Investment memo – Relaxo Footwear

Date:11/04/2023

Mcap (Rs bn)	203	Shares O/S (mn)	248
Promoter shareholding	71%	Price (Rs)	820
5 years av. Pre-tax ROCE	25%	Trailing P/E*	79

* Note: We have normalised the TTM margins by assuming 17% margins versus reported margin of 12%

Investment summary

Relaxo's problems in the last couple of quarters are led by externalities and not on account of any problem with competitive positioning or maturing/lack-of-growth opportunities in the market. In our view, Relaxo lost market share in slippers/chappals category to unorganised and small/regional players as it was late in transmitting lower RM prices to the shelf due to longer/more-complex supply chain versus small/regional players. With RM prices stabilising, company has done price corrections to restore price parity (3-4% premium) versus local players; this portfolio should revert to pre-covid growth trends (8-10% sales CAGR). Sparx (casual shoe brand) has been unaffected by all this and is growing strongly; we expect growth to continue (20% CAGR). We see Relaxo reporting strong numbers in FY24 (sales growth ~20%; EBITDA 17%) and reverting to 12-15% CAGR growth in sales thereafter. In our view, the stock would retain its pricing premium (65X 1 year forward EPS assuming 20% growth in FY24 and EBITDA margins at 17%) given: 1) the large opportunity ahead, and 2) good execution track record, and deliver returns in line with growth in sales.

Company profile

- Relaxo is a dominant company in the organised footwear market in India. It was incorporated in 1984 and IPOed in 1995. It is run by the first-generation promoters: Mr. Ramesh Kumar Dua and Mr. Mukand Lal Dua; the second generation has progressively been inducted into the company.
- It started with offering very basic products like Hawai Chappals; over the years it has diversified its product basket into more premium products/brands like Flite (premium slippers) and Sparx (casual shoe brand). In FY22, Hawai (Relaxo/Bahamas) category contributed 25% (Rs6.6 bn) to sales and Flite (premium slippers; Rs10 bn) and Sparx (Rs10 bn) contributed 37.5% each to net sales.
- The company caters to price points of: 1. Rs110-260 in Relaxo, Rs150-370 in Bahamas, Rs150-450 in Flite, Rs700-2000 in Sparx. It primarily caters to economy and mass segments of the market.
- It has grown its sales, EBITDA and PBT at a CAGR of 14%,14% and 16%, respectively in 2010-2022. Sales, EBITDA and PBT CAGR in 2017-2022 has been 10%, 12.5% and 12%, respectively.
- Relaxo sells its products through 60k multi brand outlets (Campus has 20k outlets) and 390 EBOs (Campus had 107 as of FY22). E-commerce contributes 11.5% (FY22) to sales for the overall company; it contributes ~25% to sales of Sparx brand.
- Indian footwear market was estimated at Rs720 bn in 2020 out of which sports and athleisure and casual segment wear accounted for ~80% of the market.
    - We see Campus as the only credible competition to Sparx. Global brands cater to more premium customers at price points of >Rs2000.

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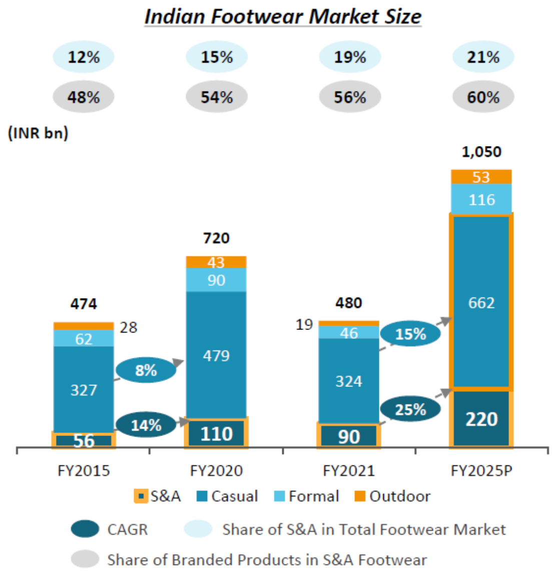
- Lot of regional brands exist in casual/sport shoe market; however, none of them have been able to scale beyond Rs3-5 bn range of sales.



Sales of casual/sports footwear of various players in India

(Rs mn)	2019	2020	2021	2022
Campus	5,949	7,320	7,113	11,942
Puma	7,301	8,936	6,503	11,267
Nike	5,537	5,168	3,344	5,026
Adidas	5,987	7,559	5,171	7,777
Reebok	3,118	3,346	2,634	3,061
Skechers	5,065	6,591	5,712	9,355
Asics	1,374	1,619	1,766	2,510

Note

1) Puma sales are for Dec year ends. So CY21=FY22

Investment rationale

1. **Growth profile is set to improve in the coming quarters.** We expect Relaxo to start reporting much better numbers versus the past 5-6 quarters going ahead as:

   a. **Problems in the non-Sparx portfolio are receding.** In our view, the lacklustre performance reported by the company in the last few quarters was on account of problems in the non-Sparx portfolio. Problems in this portfolio were on account of external factors and not on account of inability to compete in the market. Problem was the following:

      i. There was steep fall (Rs300 to Rs220 per kg) in RM (EVA: primarily used in low priced slippers) prices in the 2HCY22 which came after a very steep price increase (Rs120 to Rs300 per kg) in 1HCY22. Sudden fall in RM prices hurt Relaxo's competitive positioning versus unorganised/small players in the non-Sparx portfolio (chappals/slippers etc). Relaxo, at any point of time, has 4-5 months of RM inventory flowing through its supply chain as: a.

Given large requirements of RM, Relaxo sources RM from diverse set of global suppliers, and hence supply lead times are long which necessitates significantly higher RM inventory. Hence, it takes 4-6 months to pass on lower RM prices to retail shelves.

ii. Unorganised/small players, on the other hand, source their RM primarily from India and hence run a much shorter supply chain and hence keep lower inventory. Hence, in a scenario of the steep fall in RMs, these players are able to transmit lower RM prices to the end consumer much faster versus Relaxo. Given that this product segment serves lower income segment of consumers, ability to offer a much lower price, gave unorganised/small players significant edge versus large players like Relaxo. Hence, Relaxo lost some market share to smaller players in the last few quarters.

As per our understanding, Relaxo has bit the bullet (took aggressive price cuts in 2Q22; reflected in subdued margins) to restore price parity (3-4% premium) versus local/regional players and hence this portfolio should revert to its earlier market share/growth trajectory (~8% long term CAGR sales growth) in coming quarters. Along with the above, there were other transient problems to contend with in the non-Sparx portfolio which were:

iii. Significant (~25% or higher in some of low-priced products) price increase taken in quick succession (4 times starting from the middle of FY22) to pass on higher raw material costs and higher GST, led to push back from consumers given these product segments cater to lower strata of the society.

iv. The above phenomena also led to multiple price points existing in the market for the same product leading to disturbance in the channel. The company initiated de-stocking of the channel so as to get price discipline back.

b. **Sparx (~38% of FY22 sales) continues to do well.** Our channel checks suggest that Sparx's (~38% of FY22 sales) sales have grown ~35-40% (absolute) in FY20-22 and as per our channel checks, it on track to achieve ~1.75X sales (1H23 sales are up 30% yoy) in FY23 versus FY20 (Campus FY23 sales are estimated to be ~2X of FY20). Weak sales growth numbers delivered by Relaxo over the last few quarters are masking the strong performance of this brand. In our view, given the large opportunity in the casual/sports shoe segment in India and Sparx being one of the dominant brands in the mass segment, this brand should continue to grow at rates (15-20% CAGR) much higher than most of the other listed consumer plays. More on this later.

c. **Underperformance of Sparx versus Campus is not a case of inferior execution/brand.** Campus has grown faster in some of the recent quarters (till 1Q23) on account of its different strategy with higher focus on e-comm as go-to-market channel. The strategy seems to be working for the last couple of years, however, we note the following points:

a. Our channel checks suggest that Campus had not been able to maintain exclusivity of SKUs available online and offline with the result that an SKU available at a retail shop is available at a much cheaper price online. This has potential to create discord in the offline channel which could lead to longer term issues in scaling up this channel;

offline channel is important in the long term to create brand equity (online is perceived as more of discount channel by consumers and hence brand equity creation is limited). As per our understanding, Campus mgmt. has started addressing this issue.

b. Sparx on the other hand, is more disciplined in ensuring that SKUs available online are either different or discounts are not higher versus offline, so as to avoid cannibalization of offline sales. Hence, it follows a more measured go-to-market strategy aligning all channels of sales.

   All brands (even global ones) participate aggressively in online sale events, however, they ensure: 1) online SKUs are different from offline, 2) they keep premium SKUs only offline which protects their brand despite them extending hefty discounts online. For example: as per our understanding PUMA's online SKUs (mostly) are all manufactured in India and the company extends generous discounts on those, however, in its showrooms it keeps premium SKUs, large number of which are imported.

c. Disadvantage of over dependence on online versus offline channel is: It could become difficult (even if a company wants it later) to keep different SKUs in offline stores as lower volume of sales would imply that the company does not have minimum economic size order to place on its vendors. Hence, if the company wants to keep different SKUs offline, later, the cost per unit goes higher which erodes profitability of offline sales.

d. Online distribution is easy; it is not tough for a Sparx like brand which is well supported by a robust manufacturing back-end, to grow its sales at a much faster rate versus current rate of growth. Quantum of growth in e-comm space is driven by discounts (assuming a brand is offering good quality) a company is willing to extend. Given this nature of growth, it is easy for the crown of "online best seller" to pass from one company to another pretty quickly. Hence, in our view, Sparx growing in online channels in a measured manner is driven by strategy and not inability to compete effectively.

Sales growth of Campus in trade distribution channel has been much lower versus e-comm

(Rs mn)	2019	2020	2021	2022	CAGR (%)	9MFY23	Growth yoy (%)
Total sales	5,949	7,320	7,113	11,942	26	11,365	
Trade distribution	5,548	6,420	5,363	7,476	10	6,444	-14
D to C - online	351	571	1,501	3,929	124	4,182	41
D to C - offline (EBO)		329	249	537		739	75

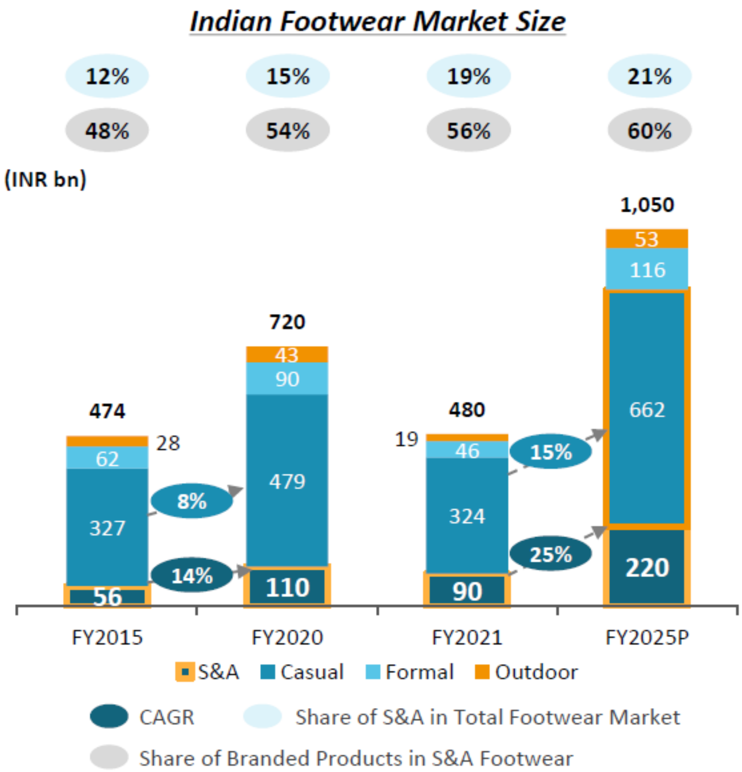
Note:

1) Segmentation in 9MFY23 has been done based on sales mix trends in TTM 9MFY23.

2) D to C (online) sales in 2019 also includes D to C offline sales.

d. **Casual/sport shoe sales for dominant brands to grow at >15% CAGR** – In our view, dominant brands in the casual/sports shoe industry, catering to mass and mass-prestige price points (Rs500 to Rs3000) would grow at higher than 15% CAGR (projected growth of the market) in the next 5 years led by market share gains from smaller brands as:

   a. Industry reports suggest that market size of casual footwear and sports/athleisure shoe category was Rs590 bn in FY20, whereas if one adds sales of all brands (listed/unlisted; total 17) which reported sales of more than Rs5 bn (FY20), it comes to Rs205 bn (at company's net sales level) and hence ~Rs320-340 bn at MRP level (assuming brands retain 60% of MRP). This suggests that a massive part of the market exists at lower price points where existing demand is addressed either by unorganised or small regional brands.



b. In our view, demand in the entry and semi-premium segments would increasingly move towards 3-4 dominant brands addressing these price points as consumers veer (driven by rising incomes) towards these brands led by their superior proposition.

We believe Sparx and Campus would be the biggest beneficiaries of this trend.

e. **We expect overall sales for Relaxo to grow at ~13-15% CAGR in the next 3-5 years.** We assume Sparx (~40% of sales) to grow at 20-25% CAGR and rest of the portfolio to grow at 8% CAGR. In our view, this would be a leading growth number in the listed consumer universe.

f. **Operating results should improve from here on.** In our view, operating numbers of Relaxo are poised for consistent improvement in the coming quarters led by:
   a. Sparx continuing to grow at 20-25% CAGR in rest of FY23 and beyond.
   b. Non-Sparx portfolio recovering to its usual growth trajectory of ~8%-10% CAGR as Relaxo has already restored price parity versus local/regional competition.
   c. Margins improving on account of declining RM prices and operating leverage impact of improving growth in sales; In our view, EBITDA margins should revert to ~17% levels (similar to FY20) in the coming quarters.

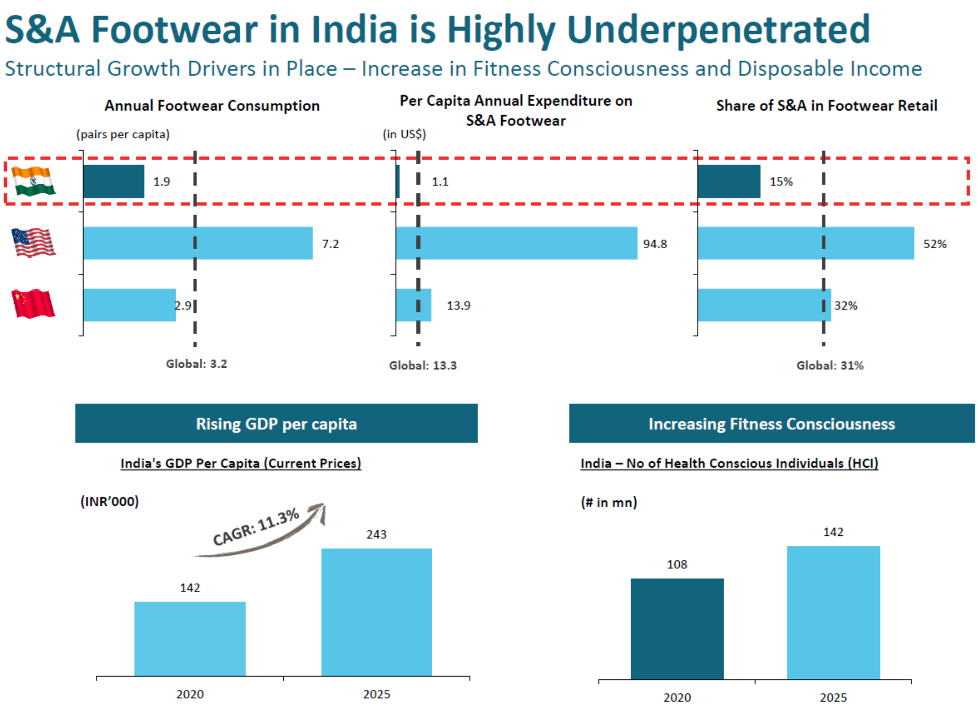
g. **Relaxo's higher degree of backward integration versus competition could give it an edge in the next 2-3 years.** Relaxo's completely backward integrated operations allow it to be more agile in managing its SKU mix and reacting to change in demand trends. Our channel checks suggest that on account of hefty import duty (in the range of 20-30%) imposed by Indian govt on imports of footwear from China, Cambodia and Vietnam, it is no longer viable to import and compete in the market. As a result, all the big brands in the business are scouting for quality vendors to outsource manufacturing; quality manufacturing is on short supply as of now.

h. Casual/sports shoe market is extremely attractive from long term growth point of view.

1. Nike's US sales (only footwear) have grown at 7% CAGR in the last 9 years, in USD terms. This is pretty high growth considering that this is an 'old consumer' category. This implies that growth in India in this category, also will be leading amongst all consumer categories for a long time to come, for brands which are able to evolve along with the customer.

Nike's sales of footwear in North America, May fiscal year-ends											
US $ (bn)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**CAGR (%)**
Sales	6,687	7,495	8,506	9,299	9,684	9,322	10,045	9,329	11,644	12,228	**7%**

2. In India, there are many levers which will drive long term growth for dominant brands: 1. Organic growth of market driven by premiumisation and higher consumption (people buying multiple pairs), 2. Consolidation of the market from very fragmented state as of now.



3. Globally, this category has not been disrupted (for incumbents) by new players by either, tapping premium niches within the category or by using new distribution channels led by e-commerce, as has happened in most of the other consumer categories. Hence, in our view entry barriers are high which bodes well for sustenance of market leading growth for incumbents in India in the long term.

4. In our view, only the companies (Indian) which would be able to evolve with consumer preferences by investing in R&D and design, will be able to leverage the above long-term trends; rest will fall by the wayside. We rate Relaxo's mgmt. as top notch and hence are hopeful that the mgmt. would be able to steer the company to gain out of the above trends.

Risks:

1. Campus has been following an aggressive e-comm focussed strategy and obviously (since we are not industry experts) has a decent probability that it could pull it off and later maybe it could align its strategy to take the offline channel also along in its growth path. If this materialises then it would become the dominant brand in casual/sports shoe category by a wide margin versus Sparx. In our view, street does not like a distant second brand even if it could be doing well in its own respect. Hence, there is a risk that Relaxo's multiples could get de-rated in that scenario.
2. Non-Sparx portfolio could grow at much lower rate versus our assumption of 6-8% CAGR. This is a mature category (given very low-price points). Also, our understanding of this category is not great and there could be risk that growth could start slowing to lower levels versus our estimates.
3. Overall look/feel (in terms of designs) of the Sparx brand seems to be a notch below some of the other players (Campus, Puma and other global brands) in the market; this observation is based on our perception and hence could be wrong. If this is true and the company is unable to contemporise its designs in the near future, it might start losing its consumer franchise in the long term which would also reflect in long term performance of the stock.

   As per our understanding, almost 50% sales of Sparx brand are in sandals category; shoes has been growing faster over the last 1-2 years and hence management focus is now more on the shoes segment. Relaxo is in the process of constructing its R&D center in Delhi which would boost its product quality in the coming years. Also, in our view, making designs more contemporary is not that tough as Relaxo has the necessary wherewithal to build a top of the line design team; our channel checks suggest that Relaxo (Campus as well) have the brand recall to attract top 10% of the students in the premier design institutes of India. Hence, we think, improving design element just requires a nudge or focus from the top management. We are hopeful that Relaxo would be able to work on the above aspects and would keep on growing its customer franchise over time.

Trailing financials

On TTM (trailing 12 months till 3Q23) basis, the company has delivered sales, EBITDA and PAT of Rs27 bn (flattish yoy), Rs3.3 bn (-22% yoy) and Rs1.54 bn (-34% yoy)

Profit and loss account (Rs mn)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Sales	14,808	17,118	16,312	19,411	22,921	24,105	23,592	26,533
Gross profit	8,354	10,039	9,053	10,580	12,198	13,712	13,559	14,366
EBITDA	2,006	2,399	2,309	3,021	3,243	4,090	4,955	4,158
PBT	1,426	1,776	1,780	2,436	2,680	2,917	3,912	3,106
PAT	1,030	1,174	1,200	1,611	1,754	2,263	2,916	2,327
Balance sheet								
Equity	3,678	4,896	6,064	7,612	11,051	12,724	15,724	17,601
Total debt	2,110	2,095	1,318	1,254	869	192	0	200
Other liabilites	343	291	332	345	435	1,554	1,543	1,614
Total sources of funds	**6,131**	**7,282**	**7,714**	**9,211**	**12,354**	**14,469**	**17,267**	**19,414**
Gross fixed assets	6,557	6,899	5,224	5,575	9,411	9,473	9,753	11,371
Net fixed assets	4,669	4,623	4,798	4,698	8,005	7,501	7,211	7,694
Other long term assets	69	962	1,236	1,926	591	2,765	3,350	3,668
Cash and cash equivalents	167	279	238	302	271	274	3,855	2,412
Inventory	2,487	2,858	2,902	3,139	3,824	4,477	4,221	6,733
Debtors	821	1,087	1,232	1,735	2,226	1,721	1,815	2,508
Loans and advances	141	216	263	231	435	22	5	13
Other current assets	58	62	34	468	763	1,651	1,301	799
Trade payables	926	1,224	1,257	1,749	1,718	1,838	2,228	2,217
Other current liabilities	1,356	1,581	1,733	1,539	2,042	2,104	2,263	2,193
Total uses of funds	**6,131**	**7,282**	**7,714**	**9,211**	**12,354**	**14,469**	**17,267**	**19,414**
Cash flow statement								
Cash from operations	1,075	1,594	1,802	1,543	1,235	3,189	5,131	560
Cash from investing	-1,298	-1,303	-894	-1,084	-569	-1,157	-4,532	146
Cash from financing	211	-313	-895	-463	-682	-2,026	-562	-698
FCF	-238	246	899	453	311	2,028	3,898	-835
Margins (%)								
Gross	56%	59%	56%	55%	53%	57%	57%	54%
EBITDA	14%	14%	14%	16%	14%	17%	21%	16%
Return ratios (%)								
ROE	32%	27%	22%	24%	19%	19%	20%	14%
Pre-tax ROCE (%)	32%	31%	27%	31%	26%	25%	29%	19%

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