Sharekhan
by BNP PARIBAS

Zydus Wellness

Recent run-up caps upside; Downgrade to Hold

Sector: Consumer Goods
Annual Report Review

	Change
Reco: **Hold**	↓
CMP: **Rs. 1,755**	
Price Target: **Rs. 1,840**	↑

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 10,120 cr
52-week high/low:	Rs. 1856/1085
NSE volume: (No of shares)	0.2 lakh
BSE code:	531335
NSE code:	ZYDUSWELL
Sharekhan code:	ZYDUSWELL
Free float: (No of shares)	1.9 cr

Shareholding (%)

Promoters	67.6
FII	4.7
DII	19.2
Others	8.5

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	16.5	28.6	36.4	8.4
Relative to Sensex	15.1	36.0	36.5	8.0

Sharekhan Research, Bloomberg

The stock price of Zydus Wellness Limited (Zydus) has moved up by ~17% post its strong operating performance in Q1FY2020, which gives us a glimpse of the acquisition of Heinz India Private limited (Heinz) being earnings positive by FY2021 (which was earlier expected to be earnings accretive by FY2022). The acquisition will enhance the portfolio of Zydus with strong brands and enhanced distribution reach. However, funding of the acquisition through debt led to some stress on the balance sheet, though working capital has remained stable. The current valuation at 31.6x is at a premium and does not provide much upside from the current level.

Increased debt to put some stress on the balance sheet; Working capital remains strong

Zydus has issued Rs. 1,500 crore worth non-convertible debentures to fund the acquisition of Heinz, which led to a substantial increase in its debt, putting some pressure on the balance sheet. Increased debt and equity (for the acquisition of Heinz) has led to dilution in return ratios, with RoE at 8.4% and RoCE at 7.1% in FY2019 (lower than 21.9% and 22.9%, respectively, in FY2018). However, the cash generated from operations increased to Rs. 212 crore in FY2019 from Rs. 81 crore in FY2018 after the acquisition. The acquisition did not put any stress on the working capital, which remained negative at -75 days in FY2019 as against -44 days in FY2018. Negative working capital and improved operating performance will further improve the company's cash flows. This gives a visibility of the company servicing its debt as per agreed terms.

Valuation

Strong operating performance of Zydus in Q1FY2020 gives us visibility of the acquisition of Heinz becoming earnings accretive by FY2021. The stock has moved by ~17% since our last update (dated July 31, 2019). The current valuation at 31.6x its FY2021 earnings is at a premium of ~7% of its historical five-year average of 30x and does not provide much upside from the current level. Hence, we downgrade the stock to Hold with a revised PT of Rs. 1,840.

Key Risks

- As Zydus operates in niche, discretionary categories, any macroeconomic slowdown will affect growth of these categories.
- Slow growth in the portfolio of Heinz will prolong the time for the acquisition to become earnings positive.

Valuation (Consolidated) — Rs cr

Particulars	FY17	FY18	FY19	FY20E*	FY21E*
Revenue	463	503	843	1,993	2,318
OPM (%)	21.4	24.9	20.7	20.0	20.7
Adjusted PAT	111	137	171	241	320
% YoY growth	5.7	22.7	25.4	40.8	32.9
Adjusted EPS (Rs.)	28.5	34.9	29.7	41.8	55.6
P/E (x)	61.6	50.2	59.1	42.0	31.6
P/B (x)	12.3	9.9	3.0	2.8	2.6
EV/EBIDTA (x)	68.7	53.3	57.7	25.1	20.6
RoNW (%)	21.5	21.9	8.4	6.9	8.6
RoCE (%)	23.0	22.9	7.1	7.6	8.7

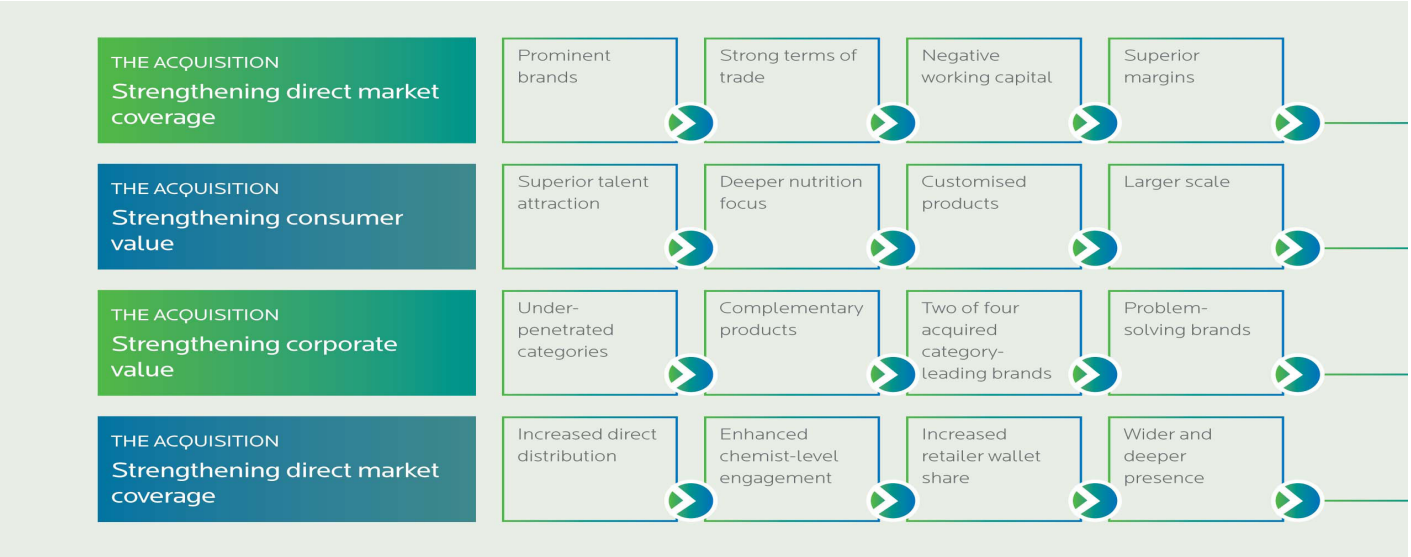
Source: Company, Sharekhan estimates **Estimates including consolidation of Heinz*

Working capital remained strong post the acquisition; Return ratios diluted due to change in capital structure

Zydus is a strong and emerging player in the health and wellness space in India. The company ended FY2019 with good operating performance post the completion of its acquisition of Heinz on January 30, 2019. (FY2019 financials included two months of Heinz). Working capital after the acquisition remained negative at -75 days in FY2019 compared to -44 days in FY2018. Debt/Equity ratio increased to 0.5 mainly due to a steep rise in debt on account of non-convertible debentures of Rs. 1,500 crore issued to fund the acquisition. The acquisition led to dilution of return ratios with RoE at 8.4% from 21.9% and RoCE at 7.1% from 22.9% earlier.

Heinz acquisition to improve the scale of business

Going ahead, the acquisition of Heinz is expected to create economies of scale and various synergistic benefits for Zydus in the medium to long term. It will help strengthen direct market coverage and enhance chemist-level engagement by increasing the combined distribution reach to over 1,800 distributors and more than two million customer touch points. The company will have a combined strength of five manufacturing facilities. With increased product portfolio and addition of newer categories, it will help the company provide wider product choice and focus on products based on customer needs and preferences. It will also help the company hold a footing in under-penetrated categories, giving scope for further expansion.



Enhanced distribution reach, expansion of international presence

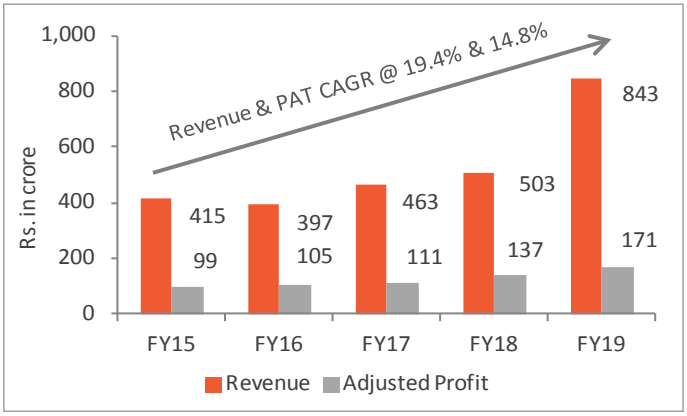
Zydus enjoys pan-India presence with a distribution reach of 2 million outlets (including indirect reach). The network comprises 1,500+ distributors and 2,000 feet-on-street representatives. The company has taken initiatives to increase its direct distribution reach in the grocery channel and to increase its shelf presence in open format stores in eight leading cities to drive brand growth. E-commerce has registered robust growth, whereas modern trade grew in double digits in FY2019. The company has extended its international presence to Middle East, Africa, South East Asia and SAARC regions, which include a total of 13 countries, with markets such as Malaysia and Kuwait added in FY2019. The company launched Sugar Free D'lite chocolates, a premium priced product in the export market. Zydus also launched Everyuth products in UAE, Bahrain and Qatar and Nutralite products in Qatar and Sri Lanka in FY2019.

Zydus retains its market leadership in most brands such as Sugar Free, Everyuth and Glucon-D

Zydus is present in diversified categories, having market leadership in five out of its seven brands. Sugar Free is India's first sugar substitute and has undisputed category leadership with 93.8% market share. The company had launched Sugarlite in December, which looks and feels like normal sugar but with 50% lower calories than normal sugar, positioned to health-conscious consumers. The company also launched Sugar Free Green Veda, an ayurvedic range of sweeteners. The market share of Everyuth scrub and Everyuth Peel-off mask stood at 32.4% and 84.9%, respectively. The brand established its leadership in advanced skincare segment. The company launched Everyuth tan-removal range under Everyuth Naturals, focusing on the concept of natural products. The company also launched Nutralite Mayonnaise in three different flavours in FY2019 - an extension to the Nutralite spreads range. In terms of acquired brands, Glucon-D is a category-leading brand with 59.5% market share and 98% product recall. Nycil is a leader in prickly heat and cooling powder category with 32.1% market share. Complan is a health food drink (HFD) with 90% brand recall. However, the market share of Complan stands at just 6%, as HFD is a highly penetrated category with steep competition. The company continued to step up investments behind brands through television commercials, media campaigns and customer sampling.

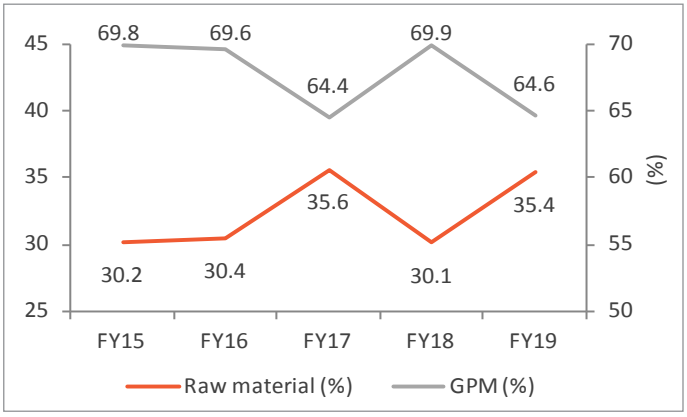
Annual Report Review in Charts

Consolidated revenue grew at a CAGR of 19.4%



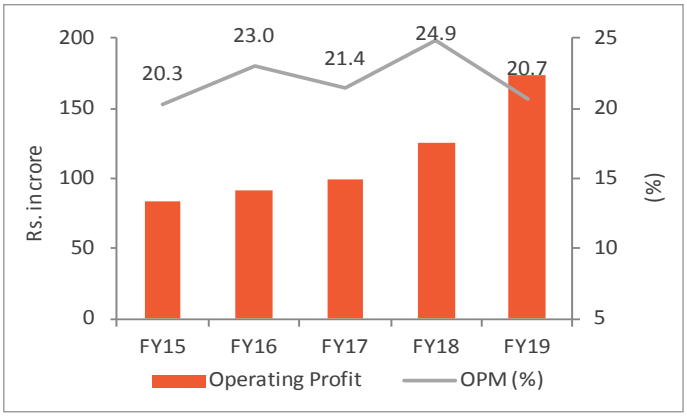
Source: Company, Sharekhan Research

GPM moderated to 64.6% in FY2019



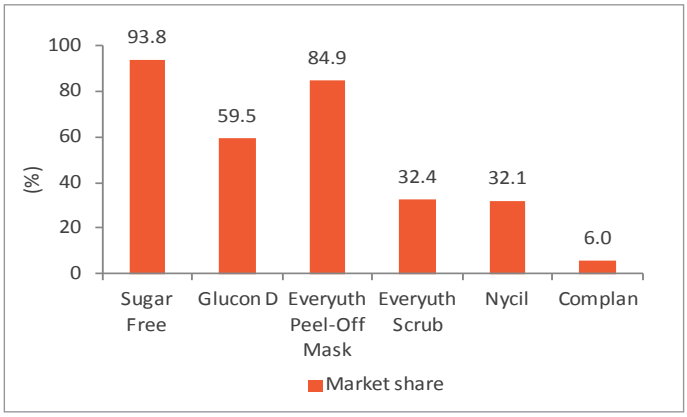
Source: Company, Sharekhan Research

OPM stood at 20.7% in FY2019



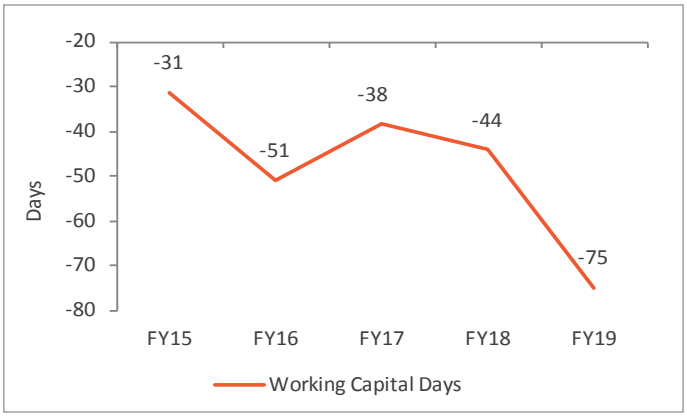
Source: Company, Sharekhan Research

Key brands maintained leadership position



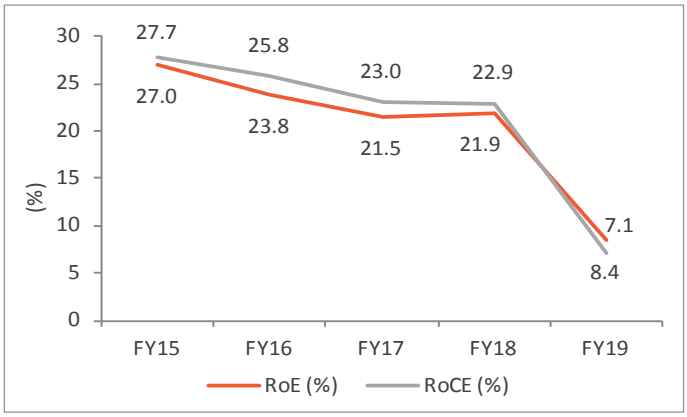
Source: Company, Sharekhan Research

Working capital remained negative



Source: Company, Sharekhan Research

Return ratios diluted due to acquisition



Source: Company, Sharekhan Research

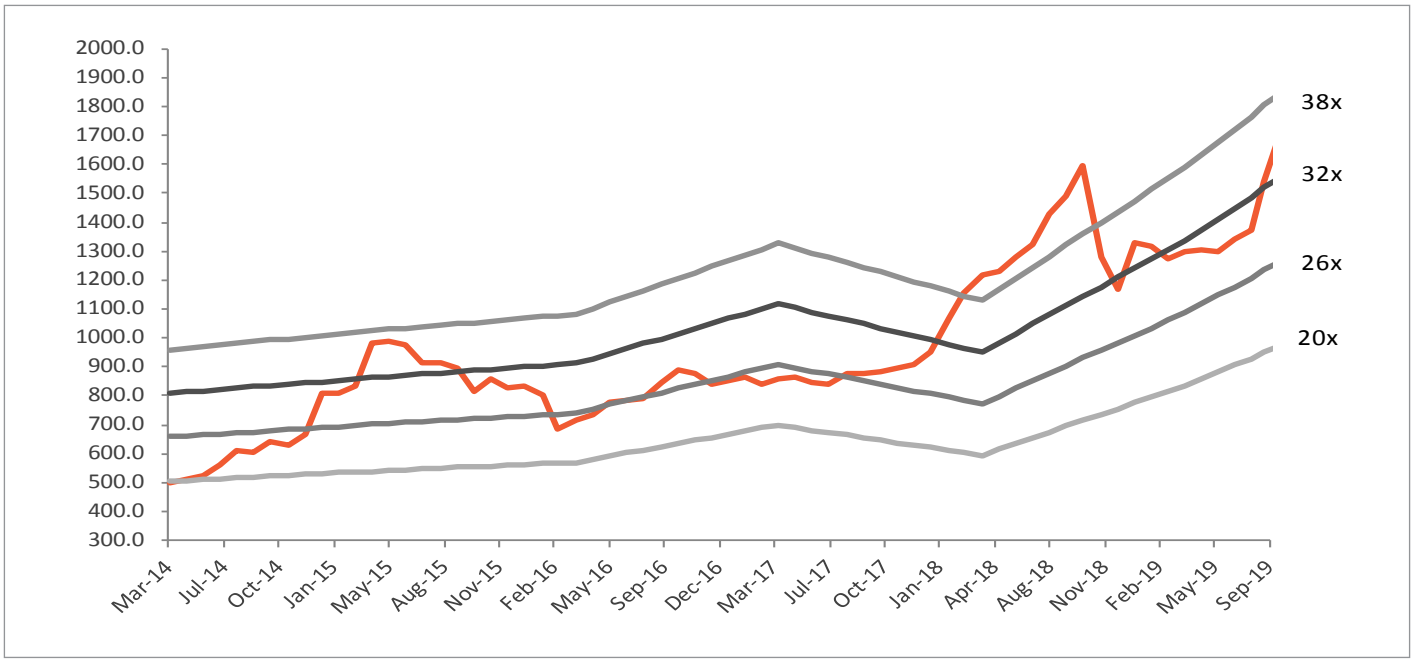
Outlook

Zydus reported a strong set of numbers in Q1FY2020, led by strong double-digit growth in Heinz portfolio. However, the performance in Q2FY2020 is expected to be soft, in-line with the slowdown in overall demand environment. The company's base product portfolio is expected to grow by 10-12%, with Sugarfree expected to see a sequential improvement in growth in the near to medium term. Heinz portfolio will continue to do well in the quarters ahead (in the backdrop of stable economic condition) as the company continues to invest on brands, re-align distribution networks and bring required SKUs into the market. The company aims to increase direct distribution reach to 5 lakh outlets from 2.5 lakh outlets currently. Moreover, synergy benefits of Heinz's acquisition would start flowing in from the coming quarters and OPM is expected to improve by 200 BPS in the next two years (we have factored in 70 BPS improvement in OPM for FY2021).

Valuation

Strong operating performance of Zydus in Q1FY2020 gives us visibility of the acquisition of Heinz becoming earnings accretive by FY2021. The stock has moved by ~17% since our last update (dated July 31, 2019). The current valuation at 31.6x its FY2021 earnings is at a premium of ~7% of its historical five-year average of 30x and does not provide much upside from the current level. Hence, we downgrade the stock to Hold with a revised PT of Rs. 1,840.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBIDTA (x)			RoCE(%)		
	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Dabur India	53.7	48.4	40.5	44.9	39.1	32.7	28.1	30.2	30.8
Zydus Wellness	59.1	42.0	31.6	57.7	25.1	20.6	7.1	7.6	8.7

Source: Company, Sharekhan estimates

About company

Zydus is the listed entity of Zydus Group and one of the leading companies in the fast-growing Indian consumer wellness market. The company's growth over the years has been led by pioneering brands such as Sugar Free, EverYuth and Nutralite and innovations offering new benefits to consumers. The company is the market leader in most of its product categories. The company has recently acquired Heinz, subsidiary of Kraft Heinz. With this, Zydus' product portfolio widened to include HFD and energy drinks. The acquisition has also boosted Zydus' revenue trajectory to ~Rs. 2,000 crore from Rs. 600 crore earlier.

Investment theme

Zydus has a portfolio of strong brands that lead their categories. The Sugarfree brand has a 94% market share in the artificial sweeteners category, while Everyuth Peel-off mask has an 84% market share. The acquisition of Heinz enhanced the company's product portfolio and distribution reach. However, the same is earnings dilutive in the initial years as the acquisition was funded through a mix of debt and equity. The acquisition will start adding to the bottom-line in another 3-4 years, in the backdrop of a stable consumption environment.

Key Risks

- **Macroeconomic slowdown:** Zydus is largely present in niche categories, which are discretionary in nature. Any slowdown in the macro environment will affect growth of these categories.
- **Slow growth in acquired brands:** Slow growth in acquired brands (Heinz's portfolio) will prolong the time for the acquisition to become earnings positive.
- **Increased competition:** Zydus is facing stiff competition in skin care products such as face wash and scrubs from multinationals, which has affected the revenue growth of these categories.

Additional Data

Key management personnel

Sharvil P Patel	Chairman
Tarun Arora	Whole Time Director and CEO
Dhanraj P Dagar	Company Secretary

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Cadila Healthcare Ltd	63.6
2	Threpsi LLP	12.5
3	Zydus Family Trust	4.1
4	Matthews International Capital Management	3.2
5	Life Insurance Corp Of India	2.2
6	Reliance Capital Trustee Co Ltd	1.7
7	Prazim Trading & Inv Company	1.4
8	PPFAS Asset Management	0.7
9	Dimensional Fund Advisors LP	0.4
10	Aditya Birla Sun Life Asset Management	0.2

Source: Bloomberg

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