SURGE CAPITAL

26th September 2022

SAFARI INDUSTRIES

Rating: **BUY**

Conviction Rating: ★★

Price: 1524

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:	Luggage
Market Cap:	Rs3600 Crores
Revenues:	Rs 878 Crores
Net Profits:	Rs 48 Crores
Net Debt:	-

✓ *Indicates attributes present in the stock*

Brief Thesis

Safari is the 3rd largest Luggage brand in India. Though the company was started in 1974, it was an insignificant player till 2012. Post takeover by Mr.Sudhir Jatia in 2012, the company has grown from just 2% market share to ~20% market share; delivering >30% growth rates.

During this scale up phase, Safari was lagging in terms of profitability and ROCEs. But now after achieving a decent scale, Mr.Jatia's focus has shifted toward profitability and capital efficiencies. This change is important for Safari as it would allow the company to continue to grow at past high rates through a mix of sales & profitability improvements and allay some of the concerns around cashflows.

This change is further supported by the changes in the industry wherein the shift in supply chain and move towards hard luggage will help drive profitability and capital efficiencies for the industry.

Ankush Agrawal

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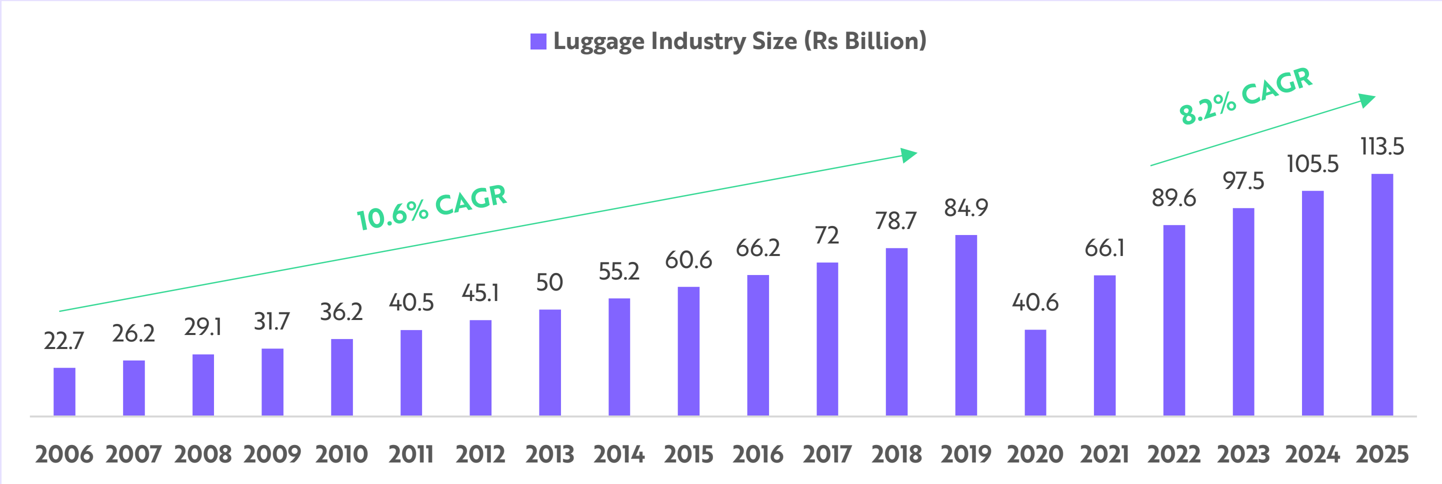
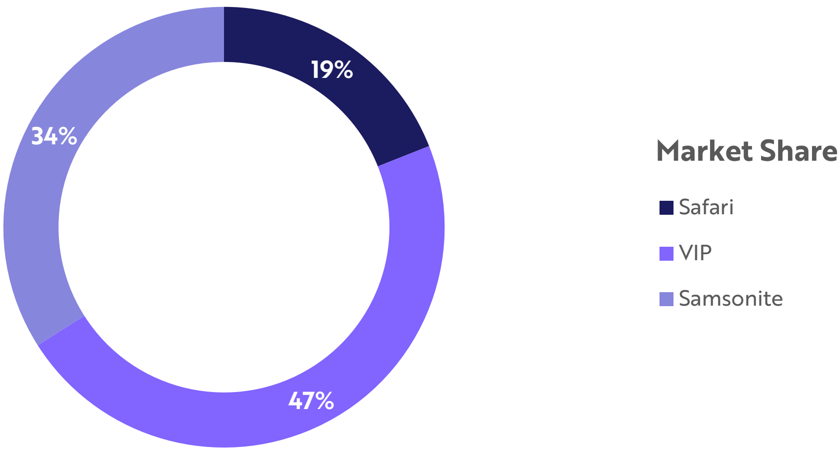
Indian Luggage Industry

Luggage industry in India is a ~9000 crore market with double digit growth rates. It is an oligopolistic market with 3 players- Safari, VIP and Samsonite representing nearly the entire organized market.





Each of these three players have leadership position (through their flagship brand) in individual segments of the market; with presence in adjacent segments through secondary brands.

Segment	Avg. Selling Price (Rs)	Leading Brand	Other Brands
Premium	>Rs7000	Samsonite	Carlton (VIP)
Economy	Rs5000-7000	VIP	Skybags (VIP) American Tourister (Samsonite) Safari (Safari)
Mass	<Rs5000	safari	Alfa, Aristocrat (VIP) Kamiliant (Samsonite)

Attractiveness of Luggage Industry

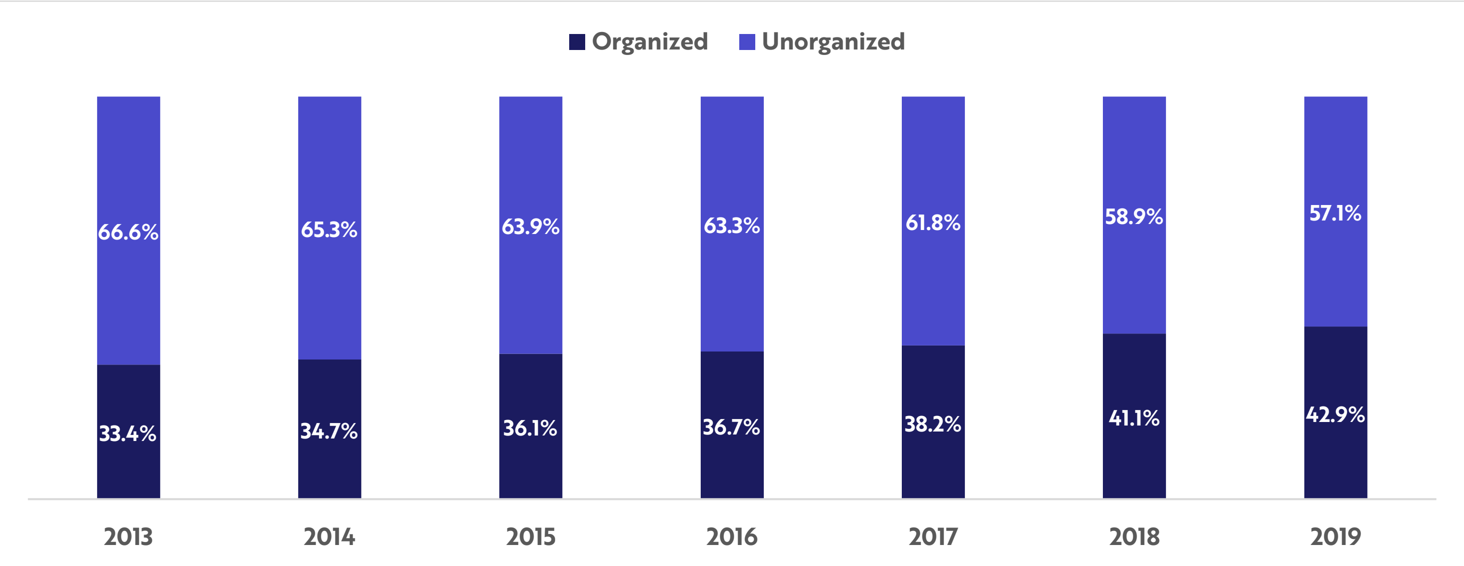
01. High Entry Barriers

- Luggage is a bulky product with large number of SKUs across various form factors, size and colors. This results in a situation wherein the end retailer can stock only few brands due to limited shelve space. Further, luggage has a long replacement cycle, wherein for the customer utility of the product spans across multiple years and thus the brand plays an important role in the buying decision.

- Because of these reasons, Luggage is an oligopolistic industry wherein only a couple of players have dominated the market. For a new player to enter & create a reasonable presence would take a lot of resources and time. Further, given that the profit pool of the industry is not very large (VIP with 50% market share makes ~150 crores in profits), it dissuades larger companies who have the time & resources.

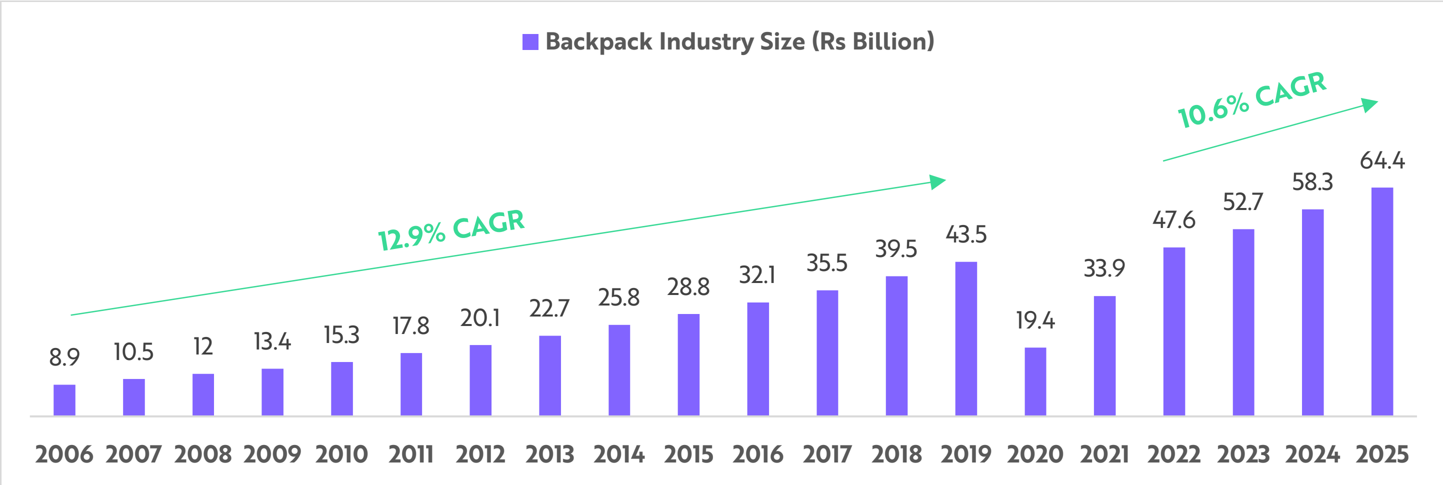
02. Strong Growth Prospects

Not only is the luggage industry growing at near double digits, unorganized players still constitute nearly half of the overall market and are losing market share to the organized players; thus, the organized players are growing at 1.5x the overall market.



03. Brand Adjacencies

- Luggage players have also been able to leverage their brands into the adjacency of Backpacks, which is a faster growing category (due to lower replacement cycle).
- Backpacks as a category is highly competitive with multiple brands and has a much larger share of unorganized players (~2/3rd)



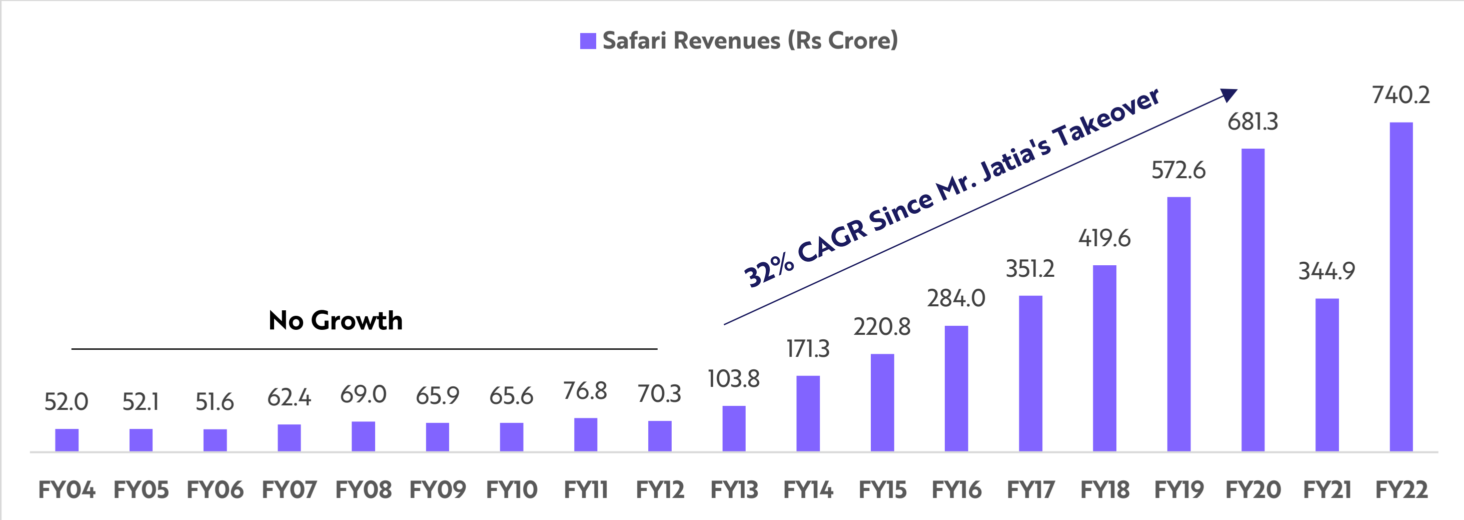
(Source: Euromonitor)

Safari Industries

Safari is the 3rd largest Luggage brand in India. The company was started way back in 1974, but was a marginal player with just 2-3% market share till 2012. The brand was revived in 2012 when Mr. Sudhir Jatia acquired 77% stake in the company.

Safari has seen exponential growth since Mr.Jatia's acquisition-

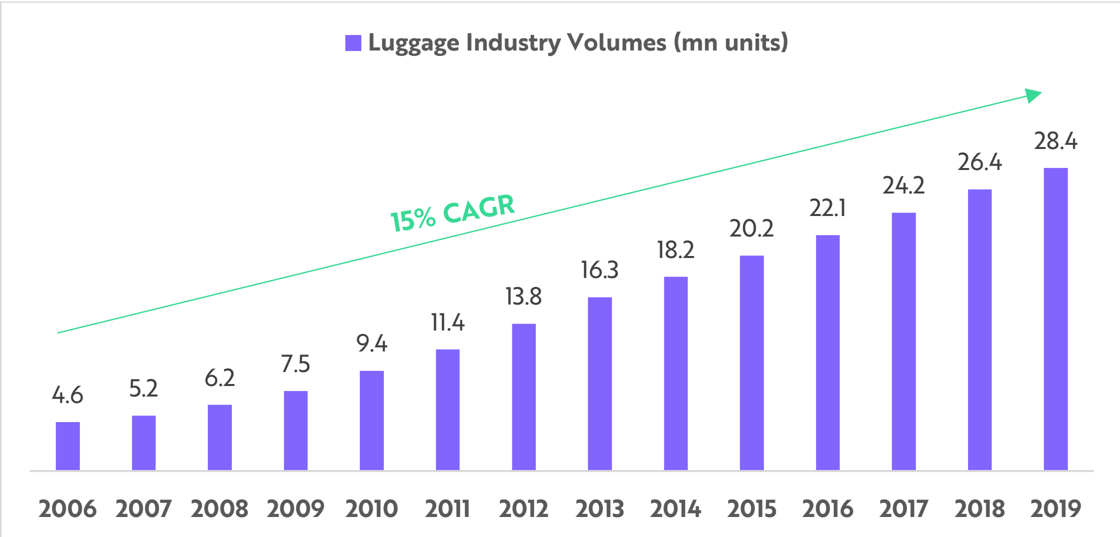
- **Mr. Sudhir Jatia is a commerce graduate from Mumbai University.**
- **Before taking over Safari, he was the MD & CEO of VIP Limited.**
- **He joined VIP through VIP's acquisition of Aristocrat Luggage Ltd in 1998.**
- **Aristocrat currently is VIP's mass market brand.**
- **Thus, he has a rich experience of ~30 years in the Luggage Industry; firstly, at Aristocrat then at VIP and now at Safari.**



Sudhir Jatia's Strategy & Vision for Safari

The primary factor that has led to Safari's growth has been Mr.Jatia's positioning of the brand as a mass market brand. This helped Safari in two ways-

A. Growth within the mass market segment of the industry has been much higher given the fact that the shift from unorganized to organized is largely happening in this segment of the market.



Volume Growth is 1.5x the Value Growth, Indicating Lower End of the Market Is Growing Faster

B. Existing players were not focusing on this segment of the market.

VIP- Had dominant position in Economy segment and was focusing to expand into the Premium Segment with its brand- Carlton. It was also trying to hold its ground within the Economy segment as the VIP brand was losing relevance with the youth; which it was able to do with Skybags.

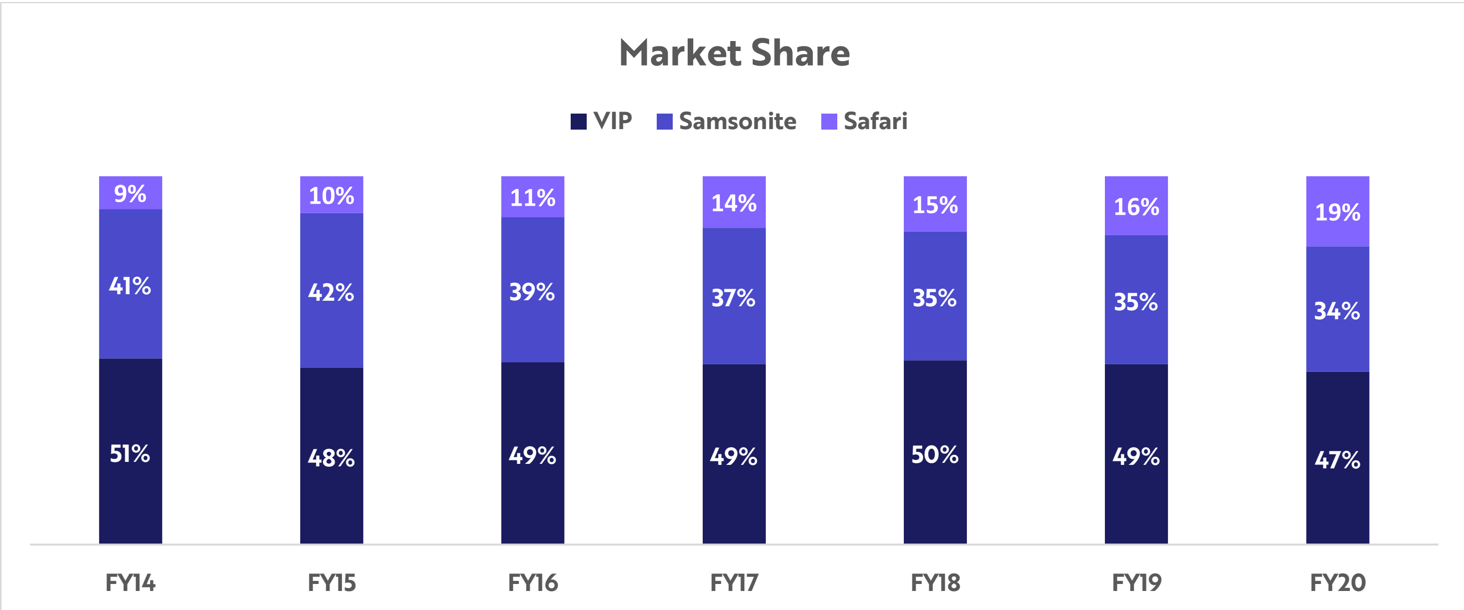
SAMSONITE- Had dominant position in Premium segment and was focusing to expand into the Economy Segment with its brand- American Tourister. It entered the mass market segment very late in 2016 with its Kamiliant Brand.

Though both the companies had presence in the mass market segment, they were not able to capture the mindshare of the consumers in this segment given that this segment was not catered by the flagship brands of the companies (which had that brand following). It was being catered by the secondary brands. Not to mention that the company's resources & focus was diverted more towards their flagship brands and not the secondary brands.

Company	Flagship Brands	Segment Catered by Flagship Brands	Other Brands
VIP	VIP and Skybags	Economy	Premium- Carlton Mass- Alfa, Aristocrat
Samsonite	Samsonite and American Tourister	Premium and Economy	Mass- Kamiliant
Safari	Safari	Mass	Mass- Magnum

"We focused on one battle at a time and put disproportionate resources at that single area"- Sudhir Jatia

Because of this singular focus on one brand & one segment (which was growing faster & not focused by existing players); Safari was able to grow in an industry like Luggage industry, wherein it is extremely difficult for new players to enter. And contrary to general belief, our understanding is that VIP & Samsonite never really lost any market share to Safari, they just were not able to capture the growth in the mass market segment, that Safari was able to capitalize on disproportionately.

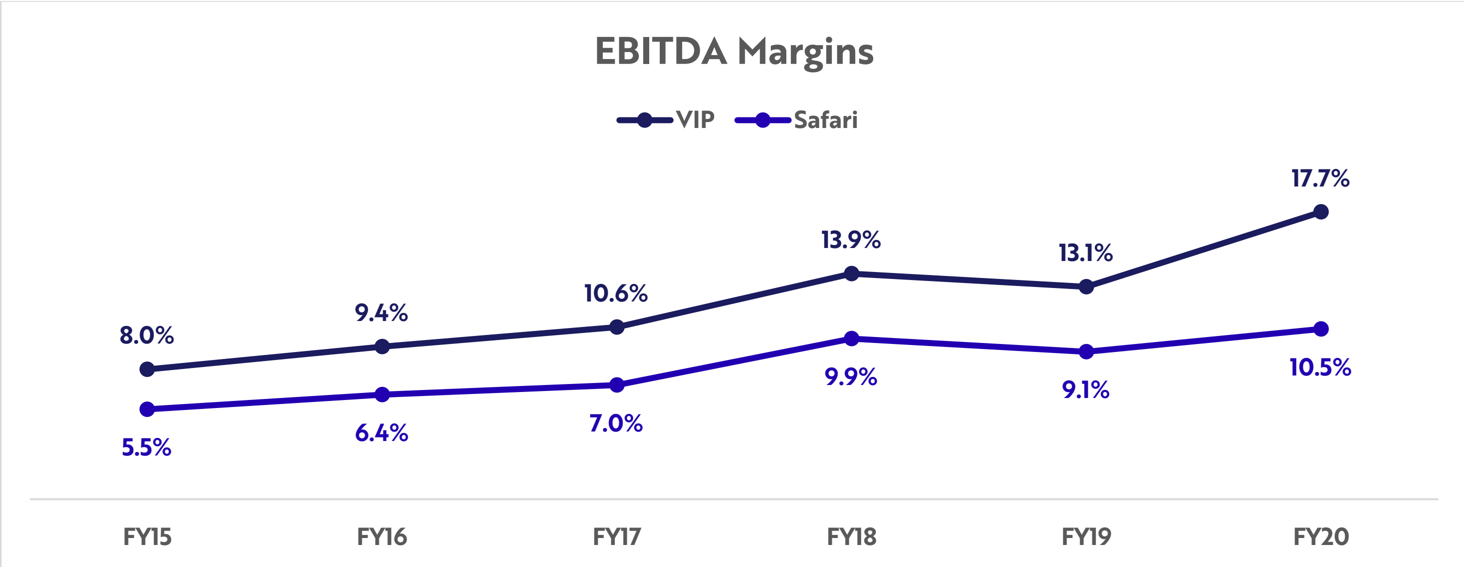


Issue of Profitability & Cashflows

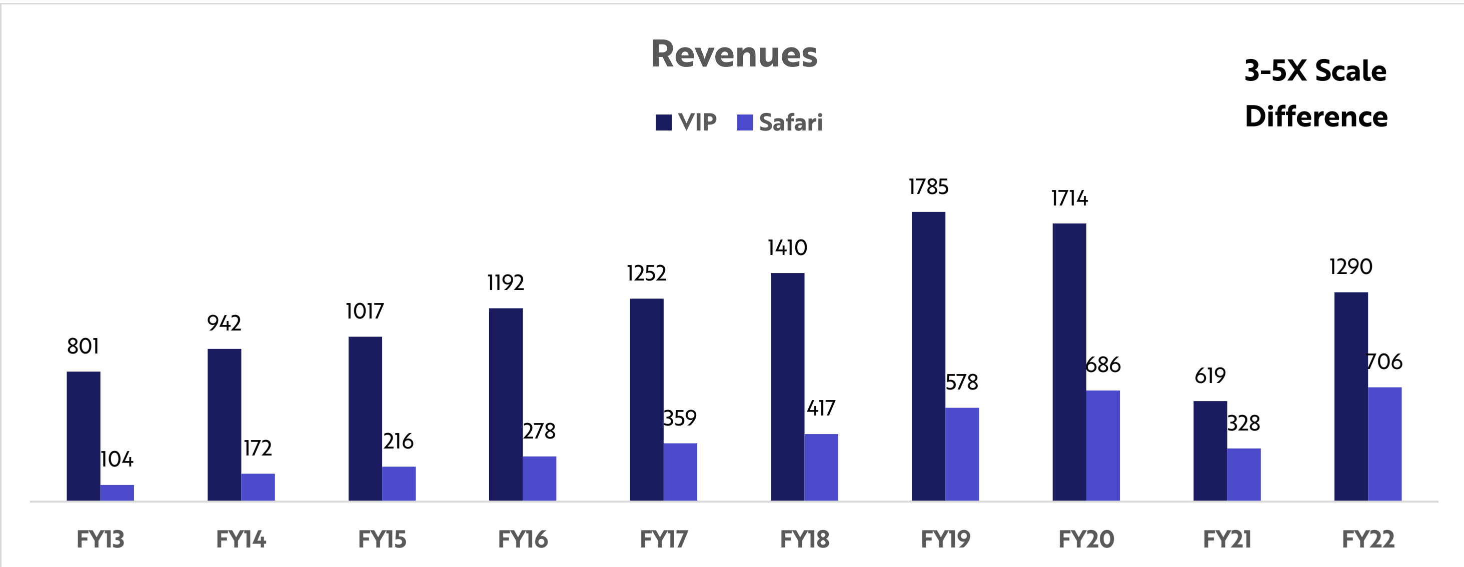
Though Safari had been doing much better than its peers like VIP in terms of growth, it did lag in terms of profitability and working capital efficiencies.

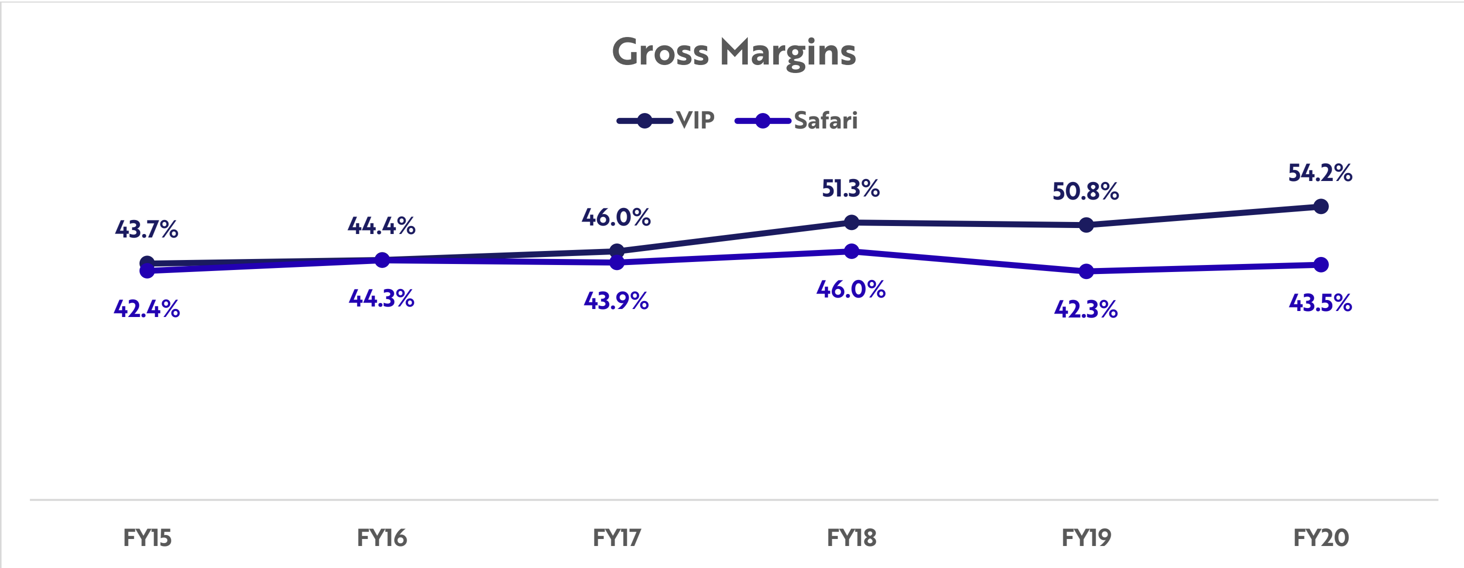
A. Profitability

Since Mr.Jatia's takeover of Safari, its profitability has improved considerably; that too year after year. However, it has always been lower than that of VIP.



The primary reason for this lower profitability for Safari is the brand's positioning. Since VIP is positioned at much higher price points of the market, it can drive a higher premium for its products visa-vi Safari. Further, the scale of VIP's operations has been 3-5x higher than that of Safari, resulting in better operating leverage.





(Note: The above comparison of gross margins is not perfectly accurate given that VIP has a much larger share of in-house manufacturing and in case of in-house manufacturing, some of the costs are not captured in the COGS part, but in the other expense line)

B. Working Capital Efficiencies

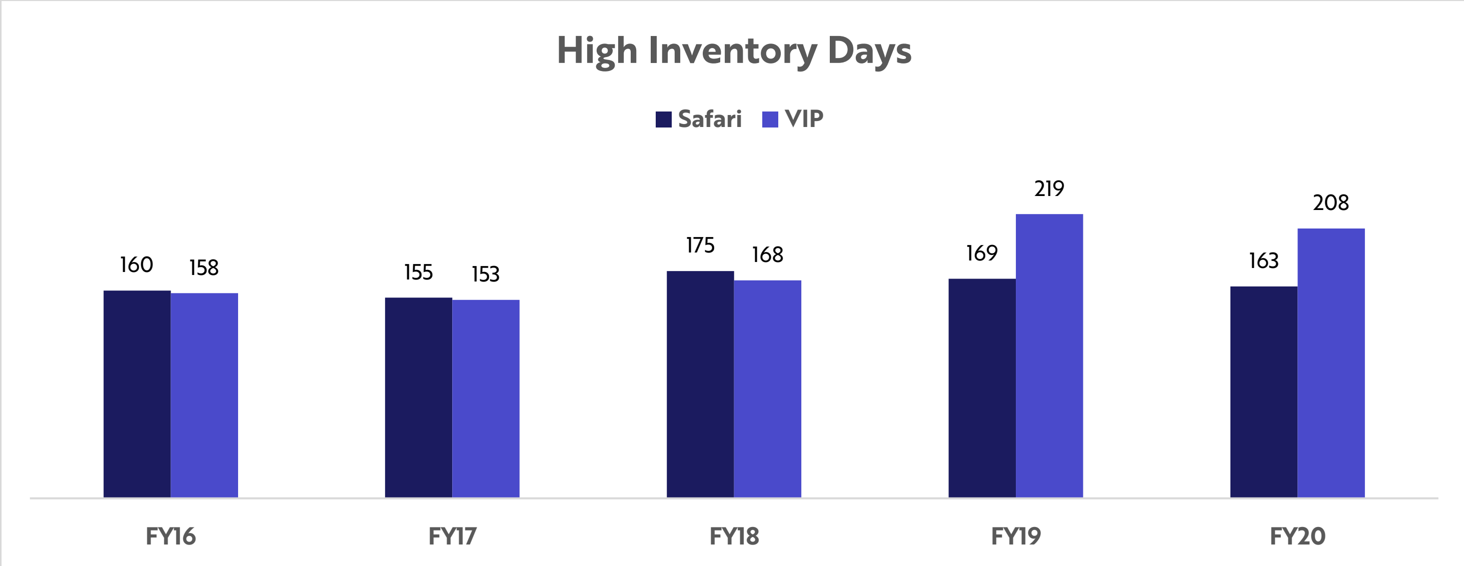
Luggage as a business has largely been a trading business wherein products have historically been sourced from manufactures in China and thus the business has large inventory cycle and high working capital requirement.

Soft Luggage (Including Backpacks)

- Labor Intensive Manufacturing
- Largely Outsourced- Earlier to China, now to Bangladesh
- 55-65% of Revenues for Players

Hard Luggage

- Largely Manufactured In-House
- 35-45% of Revenues for Players



Safari's working capital days have been much higher than VIP in the past. Part of it was on account of higher debtor days and part on lower credit days.

	FY16	FY17	FY18	FY19	FY20
Safari					
Debtor Days	62	57	71	77	77
Inventory Days	160	155	175	169	163
Creditor Days	37	49	77	66	64
Net Working Capital Days	185	162	169	180	176
VIP					
Debtor Days	46	35	46	61	57
Inventory Days	158	153	168	219	208
Creditor Days	89	78	113	132	135
Net Working Capital Days	115	110	101	148	130

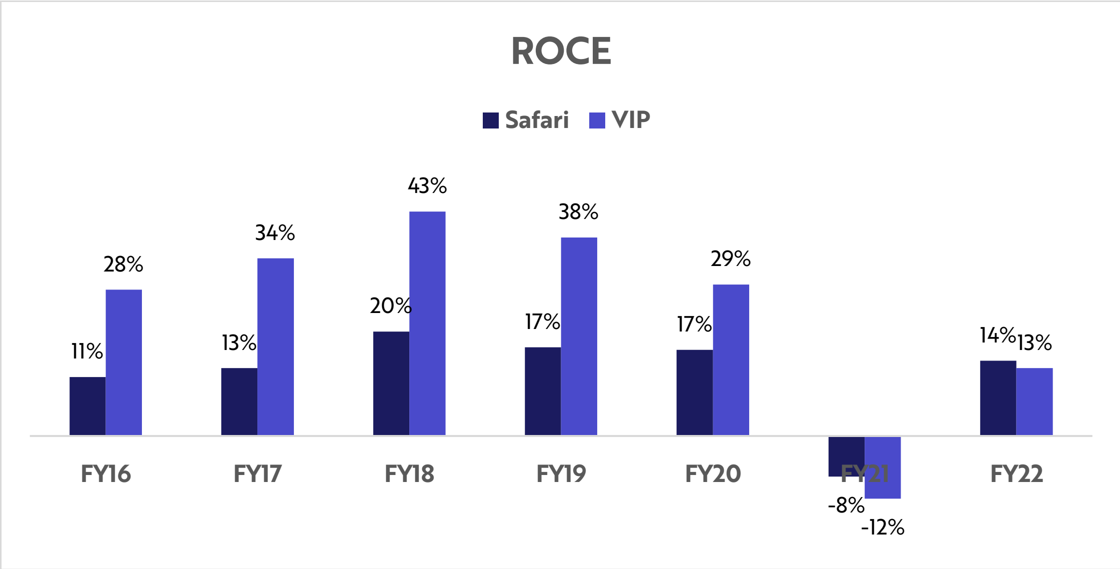
Higher Debtor Days

In order to grow, Safari had to push sales, which it did by offering higher credit period to its distributors. Further, Safari had higher reliance on CSD (Canteen stores department) as a sales channel, wherein the credit period is high.

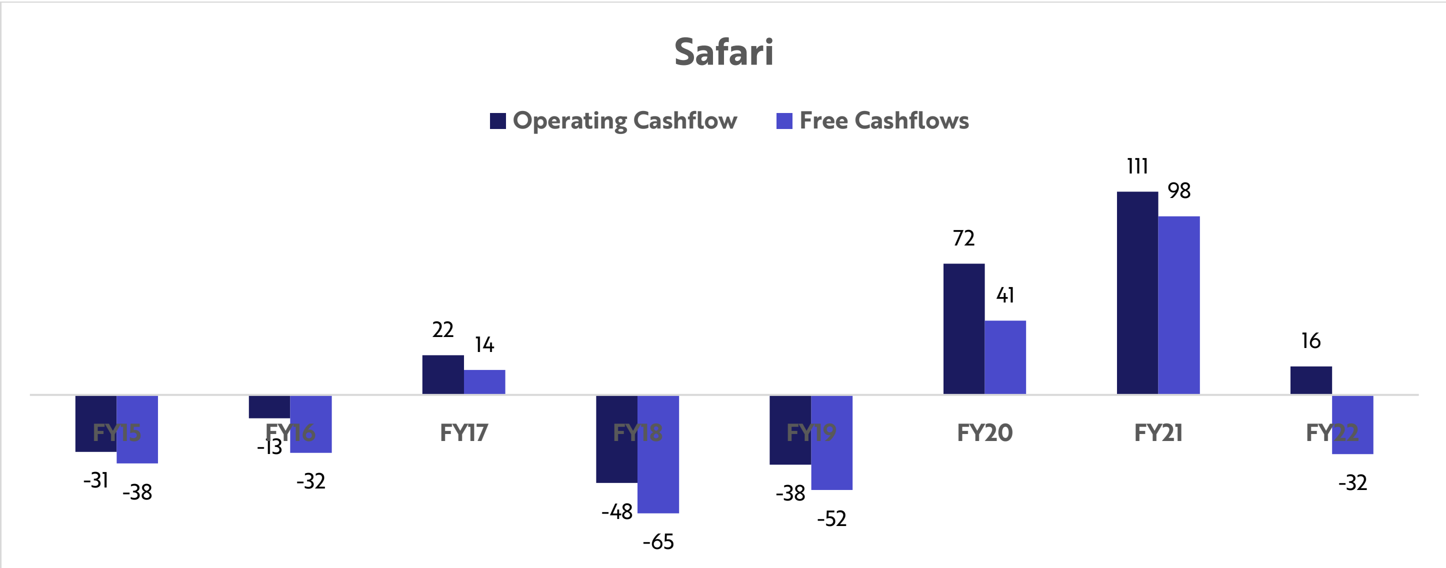
Lower Credit Days

Due to lower scale of operations, Safari had much lower negotiation power with vendors in China vs someone like VIP and thus it had a much lower credit.

Due to this high working capital requirements and lower profitability, Safari's ROCE (return on capital) has been subpar (mid-teens) and much lower than that of VIP. And given the fact that Safari has been growing at 30%, there was a huge gap between growth rate and capital generated by business, resulting in negative cashflows for the company.



Large Gap Between Safari's ROCE and its 30% Growth Rate



And in order to bridge this gap between ROCE and growth Safari had to resort to multiple equity dilutions in the past.

Year	Remark
FY15	Raised Rs70 crores though preferential issue to Tano Capital and Warrants to Promoters. 41% Dilution.
FY18	Raised Rs51 crores from Malabar. 7.2% Dilution.
FY21	Raised Rs75 crores from Investcorp. 6% Dilution.

This Negative cashflows and frequent equity dilutions has been one of the major concerns for the investor community while considering Safari as an investment.

Change- Focus on Profitability & Efficiencies

"We decided when we took over the company that with 2% market share, we are an insignificant player, so the journey was very clear that in next 5-7 years we must become atleast a double-digit market share company. Otherwise, being an insignificant player, you can be killed anytime. So, the game was very clear, which was to grow"- Mr. Sudhir Jatia

Now after becoming a significant player with nearly 20% market share, Mr. Jatia's has shifted his focus to profitability and efficiencies.

"Have now started looking at market share of profits and not just revenues"- Mr. Sudhir Jatia

The primary way Safari is looking to improve its profitability is by driving premiumization on its flagship Safari Brand. Mr. Jatia has always stated that though Safari operates in the mass market segment, it is not selling cheap products and is providing better value addition at competitive price.

According to him, Safari is a premium brand for its customer segment and now the company wants to capitalize on this by bringing some premiumization to the Safari brand, while its 2nd brand- Magnum will occupy the space left by the Safari brand in the value segment.

"Channel checks show that the Safari brand can command as high a selling price as Rs5000. Currently, the average selling price of the brand is Rs3000, which means there is still some pricing potential within the brand that can be unleashed"- Ambit Capital

We believe that with this premiumization drive and further improvement in scale of operations the company should be able to continue to improve its profitability (as seen in the past) and drive efficiencies.

The company has already improved its working capital cycle meaningfully as of FY22 and expects working capital cycle to stay at these levels going ahead.

Safari	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Debtor Days	62	57	71	77	77	132	53
Inventory Days	160	155	175	169	163	262	107
Creditor Days	37	49	77	66	64	127	71
Net Working Capital Days	185	162	169	180	176	268	88

Substantial Improvement in Working Capital

This change is important for Safari on multiple fronts. Firstly, it would allow Safari to continue to maintain high growth rates of the past, as growing sales at 30% rate might be difficult at current scale; but with improving profitability, it can still achieve high growth rates in profits with relatively lower revenue growth rates. And growing revenues at ~20% rate should not be a challenge when the industry itself is growing at 10-15%.

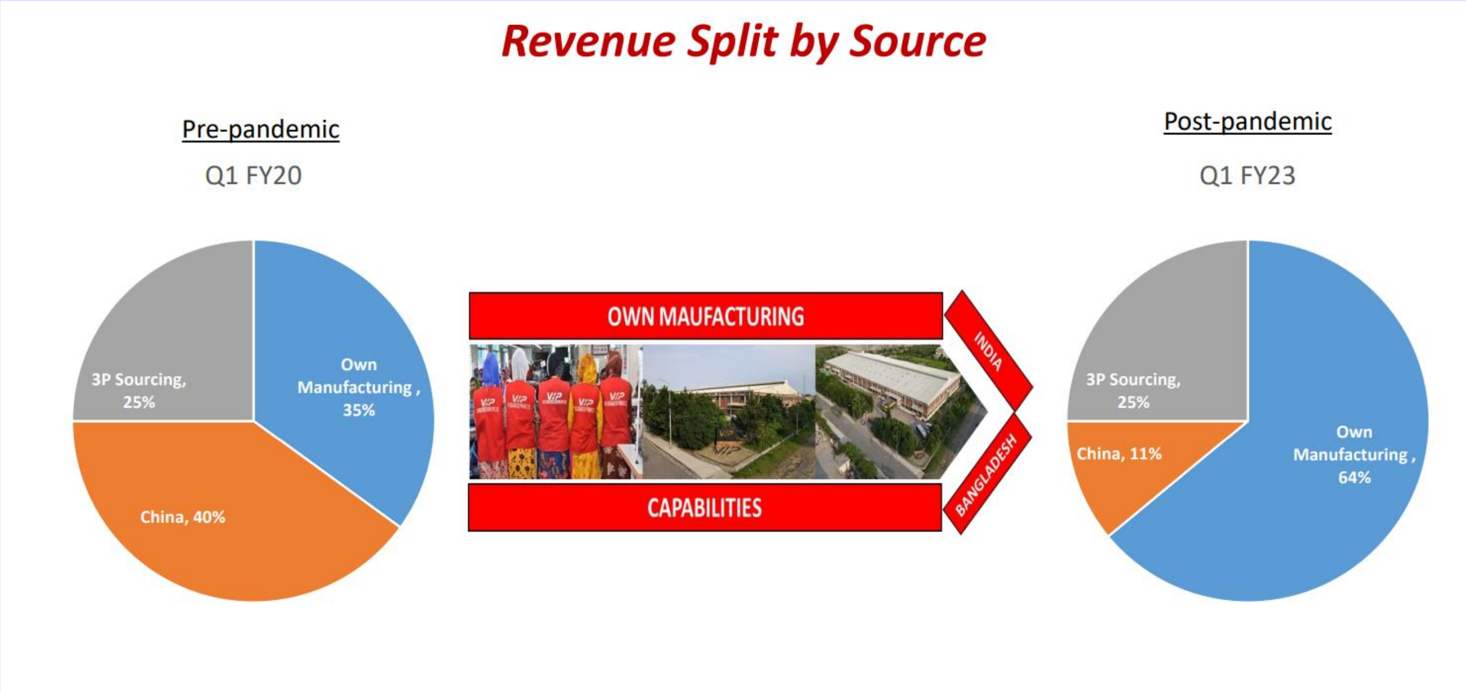
Secondly, Lower revenue growth would also mean lower capital requirements for the business, which coupled with higher profitability would result in material improvement in ROCEs.

And lastly, as ROCEs improve, the cashflows will become positive and do away with the need to dilute equity.

Industry Changes to Support This Change of Focus

As discussed earlier, Luggage industry has been sourcing a significant part of its inventory from China. However, over the last few years, there has been a shift in supply chain as China has lost its cost competitiveness to countries like Bangladesh; owing to cheaper labor costs. And this shift has accelerated during covid.

As of now, companies like Safari and VIP are importing less than 10% of their requirement from China.



(VIP Q1FY23 Presentation. Own manufacturing includes sourcing from Bangladesh through own manufacturing setup)

This shift in supply chain helps the industry on two folds-

A. Profitability

Currently, India has 15% import duty on luggage. However due to free trade agreement with Bangladesh under SAFTA, there is direct cost saving of 15% visa vi sourcing from China.

VIP Q1FY23 Concall-

Akhil Parekh:	What is the difference between landed costs of a China based manufactured luggage vis-a-vis in-house manufactured luggage in India?
Anindya Dutta:	Again, difficult to give one number on that, but in Bangladesh the raw material and the duty arbitrage overall on an apple to apple comparison is about 15% for us.

VIP Q4FY22 Concall-

Anindya Dutta:	Well the dependency on China as a source for raw material continues, but raw material has more degrees of freedom in terms of what we can do, in terms of efficiencies as far as sourcing is concerned and the convergent of raw material to finished good is a large part of it and once we control that we control that part of the cost efficiency so that definitely in place also some somewhere in the future we would also look at how we could look at and it is not about just China as a source because from here as you are doing your own manufacturing what opens up is what you can freedom of where you want to buy from could be any other country. So, that are sourcing philosophy would be to look at the cheapest source possible within the realms of quality that we have. So, just add to this I think there is a point what you asked about therefore what is the benefit, when we bring raw material into Bangladesh there is no custom duty and when we bring in FG into India there is no custom duty so that is an underlying advantage comparing to buying FG from any other source especially in China.

B. Working Capital

Sourcing from China had higher lead times; thus, higher inventory days and working capital investments. Sourcing from Bangladesh requires relatively lower working capital investments.

Further, within the luggage industry, the share of hard luggage is increasing vs the soft luggage due to changing consumer preference.

"Hard luggage within the old outright business now accounts for almost 60% which was at 50% just before the pandemic and that has been a steady increase" – VIP Q4FY22 Concall

Manufacturing of hard luggage is not as labor intensive as soft luggage and thus has been manufactured completely in-house by players like Safari and VIP. And due to this in-house manufacturing, hard luggage commands better margins and better inventory management (thus lower working capital requirements). Further, within the hard luggage itself, the industry is moving from using polycarbonate to polypropylene as raw material. And there is 2-3x differential in price of these raw materials. And both VIP and Safari have undertaken capex recently for this shift.

Snippet from Safari's FY22 Annual Report-

Company Development:
The Company continued to grow ahead of the market and the Company offers a competitive and innovative range, catering to consumer needs in all significant product categories. In order to meet the rising demand for hard luggage, the Company is also setting up a new manufacturing plant through its wholly owned subsidiary in Halol, Gujarat for additional capacity for polypropylene zippered hard luggage.

Snippets from VIP's FY22 Annual Report-

Further, the Company is planning to increase the production of Polypropylene-made products which will enable it to manage costs in a rising inflation environment. This will significantly reduce its dependence on China for sourcing of merchandise as well as enable it to gain more upstream control. It is also enhancing its Hard Luggage (HL) production capacities in Bangladesh to leverage the accelerated shift of consumer preference toward this category. Scaling up of Bangladesh's operations will provide the Company with a sustainable competitive advantage and support its overall margin profile in the oligopolistic Indian luggage market. It is also expanding its retail store network to 500 by the end of 2022-23.

With our hard luggage sales growing at a brisk pace, we are aggressively expanding our captive capacity in this segment to support volume-led growth. Our total planned capex for FY 2022-23 is ₹ 64.8 Crores, of which ₹ 3.3 Crores is directed at capacity expansion in India and Bangladesh for manufacturing of polypropylene hard luggage. This will enable us to

Expectations Going Ahead

We believe that Safari is in a very sweet spot. It is part of an oligopolistic industry wherein barriers to entry are high for new players and the industry itself is growing at double digits. Within that, Safari is operating in a segment that is growing much faster than the overall industry, proving Safari good tailwinds to grow.

Safari is also looking to drive exponential growth in the school bags segment through its brands of Genius and Genie. This is an interesting opportunity for Safari given that this segment is highly unorganized, the products have very short replacement cycle (even within the backpacks segment) and has minimal competition from branded players. And here again, Mr.Jatia is focusing on the bottom end of the segment, that is ripe for shift from unorganized to organized brands.

With continued growth in revenues and improvement in profitability, we expect Safari to continue to grow at very high rates of 30%. We have bought Safari at a market cap of ~3600 crores and a 70x multiple off its TTM profits (trailing twelve months). The multiple might high in absolute terms, but 30% growth in a B2C business is the holy grail of valuations in our market. At such growth, market does give multiples which are much higher than this. And we believe that with some of the concerns around negative cashflows and dilutions getting sorted out and with increasing size of the business, these high valuations would be supported.

Risk

The primary risk here is that of Mr.Jatia not able to improve profitability and/or maintain the working capital efficiencies. This will put pressure on both fronts- Growth and Valuations.

Non-improvement in profitability would mean that Safari would need much higher sales growth to deliver our expected 30% growth rates and that would also result in higher working capital requirements, which would then result in lower ROIC and a higher gap between growth rates & ROIC and thus a need for further equity dilutions.

However, our understanding is that the only scenario wherein Mr.Jatia would not be able to drive profitability & working capital efficiencies is one wherein he continues to focus on growth & scale. And in that scenario, the revenue growth itself would be high enough to take care of our expected 30% growth rates.

In terms of dilution, our thought is very straightforward that if a company has opportunity to grow much faster than what its ROICs & cashflows can sustain, it should try & capitalize that opportunity rather than limiting itself; even if it comes at the cost of some equity dilutions. And if the company can dilute its equity at very high multiples, then it is not a major concern for us.

If we look at Safari's history, of its three dilutions, the major one was in FY15 when it raised Rs50 crores by diluting 41% of its equity. This was understandable given at that point, Safari was a very small company with no profits and Mr. Jatia had to make certain initial investments to get the house in order. Post that, over last 5-7 years, Safari has diluted its equity only twice, with a total dilution of ~13% (one of which was during covid led business disruptions), which is hardly 1-1.5% per year kind of effect. And considering the 30%+ growth rates that Safari has been able to deliver over this period, even with this 1-1.5% dilution, it still is a significant growth.

And thus, in the above scenario as well, the change in growth rate due to dilution should not be material. In short, the scenario of profitability led growth is our primary & preferred expectation, but even if the other scenario plays out, there would still be decent returns to be made here.

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.

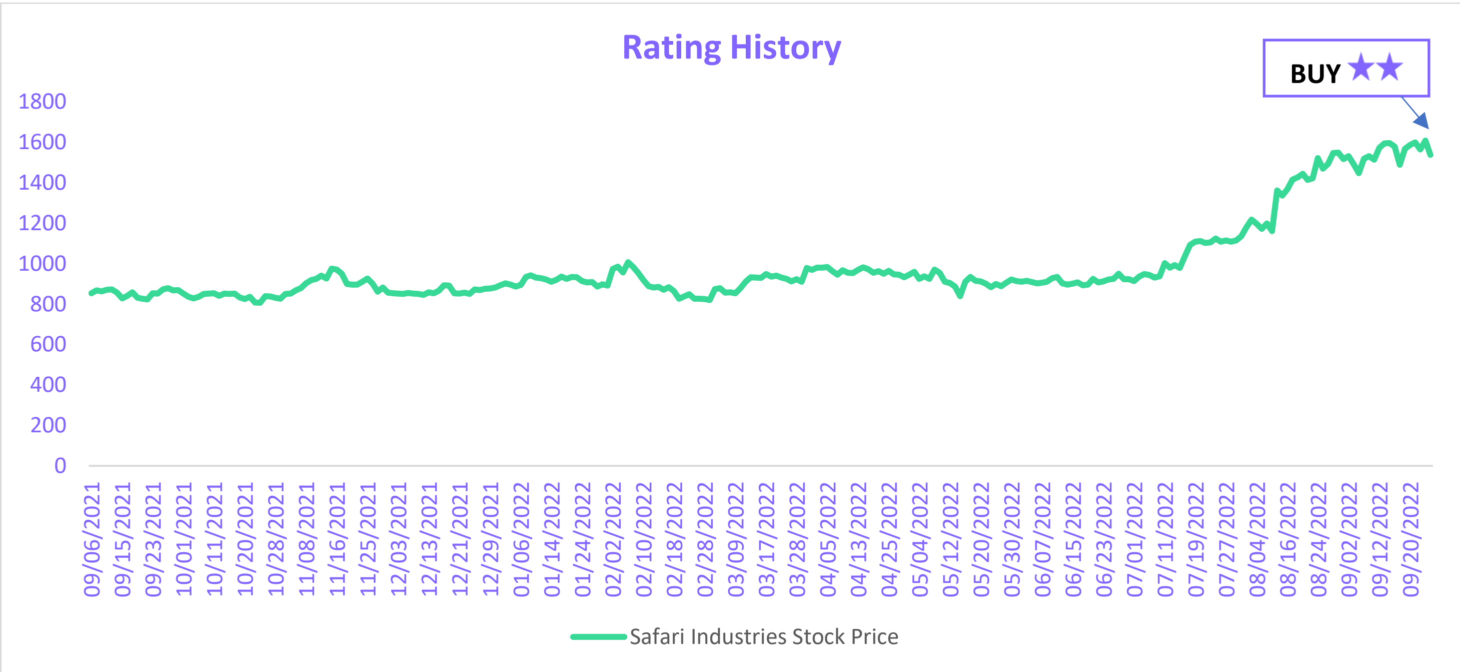
Conviction Rating:

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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The Research Analyst shall not be responsible for any loss to the Investors.

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No associates

Analyst Certification

Analyst: Ankush Agrawal

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Analyst Ownership of Stock: NO

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Further, The Analyst certify (ies) that the views expressed herein accurately reflect his (their) personal view(s) about the subject security (ies) and issuer(s) and that no part of his (their) compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report.

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