Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Zydus Wellness Ltd

Soft Q2; long-term prospects intact

Consumer Goods	Sharekhan code: ZYDUSWELL
Reco/View: Buy ↔	CMP: Rs. 1,554
	Price Target: Rs. 1,800 ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 38.44

Updated Aug 08, 2023

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

Company details

Market cap:	Rs. 9,891 cr
52-week high/low:	Rs. 1,785 / 1,364
NSE volume: (No of shares)	0.6 lakh
BSE code:	531335
NSE code:	ZYDUSWELL
Free float: (No of shares)	2.0 cr

Shareholding (%)

Promoters	68.5
FII	3.8
DII	20.2
Others	7.4

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-0.3	2.5	2.3	-11.5
Relative to Sensex	1.2	3.9	-2.9	-18.1

Sharekhan Research, Bloomberg

Summary

- Zydus Wellness Limited's (ZWL's) Q2FY2024 numbers were soft as delayed/uneven rains and slow rural demand recovery hit offtake, resulting in just a 2.4% revenue growth. Deferred tax liability on non-cash items dragged PAT by 30% y-o-y; OPM was stable y-o-y.
- Management eyes double-digit revenue growth in the medium term led by wider distribution network, marketing initiatives, innovation and scale up of international business.
- OPM is expected to rise to 17-18% in the next few years driven by improved mix and better operating leverage.
- Stock has underperformed in the past one year and trades at 30x/24x/20x its FY2024E/25E/26E EPS. We maintain a Buy on the stock with a revised PT of Rs. 1,800.

ZWL posted second consecutive quarter of low single-digit revenue growth and double-digit decline in PAT. Delayed/uneven rains in key states and slow demand recovery in rural markets impacted offtakes leading to muted 2.4% y-o-y revenue growth to Rs. 440 crore, with volume growth flat y-o-y. Personal care segment grew by 17.5% y-o-y led by Nycil and Everyuth, while food and nutrition stood flat y-o-y affected by the sweeteners portfolio. Gross margin expanded by 186 bps y-o-y led by softening of raw & packing material prices and calibrated price hikes in the past quarters, while OPM stood flat y-o-y at 3.8% due to higher employee and other expenses. Adjusted PAT fell by 30.3% y-o-y due to deferred tax liability on non-cash items.

Key positives

- Personal care segment registered 17.5% y-o-y growth.
- Key brands such as Sugar Free, Everyuth Scrub, Everyuth Peel Off, Nutralite, Glucon D, and Nycil continued to maintain a strong lead in their respective categories.
- E-Commerce contribution rose to 10% in Q2FY2024 from 8% in Q2FY2023.
- Gross margins of non-dairy products continued to improve.

Key negatives

- Volume growth stood flat y-o-y in Q2.

Management Commentary

- Urban markets continued to grow, while rural markets lagged due to rising food prices and uneven weather patterns. Volume growth stood flat in Q2.
- The management expects demand to recover in Q3 due to festive season and be back to normal in Q4. In the medium term, the management targets double-digit growth led by category growth and growing product portfolio.
- With likely fall in dairy prices in the coming quarters, gross margin is expected to be same or marginally better y-o-y. As gross margins expand, company plans to invest in ad-spends and is aiming for 17-18% OPM in next few years.
- Currency devaluation in Nigeria hit the international business' performance, while other markets posted double-digit growth. ZWL is targeting 8-10% of revenues from international business in next 4 to 5 years.
- Modern trade and e-commerce together contribute 22.4% of the company's total revenue (up from 17.5% in FY22). ZWL is aiming to improve overall reach to 3 million stores from 2.5 million stores currently and direct reach to ~7 lakh outlets from ~6 lakh outlets at present.

Revision in earnings estimates: We have reduced our earnings estimates for FY2024 and FY2025 to factor in below par performance in Q2FY2024. We will keenly monitor the company's performance in the coming quarters. We have introduced FY2026 estimates through this note.

Our Call

View – Maintain Buy with revised PT of Rs. 1,800: ZWL posted soft performance in Q2, with muted revenue growth (flat volume growth) and double-digit decline in PAT. However, ZWL is confident of delivering good performance in the quarters ahead aided by festive demand and a correction in raw material prices. With strategies in place, ZWL is expected to post double-digit revenue growth in all key brands in 3-4 years, aided by consumer-centric innovations, distribution expansion and higher marketing campaigns. Scale up in international business and new launches would act as additional growth triggers. The stock has underperformed the broader market and is trading at 30x/24x/20x its FY2024E/25E/26E earnings. We maintain a Buy with a revised price target (PT) of Rs. 1,800 (rolling over to Sept-25 earnings).

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY23	FY24E	FY25E	FY26E
Revenue	2,255	2,381	2,637	3,001
OPM (%)	15.0	15.4	16.8	17.3
Adjusted PAT	320	328	414	501
% YoY growth	3.7	2.4	26.0	21.0
Adjusted EPS (Rs.)	50.4	51.6	65.0	78.7
P/E (x)	30.9	30.1	23.9	19.8
P/B (x)	1.9	1.8	1.7	1.6
EV/EBITDA (x)	29.0	25.8	21.5	17.9
RoNW (%)	6.4	6.2	7.4	8.3
RoCE (%)	6.0	6.2	7.3	8.2

Source: Company; Sharekhan estimates

Soft Q2 – Revenue growth at 2.4% y-o-y; OPM stood stable y-o-y

ZWL's revenue growth was muted at 2.4% y-o-y to Rs. 440 crore, missing our and average street expectation of Rs. 459-462 crore. Revenue growth during the quarter was hit by delayed/uneven rains across key states impacting offtakes coupled with slow demand recovery in rural markets. Within categories, food and nutrition posted muted quarter with revenue flat y-o-y, impacted by the sweeteners portfolio, while personal care grew by 17.5% y-o-y, led by Nycil and Everyuth. Softening of raw & packing material prices and calibrated price increases taken in the past quarters aided in 186 bps y-o-y expansion in gross margin to 45.2%. However, due to higher employee and other expenses, OPM stood stable y-o-y at 3.8%, much lower than our expectation of 4.6% and average street expectation of 5.1%. Operating profit increased by 2.1% y-o-y to Rs. 16.6 crore. Muted operating performance coupled with higher interest cost and tax expense (due to deferred tax liability on non-cash items) led to 30.3% y-o-y decline in the adjusted PAT to Rs. 5.9 crore, lower than our and consensus expectation of Rs. 12-15 crore. In H1FY2024, revenue grew marginally by 1.4% y-o-y to Rs. 1,142 crore, while 294 bps y-o-y contraction in OPM and higher interest expense led to 20.1% y-o-y decline in the adjusted PAT to Rs. 16.3 crore.

Key brands retained their leadership position and continued to gain market share

Five brands – Glucon-D, Sugarfree, Nycil, Everyuth Scrub, and Everyuth Peel Off facemask maintained its leadership position in their respective categories as of September 2023. Glucon-D has with a market share of 60% maintained its No.1 position. Sugar Free gained 53 bps share and thus continued to maintain its leadership with a market share of 96.1%. Nycil has maintained its dominant position by further increasing its market share by 19 basis points y-o-y to 35.2% in the Prickly heat powder category. Complan witnessed marginal decline in market share of 23 bps to 4.4%. Everyuth Scrub has increased market share by 162 bps y-o-y to 43.4% strengthening its leadership position in the facial scrubs category. Everyuth Peel Off has maintained its number one position with a market share of 78.9% in the Peel off category, with an increase of 75 bps. Overall, the Everyuth brand is amongst the top five brands in the country with a market share of 6.1% in the facial cleansing segment.

Brand-wise performance

- **Everyuth:** Face scrub category grew by 6.2%, while peel off category declined by 0.5% in Q2FY2024. ZWL is looking to expand and scale-up its portfolio in new categories like body lotion and aloe gel.
- **Sweeteners:** Despite the World Health Organisation (WHO) report on safety concerns related to use of non-nutritive sweeteners, Sugar free offtake continued to grow. Sugar Free Green has delivered double-digit growth since last 10 quarters, driven by new campaign and distribution expansion, with contribution to sweeteners portfolio rising to 7%. Ongoing legal case on Sugarlite regarding trademark issue put supplies on hold for entire quarter impacting growth for overall Sweeteners portfolio
- **Nutralite:** Nutralite posted double-digit volume growth in Q2FY2024 aided by institutional sales, however, value growth was hit by market-driven prices. The brand has delivered consistent double-digit volume growth in 9 out of last 11 quarters driven by a wide portfolio and supported by focused B2B and B2C teams.
- **Complan:** Complan reported volume improvement in Q2 coupled with double-digit penetration growth. Growth driven by stronger campaign with 360-degree activation and price pack architecture interventions. The health food drinks category grew 4.3%.
- **Glucon-D:** Glucose powder category growth came in at 1.2%. Consumption during the quarter was impacted due to erratic weather.
- **Nycil:** Prickly heat powder category declined by 2.1% in Q2, whereas Nycil posted strong volume and penetration led growth during the quarter.

Key concall highlights

- **Volumes stood flat y-o-y:** Q2 was a mixed quarter as urban continued to grow, while rural lagged demand recovery due to rising food prices and uneven weather patterns. Volume growth stood flat in Q2.
- **Margins to improve in coming years:** Key input prices witnessed correction on q-o-q and y-o-y basis. Milk prices

came down by 2% y-o-y and 0.4% q-o-q, refined palm oil (RPO) prices fell by 25% y-o-y and 9% q-o-q, Aspartame reported 33% and 9% y-o-y and q-o-q decline in prices, while Stevia prices corrected by 14% y-o-y and 19% q-o-q. Gross margin of non-dairy portfolio continued to improve, while elevated milk prices continued to partially impact dairy portfolio's gross margin. With likely fall in dairy prices, gross margin is expected to be same or marginally better y-o-y. As gross margins expand, company plans to invest in ad-spends and is aiming for 17-18% OPM in next few years.

- **Eyeing double-digit revenue growth in medium term:** The management expects demand to recover in Q3 due to festive season and be back to normal in Q4. In the medium term, management aims for double-digit growth led by category growth and growing product portfolio.
- **Currency devaluation in Nigeria hit international business:** International business grew in double digits (lower than expected growth) in Q2. Growth during the quarter was impacted due to currency devaluation in Nigeria, while other markets posted double-digit growth. ZWL plans to launch range of new products expanding Sugarfree D'lite portfolio in the coming months. ZWL is targeting 8-10% of revenues from international business in next 4 to 5 years.
- **Rising contribution from new-age channels:** Company witnessed sharp rise in e-commerce saliency, with contribution from e-Commerce rising to 10% in Q2FY2024, from 8% in Q2FY2023. Modern trade and e-Commerce together contribute 22.4% of the company's total revenue (up from 17.5% in FY22). Growth in these channels is led by channel specific innovative marketing initiatives, increasing digital spends ahead of overall spends and e-commerce exclusive packs & launches. In terms of general trade, direct reach is currently at ~6 lakh stores and the company plans to take it to ~7 lakh stores in the coming quarters. It also plans to take overall availability of products from current 2.5 million to 3 million stores.

Results (Consolidated) Rs cr

Particulars	Q2FY24	Q2FY23	Y-o-Y %	Q1FY24	Q-o-Q %
Net Revenue	**439.9**	**429.5**	**2.4**	**702.1**	**-37.3**
Material cost	241.2	243.5	-0.9	333.0	-27.6
Employee cost	48.3	43.6	10.7	47.3	2.1
Advertisement and Sales Promotion	50.7	51.7	-1.9	104.4	-51.4
Other expenditure	83.1	74.4	11.7	100.9	-17.6
Total expenditure	**423.3**	**413.2**	**2.4**	**585.6**	**-27.7**
Operating profit	**16.6**	**16.3**	**2.1**	**116.5**	**-85.8**
Other Income	4.3	1.4	-	2.4	79.2
Interest Expense	6.5	2.9	-	5.1	27.5
Depreciation	5.8	6.4	-9.8	6.2	-6.5
PBT	**8.6**	**8.2**	**4.4**	**107.6**	**-92.0**
Tax	2.7	-0.2	-	-13.3	-
Adjusted PAT	**5.9**	**8.5**	**-30.3**	**120.9**	**-95.1**
PAT after M.I	5.9	8.5	-30.3	120.9	-95.1
Exceptional item	0.0	0.0	-	-10.5	-
Reported PAT	**5.9**	**8.5**	**-30.3**	**110.4**	**-94.7**
Reported EPS (Rs.)	0.9	1.3	-30.3	17.4	-94.7
			bps		**bps**
GPM (%)	45.2	43.3	186	52.6	-740
OPM(%)	3.8	3.8	-1	16.6	-
NPM (%)	1.3	2.0	-63	17.2	-
Tax rate (%)	31.4	-2.8		-12.4	

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector Outlook – Rural recovery on cards; margin improvement to sustain

With food inflation easing and an expected stable kharif crop, managements of most consumer goods companies are confident of witnessing a pick-up in rural demand in H2FY2024. This will also be supported by the upcoming festive season and higher government spending prior to the general elections. Overall, we expect a gradual improvement in volume growth of consumer goods companies in the quarters ahead. Crude oil prices moved up from its low but continue to remain in a comfortable zone. Other input prices are yet to see a significant jump and will provide lesser stress on the profitability in the near term. Thus, we expect the rise in gross margins to sustain in the quarters ahead. Despite higher media spends, OPM is expected to stay high y-o-y in the near term. Most consumer goods companies are optimistic about medium-term growth outlook aided by low penetration in most categories, emerging distribution channels, and improving per-capita income.

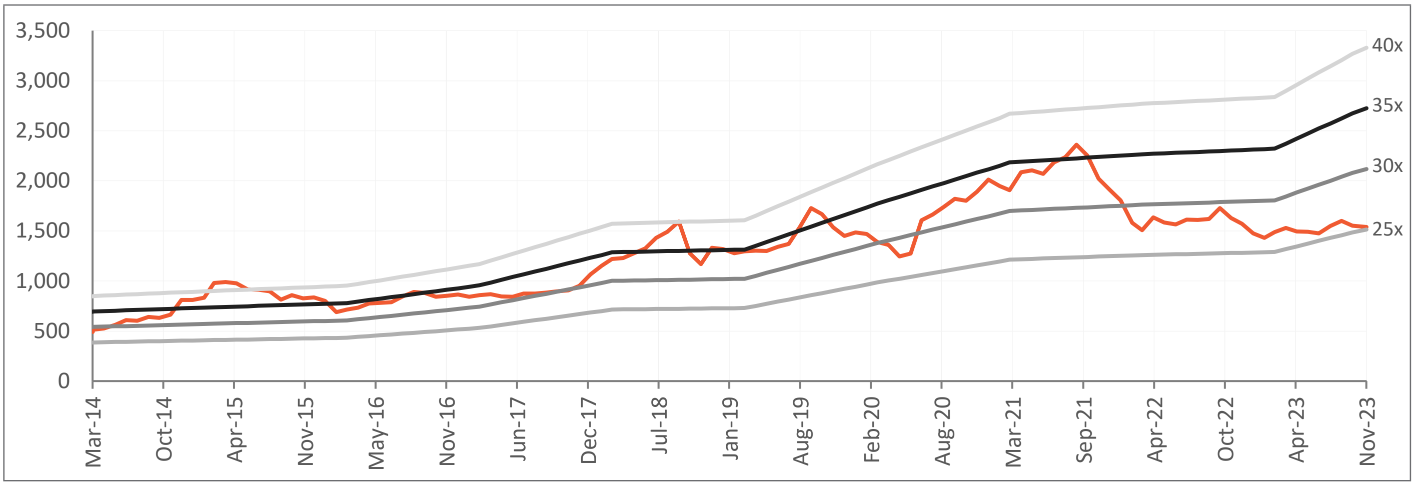
■ Company Outlook – Strong growth ahead driven by multiple levers

ZWL's H1FY2024 performance was weak as revenue grew marginally by 1.4% y-o-y to Rs. 1,142 crore, while 294 bps y-o-y contraction in OPM and higher interest expense led to 20.1% y-o-y decline in the adjusted PAT to Rs. 16.3 crore. However, management expects recovery in H2. In the medium term, ZWL banks on three pillars – accelerating growth of core brands, building international presence, and significantly growing scale – to drive growth. Scale-up of the international business and some of the new launches reaching maturity will improve growth prospects in the long run. Key brands of the company continue to maintain their strong leadership position and gain market share consistently. Margins are expected to improve with the correction in prices of key input materials.

■ Valuation – Maintain Buy with a revised PT of Rs. 1,800

ZWL posted soft performance in Q2, with muted revenue growth (flat volume growth) and double-digit decline in PAT. However, ZWL is confident of delivering good performance in the quarters ahead aided by festive demand and a correction in raw material prices. With strategies in place, ZWL is expected to post double-digit revenue growth in all key brands in 3-4 years, aided by consumer-centric innovations, distribution expansion and higher marketing campaigns. Scale up in international business and new launches would act as additional growth triggers. The stock has underperformed the broader market and is trading at 30x/24x/20x its FY2024E/25E/26E earnings. We maintain a Buy with a revised price target (PT) of Rs. 1,800 (rolling over to Sept-25 earnings).

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBITDA (x)			RoCE (%)		
	FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Dabur India	56.0	45.6	37.9	44.2	37.9	31.6	22.1	24.7	27.5
Zydus Wellness	30.9	30.1	23.9	29.0	25.8	21.5	6.0	6.2	7.3

Source: Company, Sharekhan estimates

About company

Zydus 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 Sugarfree, Everyuth, and Nutralite and innovations offering new benefits to consumers. The company is the market leader in most of its product categories. With the acquisition of Heinz India, a subsidiary of Kraft Heinz in 2019, Zydus's product portfolio widened to include health food drinks and energy drinks. The acquisition of Heinz has also boosted the company's revenue trajectory to ~Rs. 2,300 crore in FY2023 from Rs. 500 crore in FY2018.

Investment theme

Zydus has a strong brand portfolio that leads its respective categories. Sugarfree brand has a ~96% market share in the artificial sweetener category, while Glucon-D has a ~60% market share. The acquisition of Heinz (completed three years ago) has enhanced the company's product portfolio and distribution reach. Over the past three years, despite losing sales due to COVID-19, the company has consolidated and grown its market share across categories, launched multiple innovations, doubled its direct distribution reach, made significant strides in growing business ahead of the category in both online and offline organised trade, reduced cost, and simplified the organisation, leading to synergy benefits. We expect the company's revenue and PAT to report a CAGR of 10% and 16%, respectively, during FY2023-FY2026E.

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.
- **Increased competition:** ZWL is facing stiff competition in skin care products such as face wash and scrubs from multinationals, which has affected revenue growth of these categories.

Additional Data

Key management personnel

Sharvil Pankaj Patel	Chairman
Tarun Gian Arora	Chief Executive Officer
Umesh Parikh	Chief Financial Officer
Nandish P. Joshi	Company Secretary & Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Threpsi LLP	11.35
2	Nippon Life India Asset Management Company	3.50
3	ICICI Prudential Asset Management Co.	2.12
4	Norges Bank	1.58
5	Vanguard Group Inc	1.30
6	Life Insurance Corp of India	1.22
7	Tata AMC	0.86
8	SBI Funds Management	0.51
9	Aditya Birla Sun Life AMC	0.25
10	Dimensional Fund Advisors	0.22

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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Other registrations of Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669.

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