UNITED SPIRITS

Core story good; valuations attractive

October 12, 2009

Favourable macro environment a major demand trigger for IMFL industry

The 'Indian made foreign liquor' (IMFL) industry has posted a strong CAGR of 12% over the past four years on the back of favourable demographics and rising disposable incomes due to buoyant GDP growth in India. Demand for alcoholic beverages is also on the rise on account of their increasing acceptability in the social circuit and continued influence of the western lifestyle.

Dominant player with products across price points

United Spirits (USL) dominates the IMFL industry with a ~55% market share. It is present across all five segments, viz. whisky, rum, gin, brandy, and vodka, and has also entered the fast growing wine segment. We expect consumer up trading and USL's focus on main-line brands to help it register one of the highest volume growths in the Edelweiss FMCG pack.

Strong entry barriers to exist post GST

In the IMFL industry, entry barriers continue to remain strong. The need to set up manufacturing facilities in each state, procuring licences and tying up bottling arrangements are big hindrances. Also, the alcohol industry will not be under GST and, hence, competition in the industry is likely to remain low, going forward.

Balance sheet stress to ease further

In the past few quarters, timely repayment of debt has been a big overhang on the stock (interest costs were ~80% of EBIT in FY09). Proceeds from the recent sale of treasury stocks (~10.3 mn shares sold for ~INR 9 bn) have been used to prepay debt taken for the Whyte & Mackay acquisition. We expect USL to look at options like stake sale to PE investors, QIP, and balance sale of treasury stocks (8.3 mn) to further reduce its debt.

Outlook and valuations: Likely to be re-rated; initiating with 'BUY'

We believe USL is a secular play on improving consumer sentiments, backed by favorable demographics. The stock is likely to be re-rated as debt levels have started to dip to more manageable levels and re-pricing of contracts of Whyte & Mackay can potentially surprise earnings estimates. We, therefore, initiate coverage on USL with a **'BUY'** recommendation with a target price of INR 1,100 based on 21x FY11E EPS. On relative return basis, the stock is rated **'Sector Outperformer'** (refer rating page for details).

Financials

Year to March	FY08	FY09	FY10E	FY11E
Revenues (INR mn)	46,275	54,681	62,748	73,213
Growth (%)	*56.2*	*18.2*	*14.8*	*16.7*
EBITDA (INR mn)	9,642	9,853	12,602	15,322
Core PAT (INR mn)	1,848	1,877	3,559	5,336
Shares outstanding (mn)	89	103	103	103
Diluted EPS (INR)	20.9	18.2	34.6	51.8
EPS Growth (%)	*(41.8)*	*(12.7)*	*89.7*	*49.9*
Diluted P/E (x)	43.9	50.2	26.5	17.7
EV/EBIDTA (x)	14.5	14.7	10.5	8.5
ROAE (%)	12.7	8.8	12.8	15.9

Reuters : UNSP.BO *Bloomberg : UNSP IN*

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	High
Sector Relative to Market	Underweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 915
52-week range (INR)	:	1,090/425
Share in issue (mn)	:	103.0
M cap (INR bn/USD mn)	:	94.3 / 2,027.8
Avg. Daily Vol. BSE ('000)	:	1,884.7

SHARE HOLDING PATTERN (%)

Promoters*	:	34.1
MFs, FIs & Banks	:	9.8
FIIs	:	35.1
Others	:	21.0
* *Promoters pledged shares (% of share in issue)*	:	*33.2*

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	2.6	3.2	0.6
3 months	23.2	6.8	(16.4)
12 months	58.1	20.4	(37.6)

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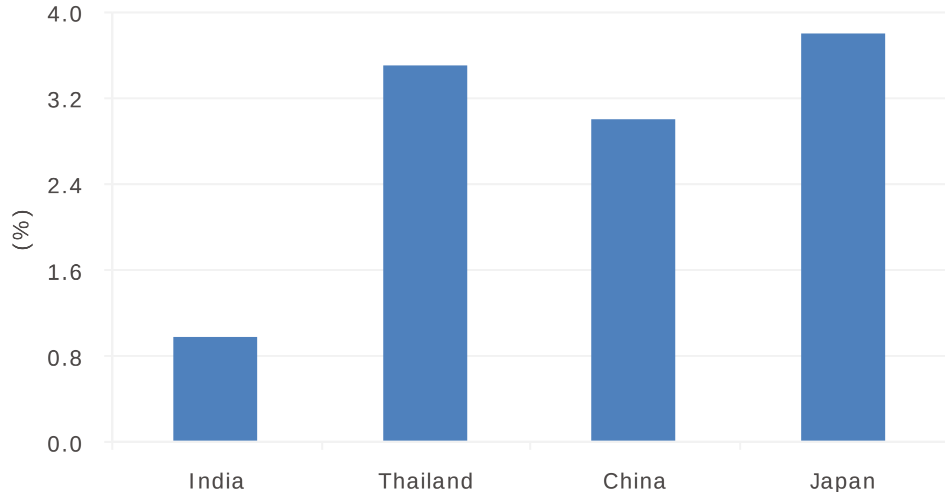
Investment Rationale

■ **Favourable macro environment to drive volume growth**

The IMFL industry has posted a strong CAGR of 12% over the past four years on the back of favorable demographics and rising disposable incomes due to buoyant GDP growth in India. Demand for alcoholic beverages is also on the rise on account of their increasing acceptability in the social circuit and continued influence of the western lifestyle. We expect this trend to continue in the foreseeable future.

Penetration still low in spite of sharp volume growth over past few years

Chart 1: Penetration low- Enough upside visible



Source: Industry, Edelweiss research

Penetration story still has enough upsides: Alcohol consumption is still low compared with the international standard. As per some research studies, per capita consumption in India is ~2 liters/ adult/ year (adjusting for undocumented consumption that accounts for ~50% of the total consumption, it is likely to be around 4 liters). This is low compared with even some other developing countries: 19 liters in Uganda and 10 liters in Russia. As per WHO's Global Status Report on Alcohol, 2004, India occupied 150th position among 184 countries in terms of alcohol consumption.

Women drinkers will be an additional growth driver

Rising alcohol consumption amongst urban Indian women: Gone are the days when drinking alcohol characterized only the vamps in Indian cinema, who were usually treated as social outcastes. Now, with rising employment levels amongst women, this scenario has changed. As per media reports, women now contribute 10% to alcohol sales in urban India (overall ~5%). A recent survey done in Karnataka reported no major difference between the amount of alcohol consumed by men and women in a typical drinking occasion. As per an industry estimate, 25% of India's total alcohol sales in 2005-15 will be driven by women.

To tap the women segment, companies are coming up with products specifically targeted at them. In the past few quarters, several flavoured and mild alcoholic products have been introduced in the market, specifically for women. These include, *Dia* (a sweet, low-alcohol content wine), Sula Vineyards offering, and USL's *Pinky Vodka* (innovatively packaged in a perfume shaped bottle, this product is made from flowers, and makes wonderful fruity cocktails). A recent survey by GSK Consumer Healthcare suggests that women belonging to SEC A and B in top 23 cities in India spend approximately INR 8 bn annually on looking and feeling good. This is the pie in which even the Indian alcohol players will be keenly interested.

Dominant player with products across price points

Strong product portfolio and brand equity

USL has achieved unparalleled dominance in the IMFL industry, holding ~55% market share in terms of volume. It is present across all five segments, viz. whisky, rum, gin, brandy and vodka and has also entered the fast growing wine segment. Pan-India manufacturing presence and robust distribution network confer high bargaining power to the company in negotiating with vendors. We expect consumer uptrading and USL's focus on main-line brands (~ 93% currently versus 72% in 2002) to help it register one of the highest volume growth (~13% CAGR over FY09-11E vs. ~17% in Q1FY10) in the Edelweiss FMCG pack. Its nearest competitor is one-fifth of USL, in sales and market share. Product portfolio spanning all segments of IMFL, presence across price segments, 19 millionaire brands (sales greater than 1 mn cases per annum) and pan-Indian manufacturing facilities lend unmatched leadership to USL and high bargaining power with vendors, suppliers and distributors. All brands of the company have high recall and it has four brands in the top 25 worldwide spirits brands. *McDowell No 1 family* is the largest spirits brand in the world with sales of 31.5 mn cases (FY09); it is also the largest FMCG brand in terms of retail sales value. *McDowell No 1 Brandy* is world's largest selling brandy. *Bagpiper Whisky* is the largest selling in its category globally.

Fig. 1: Product portfolio

Source: Company

Table 1: USL's presence - Full line portfolio across key price / value points

Type	Segment	USL's brands
Whiskey	Super premium	Antiquity Blue, Antiquity, Single Malt
Whiskey	Premium	Royal Challenge, Signature
Whiskey	Prestige	McDowell No 1
Whiskey	Regular	Derby Special Premium,
		McDowell's Diplomat, Bagpiper,
		Director's Special, Gilbey's
		Green, Old Tavern, Gold Riband,
Whiskey	Economy	DSP, Haywards
Rum	Prestige	Old cask
Rum	Regular	McDowell's No.1 Celebration
		Rum, Old Adventurer
Brandy	Prestige	McDowell's No.1, John Exshaw
Brandy	Regular	Honeybee
Vodka	Premium	Poison
Vodka	Regular	Alcazar
Vodka	Economy	White Mischief, Romanov
Scotch	Scotch	Black dog
Gin	Regular	Blue Riband Gin, Blue Riband
		Duet

Source: Company, Edelweiss research

Main line brands to lead the pack

Robust volume growth in premium brands to drive revenues

As a deliberate strategy to reduce focus on marginal and low-end brands and attempt to consolidate Shaw Wallace business post integration, USL's volume growth was slightly behind the industry volume growth in the past two-three years. We understand this as the company's effort towards focusing more on high-margin premium main-line brands and, thereby increasing market share. Consequently, lower-end brands posted sluggish/negative growth, but the proportion of main-line brands has increased from 72% in 2002 to ~93% currently of overall volumes.

Table 2: Proportion of main-line brands (%)

	Increase in share of focus brands
FY06	87.0
FY07	92.6
FY08	93.0

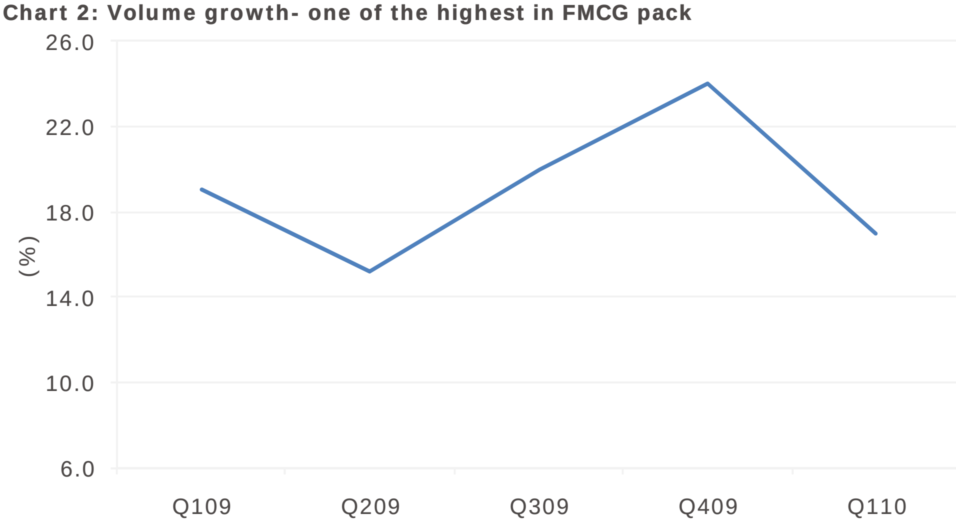
Source: Company, Edelweiss research

Post the ban on country liquor (CL) by Karnataka government in July 2007, USL began to aggressively focus on the low-end IMFL brands to take advantage of consumer up-trading from CL to low-end IMFL. We like this opportunistic strategy and expect similar moves from the company in future. USL has 19 millionaire brands. The company's standalone volume grew 20% in FY09 (compared with 11% growth in FY08) to ~88.3 mn cases (adding over 14 mn extra in FY09) with the first-line brands growing 23%.

We expect USL's volumes to chart higher growth trajectory as the company makes the most of the opportunity created at low-end and with proportion of de-focused brands already low at 7%. We do not expect significant product/brand rationalisation, going forward.

Volume growth is here to stay and one of the best in Edelweiss FMCG pack

Chart 2: Volume growth- one of the highest in FMCG pack

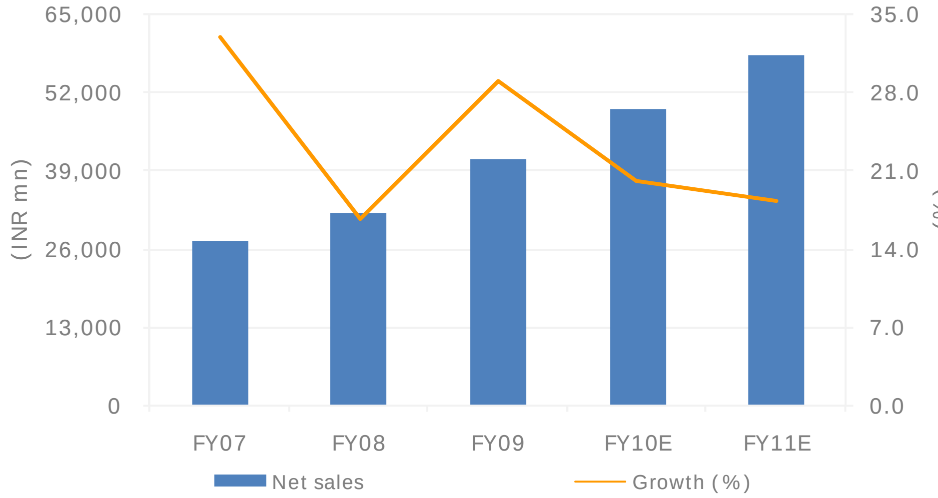


Source: Company, Edelweiss research

Within IMFL, we expect whisky and vodka to register strong growth of ~15% and 35%, respectively, while rum, brandy and gin likely to register moderate growth.

We are also enthused by the recent phenomenon of youth entering the premium segment directly against the earlier trend of entry at low end. We attribute this to the overall buoyancy in discretionary spends on account of higher disposable incomes in the hands of young consumers, and expect this trend to continue over the long term.

Chart 3: USL (Standalone) sales growth: Healthy CAGR



Source: Company, Edelweiss research

Investing in building trade marketing capability in premium products

Brand positioning and promotion augur well for future growth

Destination outlets: USL launched *Spiritz & More* its premium designer liquor stores or destination outlets. The idea is to bring respectability and up-market feel to alcohol consumption. The store identity will be the same in all cities. They will stock liquor and accessories such as dispensers and corkscrews. Also, attractive displays including video ads will play in the store. A store advisor will inform clients about the relative merits of each brand. It has shifted to key account management for these premium outlets for better servicing.

Fig. 2: Retail outlets

Source: Company

Segmented event marketing: USL is putting greater focus on interaction-led activities than awareness-led activities to increase sampling and create a consumer experience. Its strategy is to segregate and separate variants with event platforms. In case of *Black Dog*, a blended scotch whisky, it launched an 8-year old apart from the 12-year-old blend (which is already a leader in its segment with ~40% market share). In case of the 12-year-old, USL has separate, but unique events for its customers like organising jazz concerts. For customers of 8-year old, the company hosts theme-based events; customers for this segment are mostly youngsters. There will be sharp and distinct positioning of brands catering to target consumers. Even in the case of Whyte & Mackay brands, *Dalmore* is for the rich and famous.

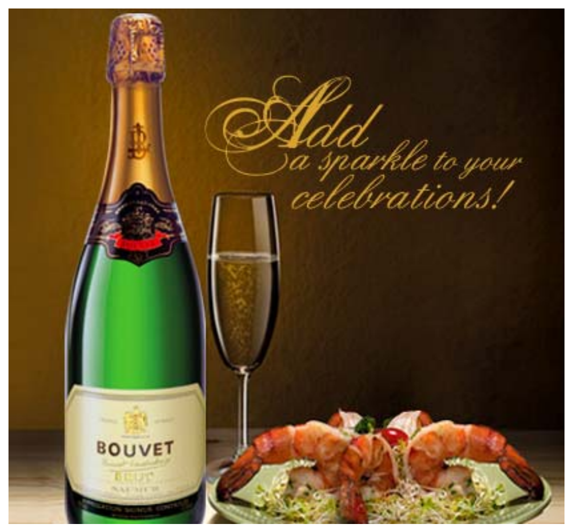
■ Entry into wines to drive long-term growth

USL has miniscule presence in the wine category with sales of ~235,000 cases in FY09. The company has added wine categories through the inorganic route and has also set up facilities in India. It acquired international brands of Bouvet Ladubay. It has enhanced existing winery facility at Baramati and is bottling bulk imported wine as well as domestic wine. We expect wine to become a growth driver over the long term. This will be on account of excellent volume growth and USL's strong distribution network. However, we have not built in upsides from wine initiatives yet.

Wine business presents a huge opportunity

- USL had acquired Bouvet Ladubay, a French winery, in 2006. Bouvet has 14 sparkling and 7 still wine brands. USL has introduced Bouvet brands in Mumbai, Pune, Delhi, Kolkata, Banglore and Goa.
- Introduced its Zinzi brand of wines, priced aggressively at INR 150-300, in Maharashtra, Delhi, Kolkata, Goa and Banglore.
- Construction of India's largest winery in Baramati at a cost of INR 700 mn. It has commenced grape crushing and it recently launched its *Four Seasons Wine* brand.
- Portfolio expansion via entry into the rapidly growing wine segment is likely to act as a catalyst for the company's growth in future. We expect wines from Baramati Winery and Four Seasons stable to do well. USL has also worked a marketing arrangement with Russian Standard Company.

Fig. 3: Wine portfolio



Source: Company

Based on the following factors, we believe wine could give USL a fantastic opportunity to enhance growth:

Low penetration: The overall market size of wines is currently 4.5 mn cases, which is expected to increase by ~35-40%. According to Associated Chambers of Commerce's estimates, domestic wine consumption is likely to rise to 9 mn liters per annum by FY10 from 5 mn liters in FY08, at a CAGR of 25% during the period. According a Rabobank International report, the domestic annual per capita wine consumption in India is the lowest at 0.006 litrs compared with China's 0.9 litres. It is 50 litres in France and Italy, 10 litres in the US and 23 litres in Australia**.** As per the UK-based International Wines and Spirits Records (IWSR), wine consumption in India is poised to grow three-fold by 2011, to 188,000 hectolitres by 2011 from 66,000 hectolitres in 2006.

Evolving consumer taste and association of wine with lifestyle: Today, wines are accepted as health drinks, and considered good if taken in measured quantities. They are associated with affluence and better lifestyle resulting in higher growth in their off take.

Low alcohol content acting as entry drink for youngsters/women: Wines and low alcohol content drinks such as breezers, mock-drinks etc are gaining popularity among youngsters and women alike.

Favourable regulatory climate: The nascent wine industry is set to benefit with Maharashtra, Chandigarh and Karnataka rolling out related consumer-friendly policies. Maharashtra has now allowed sale of wine at supermarkets. Many other state governments have reduced duties on wine and eased restrictions on distribution, allowing wine to be sold in supermarkets, and have provided incentives for wineries to establish new facilities. The Maharashtra government has given wineries the status of food processing industry and not alcoholic beverage makers.

W&M: Renegotiation in FY11 to provide upsides

W&M: Synergies to reflect from FY11

We expect W & M to largely remain flat in FY10. However, the contract with Diageo is due for renewal in FY11 and we expect upsides from this. Since W&M is the fourth largest scotch whisky player in the world, we expect at least a 10% price hike to come through post renewal, and thus increase our EPS estimates for FY11 by 9%. W&M has strong brand presence across the spectrum with heritage brands like Dalmore and Isle of Jura. W&M owns Invergordon distillery in addition to four malt distilleries. We expect W&M to add value to USL due to the following reasons:

- To ready itself to compete with international scotch brands in India.
- Strong demand growth in scotch on account of growth in China and other developing markets.
- Pricing environment is expected to remain tight on account of demand-supply mismatch.
- Secures long-term critical raw material requirements for USL's premium brands.
- Provides strong platform to fully exploit the rapidly growing Indian scotch opportunity at the premium end.

Fig. 4: W&M brands

Source: Company

Table 3: Contribution of W&M

(INR mn)	FY08	FY09	FY10E	FY11E
Sales	12,136	13,029	13,680	15,732
% of total	26.2	23.8	21.8	21.5
EBITDA	3,896	4,184	4,421	5,034
% of total	39.5	42.5	35.1	32.9

Source: Company, Edelweiss research

Table 4: Sensitivity analysis- FY11 to likely surprise on the upside

Price increase: W&M (%)	EPS FY11E (INR)	% Impact
0.0	47.4	0.0
5.0	49.6	4.7
10.0	**51.8**	**9.4**
15.0	54.0	14.0

Source: Edelweiss research

- Strong entry barriers to remain post GST

Strong entry barriers persist with low competitive intensity

In the IMFL industry, entry barriers continue to remain strong. The need to set up manufacturing facilities in each state, procuring licences and tying up bottling arrangements remain big hindrances for any new entrant. The ban on mass advertising actually favours existing players, as new players will not have any brand recall in India, at least for now. Also, the alcohol industry will not be under GST and, hence, competition in the industry is likely to remain low, going forward.

The organised alcohol industry in India comprises only three-four big players. The No. 1 player, USL, is about five times the size (in volumes and market share terms) of the second player. The top three players together hold over 75% market share of the industry, which gives them good power for pricing and bargaining with suppliers.

Incumbency advantage

Scale a big barrier to entry

In a market where licensing, manufacturing and distribution are controlled by the government, having a well-established brand presence bestows significant incumbency advantage on USL. Also, multitude of levies and taxes, especially on movement of liquor from one state to another, make it necessary to have production facilities in every state. USL, with its pan-India production facilities and bottling units, enjoys tremendous competitive advantage, which is difficult to replicate for any new player. Further, it is difficult for any new player to emulate the distribution network of USL. Additionally, ban on advertising makes it cumbersome to build brands in a marketplace. USL, with its portfolio of well-established and popular brands in every category of IMFL, straddling price points from economy to super-premium segments, is well-placed to capitalise on the booming IMFL space.

Price hikes: Various state governments are granting price hikes to industry players in lieu of rising input costs. USL had taken a price hike in Maharashtra, West Bengal and Uttar Pradesh and earlier in Tamil Nadu. Current year being an election year, price hikes have been difficult to come by. However, the company has changed nomenclatures for a few of its IMFL brands and has accorded them new status altogether, thereby, gaining a higher price for them (an indirect price hike for its product ranges).

Change in distribution in UP: Uttar Pradesh (UP) has dissolved State Corporation w.e.f. July 01, 2008, which has resulted in better bargaining powers with distributors.

Regulations to aid volume growth

Banning of country liquor: Karnataka has banned country liquor (CL) w.e.f. July 2007, creating a demand for low-end IMFL brands. USL has been a major beneficiary of this, as reflected in its recent quarterly results. Only Andhra Pradesh (AP) and Karnataka have banned CL as of date. Given that IMFL contributes significantly to the state exchequer, the possibility of other states banning CL to boost revenues cannot be ruled out.

Rationalisation of duties and taxes: A plethora of taxes and duties act as obstacles for the unstinted growth of IMFL industry. In West Bengal, excise duty has been relaxed for ordinary brands, which has helped drive volumes. Although not in the near term, we expect the Government of India (GoI) to take incremental steps to ease the operating environment for IMFL. Universalisation of taxes and duties will not only stop cross border transactions, but also reduce transaction cost for players and channelise companies' resources on value-enhancing activities.

Balance sheet stress likely to ease further

In the past few quarters, timely repayment of debt has been a big overhang on the stock (interest costs were ~80% of EBIT in FY09). Proceeds from the recent sale of treasury stocks (~10.3 mn shares sold for ~INR 9 bn) have been used to prepay debt taken for the Whyte and Mackay acquisition. We expect USL to look at options like stake sale to PE investors, QIP, and balance sale of treasury stocks (8.3 mn) to further reduce its debt (likely to target downwards of ~INR 50 bn compared to ~INR 75 bn in FY09).

Although USL has confirmed that its debt is long term in nature, downside risks from high leverage have been an overhang on the stock. We expect USL to comfortably service its debt repayment schedule.

Treasury stock sale to strengthen balance sheet

Debt status: USL had domestic borrowings of INR 17.9 bn, international borrowings of USD 619 mn in the SPV (from Citibank) and GBP 325 mn in W&M's books (from ICICI Bank) at respective Libor + 250bps before the recent sale of treasury stock. The interest rate currently paid by the company stands at 7.65%. We expect USL to further ease off stress in balance sheet. This can be done through sale of treasury stock and listing/stake sale in W&M and Bangalore Royal Challengers. We also expect internal cash generation to remain robust.

Table 5: Consolidated debt position for USL as on June 09

(INR mn)	Jun-09	Mar-09	Mar-08
Term loans	5,750	6,160	6,520
Unsecured loans	8,330	3,730	770
Working capital	7,350	7,800	5,590
Sub total	**21,430**	**17,690**	**12,880**
W&M acquisition loan with recourse	18,510	31,400	24,860
ICICI bank without recourse	28,000	25,770	28,310
Interest accrued	-	-	1,650
Total debt	**67,940**	**74,860**	**67,700**

Source: Company

USL can ease its debt position in the following three ways:

a. **Sale to PE investors, sale of treasury stock/ QIP in USL:** USL can sell stake to PE investors or sell its balance treasury shares or raise money through a QIP. In Q1FY10, USL placed 10.3 mn treasury stocks and raised INR 9 bn which was used to prepay debt in the books of USL, UK. It still has 8.3 mn treasury stocks left. This will lead to annual savings of ~ USD 15 mn on books.

b. **Divest ~49% in Whyte & Mackay:** Though management has cited no immediate intent to divest a stake to strategic investor, we believe USL could look at stake sale to deleverage itself.

c. **Financial investor in IPL:** The last edition of IPL-II has been positive for the company with its wholly owned subsidiary Royal Challenger team reaching the finals of IPL-II. Reaching finals could attract more sponsors to *Royal Challenger*. Also, most of the IPL II franchises have been reported to have broken even in cash terms. The revised higher satellite right for IPL II is also likely to have aided in early break even. All this could result in better valuations for the Royal Challenger team from prospecting financial investors.

(**For further details on IPL franchise valuations, please refer to Annexure**)

Valuation

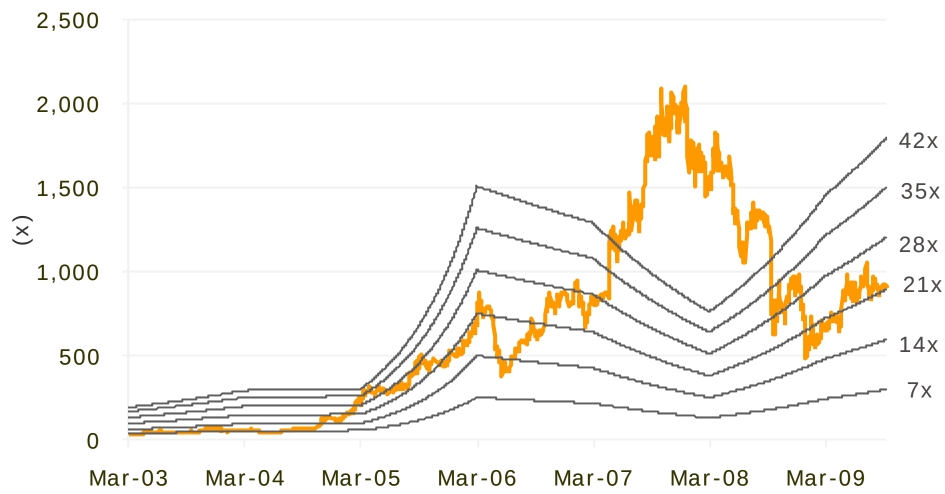
We believe USL is a secular play on improving consumer sentiments, backed by favorable demographics. The stock is likely to be re-rated as debt levels have started to dip to more manageable levels and re-pricing of contracts of Whyte & Mackay can potentially surprise earnings estimates. We, therefore, initiate coverage on USL with a **'BUY'** recommendation with a target price of INR 1,100 based on 21.0x FY11E EPS of INR 51.8. We have also valued the stock on SOTP based methodology which gives us a target price of INR 1,123. On relative return basis the stock is rated **'Sector Outperformer'** (refer rating page for details). The key risks to our call are sharper increase in raw material prices and overhang due to aviation losses in the promoter group company.

Table 6: SOTP valuations- Provides slightly higher upside

	P/E (FY11)	PAT (INR mn)	Value (INR mn)	Value per share (INR)
Domestic business	18	4,970	89,451	869
	EV/EBITDA (FY11)	EBITDA (INR mn)		
Whyte and Mackay	5	5,034	25,171	244
	Purchase cost (USD mn)			
IPL (franchise fee paid over 2 years)	111.6		1,071	10
Total			**115,694**	**1,123**

Source: Edelweiss research

Chart 4: One-year forward P/E



Source: Bloomberg, Edelweiss research

- **Peer comparison**

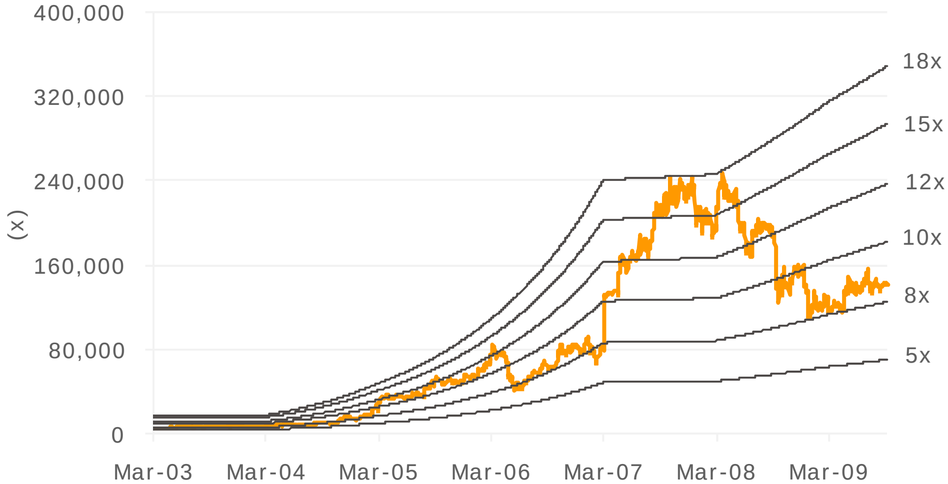
  USL's comparison with its peers at home is difficult, the company being the leader in the IMFL industry with about 55% market share in the domestic market and significant international exposure. Radico Khaitan, USL's closest competitor in the domestic market, is five times smaller than the company. International peers trade at a P/E of 12-17x on CY10 numbers, while USL is trading at 17.6x its FY11E earnings which is at a slight premium to its international peers. We believe this premium is justified on account of its higher growth and leadership in the Indian market, which is amongst the high growth spirits markets in the world.

Table 7: Peer comparison

	Market cap (USD bn)	PE (x) FY10E	PE (x) FY11E	EV/EBITDA (x) FY10E	EV/EBITDA (x) FY11E	RoE (%) FY10E	RoE (%) FY11E	Dividend yield (%) FY10E	Dividend yield (%) FY11E
Campari Group	2.7	13.1	11.9	9.1	8.2	13.8	13.7	1.8	1.9
Shanxi Xinghua	2.0	33.9	27.2	19.5	16.7	21.9	22.4	1.0	1.3
Remy Cointreau	2.0	17.4	15.3	12.4	11.4	7.9	8.9	4.1	4.2
United Spirits	**2.1**	**34.6**	**17.6**	**10.4**	**8.5**	**12.8**	**15.9**	**0.4**	**0.6**
Central Euro Distillers	1.9	14.0	11.7	11.4	9.1	10.5	12.1	0.0	0.0
Average		22.6	16.7	12.6	10.8	13.4	14.6	1.5	1.6

Source: Bloomberg, Edelweiss research

Chart 5: One-year forward EV/EBITDA



Source: Edelweiss research

Table 8: Sector valuation- cheapest FMCG stock

FMCG sector	Price (INR)	Rating	Mkt cap (INR mn)	EPS CAGR (%)	P/E (x) FY09	P/E (x) FY10E	P/E (x) FY11E	EV/EBIDTA (x) FY09	EV/EBIDTA (x) FY10E	EV/EBIDTA (x) FY11E	RoE (%) FY09	RoE (%) FY10	RoE (%) FY11E	Div. yield (%) FY09
Nestle*	2,611	Hold	213,077	15.3	44.6	38.4	33.5	24.3	20.8	18.0	127	120	108	1.6
HUL	287	Buy	566,768	4.8	25.5	26.4	23.2	20.5	21.4	18.8	140	105	101	2.9
ITC	249	Buy	864,337	15.6	28.3	24.3	21.2	16.6	14.3	12.3	25	26	26	1.6
Dabur India	137	Buy	110,708	19.3	30.3	25.2	21.3	23.2	17.6	14.7	55	51	47	1.4
Marico	90	Buy	53,592	16.3	26.8	23.0	19.8	18.5	15.0	12.8	53	44	38	0.7
Godrej	257	Buy	63,725	32.6	38.3	22.4	21.7	30.8	20.5	17.3	47	48	43	1.6
Colgate	678	Reduce	84,044	14.6	31.8	26.0	24.2	30.9	23.4	20.2	153	154	152	2.4
Asian paints	1,500	Hold	130,835	20.2	34.0	27.0	23.5	19.7	15.3	13.3	37	38	36	1.3
United Spirits	910	Buy	93,717	68.6	49.9	26.3	17.6	14.6	10.4	8.5	9	13	16	0.2

** December ending , HUL FY09 is 15 mnths number*

Source: Edelweiss research

Key Risks

Spike in raw material prices is the key risk

- **Poor rainfall can lead to sharp increase in prices of raw materials**

  Prices of molasses and ENA have already spiraled while glass prices have softened. Any further increase in prices of molasses, ENA and rebound in glass prices can impact profit margins. Rains have been deficient in FY10 which means that there will be a shortfall in the production of sugarcane in India which is likely to keep prices of ENA/molasses high even in FY11.

- **State pricing and regulatory risk**

  USL is exposed to changes in pricing by state governments. Nearly 70% of sales volumes are generated from regions where state governments control prices. Increase in taxes, changes in the distribution structure, prohibition of liquor in any state could hit USL. Recently, Maharashtra government has raised VAT on liquor from 12.5% to 20%. This could have future implication of higher VAT being imposed by other state governments as well.

- **Entry of foreign liquor could lead to higher competition**

  Baring Seagram, there has not been any significant presence of global liquor majors due to the existing regulatory environment. However, this could change with many global liquor makers evincing interest in the high growth Indian liquor market, leading to higher competition for incumbents.

- **Share pledges by promoter group companies**

  UB Holdings, USL's parent promoter company, holds 34% stake in USL. It has pledged shares as top-ups for secondary guarantees (as an additional comfort to lender) for loans and guarantees taken by its subsidiaries and associates (primarily Kingfisher Airlines). These stocks are not marked–to-market by the lender, and will be sold by the lender only when: (1) Kingfisher Airlines defaults and primary assets used by it as collateral are insufficient to cover debt obligations; and (2) UB Holdings also fails to bridge the gap.

- **Aviation business losses in promoter group company**

  USL promoters own and operate Kingfisher Airlines. With the unfavourable demand-supply situation in the Indian aviation sector, price wars have made a comeback. Occupancy rates and rupee movement can also impact performance of the business. The losses, coupled with stretched balance sheets, remain an overhang. Although there has not been any interparty transaction or funding by USL, the aviation business continues to act as an overhang on the company.

Company Description

USL is the largest spirits company in the branded spirits market in India and is the third largest spirits group in the world. It has leading brands across all categories and price segments. It has 19 millionaire brands of the nearly 140 brands that company owns. It enjoys a market share of ~55% with over 88 mn cases of liquor sold in India. It has manufacturing and bottling presence in every state in India supported by a vast distribution and marketing network across the country. It has 27 owned manufacturing units and 40 contract manufacturing facilities while reaching nearly 54,000 retail outlets in the country. USL exports its products to 18 countries. It has an aggressive acquisition strategy. It acquired the second largest Indian liquor manufacturer *Shaw Wallace*, French winemaker *Bouvet Ladubay*, and, the fourth largest Scotch whisky player in the world, *Whyte & Mackay*.

The company has also received various awards for flavours, taste and quality at the international level most prominent amongst them are Mondial, International wine Spirits Competition (IWSC) and Taste and Quality Institute. The company has been innovator with many first to its credit such as first premixed gin, the first tetra pack in spirits and first diet version of Vodka and whisky in India.

Chart 6: USL — Sales contribution mix for FY09

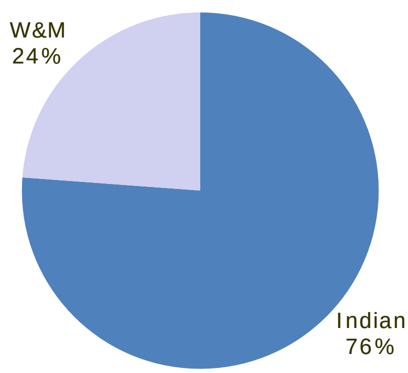
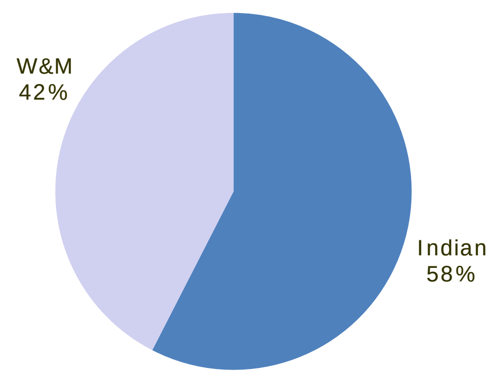


Chart 7: USL — EBITDA contribution mix for FY09



Source: Company, Edelweiss research

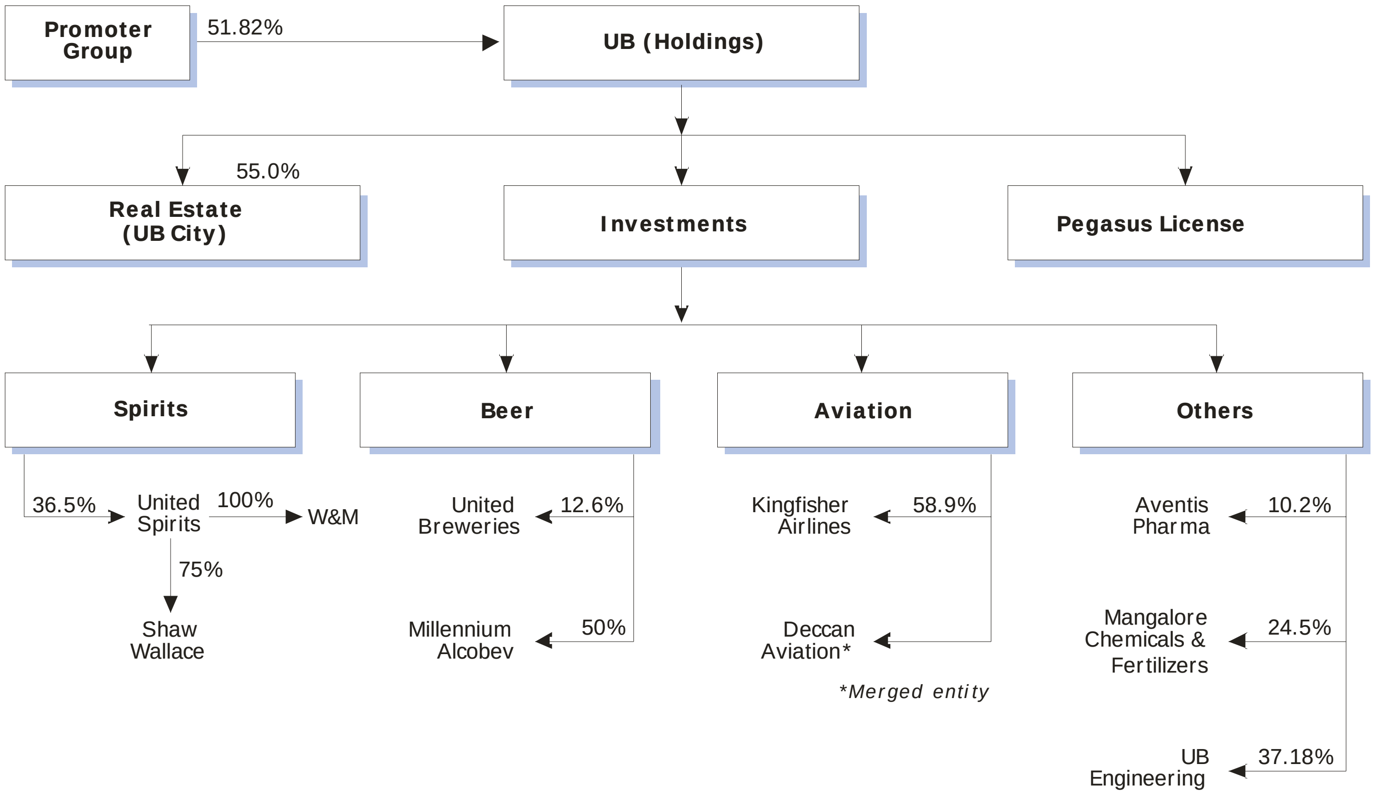
Table 9: USL's 19 Millionaire brands

Whisky	Brandy	Rum	Vodka	Gin
Bagpiper	McDowell's No.1	Celebration Rum	White Mischief	Blue Riband
McDowell's No.1	Honey Bee	Old Cask Rum	Romanov	
Director's Special	John Ex-Shaw	Old Adventurer Rum		
Old Tavern				
Haywards				
Gilbey's green Label				
Gold Riband				
Royal Challenge				
DSP Black				
Signature				

Source: Company, Edelweiss research

United spirits is a part of Vijay Mallya promoted United Breweries Group having interests in Alcohols, Beer, Aviation, Pharmaceuticals, Chemicals & fertilizers, real estate and Engineering.

Fig. 5: Group structure



Source: Company

SWOT Analysis

Strengths

- Strong market share of 55% in IMFL.
- Pan-India manufacturing presence.
- Strong distribution network.
- Strong brand equity.
- Strong incumbency advantage due to high entry barriers.
- Strong management track record.

Opportunities

- Entry into rapidly growing wine segment.
- Introduce other brands of W & M.
- Increasing premiumisation of portfolio.
- Marketing arrangement with Russian Standard Company and China foray.
- Visible shift in the urban Indian women consumers.
- Rising social acceptability of alcoholic beverages.
- Further regulatory easing in the long run.

Weaknesses

- Exports market not fully tapped.
- High regulatory risk - exposed to government policies such as increase in taxes, changes in distribution structure, and prohibition of liquor.
- Visibility on W&M business is low.

Threats

- Rising molasses and glass raw material prices.
- Global slowdown could hit scotch prices.
- Entry of foreign players - withdrawal of additional customs duty (ACD) on foreign liquor has reduced import duties on liquor from 250-550% to 150%.

Five Forces Analysis

1. **Threat of new entrants – Low**
    - Strong entry barriers still exist – manufacturing, advertising and distribution.
    - Current competitors are way behind in terms of pricing power, brand equity and distribution network.

2. **Bargaining power of suppliers –High**
    - USL is the largest consumer of molasses and glass, but suppliers are also limited.

3. **Inter-firm rivalry – Low**
    - USL is a much larger player than the other players.

4. **Bargaining power of buyers – Medium**
    - Alternatives to USL are few.

5. **Threat from substitutes - Moderate**
    - Brand equity, manufacturing and distribution are entry barriers in the IMFL segment.

Financial Outlook

- **Stake sale of treasury stock could provide further EPS upside**

USL had cross holdings in subsidiaries and group companies prior to the SWC acquisition. After restructuring and acquisition of SWC business, USL created a trust, USL Benefit Trust, to which it transferred 5.8 mn shares on account of cross holdings. In FY07, the company sold 3.5 mn shares and realized profit of INR 2,470 mn which was used to retire debt. Apart from the balance 2.3 mn shares, the company held 10.3 mn treasury shares in its subsidiary SWC which it sold in June 2009 to further reduce the debt levels taken for the Whyte & Mackay acquisition. Currently, USL holds 8.6 mn shares of treasury stock. We expect USL to further reduce its debt (likely to target downwards of ~INR 50 bn compared to ~INR 75 bn in FY09). These funds can be utilised to reduce debt on balance sheet, leading to interest costs savings.

Dilution to boost profitability

The comapny has been in talks with private equity firms like Texas Pacific Group (TPG), Temasek Holdings, Blackstone, KKR, Capital International and others for a second round of fundraising in less than two months. In the event of the stake sale, the deleveraging is likely to positively influence the company's' earnings with reduction in its interest out go (currently interest paid forms about 55% of EBIT). We have tried to build scenarios of the likely impact of the deal at 5 mn and 8.6 mn shares being issued to strategic investor at INR 1000 per share and its impact on the EPS of the company as against our base case estimates. The likely stake sale scenario may vary from our assumed scenario and could potentially be better than our assumed scenario, as well. However, we are not factoring any of these upsides in our current estimates until, the deal is concluded.

Table 10: Debt reduction at different dilution levels and varying price points

Price (INR)	10 mn	15 mn	20 mn	25 mn
800	8,000	12,000	16,000	20,000
1,000	10,000	15,000	20,000	25,000
1,200	12,000	18,000	24,000	30,000
1,400	14,000	21,000	28,000	35,000

Source: Edelweiss research

Table 11: Earnings sensitivity for 5 mn share dilution at INR 1000 per share

	FY10E			FY11E		
	Current est.	Post stake sale	% change	Current esti.	Post stake sale	% change
EBIT (INR mn)	11,543	11,543		14,166	14,166	
Interest cost (INR mn)	6,676	6,163	(7.7)	6,371	5,829	(8.5)
Debt (INR mn)	62,195	57,195	(8.0)	57,195	52,195	(8.7)
PAT (INR mn)	3,559	3,867	8.6	5,336	5,661	6.1
Shares O/s (INR mn)	103	108	4.9	103	108	4.9
EPS (INR)	34.6	35.8	3.6	51.8	52.4	1.2

Source: Edelweiss research

Table 12: Earnings sensitivity for 8.6 mn share dilution at INR 1000 per share

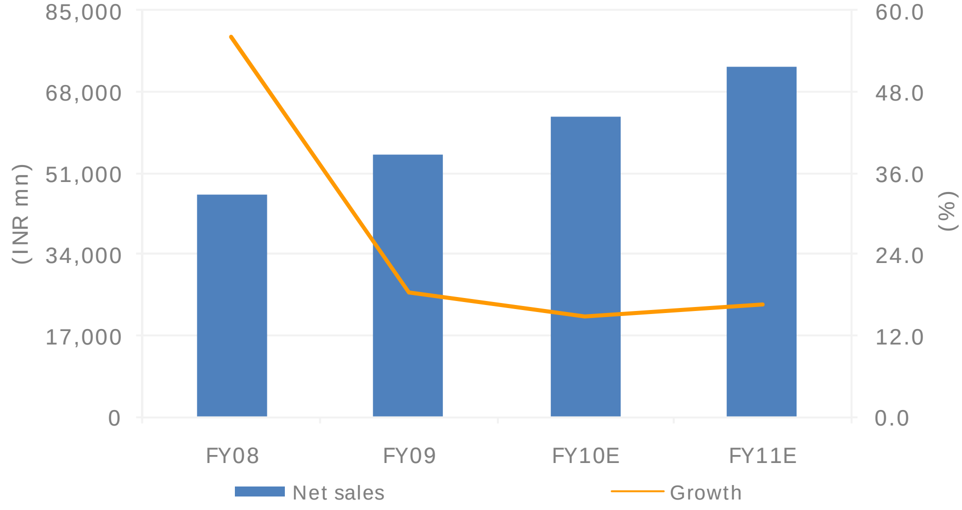
	FY10E			FY11E		
	Current est.	Post stake sale	% change	Current est.	Post stake sale	% change
EBIT (INR mn)	11,543	11,543		14,166	14,166	
Interest cost (INR mn)	6,676	5,795	(13.2)	6,371	5,439	(15.4)
Debt (INR mn)	62,195	53,595	(13.8)	57,195	48,595	(15.4)
PAT (INR mn)	3,559	4,088	14.9	5,336	5,895	14.3
Shares O/s (INR mn)	103	112	8.4	103	112	8.7
EPS (INR)	34.6	36.6	6.0	51.8	52.8	5.1

Source: Edelweiss research

- **Revenues expected to post a CAGR of 15.7% over FY09-11E**

We expect USL's consolidated net sales to post 15.7% CAGR in FY09-11E. Standalone sales will continue the growth momentum with ~18% CAGR in FY09-11E, 16% volume growth and 2% price. W&M's share of consolidated revenues in FY10 and FY11 is estimated at 22.0% and 20.0%, respectively.

Chart 8: Consolidated net sales and growth



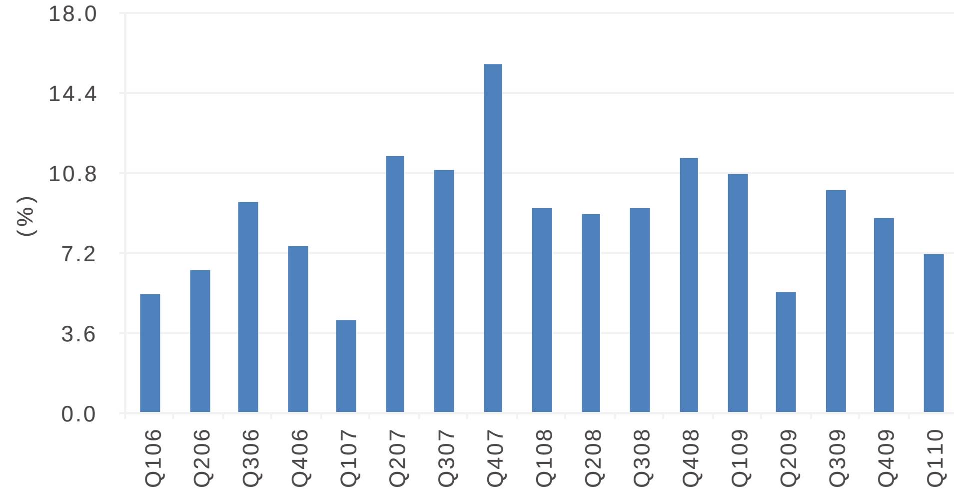
Source: Company, Edelweiss research

- **EBITDA margins likely to bounce back**

EBITDA margins to start trending up

We forecast EBITDA post 24% CAGR in FY10-11. Consolidated EBITDA margins will expand by 290 bps on account of flattening input cost, lower trade discounts and much lower advertising spends. W&M will contribute over 35% and 30% of EBITDA in FY10E and FY11E, respectively.

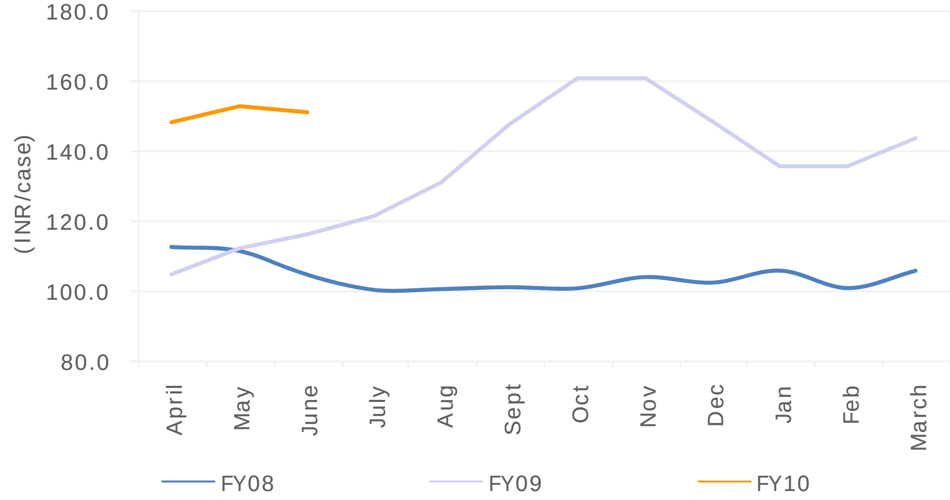
Chart 9: Advertising spend as % of sales- On decline mode



Source: Company

Molasses prices have a high correlation with sugarcane output (by-products of sugarcane crushing) in the country. As a thumb rule, molasses recovery is ~5% of the cane crushed. We expect ENA molasses prices to correct from the peak levels due to weak demand in industrial alcohol and arrival of crushing season.

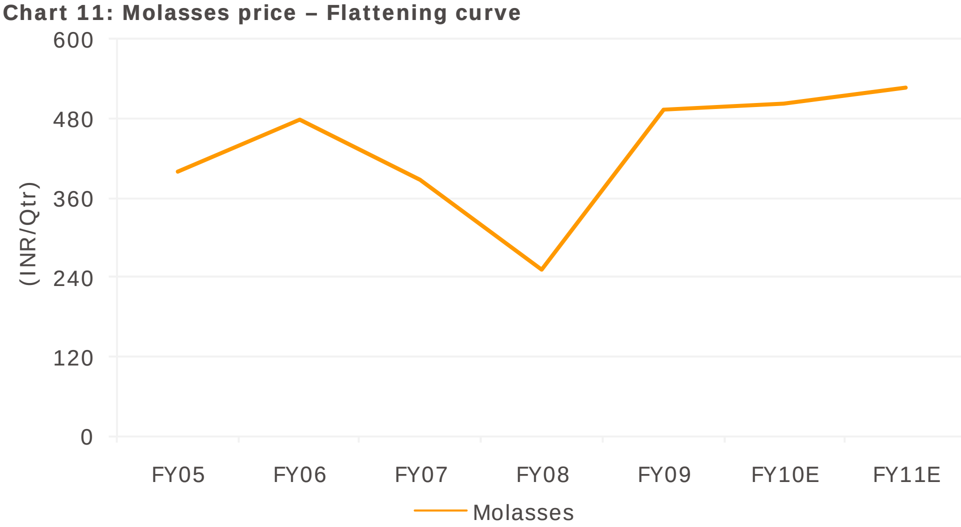
Chart 10: Price trend of wet goods (INR/case)



Source: Company, Edelweiss research

Chart 11: Molasses price – Flattening curve

Molasses cost: Likely to have peaked out

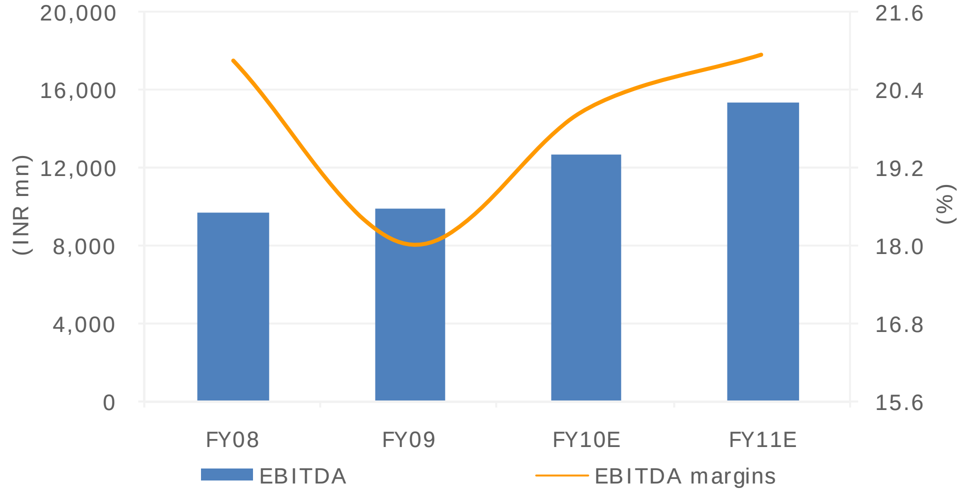


Source: Company, Edelweiss research

- **Price hikes to mitigate the risk of rise in input costs**

  In the past, USL has taken regular price hikes. However, in an election year it will be difficult to effect prices hikes - key to counter the margin pressure from high ENA and molasses prices. However, the company has changed nomenclatures for a few of its IMFL brands and has accorded them a new status altogether, thereby, gaining a higher price for them. Also, during a rising input price scenario, smaller players operating at lower end products start getting impacted and thereby lose market share. This is likely to be advantageous for larger incumbents such as USL, as they gain market share.

Chart 12: Consolidated EBITDA and EBITDA margin



Source: Company, Edelweiss research

- **Core PAT estimated to post a CAGR of 68.6% over next two years**

  We forecast USL's consolidated PAT to post a CAGR of 68.6% in FY09-11 and estimate FY 10 and FY11 EPS to be INR 34.6 and 51.8, respectively. The PAT growth could be even better in case interest rates (LIBOR) remain subdued and the rupee appreciates against dollar.

Annexure

We look at valuations of past deal and valuation benchmarks for IPL teams.

1. **Valuation of IPL done by Brand Finance:** IPL as a business proposition has been valued at USD 2bn. The valuation is done by Brand Finance which has done other valuations for Indian companies. Brand Finance took various things in valuing the brand. Most of the things were relevant if the tournament was conducted in India.

   a. Revenue lines such as broadcasting.

   b. IPL sponsorship.

   c. Team sponsorship.

   d. Merchandising and gate receipts.

   e. The effect of performance.

   f. The catchment population of the city.

   g. The capacity of the stadium.

   h. The presence of iconic players.

   Brand valuations of the IPL teams:

   a. Kolkata Knight Riders - USD 42.1 mn.

   b. Mumbai Indians - USD 41.6 mn.

   c. Rajasthan Royals – USD 39.5 mn.

   d. Chennai Super Kings – USD 39.4 mn.

   e. Delhi Daredevils – USD 39.2 mn.

   f. Royal Challengers Bangalore – USD 37.4 mn.

   g. Kings XI Punjab – USD 36.3 mn.

   h. Deccan Chargers – USD 34.8 mn.

   Valuation is an arbitrary number based on some calculations and does not reflect the real value of the team. **Thus the range is USD 35 – 140 mn.**

A brief on Royal Challengers Bangalore

Fig. 1: RC IPL team logo

Source: Company

Owners: United Spirits

Franchisee fee: USD 111.6 mn

Brand value: USD14 mn

Brand score: 50%

Sponsorships/brand associations: Wrigley's and mostly in-house brands such as Kingfisher

Financial Statements

Income statement **(INR mn)**

Year to March	FY07	FY08	FY09	FY10E	FY11E
Gross revenues	50,486	75,269	93,130	107,024	125,081
Excise duties	20,868	28,994	38,450	44,276	51,868
Net revenues	29,618	46,275	54,681	62,748	73,213
Cost of materials	16,047	20,906	26,909	31,063	35,463
Gross profit	13,571	25,369	27,771	31,685	37,750
Employee costs	2,023	4,279	4,748	5,338	6,228
Advertisement & sales costs	2,942	4,781	5,378	4,832	5,711
Other general expenditure	4,248	6,667	7,791	8,914	10,488
EBITDA	4,358	9,642	9,853	12,602	15,322
Depreciation	338	741	925	1,059	1,156
EBIT	4,020	8,901	8,928	11,543	14,166
Other income	875	1,056	1,040	1,065	1,098
EBIT incl. other income	4,895	9,957	9,968	12,608	15,264
Net interest	873	5,448	7,176	6,676	6,371
PBT	4,022	4,509	2,792	5,932	8,893
Provision for taxation	1,049	2,661	916	2,373	3,557
Core PAT	2,972	1,848	1,877	3,559	5,336
Extraordinary items	2,987	1,157	(5,959)	(2,799)	(2,799)
Prior period items	(148)	0	0	0	0
Profit after tax	6,107	3,005	(4,083)	761	2,537
Minority interest	(437)	(284)	(2)	0	0
Profit after tax after minority interest	5,670	2,721	(4,084)	761	2,537
Fully diluted shares (mn)	83	89	103	103	103
Diluted EPS (INR)	35.9	20.9	18.2	34.6	51.8
CEPS (INR)	39.1	38.0	18.0	44.8	63.0
DPS	1.2	1.7	2.1	4.0	5.7
Dividend payout ratio (%)	4.6	9.5	13.5	13.5	13.0

Common size metrics - as % of net revenues

Year to March	FY07	FY08	FY09	FY10E	FY11E
Cost of materials	54.2	45.2	49.2	49.5	48.4
Employee costs	6.8	9.2	8.7	8.5	8.5
Advertising & sales costs	9.9	10.3	9.8	7.7	7.8
Other general expenditure	14.3	14.4	14.2	14.2	14.3
Depreciation	1.1	1.6	1.7	1.7	1.6
Net interest expenditure	2.9	11.8	13.1	10.6	8.7
EBITDA margin	14.7	20.8	18.0	20.1	20.9
EBIT margin	13.6	19.2	16.3	18.4	19.3
Net profit margin	10.0	4.0	3.4	5.7	7.3

Growth metrics (%)

Year to March	FY07	FY08	FY09	FY10E	FY11E
Revenues	37.9	56.2	18.2	14.8	16.7
EBITDA	126.6	121.3	2.2	27.9	21.6
PBT	613.6	12.1	(38.1)	112.4	49.9
Net profit	574.4	(37.8)	1.6	89.7	49.9
EPS	392.0	(41.8)	(12.7)	89.7	49.9

Balance sheet **(INR mn)**

As on 31st March	FY07	FY08	FY09	FY10E	FY11E
Share capital	829	886	1,030	1,030	1,030
Reserves	12,863	19,887	22,826	32,265	34,456
Shareholders' funds	13,692	20,773	23,856	33,295	35,485
Secured loans	9,508	65,270	69,926	58,516	53,516
Unsecured loans	5,294	771	3,679	3,679	3,679
Borrowings	14,802	66,041	73,605	62,195	57,195
Minority interest	1,712	1,992	63	63	63
Term liability towards franchisee rights			4,431	3,939	3,447
Sources of funds	**30,206**	**88,806**	**101,955**	**99,492**	**96,190**
Gross block	6,822	16,985	22,919	23,904	25,057
Less depreciation	1,764	6,357	6,650	7,708	8,864
Net fixed assets	5,057	10,628	16,269	16,195	16,193
Capital work in progress	133	534	288	288	288
Investments	2,044	2,119	9,501	9,501	9,501
Foreign currency monetory item translation diff.			5,598	2,799	0
Deferred tax (net)	19	18	918	918	918
Intangible assets	11,324	53,260	44,738	44,738	44,738
Current assets	18,930	34,478	40,372	42,428	44,325
Inventories	3,553	14,850	17,458	20,034	23,375
Sundry debtors	3,991	8,370	8,880	10,190	11,889
Cash and bank balance	5,778	5,438	4,490	5,422	1,506
Other current assets	1,218	1,469	2,145	2,145	2,145
Loans and advances	4,390	4,351	7,399	4,637	5,410
Current liabilities	7,264	13,161	16,463	18,110	20,508
Liabilities	6,050	11,934	13,879	15,526	17,923
Provisions	1,214	1,228	2,584	2,584	2,584
Working capital	11,666	21,316	23,909	24,318	23,817
Uses of funds	**30,206**	**88,806**	**101,955**	**99,492**	**96,190**
BV (INR)	165	224	225	316	337

Cash flow statement

Year to March	FY07	FY08	FY09	FY10E	FY11E
Net profit	5,670	2,721	(4,084)	761	2,537
Add : Non cash charge					
Depreciation	338	741	925	1,059	1,156
Deferred tax	(66)	773	(950)	0	0
Others	(1,183)	8,428	10,003	9,443	9,138
Gross cash flow	4,759	12,663	5,894	11,263	12,831
Less: Changes in WC	2,464	9,990	3,540	(523)	3,416
Operating cash flow	2,295	2,673	2,353	11,786	9,415
Less: Capex	557	6,312	6,566	985	1,153
Free cash flow	**1,738**	**(3,639)**	**(4,213)**	**10,801**	**8,262**

Cash flow metric

Year to March	FY07	FY08	FY09	FY10E	FY11E
Operating cash flow	2,295	2,673	2,353	11,786	9,415
Financing cash flow	(2,195)	35,615	(4,166)	(10,096)	(12,406)
Investing cash flow	(939)	(38,628)	865	(757)	(926)
Net cash flow	(839)	(340)	(948)	933	(3,917)
Capex	557	6,312	6,566	985	1,153
Dividends paid	(223)	(176)	(143)	(178)	(267)

Ratios

Year to March	FY07	FY08	FY09	FY10E	FY11E
ROAE	30.8	12.7	8.8	12.8	15.9
ROACE	15.8	15.5	10.0	12.7	16.0
Debtor days	44	49	58	55	55
Inventory days	74	161	219	220	223
Payable days	167	178	201	203	199
Current ratio	2.6	2.6	2.5	2.3	2.2
Debt/EBITDA	3.4	6.8	7.5	4.9	3.7
Cash conversion cycle days	(48)	31	76	73	80
Debt/Equity	1.1	3.2	3.1	1.9	1.6
Adjusted debt/equity	1.1	3.2	3.1	1.9	1.6
Interest coverage *(x)*	4.6	1.6	1.2	1.7	2.2

Operating ratios

Year to March	FY07	FY08	FY09	FY10E	FY11E
Total asset turnover	1.1	0.8	0.6	0.6	0.7
Fixed asset turnover	6.0	5.9	4.1	3.9	4.5
Equity turnover	2.7	2.7	2.5	2.2	2.1

Du pont analysis

Year to March	FY07	FY08	FY09	FY10E	FY11E
NP margin (%)	11.5	4.6	3.4	5.7	7.3
Total assets turnover	1.1	0.8	0.6	0.6	0.7
Leverage multiplier	2.5	3.6	4.4	3.6	2.9
ROAE (%)	30.8	12.7	8.8	12.8	15.9

Valuation parameters

Year to March	FY07	FY08	FY09	FY10E	FY11E
EPS (INR)	35.9	20.9	18.2	34.6	51.8
Y-o-Y growth (%)	*392.0*	*(41.8)*	*(12.7)*	*89.7*	*49.9*
CEPS (INR)	39.1	38.0	18.0	44.8	63.0
P/E (x)	25.5	43.9	50.2	26.5	17.7
Price/BV (x)	5.5	4.1	4.1	2.9	2.7
EV/Sales (x)	2.8	3.0	2.6	2.1	1.8
EV/EBITDA (x)	18.9	14.5	14.7	10.5	8.5
Dividend yield (%)	0.1	0.2	0.2	0.4	0.6

RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk
Hindustan Unilever	Buy	SO	L
ITC	Buy	SO	L
Marico	Buy	SO	M
Godrej Consumer Products	Buy	SO	H
Nestle India	Hold	SU	L
Asian Paints	Hold	SU	M
Dabur	Buy	SO	M
Colgate Palmolive India	Reduce	SU	M
United Sprits	Buy	SO	H

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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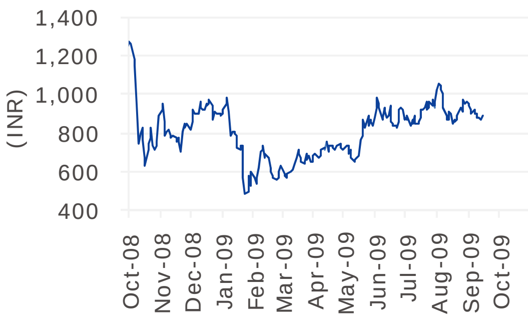
Coverage group(s) of stocks by primary analyst(s): FMCG

Asian Paints, Colgate, Dabur, Godrej Consumer, Hindustan Lever, ITC, Marico, Nestle and United Spirits

United Sprits



Recent Research

Date	Company	Title	Price (INR)	Recos
15-Sep-09	**Dabur India**	Innovation led growth; *Result Update*	125	Buy
07-Sep-09	**Marico**	Sustaining momentum; *Visit Note*	90	Buy
30-Jul-09	**Nestle India**	Growing steady; *Result Update*	2,073	Hold
29-Jul-09	**Hindustan Unilever**	Strong operating performance; *Result Update*	268	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	70	53	16	142

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	89	38	15

Access the entire repository of Edelweiss Research on www.edelresearch.com