



SH KELKAR RESEARCH NOTE

BY VALUE DUDE

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DISCLAIMER

- The views expressed here are my personal views. This is NOT a stock recommendation. Kindly do your own due diligence and/or consult a registered investment advisor before making any investment decisions.
- I currently **do not have any holdings** in the company analyzed in this note

INVESTMENT, INVESTIGATION THESIS!

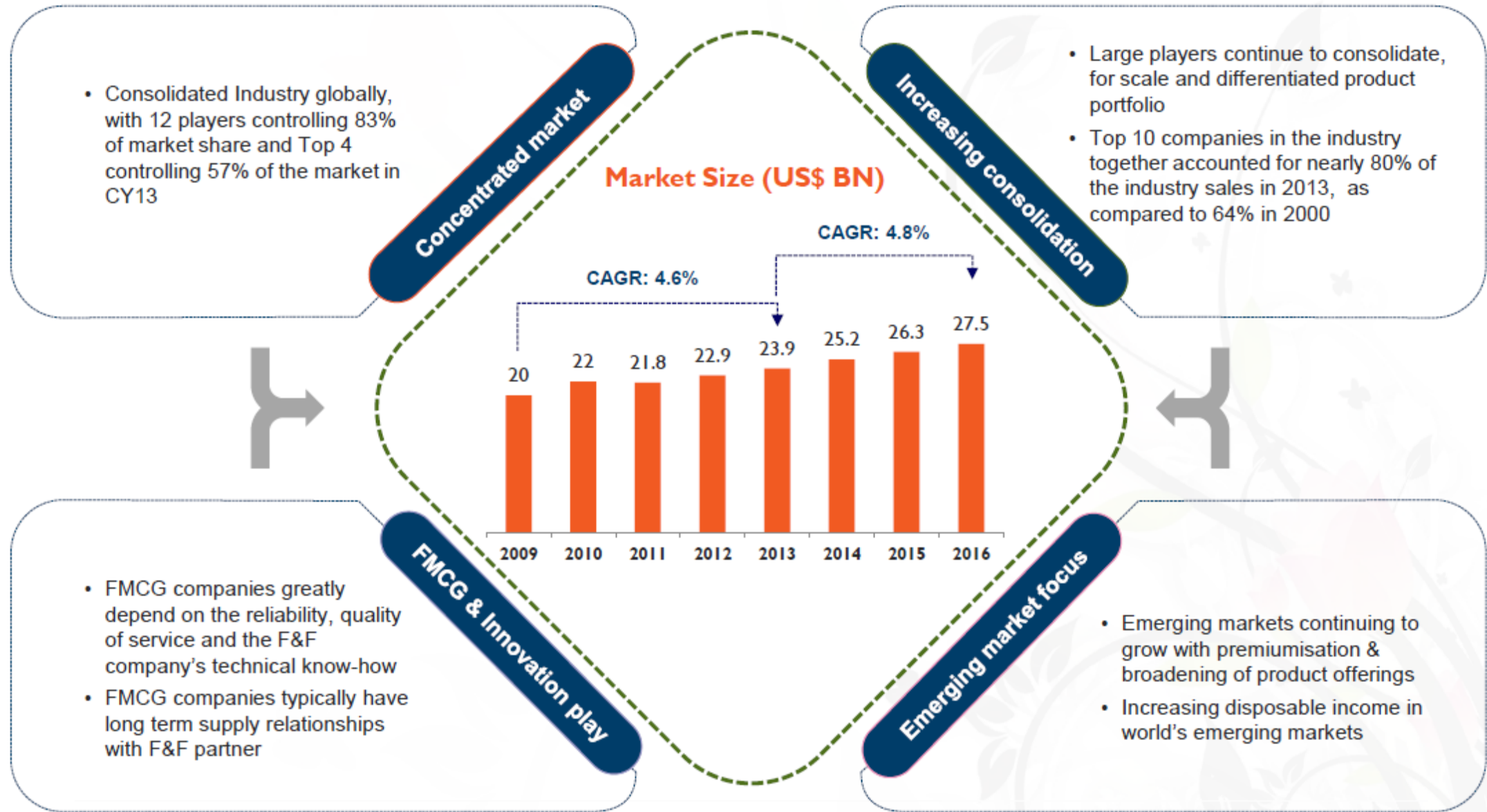
Below are the factors that got me started on investigating this company. I was heavily influenced by Peter Lynch's philosophy while writing this up. Biases are inherent and all mine!

- Overall slow growth industry (globally 4-5%) with moderately faster expected growth domestically (~8-10%)
- Niche player
- Side car to the FMCG industry, with a play on fine chemicals industry as well
- With the current Indian demographics, increasing urbanization, globally exposed population – there is a potentially growing ask for more choice in products (more unique flavors, fragrances)

My gut feel is that this sector could potentially dove tail on that wave

Key question I continue to ask myself is whether this will be a compounding machine with (almost but not quite) FMCG like characteristics or just mirror the underlying growth characteristics of the industry it operates in (i.e. a middling performer)?

GLOBAL F&F MARKET AND KEY CHARACTERISTICS



COMPANY HIGHLIGHTS

- Full service supplier with over 9,700 fragrance, ingredients and flavor products and a large library of product formulations created over 90 years
- Over 4,100 customers, including leading national and multi-national FMCG companies, blenders of fragrances and flavors, and fragrance and flavor producers
- 4 manufacturing facilities – 3 in India and 1 in Netherlands
- R&D: 18 scientists operating in Mumbai and Barneveld. Research team has developed 12 molecules over the last three years (3 patents filed); Team of 12 perfumers, two flavorists, evaluators and application executives
- Received awards like “Dream Company to Work For Award” in the manufacturing sector by the Human Resource Development Congress in February 2015, award for “Best HR Strategy in Line with Business” at the Global HR Excellence Awards in February 2015, “Best Performance in Quality Award” at Marico Samyut, 2014 and the “Learning and Development - Diversity Award” at the National Learning and Development League Conference in 2014
- Over 3,700 customers for fragrance and fragrance ingredients products, including,
 - Godrej Consumer Products Limited, Marico Limited. Wipro Consumer Care and Lighting Limited, Hindustan Unilever Limited, VINI Cosmetics Private Limited and, J.K. Helen Curtis Limited
- Over 400 customers for flavor products, including,
 - Britannia India, VICCO Laboratories, Vadilal Industries Limited and , Ravi Foods

STRATEGY AND GROWTH LEVERS

- Accelerate growth through strategic acquisitions and partnerships
- Grow the Flavor business
- Maintain and increase market leadership in the fragrance industry in India as well as other emerging markets in Asia, Africa and the Middle East.
- Added focus on increasing penetration of FMCG customers in the personal wash and fabric care products
- Strengthen products portfolio - Expand presence in the branded small pack portfolio, Introduce new products in both the fragrance and flavor segments; through our dedicated sales team, focus on national and multi-national customers;
- Optimize supply chain

MOAT – WIDTH, DEPTH

- Width – Below factors lead me to believe that SHK has a moderately wide moat
 - There are significant barriers for entry in this industry on account of following factors
 - Stringent regulatory environment
 - Volatility in prices of key inputs and difficulty in procurement
 - Need for sustained R&D to keep innovating. Requires a strong R&D team
 - Ability to maintain key customer and supplier relationships over a long period of time
- Depth – Below factors indicate that the moat is narrow
 - The industry is largely oligopolistic in nature and has fairly intense competition
 - Product lifecycles are 3-4 years (from an FMCG standpoint which is the dominant customer)

FINANCIALS

927Cr

Turnover FY16

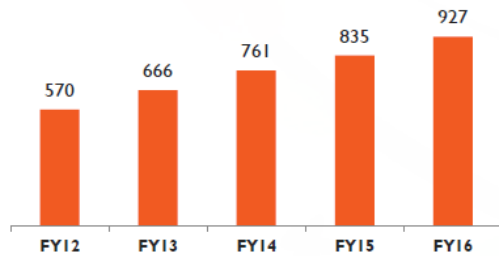
A+

CRISIL Rating

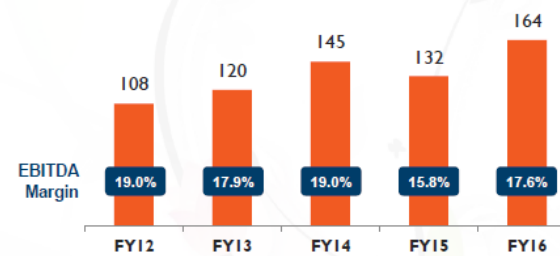
13%

Sales CAGR
2012-16

Net Revenue from Operations



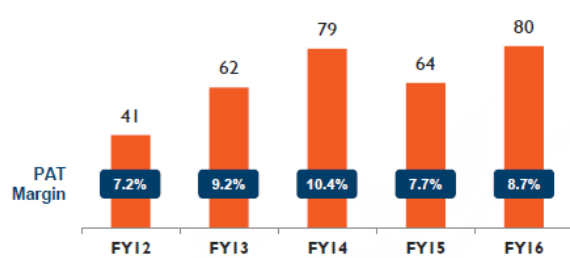
EBITDA



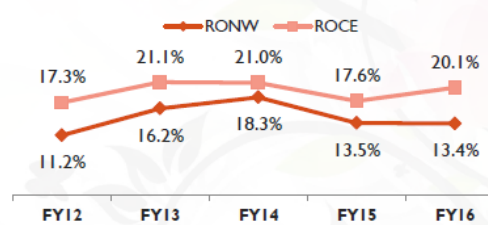
Particulars (Amount in Rs Crore)

	FY13	FY14	FY15	FY16
Cash flow from Operations	103.1	32.1	61.7	86.4
Cash flow from investing activities	-33.3	-63.7	-17.3	-22.4
Net	69.8	-31.6	44.4	64.0

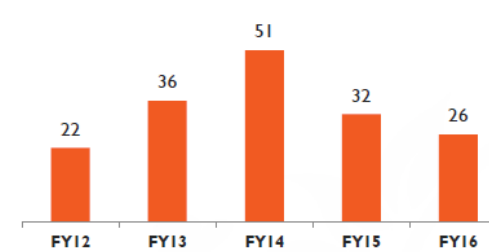
PAT



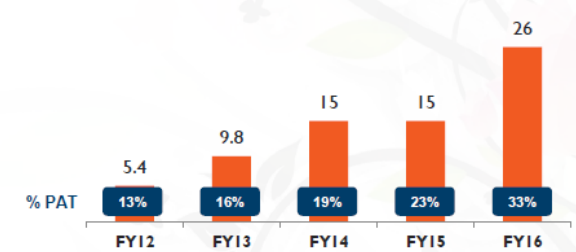
Return on Net Worth & Return on Capital Employed (%)



Capex



Dividend Declared



RISKS

- Dependent on the FMCG sector. Any slowdown in FMCG will have a knock on effect
- Regulatory risks
- Competition from large established MNC F&F companies (like Givaudan, Firmenich etc.) may impact market share and pressure margins
- Domestic/ International split is ~55-45%. Global risks, exchange rate etc. can impact business
- Lack of efficient inventory management and inability to correctly forecast market demand
- Potential conflicts of interest as some of their group companies, are engaged in the same line of business

MANAGEMENT, SHAREHOLDING

- Promoter group Management with deep industry knowledge and decades of operation in the business
- Shareholding: The promoter (non foreign PE based) group holds ~44% of the company
- Compensation: Management compensation seems to be on the higher side given the company size
 - Ramesh Vaze (Chairman): 2.11 Cr (3% of PAT)
 - Kedar Vaze (CEO): 1.32 Cr (2% of PAT)

Additional scuttlebutt and time needed to determine management quality

VALUATIONS

- Factors
 - Company went public in Nov'15 timeframe. Not sufficient data exists for financials as a listed company (though some may be found in the SHK RH prospectus)
 - Relative valuation and a reverse DCF were used to get a rough estimate of whether the company is over/under/ fair valued.
 - Intrinsic Value – Can be calculated based on future cash flows however in order to avoid price anchoring bias this was not done
- SHK is trading at a PE of 53. This is more in line with PE of the FMCG industry as opposed to the fine chemical industry
- Mr. Market is expecting growth rates of ~27% at the current price of ~INR 300. This already discounts the fact that additional CapEx will be in medium term as current average capacity utilization is only 35-40%

This leads me to conclude that at present price levels SHK is quoting at a significant premium with not much margin of safety

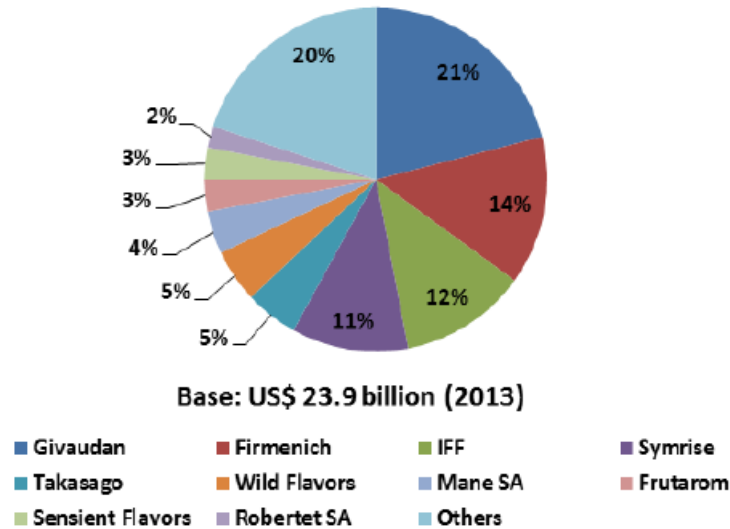


APPENDIX

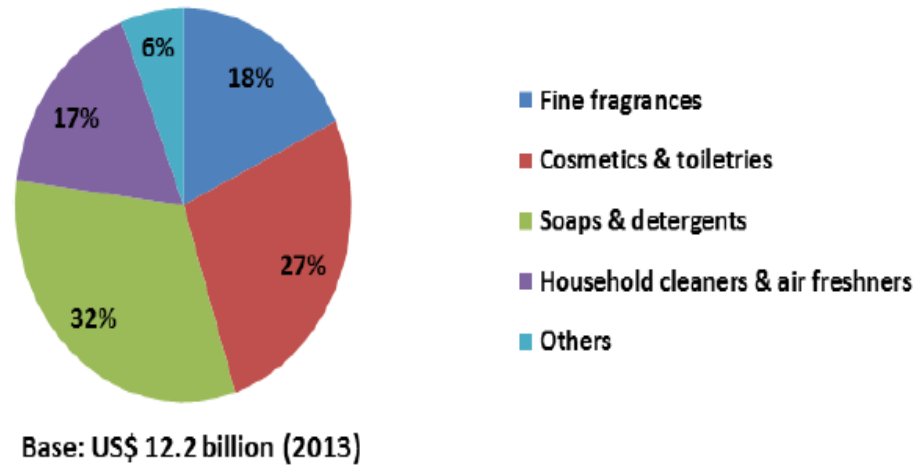
More Industry Details

GLOBAL F&F INDUSTRY

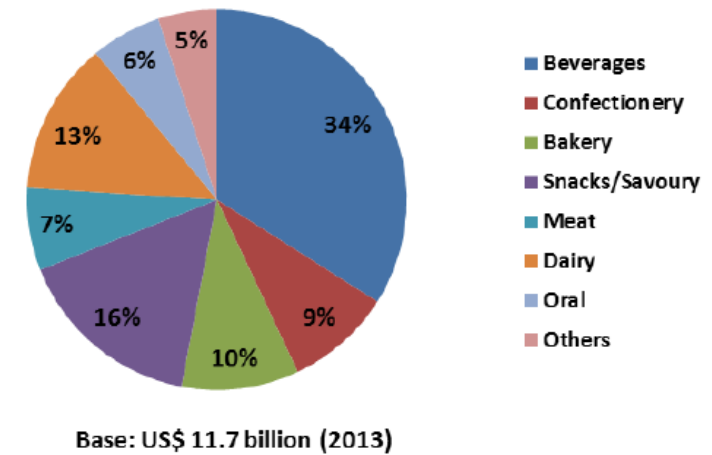
F&F Market



Fragrance Market



Flavor Market



- The global fragrance and flavor industry is estimated to be worth US\$ 23.90 billion with an almost equal split between the fragrance and flavor markets.
- The global fragrance and flavor industry is expected to grow at a CAGR of 4.7% by 2016 to reach an estimated value of US\$ 27.5 billion. (Source: Nielsen Market Study on Fragrances and flavors dated March 22, 2015)
- While the global fragrance and flavor industry is highly fragmented with thousands of players, there is increased consolidation among the larger companies.
- In the calendar year 2013, the top 12 companies operating in the global fragrance and flavor industry held approximately 83.0% of the global fragrance and flavor industry. These top 12 companies can be further broken down into the top four companies, consisting of Givaudan SA, Firmenich, International Flavors and Fragrances, Inc. and Symrise AG, that individually hold a market share of above 10.0%, and collectively hold 57.0%

GLOBAL F&F INDUSTRY CONTD.

- **Consolidation:** Increasing consolidation can be seen amongst fragrance and flavor companies, particularly of large fragrance and flavor companies taking over smaller, local fragrance and flavor companies and their market shares. Further, local fragrance and flavor companies with an established presence in the emerging markets are viewed as attractive acquisition prospects
- **Emerging Markets:** Many top fragrance and flavor companies are placing greater focus on the emerging markets of Asia-Pacific, South America, the Middle East and Africa due to urbanization and changing lifestyles that are expected to benefit FMCG companies and their fragrance and flavor suppliers. In particular, higher consumer credit coupled with rising incomes will lead to a sustained period of above average consumer spending, including the consumption of FMCG products. F&F companies with exposure to emerging markets also have a significant competitive advantage with respect to their customer base - *Emerging markets are expected to be the primary growth driver of the global fragrance and flavor industry.*
- **Barriers to Entry:** The global fragrance and flavor industry is characterized worldwide by high barriers to market entry (Established long term relationships between fragrance and flavor companies and their customers, especially FMCG manufacturers, Compliance with strict quality and regulatory standards, Most FMCG manufacturers usually avoid replacing their fragrance and flavor supplier as the overall cost of fragrance or flavor products in the context of the final FMCG product is relatively small, smaller fragrance and flavor companies or new entrants may not be in a position to spend such significant amounts on research and development etc.)

INDIAN F&F MARKET STRUCTURE

- Global MNC F&F: Largest sector in the Indian F&F industry, contributing more than 60% of the share. Significant establishments in India and preferred customer base is FMCG multinationals and Indian corporates. Major players include Givaudan, IFF, Symrise and Firmenich.
- Corporate Indian F&F: Well-established firms, many of them with decades of experience. Number of players is relatively small. Customer base is largely restricted to the traditional sector and Indian corporates. Major players includes SH Kelkar
- Small firms: MSMEs, mostly cater to the unorganized market
- The flavor market is highly fragmented. flavor purchasers may range from multinational companies to big Indian industrial houses to small-scale industrial units to local eateries to even individual homes. This is especially true in case of savoury, bakery and confectionary segments where manufacturing process is simple in comparison to other segments, which use more complex manufacturing technology.
- Fragrance market comparatively is more consolidated with majority players being either large or medium to small-scale enterprises. Although some segments do have very small players, the number is too miniscule in comparison

INDIAN F&F INDUSTRY CONTD.

SH Kelkar Market Share

Indian F&F	12%
Fragrance	21%
flavor	2%

- The total market size of the Indian fragrance and flavor industry is estimated at INR 38.05 billion in terms of value
- Out of this total value, 55.0% was attributable to the Indian fragrance market, and 45.0% to the Indian flavor market
- The Indian fragrance market grew at a CAGR of 10.1% over the last four years, and the Indian flavor market grew by a CAGR of 10.4% over the same period (Source: Nielsen Market Study on Fragrances and flavors dated March 22, 2015)
- The organized fragrance and flavor industry is expected to reach INR 35.48 billion by the calendar year 2016, and the unorganized fragrance and flavor industry is expected to reach INR 10.14 billion by the same period
- The top five companies operating in the Indian F&F industry - Givaudan SA, Firmenich, International Flavors and Fragrances, Inc., us and Symrise SA, each held a market share of approximately 23.0%, 14.0%, 14.0%, 12.0% and 7.0%, respectively (Total of ~70.0%)
- Source of competitive is by leveraging their resources and research and development facilities to produce high quality, custom-made products, particularly for their quality conscious multinational customers.

FACTORS AFFECTING THE F&F INDUSTRY

- Traditionally F&Fs commanded a high price due to the flavorist or perfumer's artistic ability and difficulty in creation. However, over the years, prices offered to fragrance and flavor houses by FMCG manufacturers to supply F&Fs have consistently gone down
- Raw materials costs for manufacturing in FMCG are on the rise. FMCG manufacturers are unable to pass on the same to consumers by increasing product costs. In view of this, price increases requested by F&F houses are strongly resisted by FMCG manufacturers (despite the genuine concern of F&F industry affected by increase in the prices of aroma and flavor chemicals that are the building blocks of their products)
- Fragrance and flavor manufacturing is not complex oil and involves simple mixing and making a blend of about 10 to 100 different chemical ingredients. On these,
- some may be natural and some synthetic. Improving fragrance delivery systems using techniques like encapsulation, sustained release, or using newer methods in counteracting specific malodours, etc., are some areas where F&F houses are concentrating to maintain their existing business and to increase profit margins. The development of captive aroma chemicals is another way larger F&F houses use to maintain leadership position and prevent cheaper imitation of their fragrance creations
- Safety Rules and Regulations Another important factor in the F&F industry is the strict safety norms, restricting the use of many chemicals, either due to governmental regulations or due to self regulation by the industry itself. For example, some fragrance ingredients are not permitted for use on grounds of safety, while some others are restricted in their level of use in fragrances, depending on the intended end-use. Products intended to remain on skin viz., "leave-on" products, such as body lotions have stricter restrictions than those for products that are washed off the skin viz. Household products (e.g. Floor Cleaners) for which there are little or no intentional skin contact. The fragrance industry is guided by the IFRA (International Fragrance Research Association) guidelines for fragrance ingredients as defined and published in the IFRA safety standards

OPERATIONS IN THE F&F INDUSTRY

- The F&F industry operations are minuscule when compared to the bulk chemical industry.
- The F&F industry still uses the batch process unlike the continuous processing methods prevalent in the chemical industry. It requires a lot more number of ingredients albeit in smaller quantities in order to create a single flavor or fragrance.
- This explains why every F&F companies manufacture their products only on receipt of confirmed purchase orders, so that their needs to keep low inventories of raw materials are met. Inventory management thus is a very important function and streamlining systems and their operations necessary.
- Maintaining sufficient quantities of aroma materials at all times is difficult without accurate forecasting of the fragrance or flavor need by the purchasing companies. This leads to long lead times, sometimes almost six to eight weeks for fragrance or flavor supply, which can be critical to end-user FMCG manufacturers.
- Environmental conditions, political upheavals, dependence on imports, are other reasons responsible in affecting availability and cost of aroma ingredients and impacting supply and demand. This has led the global F&F houses to source the raw materials from Indian suppliers, which help in bringing down the cost for procurement and reducing lead times.

FUTURE OUTLOOK

- The F&F industry today is at a crossroads with rising input costs and dropping prices of the compounded products. However, there is growth in absolute terms. Rising incomes, better education and more awareness will mean a higher inclination to spend on 'Quality Lifestyle' products for home and health, personal grooming and social symbols
- The demand for flavors will also continue to rise as the processed food market continues to grow. Regular use of flavors and fragrances in a product is no longer a luxury but a necessity for consumer acceptance. flavors and fragrances that are novel will continue to be popular and gain better and faster acceptance
- India traditionally used more of natural flavors as Indians preferred freshly prepared foodstuff unlike in Europe and America where artificial or synthetic flavor were in demand due to the use of canned frozen food and beverage. This is likely to continue.
- However, due to fundamental changes in lifestyles certain food items, beverages, confectionaries, bakery, and snacks that generally use artificial additives will increase giving a fillip to the flavor industry in times to come.
- Competition is intense in the F& F industry in terms of quality, price and services rendered to the end user. The competitive edge can only be achieved by use of captive and exclusive ingredient technology that will make ones flavor and fragrance unique and difficult to copy.
- Cost control will continue to play a very important role if one has to maintain a leading position
- The emerging markets represent major marketing opportunities. Speed in building up sizeable presence and market strength in these regions of Asia is critical for survival in view of the dwindling or near stagnant markets of the west
- Despite the presence of many international and Indian F&F houses, it is expected that more F&F houses will attempt to penetrate the Indian market and get their share of the pie. Locally grown private Indian F&F houses too are consolidating and regrouping themselves professionally to measure up to the international houses.
- With the Indian FMCG market, hotting up it is highly unlikely that local Indian F&F companies will lag behind in giving a fair competition to the global giants. It will be very interesting to watch the trajectory of this fragrant industry and savour its flavour in times to come

CURRENT STRATEGIES IN INDIA BY INTERNATIONAL F&F COMPANIES

- Companies today are currently strategizing ways to strengthen their presence and are focusing their sales expansion plans to cater to increasing demand from tier II and tier III cities that eventually drive growth
- Companies are exploring newer variants, thereby creating product differentiation to spur consumption. For e.g. instead of vanilla and chocolate we have flavors such as Tahitian vanilla with honey or white chocolate with cranberries
- Consumers nowadays are becoming progressively health conscious, providing ample opportunity for “health and wellness” food flavors like Blueberry, Grape, Aloe Vera, Pine bark, Soy,
- They are also exploring the natural and functional flavors segment for more variety and marketers are tapping this high potential segment. The concept of natural and traditional Indian herb extracts is also gaining significance in fragrance markets
- Symrise has set up its first perfumery school outside Germany. The Chennai, school intends to train Indian students to create exotic fragrances and flavors for the industry, strengthening its presence in India, as well as establish a talent pool for the Indian and the global market. International Flavor and Fragrance (IFF) India Ltd., recently announced the opening of a new facility for creating new flavors and fragrances for its business unit in Gurgaon

OTHER

- One of the major challenges for players in this industry is to address constantly changing flavor and fragrance demands from consumers. MNC players in the industry extensively focus on undertaking surveys, conducting internal research and forming consumer panels. Cost involved in the research and tracking of consumer trends through exhibitions and trade shows is substantial. Indian companies however, do not give much importance to this aspect of their business, which negatively affects their F&F creations
- Speed in fulfilling customer's demand of right F&F creations is very important to this market
- Adhering to stringent safety norms issued by the Flavor and Extract Manufacturers' Association (FEMA) and International Fragrance Association (IFRA), in the use of several chemicals in the production and creation of flavors and fragrances is also important to Indian F&F houses to succeed at the global level