

06 October 2017

Retail

Company Update

Key Statistics

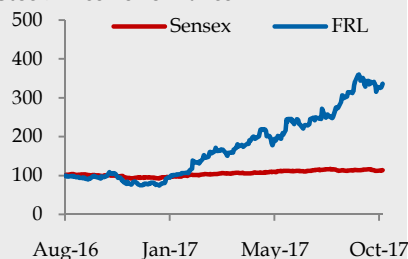
CMP (INR)	538
Upside/downside (%)	17.1
Market cap (INR/USD bn)	263.5/4.1
Shares outstanding (mn)	489.8
3 months avg volume	1.1
Dividend Yield (FY17, %)	-
52 Wk high/low	592/116
Sensex/Nifty	31,814/9,979
Bloomberg Code	FRETAIL IN

Performance (%)	1M	3M	12M
Absolute (%)	-6.7	25.4	245.8
Rel. to Sensex (%)	-7.1	26.9	232.7

Sh. Pattern, % (as on Jul-2017)

Promoter	47.7
FII	16.7
DII	4.8
Other	30.8
Total	100.0

Stock Price Performance*



* Rebased to 100 | Based on daily closing prices

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Balanced Deal; Healthy traction to continue

Future Retail Ltd. (FRL) announced acquisition of HyperCity Retail (India) Ltd. valuing the company at INR 9.1bn Enterprise Value (EV). The transaction will include combination of equity (INR 5bn), cash (INR 1.55bn) and debt (INR 2.56bn). The transaction is valued at 0.76 EV/Sales which is reasonable to our view at most of the global players are being valued at 0.8-1.5x EV/Sales TTM. HyperCity is loss making entity at EBITDA level however company had turned profitable at store level reporting INR 69mn store level EBITDA in Q1FY18. We expect HyperCity to turn positive on EBITDA in FY20E aided by high synergy between Big Bazaar and HyperCity thus curtailing the HO overheads and introduction of FBB and private labels in Food will help improving the gross margin profile of the company. We maintain our ACCUMULATE on the stock with a TP of INR 630/share and value the company at 22x FY20E EPS.

- ✓ **Deal with HyperCity, win-win situation for both players:** FRL announced acquisition of HyperCity (subsidiary of Shopper Stop Ltd.) valuing the company at EV of INR 9.1bn. HyperCity has 19 stores with total retail space of 1.34mn sqft. The transaction will include issuance of 9.3mn FRL shares at INR 537 which will be worth INR 5bn having lock-in period of 1 year, INR 1.55bn will be cash transaction and balance INR 2.56bn is the debt being transferred from HyperCity to FRL books. The transaction is valued at 0.76 EV/Sales which is reasonable to our view at most of the global players are being valued at 0.8-1.5x EV/Sales TTM. Around 65% of HyperCity business is Food portfolio while fashion is ~17%. We believe FRL focus will be to increase the Fashion portfolio through introduction of FBB's stores possibly in every HyperCity which augurs well for the company.
- ✓ **Acquisition to be earnings accretive in FY20 -** HyperCity is a loss making entity since inception however the loss has gradually come down. Q1FY18 company reported INR 62.3mn of EBITDA losses however at the store level company has turned profitable clocking INR 69mn in Q1FY18. We expect HyperCity to turn positive on EBITDA in FY20E aided by high synergy between Big Bazaar and HyperCity thus curtailing the HO overheads and introduction of FBB & private labels in Food will help improving the gross margin profile of the company.
- ✓ **Healthy traction continues; Retain ACCUMULATE with a TP of INR 630:** Given FRL's dominance in the retail space, coupled with the focus on the aggressive store expansion, we believe the company is well poised to report strong growth. To add to this, the asset light model will allow it to improve upon its earnings quality; we expect RoEs to be in excess of 28% and RoCEs in excess of 23% two years forward. At current levels, the stock trades at 26.7x/18.9x our FY19E/FY20E earnings estimates. This is at a significant discount to other players in the industry. We retain ACCUMULATE on FRL with revised TP of INR 630 based on a multiple of 22x FY20E EPS.

Year End (31 Mar)	FY16	FY17	FY18E	FY19E	FY20E
Revenues (INR mn)	68,450	170,751	206,498	267,076	324,308
Growth (%)	284.7	149.5	20.9	29.3	21.4
EBITDA (INR mn)	856	5,813	8,886	12,053	16,207
EBITDA Margin (%)	1.2	3.4	4.3	4.5	5.0
Adjusted PAT (INR mn)	146	3,683	6,940	10,112	14,256
Adjusted PAT Margin (%)	146	3,683	6,940	10,112	14,256
Adj. EPS (INR)	0.3	7.4	13.9	20.3	28.6
Growth (%)	1.8	16.6	23.9	26.9	28.6
ROE (%)	2.9	15.3	19.2	21.0	23.1
P/E (x)	1,852.4	73.2	38.8	26.7	18.9
P/BV (x)	14.4	10.6	8.3	6.3	4.7
EV/EBITDA (x)	319.4	47.1	30.4	22.5	16.4

Source: Company, YSL estimates; Note: Valuations as on 6th October 2017

We also had met with the management of FRL prior to the announcement of the transaction to gauge its performance and are enthused by strong traction seen by the company across all formats partially aided by GST which has made difficult for unorganized segment to work effectively. Festive season is also seeing healthy traction for the company. FRL is focusing a lot on improving assortment in Big Bazaar while also aggressively opening Easyday stores given the healthy traction in membership addition for the same. FRL will continue to focus on private labels and has set an aggressive target of these contributing to 70% of overall sales four years down the line from current levels of 30%. However, we don't foresee FRL's 70% revenue coming from private labels in next 4 years but are enthused by clear focus of the company on private labels which will be margin accretive.

- ✓ **Demon & GST a game changer:** Demon and GST has been a game changer for the modern trade industry given it has become more difficult for unorganized wholesalers to do business leading to market share gains for organized modern trade players. GST has also aided passage of goods becoming much faster leading to better efficiencies. In the long run the number of warehouses used can be curtailed down which will be margin accretive. SSG trend is phenomenal across format, festive season is shaping up quite well. The unorganized segment is not yet out of woods which will continue to help sustaining strong SSG going forward. We expect the sharp shift towards organized segment, which we have witnessed in last one year, to continue; we believe this shift will only quicken as organized players spread their wings and become more aggressive with their store expansions.
- ✓ **Expansion efforts on: FRL's** total store space stands at ~13.5 mnsqft (including Heritage stores) as of 30 June 2017 as compared to ~12.93 m sqft a year ago. Big Bazaar store count stood at 253 (231 year ago) while Easyday store count stood at 523 (331 a year ago). The latter includes Heritage stores (136 with 0.48 mnsqft of store space) as well. FBB store count stood at 54 stores (50 a year ago). Over the next 3 years, we expect the company to add 55 BB stores and as many as 225 Easyday store during this period, given the focus and aggression on the latter segment.

Other key takeaways of meeting

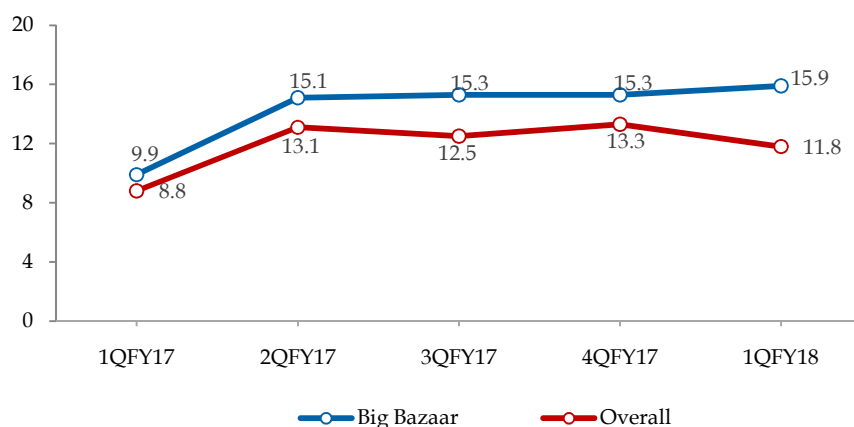
- ✓ Due to GST, passage of goods has become much faster leading to better efficiencies. In the long run, the number of warehouses used can be curtailed down due to higher efficiency. SSG trend is phenomenal across format, festive season is shaping up quite well. The unorganized segment is not yet out of woods which will continue to help organized players like FRL going forward.
- ✓ As per the company's management, once the per capita income of developed countries crossed the US\$ 2,000 mark, the following decade witnessed disproportionate growth in the retail segment. As per data, the retail industry on an average grew by 4-6x once this figure was crossed. The growth was led by food (growing 6-7x), general & home (growing 3-5x) and fashion (growing 2-3x). With India's current GDP per capita hovering at levels of US\$ ~1,725, the retail segment is at the cusp of achieving strong growth going forward.

- ✓ Company has been focusing a lot on assortments of products in the last 6-8 months which is also leading to healthy growth in Big Bazaar.
- ✓ Easy day is seeing healthy traction in membership (in which member has to pay upfront INR 1000 and can avail upto 10% discount of shopping amount upto INR 50,000). FRL already has a 0.3 million member base. The breakeven of Easyday stores is the fastest due to smaller formats and healthy traction seen in membership base. As per the company, an Easyday store requires approximately 500-700 member base to break even.
- ✓ Gross margin profile is 27-28% for Big Bazaar and FBB; 15% for Easy Day and 25% for Food Hall. Fashion has a gross margin of 40% while private brand in Big Bazaar has 5-7% better gross margins than other products.
- ✓ The average capex for a store is INR 3000-3500/sqft, the breakeven time for different format of the stores are 6-8 months Big Bazaar, 2-3 months Easyday and 8-10 months FBB.
- ✓ Fresh segment has 15% gross margin and has a wastage of 3-4%, while the business is not that appealing, it helps to bring in footfalls.
- ✓ Inventory days are highest in Big Bazaar of 110 days especially due to higher inventory days of non-food items. Easyday has 30-40 days of inventory as the share of food is quite high while FBB has 100-110 days of inventory.
- ✓ Ambition to achieve 7.5% EBIT margins in next 3 years (3.2% in FY17).
- ✓ There will be some equity component on any new acquisition as they don't want to leverage their balance sheet and wants to keep it clean.
- ✓ FRL has accumulated losses of INR 18 billion out of which has only used 3.5-4 billion; the company will pay full tax after utilization of these losses.

Key highlights

- ✓ **Strong SSG trend continues:** FRL's SSG trend continues to be firm with overall SSG at 11.8% in Q1FY18 while BB SSG stood at 15.9% YoY.

Exhibit 1: SSG run rate continues to remain firm



Source: Company, YSL

- ✓ **Store expansion aggression continues:** We expect FRL's store opening plans to be aggressive for next 3 years.

Exhibit 2: Current store count and expansion targets

Format	FY17	FY20E	3 years addition
BB	235	290	55
ED*	538	763	225
FBB	54	78	24

Source: Company, YSL; *includes Heritage's retail stores

Valuation:

Given FRL's dominance in the retail space, coupled with the focus on the aggressive store expansion, we believe the company is well poised to report strong growth. To add to this, the asset light model will allow it to considerably improve upon its earnings quality; we expect RoEs to be in excess of 28% and RoCEs in excess of 23% two years forward. While it may take a few quarters for the company to stabilize operations of its smaller stores (ED and Heritage), we expect the performance to improve substantially thereafter; especially considering that FRL is working on multiple factors to improve its financial metrics.

At current levels, the stock trades at 26.7x/18.9x our FY19E/FY20E earnings estimates. FRL's closest listed competitor is Avenue Supermart (ASL) is trading at ~65x/51x its FY19E/FY20E profits (Bloomberg estimates). While FRL has the ability to narrow the gap in financial performance as compared to that of ASL's, nonetheless, we believe the business does deserve a discount of ~63% to the multiple that ASL garners. We maintain our ACCUMULATE rating on FRL with the revised TP of INR 630 based on a multiple of 22x its FY20E EPS.

Risks:

- (i) Margin expansion/ execution does not go as planned: Apart from increasing the share of private labels, other factors such as better assortment mix coupled with lower rentals (as a result of increasing share of smaller stores) as well as better efficiencies arising out of improved efficiencies all need to play out for the company to improve upon its profitability. Failure to improve upon these, as well as execution related issues, may not result in margin expansion as estimated.
- (ii) Dilution risks: Any acquisition or major capex plans may require FRL to raise capital / dilute stake to fund the same.
- (iii) FCL's ability to create brands and demand: With FRL looking to increase the share of private labels – products from FCL's stable – a lot will depend on FCL's branding capabilities, product innovation, manufacturing capabilities and marketing & distribution efforts to drive growth and improve offtake from its stores. FCL's inability to deliver on these aspects will not allow for higher contribution from private labels and thus would defer the targeted profit margin goals.

INCOME STATEMENT

(INR Millions)

Year ending March	FY16	FY17	FY18E	FY19E	FY20E
Total operating revenues	68,450	170,751	206,498	267,076	324,308
Growth (%)	284.7	149.5	20.9	29.3	21.4
EBITDA	856	5,813	8,886	12,053	16,207
EBITDA margin (%)	1.2	3.4	4.3	4.5	5.0
Growth (%)	NM	579.5	52.9	35.6	34.5
Depreciation & amortisation	368	326	419	559	585
EBIT	488	5,487	8,467	11,495	15,622
EBIT margin (%)	0.7	3.2	4.1	4.3	4.8
Interest	498	2,042	1,826	1,732	1,766
Other income	155	238	300	350	400
Profit before tax	146	3,683	6,940	10,112	14,256
Tax	-	-	-	-	-
Adjusted net profit	146	3,683	6,940	10,112	14,256
Adjusted net margin (%)	0.2	2.2	3.4	3.8	4.4
Reported net profit	146	3,683	6,940	10,112	14,256
Reported net margin (%)	0.2	2.2	3.4	3.8	4.4
Adjusted EPS (INR)	0.3	7.4	13.9	20.3	28.6
Growth (%)	NM	2,431	88	46	41

BALANCE SHEET

(INR Millions)

Year ending March	FY16	FY17	FY18E	FY19E	FY20E
SOURCE OF FUNDS					
Share capital	87	944	980	998	998
Reserve & Surplus	17,799	24,593	31,533	41,646	55,902
Other equity	856	-	-	-	-
Total shareholder's funds	18,742	25,537	32,513	42,644	56,900
Optionally convertible debentures	1,542	1,654	1,654	1,654	1,654
Debt	9,682	10,784	12,000	13,560	12,560
Other long term liabilities/provisions	1,661	1,896	2,293	2,966	3,602
TOTAL	31,627	39,871	48,460	60,824	74,716
APPLICATION OF FUNDS					
Gross block	2,829	6,045	6,445	8,595	8,995
Less: Accumulated depreciation	220	507	926	1,485	2,069
Net block	2,609	5,538	5,519	7,110	6,926
Capital WIP	-	119	119	119	119
Investments	-	-	-	-	-
Other non-current assets	-	832	832	832	832
Total current assets	53,247	62,887	77,340	98,382	121,953
Inventories	32,972	37,352	43,704	55,976	66,639
Debtors	1,275	2,281	2,758	3,567	4,332
Cash & cash equivalents	914	1,560	6,098	6,790	12,066
Loans & advances	18,036	21,694	24,780	32,049	38,917
Other current assets	50	-	-	-	-
Total current liabilities	24,229	29,504	35,349	45,619	55,113
Net current assets	29,018	33,383	41,991	52,763	66,840
Total	31,627	39,871	48,460	60,824	74,716

CASH FLOW STATEMENT

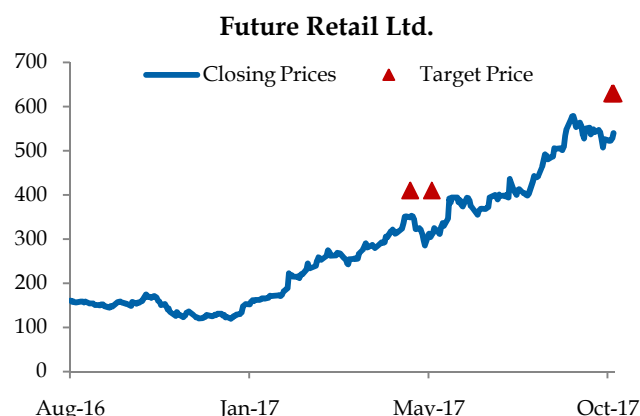
(INR Millions)

Year ending March	FY16	FY17	FY18E	FY19E	FY20E
Profit / (Loss) before tax	146	3,683	6,940	10,112	14,256
Depreciation & amortisation	368	326	419	559	585
Change in working cap Inc/dec	694	(10,046)	(12,559)	(21,462)	(24,371)
Others	1,413	8,008	10,412	13,435	17,572
Operating cash flow	2,620	1,970	5,212	2,645	8,042
Capex	(3,032)	(870)	(400)	(2,150)	(400)
Free cash flow (FCF)	(412)	1,100	4,812	495	7,642
Investments	-	-	-	-	-
Others	30	113	300	350	400
Cash flow from investing	(3,002)	(757)	(100)	(1,800)	-
Proceeds from issue of equity shares	1,881	64	36	19	-
Debt issue (net)	(1,497)	1,094	1,216	1,560	(1,000)
Dividend paid	-	-	-	-	-
Other financing cash flows	19,104	(2,042)	(1,826)	(1,732)	(1,766)
Cash flow from financing	19,489	(884)	(574)	(153)	(2,766)
NET CASH FLOWS	19,106	329	4,538	691	5,277
Opening cash	83	914	1,560	6,098	6,790
Closing cash	19,189	1,560	6,098	6,790	12,066

KEY RATIOS

Year ending March	FY16	FY17	FY18E	FY19E	FY20E
PROFITABILITY RATIOS					
EBITDA Margin (%)	1.2	3.4	4.3	4.5	5.0
Adjusted net margin (%)	0.2	2.2	3.4	3.8	4.4
Return on capital employed (%)	2.9	15.3	19.2	21.0	23.1
Return on equity (%)	1.8	16.6	23.9	26.9	28.6
EFFICIENCY RATIOS					
Asset Turnover	2.3	2.7	2.7	2.8	2.8
Debt to equity	0.5	0.4	0.4	0.3	0.2
Net debt to equity	0.5	0.4	0.2	0.2	0.0
Interest coverage	1.0	2.7	4.6	6.6	8.8
Debtor days	7	5	5	5	5
Inventory days	238	106	103	102	100
Payable days	131	65	65	65	65
PER SHARE DATA					
Diluted EPS (Rs)	0.3	7.4	13.9	20.3	28.6
Book value per share (Rs)	37.6	51.2	65.1	85.4	114.0
DPS (Rs)	0	0	0	0	0
VALUATION RATIOS					
P/E	1,852.4	73.2	38.8	26.7	18.9
P/BV	14.4	10.6	8.3	6.3	4.7
EV/EBITDA	319.4	47.1	30.4	22.5	16.4
Dividend yield (%)	-	-	-	-	-

Recommendation History



Date	Rating	Target Price	Closing Price
08-May-17	ACCUMULATE	410	349
24-May-17	ACCUMULATE	410	309
06-Oct-17	ACCUMULATE	630	538

RATING RATIONALE

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REDUCE: expected point to point decline of 10% or more

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