United Spirits (UNSP.BO)

Equity

Analyst Meet Takeaways: W&M – Less Bulk, More Brands

- **W&M: Brand focused** — Mgmt noted that W&M will focus on emerging markets and branded scotch, moving away from its current bulk business. We believe this is a long-term positive. The new business model is in keeping with W&M's status as a leading global scotch manufacturer. Execution will remain a key imponderable In the near term; earnings will be affected – mgmt has guided to EBITDA of £33m (-40%) in FY11 on a revenue base of £110m (3.5-4m cases). Mgmt expects EBITDA growth of ~15% CAGR over the next 2 years. W&M's scotch inventory of 103m litres is valued at £430m as of June 2010.
- **Domestic business: Directionally positive** — Wet goods costs have softened to Rs143/case in 1QFY11, down from ~Rs151-152/case in 1QFY10 and Rs148/case in 4QFY10. Mgmt expects input costs to remain at current levels during 2Q before softening in 2HFY11. However, mgmt noted that glass prices (~20% of COGS) are expected to harden in August by ~7%. Lower input costs coupled with better fixed cost mgmt and controlled BTL spends should ensure EBITDA margins remain ~20%. Volume growth is expected to continue at a healthy pace of 12-15% Y/Y.
- **Capital structure: Remains challenged** — Overall, gross debt is Rs56.8bn end June, up ~Rs2bn Q/Q, driven by higher requirements of working capital (~Rs1.8bn), and investments in 3 tie-up units (~Rs1.6bn). We don't expect debt levels to meaningfully reduce, despite strong profit growth, in the backdrop of: a) elevated capex spends over the next 3 years (Rs11bn – firmed up from ~Rs7-8bn earlier), and b) uncertainty on working capital/NCA. From a cash flow/debt servicing perspective, UNSP is comfortably poised. The option of selling treasury shares (8.4m shares, value of Rs11.6bn) and reducing debt is a tangible positive.
- **Maintain Buy** — Given the recent run-up in the stock, we might not see meaningful stock price appreciation in the near term, especially in the context of W&M's revised forecasts. We note W&M's EBITDA cut of ~40% could adversely impact our consolidated PAT estimates by ~13-18% over FY11-12E.

Buy/Medium Risk	1M
Price (22 Jul 10)	Rs1,381.50
Target price	Rs1,452.00
Expected share price return	5.1%
Expected dividend yield	0.2%
Expected total return	**5.3%**
Market Cap	Rs173,509M
	US$3,679M

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 (%)
2008A	1,174	13.25	-49.0	104.3	5.9	6.8	0.1
2009A	3,830	37.19	180.7	37.1	6.0	17.2	0.2
2010E	4,218	34.96	-6.0	39.5	3.6	12.1	0.2
2011E	6,571	54.46	55.8	25.4	3.2	13.5	0.3
2012E	8,552	70.87	30.1	19.5	2.8	15.3	0.3

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

United Spirits

Company description

United Spirits is the largest player in India's branded spirits market with more than a 55% market share. It pursues an inorganic growth strategy, acquiring second-largest Indian liquor manufacturer Shaw Wallace and scotch manufacturer Whyte & Mackay. While the Shaw Wallace acquisition enhanced its competitive position, raising its market share in branded spirits market, Whyte & Mackay gave it access to scotch inventory to drive the next leg of its India growth strategy. UNSP also acquired French winemaker Bouvet Ladubay - the wine arm of champagne major Taittinger and plans to introduce its products to the Indian market. UNSP also owns the Bangalore IPL cricket team 'Royal Challengers' in a 100%-owned subsidiary.

Investment strategy

We rate United Spirits shares Buy/Medium Risk (1M) with a target price of Rs1452. The company is well positioned to benefit from India's organized liquor market that is growing at a rate of ~10-15% (driven by rising disposable incomes, favorable demographics and a shift in consumption patterns). Over the last year, the stock had underperformed due to concerns on high input costs; which we believe are now baked into expectations as well as estimates and the probability of input costs further surprising negatively is limited. UNSP has demonstrated the ability to pare discretionary cost items that buffer EBITDA growth. UNSP will focus on de-leveraging its balance sheet, which should help allay concerns on the high gearing and interest cost burden. Whyte & Mackay acquisition remains a long-term strategic fit and should significantly enhance UNSP's plans to expand its presence in the Indian premium whisky segments and provide UNSP access to the European market. UNSP is well positioned to enhance the value of Whyte & Mackay's inventory of scotch whiskey, by providing access to a ready and fast growing market for premium whisky.

Valuation

Our target price of Rs1452 is based on a two-part EV/EBITDA methodology. We value the domestic operations at 15x FY11E EV/EBITDA. The multiple is at a 25% premium to international peers. We think this is merited, given that: a) volume growth in India continues at mid teen levels vs. nominal growth in developed markets, b) With >55% market share, UNSP's market positioning in a high growth market is attractive, and c) India's demographic story is also attractive from a longer term alcohol consumption story. We value the W&M EBITDA stream at 9x (which is a ~25% discount to the global majors). We think this discount is merited, because of W&M's status as a bulk scotch manufacturer (primary revenue streams are of bulk scotch, though it does have a burgeoning branded scotch whisky business). Over the longer term, we think that W&M could re-rate, especially as management focuses on building the branded business. The bulk scotch inventory also provides the company with a real option of selling down part of the stock and reducing overall debt levels.

Risks

We rate United Spirits shares Medium Risk, instead of High Risk as suggested by our quantitative risk-rating system, which tracks 260-day historical share-price volatility. We believe that this is warranted given that UNSP benefits from favourable demographic trends and consumption patterns in India, which offer better growth prospects. Further, strong domestic volume growth continuing in a challenging environment is an encouraging trend. The key downside risks to our rating and target price include: 1) the liquor industry is highly regulated and thus 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) a significant uptrend or delay in correction of molasses/ENA and packaging costs could adversely impact operating margins; 3) high interest expenses may impact earnings growth, if United Spirits is unable to deleverage its balance sheet over the medium term.

Appendix A-1

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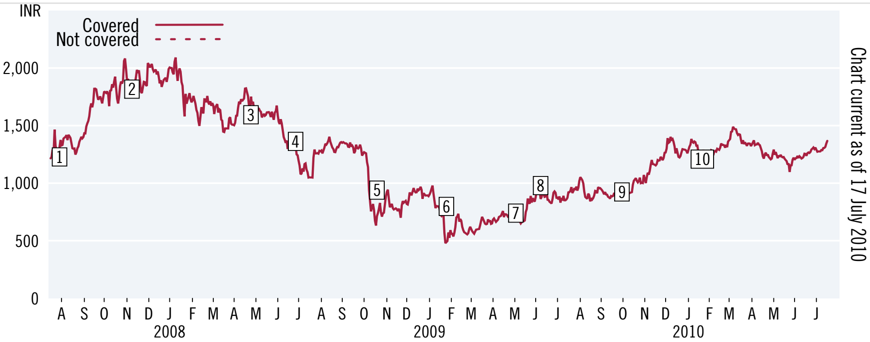
United Spirits (UNSP.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Jamshed Dadabhoy
Covered since May 6 2008



Date	Rating	Target Price	Closing Price
1 29-Jul-07	1L	*1,463.00	1,246.45
2 8-Nov-07	1L	*2,164.00	1,856.20
3 24-Apr-08	1L	*2,037.00	1,752.00
4 26-Jun-08	1L	*1,574.00	1,327.30
5 20-Oct-08	*1M	*930.00	712.80
6 24-Jan-09	*3H	*454.00	478.25
7 4-May-09	3H	*628.00	731.60
8 7-Jun-09	*3M	*901.00	931.20
9 30-Sep-09	*1M	*1,142.00	914.60
10 21-Jan-10	1M	*1,452.00	1,222.70

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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