Stock Chosen	Sector	Face Value	Market Cap.	Stock Price (6th Nov)	Judgement
Avenue Supermarts Ltd.	Department stores	10.00	831998.25	1417.70	Sell

Summary –

I believe that the stock DMART at its current price of 1417.7 is highly overvalued in spite of the fact that it is one of the fastest-growing and most profitable retail chain in India due to significant gains (close to 120%) realized by the stock just after its listing. And thus the stock is highly sensitive to any short-term threats posed by rising e-commerce in food and personal product retail sector. Moreover, ASL might find it difficult to maintain its high EBITDA margin during expansion owing to stringent control of operational cost which would lead to the correction in its stock price.

Company –

Avenue Supermarts Ltd. is a Mumbai based company which operates under the brand name DMart has supermarkets across India offering home and personal use products. As of October 2018, it has 160 stores across India in the states of Maharashtra, Andhra Pradesh, Telangana, Gujarat, Madhya Pradesh, Chhattisgarh, Rajasthan, National Capital Region, Tamil Nadu, Karnataka, and Punjab. ASL's store network is augmented by own distribution centers located mainly in the west and direct supply from suppliers.

The product portfolio comprises of Food (53% share), Non-Foods FMCG (21% share) and General Merchandise & Apparel (26% share, includes apparel, plastic goods, home furnishing, toys, etc.). The target segment of ASL is lower middle, middle and aspiring upper-middle-class income groups.

Industry –

1) Organized retail is expected to grow at a CAGR of 20% with $115B revenue projected in the year 2020.
2) Modern retail is classified into Hypermarkets, Supermarkets, Modern Convenient stores, and Hybrid Supermarkets. Gross margins for Hypermarkets are higher than supermarkets because of category mix but have lower productivity than supermarkets.
3) Productivity comparison of key players shows a very high value for D-Mart and signifies its tight operational controls being at play.

Hypermarkets			Supermarkets			Regional Players		
Player	Sales/Sqft (Rs).-2012	Sales/Sqft. (Rs)-2016	Player	Sales/Sqft (Rs).-2012	Sales/Sqft. (Rs)-2016	Player	Sales/Sqft (Rs).-2012	Sales/Sqft. (Rs)-2016
Reliance Mart	5,000-6,000	8,500-9,500	D-Mart	12,000-12,500	28,000-30,000	Regional Player	8,500-9,500	17,000-17,500
Star Bazaar	6,500-7,500	11,000-13,000	Reliance Fresh	9,000-10,000	17,500-18,500			
Big Bazaar	5,500-6,500	9,500-10,500	Food Bazaar	7,500-8,500	15,000-15,500			
Spencer - Hypermarket	6,000-7,000	16,000-17,000	Spencer - Supermarket	7,000-8,000	17,500-18,500			
More-Megastore	4,500-5,500	8,500-9,500	More	5,000-6,000	8,000-9,000			
Hypercity	5,000-6,000	7,000-8,000	EasyDay	7,500-8,500	15,000-16,000			

Source: Company reports.

4) Market share of various players is as follows –

Future Group	Reliance	D-Mart	Spencer's	Hypercity	More	Star	Others
17%	10%	9%	4%	2%	5%	2%	51%

Approach to Valuation–

I have used a DCF approach mixed with comparable company multiples and qualitative assessment to value the company and arrive at a fair share price. In a two year horizon period, I except corrections in the pricing of stock and thus the real value of the stock is estimated in the present and a forward multiple will b

1) DCF Valuation.

Key Assumptions –

a) Revenue will grow at a CAGR of 25% for next two years followed by a growth of 20% for next three years given the high growth rate of 20% in the sector and D-Mart witnessing 38% growth rate in the year 2018 led by a cut in prices across various categories.
b) The EBITDA margin for the next 5 years is assumed to be fixed at its current value, i.e. 8%.
c) Gross margin is expected to up to 15% from 14.3% and remains there for the next 5 years.
d) WACC of 11% is assumed given the capital structure of the firm.
e) The terminal growth rate of 4% is assumed.
f) The capital structure of the firm is assumed to remain fixed.

Given the above assumptions, we arrive at an equity value of 57353.36cr implying a share price of 919. Thus after 2 years, the value of the stock or the future value of the stock would be 1132.3

Thus the stock appears to be overvalued.

2) Multiple based Valuation beyond the year 2023.

a) P/E and EV/EBITDA multiple is preferred for valuation of retail stocks.
b) The multiples chosen are forward multiples and represent the implied value of the stock after two years.
c) The EV/EBITDA multiple for the stock is chosen as 37x which is significantly higher than its global peers of average 10x owing to the fact that the company is the most profitable in terms of EBITDA margins and witnessing growth upwards of 35% for past 4 years.
d) The P/E multiple is chosen as 95x almost 5 times from its industry peers and down from 172x which it traded at in the year 2017 owing to the fact that the firm is showing supernormal growth but maintaining the high growth of 38% will be difficult, and future growth is expected to be at 25%.

Multiple Used	P/E	EV/EBITDA
Equity Value	74525.05cr	81405.6cr
Stock Price implied	1194.15	1304.4

3) Qualitative Assessment –

a) FCFF to remain stagnant in the short term in comparison to its peers because of the ownership model that ASL follows which is capital intensive and thus requires upfront cash.
b) The F&G retail is now more than ever being impacted by e-commerce which can afford to sell at a much lower price owing to reduced operating costs. Thus, the emergence of e-commerce stores have negatively impacted the growth of brick and mortar stores, and it would be extremely difficult for D-mart to maintain growth levels of more than 25%. Although, internet penetration levels are low now but are rising at an unprecedented rate with reduction of data prices in the telecom sector.
c) The current P/E multiple of D-Mart is significantly high (almost thrice) compared to its global peers, and thus a sharp correction is expected in the near future.

Major risk and threats identified are –

1) Increase competition by the entry of organized peers in view of relaxation of FDI norms.
2) Increased competition from online players which are growing at an alarming rate owing to the backing by global giants like Walmart, Tata, Amazon, etc.
3) Weak consumer sentiments.
4) Increase in land and property prices.

Major Weakness of the Company –

1) Limited national presence.
2) No private label
3) Low gross margins
4) High model switching cost to e-commerce or leasing owing to the ownership model.

Making a case for Buy –

Summary –

The Company saw a 38% year on year growth in revenue owing to its sharp cut in prices which reduced its profitability. The level of growth in stores required to maintain this revenue growth cannot come by the complete ownership of stores structure that the company has followed. But given the fact that the Company is now open to explore leasing model, the growth will be tremendous owing to 20% CAGR in the organised retail market. I believe that growing at the expense of profits is a good strategy in the near term since it helps to increase its footprint across the country and create a brand value by launching a private label which could be leveraged in future.

Major reasons for upward growth and increase in share price –

1) Revenue Growth – D-Mart displayed a strong revenue growth of 39% led majorly by cutting prices and increase in retail area by 21%. New stores in the range of 25-30 are expected in each of the next two years which would help in maintaining the growth.
2) EBITDA margins – Although margin performance was weak, but employee and other operational cost were lower for the previous quarter showing a tight cost control. EBITDA per square feet rose by 1% YoY and increase in depreciation cost limited the PAT growth to 18%. The product mix is expected to increase in future in favor of general merchandise and better procurement enabling EBITDA margin to touch levels of 9.5%.
3) Working Capital – D-Mart is not expected to increase its working capital despite its strong inclination towards growth. The current working cycle is 22 days.

Approach to Valuation–

I have used a DCF approach mixed with comparable company multiples and qualitative assessment to value the company and arrive at a fair share price.

1) DCF Valuation.

Key Assumptions –

a) Revenue will grow at a CAGR of 35% for next five years given the high growth rate of 20% in the sector and D-Mart witnessing 38% growth rate in the year 2018 led by a cut in prices across various categories.
b) The EBITDA margin for the next 5 years is assumed to be fixed at its current value, i.e. 9%.
c) Gross margin is expected to up to 16% from 14.3% and remains there for the next 5 years.
d) WACC of 11% is assumed given the capital structure of the firm.
e) The terminal growth rate of 6% is assumed.
f) The capital structure of the firm is assumed to remain fixed.

Given the above assumptions, we arrive at an equity value of 94448.94cr implying a share price of 1513.4. Thus the stock appears to be undervalued.

2) Multiple based Valuation beyond the year 2023.

a) P/E and EV/EBITDA multiple is preferred for valuation of retail stocks.
b) The EV/EBITDA multiple for the stock is chosen as 45x which is significantly higher than its global peers of average 10x owing to the fact that the company is the most profitable in terms of EBITDA margins and witnessing growth upwards of 35% for past 4 years.
c) The P/E multiple is chosen as 130x almost 12 times from its industry peers and down from 172x which it traded at in the year 2017 owing to the fact that the firm is showing supernormal growth but maintaining the high growth of 38% will be difficult, and future growth is expected to be at 35%.

Multiple Used	P/E	EV/EBITDA
Equity Value	101981.6cr	99006.81
Stock Price implied	1634.1	1586.432

3) Qualitative Assessment –

a) Productivity – D-mart has shown high revenue growth because of its competitive prices, notably around 5-10% lower than the market. During my visit to D-Mart, I noticed a deviation in product strategy from other retailers. Normally food retailers offer some products at steep discounts in order to attract and retain customers whereas D-Mart offers the lowest price across all segments while maintaining profitability. It does so by tight cost controls. During my visit, I recognized a few reasons as to why D-Mart attracts customer –
   a. Discount is offered throughout the year and thus provide the customer with the satisfaction of knowing that they are buying at the lowest price anytime they purchase.
   b. The freshness of products and a wide range of daily essentials like household supply, food, etc.

b) Effective store expansion strategy – ASL has effectively identified suitable store locations, and their success can be verified by the fact that no store has been closed as of date. Various factors including population density, customer/vehicle traffic, customer accessibility, potential growth of the local population, future development trends, etc. are used. ASL targets a minimum of 10% ROIC over a period of 2 years to count it as sustainable. ASL's strategy also focuses on choosing a location which increases the efficiency of the supply chain and thus opens stores within a few kilometers of its distribution center. ASL plans to add 2.1mn sqft over the next two years with the aim of increasing penetration in Maharashtra and Gujarat.

c) High operating efficiency – ASL predominantly follows the ownership-based model which has helped it to maintain the operation cost very low and thus offers one of the best in industry operating margin. On EBITDAR basis (EBITDA before rent) ASL scores well above its competitors.

Opportunities for further improvement –

1) Significant potential to increase market share by expansion across various geographical areas given low penetration of modern markets in many parts of the country
2) Benefits of introducing products under its own brand label.
3) Venturing into e-commerce to further fuel its growth.

Strengths of the Business are –

1) Low prices with prudent store expansion strategy
2) Best in class productivity
3) Ownership model helps in cutting operational cost and shields from rent rate fluctuations.
4) Efficient Supply chain infrastructure
5) Direct procurement from manufacturers often commands high bargaining power for D-Mart.

Management –

1) The management consists of people with diverse experience under the leadership of Mr. Radhakrishna Damani who is also the founder of D-Mart.
2) The company is run by the founder who is also the promoter of Avenue Supermarts Limited eliminates the Principal-Agent problem, thus improving corporate governance.
3) Many of the top management are from the FMCG sector and finance sector especially the securities market which is leveraged in deriving customer insights.
4) The management has an average experience of more than 15 years with most of the people with experience over 20 years.