

Sector update

Hatsun Agro (HOLD)

Heritage Foods (BUY)

Parag Milk Foods
(HOLD)

Dairy

Outlook CY21: Sector at cyclical high margins

Due to reduction in milk procurement prices, the dairy companies under our coverage reported life-high margins in CY20. While there was some impact on revenues due to lower sales to HoReCa and institutions, the B2C sales were not impacted in CY20. Milk procurement prices declined due to (1) reduction in demand from HoReCa and B2B consumers and (2) normal monsoon as well as flush season. Global SMP prices declined c.10% which also impacted milk prices in India. In H1CY21, we model the dairy companies to continue to report life-high margins. However, we expect milk procurement prices to increase in H2CY21 and expect reduction in EBITDA margins in H2CY21. We model the Dairy companies under our coverage to report revenue and PAT growth of 12% and 28%, respectively in CY21, YoY. Stock calls: Retain BUY on Heritage, HOLD on Hatsun and Parag.

- ▶ **What happened in CY20:** Stock prices of dairy companies (Heritage & Parag) declined 12-15% whereas Hatsun's share price increased c.40% due to better earnings. The revenue growth of dairy companies was in the range of min-single digits in CY20, YoY whereas PAT growth was 60-100%, YoY. EBITDA margins expanded due to reduction in milk procurement prices.
- ▶ **Lower milk procurement prices:** Milk procurement prices declined 12% in Dec'20 from Dec'19 levels. Key reasons for higher milk procurement prices were (1) lower demand for milk from B2B customers, (2) lower demand for value added products such as ice-cream, (3) normal monsoon in CY20 and (4) normal flush season in CY20.
- ▶ **Lower global SMP prices:** Due to lower demand for milk globally, SMP prices declined to US\$2,799 in Dec'20 from US\$3,036 in Jan'20.
- ▶ **Deflation in animal feed prices:** The animal feed prices also declined during CY20 and key reasons were (1) Lower demand from farmers due to lower milk prices, (2) Higher production of food-grains and (3) availability of green fodder due to normal monsoon. Godrej Agrovet's animal feed prices deflated 3% in Q3CY20.
- ▶ **What to expect in CY21:** We expect milk procurement prices to remain lower in H1CY21 but increase in H2CY20 due to rising food inflation which will push animal feed prices upwards. We also model dairy companies to raise prices in H2CY21. We model the dairy companies under our coverage to report revenue and PAT growth of 12% and 28%, respectively in CY21 over CY20.
- ▶ **Stock Calls:** We maintain Heritage as our top pick in Dairy sector with BUY rating. While we remain structurally positive on Hatsun, we need more comfort on valuations to turn bullish. Hence, we rate Hatsun HOLD. We also maintain HOLD rating on Parag as the company is unlikely to retain benefits of lower milk procurement prices. It generates c.35% revenues from B2B consumers.

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Valuation summary

Company	Reco	CMP	TP	EPS (Rs)			P/E (x)			RoE (%)		
		(Rs)	(Rs)	FY20	FY2E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Hatsun	HOLD	785	820	6.9	12.8	17.0	113.1	61.5	46.1	12.3	20.7	24.3
Heritage	BUY	328	400	12.5	33.7	33.3	26.1	9.7	9.8	8.9	28.2	22.3
Parag	HOLD	116	112	11.2	10.3	13.1	10.4	11.2	8.9	11.0	9.2	10.6

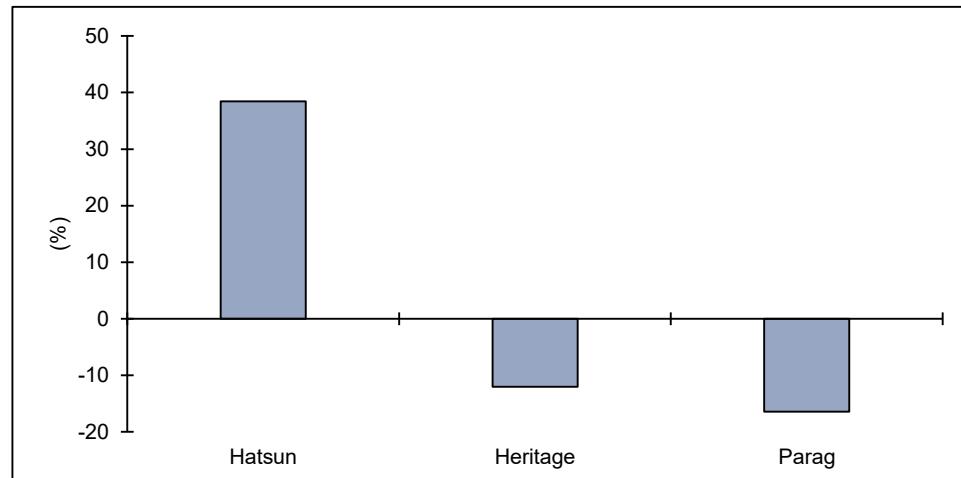
Source: Company data, I-Sec research

Dairy sector: Outlook CY21

What happened in CY20?

The stock prices of dairy companies (Heritage and Parag) declined in CY20 due to slowdown in revenues and lower HoReCa sales. However, there is recovery in stock prices in H2CY20 with recovery in margins and earnings. Hatsun reported strong price performance in CY20 with improvement in earnings.

Chart 1: Stock price performance of Dairy stocks in CY20YTD

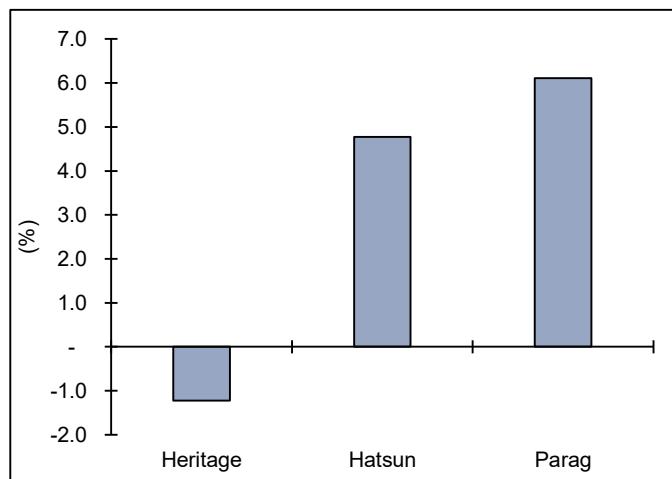


Source: Bloomberg, I-Sec research

Revenue and PAT growth of Dairy stocks in CY20

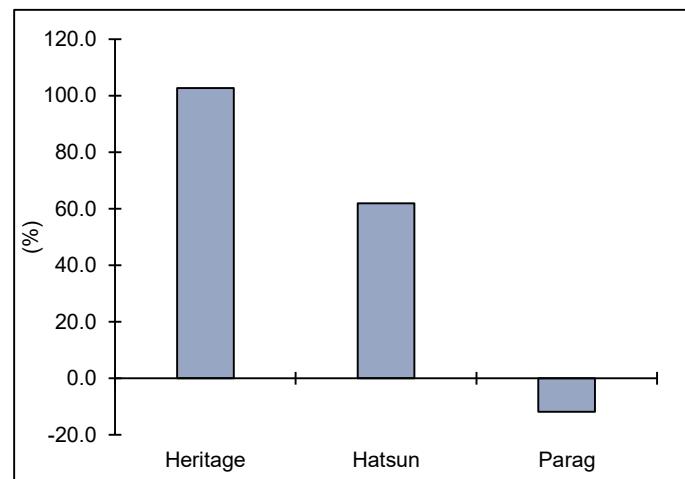
The revenues of dairy companies grew in the low-mid single digits in CY20, YoY. PAT growth of Heritage and Hatsun was in the range of 62-100%, YoY. PAT growth was higher than revenue due to expansion in EBITDA margins and lower effective tax rates.

Chart 2: Revenue growth of Dairy companies in CY20



Source: Company, I-Sec research

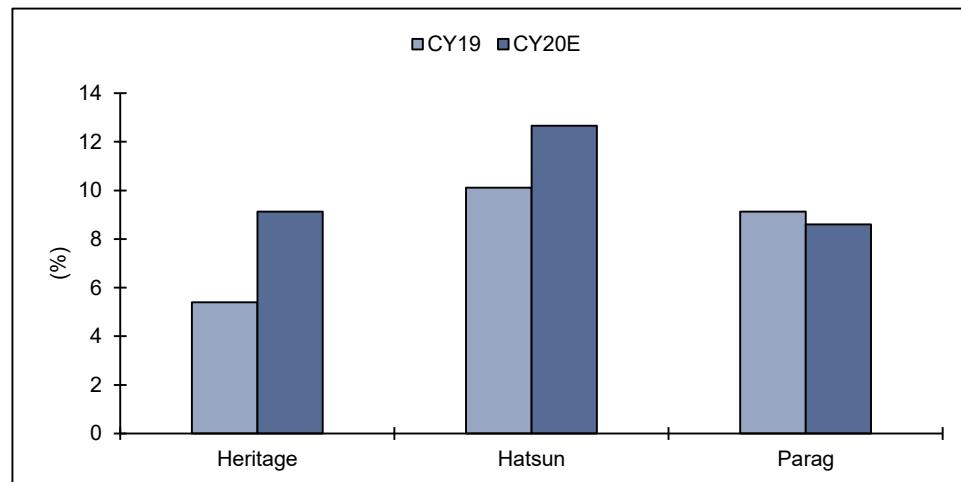
Chart 3: PAT growth of Dairy companies in CY20



Improvement in EBITDA margins of Dairy companies

The EBITDA margins of dairy companies expanded in CY20 over CY19 due to lower milk procurement prices. Higher availability of milk and lower demand due to covid resulted in expanding EBITDA margins of dairy companies. Dairy companies have not cut selling prices in-spite of reduction in milk procurement prices. Hatsun also benefitted due to backward integration.

Chart 4: EBITDA margins of dairy companies expanded in CY20

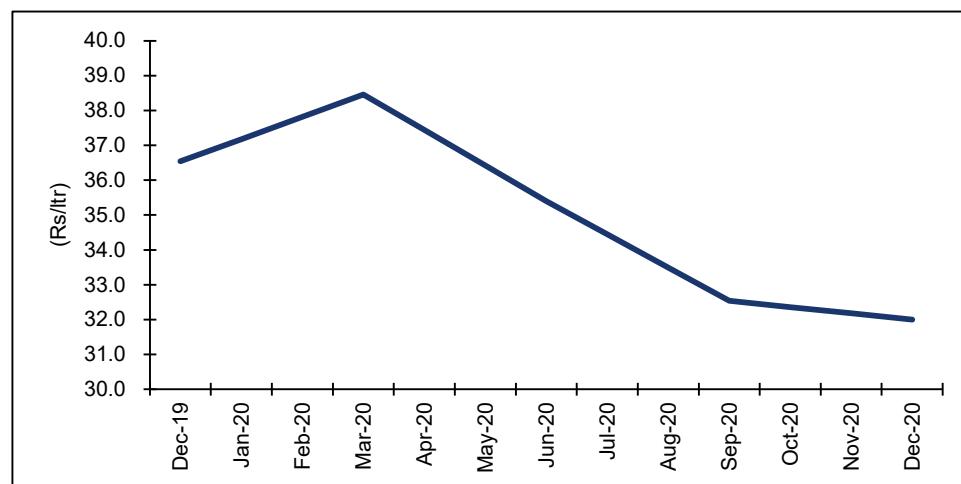


Source: Company, I-Sec research

Milk prices and key events in CY20

The year CY20 commenced with higher milk prices but with commencement of covid in Feb-Mar'20, the milk prices started declining. There was reduction in consumption of ice-cream and the consumption by HoReCa sector also started declining. The demand from HoReCa segment started declining from Mar'20. However, with gradual re-opening up of the economy, the milk prices have stabilized at lower level.

Chart 5: Milk procurement prices declined in CY20



Source: Company, Industry, I-Sec research

Key events in CY20

Higher milk prices: The year (CY20) commenced with higher milk prices. Due to muted flush season in CY19-20, the milk prices were higher in beginning of CY20.

Beginning of covid: Post commencement of covid, the demand from HoReCa sector declined resulting in sharp correction in milk procurement prices.

Normal monsoon: Normal monsoon as well as timely beginning of monsoon resulted in further reduction in the milk prices.

Gradual re-opening of economy: Gradual re-opening up of economy from Jun'20 resulted in higher demand for milk from HoReCa sector.

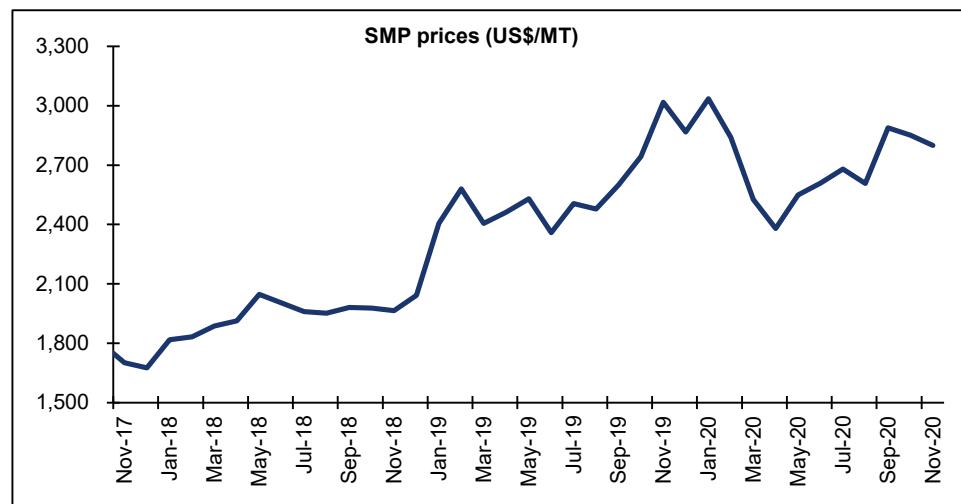
Normal flush season: The flush season commenced normally in CY20. Normal monsoon and availability of green fodder resulted in pushing milk prices further down.

Lower milk prices: Milk prices will end CY20 at its lowest level during the year. However, the cattle feed prices have started rising and are expected to impact the milk prices in H1CY21.

Higher SMP prices

The skimmed milk powder prices declined to US\$2,380/MT in Apr'20 from US\$3,036 in Jan'20. The key reason for higher SMP prices was reduction in milk demand but higher supply. However, SMP prices have now recovered with recovery in global GDP. The SMP prices have recovered to US\$2,799/MT in Nov'20.

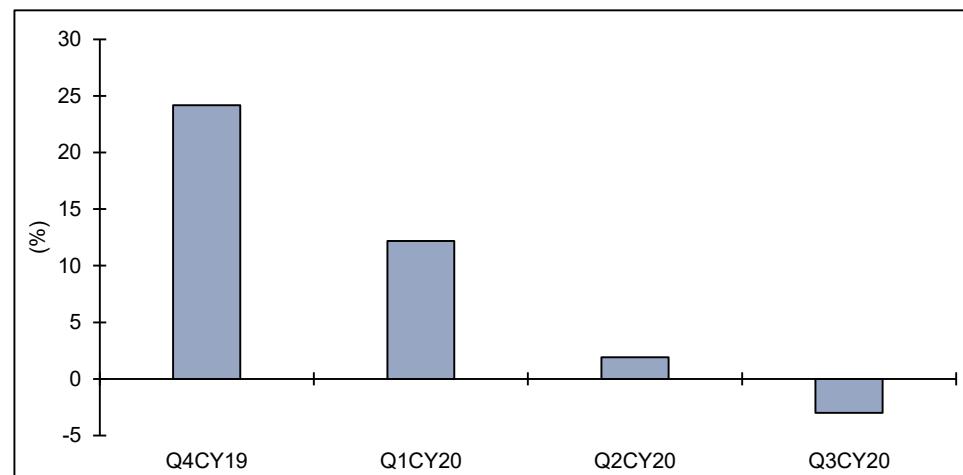
Chart 6: Skimmed milk powder prices



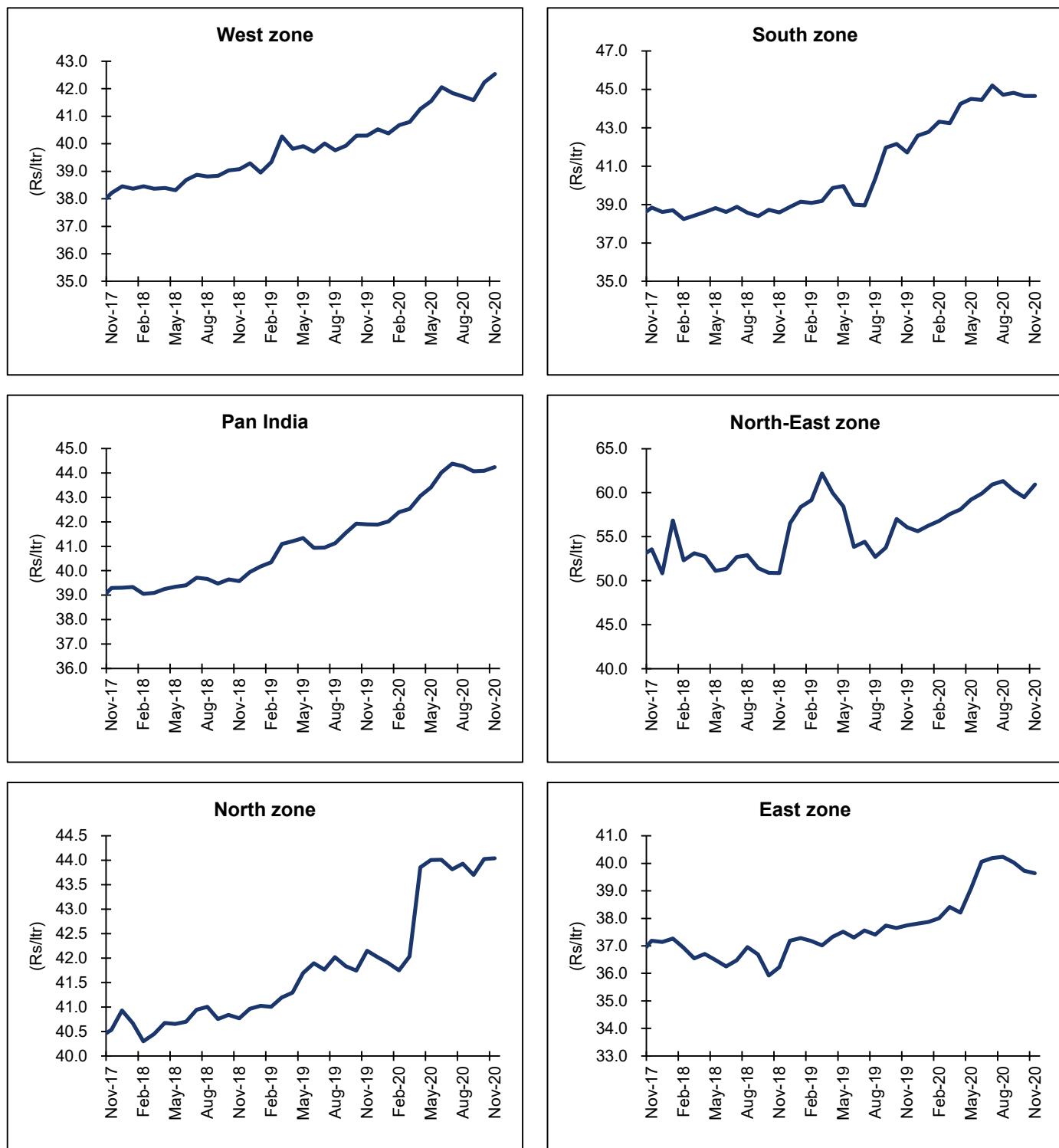
Source: Company, Industry, I-Sec research

Gradual reduction in prices of animal feed

There was steady reduction in animal feed price hikes by Godrej Agrovet. It had raised prices by 24.2% in Q4CY19 whereas there was price deflation of 3% in animal feed prices in Q3CY20. Key reason for lower animal feed prices was higher availability of food-grains and normal monsoon. We expect low double digit inflation in animal feed prices in CY21 due to rising food inflation.

Chart 7: Inflation in animal feed prices*

Source: Company, I-Sec research *Price hikes by Godrej Agrovet

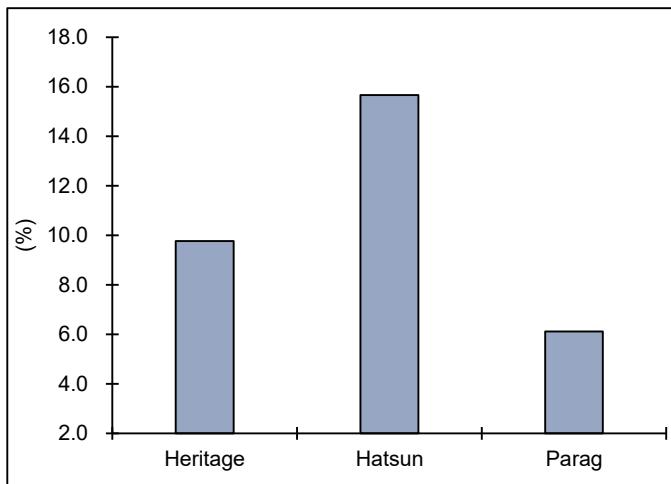
Chart 8: Milk prices in India and its regions

Source: Company, Department of consumer affairs, I-Sec research

What to expect in CY21?

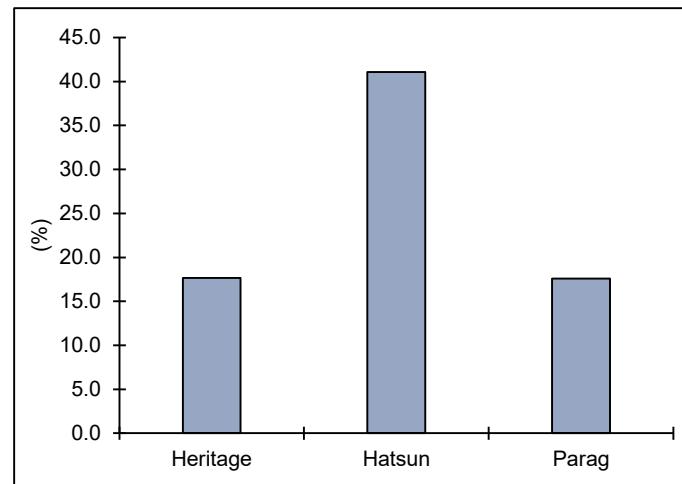
We expect the milk demand to increase in CY21 over CY20. We do not expect dairy companies to raise prices in H1CY21 but expect some price hikes in H2CY21. We expect PAT growth to remain strong (Higher than revenue growth) in CY21.

Chart 9: Revenue growth in CY21E, YoY



Source: Company, I-Sec research

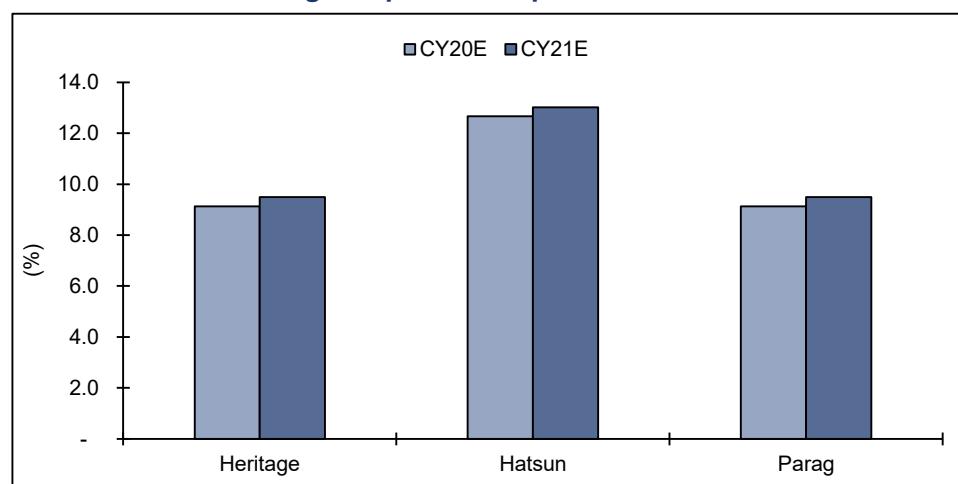
Chart 10: PAT growth in CY21E, YoY



EBITDA margins to expand in H1CY21 but decline in H2CY21

EBITDA margins of dairy companies are expected to expand 50-100bps in H1CY21 compared to H1CY20. As the margins of dairy companies are above 'Mean PE + 1SD', we expect correction in margins in H2CY21. However, for the CY21, we model margins to be better than margins in CY20.

Chart 11: EBITDA margin expansion expected in CY21E

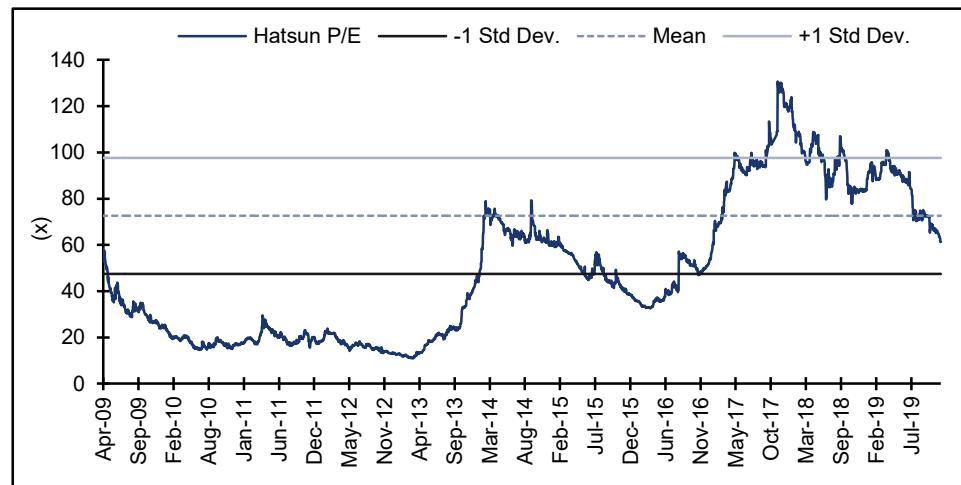


Source: Company, I-Sec research

Stock calls

Hatsun Agro: Hatsun is likely to focus more on growing its business in Maharashtra in CY21. Its dairy plant at Solapur, Maharashtra, Andhra Pradesh and Tamil Nadu are likely to commence production in CY21. We also model reduction in losses of Oyalo business. We model Hatsun to report revenue and earnings CAGR of 11% and 56.5% over FY20-22. While we remain structurally positive on Hatsun, we need more comfort on valuation to turn bullish on the name. Maintain HOLD with DCF-based target price of Rs820 (implied P/E 49x FY22E; Earlier TP-Rs830).

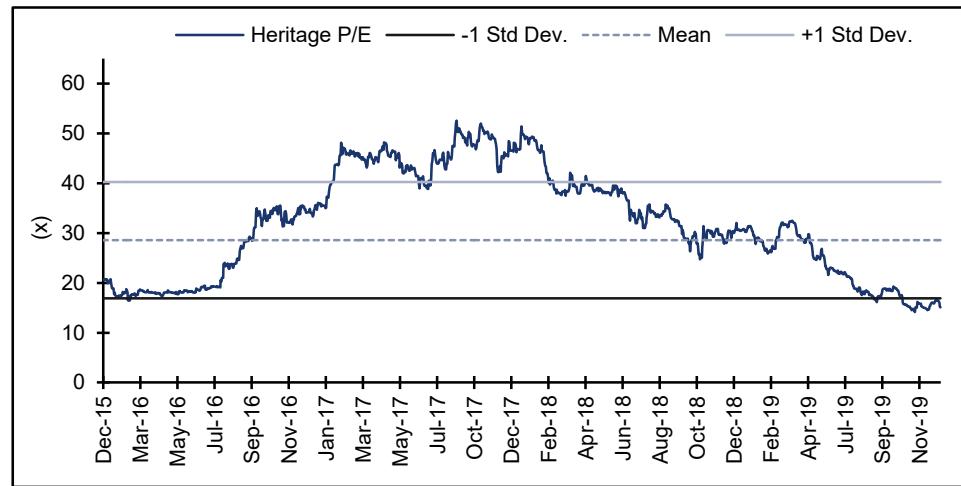
Chart 12: Mean P/E and standard deviation



Source: Bloomberg, I-Sec research

Heritage Foods: Heritage is likely to focus more on its premium yoghurts business in CY21. It has sold the entire stake in Future Retail and plans to use proceeds to repay debt. We expect interest cost savings in CY21. The savings can be used for organic growth as well as higher brand building activities. The animal feed segment is also expected to improve profitability in CY21 as the teething issues are almost over in CY19-20. We model Heritage to report earnings CAGR of 63% over FY20-22E. Maintain BUY with DCF-based target price of Rs400 (implied P/E 12x FY22E).

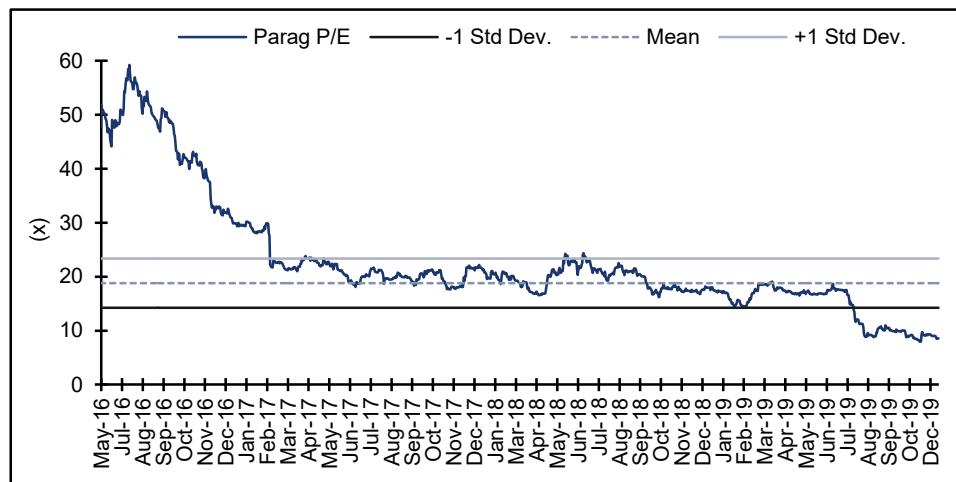
Chart 13: Mean P/E and standard deviation



Source: Bloomberg, I-Sec research

Parag Milk Foods: We expect Parag Milk Foods's CY21 to be sharply better than CY20 with gradual reopening up of the economy. There will be higher demand from HoReCa segment. Also the sales to institutions will increase. Parag's key region (i.e. West Maharashtra) was severely impacted due to covid. We expect recovery in key regions of Parag which will lead to healthy growth in CY21, YoY. We model earnings CAGR of 8.3% over FY20-22E. Maintain HOLD with DCF-based target price of Rs112 (implied P/E 8xFY22E; Earlier TP-Rs108).

Chart 14: Mean P/E and standard deviation



Source: Bloomberg, I-Sec research

Table 1: Change in target prices

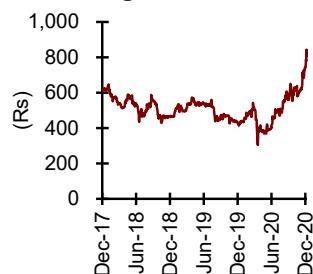
	Rating		Target price (Rs)	
	Old	New	Old	New
Hatsun	Hold	Hold	830	820
Heritage	BUY	Buy	400	400
Parag	Hold	Hold	108	112

Source: Company, I-Sec research

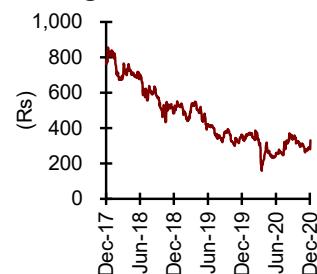
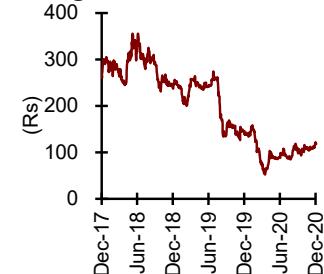
Table 2: Key financials and valuations

Company	CMP (Rs)	Market Cap (Rs mn)	RoE (%)		CAGR (%) FY19-22E			P/E (x)	
			FY20E	FY21E	FY22E	Revenue	PAT	FY21E	FY22E
Hatsun	785	1,26,943	12.3	20.7	24.3	11.0	56.5	61.5	46.1
Heritage	328	15,219	8.9	28.2	22.3	4.8	63.0	9.7	9.8
Parag	116	9,737	11.0	9.2	10.6	2.2	8.3	11.2	8.9

Source: Company, I-Sec research

Price charts**Hatsun Agro**

Source: Bloomberg

Heritage Foods**Parag Milk Foods**

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