Varun Beverages ltd

IPO Note

(Avoid)

Analyst:

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25 October 2016

IPO details

Key Data	
Issue Opens	26-Oct-16
Issue Closes	28-Oct-16
Equity Shares Offered (in mn.)	25
QIB	Up to 50%
NIB	Min 15%
Retail	Min 35%
Face Value (`)	10
Price Band (`)	440-445
Max. Issue Size (` mn)	11,125
Lot Size (Eq. Shares)	33 and multiple thereof

	Pre Issue # mn Shares	% Holding	Post Issue^ # mn Shares	% Holding
Promoters	144.2	86.3%	134.2	72.3%
Non-promoters	22.8	13.7%	22.8	13.9%
Offer for sale			10.0	5.5%
Fresh Issue			15.0	8.3%
Total	166.9	100.0%	181.9	100.0%

Promoters

- RJ Corp ltd
- Varun Jaipuria
- Ravikant Jaipuria
- Ravikant Jaipuria & Sons (HUF)

Valuation	@`440 per share	@`445 per share
Market Cap (` mn)	80,036	80,946
Net Debt (` mn)	23,408	23,408
Enterprise Value (` mn)	103,444	104,354
EV/ Sales	3.0	3.1
EV/ EBIDTA	16.3	16.5
P/B	11.9	12.0
P/E	93.6	94.7

Object of Offer for sale	
▪ Prepayment or scheduled repayment of a portion of outstanding indebtedness availed by our Company	` 5400 mn
▪ General Corporate purposes	--
▪ TOTAL	` 11125 mn

* Shares issued calculated at both price band and maximum issue size

^ NOTE: Valuation Parameters considered are for fully subscribed issue and CY15 financials

Source: Red Herring Prospectus, Destimoney Research

A Pepsi & Co. bottler with many concerns for long term investors

- *Second largest independent Pepsi's bottler & distributor, has its wings mainly around the northern territory of India*. :Incorporated in 1995, Varun Beverages Ltd is franchisee of carbonated soft drinks (CSDs) and non-carbonated beverages (NCBs) sold under trademarks owned by PepsiCo in India and internationally. It have been associated with PepsiCo since the 1990s. As of March 31, 2016, it has been granted franchises for various PepsiCo products across 17 States and two Union Territories in India. It currently operates 17 production facilities across India and 5 production facilities in their international licensed territories. Its distribution network in India includes 57 depots and 1,389 delivery vehicles.
- *Bottling Agreement with Pepsi is pretty one sided not leaving much freedom for VBL:* VBL has weaker agreement with Pepsi as compared to its peers like AmBev in Latin America and Britvic in UK. The Agreement has no perpetuity, pricing power, negotiation for concentrate prices amd freedom to launch own brands .These factors leave VBL's business to risk of disruption if Pepsi does not renew contract or start substituting VBL by launching parallel operations.
- *Although it is planning to expand internationally but still Internatinal Business is expected to remain below 20% in the next 5 years:* India forms the bulk of business, accounting for 84% of VBL's total sales. The India share has grown in FY15 riding on acquisition of new territories from Pepsi. Prior to this acquisition, over FY12-14, India formed approximately 80% sales. It is expected that the Indian share will remain 80%+ as addition of new geographies like Zambia, Mozambique and potentially Zimbabwe is unlikely to contribute significantly to international sale.
- *High dependence on the Carbonated Soft Drinks which is losing its share and expected to be grow slow:* In VBL's topline, Carbonated Soft drinks are almost 82% in sales by volume with Non Carbonated Beverages being 6% and the rest of the share acquired by Aquafina. The carbonates are expected to grow at a CAGR of 10.9% while the Non carbonates and water are expected to grow at a CAGR of 26% and 21% over the next 5 years respectively..This massive dependence on the CSD segment is a negative for VBL.
- *In pursuit of growth through capital intensive business, returns have taken a setback:* VBL has incurred huge capex in the past few years which has put pressure on the balance sheet and bottom line with constant dilution for equity shareholders and rising debt. Its growth of 31% CAGR in the past 5 years has largely come from its investments i.e. Inorganic growth. In absence of this high level of investment ,organic growth slides to 12% CAGR. Due to the heavy Investments ROCE and ROE have suffered. This is evident from the fact that despite healthy EBIDTA of 18%,VBL is struggling to achieve double digit ROCE.
- At an upper price band of Rs 445 the company values itself at 94.7 EPS and 16.5x EV/EBIDTA .Given the company's dismal returns and our doubt over sustainability of profits, we think that the company is overvalued. Hence , we recommend investors to *AVOID* the IPO

Journey so far…

2016	• Incorporation of Varun Beverages (Zimbabwe) (Private) Limited • Acquisition of 85% of the shareholding of VBZP
2016	• Company acquired entire shareholding of Arctic International Private Limited in Varun Beverages (Zambia) Limited
2016	• Company acquired entire shareholding of Arctic International Private Limited in Varun Beverages Mozambique, Limitada with the company pursuant to the order of High Court of Delhi dated March 12, 2013
2015	• Business transfer agreement through which our Company acquired PepsiCo India's business of manufacturing, marketing, selling and distributing soft drink beverages and syrup mix in Bazpur, Jainpur, Satharia and Panipat
2015	• Business transfer agreement through which the Company acquired PepsiCo India's business in the Indian states of Uttar Pradesh (excluding certain territories), Uttarakhand, Himachal Pradesh, Haryana (excluding certain territories) and the Union Territory of Chandigarh
2013	• Our Company acquired the business of manufacturing and marketing of soft drink beverages and syrup mix in Delhi, India
2012	• Merger of VBIL with our Company pursuant to the order of High Court of Delhi dated March 12, 2013
2004	• Merger of DBL with our Company pursuant to the order of High Court of Delhi dated October 6, 2004
1999	• Started operations in Alwar, Jodhpur and Kosi
1996	• Started operation at Jaipur
1995	• Incorporation of our Company as public limited company

Source: Red Herring Prospectus

Weak Bottling Agreement questions VBL's sustainability and longevity

- Pepsi tends to run most operations inhouse through two entities- Pepsi Bottling Group (PBG) and Pepsi Americas-that it acquired in 2010.Some of the key bottlers that it runs Independently are AmBev in Latin America,Britvic in UK,Pepsi Phillipines and VBL in India.Traditionally most bottling agreements in the US used to be exclusive and for perpetuity. While perpetuity norms are increasingly being dropped, exclusivity is still retained. Also, most of the Pepsi bottlers are allowed to run their own brands within the limit to competition.Also pricing power rests with bottlers and not with Pepsi..Some of the key factors of concern in the agreements are:

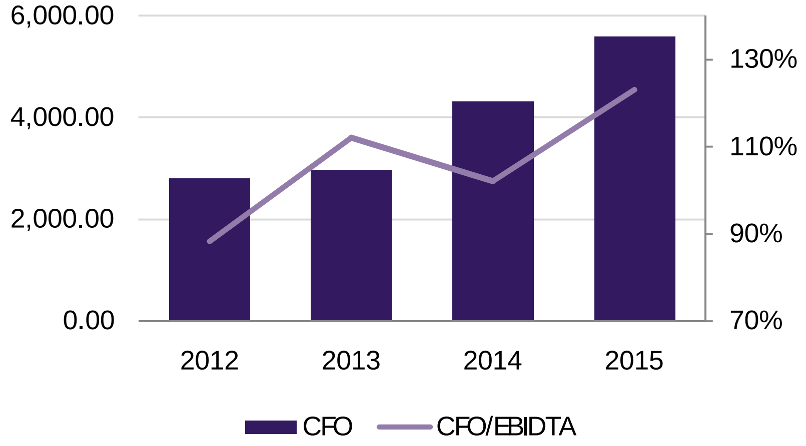
- Branding:VBL does not own any brands of its own. Pepsi does not allow it to develop and market its own parallel brands. Even the marketing spend on brand Pepsi is done by Pepsi. So, VBL is dependent on Pepsi to create brand awareness and customer pull for a product that it sells.
- Pricing power: Unlike globally where Pepsi bottlers determine their own pricing within the channels they serve, in India the concept of MRP makes it imperative that Pepsi determines prices across its markets.
- New product Launch: Innovation is the key driver of growth for most FMCG companies. This helps them create brand extensions, premiumise and close product gaps with competition. VBL is not allowed to market its own products and it is completely dependent on Pepsi for new launches.
- No cost Control; The worst thing for VBL is that not only does it not control selling price, it does not control cost of its key raw material – concentrate (33% of COGS). As per the agreement, Pepsi is free to decide pricing for selling concentrate. It is not too unreasonable to expect that in case VBL is able to generate healthy economics, some of it can be weaned away by Pepsi by taking price hikes for concentrate.

A broad comparison of Master Bottling Agreements (MBA) or Exclusive Bottling Agreements (EBAs) that Pepsi has with its bottlers highlights VBL has a weaker agreement vs peers as it has no perpetuity, exclusivity, pricing power, negotiating / fixed formula for concentrate prices and freedom to launch own brands. These expose VBL to risk of disruption if Pepsi does not renew contract or starts substituting VB L by launching parallel operations. Economics of the business are also impacted because VBL does not have the power to determine selling price and no say in concentrate prices.

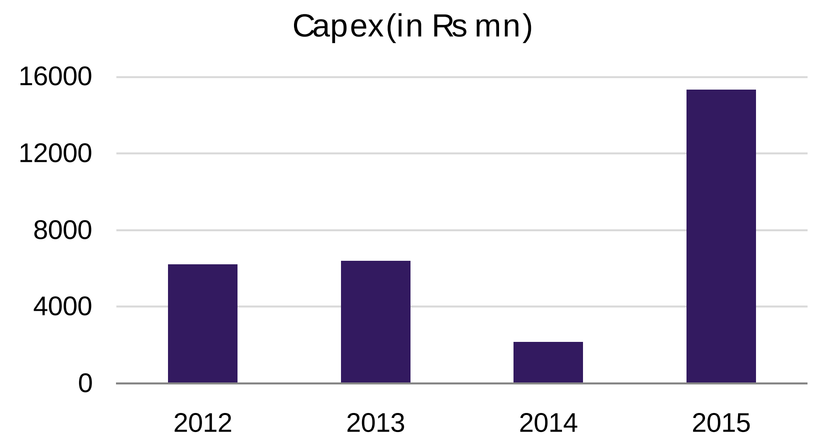
Source: Red Herring Prospectus, Destimoney research

Heavy capex in the previous years coupled with low/negative returns post concerns about the longevity of the business.

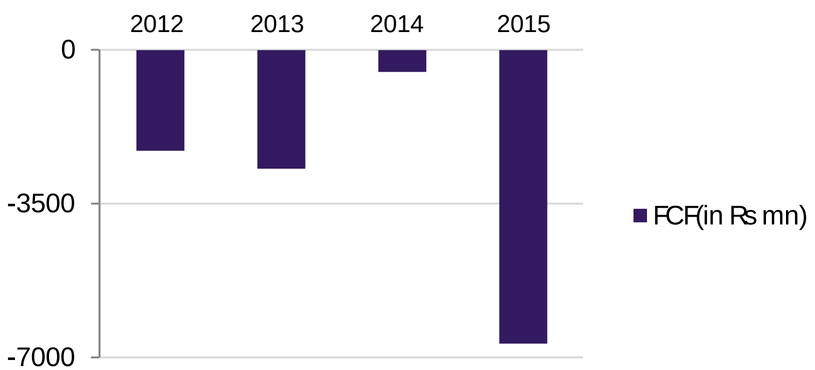
Positive CFO throughout…



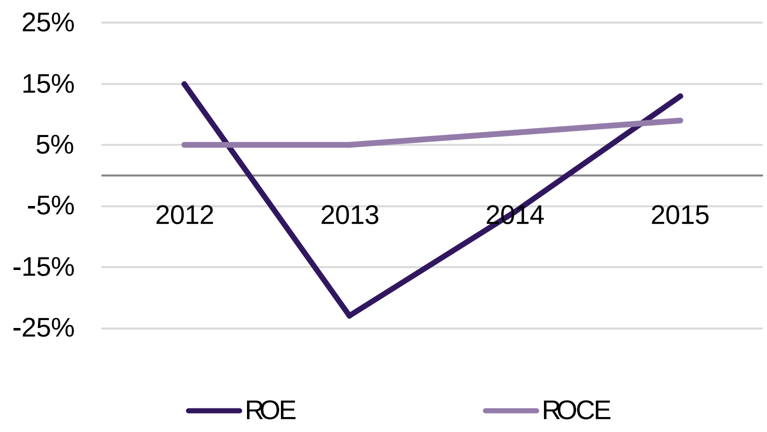
Financing Capital Expenditure..



Cause FCF to be negative throughout



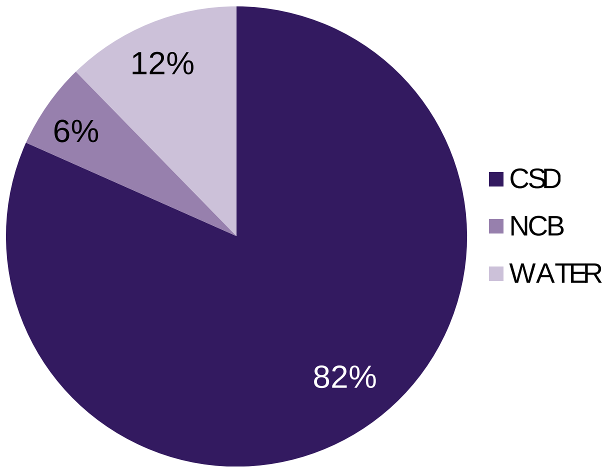
Erratic returns



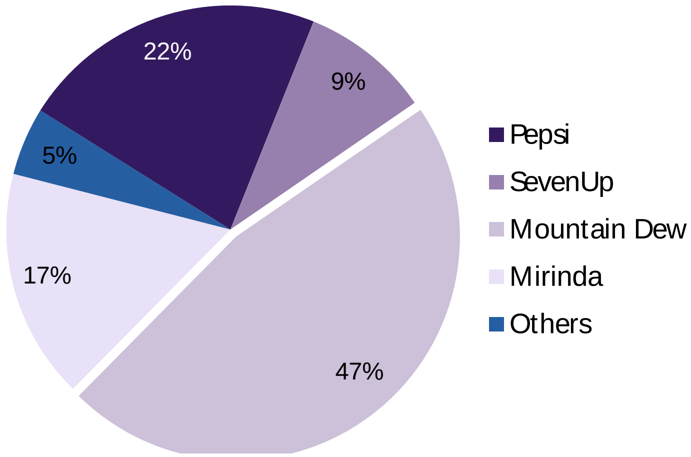
Source: Red Herring Prospectus, Destimoney Research

High Inorganic growth, Insignificant International market puts doubt on existing growth of VBL

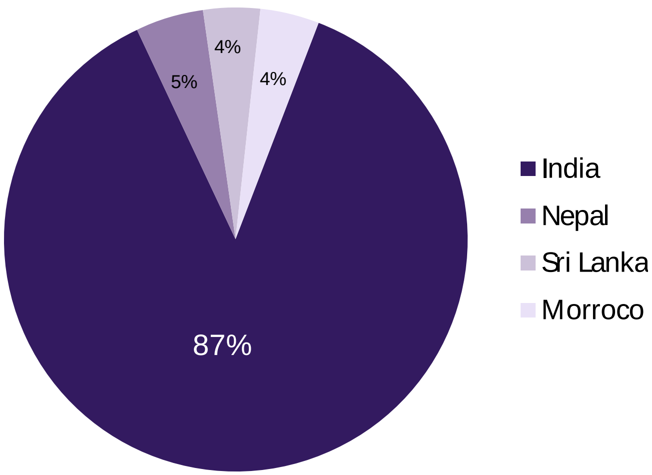
82% revenue comes from CSD versus global average of 39%



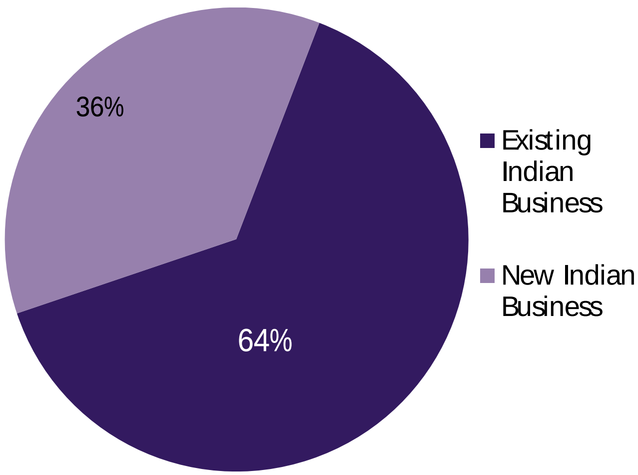
Mountain Dew, with CAGR of lead the CSD pack



International market remains insignificant



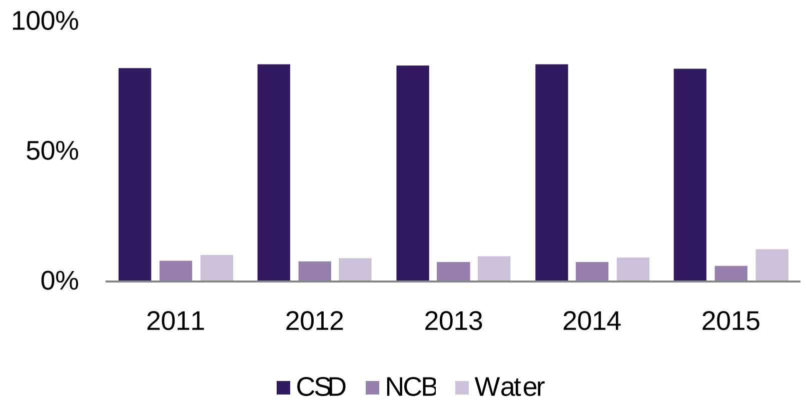
High inorganic growth questions sustaibility



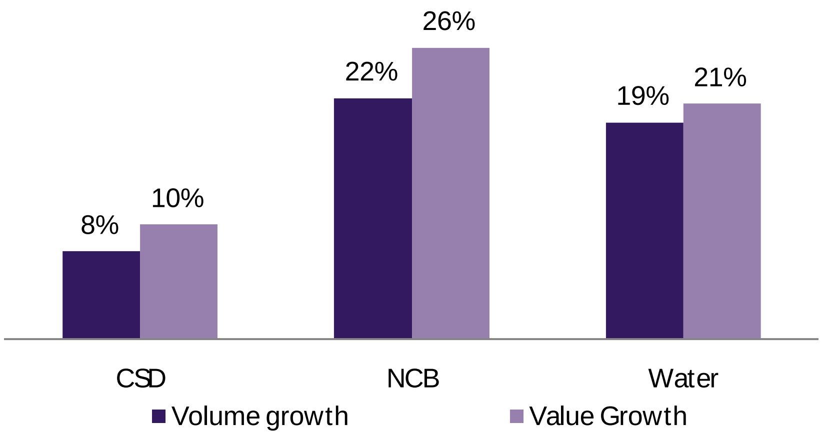
Source: Red Herring Prospectus, Destimoney research

Slow growth in the CSD Segment would really impact VBL's business as the possibility to shift to high growth segments seems highly unlikely

CSD share in total revenue remains at the same level ..



Expected Industry CAGR over 2016-2020… .
CSD lacking behind



- Carbonated Soft drink's share in VBL's total revenue was 81.99% ,83.52% ,83.11% ,83.55% and 81.66% in 2011,2012,2013,2014 and 2015 respectively. Given the nature of its dependence on Pepsi & Co. it is not possible that it could increase the share of the other segments in its total basket.
- The CSD market is expected volume over the next years is just 8% as compared to 22% in the juices market and 21% in the Bottled water market. This will see a high impact on the business growth of VBL as it cannot shift to other segments because of the tight agreement with Pepsi & Co.

Source: Red Herring Prospectus, Destimoney research

Investment rationale

- Given the nature of the business, any comparison with Indian FMCG players is unjustified. Further its present agreement with Pepsi & Co. remains a cause of worry. At an upper price band of Rs 445 the company values itself at 94.7 EPS and 16.5x EV/EBIDTA .Given the company's dismal returns and our doubt over the sustainability of profits, we think that the company is overvalued. Hence , we recommend investors to *AVOID* the IPO

Source: Destimoney Research, RHP

NOTE: Valuation Parameters considered are for fully subscribed issue and CY 15 financials at upper price band level

Consolidated Summary Financials

Income Statement

Particulars	CY12	CY13	CY14	CY15	H1 CY16
Revenue	18,000	21,151	25,024	33,941	25,297
Cost of materials consumed	10,278	11,992	13,761	17,165	11,978
Employee Exp	1,524	1,830	2,168	3,238	2,108
Other Expenses	3,917	4,418	5,250	7,199	5,168
EBIDTA	2,280	2,910	3,846	6,340	6,043
Other Income	442	174	147	143	97
Depreciation	1,358	1,844	2,101	3,174	1,895
Finance costs	1,156	1,697	1,854	1,688	1,112
PBT	208	-457	38	1,621	3,133
Tax Expense	-42.61	-52.18	248.12	766.21	997.28
PAT	251	-405	-210	855	2,135

Particulars	FY12	FY13	FY14	FY15	H1FY16
EBIDTA Margin	13%	14%	15%	19%	24%
PAT Margin	1%	-2%	-1%	3%	8%
ROE	15%	-23%	-6%	13%	23%
ROCE	5%	5%	7%	9%	12%

Balance Sheet

Particulars	FY12	FY13	FY14	FY15	H1FY16
LIABILITIES					
Share Capital	268	1338	3338	5838	5857
Reserves & Surplus	1449	416	93	885	3258
Share Application Money	0	400	0	0	0
Long Term Borrowings	13628	16952	16302	15795	18375
Deferred Tax Liabilities (Net)	725	638	812	1512	2292
Other Long Term Liabilities	352	314	111	6363	3151
Long Term Provisions	138	176	259	440	533
Short Term Borrowings	3384	3376	5085	2524	3004
Trade Payables	907	1392	1806	1846	3297
Other Current Liabilities	4633	4829	4967	8798	12407
Short Term Provisions	65	63	176	374	781
Total liabilities	25548	29894	32950	44375	52955
ASSETS					
Tangible Assets	16838	22157	22132	31057	34405
Intangible Assets	194	1493	1321	3839	3609
Capital Work in Progress	1893	274	248	379	192
Goodwill	95	95	95	95	2367
Non Current Investments	0	9	18	33	48
Deferred Tax Assets (Net)	13	38	34	27	28
Long Term Loans & Advances	644	369	446	1190	1846
Other Non current Assets	25	21	68	50	53
Inventories	2306	2464	2893	4247	5592
Trade Receivables	907	652	973	979	1479
Cash & Cash Equivalents	384	509	344	581	1155
Short Term Loan and Advances	2198	1709	1251	1804	2024
Other Current Assets	50	102	108	94	159
Current Investments	0	0	3020	0	0
Total assets	25548	29894	32950	44375	52955

Source: Red Herring Prospectus

Key Risks

- Under the PepsiCo India Agreements, it has been granted the franchise for various licensed territories across 17 States and two Union Territories in India. The PepsiCo India Agreements are valid for a period of ten years until October 2, 2022 and may be renewed, at the discretion of PepsiCo India / PepsiCo Inc., for successive terms of five years. In addition, its franchises are on a non-exclusive basis and PepsiCo is entitled to undertake the production, distribution or sale of the PepsiCo products and brands either appoint other third party franchisees for these territories and sub-territories licensed to it. Although PepsiCo has in the past renewed such franchise agreements in its favour, and also granted franchises for additional territories and sub-territories to it, there can be no assurance that in the future PepsiCo will not terminate or discontinue franchise arrangements for cause, including any failure by it to meet performance standards or any breach by it of applicable terms and conditions under such agreements, or without cause, and undertake production and distribution activities directly or through other franchisees in its licensed territories and sub-territories.
- VBL may be unable to grow business in semi-urban and rural markets, which may diversely affect business prospects and results of operations
- An inability to integrate the operations of, or leverage potential operating and cost efficiencies from, the recently acquired 2015 New India Sub-Territories or additional acquired territories or sub-territories in the future may adversely affect the business and future financial performance

Source: Red Herring Prospectus

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