Stock Update

Significant EPS dilution, downgraded to Hold

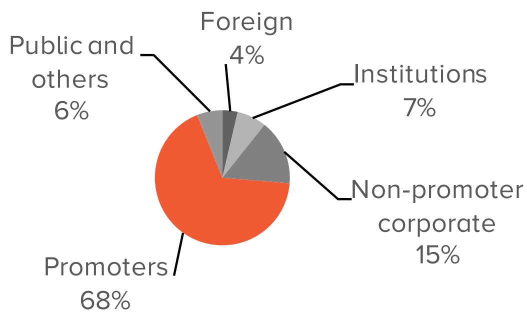
Zydus Wellness

Reco: Hold | CMP: Rs1,337

Company details

Price target:	Rs1,410
Market cap:	Rs7710 cr
52-week high/low:	Rs1,830/1,085
NSE volume: (No of shares)	15,095
BSE code:	531335
NSE code:	ZYDUSWELL
Sharekhan code:	ZYDUSWELL
Free float: (No of shares)	1.9 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	0.6	3.7	7.2	1.9
Relative to Sensex	-1.1	-6.4	-4.4	-11.4

Key points

Q4FY2019 reported financials are not comparable on a y-o-y basis and q-o-q basis due to consolidation of Heinz for two months

- **Comparable revenue grew by 7%, while margins stood at 14-15%:** In Q4FY2019, consolidated net revenue (including revenue of Heinz for two months) of Zydus Wellness (Zydus) stood at Rs. 416 crore, while comparable revenue grew by 7% due to slowdown in domestic consumption affecting growth of categories such as *Sugarfree* and scrubs during the quarter. Aggregate revenue for Heinz for February and March was Rs. 265 crore. New products launched in the last one year contributed 4% to Q4FY2019 turnover. Gross margin on reported basis decreased by 697 BPS y-o-y to 59.8% due to increased raw-material costs as a percentage of sales. Consolidated operating margin (OPM) declined by 711 BPS to 18.3% during the quarter mainly on account of higher advertisement and promotion spends as well as certain one-off items related to the acquisition. OPM for Heinz was at ~20%, which also toned down consolidated OPM. Comparable OPM for Zydus in Q4FY2019 stood at 14-15% (based on our calculations) as compared to ~25% in Q4FY2018. Consolidated operating profit stood at Rs. 76 crore in Q4FY2019 as against Rs. 33.4 crore in Q4FY2018 (on comparable basis declined by 14% y-o-y). Consolidated adjusted PAT came in at Rs. 62.3 crore for Q4FY2019 as against Rs. 35.7 crore in Q4FY2018.

- **Maintained leadership position in key categories:** The company's pillar brands *Everyuth* and *Nutralite* along with the acquired brands *Complan* and *Glucon D* performed well in FY2019. *Sugarfree* maintained its leading position with a market share of 93.8% propelled by promotional spends, but category growth was just 1.4% in FY2019. *Everyuth* portfolio posted strong growth during the quarter and the fiscal driven by strong growth in e-commerce business and higher traction to new launches. *Everyuth Peel-Off Mask and Everyuth Scrub* continue to lead their categories with market shares of 84.9% and 32.4% (category growth of 19.6% and 19%), respectively. *Nutralite* registered double-digit growth, driven by volumes. *Glucon D* witnessed slowdown in the quarter due to delayed winters but maintained its number one position with a market share of 59.5% in the glucose powder category. Nycil remained number one with a market share of 32.1% with recovery seen in South. Two new variants of *Nycil, Cool Aloe* and *Cool Lime*, were launched during the quarter. The MFD category grew by 8.9% with *Complan's* market share at 6% and the company is intending to focus on the core brand to perform well in the coming years.

- **Outlook – Base portfolio and Heinz portfolio to grow in single digit; Consolidated OPM to stand at 20%:** Revenue of Zydus Wellness grew by 13% (largely volume-led growth) on comparable basis in FY2019 with brands such as *Everyuth Scrub*, *Everyuth* peel-off and *Nutralite* achieving double-digit growth during the fiscal. With near-term headwinds of slowdown in the domestic market, we expect Zydus's base portfolio to grow by 8-9% in FY2020. Further, management is targeting *Heinz* portfolio revenue to grow in high single digit, as brands such as *Glucon D* and *Nycil* are likely to perform well in the coming quarters, while *Complan* will likely witness slow recovery in terms of growth as focus will be on re-staging the distribution for the brand. Heinz has gross margins of 54-55% and OPM of 20%, which management expects to maintain in FY2020. Thus, we expect consolidated OPM of Zydus to tone down to 20% from its earlier levels of 23-25%. However, management is targeting to improve OPM to 24% by FY2024 through cost efficiencies and synergistic benefits. The company will have interest burden of Rs. 150 crore-160 crore per annum as 33% of funding was done through debt (raised Rs. 1,500 crore through non-convertible debentures), while ~55% of funding was done through equity dilution.

- **Valuations – Downgrade to Hold with a revised PT of Rs. 1,410:** Zydus got access to the strong portfolio of brands, which has strong brand recall in the domestic market. However, the acquisition would result in substantial EPS dilution for FY2020/FY2021 due to higher interest cost and increased equity. Further, we have not incorporated amortisation of goodwill of Rs. 3,800 crore as management has not given any indication regarding the period of amortisation (will act as exceptional item in our estimates). We believe it will take 3-4 years for the company to gain the desired benefits from Heinz acquisition. However, management is targeting to significantly improve the performance of the consolidated entity over two to three years and repay debt through its internal accruals (Payment schedule of Rs. 500 crore per year from FY2022). We will keenly monitor the performance in the coming quarters. In view of near-term headwinds of consumption slowdown and earnings dilution, we downgrade our rating on the stock with a revised price target (PT) of Rs. 1,410 (valuing the stock at 34x its FY2021 revised earnings).

Valuation (Consolidated) Rs cr

Particulars	FY2017	FY2018	FY2019*	FY2020E*	FY2021E*
Net sales (Rs cr)	462.6	503.2	842.8	1898.0	2104.8
Adjusted net profit (Rs cr)	111.3	136.5	171.2	190.1	239.0
Adjusted EPS (Rs)	28.5	34.9	29.7	33.0	41.5
% y-o-y change	5.7	22.7	-15.0	11.0	25.7
PER (x)	46.9	38.3	45.0	40.5	32.3
EV/EBIDTA(x)	52.2	40.3	43.9	20.1	17.5
RoCE (%)	23.0	22.9	7.1	7.3	8.1
RoNW (%)	21.5	21.9	8.4	5.5	6.6
OPM (%)	21.4	24.9	20.7	20.0	20.7

** Financials are including the Heinz consolidation*
 # PAT estimates are excluding the amortisation cost on the Goodwill of Rs. 3,800 crore

Results (Consolidated) Rs cr

Particulars	Q4FY19*	Q4FY18	YoY %	Q3FY19	QoQ %
Total Revenue	416.2	131.7	216.1	145.4	186.2
Total expenditure	340.1	98.3	246.2	107.7	215.8
Other Income	8.5	8.0	6.3	10.4	-18.5
Interest Expense	28.8	0.4	6745.2	0.5	6150.0
Depreciation	6.3	2.2	192.1	2.1	199.0
PBT	49.5	38.8	27.4	45.6	8.6
Tax	-12.8	3.1	-514.1	5.2	-348.6
PAT (before M.I)	62.3	35.7	74.3	40.4	54.2
Minority Interest	0.0	0.7	-100.0	0.7	-100.0
PAT (after M.I)	62.3	35.1	77.6	39.7	57.0
Exceptional item	0.0	1.2	-	0.0	
Reported PAT	62.3	36.3	71.9	39.7	57.0
Reported EPS (Rs.)	15.9	9.3	71.9	10.2	57.0
			BPS		**BPS**
Gross margins (%)	59.8	66.7	-697	68.0	-829
OPM(%)	18.3	25.4	-711	25.9	-767

** Q4FY2019 financials are not comparable on y-o-y basis and q-o-q basis due consolidation of Heinz for two months*

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