INDIA RESEARCH

United Spirits

Rs725
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs72.6bn; US$1.5bn

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Result: Q2FY09

Comment: Squashing apprehensions via performance!

Key Valuation metrics

Year	Net Sales	yoy chg (%)	Net profit	EPS (Rs)	yoy chg (%)	EV / E	PER (x)
FY06	20969	72.9	420	5.1	(1.9)	27.8	143.0
FY07	29249	39.5	2,973	31.5	520.7	17.8	23.0
FY08	46734	59.8	3,116	31.1	(1.1)	9.9	23.3
FY09E	53683	14.9	4,217	42.1	35.3	8.5	17.2
FY10E	62111	15.7	6,338	63.3	50.3	6.5	11.5

Quashing aside significant apprehensions with regards its operating numbers, United Spirits (USL) reported revenue growth of 20% at Rs9bn (our estimate at Rs9.1bn), EBTIDA growth of 17% at Rs1.8bn (our estimate at Rs1.9bn) and net profit of Rs0.94bn, up 17% (our estimate of Rs1bn). Volume growth for the quarter stood at 15%, with continued growth at the top end brands. EBITDA margins decline has been marginal at 50bps, in the context of sharp spurt in input costs i.e. packaging, ENA and others costs. USL has shown a 42% increase in raw material costs resulting in a 610bps increase yoy and yet managed to ensure stability in margins on the back of increased focus on premium brands and lower other costs (ASP spends and employee costs).

We expect a 12%+ volume and 15% revenue growth sustaining over the next 2 years on the back of a series of favourable regulatory reforms (eg. AP, country liquor bar in Karnataka, price hikes in TN, Karnataka, UP, Punjab, MP etc). Along with sharper gains in W&M's portfolio (current year EBITA of GBP60m) given a 30% increase in scotch prices, bodes well for the longer term cash generation within USL, as old contracts come up for re-negotiation. We believe that recent fall in USL's stock price was mainly on the back of perceived operational concerns (volume growth, molasses prices, IPL losses) as indeed non-operational concerns (impact on USL's balance sheet for funding Kingfisher Airlines). While "non-operational concerns remain" (management stressed that there was no inter-group funding and thereby the risk to USL balance sheet being at the bare minimal), USL has once again proven the operational superiority of its business model.

Our core thesis with regards USL comes on the back of continued operational gains, growth in its global businesses as also potential value unlocking through a) treasury stock sale b) value in IPL and c) value creation opportunity in W&M. Valuing USL's business operations on sum of the parts basis (domestic operations at 20x FY10E earnings, W&M at 12x FY10E EV/ E, 13.9m treasury stock at current valuations and IPL team ownership at the acquisition price of USD112m), we arrive at a target price of Rs1236 per share. With 67% upside from the current levels, we reiterate Outperformer call on USL.

HIGHLIGHTS OF Q2FY09 AND MANAGEMENT INTERACTION POST RESULTS

- Marginally lower than our estimates, United Spirits (USL) has reported revenue growth of 20% at Rs9bn, EBITDA of Rs1.8bn and PAT growth of 17% at Rs0.94bn.
- Even though high raw material prices (46% increase yoy) have lead the total material costs to grow by 35% yoy, the overall profitability in the quarter has been sustained on the back of a 17% degrowth in employee expenses and a 27% degrowth in ASP spends (last quarter had the heavy spends of IPL). Further focus on price increase in free markets and driving up-gradation has ensured healthier portfolio margins.
- Going ahead, the prices of raw material are expected to stabilize on the back of the better crushing season in Q3, USL's bargaining power (largest procurer of molasses in India) and increased grained based alcohol reducing its dependence on molasses. The management estimates the cost of materials to average at around 52% of sales going ahead.
- USL continues its focus on premium end of its portfolio – of the 2.7m cases added during the quarter, 2.6m were added at the upper end of the portfolio.
- Shaw Wallace & Company Ltd (SWCL) contributed Rs 73.9m to the EBITDA, Rs 32.9m to the PBT and Rs 18m to the PAT of USL. The final hearings at the Calcutta high court have been concluded taking the process of the merger to final stages.
- Provisional results for White and Mackay have shown a one-third increase in sales and an 83% increase in EBITDA compared to the H1FY08. The average price per liter of W&M stock has been estimated to be 30% higher than what it was at the time of acquisition. USL expects India to emerge as a strong scotch market to fuel a sustained 25% growth over the longer term (as the portfolio mix moves from bulk to branded).
- **Management has stated that there is no cross funding of other group entities mainly Kingfisher Airlines via USL.**
- USL has domestic debt of Rs14bn and overseas debt of US$619m through Citibank and GBP325m through ICICI Bank for the acquisition of W&M. Both these loans have an extended moratorium on repayments and hence **during the current fiscal there are no repayments due on either loan**. **FY10 requires repayments of US$90m to Citibank whereas ICICI Bank repayments commence from FY11.**
- On the back of the increase in Wine consumption in India, USL has build the largest vineyard in the country (to commence operations by Jan09) with a capacity to produce 1mn cases.
- With regards to statements made by the health minister not in favour of the alcohol industry, the management clarified that the health minister does not have any constitutional power in the matter and that alcohol was strictly a State subject.

❑ Growth to continue – Premium brands and better regulatory environment

The IMFL industry is growing at 12%, with value growth ahead of volume growth on the back of up trading and price hikes. USL has shown strong resilience with ytm growth of 17% for H1FY09, ahead of our full year estimates of 12% volume growth. Whilst cost pressures continue, the industry in general and USL in particular has been able to ensure increase in prices in few states like – Tamil Nadu, Karnataka, UP, Uttarakhand, Punjab, Chandigarh, Haryana, MP, etc. Regulatory environment has further turned in favour of IMFL – Karnataka has banned country liquor and easing regulations in UP. We expect continued momentum in USL's core portfolio which will be further fortified with the entry of Wine (Jan09) as also launches at the premium end of portfolio via W&M brands.

❑ Group under stress – But USL "holds on" to its potential value drivers (can unlock close to US$500m)

UB, as a group is believed to be under stress due to the fact that it makes a loss of Rs15bn in aviation, while the group profits including that of USL stands at around Rs7bn. **However, as an operational business USL has shown no signs of funding constraints or more importantly no desperation to unlock value in some of its other operating assets under USL.**

a) USL, through its 100% subsidiary – Royal Challenger Sports Private Limited, owns the franchisee rights for Bangalore Team. RCSPL has invested USD111.6m towards acquisition of rights with the amount payable over the next 10 years. Our belief is that ALL franchisees of IPL will make money in Year 2 and there is a material value accretion in this business – both operational as also financial for USL. USL's management does not seem to be in a major rush to encash on the same in the near term and are willing to exploit the full benefit of its team before they look at financial investors in this space, sometime next year.

b) The treasury stock of 13.9m shares is presently worth Rs10bn at current prices. There is a stated intent to use this stake to partly fund its debt repayment. USL, to our reading, has again not been very desperate to move this block out – a reflection of the companies' not-so-desperate-position with regards its cash-flows.

c) W&M – continues to build its portfolio whilst scotch continues to remain in tight supply environment. Revenue and EBITDA growth numbers have been robust and are expected to remain so over the coming couple of years. Potential value unlocks (a possible IPO) is also a strong possibility in W&M, an option which USL, again has not exercised as yet.

❑ Valuation - Reiterate Outperformer – price target of Rs1236

"Assuming that non-operational issues are capped", we see tremendous merit in USL as a stock. We value USL on SoTP valuations, with the basis being unders. Maintain outperformer with a price target of Rs1236, an upside of 67% from current levels of Rs740.

SOTP Valuations

Segment	Basis of valuations	Value	Value per share
Domestic operations	20x FY10E Earnings (Consumer valuations)	108,586	1,084
Whyte & Mackay	12x FY10E EV/ EBITDA (Acquisition multiples)	70,031	699
Treasury Stock	Current value for 13.9m shares (mkt value)	10,286	102
IPL	Acquisition price of USD111.6m (at cost)	4,687	47
Total Value		**193,590**	**1,936**
Less Net Debt		70,000	700
Net Equity value		**123,590**	**1,236**

Source: IDFC SSKI Research

Quarterly results

(Rs Mn)	Q2FY08	Q3FY08	Q4FY08	FY08E	Q1FY09	Q2FY09	FY09E	FY10E
Net Sales	**7,526**	**8,890**	**7,590**	**46,734**	**10,134**	**9,020**	**53,683**	**62,111**
% yoy	(0.1)	14.9	16.5	59.8	32.3	20	14.9	14.9
EBITDA	**1,549**	**1,708**	**1,353**	**10,820**	**2,152**	**1,809**	**12,419**	**15,466**
EBITDA %	20.6	19.2	17.8	23.2	21.2	20.1	23.1	24.9
Net interest	328	328	329	5,243	341	395	5,302	5,075
Depreciation	72	90	85	911	82	87	1,014	1,108
Other Income	42	96	107	357	72	106	382	427
Profit before Tax	1,191	1,387	1,047	5,023	1,801	1,433	6,485	9,710
Tax	389	505	384	1,906	620	494	2,268	3,372
Extraordinary	-	-	-		-			
Profit After Tax	**802**	**882**	**651**	**3,116**	**1,171**	**939**	**4,217**	**6,338**
% yoy	20.1	(74.3)	21.6	4.8	33.7	17	35.3	50.3

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Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index