7 September 2010 | 8 pages

United Spirits (UNSP.BO)

Equity

Takeaways from India Investor Conference, Sept 6-7

- **Takeaways from India Conference** — United Spirits (UNSP) presented at Citi's India Conference on September 7. Below are key takeaways:
- **Parent EBITDA margins sustainable at ~20%** — Volumes have seen a strong pick-up in July & August, post the renewal of retailer licenses in AP– we see little risk to our FY11 volume est. of 112m cases (+12% YoY growth, despite 6% YoY growth in 1Q). Input cost pressures have likely peaked – ENA costs at ~Rs140/case (FY10 avg. Rs152); and are likely to soften further in 2HFY11. Mgmt would invest Rs11bn in 3 yrs in primary distilleries, bottling units & malt spirit facilities.
- **Other trends in the Indian market** — a) Interestingly, growth in smaller cities has been stronger than large cities, across segments – cities with populations between 0.5-5m have 40%+ YoY growth. b) Country liquor market has shrunk – it's now the same size as the organized segment as consumer tastes, state policies and health awareness is driving organized sale of alcohol.
- **W&M's branded shift** —Strategically, W&M focus would be on emerging markets (Russia and China) – plans to reduce UK share of branded business from 45% to <30% in the next three years. Further, it intends increasing share of premium Scotch whisky through single malts and high-end blended scotch rare editions. Mgmt guided to ~25% growth in single malts over next three years through Dalmore & Jura. Overall, mgmt expects to attain EBITDA of £50m in the next 3-4 years. Despite the near-term earnings drop, mgmt notes that the 'new' business model of W& M will still provide an accretive EPS at the consolidated level. The company would likely consider refinancing its debt (not repayment).
- **W&M and India** — Mgmt targets sales of 275K cases (~20% Scotch market share) at a 35% CAGR over next two years from 150K case sales in FY10 at ~15% share. This will be supported by introductions of both value and high vintage variants, as well as by ramping up distribution to ~25K retail outlets from ~15K now.

Buy/Medium Risk	**1M**
Price (07 Sep 10)	Rs1,525.90
Target price	Rs1,622.00
Expected share price return	6.3%
Expected dividend yield	0.1%
Expected total return	**6.4%**
Market Cap	Rs191,644M
	US$4,118M

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	115.2	6.5	6.8	0.1
2009A	3,830	37.19	180.7	41.0	6.6	17.2	0.1
2010E	3,826	31.71	-14.7	48.1	4.1	11.0	0.1
2011E	5,610	46.49	46.6	32.8	3.6	11.7	0.2
2012E	7,893	65.41	40.7	23.3	3.2	14.5	0.3

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	115.2	41.0	48.1	32.8	23.3
EV/EBITDA adjusted (x)	23.5	25.3	19.2	15.9	12.9
P/BV (x)	6.5	6.6	4.1	3.6	3.2
Dividend yield (%)	0.1	0.1	0.1	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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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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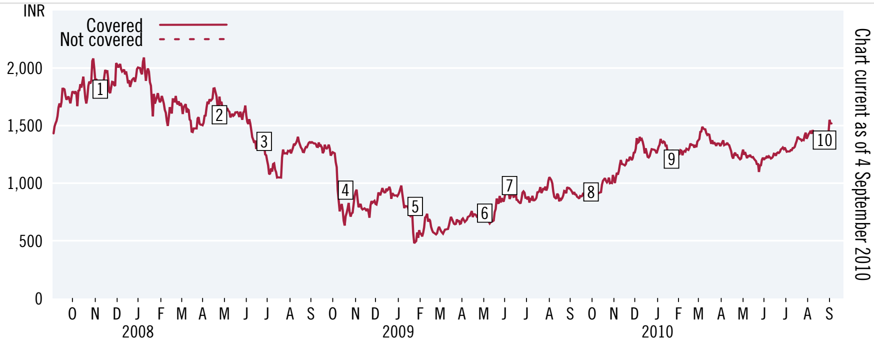
United Spirits (UNSP.BO)

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
10 25-Aug-10	1M	*1,622.00	1,374.15

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	47%	45%	40%

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