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Avenue Supermarts

NOT RATED

PRE-IPO NOTE

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D is for Different

Avenue Supermarts (ASL) has become the most profitable supermarket chain (D-Mart) in India despite being a late entrant. It has demonstrated controlled aggression (12 stores in FY08 to 110 in FY16), prudence in costs, focus on inventory turns (12x-on COGS) and above all followed the 'unconventional' model of owning stores. ASL, in many ways, imbibes Wal-Mart's penchant for control over costs and Costco's drive for inventory turns. Savings in finer aspects like store-level costs, deploying higher racks for storage and strong IT processes have resulted in 2x throughput of closest Indian peers. RoE of 24% will likely improve with maturing stores (42% are less than three years old) and de-leveraging from IPO proceeds. Given the strong balance sheet and proven and scalable business model, valuation (₹187bn) of 58x FY16 EPS and 2.3x FY16 EV/sales seem inexpensive.

Store ownership and cost control at the core of this well-oiled machine

ASL's philosophy of owning stores rather than leasing is central to low store cost (opex per sq ft is 30% lower than peers). Also, half of ASL's manpower cost base is contract labour (2% of sales), which imparts flexibility to manage store's peak/trough hours. ESOPs have ingrained a sense of ownership and keep employee cost low, at 2% of sales.

Lowest gross margins but highest inventory turns

Keeping fixed costs low helps give customers better prices and generate high asset turns (3.5x). Unlike peers, ASL has negligible creditor days as it prefers getting cash discount and passing them on to customers, thereby generating higher inventory turns and operating leverage. 12x inventory turns coupled with 150bps margin improvement driven by SSG (average 24% over FY12-16) has driven RoE from 9% in FY12 to 24% in FY16.

This discount retailer will warrant premium valuations

ASL's valuations may appear to be among the most expensive for a supermarket in recent times. However, equity value of ₹187bn basis 10% dilution implies valuation of 58x FY16 EPS and 2.3x FY16 EV/sales. This is not expensive given historical execution, future gains from private labels and improved bargaining power as ASL begets scale. At 12x inventory turns, investors should focus on gross margin levers given the impact on RoCE. We only have to look at early days (comparable to current Indian landscape) of Wal-Mart and Costco, which not only enjoyed premium valuations but also demonstrated FCF/RoCE generation with scale (Wal-Mart's US$4bn FCF in CY96 jumped to US$18bn in CY15). Key risk: Price war by online/offline peers with deep pockets in key regions could hit gross margins and RoCE.

Sound store economics - confluence of cost control and capital efficiency

	FY12	FY13	FY14	FY15	FY16
Revenue per store (₹ mn)	400	570	683	785	862
Store-level EBIT (₹ mn)	28	40	51	61	68
Store-level EBIT Margin (%)	**7%**	**7%**	**8%**	**8%**	**9%**
Store-level Capital employed (₹ mn)	179	194	198	216	223
Store-level RoCE (%)	**16%**	**22%**	**26%**	**29%**	**31%**
SSG (%)	**20%**	**32%**	**26%**	**22%**	**22%**
Company-level EBIT margin (%)	4.6%	5.1%	6.1%	5.9%	6.6%
Company-level RoCE (%; pre-tax)	11%	15%	21%	21%	24%

Source: DRHP, Ambit Capital research

Consumer Discretionary

Key questions for management

On owned stores and costs

- What are the advantages of the owned store model and pace of scalability of this model?
- Does the company envisage any further increase in central costs and why?
- Sales and profit trajectory of stores historically and whether they are different in smaller cities

On product mix and inventory management

- Is the same-store sales growth sustainable (average SSG was 24% over FY12-16)?
- How does the sales mix of a store change as it matures? Is it materially different in the first year from the system average?
- How does the company ensure timely availability of products given the high turns? How many stores/area span can a distribution center service?

On gross margin/capital allocation/FCF generation

- At what point will the company look at increasing the share of private labels (beyond groceries)?
- At what level of operations – scale/portfolio of mature stores – can the company become FCF positive?
- What are the factors (pertaining to store operations) that determine the price ASL is willing to pay buy properties for store?
- What are the reasons for not owning 100% stake in ecommerce venture?

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Own the costs to own the customer

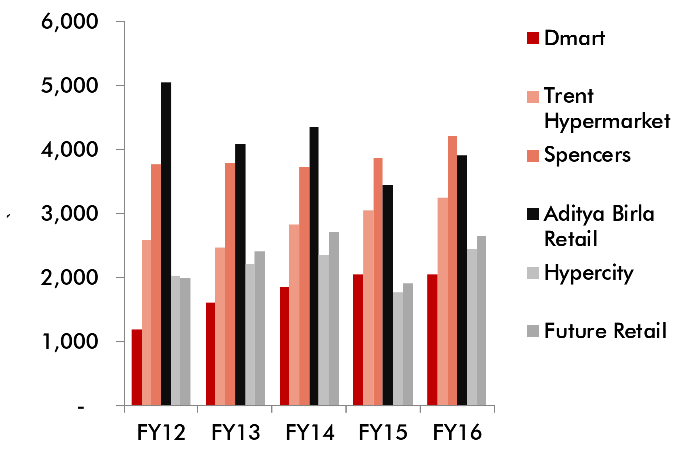
ASL's philosophy is similar to that of Wal-Mart; i.e. offer low prices on an everyday basis. The target audience is low middle income, middle income and aspiring upper middle income consumers. These groups look at value for money in their daily shopping. The key to success in this model is consistently achieving low procurement and operations cost. With the own-store model, ASL has eliminated rental costs (5% for peers). Following a cluster-based approach, it has kept distribution costs and lead time low. The company's central costs at 1% of sales are lower than peers (6%) primarily due to a lean corporate structure, where employee costs are at 2% of sales. The end-result is that ASL's operating costs per sq ft are ~37% lower than peers.

"As a measure for optimum utilisation of our space resources, we have adopted an efficient racking system by deploying higher racks to maximise the space available in store. The upper racks are utilised for storage and the lower ones for display." – Management commentary in the DRHP

Real estate is the key to keeping overheads low

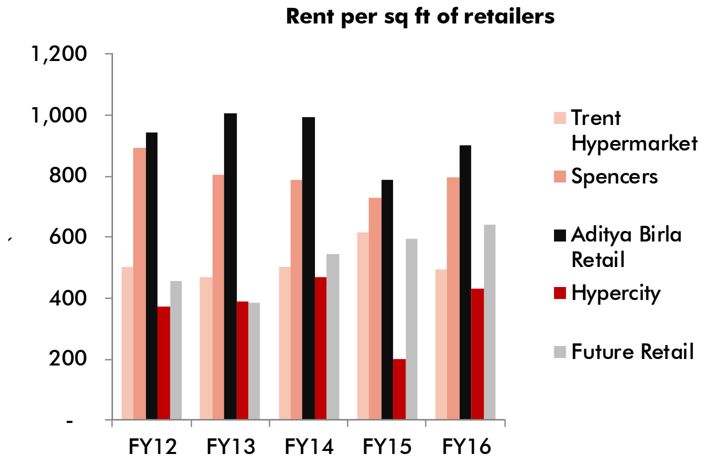
Owned properties give the freedom to allocate space to high margin but relatively slow-moving margin apparel and general merchandise without pressure of rental costs. Moreover, it also helps the company deliver low prices and thus driving asset turns despite owning the property.

Exhibit 1: ASL's opex per sq ft is the lowest vs its peers...



Source: DRHP, Ambit Capital research

Exhibit 2: ...as ASL owns all its properties



Source: Ambit Capital research

Low employee costs and central costs

ASL has kept its employee base lean in the context of its size and operations. Despite operating 3.4mn sq ft, the company has only 4,452 employees on its rolls (as on August 31, 2016), i.e. it has nearly half the employees on rolls per sq ft than peers. The company takes most of front-end staff on contract (2% of sales). This gives it the flexibility to allocate manpower as per the peak/trough hours or days for stores, thus reducing the fixed costs at the store level. The company started its ESOP in FY14 and 1,565 employees have ESOPs (including store managers), thus creating a culture of ownership amongst employees even at the store level.

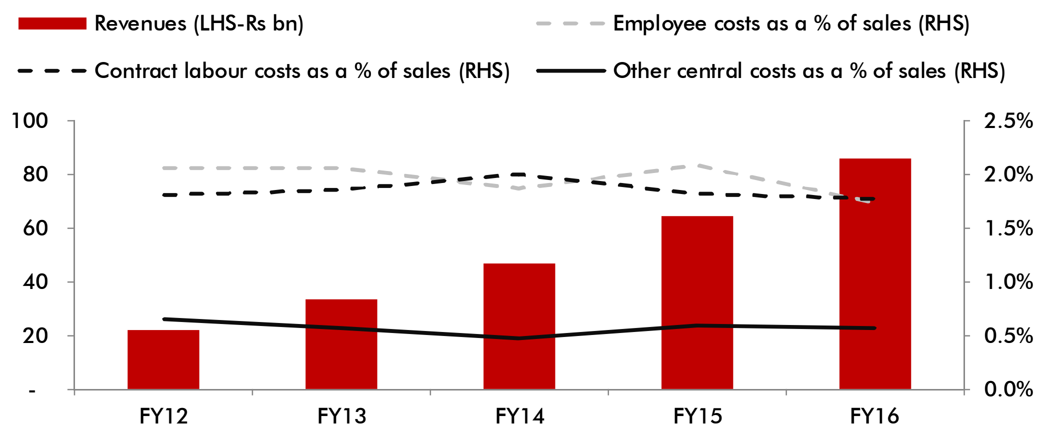
4.1mn shares are granted as ESOPs to 1,565 employees

Exhibit 3: ASL employs the least employees on roll per sq ft

Company	Employees	Area (mn sq ft)	Sq ft per employee
ASL	4,225	3.3	778
Trent Hypermarket	1,568	0.7	450
Hypercity	2,660	1.3	489
Future Retail	32,012	12.9	400

Source: DRHP, Ambit Capital research

Exhibit 4: Central costs are low at 2.3% of revenues



Source: DRHP, Ambit Capital research

Clustered stores help bring down distribution costs

The company opens new stores within a radius of a few kilometers of existing stores and distribution centres. Moreover, the cluster approach helps develop a better understanding of local/regional needs and preferences and, thus, tailor the offerings (basis regional preference, economic strata, etc). The company has opened stores starting in the western region of India and gradually moved to the south-west followed by south-east.

Exhibit 5: Its cluster strategy has made ASL concentrated in West India (81% of revenues in FY16)

Location of stores	FY12	FY13	FY14	FY15	FY16	As on Sep 15, 2016	Revenue contribution
Mumbai	34	40	46	50	58	58	62.6%
Gujarat	14	14	17	22	26	26	18.8%
Telangana	4	5	7	9	13	13	10.2%
Karnataka	3	3	5	5	6	7	6.1%
Andhra Pradesh				1	3	3	1.0%
Madhya Pradesh				1	3	3	0.9%
Chhattisgarh					1	1	0.4%
NCR						1	-
Total	**55**	**62**	**75**	**89**	**110**	**112**	
Total Retail Space (mn sq ft)	1.55	1.76	2.14	2.66	3.33	3.40	

Source: DRHP, Ambit Capital research

Key questions for management on owned stores and costs?

- What are the advantages of the owned-store model and its scalability?
- Do you envisage any further increase in central costs and if so why?
- What is the sales and profit trajectory of a typical store in a metro/non-metro area?

Using low margins to drive high inventory turns

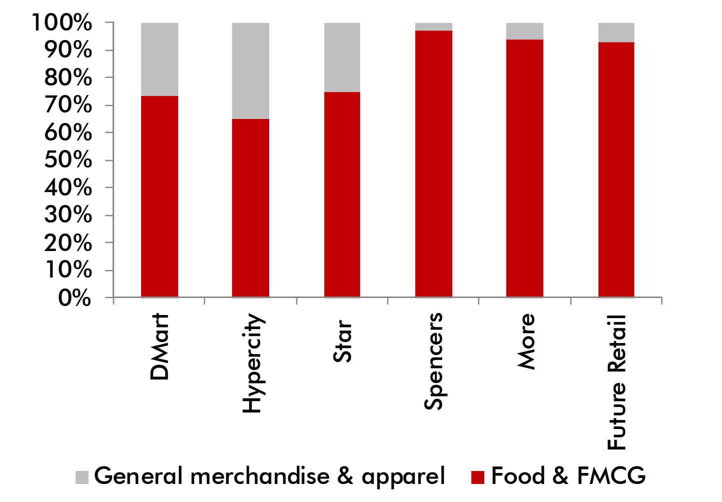
ASL has clocked high inventory turns of 12x over FY13-16 (as against 6x of peers) by offering lower prices, thereby operating at 3.5x asset turns despite owning the properties. The company has invested the savings from rentals and low central costs to offer low prices, which drive higher footfalls and, thus, high sales density (2x that of peers). The product mix and offering are skewed towards essentials, with food and FMCG accounting for 75% of revenues. The attractive pricing of food and FMCG draws footfalls as evident from 10% CAGR in bill cuts per store per day over FY12-16. Meanwhile, the high gross margin (25-30%) categories of apparel and general merchandise, which account for 25% of revenues, helps maintain profitability.

"We believe that we have been successful in foods category due to our deep knowledge of product assortment, pricing dynamics and strong supplier relationships." Management commentary in DRHP

Product portfolio and pricing are focused at driving throughput

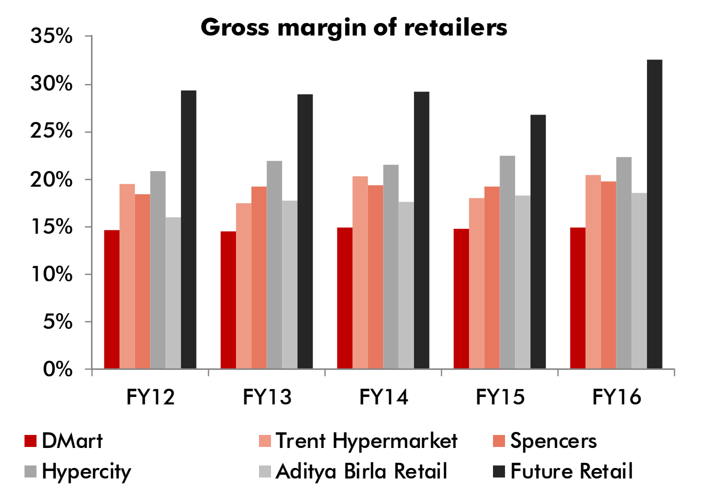
The product portfolio is predominantly food (53% of revenues) and non-food FMCG (21% of revenues), which cater to the daily needs of an average Indian household. The company has consistently passed on any benefits of cost in the essentials to the consumer as is evident from (a) the bill cuts, (b) SSG and (c) gross margins.

Exhibit 6: Revenue mix of retailers...



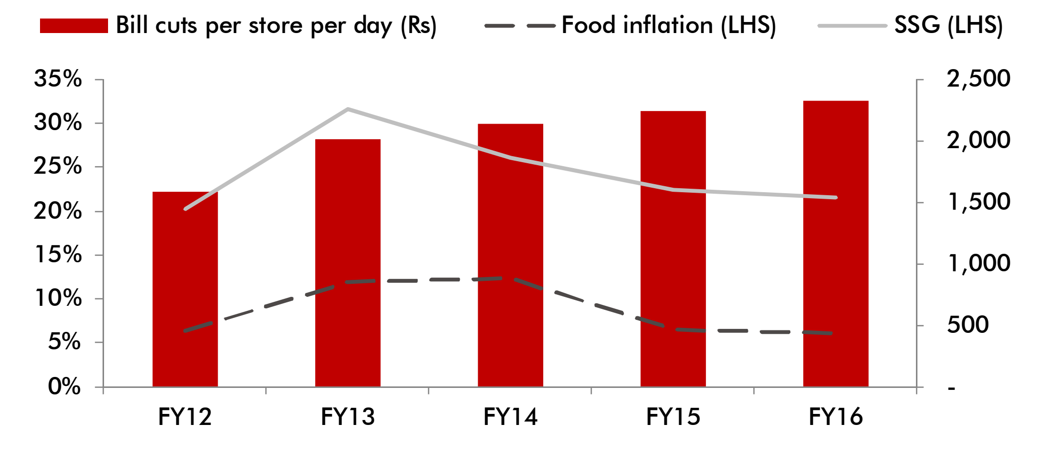
Source: DRHP, Ambit Capital research

Exhibit 7: ...and their gross margins



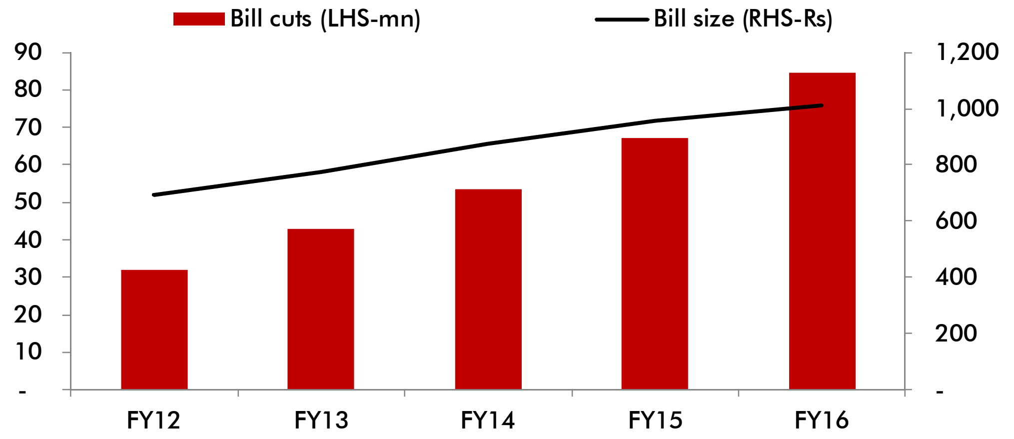
Source: DRHP, Ambit Capital research

Exhibit 8: Food inflation has aided SSG as low prices offered by ASL have attracted more customers seeking value...



Source: DRHP, Ambit Capital research

Exhibit 9: Value proposition has driven bill cuts as well as ticket size

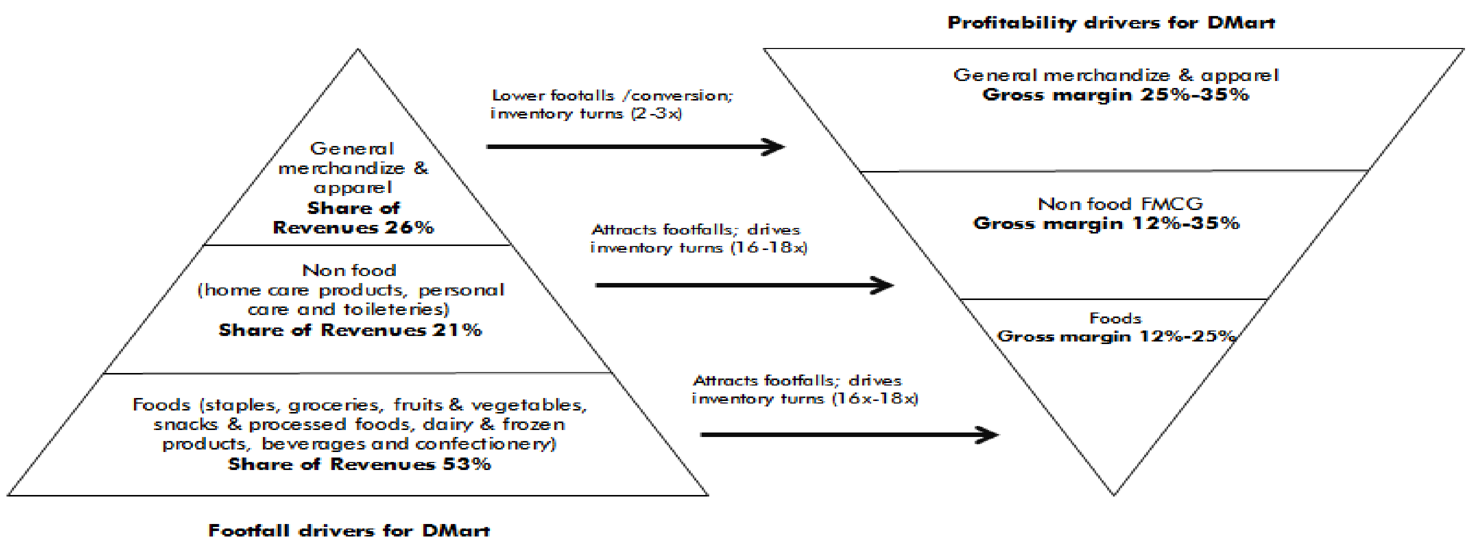


Source: DRHP, Ambit Capital research

Revenue mix - each category has designated role for customer acquisition, covering costs and margins

While food and non-food FMCG drive the throughput, apparel and general merchandise drive profitability of the business. The store and product portfolio is designed to drive high conversions for food and FMCG while generating sufficient conversion to drive apparel and general merchandise. The apparel and general merchandise on offer appeals to masses and offers a credible alternative to the unorganised market not only in pricing but also in ambience (the stores have trial rooms).

Exhibit 10: Food & FMCG drive footfalls whereas general merchandise & apparel drive margins for ASL



Source: DRHP, Ambit Capital research

Smart merchandising directed at inventory turns

"We believe that our merchandising and private labels have helped us differentiate ourselves from our competitors, in addition to achieving good margins." - Management commentary in DRHP

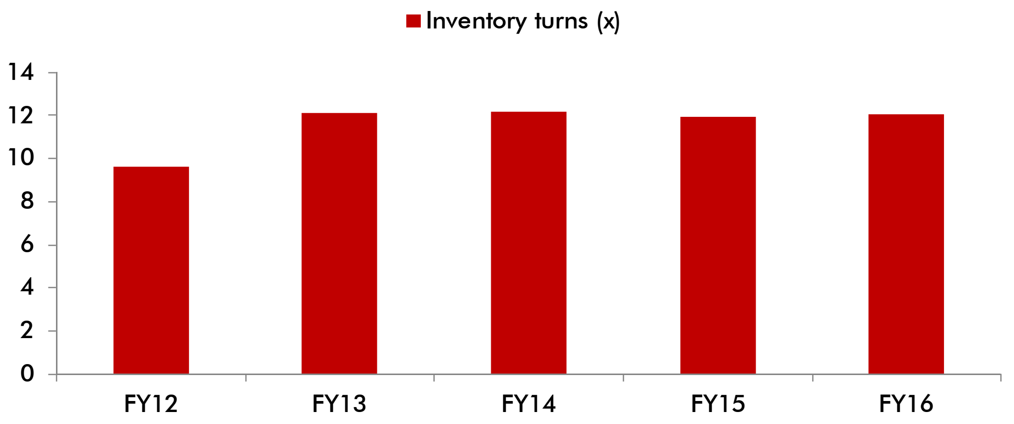
During our channel checks, we came across one such example of differentiated merchandising. Typically, a Buy One Get One (BOGO) offer on FMCG or food doesn't translate into increase in consumption by a consumer. It is more likely to be postponement of future demand. Here, ASL offers a smart offer – in case of a product with BOGO offers, a customer is allowed to buy only one piece for half the price (seldom seen in food/FMCG). This does two things: (a) makes the product affordable to a larger set of customers, including those from the lower economic strata who would find the BOGO ticket size high; and (b) thus, making more sales than it would in a pure BOGO offer.

Strong IT systems and processes are the backbone of the company

All of the company's stores utilise a computerised inventory management system, which enables tracking of inventory levels as well movement of SKUs on a daily basis. Moreover, the inventory management systems of all stores are synchronised with the distribution centres and offices, enabling periodic sharing of information and data. This allows the company to control inventory effectively across each store. The systems are flexible at the store where discounts are offered.

During our routine store visits we came across D-Mart stores which offered higher discounts (due to competition) than most.

Exhibit 11: ASL has sustained healthy inventory turns

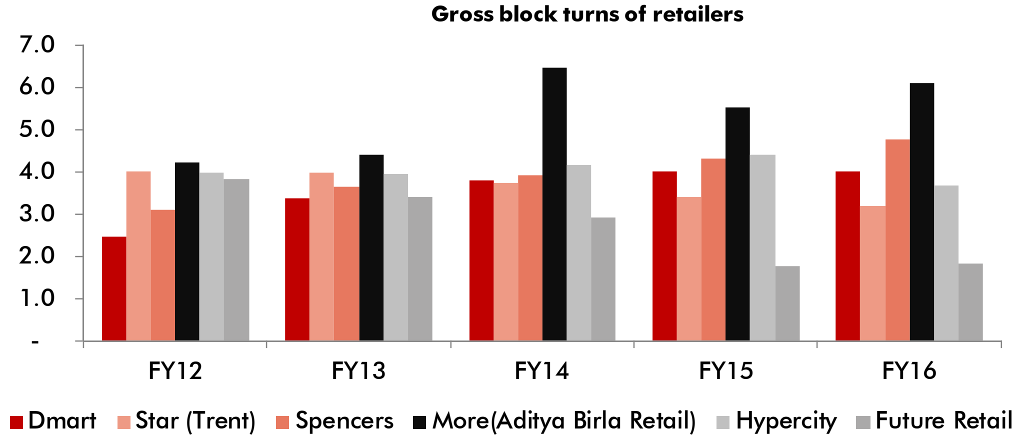


Source: DRHP, Ambit Capital research

Working capital efficiencies derived from inventory not creditors

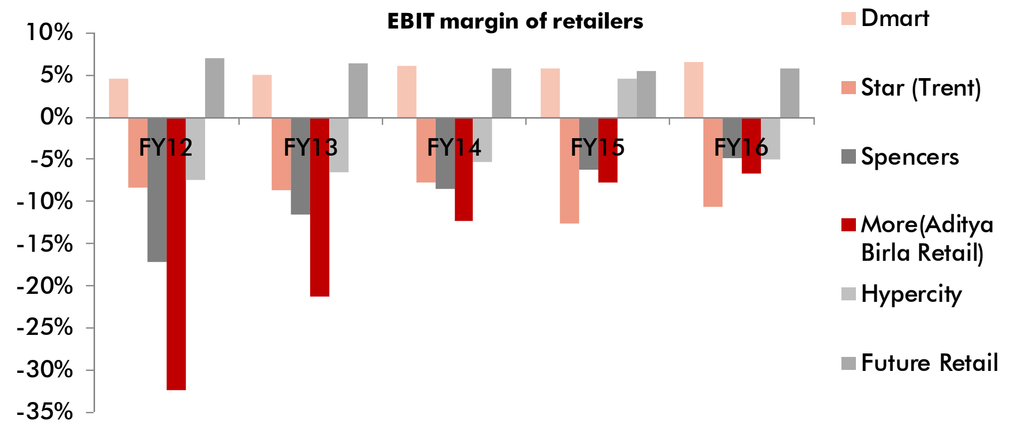
ASL's throughput is 2x that of peers with the lowest gross margins (500bps lower than peers). The focus is on inventory turns as against gross margins by giving lower prices and driving higher footfalls. Inventory turns drive not only working capital turns but also operating leverage.

Exhibit 12: ASL's gross block turns have improved from 2.5x in FY12 to 4x in FY16 despite owning real estate...



Source: DRHP, Ambit Capital research

Exhibit 13: ...and is the only profitable one



Source: DRHP, Ambit Capital research

Exhibit 14: Working capital of ASL vs peers

Working capital metric	FY12	FY13	FY14	FY15	FY16
Inventory days					
ASL	38	30	30	31	30
THL	59	39	34	39	42
Hypercity	52	57	60	66	76
ABRL	44	38	40	28	36
Spencers	39	36	39	42	44
Future retail	121	140	117	166	155
Creditor days					
ASL	12	10	10	8	8
THL	55	55	67	71	56
Hypercity	34	39	46	50	48
ABRL	35	56	78	36	37
Spencers	41	45	49	51	50
Future retail	59	113	72	44	80

Source: DRHP, Ambit Capital research

Key questions for management on product mix and inventory management?

- What is the sustainability of high same-store sales growth? Average SSG was 24% over FY12-16;
- How does the sales mix of a store change as it matures? Is it materially different in the first year from the system average?
- How does the company ensure timely availability of products given the high turns? How many stores/areas can a distribution centre service?

Valuation: Premium for execution and scalability

ASL focuses on low costs and hence, low prices for consumers, a model which resemble that of Wal-Mart; its gross product mix (skewed towards food/FMCG) resembles that of Costco. Consequently, the formative and maturing years of Wal-Mart and Costco give a relevant perspective while evaluating valuations for ASL. As in the case of Wal-Mart and Costco, turning FCF-positive is a key criteria for ascribing valuation multiples besides growth and RoCE. The two companies historically traded over 30x one-year forward earnings either when their RoCE was above 20% or when they turned FCF-positive in late nineties (after nearly two decades of expansion).

Sound store economics has created a template to scale

ASL's store economics is sound and has passed the test of scale. The store-level RoCE has nearly doubled over FY12-16 despite addition of stores. With presence in 41 cities across 8 states, the format has been established. Moreover, with low central costs, store-level RoCE has translated to company-level RoCE.

Exhibit 15: Store economics – driven by high throughput

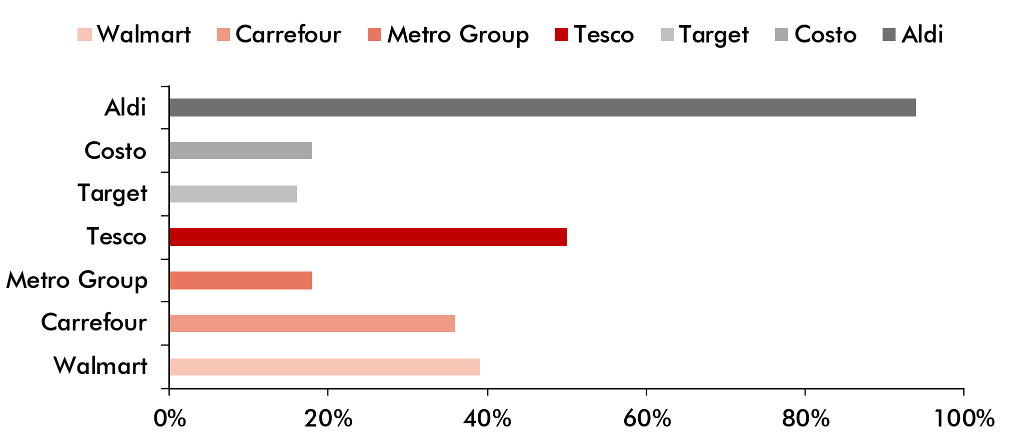
	FY12	FY13	FY14	FY15	FY16
Revenue per store (₹ mn)	400	570	683	785	862
Store-level EBIT (₹ mn)	28	40	51	61	68
Store-level EBIT Margin (%)	**7**	**7**	**8**	**8**	**9**
Store-level Capital employed (₹ mn)	179	194	198	216	223
Store-level RoCE (%)	**16**	**22**	**26**	**29**	**31**
SSG (%)	**20**	**32**	**26**	**22**	**22**
Bill size (₹)	692	774	877	958	1,013
Company-level EBIT margin (%)	4.6	5.1	6.1	5.9	6.6
Company-level RoCE (%-pre-tax)	11	15	21	21	24

Source: DRHP, Ambit Capital research

Private labels and higher bargaining power come with scale…

Today, ASL is the second-largest organised player in the food and grocery space after Reliance. Modern trade in this space has flattered to deceive (poor execution/overambitious expansion) and resultantly there has not been a profitable player with scale except ASL. With further scale, ASL can invest in developing share of private labels in non-grocery FMCG and have more bargaining power with suppliers and FMCG companies. Globally, leading retailers have 20-50% of their revenues coming from private labels.

Exhibit 16: Share of private labels of leading global players



Source: Ambit Capital research

...resulting in margin expansion and RoCE accretion

At high inventory turns of 12x, a 100bps change in EBIT margin (driven by gross margin) improves RoCE by 400bps. Therefore, the changes that scale can bring about in ASL's margin profile have a multiplier effect on capital efficiency.

Exhibit 17: While sales density is comparable with global peers, the population density catered to and product mix are very different; ASL's closest peer is Costco

FY16/CY15	ASL	Wal-Mart	Costco	Target
Gross margin (%)	15	25	13	30
Sales per sq ft (USD)	420	422	1,151	308
EBIT per sq ft (USD)	28	21	3	23
Asset turns (x)	3.1	2.4	3.6	1.8
Inventory turns (x)	12.0	10.8	11.5	6.2
CFO (pre-tax)/EBITDA (%)	92	103	92	96
5-yr revenue CAGR (%)	40	2	5	2
EBIT margin (%)	6.6	5.0	3.2	7.5
RoCE (% - post-tax)	16			
Share of Private label (%)	NA	40%	20	18
Creditor days	8	39	20	53
Product mix:	Foods-53%, Non-foods-21%, General merchandise & apparel-26%	NA	Foods-22%, Sundries-21%, Hardlines-16%, Softlines-11%, Fresh foods-14%, Ancilliary-16%	Household essential-26%, Food & Pet supplies-21%, Home furnishing & décor-17%, Apparel & accessories-19%, Hardlines-17%,

Source: DRHP, Ambit Capital research

FCF generation elevates valuation multiples

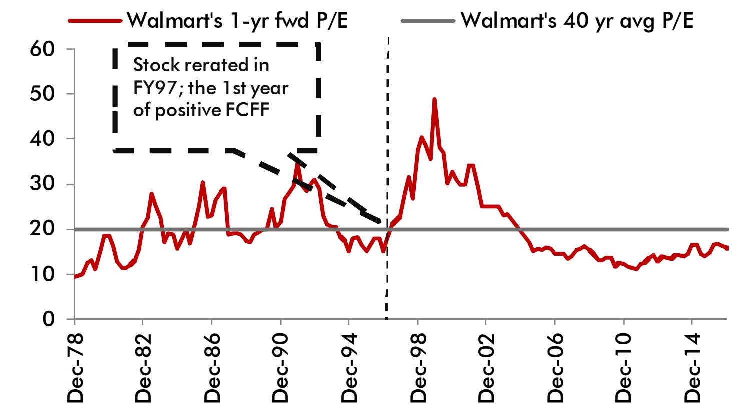
We use Wal-Mart and Costco as references as ASL's operations draw similarities from Wal-Mart (cost control) and Costco (revenue mix and inventory turns). The valuations of both these companies re-rated significantly when they began generating free cash flows. ASL has so far been FCF negative. However, the IPO proceeds and existing land (book value of ₹1.58bn) will be utilised for new stores (2.1mn sq ft/50 stores) can expedite FCF generation.

Exhibit 18: Pace of expansion will increase from FY19E

Particulars	Total estimated cost (to be financed from net proceeds of the issue)	FY18E	FY19E	FY20E
Construction area for stores greenfield (mn sq ft)	0.90	0.20	0.35	0.35
Construction cost of stores (greenfield) (₹ mn)	1,787	397	695	695
Area fit outs for stores (mn sq ft)	2.10	0.45	0.83	0.83
Purchase of fit outs of stores (greenfield + buyout) (₹ mn)	1,880	403	738	738

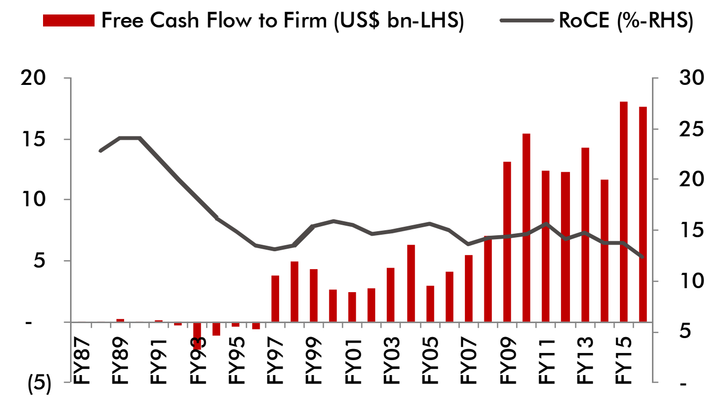
Source: DRHP, Ambit Capital research

Exhibit 19: Wal-Mart multiples re-rated…



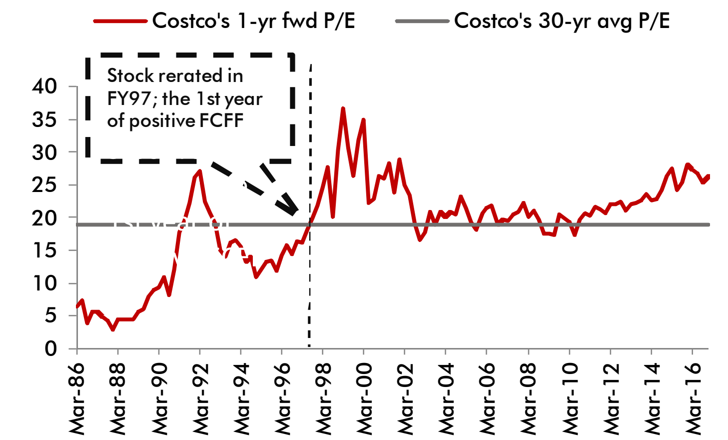
Source: Bloomberg, Ambit Capital research

Exhibit 20: …as it delivered positive FCF in FY1997



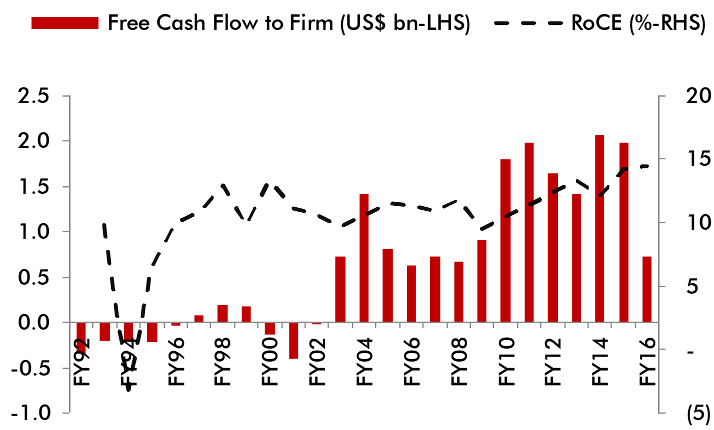
Source: Bloomberg, Ambit Capital research. Note: RoCE is post-tax

Exhibit 21: Costco has sustained valuation premium over Wal-Mart…



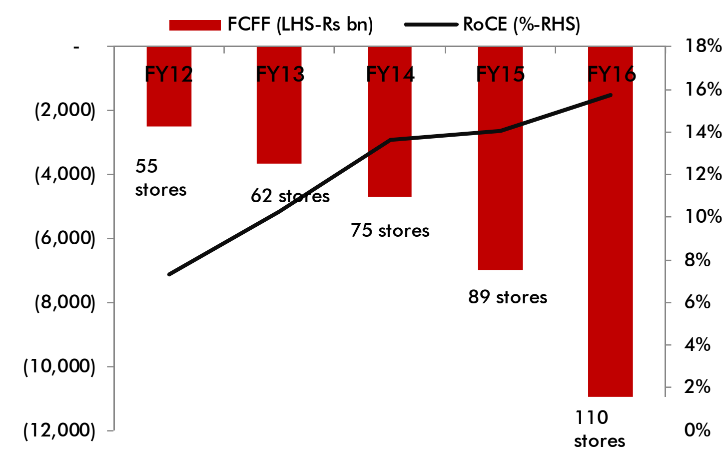
Source: Bloomberg, Ambit Capital research

Exhibit 22: ..as it has improved and sustained RoCE



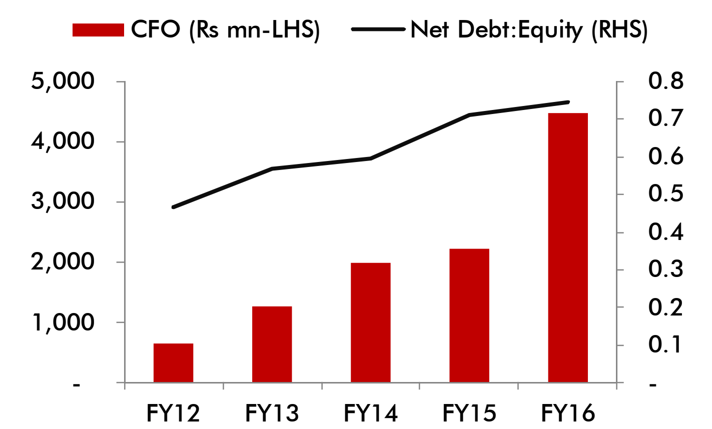
Source: Bloomberg, Ambit Capital research. Note: RoCE is post-tax

Exhibit 23: ASL too has made negative FCF…



Source: DRHP, Ambit Capital research. Note: RoCE is post-tax

Exhibit 24: …but has clocked a staggering CFO CAGR of 62% over FY12-16



Source: DRHP, Ambit Capital research

Proceeds would be used to repay debt and fund expansion

The proceeds of the IPO would be used to repay debt (₹10.8bn) and setting up of new stores (₹3.6bn). This will bring debt-equity ratio to 0.3x and add ₹600mn (post-tax interest cost savings) to PAT.

Exhibit 25: Utilisation of proceeds of the issue to set up stores and pay-off debt

	Amount (₹ mn)	Estimated Utilisation of Net Proceeds (₹ mn)		
		FY18E	FY19E	FY20E
Gross Proceeds of the Issue	18,700			
Repayment or prepayment of a portion of loans and redemption or earlier redemption of NCDs availed	10,800	6,250	3,200	1,350
Construction and purchase of fit outs for new stores	3,666	800	1,433	1,433
General corporate purposes	NA	NA	NA	NA

Source: DRHP, Ambit Capital research

Promoter's guidance and management execution imbibed with culture of ownership

One of the promoters, Mr. Radhakishan Damani, has been instrumental in developing and monitoring strategies. Mr. Ignatius Navil Noronha, the CEO, has been with the company for 12 years and joined as Head of Operations in FY05 when the company had only three stores. The managerial team led by Mr. Noronha has demonstrated execution of the above strategies as evident from ASL's financial performance and emergence as the most profitable food and grocery retailer in India. Moreover, nearly a third of the employees from key managerial personal to store managers have equity stake in the company, imparting a sense of ownership.

Exhibit 26: Shares held by key managerial persons

Name	Position	No. of shares (mn)	% of outstanding shares
Ramesh S. Damani	Chairman and Independent Director	0.1	0.02%
Ignatius Navil Noronha	Managing Director	13.7	2.44%
Ramakant Baheti	Chief Financial Officer and Executive Director	3.2	0.57%
Elvin Machado	Executive Director	0.4	0.07%

Source: DRHP, Ambit Capital research

Questions for management on gross margins, capital allocation and FCF

- At what point will the company look at increasing the share of private labels (beyond groceries)?
- At what level of operations of scale and portfolio of mature stores would the company become FCF positive?
- What are the factors (pertaining to store operations) that determine the price that the company is willing to pay and buy properties for the store?

Income statement

Year to March	FY12	FY13	FY4	FY15	FY16
Net Sales	**22,086**	**33,409**	**46,865**	**64,394**	**85,881**
Gross Profit	3,246	4,834	7,021	9,522	12,803
Employees cost	453	687	873	1,341	1,486
Other expenses	1,413	1,997	2,729	3,592	4,683
EBITDA	**1,380**	**2,150**	**3,418**	**4,590**	**6,635**
Depreciation	375	458	570	815	984
EBIT	**1,006**	**1,692**	**2,848**	**3,775**	**5,651**
Non-operating Income	138	143	158	183	180
Interest expenditure	260	426	557	724	908
PBT	**884**	**1,409**	**2,449**	**3,233**	**4,922**
Tax expenses	282	472	835	1,109	1,716
Adjusted PAT	**602**	**937**	**1,614**	**2,124**	**3,206**

Source: DRHP, Ambit Capital research

Balance Sheet

Year to March	FY12	FY13	FY4	FY15	FY16
Shareholders' equity	5,335	5,441	5,468	5,615	5,615
Reserves & surplus	1,482	2,455	4,088	6,377	9,589
Total net worth	**6,820**	**7,898**	**9,556**	**11,993**	**15,205**
Loan funds	3,807	5,261	6,408	9,043	11,935
Deferred tax liability	130	201	265	305	399
Total liabilities	**10,756**	**13,360**	**16,229**	**21,340**	**27,539**
Gross block	9,064	10,950	13,969	18,321	24,920
Net block	**7,791**	**9,247**	**11,717**	**15,281**	**20,935**
Inventories	1,957	2,762	3,783	5,396	6,717
Debtors	56	133	95	71	84
Cash and cash equivalents	479	616	554	380	351
Loans & Advances	535	821	881	1,283	1,798
Total current liabilities & provisions	1,152	1,561	1,847	2,208	3,463
Net current assets	**1,890**	**2,773**	**3,469**	**4,926**	**5,493**
Total assets	**10,756**	**13,360**	**16,229**	**21,340**	**27,539**

Source: DRHP, Ambit Capital research

Cash flow statement

Year to March	FY12	FY13	FY4	FY15	FY16
PBT	887	1,411	2,449	3,226	4,929
Depreciation	375	457.9	570.1	815.4	984.3
(Increase)/Decrease in working capital	(577)	(653)	(827)	(1,520)	(686)
Tax	285	367	750	1,000	1,641
Cash flow from operating activities	**654**	**1,271**	**1,981**	**2,220**	**4,471**
Capex	(1,833)	(2,394)	(2,717)	(4,774)	(6,481)
Cash flow from investing activities	**(1,289)**	**(2,309)**	**(2,702)**	**(4,739)**	**(6,583)**
Net borrowings	820	1,454	1,148	2,634	2,892
Interest paid	(249)	(422)	(552)	(621)	(816)
Cash flow from financing activities	**935**	**1,175**	**652**	**2,345**	**2,082**
Net change in cash	299	137	(68)	(174)	(30)
Closing cash balance	477	614	546	372	342
Free cash flow	**(1,179)**	**(1,119)**	**(724)**	**(2,549)**	**(1,989)**

Source: DRHP, Ambit Capital research

Ratio analysis/Valuation parameters

Year to March	FY12	FY13	FY4	FY15	FY16
Gross margin (%)	14.7%	14.5%	15.0%	14.8%	14.9%
EBITDA margin (%)	6.2%	6.4%	7.3%	7.1%	7.7%
EBIT margin (%)	4.6%	5.1%	6.1%	5.9%	6.6%
Net profit margin (%)	2.7%	2.8%	3.4%	3.3%	3.7%
Net debt/equity (x)	0.4	0.2	0	-0.1	-0.1
Asset turnover (x)	2.0	2.7	3.1	3.4	3.5
Working capital turnover (x)	11.2	14.1	15.0	15.3	16.4
Gross block turnover (x)	2.5	3.4	3.8	4.0	4.0
RoCE (%- pre-tax)	10.8%	15.4%	20.6%	21.4%	24.2%
ROE (%)	8.8%	12.7%	18.5%	19.7%	23.6%

Source: DRHP, Ambit Capital research

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BUY	>10%
SELL	<u><</u>10%
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UNDER REVIEW	We will revisit our recommendation, valuation and estimates on the stock following recent events
NOT RATED	We do not have any forward looking estimates, valuation or recommendation for the stock
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