SURGE CAPITAL

3rd April 2024

V2 RETAIL

Rating: BUY

Conviction Rating: ★★

Price: 488.7

Surge Capital Focuses on Six Key Attributes of Long-Term Earnings Growth

- Strong Business Model
- Innovation & Pivot
- Change & External Trend ✓
- Optionalities
- Leadership & Edge
- Stellar Management Execution

Industry:	Retail
Market Cap:	Rs1700 Crores
Revenues:	Rs1062 Crores
Net Profits:	Rs31 Crores
Net Debt:	Rs48 Crores

✓ *Indicates attributes present in the stock*

Brief Thesis

V2 Retail is value fashion retailer focused on Tier-2 & beyond cities.

The company is founded by Mr. Ram Chandra Agrawal who had earlier founded Vishal Mega Mart. Post Vishal's downfall and after selling the same in 2011, he started V2.

V2 in its initial years till FY17 was very successful but since FY18 it had been facing challenges. During this period of challenges, the company has adopted certain strategies which are historically proven strategies of strong retailers.

The outcome of these strategies has been reflecting in V2's extremely strong performance in FY24- both on absolute basis and relative to its peer.

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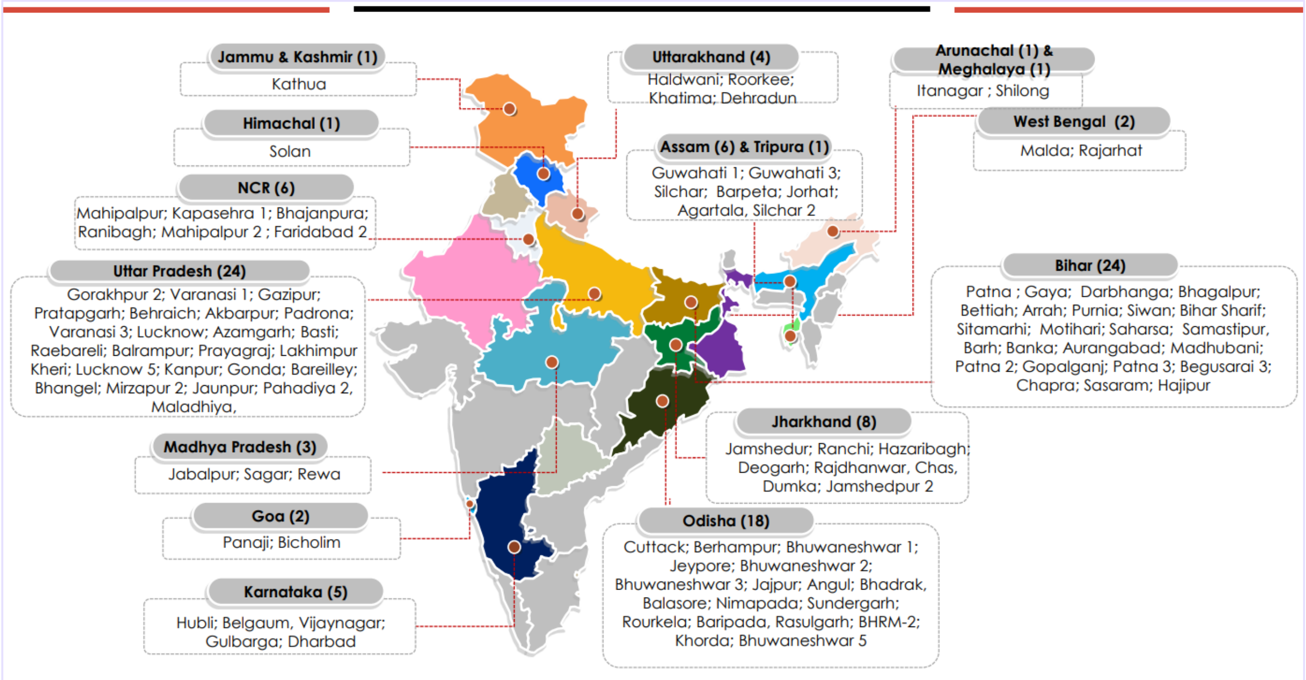
V2 RETAIL- BUSINESS & SOME HISTORY

V2 is a value retailer with focus on apparel and general merchandise. The company operates 117 stores in tier-2 & beyond cities, primarily in northern & eastern parts of India.



The company is founded by Mr. Ram Chandra Agrawal who had earlier founded Vishal Mega Mart.

History of Vishal Mega Mart

2001: Vishal Mega Mart was founded as Vishal Retail

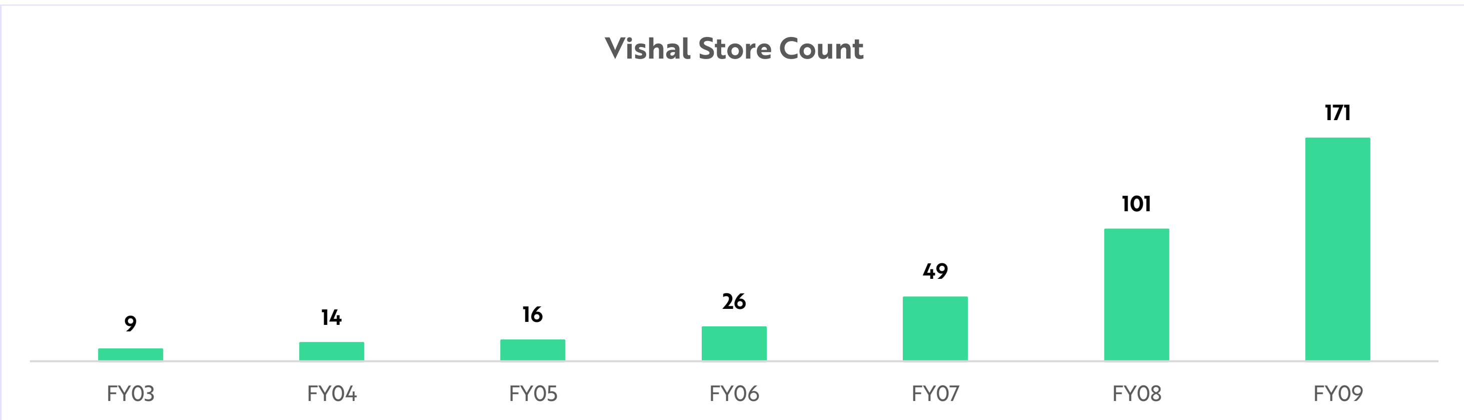
2004-2006: Company grew rapidly at a CAGR of ~90% to reach revenues of Rs600 crores in FY07

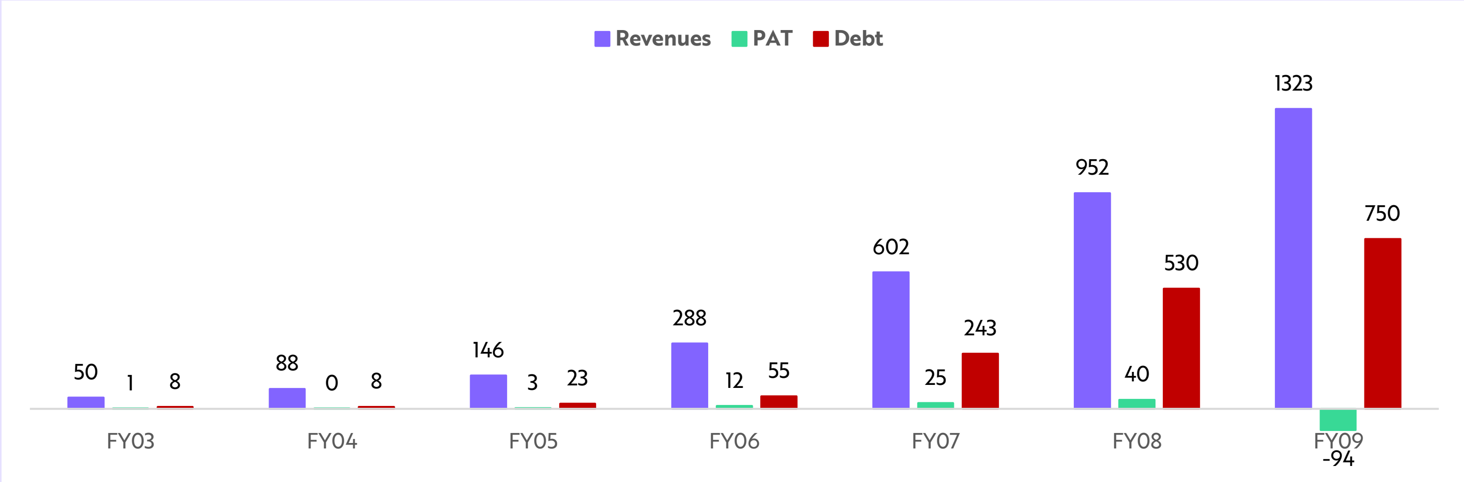
2007: Company went public and raised Rs110 crores; market cap of >Rs2000 crores.

2008- 2009: Company got under a debt trap as it had been expanding aggressively on the back of short-term loans (even before the IPO) and was unable to raise further funds in a very challenging external environment of global financial crisis.

2010: Company went under CDR (corporate debt restructuring) as its debt had ballooned to >Rs700 crores

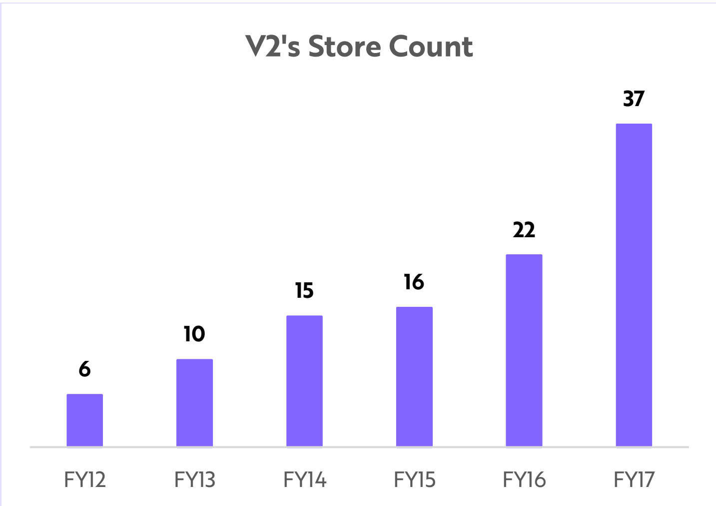
2011: Through the CDR process, the business & Vishal brand was to sold to Shriram Group & TPG for Rs70 crores.

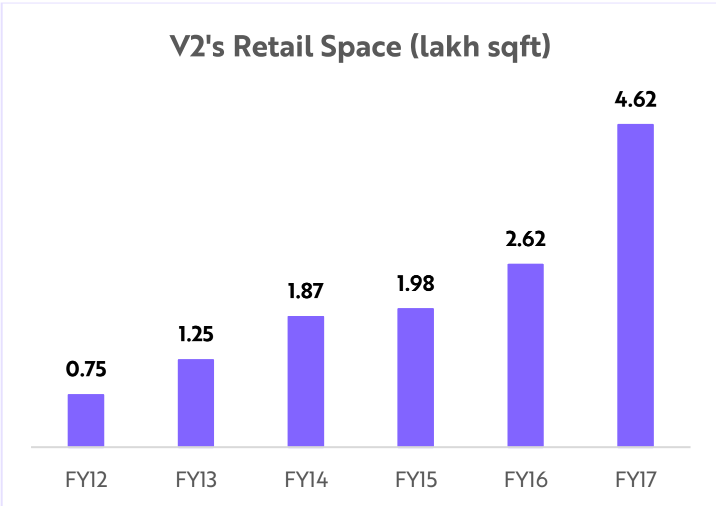


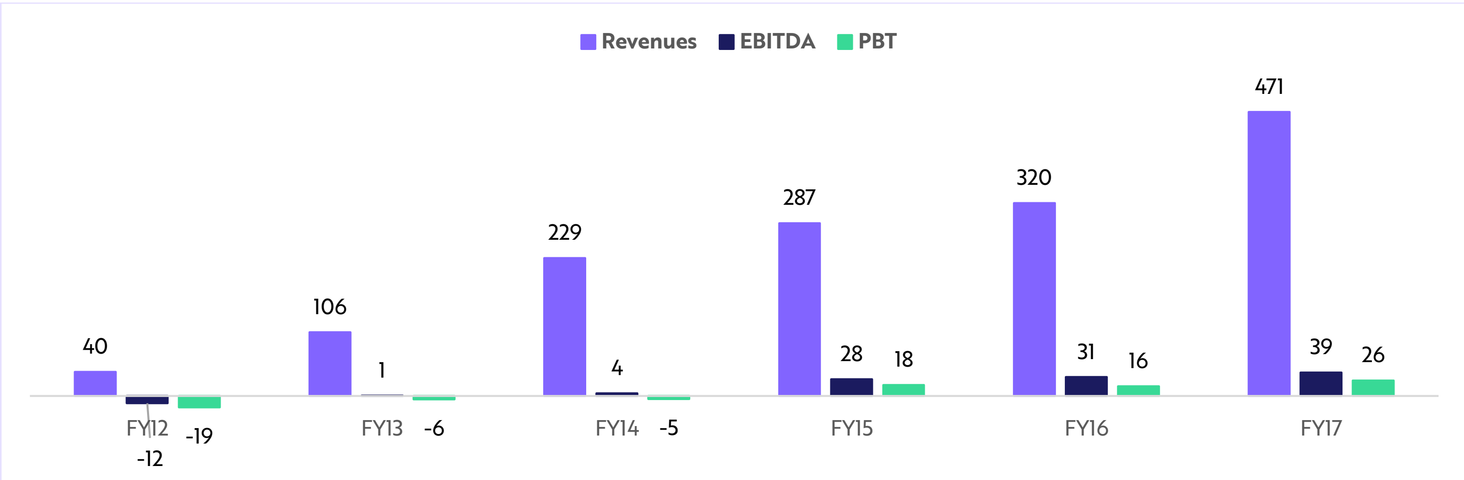


Immediately post selling the brand & business of Vishal, Mr. Agrawal made a fresh start with a new brand- V2 in 2011. And within just few years, V2 scaled up very well and was doing better than its older & larger listed peer- Vmart.

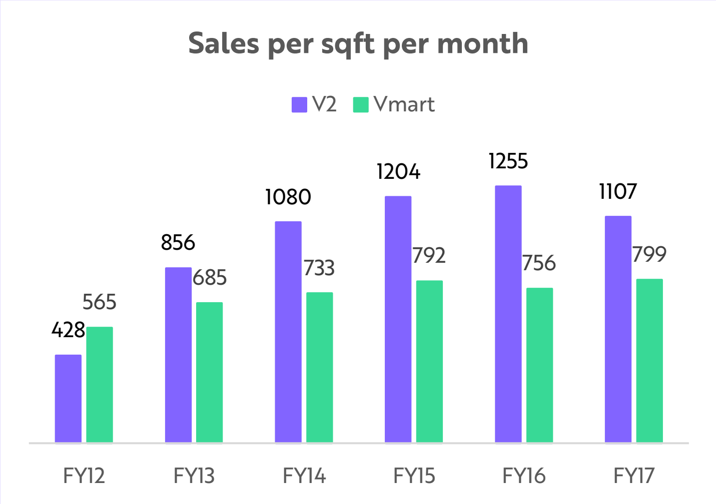
(note: promoters of Vmart are cousins of Mr. Ram Chandra Agrawal and were associated with Mr. Ram Chandra Agrawal's business in early 2000s, post which they separated to start Vmart)



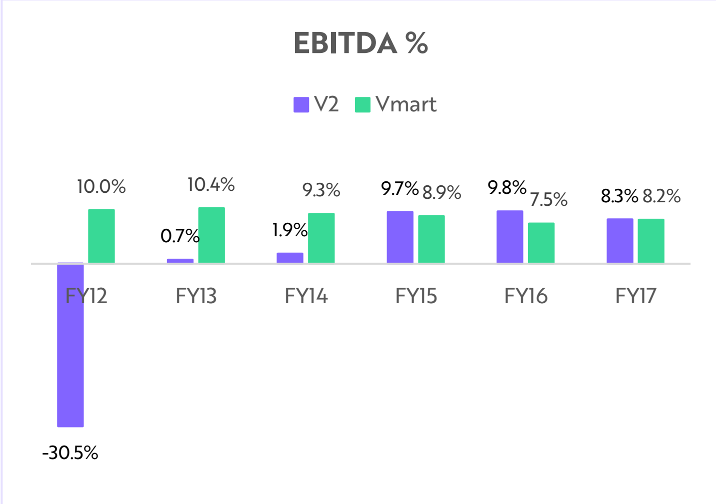




V2 had better throughput per store….



V2 had similar or better EBITDA margins despite operating at half the scale of Vmart….



PERIOD OF CHALLENGES

Post its successful run till FY17, V2 started facing challenges from FY18 onwards wherein its SSG (same store sales growth) turned negative.

This was a combine effect of-

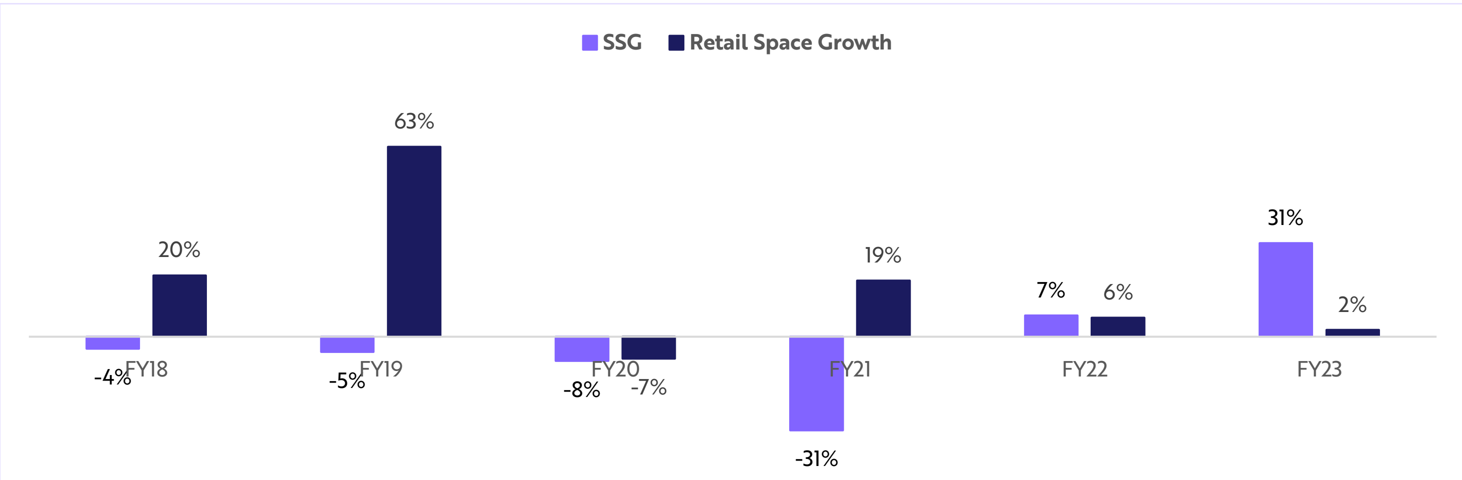
- Poor economic background post demonetization & GST that impacted company's highly economic sensitive consumers.
- Heighten competitive intensity in the value retailing market.

Management in V2's Q4FY18 Concall-

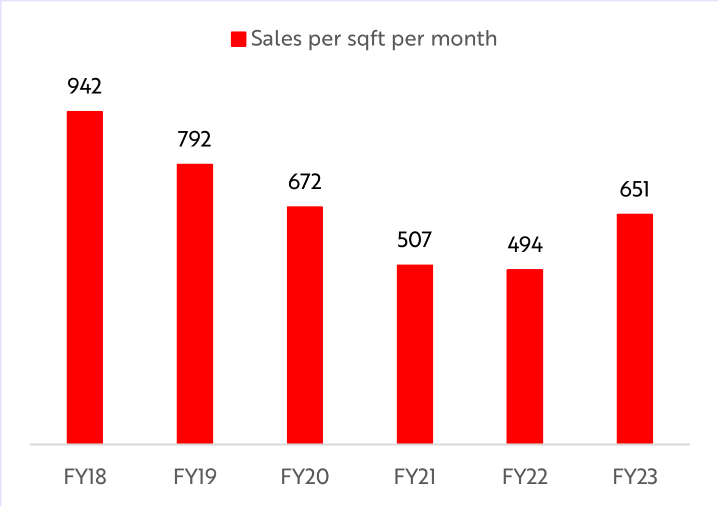
"We are seeing heighten competitive intensity wherein 3-4 new players have opened shops next to our stores"

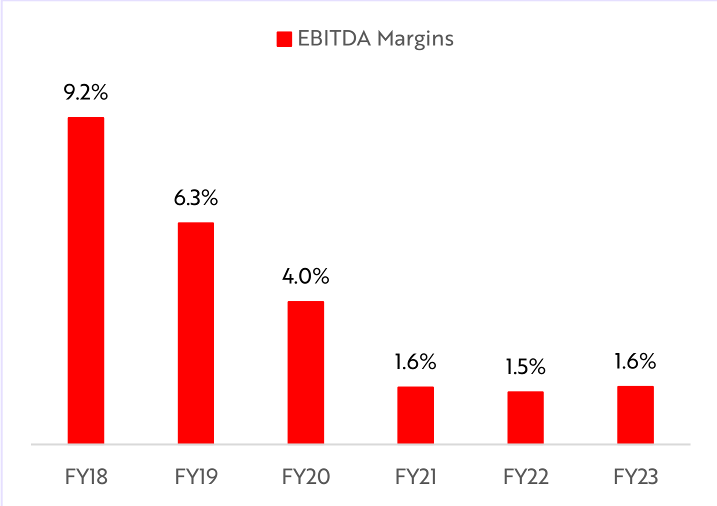
And within this poor SSG scenario, the company made the classic mistake of rapid store expansion;

Significant expansion despite negative SSG….



leading to poor throughput & profitability….





To understand the importance of SSG and the impact of low SSG + High store additions, members should read the following Knowledge Base post- https://www.surgecapital.in/post/ssg-the-most-important-metric-in-retailing

ATTRIBUTES OF MOST SUCCESSFUL RETAILERS

Over the years we have seen that some of the strongest & most profitable retailing businesses have followed two key strategies;

A. Control over a larger part of value chain

Retailing as a business is traditionally a low margin business given that the retailer does not own the brand or product and thus the gross margins are very low i.e a retailer only captures the trading margin.

Historically, introducing private labels has been one of the key strategies to capture a larger value & increase gross margins.

And some retailers have moved to a model wherein 100% of the business is private labels and thus they capture a much larger share of value and eventually create a competitive advantage that is not just reliant on the ability to sell but also on the product proposition.

Trent is a great example of this wherein its success with Westside is based entirely on this strategy; and it replicated the same strategy for Zudio and is now implementing the same with Star Bazaar.

Snippet from Trent's Annual Report-

Differentiated business model

Own brands contribute over 97 percent of total revenues. Westside's "own-brand-led" business model allows active control across the value chain with respect to key aspects of design, branding, sourcing, logistics, pricing, display, promotion and selling. We deliver latest fashion trends through a portfolio of differentiated in-house brands. This business approach has been more robust and sustainable than the department store models that predominantly retail third party brands including from a 'return on capital employed' perspective. Empirical evidence also seems to suggest that globally, retailers who control the entire value chain are relatively more successful.

Another good example here is that of Cantabil;

Level of Control

- 2/3rd of products manufactured in house
- Retails products entirely through own brand outlets of which 75% are company owned & operated

Outcome

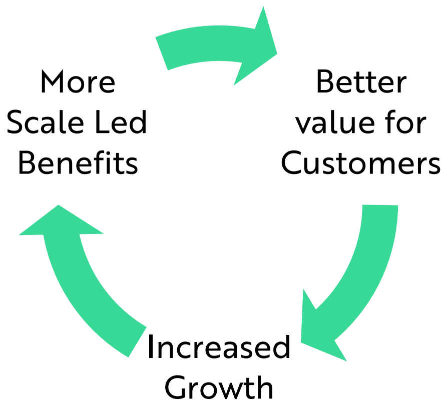
- ~55% gross margins (very high for apparel as a category)
- ~20% EBITDA and ~17% PBT margins
- >30% ROCEs
- All this with a throughput of ~Rs1000 per sqft per month

B. Scale economics shared

Scale economics shared as an idea has been popularized on the back of business model of Costco. The whole thought process behind this model is that instead of retaining benefits of scale for itself, the company passes on the incremental benefit to its customers while maintaining its existing profitability.

The outcome of this strategy is that, overtime the value that a customer gets continues to increase and that leads to increased growth rates. Further, it becomes extremely difficult for other players to offer same value to customers as they would be operating at a lower scale.

It essentially it creates a positive feedback loop wherein-



Dmart operates under the same business model.

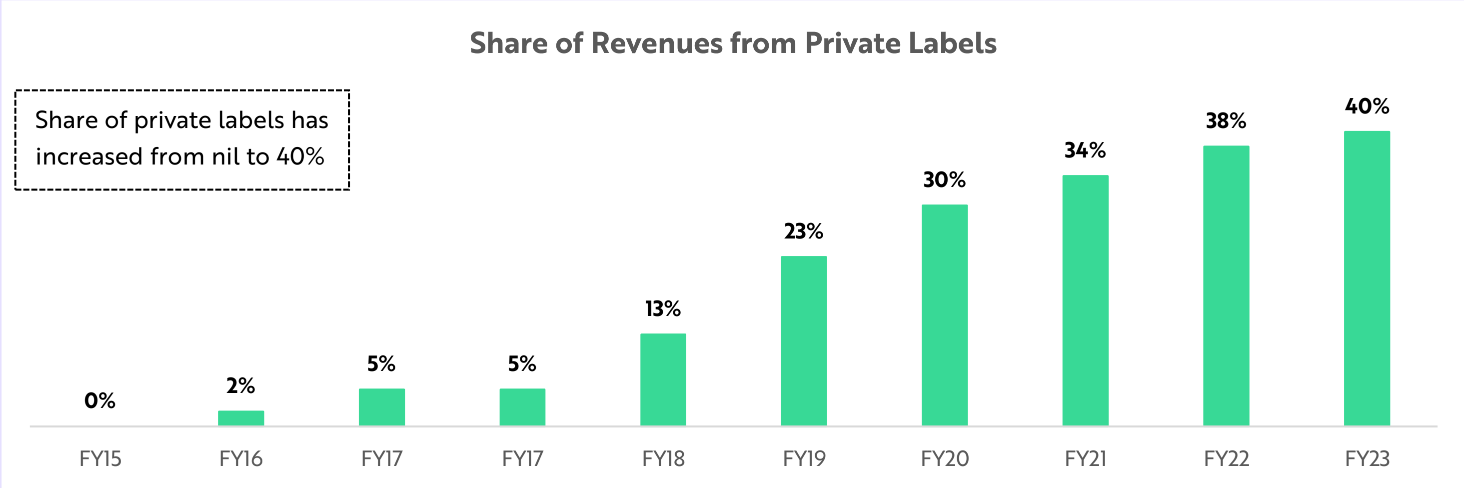
This framework holds very strong relevance in value retailing given that the end customers in value retailing segment are primarily looking for value; pricing is the key decision factor for such consumers.

Whatever value a retailer might give away in form of lower gross margins for itself would end up adding much more in absolute profits as;

1. Higher value for consumers means higher revenues & growth
2. And higher revenues will lead to better operating leverage and thus improved margins at operating level

V2 over last many years has focused on adopting similar strategies discussed above;

A. It has focused on increasing its share of private labels



B. Company incorporated a subsidiary- V2 Smart Manufacturing limited to in-source some of its products and through this subsidiary the company currently meets 20-25% of its sourcing requirements.

C. Instead of increasing its gross margins on the back of above two initiatives, V2 has passed on these benefits to end consumers.

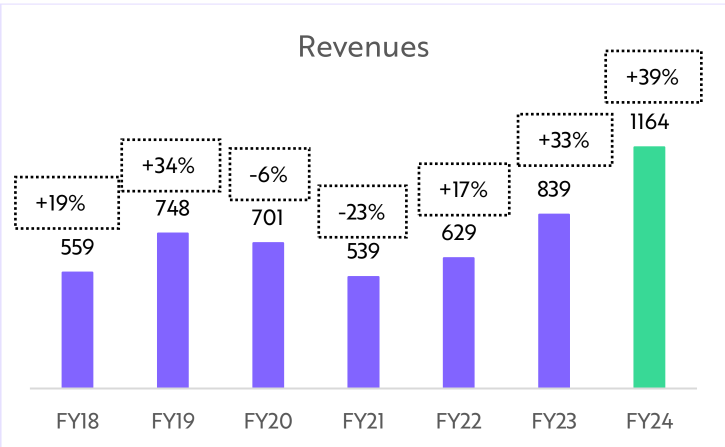
V2's Management in an ET NOW Interview few months back-

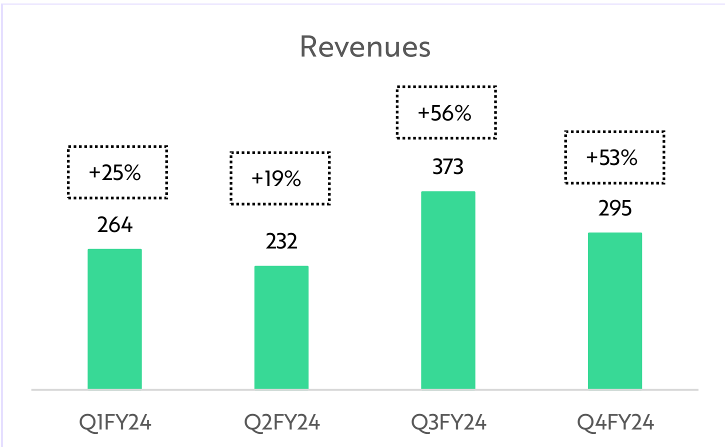
"Last few years have been about consolidating and reinventing ourselves and we worked on a lot of pointers be it supply chain, inventory management, product development and we also focused on giving more value to our consumers. So, we have also reduced our gross margins."

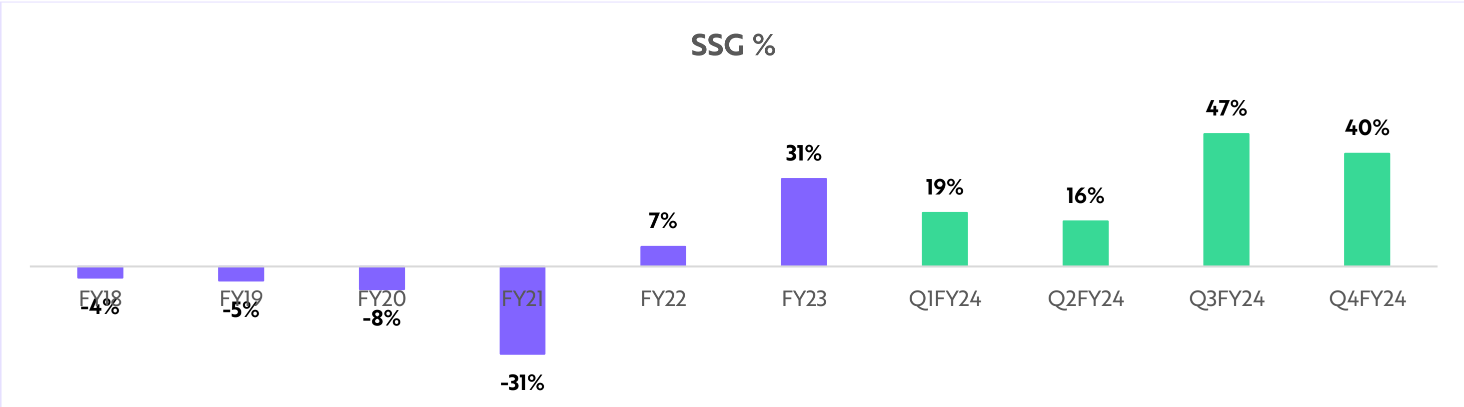
"Currently whatever margins benefit we are getting from producing on our own or doing our own product development we are transferring the whole benefit to our consumers"

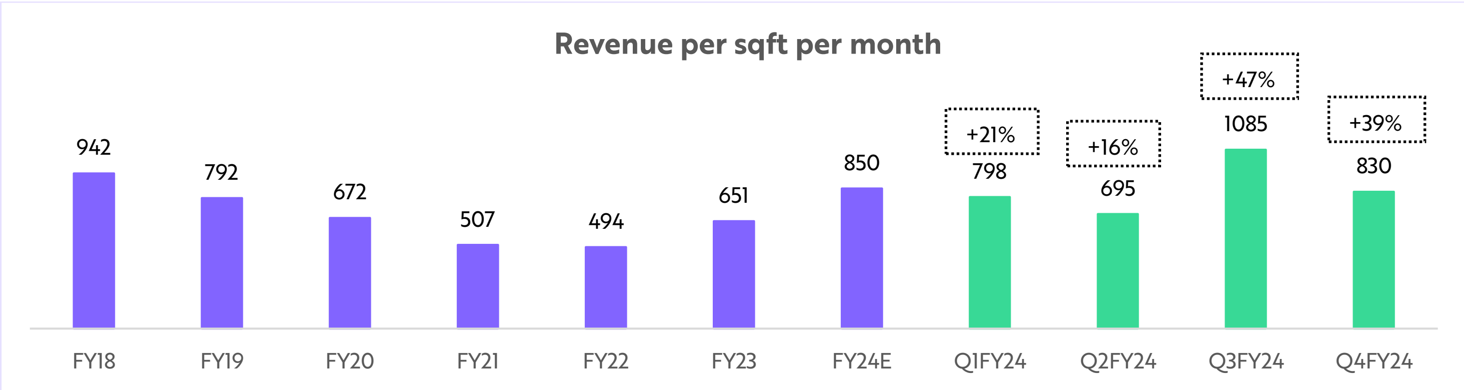
"Want to maintain a gross margins of 29-30%"

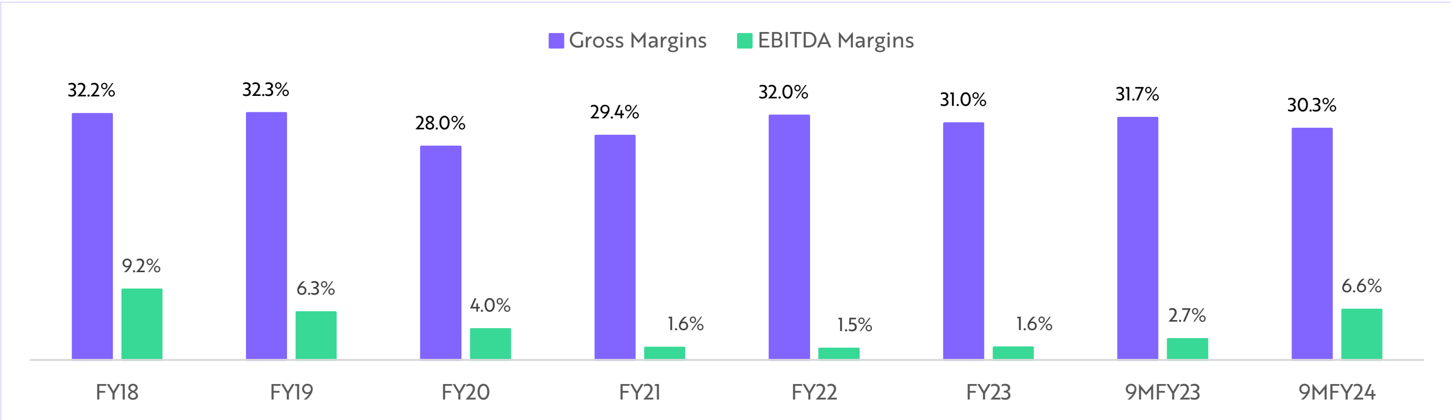
The outcome of above changes is visible in company's performance in FY24 wherein it has reported very strong revenue growth, led by strong improvement in SSG & throughput and has seen strong expansion in margins;



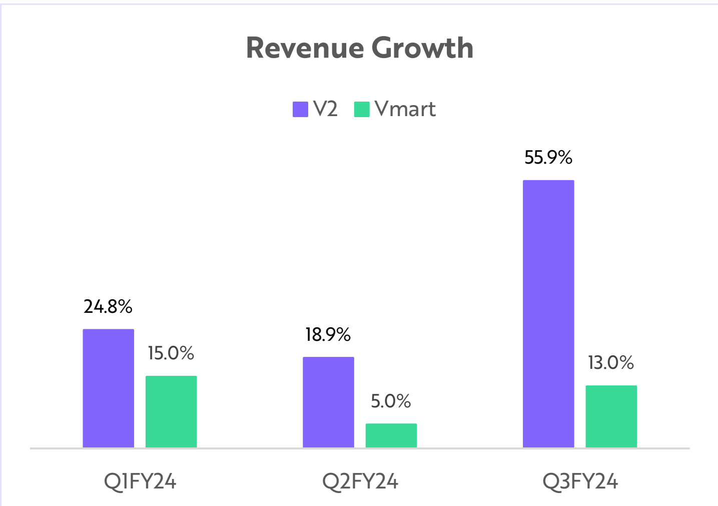


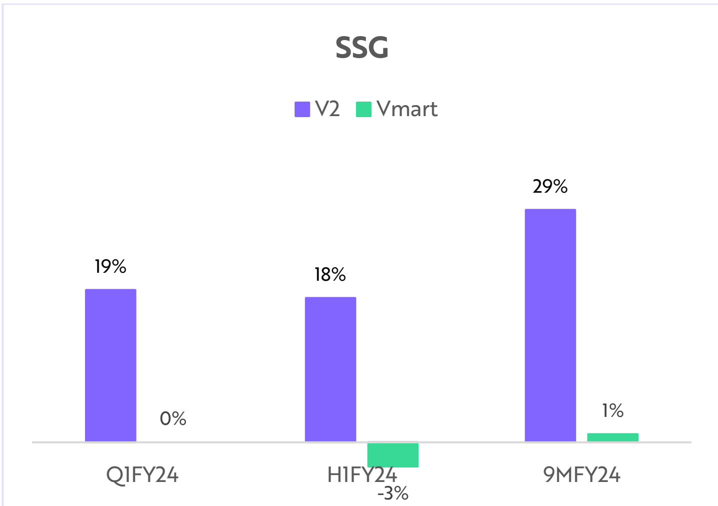


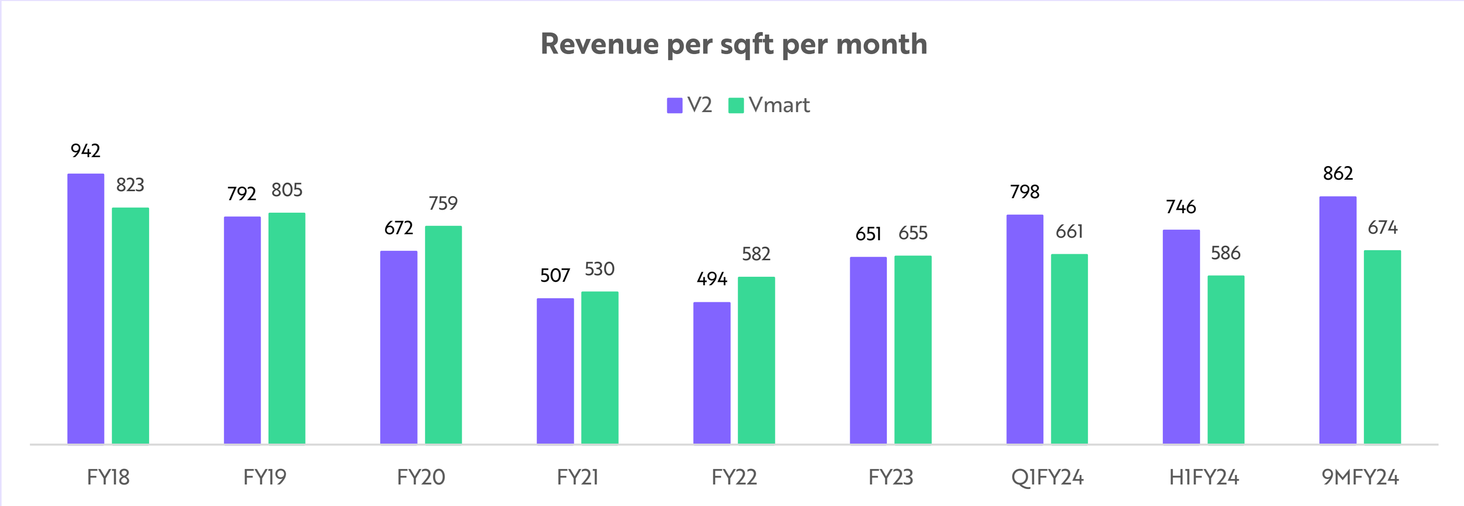




The performance is substantially better than its larger peer Vmart;







Side Note: Impact of Ind-AS 116

Under Ind-AS 116, accounting of leases has undergone change such that instead of booking rent as an expense. Rent expense is charged to PnL through finance cost & depreciation. Under this, rent cost charged to PnL is higher than the actual rental costs in the initial years by 30-40%.

Since value retailers like V2 operate on very thin margins of mid-high single digits, this 30-40% higher charge has a material impact on reported profitability of the business vs the actual profitability.

And thus, it is better to look at pre-IndAS 116 disclosed numbers here.

EXPECTATIONS GOING AHEAD

V2's progress towards proven strategies of strong retailers, its recent strong performance (both absolute & relative to its peer) and further scope of large improvement in its margins & throughput (based on delta between its current metrics and past metrics); is what gives us confidence & conviction of possible strong returns here.

We believe that V2 can grow revenues at strong rates of 30% (SSG + store additions) over next 2-years along with substantial increase in profitability, and that will lead to non-linear growth in profits for the company.

We are buying the stock at a market cap of ~1700 crores which is ~44x its expected FY24 profits (pre-IndAS 116), which we believe can re-rate some bit purely on the back of very strong growth that the company will report going ahead.

RISKS

A. Not a Very Strong Business Model

Value fashion as a business is not a great business to begin with. It is a highly competitive industry with very low customer loyalty and that reflects in low profitability of the business.

Further, our understanding is that in this business the store does not have any SSG post the initial 2-3 years and that further complicates the situation. Though on the other hand, store level breakeven & initial scaleup happens within the 1st year itself. As a result, the impact on margins due to SSG being lower than store addition is relatively lower in this business.

So, the whole game in this business is about store additions & throughput (sales per sqft per month). Any impact on throughput has a material impact on company's overall profitability- both on the upside & downside.

Our risk on this point is relatively managed from the fact that current profitability & throughput are somewhere in the middle of- very low levels seen in last few years & the strong levels seen pre-FY18. And thus, we are not taking a downside risk from peak/optimal profitability.

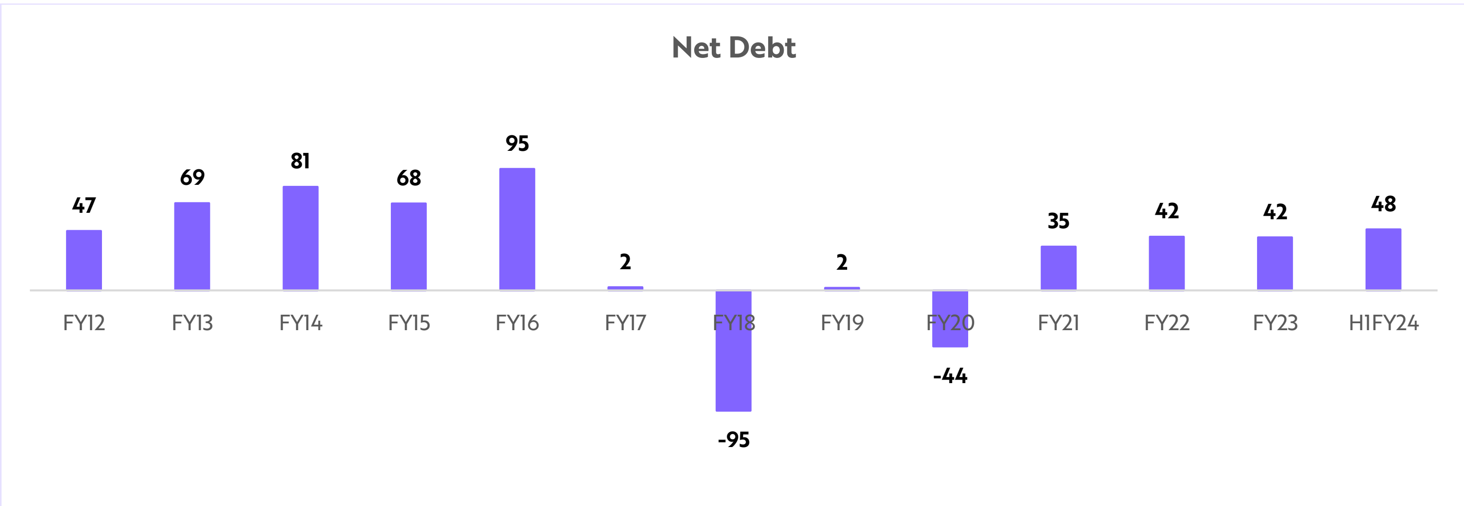
But because of the nature of business, we do not see ourself as holding this stock for say 3-5 years; our bet here is a relatively shorter term in nature i.e next 2-years.

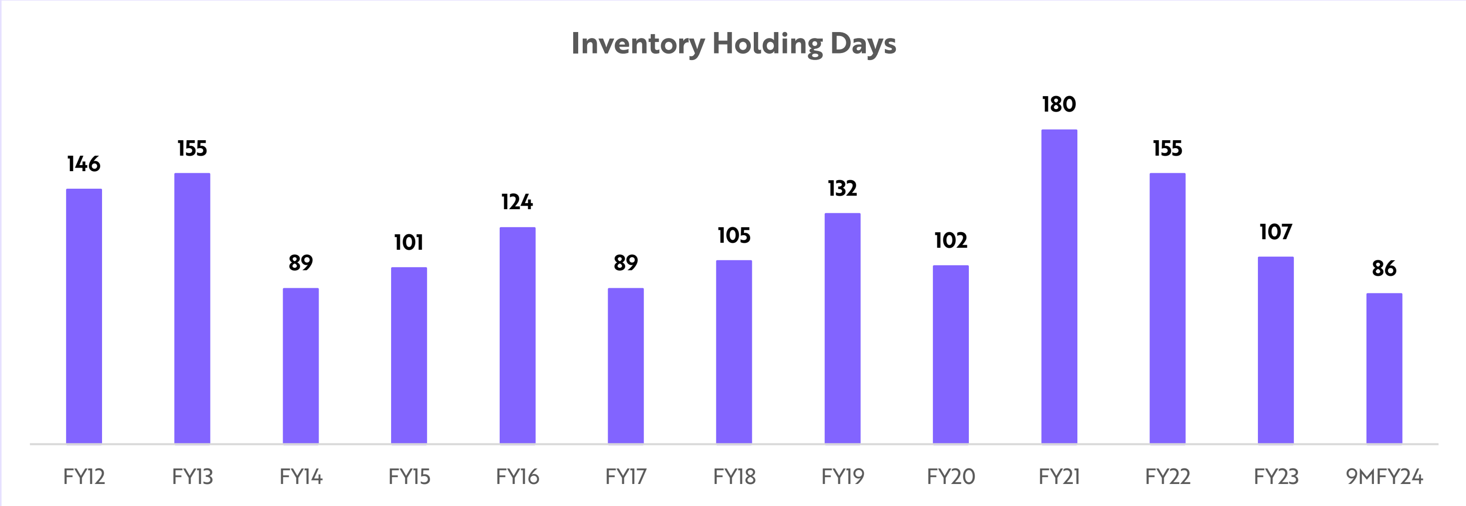
B. Past Blowup

The fact that the management in the past had a major blow-up with Vishal Mega Mart makes an investor think about risk associated with the possibility of something similar happening in the future.

Though the apprehension is correct, but we believe that the probability of a similar blow-up is much lower in managements who had already made the mistake once.

Also, if we look at some of the key metrics like debt and inventory level, from which a material risk might emerge, they have been under control.




Inventory Holding Days
146
155
89
101
124
89
105
132
102
180
155
107
86
FY12
FY13
FY14
FY15
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FY17
FY18
FY19
FY20
FY21
FY22
FY23
9MFY24

Ratings Explanation:

Buy: Expected total return (price appreciation plus dividend yield) of more than 10% over next 12 months.

Hold: Expected total return (price appreciation plus dividend yield) of +/- 10% over next 12 months.

Exit: No Further Coverage/Update on the stock.

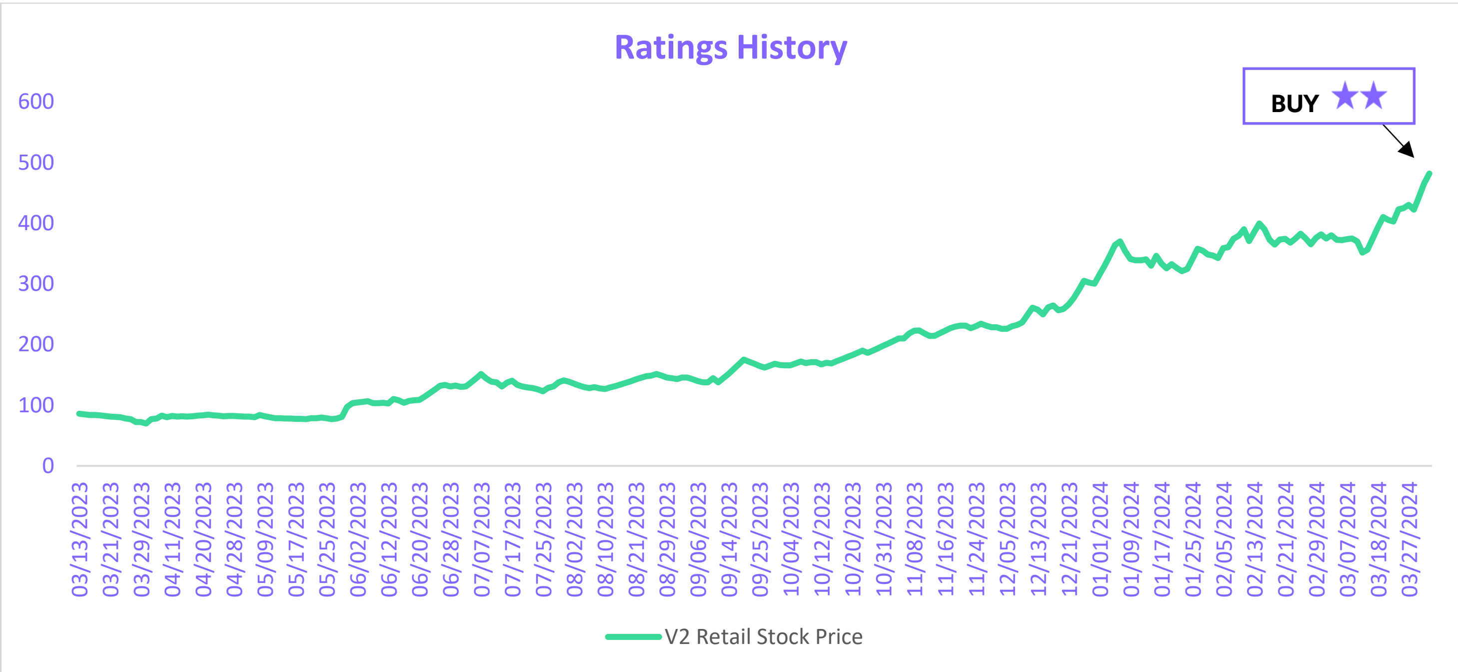
Conviction Rating:

Conviction rating reflects our understanding of return:risk ratio of the underlying stock for next 12 months. The rating is given within a range of 1-5 stars, wherein each higher star reflects a higher return:risk ratio; so, 1 star indicates a low return:risk ratio and 5 star indicates a high return:risk ratio.

The rating is based on our qualitative understanding of how the four factors of- Price Action, Earnings Growth, Valuations & Perception will play out over next 12 months for the stock.

Conviction ratings are to be read along with Buy & Hold ratings and no conviction rating is assigned for stocks with Exit rating.

Note: Ratings are valid till changed.



Note: Above chart indicates ratings assigned (including changes) over the period of coverage of stock.

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No associates

Analyst Certification

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Analyst Ownership of Stock: NO

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