

## VADILAL INDUSTRIES

Rating: Conviction Rating:

**BUY**

Price: 1480



### Surge Capital is focused on Six Key Attributes of Long-Term Earnings Growth

-  Strong Business Model
-  Innovation & Pivot
-  Change & External Trend ✓
-  Optionalities
-  Leadership & Edge
-  Stellar Management Execution

Industry:	Ice-Creams
Market Cap:	~Rs1050 Crores
Revenues:	Rs653 Crores
Net Profits:	Rs40 Crores
Net Debt:	Rs90 Crores

✓ Indicates attributes present in the stock

### Brief Thesis

Vadilal Industries is the flagship company of the century old Vadilal Group. Vadilal is one the leading ice-creams brand in India.

Since 2015, Vadilal Industries have started marketing its ice-creams in the US markets. US business has grown at rapid pace over these years and is highly profitable given that the realizations in the US are nearly double than that in India.

The US business now accounts for a dominant share of Vadilal's profits and continues to grow at high rates, translating to potential high earnings growth for Vadilal Industries as a whole in coming years.

However, there are family disputes between the promoters making Vadilal a high return with a high tail risk kind of an investment.

Vadilal is a well know ice-creams brand in India. The brand has a legacy of over a century and was started in 1907. Vadilal Industries is the group’s flagship company that undertakes manufacturing of all products and distribution in the exports markets, whereas distribution in India is done by another listed group company- Vadilal Enterprises. *(finer aspects of group’s structure are detailed in later sections)*

The brand is said to command a 16% share of organized Ice-creams market in India. Vadilal also has a range of processed foods products like frozen vegetables, curries, ready-to-cook products etc.

Vadilal Industries currently markets its products under two brands-



Ice Creams – Domestic Market  
(Distribution by Vadilal Enterprises)



Ice Creams and Processed Foods–  
International Market  
(Distribution by Vadilal Industries)

Processed Foods - Domestic Markets  
(Distribution by Vadilal Enterprises)

### Ice Creams - Brands Portfolio

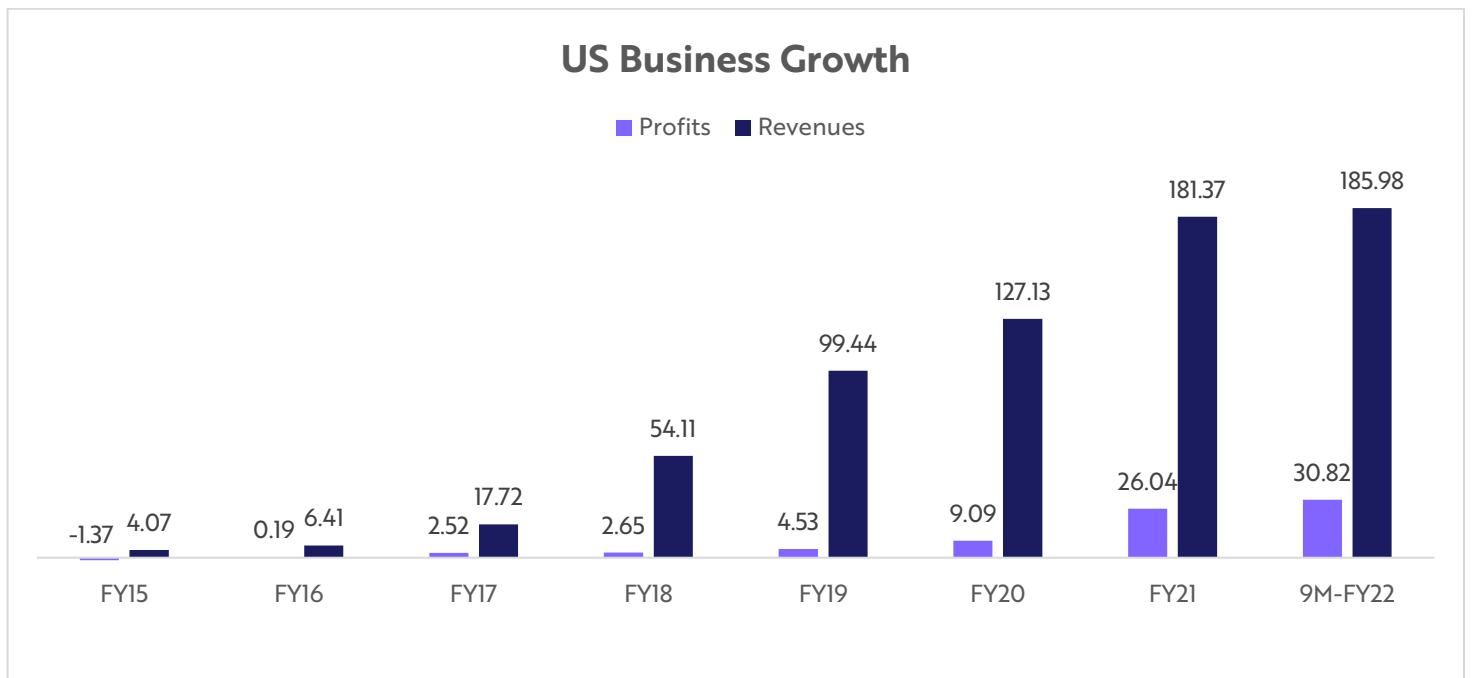


## US Business- The Change & Trend

Vadilal had been exporting its processed food products to various countries for decades, but the business could never really scale and lacked profitability. All this changed in 2015, when the company introduced its Ice-Creams in the US markets.

**“We have been doing international business in frozen foods category for last 25 years. But we failed at it and were losing money on it. Introducing ice-creams and some other products have turned around the same.”** - Rajesh Gandhi, Managing Director (Q2FY19 Concall)

Ice-Creams has been a major success for Vadilal in the US and the growth has been phenomenal-



Vadilal has become the largest Indian Ice-creams brand in the US and Ice-creams constitutes >70% of Vadilal’s international business.



Further, the realization in the US markets for Vadilal's products is nearly double than that in India and thus the profitability of the US business is quite high.

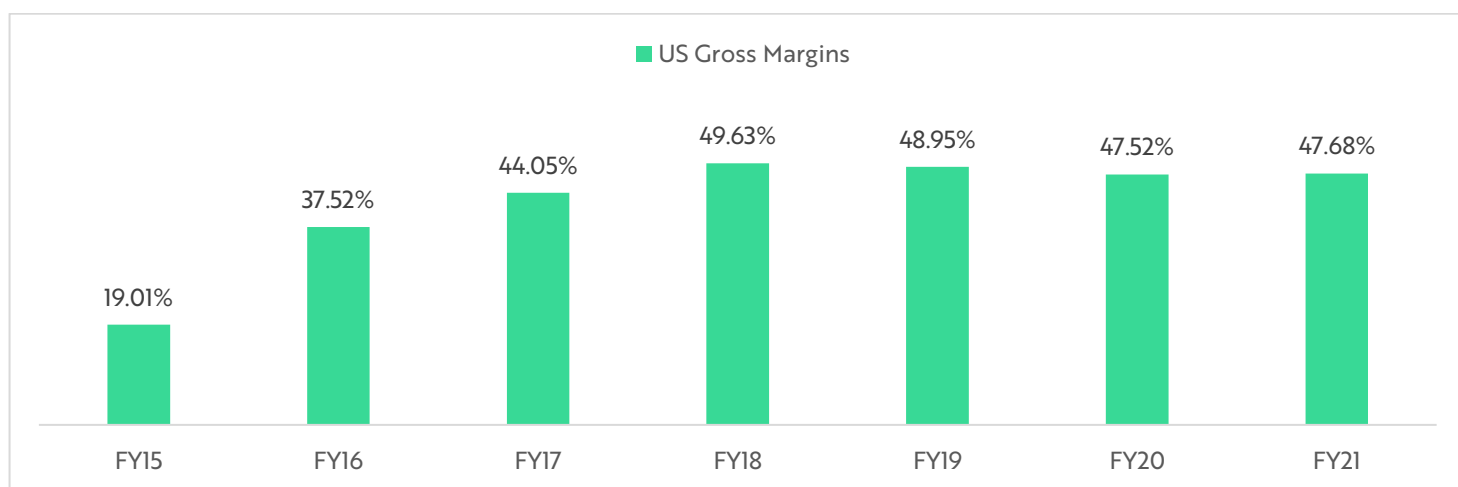
There are two legs of profitability when it comes to the US business-

1. The Indian entity- Vadilal Industries manufactures and sells the products to US subsidiary at the same profitability as it would sell in the domestic markets to its distribution entity- Vadilal Enterprises. This is the 1st leg of profits from the US business, which gets booked in the Indian Standalone entity.

"For India business, exports business EBITDA margins are similar to domestic business."- Q1FY19 Concall

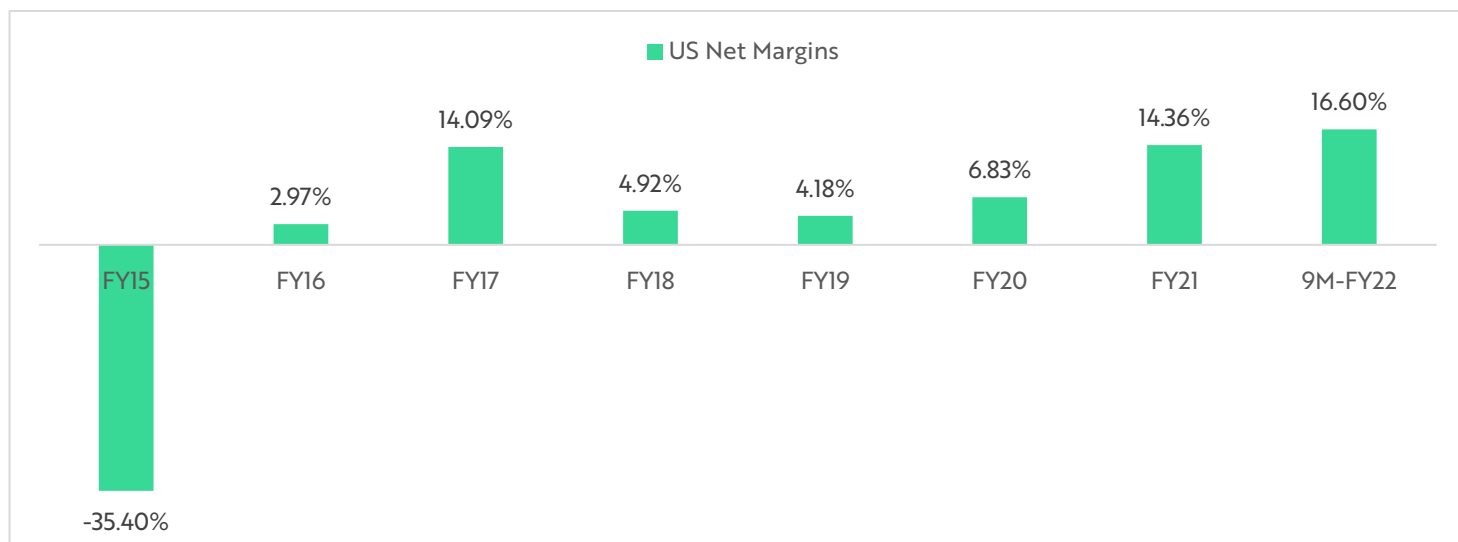
"International business would not subtract profitability from domestic business."- Q3FY18 Concall

2. The US Subsidiary then sells the products at ~50% gross margins ie. 100% markup on sales of Indian entity. This is the 2nd leg of profit from the US business, getting booked in the US subsidiary.



Another thing to note here is that the US business is essentially a distribution business with investments only in distribution assets like warehouses, sales team etc. And since these are largely fixed costs, there exists large operating leverage.

"In long term, expect US business to be 15-20% Net margin business."- Q4FY18 Concall





We believe this success in the US market is largely on the back of brand pull that Vadilal commands. Being such an old brand associated with Ice-creams, multiple generations of Indian diaspora in the US would recognize & trust the brand.

## Robust Expansion in U.S. market



- Latent demand for quality Indian products driving strong volume growth in US ice cream sales
- 50-member team reaching 40 plus US states and ~70% of local Indian diaspora
- Deriving significant benefit from the existing processed foods distribution network in the US
- Expanding product base within existing categories, launched new categories such as Indian Mithai and Paneer



While doing some background research, we found this video wherein a blogger was getting strangers taste Kulfis in New York, USA. And interestingly the products were of Vadilal. More than anything it speaks good of Vadilal’s product placement and distribution in the US markets.



<https://www.youtube.com/watch?v=Bw0WqBJgkYQ>

With this new found traction within the US for the brand, Vadilal Industries is now looking to venture into newer foods categories.



“Have added Mithai to US portfolio and that have done very well. Manufacturing for the same is being done by 3rd party.”- Q2FY19 Concall





We believe that even though these new products can provide some additional growth, but given the competition in these categories from multiple Indian brands like MTR, Haldirams etc it would be difficult to scale the same, something that had been the case for Vadilal before it introduced its Ice-creams in the US.

But we believe their does lies some optionality from Vadilal’s ice-creams getting introduced in other export markets like UK, Australia, Gulf region etc, wherein Vadilal already has a processed foods distribution network. Company has already started taking some steps in this direction-

“We saw some initial thrust with ice creams in African countries as well. This year will be the year of exploring more opportunities in this region. MEA region will see deeper penetration from Vadilal under ice-cream category”- FY19 Annual Report

## Domestic Business

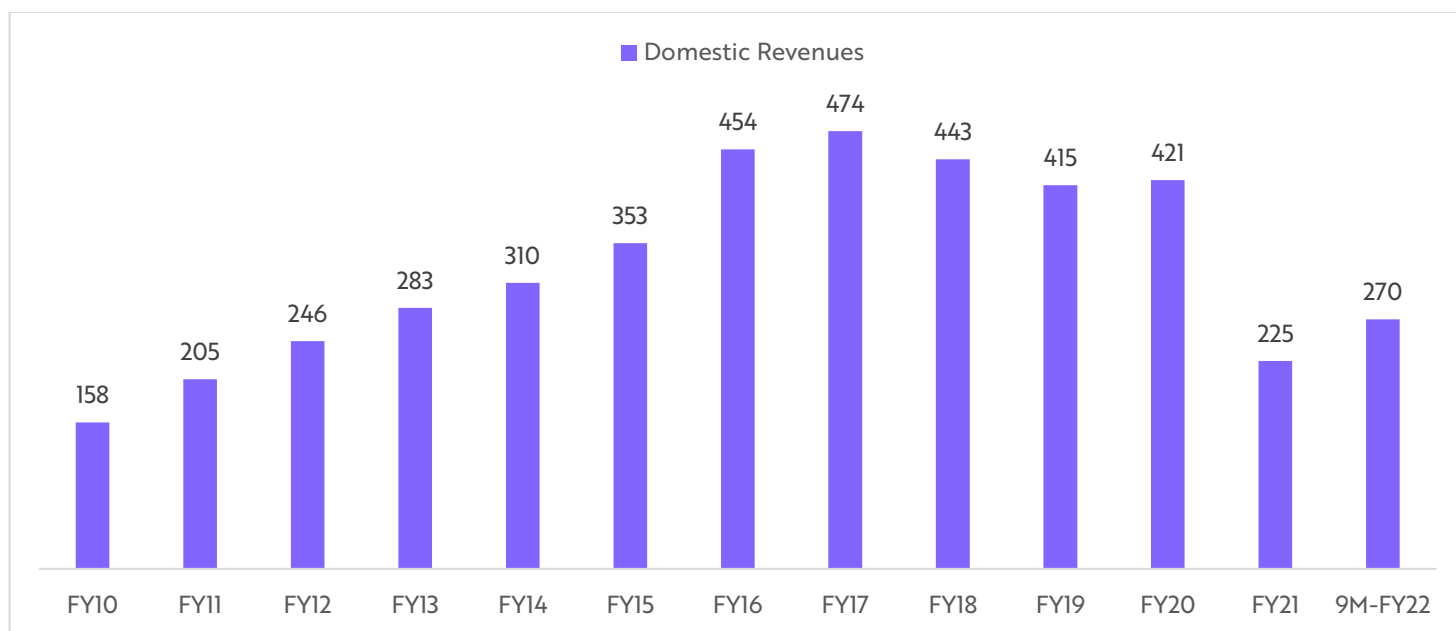
Vadilal Industries primarily sells Ice-creams in the domestic market with some processed foods business.

Vadilal Industries has rights to sell ice-creams under the Vadilal brand in all states except for Maharashtra and Southern states (ex-Tamil Nadu). The rights to these states are held by another entity of Vadilal Family. *(finer aspects of group structure are detailed in later sections)*

Entire domestic distribution of Vadilal Industries is done through Vadilal Enterprises (listed promoter group company). This dual structure was originally established to save some excise duties, but is no longer relevant under GST.

Vadilal Enterprises is basically a cost center given that all the sales & marketing expense for domestic business is done by Vadilal Enterprises, royalty payments to promoter entity for Vadilal brand sales in the domestic business is also done by Vadilal Enterprises and capex spends in freezers to expand distribution is also done by Vadilal Enterprises; so net-net it does not make any money.

In the domestic market, Vadilal has done fine over last decade except for last few years.

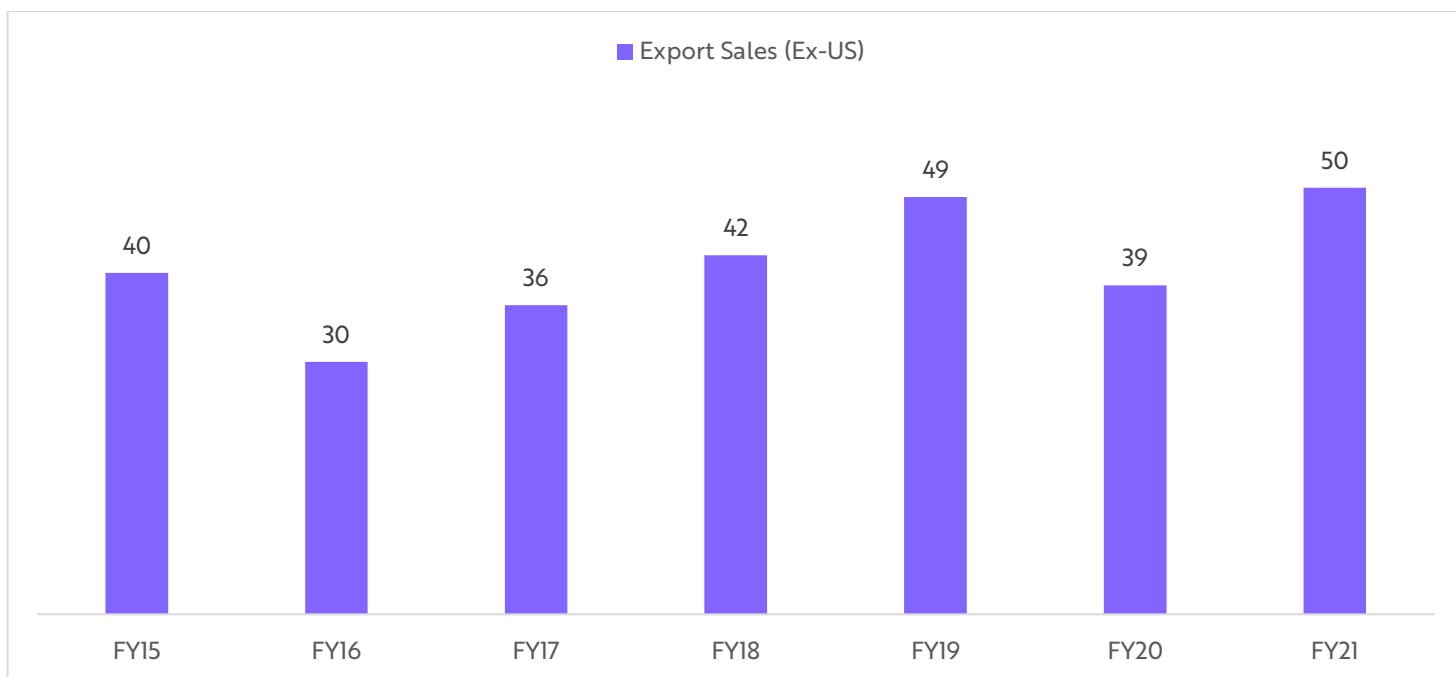


*(Note: These figures represent sales made by Vadilal Industries to Vadilal Enterprises. Number for 9M-FY22 is based on 9-Months results of Vadilal Enterprises)*

### Reasons for subdued performance over last few years-

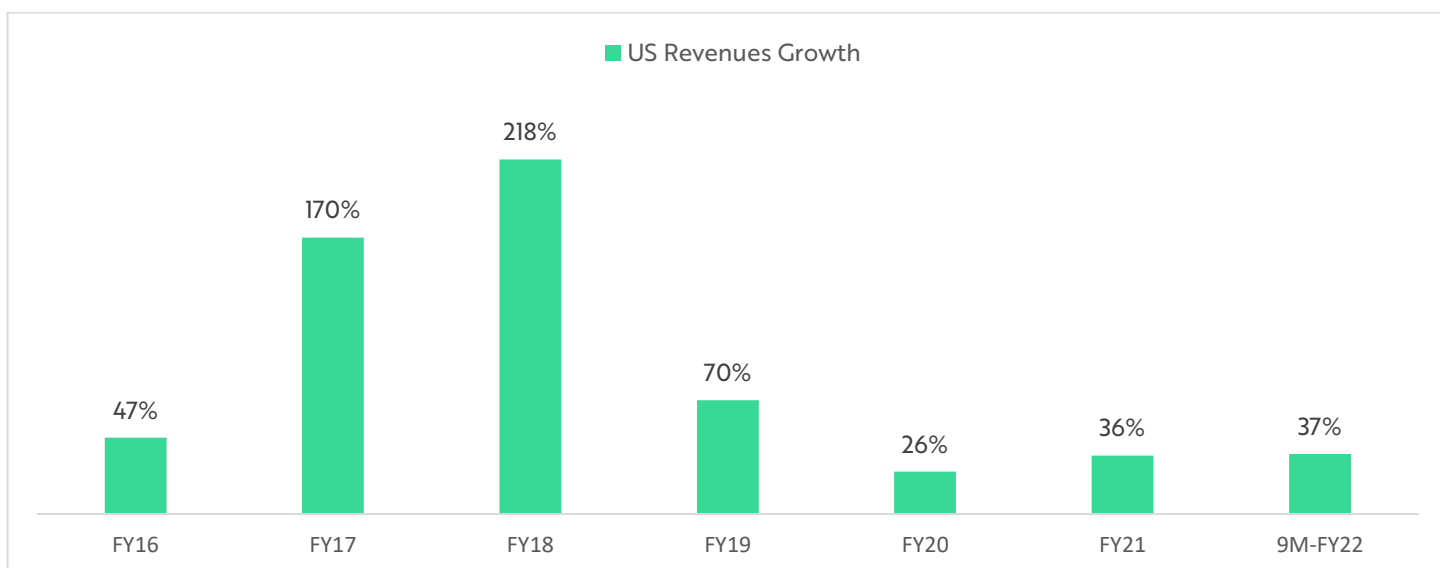
1. Post GST, Vadilal Industries have started billing Vadilal Enterprises on ex-factory basis ie. not taking up the costs of transportation till C&F locations. This way billed revenues are lowered with a similar impact on costs.
2. Company had to absorb some impact of higher GST rate of 18% on ice-creams, which exceeded earlier VAT rates in some states.
3. Last 2-years have been impacted by Covid.





### Possible Growth

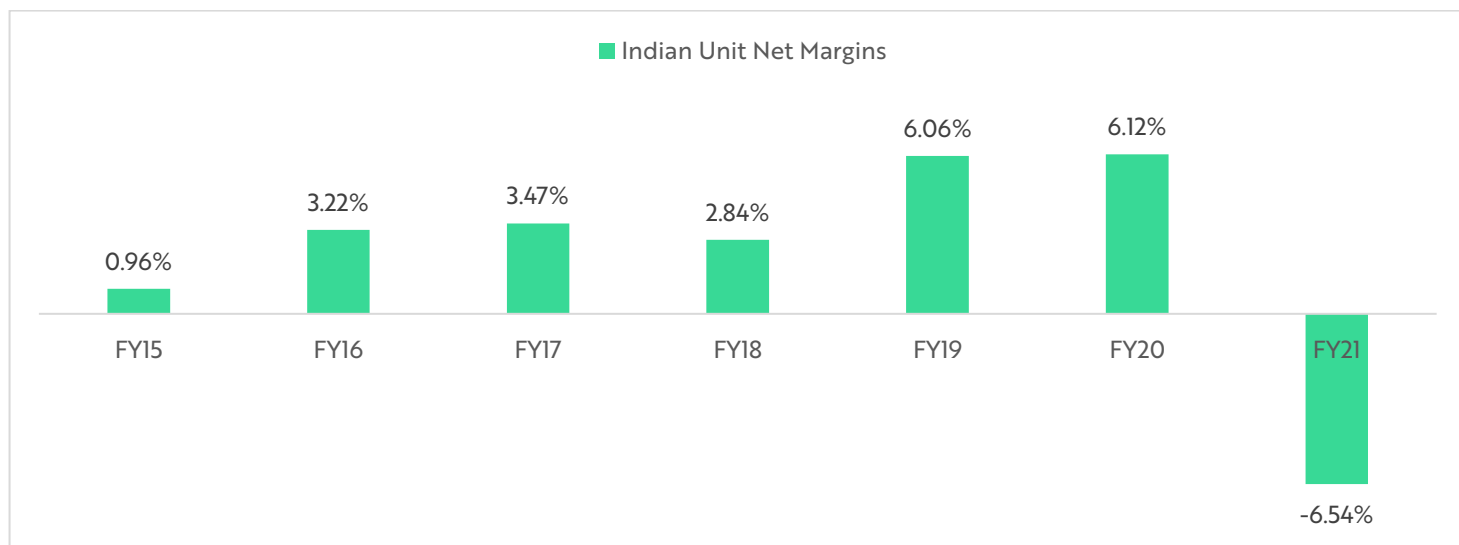
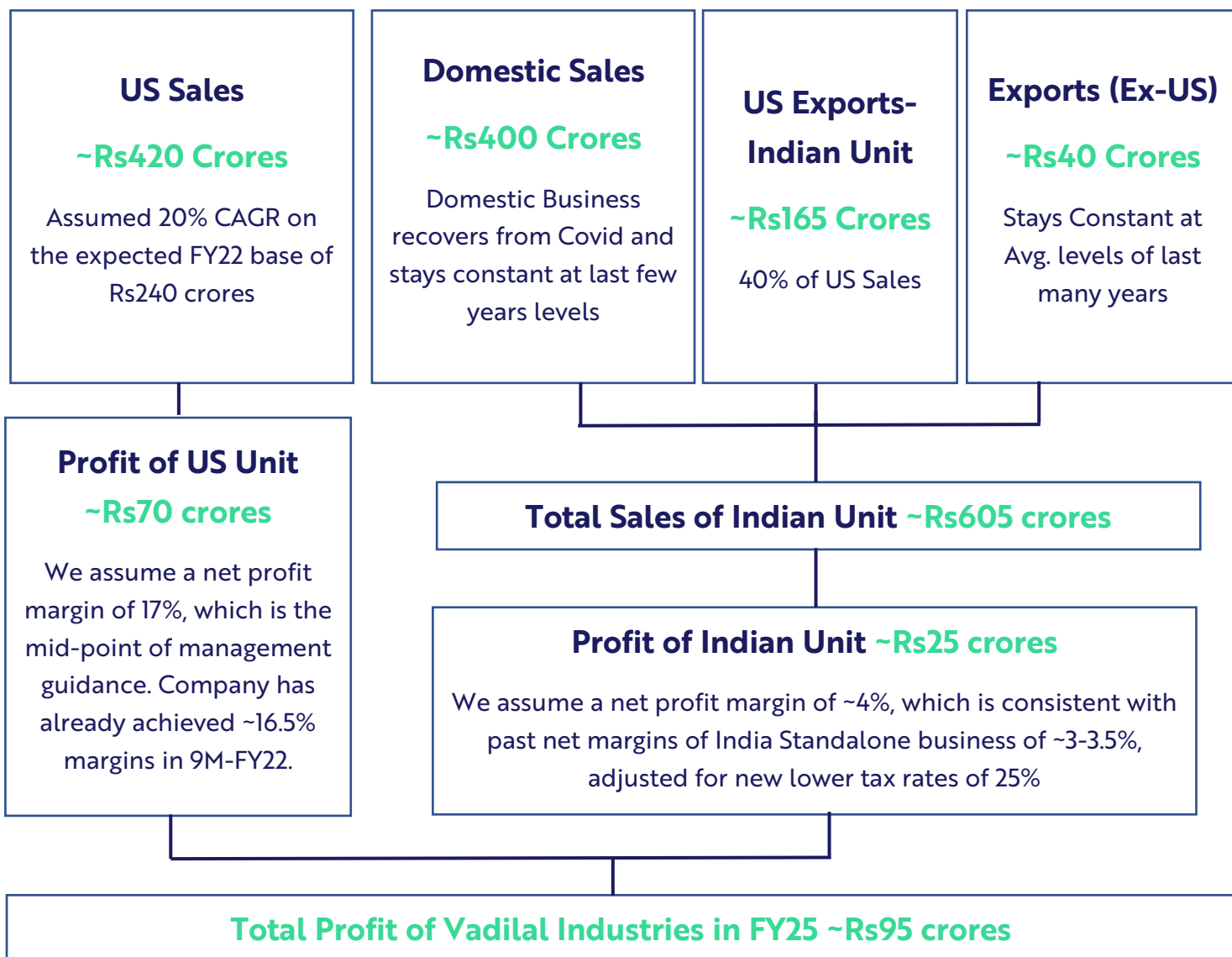
The US business now account for >50% of Vadilal’s consolidated profits, considering normalized pre-covid profits of the domestic business. And with US business continuing to grow at high rates, we believe that on an overall basis, Vadilal Industries has potential to grow earnings at very high rates going ahead.



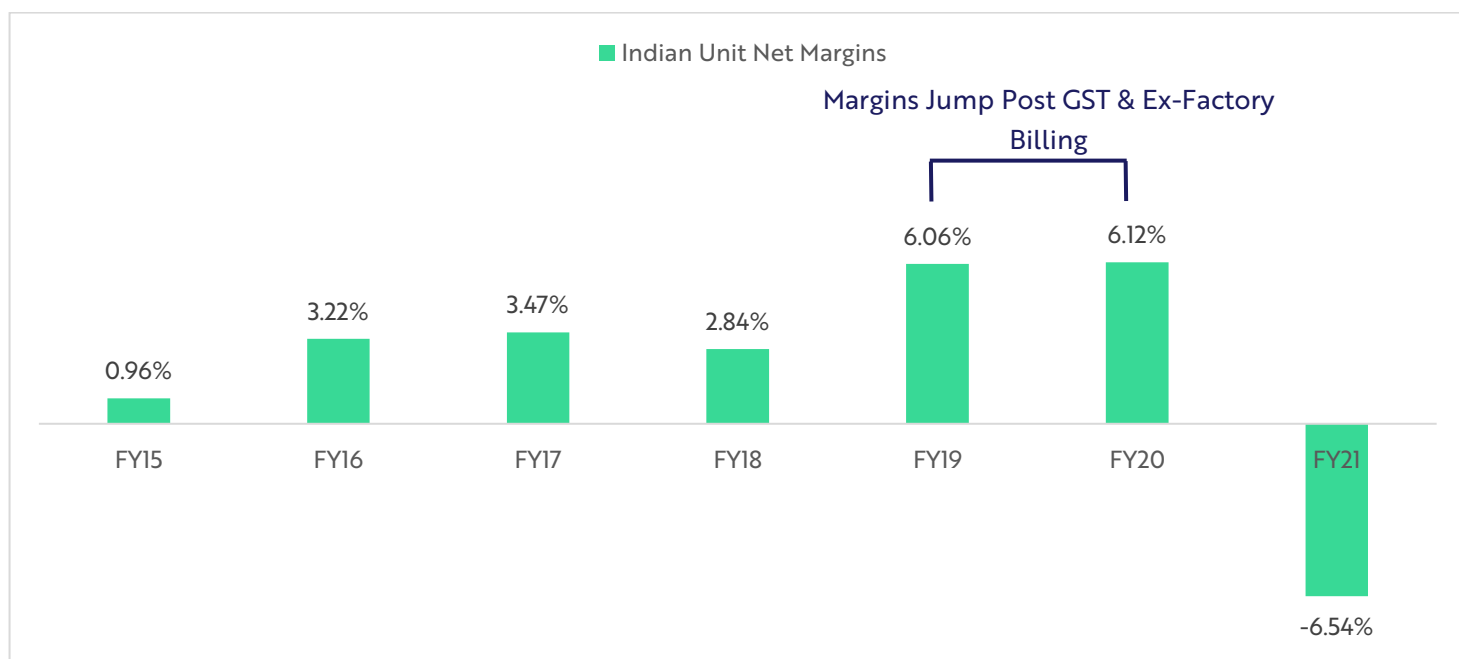
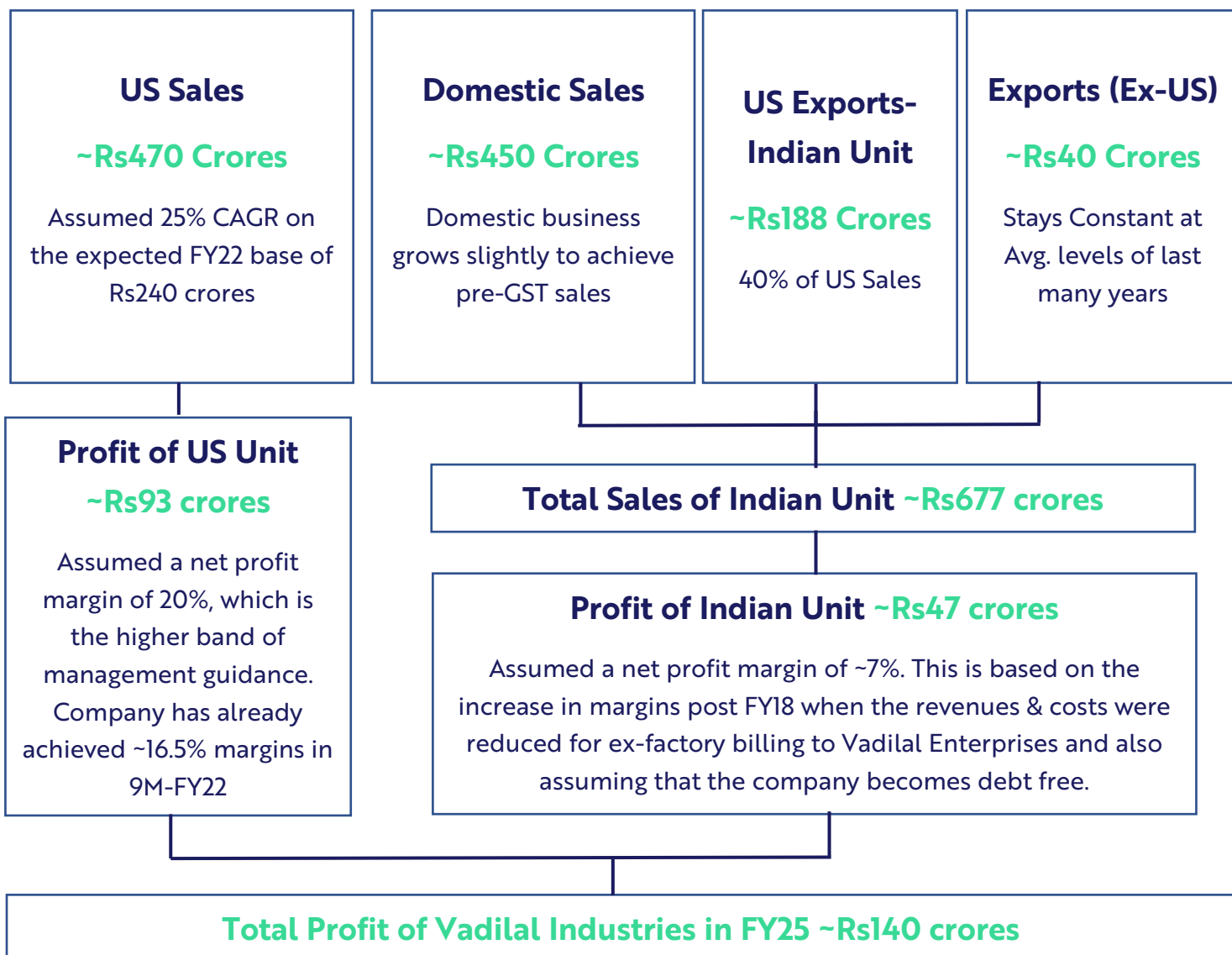
We have considered a base, bull and bear case scenario to get a rough understanding of the quantum of profits that Vadilal can deliver in FY25.

*Note: US Exports-Indian Unit represents the exports value of goods sold by Indian unit to US subsidiary for sales; the 1<sup>st</sup> leg of profit as discussed above. We have considered this as 40% of US subsidiary’s actual sales value; and the same is consistent with past trends and considering the 50% gross margins of US subsidiary with some adjustments for taxes, duties, freight etc*

## 1. Base Case

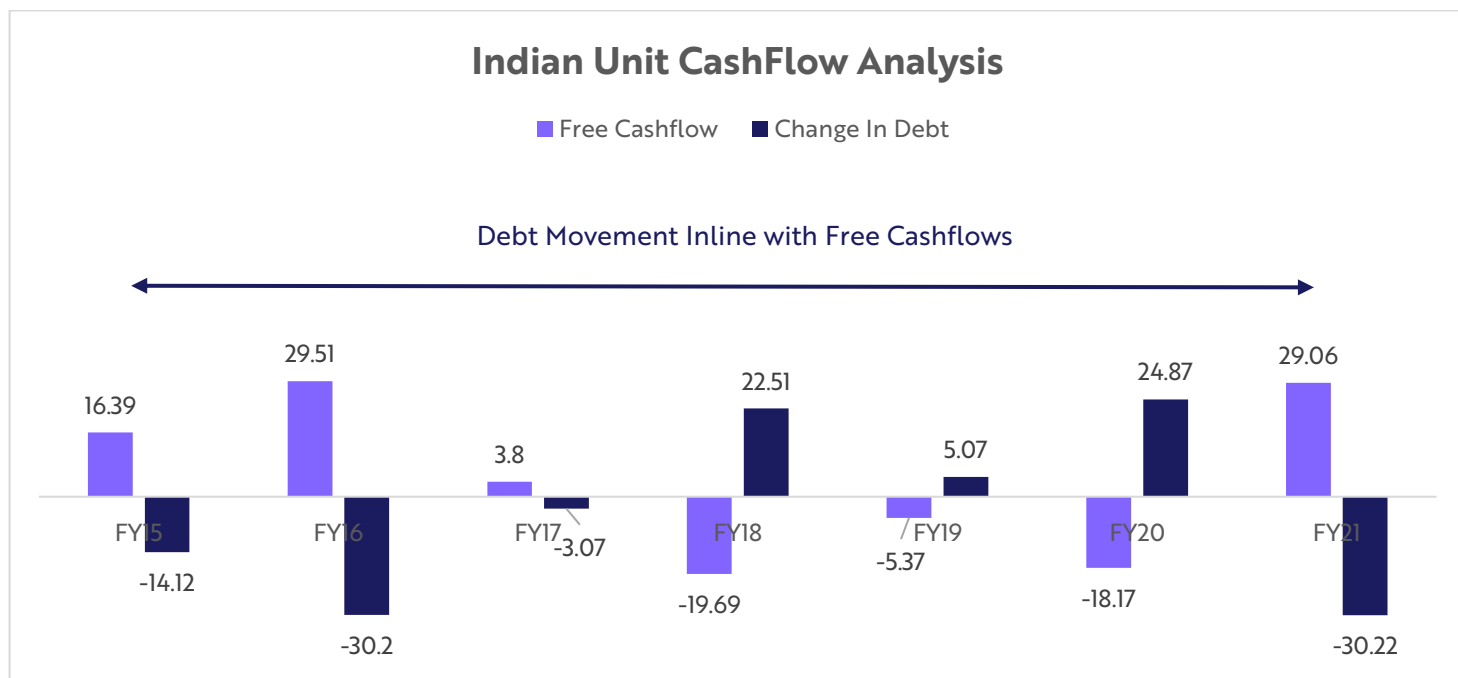
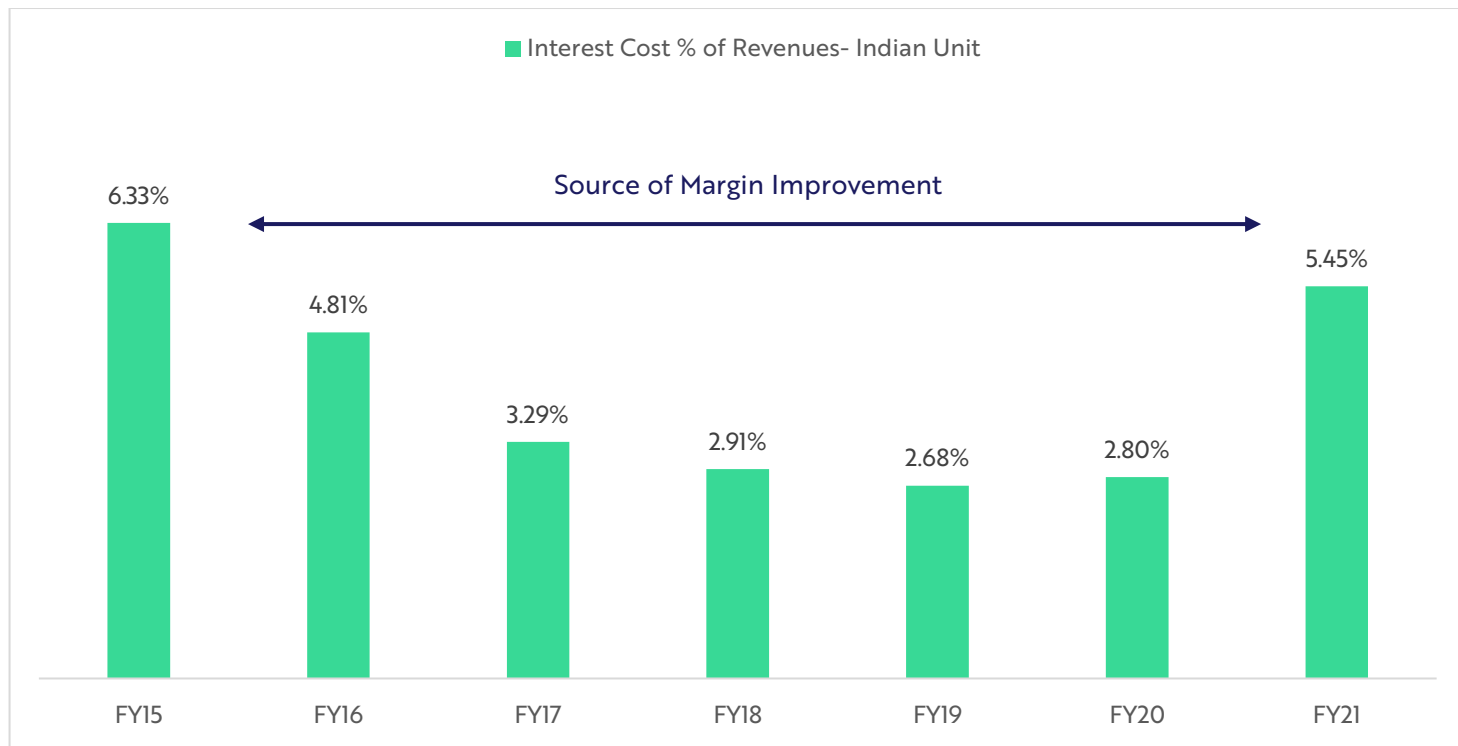


## 2. Bull Case



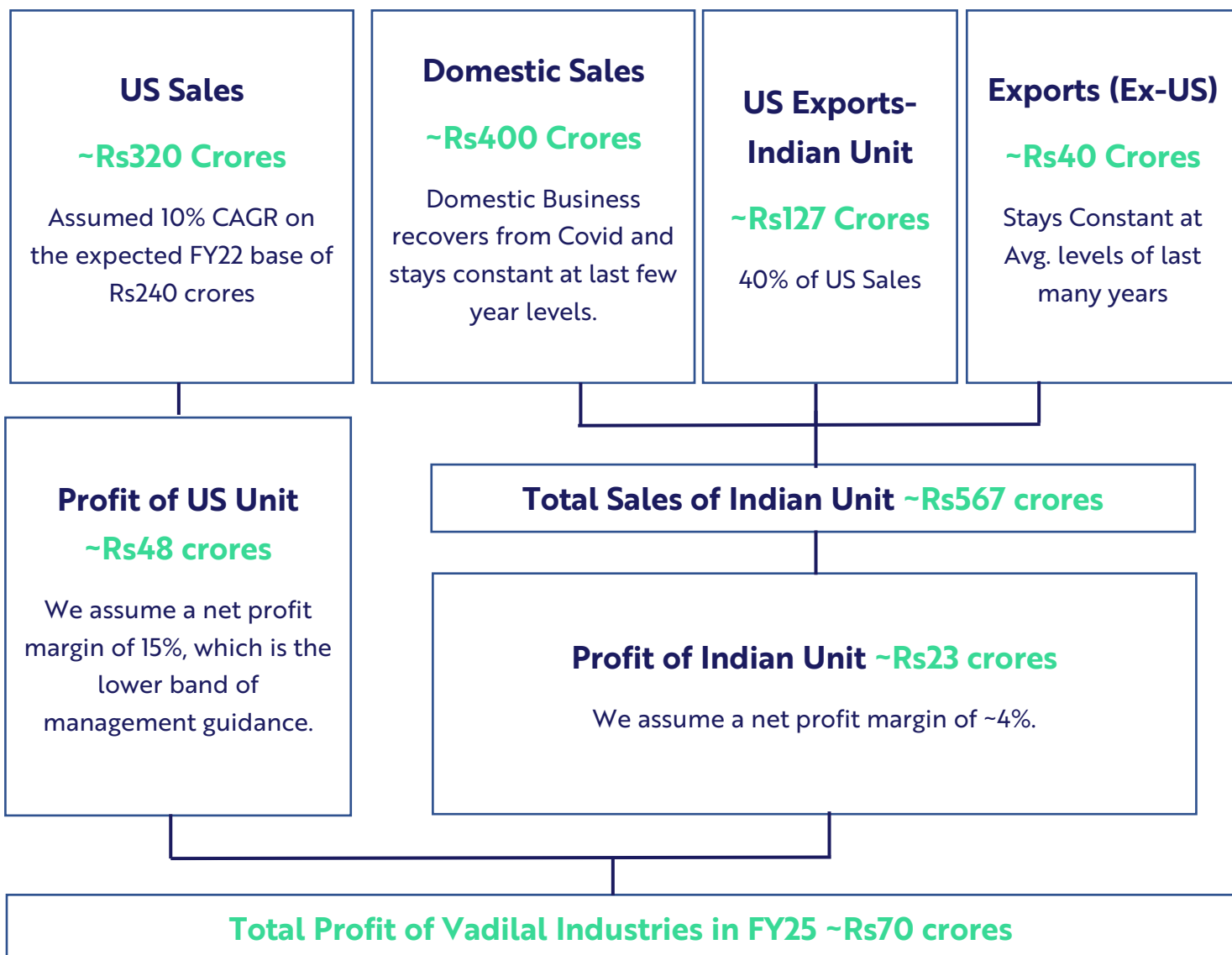


Vadilal has large interest costs, however with high profitability in the US business, the company has been generating strong cash which should be used to pay-off debt. Historically, management has always used free cashflow after capex & interest costs to reduce debt. Vadilal currently has a debt of Rs136 crores in Indian unit and a cash of ~Rs45 crores (majorly in the US subsidiary).



(Free Cashflows= Cashflow from Operations – Capex – Interest payments)

## 3. Bear Case

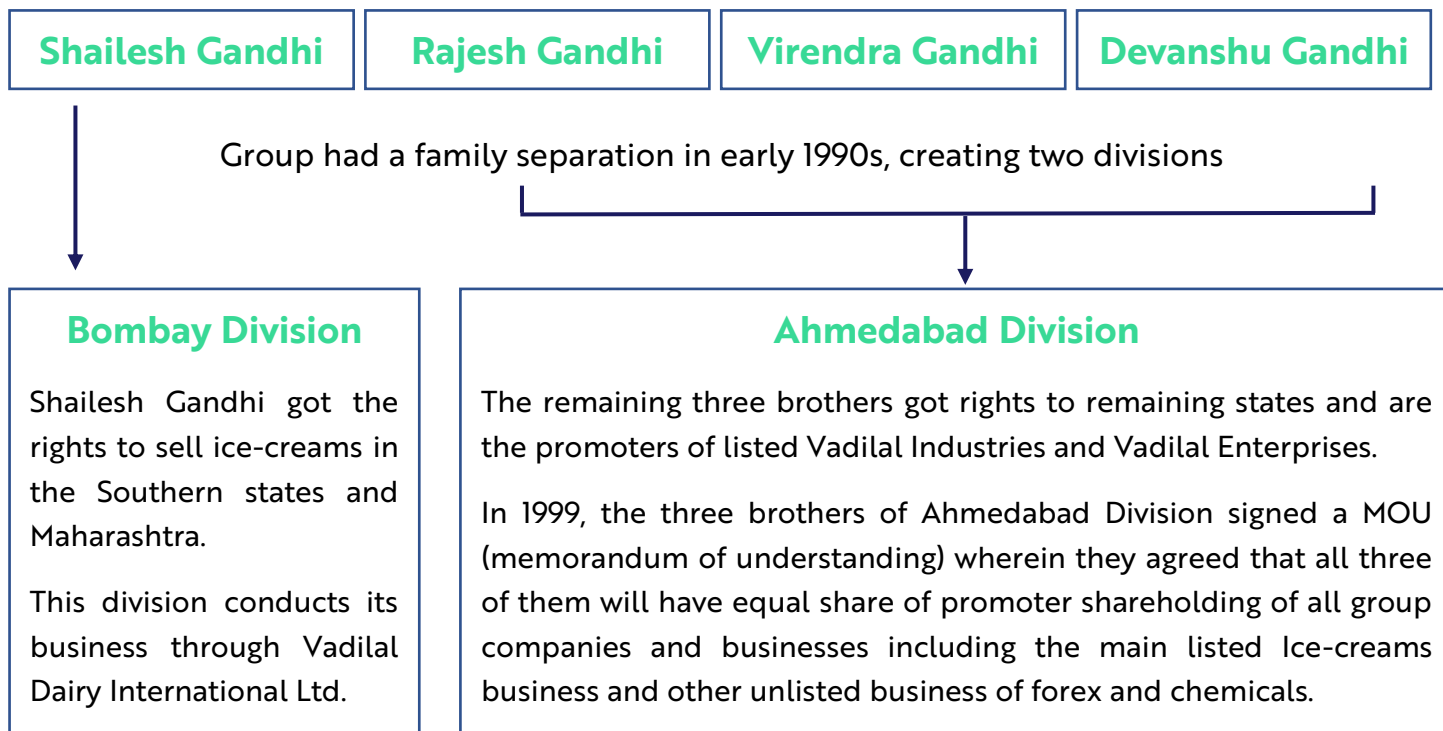


In trailing twelve months, Vadilal has generated net profits of Rs40 crores. Considering the above scenarios, Vadilal could grow its profits by 2-3.5x over next 3-years; making it a high growth opportunity and this is what interests us here that, we have a consumer company with high growth rates; that too available at a reasonable valuation multiple of 26x.

However, there is a major risk here and that possibly explains the lower valuation multiple and interest in the stock.

## Risk- Promoter Disputes

Vadilal group was founded by Vadilal Gandhi in 1907 and is currently run by the 4<sup>th</sup> generation of the family. The 4<sup>th</sup> generation has four brothers-



### 2015

Disputes between the three brothers emerged when Virender Gandhi accused Rajesh Gandhi & Devanshu Gandhi of removing him from the board & management of Vadilal Chemicals and that they have used funds of Vadilal Chemicals to fund a construction business wherein Rajesh Gandhi & Devanshu Gandhi had major ownership.

The case went to NCLT (then company law board), wherein very early on, both parties stated that they are working out a family settlement and thus the case kept getting adjourned. But even after 5-years, the same has not been settled yet.

### 2019

Disputes emerged between Rajesh Gandhi & Devanshu Gandhi wherein both of them accused each other of various things around using Vadilal Industries and Vadilal Enterprises funds for personal use, mismanagement of price sensitive info, improper appointment of independent directors etc.

Even though both of them later on withdrew most of these allegations, the disputes have continued. Very recently in FY21, one of them alleged that the other had not followed proper process in relation to ~Rs38 crores of marketing expense of Vadilal Enterprises.



During this period, two independent directors resigned from Vadilal Industries stating the hostile atmosphere of board & committee meetings and also raised issues regarding arm's length pricing between Vadilal Industries and Vadilal Enterprises for sale of goods.

Deloitte also resigned as the auditor of Vadilal Industries stating that since the board has not been able to complete investigation into the allegations made by both promoters in due time, their firm policy does not allow them to continue the engagement.

**In short, all the three promoters- Rajesh Gandhi, Virendra Gandhi and Devanshu Gandhi have disputes among each other.**

We believe that such family disputes never get resolved and the relations never heal, and the only way to settle the same is to have a separation.

But the problem in case of Vadilal is that, there aren't many businesses in the group to split between them. Ice-creams is the only major business and given that the rights of some states are already with the fourth brother- Shailesh Gandhi; it would not be feasible to split the remaining markets between three brothers.

So, the only option left is to exit the business and split the proceeds. And this is an option that Vadilal's promoters seems to have been exploring.

## Promoters Exit

First news of promoters looking to exit surfaced in 2017, indicating that the promoters have appointed an investment bank to scout for possible buyers.

Then in Jan'20, the news resurfaced, indicating that Private Equity firms- Arpwood Partners and PAG together are looking to buyout entire stake of promoters in Vadilal Industries + Vadilal Enterprises, valuing the companies at ~Rs1000 crores. The news also stated that the talks between promoter group and PE firms were ongoing for long time, but the same got delayed due to pending litigation between brothers.

However, no such deal has materialized yet; maybe Covid affected the same. We believe that one of the reasons why the promoters have not been able to exit the business even after trying to do so for so many years is because of the brand & trademark issue.

## Vadilal Trademark Issue

The Vadilal brand & trademarks are owned & registered in the name of Vadilal International Pvt Ltd.

This is a promoter group entity through which the promoters hold 39% stake in Vadilal Industries, out of total ~65% promoter stake. The brand & trademarks have been licensed to the listed Vadilal Industries and Vadilal Enterprises by Vadilal International Pvt Ltd through a 15-year agreement starting around 2012.

But the problem is that the Ahmedabad Division (owners of Vadilal Industries) are not the sole owners of the brand, they share the same with the Bombay Division (Shailesh Gandhi- Vadilal Dairy International Ltd) as per the 1990s family separation.

Now if we think about it, any potential buyer would want unencumbered rights to the brand.

In the current scenario, even if the Ahmedabad division wants to sell out, they probably might need some sort of NOC from the Bombay division as well, given that they share the Vadilal brand. Plus, in future, any decisions related to the brand might need similar approval/consultation with the Bombay division. This is not an ideal situation for any potential buyer.

And this issue is evident from the fact that when the Ahmedabad division wanted to market the products in the exports market, they could not use the Vadilal brand straight forward. They could only use the same with a prefix or suffix, which is what resulted in a separate brand of Vadilal Quick Treat.

Only in their exclusive geographies of Indian states (ex- South & Maharashtra), is where they can use the Vadilal brand straight forward.

Now there do exists a possibility wherein a potential buyer also buys out the Bombay division, which itself is not doing well; hardly ~50 crores topline business. But it is not something that we would base our thesis on, if it happens then that could be a positive.

## The bigger questions for us are-

### A. How does these promoter disputes affect business performance?

The business performance has not been affected over last 5-years. In fact, the entire US business has been built over this period. Both Rajesh Gandhi and Devanshu Gandhi have been part of day-to-day activities of the company this whole period. Virendra Gandhi had retired from day-to-day management in 2013.

### B. How does this impact market's perception and thus stock's valuations?

Well, this is where the real risk lies in Vadilal Industries. Such issues do impact stock valuations and this is probably the reason why a high growth consumer business like Vadilal currently trades at ~26x multiple; compared to much higher multiple for other B2C FMCG companies.

## Expectations Ahead-

We believe that Vadilal Industries as a business is very well placed in terms of growth, on the back of its US business. But with issues around promoter disputes, there exists a risk in the form of valuation de-rating.

**But this risk coupled with the recent downfall in domestic business due to covid is what creates this opportunity wherein the stock & the underlying strong trend of US business is being ignored by the market.**

Our understanding & experience of the markets have been that if the business keeps doing well, overtime the markets have a tendency to overlook such things, unless and until there are events or actions that are against the direct interests of investors, which is not the case here; promoters are not trying to short-change the investors.

This is not to say that it takes care of the risk; it doesn't and thus **Vadilal is a high return with a high tail risk kind of an investment**. We are buying Vadilal at ~1050 crores market cap ie. 26x trailing twelve months earnings and we see three possible scenarios-

A. Market takes cognizance of underlying business growth, but continues to give a lower multiple compared to other similar B2C businesses given the risk and thus valuations stay at current levels; in which case we make high returns led by high earnings growth. **(Our Primary Expectation)**

B. Market continues to ignore the stock due to promoter issues and thus the valuations continue to compress to say a low multiple of 10x; here we would end up with no returns.

C. If somehow the promoters are able to sellout to a private equity, it would be positive for valuation multiple and thus our returns could be much higher than the earnings growth.



## Ratings Explanation:

**Buy:** Expected total return (price appreciation plus dividend yield) of more than 10% over next 12 months.

**Hold:** Expected total return (price appreciation plus dividend yield) of +/- 10% over next 12 months.

**Exit:** No Further Coverage/Update on the stock.

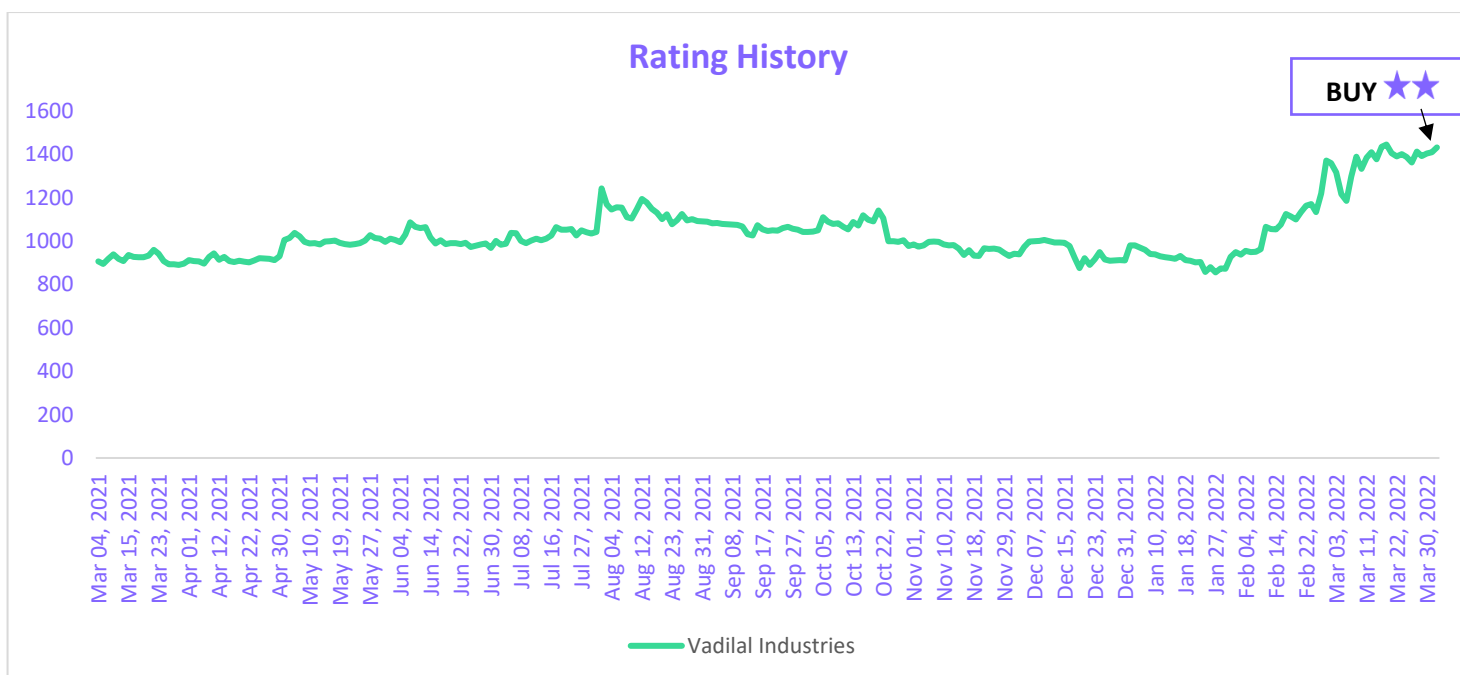
## Conviction Rating:

Conviction rating reflects our understanding of return:risk ratio of the underlying stock for next 12 months. The rating is given within a range of 1-5 stars, wherein each higher star reflects a higher return:risk ratio; so, 1 star indicates a low return:risk ratio and 5 star indicates a high return:risk ratio.

The rating is based on our qualitative understanding of how the four factors of- Price Action, Earnings Growth, Valuations & Perception will play out over next 12 months for the stock.

Conviction ratings are to be read along with Buy & Hold ratings and no conviction rating is assigned for stocks with Exit rating.

**Note: Ratings are valid till changed.**



Note: Above chart indicates ratings assigned (including changes) over the period of coverage of stock.

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No associates

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