19th, September, 2016

Kwality Ltd

"On Strong Profitability Growth Path"

Nirmal Bang Research (Division of Nirmal Bang Securities Pvt. Ltd.)
B-2, 301/302, 3rd Floor, Marathon Innova, Off Ganpatrao Kadam Marg,
Lower parel (W), Mumbai - 400 013.
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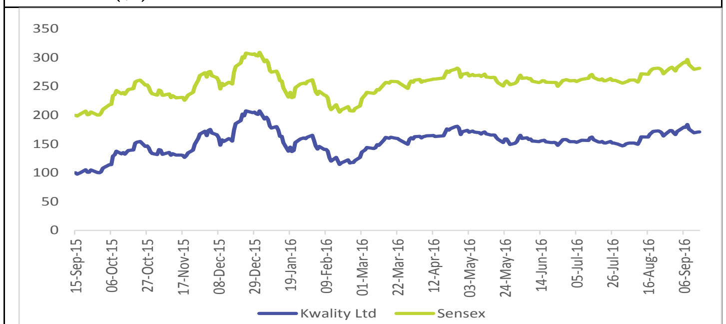
Website : www.nirmalbang.com

Initiating Coverage — KWALITY LTD

Recommendation	BUY
CMP (Rs.)	Rs.120
Target Price (Rs.)	Rs.150 (Upside 25%)

Stock Details	
BSE Code	531882
Bloomberg Code	KWALITY IN
Market Cap (Rs. cr)	2852
Free Float (%)	35.0
52- wk HI/Lo (Rs)	153.7 / 68
Avg. Volume (Monthly)	1144500
Face Value (Re)	1
Dividend (%) (FY 16)	10
Shares o/s (Crs)	23.4

Relative Performance	1Mth	3Mth	6Mth	1Yr
KWALITY IN (%)	-5.3	9.6	5.9	71.1
SENSEX (%)	0.9	6.3	15.7	10.5



Shareholding Pattern as on 30th June, 2016	
Promoters Holding	64.9
FIIs	0.3
DIIs	-
Public & others	34.8

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Snapshot: Kwality is one of the largest manufacturer of milk & milk products in the private dairy sector in India with processing capacity of over 3.2 mn litres/day. With its diverse product portfolio, comprising of milk powder and fresh milk products, the company caters to customers under its "Kwality" and "Dairy Best" brand. Recently, the company won legal battle of "Kwality" brand.

INVESTMENT RATIONALE

Building consumer-focused dairy products company: Kwality is transforming rapidly from a traditional B2B dairy player to a consumer-oriented branded products company. At present, the company derives 68 per cent revenues from institutional segment and balance from retail segment. Over the next three years, the company intends to increase consumer business from the present 32 per cent to 70 per cent on the back of capacity expansion, widening product portfolio including value-added products (VAP) like flavored milk, paneer, cheese, and butter, among others, brand building and increasing distribution reach.

Enhanced focus on VAP to expand EBITDA margin sharply: Kwality reported gross profit margin and EBITDA margin at 9.4 per cent and 6.1 per cent respectively in FY16, mirroring product mix (liquid milk revenue at 53 per cent) and business mix. We believe product mix shift towards VAP with higher realizations coupled with B2C business model will expand EBITDA margin (8-9 per cent) over long term. However, increase in brand building cost will offset gross margin expansion in the short-run.

Free cash flows to aid deleveraging: Kwality has been reporting negative operating cash flows / free-cash flows over the last two years. This has also resulted into increase in debt from Rs. 1096 crore in FY14 to Rs. 1500.6 crore in FY16. Interest expense as percentage of EBITDA has remained at elevated levels (40 per cent) during the same period. Now, the company is entering into higher free-cash flows period aided by EBITDA margin expansion and reduction in working capital cycle.

Valuation & Recommendation: Business model transformation, expansion in EBIDTA margin, decline in working capital cycle and de-leveraging are key value drivers for re-rating in the stock. We estimate Kwality to clock 23 per cent CAGR in net earnings over FY16-FY19, among the best in dairy sector. RoCE will improve significantly from 18.5 per cent in FY16 to 24.3 per cent in FY19, largely attributable to margin expansion. **With strong free cash flows and debt repayment, the stock is set to re-rate over the medium term. We value the company at 10x FY18 EBITDA to derive a price target of Rs150. We recommend BUY on the stock with a price target of Rs150 over the next 9-12 months.**

Particulars (Rs Cr)	Net Sales	*Growth (%)*	EBITDA	PAT	EPS (Rs)	P/E (x)
FY'16	6414.1	9.1%	388.7	173.6	7.8	16.0
FY'17E	6288.0	-2.0%	417.7	173.7	7.8	16.0
FY'18E	6596.8	4.9%	474.7	203.5	9.1	13.6
FY'19E	7052.4	6.9%	624.2	322.8	14.4	8.6

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BUSINESS MODEL ANALYSIS

Kwality is a dairy company with over 3.2 million liters milk processing capacity with high concentration towards institutional segment. Over the years, the company has established strong presence in India's largest production and consumption markets i.e. Rajasthan, Haryana, UP and Punjab. Over the last three years, the company has enhanced its focus towards retail business and increasing procurement directly from farmers.

In FY16, the company derived 32 per cent of its revenues from retail segment compared to 25 per cent in FY14. As far as milk procurement is concerned, the company procured over ~ 20 per cent of its daily requirement from farmers directly in FY16 against 14 per cent in FY14.

We believe sustainable superior profitability in dairy sector is dependent upon three critical success factors, namely, direct procurement mix, robust product portfolio and retail / branded product business mix. Kwality is moving from traditional B2B business model to B2C business model with strong focus on direct milk procurement infrastructure, high-margin branded value-added products and brand building. This will improve business profitability, reduce working capital and strong free-cash flow generation on consistent basis.

Exhibit 1: Transforming business model from B2B to B2C with strong focus on value-added products

Current Business model	Strategic changes to Business Model
• Direct milk procurement ~ 18% • Business mix between institutional and retail segment stands at 70 per cent and 30 per cent respectively • Small product portfolio with no major value added products' contribution • EBITDA margin at 6 per cent • Stretched working capital cycle • Negative operating cash flows / free-cash flows	• Increase direct milk procurement to 50% over the next three years • Retail business mix to increase from current 30 per cent to 70 per cent over the next three years. • Capacity expansion in value-added product categories and rolling out various value-added branded products • EBITDA margin to increase from 6 per cent in FY16 to 9 per cent in FY19 on the back of higher revenues from high-margin value-added products. • Shift towards B2C to improve working capital cycle and support deleveraging • Generating higher free cash flows

Source: Nirmal Bang PCG Research

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INVESTMENT RATIONALE

Building consumer-focused dairy products company

Kwality is transforming rapidly from a traditional B2B dairy player to a consumer-oriented branded products company. Presently, the company derives 68 per cent revenues from institutional segment and balance from retail segment. Over the next three years, the company intends to increase consumer business from the present 32 per cent to 70 per cent on the back of capacity expansion, widening product portfolio including value-added products (VAP) like flavored milk, paneer, cheese, butter, among others, brand building and increasing distribution reach.

We believe sustainable and profitable growth in dairy business depends upon three important areas, namely, milk procurement model, robust product portfolio and retail / branded product business mix. The company is setting up a new plant (mainly focusing on value-added products) with total CAPEX of Rs. 400 ccrore along with Rs. 120 crore towards building milk procurement infrastructure. Post this expansion, the company will increase direct milk procurement mix from current 20 per cent to 50 per cent over the next three years. This will ensure consistent and quality milk availability for value-added products manufacturing. After reaching certain scale in dairy business (processing 3.2 mn liters milk per day), the company is now adding products like flavored milk, UHT, milk sweets, cheese, yoghurts, table butter into the product portfolio coupled with increasing sales to consumer segment.

Exhibit 2: Revenue growth

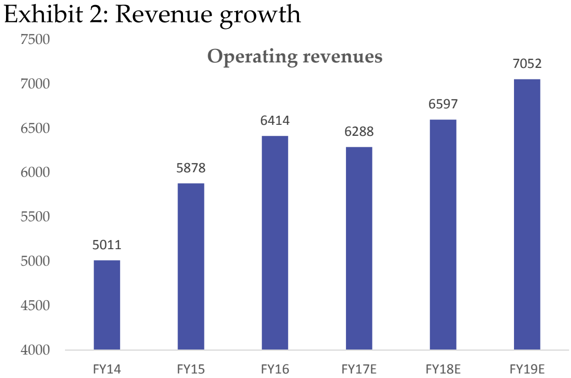
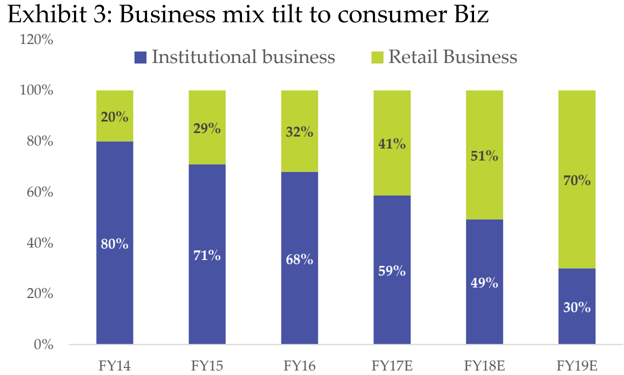


Exhibit 3: Business mix tilt to consumer Biz



Source: Company, Nirmal Bang PCG Research

To increase consumer business, the company has come out with a strong product pipeline of value-added products under "KWALITY" mother brand architecture with leading Bollywood actor Akshay Kumar as the brand ambassador. The targeted high milk consuming markets like Delhi, UP, Haryana and Rajasthan coupled with new and fresh dairy products will drive revenue growth, expansion in gross profit margin & EBITDA margin and substantial reduction in overall working capital requirement over the next few years.

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The company has engaged marketing partners for roll-out integrated marketing strategy for value-added and youth dairy products over the next few years. Marketing partners include McCANN & Cheil India for creative, Zenith Optimedia for media planning and digital Quotient in digital space. We believe business model moving from low margin business / B2B segments to value-added high margin business / B2C segment over the next three years which will help to deliver structural EBITDA margin expansion.

Enhanced focus on VAP to expand EBITDA margin sharply

Kwality reported gross profit margin and EBITDA margin at 9.4 per cent and 6.1 per cent respectively in FY16, mirroring product mix (liquid milk revenue at 53 per cent) and business mix. We believe product mix shift towards VAP with higher realizations coupled with B2C business model will expand EBITDA margin (8-9 per cent) over long term. However, increase in brand building cost will offset gross margin expansion in short-term.

The company is spending ~ Rs. 120 crore for building robust direct milk procurement infrastructure like setting up 20-25 milk chilling centers and controlled temperature vehicles. The company will also begin farmers connect program at a large scale to help better cattle feeds and higher yields from cattle. Post capacity expansion, the company will process over 4 mn litres milk in at its manufacturing facilities.

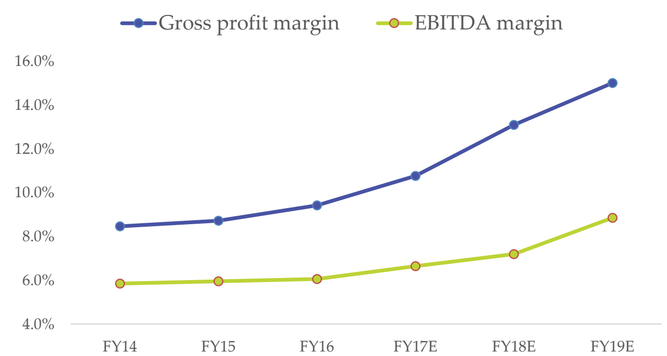
Broadly, product portfolio is divided into three categories like lower margin products (4-5 per cent EBITDA margin, mid margin products (9-10 per cent EBITDA margin) and high margin products (20 per cent EBITDA margin). New capacity will help to attain value-added high margin products revenue close to ~ Rs. 2500 crore - Rs. 3000 crore into the consolidated net sales by FY19.

Exhibit 4: Drivers of EBITDA expansion

Categories	EBITDA
Low margin products	4-5%
Mid-margin products	9-10%
High-margin products	20% plus
FY16 Revenues	6414.1
EBITDA margin	6.1%
Rev from high-margin products - FY19	2500
Consolidated Revenue -FY19	7052.4
EBIDTA expansion - VAP (in bps)	300
FY19 EBITDA margin	8.9%

Source: Company, Nirmal Bang PCG Research

Exhibit 5: Gross margin & EBITDA trend



We expect EBITDA margin to increase from 6.1 per cent in FY16 to 8.9 per cent in FY19 aided by high-margin value added products revenue and change in business segment mix from B2B to B2C. We believe structural drivers for gross profit margin & EBITDA margin coupled with change in business model will sustain improved profitability (9 per cent-10 per cent EBITDA margin) over long term.

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Free cash flows to aid deleveraging

The Company has been reporting negative operating cash flows and free-cash flows over the last two years. This has also resulted into increase in debt from Rs. 1096 crore in FY14 to Rs. 1500.6 crore in FY16. Interest expense as percentage of EBITDA has remained at elevated levels (40 per cent) during the same period. Now, the company is entering into higher free-cash flows phase aided by EBITDA margin expansion and reduction in working capital cycle. Core working capital cycle will reduce from 101days in FY16 to 82days in FY19, leading strong growth in free-cash flows. The company will use free-cash flows to reduce balance sheet leverage. Debt to equity ratio will decline from 1.7x in FY16 to 0.5x FY19 driven by ~ Rs. 745 crore debt repayment over FY17-FY19. Consequently, interest expense / EBITDA ratio to fall sharply from 41 per cent in FY16 to 20.8 per cent in FY19, driving net profit growth.

Exhibit 6: Reduction in debts

Rs in crore	FY14	FY15	FY16	FY17E	FY18E	FY19E
Core working capital cycle (in days)	98.5	97.1	100.9	97.0	89.0	82.0
Operating cash flows	-13.6	17.0	149.4	456.2	462.0	528.9
Free cash flows	45.5	126.4	374.4	636.2	522.0	558.9
Gross debt	1096.0	1249.1	1500.6	1380.6	1155.6	755.6
D/E	2.6	1.9	1.7	1.3	0.9	0.5
Interest / EBITDA	39.4%	40.1%	40.5%	38.5%	31.6%	20.8%

Source: Company, Nirmal Bang PCG Research

Superlative net earnings growth and sustained higher return on equity

Net profit grew 9.4 per cent CAGR to Rs. 173.6 crore over FY14-FY16 aided by 15.1 per cent growth in EBIDTA offset higher interest expense. We believe new capacity led revenue growth, EBIDTA expansion and debt repayment will drive net earnings over the next few years. We expect the company to deliver 23 per cent CAGR in net earnings over FY16-FY19, among the best in dairy sector. Superlative net earnings growth and balance sheet deleveraging will expand RoCE from 18.5 per cent in FY16 to 24.3 per cent in FY19. We believe strong earnings growth coupled with improving RoCEs would lead to re-rating over the medium term.

Exhibit 7: Net profit

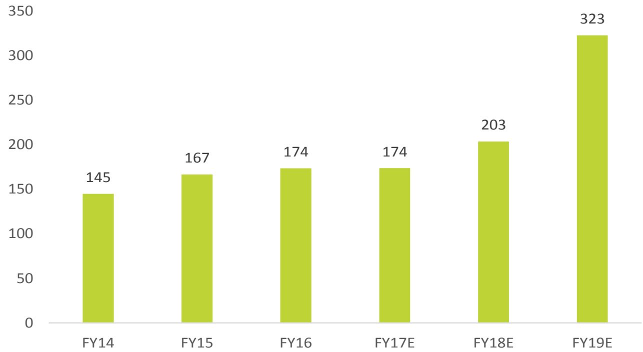
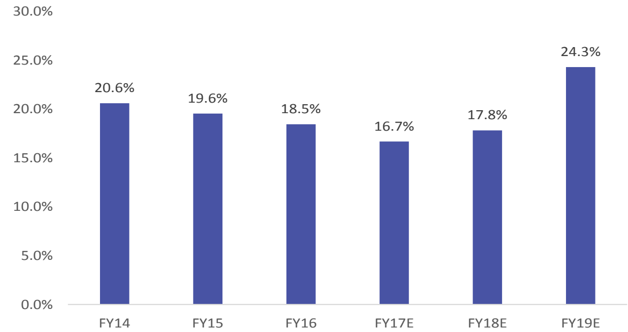


Exhibit 8: RoCE



Source: Company, Nirmal Bang PCG Research

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RISKS & CONCERNS

- **Availability and price volatility of raw milk**
  Kwality's business depends on its ability to procure sufficient good quality raw milk at commercially viable prices. Though the company has long-standing relationship with milk farmers and milk contractors, it has not entered into any formal supply agreements. In the event Kwality is unable to increase the supply of raw milk at reasonable prices or at all, or even maintain current milk supplies due to increasing competition, its growth may get impacted. The company is looking to increase direct procurement mix from current 20 per cent to 50 per cent over the next five years.

- **Increased price intensity among private dairy players**
  Entry of large corporate groups like Godrej, Mahindra and ITC into the dairy sector coupled with aggressive growth plans of co-operative dairies (Amul / Mother Dairy) may impact dairy product prices adversely especially in value-added product segment which in turn impact profitability. Kwality's brand focus strategy and faster product portfolio rollout would mitigate these risks to large extent.

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VALUATION AND RECOMMENDATION

Business model transformation, expansion in EBIDTA margin, lower working capital cycle and de-leveraging are key value drivers for re-rating in the stock. We estimate Kwality to clock 23 per cent CAGR in PAT over FY16-FY19, among the best in the dairy sector. RoCE will improve significantly from 18.5% in FY16 to 24.3% in FY19 largely attributable to margin expansion. Kwality's success is largely dependent upon disciplined execution of product expansion and branding & distribution strategies. Strategic resets in milk procurement model, product portfolio and business mix are steps in the right direction.

At Rs120, the stock is trading at 9.9x FY17 EV/EBITDA and 8.1x FY18 EV/EBITDA, a 40 per cent discount to peers. Negative free cash flows and balance sheet leverage are primary factors for such a high valuation discount. **With strong free cash flows and debt repayment, the stock is set to re-rate over the medium term. We value the company at 10x FY18 EBITDA to derive a price target of Rs150. We recommend BUY on the stock with a price target of Rs150 over the next 9-12 months. Key risk to our view are sharp rise in milk procurement price & skimmed milk price and price wars among dairy players.**

Exhibit 9: Peer comparison and Relative Valuation

INR CRORE	Hatsun Agro	Heritage Foods	Kwality	Parag Milk Foods	Prabhat
M cap	5161	1881	2852	2796	889
Net debt	604.1	109.7	1414.3	165.0	146
EV	4422.1	1324.7	4053.3	2481.0	1100
EV/EBITDA	18.3	12.6	9.6	22.3	11
Asset turn	5.1	7.4	16.3	4.9	2.6
Gross profit margin	27.7%	21.1%	9.4%	25.1%	22.3%
EBITDA margin	8.8%	5.5%	6.1%	8.7%	10.2%
RoCE	24.6%	26.2%	22.7%	19.5%	10.3%
PE (x)	84.0	28.5	16.3	59.0	36.3
Working capital days	23.1	13.7	100.9	72.5	81.8

Source: Companies, Nirmal Bang PCG Research

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COMPANY BACKGROUND

Kwality Ltd. is one of the largest processor of dairy products in the private sector in India. The company was incorporated in 1992 as backward integration unit of Kwality Ice Creams and acquired by the present promoters in 2003. Presently, the company has processing capacity of 3.2 million litres of milk per day with six milk processing units across Rajasthan, Haryana and UP. Presently, the company is procuring ~ 20 per cent of milk requirement directly from more than 3,00,000 farmers spread across 4500 villages through 22 milk collection centres (MCCs). The company sells its dairy product under "Dairy Best" brand. **Kwality has successfully come out of a branding-related legal dispute after Graviss Holding withdrew its case on May 31, 2016.** The company is also having a wholly-owned subsidiary (KDPF) in Dubai as a trading arm. Dubai subsidiary imports dairy products from India, Australia, New Zealand and Eastern European countries and sells products, both domestically and export to Middle East, Bangladesh, China, Thailand and Africa. The Dubai subsidiary contributed Rs. 690 crore to the topline and Rs. 29.3 crore to PAT at consolidated level in FY16.

The company reported operating revenues, EBIDTA and consolidated PAT of Rs. 6414 crore , Rs389 crore and PAT Rs. 173.6 crore respectively in FY16. Out of consolidated sales, the company derives ~ Rs4370 crore from the manufacturing operation and balance as trading turnover in India and Dubai business.

Traditionally, the company's primary focus is B2B segment rather than retail consumer segment. With capacity expansion in value –added products along with increase in distribution reach in target markets will see higher growth retail business mix over the next 3-4 years.

The promoter (Mr. Sanjay Dhingra) holds 64.95% stake in the company. Recently, the company announced that it will raise Rs. 60 crore from the Bennett Coleman in a preferential allotment. **Apart from this, the company has received capital commitment amounting to Rs. 520 crore under structured finance from KKR PE in July 2016.**

Exhibit 10: Revenue split FY2016

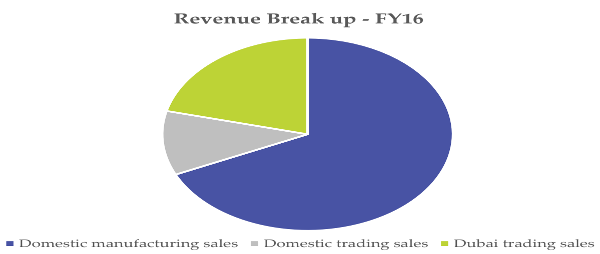
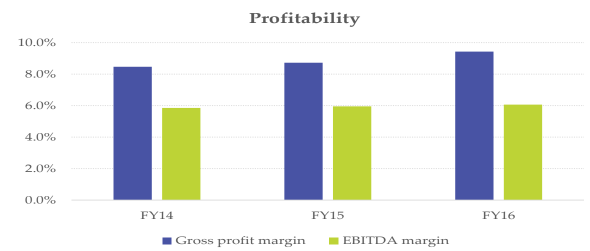


Exhibit 11: Gross margin & EBITDA trend



Source: Company, Nirmal Bang PCG Research

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Exhibit 12: Business snapshot

	2011	2013	2016
Sales (Rs. crore)	1602.5	3691.6	5724.1
EBITDA (Rs. crore)	98.8	213.3	378.6
Direct procurement farmers	10000	100000	300000
Processing capacity (mn kg)	957	986	1244

Source: Company Note: Above financial are standalone basis.

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FINANCIALS

INR CRORE	FY15	FY16	FY17E	FY18E	FY19E
INCOME STATEMENT					
Operating revenues	5878.3	6414.1	6288.0	6596.8	7052.4
Gross profit	512.5	604.6	677.4	864.0	1059.0
Employee expense	24.3	34.3	44.5	57.9	72.4
Other operating expense	138.3	181.6	215.1	331.3	362.5
EBITDA	349.9	388.7	417.7	474.7	624.2
Other income	11.7	29.8	16.0	18.0	20.0
Depreciation	25.3	23.4	34.8	64.0	72.0
EBIT	336.4	395.2	398.9	428.7	572.2
Interest	140.3	157.4	161.0	150.0	130.0
Profit before tax	196.1	237.7	237.9	278.7	442.2
Tax expense	29.5	64.1	64.2	75.3	119.4
PAT	166.5	173.6	173.7	203.5	322.8

INR CRORE	FY15	FY16	FY17E	FY18E	FY19E
CASH FLOW STATEMENT					
EBITDA	349.9	388.7	417.7	474.7	624.2
Operating cash flows before WC adjustment	394.3	391.9	417.7	474.7	624.2
Working capital changes	-347.8	-178.4	102.8	62.5	24.2
Tax paid	-29.5	-64.1	-64.2	-75.3	-119.4
Operating cash flow activities	17.0	149.4	456.2	462.0	528.9
CAPEX	-109.4	-225.0	-180.0	-60.0	-30.0
Free cash flows	-92.5	-75.6	276.2	402.0	498.9
Cash flows from investing activities	-108.5	-183.6	-164.0	-42.0	-10.0
Cash flows from financing activities	104.2	91.6	-283.7	-377.7	-532.7
Change in cash	12.6	57.3	8.5	42.3	-13.8
Opening cash balance	16.2	28.9	86.2	94.7	137.0
Closing balannce	**28.9**	**86.2**	**94.7**	**137.0**	**123.3**

INR CRORE	FY15	FY16	FY17E	FY18E	FY19E
BALANCE SHEET					
Equity share capital	21.9	22.4	22.4	22.4	22.4
Reserve & Surplus	624.3	829.3	1000.3	1201.1	1521.2
Money received against warrants	18.8	12.5	12.5	12.5	12.5
Networth	664.9	864.2	1035.2	1236.0	1556.1
Borrowings	1249.1	1500.6	1380.6	1155.6	755.6
Long term provisions	1.4	1.8	1.8	1.8	1.8
Trade paybles	52.0	52.1	51.7	54.2	58.0
Other current liabilities	28.1	83.9	83.9	83.9	83.9
Short term provisions	70.3	48.0	48.0	48.0	48.0
TOTAL	**2065.9**	**2550.6**	**2601.2**	**2579.5**	**2503.3**
Fixed assets	185.7	267.4	412.7	408.7	366.7
Long term loans and advances	88.2	179.1	179.1	179.1	179.1
Other non current assets	1.7	0.7	0.7	0.7	0.7
Deffered tax assets (net)	1.5	11.8	11.8	11.8	11.8
Current assets	1788.8	2091.5	1996.9	1979.2	1945.0
- Inventories	291.0	170.6	172.3	180.7	193.2
- Trade receivables	1324.6	1655.4	1550.5	1482.0	1449.1
- Cash and cash equivalents	28.9	86.2	94.7	137.0	123.3
- Short term loans and advances	143.8	177.2	177.2	177.2	177.2
- Other current assets	0.5	2.2	2.2	2.2	2.2
TOTAL	**2065.9**	**2550.6**	**2601.2**	**2579.5**	**2503.3**

RATIO ANALYSIS	FY15	FY16	FY17E	FY18E	FY19E
Growth					
Net sales	17.5%	9.1%	-2.0%	4.9%	6.9%
Gross profit	20.9%	18.0%	12.0%	27.6%	22.6%
EBITDA	19.3%	11.1%	7.4%	13.7%	31.5%
EBIT	18.3%	17.5%	1.0%	7.5%	33.5%
PBT	16.1%	21.2%	0.1%	17.1%	58.6%
PAT	14.9%	4.2%	0.1%	17.1%	58.6%
EPS	6.7%	1.8%	0.1%	17.1%	58.6%
Margin					
Gross profit margin	8.7%	9.4%	10.8%	13.1%	15.0%
EBITDA margin	6.0%	6.1%	6.6%	7.2%	8.9%
EBIT margin	5.7%	6.2%	6.3%	6.5%	8.1%
PAT margin	2.8%	2.7%	2.8%	3.1%	4.6%
Operating efficiency					
RoE	30.5%	22.7%	18.3%	17.9%	23.1%
RoCE	19.6%	18.5%	16.7%	17.8%	24.3%
Fixed asset turnover	31.7	24.0	15.2	16.1	19.2
Working capital turnover	3.8	3.6	3.8	4.1	4.5
Working capital cycle (days)	97	101	97	89	82
Financial leverage					
Interest exp / EBITDA	40.1%	40.5%	38.5%	31.6%	20.8%
Debt / Equity (x)	1.9	1.7	1.3	0.9	0.5
Net Debt / Equity (x)	1.8	1.6	1.2	0.8	0.4
Per share data & valuation					
EPS	7.6	7.8	7.8	9.1	14.4
Growth in EPS	6.7%	1.8%	0.1%	17.1%	58.6%
BVPS	30.4	38.6	46.2	55.2	69.5
PE (x)	15.9	15.6	15.6	13.3	8.4
PB (x)	4.0	3.1	2.6	2.2	1.7
EV/EBITDA (X)	11.6	11.0	9.9	8.1	5.6

Source: Nirmal Bang PCG Research

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