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# Zydus Wellness

## Soft Q2; de-leveraging on track

Consumer Goods | Sharekhan code: ZYDUSWELL | Result Update

Stock Update

| 3R MATRIX | + | = | - |
|---|---|---|---|
| Right Sector (RS) | ✓ | | |
| Right Quality (RQ) | ✓ | | |
| Right Valuation (RV) | ✓ | | |

\+ Positive = Neutral - Negative

| Reco/View | Change |
|---|---|
| Reco: **Buy** | ↔ |
| CMP: **Rs. 1,785** | |
| Price Target: **Rs. 2,300** | ↔ |

↑ Upgrade ↔ Maintain ↓ Downgrade

### Company details

| | |
|---|---|
| Market cap: | Rs. 11,360 cr |
| 52-week high/low: | Rs. 1,950/1,070 |
| NSE volume: (No of shares) | 0.2 lakh |
| BSE code: | 531335 |
| NSE code: | ZYDUSWELL |
| Free float: (No of shares) | 2.2 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | 64.8 |
| FII | 1.4 |
| DII | 26.1 |
| Others | 7.7 |

### Price chart


### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | -2.5 | 3.4 | 36.7 | 5.6 |
| Relative to Sensex | -4.5 | -4.2 | 11.4 | 3.6 |

*Sharekhan Research, Bloomberg*


### Summary

- Q2FY2021 revenues grew by 5% to Rs. 342 crore but a fall in gross margins dragged down OPM by 141 bps to 7.9%.
- However, excluding impact of GST budgetary support (ceased for Sitarganj plant from January) revenue would have grown by 9.3%. Sugarfree and Nycil registered strong double-digit growth.
- Company has identified three growth pillars for the medium to long term - 1) Driving synergistic benefits from Heinz acquisition, 2) new products and 3) wider international footprint.
- With a three-pillar strategy, ZWL is strongly placed to achieve earnings CAGR of 27% over FY2020-23. We stick to our Buy rating with unchanged PT of Rs. 2,300.


**Zydus Wellness Limited's (ZWL's) revenue grew by 5% y-o-y to Rs. 342 crore, almost in line with our expectation of Rs. 336.5 crore driven by leadership position and market share gains across key categories. High input prices (palm oil prices increased by ~30%) led to a 301 bps decline in gross margins to 53.7%. In spite of this, OPM fell by 141 bps to 7.9%, largely due to lower advertisement costs and other expenditure. Operating profit declined by 10.9% y-o-y to Rs. 27.1 crore due to lower operating leverage. Pre-tax loss stood at Rs. 7.4 crore and adjusted loss stood at Rs. 27 crore. ZWL paid a one-time debenture redemption premium of Rs. 98 crore, which was recorded as exceptional item in Q2 resulting in reported loss of ~Rs. 105 crore. The company raised Rs. 1,000 crore through a preferential allotment and QIP. As part of a strategic initiative to pare debt, ZWL has bought back its own non-convertible debentures (NCDs) worth Rs. 1,105 crore, which will help the company reduce its debt burden and deleverage balance sheet. ZWL has further bought back Rs. 350 crore worth of NCDs in October. Completion of the buyback of NCDs would result in a significant decline in interest cost in H2FY2021. The company has identified three growth pillars from a medium to long-term perspective 1) Driving synergistic benefits from acquisition of Heinz, 2) new products and 3) expanding its international footprint. Except for palm oil, other input prices have corrected from its highs and have remained benign in past few months. This would reduce pressure on margins in coming quarters. However, the company's medium target is to achieve an OPM of ~20%.**

### Key positives

- *Sugarfree* registered strong double-digit growth on the back of strong traction to *Sugarlite* and higher contribution from e-Commerce channel.
- *Sugarfree* grew by 100% and *Complan* grew by 200% on e-Commerce channel (4.5% of overall revenues).
- Debt reduction would result in strong growth in PAT due to decline in interest costs.

### Key negatives

- GST budgetary support to Sitarganj facility ceased in January, resulting in lower revenue growth (FY2020 benefit was Rs. 32 crore).
- Higher input prices dragged down gross margins by 301 bps.

### Our Call

**View: Retained Buy with an unchanged price target of Rs. 2,300:** We have broadly maintained our earnings estimates for FY2021/22/23. With its three pillars strategy, ZWL and reduction in debt, ZWL is well-verged to achieve a 27% earnings CAGR over FY2020-23 (with OPM expanding by 130-150 bps over the same period). The company has strong presence in niche categories, which are largely health & hygiene-centric and gaining good acceptance amid the COVID-19 environment. It is focusing on expanding in the rural markets with the help of scaled-up distribution led by the Heinz acquisition and expanding footprints in the international market. The stock is currently trading at 37.9x/30.3x its FY2022/23E EPS, which is at a discount to some of the large consumer goods stocks. We maintain our Buy recommendation on the stock with an unchanged price target of Rs. 2,300.

### Key risk

Any slowdown in the sales of key categories or disruption caused by frequent lockdowns or any seasonal vagaries would act as a key risk to earnings estimates.

**Valuation (Consolidated)** Rs cr

| Particulars | FY19 | FY20 | FY21E* | FY22E* | FY23E* |
|---|---|---|---|---|---|
| Revenue | 843 | 1,767 | 1,731 | 1,974 | 2,290 |
| OPM (%) | 21.9 | 18.2 | 17.8 | 18.8 | 19.5 |
| Adjusted PAT | 182 | 186 | 193 | 303 | 379 |
| % YoY growth | 33.1 | 2.3 | 3.8 | 56.9 | 25.1 |
| Adjusted EPS (Rs.) | 28.3 | 28.9 | 30.0 | 47.1 | 59.0 |
| P/E (x) | 56.6 | 55.4 | 59.4 | 37.9 | 30.3 |
| P/B (x) | 3.0 | 3.0 | 2.4 | 2.3 | 2.2 |
| EV/EBIDTA (x) | 55.4 | 31.5 | 36.4 | 30.0 | 24.3 |
| RoNW (%) | 8.9 | 5.4 | 4.7 | 6.3 | 7.4 |
| RoCE (%) | 7.4 | 6.1 | 5.6 | 6.6 | 7.6 |

*Source: Company; Sharekhan estimates*
**Estimates are considering the impact of debt reduction and equity dilution post the recent equity issuance through QIP*

**Revenue grew by 5% y-o-y; unfavourable mix affected margins:** Q2FY2021 net revenue grew by 4.9% y-o-y to Rs. 342 crore as against Rs. 537.4 crore in Q2FY2020. Net revenue was lower on account of a GST budgetary support withdrawal for the Sitarganj plant from January 2020 onwards, which lowered other operating income. Excluding this, gross revenue growth stood higher at 9.3% y-o-y. Most key brands including Everyuth scrub, Everyuth Peel-off, Glucon-D and Nycil maintained their leadership positions. Gross margins declined by 301 bps to 53.7% due to an unfavourable revenue mix. Despite a significant decline in gross margins, lower advertisement spends limited the fall in OPM to 141 bps which stood at 7.9%. Operating profit declined by 10.9% y-o-y to Rs. 27.1 crore due to lower operating leverage. Pre-tax loss came in at Rs. 7.4 crore and adjusted loss came in at Rs. 27 crore in Q2FY2021 as against Rs. 4 crore in Q2FY2020. There was a pre-tax exceptional item of Rs. 98 crore pertaining to debenture redemption premium. Thus, the company reported a loss of Rs. 105.3 crore in Q2FY2021.

## Key Conference call takeaways

- *Sugarfree* registered double-digit growth (crossed pre-COVID levels) driven by higher in-home consumption, consistent investment in digital media and increased footprint on the e-Commerce channel. *Glucon-D* and *Nycil* also saw good growth due to media campaigns whereas *Everyuth* and *Nutralite* witnessed sequential improvement. *Complan* saw good growth from general trade and e-Commerce channels. Upcoming festive season has seen some recovery in discretionary products such as *Everyuth*.
- The e-Commerce channel that contributes ~4.5% to overall revenue, grew by 130% y-o-y in Q2FY2021. General trade saw 10% growth. Super stockists' trade grew by 30%, largely led by rural demand. However, modern trade (contributes 13-14% to revenues) remained subdued, declining in double-digits. The company expanded its chemist channel network, which responded well. International business contributed ~5% to total revenue.
- During the quarter, the company launched *Glucon-D ImmunoVolt* to tap heightened demand for immunity products for kids. *Complan* was launched in a small 75-gram sachet at Rs. 30 per pack promoted by consumer offers. *Nutralite* choco-spread was launched on the e-Commerce and modern trade platforms in two healthy variants. The company also launched *Everyuth* aloe vera & cucumber gel in the face moisturiser segment.
- Prices of key commodities such as skimmed milk are down by 15-18% and the benefit of the same is expected to be reflected in the coming quarters. Overall, gross margins are expected to improve in the near term. OPM would remain under pressure in FY2021 but is expected to expand in the medium term.
- Under project *Vistaar*, the company plans to expand its direct distribution reach by 1.5 lakh outlets, from 3.5 lakh outlets currently to 5 lakh outlets by FY2021-end.
- The company has successfully completed a preferential issue and QIP by raising Rs. 350 crore and Rs. 650 crore, respectively. These proceeds will be used towards redemption of non-convertible debentures of Rs. 1,105 crore, as a part of strategic initiative to reduce debt by the company. ZWL's net debt currently stands at Rs. 250 crore. This will help the company strengthen its balance sheet.
- The company's zero-tax benefit is expected to continue for another 4-5 years.

**Results (Consolidated)** Rs cr

| Particular | Q2FY21 | Q2FY20 | y-o-y (%) | Q1FY21 | q-o-q (%) |
|---|---|---|---|---|---|
| Net Revenue | 342.0 | 326.0 | 4.9 | 537.4 | -36.4 |
| Total expenditure | 314.9 | 295.6 | 6.5 | 415.0 | -24.1 |
| Operating profit | 27.1 | 30.5 | -10.9 | 122.4 | -77.8 |
| Other Income | 2.8 | 4.0 | -28.9 | 1.8 | 54.4 |
| Interest Expense | 30.8 | 35.1 | -12.2 | 34.6 | -10.9 |
| Depreciation | 6.5 | 3.8 | 69.9 | 6.4 | 1.1 |
| PBT | -7.4 | -4.5 | - | 83.2 | - |
| Tax | 19.6 | -0.6 | - | -6.1 | - |
| Adjusted PAT | -27.0 | -4.0 | - | 89.2 | - |
| Exceptional item | -78.4 | -8.0 | - | 0.0 | - |
| Reported PAT | -105.3 | -12.0 | - | 89.2 | - |
| Reported EPS (Rs.) | -16.6 | -2.1 | - | 15.5 | - |
| | | | bps | | bps |
| GPM (%) | 53.7 | 56.7 | -301 | 55.7 | -198 |
| OPM(%) | 7.9 | 9.3 | -141 | 22.8 | - |

*Source: Company; Sharekhan Research*

## Outlook and Valuation

### ■ Sector View – Supply chain back to normal; heath & wellness products gaining good traction

Consumer goods companies saw strong revival in June with production and supply recovering to 90% of pre-COVID levels. With a strong pick in rural demand, general trade normalising and higher sales through online channels, we expect normalisation in business performance from H2FY2021. Amid COVID-19, hygiene and immunity boosting products are gaining good traction. We expect this trend to continue in the near to medium term. Most consumer goods companies would be launching new products in these categories in the near to medium term.

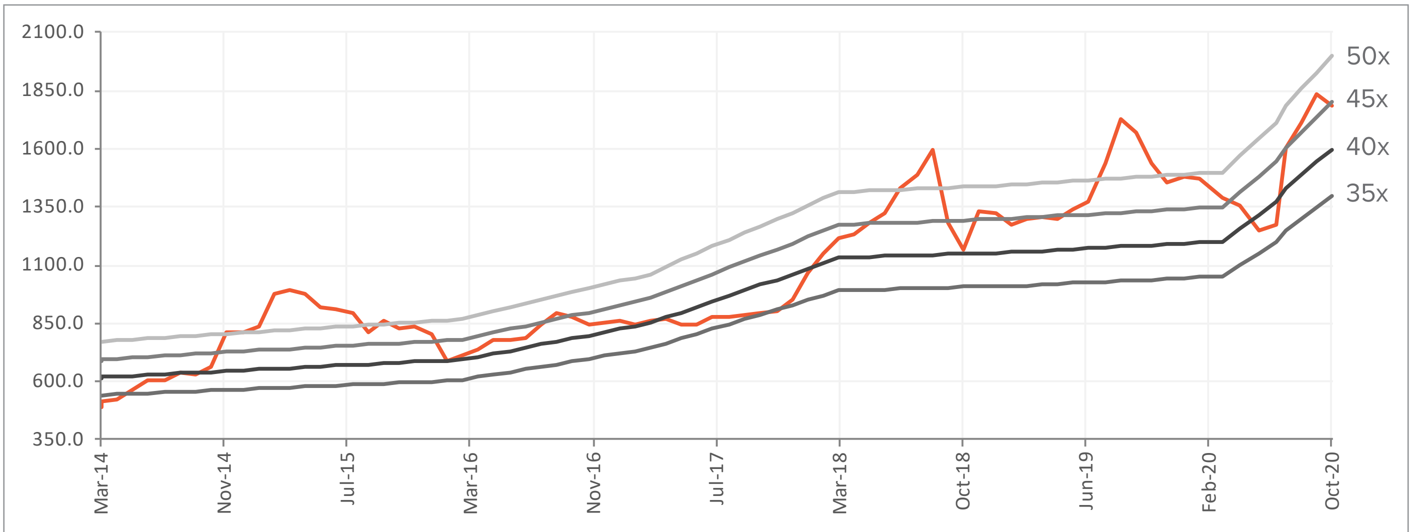
### ■ Company Outlook – Q2 is seasonally weak quarter; long-term growth prospects intact

Q2 is seasonally weak quarter for ZWL due to lower sales of energy drink during the monsoon period. The company has identified 3-pillars growth from medium to long term perspective - 1) Driving synergistic benefits from acquisition of Heinz, 2) new product launches and 3) expanding its international footings. Except for palm oil, other input prices have corrected from its high and have remained benign in past few months. This would reduce pressure on the margins in the coming quarters. However the company's medium-term target is to achieve OPM of ~20%. Further, reduction in the debt on books strengthens its balance sheet and helps the company focus more on improving growth prospects of its existing business.

### ■ Valuation – Retain Buy with unchanged PT of Rs. 2,300

We have broadly maintained our earnings estimates for FY2021/22/23. With its three pillars strategy, ZWL and reduction in debt, ZWL is well-verged to achieve a 27% earnings CAGR over FY2020-23 (with OPM expanding by 130-150 bps over the same period). The company has strong presence in niche categories, which are largely health & hygiene-centric and gaining good acceptance amid the COVID-19 environment. It is focusing on expanding in the rural markets with the help of scaled-up distribution led by the Heinz acquisition and expanding footprints in the international market. The stock is currently trading at 37.9x/30.3x its FY2022/23E EPS, which is at a discount to some of the large consumer goods stocks. We maintain our Buy recommendation on the stock with an unchanged price target of Rs. 2,300.

**One-year forward P/E (x) band**




*Source: Sharekhan Research*

**Peer Comparison**

| Particulars | P/E (x) | | | EV/EBIDTA (x) | | | RoCE (%) | | |
|---|---|---|---|---|---|---|---|---|---|
| | FY20 | FY21E | FY22E | FY20 | FY21E | FY22E | FY20 | FY21E | FY22E |
| Dabur India | 58.6 | 54 | 42.4 | 49 | 43.7 | 34.1 | 27 | 26.7 | 30 |
| Zydus Wellness | 55.4 | 59.4 | 37.9 | 31.5 | 36.4 | 30.0 | 6.1 | 5.6 | 6.6 |

*Source: Company, Sharekhan estimates*

## About company

ZWL is the listed entity of Zydus Group and one of the leading companies in the fast-growing Indian consumer wellness market. The company's growth over the years has been led by pioneering brands such as Sugar Free, EverYuth, and Nutralite and innovations offering new benefits to consumers. The company is the market leader in most of its product categories. The company has recently acquired Heinz India, a subsidiary of Kraft Heinz. With this, ZWL's product portfolio widened to include health food drinks and energy drinks. The acquisition of Heinz has also boosted ZWL's revenue trajectory to ~Rs. 1,700 crore from Rs. 600 crore earlier.

## Investment theme

ZWL has a strong brand portfolio that leads their respective categories. The Sugarfree brand has a ~94% market share in the artificial sweeteners category, while Glucon-D has an ~59% market share. The acquisition of Heinz has enhanced the company's product portfolio and distribution reach. However, the same was earnings dilutive in the initial years, as the acquisition was funded through a mix of debt and equity. The acquisition will start adding to the bottom-line in another 2-3 years, in the backdrop of a stable consumption environment. Higher demand for wellness and nutrition related products and increase in in-home consumption in the pandemic situation would augur well for ZWL in the near term.

## Key Risks

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

## Additional Data

**Key management personnel**

| | |
|---|---|
| Sharvil P Patel | Chairman |
| Tarun Arora | Whole Time Director and CEO |
| Umesh Parikh | Chief Financial Officer |
| Dhanraj P Dagar | Company Secretary |

*Source: Company Website*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | Threpsi LLP | 12.5 |
| 2 | Life Insurance Corp of India | 4.3 |
| 3 | Matthews International Capital Man | 2.5 |
| 4 | Reliance Capital Trustee Co Ltd | 1.7 |
| 5 | Prazim Trading & Inv Co | 1.4 |
| 6 | PPFAS Asset Management | 1.3 |
| 7 | L&T Mutual Fund Trustee Ltd | 0.4 |
| 8 | Dimensional Fund Advisors LP | 0.2 |
| 9 | Aditya Birla Sun Life Asset Management | 0.2 |
| 10 | IndiaFirst Life Insurance Co Ltd | 0.1 |

*Source: Bloomberg*

## Understanding the Sharekhan 3R Matrix

| | |
|---|---|
| **Right Sector** | |
| Positive | Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies |
| Neutral | Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies |
| Negative | Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability. |
| **Right Quality** | |
| Positive | Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance. |
| Neutral | Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable |
| Negative | Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet |
| **Right Valuation** | |
| Positive | Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment. |
| Neutral | Trading at par to historical valuations and having limited scope of expansion in valuation multiples. |
| Negative | Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple. |

*Source: Sharekhan Research*

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