

Varun Beverages Limited

Need more sugar

Varun Beverages (VBL) is PepsiCo India's bottling franchisee, operating since last 25 years. It is engaged in the business of producing and distributing wide range of PepsiCo's beverages. It has total 21 manufacturing facilities in India and a few other countries. Indian operations account for 82% of its total revenues while rest of the revenues comes from other countries.

Positives: (1) VBL is the one of the largest bottling franchisee of PepsiCo and accounts 44% of PepsiCo India's revenues (2) In 2015, VBL acquired PepsiCo India's business in few states which in our opinion has better profitability (3) The company has been able to de-leverage its balance sheet partially and improve profitability in CY2015.

Investment concerns: (1) VBL's financial performance has remained lackluster in last four years with losses reported in CY2013 and CY2014. Overall profitability has remained inconsistent which does not give a strong sense of VBL being a strongly profitable franchisee (2) The numbers reported by the company indicate that in CY2015, the beverage volumes from existing territories declined by 7% which indicates de-growth in existing business (3) Our sense is that VBL has limited strategic flexibility to improve its business further as key decisions such as advertising, product launches, etc will be determined by PepsiCo. (4) VBL operates an asset heavy model which means it requires a huge capex for growth, in absence of which its RoE will be impacted.

Valuation and outlook: On CY2015's PAT of ₹87cr, the issue, at its upper band is priced at the P/E ratio of 85.4x which looks expensive. The issue still looks expensive at P/E of 51.4x, calculated on estimated CY2016E PAT of ₹157cr. We note that a lot of MNC brands have presence in India through franchisees. Few of these franchisees have been able to grow their business by taking strategic decisions such product launches, advertising etc. which is not the case with VBL. **Considering its inconsistent financial performance, low RoE, asset heavy business model and high valuation, we rate this IPO as 'Neutral'.**

Key Financials (Consolidated)

Y/E Dec. (₹ cr)	CY2012	CY2013	CY2014	CY2015	H12015	H12016
Net Sales	1,800	2,115	2,502	3,394	2,232	2,530
% chg		17.5	18.3	35.6	NA	13.3
Net Profit	25	(41)	(22)	84	166	207
% chg		(264.1)	(46.8)	(483.3)	NA	24.6
EBITDA (%)	13	14	15	19	21	24
EPS (₹)	1.5	(2.4)	(1.2)	5.2	10.0	12.6
P/E (x)	295.9	NA	NA	85.4	NA	NA
P/BV (x)	43.3	42.4	21.7	11.1	NA	NA
RoE (%)	14.6	(23.5)	(6.4)	12.5	NA	NA
RoCE (%)	4.9	4.8	7.0	10.1	NA	NA
EV/Sales (x)	5.5	4.7	3.9	2.9	NA	NA
EV/EBITDA (x)	43.3	33.9	25.7	15.6	NA	NA

Source: Company, Angel Research

NEUTRAL

Issue Open: October 26, 2016

Issue Close: October 28, 2016

Issue Details

Face Value: ₹10

Present Eq. Paid up Capital: ₹586cr (June 2016)

Fresh Issue: 1.5 cr Shares

Offer for Sale: 1.0 cr Shares

Post Eq. Paid up Capital: ₹182.0cr

Issue size (amount): ₹1,110*-1,112cr**

Price Band: ₹440-445

Lot Size: 33 shares and in multiple thereafter

Post-issue implied mkt. cap: ₹8,005.9cr - 8,096.8cr

Promoters holding Pre-Issue: 86.3%

Promoters holding Post-Issue: 73.7%

Note: *at Lower price band and **Upper price band

Book Building

QIBs	50% of issue
Non-Institutional	15% of issue
Retail	35% of issue

Post Issue Shareholding Pattern

Promoters Group	73.7
DII's/FII's/Public & Others	26.3

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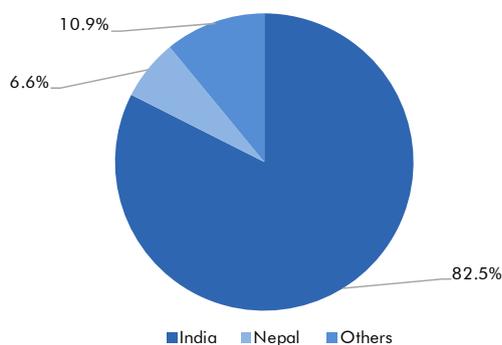
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Company background

Varun Beverages (an RJ Corp group company) is PepsiCo's largest bottling franchisee of Carbonated Soft Drinks (CSD) and non-carbonated beverages (NCBs) in the world outside USA. Varun Beverages (VBL) has been associated with PepsiCo since 1990s and is engaged in producing and distributing PepsiCo beverages. VBL, produces and distributes wide range of PepsiCo's CSD and NCBs such as, Pepsi, Diet Pepsi, Seven-Up, Tropicana Slice, Aquafina, etc. PepsiCo has granted Varun Beverages total 17 states and 2 Union Territories in India and certain territories of Nepal, Sri Lanka, Morocco, Mozambique and Zambia in international markets. VBL is also expecting PepsiCo's franchisee rights in Zimbabwe and is in process of setting up a Greenfield facility there. Its distribution network included 57 depots and 1,389 delivery vehicles in India and six depots and 342 delivery vehicles in International market by end of December 2015.

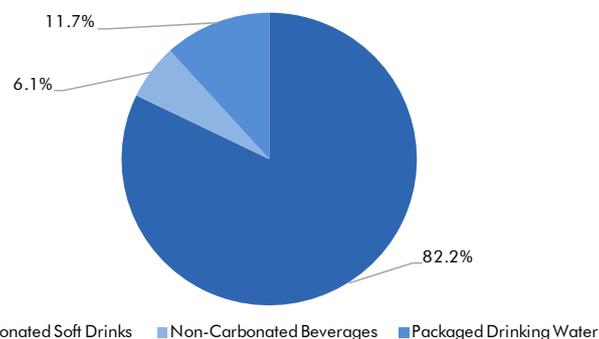
VBL has total 16 production facilities with an annual production capacity of 3,438.4 million liters in India and, 5 production facilities with annual production capacity of 991.6 million liters in international licensed territories by March 2016. Besides, producing and distributing the beverages, VBL also has backward integration and produces preforms, crowns, corrugated boxes and pads, plastic crates and shrink-wrap films in certain production facilities.

Exhibit 1: Revenue mix



Source: Company, Angel Research

Exhibit 2: Product mix



Source: Company, Angel Research

Issue details

This IPO is a mix of OFS and issue of fresh shares. The company is selling fresh 1.5cr shares whereas total 1.0cr shares will be sold through OFS.

Exhibit 3: The issue

Route	No of shares in cr.	Total value
OFS	1	₹440cr* - ₹445cr**
Fresh issue	1.5	₹660cr* - ₹667cr**
Total	2.5	₹1,110cr* - ₹1,112cr**

Source: RHP, Angel Research; Note:*at Lower price band and **Upper price band

Objects of the offer

- ₹540cr will be used for prepayment of debt
- Rest of the net proceeds will be used for general corporate purposes

The portion allocated to general corporate purpose looks to be very high (~50% of the gross proceeds). We believe that this will also be used to repay its certain non interest bearing debt.

The company, through a business transfer agreement with PepsiCo India in November 2014 acquired PepsiCo India's business of manufacturing, marketing, selling and distributing soft drink beverages and syrup mix in Uttar Pradesh, Uttarakhand, Himachal Pradesh, Haryana and the Union Territory of Chandigarh for ₹1,158cr. With that, VBL also acquired PepsiCo's four factories located in Uttarakhand, UP and Haryana. The company has been permitted by PepsiCo to pay this amount in equal installments and as of June 2016, an amount of ₹623.5cr is left in form of deferred payments to PepsiCo India. We believe that the company will use the IPO proceeds after debt repayment to repay some, if not most of the deferred payment to PepsiCo India. The company however has not explicitly mentioned this in the RHP.

Exhibit 4: Shareholding pattern

Particulars	Pre-Issue (%)	Post-Issue (%)
Promoter & Promoter Group	86.3%	73.7%
Others	13.7%	26.3%
Total	100.0%	100.0%

Source: Company, Angel Research

Earlier this month, the company converted its hybrid instruments and preference shares to common equity share. This includes conversion of Compulsory Convertible Debentures (CCDs) worth ₹414cr and Compulsory Convertible Preference Shares (CCPSs) worth ₹450cr. This led to an addition of 31.3 million fresh shares in its equity. With this conversion, there are no preference shares / convertible debentures left on the company's balance sheet.

With fresh issuance of 1.5cr shares through this IPO, the company will further see 9% equity dilution.

Investment Rationale

Largest PepsiCo franchisee in the world: Varun Beverages (VBL) is the largest franchisee of carbonated soft drinks (CSDs) and non-carbonated beverages (NCBs) of PepsiCo in the world of outside USA. The company produces and distributes a wide range of CSDs, NCBs and packaged drinking water. VBL has been in this business since last 25 years and has been able to increase licensed territories and sub-territories in India to current 17 states and 2 UT.

VBL's contribution in total PepsiCo's volumes has gone up from 26% in CY2011 to 44.1% in CY2015. PepsiCo during this period has seen its soft drink sales volumes in India increasing from 1,654.9 million liters (ML) in CY2011 to 2,688.1 ML in CY2015 (13% CAGR). During this period, VBL has reported 28% CAGR in sales volumes from 437.9 ML in CY2011 to 1,186.04 ML in CY2015. The strong revenue growth can be attributed to 1) overall increase in PepsiCo's business (organic growth) 2) increase in the licensed territories granted to VBL by PepsiCo (inorganic growth). Organically, VBL's beverage volumes declined by 7% to 759.5 ML in CY2015 however overall sales volumes increased by 45% due to acquisition of additional territories from PepsiCo. The new territories contributed 36% of the total sales volumes. We believe that the company will have to keep adding new revenue territories to remain on a growth trajectory. The decision to grant new territories remains with PepsiCo.

VBL also operates similar business model in other countries like Sri Lanka, Nepal, Morocco, Mozambique, Zambia and Zimbabwe however its contribution in PepsiCo's business there is not provided by the company. These regions at the moment contribute ~15% of VBL's total revenues hence they are relatively less significant at the moment.

Exhibit 5: VBL's product portfolio licensed from PepsiCo

Product	Territories	Product	Product	Territories
Pepsi	 India, Nepal, Sri Lanka, Morocco, Zambia, Mozambique	Tropicana Slice		India, Nepal
Seven-Up	 India, Nepal, Sri Lanka, Morocco, Zambia, Mozambique	Nimbooz		India
Mountain Dew	 India, Nepal, Sri Lanka, Zambia	Tropicana Frutz		India, Sri Lanka
Mirinda	 India, Nepal, Sri Lanka, Morocco, Zambia, Mozambique	Aquafina		India, Sri Lanka
Evervess	 India, Nepal, Sri Lanka, Zambia, Mozambique			

Source: Company, Angel Research

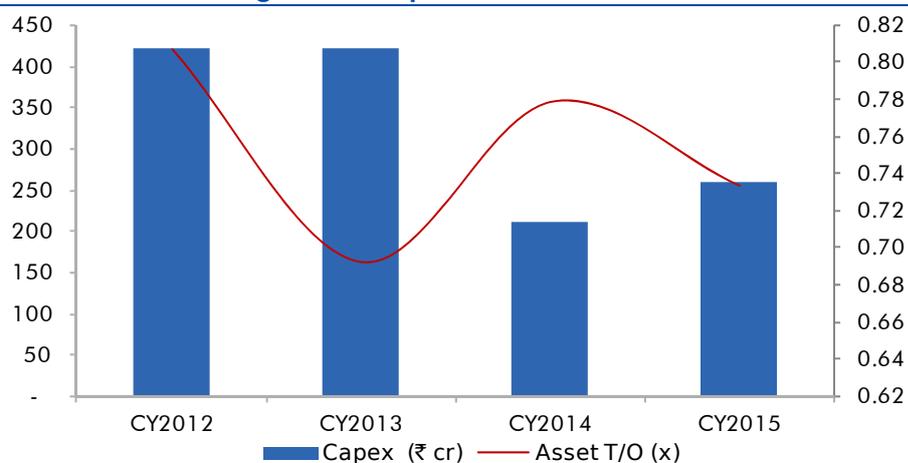
High dependence on Pepsi: VBL has 100% dependence on PepsiCo for its revenues. PepsiCo at a time is playing as a raw material supplier, licensor and franchisee partner. As per its agreement with PepsiCo, VBL is required to buy concentrates from Pepsi as well as pay royalty of 5% on certain non-CSD products. In exchange brand promotion and advertising is taken care of by PepsiCo. There are three very important aspects of VBL's partnership agreement with PepsiCo: 1) product pricing 2) raw material pricing 3) Brand promotion.

- **Product pricing** – The product prices are decided by PepsiCo and not by VBL. PepsiCo's pricing depends upon various factors including the prices set by its competitors. So we believe that VBL has no say in the pricing of the products hence exerts no command on the products they sell.
- **Raw material pricing** – As per agreement, VBL purchases concentrate from PepsiCo. Concentrate is the most important ingredient of the carbonated soft drinks and prices of which are determined by PepsiCo in discussion with VBL. Even though PepsiCo considers VBL's opinion at the moment, in longer term this is negative for VBL as a unilateral pricing determined by PepsiCo will impact VBL's financial performance. The cost of concentrate was between 28-34% from 2014 and H1CY2016 which means it is a significant expense to VBL.
- **Brand promotion** – PepsiCo takes care of marketing of its brands however merchandising at the relevant points of sale level is done by VBL. We believe that this is positive for VBL as brand promotion would cost it a large chunk of money.

Overall we see the pricing arrangements to be negative to VBL as it has no pricing power over raw materials and its products.

Capital intensive business with low asset turnover: VBL is operating a capital intensive model without showing significant economies of scale. While it is true that high capital investments act as an entry barrier, it is equally offset by its nearly non-existent pricing power. For PepsiCo, it is difficult to replace VBL due to the capital intensive nature of the business and VBL's experience and strong distribution abilities would score if PepsiCo decides to look for a new partner.

Exhibit 6: Increasing assets despite lower asset turnover



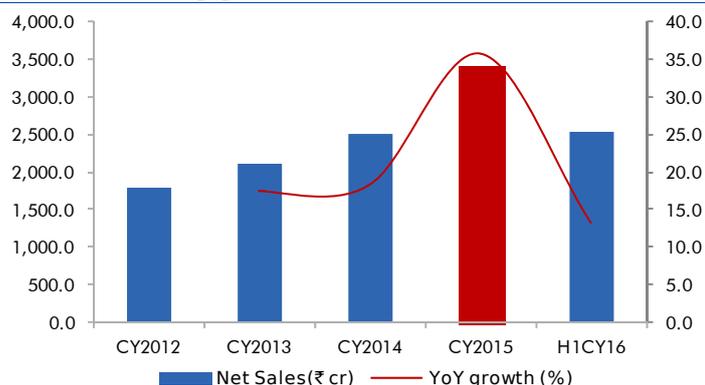
Source: Company, Angel Research

Companies which create significant entry barriers in their industry also enjoy superior return ratios. However this is not a case with VBL. Due to its partnership with PepsiCo, VBL cannot produce any other competitive beverages. This means despite acquisition / addition of new capacity, VBL is not allowed to leverage on its additional capacities and industry experience. This is reflected in its gross asset turnover ratio which has remained well below 1x showing lower turnover of its fixed assets. The company has also aggressively added new capacities in last few years which have also led to decline in its asset turnover.

Inconsistent profitability: VBL's financial performance has been inconsistent with losses reported in CY2013 and CY2014. Overall its top line has witnessed a CAGR of 25% from CY2011 to CY2015. The CAGR works out to be 51% at the bottom-line, this has only improved in CY2015 thanks to the acquisition of PepsiCo India's additional territories which helped it improve its profitability.

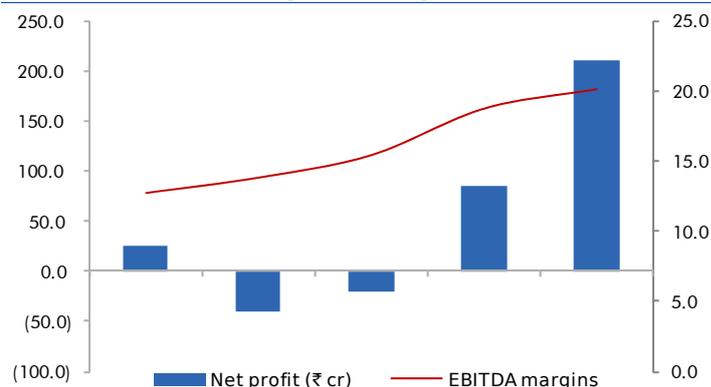
VBL's has decent performance at EBITDA level with margins increasing from ~13% in 2011 to ~19% in CY2015. The same however is not reflected in its EBT which has shown drastic decline due to the high depreciation costs which represents more than 50% of its EBITDA. Owing to its high leverage, VBL's profitability eroded significantly in CY2013 and CY2014 as its interest costs took away decent profitability at EBITDA level. The company has also seen poor set of return ratios. Return on Equity in CY2015 was at 12.5% vs. 14.6% in CY2011. VBL has also seen poor cash generation in all years despite having strong cash flow from operations.

Exhibit 7: Strong growth in 2015



Source: Company, Angel Research

Exhibit 8: Inconsistent profitability



Source: Company, Angel Research

By end of H1CY2016, VBL has ₹2,138cr in debt (excluding PepsiCo's debt of ₹623cr) Due to its high leverage and lower profitability, debt to equity ratios went up to as high as 11.6x in CY2013. With reduction in debt and improved profitability in last 18 months, debt to equity ratio has come down to 2.3x.

Outlook and Valuation: Overall we see VBL as a weak franchisee due to the inconsistent profitability and poor pricing power. Due to the nature of its business, (bottling, distribution and license to sell PepsiCo's products), it can neither be classified as a pure bottler nor a pure distribution company. We believe that there is no comparable peer for the company in India.

On its upper band of price or ₹445, the issue is priced at P/E ratio of 85.4x of its CY2015 EPS of ₹5.2 which we believe is expensive. **Considering its high dependence on PepsiCo, low return ratios, poor profitability and high valuation we rate this IPO 'Neutral'**

Upside risks

Grant of more territories by PepsiCo: PepsiCo's decision to grant more territories to VBL in future will increase VBL's financial performance significantly.

Decline in Concentrate prices by PepsiCo: VBL is dependent on PepsiCo for concentrate supply, prices of which are decided by PepsiCo. If PepsiCo decides to cut the concentrate prices, it will lead to improve VBL's performance.

Income Statement

Y/E December (₹ cr)	CY2012	CY2013	CY2014	CY2015
Total operating income	1,800	2,115	2,502	3,394
% chg		17.5	18.3	35.6
Total Expenditure	1,572	1,824	2,118	2,760
Raw Material Consumed	1,028	1,199	1,376	1,716
Personnel Expenses	152	183	217	324
Others Expenses	392	442	525	720
EBITDA	228	291	385	634
% chg		27.7	32.1	64.9
(% of Net Sales)	12.7	13.8	15.4	18.7
Depreciation & Amortisation	136	184	210	317
EBIT	92	107	174	317
% chg		15.7	63.4	81.5
(% of Net Sales)	5.1	5.0	7.0	9.3
Net Interest charges	71	152	171	155
Recurring PBT	21	(46)	4	162
% chg		(318.7)	(108.3)	4,195.2
Extraordinary Expense/(Inc.)	-	-	-	-
PBT (reported)	21	(46)	4	162
Tax	(4)	(5)	25	77
(% of PBT)	(20.4)	11.4	657.3	47.3
PAT before MI	25	(40)	(21)	86
Minority Interest (after tax)	0	(0)	-	-
Profit/Loss of Associate Company	-	1	1	2
PAT after MI (reported)	25	(41)	(22)	84
Exceptional Items	-	-	-	-
Reported PAT	25	(41)	(22)	84
% chg		NA	NA	NA
(% of Net Sales)	1.4	(1.9)	(0.9)	2.5
Basic EPS (₹)	1.5	(2.4)	(1.2)	5.2
Fully Diluted EPS (₹)	1.5	(2.4)	(1.2)	5.2
% chg		NA	NA	NA

Balance Sheet

Y/E December (₹ cr)	CY2012	CY2013	CY2014	CY2015
SOURCES OF FUNDS				
Equity Share Capital	27	134	334	584
Reserves & Surplus	145	42	9	89
Shareholder's Funds	172	175	343	672
Share application money	-	40	-	-
Minority Interest	0	0	-	-
Total Loans	1,701	2,033	2,139	1,832
Other long term liabilities	35	31	11	636
Long-term provisions	14	18	26	44
Deferred Tax Liability	72	64	81	151
Total Liabilities	1,994	2,361	2,600	3,336
APPLICATION OF FUNDS				
Gross Block	2,231	3,055	3,214	4,627
Less: Acc. Depreciation	527	689	868	1,137
Net Block	1,703	2,365	2,345	3,490
Capital Work in Progress	189	27	25	38
Goodwill	10	10	10	10
Investments	0	1	2	3
Other long term assets	68	43	55	127
Current Assets	584	544	859	770
Investments	0	0	302	0
Inventories	231	246	289	425
Sundry Debtors	91	65	97	98
Cash	38	51	34	58
Loans & Advances	220	171	125	180
Other Assets	5	10	11	9
Current liabilities	560	628	695	1,102
Net Current Assets	24	(85)	164	(331)
Total Assets	1,994	2,361	2,600	3,336

Cash Flow Statement

Y/E December (₹ cr)	CY2012	CY2013	CY2014	CY2015
Profit before tax	21	(46)	4	162
Depreciation	136	184	210	317
Change in Working Capital	20	(12)	44	(41)
Interest / Dividend (Net)	107	157	175	153
Direct taxes paid	(11)	(4)	(11)	(43)
Others Expenses	8	18	9	12
Cash Flow from Operations	280	297	431	560
(Inc.)/ Dec. in Fixed Assets	(421)	(421)	(212)	(260)
(Inc.)/ Dec. in Investments	(91)	(0)	(302)	307
Others Expenses	5	(153)	14	(339)
Cash Flow from Investing	(507)	(574)	(500)	(292)
Issue of Equity	-	-	-	-
Inc./(Dec.) in loans	340.5	395.0	83.7	(667.7)
Dividend Paid (Incl. Tax)	-	-	-	-
Interest / Dividend (Net)	(111.3)	(160.7)	(185.9)	(151.4)
Others	-	40.0	160.0	570.0
Cash Flow from Financing	229	274	58	(249)
Inc./(Dec.) in Cash	3	(2)	(11)	19
Opening Cash balances	15.7	18.7	16.5	5.2
Closing Cash balances	18.7	16.5	5.2	24.3

Key Ratios

Y/E December	CY2012	CY2013	CY2014	CY2015
Valuation Ratio (x)				
P/E (on FDEPS)	295.9	NA	NA	85.4
P/CEPS	46.2	51.3	39.1	18.4
P/BV	43.3	42.4	21.7	11.1
Dividend yield (%)	0.0	0.0	0.0	0.0
EV/Sales	5.5	4.7	3.9	2.9
EV/EBITDA	43.3	33.9	25.7	15.6
EV / Total Assets	3.9	3.3	3.0	2.2
Per Share Data (₹)				
EPS (Basic)	1.5	(2.4)	(1.2)	5.2
EPS (fully diluted)	1.5	(2.4)	(1.2)	5.2
Cash EPS	9.6	8.7	11.4	24.2
DPS	0.0	0.0	0.0	0.0
Book Value	10.3	10.5	20.5	40.3
Returns (%)				
ROCE	4.9	4.8	7.0	10.1
Angel ROIC (Pre-tax)	5.6	5.0	7.2	10.4
ROE	14.6	(23.5)	(6.4)	12.5
Turnover ratios (x)				
Asset Turnover (Gross Block)	0.8	0.7	0.8	0.7
Inventory / Sales (days)	82	75	77	90
Receivables (days)	17	10	13	9
Payables (days)	32	42	48	39
WC cycle (ex-cash) (days)	66	43	41	60
Solvency ratios (x)				
Net debt to equity	9.7	11.3	6.1	3.6
Net debt to EBITDA	7.3	6.8	5.5	3.8
Interest Coverage (EBIT / Interest)	1.3	0.7	1.0	2.0

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