INDIA RESEARCH

United Spirits

Rs863
OUTPERFORMER

Annual report read–"No funding to Aviation"

Mkt Cap: Rs86.4bn; US$1.8bn

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Redirecting of healthy cash flows of United Spirits to funding the losses of 'Kingfisher Airlines' and "sponsor leverage" have been the key non operational concerns on United Spirits. Albeit a strong operational performance in H1FY09 (17% volume growth, 26% revenue and PAT growth), USL's stock has just about tracked Sensex (not a bad performance though!). This we believe has been primarily on account of the non-operational overhangs. While the management has in the past too guided that no group funding is happening through United Spirits or any of its stepped down subsidiaries, the Annual Report of 2007-08 just reiterates the same. The Annual Report suggests that no funds have been redirected towards any of the group's loss making entity – neither in the form of debt, nor loans and advances nor corporate guarantees. As non-operational concerns take a back seat and business operations continues to be on a strong growth path, we maintain our Outperformer rating on United Spirits.

KEY HIGHLIGHTS OF FY08 ANNUAL REPORT

❑ Balance Sheet details

- Consolidated share capital lower on account of netting off of cross holding with Shaw Wallace. Total treasury stock arising out of mergers of various companies would be at 13.9m shares.
- Consolidated debt includes debt of Rs58bn in the books of Whyte & Mackay and debt raised to fund the W&M acquisition. Of the consolidated Rs67bn of gross debt, Rs1.6bn is payable by March 2009
- Another USD90m would be payable in FY10 (as part repayment schedule of loans against W&M) in two tranches – one in May 2009 and second in September 2009. We believe that USL is comfortably placed to repay the debt with Rs5bn of cash on the consolidated books and Rs5bn+ of cash profit generation in FY09.
- Inventory includes Rs10.2bn of inventory in W&M books (valued at cost). Current realizable value of the inventory is GBP450m (as against GBP395m at the time of acquisition). As against 115m litres of Scotch inventory on the books of W&M at the time of acquisition, current inventory stands at ~110m litres.
- Debtor days in standalone books have remained flat at 47 days. Debtor days in consolidated books are at 66 days. Debtors over 6 months at just Rs213m in the consolidated books.
- Loans and Advances in the standalone books is at Rs18bn, which includes Rs15bn to subsidiaries (mainly towards its 100% sub USL Holdings for W&M). Rs1.8bn is towards advance tax. Of the total Rs4.6bn of loans and advances in the consolidated accounts, Rs3.7bn is towards advance against acquisition of trade marks.

Consolidated Standalone

(Rs m)	FY08	FY08	FY07
Share Capital	886	1,002	1,022
Reserves & Surplus	19,152	19,092	12,398
Debt	67,689	11,621	14,678
Minority Interest	1,992		
Deferred Tax Liability	18		8
Total Source of Funds	**89,737**	**31,714**	**28,106**
Fixed Assets	64,423	5,290	4,645
Investments	2,119	6,572	6,625
Deferred Tax Assets		5	
Working Capital			
Inventories	14,850	3,844	2,937
Sundry Debtors	8,370	4,135	3,552
Cash & Bank Balances	5,438	280	3,736
Other current assets	1,469	1,188	1,112
Loans & Advances	4,583	18,158	11,295
Total Current Assets	**34,710**	**27,604**	**22,631**
Liabilities	10,303	7,298	5,331
Provisions	1,211	459	464
Total Current Liabilities	**11,514**	**7,757**	**5,795**
Net Current Assets	**23,196**	**19,848**	**16,836**
Total Application of Funds	**89,737**	**31,714**	**28,106**

❑ Off Balance Sheet items

- Corporate Guarantees in the standalone entity is to the tune of Rs24.9bn towards USL Holdings. Corporate Guarantees in the consolidated books is only to the tune of Rs142m. There is NO Corporate Guarantees towards the Aviation business.

❑ Operational parameters

- Revenue growth in the standalone entity stood at 17% with underlying volume growth at 11%. Value growth is primarily driven by higher growth in the premium segments
- Overall IMFL industry has grown by 14% in FY08. With country liquor ban in Karnataka (one of the largest liquor markets), there was a sharp jump in the sales of the mass segment IMFL brands. The mass segment of IMFL industry added 21m cases, while the premium segment added 11m cases.
- With addition of Romanov Vodka, USL has 17 Millionaire brands. McDowell sales grew by 25% at 27.8m cases, while that of Bagpiper touched 14m cases.
- Consolidated business includes Rs12bn of revenues from W&M and Rs2.9bn in Shaw Wallace & Co.
- Better product mix and the scale of operations have helped margin expansion of 310bp in the standalone entity at 18.8%. Consolidated EBITDA margins stood at 22.9%, with W&M margins at ~33%
- Interest cost of Rs5.4bn is mainly attributed to USD1.2bn of debt to fund W&M acquisition.

	Consolidated	Standalone	
	FY08	FY08	FY07
Revenues	46,274.5	31,731.3	27,205.3
EBITDA	10,617.1	5,974.0	4,262.1
EBITDA Margin	**22.9**	**18.8**	**15.7**
Interest Cost	5,447.6	1,285.1	1,067.6
PAT (post minority interest)	**2,720.6**	**3,112.8**	**2,312.8**

❑ Snapshot of W&M Balance Sheet

W&M	Rs m
Liabilities	
Secured Loans	29,951
Unsecured Loans	29,193
Current Liabilities	3,874
Provisions	128
Deferred Tax Liability	1
Assets	
Net Block	4,334
Goodwill on Consolidation	41,931
Investments	10
Inventories	10,160
Sundry Debtors	3,330
Cash & Bank Balances	3,097
Loans & Advances	682

❑ Operational Outlook – impressive

Operational outlook for USL continues to look attractive in the domestic as well as international markets.

Domestic growth at 15%+ - 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 volume growth of 17% for H1FY09, ahead of our full year estimates of 12% volume growth. Overall value growth stood at 26%. USL 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. While all this would ensure that USL's domestic operations continue to grow at over 15% CAGR over FY08-10, further trigger comes in the form of recent acquisition of Balaji Distrillers, currently a contract manufacturer for USL. Besides adding Rs8bn of throughput to USL from FY10 onwards, this acquisition gives USL direct manufacturing facility in Tamil Nadu, thereby saving upon its taxes.

International operations: W&M's international operations would continue to witness healthy growth with spirits price moving northwards and supply constraints for Scotch.

❑ Cloud off the non operational issues

The Annual Report for FY08 largely addresses the non operational concerns that clouded USL's stock performance. The Annual Report suggests that no funds have been redirected towards any of the group's loss making entity – neither in the form of debt, nor loans and advances nor corporate guarantees. Also we have always maintained that though the Group clearly has funding constraints for its aviation business, none of the acts of the Group have signaled the desperation to unlock value. For instance

- 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.
- The treasury stock of 13.9m shares is presently worth Rs11bn 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.
- 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.

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Disclaimer

Explanation of Ratings:

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

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