Company

25 August 2010 | 11 pages

United Spirits (UNSP.BO)

Virtue – and Value – in Vice

Equity ☑
Target price change ☑
Estimate change ☑

- **We did a quick call with mgmt…** — a) Domestic volume growth remains strong — volume growth was >20% in July with frontline brands growing 21%; b) cost pressures are reasonably contained - mgmt believes wet goods/case will be in the range of Rs141-43/case (vs. avg. of Rs151/case in FY10); and c) price hike cycle will commence, and mgmt thinks 2.5% price hike for the portfolio is achievable. We believe the EBITDA margin of 19.6% in 1Q should increase beyond 20%, buoyed by operating leverage (volumes) in 2Q and higher gross margins in 3/4Q.

- **…Consequently, increase TP to Rs1,622** — Admittedly, our consolidated EBITDA estimates are pared by 4-11% over FY11-12E, primarily to incorporate the revised W&M estimates (down by 39-44%). Our parent EBITDA estimates have been increased by 2-8%. Our TP increase is driven by a) a roll forward to Dec 11E from Mar11E (we maintain target multiples of 15x & 9x EV/EBITDA for UNSP and W&M respectively). Given IPL's success, we conservatively value the Bangalore IPL franchise at Rs44/share (at original investment value).

- **W&M: branded shift results in near-term earnings impact** — Mgmt has guided to EBITDA of £33m in FY11 on a revenue base of £110m. It targets attaining EBITDA of £60m in 5 years. Strategically, we think the shift to branded products is a positive. We don't increase the multiple despite the better quality of earnings, given the significant execution risks embedded. From an asset perspective, W&M's scotch inventory is ~103m litres, valued at £430m as of Jun10.

- **Debt repayment needs to be balanced with escalating capex & working capital** — Leverage is expected to remain high – gross debt should remain between ~Rs56-58bn till FY12 despite strong profit growth, driven by higher working capital requirements & capex. Our estimates factor ~Rs12bn capex over the next 3 years.

- **Key risks** — a) Elevated interest costs; b) Execution remains an imponderable in W&M's new strategy; and; c) other group related risks.

Buy/Medium Risk	**1M**
Price (25 Aug 10)	Rs1,351.10
Target price	Rs1,622.00
from Rs1,452.00	
Expected share price return	20.1%
Expected dividend yield	0.2%
Expected total return	**20.2%**
Market Cap	Rs169,690M
	US$3,618M

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	102.0	5.8	6.8	0.1
2009A	3,830	37.19	180.7	36.3	5.8	17.2	0.2
2010E	3,826	31.71	-14.7	42.6	3.6	11.0	0.2
2011E	5,610	46.49	46.6	29.1	3.2	11.7	0.2
2012E	7,893	65.41	40.7	20.7	2.8	14.5	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.

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	102.0	36.3	42.6	29.1	20.7
EV/EBITDA adjusted (x)	21.3	23.1	17.4	14.4	11.8
P/BV (x)	5.8	5.8	3.6	3.2	2.8
Dividend yield (%)	0.1	0.2	0.2	0.2	0.3
Per Share Data (Rs)					
EPS adjusted	13.25	37.19	31.71	46.49	65.41
EPS reported	30.72	-39.66	31.71	46.49	65.41
BVPS	234.52	231.64	376.66	419.62	480.05
DPS	1.50	2.09	2.06	3.02	4.25
Profit & Loss (RsM)					
Net sales	46,275	54,681	64,059	68,940	80,285
Operating expenses	-37,374	-45,753	-52,580	-55,224	-63,007
EBIT	**8,901**	**8,927**	**11,479**	**13,717**	**17,278**
Net interest expense	-5,448	-7,176	-6,240	-5,586	-5,684
Non-operating/exceptionals	1,063	1,038	472	500	550
Pre-tax profit	**4,516**	**2,790**	**5,710**	**8,630**	**12,143**
Tax	-2,661	-916	-1,884	-3,021	-4,250
Extraord./Min.Int./Pref.div.	865	-5,959	0	0	0
Reported net income	**2,721**	**-4,084**	**3,826**	**5,610**	**7,893**
Adjusted earnings	1,174	3,830	3,826	5,610	7,893
Adjusted EBITDA	9,642	9,853	12,552	14,806	18,413
Growth Rates (%)					
Sales	58.2	18.2	17.2	7.6	16.5
EBIT adjusted	121.4	0.3	28.6	19.5	26.0
EBITDA adjusted	121.3	2.2	27.4	18.0	24.4
EPS adjusted	-49.0	180.7	-14.7	46.6	40.7
Cash Flow (RsM)					
Operating cash flow	**-8,361**	**-7,040**	**-5,890**	**4,667**	**4,878**
Depreciation/amortization	741	926	1,073	1,090	1,135
Net working capital	-9,990	-3,540	-10,788	-2,033	-4,150
Investing cash flow	**-48,724**	**-5,182**	**6,241**	**-4,000**	**-7,000**
Capital expenditure	-6,713	-6,321	-800	-4,000	-7,000
Acquisitions/disposals	-42,011	1,139	7,041	0	0
Financing cash flow	**55,588**	**17,233**	**158**	**-2,167**	**2,122**
Borrowings	51,240	7,564	-17,119	-1,248	3,214
Dividends paid	-159	-252	-291	-427	-601
Change in cash	**-340**	**-948**	**510**	**-1,500**	**0**
Balance Sheet (RsM)					
Total assets	**101,986**	**118,418**	**119,428**	**125,047**	**137,686**
Cash & cash equivalent	5,438	4,490	5,000	3,500	3,500
Accounts receivable	8,370	8,880	11,160	12,800	14,997
Net fixed assets	11,163	16,558	16,285	19,195	25,060
Total liabilities	**79,221**	**94,500**	**73,914**	**74,350**	**79,697**
Accounts payable	9,256	9,256	9,878	11,123	12,713
Total Debt	66,041	73,605	56,486	55,238	58,452
Shareholders' funds	**22,765**	**23,919**	**45,514**	**50,697**	**57,989**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.8	18.0	19.6	21.5	22.9
ROE adjusted	6.8	17.2	11.0	11.7	14.5
ROIC adjusted	11.9	9.7	10.9	11.2	12.5
Net debt to equity	266.2	289.0	113.1	102.1	94.8
Total debt to capital	74.4	75.5	55.4	52.1	50.2

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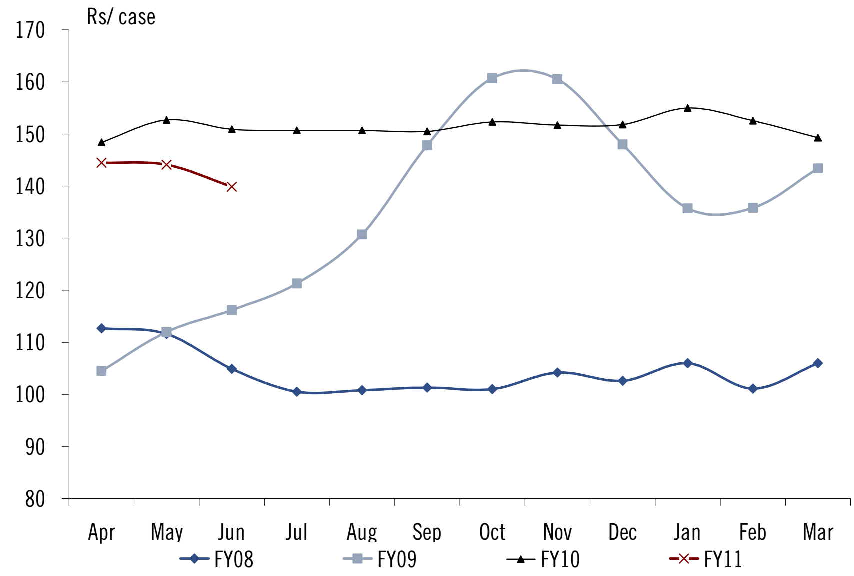
Reiterate Buy: Target Price of Rs1,622

We expect a) healthy revenue growth (driven by steady volumes at ~12%+ Y/Y + 2-2.5% pricing benefits + mix changes), b) benign input cost environment and c) lower discretionary expenses to drive a strong 39% EBITDA CAGR over FY10-12E in the domestic business. We forecast 6ppt expansion in EBITDA margins to ~22% between FY10-12.

Figure 1. United Spirits: Trends in Wet Goods Costs (Rs/case)



Source: Company Reports

Despite near-term cuts in earnings estimates in W&M (by ~40%), we think the branded shift will be a positive over the long term.

We increase our target price for UNSP to Rs1,622 from Rs1452 earlier as we: a) factor in our revised earnings forecasts (EBITDA cut by 4-11% over FY11-12E driven by W&M's new strategy), b) roll forward to Dec 11E from Mar11E, while maintaining our target multiples of 15x and 9x EV/EBITDA for UNSP and W&M, respectively. We ascribe Rs44/share to the Bangalore IPL franchise at the investment value.

Earnings Revision Summary

Figure 2. United Spirits (Consolidated): Earnings Revision Table

Year to 31-Mar	2011E			2012E		
	Old	New	% Chg	Old	New	% Chg
Sales (Rs Mils.)	72,017	68,940	-4%	80,877	80,285	-1%
EBITDA (Rs Mils.)	16,696	14,806	-11%	19,187	18,413	-4%
EBITDA Margin (%)	*23.2%*	*21.5%*		*23.7%*	*22.9%*	
Net Profit (Rs Mils.)	6,571	5,610	-15%	8,552	7,893	-8%
Diluted EPS (Rs)	54.5	46.5	-15%	70.9	65.4	-8%
Dividend Per Share (Rs)	3.5	3.0	-15%	4.6	4.3	-8%

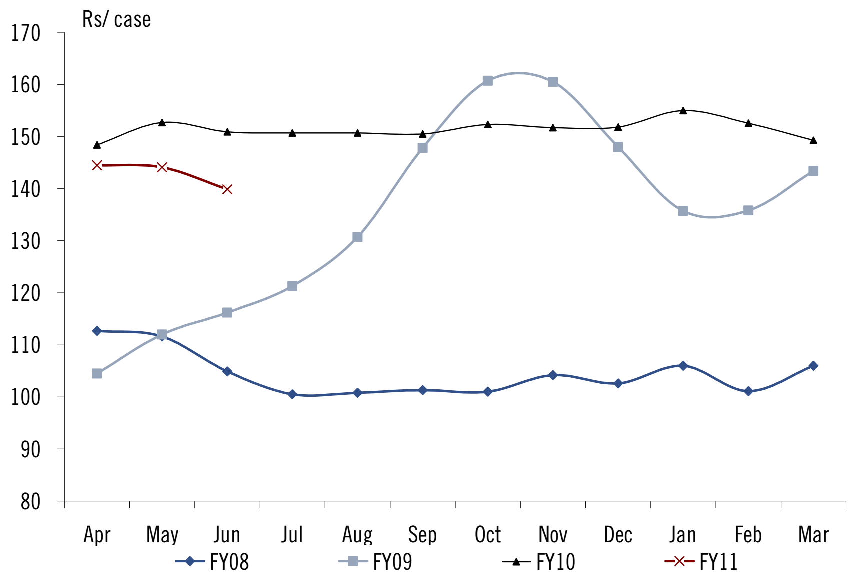
Source: Citi Investment Research and Analysis estimates

Our domestic business profits are increased by 2-8% over FY11-12E as we tweak gross margin forecasts.

We incorporate W&M's revised guidance in our estimates – pare W&M EBITDA by 39-44% over FY11-12E. Mgmt expects ~15% EBITDA CAGR for W&M over the next 2 years.

Overall, consolidated EBITDA estimates are revised downwards by 4-11% over FY11-12E. EPS estimates are lowered by 8-15% given the operating profit cut and changes to the interest costs. 2010E EPS/EBITDA estimates are down 9%/9% respectively.

Figure 3. United Spirits: Trends in Wet Goods Costs (Rs/case)



Source: Company Reports

Gross Debt to Remain at Elevated Levels

Overall, gross debt is Rs56.8bn (end June), and has been driven up by higher requirements of working capital and investments in tie-up units. We don't expect debt levels to meaningfully reduce, despite strong profit growth, against the backdrop of: a) elevated capex spends over the next 3 years (we factor Rs12bn for the next 3 years) and b) uncertainty on working capital/NCA. That said, from a cash flow/debt servicing perspective, UNSP is comfortably poised.

Figure 4. United Spirits (Consolidated): Debt Profile (in Rs Mn)

	Mar-10	Jun-10
Capex Loans/ Term Loans	6140	4410
Working Capital/ Unsecured Loans	14,080	17,260
Term Loans : Acquisition of W & M	12,840	12,840
Sub -Total	**33,060**	**34,510**
W & M Acquisition Loan - Without recourse	21,860	22,310
Total Gross Debt	**54,920**	**56,820**
Cash & Bank Balance	7500	4690
Total Net Debt	**47,420**	**52,130**

Source: Company Reports

Figure 5. United Spirits (Parent): Profit and Loss Statement (Rs Mn, %)

Year ended Mar 31	2008	2009	2010E	2011E	2012E
Total revenues	51,785	71,131	87,487	107,784	126,754
Less: Excise Duties	23,343	33,654	42,548	53,353	62,743
Net Sales	**28,442**	**37,477**	**44,939**	**54,431**	**64,011**
% change YoY	*16.7%*	*31.8%*	*19.9%*	*21.1%*	*17.6%*
Income from brand franchise	373	460	773	873	987
Sale from tie-up units	2,917	2,958	3,495	4,050	4,535
Net Operating income	**31,731**	**40,895**	**49,207**	**59,354**	**69,533**
% change YoY	*16.6%*	*28.9%*	*20.3%*	*20.6%*	*17.2%*
Material Costs	9,281	13,641	17,137	18,436	19,666
% of gross sales	*17.9%*	*19.2%*	*19.6%*	*17.1%*	*15.5%*
Packing Material	6,563	9,478	10,431	12,033	14,091
% of gross sales	*12.7%*	*13.3%*	*11.9%*	*11.2%*	*11.1%*
Gross Profit	**15,887**	**17,777**	**21,638**	**28,884**	**35,775**
% of gross sales	*30.7%*	*25.0%*	*24.7%*	*26.8%*	*28.2%*
Total Variable Expenses	**4,807**	**5,453**	**6,317**	**8,246**	**10,043**
% of gross sales	*9.3%*	*7.7%*	*7.2%*	*7.7%*	*7.9%*
Fixed Expenses					
Salaries and Wages	2,280	2,592	2,962	3,377	4,221
% of gross sales	*4.4%*	*3.6%*	*3.4%*	*3.1%*	*3.3%*
Other Expenses (SG&A)	2,827	3,455	4,294	4,988	5,950
% of gross sales	*5.5%*	*4.9%*	*4.9%*	*4.6%*	*4.7%*
EBITDA	**5,974**	**6,276**	**8,065**	**12,273**	**15,561**
% of gross sales	*11.5%*	*8.8%*	*9.2%*	*11.4%*	*12.3%*
% of net sales	*18.8%*	*15.3%*	*16.4%*	*20.7%*	*22.4%*

Source: Company Reports and CIRA Estimates

Figure 6. United Spirits (Consolidated): Profit and Loss Summary (Rs Mn, %)

Year ended Mar 31	2008	2009	2010E	2011E	2012E
Net Operating income	**46,275**	**54,681**	**64,059**	**68,940**	**80,285**
% change YoY	*58.2%*	*18.2%*	*17.2%*	*7.6%*	*16.5%*
Gross Profit	**25,369**	**27,771**	**30,060**	**35,114**	**42,857**
% of gross sales	*35.4%*	*31.2%*	*29.5%*	*30.1%*	*31.3%*
EBITDA	**9,642**	**9,853**	**12,552**	**14,806**	**18,413**
% of gross sales	*13.4%*	*11.1%*	*12.3%*	*12.7%*	*13.5%*

Source: Company Reports and CIRA Estimates

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 Rs1622. 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). On steady revenues, as input costs sequentially decline, gross margins should witness a sharp expansion. UNSP has demonstrated the ability to pare discretionary cost items that further buffer EBITDA growth. 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 Rs1622 is based on a two-part EV/EBITDA methodology. We value the domestic operations at 15x Dec11E 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. While over the longer term, we think that W&M could re-rate, given management focus on building the branded business; but it is still early days – thus we maintain the discount given the execution risks. We also ascribe Rs44/share to value the Bangalore IPL cricket team franchise at investment.

Risks

We rate United Spirits shares Medium Risk, instead of Low Risk as suggested by our quantitative risk-rating system, which tracks 260-day historical share-price volatility. We believe this is warranted as the capital structure of the company remains a challenge vis-à-vis peers – gross debt remains high, in the backdrop of: a) elevated capex spends over the next 3 years, and b) uncertainty on working capital / NCA. However, from a cash flow / debt servicing perspective, UNSP is comfortably poised.

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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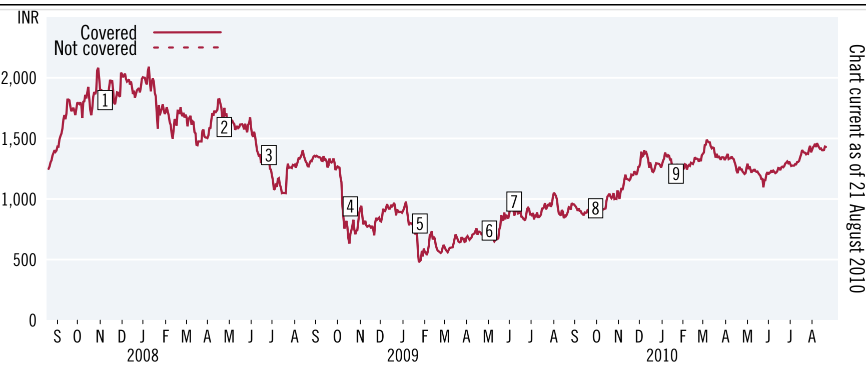
IMPORTANT DISCLOSURES

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	8-Nov-07	1L	*2,164.00	1,856.20
2	24-Apr-08	1L	*2,037.00	1,752.00
3	26-Jun-08	1L	*1,574.00	1,327.30
4	20-Oct-08	*1M	*930.00	712.80
5	24-Jan-09	*3H	*454.00	478.25
6	4-May-09	3H	*628.00	731.60
7	7-Jun-09	*3M	*901.00	931.20
8	30-Sep-09	*1M	*1,142.00	914.60
9	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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Data current as of 30 Jun 2010	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	47%	45%	40%

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