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Heritage Foods India Ltd

Got Milk?

Rarely does one come across a business with hardly any hard constraint. Heritage's is one such business. This private sector dairy company, which has delivered profitable growth in each year of the last decade, still does not have any hard growth constraints. Soft constraints like management span and ambition are what preclude its steep linear earnings growth curve to become convex.

Fair Value Rs.168 (Range: 150-195)

Price Rs.48

+250%

The stock currently trades at 71% discount to our estimated fair value implying a potential appreciation of 250%. It may take 1-2 years for the price-value gap to bridge. The stock is currently available at 3.2x trailing EPS. We expect EPS to grow at an average annual rate of 20% till FY07.

Key Data

Market Cap	Rs.480mn
Shares Outstanding	9.99mn
52 week High-Low	51.50 – 24.75
Average Daily Volume (BSE+NSE 12 months)	5,000 shares

Shareholding %

Promoters	43.25
Institutional Investors	0.51
Others	56.25

Major Shareholders

Nara bhuvanewari	16.07
Nara Lokesh	11.34
V Sudha Sarada	7.91
Megabid Finance	4.95
Mohan Babu Manchu	2.37

Stock Performance

3 months	+12%
6 months	+35%
12 months	+66%

Multiple Valuation

	FY04E
EV/EBIT	1.7
Market Cap/Sales	0.2
P/E	2.7
P/BV	0.8

Key Investment Points

- Heritage is in the business of procurement, processing, and distribution of milk and milk products.
- It has consistent track record of profitable growth since its inception in 1992.
- Existence of huge untapped growth potential – double digit volume growth to continue over next five years.
- High margin value-added and innovative products in pipeline.
- Low capital intensity of the business – generates more cash than needed to sustain normal growth.

Value Kickers

- The company is cash rich. A sagacious use of cash either for pursuing aggressive growth opportunities or for buyback will add to value.
- Induction of a strategic partner, as is being talked about, will bridge the price-value gap faster.

Party Poopers

- Drought in milk procurement areas may adversely impact business volume and earnings in short term.
- Rising competition and consequent rise in trade clout may impact margins in core liquid milk business.
- Failure to expand into new regions may limit growth.





Executive Summary

Heritage Foods (India) Ltd, a company with trailing revenues of Rs. 1.8 billion, is in the business of milk procurement, processing and distribution in south India.

The company was started in 1992 when dairy sector was opened to private sector. It is one of the few well-performing companies in this business. It has been consistently growing since inception. Over the last five years, its revenues have grown three-fold and after-tax profit five-fold. We expect the company to continue on its growth path. The root of its success has been a right beginning. It started with liquid milk and then moved to milk products. Most of the early private sector entrants like Amrut, Indiana, Ravilela, and JK Food started with value-added products. A strong grip on liquid milk is a must for success in this business.

The company, based in Hyderabad, is promoted and owned by family and/or friends of Mr. Chandrababu Naidu, the incumbent chief minister of Andhra Pradesh. Promoters have raised their stake in the company by around 10% in calendar 2002 to 43.25%.

Liquid milk contributes around 84% of sales. Milk products contribute the balance sales. Most of the milk and milk products are sold in the state of Andhra Pradesh, Tamilnadu, Karnataka, and Pondichery. It sells liquid milk under the brand 'Heritage'.

Heritage procures milk from farmers, processes it at its processing and chilling plants, packs it at its packaging plants, and distributes. About 85% of sales are in the form of liquid milk either loose or in pouches and rest is in the form of milk products. Liquid milk gives higher profit margin than milk products. The milk that can not be sold in liquid form is converted into milk products. About 10-15% of sales comes from institutional segments like hotels, sweet makers, etc; and the rest is retail sales.

Buffalo and cow milk contributes 40% and 60% respectively to its milk procurements respectively. It procures largely buffalo milk from Andhra Pradesh and cow milk from Chennai and Karnataka.

Heritage gets competition from co-operatives and private sector players. Co-operatives are market leaders in all the markets. The Andhra Pradesh Co-operative Dairy Development Federation is the biggest competitor in the company's home state. APCDDF with its brand 'Vijaya' has total sales of around Rs.10 billion, of which 50% is from milk. Some of the private sector players like Hatsun Agro Products Ltd have significant presence in three southern states except the Andhra Pradesh. Britannia has also launched loose milk (Brand: Milkman) in some of the southern cities and is expanding. However, Britannia is unlikely to be a threat, as raw milk is not under its control.

Heritage has an impeccable track record. Over last five years, revenues and after-tax profit grew at an average annual rate of 24% and 33% respectively. It pays full tax. It had a buy back of equity shares in FY03 and this buyback reduced its equity capital by 7.4% to Rs.99.9 million. As a result, EPS for the first 9 months of FY03 has grown 59.1% to Rs.11.75 (annualized EPS Rs.15.67). EBITDA margins, which have been stable at around 10-11%, have been on the rise over last two years. EBITDA margin was 12% for FY02 and 14% for



the first 9 months of FY03. Return on equity has been consistently above 26%. The peak debt/equity was 0.6%. The company has become almost debt free now.

Almost the entire sales take place in cash. Debtors are negligible. Inventory is minimal given the perishable nature of the product.

There is huge untapped market for pouch milk driven by demand for unadulterated milk. Heritage can conservatively grow at 15% in volume terms by expanding into new cities/towns and capturing a slice of loose milk market.

Book value per share is Rs.44 and trailing EPS is Rs.15. The stock is currently available at Rs.48. We expect the after-tax profits and EPS to grow at an average annual rate of 20% over next four years. We estimate fair value per share at around Rs.168 based on discounted cash flows. Our fair value estimate is 11 times the trailing EPS (Rs.15.19). At current price of Rs.48, the stock is available at 2.7 times FY04 estimated EPS (Rs.17.46).

There has been unconfirmed news of a few MNCs, which are in the dairy business, showing interest in taking a stake in the company. Rabo bank is reported to have taken a proposal to Heritage on behalf of an MNC. There also has been unconfirmed news of Mr. Chandrababu Naidu interested in selling his stake in the company to a strategic buyer.

Sector Silhouette

India is the largest producer and processor of liquid milk in the world. India accounts for around 16% of the world milk production. The US and Russia are number two and three respectively. About half of the liquid milk is converted into milk products. About 75-80% of the market is in unorganized sector. Co-operative sector has 50-60% market share in liquid milk in India. State governments used to be significant players earlier. Now, Maharashtra is the only state with a significant involvement in the dairy sector. It provides subsidy to milk schemes but said recently that it would withdraw the subsidy. The dairy sector was opened to private sector in 1992.

As per a study in India Development Report 2002, Indians would over next two decades move towards consuming milk and milk products in large quantities from consuming cereals in large quantities at present. Consumption of milk and milk products is likely to witness growth of 159% to 166 million tonnes by 2020 from 64 million tonnes in 2000. The 2002 consumption was 84 million tonnes -- an average annual growth of 15% in last two years, as against projected growth of 5% per annum till 2020. In all probability, according to our estimates, the actual growth is likely to be much higher than 5%.

As per a McKinsey study, as income rises, demand for milk and demand for quality rise. This will drive the growth of packaged milk and milk products.

Of the total liquid milk production in India, the producers themselves consume 40%. Most of the milk farmers in India have only one milch animal with average milch animal per milk farmer being 1.43. There are around 100 million milch animal and 70 million milk farmers in India. Of the saleable balance, only around 20% is packaged and traditional milkmen sell the rest 80% in loose form. The loose milk is quite adulterated and bacteria level is high due to shabby handling and storage. Therefore, the market is shifting towards packaged milk from loose milk.



In milk products, India faces an unfair competition from some of the developed countries like the US and EU, where milk products get high export subsidies. The domestic ghee industry faces such unfair competition from butter oil imports from Australia and New Zealand. To protect the domestic ghee industry, import duty on butter oil has been kept at 40%, which is also the bound rate effective 2004. In fact, milk products category is the only significant category that has import duties higher than the peak import duty of 25%. The EU and the US subsidizes exports by as much as 30-60% in case of major dairy products like skimmed milk powder (SMP), whole milk powder (WMP), and butter. Butter export subsidy in the EU is at present at a five-year high.

Indian milk product makers do not have access to European Union market. Under the Marrakesh Agreement, the EU was required to open up its market during 2000-2003. However, it has now been postponed to 2004-08. It is expected that the EU will allow imports of milk products from India in a phased manner from next year. Export of milk products could get a big boost if EU market opens up for Indian milk products. The Export Inspection Agency under the Commerce Ministry has already granted approval to 35 processing plants including those of Nestle, Amul, and Mother Dairy to process milk products for exports. These units, which are located in western and northern India, are required to obtain export certification for selling milk products in the EU.

Milk and milk products are allowed to be imported without any duty from Nepal. Milk and milk imports from other countries are generally not economical duty to high import duties. Without export subsidy, the US and the EU can not be competitive in international dairy market. Dairy products are not liable to any indirect tax in India.

Liquid milk is a high volume low margin business. Attaining high sales volume is a critical success factor. A prerequisite for attaining high volumes is an efficient milk procurement system. Procurement or collection of milk in India is complicated due to highly fragmented milk production by small farmers with mostly one or two milch cattle. Over two thirds of Indian population relies on agriculture and agriculture production is largely non-mechanized. Therefore, farmers use cattle to work on farms. Cattle generate additional income for farmers by way of milk. China, Indonesia, and Malaysia also have this kind of fragmented milk production. Other countries have mechanized farming and large dairy farms for milk production. A comparison of the top two milk producers - India and the US brings out this contrast. India produces around 84 million tonne milk with 100 million milch animals and 70 million farmers. The US produces around 75 million tonne milk with just 9 million milch animals and a mere 110,000 dairy farmers.

Investment Points

Underlying growth of 15% in liquid milk over foreseeable future

Heritage has immense potential to grow in the milk and milk product business. The market for milk alone is expected to grow at 10-15% in volume terms driven by growth in population, rising income levels and health consciousness. While a section of medial practitioners and others have been lately discouraging milk consumption, the Indian food habits will ensure a negligible impact from this. Heritage can conservatively grow its liquid milk



volume at 15%, as it gains market share from loose milk, and expands to new geographical areas. Of the 3700 cities and towns in India, only about 800 cities and towns are served by the organized milk sector. This leaves the organized sector with huge untapped market.

Operating margins improved lately, to remain stable going forward

Operating margins (EBITDA/Sales), which have been stable at around 10-11%, have been on the rise over last two years. EBITDA margin was 12% for FY02 and 14% for the first 9 months of FY03. We expect EBITDA margins to stabilise at around 12% despite rising competition and rising retailer margins, as contribution of value-added products rise going forward. Margins are most sensitive to milk procurement prices. Cost of procured milk constitutes 70% of sales value.

Milk products have high growth potential

As households climb up the income ladder, a re-allocation of expenditure towards milk and milk products happen. For example, the consumption of butter has improved significantly in smaller towns, as increase in income levels has created a whole new class of butter consumers in the country.

Rising penetration of refrigerators at home and improvement in availability of cold chain in the country have also led to spike in consumption of butter, cheese, and other milk products.

Packaged milk products are gaining market share from loose milk products. For example packaged curd is now selling in good quantities in south India. In Bangalore, the state co-operative brand 'Nandini' and GCMMF brand 'Amul' sell 30 ton per day and 15 ton per day respectively of packaged curd.

Ghee is the largest selling milk product in India. Heritage sells ghee in bulk to institutional customers like Britannia, Nestle, Haldiram's, hotels, sweet shops and wholesalers in Chennai. Chennai has the biggest wholesale ghee market. It currently does not sell ghee in branded package, but has plans to launch branded, packaged ghee in future. Heritage's ghee commands premium price in the market due to its quality. It sells special quality ghee to Ayurvedic medicines makers.

Realisations from milk products may rise if EU market opens up

Currently the EU does not allow import of milk products from India. It is expected that the EU market will open up for Indian milk products from 2004 in a phased manner. This will be a huge opportunity for India. Even if Heritage does not participate in exports, it will gain from higher Realisations in the Indian market, as supply of milk products for the Indian market will become tight.

We believe that export subsidies by the US and the EU are not going to be tenable under WTO for long. There are reports that the total export subsidies have already come down by around 40%. As export subsidies decline or vanish, international market will become attractive for export.



Launch of value-added products under consideration

Heritage is considering launch of various value-added milk products such as milk flavoured with real fruits (not with fruit essence), nutritional products, and cultured milk products. These are likely to be low volume but high margin products. They will be sold mainly on health platform - a platform that's biggest sales driver of food products worldwide and lately in India.

Nutritional products

Heritage is working on a project for milk-based nutritional products. The company was negotiating with US Foods and Pharmaceuticals (UFP) for a technical collaboration in this area. This may materialize by next financial year. UFP is already marketing its products in China and Middle East.

Cultured milk products

The company has started working on cultured milk products. It has already launched a pro-biotic curd based on a culture imported from Denmark. It is setting up two centers for cultured milk products.

Innovation to seed future growth

If you thought milk is a commodity business with no potential for innovation, think again. Heritage has been working on a few innovation ideas to seed future growth. Its first innovation came in packaging in the form of curd in sachet. It is now the largest sachet curd selling company. It also launched curd in cups like other players. It was the first company to launch pro-biotic curd, which uses culture imported from Denmark as input. Till date, no other company has entered into cultured milk products in India.

Heritage is carrying out research and development in association with Dolher of Europe. Dolher also supplies pulp for fruit-based milk products. Heritage is currently developing milk products for Indian palate like cream cheese with garlic or pepper.

No hard constraint to growth

There is really no hard constraint to Heritage's growth. It is cash rich even after a share buyback program. It is debt free and can leverage if required. Besides, it has some unutilized freehold land worth around Rs.40-50mn. This can also be sold to raise cash. It can expand capacities, expand into new geographical markets given that there is still huge scope for penetration in the southern states it operates in currently. Then there are other states to enter into. It has cost competitiveness to take on competition in any market. Yet, the company has not targeted explosive growth. Its been growing at an average annual rate of around 25% in volume terms over last five years. There are only soft constraints like management span and ambition.

Low capital intensity of the business

Heritage has been very efficient in utilising capital. Capital intensity of its business is very low with asset turnover of over four. Net working capital is just around 4% of sales. Receivables are almost zero as the almost the entire sales take place on cash. There is absolutely no risk of bad debt.



Bulk of the capital investment is in the form of chilling and pasteurizing units. Chilling milk at sourcing points is critical, as this improves yield of milk products significantly and restricts the growth of bacteria. A 25,000 liters per day processing station costs around Rs.10mn and similar size packing station costs around Rs.10-15mn.

Going forward also, capex requirement will not be very high and will be in line with past requirements. The company is currently setting up a packing station and two centers for cultured products. It commissioned two new facilities at Dindugal and Guntur in Dec-02. Inventories will rise for good, as the company has installed freezer to hold higher quantities for longer period. Sometimes it becomes imperative to hold inventories looking at market dynamics.

Tie-up/(s) with international dairy major/(s) is a possibility

The company in its quest for innovation may tie-up with international dairy majors who can bring better technology or other innovations to complement the company's skills, knowledge, and abilities. Heritage currently generates more cash than what it needs to sustain growth. It is unlikely to tie-up with other dairy companies merely for funds.

Risks / Concerns

Higher Proportion of cow milk in procurement

Processing plants in cow belts have a relative disadvantage vis-à-vis those in buffalo belt. Milk procurement has to be done from within 250-km radius of the processing plant keeping in mind its perishable nature and transportation cost & infrastructure. Quality and milk product yields are better in buffalo milk and therefore profitability is higher in buffalo milk than that in cow milk. As cow milk accounts for 60% of the total procurement by the company currently, processing margins remains a concern. The unsold cow milk, which has to be converted into milk products, fetch lower margin than milk products made from buffalo milk.

Rising retail margins

With the rise in competition in pouch milk, retail margins are rising. Mother Dairy had to double retail margin last year in Delhi from 40 paise to 80 paise a liter. Smaller players offer Re.1 to Rs.2 a liter to retailers. Heritage currently offers Re.1 to Rs.1.50 a liter to retailers.

Political Risk

In Dec-01, Naxalites damaged one of the company's plants. Though plant properties are fully insured, the disruption does cause temporary loss of profit.

In April 2001, Mr. Mohan Babu, the former Telugu Desam Rajya Sabha member and actor, filed a petition in the Andhra Pradesh High Court for winding up of the company alleging irregularities and mismanagement of the company. He leveled several charges against the Andhra Pradesh Chief Minister Mr. N.



Chandrababu Naidu, and his wife Mrs. N Bhuvanewari, who is one of the directors of the company. The Court had, however, dismissed the petition.

While the company has not witnessed any major adverse impact of its main promoter being in politics so far, it remains a possibility.

Co-operative sector competitors get government support

The co-operative sector is the biggest competitor with 50-60% market share. The co-operative sector gets government support, which is not available to corporate sector. An enhancement in support to co-operative sector in any form may affect the company.

Drought impacts volume adversely

Drought in its procurement areas leads to shortage of milk output. This in turn impacts the quantity of milk it can procure, process, and sell. However, a prolonged drought has a positive impact on the company. In a prolonged drought, farmers shift from agriculture to animal husbandry.

Heritage is a price-taker

Heritage does not have pricing power in the liquid milk market. It is a price-taker. Large milk co-operatives are the price-maker. Heritage prices its liquid milk either at par or at small discount to these co-operatives. However, despite being a price taker, it has been generating positive economic returns. As it acquires scale, it may begin to assume a role in pricing.

As income level rises across the board, price-sensitivity will fall rapidly. This will give higher pricing power to the sector as a whole. According to a World Bank study, the price elasticity of milk falls more rapidly than that of other food products, as income level rises.

Source: World Bank	Income Level		
Price Elasticity of	Low	Middle	High
Milk	0.93	0.71	0.35
Meat	0.82	0.65	0.33
Cereals	0.56	0.41	0.19

An associate company in same business

Heritage has an associate company "Sree Lakshmi Narashima Dairy Specialities (P) Ltd" in the same line of business. Of the total raw milk purchased in FY02 (Rs. 1,060 million), 4.8% in terms of value was purchased from this associate company. We estimate that in terms of volume, it was only around 3.5%. The management should merge this associate company with Heritage to alleviate any real or perceived concern that minority shareholders may have in this regard.



Ownership profile and Management

Mr. N Chandrababu Naidu, his family and friends are main owners of Heritage. They own 43.25% stake in the company. Their stake in the company has gone up by 9.67% during calendar year 2002. There has been a buy back of shares during the year and some creeping acquisition. The company may do another round of buy back given the surplus cash position and substantial undervaluation of its stock. In fact, buy back of shares would be a more sagacious way of repaying cash to shareholders than paying dividend.

Dr. V Nagaraja Naidu, the whole-time director, leads the management team. He holds a Doctorate in Financial Management and has been with the company since its inception. There is a senior person in charge of each of the important functions like operations, marketing, processing & engineering, procurement & inputs, quality assurance, finance, and human resources.

Pricing / Valuation

At end Dec-02, book value per share was Rs.44 and trailing EPS was Rs.15. The stock is currently available at Rs.48. We expect the after-tax profits and EPS to grow at an average annual rate of 20% over next four years. We estimate fair value per share at around Rs.168 based on discounted cash flows. Our fair value estimate is 11 times the trailing EPS (Rs.15.19). At current price of Rs.48, the stock is available at 2.7 times FY04 estimated EPS (Rs.17.46). If the company resorts to another round of share buy back, the value per share will improve further.

Key assumptions are an average of 18% liquid milk volume growth till FY07, stable margins, and cost of equity at 20%. We have estimated fair value under stress at Rs.125. The key change has been a reduction in liquid milk volume growth to 10%. We have not built in any increase in price realization in any of the scenarios.

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Near term performance

In the first nine months of FY03, sales grew 16.2% to Rs.1.4 billion; PAT increased 47.2% to Rs.117 million and annualized EPS rose 59.1% to Rs.15.67. Heritage is yet to publish results for the quarter ended Mar-03. It will publish the audited results by end May-03. It commissioned a procurement, processing and packing plant in Dindugal district of Tamil Nadu and another procurement and processing plant in Guntur district of Andhra Pradesh in Dec-02. Due to these expansions, depreciation will be high while result of expansion will take time to reflect in financials. Due to drought like conditions in some of the procurement areas, milk procurement volume is low and cost of procurement is 5-10% higher YoY. Moreover, due to higher fuel prices, transportation cost was high in the last quarter. All these imply a near flat quarter and lower growth in the first half of FY04. The second half of FY04, however, is likely to be much better.