“United Breweries Q3FY18 Earnings conference call”

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Moderator: Ladies and gentlemen good day and welcome to the United Breweries Q3FY18 Earnings Conference Call hosted by IDFC Securities. As a reminder all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during this conference call you may signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Harit Kapoor of IDFC Securities. Thank you and over to you sir.

Harit Kapoor: Thank you Mallika. On behalf of IDFC Securities we would like to welcome you all to the Q3 FY18 Conference Call of United Breweries. We have with us senior management of United Breweries, Steven Bosch – CFO and Mr. Poonacha from Finance and Investor Relations. I would like to hand over to Steven for the opening remarks. Over to you Steven.

Steven Bosch: Thank you Harit. Thank you everybody for joining the call. Good afternoon and this is our quarterly results conference call for Q3.

Our results for the quarter are showing the effects of an improved industry with UBL outperforming the beer industry. The company recorded volume growth in all regions except for the west. Our volumes grew by about twice that of the industry growth rate of 6% in Q3. Our market share increased by around 200 basis points and revenues net of excise duties were up by 14% Q-o-Q. We have been able to outperform the market despite the temporary absence that we have seen in Maharashtra.

Following an announced excise duty increase in October, we did not supply to the market for about 2 months due to a lack of clarity on the duty structure. We are pleased to inform that the situation in Maharashtra has now been solved with business as usual since the end of December after the revised pricing structure was finally clarified. For the quarter if you look at our profitability, our gross profit margin was slightly impacted on account of the effects of GST on the input costs as well as higher input prices of barley, sugar and rice as compared to last year. Furthermore, our state mix has been an important factor here with the limited sales realized in Maharashtra but on the other hand, strong growth in markets like Andhra Pradesh and Telangana.

Our normalized EBITDA grew by 18% Q-o-Q and with the term normalized we are referring to an adjustment made for a large government subsidy that we obtained last year in Q3 2016 and this subsidy was towards capital investments made in Aurabarlngabad Brewery and amounted to more than Rs. 30 crores. Adjusted for that incidental we saw healthy profit growth in the quarter, also the result of good cost control and capturing the benefits of operating leverage with our volumes picking up.

Then on a year-to-date basis for the last nine months, we have seen an industry that is back in growth mode.

Whilst the beer market as a whole has recorded a volume growth of about 3%, our volumes have gone up by some 6% and our net revenue is up 13% for the first nine months. The first couple of months of the year were clearly impacted by the highway ban implementation but there has been an upward trend since the end of Q1 and the highway ban impact is now largely behind us with some pockets of the Indian market still affected, that is mostly in Kerala and in Tamil Nadu. For the balance of year, we do expect the industry growth to continue, however some announced changes in excise policies in several states may trigger some supply distortions. An example here would be West Bengal where we recently saw the announcements of rather steep excise increase and also there the volumes goals are likely to be impacted.

Having said that the overall PAN India market growth expectation of mid-single digit growth is maintained.

That is it for my introduction and operator, Harit let us move to Q&A. Thank you for now and looking forward to your questions.

Moderator Thank you very much sir. Ladies and gentlemen, we will now begin with the question and answer session. We have the first question from the line of Sonali Salgonkar from BOB Capital Market, please go ahead.

Sonali Salgonkar: Sir my first question is pertaining to the volume growth in the industry. Now if we look at the historical trend of United Breweries it being the market leader, till I think 2010-11 we were clearly in high double-digits in terms of volume growth, post which the industry as well as our company started reporting lower volume growth. So my question is when do you foresee the industry as a whole recovering back these numbers of double digits, may be not the high double digits but at least double digits like up till the mid-teens. And what could be the triggers leading to that?

Steven Bosch: I think you are referring to a period some 6-7-8 years ago where the growth was really strong double-digit. Over the last 4-5-6 years growth has been more muted, and the more recent past up to last year there was even a small decline of the industry and that is all related to the regulatory framework or regulatory environment we are working in, with constant excise increases, and issues related to the availability of beer. For instance, the recent example of the highway ban, in some markets lack of affordability of beer, sometimes compared to spirits being the more affordable product. So there are some regulatory/excise related issues that do continue to hinder further growth. But in absence of such impediments we would see a continued strong growth for the industry.

Sonali Salgonkar: So the current excise duty for the beer industry on an average I am saying is at around 55%. Do you foresee that to increase in the near future?

Steven Bosch: Well I just gave you example or two examples in my introduction, of markets like Maharashtra, like West Bengal and they will definitely not be the last markets to announce excise increases. So yes, the percentage of 55% that we are seeing now is after multiple years of increases. So I think a couple of years ago the percentage of excise what less than 50%, more towards the 45-46%. So there has been an increasing trend and that trend is likely to continue.

Sonali Salgonkar: Sir and just a bookkeeping question, this quarter we saw the tax rate at about as a percentage at about 40%. How should we look at the tax rate going forward?

PA Poonacha: In quarterly results what happens is the tax rate effective for the quarter is resultant of the YTD tax rate which is based on current tax and deferred tax which has implications with respect to the timing difference between the fiscal and the company books. So if you look at the year end picture for the full year, you should look at in the region of 35%.

Sonali Salgonkar: And also in the opening remarks you mentioned that your market share has gone up by 200 bps, so would it be at around 53% right now or more than that?

Steven Bosch: I would say it is around 52-53% range.

Sonali Salgonkar: Last question, the government subsidy of more than Rs. 30 crores which you mentioned was reflecting in the other non-operating income in Q3 FY17. Is that correct?

Steven Bosch: Yes.

Moderator: Next question is from the line of Ashit Desai from SBI Cap Securities, please go ahead.

Ashit Desai: First question is again on volume growth, if you look at industry volume growth of 6%, this is on a back of 8% decline last year. That does not look too good. So how do you see volumes, industry volumes going forward and if we were to look at a normalized trend excluding Maharashtra if you can give us the volume trends for industry in UBL?

Steven Bosch: Yes, the volume trend as we have expressed, as we have guided before, would see a continued mid-single digit volume growth for the industry in the absence of big shocks like the highway ban for instance. That is expected to continue and of course Maharashtra is a big market with UBL not being the only party not supplying for most of the quarter in Maharashtra. That has also impacted the volume in the total country.

Ashit Desai: Yes, so if we exclude Maharashtra Steven, what would be the industry and UBL volume growth?

Steven Bosch: Yes, again so our guidance for the coming quarters is the mid-single digit growth and Maharashtra will of course will be back to normal with of course a higher MRP than that was applicable before October. So there also you got to see the impact that needs to be digested by the consumer on account of this higher price.

Ashit Desai: And secondly one of the players had mentioned about distribution challenges in UP, Punjab, Haryana. So was there any impact from these markets in this current quarter and going forward what was the possible impact that one can expect from these markets?

Steven Bosch: When it comes to the impact so far up to Q3, no impact really that we saw. In Haryana and other markets we mentioned it may come in the coming months up to March before the start of the New Year. But we will get to see exactly how these policy changes will pan out. It is not yet fully clear when it comes to any policy changes.

Ashit Desai: How large are these markets for us?

Steven Bosch: Markets like Haryana, is not a big market for us. Same is true for Punjab. They are maybe a percent, one or two. UP is a bigger market. UP we follow closely to understand how this policy change will pan out. So now there is this monopolist, that situation may change into many wholesalers each controlling a region in UP. So that may change the situation a bit. UP is the larger of the markets, Haryana and Punjab are clearly small.

Ashit Desai: And do you see this corporation model turning out better for the industry, for the working capital, margins etc?

Steven Bosch: For UB I think generally over the years we have seen that a corporation model is beneficial. It is reliable, let us say a reliable customer with no credit risk. It gives an opportunity to really have a level playing field in the market, and with our brands being strong brands, it is beneficial to have a level playing field when it comes to distribution. And of course you will not face any issues when it comes to risk on receivables, like in some markets you may have.

Moderator: The next question is from the line of Anuj Bansal from Ambit Capital, please go ahead.

Anuj Bansal: Expanding on Ashit's question, one of the reasons why some other players have talked about Haryana, route to market being an issue is because of the credit risk, so obviously the demand situation remains intact, but they are worried that as some of these wholesalers got off business there might be credit risk. So what is your reading of the situation on that front? That is first question. And the second question is for Maharashtra, exactly when did sales resume? Did they resume within the Quarter 3 itself or resumption happened largely in Quarter 4 as we speak now?

Steven Bosch: So your first question is around Haryana and the credit risks there. Yes, you are correct, we do operate in a market where you have multiple wholesalers with their regional strongholds. They are run by private individuals and the credit, the collection risk is there as opposed to a market where you have a corporation. We have over the last quarter been carefully looking at the situation and monitored the credit risk. So we still need to see exactly what is going to happen in April and we are actively managing our balance sheet or actively managing the credit risk in the meantime.

Anuj Bansal: Sir if I can just expand on that one, have you changed your collection policy because the reason I am asking is the credit risk which is inherent to the business will be enhanced right now because some of these wholesalers would be anticipating going out of business in few months time and they might feel less obligated to settle their dues, so not a good thing from their behalf but this is a practical business which might be coming up that some of these might feel they are not obligated to pay their past dues anymore and the credit risk which is inherent might actually be enhanced at this point in time. So have you by any chance changed your terms of trade at this point in time?

Steven Bosch: Yes, we have been extra vigilant or careful to not over extend where the customer looks like a potential risk. So it is on our radar and of course for me it is important to see what this policy change will actually result in. So that policy is also still not comprehended.

Anuj Bansal: And on Maharashtra then?

Steven Bosch: Maharashtra situation got resolved in last week of December so round about 26th of December there has been some primary sale in the last week of the quarter.

Anuj Bansal: So it has not got restocked to the prior levels but some of it did happen in quarter 3 itself. So whatever destocking would have happened since October some of it got restocked in the channel in quarter 3 itself and there might be only some spillover effect in quarter 4 now.

Steven Bosch: Yes, it was a very small portion, you need time to restart your packing lines and so on, so limited dispatches to the market. So in 4-5 days we have been able to do what we could. It clearly has resulted in some further pipeline filling at the start of Q4.

Moderator: Next question is from the line of Amar Kalkundrikar from HDFC Mutual Fund, please go ahead.

Amar Kalkundrikar: Sir you have made a comment that corporation market is sort of good for you on a relative basis. Can you elaborate on that a little more? I thought you will have more restrictions on lesser freedom in pricing those markets, so can you just elaborate that comment please?

Steven Bosch: Yes, so even within the corporation model, you have of course multiple types of policies, one where you can pursue price increases on a regular basis. Others where price control is much stricter, where you are not granted on annual or more regular basis price increases. Leaving aside the pricing or excise regime, in a government led distribution model over the past years, we have seen that we are getting a fair share of the market with brands that have a strong equity and are preferred by consumers.

Amar Kalkundrikar: You mean to say that these corporations do not try to intervene or favor one party versus another, whatever is the pull at consumer level that is what becomes primary demand?

PA Poonacha: I will step into clarify here. If you see what Steven was trying to say is, each corporation when it comes to pricing is a little different. For example, the corporation in Karnataka the pricing is free to the supplier of beer, meaning there is a particular multiplier wherein if your ex-brewery price is x, what the duty is, what the case margin is, what the MRP is. However, if you go to another state like AP or Telangana there the price is fixed by the state government wherein if you want an enhancement in the ex-brewery price you need to apply to the government and they would once in three years give us an increase, the last price increase agreed was in 2015. So they would consider and give us a price increase. So that is with respect to price. With respect to ordering, most corporations order based on secondary sale, meaning to say, that at the end of each month based on the previous month's sales from the corporation depots to the retail, on that percentage basis they give out permits to the various suppliers of beer. So that is with respect to most corporations, baring the Tamil Nadu Corporation, they give it based on capacity or some other formula they have which, is not necessarily market pull driven. So with respect to ordering only Tamil Nadu is an exception. That is the clarification I want to give you.

Moderator: The next question is from the line of Abhishek Banerjee from UBS, please go ahead.

Abhishek Banerjee: Just wanted to understand is there a market share gain for the brewery business overall from the spirits business given you are actually growing volumes whereas the spirits business overall would not be. That is one question. And the second is for the corporation model, could you please explain us what happens to the working capital for the brewer and what happens to the working capital for retailer say when a state is moving from distributor model to a corporation model.

PA Poonacha: I will take the second one first. You are talking about working capital block with respect to the government corporation, right?

Abhishek Banerjee: Yes, as in vis-à-vis a distribution model.

PA Poonacha: Now if you look at an open market or a distribution model like Maharashtra, it is purely on your credit terms, wherein, where you say cash and carry, you get your money upfront and you lift the stock, or if you take open market like Haryana with your credit term you dispatch on the credit term you have an instrument in hand to bank at a later date. So that is with respect to open markets. With respect to corporations, each corporation has their own formulae. Now most corporations pay only after secondary sales, meaning where the corporation bills the retailer, after that they will pay the supplier of beer. In case of Andhra Pradesh it is almost 45 days after sales. That means, if they sell in this week then 45th day from this week they would pay you the secondary sales that they have made. So they are enjoying more working capital than what they have actually put in. That is with respect to certain markets. There are other markets like Kerala where including retail is run by the corporation. So there when you are finally sell from retail we get paid. In Tamil Nadu though the corporation also runs a retail. They have another model where you get close to half the payment based on dispatch itself and the other half on the product reaching the depot. So each corporation is different and the credit terms are different. So baring Tamil Nadu model where a portion of the working capital is funded by the government, in most corporations all the working capital is funded by the supplier of beer. What was the other question?

Abhishek Banerjee: Yes, so just expanding on this, so in essence basically once the state moves from distribution to a corporation model, there is some excess working capital required for the suppliers. And now just trying to understand the other part of the working capital need, which is working capital need with a retailer. Now, from what I understand where there are 3-4-5 distributors who are distributing to the retailer, there is some competition aspect. And actually, the retailers also get some favorable credit terms, whereas that is not the case with corporations. So in that kind of scenario do you actually see a negative implication for demand as in, will these retailers actually down-stock to ensure that they are having to pay less, something of that sort?

PA Poonacha: If you look at how a retailer operates, retailer has limited space, meaning he would have so many sq. ft. of place to display and hold stock. Now he would hold stock of brands which sell the fastest. Meaning to say that if he has to have a choice between plugging his money on brands, he would plug his money on the fastest moving brand, so it will work better for us.

Abhishek Banerjee: And the other question was are you seeing a structural shift in terms of consumption moving from spirits to beer? As in, I know it is a very futuristic question given the relative sizes of the two markets but trying to just understand because spirits overall the industry is not really seeing growth, whereas you are seeing mid-single digit growth 3-4-5% whatever. Is there any structural shift that is happening there or is it more a function of may be excise increases being more delayed in case of beer than in spirits?

PA Poonacha: The data you have got it shows that spirit is going less than beer, your source of data I am not able to get, because if you take spirits, I mean you need to take spirits along with country spirits also. It is not IMFL alone because consumer of alcohol be it beer, be it spirit, be it country spirit, his choice will fluctuate based on price points. So if you are looking at IMFL alone vis-à-vis beer it is not the right way of looking at things.

Abhishek Banerjee: So from that point of view you would say that, maybe country spirits is actually growing faster which we are not actually capturing in?

PA Poonacha: I do not know, because without numbers I cannot comment, but all I can say is the consumer would fluctuate based on the put down price, you need to consider the various options he has.

Moderator: The next question is from the line of Mayur Gathani from OHM Group, please go ahead.

Mayur Gathani: Sir just wanted some outlook on your raw material prices you mentioned in the opening remarks about high barley and high sugar prices, so how do you see that impacting?

PA Poonacha: Barley prices for this year, I do not think you will find more impact in our financials. Reason being we have already procured the barley required for this financial year. Now the price of barley going forward, it depends on the crop. The crop would start coming only in March-April, so once the crop comes in, only then we can comment. With respect to rice I think it should be fairly stable but sugar there is upward trend.

Mayur Gathani: And just to reiterate, you mentioned the volume growth for the industry was 3% in the last months and UB grew 6%?

PA Poonacha: Yes, you are right.

Mayur Gathani: And you still see some impact of highway ban on Tamil Nadu and Kerala, I mean the rest of the country is more or less in place. Why these two specific states are still lagging behind?

PA Poonacha: It is rest of Maharashtra and Kerala.

Steven Bosch: And Tamil Nadu as well. So I think for those markets you see that the government has been not really been willing or not been able to find suitable, alternative locations outside of the municipal limits. So it is more of a difficulty to get all the outlets back to the level they were before the highway ban was implemented.

Mayur Gathani: Okay, so rest of Maharashtra and Tamil Nadu?

Steven Bosch: And Kerala. Tamil Nadu and Kerala we have highlighted in particular also because in Maharashtra there were other issues that we faced of course in Q3.

Moderator: Next question is from the line of Sonali Salgonkar from BOB Capital Markets, please go ahead.

Sonali Salgonkar: Just one question, what is your CAPEX guidance currently and what is your capacity utilization right now on an average?

Steven Bosch: CAPEX guidance in terms of annual CAPEX spend is around Rs. 250-300 crores so that is the guidance we give. And secondly, we are looking at round about 70% of capacity utilization.

Sonali Salgonkar: Sure. Sir I am just reconfirming one more industry, your 9-month industry growth was at 3% volumes and just for Q3 the industry growth was 6% volume, right?

Steven Bosch: Yes, correct.

Sonali Salgonkar: So in Q3 UBL volumes were twice that of industry, so around 12%?

Steven Bosch: Correct, yes.

Moderator: Next question is from the line of Vivek Mistry from SBI Caps Securities, please go ahead.

Vivek Mistry: So I would like to know one thing, what is your current quarter A&P spend and how it has increased and given that you have gained 200 base market share in the current quarter what are competitors doing? Are they increasing their A&P spend?

PA Poonacha: This is one number that we do not share, and we have clubbed this with our other spends with respect to discounts. Reason being we are market leaders and we are a listed company, we won't want companies to know what spends we are making on brands.

Vivek Mistry: Okay, and given that you are have gained market share, have you seen any increase in A&P spend or any increase in activity from the competitors?

PA Poonacha: Yes, we have seen activities in the competition, competition spends larger amounts towards discounting but we as market leaders do not do much of discounting. We believe in band building, which we have done even in years were the volumes have tanked also.

Moderator: The next question is from the line of Harit Kapoor from IDFC Securities, please go ahead.

Harit Kapoor: Couple of questions from my end. Just wanted to check firstly you had mentioned input cost pressure has been one of the reasons for the gross margin reduction, of course along with big impact being mix. So just wanted to get your sense of what the trend is like on the inflation front for you in terms of – if you can give us a sense on what the average input cost inflation is looking like or it was in Q3 and is looking like going forward?

PA Poonacha: Like I just mentioned our major costs are barley, rice, sugar and bottles and with respect to this financial year I do not see a very big change in what we have already seen. But the coming year we need to see, how the barley crop pans out and how the glass industry is placed, I mean there is a lot of things which we need to look at with respect to glass. Because even if you have the returnable bottles, the percentage of new glass we need to buy, so that is a variant of several external factors which are difficult to predict for more than a quarter.

Harit Kapoor: The other thing was if you kind of look at your other expenses line for the last several quarter, it has been growing, the increase has been lesser than the sales increase. Now if you could just you know, which means obviously some operating leverage is coming through, if you could just give a sense on where the saving is coming from on the cost line, whether it is slightly lower A&P part as well it is just your cost initiatives which are kind of helping this come through?

PA Poonacha: There are cost initiatives, there are initiatives with respect to lower discounts with better managed freight cost. It is a host of things started.

Harit Kapoor: I mean just to take that point further, if you look from FY14 to FY18, last four years you have seen some pressure on the gross margins because of inadequate price increases and also the higher input cost but that pressure has not really resulted in a contraction on the EBITDA margin. That is a testament to the kind of cost initiatives we have taken as well A&P is not going up drastically. Just wanted to get a sense of how much more is there in the time to kind of continue driving this and will Advertising and Promotion also be a part of this saving going forward?

PA Poonacha: I can only comment on what we have done till date. For example, if you look at even this financial year from April 1 onwards after the GST came in, I mean we have negotiated vendors, we have ensured that whatever input credits that they have got, they have passed onto us. And they have also been some increases on account of the inflationary trend of input cost. A part of this is already met by the price increases wherever we can take in open markets, but the GST impact being there, I mean you have seen the margins getting hit in this financial year. But what we always try to achieve is try to have control over cost and to the extent the cost push we try to manage it with price increases in markets where we have a flexibility of increasing our prices. So that is how we look at in what has already happened. With respect to cutting down on brand building spends, no, we will not be doing that. We believe that our biggest assets are our brands and that is what is driving our business and that is what is keeping us as market leaders. So we will look at spending on brands in a more rational way but it will not go downwards.

Harit Kapoor: The other one was on the premium brands growth versus the mid and mass brands. If you look at brands which are say Kingfisher Ultra and above, as well as new launches you have done whether it is Storm, Buzz as well as the imported brands, if you could just give a sense on what are the kind of growths in that segment, which is a very small segment for you and for the industry but what are the kind of growth there versus your average growth?

PA Poonacha: All those brands are growing at high double-digit and they are doing very well. But the base is very-very small.

Harit Kapoor: How much would it be overall in terms of share now? Would it be 2-3-4%, what would it be?

PA Poonacha: If you look at, most of this are in the mild or lager segment. If you look at that, that itself is about 18-20%. I mean if you look at these premium brands, if you look at the overall industry, a percentage and half.

Harit Kapoor: Okay, last thing is if you could just give a sense on what the debt would be now vis-à-vis as compared to March from now?

Steven Bosch: I will just give you the exact number. The debt is around Rs. 440 crores as of December.

Moderator: As there are no further questions from the participants, I would now like to hand the conference over to Mr. Harit Kapoor for closing comments.

Harit Kapoor: Thanks Mallika. On behalf of IDFC we would like to thank the management of United Breweries as well as all the participants on the call for taking out time. Over to you Steven for your closing remarks.

Steven Bosch: Thank you Harit, thank you everybody for joining the call and we look forward to our upcoming call for Q4, end of year, so speak to you then. Thank you.

Moderator: Thank you very much members of the management. Ladies and gentlemen on behalf of IDFC Securities that concluded this conference call. Thank you for joining us and you may now disconnect your lines.