Dimensional Securities Pvt Ltd.

Butterfly Gandhimathi Appliances Ltd.
Initiating Coverage

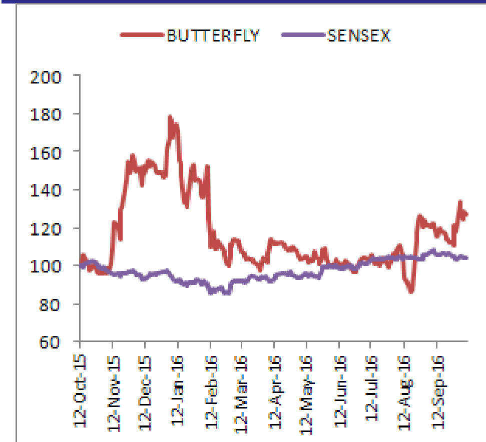
Date: 13th October, 2016
Recommendation: BUY
CMP: 202
Target Price: 418

MARKET DATA - BGAL	
Networth (₹Cr)	235
P/BV Ratio (FY17E) (x)	1.5x
EPS (FY16E) (₹)	7.1
Market Price (₹)	202
P/E Ratio (FY17E) (x)	22.1x
52 Week High (05/01/2016)	307
52 Week Low (17/08/2016)	138
Market Capitalisation (₹Cr)	362

AVERAGE MONTHLY VOLUME ('000)	
BSE	35
NSE	93

SHARE HOLDING PATTERN (Jun-16) (%)			
Promoters	FII, DII	AIFs	Others
65.13	0.00	13.72	21.15

INDEXED PRICE CHART



Return	3M	6M	12M
BGAL	19.4%	16.5%	33.6%
Sensex	3.4%	12.8%	5.9%

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Butterfly Gandhimathi Appliances Ltd. (BGAL) is a leading manufacturer of kitchen appliances with dominant market shares in key categories in south India. The company has been able to grow at a market leading growth rate. BGAL has also been producing kitchen appliances for the Tamil Nadu government's public distribution schemes which have dragged down return ratios due to heavy working capital requirements. The management however has shifted focus from the government contracts business to the B2C business, which we believe would help reduce debt, increase return ratios and drive a re-rating for the company. We initiate coverage on BGAL with a target price of ~ ₹418/share implying a 108% upside from the current market price.

Strong brand Moat for the Company in Key Markets

Most brands in the industry are over ~30 years old making it difficult for foreign brands to establish a sizable market presence. This especially for products such as the table top wet grinder (TTWG) which are largely used for Indian culinary preparations.

The "Butterfly" brand is a house-hold name in South India, trusted for quality & durability. The brand allows the company superior pricing power which is evident from the higher gross margins as compared to peers.

Exit from the Government Contracts business an underappreciated positive

Exiting the government contracts business would allow the company to free up ~150 Cr of working capital requirements which could be used to repay debt and significantly reduce interest costs. The move would also free-up capacity currently used for the low gross margin government contracts business, allowing the company to grow with negligible cap-ex for the next 5-6 years.

~90% of the government contracts business was for the TTWG product, where the company is the undisputed market leader with a market share of ~50%. Thus it would be highly probable that the public distribution contracts would have cannibalized high margin B2C sales for the company.

We believe the exit from the government contracts business would allow the management to focus on the B2C business, change the leverage profile of the company and significantly improve return ratios going forward.

In-House Production ensures Better Quality and High Operating Leverage

The company manufactures its core products in-house. The same provides better quality and higher operating leverage as compared to peers.

High Brand Investments Supress near Term Profitability

The company invested a massive ~15% of FY16 B2C sales into its brand. These investments supress near term profitability and penalize valuations, whilst helping strengthen the brand moat the company enjoys.

Financial Outlook, Valuation & Risks

We expect BGAL's return ratio's & leverage metrics to improve significantly as the company exits the value destructive government contracts business. We value the company at 20.0x FY18 earnings at ₹418/share.
However If the company re-enters the government contracts business, we would change our view and downgrade the company as it would destroy shareholder value.

Financial summary:

Particulars ₹Cr	Net Sales	Growth (%)	EBITDA	EBITDA (%)	PAT	EPS	P/E	ROE	ROCE
FY16	899	70%	66	7.3%	13	7.1	28.8	5%	8%
FY17E	534	-41%	60	11.2%	17	9.2	22.1	7%	10%
FY18E	614	15%	74	12.0%	37	20.9	9.8	14%	10%
FY19E	707	15%	91	12.9%	49	27.6	7.4	16%	12%
FY20E	813	15%	112	13.8%	65	36.2	5.6	18%	14%

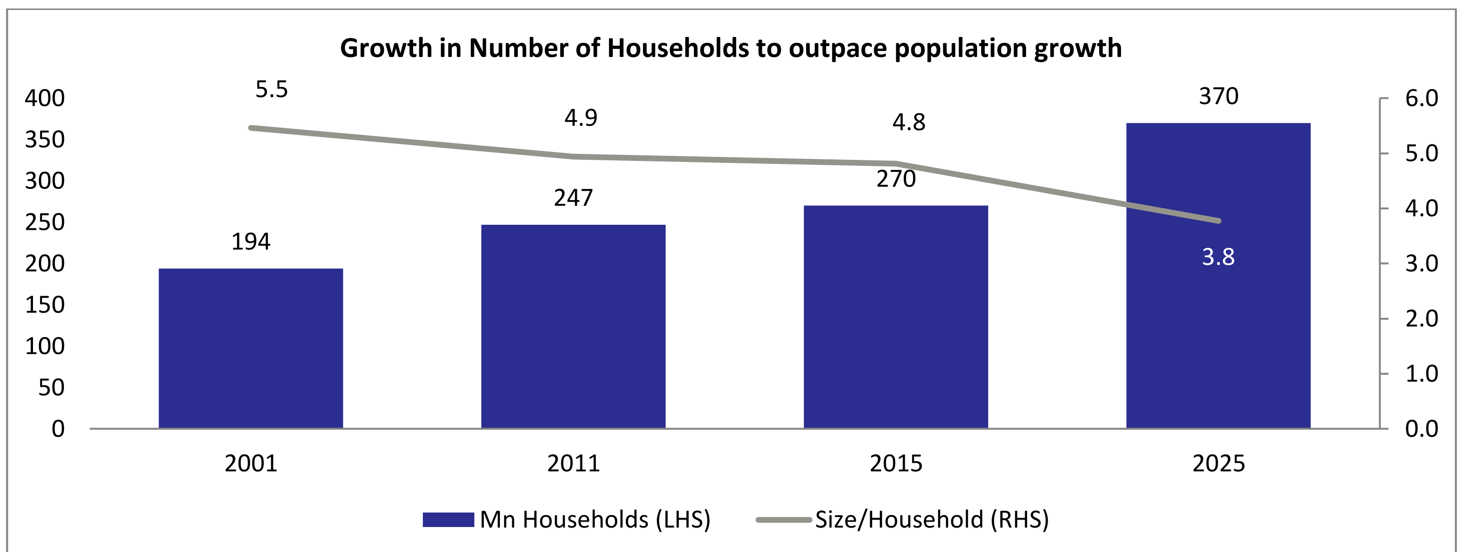
Industry Outlook

The size of the Indian kitchenware industry is estimated to be between of ₹12,000 Cr-14,000 Cr. However no single product category forms over 20% of the Industry.

- The industry is highly fragmented with un-organized players having significant shares of ~50% across most categories
- However the organized segment in most categories is dominated by the top 3 players
- This allows for large opportunities for companies to create brand extensions into allied products and capture share from the un-organized sector thereby comfortably growing at mid-teen rates

The Indian kitchen-ware industry shows a secular growth with two major growth drivers:-

- Premiumization:- The industry is evolving from being focussed on functionality to being aesthetic and convenient
  - This shift increases customer focus on brands, product designs, allowing companies to exercise pricing power
- Positive Demographic Age Curve: - ~ 25% of India's population is aged 15 – 25 implying ~115 mn new households and kitchens which would be set-up over the next decade. (Nuclear Family Rate of 70% in line with existing statistics)
  - This is over twice the number of new households created in the past 10 years which would help drive volume growth at an escalated pace for the Industry



Source: World Bank Data

While we do not have specific product wise data for the Industry given the large number of un-organized players, we expect kitchen appliances to grow at a faster pace than white goods which have grown at a CAGR of ~20% over the past decade due to the following reasons:-

- Relatively smaller ticket sizes for kitchen appliances leading to faster adoption and penetration
- Frequent use and faster replacement driven by a reduction in repairs
  - The average lifespan of a Juicer/Mixer/Grinder has declined from 8-10 years to 4-5 years
- Introduction of new products, as the variety of dishes prepared increases in the Indian kitchen
  - e.g. Butterfly's flagship product the TTWG is used to prepare batter for Idli's & Dosa's
  - These preparations have seen increasing acceptance in the rest of the country thereby opening up fresh markets
- Foreign brands have negligible product & design expertise in these specific categories and thus pose a negligible threat to entrenched Indian brands such as TTK & Butterfly

The Government Contracts Business, Has Been a Drag on the Company's Financials

Splitting BGAL's FY16 Financials between the B2C business & the Govt. Order business gives a clear picture of the underlying strength the B2C business has displayed, and the extent to which the now discontinued government contracts business had destroyed value.

Particulars (FY16) ₹Cr	BG B2C	BG Govt.	Rationale
Gross Revenues	534	461	*Source: FY16 Annual Report*
Excise Duty	66	28	*Source: FY16 Annual Report*
Duty Rate (%)	12.30%	6.07%	*Source: FY16 Annual Report*
Discounts	2.68	0	Assuming discounts to be a B2C expense
Net Sales	466	433	
RM Cost	265	382	
Gross Profit	200	51	
Gross Margin	***43.0%***	***11.7%***	*Source: DSPL Research*
Employee Expenses	49.04	12.26	20% (Contract Labour) used for the government contract
(%) of sales	10.5%	2.8%	
Advertising Expenses	68.0	0	Expensed towards the B2C Business
(%) of sales	15%	0%	
Other Expenses	47	9	9 Cr toward B2B business, lease rentals on warehouse & other variable expenses
EBITDA	36	29	
EBITDA (%)	7.8%	6.8%	
Depreciation	11.5	0	Expensed to the B2C business
EBIT	25	29	
EBIT (%)	5.3%	6.8%	Charging the incremental interest on WC debt to the contract manufacturing business (Assuming the same interest rate for short term & long term debt)
Interest	7.7	26.8	
PBT	17.0	2.6	
Tax	6.0	0.9	Same tax rate assumed
Rate (%)	35.4%	35.4%	Actual rate paid (FY16)
PAT	11.0	1.7	B2C business ROCE lower due to heavy advertising expenses, ~15% of sales which should moderate to ~12% going ahead
ROCE (%)	**7.5%**	**1.1%**	
Capital Employed			
Fixed assets	174	0	Would remain same assumed for the B2C Business
Inventories	51	73	Split in ratio of COGS
Receivables	120	137	Source:- Annual Report
Payables	43	62	Split in ratio of COGS
Total Capital Employed	301	**149**	
Days of WC (Sales)			
Inventories	40	62	
Receivables	94	116	
Payables	34	52	Incremental WC requirements of Contract business funded by Short term borrowings
Borrowings			
Short Term	Nil	**149**	Source Annual Report FY16 (Completely for B2B Business WC)
Long Term	43	Nil	Source Annual Report FY16 (Core business Debt)

- Despite having higher EBIT margins and providing revenue visibility, the government contracts business is value destructive
- After accounting for working capital requirements it is a ~1% ROCE business requiring the company to borrow for working capital requirements at significantly higher rates
- As the government contracts business gets discontinued the company would free ~₹150 Cr from working capital requirements which would be used to de-lever the balance sheet resulting in significant interest cost savings

Peer Comparison:

The company has significantly lagged behind its peers in the kitchen appliances segment in terms of value creation over the past 5 years. Despite the B2C branded business having performed on par with TTK Prestige & Hawkins across metrics.

Comparison with Peers (Butterfly Branded Business):

Particulars ₹Cr	Butterfly	TTK	Hawkins	Comments
5 Year Stock Price CAGR	-6.8%	15.9%	14.8%	
Gross Revenues	534	1559	571	Superior Revenue growth rate, on par with the best in the Industry, TTK Prestige
5 Year Revenue CAGR	**14.9%**	**14.8%**	**10.3%**	
Excise Duty (%) of gross	12.3%	2.2%	4.7%	Significantly higher excise duty rate as compared to peers, due to higher in-house manufacturing
Revenue Before Discounts	468	1525	544	
Discounts (%) of gross	0.5%	5.6%	10.1%	
Net Revenues	**466**	**1437**	**487**	Lower discounts, indicate the strength of the brand
RM Cost	265	958	290	
Gross Profit	200	479	197	Superior gross margins to peers, despite dilution in margins from the non-south business
GP Margin % net sales	**43.0%**	**33.3%**	**40.4%**	
Employee Expenses	49	111	70	
(%) of net sales	10.5%	7.8%	14.3%	
Advertising Expenses	68	94	26	high investments in branding which depress near term profitability
(%) of net sales	14.6%	6.6%	5.3%	
Other Expenses	47	81	30	
(%) of net sales	10.1%	5.7%	6.2%	
EBITDA	36	192	71	Margins lower than peers, largely because of advertising spends which are actually brand investments, higher adjusted margins as compared to peers on an EVA basis
EBITDA % of net sales	**7.8%**	**13.4%**	**14.6%**	
EBITDA + Ad Spends	104	286	97	
EBITDA+ Ad Spends Margin (%)	**22.3%**	**19.9%**	**19.9%**	
ROCE (%)	11.6%	26.0%	62%	Suppressed margins & lower asset turns impact return ratio adversely
Fixed Assets	174	369	31.2	Peers have historical assets & outsource a larger share of production, while Butterfly is operating at a ~50% capacity utilization ex Govt. Contracts
FA Turns (Net Revenues)	2.7x	3.9x	15.6x	
Receivables	120	175	45	
Inventories	51	325	83	
Payables	34	132	45	
Total WC	137	368	83	
WC Turns	3.4x	3.9x	5.8x	BGAL lags peers on working capital metrics as the company aims to create a market in Non South geographies which requires higher WC investments; Working capital efficiency should improve as the company gains share in non-south markets and management increases focus on the B2C business
Total Capital Employed	311	737	114.2	
WC Days (Net Sales)	107	93	62	
Receivable Days	94	44	34	
Inventory Days	40	83	62	
Payable Days	27	34	34	
Valuation Ratios				*Assigning no value to the contracts business*
PE/ FY16	29.5x	49.1x	38.7x	
EV/EBITDA FY16	10.2x	29.1x	21.7x	Not counting, Short term Debt used for the contracts business, which would be repaid
EV/EBITDA Adjusted FY16	3.6x	19.5x	15.9x	Adjusted for Ad Spends

One can observe a significant valuation gap between BGAL & its peers. We believe the company is capable of bridging this valuation gap going ahead as return ratio's and margins improve.

Key Drivers of Value Creation Going Ahead:

Shutting down of the Government Contracts Vertical:-

- This driver is key to an investment thesis in BGAL as it would also increase management focus toward the B2C business
- Shutting down the Govt business would free ~150 Crs of working capital which would reduce debt and the interest burden as there are no cap-ex requirements until FY-20
- Distribution of TTWG products has most probably cannibalized sales/future sales from the B2C arm, given that butterfly is already a market leader in the TTWG segment with over ~50% market share

Rationalizing Advertising Spends:

Particulars ₹Cr	FY11	FY12	FY13	FY14	FY15	FY16	Average
Ad Spends	16	46	49	49	37	68	53
Ad (%) of sales	6.0%	12.9%	11.1%	9.6%	7.6%	12.7%	9.9%

- The company's need for future advertising & opportunity to rationalize the same would be driven by the following factors
  - New segments & the discontinuation there-off: - The Company inherited a few electrical appliance segments which are non-core to the company (E.g. Fans, Iron Box, Heater, Air Cooler) etc.
    - Fans segment has been discontinued, such moves would help rationalize expenses toward these segments
  - Competition in key categories and competitors ad-spends on an absolute basis

Particulars (%)	LPG Stoves	Mixer Grinder	TTWG	Cookers & cookware	Others	Revenue
(%) of BGAL revenues	**19%**	**14%**	**49%**	**8.6%**	**9.4%**	**995**
(%) of Govt. Contract Sales	0%	10%	90%	0%	0%	461
(%) of B2C Revenues	35.4%	17.4%	13.6%	16.0%	17.6%	534
(%) of sales TTK Prestige	12%	4.0%	3.2%	56%	25%	1559
(%) of Sales Hawkins	0%	0%	0%	97%	3%	571
(%) of market unorganized	40-50%	40-50%	~50%	35%	NA	NA
Replacement Cycle	~5 years	~5 years	8-10 years	6-7 years	NA	NA
Position	Top 3	Top 3	#1	3-4% Share	NA	NA

  - Share of Voice competition with Hawkins will be negligible as Hawkins has a East India & North India presence as against BGAL's South India Dominance, more-over even the segments have a small overlap of ~16% of BGAL's revenues
  - Both TTK & BGAL have a strong south presence in the south (60% of TTK sales) and compete heavily in the LPG stoves and Cookers segment which together constitute 68% of TTK revenues, 51% of BGAL revenues.
  - BGAL can have a clear share of voice leadership in the mixer, grinder & TTWG segments in South India as these are non-core segments for TTK contributing just ~7% of revenues
  - Entry into new geographies:- would necessitate a higher ad spend as compared to competitors
  - BGAL should be able to maintain the current revenue growth rate of ~15% while maintaining an ad spend of ~12% of sales in line with management guidance
  - This expenditure rationalization would create an EBITDA margin expansion of ~250bps for the business in FY17

GST should create opportunities for market share gains from the unorganized segment:-

- As almost all the segments where the company operates have a high share of unorganized sector sales
- Given most of the Inputs would be under the tax net (Metals etc.) the sector should witness a good tailwind as the unorganized sector would be unable to compete when under the tax net (Even organized players have just a 10-15% EBITDA margin)
- The benefits would come in the form of increased revenue growth which however would be tough to quantify

Increased Profitability in the Non South Business:-

- The Non-South business today contributes ~15% of the Company's sales and generates a lower gross margin of ~30% due to increased discounts & distribution incentives
- The Non-South markets remain a focus area for BGAL as they aim to increase the contribution of Non-south markets to 25% of top-line by FY20
- This increase in Non-South sales would also be coupled with an increase in gross margins up from the current ~30% to ~40%, slightly below the South Market gross margins of ~45%
- This would increase the overall gross margins of the company by ~1% by FY20

SWOT Analysis:-

Strengths:-

- Strong brand image in key South markets with dominant market share in key categories
- Integrated manufacturing, Product R&D wherein the company also manufactures the dyes, casts & moulds for new products
  - This gives the company ~3 years of exclusivity for new product designs before competitors are able to replicate the same

Weakness:-

- Negligible presence and brand recall in Non-South market which forms 60% of the country's kitchenware market
- Higher working capital requirements as compared to peers, however offset by a higher gross margin and lower discounting

Opportunities:-

- The company can be expected to benefit from strong replacement demand of ~16 lac units/ year in the TTWG segment FY18 onward, as the units distributed under the government distribution programme would be due for replacement
- Working capital freed from the government contracts business would significantly reduce debt & interest expenses, allowing the company financial freedom to better peruse growth in the B2C segment
- New marketing channels opening up such as E- Commerce, Modern Retail, CST Canteens and Exports

Threats:-

- Lot of MNC brands are entering the segment priced at a premium
  - Competition to be more ethical based on product quality & pricing
  - However new brands will take a long time to establish themselves
- Strong service set-up needed, as products such as gas stoves are essential in the day to day life of consumers
  - Service set-ups are initially loss making for the first 10 years
  - The company enjoys an incumbent service network set-up as a moat in the core South markets, however would have to spend to set-up the same in the Non-South markets
- The company would witness a sharp revenue drop in FY17 due to the decline of the government contracts business
  - Better absorption of fixed costs, cutting down variable costs would be key to ensuring profitable growth

Key Risks to Investment Thesis:-

- Management returning to the B2B business vertical, chasing opportunistic government business would completely change the investment thesis and destroy significant shareholder value
- Prestige shifting focus to concentrate on the TTWG/Mixer grinder segment which today contribute just 3 & 4% of revenue for the company respectively could require BGAL to increase advertising spends, thus impacting profitability and valuations
- Failure to build a brand or expand profitably in the Non-South markets could be an indefinite drag on the financials

Valuations & Outlook:-

- The company is valued very attractively and currently quotes at 9x FY18 PE is a sharp 70+% discount to listed peers
- We value the company at 20.0x FY18 EPS at ₹418/share which implies a ~108% upside from the current market price

Profit & Loss

Particulars (₹Cr)	FY16	FY17E	FY18E	FY19E	FY20E
Net sales	**899**	**534**	**614**	**707**	**813**
YoY (%)	*70%*	**-40.5%**	**15.0%**	**15.0%**	**15.0%**
Total expenses	**833**	**474**	**541**	**615**	**700**
Raw Material Cost	648	**304**	**349**	**400**	**457**
Employee costs	61	**52**	**56**	**60**	**64**
Other Manufacturing Cost	56	**53**	**61**	**71**	**81**
Advertising Expenses	68	**64**	**74**	**85**	**98**
EBITDA	**66**	**60**	**74**	**91**	**112**
EBIDTA (%)	7.3%	**11.2%**	**12.0%**	**12.9%**	**13.8%**
Depreciation	12	**12**	**11**	**11**	**11**
EBIT	**54**	**48**	**63**	**80**	**101**
Interest	34	**23**	**5**	**4**	**2**
Other income	0	**0**	**0**	**0**	**0**
PBT	**20**	**25**	**57**	**76**	**99**
Less: Taxation	7	**9**	**20**	**26**	**34**
Effective tax rate (%)	35.4%	**34.6%**	**34.6%**	**34.6%**	**34.6%**
PAT	**13**	**17**	**37**	**49**	**65**
PAT (%)	**1.4%**	**3.1%**	**6.1%**	**7.0%**	**8.0%**

Key Ratios

	FY16	FY17E	FY18E	FY19E	FY20E
EPS (Rs)	7.1	9.2	20.9	27.6	36.2
Book value (Rs)	131.2	138.1	153.8	174.5	201.7
Dividend per share (Rs)	1.3	2.0	4.4	5.9	7.7
Debt Equity Ratio	0.8	0.2	0.1	0.1	0.0
Payable Days	43	35	35	35	35
Debtor Days	105	89	89	89	89
Inventory Days	50	45	45	45	45
ROCE (%)	8%	10%	10%	12%	14%
Recurring ROE (%)	5%	7%	14%	16%	18%
ROA (%)	8%	10%	10%	12%	14%
Div Yield (%)	0.6%	1.0%	2.2%	2.9%	3.8%
Valuation Ratios					
PE (x)	29.4	22.1	9.8	7.4	5.6
Price/book value (x)	1.6	1.5	1.3	1.2	1.0
EV/sales (x)	0.6	1.0	0.9	0.8	0.7
EV/EBITDA (x)	8.4	9.1	7.4	6.0	4.8
Earnings growth					
EBITDA (%)	51%	-9%	23%	23%	23%
EPS (%)	348%	30%	126%	32%	31%
PAT (%)	348%	30%	126%	32%	31%

Balance Sheet

(Rs Cr)	FY16	FY17E	FY18E	FY19E	FY20E
Equity capital	18	18	18	18	18
Reserves	217	229	257	294	343
Net worth	**235**	**247**	**275**	**312**	**361**
Total borrowings	192	45	35	20	0
Minority Interest	0	0	0	0	0
Non Current Liabilities	9	9	9	9	9
Current Liabilities	150	96	104	113	123
Total liabilities	**586**	**398**	**424**	**454**	**493**
Net block	174	170	167	164	161
Investments	0	0	0	0	0
Others					
Current assets	**413**	**228**	**257**	**291**	**333**
Inventories	124	66	76	87	100
Debtors	257	130	150	172	198
Cash	13	13	13	13	16
Other Current assets	18	18	18	18	18
Total assets	**586**	**398**	**424**	**454**	**493**

Cash Flow

(Rs Cr)	FY16	FY17E	FY18E	FY19E	FY20E
Net profit	13	17	37	49	65
Depn and w/o	12	12	11	11	11
Others	0	0	0	0	0
Change in working cap	(32)	131	(22)	(25)	(29)
Op. Cash flow	**(8)**	**159**	**27**	**36**	**47**
Capex (Net)	(9)	(8)	(8)	(8)	(8)
Investments	0	0	0	0	0
Inv. Cash flow	**(9)**	**(8)**	**(8)**	**(8)**	**(8)**
Dividend	(3)	(4)	(9)	(12)	(16)
Fresh Equity	0	0	0	0	0
Minority interest	0	0	0	0	0
Debt	18	(147)	(10)	(15)	(20)
Others	0	0	0	0	0
Fin. Cash flow	**15**	**(151)**	**(19)**	**(28)**	**(36)**
Net change in cash	(2)	0	0	0	3
Opening cash	15	13	13	13	13
Closing cash	**13**	**13**	**13**	**13**	**16**

Source: Company, DSPL

ANALYST CERTIFICATION

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