Company Results Review

23 January 2007 | 9 pages

United Spirits (UNSP.BO)

Buy: The Party Continues as 3Q Beats Expectations

- Results continue to beat expectations — United Spirits is on a roll, reporting yet another quarter of ahead of expectations earnings. 3QFY07 net profits (pre-exceptional) grew 433% yoy (20% ahead of expectations) driven by 51% sales growth and 132bps EBITDA margin expansion. Exceptional income was Rs2.65bn.
- Product mix continues to improve — Product mix improvements are driving both sales growth and margin expansion. UNSP's strategy of pruning low-margin tail-brands and focusing on higher margin first-line brands is paying-off – share of first-line brands has increased from 75% to 90% over the last 5-6 quarters.
- Entry into wine segment bodes well — UNSP is looking to enter the high-growth wine segment soon with the launch of its brand 'Zinzi' , priced between Rs200-Rs600 per bottle and 'Bouvet Ladubay' at the higher end (>Rs600 per bottle).
- White & Mackay acquisition — According to the management, talks are still under way and if the deal goes through, it will be funded through sale of treasury stock and non-recourse debt in White & Mackay's books.
- Among best Indian consumption plays — UNSP is one of the best long-term consumption growth stories in our view; leveraged to a young Indian population (50% below 25 years of age) and changing social habits driving sustained long-term liquor consumption growth. As a market leader, UNSP is best positioned to benefit from this trend. Buy/Low Risk (1L).

Buy/Low Risk	**1L**
Price (23 Jan 07)	Rs819.85
Target price	Rs1,080.00
Expected share price return	31.7%
Expected dividend yield	0.1%
Expected total return	**31.8%**
Market Cap	Rs77,461M
	US$1,756M

Price Performance (RIC: UNSP.BO, BB: UNSP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	267	5.17	25.2	158.7	14.7	9.5	0.1
2006A	801	8.47	64.0	96.7	7.3	11.9	0.0
2007E	2,292	24.26	186.2	33.8	6.3	20.0	0.1
2008E	3,348	35.43	46.1	23.1	5.3	24.9	0.1
2009E	4,099	43.37	22.4	18.9	4.5	25.9	0.1

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	158.7	96.7	33.8	23.1	18.9
EV/EBITDA adjusted (x)	126.1	27.4	15.7	12.8	10.6
P/BV (x)	14.7	7.3	6.3	5.3	4.5
Dividend yield (%)	0.1	0.0	0.1	0.1	0.1
Per Share Data (Rs)					
EPS adjusted	5.17	8.47	24.26	35.43	43.37
EPS reported	5.17	8.47	24.26	35.43	43.37
BVPS	55.60	112.12	130.16	154.38	181.05
DPS	0.50	0.24	0.52	0.78	0.98
Profit & Loss (RsM)					
Net sales	11,555	21,100	25,492	29,232	33,522
Operating expenses	-11,081	-18,558	-21,077	-23,869	-27,177
EBIT	**474**	**2,542**	**4,415**	**5,363**	**6,345**
Net interest expense	-321	-1,648	-1,540	-1,080	-990
Non-operating/exceptionals	275	250	400	500	500
Pre-tax profit	**428**	**1,144**	**3,275**	**4,783**	**5,855**
Tax	-59	-343	-982	-1,435	-1,757
Extraord./Min.Int./Pref.div.	-102	0	0	0	0
Reported net income	**267**	**801**	**2,292**	**3,348**	**4,099**
Adjusted earnings	267	801	2,292	3,348	4,099
Adjusted EBITDA	631	2,803	4,706	5,674	6,675
Growth Rates (%)					
Sales	7.8	82.6	20.8	14.7	14.7
EBIT adjusted	20.9	436.0	73.7	21.5	18.3
EBITDA adjusted	5.9	344.6	67.9	20.6	17.6
EPS adjusted	25.2	64.0	186.2	46.1	22.4
Cash Flow (RsM)					
Operating cash flow	**882**	**-35**	**2,020**	**3,076**	**3,765**
Depreciation/amortization	156	261	292	311	330
Net working capital	459	-1,098	-564	-583	-664
Investing cash flow	**-2,911**	**-12,084**	**-550**	**-350**	**-350**
Capital expenditure	-137	-1,887	-550	-350	-350
Acquisitions/disposals	-2,774	-10,197	0	0	0
Financing cash flow	**2,300**	**17,180**	**-2,587**	**-3,059**	**-2,579**
Borrowings	2,520	10,261	-2,000	-2,000	-1,000
Dividends paid	-118	-235	-587	-1,059	-1,579
Change in cash	**271**	**5,061**	**-1,117**	**-333**	**835**
Balance Sheet (RsM)					
Total assets	**11,407**	**32,651**	**33,586**	**34,928**	**37,655**
Cash & cash equivalent	425	5,485	4,368	4,035	4,870
Accounts receivable	1,793	3,058	3,730	4,290	4,933
Net fixed assets	2,195	3,821	4,079	4,118	4,138
Total liabilities	**8,533**	**22,056**	**21,286**	**20,339**	**20,546**
Accounts payable	2,542	5,781	6,984	8,009	9,184
Total Debt	5,739	16,000	14,000	12,000	11,000
Shareholders' funds	**2,875**	**10,595**	**12,300**	**14,589**	**17,109**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	5.5	13.3	18.5	19.4	19.9
ROE adjusted	9.5	11.9	20.0	24.9	25.9
ROIC adjusted	8.5	36.6	44.0	45.9	49.6
Net debt to equity	184.9	99.2	78.3	54.6	35.8
Total debt to capital	66.6	60.2	53.2	45.1	39.1

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3QFY07 beats expectations, the party continues

3QFY07 results were ahead of expectations, with net profits pre exceptionals growing 433% yoy. Profit growth was driven by sales growth of 51% and EBITDA margin expansion of 132bps to 16.5%. According to the management, EBITDA margin expansion is likely to continue. The company recorded an exceptional income of Rs2.65bn on account of the sale of some of its treasury stock. We are wary of such piecemeal stock sales – we believe that the company will be able to derive a much better bargain from a strategic investor and as such should not sell its treasury stock on a piecemeal basis.

Figure 1. 3QFY07 and 9MFY07 Results Summary (Rupees in Millions, Percent)

	3Q06	3Q07	% Change	9M06	9M07	% Change
Gross Sales	9,292.5	10,760.4	15.8	26,222.8	32,979.4	25.8
Excise Duty	-4,153.5	-3,026.2	-27.1	-11,511.6	-12,374.9	7.5
Net Sales	**5,139.0**	**7,734.2**	**50.5**	**14,711**	**20,605**	**40.1**
Total Expenditure	-4,360.4	-6,460.3	48.2	-12,838.7	-16,964.6	32.1
EBITDA	**778.6**	**1,273.9**	**63.6**	**1,872.5**	**3,639.9**	**94.4**
EBITDA Margin (%)	15.2	16.5	132 bps	*12.7*	*17.7*	494 bps
Interest	-438.4	-288.9	-34.1	-1,192.4	-813.7	-31.8
Depreciation	-65.0	-33.9	-47.8	-187.0	-196.8	5.2
Other Income	47.0	142.6	203.4	174.8	170.8	-2.3
PBT	**322.2**	**1,093.7**	**239.4**	**667.9**	**2,800.2**	**319.3**
Provision for taxation	-178.1	-325.1	82.5	-431.8	-1,017.1	135.5
Tax Rate (%)	*55.3*	*29.7*	-2555 bps	*64.7*	*36.3*	-2833 bps
Net Profit	**144.1**	**768.6**	**433.4**	**236.1**	**1,783.1**	**655.2**
Net Profit Margin (%)	*2.8*	*9.9*	713 bps	*1.6*	*8.7*	705 bps
Non-recurring items	0.0	2,656.7	nm	-	2656.7	nm
Net Profit After Exceptionals	**144.1**	**3,425.3**	**2,277.0**	**236.1**	**4,439.8**	**1,780.5**

Source: Company Reports and Citigroup Investment Research

Figure 2. 3QFY07 and 9MFY07 Cost Details (Rupees in Millions, Percent)

	3Q06	3Q07	% Change	9M06	9M07	% Change
(Inc)/Dec in stock in trade	-3.7	485.2	nm	-41.4	262.1	-733.1
Consumption of Raw materials	1,235.4	1,485.3	20.2	3,437.4	3,714	8.0
Purchase of finished goods	135.8	705.3	419.4	500.7	2,735.8	446.4
Consumption of other materials	1,180.2	1,453.6	23.2	3,423.3	4,058.6	18.6
Total Raw materials costs	**2,547.7**	**4,129.4**	**62.1**	**7,320**	**10,770.5**	**47.1**
As a % of sales	*49.6*	*53.4*	382 bps	*49.8*	*52.3*	251 bps
Staff Cost	**368.8**	**514.8**	**39.6**	**11,72.5**	**1,316**	**12.2**
As a % of sales	*7.2*	*6.7*	-52 bps	*8.0*	6.2	-174 bps
Other expenditure	**1,443.9**	**1,816.1**	**25.8**	**4,346.2**	**4,878.1**	**12.2**
As a % of sales	*28.1*	*23.5*	-462 bps	*29.5*	*23.7*	-587 bps

Source: Company Reports and Citigroup Investment Research

Sales growing strong, product mix improving

While overall volumes for United Spirits are growing in the range of 8%-9%, its sales growth is much higher at 18%-20%, driven by significant product-mix improvement. The company has been increasing focus on its high-margin front-line brands (35 brands of total 145 brands) and has been pruning its low-end tail brands. These 35 brands contribute 85% to United Spirits' gross margins. As a result, sales contribution from front-line brands has increased from 75% to 90% over the last few quarters, and we expect this to increase to 95%. Also, within the front-line brands, contribution from relatively higher-margin products (white spirits) is increasing.

Sales composition from higher-margin premium whiskey segments has been increasing; those from economy have been declining.

Figure 2. United Spirits – Margin Contribution and Sales Composition Across Segments

	FY06 Margin Contribution (%)	Sales Composition (%)		
		FY06	FY05	FY04
Scotch / Super	4.7	0.4	0.3	0.2
Premium	22.5	4.3	4.3	4.1
Deluxe	29.0	19.5	19.9	19.1
Regular	38.0	64.3	56.2	47.6
Economy	5.8	11.6	19.3	28.9
Whiskey - Total	**73.0**	**58.6**	**57.2**	**59.9**
Rum	**11.0**	**18.1**	**19.9**	**18.9**
Brandy	**8.0**	**18.3**	**18.1**	**16.6**
Gin	**3.0**	**2.2**	**2.5**	**2.9**
Vodka	**5.0**	**2.8**	**2.2**	**1.7**

Source: Citigroup Investment Research

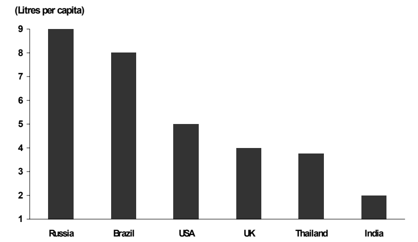
Entry into wine segment bodes well

United Spirits is looking to enter the high-growth wine segment with the launch of its brand 'Zinzi' , priced between Rs200-Rs600 per bottle and 'Bouvet Ladubay' at the higher end (>Rs600 per bottle).

White & Mackay acquisition: Discussion still under way

According to the United Spirits management, talks to acquire White & McKay are still under way. We believe that this acquisition would be a good strategic fit for United Spirits. However, we would be wary of any excessive valuations being paid for acquiring this company. United Spirits already has a highly leveraged balance sheet, and raising further debt could strain the balance sheet. While United Spirits management has not indicated the likely size of this acquisition, it would be looking at selling 18% treasury stock to partly fund this acquisition. Management has also indicated that debt could be raised in the books of White & Mackay, without recourse to United Spirits' assets. We understand from the management that White & Mackay sells about 10m cases and had sales of US$150m and EBITDA profit (before restructuring costs) of US$25m last year.

Figure 3. Per Capita Liquor Consumption



Source: Company Reports

Among best consumption plays in India

To us, United Spirits is one of the best consumption plays in India, leveraged to a young population and changing social habits driving greater acceptability to liquor. Alcohol consumption in India typically begins at around 18 years of age in India, and with almost 50% of the population currently below 25 years of age, a significant amount of incremental population demanding alcohol is likely to be added over the next 10-15 years. Over the next ten years, an additional 150m of population will be added to the 20-year-plus age segment, the target population for liquor consumption.

With a 53% market share, United Spirits is well positioned in a fast-growing Indian liquor industry that has high entry barriers. Favorable demographics, rising income levels and changing social habits are driving strong growth for branded liquor in India. We estimate that liquor consumption (branded) in India is likely to growth at a CAGR of 13% over the next 5 years, up from the historical growth rate of about 10%. As such, per-capita consumption of liquor in India is low – about 2 liters per capita compared to 3.8 liters in Thailand, 5 liters in the US and 9 liters in Russia.

United Spirits

Company description

United Spirits is the largest player in India’s branded spirits market. It pursues an inorganic growth strategy, with its latest acquisition being the second-largest Indian liquor manufacturer, Shaw Wallace. The acquisition has significantly enhanced its competitive position, increasing its market share in branded spirits to 53%. It is also exploring international growth opportunities, and recently acquired French winemaker Bouvet Ladubay — the wine arm of champagne major Taittinger.

Investment thesis

We rate United Spirits a Buy (1L), with a target price of Rs1080. India’s organized liquor market is growing at a rate of 13%, driven by rising disposable incomes, favorable demographics and a shift in consumption patterns. Being the market leader, United Spirits looks well positioned to benefit from this growth rate. Its acquisition of Shaw Wallace has strengthened its competitive position. It has a 53% share of India’s organized liquor market, which is characterized by high entry barriers. The Shaw Wallace acquisition should bring procurement, product and marketing synergies, and drive significant cost savings and a significant margin expansion over the next three years, on our estimates. United Spirits is also simplifying its shareholding structure, with all liquor companies being merged into a single entity. The non-core assets have been hived off into a separate listed company. Treasury stock of 18% could potentially be sold to strategic investors at a large premium. United Spirits is exploring international acquisitions to fuel growth. We do not rule out international joint ventures going forward. After the recent capital-raising and debt repayment, gearing has declined. Steady sales growth, margin expansion and lower interest costs should drive an EPS CAGR of 72% in FY06-09E. United Spirit's capital efficiency is looking up amid strong earnings growth.

Valuation

Our target price of Rs1080 is based on 25x P/E for FY08E, adjusted for the 18% treasury stock that the company will hold after restructuring of the shareholding. United Spirits, in our view, could realize significant value from the treasury stock if it sold it to a strategic partner, especially a foreign player looking to enter the highly restricted Indian market. Our target multiple is at a 25-35% premium to the global 2007E average in recognition of 1) United Spirit's dominant position in India's liquor market, 2) strong demand growth of 13%, driven by rising incomes and market-share gains at the expense of the unbranded sector, 3) high barriers to entry, and 4) a 72% three-year EPS CAGR, almost 3x higher than the global peer group average. Our target multiple is at a 10-15% discount to the average 2008E multiple for the Indian consumer universe in view of the company's much higher gearing (vs. net cash for the Indian consumer universe) and lower capital-efficiency ratios. We use adjusted EV/EBITDA as our second valuation methodology and ascribe a multiple of 15x FY08E EV/EBITDA, which equates to Rs1050. Our EV/EBITDA multiple is based on a 20-25% premium to the 2008E global peer group average multiple, justified in our view for the reasons stated above.

Risk

We rate United Spirits Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share-price volatility. The key downside risks to our rating and target price include: 1) The liquor industry is highly regulated. Any change in policy (like increase in taxes, further control on distribution or an outright ban on liquor sales in some states) could adversely impact growth and profitability. 2) Easing the norms for entry of foreign players could increase competition and hurt growth prospects. 3) The company is looking for international acquisitions. Any bad buyout would result in further pressure on gearing and interest costs. 4) A general slowdown in GDP / income growth could lead to slowdown in market growth and sales.

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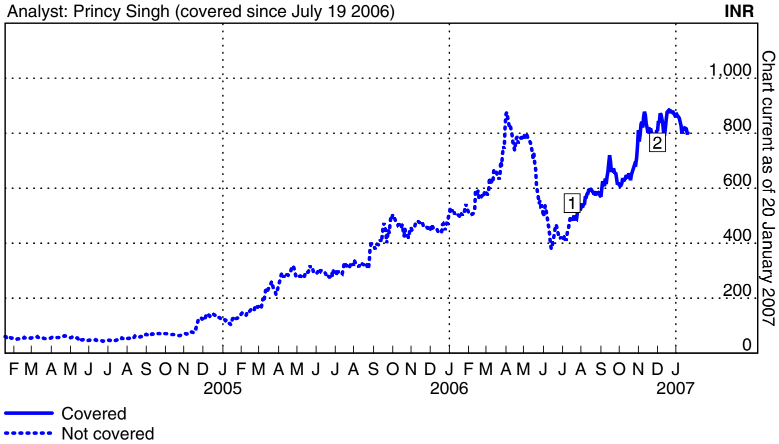
United Sprits (UNSP.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since July 19 2006)

INR



#	Date	Rating	Target Price	Closing Price
1:	18 Jul 06	1L	694.00	486.65
2:	1 Dec 06	1L	*1,080.00	807.65

*Indicates change.

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