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the CornerOffice
Interaction with the CEO

Business model intact; equally focused on both formats

We hosted an interactive session with Mr. Sanjay Purohit, WTD and Group CEO of Sapphire Foods India Limited (Sapphire), to inspect the industry outlook, explore a significant new opportunity, and discuss the prospects for long-term growth. The key takeaways from the discussion are highlighted below:

Current scenario remains subdued…

The Quick Service Restaurant (QSR) industry has encountered several difficult challenges in the past year. Further, with the shift of vegetarian period such as Navratri and Shraad impacting Oct'23, achieving Same Store Sales Growth (SSSG) becomes challenging for 3QFY24. Subsequently, margins may witness limited improvement. Stable inflation and raw material prices are anticipated to help sustain gross margin at a similar level. Sri Lanka has shown signs of recovery, witnessing green shoots and an improved economy, which should contribute to increased revenue and profitability.

…but multi-decade opportunities beckon in the long run

The growth opportunity is substantial for all the QSR players, thanks to the rising consumption and improved per capita metrics. Management maintains its guidance to double the store count within the next 3-5 years, while also aiming for a higher single-digit SSSG. It further aims to improve the revenue and EBITDA by 25% and 30%, respectively. Looking further ahead, the company aspires to reach 5,000 stores in the long term. Sapphire wants to keep both the brands, KFC and Pizza Hut (PH), under its umbrella, maximizing the potential of each brand within its portfolio.

Sapphire Foods Ltd

Mr. Sanjay Purohit, WTD & Group CEO

He has over 30 years of experience in building and successfully growing exceptional brands and organizations. He has had a stellar and successful career across consumer product companies such as Levi Strauss & Co., Cadbury India, Asian Paints, and Mobil Oil Corp.

Rational approach towards store additions

Sapphire evaluates the store expansion based on the achievement of the hurdle rate, i.e., achieving a payback period of three years and reaching 70-80% of the brand's average daily sales (ADS) in the first year. The company would slow down the pace of expansion (as it did in PH), if the new store is unable to meet the required criteria within the first year. Even in the best scenario, when experiencing a significant rise in store ROM, such as a more than 20% (currently for KFC), management is keen to capitalize further on the market potential. Sapphire plans to open new stores in the same geographical area in order to attract more customers. The target remains the same: to double the number of stores in the next 3-5 years.

PH: witnessing heightened competition

The competition in the pizza category has intensified with ~4,000 stores being operated by various regional players. Currently, the weak demand environment has led to a decline in sales for all the pizza brands. However, margins have increased in the PH format in the last 4-5 years owing to a reduction in store size. The company doesn't expect many problems from the overlapping territory with DEVYANI, as the latter cannot open a store within a 10-minute driving distance to Sapphire PH stores.

Valuation and view

We factor in a revenue/pre-Ind AS EBITDA CAGR of 23%/30% over FY23-25E. The stock trades at an inexpensive multiple of 19x FY25E Pre-Ind AS EBITDA. We have assigned an FY25E EV/EBITDA (pre-Ind AS 116) multiple of 25x to the KFC business, based on its robust metrics (ADS and restaurant EBITDA margin), and 15x to the PH business. These multiples are at 50% discount to the target multiples of DEVYANI's KFC/PH businesses (50x/30x) due to the following difficulties that Sapphire faces in terms of trade: 1) Sapphire's territorial rights in KFC are primarily in states with a relatively higher vegetarian population, and 2) DEVYANI can venture into Sapphire's territories with PHD format stores, which require lower capex. While a discount to its multiples is justified given the aforementioned challenges, the earnings growth opportunity for Sapphire is still attractive enough to warrant an investment case despite the near-term uncertainty regarding demand recovery. **Reiterate BUY with an SoTP-based TP of INR1,670.**

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Detailed takeaways

Current scenario remains subdued…

- The performance in Oct'23 was hit by Navratri and Shraad (vegetarian days), which contributed to a challenging SSSG. This aligns with the trends observed in 1HFY24 across both formats. However, over time, the addition of new stores is expected to contribute to an increase in ADS as they progress towards maturity.
- Gross margin to remain stable led by moderating inflation levels.
- Sri Lanka has shown signs of recovery, symbolized by these green shoots and overall improvements in its economy. Furthermore, the stabilization of raw material prices is anticipated to improve margins.
- Sri Lanka is potentially reaching a bottom in its economic trajectory, accompanied by noticeable improvements in both revenue generation and overall profitability.

…but would report 25%/30% revenue/EBITDA growth over 3-5 years

- Sapphire's ambition is to double the number of stores, increase revenue/EBITDA by 25% / 30% over the next 3-5 years, and to reach 5,000 stores in the long term.
- The **driving factors** remain: a) increase in per capita income and GDP, which leads to an increase in outdoor dining activities, and b) retail development, such as improvements in highway infrastructure and the addition of metro stations, etc.
  - The increased prosperity has also contributed to a rise in the consumption of per capita animal protein (e.g., chicken), which has increased to 3.1kg from 400gm and is now expected to reach 9.1kg in the next eight years.
- **Huge growth roadmap:** The growth opportunity is immense for all the QSR players. The differentiation in marketing skills and execution excellence will lead to higher operating performance for the company.
- **Management capability:** Having Board members with diverse experience spanning multiple industries is a significant advantage for the company. Such a dynamic mix of expertise enables a comprehensive understanding of different industries, providing the company with a broader perspective on market dynamics.

Store expansion resonates a multi-decade opportunity

- The company evaluates store expansion based on **hurdle rate:**
  - A 1,600 sqft store of KFC, for example, has a payback period of three years
  - Stores are able to achieve brand ADS between 70% and 80% within their first year of operations
  - If a store achieves ~40-50% of the brand's average ADS, it may choose to slow down expansion for that specific format, similar to what has been observed in the case of PH.
- Further, the company has an **agreement with Yum! Brands** for store expansion. If the company determines that further store expansion might not be advantageous, it retains the ability to renegotiate terms with Yum! Brands. This flexibility has been exercised multiple times in the past three to four years (three times with PH and once with KFC), showcasing its approach to adjusting strategies based on market conditions or internal considerations.

- **KFC:** The company will continue to generate ~20% ROM for KFC stores and any additional margin accrual will be reinvested in the business.
  - The average store size is 1,600sqft for KFC. A store requires 10% of its capex for refurbishment in the fifth year and 50-60% of store capex in the 10^{th} year.
- **PH: Capex per store of PH (Sapphire) is INR15.0m, which is similar to Domino's capex of INR14.0-14.5m, despite having a slightly larger store size.**

PH: witnessing heightened competition

- The company wants to maintain at least two brands, i.e., KFC and PH. Hence, the focus will be equally distributed between both these brands.
- The competition in the pizza category has intensified with ~4,000 stores being operated by various regional players.
  - La Pinoz reached a count of ~600-650 stores; while other brands such as Mojo Pizza are growing well.
- Being the second player (with 1/4th of the revenue compared to Jubilant), the company has currently experienced a decline in revenue due to macro challenges.
- However, margins have increased in the PH format in the last four to five years, owing to reduction in store size. The new store addition (with a smaller store size) in PH is able to generate higher margins, and as a result, the overall margin improves on a brand level.
- In the short term, the company will not face many problems as DEVYANI cannot open a store within a 10-minute driving distance of Sapphire PH stores. Moreover, in the long term, DEVYANI (PH) will be competing with Dominos stores, which may not have any adverse impact on the Sapphire format.
  - DEVYANI can open delivery-based stores, while Sapphire can open omni-channel stores.

Others

- PH is consistently recognized as a strong brand in consumer surveys for both: a) its dine-in experience, and b) product quality.
- The goal is to establish a brand based on three key factors: Product, Quality, and Innovation.
- Management also monitors the store rating and works to improve it in order to enhance the dine-in experience.
- KFC is a "Cook to Plan" brand, while Pizza Hut is a "Cook to Order" brand. Hence, depending on the demand forecast, KFC keeps its products ready in order to improve turnaround time without compromising product quality.
- Under PH: consumer priorities are shifting towards predictability and delivery quality, rather than just speed. It is also collaborating with aggregators to anticipate the arrival of delivery personnel for pizza preparation. This collaboration aids in strategic planning, enabling the preparation and delivery of fresh, and high-quality products to customers.
  - It also runs demand forecasting on an hourly basis, which helps reduce wastage.
- **Royalty will remain at 6%.**

Company background

- Sapphire Foods started seven years ago with 240 stores in both India and Sri Lanka and has expanded to 814 stores as of 2QFY24.
- The company has achieved a 'Top 3' status in the Yum metrics globally.
- The company started with a slow store expansion as the model was not strong, but accelerated the expansion mode once the model became fit.
- Therefore, the capital allocation strategy has been redefined with the opening of smaller compact stores that require lower capex in order to enhance store-level efficiencies.
- It took KFC 15 years to reach 100 stores after its launch in 1995.
- **The company's current goal is to double the number of stores within the next 3-4 years and reach a significant milestone of 4,000 stores in the long term.**

Financials and valuations

Income Statement consol. (INR m)

Y/E March	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
Net Sales	**11,938**	**13,404**	**10,196**	**17,216**	**22,656**	**27,599**	**34,101**
Change (%)		12.3	-23.9	68.8	31.6	21.8	23.6
Raw Materials	3,946	4,317	3,099	5,278	7,407	8,680	10,738
Gross Profit	**7,992**	**9,087**	**7,097**	**11,938**	**15,249**	**18,919**	**23,363**
Margin (%)	66.9	67.8	69.6	69.3	67.3	68.6	68.5
Operating Expenses	6,532	7,232	5,853	8,888	10,965	13,773	16,543
EBITDA	**1,460**	**1,856**	**1,244**	**3,050**	**4,284**	**5,146**	**6,821**
Change (%)		27.1	-33.0	145.2	40.4	20.1	32.5
Margin (%)	12.2	13.8	12.2	17.7	18.9	18.6	20.0
Depreciation	1,547	1,913	2,091	2,135	2,642	3,058	3,752
Int. and Fin. Charges	720	722	756	781	869	966	1,127
Other Income	125	113	616	380	311	383	343
Profit before Taxes	**-683**	**-666**	**-987**	**514**	**1,084**	**1,506**	**2,284**
Change (%)		-2.5	48.2	-152.1	111.0	38.9	51.7
Margin (%)	-5.7	-5.0	-9.7	3.0	4.8	5.5	6.7
Total tax	11	-17	12	54	-1,248	376	571
Tax Rate (%)	-1.6	2.6	-1.2	10.5	-115.1	25.0	25.0
Adjusted PAT	**-694**	**-649**	**-999**	**460**	**1,079**	**1,129**	**1,713**
Change (%)		-	-	L/P	134.6	4.7	51.7
Margin (%)	-5.8	-4.8	-9.8	2.7	4.8	4.1	5.0
Minority Interest	0	0	-14	-5	0	0	0
Exceptional/Prior Period inc	0	944	0	0	0	0	0
Reported PAT	**-694**	**-1,592**	**-985**	**465**	**2,332**	**1,129**	**1,713**

Balance Sheet (INR m)

Y/E March	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
Share Capital	431	502	528	635	635	635	635
Reserves	3,585	4,742	4,271	9,436	11,924	13,053	14,766
Net Worth	**4,016**	**5,245**	**4,799**	**10,071**	**12,559**	**13,689**	**15,402**
Loans	853	592	520	612	443	443	443
Other Liability	5,455	5,744	5,692	7,283	9,185	10,557	11,728
Minority Interest	11	3	-12	-17	-20	-20	-20
Capital Employed	**10,335**	**11,582**	**11,000**	**17,949**	**22,167**	**24,668**	**27,552**
Gross Block	5,473	6,567	6,905	8,948	12,134	14,986	17,896
Less: Accum. Depn.	1,587	2,221	2,974	3,487	4,428	6,055	8,110
Net Fixed Assets	**3,886**	**4,346**	**3,932**	**5,462**	**7,706**	**8,931**	**9,786**
Capital WIP	210	215	304	327	565	565	565
Goodwill	2,539	1,622	1,622	1,622	1,622	1,622	1,622
Other Intangible assets	767	688	551	566	647	712	783
Right to Use Assets	4,859	4,953	4,739	6,251	7,915	8,954	9,761
Investments	**0**	**155**	**267**	**1,525**	**659**	**2,500**	**3,000**
Current	0	155	267	1,525	659	2,500	3,000
Curr. Assets, L&A	**3,414**	**1,828**	**2,074**	**5,890**	**5,607**	**4,447**	**5,758**
Inventory	381	444	474	652	993	1,210	1,495
Account Receivables	224	46	78	141	179	219	270
Cash and Bank Balance	1,865	392	500	2,546	2,204	387	887
Others	944	947	1,022	2,551	2,231	2,632	3,106
Curr. Liab. and Prov.	**5,340**	**2,224**	**2,490**	**3,692**	**2,554**	**3,061**	**3,722**
Account Payables	1,142	1,307	1,440	1,991	2,170	2,643	3,266
Other Liabilities	4,051	767	887	1,525	207	224	242
Provisions	147	151	163	176	177	194	214
Application of Funds	**10,335**	**11,582**	**11,000**	**17,949**	**22,167**	**24,668**	**27,552**

E: MOFSL Estimates

Financials and valuations

Ratios

Y/E March	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
Basic (INR)							
EPS	**-16.1**	**-12.9**	**-18.9**	**7.2**	**17.0**	**17.8**	**27.0**
Cash EPS	19.8	25.2	20.7	40.8	58.6	65.9	86.0
BV/Share	93.2	104.4	90.9	158.5	197.7	215.4	242.4
Valuation (x)							
P/E	N/M	N/M	N/M	194.8	83.0	79.3	52.3
Cash P/E	71.2	56.0	68.1	34.5	24.1	21.4	16.4
EV/Sales	5.5	5.7	7.8	5.4	4.3	3.5	2.9
EV/EBITDA	44.7	41.3	64.2	30.6	22.5	19.0	14.4
P/BV	15.1	13.5	15.5	8.9	7.1	6.5	5.8
Return Ratios (%)							
RoE		-14.0	-19.9	6.2	9.5	8.6	11.8
RoCE		0.5	-2.1	8.0	20.9	7.9	9.8
RoIC		-0.6	-8.1	6.5	20.5	7.3	9.2
Working Capital Ratios							
Debtor (Days)	7	1	3	3	3	3	3
Asset Turnover (x)	1.2	1.2	0.9	1.0	1.0	1.1	1.2
Leverage Ratio							
Debt/Equity (x)	0.2	0.1	0.1	0.1	0.0	0.0	0.0

Cash Flow Statement (INR m)

Y/E March	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
OP/(loss) before Tax	-683	-1,610	-987	514	1,084	1,506	2,284
Depreciation	1,547	1,913	2,091	2,135	2,642	3,058	3,752
Net interest	627	620	697	677	666	583	784
Others	94	1,052	-378	117	117	0	0
Direct Taxes Paid	-38	-27	-30	-86	-21	-376	-571
(Incr)/Decr in WC	-46	182	147	592	-669	-150	-150
CF from Operations	**1,501**	**2,130**	**1,541**	**3,949**	**3,818**	**4,620**	**6,099**
Incr in FA	-1,744	-1,415	-734	-2,844	-3,825	-2,917	-2,981
Free Cash Flow	**-243**	**715**	**807**	**1,105**	**-6**	**1,703**	**3,118**
Pur of Investments	-1,585	1,313	-55	-4,078	910	-1,841	-500
Others	1,697	-1,419	-128	1,890	879	434	396
CF from Invest.	**-1,632**	**-1,522**	**-917**	**-5,032**	**-2,036**	**-4,323**	**-3,086**
Issue of Shares	2,321	0	444	4,690	0	0	0
Incr in Debt	646	-218	61	-176	-192	0	0
Dividend Paid	0	0	0	0	0	0	0
Net interest Paid	-709	-699	-758	-780	-864	-62	-62
Others	-490	-1,165	-263	-604	-1,068	-2,052	-2,452
CF from Fin. Activity	**1,767**	**-2,081**	**-515**	**3,130**	**-2,125**	**-2,114**	**-2,514**
Incr/Decr of Cash	**1,636**	**-1,473**	**109**	**2,046**	**-342**	**-1,817**	**500**
Add: Opening Balance	228	1,865	392	500	2,546	2,204	387
Closing Balance	**1,865**	**392**	**500**	**2,546**	**2,204**	**387**	**887**

E: MOFSL Estimates

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