Initiating Coverage Report

28th Nov 2019

Varun Beverages Limited

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Varun Beverages Ltd.

Sector: Containers and Packaging

Brief Overview

CMP (INR) (As on 28th Nov 2019)	720
Target (INR)	888
Upside(%)	23
Recommendation	**Strong Buy**

BSE Code	540180
NSE Code	VBL
Reuters Ticker	VARB.BO
Bloomberg Ticker	VBL IN

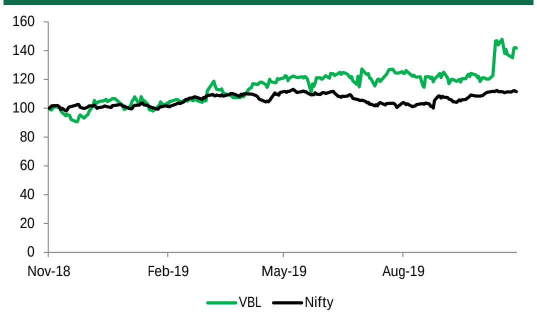
Stock Scan

Market cap (INR Cr.)	20799
Outstanding Shares (Cr.)	28.87
Face Value (INR)	10
Dividend Yield(%)	0.23
P/E (x)	46.3
P/B (x)	4.3
Debt/Equity (x)	0.9
Beta vs. Sensex	0.52
52 Week High/ Low (INR)	789/455
Avg. Daily Volume (NSE)/1yr	163010

Shareholding Pattern (%)

	Sep-2019	Jun 2019	Mar 2019
Promoters	68.43	73.56	73.56
Institutions	25.56	20.84	19.93
Non-Institution	6.02	5.60	6.51

Stock vs. Nifty (Relative Returns)



Source: NSE

Varun Beverages Ltd.: A steady performer

We initiate coverage on Varun Beverages with a Strong Buy rating. Varun Beverages is one of the largest franchisees in the world (outside USA) of carbonated soft drinks ("CSDs") and non-carbonated beverages ("NCBs") sold under various trademarks owned by PepsiCo. PepsiCo CSD brands produced and sold by Varun include ***Pepsi, Pepsi Black, Mirinda, Mountain Dew***, etc. PepsiCo NCB brands produced and sold by Varun include ***Tropicana*** products. Packaged drinking water is sold under the brand ***Aquafina and Aquavess***. Very recently, Varun has ventured into ***ambient temperature value added dairy based beverages in India***. Varun operates in India, Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe. The key aspects which draw attention to Varun's business are:

- **Huge market opportunity with high growth potential:** India is a highly under penetrated market when it comes to soft drinks consumption with per capita consumption of soft drinks at 44 bottles in 2016 compared to 1,496 bottles in the US.

- **Rural Electrification:** This is a game changer which really propels Varun's growth trajectory to new heights. The soft drinks industry including Varun will immensely benefit from this as there will be increased penetration of refrigerators with the end consumers and visi-coolers with the retailers.

- **Integration and expansion of distribution network:** Varun relentlessly focuses on integration and expansion of its distribution network in India and abroad.

We have valued the stock at a P/E multiple of 30x to CY2021E EPS of INR 29.60 to arrive at a **Target Price of INR 888**. We thus maintain a "**Strong Buy**" rating on the stock.

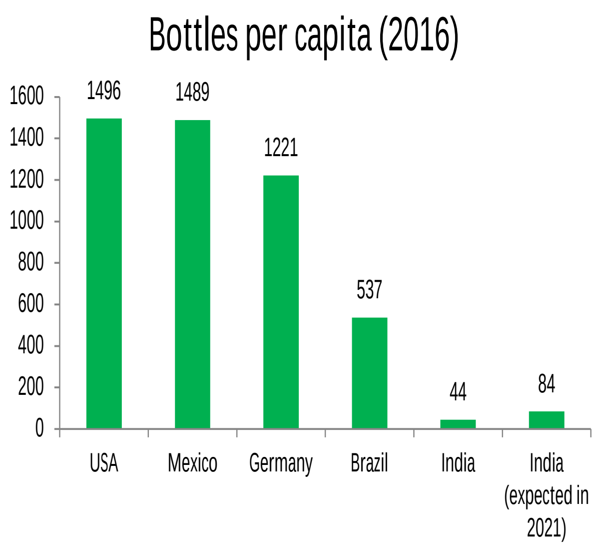
Financial Performance at a glance (Consolidated)

Particulars (INR Cr)	CY17	CY18	CY19E	CY20E	CY21E
Net Sales from ops.	4004	5105	6963	7891	9113
Growth %	4%	28%	36%	13%	15%
EBITDA	836	1007	1467	1586	1868
EBITDA Margin (%)	20.9%	19.7%	21.1%	20.1%	20.5%
Net Profit	210	293	502	623	854
Net Profit Margin (%)	5.2%	5.7%	7.2%	7.9%	9.4%
EPS	7.28	10.14	17.39	21.57	29.60
BVPS	61.29	69.23	114.94	131.94	155.83
P / E (x)	99.0	71.0	41.4	33.4	24.3
P / BV (x)	11.8	10.4	6.3	5.5	4.6
ROE (%)	11.9%	14.7%	15.1%	16.3%	19.0%
ROCE(%)	13.2%	14.5%	17.9%	20.2%	25.0%

Source: Company Data, SMIFS Research

Investment Rationales

Soft drinks consumption of various countries



Source: Company Data, SMIFS Research

Huge market opportunity with high growth potential

India ranks as one of the fastest growing economies in the world. World Bank has projected India's GDP growth rate at 6%, 6.9% and 7.2% for the financial years 2020, 2021 and 2022 respectively. Growth in consumer spending, urbanisation, rural consumption and rise in income levels can make India the third largest consumer market in the near future and all of these factors would have a very favourable impact on the consumption of soft drinks. Market volume of Indian soft drinks was 33,559 million litres in 2018. ***It is anticipated that soft drinks would record the highest volume growth among all commercial beverages with a CAGR of 6.9% between 2019 and 2024 and an incremental volume of 11,890 million litres during 2019 and 2024***. India's per capita consumption of soft drinks in 2016 was 44 bottles, which was very low compared to mature markets like the US (1,496 bottles), Mexico (1,489 bottles), Germany (1,221 bottles), Brazil (537 bottles) - *Source: Company Data*. This under penetration is likely to correct with consumption expected to almost double to 84 bottles by 2021.PepsiCo was the second largest company in the soft drinks industry in India in 2018, with value and volume shares of 17.6% and 9% respectively.

PepsiCo is the second largest company in the juice and nectars categories in India with volume shares of 20.2% and 19.7% respectively in 2018.

Gatorade and Sting are among the top five brands in terms of volume and value shares in the sports and energy drinks categories respectively.

Focus on new variants of soft drinks and beverages

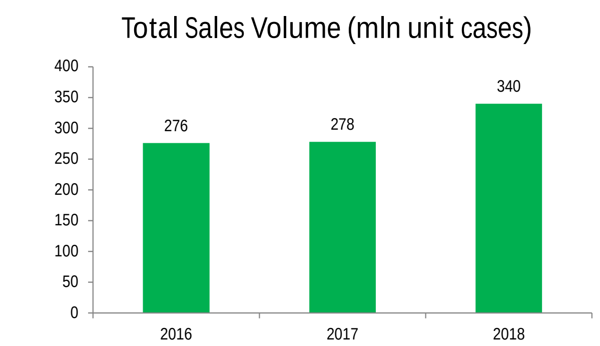
While sugary carbonated beverages still form the bulk of carbonated beverages sales, various leading producers including PepsiCo are concentrating on offering ***low sugar beverages*** as consumers are becoming more conscious of healthy living. PepsiCo is the second largest company in the juice and nectars categories in India, through its brand Tropicana with volume shares of 20.2% and 19.7% respectively in 2018. The juice category in India is expected to grow at a CAGR of 8.8% in volume terms between 2019 and 2024—*Source: Company Data*. Energy drinks and sports drinks were among the leading categories of beverages in terms of volume growth in 2018 for PepsiCo - Gatorade and Sting are among the top five brands in terms of volume and value share in the sports drink and energy drink categories respectively in India in 2018. In order to capitalize on this trend of healthy living Varun has recently commissioned a backward integrated manufacturing unit at Pathankot, which caters to Tropicana juices and carbonated soft drinks (CSD)

Investment Rationales

Varun on behalf of PepsiCo continues to make all endeavours to implement new brand and product launches. Dairy based beverages are an example.

products in aluminium cans at a capex of Rs 480 crores, making Varun the sole outsourced manufacturer of Tropicana in India. Varun continues to make all endeavours to implement new brand and product launches as well as new flavours, packages and SKUs for PepsiCo, particularly in the fast-growing non-carbonated beverages (NCB) space. Further, Varun also intends to launch certain products and brands in smaller packages to target the semi -urban and rural markets in India.

Sales volume growth between 2016 & 2018



Source: Company Data, SMIFS Research

Ability to achieve scale and volume growth has already been exhibited

The association of Varun with PepsiCo dates back to 1990s. During this period, Varun has consolidated the business association with PepsiCo by increasing the number of licensed territories and sub-territories, and expanding the distribution network. ***As of Sept 30, 2019, Varun operates franchises for various PepsiCo products across 27 states and 7 union territories in India besides operating franchises in Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe***. Total sales volumes grew at a CAGR of 11.07% from 275.22 million unit cases in CY 2016 to 339.55 million unit cases in CY 2018 and was 409 million unit cases in the nine months ended Sept 30, 2019.

Varun operates franchises for various PepsiCo products across 27 states and 7 union territories in India besides operating in Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe.

Varun has acquired territories in the South and West regions of India in May 2019 at a consideration of Rs 1615 crores and these territories have been classified as New India Sub-Territories in this report. Sales volume from the New India Sub-Territories was 24.75 million unit cases contributing to 8.67% of Varun's total sales volume in the six months ended June 30, 2019. Varun works closely with PepsiCo to implement operational best practices, garner supply chain efficiencies from its large production capacities and distribution network, and implement dynamic "push" marketing strategies taking PepsiCo products directly to customers through retailers and point-of-sale displays, and "pull" marketing initiatives through advertisement and promotional offers. Varun's exhibited ability to grow PepsiCo product sales has led to PepsiCo licensing additional territories to Varun, including those that were earlier directly operated by PepsiCo or by third-party bottlers. In particular, as part of PepsiCo's strategy of consolidating certain PepsiCo-operated sub-territories in India with long-term bottling partners, Varun entered into the PepsiCo India BTA pursuant to

Investment Rationales

In 2019, Varun was granted the right to operate in South and West regions of India by PepsiCo.

which it was granted the franchise for the 2019 New India Sub-Territories. As these 2019 New India Sub-Territories are geographically contiguous with the 2019 Existing India Sub-Territories, Varun will also be able to benefit from cost and operational efficiencies as well as get benefits of economies of scale.

Varun has key strategic alignment with PepsiCo in sales and marketing, product development and raw material procurement.

Creating value through strategic alignment with PepsiCo

Varun has key strategic alignment with PepsiCo in three areas, viz., sales and marketing, product development and raw material procurement. Varun has strong sales teams that work closely with PepsiCo to develop and implement local advertising and marketing strategies and special sales schemes. Varun also works with PepsiCo's product development team to strategise new product launches in India besides working closely with PepsiCo on production techniques, quality control, environmental matters as well as new packaging and product development initiatives. Varun sources high quality raw materials from reputed suppliers that are pre-approved by PepsiCo .

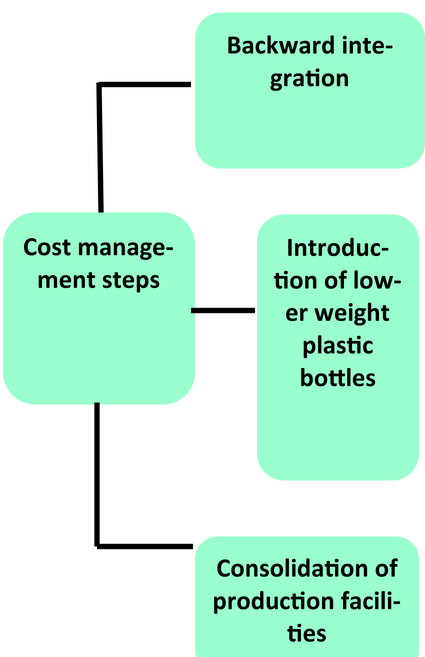
The key objectives of Varun's acquisitions were to supplement the business verticals, strengthen the product portfolio, and increase the sales volume and market share.

Successful track record of acquisitions

Varun has been very successful in acquiring and integrating new territories, additional franchisee rights as well as additional businesses through strategic acquisitions. The key objectives of these acquisitions were to supplement the business verticals, strengthen the product portfolio, and increase the sales volume and market share. By successfully leveraging its association with PepsiCo, Varun has been able to expand internationally in Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe and Varun intends to continue to play a significant role in the consolidation of PepsiCo's production and distribution operations in South Asia and Africa. Varun believes that the fragmented nature of the industry that it operates in will continue to offer consolidation opportunities, and it intends to continue its strategic expansion plans in underserved markets and geographies that complement its existing operations. Varun continues to work closely with PepsiCo to identify such strategic consolidation opportunities.

Investment Rationales

> **Varun's production facilities across India are strategically located in geographical proximity to various target markets, which result in lower transportation and distribution expenses and enables Varun to leverage economies of scale.**



Strategically located robust production capabilities with backward integration

Varun operated thirty two production facilities across India and six production facilities across international licensed territories as of Sept 30, 2019 with peak month production capacity of its production facilities in India and international territories at 107.94 million unit cases and 22.14 million unit cases, respectively. Varun utilises advanced machinery and production techniques in its manufacuring processes for water treatment and packing, amongst other processes in some of its production facilities. Varun has GPRS-enabled handheld devices and systems called SAMNA (Sales Automation Management for the New Age) in some of its operations to automate field work processes and enable access to real-time sales information from production facilities, warehouses and distribution centers across India. These techniques enable Varun to improve production efficiencies and reduce personnel costs. The production facilities across India are strategically located in geographical proximity to various target markets, which result in lower transportation and distribution expenses and enables Varun to leverage economies of scale. Further, Varun's production facilities in Kosi, Hardoi, Pathankot and Guwahati in India, and its production facilities in Nepal, Sri Lanka and Zimbabwe manufacture preforms while two of Varun's production facilities in Jaipur and Alwar manufacture crowns, shrink-wrap films, plastic shells and corrugated boxes and pads.

Focus on cost efficiencies and technology

Varun has taken a number of steps towards reduction of cost of goods sold, effective management of operating expenses, and improvement in cash flows. Backward integration of production facilities and a centralized procurement team are illustrations of such steps. Consolidation of production activities has ensured that all components of Varun's products are supplied internally. Introduction of lower weight plastic bottles and reduced size of bottle caps have enabled Varun to reduce polyethylene terephthalate (PET) costs. Consolidation of production facilities and depots post implementation of GST in India has helped in the reduction of freight and distribution costs. The recent commencement of production in Varun's backward integrated facility at Pathankot will enable it to increase production volumes of Tropicana juices, preforms and CSD products in aluminium cans and improve operating margins.

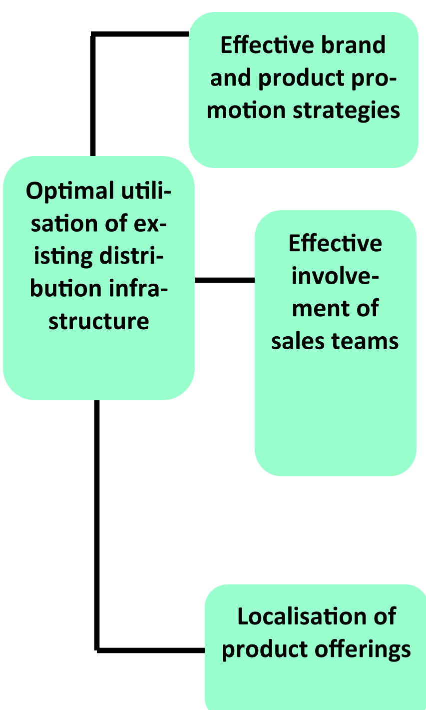
Investment Rationales

Varun continues to plan its capital expenditure sensibly and introduce advanced technologies in order to improve operational efficiencies.

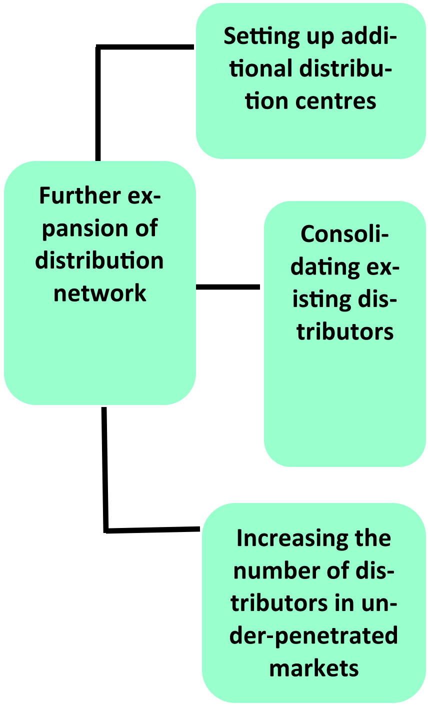
Varun continues to plan its capital expenditure sensibly by focusing on more profitable areas of business such as chilled equipment for use in immediate-consumption channels. Varun also continues to introduce advanced technologies in order to improve operational efficiencies and work processes in its operations - Varun has introduced GPRS-enabled handheld devices and systems called SAMNA (Sales Automation Management for the New Age) in some of its operations to automate field work processes and enable access to real-time sales information from production facilities, warehouses and distribution centres across India, thereby ensuring integrated operational data from manufacturing, planned procurement and superior tracking of transportation of products from distributors to the retail point-of-sale.

Focus on integration and expansion of distribution network

Varun tirelessly focuses on increasing sales volumes in its licensed territories and sub-territories by expanding and integrating its distribution network, optimizing its distribution operations and increasing product supply to under-penetrated markets, particularly to semi-urban and rural areas. Varun at present is in the process of integrating its existing distribution network with the 2019 New India Sub-Territories and believes that this integration will enable it to ensure cost and operational efficiencies as well as economies of scale.



Varun relies on optimal utilisation of its existing distribution infrastructure by implementing effective brand and product promotion strategies through intensive interaction with distributors, effective involvement of its sales team at points of sale, and expanding the range of product offerings in some markets and areas to specifically cater to regional and local consumer preferences. ***Varun had 1,216 primary distributors (i.e., parties to whom sales in excess of 10,000 unit cases of PepsiCo beverages in the month of June 2019 were recorded) in India and 345 distributors in its international territories as at June 30, 2019***. Varun intends to further expand its distribution network by setting up additional distribution centers, consolidating existing distributors and increasing the number of distributors in under-



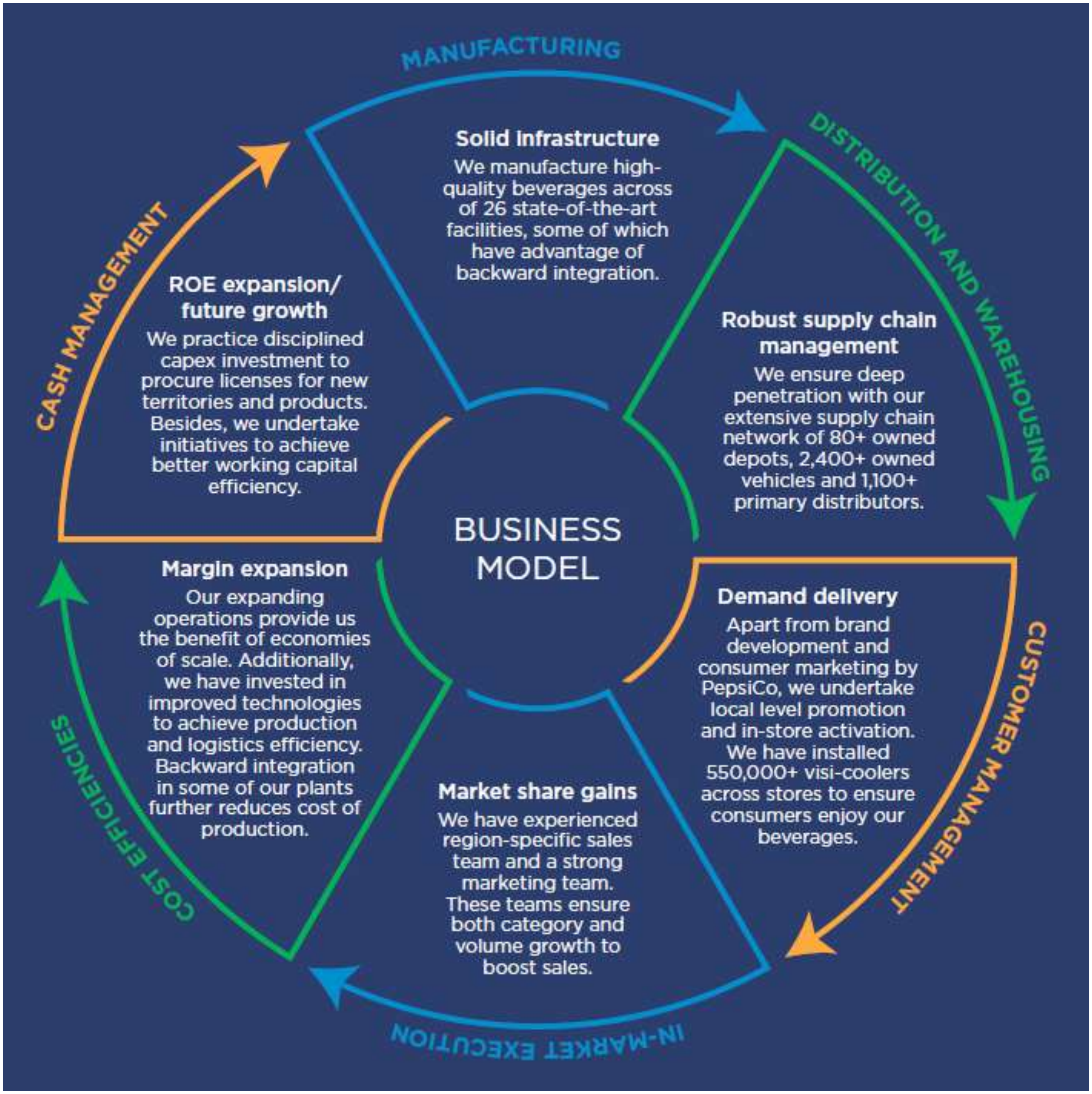
penetrated markets. Varun is of the belief that these measures will enable it to increase the availability of its beverages across its licensed territories and sub-territories, including the 2019 New India Sub-Territories, which will in turn will increase the brand awareness and sales of PepsiCo beverages.

Electrification of rural areas

While GOI's aim of 100% electrification of all villages in India has been achieved, not all households and small retailers in villages have access to electricity. As the reach of electricity increases, the soft drinks industry including Varun will immensely benefit as there will be increased penetration of refrigerators with the end consumers and visi-coolers with the retailers.

Business Model

Varun's business model is depicted in the diagram below:



Source: Company Data

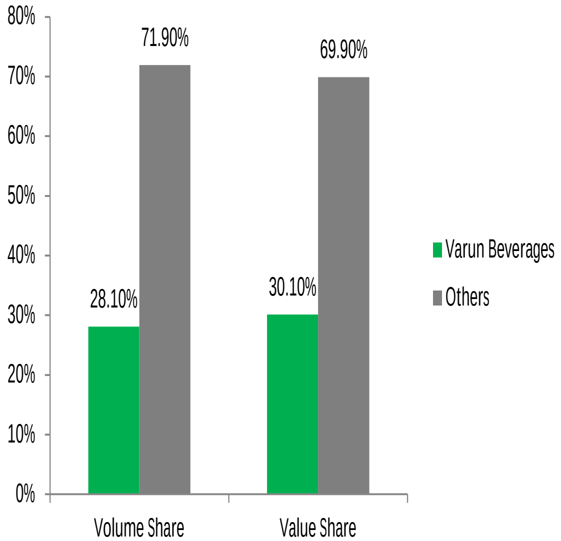
Product Portfolio

Varun’s product portfolio is illustrated below:

Source: Company Data

Industry Overview

Varun's market share of carbonated beverages



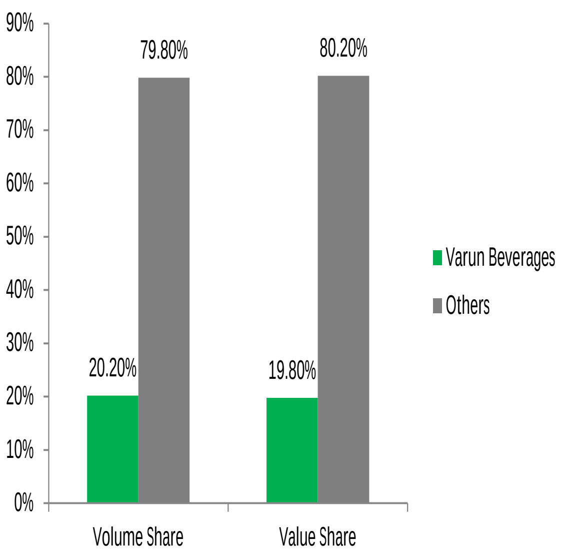
Source: Industry Data, SMIFS Research

Carbonated Beverages

Carbonated beverages are sweetened, non-alcoholic drinks containing carbon dioxide and include cola and non-cola flavours. Further, cola and non-cola flavours are divided into regular and low calorie types. While the per capita consumption level in India of soft drinks including carbonated beverages was very low at 44 bottles in 2016 compared to 1496 bottles in the US, and this under penetration provides a huge room for growth, ***carbonated beverages have lost momentum recently in India due to imposition of higher GST rates and people's fascination towards healthier drinks***. GST rate now stands at 40% for this category, which has led to substantial increase in prices. PepsiCo's volume and value share were 28.1% and 30.1% in the carbonated beverages category in India in 2018.

Larger companies have been losing market share to local players in the recent past and both Coke and PepsiCo have introduced new marketing strategies to address this. For example, ***PepsiCo started printing and labelling Pepsi cans and bottles with popular colloquial words in eight regional languages to attract consumers across India***. A large and young population base is driving demand for new and innovative flavors of carbonated beverages in India. Companies are beginning to add fruit juices with carbon dioxide besides launching carbonated beverages with natural ingredients.

Varun's market share of juices



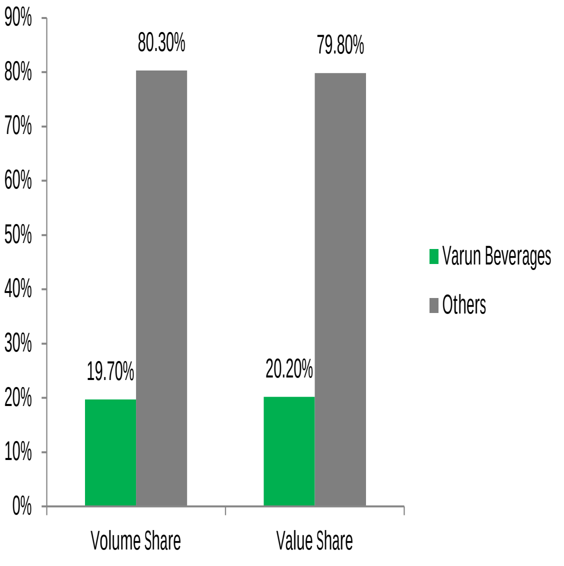
Source: Industry Data, SMIFS Research

Juices

Juices are 100% fruit juice or vegetable juice with no added ingredients except permitted minerals and vitamins. PepsiCo is among the leaders in this category in India with volume and value shares of 20.2% and 19.8% respectively in the juice category in India in 2018. ***Juices are among the biggest beneficiaries of changing consumer preferences towards soft drinks, with growing awareness on the risks of high consumption of sugary drinks. This change in preference along with a wide range of flavours and increasing accessibility of these products have driven a strong 11.9% volume growth in 2018 for the segment as a whole in India***. These aspects are expected to remain favourable in the foreseeable future. Further, several manufacturers are expected to bolster their portfolio of offering by adding new flavours and expanding their operations across newer territories.

Industry Overview

Varun's market share of nectars

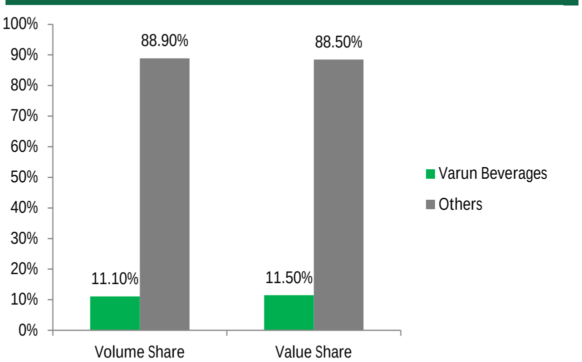


Source: Industry Data, SMIFS Research

Nectars

Nectars are diluted fruit/vegetable juice and pulp with a juice content of 25% to 99.99%. Sweetening agents such as sugar, honey, syrups and/ or sweeteners may be added along with permitted minerals and vitamins. ***Nectars are the largest category in the juice nectar still drinks category (JNSD) in India with sales volume of 259.3 million litres in 2018***. The wide appeal of nectars, especially to those seeking to move away from carbonated beverages lies in the fact that nectars are available in many flavours, have fruit content and are increasingly distributed across various channels. In the future, demand is forecast to rise for single as well as mixed fruits and vegetable variants, besides, continued addition of new flavours along with attractive pack sizes should also bolster growth. PepsiCo was the second largest company in the nectars category in India with volume and value shares of 19.7% and 20.2% in 2018.

Varun's market share of still drinks



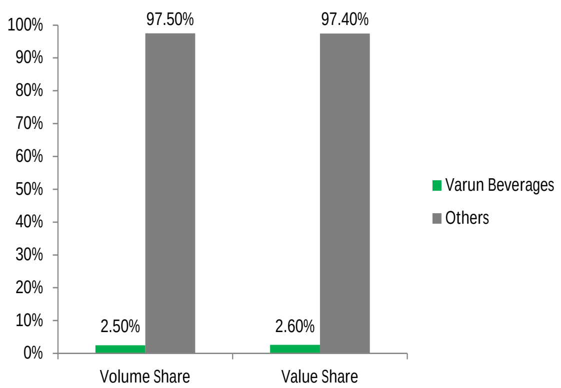
Source: Industry Data, SMIFS Research

Still drinks

Still drinks are flavoured, ready to drink, non-carbonated products, which maybe fruit or non-fruit based with juice content of up to 24.9%. Still drinks may also contain added sugar, artificial flavours and colours. ***Still drinks are most popular among JNSD categories, contributing to 84% of volume share***. Rising preference for more natural and less sugary drinks has led to the popularity of still drinks. The category is more fragmented compared to juices and nectars with regional, national and international players. PepsiCo's volume and value shares in India were 11.1% and 11.5% for this category in 2018.

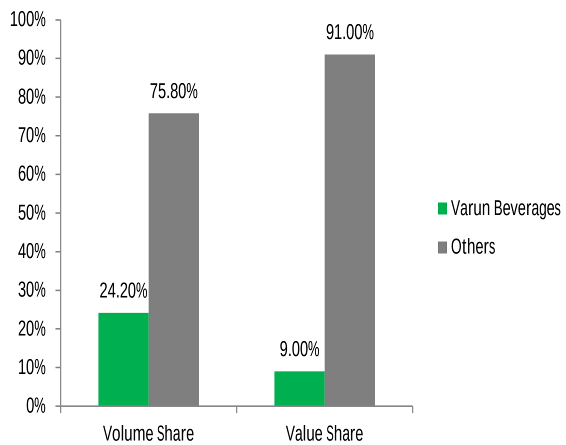
Industry Overview

Varun's market share of sports drinks



Source: Industry Data, SMIFS Research

Varun's market share of energy drinks



Source: Industry Data, SMIFS Research

Sports drinks

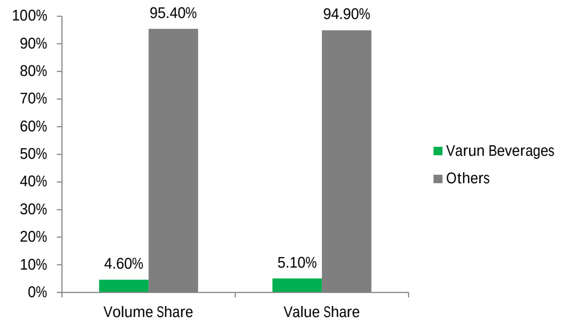
Sports drinks are performance-enhancing products, described as 'isotonic' or 'in balance with', 'hypertonic' or 'lighter than', 'hypotonic' or 'heavier than', body fluids. ***Growing consumer interest towards fitness and sports, particularly in urban areas and growing awareness of such beverages are helping sports drinks to grow***. Sports drinks are primarily consumed by sports enthusiasts and gym-goers to regain essential vitamins, electrolytes, and minerals lost due to rigorous physical activity, in addition to hydration. PepsiCo's volume and value shares in 2018 were 2.5% and 2.6% for this category in India.

Energy drinks

Energy drinks are energy-enhancing products, mainly carbonated and containing stimulants such as caffeine, taurine, guarana, glucuronolactone, yerba mate, along with glucose syrup (corn syrup) and maltodextrin. ***There was a period of subdued growth in India because of bans arising from non-compliance of caffeine content; however, sales regained momentum again from 2017 onwards***. More and more young people in India are consuming energy drinks to handle hectic schedules and strenuous activities. Increasing trend of social gatherings where consumption of these products is gaining popularity and their use as cocktail mixtures are also fueling growth. PepsiCo's volume and value shares in 2018 were 24.2% and 9% for this category in India.

Industry Overview

Varun's market share of packaged drinking water



Source: Industry Data, SMIFS Research

Packaged drinking water

Packaged drinking water is plain, still, carbonated and low carbonated water of up to 10 litres. ***Health concerns arising from quality issues in water from utility has primarily driven demand for packaged drinking water***. As per Industry data, volumes are expected to grow at a CAGR of 9% between 2019 and 2024. Increasing use of water filters is however a threat to the sales growth of packaged drinking water. PepsiCo's volume and value shares in 2018 were 4.6% and 5.1% for packaged drinking water in India.

Flavoured water

Flavoured water benefits from ***increasing consumer perception of it being healthier than carbonated soft drinks and sugary drinks, such as, nectars and still drinks***. The category is in its nascent stages and recorded a sales volume of 28.7 million litres in 2018. Corporate customers are showing an increase in fondness for flavoured water. The category recorded a 15.7% volume growth in India in 2018. PepsiCo is not yet present in this segment.

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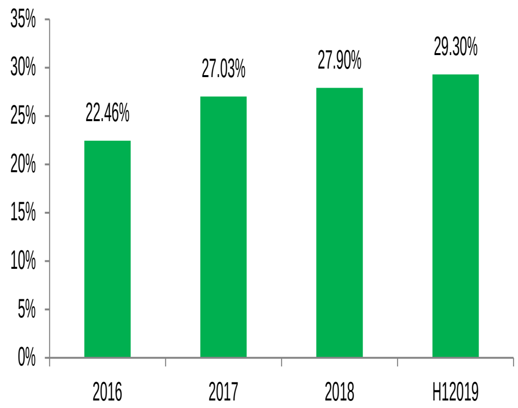
Key Risks

Termination or non-renewal of PepsiCo India Agreements or PepsiCo International Agreements or Tropicana India Agreement or Tropicana India TSDA by PepsiCo India/ PepsiCo Inc./ SVC/ PepsiCo International Entities or TPI or any material modification to the existing terms in such agreements adverse to Varun's interest will materially and adversely affect Varun's ability to continue its business and operations and its future financial performance

Varun's business is entirely dependent on the contracts it has entered into with PepsiCo and its various affiliates.

It should be noted that Varun's business is entirely dependent on the contracts it has entered into with PepsiCo and its various affiliates. These contracts govern the franchise operation rights for specified number of years (***current India operations contract is valid till April 2039***), notice period necessary for severing the relationship, price of exercising the assets call option rights or shares call option rights by PepsiCo India and/ or PepsiCo Inc in the event of contract termination, maintenance of controlling stake in Varun by the Jaipuria family, maintenance of debt equity ratio below the level of 2:1, etc. The point is Varun's business unlike that of many retail or consumer facing business is directed and governed to quite an extent by PepsiCo. Hence, if Varun fails to adhere to the various terms and conditions contained in the contracts, the business relationship between Varun and PepsiCo would come to a halt and this is the inherent risk of Varun's business model.

Cost of concentrate as a % of raw material costs



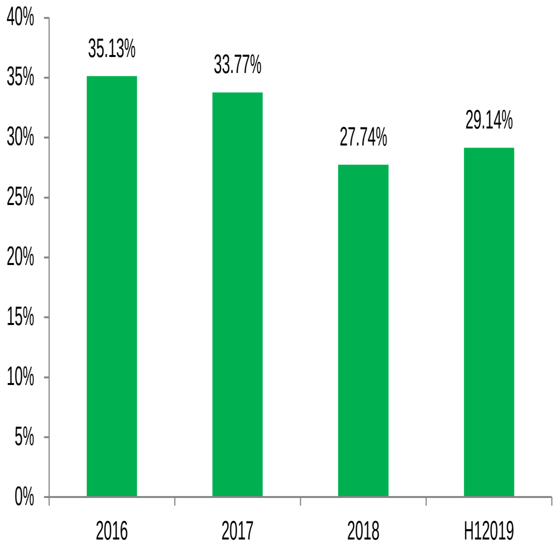
Source: Industry Data, SMIFS Research

Mandatory purchase of concentrates from PepsiCo and payment of royalties to Pepsi

The cost of concentrate purchased from PepsiCo forms a major part of the raw material costs. For CY 2016, CY 2017, CY 2018 and for the six months ended June 30, 2019, the cost of concentrate was 22.46%, 27.03%, 27.90% and 29.30% respectively of the total cost of raw materials consumed. ***Till now, the concentrate price is determined by PepsiCo in discussions with Varun, after taking into account the selling price, input price and other market conditions***. ***However, there can be no assurance that such practice will continue in the future or that Varun will be able to pass on any increase in concentrate costs to its customers***. Further, Varun is required to pay royalty on Aquafina water and Evervess soda to PepsiCo at current rates of 1.3% and 1% of net realization respectively. The royalty terms are discussed between Varun and PepsiCo; however, there can be no assurance that in the future the royalty terms will remain conducive for Varun. Further, ***there is also no assurance that PepsiCo will in the future not require Varun to pay royalty for other PepsiCo products***.

Key Risks

Sugar as a % of raw material costs



Source: Company Data, SMIFS Research

An interruption in the supply or significant increase in the price of raw materials or packaging materials may adversely affect Varun's business, prospects, results of operations and financial condition

Sugar and pet chips are two of the key raw materials apart from concentrate that Varun procures. Sugar represented 35.13%, 33.77%, 27.74%, and 29.14% of the total cost of raw materials consumed in CY 2016, 2017 and 2018 and in the six months ended June 30, 2019, respectively. ***Varun typically does not enter into long term purchase agreements with sugar manufacturers or pet chips manufacturers. Thus, in the absence of long term supply contracts, Varun is susceptible to a sudden and significant increase in prices of sugar and pet chips***. Additionally, Varun is susceptible to the risk that one or more of the existing sugar or pet chips suppliers may discontinue supplies to Varun, and unless Varun is able to enter into alternative arrangements in a timely manner and on favourable terms, Varun's business operations and financial performance may get adversely affected with a negative impact on margins.

Varun's growth plans and expansion strategies are subject to prior approval of PepsiCo, and an inability to secure such approval may adversely affect its business prospects and future financial performance

Varun continues to evaluate acquisition of production facilities as well as franchises for new territories and other PepsiCo products, subject to prior approval from PepsiCo.

Varun continues to evaluate acquisition of additional production facilities as well as franchises for additional licensed territories and sub-territories. Varun also intends to obtain franchises for other existing or newly introduced beverage products of PepsiCo. Under the PepsiCo Agreements, any such acquisition will require prior approval from PepsiCo. While in the past, PepsiCo granted franchises for additional licensed territories and sub-territories to Varun from time to time, including territories that were earlier operated directly by PepsiCo or by other franchisees, there can be no assurance that PepsiCo will continue to grant Varun franchises for additional territories or sub-territories or provide approval for the acquisition of additional production facilities in the future. In addition, if PepsiCo were to grant other franchisees, the franchise rights to territories currently licensed to Varun, it may materially and adversely affect Varun's business operations and future financial performance. Varun's growth plans and expansion strategies are therefore subject to the approval of PepsiCo and if PepsiCo were to deny any such approval for any reason, it could adversely affect its prospects.

Key Risks

Bad weather conditions, including disturbed summers or untimely rains during summers, may adversely affect Varun's sales volumes.

Adverse weather conditions during the summer months in India may materially and adversely affect Varun's sales

Sales of PepsiCo beverages are considerably higher in the summer months of April through June in India, due to the hot weather, and considerably lower during the winter months of December through February. In CY 2018, Varun's sales volume in India during the quarter of April to June accounted for 43.33% of the annual sales volume in India. Bad weather conditions, including disturbed summers or untimely rains during the peak season of summer, may adversely affect Varun's sales volumes, and could therefore have a disproportionate impact on Varun's results of operations for the year. Further, the seasonality of Varun's results of operations may be affected by unforeseen circumstances that affect Varun's production during such peak periods, such as any downtime to production due to breakdown of equipment, shortage of raw materials, inadequate inventory planning and other interruptions to timely production and delivery of Varun's products to the market.

SWOT Analysis

Strengths

- High market share.
- Operation spanning the entire value chain: right from preform and crown manufacturing to the bottling and distribution of the beverages. Concentrate for carbonated beverages and juices are procured from Pepsi.
- Rich experience in manufacturing and distribution of beverages.

Weaknesses

- Consumer perception of carbonated beverages as unhealthy products.
- Interruption in the supply or significant increase in the price of raw materials and the inability to pass on the price increase to end consumer.

Opportunities

- Market penetration in India for each of Varun's products is very low compared to global standards.
- Juices and no sugar carbonated beverages present a huge growth opportunity.
- Electrification in rural areas of India would lead to significant growth of cold carbonated and non carbonated beverages.

Threats

- Potential of plastic ban by the Government of India, may affect the bottling of beverages in PET bottles, though PET bottles are recyclable.

Company Overview

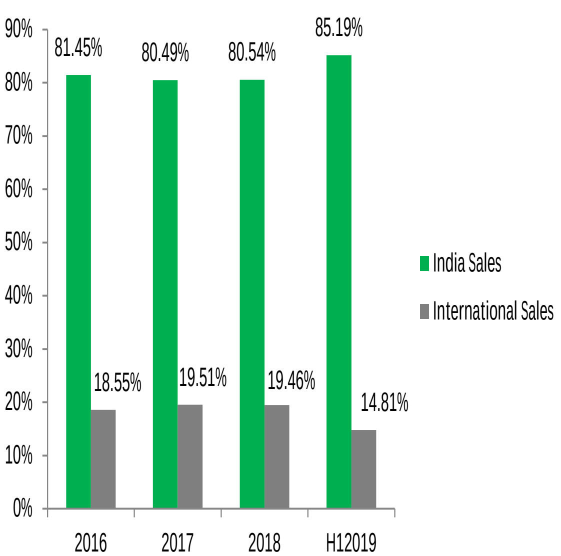
Source: Company Data

Varun Beverages is one of the largest franchisee in the world (outside USA) of carbonated soft drinks ("CSDs") and non-carbonated beverages ("NCBs") sold under trademarks owned by PepsiCo Inc., PepsiCo India, Stokely-Van Camp Inc. ("SVC"), Tropicana Products Inc. ("TPI") and/ or their affiliates (collectively, "PepsiCo"). ***It is a solid proxy play on the long-term growth story of the soft drinks industry in India.*** It is a part of the conglomerate RJ Corp, which has diverse interests in beverages, fast-food restaurants, retail, ice cream, dairy products, healthcare and education.

Varun produces and distributes a wide range of CSDs, as well as a large selection of NCBs, including packaged drinking water. PepsiCo CSD brands produced and sold by Varun include ***Pepsi, Pepsi Black, Diet Pepsi, Pepsi Max, Mirinda Lemon, Mirinda Orange, Mountain Dew, Slice Fizzy, Seven-Up, Seven-Up Nimbooz Masala Soda, Teem, Sting, Duke's and Evervess***. PepsiCo NCB brands produced and sold by Varun include ***Tropicana Slice, Tropicana Frutz (Lychee, Apple and Mango), Tropicana Juices (100%, Delight and Essentials), Seven-Up Nimbooz, Gatorade, Aquafina flavour splash, Ole***, as well as packaged drinking water under the brand ***Aquafina and Aquavess***. Very recently, Varun has ventured into ***ambient temperature value added dairy based beverages under the Cream Bell brand***.

As of June 30, 2019, Varun has been granted franchises for various PepsiCo products across 27 States and 7 Union Territories in India. India is Varun's largest market and contributed to 81.45%, 80.49%, 80.54% and 85.19% of Varun's total sales volume (in million unit cases) in CY 2016, CY 2017, CY 2018, and in the six months ended June 30, 2019, respectively. ***Varun has also been granted the franchise for various PepsiCo products for the territories of Nepal, Sri Lanka, Morocco, Zambia and Zimbabwe***. Varun has been associated with PepsiCo since the 1990s and has consolidated its business association with PepsiCo over two and a half decades, increasing the number of licensed territories and sub-territories covered by it, producing and distributing a wider range of PepsiCo beverages, introducing various SKUs in its portfolio, and expanding its distribution network.

Varun's geographical sales mix



Source: Company Data

Varun got listed on the BSE and NSE in Nov 2016 through an IPO comprising of 25 mln equity shares at a price of Rs 445 per equity share aggregating to Rs 1112.50 crores. ***Varun recently did a QIP in Sept 2019 through which it garnered Rs 900 crores*** by issuing 14,705,882 equity shares at a price of Rs 612 per share. The entire QIP amount was used to pay debt.

Key Management Team

- **Mr. Ravi Kant Jaipuria— Promoter and Chairman**

  Mr. Ravi Kant Jaipuria is the promoter and chairman of the Company with over three decades of experience in conceptualizing, executing, developing and expanding food, beverages and dairy business in South Asia and Africa. He holds immense reputation as an entrepreneur and business leader. He also holds the distinction of being the only Indian to receive PepsiCo's award for International Bottler of the Year, awarded in 1997 and is the founder of RJ Corp.

- **Mr. Varun Jaipuria— Whole-time Director**

  Mr. Varun Jaipuria attended Millfield School, Somerset, England and has 10 years of experience in the soft drinks industry. He has been with the Company for 10 years and has been responsible for the development of new business initiatives that includes implementation of sales automation tools.

- **Mr. Raj Pal Gandhi— Whole-time Director**

  Mr. Raj Pal Gandhi is a commerce graduate from University of Delhi, and a qualified chartered accountant, he has over three decades of rich experience in the field of finance, strategy, legal and M&A. He has been with the Group since 1993 and has been instrumental in strategizing its diversification, expansion, mergers and acquisitions, capex funding and institutional relationship.

- **Mr. Kapil Agarwal— Whole-time Director and CEO**

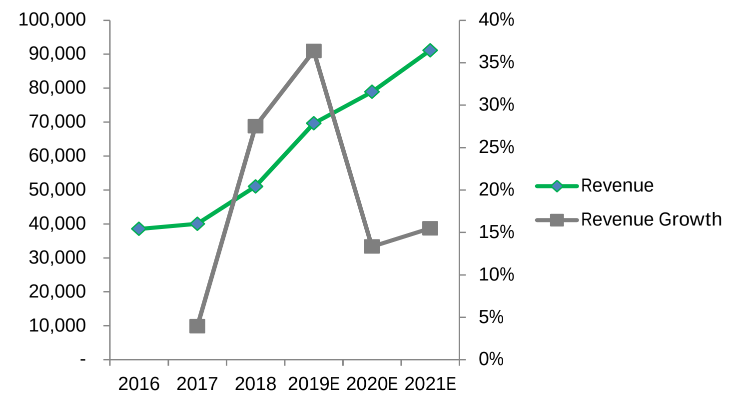
  Mr. Kapil Agarwal is a commerce graduate from Lucknow University and holds a post-graduate diploma in business management from the Institute of Management Technology, Ghaziabad. He has been with the Group since 1991 and currently heads the operations and management as CEO. He has nearly three decades of experience in sales and marketing.

- **Mr. Vikas Bhatia— Executive Director and CFO**

  Mr. Vikas Bhatia is a commerce graduate from Calcutta University, and a qualified chartered and cost accountant. He is with the Company since Jan 2019. He possesses nearly three decades of experience in finance with reputed multi national companies.

Key Performance Indicators

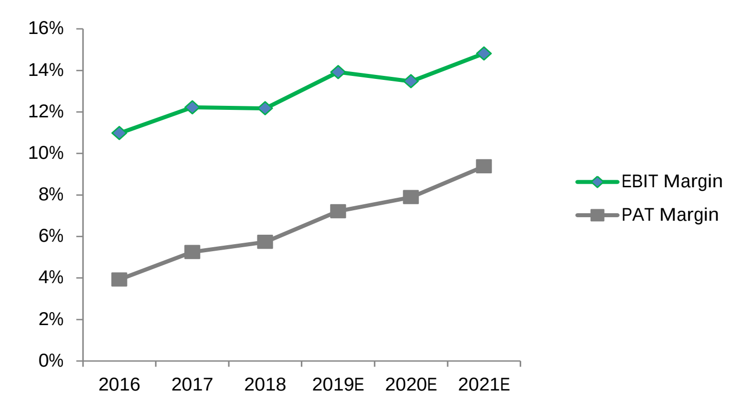
Revenue & Revenue Growth



Source: Company Data, SMIFS Research

Revenue from operations is expected to grow at a CAGR of 21% between CY2018 and CY2021E. This would be accompanied by a volume CAGR of 22% during the same period.

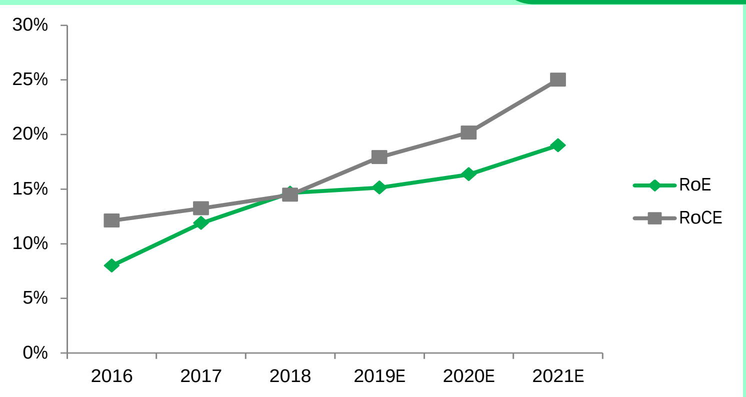
Profit Margins



Source: Company Data, SMIFS Research

EBIT Margins are expected to be in the range of 13.5-14.8% between CY2019E and CY2021E while PAT Margins are expected to be in the range of 7.2-9.4% in the same period.

RoE and RoCE

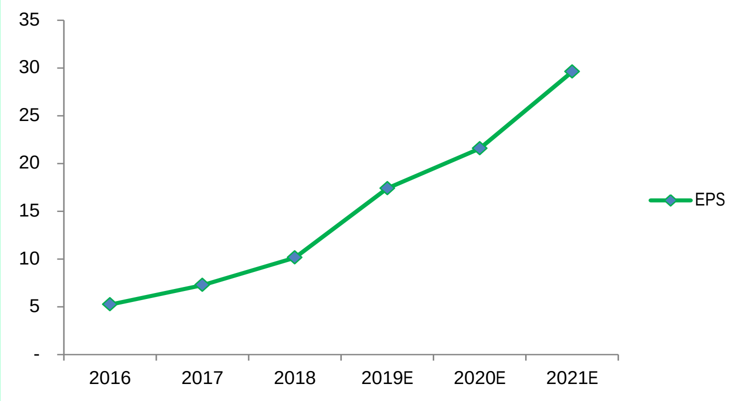


Source: Company Data, SMIFS Research

RoE and RoCE are expected to remain in the ranges of 15.1-19.0% and 17.9-25.0% respectively between CY2019E and CY2021E.

Key Performance Indicators

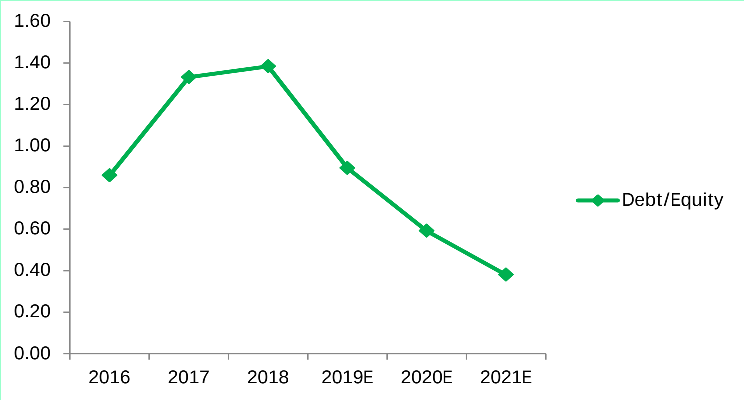
EPS Growth



Source: Company Data, SMIFS Research

EPS is expected to grow at a CAGR of 43% between CY2018 and CY2021E.

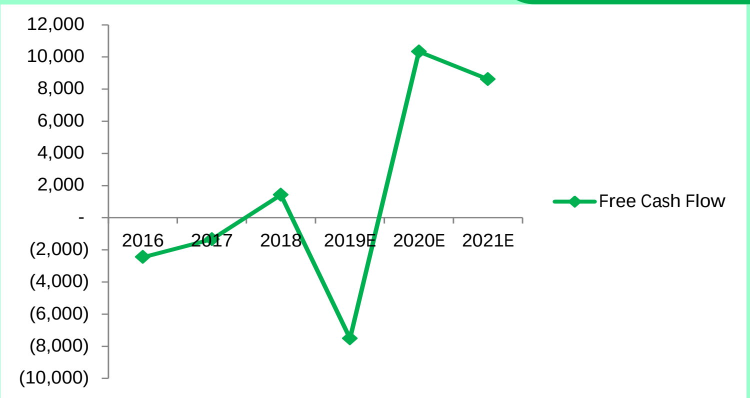
Debt/Equity Ratio



Source: Company Data, SMIFS Research

Our assumptions indicate a steady decrease in Debt/Equity ratio from 0.89 in 2019E to 0.38 in 2021E.

Free Cash Flow Generation



Source: Company Data, SMIFS Research

Varun has been acquisitive and growth oriented in nature because of which its free cash flow was negative in 2016 and 2017 and it is expected to remain negative in 2019E. However, due to minimal capex in 2020E and 2021E, free cash flow is expected to turn positive.

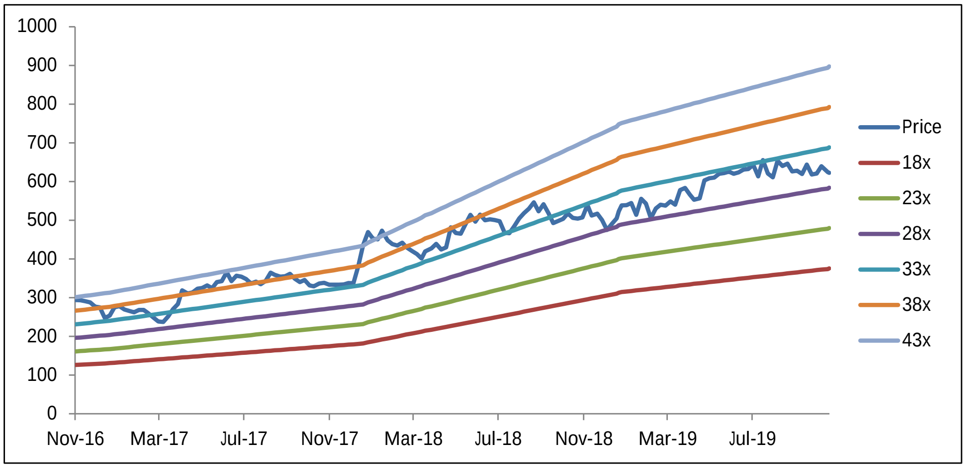
Outlook and Valuation

The market for soft drinks including carbonated beverages and juices along with packaged drinking water is highly under penetrated in India and the per capita consumption of soft drinks in India is way below global standards as already pointed out.

Varun is in a sweet spot as it is the largest bottler of PepsiCo outside the United States and enjoys a high market share in India besides being present in five other countries. Varun has catered to the challenges in the carbonated soft drinks space by introducing healthier products like zero sugar varieties of Pepsi.

Varun has been a fairly acquisitive company and because of this nature it is now catering to more than 80% of PepsiCo sales in India. Varun intends to leverage on this strength by focusing on under penetrated international territories. Varun's focus on backward integration has helped it to improve on its operating margins and the proximity of Varun's manufacturing plants to various parts of India has helped it to save on logistics cost.

Electrification of rural areas in India is supposed to be a game changer and is expected to provide a huge boost to the sales of carbonated beverages and non carbonated beverages in India.



Source: SMIFS Research

We have valued the stock at a P/E multiple of 30x to CY2021E EPS of INR 29.60 to arrive at a **Target Price of INR 888**. This gives an upside of 23% based on current market price of INR 720. We thus maintain a " **Strong Buy**" rating on the stock.

Peer Comparison

Peers	P/E			P/CF			P/B			RoE(%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Varun Beverages	41.4	33.4	24.3	14.3	16.1	16.9	6.3	5.5	4.6	15.1%	16.3%	19.0%
Tata Global Beverages	34.6	30.1	26.5	25.0	23.2	NA	2.4	2.3	2.2	7.5%	8.0%	8.5%
CCL Products	16.3	13.4	11.9	13.3	10.9	9.6	2.9	2.6	2.3	19.0%	20.5%	20.9%
Coca-Cola Amatil	21.9	20.7	19.6	11.9	11.8	11.1	5.3	4.9	4.6	24.1%	25.0%	24.5%
Coca-Cola European Partners	18.1	16.5	15.3	12.0	10.8	10.2	3.4	3.3	3.3	18.3%	20.0%	21.2%

Source: SMIFS Research, Bloomberg

Financial Details

Income Statement (Consolidated)					
Particulars (INR Cr.)	CY17	CY18	CY19E	CY20E	CY21E
Revenue from operations	4004	5105	6963	7891	9113
Revenue Growth	4%	28%	36%	13%	15%
Cost of goods sold	1810	2244	3133	3543	4083
Employee benefits expenses	463	583	817	1026	1157
Other expenses	895	1272	1546	1736	2005
EBITDA	836	1007	1467	1586	1868
EBITDA Margin	20.9%	19.7%	21.1%	20.1%	20.5%
EBITDA Growth	5%	20%	46%	8%	18%
Depreciation & Amortisation	347	385	498	523	518
EBIT	489	622	969	1063	1350
Interest Cost	212	213	270	187	142
Other Income	13	22	10	12	13
PBT	291	434	714	894	1227
Tax expense	77	134	214	268	368
PAT	210	293	502	623	854
PAT Margin	5.2%	5.7%	7.2%	7.9%	9.4%
PAT Growth	39%	39%	71%	24%	37%

Balance Sheet (Consolidated)					
Particulars (INR Cr.)	CY17	CY18	CY19E	CY20E	CY21E
Share Capital	183	183	289	289	289
Reserves & Surplus	1585	1824	3020	3514	4208
Networth	1768	2006	3309	3803	4497
Long term Borrowings	1691	1980	1755	1110	518
Other Non-Current Liabilities	235	304	341	358	383
Short term Borrowings	353	378	748	497	597
Other Current Liabilities	1235	1363	1718	1998	1939
Total Equity & Liabilities	5284	6031	7870	7765	7933
Net Tangibile Asset	3687	4213	5896	5614	5451
Other Non Current Assets	628	678	664	693	725
Inventories	439	578	766	872	1064
Trade Receivables	150	128	229	250	325
Cash and Cash Equivalents	65	43	47	64	71
Other Current assets	276	391	269	272	298
Assets classified as held for sale	38	-	-	-	-
Total Assets	5284	6031	7870	7765	7933

Source: Company Data, SMIFS Research

Financial Details

Cash Flow Statement (Consolidated)					
Particulars (INR Cr.)	CY17	CY18	CY19E	CY20E	CY21E
PBT	290	431	708	889	1221
Depreciation & Amortisation	347	385	498	523	518
Interest expense	203	204	270	187	142
(Increase)/Decrease in CA	(89)	(278)	(131)	(149)	(293)
Increase/(Decrease) in CL	(107)	228	335	116	19
Taxes Paid	(57)	(73)	(214)	(268)	(368)
Cash Flow from Operating Activities	620	1000	1459	1289	1231
Capital Expenditure	(754)	(858)	(2211)	(256)	(370)
Interest Received	5	6	8	7	7
Cash Flow Investing Activities	(745)	(873)	(2203)	(239)	(373)
Increase/(Decrease) in Borrowings	727	457	201	(714)	(545)
Cash Flow from Financing Activities	159	(84)	748	(1033)	(851)
Net Cash Flow	33	42	4	17	7
Closing Balance	65	43	47	64	71

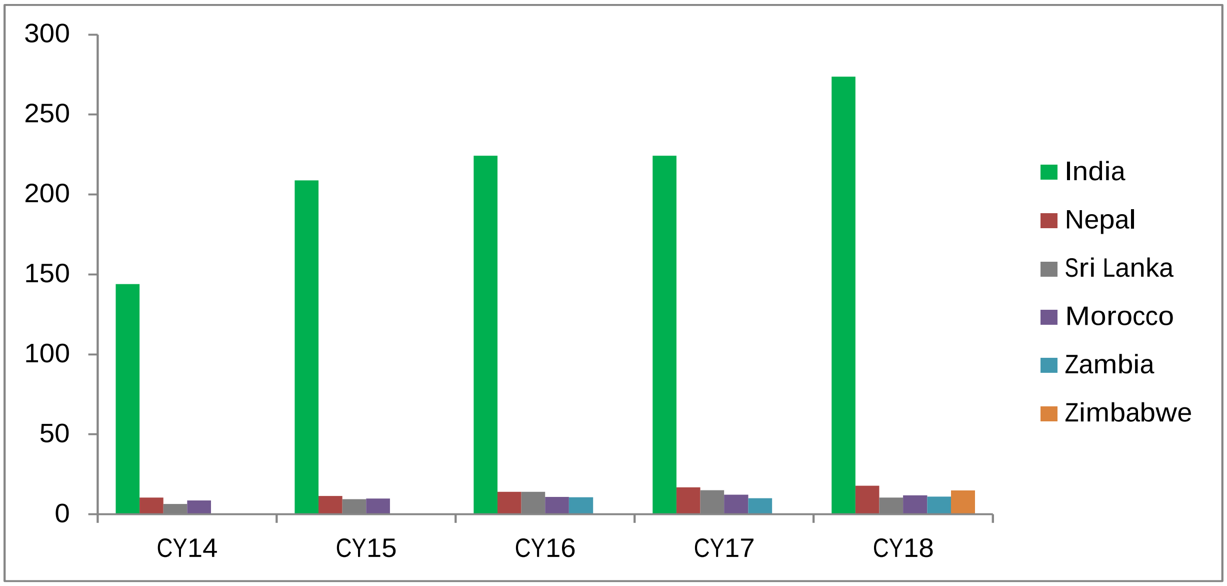
Key Ratios (Consolidated)					
Particulars	CY17	CY18	CY19E	CY20E	CY21E
Margins					
Gross Margin	54.8%	56.0%	55.0%	55.1%	55.2%
EBITDA Margin	20.9%	19.7%	21.1%	20.1%	20.5%
PBT Margin	7.3%	8.5%	10.3%	11.3%	13.5%
PAT Margin	5.2%	5.7%	7.2%	7.9%	9.4%
Solvency Ratios					
Current Ratio	0.6	0.7	0.5	0.6	0.7
Debt/Equity	1.3	1.4	0.9	0.6	0.4
Net Debt/Equity	1.3	1.3	0.9	0.6	0.4
Interest Coverage	2.3	2.9	3.6	5.7	9.5
Profitability Ratios					
RoE	11.9%	14.7%	15.1%	16.3%	19.0%
RoCE	13.2%	14.5%	17.9%	20.2%	25.0%
Valuation Ratios(x)					
P/E	99.0	71.0	41.4	33.4	24.3
P/S	5.2	4.1	3.0	2.6	2.3
P/B	11.8	10.4	6.3	5.5	4.6
P/CFO	33.6	20.8	14.3	16.1	16.9

Source: Company Data, SMIFS Research

Annexure 1— Geographical Distribution of Volumes Sold

Volumes Sold (Million Unit Cases)					
Country	CY14	CY15	CY16	CY17	CY18
India	143.97	208.88	224.24	224.24	273.60
Nepal	10.54	11.40	14.01	16.92	17.91
Sri Lanka	6.54	9.52	14.14	15.05	10.50
Morocco	8.75	9.89	10.77	12.30	11.86
Zambia			10.67	10.01	11.08
Zimbabwe					15.05
Consolidated	169.80	239.69	273.84	278.52	340.01

Source: Company Data



Source: Company Data

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