**Investment thesis: Delhivery Limited (Emerging Leader, Phase 3 company)**
We took an initial position of 3% in Delhivery, a logistics firm.

- Logistics is an industry with decadal tail winds. We believe the sector will grow 12%+ and leaders can grow at 15%+ for long periods of time.
- Delhivery has a competitive edge and is investing to enhance the same.
- It can be 20% ROE business at scale.
- We are aligned with the thought process of the promoter / management team.
- We are paying a price that is broadly reasonable.

**What does Delhivery do?**
Delhivery is India's largest fully integrated third party logistics services provider with its nationwide network covering over 18,600 pin codes. The company provides a wide range of logistics services.

| Segment | Description | Revenue share FY23 | Competitive position |
|---|---|---|---|
| Express Parcel Delivery (EPD) | Caters to e-commerce players both for shipping products and managing reverse logistics. | ~63% | Largest player in the third-party EPD industry (i.e., excluding captive logistics of Amazon and Flipkart)<br>• ~40% volume market share<br>• ~2x higher shipments than the closest competitor[1] |
| Part Truck Load (PTL) freight | Caters to product movement where customers don't have enough volumes to fill a truck by aggregating loads from multiple customers before shipping it to end destinations.<br>The shipping requirements could be express (time sensitive) or normal. | ~16% | Number 3 player with potential to gain market share from unorganized segment. |
| Supply Chain Services (SCS) | Solution for customers who want to outsource all or multiple parts of their logistics like transportation, inward store management & warehousing. | ~11% | |
| Truck Load (TL) freight | A customer can fill an entire truck of a logistic partner | ~6% | |
| Others | Technology services, cross border logistics services | ~4% | |

In this note, we focus on the 2 main segments EPD and PTL which contribute about 80% of revenue.

There are 4 key variables critical to long term success in Logistics.

- Scale: essential to have the best cost structure vs peers.
- Fastest delivery times with highest service levels, i.e., minimal misplaced or damaged deliveries.

[1] Spark Capital

- Technology leadership: capability to manage rapid variations in demand. Also key to improving network efficiencies on parameters such as truck turnaround time, utilization levels which allow one to operate at the lowest cost structure.
- A willingness to continuously re-invest to be competitive on costs and technology. Aiming to boost profitability at expense of growth will lead to a decline in competitive position.

**Early years and reaching the leadership position in EPD industry.**

Delhivery was founded by five engineers[2] in 2011. Existing logistics solutions at that point were not addressing the needs of E-commerce industry. The existing logistics players were:

- Taking 3-5 days to deliver when E-commerce companies wanted them to deliver in 1-2 days to gain share from offline retail.
- Neither equipped to handle Cash on Delivery (COD) nor to manage reverse logistics for shipments returned by customers.
- Their technology did not allow real-time order tracking.

The hypothesis of the founders was that they could build a better logistics company by:

- Building the widest coverage as Ecommerce was seeing fast adoption beyond the top cities.
- Providing fastest delivery times with highest service levels (i.e., minimal misplaced or damaged deliveries) at lowest cost by operating a mesh network3 and making appropriate technology investments. Existing players were following the traditional hub and spoke model which was not the most cost efficient4 and we were also underinvested in technology.
- Enabling COD and reverse logistics.

Delhivery claims it has built the lowest cost network:

- Its "mesh" network offers more flexibility, lower shipping times and lower cost vs a traditional "hub and spoke" model which follows fixed shipment paths and offers lower flexibility and higher costs.
- Making significant upfront investments in technology5 which would in the long run help run their operations more efficiently than peers.
- Investing in best-in-class network infrastructure such as automated sorting centers to improve overall productivity and reduce errors.

The lack of competitive data means we cannot independently verify this claim. But this hypothesis is not contested by peers we have spoken to.

By creating the fastest delivery at the lowest cost, and by sharing gains with customers, Delhivery is creating a virtuous cycle which would enable it to maintain its dominant market share.

- Widest coverage and fast delivery attract customers.
- They gain scale which further improves their cost position.
- By passing a part of scale benefits back to customers, they help reduce shipping costs for customers which help expand the ecommerce market by making more categories cost competitive vs off-line.

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[2] Sahil Barua, Mohit Tandon, Bhavesh Manglani, Suraj Saharan and Kapil Bharati

[3] A mesh network can directly connect to intermediate processing centres, service centres or delivery centres in real-time as opposed to a hub and spoke model which follows fixed shipment paths and offers lower flexibility resulting in higher costs.

[4] Inefficient networks meant higher costs for logistics companies which would indirectly be passed on the E-commerce companies which were loss-making slowing the pace of growth of E-commerce penetration.

[5] Applications which allowed the company to govern the transaction flows from end to end, improve precision and service levels, use transaction data and to facilitate real time operational decisions, process network data collected to build capabilities like route optimization, load aggregation, ETA prediction etc. were built in-house.

- This also helps them gain additional market share, which further drives down costs and helps create a virtuous cycle.

Consistent execution of this strategy over the last decade has led to Delhivery becoming the largest third-party player in the EPD industry with ~40% volume market share and ~2x the scale of the next competitor (excluding captives). EPD revenues have grown at a CAGR of 38% between FY18-FY23.

**Next stage of evolution: Building PTL business to further leverage EPD industry leadership.**
Delhivery is now using its scale in the Express Parcel Delivery (EPD) business to build scale in the Part Truck Load business. The PTL industry, is large (~Rs 70000 Cr) and largely unorganized[6].

If Delhivery could execute as well here as they did in the EPD segment, they can gain disproportionate scale vs. its peers.

- Delhivery will operate an integrated network (common warehouse and trucks) for its EPD and PTL segment. This would result in better utilisation for existing infrastructure, leading to further reduction per unit cost.
- Unlike traditional logistics companies which run separate networks for express and non-express shipments, Delhivery's integrated network aims to run on express alone given it was built around needs of their EPD customers. Hence, many potential PTL customers who were used to time indefinite service would enjoy a much faster service at the same or better pricing vs. earlier. This could aid market share gains in a highly fragmented industry.
- Delhivery is deploying 46 feet vs. industry standard of 32 feet trailers and very large facilities7. These reduce costs by ~25% per unit vs smaller ones.
- Unorganized players have low overhead and therefore can be very competitive on specific dedicated routes, but they may struggle to keep up with investment requirements and technology integrations. Many customers don't want to work with multiple logistics players to reduce admin complexity. Hence, a larger share of PTL could shift to organized players.

As Delhivery's organically built PTL business was subscale and entry barriers were high to build a pan-India PTL business, it acquired Spoton (a leading player in express PTL) in August 2021 to build scale.

**Tough to replicate Delhivery's competitive position.**
Delhivery's competitive edge is tough to replicate and should result in increasing market share for Delhivery over the years:

- Delhivery is the lowest cost operator given its significant scale advantage vs. peers in EPD segment and this edge is improving as it is scaling its PTL segment. Delhivery can use this position to defend or gain market share. Delhivery's contention (something which we are unable to verify independently due to lack of data on other players) is that they have built their network such that they have the lowest cost of operations on first, mid and last mile which means no aggregator can unbundle these legs of transportation to give lower price.

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[6] The PTL industry is split into economy PTL (~Rs 54000 crores) which is ~10% organised and express PTL (~Rs 16000 crores) which is ~55-60% organised according to various sources such as management interactions, Spark Research.

[7] The mega gateway at Bhiwandi is one of India's largest logistics facilities and combines automated hub, sortation, returns, and freight operations with the capability to handle EPD and PTL freight volume simultaneously. Spread over 1.2 mn sq ft, it has 196 docking stations and is designed to transact over 8,000 tonnes of freight, with 1600 vehicles transiting through it daily, ~ a vehicle every minute.

- Our interactions with Delhivery's peers suggests that the technology applications built by Delhivery are significantly superior to anyone else in the industry which allows them to run their networks much more efficiently8.
- Delhivery's strong balance sheet (~Rs 5000 crores in cash) and ability to price the lowest given the lowest cost structure should act as a big deterrent for a player who wants to compete irrationally on price. Delhivery claims that its costs are even lower than that of captive players like Amazon which give the latter no incentive to attack incumbents as it has done in the US.

**The leadership team inspires confidence.**
Strong management teams tend to surprise on the upside which cannot be seen today (an adjacency we couldn't imagine, superior execution vs. our expectations, etc.). We like the fact that they are focused on long-term outcomes and enhancing their competitive edge. There is consistency, clarity, and granularity in thought process and shareholder communication.

Their candour in admitting what went wrong with the acquisition of Spoton (challenges in the IT system and process integration between the 2 companies resulting in poor service levels as well as acquiring customers which they didn't want to work with led to PTL volumes dropped by ~43% in process of integrating Spoton with Delhivery) and ability to resolve this challenge give us comfort that we can trust this management team.

Even the venerable HDFC Bank has underinvested in technology which has got exposed in the last 2 years. Teams will commit errors, but willingness to acknowledge them gives comfort that management deals with reality rather than wishes it away.

**Steady state economics of this business and ascertaining fair price.**
Delhivery is investing aggressively on both capex and opex to gain market share and is not profitable at present as profits in some segments are funding losses elsewhere. Revenue growth will be accompanied by high incremental gross profit growth as seen in the last few quarters:

| Particulars (Rs crores) | Q2FY23 | Q3FY23 | Q4FY23 | Q1FY24 | Q2FY24 |
|---|---|---|---|---|---|
| Incremental revenue in transport segment | 107 | 59 | 29 | 44 | 35 |
| Incremental Gross Profit (GP) in transport segment | 53 | 58 | 41 | 17 | 18 |
| Incremental GP Margin | 50% | 98% | 141% | 39% | 51% |

We expect the high incremental gross profit margin to continue till capacity utilization normalizes. Further, there will be operating leverage on the fixed overheads in the business leading to rapid profit growth. As this plays out, it is not unreasonable to expect Delhivery to generate 18-20% ROE when it reaches critical scale as one of the largest and the lowest cost operator in the industry:

[8] One example of this is Delhivery's technology deciding how the shipments in a truck should be loaded before the truck is filled to ensure fastest loading and unloading timelines and least potential damage to a shipment while peers use manual judgement to do the same.

| Revenues | ~9000 crores | ~25000 crores | ~45000 crores |
| --- | --- | --- | --- |
| Freight, handling | ~73% | ~71% | ~70% |
| **Gross profits** | **~27%** | **~29%** | **~30%** |
| Direct costs like employees, rent, etc. | ~15% | ~12% | ~10% |
| **Service EBITDA** | **~12%** | **~17%** | **~20%** |
| Corporate overheads | ~11% | ~6% | ~5% |
| **Pre-Ind AS 116 EBITDA (pre-ESOP)[9]** | **~1%** | **~11%** | **~15%** |
| Depreciation | ~8% | ~5% | ~4% |
| Core PBT[10] | ~-7% | ~6% | ~11% |
| **Core PAT[10]** | **~-7%** | **~4%** | **~8%** |
| **Operating Cash Flow as % of revs.** | **~-1%** | **~7%** | **~10%** |
| **Free Cash Flow[11] as % of revs.** | **~-8%** | **~2%** | **~6%** |
| **ROE** | **NA** | **~12%** | **~20%** |

Note: We use ranges for our internal evaluation and have shared mid-points for above discussion.

| Peer companies (FY23) | Revenues (Rs crores) | Pre-IndAS 116 EBITDA margin | PAT Margins | ROE |
| --- | --- | --- | --- | --- |
| Safexpress (Express PTL) | 3110 | 11% | 8% | 15% |
| TCI Express (Express PTL) | 1241 | 16% | 11% | 23% |
| Blue Dart (Air cargo and Express PTL) | 5172 | 13% | 7% | 33% |

One cannot use traditional valuation metrics such as earnings or cash flow multiples to value Delhivery at this point given that the business is sub-scale. Our approach is to estimate the broad conservative Core PAT and Free Cash Flow (FCF) the business could generate in a decade and value the business then at ~30x Core PAT plus cash on books for a ~20% ROE business at that time. That would imply ~40x FCF plus cash on books. We then discount that price to today to obtain a price we are willing to pay for an initial position. Based on this approach, the current price is reasonable for our initial base position.

**Risks we are aware of.**

Inability to scale the PTL business would impact profitability estimates. There are strong regional players in the PTL segment who can match speed and reliability of larger pan-India players in the region or specific routes where they operate at much lower cost structures.

While the Rail Dedicated Freight Corridor (DFC) will not be a disruptor of EPD given it may still be faster[12] and cheaper to ship EPD parcels using road given DFC can't offer the last mile connectivity[13], the express PTL business growth could be impacted if DFC becomes a cheaper option vs. road for some customers like those sending shipments to ports for exports. However, this is something we will evaluate as we go along.

[9] We build ESOP impact by assuming a fully diluted share count when thinking about our entry price.
[10] We have used Core PBT and Core PAT which is PBT and PAT excluding treasury income.
[11] Free cash flow defined as Operating cash flow less capex.
[12] Moving freight from California to D.C. takes seven to ten days on the rails; a truck driving team can shrink that to 2.5 days while offering door-to-door (The Secret Life of Groceries (p. 99). Penguin Publishing Group).
[13] Given that the last mile is the most expensive leg of a delivery, Delhivery's overall cost structures may not be significantly inferior vs transporting via rail. In this Amazon AI Conclave 2019 - Talk by Delhivery, they mention that last mile is 25-30% of the total cost of delivering a shipment though the distance covered in this leg of the segment is less than 10% of the total distance the shipment travels implying it is the most expensive leg.