INDIA RESEARCH | CONSUMER GOODS | BSE SENSEX: 18174 | MARCH 11, 2011

United Breweries (UBL)

EVENT UPDATE

OUTPERFORMER

Rs473

Mkt Cap: Rs114bn; US$2.5bn

Event:

United Breweries (UBL) has announced the merger of Chennai Breweries, the brewery unit of Balaji Distilleries, with itself. Balaji is now owned by United Spirits (USL). The merger is being facilitated by a share swap that values the 13m-case brewery capacity at Rs4bn. We have reservations on the value at which the merger has been done.

Details of the transaction:

- Balaji Distilleries has a strong presence in the alcoholic beverage industry in Tamil Nadu. It owns a brewery unit with an annual capacity of 12.76m cases and a 11.88m-case distillery unit.
- Balaji operated as a contract manufacturer for UB Group (for both USL and UBL). It suffered from heavy losses and was declared sick by BIFR in December 2006. The company's total accumulated losses stood at Rs3.55bn as of 31 March 2010.
- As part of the BIFR process, Balaji entered into a merger agreement with USL and also agreed to transfer the brewery assets to UBL post the merger with USL. As a part of the agreement, UBL paid an advance of Rs1.55bn to the promoters of Balaji to lock in the brewery asset.
- In January 2011, USL received final approval from the High Court and, according to the scheme of arrangement, issued 5.2m shares of USL to Balaji (acquired distillery and brewery unit).
- UBL has now acquired the brewery assets of Balaji, housed in a subsidiary named Chennai Brewery, from USL via a share swap. Further, the advance of Rs1.55bn paid to the erstwhile promoter of Balaji will be repaid to UBL over the next six months.
- According to the merger arrangement with USL, UBL will issue 17 shares of UBL for every 30 shares held in Chennai Brewery. In effect, UBL will do a total issuance of 8.5m shares to USL, valuing the brewery unit at Rs4bn at the CMP of Rs471. Post the merger, the total equity base of UBL would be 264.4m shares, while the holding of the promoter group would be 74%.
- Over the past 12-18 months, the UB Group has focused on improving the operational performance of Balaji. For the brewery unit (Chennai breweries) in particular, UBL is expected to improve the operating profit of the unit from Rs160m in FY10 to Rs390m in FY11.

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Value of the transaction:

UBL has valued Balaji's brewery capacity of 13m cases in Tamil Nadu at Rs4bn. A greenfield capacity of the same size would require a capex of Rs2.6bn. The management believes the transaction value is justified given a gestation period of 18-24 months for setting up a greenfield capacity (implying forgoing an EBITDA of Rs500m-600m) and the premium to operate a brewery asset in Tamil Nadu (which has only four brewery units) and keep out competition in the state.

We have the following reservations on the deal:

- The brewery asset acquired by UBL has a capacity of 13m cases, which is ~4% of the total industry. The value of Rs4bn implies an industry capital employed of Rs100bn. We have reservations because UBL, has ~30% of industry capacity and a total capital employed of Rs20.5bn, implying industry capital employed should be in the range of Rs75bn.
- UBL is expected to earn an EBITDA of ~Rs390m from the acquired brewery assets. The value of Rs4bn for this implies a sub-optimal RoCE of 7-8%, which is also lower than UBL's current RoCE of ~13%.
- USL completed the acquisition of Balaji Distilleries (distillery and brewery) in January 2011 by issuing 5.2m shares. Taking into account the average stock price of USL over January and February, it implies a value of ~Rs6.4bn which USL paid for acquiring Balaji Distilleries. UBL acquiring the brewery assets at Rs4bn implies a value of ~Rs2.4bn for the 12m-case distillery unit that has been retained by UBL.

Our view:

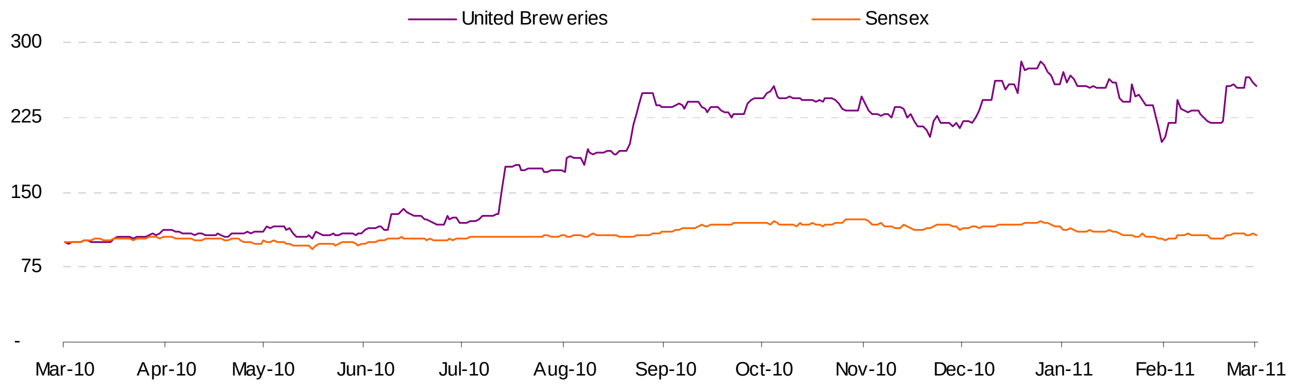
Our positive stance on UBL has played out well, with the stock having outperformed the Sensex by 140% over the past 12 months. UBL, with a 53% market share of the Indian beer industry, generates profits of less than Rs2bn; implying profitability of the fastest growing beer market is less than Rs4bn! Our sense is that, as market share consolidates in the hands of UBL (gap between UBL and SAB Miller is now 30%, from below 5% earlier), cost benefits will begin to accrue and the inherent profitability of the business will come to the fore. Take the case of United Spirits (60% of the IMFL market). Close competition from Shaw Wallace had kept distribution costs high and margins under pressure. After it acquired Shaw Wallace, its selling and distribution costs (brand spends and trade margins) dropped sharply, pricing power improved and profitability increased by 1000bp. We believe a similar scenario is shaping up for UBL which would result in a significantly improved margin profile and, thereby, profitability in the long run. However, given our reservations on the Balaji deal and UBL's stretched valuations (50x FY12E PER and EV/EBITDA of 26x), we believe the stock may see some pressure in the near term. However, we continue to maintain our long-term structural positive call on the business and maintain Outperformer.

Key financials

	FY07	FY08	FY09	FY10	FY11E	FY12E
Net sales (Rs m)	11,918	15,281	18,991	22,340	31,089	37,006
Adj. net profit (Rs m)	476	467	382	824	1,733	2,427
Shares in issue (m)	216	216	216	240	240	256
Adj. EPS (Rs)	2.2	2.2	1.8	3.4	7.2	9.5
% change	*160.9*	*(1.8)*	*(18.3)*	*94.1*	*110.3*	*31.4*
PE (x)	213.8	217.8	266.6	137.3	65.3	49.7
Price/ Book (x)	35.5	32.2	13.3	13.5	10.4	9.2
EV/ EBITDA (x)	72.9	60.1	49.3	52.5	32.9	25.7
RoE (%)	17.9	15.5	7.1	10.3	18.0	20.2
RoCE (%)	9.9	9.1	8.7	6.9	12.5	16.8

Source: IDFC Securities Research

Relative price performance



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Explanation of Ratings:

1. Outperformer: More than 5% upside to Index
2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: More than 5% downside to Index

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