Viewpoint

Steaming hot; Re-initiate with a positive stance

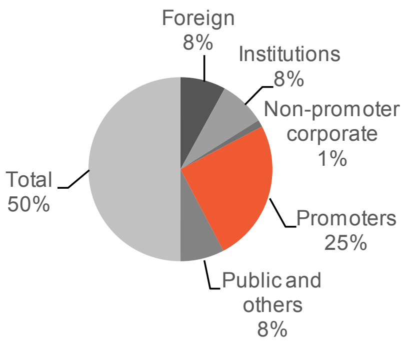
McLeod Russel

View: Positive | CMP: Rs211

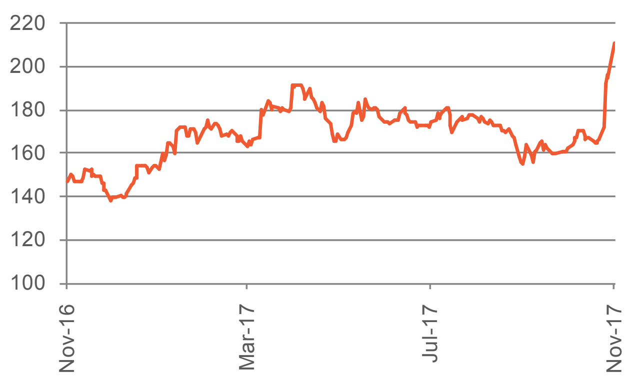
Company details

Market cap:	Rs2,310 cr
52-week high/low:	Rs215/138
NSE volume: (No of shares)	2.1 lakh
BSE code:	532654
NSE code:	MCLEODRUSS
Sharekhan code:	MCLEODRUSS
Free float: (No of shares)	5.5 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	23.6	11.4	19.2	35.9
Relative to Sensex	19.5	4.3	6.1	3.0

Key points

- **Tea prices – At an inflection point:** Global tea production is likely to record a decline in 2017, primarily on account of crop losses in Kenya (one of the world's largest tea exporter). Kenya's production for January 2017-September 2017 was significantly lower by 12.4% YoY at 303.55million kg (mkg) owing to unfavourable weather conditions experienced during the first quarter of the year. For the rest of the season, production is expected to be lower in Africa. In India, tea production up to August-end was ahead of last year's production by 33mkg. However, in September, there was record loss of crop of around 44mkg due to bad weather and total production in September was down by 23.3% YoY. Nevertheless, there is continuous rise in tea demand in regions such as Europe and Iran, which enhances the gap of demand and supply. Reduced global availability of tea is likely to result in the continuation of an upward price trajectory across most international auction centres, which, in turn, would push tea prices in India to much higher levels over the next couple of years.

- **Rising tea prices to propel McLeod margins:** McLeod Russel (McLeod) is the largest tea producer in India. Thus, the company will benefit from rising demand supply gap in the global tea market. For FY2018, though production is expected to be flat on a YoY basis, an uptick in realisation will help improve margins of the company. We expect realisation for the company to rise by 8% in FY2018. While for FY2019 and FY2020, we expect average realisation to increase by 15-16%. Moreover, as 45-50% of cost is fixed in nature (in terms of employee cost), operating leverage will lead to margin expansion going ahead. We expect operating margins to rise to 11.3% in FY2020 from 4.7% in FY2018.

- **Commoditised business with a lean balance sheet:** Though McLeod is in the business of tea production, which is a commoditised business, it has a strong balance sheet with debt equity being 0.4 times in FY2017. Moreover, its working capital cycle was under control at 48 days in FY2017. With the expected increase in profitability, we expect cash flows to improve further, which will help the company to support its business operations in future. Further, return ratios are expected to improve with RoE and

RoCE standing at 11.7% and 13.5% by FY2020E as against 3.3% and 6.4%, respectively, in FY2017.

- **View – Re-initiate coverage with a positive stance and expect 18-20% upside from here:** McLeod is the largest privately held tea plantation company in the world. Reduction in global tea production and continued high demand for tea will lead to rise in tea prices, both in domestic as well as export markets. We expect revenue to report a CAGR of 17% from FY2017-FY2020E and profit to post a CAGR of 60% during the same period. The stock is currently trading at 6.6x its FY2020E earnings. We had booked out of stock at Rs.246 more than two years ago, sensing the downturn in tea prices. However, the scenario is changing for good now. Hence, we re-initiate coverage with a positive view on the stock and expect potential upside of 18-20% from here.

- **Key concern:** Any improvement in global tea production or significant drop in Indian tea production will hamper the overall business performance of McLeod.

Valuation (Consolidated) Rs cr

Particulars	FY16	FY17	FY18E	FY19E	FY20E
Net Sales	1900.1	1776.4	1899.8	2349.5	2839.3
Operating Profit	144.0	14.7	89.6	174.9	320.6
Adjusted PAT	35.0	64.5	56.3	135.8	263.2
Adj. EPS (Rs.)	4.2	7.8	6.8	16.5	31.9
OPM(%)	7.6	0.8	4.7	7.4	11.3
PE(X)	49.7	27.0	30.9	12.8	6.6
EV/EBIDTA (X)	16.4	167.4	27.3	13.4	6.6
RoE(%)	1.8	3.3	2.8	6.6	11.7
RoCE(%)	5.5	6.4	6.5	9.3	13.5

Company profile: McLeod is India's largest tea producer with domestic production of ~85mkg (FY2017) and production from Vietnam and Africa at ~29mkg (FY2017). McLeod manufactures more than 115mkg of tea in a year from its tea estates in Assam, West Bengal, India, Vietnam, Uganda and Rwanda. The company manages approximately 50 tea estates in Assam Valley; over five in Dooars region of West Bengal; approximately three factories in Vietnam; over six estates in Uganda; and two estates in Rwanda

Indian tea production – Shortfall in North India to drive prices: Tea production in India up to August-end was ahead of last year's production by 33mkg. However, in September, there was record loss of crop of around 44mkg due to bad weather and total production declined by 23.3% YoY. Tea production in Assam, which accounts for over 50% of the country's annual production, fell by 27.2% to 81.75mkg in September because of unseasonal torrential rain. Production in West Bengal's Dooars region dipped by 19% to 43mkg in the same month. Moreover, production in October-November together is expected to be behind by around 10mkg. Overall, production for India is expected to be 1,200mkg-1,220mkg for the full year, which is lower than the previous projection of 1,300mkg this year. Hence, a production shortfall in north India will result in a supply shortfall. Thus, prices are expected to improve domestically as well as in the export market due to demand-supply gap.

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