Heritage Foods Ltd — FY 2023 Annual Report Analysis

Annual Report Analysis (Consolidated)

Investor Snapshot

#	Analytical point	Sentiment
1	**Maintains a dominant regional procurement moat with a network of 300,000+ farmers, supporting a successful expansion into the Odisha market.**	—
2	**Delivered robust top-line momentum with revenue growing 20.86% YoY to □3,240.65 Cr, despite a challenging macroeconomic environment.**	—
3	***EBITDA margins collapsed to 4.27% from 7.33% as a 34% surge in raw material costs significantly outpaced the company's price hikes.***	—
4	***Bottom-line performance deteriorated sharply with PAT falling 39.94% to 57.98 Cr, driven by the "scissors effect" of rising costs and margin compression.***	—
5	***Short-term debt skyrocketed from 3.76 Cr to 129.85 Cr to bridge a massive working capital gap, raising the D/E ratio to 0.18.***	—
6	***Cash Flow from Operations (CFO) turned negative at - 60.51 Cr, failing to convert accounting profits into actual cash due to an inventory trap.***	—
7	Capital allocation remains aggressive with □23.20 Cr in dividends being funded by debt and rights issue proceeds rather than internal accruals.	—
8	***Earnings quality is poor with a CFO/PAT ratio of -1.04, exacerbated by an 84% explosion in inventory and a 318% spike in semi-finished goods.***	—
9	Governance is characterized by a clean audit, 0% promoter pledge, and a credit rating upgrade to A+, though KMP pay exceeds 14% of PAT.	—
10	***Significant risk resides in the 23% of trade receivables now classified as credit impaired and the persistent losses from the Heritage Novandie JV.***	—
11	Outlook depends on the liquidation of high-cost SMP stocks and the Value-Added Product (VAP) mix reaching 35% to restore margins to 7-8%.	—
12	Investment Stance is Watch; monitor for inventory levels dropping below □250 Cr and a return to positive CFO/PAT normalization.	—

Final research summary: heritage foods ltd (hfl) - FY 2023

1. Business overview

- **Business Model:** Vertically integrated dairy model encompassing milk procurement, processing, and distribution, supplemented by value-added products (VAP) and cattle feed.
- **Revenue Drivers:** Transitioning from a liquid milk provider to a branded health and nutrition player; growth driven by volume expansion in 11 states and a strategic push into high-margin VAP (Curd, Paneer, Ghee, Ice Cream).
- **Cost Drivers:** Raw milk procurement is the primary cost, which saw double-digit inflation in FY23 due to fodder costs and Lumpy Skin Disease; Power, Fuel, and Freight are significant operational overheads.

- **Industry Position:** Dominant player in South India (AP, Telangana, Karnataka, TN) with aggressive expansion into Northern and Eastern markets.
- **Expansion Plans:** Targeting a long-term revenue goal of ₹6,000 Cr; recently entered Odisha for procurement to support growth.
- **Capacity:** Processing capacity of 2.65 million liters per day (MLPD) and chilling capacity of 2.21 MLPD, providing headroom for scaling.
- **Backward Integration:** Operates Heritage Nutrivet Ltd (Subsidiary) for cattle feed to ensure milk quality and farmer stickiness.
- **Renewable Energy:** 10.50 MW of Solar and Wind capacity used for captive consumption to hedge power costs.
- **Moat:** Deep procurement network of 300,000+ farmers across 10,500+ villages using a "direct procurement" model to ensure supply security.

2. Management commentary & outlook

- Management is pivoting toward an "Omni-channel presence" and deepening penetration in metropolitan markets to drive the next phase of growth.
- A "rough patch" of 12-15 months characterized by unprecedented raw milk inflation is expected to ease, with margin recovery anticipated toward the end of FY24.
- Management highlighted a structural shift from buffalo to cow rearing due to maintenance costs, which reduces average fat content and pressures the pricing of high-fat products like Ghee.
- Digital transformation is being prioritized through the VET+ mobile app (100,000+ users) to improve farmer engagement and milk yields.
- The Heritage Novandie Foods JV (yogurts) is viewed as a strategic long-term bet on premiumization despite current losses.
- The successful ₹23.20 Cr rights issue and the credit rating upgrade from A to A+ are cited as evidence of financial discipline and liquidity management.
- Management remains highly optimistic about topline performance, aiming for a CAGR that outpaces the industry forecast of 13.2%.
- The reclassification of several promoter group members to the "Public" category was executed to streamline governance, as these individuals have no active management involvement.
- **Management Tone Verdict:** Management exhibits high "operational confidence," evidenced by aggressive expansion into Odisha and the pursuit of the ₹6,000 Cr target. They are realistic about supply-demand gaps, providing granular explanations for margin compression due to cattle disease and fodder costs. The tone is focused on the "stickiness" of farmer relationships as a competitive defense. While the upgrade in credit rating and successful Rights Issue signal discipline, the reliance on softening commodity prices by late 2023 introduces external dependency.

3. Financial analysis

3.1 Financial statements

3.2 Financial analysis summary

- **Revenue from Operations** grew by 20.86% to ₹3,240.65 Cr, driven by volume and price increases, though quality was impacted by a 17.91% rise in Discounts & Rebates to ₹129.33 Cr, which now consume 3.99% of gross sales.

- Despite top-line growth, **PAT** plummeted by 39.94% to ₹57.98 Cr as Cost of Materials Consumed surged by 34.12% to ₹2,763.68 Cr, indicating an inability to pass on milk procurement price hikes, leading to a sharp contraction in EBITDA Margin from 7.33% to 4.27%.
- A critical red flag is the **84.10%** explosion in Total Inventory to ₹378.95 Cr, far outstripping Revenue growth; specifically, Semi-finished Goods (Skimmed Milk Powder/Ghee) skyrocketed by 318.43% to ₹145.74 Cr, signaling a massive blockage of capital in high-cost buffer stocks.
- This inventory buildup caused **Cash Flow from Operations (CFO)** to turn negative at -₹60.51 Cr, a severe deterioration from ₹148.98 Cr in FY22, resulting in a CFO / PAT ratio of -1.04 and indicating that reported profits are not translating into liquidity.
- To fund this working capital gap, the company pivoted to external financing, with **Short-term Borrowings** skyrocketing from ₹3.76 Cr to ₹129.85 Cr, primarily through floating-rate bank loans which increased the Debt / Equity Ratio to 0.18.
- **Trade Payables** decreased by 13.48% to ₹44.88 Cr despite higher procurement, suggesting the company is paying milk farmers faster to secure supply, further straining the cash conversion cycle as Payable Days dropped to 5.92 days.
- **Finance Costs** remained relatively stable at ₹7.18 Cr because the debt surge occurred late in the year, but Interest Coverage Ratio halved to 11.86x, reflecting the combined impact of lower EBIT and rising debt levels.
- **Property, Plant & Equipment** increased to ₹619.54 Cr supported by Capex of ₹56.45 Cr, while Lease Liabilities jumped to ₹33.61 Cr due to new distribution centers, contributing to a 14.70% rise in Depreciation to ₹53.15 Cr.
- The **Share of Loss in Joint Venture** (Heritage Novandie) increased to ₹8.52 Cr, acting as a persistent drag on PAT despite a fresh capital infusion of ₹5.50 Cr during the year.
- **Return on Equity (ROE)** nearly halved to 7.97% from 14.66%, driven by the collapse in PAT Margin and a bloated asset base, while ROCE fell to 9.51%, now sitting uncomfortably close to the company's cost of debt.
- **Free Cash Flow (FCF)** turned deeply negative at -₹116.96 Cr, forcing the company to rely on CFF of ₹93.41 Cr to sustain operations, highlighting a shift from a self-funding model to one dependent on external capital.
- **Trade Receivables** grew 51.57% to ₹28.01 Cr, double the rate of Revenue growth, with 23% of the balance now classified as "Credit Impaired," suggesting deteriorating collection quality.
- **Other Expenses** reached ₹274.87 Cr, driven by Freight Outwards (₹94.46 Cr) and Power and Fuel (₹48.12 Cr), while Selling and Distribution expenses nearly doubled to ₹26.50 Cr, signaling aggressive marketing to push volumes.
- **Capital Advances** saw a sharp jump to ₹4.87 Cr from ₹0.34 Cr, indicating active upcoming Capex for processing or cold-chain capacity.
- **Overall Synthesis:** Heritage Foods' FY23 was defined by a "scissors effect" where soaring procurement costs and a massive inventory-led working capital trap neutralized robust revenue growth, resulting in negative cash generation and a significant increase in short-term financial leverage.

3.3 Contingent liabilities & commitments

- **Pending Litigations:** The auditor draws attention to Note 43(b) regarding pending litigations and their potential impact on the financial position.
- **Guarantees Provided:** The company carries a financial guarantee liability of ₹**0.75 Cr** (FY23) vs ₹0.92 Cr (FY22). Additionally, corporate guarantees of ₹20.75 Cr for Heritage Nutrivet and ₹22.00 Cr for Heritage Novandie were noted in governance disclosures.
- **Tax Disputes:** While specific amounts were not tabulated, the auditor's emphasis on Note 43(b) includes tax-related litigations.

3.9 Earnings quality & forensic checks

#	Check	Impact	Status	Notes detail
1	PAT vs CFO trend	Profit ↓ — earnings overstate cash; ₹173 Cr inventory build drives negative ₹60.51 Cr CFO.	—	Cash flow statement shows massive divergence due to working capital blockage.
2	Receivables & channel-stuffing signal	Revenue ↑↓ — channel stuffing risk; combined working capital assets rose 79% vs 21% sales.	—	Inventory spike (84%) and Receivables (51%) significantly outpace sales growth.
3	Revenue timing	Revenue ↑ — strong forward demand; customer advances surged 321% providing future revenue visibility.	—	Significant jump in advances from customers indicates improved dealer collections or demand.
4	Revenue from related parties %	Neutral — minimal revenue circularity; RPT sales are immaterial to the ₹3,240 Cr top-line.	—	Dues from Heritage Novandie are negligible relative to total operations.
5	Inventory vs revenue growth	Profit ↓ — margin risk; 84% inventory growth vs 21% revenue suggests overstocking high-cost milk.	—	Semi-finished goods (SMP/Ghee) rose 318%, indicating massive buffer stock or slow off-take.
6	Inventory valuation method change	Neutral — consistent accounting; Weighted Average Cost method maintained to smooth volatile milk prices.	—	Policy remains consistent, though susceptible to write-downs if market prices fall.
7	Exceptional items in operating profit	Profit ↑ — base effect distortion; FY22 exceptional loss of ₹9.14 Cr makes FY23 growth look stronger.	—	Comparative profitability is inflated by the absence of prior-year one-off charges.
8	Depreciation rate vs useful life policy	Profit ↑ — lower expense recognition; P&M useful life up to 20 years exceeds standard schedules.	—	Broad range for useful lives allows management discretion in annual depreciation charges.
9	Provision reversals boosting PAT	Neutral — no significant reversals; earnings quality not artificially inflated by releasing prior provisions.	—	Other expenses show standard operational costs without significant credit reversals.
10	Tax rate consistency + cash tax vs P&L tax	Profit ↑ — non-cash tax benefit; MAT credit entitlement of ₹1.19 Cr recognized in deferred tax.	—	Company utilizes MAT credits, suggesting expectation of future taxable profits.
11	CWIP age and stalling projects	Neutral — expansion on track; sharp jump in capital advances indicates active upcoming CAPEX.	—	Increase in advances suggests new processing or cold-chain capacity.
12	Deferred tax asset recognition adequacy	Profit ↑ — tax asset support; DTA includes MAT credits which require future profitability to realize.	—	Recognition is based on the probability of sufficient future taxable income.
13	RPT quantum and trend	Profit ↓ — investment drain; JV losses increased to ₹8.52 Cr requiring continuous capital support.	—	Heritage Novandie Foods remains loss-making, eroding the carrying value of the investment.
14	Dividend paid vs FCF adequacy	Profit ↓ — liquidity strain; dividends paid despite negative FCF and high short-term debt.	—	Dividends and inventory build are being funded by new bank borrowings.
15	Auditor reliance on unaudited data	Neutral — immateriality; reliance on unaudited info for SKIL Raigam Power associate.	—	Auditor deemed the impact immaterial to consolidated statements.
16	Discount Scheme Complexity	Revenue ↑↓ — manual override risk; auditor flagged discount complexity as a KAM.	—	

#	Check	Impact	Status	Notes detail
				Complexity of various schemes requires high IT control integrity and manual testing.

4. Management & governance

A. Auditor Report & Key Audit Matters * **Audit Opinion:** Unqualified. * **KAM: Revenue Recognition (Discounts and Rebates):** Auditor identified complexity in discount schemes as a risk for overstatement. Management uses IT controls and manual journal testing to mitigate this. * **Emphasis of Matter:** Note 43(b) regarding pending litigations. * **Other Matter:** Reliance on unaudited financial information for associate SKIL Raigam Power (immaterial). * **Auditor:** M/s. Walker Chandiok & Co. LLP (re-appointed for 5 years from FY22).

B. Related Party Transactions | Party | Relationship | Nature | Amount (□Cr) | Concern | | ------- | ---------- | -------- | ---------- | --------- | | Heritage Finlease Limited | Significant Influence | Remittance of loan proceeds | 186.08 Cr | ***High cash handling for promoter entity*** | | Heritage Nutrivet Limited | Wholly Owned Subsidiary | Purchase of Goods (Cattle Feed) | 74.38 Cr | Dependency on captive supply | | Heritage Novandie Foods | Joint Venture | Share of Loss | 8.52 Cr | ***Continuous drag on profitability*** | | NTR Memorial Trust | Significant Influence | CSR Expenditure | 2.55 Cr | Related party implementing CSR | | Heritage Finlease Limited | Significant Influence | Lease Rentals Paid | 2.65 Cr | Asset leasing from promoter entity |

- **RPT Verdict:** Monitor. Total RPT is 8.38% of revenue. The remittance of □186.08 Cr to Heritage Finlease for loan collections represents a significant volume of non-core cash flow.

C. Shareholding * **Promoter Group:** 41.30% (Post-reclassification). * **Public:** 58.70%. * **Pledging:** 0% reported. * **Note:** Five individuals reclassified from Promoter to Public category due to lack of management involvement.

D. Board Composition + KMP Compensation * **Board:** 7 Directors; 57.14% Independent; 3 Women Directors. * **Family Compensation: N Bhuvaneswari** (VC & MD) and N Brahmani (ED) are mother-in-law and daughter-in-law. Combined remuneration is □8.62 Cr, representing 5.73% of EBITDA. * **YoY Analysis:** Promoter-KMP pay decreased by ~37% in line with lower profits. However, **CEO Srideep Kesavan's** pay rose 58.10% to □1.61 Cr despite a 25.62% drop in consolidated EBITDA.

F. Capital Allocation & Capex | Action | FY current (□Cr) | FY prior (□Cr) | Signal | | ------- | ---------- | ---------- | -------- | | Dividends | 23.20 Cr | 23.20 Cr | — | | Capex (Capital Advances) | 4.87 Cr | 0.03 Cr | — | | Acquisitions (JV Investment) | 5.50 Cr | 2.70 Cr | — | | Net Debt Change (ST) | 126.09 Cr | 3.76 Cr | — | | Working Capital Investment | 173.11 Cr | 20.58 Cr | — |

- **CAPEX Analytical Notes:**
  - **CFO Coverage of Capex:** Ratio is -12.42. **CFO is insufficient to fund even maintenance capex.**
  - **Nature of Capex:** Focused on **Capital Advances (□4.87 Cr)** for future capacity.
  - **Deployment Efficiency:** Revenue grew 20.86%, but the **massive inventory buildup** suggests current assets are not yet operating at optimal efficiency.
  - **Key Takeaway:** Dividends and Capex are currently **debt-funded** due to negative CFO.

H. Risks * **Milk Price Volatility:** RM costs rose 34% vs 21% Rev growth. Impact: Gross margin contraction. (Severity: High) * **Lumpy Skin Disease:** Disrupted supply chain and reduced milk production. (Severity: High) * **Inventory Obsolescence: 84% spike in inventory** (SMP/Ghee) risks write-downs if prices crash. (Severity: High) * **JV Losses:** Heritage Novandie JV lost □8.52 Cr. Impact: Erosion of investment value. (Severity: Medium) * **Interest Rate Risk:** Shift to **floating rate short-term debt** (□129.85 Cr). Impact: Rising finance costs. (Severity: Medium)

5. Scorecard & verdict

Part a: scorecard

Dimension	Rating (1–5)	Delta	Key evidence	One-line rationale
Business quality	4	→	21% Rev growth; 300k farmer network	Strong procurement moat and successful regional expansion.
Financial health	2	↓	D/E rose to 0.18; CFO -₹60.5 Cr	Liquidity strained by inventory trap and debt-funded dividends.
Earnings quality	2	↓	CFO < PAT; 84% Inventory growth	Profits not backed by cash; massive divergence in inventory vs sales.
Management & governance	4	→	Clean audit; 0% pledge; reclassification	Transparent disclosures and proactive promoter reclassification.
Capital allocation & earnings visibility	2	↓	ROCE 9.5%; Debt-funded dividends	Returns falling toward cost of debt; working capital blocking FCF.

Business positives (for this company this year) * **Revenue Growth:** Achieved **20.86%** YoY growth to ₹3,240.65 Cr despite a challenging macro environment. * **Credit Strength:** Credit rating upgraded from **A to A+**, reflecting long-term balance sheet resilience. * **Market Expansion:** Successfully entered the **Odisha** market for procurement, supporting the ₹6,000 Cr revenue vision. * **Equity Infusion:** Successfully raised **₹23.20 Cr** via a Rights Issue to support working capital. * **Governance Maturity:** Reclassified non-active promoters to the "Public" category, streamlining the governance structure.

Business negatives / concerns (for this company this year) * **Cash Flow Stress: CFO turned negative (-₹60.51 Cr)**, failing to convert PAT (₹57.98 Cr) into cash. * **Inventory Trap: Total Inventory exploded by 84%**, with Semi-finished goods (SMP) up 318%, indicating a massive capital blockage. * **Margin Compression: EBITDA Margin collapsed to 4.27%** from 7.33% due to a 34% surge in raw material costs. * **Rising Leverage: Short-term debt skyrocketed to ₹129.85 Cr** (from ₹3.76 Cr) to fund working capital. * **JV Drag:** The Heritage Novandie JV remains a persistent drain, contributing a **₹8.52 Cr loss**. * **Receivable Quality: 23% of trade receivables** are now classified as "Credit Impaired."

OVERALL SCORECARD SUMMARY Heritage Foods is currently navigating a period of significant financial strain despite robust top-line momentum. While the business maintains a strong procurement moat and is successfully expanding its geographic footprint, its financial health has deteriorated due to a massive inventory-led working capital trap. Earnings quality is currently poor as profits are entirely non-cash, and the company has shifted to a debt-reliant model to fund operations and dividends. The trajectory is "Stable but Strained," requiring a sharp liquidation of inventory and margin recovery to restore its self-funding status.

Part b: governance check matrix

#	Check	Status
1	Audit opinion clean?	—
2	Promoter pledge = 0?	—
3	KMP pay < 5% of PAT?	—
4	RPT quantum < 5% of revenue?	—
5	Board > 50% independent?	—
6	At least 1 woman director?	—
7	No statutory dues outstanding?	—
8	No fraud reported?	—
9	Audit trail enabled?	—
10	Frequent Auditor change	—

Final line: "Total: 7/10 — Governance Rating: 4"

Part c: investor verdict

Thesis: A dominant South-Indian dairy player with a strong procurement moat, currently facing a temporary but severe liquidity crunch due to high-cost inventory buildup and raw milk inflation.

Overall stance: Watch

Rationale: While revenue growth is strong, the negative CFO and massive inventory spike suggest significant near-term valuation risk if milk fat prices soften. Re-evaluate when: Inventory levels drop below ₹250 Cr and CFO/PAT returns to > 1.0x. BULL CASE: Rapid liquidation of SMP stocks at high prices + VAP mix reaching 35% of revenue, driving EBITDA margins back to 7-8%. BEAR CASE: A crash in Ghee/SMP prices leading to massive inventory write-downs + continued high-cost debt to fund losses. Key monitorable: Inventory Days: Current 50 days → Watch threshold < 40 days.