Initiating Coverage

Varun Beverages Ltd.

November 26, 2021

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Varun Beverages Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
FMCG	Rs.912	Buy in Rs 908-916 band and add more on dips to Rs. 817-823 band	Rs.999	Rs.1073	2 quarters

HDFC Scrip Code	VARBEVEQNR
BSE Code	540180
NSE Code	VBL
Bloomberg	VBL:IN
CMP (Nov 25, 2021)	912
Equity Capital (Rs Cr)	433
Face Value (Rs)	10
Equity Share O/S (Cr)	43.3
Market Cap (Rs Cr)	39,839
Book Value (Rs)	122
Avg. 52 Wk Volumes ('000s)	34000
52 Week High	1020
52 Week Low	496

Share holding Pattern % (Sept, 2021)	
Promoters	64.89
Institutions	28.49
Non Institutions	6.62
Total	100.0

* Refer at the end for explanation on Risk Ratings

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Our Take:

Varun Beverages Limited (VBL) is part of RJ Corp. group and is PepsiCo's second largest franchisee (outside US) of carbonated soft drinks (CSD) and non-carbonated beverages (NCBs). A strategic franchisee partner of PepsiCo in India, VBL over three decades has developed a significant and mutually beneficial business association. VBL's strong relationship with PepsiCo is reflected in the large number of franchisee territories and sub-territories granted/acquired by it over the years as it now covers 90% of India. Its share of PepsiCo India's beverages volume sales has increased from 26% in FY11 to 85%+ now. Besides India, it has been granted franchise rights for other South Asian and African countries.

With end-to-end execution capabilities and presence across the entire beverage value chain, the company's profile is not restricted to being just a bottler. VBL's vast operational experience, widespread integrated distribution network and in-depth market knowledge lends significant value to the distribution and sale of PepsiCo products in India. PepsiCo transferring its own bottling plants to VBL over the past few years bears testimony to the latter's varied and rich track record.

With PepsiCo's best-in class portfolio (Pepsi, Mirinda, Mountain Dew, 7 Up, Tropicana, Aquafina, etc), VBL is well placed to cater to changing consumer preferences. India's young population, rising on-the-go consumption and improving retail network (with rapid electrification across country) offers a multi-billion-dollar opportunity for the beverages manufacturers. VBL, with a monopoly of PepsiCo India's beverage business, is a solid proxy play on the long-term growth story of the soft drinks category in India.

Valuation & Recommendation:

VBL has delivered a healthy revenue CAGR of ~22% over CY12-19 (pre-Covid), with 21% CAGR in domestic revenue growth, aided by 20% volume CAGR which again is driven by acquisition of territories. The international business (~23% of CY20 revs.) has witnessed a strong growth of 23% CAGR over CY12-19, on a low base and with entry in newer international markets. Likewise, it has delivered 36% PAT CAGR over last 10 years. Going ahead, we expect VBL to report strong Revenue/EBIDTA/PAT CAGR of 24%/28%/51% over CY20-23E, driven by a) continuous focus on distribution expansion and sustained share gains from consolidation of South and West territories, b) focus on expanding fast growing NCBs through constant product innovation and new launches and c) healthy growth momentum in International business.

The company had been on an acquisition spree for last few years, which impacted its Free Cash Flow (FCF). However, with already 90% volumes of the PepsiCo's India beverage under VBL, the growth for VBL in the future would be largely led by organic route in India. Improvement in capacity utilisation, margin expansion and consolidation of operations will lead to improvement in FCF going forward. It has repaid debt to the extent of Rs. ~2200 Cr over past 2 years and with strong FCF generation, we expect a sharp reduction in debt over next 2-3 years. Reduced capex intensity and focus on debt reduction, better margins and improved asset turnover would lead to steady improvement of ratios.

Improving financial strength, solid business model with well established brand portfolio, along with robust growth prospects (low per capita consumption, favourable demographics, increasing penetration with rising electrification) makes VBL an attractive investment bet, in our view. **We think the base case fair value of the stock is Rs 999 (32x CY23E EPS) and the bull case fair value of is Rs 1,073 (34x CY23E EPS). Investors can buy the in stock Rs 908-916 band (29x CY23E EPS) and add more on dips to Rs 817-823 band (26x CY23E EPS). At LTP of Rs 912, it quotes at ~31x CY23E EPS.**

Financial Summary

Particulars (Rs Cr)	Q3CY21	Q3CY20	YoY-%	Q2CY21	QoQ-%	CY19	CY20	CY21E	CY22E	CY23E
Net Income	2398	1803	33.0%	2450	(2.1)%	7,130	6,450	8,581	10,653	12,330
EBITDA	495	381	29.9%	571	(13.4)%	1,448	1,202	1,690	2,141	2,540
APAT	258	161	59.8%	319	(19.1)%	465	396	716	1,058	1,358
Diluted EPS (Rs)	5.6	3.5	59.8%	7.1	(19.1)%	16.1	13.7	16.5	24.4	31.4
RoE-%						17.4	11.5	18.7	23.1	24.2
P/E (x)						56.7	66.6	55.1	37.3	29.1
EV/EBITDA (x)						29.5	35.4	24.8	19.1	15.6

(Source: Company, HDFC sec)

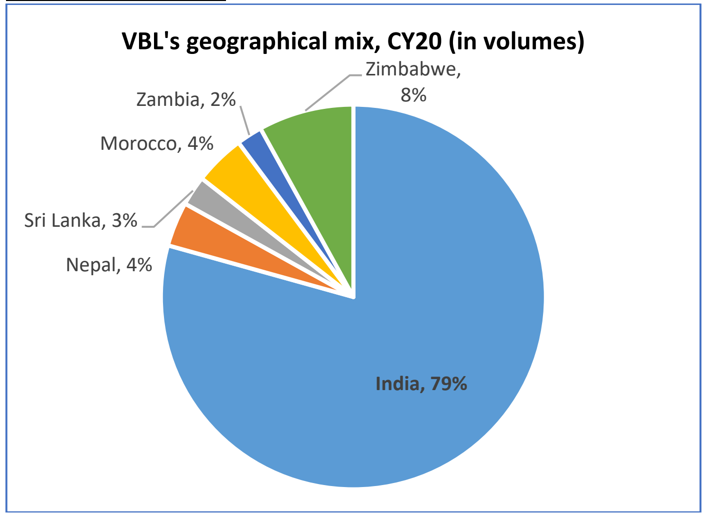
Q3CY21 Result Update

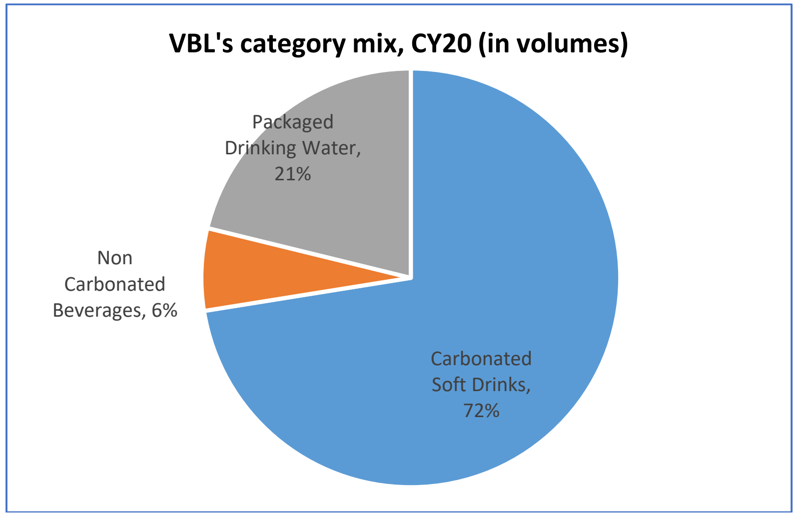
Revenue from operations grew by 33.0% YoY in Q3CY21 to Rs. 2398 Cr led by 28.4% volume growth & 3.6% realisation increase. Volumes stood at 153.3 million cases in Q3CY21 as compared to 119.5 million cases in Q3CY20. Carbonated Soft Drinks (CSD) constituted 70%, Juice 5% and Packaged Drinking water 25% of total sales volumes in Q3CY21. On a two year CAGR basis, organic volumes grew at 11% CAGR. Realisation increase was largely driven by increasing realisation in international territories (~10%) despite a high proportion of water in the product mix. Gross margins contracted 278 bps mainly on account of higher PET & sugar prices, which have gone up by 18% & 2% YoY respectively. The company was able to save 163 bps in employee spends (percentage to sales) & 65 bps in overhead spend due to the operating leverage. EBITDA grew 30% to Rs 494.7 Cr. EBIDTA margins contracted 50 bps to 20.6%. Led by higher operating profit and 26%

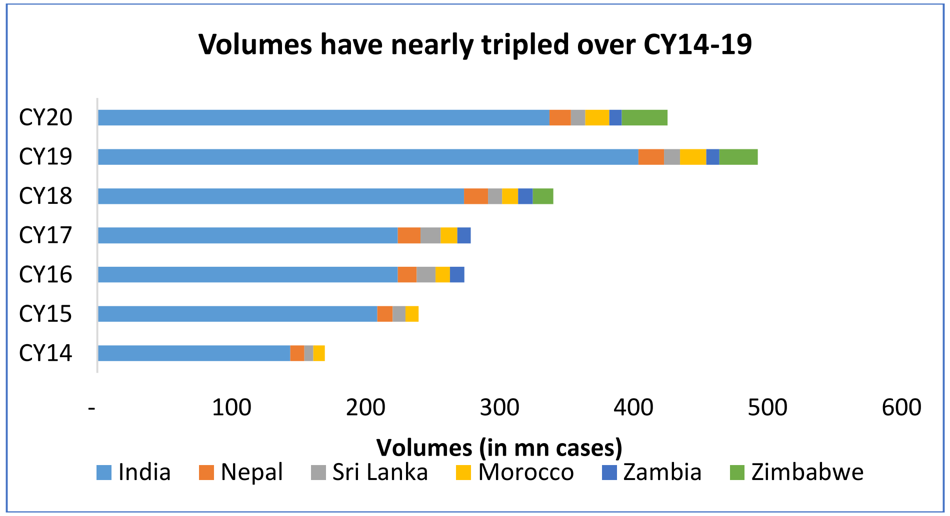
dip in interest expense, PAT grew at a splendid 59.8% to Rs 257.9 Cr. The company has repaid Rs 600 Cr of debt in the last six months while current debt levels are Rs 2400 Cr. Average cost of debt for the company has come down by 100 bps in the last one year to 5.5%.

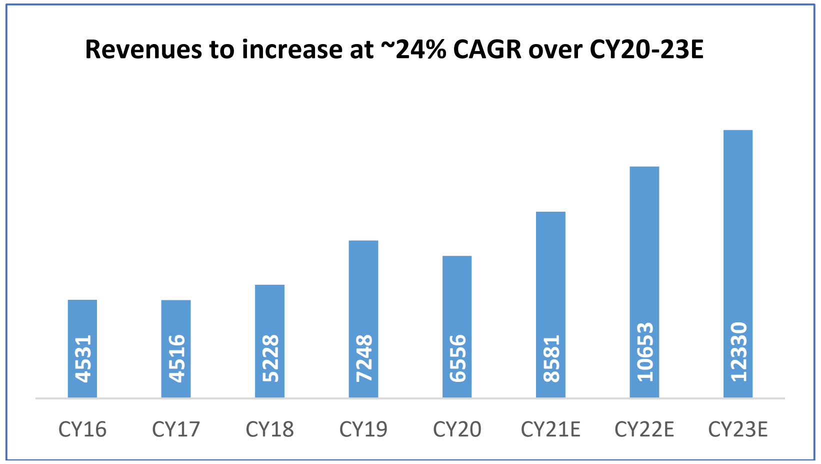
VBL has planned to set up a new plant in the state of Bihar as it was unable to service the market in the region, leading to lower market share. Earlier, products were transported to Bihar from neighboring states to meet the requirement. With Bihar being one of the most populous states in India, VBL aims to capitalize on the growing demand in the region. The new plant is expected to be commercialized over the next 6–8 months (in CY22) at capex cost of Rs 285 Cr. Furthermore, VBL is setting up a new plant in Kutwa (close to the Pathankot facility) to manufacture PET bottles and closures. The new capacity is expected to be operational by Mar'22.

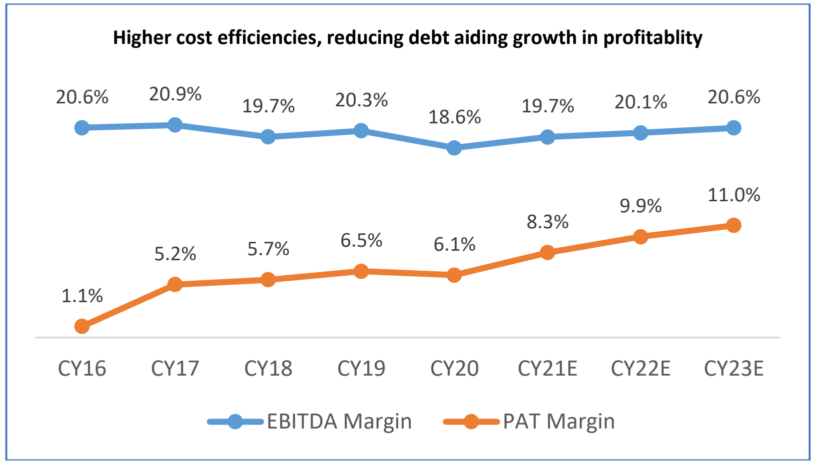
Overview of VBL

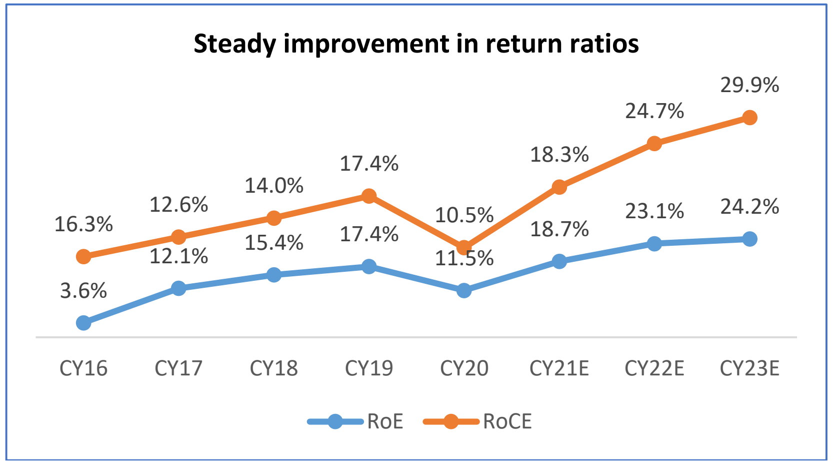












(Source: Company, HDFC sec)

Long Term Triggers

VBL: One of the largest PepsiCo franchisee

VBL has been associated with PepsiCo since the 1991 and has over three decades consolidated its business association with PepsiCo, increasing the number of licensed territories and sub-territories covered by the company, producing and distributing a wider range of PepsiCo beverages, introducing various SKUs in the portfolio and expanding the distribution network.

The fact that the relationship has been well nurtured is evident from gradual consolidation of VBL's presence across contiguous geographies. VBL has increased its share of PepsiCo's India beverages volume sales (based on its sales to end customers) from 26.5% in CY11 to 44.1% in CY15 and to 85%+ now. Being granted franchises for various PepsiCo products across 27 States and 7 Union Territories, it covers 90% of India now. Although, India is VBL's largest market, it has also been granted the franchise for various PepsiCo products for the high-growth potential territories of Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe.

Dissecting VBL's agreement with PepsiCo

As per the arrangement with PepsiCo, VBL has to set aside 20% of net revenues, of which, 14% is paid to PepsiCo, 8% as concentrate cost that VBL purchases from Pepsi and 6% for the payment towards 'above the line' (ATL) advertising spends. The remaining 6% has to be spend by VBL on below the line (BTL) marketing. For products, wherein there is no concentrate involved, VBL pays royalty of ~1.3% for Aquafina and 1% for Evervess Soda.

Given the proven ability of VBL to strengthen the market share of PepsiCo, in 2019, bottling appointment and trademark license agreement for India with PepsiCo India has been extended till April 30, 2039, from October 2, 2022.

<u>VBL is a much more than mere bottler…</u>

A bottler merely manufactures the product and supplies it back to the brand owner for a small conversion fee. VBL is much more than a pure bottler – in fact, the company is present almost across the entire value chain.

VBL straddles across the entire value chain…

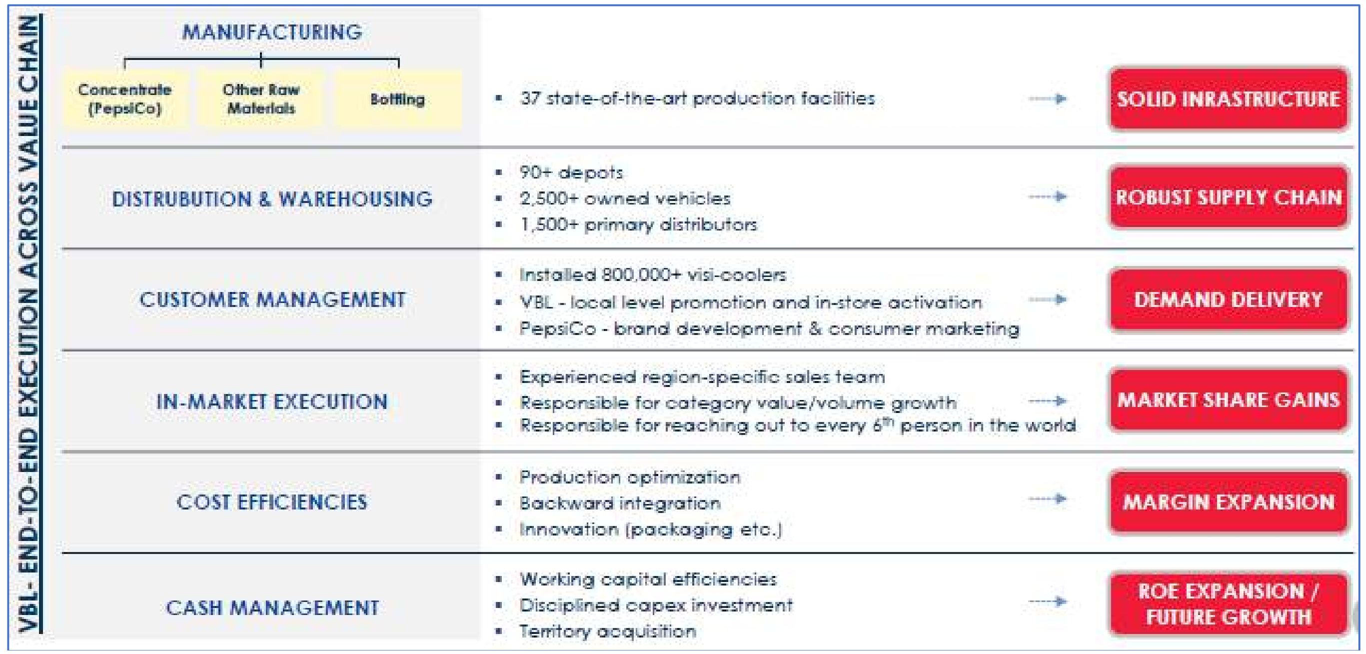
VBL's presence across the entire value chain more than signifies that it is not just a bottler but makes significant contribution across the value chain. As per its agreement with PepsiCo, responsibilities of both players are clearly spelt out. VBL with its end-to-end execution capabilities, is responsible for manufacturing, distribution and warehousing, customer management and in-market execution, to managing cash flows and future growth. PepsiCo offers brands, concentrates and marketing support to VBL, which then takes complete control over the manufacturing and supply chain processes, driving market share gains, enhancing cost efficiencies and managing capital allocation strategies.

Distribution of responsibilities between VBL and PepsiCo

Robust infrastructure in place

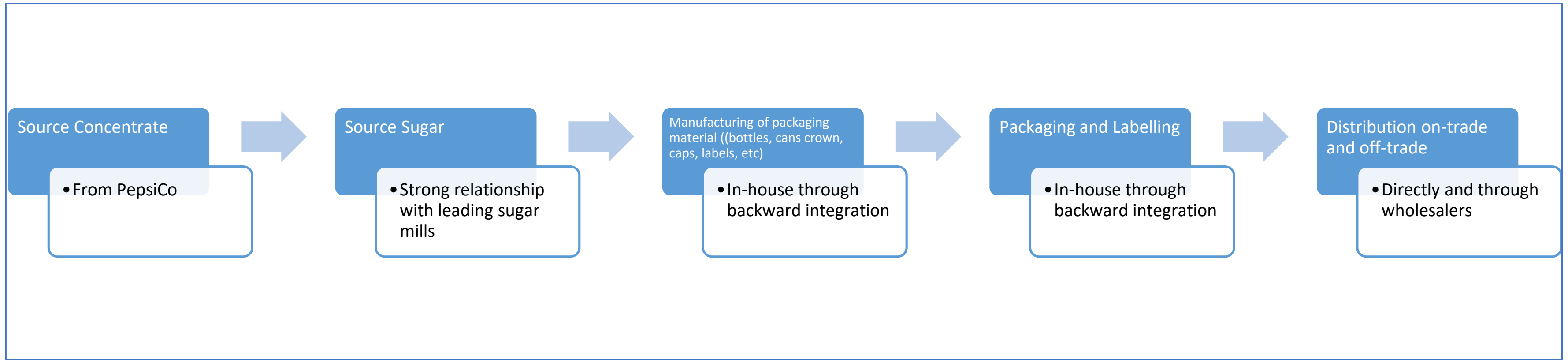
VBL has also made significant investments towards establishing a robust back-end infrastructure, be it manufacturing of preforms, crowns, caps, shrink-wrap films, corrugated boxes and plastic crates. This ensures that VBL's reliance on third party vendors is limited. It also helps the company harness operating leverage benefits, thereby lending fillip to margins.

End-to-end execution across value chain



Other than PepsiCo providing the concentrate, consumer marketing and brands to VBL, the latter charts its own success with complete control over the manufacturing and supply chain process, driving market share and cost efficiencies.

Process Flowchart



From pricing perspective, prices are decided taking into account the input cost prices and competitive scenario and changes in MRP are effected by VBL in its territories. This way, VBL's cost pressure and margin requirement are duly taken care of.

From 26% in 2011, VBL now controls ~90% of PepsiCo India's beverage business

VBL has achieved monopoly in India, in terms of selling PepsiCo's products, by consolidating its bottling operations with relentless acquisition of new territories in past few years. These were either franchised to other bottlers of PepsiCo or operated by PepsiCo directly. VBL has been strategically targeting territories that either have significant growth opportunities for PepsiCo products or are located contiguous or in close proximity to its existing licensed territories and sub-territories. This benefits VBL from operating and freight, transportation and distribution cost efficiencies perspective.

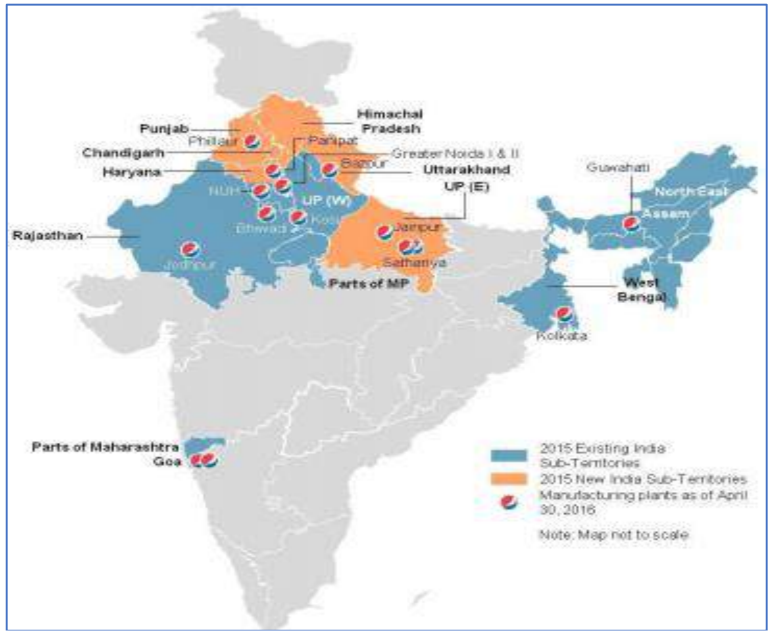
VBL's contribution to PepsiCo India's volume increased from 27% in CY11 to 45% in CY16 and gradually to 85%+ in CY19. PepsiCo as a direct bottler controls a mere 3% of the volumes that too in bulk water, while two other bottlers control 7% of the Geography (Andhra Pradesh and Jammu & Kashmir).

VBL's recent territory acquisitions in India

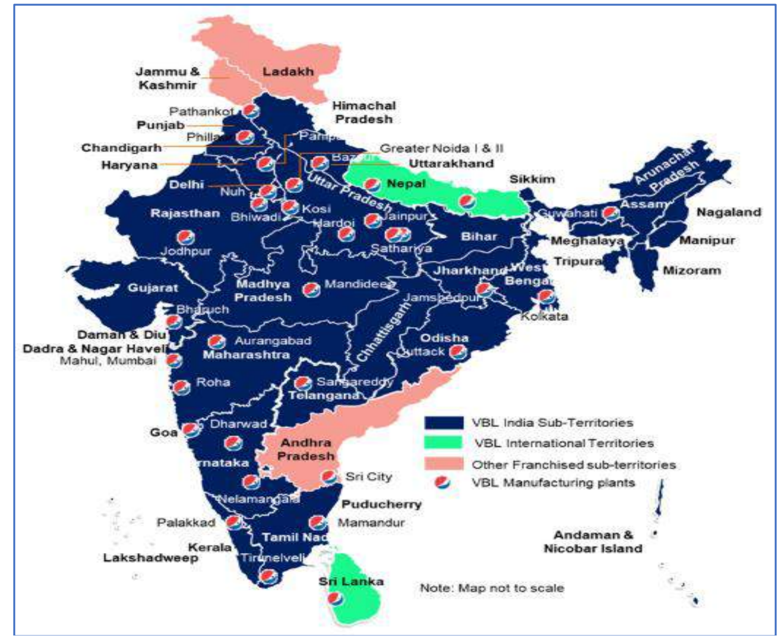
Year	Particulars
2013	Acquired the Delhi territory
2015	Territories in parts of Uttar Pradesh, Uttarakhand, Himachal Pradesh, parts of Haryana, Punjab and the Union Territory of Chandigarh
2017	Territories across the states of Madhya Pradesh (certain parts) and Odisha
2018	Territories in the state of Jharkhand (with production facilities), Chhattisgarh and Bihar

2019	Territories of parts of Maharashtra (14 districts), parts of Karnataka (13 districts) and parts of Madhya Pradesh (3 districts)
2019	Sub-territories across seven states – Gujarat, parts of Maharashtra, parts of Karnataka, Kerala, Tamil Nadu, Telangana and parts of Andhra Pradesh and five union territories of Daman & Diu, Dadra and Nagar Haveli, Puducherry (except Yanam), Andaman &Nicobar Islands and Lakshadweep

VBL in 2016



VBL in 2020



<u>With strong manufacturing network now in place, focus on distribution expansion to drive the growth</u>

The soft drinks distribution requires relatively complex distribution because of the nature of packaging, refrigeration requirements and limited shelf life. Bottling is the pivotal step between high volume beverage production and distribution in smaller units to consumers. Operations require investment in multiple plants close to consumption markets and also in delivery fleet and refrigeration.

With series of aggressive investments over past 5 years, VBL has doubled the number of production facilities (including inorganic), driving faster reach and reducing freight cost. It has franchisee rights in all Indian states (barring Andhra Pradesh and J&K). With 90% geography of the PepsiCo's India beverage already under VBL umbrella, the growth for VBL would be largely led by organic route in India, primarily through distribution expansion.

Focus on distribution expansion

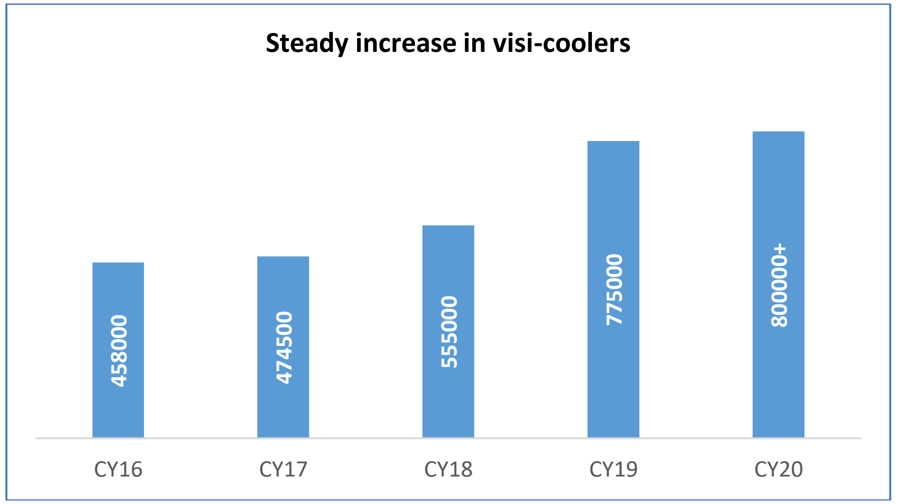
VBL currently reaches only ~1.8 mn outlets pan-India. HCCB, Coca-Cola's largest bottler, has a reach of ~2.6 mn outlets (serves 60% of Coca Cola's territories vs. 85% plus that VBL serves for PepsiCo), which is naturally an extension available for VBL. In addition, if we look at the total addressable market, India's population of retail outlets is 9-10 mn and major FMCG companies on average reach in excess of 5 mn outlets. This implies a penetration of less than 50%, enhancing growth visibility for many years ahead.

Cooler addition is the key…

The biggest lever for increasing distribution is addition of Visi Coolers. Refrigeration is a key element and coolers play an integral role in a brand's plans for success. Increasing cooler coverage and the number of cooler doors among retailers is important to ensure that a wide variety of products are properly displayed.

For outlets which don't have any Visi Coolers, given that the cost of the machine is borne by VBL (~Rs 20,000/Visi Cooler), it mainly boils down to infrastructure issues, which are improving driven by rising electrification across the country. Once a Visi Cooler is installed, the customer executive (from VBL) tries to get the Pepsi products placed prominently at the front. Addition of a Visi Cooler itself helps drive outlet volumes driven by prominent display and higher consumption due to chilling of products. Overall VBL plans to add ~80,000 retail outlets every year and install ~40,000 Visi Coolers, especially in semi-urban and rural regions.

A PepsiCo Visi Cooler



Continued distribution expansion

Particulars	CY15	CY16	CY17	CY18	CY19
Distribution Vehicles (nos.)	1731	2024	2100	2400	2500+
Depots owned (nos.)	63	71	72	80	90+
Primary Distributors (nos.)	822	1186	1100+	1100	1500+

(Source: Company, HDFC sec)

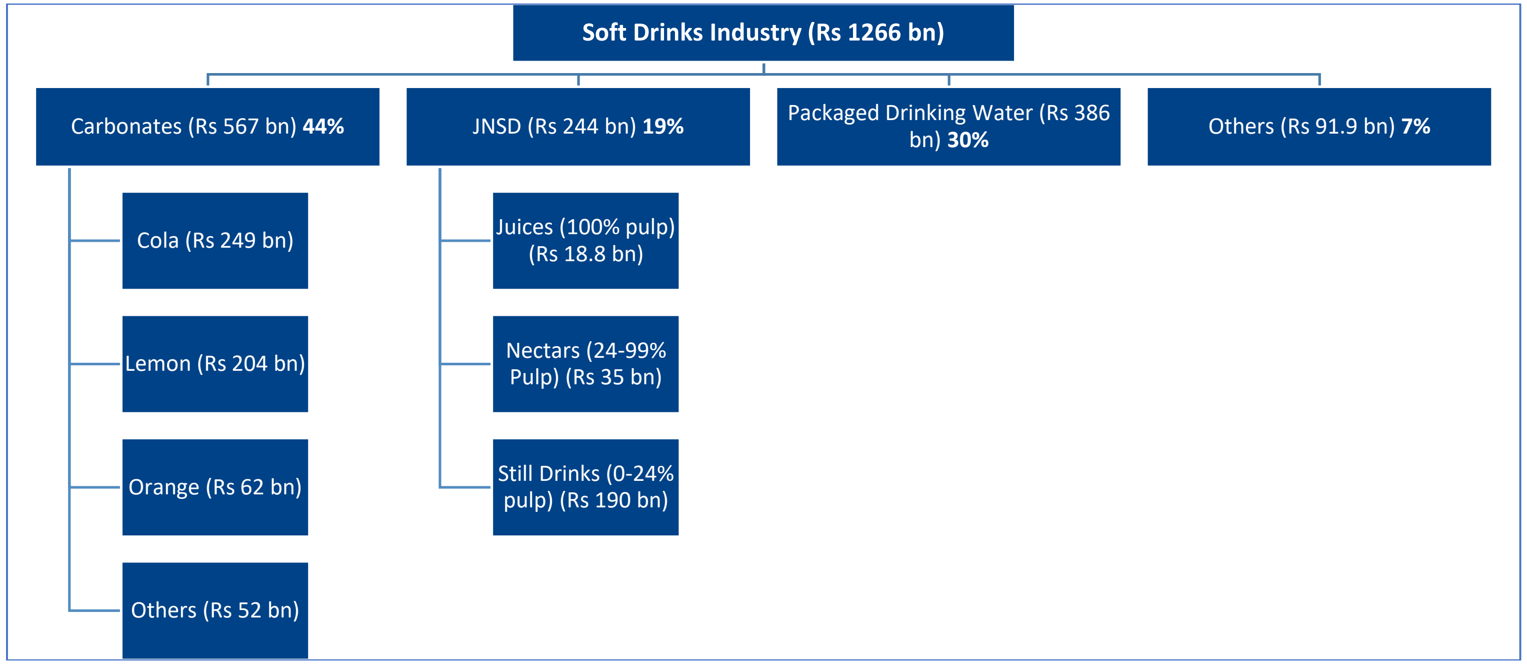
Newly acquired territories to drive the growth

The South and West territories were operated by PepsiCo before VBL acquired them in CY19. Distribution and volumes were downsized, before VBL took over. Also, PepsiCo's current market share in South & West is lower at 25%, whereas in North and East regions it has a market share of ~40%

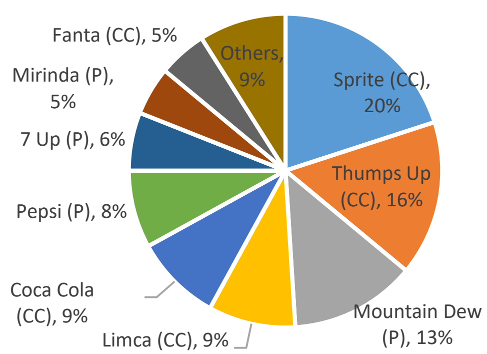
VBL has in its previous acquisitions of territories successfully managed to scale-up volumes and market share – seen in the case of territories acquired from SMV Beverages in CY18. According to management, the biggest improvement it needs to focus on is to increase the number of outlets in South and West, which were not being served during PepsiCo's time. The company is addressing this by adding more people, vehicles, distributors and Visi Coolers. According to VBL, it has not even reached 50-60% of the outlets and will take around two more years to reach full penetration. Also, since acquisition in May 2019, VBL has still not had the opportunity to drive sales as it has missed out on the peak season (Apr-Jun) in CY20 and CY21 due to Covid-19 pandemic.

Opportunities galore in a multi-billion Indian soft drinks industry

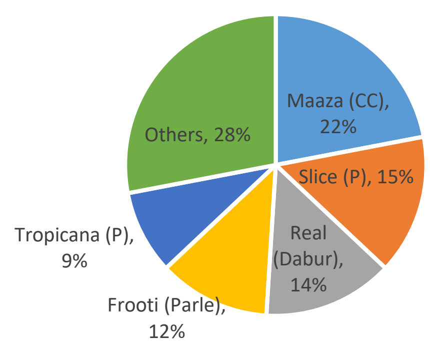
The Indian soft drink industry is pegged at 33,559 mn liters in volume terms and Rs 1,283 bn in value terms. Majority of volume share is contributed by packaged drinking water (PDW) at 48%, followed by bulk/HOD water at 23% and Carbonated Soft Drink (CSD) at 19%. However, in value terms, the sector is majorly dominated by CSDs, which contribute 44% (Rs 567 bn), followed by PDW at 30% (Rs 385 bn). JNSD category which includes juices, nectar, still drinks, contributes 19% (Rs 244bn) to the soft drinks industry. Other forms contributing the remainder ~7% include bulk water, energy drinks, sports drinks, flavoured water etc.



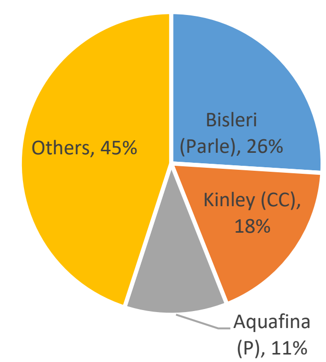
Coca Cola is the market leader in carbonates..



..while PepsiCo leads the JNSD category



PepsiCo is 3rd largest player in PDW



(Note: P – Owned by PepsiCo, CC – Owned by Coca Cola)

(Source: Industry, HDFC sec)

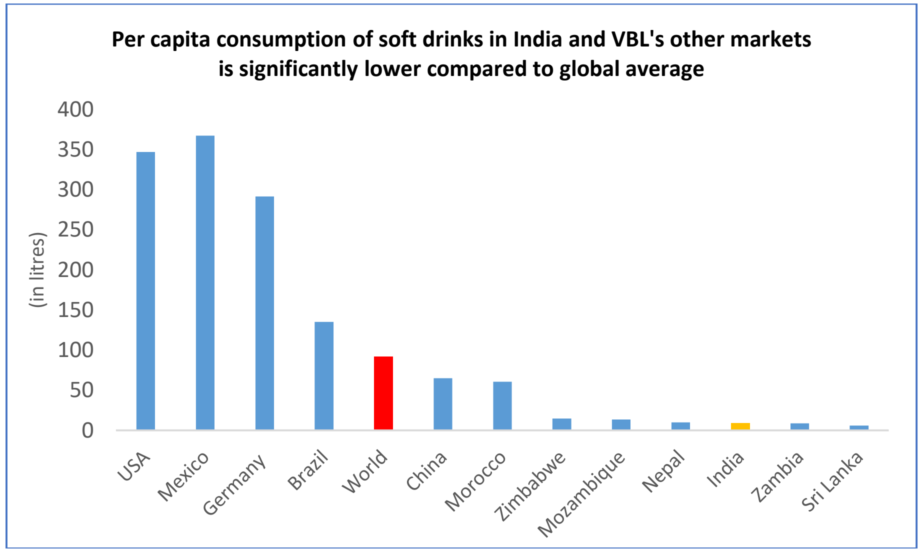
PepsiCo *vs* Coca Cola (in India)

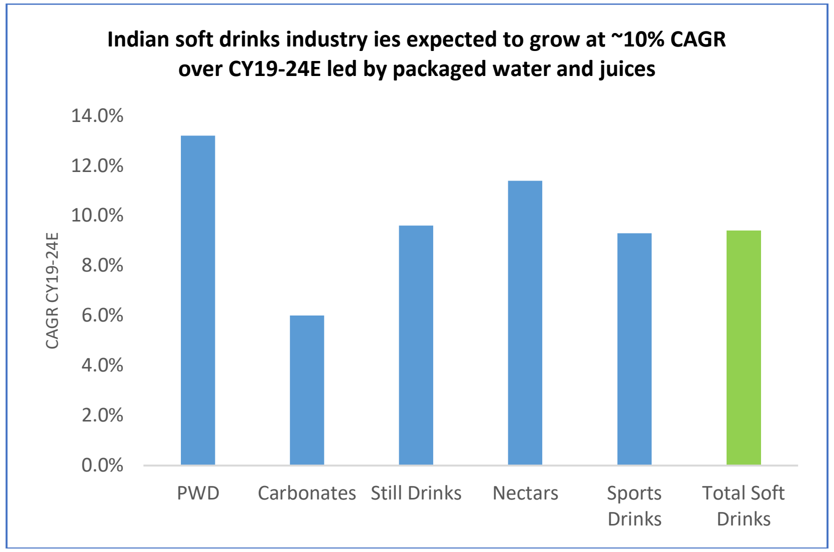
Parameter	PepsiCo	Coca Cola
Market Share in Indian Soft Drinks Industry	~36% in CY19 (vs ~32% in CY12)	~56% in CY19 (vs ~61% in CY12)
Manufacturing Facilities (in nos.)	~37 (31 – VBL)	57
No. of Depots	90+	~120
Distribution network (no. of outlets)	~2 mn (1.76 mn - VBL)	~2.6 mn
Restaurant Tie ups	KFC, Pizza Hut, Domino's, Burger King, Wimpy and Subway	McDonald's
Brands		
CSD (Cola)	Pepsi	Coca Cola, Thums Up
CSD (Lemon)	Mountain Dew	Sprite
CSD (Orange)	Mirinda	Fanta
Fruit Drinks (Mango)	Slice	Maaza
Fruit Juices	Tropicana	Minute Maid
Packaged Water	Aquafina	Kinley
Sports Drink	Gatorade	Powerade

(Source: Industry, HDFC sec)

PepsiCo India has marginally gained market share, while Coca Cola has lost some over last decade. Going ahead, with recent acquisition of territories by VBL (leading to 90% India coverage), high potential launches coupled with VBL's superior execution capabilities, we expect PepsiCo India to gradually gain market share.

Consumption of soft drinks in India is much lower than that in developed nations (at 44 bottles per capita in India v/s 1,496 bottles per capita in the US) due to lower per capita income/low household electrification. However, this is expected to change with increasing disposable income and growing electrification in the country on the back of several government initiatives.





(Source: Industry, HDFC sec)

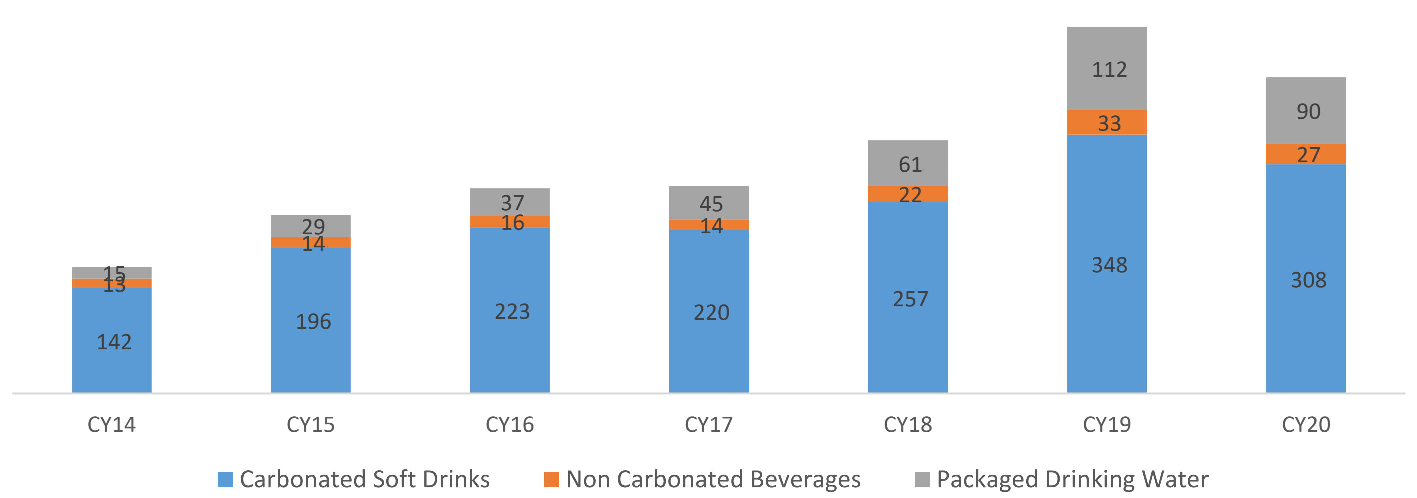
Structural shift in soft drinks industry with increasing salience of NCBs

The trend over the last decade has been to increase portfolio and reduce share of carbonated drinks. As a result, portfolio of all major beverage companies has seen a sizeable expansion over the past decade. The NCB segment is expected to be the biggest beneficiary of the changing preference towards healthy habits. Increased awareness among the populace with respect to the dangers of high consumption of sugary drinks (CSDs) has led to a slight shift toward NCBs. Thus, the category is expected to witness a stronger growth vis-à-vis CSDs.

VBL with its all-round portfolio is well placed to ride the tide

VBL has a strong presence across all the key segments of the soft drinks industry, with salience towards carbonated soft drinks (CSD). The non CSDs include juices, nectars and still drinks (JNSD) and packaged drinking water.

Constant increase in volumes (ex-CY20) with increasing contribution from Packaged Drinking Water



(Source: Company, HDFC sec)

Carbonated Soft Drinks to lose the fizz?

As per the Global Data report, the CSD market (~Rs 567 bn) in India is anticipated to register a CAGR of 3%/6% in terms of volume/ value over CY19-24E.The volume contribution from this segment for VBL has been coming down over the years, from ~83% in CY12 to ~72% in CY19. This was led by faster growth in other segments as well as higher taxes and change in perception as them being non-healthy drinks. However, we believe VBL's volume in CSD segment would grow faster than industry, at ~7% CAGR over CY20-23E, led by gaining market share in recently acquired territories and pushing Low Unit Packs (LUPs) for higher penetration. Key CSD brands sold by PepsiCo include Pepsi, Mirinda, Mountain Dew, 7UP etc. The new variant – Mountain Dew – Ice’ (a lemon fruit juice-based drink) –launched to compete with Limca is performing well. The management aims to capture a major chunk of the 600m unit case market of lime drinks going forward.

Focus on NCBs to tap into changing consumer preferences…

JNSDs (~Rs 244 bn) is one of the fasting growing segments amongst soft drinks as per GlobalData report. It formed ~19% of the soft drinks segment and is expected to post ~10% CAGR over CY19-24E. The segment has been one of the biggest beneficiaries of changing consumer preferences towards soft drinks. Change in consumer preference, wide range of flavours and increasing accessibility would ensure robust growth for the segment in the foreseeable future.

VBL has acquired the distribution rights for the juices and nectars of PepsiCo in 2018. As a result, there is ample scope for the juices and nectars to grow through VBL's wide distribution network of CSDs, which are still untapped. Key brands for VBL in the segment are Tropicana and Slice.

Higher investments by VBL – In order to capture the bigger piece of fast growing JNSD market, VBL invested ~Rs 550 Cr to setup an in-house facility in Pathankot, Punjab. It has started manufacturing of the juices through this plant recently. This fully backward integrated manufacturing facility has the scope for margin improvement for VBL.

The company’s future strategy for NCB includes: 1) enhancing market penetration and availability through a widespread distribution network (currently only ~50k vs ~1.75mn overall); 2) developing brand preferences via sampling and visibility programmes; and 3) launching new and novel flavours introduced by PepsiCo. The per unit realization and margins are highest in the juices segment compared to blended realizations for VBL. The segment formed ~6% of the total volumes in CY19 for VBL. The volume CAGR in the segment was a robust 16% over CY12-19, while we expect it to post 19% CAGR over CY20-23E. Increasing salience of JNSD will also help VBL counter cyclicality issue of CSDs

Un*tap*ped growth potential in Packaged Drinking Water

With growing health concerns, Packaged Drinking Water (PDW) has been the fastest growing category over the past few years and increasing trust on PDW. PDW market (~Rs 386 bn) is expected to register CAGR of 13% over CY19-24E as per GlobalData report. VBL's volume in the segment has registered a CAGR of ~36% over CY12-19 and forms ~22% of the total volumes, as of CY19. The high growth in the segment was also a result of entry in new geography like Morocco and Sri Lanka, besides robust industry growth. Key brand for VBL in the segment is Aquafina. We believe it would grow in high-teens over CY20-23E. Though, the gross margins here are less, the contribution margins are fairly similar with no concentrate cost.

Venturing into new categories – Milk-based and Energy drinks

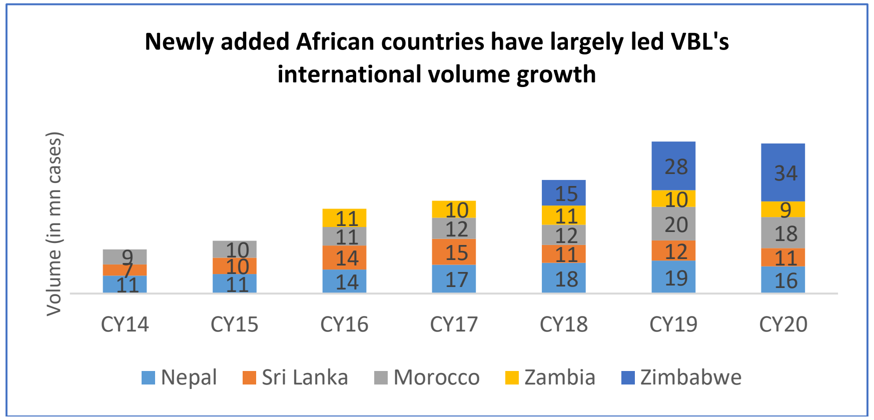
To further diversify its product portfolio, VBL ventured into a new product category – dairy-based drinks. In 2018, it took up the rights for Quaker Oats Milk from PepsiCo. However, it was discontinued later. VBL also has another dairy brand via 'Creambell' (a brand licensed from Devyani Foods). According to the current arrangement, VBL pays Rs 1.2mn annually to Creambell as fees, irrespective of the volumes sold. Also, VBL is paying ~1% of its net sales in this product to PepsiCo for using the same infrastructure for manufacturing and distribution. With increased awareness and shift toward healthy consumption habits, flavored milk and other non-carbonated milk related energy drinks are gradually gaining traction. Management expects this category to contribute meaningfully to sales over the next decade.

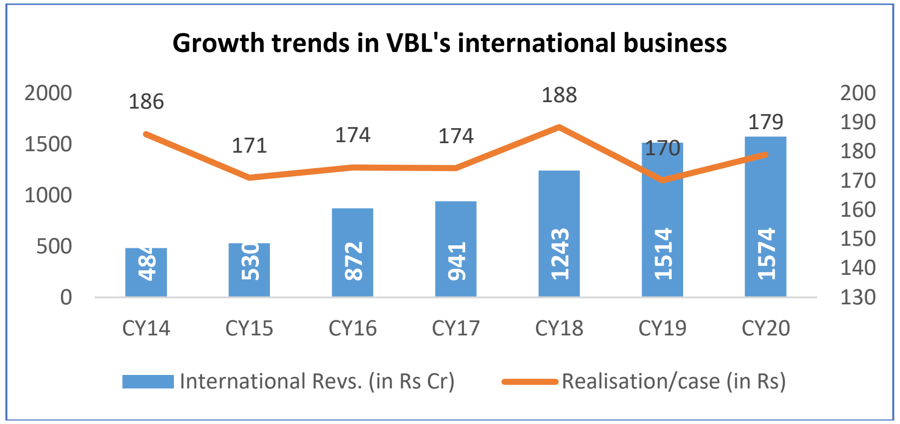
In the energy drinks category, VBL in late CY17 launched 'Sting', which is seeing a strong growth. Sting is priced very aggressively, compared to competition such as Red Bull and Monster, with PET offering at a steep discount to these competitors. The brand has seen strong acceleration in the last two years and accounts for 5-7% of India volumes. Despite pandemic disruptions, the brand grew 2.5x in CY20 and in Q1CY21 it has already surpassed CY20 volumes and we expect this momentum to sustain in the medium term.

<u>High growth potential in International markets</u>

Besides India, VBL has franchise rights in five more countries– Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe - for distribution of Pepsico's products. VBL's strategic foray in these territories is driven by under-penetration of soft drinks in the region and visibility of double digit growth. Of the total volume for VBL in CY19, International and India volume contribution stood at 18% and 82% respectively. The management has guided that India volumes would continue to be a major contributor and will be maintained at ~80% of the overall volumes. Globally, PepsiCo has been consolidating its bottlers and given VBL's prowess/execution capabilities to drive growth, PepsiCo might consider VBL for its bottling operations in other geographies as well.

Additionally, the peak season in most overseas market is Q3 & Q4, as compared to India (~45% in Q2). This helps counter the cyclicality in domestic markets. Compared to India, VBL expects the organic growth to remain higher in the international markets but expects volume growth to be high single digit in CY20-23E. While most International markets offer stable environment, Zimbabwe, the largest international market for VBL is witnessing hyper-inflation and political instability. This leads to critical currency risk.





	India	Nepal	Sri Lanka	Morocco	Zambia	Zimbabwe
Entered in year	**1991**	**1997**	**2010**	**2011**	**2016**	**2018**
Brand presence						
Pepsi	✓	✓	✓	✓	✓	✓
Mirinda	✓	✓	✓	✓	✓	✓
7 Up	✓	✓	✓	✓	✓	✓
Mountain Dew	✓	✓	✓	✓	✓	✓
Slice	✓	✓				
Tropicana	✓					
Aquafina	✓	✓	✓	✓	✓	✓
Sting	✓		✓			✓

(Source: Company, HDFC sec)

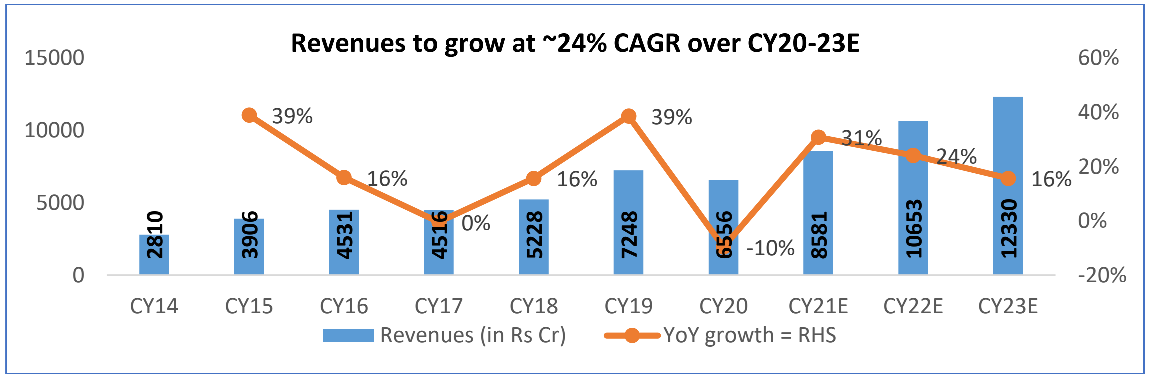
Financial Triggers

NCBs, consolidation of new territories to drive the topline growth

VBL has delivered a healthy revenue CAGR of ~22% over CY12-19 with 21% CAGR domestic revenue growth aided by 20% volume CAGR due to contribution from acquisition of territories, new launches and organic growth. Over the same time, realization growth was a muted 1.3% on account of sustained rate of increase in taxes in last few years and increase in contribution of lower realization water segment. The international business contributed ~21% to the consolidated revenue in CY19 and has witnessed strong growth of 23% CAGR over

CY12-19 on a low base, entry in newer international markets and new launches like water in Morocco. Despite poor macros and regional problems VBL's volume growth has been steady with market share gains.

In CY20 it reported a de-growth of 9.5%, with outbreak of Covid-19 and subsequent lockdown leading to curtailed discretionary spends Going ahead, we expect, VBL to deliver revenue CAGR of 24.1% over CY20-23E, mainly due to (a) sharp increase in volumes post consolidation of newly acquired territories, (b) market share gain in new territories, re-organisation of dealer network and improvement in retail touch points, (c) improving product mix, with shift toward higher margin products like NCBs, (d) robust volume growth on increase in consumption and (e) increasing revenue share from international operations.



(Source: Company, HDFC sec)

With higher cost efficiencies, expect EBITDA margins to expand ~340 bps over CY20-23E

On the gross margin front;

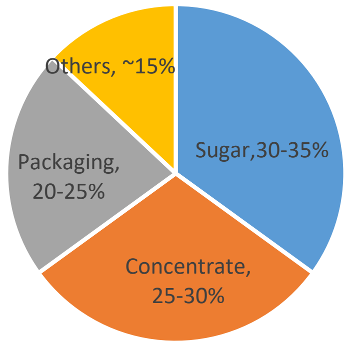
VBL's gross margins have improved ~1400 bps over CY12-20 to 57.1% in CY20 on account of 1) larger scale of operations leading to higher economies of scale with improving sourcing capabilities 2) multiple initiatives in reducing the COGS and effective management of expenses and, c) backward integration for manufacturing of PET chips. Key raw materials for VBL include concentrate, sugar and PET, which together form ~80% of RM cost;

Concentrate – Flavoured concentrate is used in manufacturing CSDs and juices, where it is mixed with sugar and treated water. VBL pays 8% of sales as concentrate cost to PepsiCo. PepsiCo's concentrate plant in Patiala, Punjab, caters to concentrate requirements in India, Sri Lanka and Nepal. For VBL's African markets, concentrate is imported from Pepsico's facilities in Ireland.

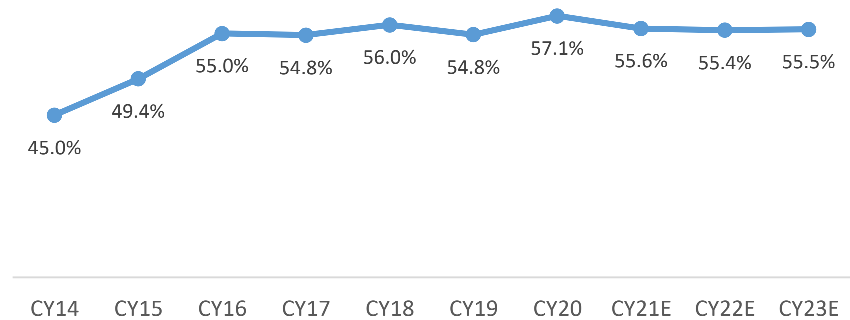
Packaging - PET is a dominant packaging material in the soft drinks space, with ~85% of products sold in PET bottles, ~12% in glass and aluminum cans and tetra packs making up ~2-3%. VBL has made significant investments in establishing a robust back-end infrastructure, be it manufacturing of preforms, crowns, caps, shrink-wrap films, corrugated boxes and plastic crates. This ensures limited reliance on third-party vendors. It also helps the company harness operating leverage benefits, thereby boosting margins. Furthermore, VBL is setting up a new plant in Kutwa (close to the Pathankot facility) to manufacture PET bottles and closures. The new capacity is expected to be operational by Mar'22. PET being a derivative of crude oil, the prices are largely driven by the same. It is also undertaking measures to light weight PET preforms which will help to further reduce the cost.

Sugar – Sugar is sourced from mills in Maharashtra and Uttar Pradesh. In recent times Sugar prices have witnessed inflationary headwinds. However, with increased operations, VBL is likely to have superior bargaining power with suppliers.

Concentrate, Sugar and packaging account for ~85% of VBL's raw materials



Improving product mix and cost efficiencies to aiding gross margin expansion



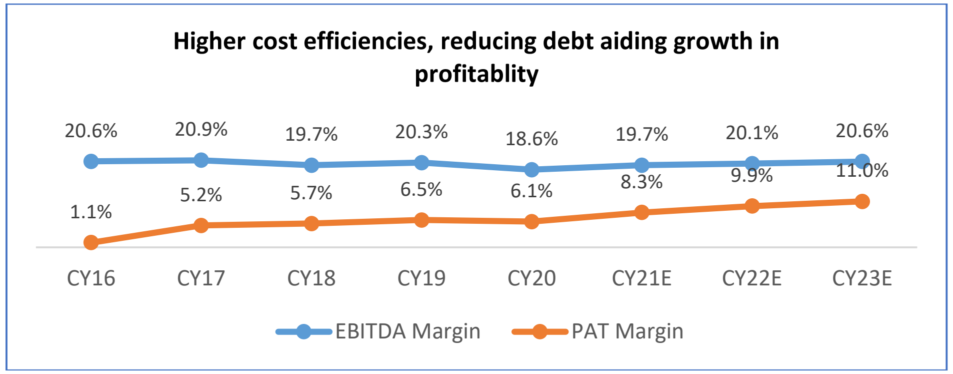
(Source: Company, HDFC sec)

Economies of scale to drive operating efficiencies

The significant gross margin expansion led to 760 bps EBITDA margin expansion over CY12-19. Additionally, synergy benefits of economies of scale (optimization of freight, transportation and distribution costs over larger territory base and various other costs) aided the margin expansion. However, the India margins declined ~500bps over CY17-20, led by consolidation of low-margin territories and Covid-19. Going ahead, we expect the company to regain the lost India margins with a leaner cost structure and operating leverage with increased scale of operation (VBL captures ~85% of total sales volume of PepsiCo India vs. 45% in CY15).

PAT likely to grow at 51% CAGR over CY20-23E

VBL has delivered 36% PAT CAGR over the last 10 years. This strong growth trajectory is likely to continue due to improved volumes and operating leverage. We expect it to deliver 51% PAT CAGR over CY20-23E on the back of increasing operating profit and lower interest cost. In H1CY21, the company repaid ~Rs 466 Cr debt leading to 37% reduction in interest cost.



(Source: Company, HDFC sec)

<u>Strong cash generation to strengthen the balance sheet</u>

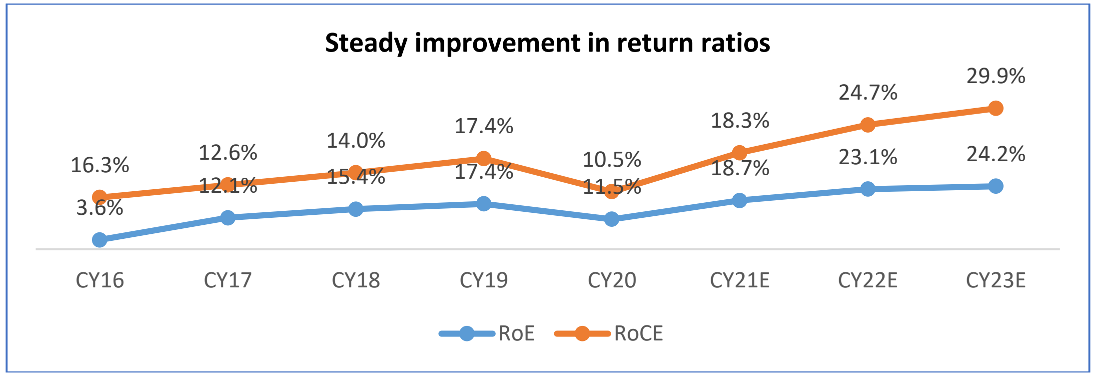
VBL's net debt had ballooned to ~Rs. 3,500 Cr by Jun-19, largely due to big acquisitions of PepsiCo's South & West India territories. In September 2019, VBL raised Rs 900 Cr through qualified institutional placement route (QIP) @ Rs.612/share, diluting ~5% equity and this was utilised for repayment. Over past 2 years, it has repaid ~Rs 2200 Cr debt, following a disciplined approach and despite pandemic.

VBL's FCF over past few years has been negative, as large part of its cash flows was diverted to organic and inorganic expansion in India and overseas. Going forward, with no major acquisitions lined up (with ~60% utilisation levels domestically we don't foresee any major capex over next 2-2.5 years) with VBL now controlling ~90% of PepsiCo's India beverage business, we expect strong FCF generation. It will also be supported by superior operating cashflows (OCF) on account of improving profitability. We expect the company to generate ~Rs 5,500 Cr of OCF, most of which will flow to FCF with reduced capex needs. The management has given an organic capex guidance of 1x depreciation.

The company has repaid ~Rs 466 Cr debt in H1CY21 and we expect this trend to continue going forward. Further, the size of acquisitions in future, if any, is expected to be nowhere close to earlier ones and this can be easily funded via internal cash flows.

<u>Steady improvement in return ratios</u>

VBL has considerably improved its return ratios over the past decade (RoCE of 18% in CY19 vs. 5% in CY13). Going ahead, we expect a steady improvement with reduced capex intensity and focus on debt reduction, better margins and improved asset turnover.



(Source: Company, HDFC sec)

Key Risks

Agreement with PepsiCo - VBL carries risk of cancellation or non-renewal of franchisee agreement from PepsiCo. VBL's relationship with PepsiCo is governed by agreements for different geographies. VBL's agreements with PepsiCo India are valid for till May 2039 and parties can renew their respective agreements for successive terms of five years each. PepsiCo, however, is entitled to unilaterally terminate these by giving written notice of 12 months. Also, there is a call option in place for PepsiCo to purchase the assets of VBL at an agreed price plus or minus 30%, depending on the reason of termination.

Seasonality: Sales of PepsiCo beverages are significantly higher in summer months of April to June (~45%) due to heat and warm weather and considerably lower during winter months of December to February. Bad weather conditions, including disturbed summers or untimely rains during peak sales season of summer, may adversely affect its sales.

Failure to ramp-up the recently acquired territories - Post series of acquisitions in the last few years, VBL has emerged as the largest partner of PepsiCo in India. Inability to integrate the operations or leverage potential operating and cost efficiencies from the newly acquired territories and sub-territories may adversely affect VBL's business and future financial performance.

Consumer preference risk - Failure to adapt to changing consumer health trends and address concerns about the health effects of soft drink consumption may adversely affect the demand. However, VBL works closely with PepsiCo and latter's new product plan lays more emphasis on healthy products with zero/limited calorie content and sugar content, in line with changing consumer needs.

Foreign Currency Risk: The functional currency of the Holding Company is Indian Rupees. Most of the transactions of the Holding Company and other entities/companies are carried out in the respective local currency. Exposures to currency exchange rates mainly arise from the overseas operations and external commercial borrowings etc., which are primarily denominated in their respective local currency

Susceptibility to changes in regulations - The domestic beverage industry remains susceptible to regulatory changes regarding the content in soft drinks and increasing environmental concerns over ground water depletion and discharge of effluents by bottling plants in India. Evolving issues related to disposal of plastic may also impact the industry.

Company Background

Varun Beverages Limited (VBL) is part of the RJ Corp group, a diversified business conglomerate with interests in beverages, quick-service restaurants, dairy and healthcare. The group has authorized franchisees of KFC, Costa Coffee and Pizza Hut and owns the ice-cream brand Creambell and the South Indian restaurant chain Vaango. VBL is a key player in beverage industry and one of the largest franchisee of PepsiCo in the world (outside USA). The Company produces and distributes a wide range of carbonated soft drinks (CSDs), as well as a large selection of non-carbonated beverages (NCBs), including packaged drinking water sold under trademarks owned by PepsiCo. PepsiCo CSD brands produced and sold by VBL include Pepsi, Diet Pepsi, Seven-Up, Mirinda Orange, Mirinda Lemon, Mountain Dew, Mountain Dew Ice, Seven-Up Nimbooz Masala Soda, Evervess, Sting, Gatorade and Slice Fizzy Drinks. PepsiCo NCB brands produced and sold by the company include Tropicana Slice, Tropicana Juices (100%, Delight, Essentials), Nimbooz, as well as packaged drinking water under the brand Aquafina.

VBL has been associated with PepsiCo since the 1990s and has over three decades consolidated its business association with PepsiCo, increasing the number of licensed territories and sub-territories covered by the company, producing and distributing a wider range of PepsiCo beverages, introducing various SKUs in the portfolio and expanding the distribution network. As on date, VBL has been granted franchises for various PepsiCo products across 27 States and 7 Union Territories in India. VBL has 31 manufacturing plants in India and 6 manufacturing plants in international geographies (two in Nepal and one each in Sri Lanka, Morocco, Zambia and Zimbabwe). VBL's share of PepsiCo beverages volume sales increased from ~ 26% in Fiscal 2011 to 85%+ now.

Subsidiaries of VBL

Particulars	Varun Beverages (Nepal) Private Ltd.	Varun Beverages Lanka (Private) Ltd.	Varun Beverages Morocco SA	Varun Beverages (Zambia) Ltd.	Varun Beverages (Zimbabwe) (Private) Ltd.
Country	Nepal	Sri Lanka	Morocco	Zambia	Zimbabwe
Holding	100%	100%	100%	90%	85%
Revenue (in Rs Cr)	391.3	167.9	328	153	723.5
PAT (in Rs Cr)	29.6	-2.7	-17	-41	172

Financials

Income Statement

(Rs cr)	CY19	CY20	CY21E	CY22E	CY23E
Net Revenues	**7130**	**6450**	**8581**	**10653**	**12330**
Growth (%)	*39.7*	*(9.5)*	*33.0*	*24.1*	*15.7*
Operating Expenses	5682	5248	6890	8512	9790
EBITDA	**1448**	**1202**	**1690**	**2141**	**2540**
Growth (%)	*43.8*	*(17.0)*	*40.7*	*26.7*	*18.6*
EBITDA Margin (%)	***20.3***	***18.6***	***19.7***	***20.1***	***20.6***
Depreciation	489	529	563	602	644
Other Income	43	37	94	85	74
EBIT	**1002**	**710**	**1222**	**1624**	**1970**
Interest expenses	310	281	190	134	67
PBT	**692**	**363**	**1032**	**1491**	**1903**
Tax	224	5	268	388	495
Adj. PAT	**465**	**396**	**716**	**1058**	**1358**
Growth (%)	*60.3*	*(14.9)*	*81.1*	*47.7*	*28.4*
EPS	16.1	13.7	16.5	24.4	31.4

Balance Sheet

As at March	CY19	CY20	CY21E	CY22E	CY23E
SOURCE OF FUNDS					
Share Capital	289	289	433	433	433
Reserves	3040	3235	3700	4606	5748
Shareholders' Funds	**3328**	**3524**	**4133**	**5039**	**6181**
Minority Interest	31	65	112	157	207
Total Debt	3410	3205	2475	1520	420
Net Deferred Taxes	283	226	226	226	226
Total Sources of Funds	**7052**	**7020**	**6946**	**6943**	**7034**
APPLICATION OF FUNDS					
Net Block & Goodwill	6479	6409	6441	6459	6495
CWIP	64	67	67	67	67
Investments	0	0	1	1	1
Other Non-Curr. Assets	174	183	233	281	335
Total Non Current Assets	**6717**	**6659**	**6742**	**6808**	**6898**
Inventories	882	929	1081	1255	1385
Debtors	173	242	259	292	338
Cash & Equivalents	171	190	51	72	192
Other Current Assets	447	439	565	698	820
Total Current Assets	**1672**	**1800**	**1956**	**2317**	**2734**
Creditors	478	511	596	766	907
Other Current Liab & Provisions	859	927	1156	1416	1691
Total Current Liabilities	**1337**	**1438**	**1752**	**2182**	**2598**
Net Current Assets	335	361	204	135	137
Total Application of Funds	**7052**	**7020**	**6946**	**6943**	**7034**

Cash Flow Statement

(Rs Cr)	CY19	CY20	CY21E	CY22E	CY23E
Reported PBT	691.9	362.5	1,032.0	1,490.6	1,902.8
Non-operating & EO items	35.1	45.1	-59.9	-42.8	-43.0
Interest Expenses	297.2	264.1	190.3	133.9	67.0
Depreciation	488.6	528.7	562.5	602.0	644.3
Working Capital Change	-85.1	-110.9	27.9	85.5	106.8
Tax Paid	-120.1	-77.5	-268.3	-387.6	-494.7
OPERATING CASH FLOW (a)	**1,307.6**	**1,012.0**	**1,484.6**	**1,881.6**	**2,183.1**
Capex	-733.1	-535.6	-595.0	-620.0	-680.0
Free Cash Flow	574.5	476.4	889.6	1,261.6	1,503.1
Others	-1,586.8	63.9	0.0	0.0	0.0
INVESTING CASH FLOW (b)	**-2,319.9**	**-471.7**	**-595.0**	**-620.0**	**-680.0**
Debt Issuance / (Repaid)	648.7	-213.1	-730.0	-955.0	-1,100.0
Interest Expenses	-303.5	-277.4	-190.3	-133.9	-67.0
Share Capital Issuance	900.2	0.0	0.0	0.0	0.0
Dividend	-69.0	-72.2	-108.3	-151.6	-216.5
FINANCING CASH FLOW (c)	**1,107.3**	**-573.7**	**-1,028.6**	**-1,240.4**	**-1,383.5**
NET CASH FLOW (a+b+c)	**95.0**	**-33.4**	**-139.0**	**21.2**	**119.6**
Opening balance of cash	**171.1**	**190.1**	**51.1**	**72.3**	**191.9**
Closing balance of cash	**266.1**	**156.6**	**-87.9**	**93.5**	**311.5**

One-year Share Price Chart

Key Ratios

Particulars	CY19	CY20	CY21E	CY22E	CY23E
Profitability Ratios (%)					
EBITDA Margin	20.3	18.6	19.7	20.1	20.6
EBIT Margin	14.0	11.0	14.2	15.2	16.0
APAT Margin	6.5	6.1	8.3	9.9	11.0
RoE	17.4	11.5	18.7	23.1	24.2
RoCE	17.4	10.5	18.3	24.7	29.9
Solvency Ratio (x)					
Net Debt/EBITDA	2.2	2.5	1.4	0.7	0.1
Net D/E	1.0	0.9	0.6	0.3	0.0
Per Share Data (in Rs)					
EPS	16.1	13.7	16.5	24.4	31.4
CEPS	33.0	32.0	29.5	38.3	46.2
BV	115.3	122.1	95.4	116.4	142.7
Dividend	2.5	2.5	2.5	3.5	5.0
Turnover Ratios (days)					
Debtor days	7.7	11.7	10.6	9.4	9.3
Inventory days	37.4	51.2	42.8	40.0	39.1
Creditors days	20.3	28.0	23.6	23.3	24.8
Valuation					
P/E	56.7	66.6	55.1	37.3	29.1
P/BV	7.9	7.5	9.6	7.8	6.4
EV/EBITDA	29.5	35.4	24.8	19.1	15.6
EV / Revenues	6.0	6.6	4.9	3.8	3.2
Dividend Yield (%)	0.3	0.3	0.3	0.4	0.5

HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

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