JM JainMatrix Investments

A quality report by JainMatrix Investments

Apex Frozen Foods - IPO - An Apex Buy	• **Small Cap with Rs. 547 cr. Mkt cap** • **Industry – Seafood**
• **20th Aug 2017, IPO Open 22–24 Aug at Rs. 171-175 range** • **P/E: 22.4 times TTM, P/B: 2.45 times** • **Advice: BUY with a 2 year perspective**	APEX FROZEN FOODS LIMITED

- **Overview:** Apex is a Kakinada AP based integrated producer and exporter of frozen shrimp. Exports are to the U.S., UK, and other European countries. In FY17 Revenues and PAT were Rs 709.7 crore & Rs 24.4 crore, and they have grown at 29.1% & 26.9% CAGR resp. from FY13-17.
- **Operations:** Apex operates a shrimp processing facility in Kakinada AP of capacity 9,240 Metric Tons Per Annum and also leases an additional 6,000 MTPA. It also operates a shrimp farm which provides 15-20% of raw produce. These products are exported through nearby seaports to customers. The post IPO plans are to expand own processing facilities by 20,000 MTPA, increase its value-added product portfolio and expand shrimp farming area. Apex has a 2.3% share in volumes of shrimp exports from India.
- **Risks:** 1) Promoter and promoter group dominate in current pre-IPO shareholding and executive positions in Apex. Top two promoter's compensation was 22.2% of PAT in FY17. 2) Shrimp prices can suffer swings that can adversely affect Apex. Farming is also prone to weather change and disease. 3) INR has strengthened affecting exporters. 4) High competition globally in sector.
- **Opinion:** This IPO offering is rated BUY, and investors can invest with a 2 year perspective.

Here is our research report on Apex Frozen Foods Ltd. IPO. (Apex)

IPO highlights

- Apex is an integrated producer and exporter of ready-to-cook frozen shrimp to developed economies including the U.S., UK, and other European countries.
- This IPO opens: 22–24th Aug 2017 with the Price band: Rs. 171-175 per share.
- The IPO issue size is Rs. 152.3 cr. at UMP. The selling shareholders will receive Rs. 25.4 cr. of this.
- Shares offered in IPO are 83 lakh out of which 14.5 lakh are tendered under OFS route. The FV is Rs. 10 and market Lot is 80 nos. These shares are 26.6% of equity.
- Apex would benefit with fresh issue of shares and the proceeds of Rs. 126.9 cr. would be used for:

Utilization of Net Proceeds	Amt. (Rs. In cr's.)
Setting up a new Shrimp processing unit with a capacity of 20,000 MTPA at East Godavari, AP	90.15
General corporate purposes	31.72
Other	5.01
Total	126.88

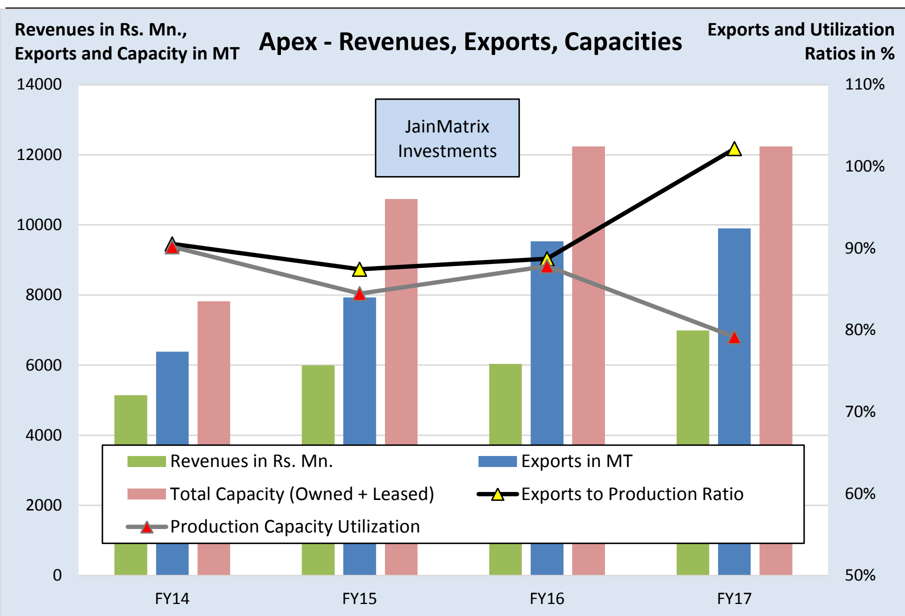
Exhibit 1 – Utilization of net proceeds from fresh issue of shares

- The promoter and his group own 99.9% in Apex which will fall to 72.08% Post-IPO. Karuturi S Murthy and Karuturi Padmavathi have tendered 7.55% and 15.41% of pre-IPO shares for the OFS.

- The IPO share quotas for QIB, NIB and retail are in ratio of 50:15:35, a positive for Retail.
- The unofficial/ grey market premium for this IPO is in the range of Rs. 25. This is a positive.

Introduction to Apex

- Apex is a Kakinada, AP based integrated producer and exporter of ready-to-cook shrimp products.
- Revenues & PAT in FY17 were Rs 709.7 crore & Rs 24.4 cr. Apex has 1,344 employees totally.
- It exports its frozen products to food companies, retail chains, restaurants, club stores, and distributors in the U.S., UK and Europe. Some major customers in the U.S. include Chicken of the Sea Frozen Foods, Ocean World Ventures LLC, and Pacific Sea Food Group.
- Apex operates a few shrimp farms near the Kakinada processing plant in AP. The total cultivable farming land available to the company is 1,338 acres, of which 106 acres are owned and the rest are leased. The company is able to fulfill 15-20% of its raw shrimp requirements from these farms.
- Fig 2a shows that majority of revenues are from USA. From Fig 2b, we can see that revenues and exports have been steadily trending upward along with the exports to production ratio. However, capacity utilization declined in FY17. This is a negative. In Fig 2c we see the in house brands of Apex.
- Leadership is Karuturi S Murthy (CMD), Karuturi S Chowdary (ED), G V Raghava Raju (Purchase), H. Rajashekhar (Operations), V. Thiyagarajan (Farm in Charge) and D. S. Madhavi (QA).



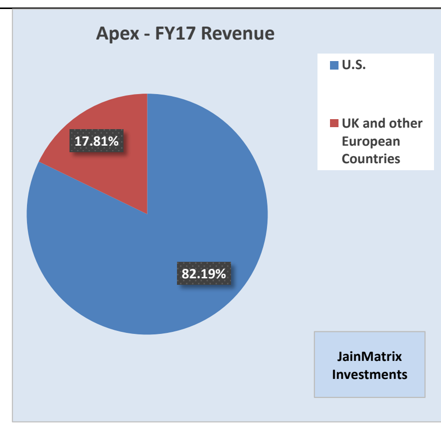


Fig 2a – Revenue Mix, Fig 2b – Revenues, Exports and Capacities, Fig 2c - Brands

Remuneration	2015	2016	2017
Top two Promoters	4.0	4.0	3.5
Dividend			1.9
Total	4.0	4.0	5.4
Percentage of PAT	21.79	20.75	22.22

Fig 2d – Remuneration Rs cr. (Source RHP)

News, Updates and Strategies of Apex

- Promoter: Karuturi S Murthy, the founder of Apex, currently holds 40% stake. He has 22 years experience in aquaculture after setting up Apex Exports in 1995, which later became Apex Frozen Foods. He heads the company and handles strategic and business dev. decisions. Karuturi S Chowdary is

Murthy's son, also holds 40% stake, and has 12 years experience in aquaculture, and is involved in operations and marketing activities.

- Promoter salary & dividend are high, see Fig 2d. It was 21.8%, 20.8% and 22.2% of PAT over FY15-17.
- The U.S. Dept. of Commerce has imposed an anti-dumping duty on frozen warm water shrimp from India (and a few more countries). The U.S. DoC has pegged its preliminary anti-dumping duty on Indian shrimp at an average rate of 1.07%, according to the Business Standard.
- Logistics are very good. Apex processes at the Kakinada plant, and procures from its own farm and others all close by. Exports are from ports of Kakinada (20 Kms) and Vizag (150 Kms).
- In April, Apex and Royale Marine Impex agreed to extend their agreement to allow Apex to lease an additional 3,000 MTA processing capacity (total is 6,000 MTA) valid till FY18.
- Apex plans to grow its business by: 1) capacity expansion with a new processing facility of 20,000 MTA. 2) Increase its value-added product (VAP) portfolio - 5,000 MTA of the new facility will be for VAP such as cooked, dusted, and breaded shrimp. 3) Expand global footprint to Midde East, Africa, and Russian markets. 4) Expand shrimp farming area to increase the ratio of raw materials from own farms.

Shrimp Exporting Industry

- The shrimp exporting industry in India underwent a big shift in 2009 when the Govt. approved commercial production of Whiteleg (Vannamei) shrimp. The species is more resistant to disease, grows faster, and is cheaper than the Tiger Shrimp, that was popular at the time.
- In FY16, India was the 2nd largest producer of Whiteleg shrimp, after disease and labor issues affected production in Vietnam, Thailand, Indonesia, and China.
- Govt. Agencies and the Marine Products Export Development Authority (MPEDA) are targeting an expansion of aquaculture by 20% per year. With a big coastline of 8,000 kms, there is great potential for growth. MPEDA is also encouraging freshwater aquaculture in inland areas.
- The U.S. imported 188,617 MT of Indian seafood in FY17, an increase of 22.72% YoY volume wise and 33% value wise. The EU accounted for 16.73% of India's seafood exports in FY17.
- India is currently the top exporter of shrimp to USA. Shrimp exports grew 16.2% in FY17 in volume to 434,400 MTs and 20.3% in value to Rs. 24,439 cr. After only 3% growth in FY16 due to reduced prices, the industry bounced back in FY17 (MPEDA). See Fig 3.

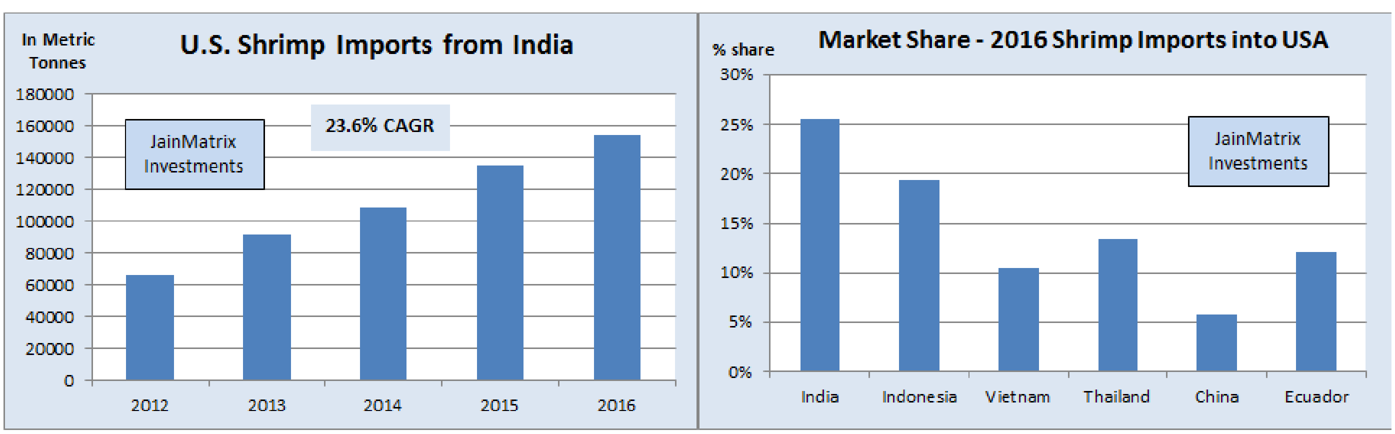


Fig 3 – Shrimp Imports by USA

- GST will have no effect on the Shrimp exports as it does not apply to raw shrimp or exports.

- Exports for Vannamei shrimp grew 28.5% YoY to 329,766 MTs. In value terms, 49.55% of Whiteleg Shrimp was exported to the U.S. followed by 23.28% to South East Asia, 13.17% to the EU, 4.53% to Japan, 3.02% to the Middle East and 1.35% to China (MPEDA).
- Shrimp exports may grow at 17-19% CAGR along with aquaculture at 11-13% till 2021 (CRISIL- RHP).
- With the U.S. operating at a massive trade deficit, President Trump has signed an executive order to enforce countervailing duties strictly on countries held to be dumping goods. He has also ordered the Dept. of Commerce to review trade deficits contributing to the consolidated $500B deficit USA had in 2016. The shrimp trade deficit was estimated to be roughly $4.5B in 2016.
- Apex has a 2.3% share in volumes of shrimp exports from India.

Financials of Apex

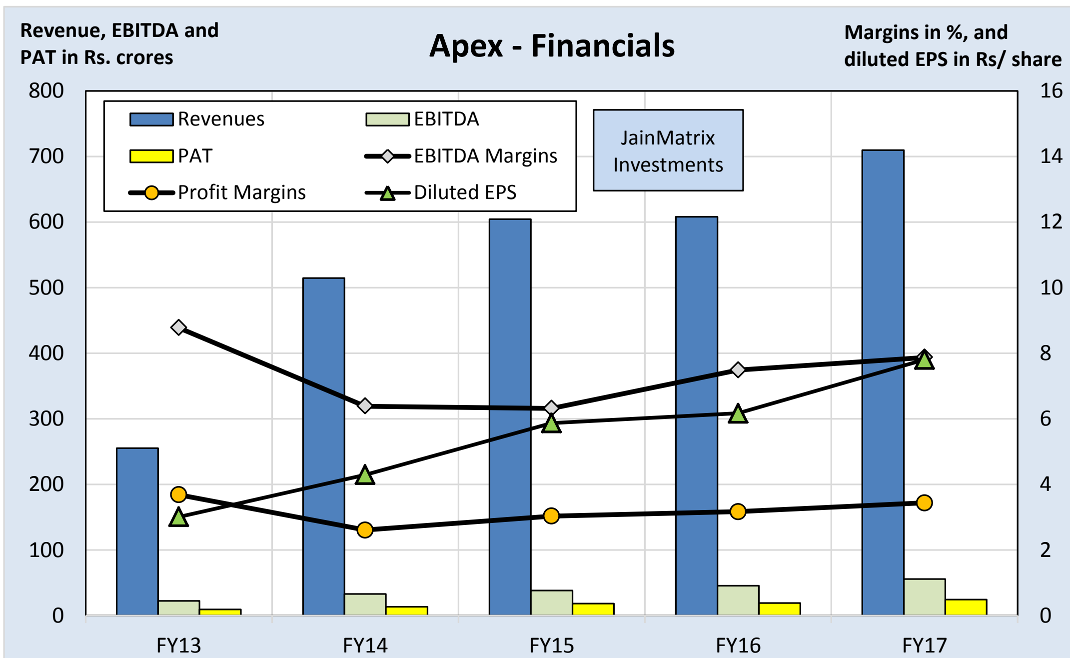


Fig 4 – Apex Financials

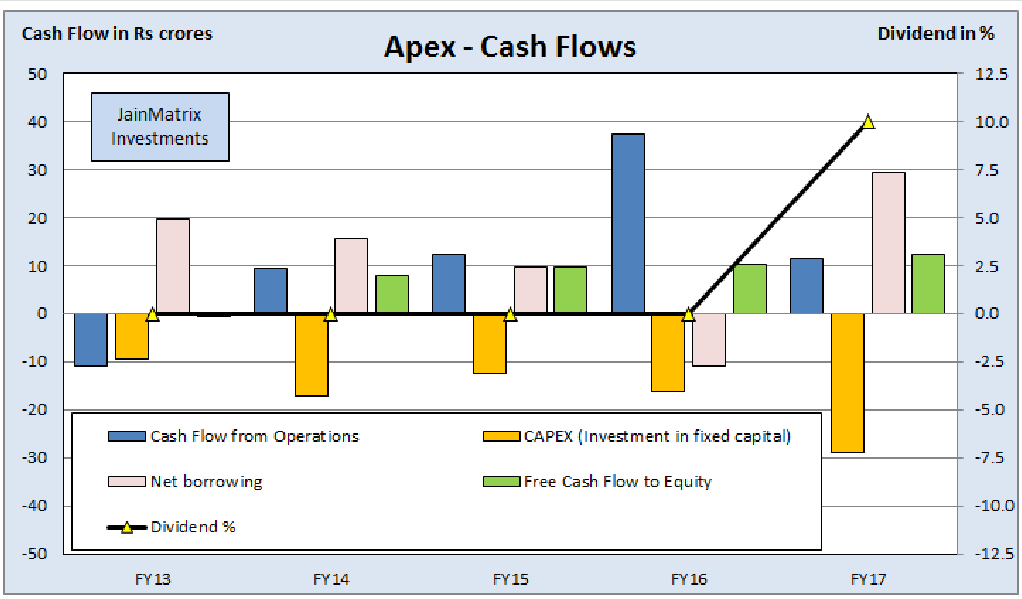


Fig 5 – Apex Cash Flow

- Apex Revenues, EBITDA and PAT have grown at 29.1%, 25.6% and 26.9% CAGR from FY13-17, Fig 4.
- EPS has more than doubled over 5 years as the company grew exports and expanded capacity. EPS shown here is diluted, post IPO, assuming it is successful and price is at UMP.
- Exports also grew by 15.7% CAGR in from FY14-17. In FY16, while Revenues and EPS grew, the lower growth can be attributed to low shrimp prices causing a slowdown in industry exports.
- EBITDA margins improved in the last 2 years and PAT margins increased 3 years in a row.
- Margins are slim in shrimp exports as raw material prices are market driven, but this can be mitigated by backward integration into farming as Apex is planning.
- Apex has positive and increasing Free Cash Flows in the last 5 years. After repaying debt in FY16, the company took on fresh borrowings in FY17 to fund capital expenditures. See Fig 5.
- Apex declared its first dividend in FY17 at Rs. 1/share equaling 10% of the FV.

Benchmarking

We benchmark Apex against Avanti Feeds, Zeal Aqua, and Waterbase. Many other players like Falcon Marine Exports and Nekkanti Seafoods are privately held. See Exhibit 6.

- Valuations of Apex appear attractive with a post-IPO P/E of 22.41 and P/B of 2.45.
- Sales have grown moderately over 3 years. Avanti's growth appears high because of its aquafeed business, but the exporting segment revenue grew at 12.3% CAGR.
- Profits have grown at double the pace of sales as margins improved. Meanwhile Zeal Aqua and Waterbase had declining profits over the same time period. Apex is fairly leveraged with a D/E ratio of 1.14 falling at the high end of the peer group. However, post-IPO this ratio should fall to around 0.49.

Particulars	Apex	Avanti Feeds	Zeal Aqua	Waterbase
Revenues (FY17) (Rs. in cr.)	710	2,733	175	332
EBITDA (FY17) (Rs. in cr.)	56	352	10	25
Profits (FY17) (Rs. in cr.)	24	213	2	13
Market Cap (Rs. In cr.)	547	8,622	178	421
PE (x) TTM	22.41	40.20	100.20	33.50
Price to Book Value (x)	2.45	13.50	4.8	3.8
3 Yr CAGR Sales (%)	11.31	34.16	8.68	13.30
3 Yr CAGR Profit (%)	22.05	45.02	-20.33	-2.55
Debt to equity ratio (x)	0.49	0.03	1.34	0.20
EBITDA Margin (%)	7.87	12.86	5.56	7.50
Net Profit Margin (%)	3.44	7.78	1.01	3.78
Return on Equity (%)	25.22	41.80	6.20	12.00
RoCE (%)	46.86	45.87	17.39	21.88
Dividend Yield (%)	0.57	0.55	0.00	0.00

Exhibit 6 – Benchmarking

- Margins are high, again Avanti is higher due to the aquafeed business.
- ROCE is excellent and better than ROE, perhaps because of high interest and Tax.
- The dividend yield is the highest. It has been calculated basis FY17 dividend and UMP of IPO.

Positives for Apex and the IPO

- Valuations based on peer group analysis look attractive.
- With this IPO, Apex will get funds for a capacity expansion of 216% of processing facilities. Margin expansion can come from scale increase, VAP and backward integration into farming.

- The Govt. particularly AP is supporting the aquaculture industry, providing growth and employment.
- Shrimp exports are expected to continue their high growth over the next 5 years with massive global market potential and the increasing focus on healthy food consumption in developed economies.
- With a just 2.2% market share in shrimp exports from India, there is ample upside potential for Apex.

Risks and Negatives for Apex and the IPO

- The current shareholders are dominated by the promoter and promoter family. Other IPOs have had PE participation as investors, but not Apex. Senior executives & directors too are dominated by them. For Apex to grow well over the years it will need to hire and develop professional managers.
- Top 2 promoters compensation was high (see Fig 2d) but at 22.2% of PAT in FY17 it is not excessive.
- Processing capacity utilization has declined slightly each of the last two years indicating operations may not be running as efficiently as they should.
- While Apex was able to grow exports by 20% in FY16 in a down year, it is concerning that exports grew at only 3.82% in FY17 when overall shrimp industry exports grew at 16.2%.
- Shrimp prices have seen volatile swings that can adversely affect Apex and the industry.
- India has benefited from disease affecting shrimp production of Vietnam, Thailand, Indonesia, and China. As these countries emerge from the problem, they make take back market share from India.
- The cultivation of shrimp is highly dependent on climactic conditions such as rain, and any sharp variation – excess as well as insufficient rains, will affect shrimp farming. It is also disease prone.
- USA under President Trump is making an effort to lower trade deficits by raising tariffs on imports. This could squeeze margins for Indian exporters. U.S. has a trade deficit with regards to shrimp.
- After many years of weakening, the INR gained against the USD by 7% in the last 10 months (from Rs 68.5 to 63.7). Our view is that it will be in 60-65 range in the next one year. This will affect Apex.

Overall Opinion and Recommendation

- Shrimp exports is a sunrise industry with a small base, ample global and India markets, opportunities for value addition and branding. The environment is also conducive with govt. support.
- Apex revenues and earnings have grown substantially over the last 5 years as the company added processing capacity, exports and backward integration into shrimp farming.
- The IPO will enable Apex to more than double shrimp processing capability. This is a good opportunity as current capacity utilization is in the 80-90% range. With the exports focus, demand may not be a constraint, so Apex should be able to grow fast after new capacity commissioning.
- Promoters and management are industry veterans with experience handling the business.
- The main risks are high Promoter compensation and strengthening of INR against USD.
- This IPO offering is rated BUY, and investors can invest with a 2 year perspective.