

# STOCKSCAN: V-MART RETAIL LTD.

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India is witnessing a wave of urbanization. Aspirations of higher income and higher standard of living have drawn more people from villages to towns and cities. Though some amount of this shift is happening to Tier-1 cities, there has been a significant increase in population of Tier-2 and Tier-3 cities as some of the businesses are shifting to these cities due to rising real estate costs in Tier-1 cities. With rising prosperity in Tier-2 and 3 cities, spending power too has gone up and it offers a potential target market for the Indian retail industry.

Retailers, especially in the organised segment are therefore targeting the middle-class populace by ensuring the availability of varied products at various price ranges to match the needs of the common man. With rising per capita income and large footfalls from neighbouring smaller towns and villages, Tier-2 and Tier-3 cities are becoming a value proposition for organised retail to expand its footprint.

V-Mart is one of the pioneers in India in setting up stores in the value-for-money retail segment across various small Indian towns and cities like Sultanpur, Ujjain and Motihari, among others. Around 93% of the company's sales is from high-margin apparels and general merchandise, and the remaining 7% is from the low-margin kirana (grocery) business. From 22 stores (2.1 lakh square feet) in FY08, V-Mart has increased its reach to currently operate 141 stores (11.9 lakh square feet) spread across 150 cities, mostly in the states of Bihar and Uttar Pradesh. The company faces competition from retail majors like Pantaloon, Trent and Shoppers Stop. However, all these retail chains focus mainly on Metros and Tier-1 cities, while V-Mart's sole focus are Tier-2 and 3 cities. It faces minimal competition from large players in these cities. Rural India accounts for two-fifths of the total consumption in India. And there are about 1,600 Tier-2 and Tier-3 cities in India. Which means the opportunity size for companies like V-Mart is huge, and there is a long runway for growth given the current under-penetration in these markets. Competition in V-Mart's target cities comes from local and niche players. However, as its brand image and value proposition grows, it is bound to gain market share from local players.

Anyways, the company's sales growth during the past five years (FY12-FY17) has been around 29% CAGR, while net profit growth has been around 30% CAGR. Sale per square foot per month – critical

number for retail business – has grown from Rs 565 in FY12 to Rs 799 in FY17 (Shoppers Stop – Rs 765), or a 7% CAGR. In fact, going by last year's numbers, the company's sales per square foot number from Tier-3 towns was around 20% than what it earned in Metros and Tier-2 cities, which talks about the purchasing power in the former and about the company's asset productivity. Gross margin has been around 25% over the years. The only real advantage a retailer can have over competitors is how it manages its costs, and whether it can keep them low vis-à-vis competition. V-Mart scores well on this account, with its various key cost heads like rent and employees lower than competitors. The company gets this advantage by operating in Tier-2 and Tier-3 cities, where the overall cost of doing business is low.

In retail, profitability is also critically linked to the speed with which shelves can be evacuated, and success is derived from the knowledge of where merchandise lies across stores and superior inventory management. As a strategy, instead of rolling out stores at random, V-Mart opens stores only within 150-kms from each other. This helps it leverage efficiencies in brand spending, procurement, supply chain, logistics and inventory management. This strategy looks like what the US retail giant Wal-Mart adopted in its growing years – setting up stores closer to each other. Another good part of V-Mart's model is that instead of prevailing attitude of other retailers to locate their stores in high-end malls, the company sets up its stores in downtown locations. The effect is seen in consistently positive and rising operating cash flows and a near zero-debt situation, which is unlike most other retailers. While it's too short a time to call this strategy fool proof and sustainable, the management seems to be taking steps in the right direction to improve the operational effectiveness of the business.

Return on equity stood at 15% in FY17, which is around the average V-Mart has earned over the past few years but significantly higher than what its larger peers like Shoppers Stop and Trent earn (negative to low single digits). The company is in a comfortable situation to fund its growth through internal accruals – cash from operations has been on a consistent rise. Balance sheet has remained lean over the years, especially owing to good working capital management. Working capital to sales, for instance, has come down from 21% in FY13 to 12% in FY16. Debt/equity in FY17 stood

at 0.1x, which along with strong cash flow generation, gives the company enough capacity to suffer bad times.

Competitive advantage for V-Mart comes from its learnings over the years of managing prudent supply-chain system in low resourceful Tier-2 and Tier-3 cities, even as most other retailers have an experience of doing things in the relatively simpler to manage Tier-1 cities. Retail is a competitive business and thus it's important for companies to manage their stores well. Maintaining low cost operation is critical. V-Mart's management has shown itself to be sensible on these accounts over the years. The company has been almost debt-free throughout, margins have remained stable and better than the industry, and inventory turns have improved. Plus, the management has been cautious on its growth aspirations. Overall, a conservative approach towards growth, shunning debt and using internal resources to fund the expansion, tight control on costs, and high-quality disclosures suggest a high-quality management team at helm.

As for risks, rise of e-commerce is one key challenge to V-Mart's business model and growth prospects. Competition may also intensify from multi-brand FDI in retail. The industry has low entry barriers. It's not tough to open retail stores. However, understanding customer needs, managing supply chain, and learning curve should act as a source of competitive advantage for V-Mart.

The stock currently trades at around 53 times its trailing 12-months earnings (earnings yield of 1.9%), which is significantly higher than the earnings average multiple it has traded at over the past few years. Free cash flow yield stands at just about 1.3%.

Overall, V-Mart is a bet on the management's ability to exploit this big opportunity that lies ahead by replicating the sensibility with which they have managed their business in the past. But like a lot of things can go right – rising consumption, higher sales growth, continued control on costs, greater cash flows – lot of things may also go wrong – greater competition, slower growth, rising costs, and high financial leverage – that would cause them to be over-optimistic. While evaluating the business, understand the risks and opportunities better, and then apply a margin of safety to assess whether the stock is worth owning or not, and at around what price. ●