5.7	7.5	10.1	13.0
Current liabilities and provisions	**30.9**	**28.5**	**47.8**	**66.8**	**87.5**
Sundry creditors	24.3	21.6	28.8	37.6	47.1
Other current liabilities	4.4	5.5	7.3	9.6	12.0
Provisions	2.2	1.4	11.7	19.7	28.4
Net current assets	**20.1**	**36.6**	**41.3**	**61.8**	**83.6**
Capital deployed	**114.9**	**139.6**	**334.2**	**368.5**	**420.5**

Cash flow statement

Rs cr

Particulars	FY11	FY12	FY13E	FY14E	FY15E
Operating cash flow before WC changes	30.3	30.1	39.6	60.5	82.6
Changes in WC	-2.4	-16.6	5.6	1.3	0.4
Cash flow from operating activities	27.9	13.5	45.1	61.9	83.0
Cash flow from financing activities	5.0	7.5	171.1	-5.0	-5.0
Cash flow from investing activities	-32.0	-21.1	-206.1	-35.0	-55.9
Net change in cash and cash equivalents	**0.9**	**-0.1**	**10.2**	**21.9**	**22.2**
Opening cash balance	3.8	4.8	4.7	14.9	36.8
Closing cash balance	4.8	4.7	14.9	36.8	59.0

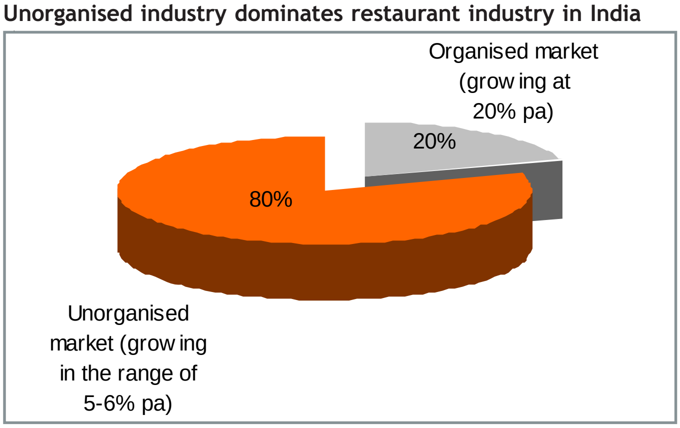
Key ratios

Particulars	FY2011	FY2012	FY2013E	FY2014E	FY2015E
Gross margins (%)	74.3	74.0	73.6	75.4	76.9
OPM (%)	21.9	19.1	17.3	20.3	22.1
NPM (%)	9.3	8.8	9.1	11.3	12.8
Fully diluted EPS (Rs)	3.4	3.7	5.0	8.4	12.1
P/E (x)	50.1	46.6	34.3	20.4	14.1
Price/book value (x)	6.1	5.2	2.6	2.3	2.0
EV/EBIDTA (x)	16.2	16.7	18.3	11.1	7.7
EV/sales (x)	3.5	3.2	3.2	2.3	1.7
Market cap/sales (x)	3.5	3.1	3.1	2.3	1.8
RoE (%)	19.5	16.2	10.9	11.8	14.9
RoCE (%)	24.3	21.5	15.9	17.4	22.1

Annexure: Indian restaurant industry

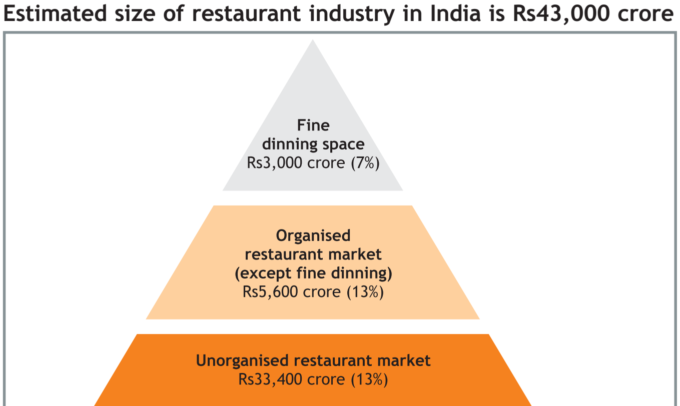
- The size of the Indian restaurant industry is close to Rs45,000 crore and the industry is growing at a brisk pace due to the growing tendency of Indians to eat out. The restaurant industry can be further classified into organised (accounting for 20% of the market size) and unorganised (80% of the market size). The organised market is dominated by a few global and domestic food chains (including McDonald's, KFC, Jubilant Foodworks, Speciality Restaurants, Blue Foods and Mars Group).
- The changing demographics of India, growing consumption of new cuisines, increasing brand awareness and rising footfalls in malls, multiplexes and food courts are some of the key growth drivers of the organised restaurant industry.
- Fine dining is an upcoming format in urban India which is gaining good acceptance for serving the highest quality of food and services in a soothing atmosphere. The size of this market is estimated at Rs3,000 crore. The average bill size in the fine dinning space ranges between Rs650 and Rs3,000 per person. The industry has an OPM of close to 40%, which is higher in comparison to the 15-25% OPM in the QSR industry.

Unorganised industry dominates restaurant industry in India



Source: Industry report

Estimated size of restaurant industry in India is Rs43,000 crore

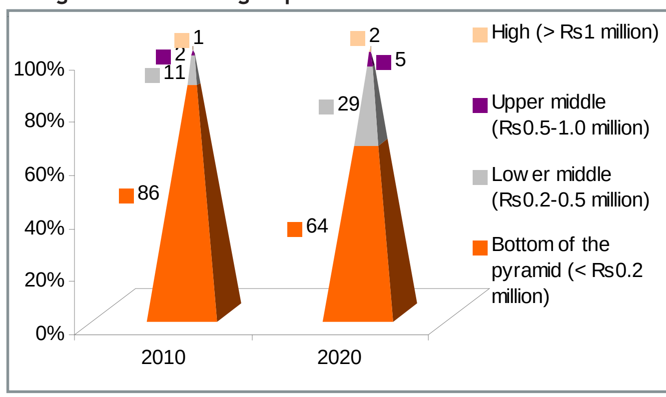


Source: Industry report

Key growth drivers of fine dinning industry

- **Rising disposable income coupled with increasing population of youth bodes well for the industry:** The rising affluence in the metros and tier-I and tier-II cities has provided the fine dining industry with an increased target audience. The growing population of the youth with high disposable incomes and a rising tendency among them to dine out would surely help the industry in making inroads into the tier-I and tier-II cities.

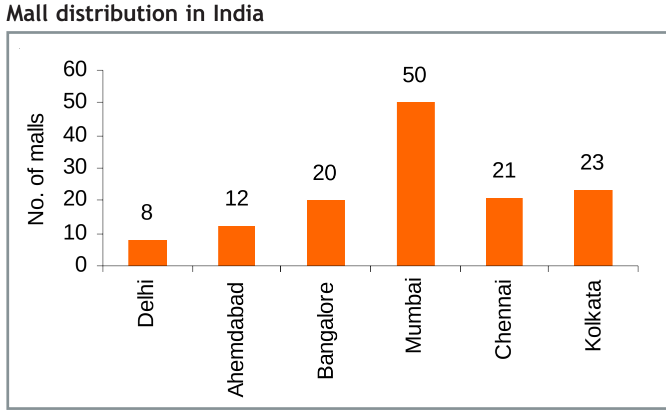
Rising middle income group in India



Source: Industry report

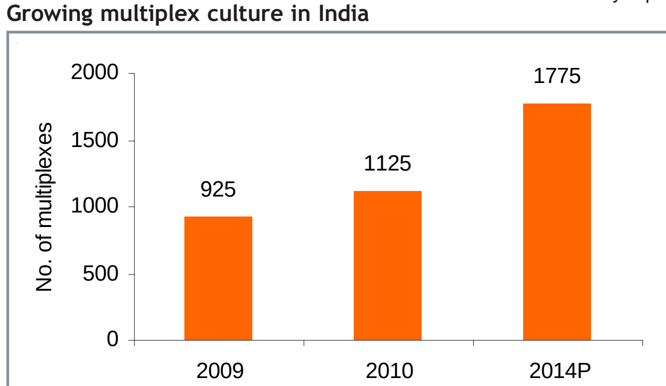
- **Boom in mall and multiplex culture:** Many cities (including the key metros) in India have witnessed a boom in mall and multiplex construction activity in the last decade. This has encouraged families to dine

Mall distribution in India



Source: Industry report

Growing multiplex culture in India

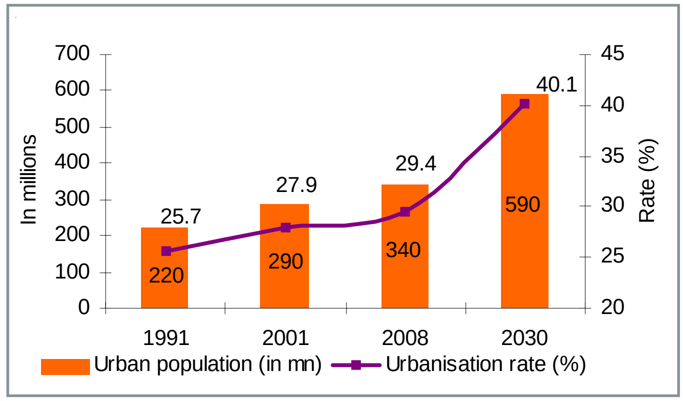


Source: Industry report

out. Weekends especially see increased footfalls in malls. An expanding middle-class consumer base coupled with an increase in the frequency of dining out is a good long-term driver of the industry's growth.

- **Nuclear families:** The trend of nuclear families with working parents is growing by the day. This factor would also boost the demand for take-aways. The take-away model should be able to gain prominence in the coming years.
- **Urbanisation:** India is witnessing rapid development in its tier-II and tier-III cities. These cities are relatively under-penetrated as compared with the metros. We believe that in the coming years, as these cities develop, the affluent middle class would start dining out with an increasing frequency. Hence, we believe the industry still has plenty of scope to expand its business.

Growing urbanisation in India



Source: Industry report

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