

A Liquor Company (ABC)

ABC is a listed liquor company which is present in only one state. It is a family owned enterprise in which the promoter family has a dominant stake. The promoter family also manages the company. The company is a significant player in its own segment. ABC was started almost 25 years back and has done well quite well during this time. In the last fifteen years the gross sales of the company has risen almost 18 times. In last few years there has been a significant improvement in the profitability of the company making it a good investment opportunity.

Recommendation

We recommend that the shares of the company should be accumulated at current prices. Though there are taxation issues with the liquor industry and size of the company is relatively small, the current valuation and growth potential should deliver high return for patient investors. The ideal time horizon for investment would be five years. We expect a compounded return of 20 per cent during this period from the current price. (17 December 2007)

Investment Thesis

- **High and increasing promoter stake:** The promoters have been increasing their stake in the company over last seven years. The stake has increased from less than one third of the company to more than two third in this period. The promoters who are also managing the company know more about the company than anybody else. A significant and slow increase in their stake signals a good investment opportunity.
- **Branded product with increasing market share:** The company share in the market has increased consistently, especially in last five years. The capacity of production has increased by 2.5 times in last four years. The proportion of tax revenue that company has paid to state exchequer has also increased significantly. The current utilisation level of capacity is only two third of the capacity. So the company can increase production by 50 per cent before it would have to go for capacity expansion.
- **High free cash flow yield, Return on Equity:** At current prices the free cash flow yield of the shares is around 5 per cent. This free cash flow is after incurring significant capital expenditure which involved a capacity expansion by 50 per cent. The company has always generated significant free cash flow and operating cash flow. The return on equity has been higher than 30 per cent in last two years.
- **Improvement in Debt Equity ratio:** The debt equity ratio has improved from 2:1 in March 2002 to 0.4:1 in March 2007. This reduction in debt has improved the financial position of the company significantly. The company is in position to pay up all its debt in next two years. It would lead to significant savings in terms of interest costs.
- **Reasonable Valuation:** The shares of the company are available at less than 8 times last twelve months earnings. If we annualize the first half earnings the price of the shares would be 7 times FY08 earnings. Even if the company does not grow the shareholders would still get decent returns.

Risks

- **High taxation, policy risks:** The liquor industry suffers from a very high level of taxation. Of the 100 rupees that is paid to ABC 62 rupees goes as indirect tax. In case this taxation level is increased that can create problems for the company. Apart from this there are other policy issues for liquor companies.
- **Liquidity risk:** The shares are at times thinly traded on stock exchanges. The time taken for purchasing large quantities of shares can be substantial.