

Operating leverage offsets gross margins pressure

About the stock Varun Beverages is one of the largest franchisees of PepsiCo in the world. The company produces & distributes carbonated drinks, juices & packaged drinking water in six countries including India. Some of the PepsiCo brands produced by VBL includes Pepsi, Diet Pepsi, Seven-Up, Mirinda, Mountain Dew, Nimbooz, String, Slice, Tropicana, Aquafina among others.

- The company has operations in India (except Andhra Pradesh, J&K & Ladakh), Sri-Lanka, Nepal, Morocco, Zambia & Zimbabwe

Q1CY22 Results: Varun Beverages reported robust volume growth of 18.7%.

- Sales were up 26.2% YoY led by strong recovery in volumes
- EBITDA was at ₹ 531 crore, up 39.1% YoY, with margins at 18.8%
- Consequent PAT grew 98.2% to ₹ 271.1 crore

What should investors do? Varun Beverage's share price has given 4.9x return (from ₹ 215 in April 2017 to ₹ 1059 in April 2022).

- We revise our CY23 earnings number upwards with robust volume growth, margin expansion through operating leverage & reduction in debt & interest
- We upgrade the stock from HOLD to **BUY** rating

Target Price and Valuation: We value the stock at ₹ 1300, valuing the business 24x CY23 EV / EBITDA

Key triggers for future price performance:

- With normalisation of mobility, strong summer season after acquisition of South & West territories is likely to drive robust volume growth
- The company has launched several new brands in last two years i.e. String, 'Mountain Dew ICE', Milk based beverages. New products are contributing ~10% to volumes and are likely to aid revenues, going forward
- Given the capex requirement equal to depreciation, VBL would be able to completely de-leverage its balance sheet in the next three to four years with strong free cash flow. The reduction in interest cost to boost profitability

Alternate Stock Idea: We like Tata Consumer Products in our FMCG coverage.

- Strong innovation & premiumisation strategy in salt, tea, Sampaan & Soulful in India market expected to drive sales and margins
- We value the stock at ₹ 910 on ascribing 55x FY24 earnings multiple

Key Financial Summary

	CY19	CY20	CY21	5 Year CAGR (CY16 - CY21)	CY22E	CY23E	CAGR (CY21-23E)
Net Sales	7129.6	6450.1	8823.2	18.0	10911.7	12172.5	17.5%
EBITDA	1447.7	1201.9	1654.6	15.8	2217.7	2481.9	22.5%
EBITDA Margin %	20.3	18.6	18.8		20.3	20.4	
Net Profit	472.2	362.1	746.1	73.1	1120.8	1312.6	32.6%
EPS (₹)	16.36	8.36	17.23	45.6	25.88	30.31	32.6%
P/E	64.7	126.7	61.5		40.9	34.9	
RoNW %	14.2	10.3	18.3		22.8	23.0	
RoCE (%)	15.5	10.9	17.1		25.6	29.7	

Source: Company, ICICI Direct Research



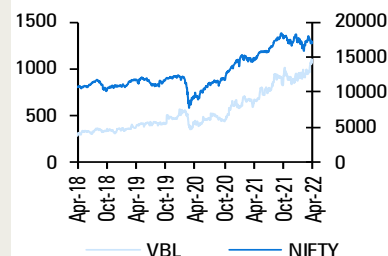
Particulars

Particulars (₹ crore)	Amount
Market Capitalization	45,860.3
Total Debt (CY21)	3,341.9
Cash & Investments (CY21)	336.0
EV	48,866.2
52 week H/L (₹)	1140 / 603
Equity capital	288.7
Face value	10.0

Shareholding pattern

(in %)	Jun-21	Sep-21	Dec-21	Mar-22
Promoter	65.8	64.9	64.9	64.9
IIL	20.7	21.7	21.2	21.0
DII	5.8	6.8	7.1	7.2
Others	7.7	6.6	6.8	6.9

Price Chart



Recent event & key risks

- VBL commissioned beverage plant in Bihar & new backward integrated unit in J&K during Q1CY22
- Key Risk:** (i) Any disruption due to Covid-19 waves (ii) Incessant increase in RM cost like PET & Sugar may impact gross margins adversely

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Key takeaways of recent quarter

Q1CY22 Results: Early summer & extreme heat driving volumes at stupendous pace

- Varun Beverage saw strong revenue growth of 26.2% to ₹ 2827.5 crore led by 18.7% volume growth & 6.3% realisation growth. The company clocked a volume of 180 million cases during the quarter, which includes 70% volumes from carbonated drinks (CSD), 7% from juices & 23% from water
- The growth was driven by strong demand conditions across geographies. Realisation increase came from price hikes in select SKUs (1-2%) in India, reduction in trade discounts (2-3%) and change in product mix (~2%). With increase in out of home activity, single pack & 'on-the-go' sales have grown significantly. Single pack commands relatively higher margins
- Gross margins contracted 427 bps during the quarter mainly on account of higher PET chip prices. Though the company has reduced the weight of PET bottles & procured high inventories of PET chip before the season, still incessant commodity inflation adversely impacted gross margins
- With the operating leverage benefits & cost cutting measures, VBL saved 511 bps in overhead spends & 91 bps in employee spends in Q4. This led to 39% jump in operating profit to ₹ 531 crore with 175 bps expansion in operating margins. Given, high growth in operating profit & 19% dip in interest cost, net profit grew by a stupendous 98.2% to ₹ 271.1 crore
- VBL commissioned new beverage manufacturing plant in Bihar and new backward integrated unit in J&K during Q1CY22. It also entered into an agreement to manufacture "Kurkure Puffcorn" for PepsiCo India & invested ₹23 crore towards manufacturing plant
- The company has written off (₹ 14.6 crore) plant & machinery (CSD glass & cane line) at Roha, Maharashtra & moved the packaged drinking water line to Paithan plant. The plant was running on sub-optimal capacity utilisation
- Energy drink 'Sting', milk based beverages & Tropicana juices are growing at rapid pace & manufacturing line are running at 100% utilisation. String now contributes 6-7% whereas Tropicana & Milk based beverages are contributing 2% & 0.5% to the volumes. Its Pathankot facility for Tropicana is running at full capacity and the company would set up a second Tropicana plant by next season
- Capacity utilisation levels were closer to 65% in the peak month of 'May' in pre-Covid summer (2019). However, it would be closer to full utilisation in May in the current season (2022). This depicts strong demand conditions for beverage category
- All international territories have witnessed high growth led by extreme heat, low base & enhanced reach. Sri-Lanka & Morocco saw 37% & 50% volume growth during the quarter
- Despite steep commodity inflation, the company has secured its supplies for PET chip for the season. Other key raw material like sugar prices are likely to remain benign. Considering, high operating leverage, the company would be able to clock operating margins in the range of 20-21%
- Net debt is at ₹ 3100 crore as on March 2022 while the capex would be equal to depreciation provisioning. The company would be utilising part of the cash flows for debt repayment & capex
- The Board has recommended a bonus issue of one equity share for every two equity shares held as on the record date

Exhibit 1: Peer Comparison

Sector / Company	CMP (₹)	TP (₹)	Rating	M Cap (₹ Cr)	Sales growth (%)			EBITDA Margins (%)			P/E(x)			RoE (%)			RoCE (%)		
					FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Nestle (NESIND)	18428	19050	Hold	175243	10.2	10.2	0.0	24.4	23.2	0.0	75.5	71.9	62.3	111.3	110.4	111.8	58.7	58.8	62.9
Tata Consumer (TATGLO)	812	910	Buy	70404	8.9	8.4	9.7	13.86	14.6	14.92	65.1	54.36	47.12	7.204	8.334	9.185	8.882	9.947	10.79
Varun Beverage (VARBEV)	1059	1300	Buy	45860	36.8	26.2	0.0	18.8	20.3	20.4	61.5	40.9	34.9	18.3	22.8	23.0	17.1	25.6	29.7
Zydus Wellness (ZYDWEL)	1682	2200	Buy	10819	10.4	9.6	10.5	18.2	19.5	20.1	33.1	27.2	23.3	6.9	8.3	9.4	6.7	8.0	9.1

Source: Company, ICICI Direct Research

Varun Beverages has been able to grow the volumes at a splendid pace after two years of disruption due to covid-19 during summers. The growth was aided by low base & early onset of summer season with extreme heat in North India. Further, the company has also got the benefit of acquired Southern & Western territories two years after acquisition. VBL was agile in procuring key raw material (PET chips) well in advance to safeguard from volatility in commodity prices. We believe higher volume growth would result in operating leverage benefits going forwards as well, which would help it sustain operating margins despite pressure on gross margins. We like the strategy of introducing new products (Sting, Milk based Beverages & Tropicana) to grow through volumes over the longer period. We maintain our positive stance on the stock. We upgrade the stock from HOLD to **BUY** rating with a revised target price of ₹ 1300 (earlier: ₹ 1050).

Exhibit 2: Variance Analysis

Particulars (₹ crore)	Q1CY22	Q1CY21	YoY (%)	Q4CY21	QoQ (%)	Comments
Net Sales	2,827.5	2,240.9	26.2	1,734.3	63.0	Net sales grew by 26.2% led by 18.7% volume growth & 6.3% realisation growth
Raw Material Expenses	1,370.2	990.2	38.4	773.8	77.1	Gross margin contracted by 427 bps on account of steep commodity inflation in PET chip prices. The company has procured Key raw material inventories before the season itself
Employee Expenses	275.1	238.4	15.4	259.8	5.9	
Other operating Expenses	651.2	630.7	3.3	493.1	32.1	The company was able to save overhead spends by 511 bps due to cost rationalisation measures & operating leverage
EBITDA	531.0	381.6	39.1	207.6	155.8	Operating profits jumped up 39.1%
EBITDA Margin (%)	18.8	17.0	175 bps	12.0	681 bps	With operating leverage & cost rationalisation measures, the company was able to expand margins by 175 despite contraction in gross margins
Depreciation	131.3	134.7	-2.5	129.3	1.6	
Interest	47.0	57.9	-19.0	37.3	25.9	Interest cost down by 19% due to considerable decline in debt in last one year
Other Income	8.5	5.7	48.5	0.9	896.3	
PBT	361.2	194.7	85.5	41.9	763.1	
Exceptional Items	0.0	0.0		0.0		
Tax Outgo	90.1	57.9	55.6	9.3	872.9	
PAT	271.1	136.8	98.2	32.6	731.8	Given, high operating profit growth & interest cost reduction, Net profit grew by 98.2%
Adj. PAT	271.1	136.8	98.2	32.6	731.8	

Source: Company, ICICI Direct Research

Exhibit 3: Change in estimates

(₹ Crore)	CY22E			CY23E			Comments
	Old	New	% Change	Old	New	% Change	
Net Sales	9,869.9	10,911.7	10.6	10,852.5	12,172.5	12.2	With the robust Q1 numbers & high demand for beverages in extreme summer, we have changed our volume estimates for CY22 & CY23
EBITDA	1,929.1	2,217.7	15.0	2,156.0	2,481.9	15.1	
EBITDA Margin(%)	19.5	20.3	78 bps	19.9	20.4	52 bps	The company procured PET chip prices last quarter itself to safeguard from volatility from raw material prices. This along with operating leverage, we are changing our earnings estimate numbers as well
PAT	886.5	1,120.8	26.4	1,093.3	1,312.6	20.1	With the expected reduction in debt levels, we upgrade our earnings estimates as well
EPS (₹)	20.5	25.9	26.4	25.2	30.3	20.1	

Source: ICICI Direct Research

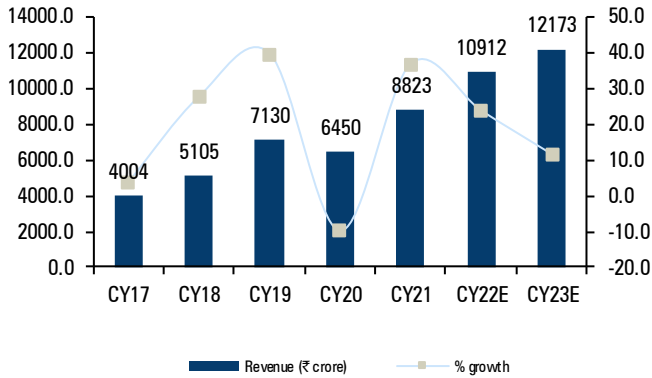
Exhibit 4: Assumptions

Particulars (in million cases)	Current						Earlier		Comments
	CY18	CY19	CY20	CY21	CY22	CY23	CY22	CY23	
Carbonated Products	257.0	347.0	309.0	399.8	479.8	523.5	439.8	470.6	We changed our volume estimates given strong demand conditions in summer season & low base of last year
Non Carbonated drinks	22.0	33.0	26.0	36.1	44.5	49.8	41.6	46.5	
Water	61.0	111.0	90.0	132.3	165.4	185.2	153.5	171.9	

Source: ICICI Direct Research

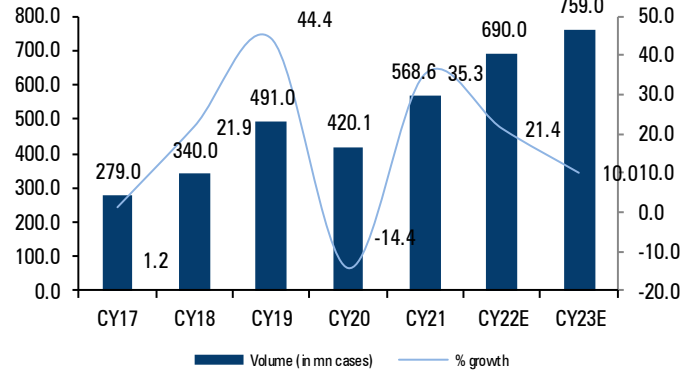
Key Metrics

Exhibit 5: Revenue growth trend (₹ crore)



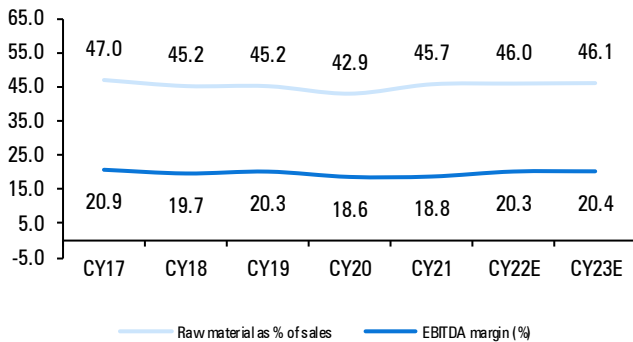
Source: Company, ICICI Direct Research

Exhibit 6: Volume recovery to drive growth



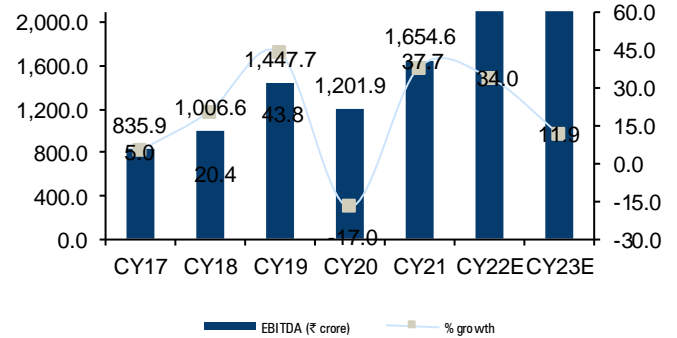
Source: Company, ICICI Direct Research

Exhibit 7: Raw material to sales & EBITDA margins (%)



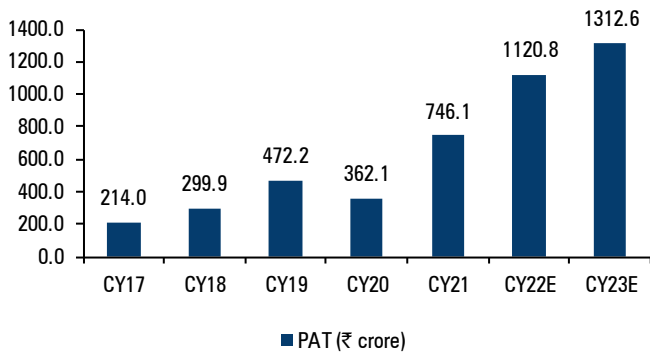
Source: Company, ICICI Direct Research

Exhibit 8: EBITDA (₹ crore) & EBITDA growth (%) trend



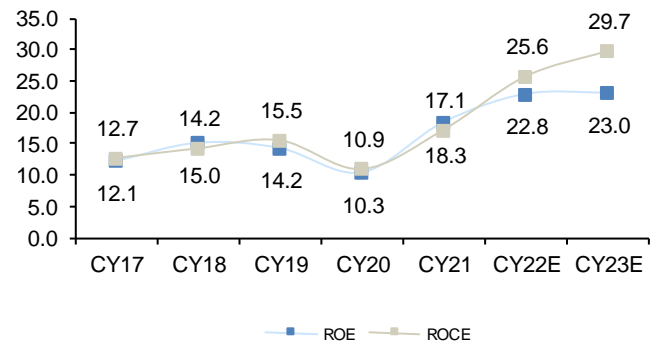
Source: Company, ICICI Direct Research

Exhibit 9: Earnings to grow on low base in CY21E (₹ crore)



Source: Company, ICICI Direct Research

Exhibit 10: Return ratio trend (%)



Source: Company, ICICI Direct Research

Exhibit 11: Valuation

	Sales (₹ cr)	Growth (%)	EPS (₹)	Growth (%)	PE (x)	EV/EBITDA (x)	RoNW (%)	RoCE (%)
CY20	6450.1	-9.5	8.4	-48.9	126.7	40.3	10.3	10.9
CY21	8823.2	36.8	17.2	106.1	61.5	29.1	18.3	17.1
CY22E	10911.7	23.7	25.9	50.2	40.9	21.2	22.8	25.6
CY23E	12172.5	11.6	30.3	17.1	34.9	18.6	23.0	29.7

Source: Company, ICICI Direct Research

Financial Summary

Exhibit 12: Profit and loss statement				
	₹ crore			
	CY20	CY21	CY22E	CY23E
Total operating income	6450.1	8823.2	10911.7	12172.5
Growth (%)	-9.5	36.8	23.7	11.6
Raw Material Expenses	2763.9	4034.7	5014.0	5610.4
Employee Expenses	889.7	1007.7	1200.3	1339.0
Marketing Expenses	0.0	0.0	167.0	186.2
Other expenses	1594.6	2126.2	2312.9	2555.1
Total Operating Expenditure	5248.3	7168.6	8694.1	9690.6
EBITDA	1,201.9	1,654.6	2,217.7	2,481.9
Growth (%)	-17.0	37.7	34.0	11.9
Depreciation	528.7	531.3	596.5	630.6
Interest	281.1	184.7	149.0	124.2
Other Income	37.0	67.9	42.5	46.7
PBT	429.0	1006.6	1514.6	1773.8
Total Tax	5.2	260.6	393.8	461.2
Minority interest	0.0	0.0	0.0	0.0
Profit from Associates	4.8	0.0	0.0	0.0
PAT	428.6	746.1	1,120.8	1,312.6
Growth (%)	-23.3	106.1	50.2	17.1
EPS (₹)	8.4	17.2	25.9	30.3

Source: Company, ICICI Direct Research

Exhibit 13: Cash flow statement				
	₹ crore			
(Year-end March)	CY20	CY21	CY22E	CY23E
Profit After Tax	599.6	968.9	1,269.8	1,436.8
Add: Depreciation	523.2	531.3	596.5	630.6
(Inc)/dec in Current Assets	-98.6	-596.8	244.3	-226.9
Inc/(dec) in CL and Provisions	-12.3	328.1	-240.7	252.2
CF from operating activities	1,012.0	1,231.4	1,870.0	2,092.6
(Inc)/dec in Investments	107.4	0.0	0.0	0.0
(Inc)/dec in LT loans & advances	0.0	0.0	0.0	0.0
(Inc)/dec in Fixed Assets	-535.6	-815.4	-186.7	-579.3
Others	8.7	-87.7	0.0	0.0
CF from investing activities	-471.1	-1,010.6	-186.7	-579.3
Issue/(Buy back) of Equity	0.0	0.0	0.0	0.0
Inc/(dec) in loan funds	-470.9	109.7	-1,200.0	-900.0
Dividend paid & dividend tax	-72.2	-108.3	-280.2	-525.0
Others	-277.4	-179.1	-149.0	-124.2
CF from financing activities	-573.7	-177.7	-1,720.0	-1,521.9
Net Cash flow	-32.8	43.1	-36.7	-8.6
Opening Cash	138.0	104.6	150.8	114.0
Other Bank balance	85.5	185.9	185.9	185.9
Closing Cash	104.6	150.8	114.0	105.4

Source: Company, ICICI Direct Research

Exhibit 14: Balance Sheet				
	₹ crore			
(Year-end March)	CY20	CY21	CY22E	CY23E
Liabilities				
Equity Capital	288.7	433.0	433.0	433.0
Reserve and Surplus	3235.3	3646.9	4487.5	5275.1
Total Shareholders funds	3524.0	4079.9	4920.5	5708.1
LT Borrowings & Provisions	1979.6	1813.3	1013.3	263.3
Deferred Tax Liability	225.9	311.1	326.7	343.0
Total Liabilities	6023.4	6561.6	6480.2	6545.1
Assets				
Gross Block	8,542.5	8,974.6	9,621.2	10,171.2
Less: Acc Depreciation	2,715.4	3,246.6	3,843.1	4,473.8
Net Block	5,827.2	5,728.0	5,778.1	5,697.5
Capital WIP	66.8	496.6	50.0	50.0
Net Intangible Assets	557.2	558.6	586.5	615.8
Non-current Investments	0.1	0.8	0.8	0.8
Goodwill	24.2	24.2	24.2	24.2
Current Assets				
Inventory	928.8	1,448.1	1,060.9	1,183.4
Debtors	241.8	221.2	272.8	304.3
Loans and Advances	10.0	9.5	303.1	338.1
Other Current Assets	251.8	301.9	24.2	27.1
Cash	104.6	150.8	114.0	105.4
Deferred Tax Assets	11.0	2.4	2.4	2.4
Current Liabilities				
Creditors	511.4	711.8	727.4	811.5
Provisions	33.2	49.7	90.9	101.4
Short term debt & other CL	1,886.5	2,244.8	1,592.5	1,600.1
Application of Funds	6,023.4	6,561.6	6,480.2	6,545.1

Source: Company, ICICI Direct Research

Exhibit 15: Key ratios				
(Year-end March)	CY20	CY21	CY22E	CY23E
Per share data (₹)				
EPS	8.4	17.2	25.9	30.3
Cash EPS	20.6	29.5	39.7	44.9
BV	81.4	94.2	113.6	131.8
DPS	1.7	2.5	6.5	12.1
Cash Per Share	62.7	75.0	88.7	103.3
Operating Ratios (%)				
EBITDA Margin	18.6	18.8	20.3	20.4
PBT / Total Operating income	5.6	11.4	13.9	14.6
PAT Margin	5.6	8.5	10.3	10.8
Inventory days	52.6	59.9	35.5	35.5
Debtor days	13.7	9.2	9.1	9.1
Creditor days	28.9	29.4	24.3	24.3
Return Ratios (%)				
RoE	10.3	18.3	22.8	23.0
RoCE	10.9	17.1	25.6	29.7
Valuation Ratios (x)				
P/E	126.7	61.5	40.9	34.9
EV / EBITDA	40.3	29.1	21.2	18.6
EV / Net Sales	7.5	5.5	4.3	3.8
Market Cap / Sales	7.1	5.2	4.2	3.8
Price to Book Value	13.0	11.2	9.3	8.0
Solvency Ratios				
Debt/EBITDA	2.2	1.5	0.6	0.1
Debt / Equity	0.8	0.6	0.3	0.1
Current Ratio	0.7	0.7	0.8	0.8
Quick Ratio	0.2	0.1	0.3	0.3

Source: Company, ICICI Direct Research

Exhibit 16: ICICI Direct coverage universe (FMCG)

	CMP	TP	M Cap	EPS (₹)			P/E (x)			Price/Sales (x)			RoCE (%)			RoE (%)			
	(₹)	(₹)		Rating	(₹ Cr)	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E
Colgate (COLPAL)	1,647	1,575	Hold	37,937	38.5	40.8	45.0	42.8	40.3	36.6	7.4	6.8	6.2	109.6	112.7	116.7	84.9	86.6	89.7
Dabur India (DABIND)	572	745	Buy	98,242	10.9	12.2	13.6	52.7	47.0	42.1	8.9	8.1	7.3	26.0	27.3	27.8	22.7	23.2	23.2
Hindustan Unilever (HINLEV)	2,242	2,200	Hold	503,770	37.5	39.5	43.6	59.7	56.8	51.4	10.0	9.1	8.5	20.2	21.9	24.2	18.1	19.1	21.2
ITC Limited (ITC)	261	260	Hold	287,822	12.6	14.6	16.2	20.8	17.9	16.1	5.0	4.8	4.3	32.4	35.9	38.5	25.0	27.7	29.6
Jyothy Lab (JYOLAB)	154	150	Hold	5,133	4.2	6.2	6.5	36.2	24.7	23.6	2.3	2.2	2.0	19.1	26.6	28.0	16.5	23.1	23.7
Marico (MARLIM)	543	550	Buy	60,768	10.0	11.4	12.3	54.0	47.5	43.9	6.3	5.9	5.5	42.6	47.5	49.1	38.4	41.4	42.7
Nestle (NESIND)	18,428	19,050	Hold	175,243	222.4	252.9	291.6	82.8	72.9	63.2	12.0	10.8	9.8	58.7	58.8	62.9	111.3	110.4	111.8
Tata Consumer Products (TAT)	812	910	Buy	70,404	11.7	14.1	16.2	69.2	57.7	50.1	5.6	5.1	4.7	8.9	9.9	10.8	7.2	8.3	9.2
VST Industries (VSTIND)	3,254	3,425	Hold	4,986	229.3	252.9	290.5	14.2	12.9	11.2	4.2	3.9	3.6	39.2	44.6	50.6	30.0	33.4	37.8
Varun Beverage (VARBEV)	1,059	1,300	Buy	45,860	17.2	25.9	30.3	61.5	40.9	34.9	5.2	4.2	3.8	17.1	25.6	29.7	18.3	22.8	23.0
Zydus Wellness (ZYDWEL)	1,682	2,200	Buy	10,819	51.4	62.6	73.0	32.7	26.9	23.0	5.3	4.8	4.3	6.7	8.0	9.1	6.9	8.3	9.4

Source: Bloomberg, ICICI Direct Research

RATING RATIONALE

ICICI Direct endeavors to provide objective opinions and recommendations. ICICI Direct assigns ratings to its stocks according to their notional target price vs. current market price and then categorizes them as Buy, Hold, Reduce and Sell. The performance horizon is two years unless specified and the notional target price is defined as the analysts' valuation for a stock

Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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