Stock Idea : Agro-Tech Foods Ltd.

Date: 25th May, 2016
Recommendation: UNRATED
CMP: 521
MCap: 1,279

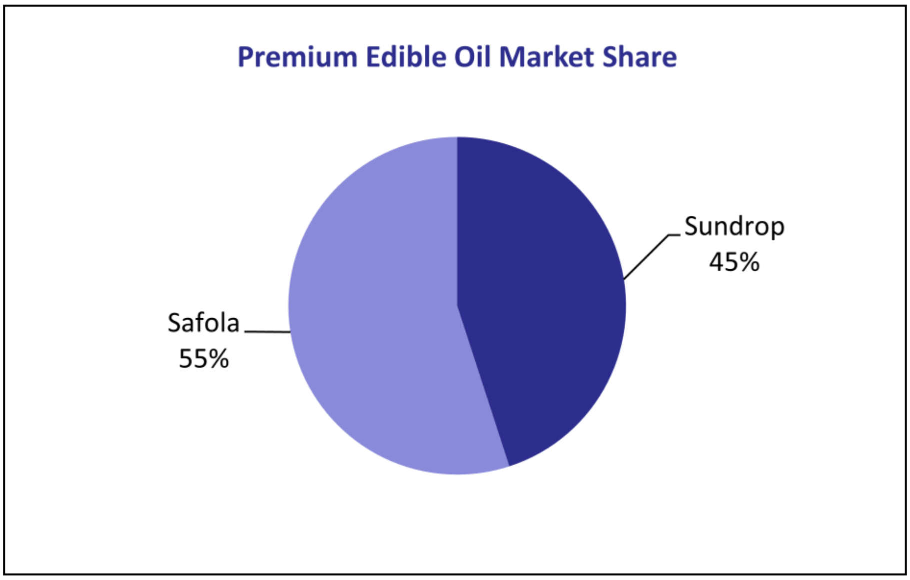
We like ATFL (Agro-Tech Foods Ltd.) at current levels (CMP: 520) based on the arguments stated below. While we do not have coverage on the stock, we believe the story has a long term potential and could generate returns in line with the broader market with substantially lower risks, over the next 3 to 5 years.

Company Overview: Agro Tech Foods (ATF), a subsidiary of global food major ConAgra Foods (ConAgra), is a dominant player in the domestic organized edible oil market with the "Sun drop" brand. With the launch of "Act II" in 1999, Agro Tech diversified from the low margin edible oil business into the higher margin ready to eat and packaged food categories. The company is incrementally looking to leverage ConAgra food's global portfolio of brands and products to build a formidable portfolio in fast growing categories.

ConAgra Foods is one of North America's leading packaged food companies with recognized brands such as Marie Callender's®, Healthy Choice®, Slim Jim®, Hebrew National®, Orville Redenbacher's®, Peter Pan®, Reddi-wip®, PAM®, Snack Pack®, Banquet®, Chef Boyardee®, Egg Beaters®, Hunt's® and many others found in grocery, convenience, mass merchandise and club stores. The company generated ~USD16bn in revenues for the year 2015. We believe this vast packaged foods portfolio could be gradually introduced to the Indian sub-continent via Agro-Tech Foods.

Business Outlook:

- **Edible Oil Business (~78% of Revenues)**
    - The Edible oil business has shown muted growth over the past decade, but serves as a steady cash-cow
    - Despite lower advertising spends the company has maintained its market share in the premium edible-oils segment with a market share of ~45%
    - This market share is driven by an industry leading distribution network in the Edible Oil's category with 70,000 stores as compared to Marico's 45,000 stores for it's Safola brand
    - Given lack of focus towards the segment we expect Sundrop to maintain market share in the edible oil's category as cash-flows are diverted to build a strong foods portfolio
    - Manufacturing for the Edible Oil's business is 100% outsourced making the business a high ROE cash machine for the company



- **Foods Portfolio:- (~22% of Revenues)**
  - **Distribution**
    - The foods business today has a distribution reach of ~250,000 stores
    - Management aims to invest in distribution and grow the same by 60-70,000 stores/ year over the next 3-5 years
    - HUL in comparison has over ~70,00,000 stores across India, leaving Agro Tech Foods many years of growth ahead of it, driven by an expanding distribution network
  - **Product Focus**
    - The company is leveraging technological know-how to launch premium products in niche categories which are difficult to replicate
    - The growth might be slightly lower than competition given that the company is setting out to build new categories, however once established these brands would become synonymous with the category creating insurmountable moats. E.g. "Act 2 Pop Corn"
    - Despite being priced at a 25-30% premium to competition the company's products display category leadership attributes by being leaders in their respective categories
      - E.g. Act 2 Pop Corn, Sun-drop Peanut Butter
    - New product launches:
      - The company is leveraging its strong brands such as Act 2 and Sun-drop to launch products from an existing platform
        - Act 2 is being built as a snacks brand and has been used as a platform to launch snack products such as puffs and nachos apart from the existing popcorn category
        - Sun-drop is being built as a brand to launch healthy food categories such as peanut butter, granola bars
- **Current Strategy**
  - The management is currently focused on growing distribution and launching additional products with negligible advertising spends
  - The management would focus on launching new products and advertising campaigns once it has built a sizable store distribution network (~500,000 stores)

Future Business Outlook:-

- **Revenues:** Over the next 3-5 years the management aims to grow the food's business to 50% of sales, while maintaining flattish growth in the Edible oil business, implying a 100% growth in the packaged food's business
- **Margins:** Gross margins for the overall business today stand at 24% which the management aims to increase to 40% over the next 3-5 years powered by increased share from the food's business where the management aims for a 50% gross margin
- We believe the above targets are achievable and can be surpassed given the leadership attributes exhibited

What We Like:-

- **Management Focus:**
  - The management is willing to sacrifice near-term profitability for long term gains, by focusing on the faster growing foods segment with much greater potential
- **Capital Allocation Prudence:**
  - The management has strategically invested in building distribution and back-end capabilities before embarking on aggressive product launches and advertising campaigns
- **Potential for Exponential Growth:**
  - ATFL is building a platform to launch a vast portfolio of food products, both proprietary and from ConAgra's portfolio which could grow revenues and margins exponentially going forward
- **Inherent Moat in FMCG businesses driven by Taste:**
  - Customers are highly sensitive to taste, Food brand's usually have much higher customer loyalty and lower switching rates, requiring lower incremental advertising and promotional expenses once mature.
    - I.e. A customer would be more amenable to switch his/her brand of soap or shampoo as compared to the brand of toothpaste or packaged food products
    - This customer nature is incumbent friendly and protects category leaders from new entrants

Valuations:

- The business currently trades at a market cap of ₹~1250 Cr, EV of ~1350 Cr
- We believe the EBITDA is suppressed due to long term investments in building a leading food's portfolio and thus would value the business using the SOTP method
  - **Edible Oil Business:**
    - The Edible Oil business generates a steady EBITDA of ~60 Cr/Year which we expect should remain stagnant/ show low single digit growth going forward. We value the same at 12.0x EBITDA, implying a valuation of ~₹760 Cr
  - **Foods Business:**
    - The foods business is still nascent given large set-up costs and the immense potential to launch new products.
    - In FY16 the Foods business generated ~ ₹172 Cr in sales and was nearing EBITDA breakeven.
    - We believe ATFL has a superior brand and product portfolio and business moat as compared to the below peer's in the small/mid cap food product companies and deserves a higher than average, 5.0x EV/Sales multiple valuing the foods business at ~₹860 Cr
    - A 5.0x EV/Sales multiple looks steep but is a ~35% discount to Nestle India's valuation (Similar MNC Parentage, marquee brands with good recall, the potential to add future products)
    - Despite the high multiple ascribed we believe the potential to deliver best in class growth, driven by a robust product portfolio is huge

Peer Valuations (Mid/Small Cap FMCG Food Companies)

	Small & Mid Cap Branded Food Companies			Large Cap Branded Food Companies	
Particulars (₹Cr)	DFM Foods	Tasty Bite Eatables	Manpasand Beverages	Nestle	Britannia
EV	2200	720	2850	62,000	31,500
Sales FY16	389	208	556	7,961	7,947
EV/Sales	5.6x	3.5x	5.1x	7.8x	4.0x
Average	4.7x			5.9x	

Revenue growth acceleration over medium to long term:-

Backed by increasing category acceptance and new product launches we expect growth to accelerate for the company over the next 3-5 years. As the foods business accelerates and builds profitability with scale over the next 3-5 years, we believe the business could be valued substantially higher. Though we do not have coverage on the stock, based on our estimates and understanding of the business we remain positive on the stock with a 3-5 year period.

Revenues (₹Cr)	FY13	FY14	FY15	FY16
Edible Oil Business	624.9	605.2	568.5	610
(Growth %)		-3.2%	-6.1%	7.3%
Foods Business	138	151	159	172
(Growth %)		8.6%	5.3%	8.2%

ATFL has incurred ₹1.5bn Cap-ex over the past 5-6 years to set up new plants for the foods business. Going ahead, over the next 3-4 years, the company proposes to set up more new plants for which it has earmarked Cap-ex of ~₹25 Cr per annum.

The company believes that these manufacturing capabilities would be capable of generating asset turns of ~3.0x to 4.0x at optimal utilization levels working out to potential revenues of ~₹6Bn for the foods segment once the backdrop for exponential growth is set

Particulars (₹Cr)	FY12	FY13	FY14	FY15	FY16
Revenues	704.5	788.9	764.8	759.7	782.1
EBITDA	56.3	67.1	70.4	61.3	56.9
EBITDA Margin (%)	8.0%	8.5%	9.2%	8.1%	7.3%
PAT	36.1	41.6	43.1	37.3	23.4
EPS	14.8	17.1	17.7	15.3	9.6
Price as of 31st March	451	493	504	625	520
P/E	30.5	28.8	28.5	40.8	54.2

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