# United Spirits UNSP.NS UNSP IN

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Hangover to last for a while

## Downgrade to Neutral on near-term overhangs; core business valuation remains attractive

October 7, 2011

| | |
|---|---|
| **Rating**<br>Down from Buy | **Neutral** |
| **Target price**<br>Reduced from 1800 | INR 850 |
| **Closing price**<br>October 3, 2011 | INR 776 |
| **Potential upside** | +9.6% |

### Action: Cutting estimates and downgrading to Neutral

We cut our FY12F and FY13F earnings estimates by ~30% and downgrade the stock to Neutral to reflect our lowered expectations for domestic business profitability. While we expect FY12F to be a year of consolidation marked by stable EBITDA per case in the domestic business, we expect marginal improvement into FY13F. We believe near-term overhangs, particularly the group company Kingfisher Airlines, will hold back stock price performance; however, valuation at 15.3x FY13F P/E remains attractive, in our view.

### Catalysts: Softening raw material prices a positive catalyst for FY13F

As the company continues to build more in-house capacity post the acquisitions of Pioneer and Sovereign distilleries, we believe it will be able to capture more of the distillation margins over the next couple of years. This should, in our view, help improve profitability of the domestic business. However, we are not building in any material improvement in profitability in our numbers as visibility on that remains low.

### Valuation: Near-term concerns outweigh valuations

On our revised numbers, UNSP trades at 15.3x FY13F P/E, a steep 38% discount to the FMCG sector average. While we expect UNSP to deliver 20% earnings growth in FY13F, we expect FY12F to be a year of consolidation. While valuation at 15.3x FY13F looks attractive, near-term concerns over the balance sheet and funding requirement at group company Kingfisher Airlines will likely remain overhangs, in our view. We prefer to remain on the sidelines in the near term.

| 31 Mar | FY11 | FY12F | | FY13F | | FY14F | |
|---|---|---|---|---|---|---|---|
| Currency (INR) | Actual | Old | New | Old | New | Old | New |
| **Revenue (mn)** | 73,762 | 83,721 | 88,026 | | 102,503 | | 117,386 |
| **Reported net profit (mn)** | 5,695 | 7,674 | 5,312 | | 6,395 | | 7,819 |
| **Normalised net profit (mn)** | 4,680 | 7,674 | 5,312 | | 6,395 | | 7,819 |
| **Normalised EPS** | 37.18 | 61.10 | 42.20 | | 50.81 | | 62.12 |
| **Norm. EPS growth (%)** | 60.4 | 43.4 | 13.5 | | 20.4 | | 22.3 |
| **Norm. P/E (x)** | 20.9 | N/A | 18.4 | N/A | 15.3 | N/A | 12.5 |
| **EV/EBITDA (x)** | 13.5 | 8.4 | 11.6 | | 10.0 | | 8.8 |
| **Price/book (x)** | 2.2 | N/A | 2.0 | N/A | 1.8 | N/A | 1.6 |
| **Dividend yield (%)** | 0.4 | N/A | 0.5 | N/A | 0.6 | N/A | 0.9 |
| **ROE (%)** | 13.7 | 15.8 | 11.4 | | 12.4 | | 13.6 |
| **Net debt/equity (%)** | 129.6 | 72.8 | 112.5 | | 97.5 | | 84.1 |

Source: Nomura estimates

**Key company data:** *See page 2 for company data and detailed price/index chart.*
**Rating:** *See report end for details of Nomura's rating system.*

### Anchor themes

The Indian spirits industry is an attractive long-term opportunity, in our view, supported by positive demographics, low per capita consumption and ongoing premiumisation trends. United Spirits, with ~50% share of the market, is well placed to benefit in the long term.

### Nomura vs consensus

We are 4-5% below consensus for FY13F and only expect some improvement in profitability over the next couple of years.


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See Appendix A-1 for analyst certification and important disclosures. Analysts employed by non US affiliates are not registered or qualified as research analysts with FINRA in the US.

# Key data on United Spirits

## Income statement (INRmn)

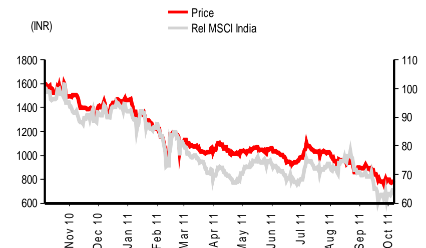
| Year-end 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| **Revenue** | **63,623** | **73,762** | **88,026** | **102,503** | **117,386** |
| Cost of goods sold | -31,778 | -38,527 | -46,149 | -54,273 | -63,265 |
| **Gross profit** | **31,845** | **35,235** | **41,877** | **48,231** | **54,121** |
| SG&A | -16,805 | -18,553 | -22,167 | -25,424 | -28,167 |
| Employee share expense | -5,452 | -5,938 | -7,315 | -8,527 | -9,828 |
| **Operating profit** | **9,588** | **10,744** | **12,395** | **14,280** | **16,126** |
| | | | | | |
| **EBITDA** | **10,538** | **11,768** | **13,524** | **15,499** | **17,424** |
| Depreciation | -950 | -1,023 | -1,129 | -1,219 | -1,299 |
| Amortisation | 0 | 0 | 0 | 0 | 0 |
| EBIT | 9,588 | 10,744 | 12,395 | 14,280 | 16,126 |
| Net interest expense | -6,187 | -5,575 | -5,611 | -5,965 | -5,865 |
| Associates & JCEs | 0 | 0 | 0 | 0 | 0 |
| Other income | 1,444 | 2,137 | 1,144 | 1,230 | 1,409 |
| **Earnings before tax** | **4,845** | **7,307** | **7,929** | **9,545** | **11,669** |
| Income tax | -1,932 | -2,652 | -2,616 | -3,150 | -3,851 |
| **Net profit after tax** | **2,913** | **4,655** | **5,312** | **6,395** | **7,819** |
| Minority interests | 5 | 26 | 0 | 0 | 0 |
| Other items | 0 | 0 | 0 | 0 | 0 |
| Preferred dividends | 0 | 0 | 0 | 0 | 0 |
| **Normalised NPAT** | **2,918** | **4,680** | **5,312** | **6,395** | **7,819** |
| Extraordinary items | -3,145 | 1,015 | 0 | 0 | 0 |
| **Reported NPAT** | **-227** | **5,695** | **5,312** | **6,395** | **7,819** |
| Dividends | -366 | -379 | -441 | -566 | -881 |
| **Transfer to reserves** | **-593** | **5,316** | **4,872** | **5,829** | **6,937** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 23.8 | 20.9 | 18.4 | 15.3 | 12.5 |
| FD normalised P/E at price target (x) | 26.1 | 22.9 | 20.1 | 16.7 | 13.7 |
| Reported P/E (x) | na | 17.1 | 18.4 | 15.3 | 12.5 |
| Dividend yield (%) | 0.4 | 0.4 | 0.5 | 0.6 | 0.9 |
| Price/cashflow (x) | na | na | 21.4 | 21.4 | 20.9 |
| Price/book (x) | 2.5 | 2.2 | 2.0 | 1.8 | 1.6 |
| EV/EBITDA (x) | 14.1 | 13.5 | 11.6 | 10.0 | 8.8 |
| EV/EBIT (x) | 15.5 | 14.8 | 12.6 | 10.8 | 9.5 |
| Gross margin (%) | 50.1 | 47.8 | 47.6 | 47.1 | 46.1 |
| EBITDA margin (%) | 16.6 | 16.0 | 15.4 | 15.1 | 14.8 |
| EBIT margin (%) | 15.1 | 14.6 | 14.1 | 13.9 | 13.7 |
| Net margin (%) | -0.4 | 7.7 | 6.0 | 6.2 | 6.7 |
| Effective tax rate (%) | 39.9 | 36.3 | 33.0 | 33.0 | 33.0 |
| Dividend payout (%) | na | 6.7 | 8.3 | 8.9 | 11.3 |
| Capex to sales (%) | 2.3 | 4.8 | 1.8 | 2.0 | 1.7 |
| Capex to depreciation (x) | 1.6 | 3.5 | 1.4 | 1.6 | 1.5 |
| ROE (%) | -0.8 | 13.7 | 11.4 | 12.4 | 13.6 |
| ROA (pretax %) | 9.1 | 9.5 | 9.9 | 10.9 | 11.6 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 16.4 | 15.9 | 19.3 | 16.4 | 14.5 |
| EBITDA | 34.0 | 11.7 | 14.9 | 14.6 | 12.4 |
| EBIT | 38.2 | 12.1 | 15.4 | 15.2 | 12.9 |
| Normalised EPS | na | 60.4 | 13.5 | 20.4 | 22.3 |
| Normalised FDEPS | na | 14.1 | 13.5 | 20.4 | 22.3 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (INR) | -1.80 | 45.25 | 42.20 | 50.81 | 62.12 |
| Norm EPS (INR) | 23.18 | 37.18 | 42.20 | 50.81 | 62.12 |
| Fully diluted norm EPS (INR) | 32.57 | 37.18 | 42.20 | 50.81 | 62.12 |
| Book value per share (INR) | 306.70 | 352.03 | 387.89 | 431.23 | 483.06 |
| DPS (INR) | 2.91 | 3.01 | 3.50 | 4.50 | 7.00 |

Source: Nomura estimates

**Notes**

Muted profit growth in FY12F on the back of high input costs, but improvement in FY13F

### Price and price relative chart (one year)




| (%) | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (INR) | -13.2 | -21.2 | -51.5 |
| Absolute (USD) | -19.0 | -28.5 | -56.1 |
| Relative to index | -9.7 | -6.9 | -28.8 |
| Market cap (USDmn) | 2,063.4 | | |
| Estimated free float (%) | 86.5 | | |
| 52-week range (INR) | 1688.2/740 | | |
| 3-mth avg daily turnover (USDmn) | 5.33 | | |
| Major shareholders (%) | | | |
| HSBC Global Investments | 7.5 | | |
| Capital International | 6.3 | | |

Source: Thomson Reuters, Nomura research

## Cashflow (INRmn)

| Year-end 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| EBITDA | 10,538 | 11,768 | 13,524 | 15,499 | 17,424 |
| Change in working capital | -4,743 | -11,210 | -1,530 | -2,682 | -4,039 |
| Other operating cashflow | -8,201 | -4,566 | -7,440 | -8,259 | -8,722 |
| **Cashflow from operations** | **-2,406** | **-4,008** | **4,554** | **4,558** | **4,663** |
| Capital expenditure | -1,479 | -3,575 | -1,609 | -2,000 | -2,000 |
| **Free cashflow** | **-3,885** | **-7,583** | **2,945** | **2,558** | **2,663** |
| Reduction in investments | 8,236 | -279 | 0 | 0 | 0 |
| Net acquisitions | 2,295 | -1,876 | 0 | 0 | 0 |
| Reduction in other LT assets | 0 | 0 | 0 | 0 | 0 |
| Addition in other LT liabilities | 0 | 0 | 0 | 0 | 0 |
| Adjustments | 0 | 0 | 0 | 0 | 0 |
| **Cashflow after investing acts** | **6,646** | **-9,738** | **2,945** | **2,558** | **2,663** |
| Cash dividends | -366 | -379 | -441 | -566 | -881 |
| Equity issue | 15,460 | 52 | 0 | 0 | 0 |
| Debt issue | -18,543 | 8,748 | -4,163 | 0 | -1,000 |
| Convertible debt issue | 0 | 0 | 0 | 0 | 0 |
| Others | 0 | 0 | 0 | 0 | 0 |
| **Cashflow from financial acts** | **-3,449** | **8,421** | **-4,604** | **-566** | **-1,881** |
| **Net cashflow** | **3,197** | **-1,317** | **-1,659** | **1,992** | **782** |
| Beginning cash | 4,490 | 7,687 | 6,370 | 4,711 | 6,703 |
| Ending cash | 7,687 | 6,370 | 4,711 | 6,703 | 7,485 |
| Ending net debt | 47,376 | 57,440 | 54,936 | 52,944 | 51,162 |

Source: Nomura estimates

**Notes**

Capex includes some amounts for acquiring smaller distilleries

## Balance sheet (INRmn)

| As at 31 Mar | FY10 | FY11 | FY12F | FY13F | FY14F |
|---|---|---|---|---|---|
| Cash & equivalents | 7,687 | 6,370 | 4,711 | 6,703 | 7,485 |
| Marketable securities | 1,265 | 1,544 | 1,544 | 1,544 | 1,544 |
| Accounts receivable | 21,211 | 31,097 | 31,513 | 33,140 | 36,477 |
| Inventories | 17,462 | 21,168 | 25,323 | 29,487 | 33,447 |
| Other current assets | 3,219 | 3,207 | 3,859 | 4,493 | 5,146 |
| **Total current assets** | **50,845** | **63,387** | **66,950** | **75,367** | **84,099** |
| LT investments | 0 | 0 | 0 | 0 | 0 |
| Fixed assets | 18,194 | 20,690 | 21,170 | 21,951 | 22,652 |
| Goodwill | 42,444 | 44,320 | 44,320 | 44,320 | 44,320 |
| Other intangible assets | 0 | 0 | 0 | 0 | 0 |
| Other LT assets | 0 | 0 | 0 | 0 | 0 |
| **Total assets** | **111,483** | **128,397** | **132,440** | **141,639** | **151,071** |
| Short-term debt | 6,362 | 10,967 | 10,967 | 10,967 | 10,967 |
| Accounts payable | 14,912 | 18,331 | 21,946 | 25,556 | 29,266 |
| Other current liabilities | 2,819 | 1,771 | 1,847 | 1,982 | 2,181 |
| **Total current liabilities** | **24,094** | **31,068** | **34,761** | **38,504** | **42,414** |
| Long-term debt | 48,700 | 52,844 | 48,680 | 48,680 | 47,680 |
| Convertible debt | 0 | 0 | 0 | 0 | 0 |
| Other LT liabilities | 0 | 0 | 0 | 0 | 0 |
| **Total liabilities** | **72,794** | **83,912** | **83,441** | **87,184** | **90,094** |
| Minority interest | 85 | 175 | 175 | 175 | 175 |
| Preferred stock | 0 | 0 | 0 | 0 | 0 |
| Common stock | 1,207 | 1,259 | 1,259 | 1,259 | 1,259 |
| Retained earnings | 35,116 | 40,528 | 45,342 | 51,097 | 57,920 |
| Proposed dividends | 0 | 0 | 0 | 0 | 0 |
| Other equity and reserves | 2,281 | 2,523 | 2,223 | 1,923 | 1,623 |
| **Total shareholders' equity** | **38,604** | **44,310** | **48,824** | **54,279** | **60,802** |
| **Total equity & liabilities** | **111,483** | **128,397** | **132,440** | **141,639** | **151,071** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 2.11 | 2.04 | 1.93 | 1.96 | 1.98 |
| Interest cover | 1.5 | 1.9 | 2.2 | 2.4 | 2.7 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 4.50 | 4.88 | 4.06 | 3.42 | 2.94 |
| Net debt/equity (%) | 122.7 | 129.6 | 112.5 | 97.5 | 84.1 |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 107.5 | 129.4 | 130.2 | 115.1 | 108.2 |
| Days inventory | 200.5 | 183.0 | 184.4 | 184.3 | 181.5 |
| Days payable | 165.3 | 157.5 | 159.7 | 159.7 | 158.1 |
| Cash cycle | 142.7 | 154.9 | 154.8 | 139.7 | 131.6 |

Source: Nomura estimates

**Notes**

Working capital will only improve gradually over the next two years, in our view

## Stock de-rating has been significant in the last year…

UNSP has by far been the worst-performing stock over the past few months in our consumer coverage universe and has yielded a negative 47% return since the start of the year. Consequently, the stock has underperformed the markets by 26% and the consumer index by a remarkable 51%.

The company has witnessed a structural de-rating (see chart below) as the average P/E has come down from 35x to 17x one-year forward earnings since the start of the year. Even if we look at the long-term average, UNSP has traded at 25x one-year forward earnings over the past eight years. The de-rating has been sharp and severe, especially in the past year or so.

**Fig. 1: United Spirits one-year forward P/E**

Source: Bloomberg, Nomura research

## …and not without reason

However, the de-rating has not been without reason and there have been several issues, such as corporate governance, quality of disclosures, mounting leverage and performance of other group companies, that have taken a toll on the stock price. We highlight those issues in detail in this report:

**Domestic business profitability to remain constrained**
UNSP, in our view, remains an attractive long-term story and a classic play on the consumption-related theme in India. However, the key issue confronting the company, in our view, is that for some reason volume growth has never translated into higher profitability. What concerns us is that: 1) companies of much smaller size (both in terms of market cap and revenues and with a much less premium portfolio make better margins, and 2) despite a double-digit volume CAGR, EBITDA/case for UNSP is 12% lower than 2008 levels. Moreover, in our view, we continue to see several headwinds for its domestic business profitability and highlight three key factors: 1) strong Extra Neutral Alcohol (ENA) prices, which have not corrected despite a bumper sugar cane crop, 2) steep rises in glass prices, and 3) a lack of pricing power.

**Balance sheet to remain leveraged in the near term**
One of the key issues investors have had with UNSP, in our view, is its high leverage and we do not expect debt levels to come down in the next few years. Management has highlighted that it would look to increase UNSP's in-house production capacity. This is likely to keep debt levels high in our view.

Furthermore, the company also plans to invest INR6bn over the next year or so in a glass manufacturing unit, which, in our view, should help it have more control over packaging costs. The company has spoken about liquidating treasury shares valued at INR10bn to pare down its debt (*USL seen readying to take next step to deleverage*, *Business Standard*, October 1, 2011). However, management may opt to wait for better valuations than the current share price; hence, we believe in the near term the balance sheet will continue to remain leveraged.

**Concerns over group company Kingfisher Airlines**

Although the group company Kingfisher Airlines has no direct link with UNSP, except for both having the same promoters, Kingfisher Airlines has been in the news for all the wrong reasons — mounting losses and the need for new fund infusion. Press reports suggest Kingfisher Airlines has defaulted in its payments to oil marketing companies (Kingfisher owes over INR2bn to AAI, *Economic Times*, August 25, 2011) as well as delayed salaries to employees (Kingfisher delays salary payment, *Business Standard*, August 14, 2011). Auditor comments in the Kingfisher Airlines annual report say that the net worth of the company is completely eroded and the company will need to infuse funds to keep the business going.

Flow of funds from UNSP to Kingfisher Airlines (although indirectly, elaborated in detail inside) is a cause of concern for us.

## Downgrade to Neutral on near-term overhangs

We have also cut our target multiple significantly to account for the issues highlighted above. We now value the domestic business at 11x FY13F EBITDA and the W&M business at 8x FY13F EBITDA. Our target price goes down from INR1,800 to INR850 to account for both the >30% earnings cut as well as cut in target multiples.

We believe there remain a number of short-term headwinds that can rein in the stock price performance. The stock has seen a sharp de-rating in the past few months, and with many issues still unresolved as highlighted in this note, we believe a re-rating back to historical averages will be a slow and gradual process.

As investors get more clarity on some of the issues we highlight in this note and the company starts to reap some of the benefits of the investments it has made in the last year or so, we see scope for a re-rating back to its historical levels. However, we believe that until there is clarity on these issues the stock price performance will remain muted. We downgrade to Neutral and look for these issues to be resolved before taking a fresh look at the company. Our reduced TP of INR850 provides potential upside of 12.4% from current levels.

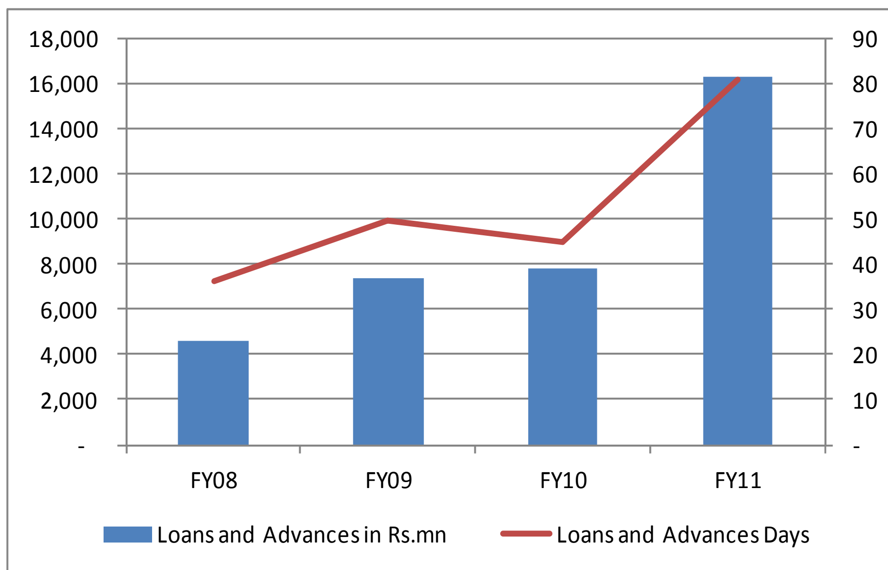
# FY11 annual report – Key takeaways

The company's annual report for FY11 was published recently. We highlight a few key takeaways from the report and look back at how FY11 panned out. The balance sheet for FY11 reveals a number of important items which we highlight below.

**Increase in loans and advances**

Loans and advances increased from INR7.8bn as at the end of March '10 to INR16.3bn at March '11. In terms of number of days of sales, loans and advances increased from 45 days to 81 days during the same period. Loans to tie-up units increased marginally from INR2.3bn to INR2.5bn. Provisions for doubtful advances also increased from INR747mn to INR1.02bn. However, the most important change is an increase of INR7.9bn in 'other advances', which the company had made. Of this increase, close to INR1bn is on account of advances paid towards cost of investment in Pioneer Distilleries as of March 2011. There is also an amount of INR3.95bn, paid by United Spirits to UB Holdings Limited. In the UB Holdings Limited annual report, there is a transfer of INR5.75bn to Kingfisher Airlines made in FY11 along with INR6.3bn investment made into Kingfisher Airlines. This remains a cause of concern for us.

**Fig. 2: Loans and advances have seen an increasing trend**




Source: Company data, Nomura research

**Increase in total debt**

Gross debt on the balance sheet increased from INR55bn to INR63.8bn, taking the total D/E to 1.5x as at the end of FY11. Off the total gross debt, INR6.2bn is payable within one year, increasing vs last year when the amount due and payable within a year was INR3.5bn. We estimate free cash flow in FY12 of INR2.9bn. Hence, although the quantum of amount due within a year is not very large considering the company has debts of close to INR64bn, it will, we believe, involve a refinance charge as the company is unlikely to pay off the debt in the short term.

The company has also accepted additional fixed deposits to the tune of INR3.2bn which are classified as unsecured loans. Of the portion of unsecured loans, the company has INR2.3bn in fixed deposits due within one year and INR4.09bn in short-term loans from banks due within one year. Here again, the company may be able to refinance the debt, but it will involve a charge, which will come through during the year.

We do not see debt levels coming down in the next year as the company may choose to invest in buying smaller distilleries and not choose to pay down debt. Debt/equity now stands at 1.5:1, which is roughly at the same level as last year, but is clearly much higher than for other consumer companies in our coverage universe.

Even if we look at other metrics related to consumer companies with debts on their balance sheets, we see that UNSP is inferior on all counts. This will be an increasing source of concern in the near term, in our view.

**Fig. 3: Debt position not as comfortable as other consumer companies – FY12F**

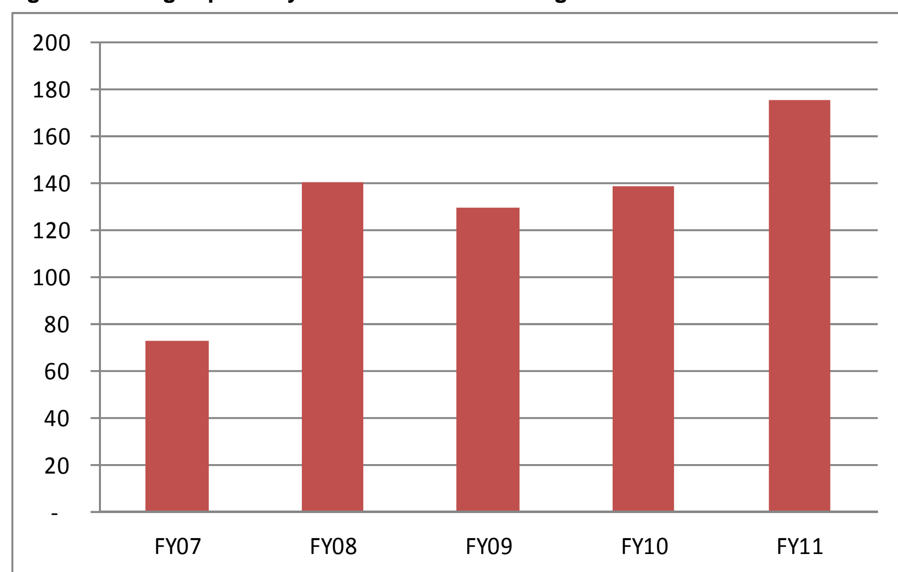
| | D/E (x) | FCF Rs. mn | Interest Coverage (x) |
|---|---|---|---|
| Marico | 0.8x | 1,277 | 11.9x |
| Dabur | 0.5x | 7,278 | 17.0x |
| GCPL | 1.1x | 4,962 | 8.7x |
| United Spirits | 1.3x | 2,920 | 2.6x |

Source: Company data, Nomura research

**Working capital has increased**

On account of the increase in loans and advances, increase in inventory days and increase in current liabilities, there was a significant increase in working capital days, which moved to 174 days from 139 days at the end of last year. A large part of this was on account of the increase in loans and advances, but there was some increase in inventories as well. The loans and advances number should ideally come down in FY12, which should help ease the working capital requirement, but we do not have clarity on the situation at this time. If this continues, then the company could continue to see a significant amount of capital locked in working capital, which will raise the interest payments into next year.

**Fig. 4: Working capital days has seen an increasing trend**




Source: Company data, Nomura research

**EBITDA per case in the domestic business still below FY08 levels**

EBITDA per case for the domestic business increased to INR83 per case in FY11, which is a significant 25% improvement on FY10. However, this is still 12% lower than 2008 profitability levels. The expectation of the company and the market at the start of the year was for significant easing off on ENA prices which would help EBITDA per case be nearer to the INR95-100 mark for the year. However, the correction in ENA prices did not really materialise during the year, which meant EBITDA/case never really saw the kind of improvement that was expected at the start of the year. We do not expect any material softening of ENA prices, which may mean EBITDA/case remains largely at similar levels in FY12. Packaging material costs have also increased by ~17% in FY11, which has also resulted in muted profitability improvement. The improvement in FY11 is largely on account of significant savings on account of staff costs and manufacturing expenses.

# Our key concerns on UNSP

## Distribution structure limits pricing power

The distribution structure in India varies by state, and three basic types of systems are in place across the country. The basic principle behind each system is outlined below:

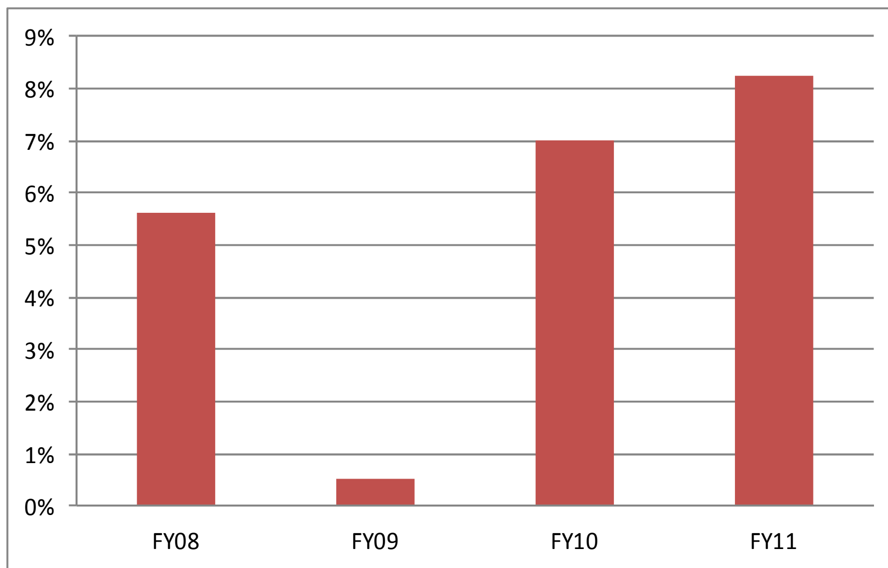
- Government controlled – Pricing controlled by the state government
- Auction states – Licences for distribution are auctioned by the government
- Open market – Pricing is market determined

**Companies lack pricing power in government-controlled states**
Almost 75-80% of industry volumes come from states where pricing and distribution is controlled by the government. Key controlled markets are Karnataka, Andhra Pradesh, Tamil Nadu and Kerala (together these states account for ~60% of industry volumes). Pricing in these states is dependent on the government, which makes it difficult to achieve consistent pricing (the company is not able to increase prices consistently like other consumer companies) over a period of time. As an example, a recent news article (Brewers in Kerala to stop liquor production on pricing issue, *Hospitality Biz*, August 23, 2011) suggested that the issue of pricing has created a significant rift between the government and manufacturers. There are suggestions that liquor manufacturers may even stop production if the government does not approve price increases to cover the increased cost of materials. This is one of the key reasons why pricing power is limited in India, as government-controlled states are reluctant to increase prices.

**Surprisingly no pricing power even in open market**
There are some important free priced markets such as Maharashtra, Goa, Pondicherry, where pricing is market determined. India is a highly consolidated market with the top 4-5 players having an ~80% market share; United Spirits has a ~55% share of the Indian market. In other consolidated markets around the world, the price/mix benefit has been much greater, especially for a product where the elasticity of demand is not high. However, the reported numbers for UNSP clearly show that the price/mix benefit has not been a big contributor to the revenue growth numbers over the past six years or so.

If we look at the realisation numbers over the past few years, the actual delivered price/mix improvement has not been significant. The chart below indicates the realisation improvement on a y-y basis over the past four years. The company has seen an average realisation improvement of ~6%. Remember this also includes mix improvement, which we estimate at 2-3%, making the pricing impact only to the tune of 3% or so.

**Fig. 5: Realisation improvement y-y**




Source: Company data, Nomura research

This lack of one single pricing mechanism across the whole country has been and will continue to be an issue for companies in the Indian made foreign liquor (IMFL) space, in our view. Pricing structure is also different for different brands across the country and pricing is also not entirely dependent on the manufacturer across the country. In case of a sharp rise in input prices of materials or packaging material, the company has the option to pass on the increase in costs to consumers in only a few states. This means in the event of a sharp increase in commodity costs it will be difficult for manufacturers to pass on the increase to consumers in time to protect profitability.

In the absence of significant changes in the market structure for distribution and pricing, we see this trend as continuing and for price/mix benefit to only contribute mid single digits to revenue growth over the near to medium term.

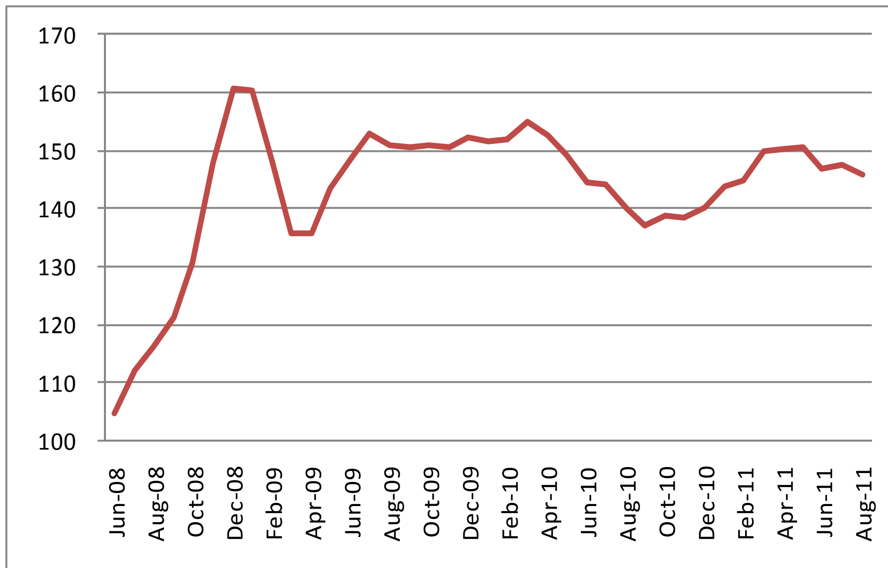
## Unlike expectations, input prices have not softened

At the start of FY11, the company and the market expected a significant softening of ENA prices which would have helped company profitability. ENA prices have not corrected by any significant amount and are largely flat vs the start of the year. So far in FY12, ENA prices have not really changed by much with the average price hovering around the INR147 mark vs. the INR144-145 range in the same period last year.

Glass, the key packaging material for spirits companies, has seen a significant rise in price over the last year or so (+17% in FY11 on a y-y basis). This has also ensured that domestic business profitability has not improved as companies have not been able to pass on the full impact of the rise in glass costs to consumers.

Indications from Industry players are that ENA prices may start to rise again. If that comes through, then domestic business profitability would be under pressure in the absence of significant price increases. As we have highlighted above, price increases are difficult to come by and hence any sharp increase in input prices will be negative for domestic business profitability.

**Fig. 6: ENA price trend (INR per case)**

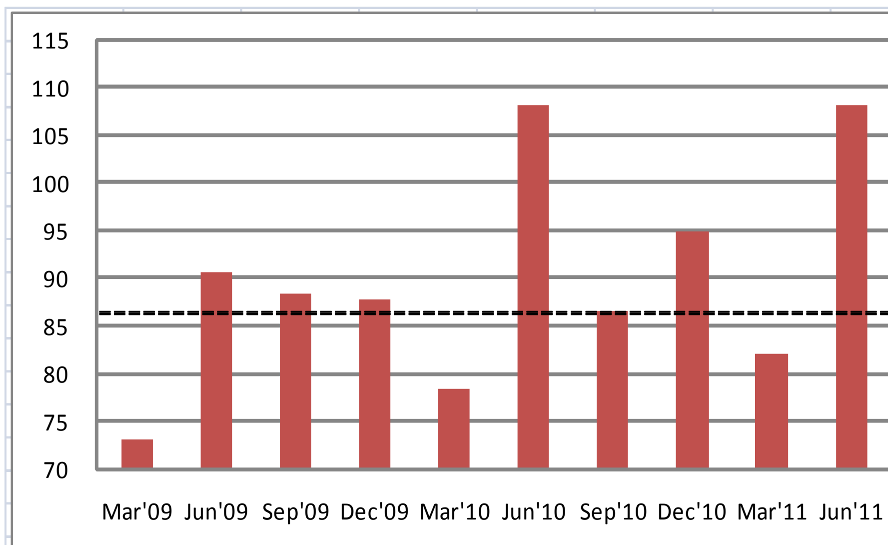



Source: Company data, Nomura research

## Domestic business profitability has remained constrained

With the price/mix benefit offset by stable ENA prices and rising glass prices, domestic business profitability has remained constrained over the last few quarters. This situation was expected by both the market and company to be much different at the start of FY2011, but that has not played out as expected. If we look at the EBITDA per case on a quarterly basis, it has been volatile, but has largely remained within a narrow band. Unless there is a significant correction in ENA and glass prices, we expect this to continue with pricing action difficult to come. The company has had some benefit from improving mix, with consumers trading up to more premium brands, but this has only resulted in 2-3% net sales growth over the past few years. While we expect this to continue, we do not expect this to be a game changer in the medium term. The company does spend a significant amount of money on promotions, which nullifies partially the mix benefits.

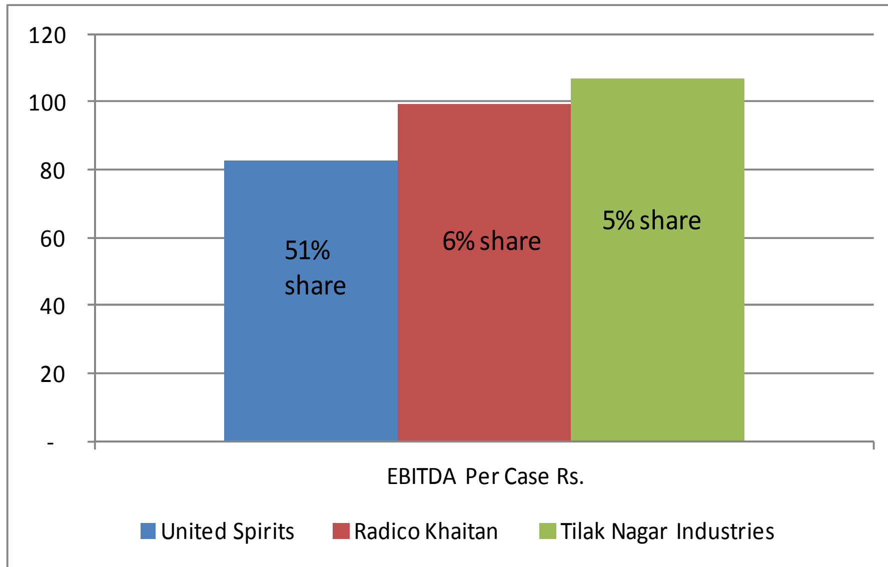
**Fig. 7: EBITDA per case quarterly trend (INR)**




Source: Company data, Nomura research

**Domestic profitability still below other smaller competitors**
Although UNSP is by far the largest spirits manufacturer in India with a market share of close to 50%, profitability measured in terms of EBITDA per case is still lower than those of smaller competitors, e.g. Radico Khaitan and Tilaknagar Industries. One reason for this could be that UNSP may be spending more money on A&P than its competitors, which may benefit the company in the long term by driving the premiumisation, but in the short term this has ensured profitability is lower than that of its competitors.

**Fig. 8: EBITDA per case for top players in the Indian spirits market in FY11 (INR)**

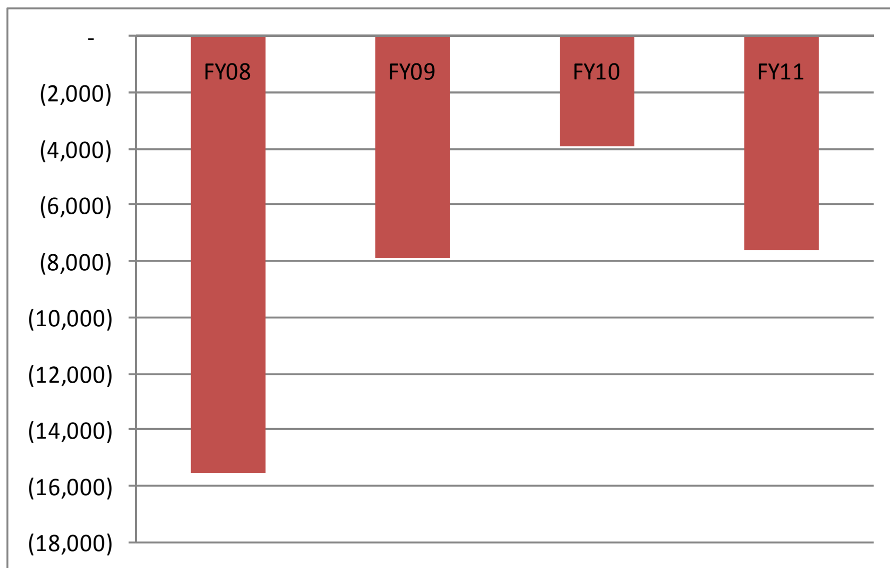



Source: Company data, Nomura research

## UNSP cash flows and EBITDA performance disappointing

We believe that while UNSP's core business is an attractive option for investors, there have been a few issues which have resulted in cash flow performance being not as robust as other consumer companies. One of the key concerns we have raised in this note is working capital, which has deteriorated over the years. Even EBITDA since FY08 has grown only by a CAGR of 3%, which is much lower than the volume growth. Hence cash flow progression has not been strong for UNSP despite being in a business which is inherently a high cash flow business. The company continues to invest in capex to have more in-house capacities, holding back free cash generation. We believe while the free cash generation will likely improve over the next couple of years as profitability of the domestic business improves, visibility on that front remains low at this time.

**Fig. 9: UNSP – FCF continues to be negative**




Source: Company data, Nomura research

## Potential catalysts to help improve profitability in the medium term in place

We highlight below a number of potential catalysts that could help improve profitability into FY13F, but the timing on when this improvement will come through remains uncertain. Some of the key trends we would watch for are as below:

**Acquisitions to help improve profitability from 3QFY12**
United Spirits expects benefits from its recent acquisitions (FY11) of distilleries to start accruing from 3QFY12 as it takes some time to get the distilling capacity to work, as per UNSP standards. The company estimates that the benefit of savings from third-party distillation margins on a per-case basis will be ~INR30 and this should flow through to 40% of the company's total volumes. This, in theory, could mean EBITDA per case improves to INR100 at the overall company level. Our numbers do not capture this improvement in FY12F, but start to capture it only in FY13.

**Premiumisation trends sustainable**
The company is looking to increase premiumisation trends by continuing to invest in brands over the longer term. This, in our view, has already started to show benefits with mix improvement accounting for 2-3% of net sales growth on average over the last few years. The company has given up competing at some of the lower price points across segments, which has helped improve profitability by focusing on value growth vs. volume growth. However, we do not expect a marked shift upwards in the near term.

**Price hike negotiations continuing**
The company continues to be in negotiations with state governments with regard to price hikes and is hopeful of seeing some price hikes being granted over the next few months, according to industry sources. This should aid net sales growth over the medium term. With demand continuing to be robust, the company sees price increases as being acceptable for the consumer, especially in a discretionary segment such as alcoholic drinks. However, as highlighted above, negotiations with governments on pricing is a tough and time-consuming exercise.

**Mix of molasses and grains account gives some protection on input costs**
Within the raw material mix, molasses now accounts for 60% and grains account for 40% of overall raw materials. This has changed significantly from a 90/10 mix a couple of years ago. In addition, the company has decided to invest in a glass manufacturing unit, which should give it further control over input costs in the medium term. Reports (USL to invest 600cr in glass plants, *Times of India*, March 21, 2011) indicate that in a bid to integrate backwards, United Spirits is looking to invest INR5-6bn to set up a glass manufacturing unit. This is another step USL is taking towards having more control over input costs (the company has invested in ENA manufacturing units over the past six months). These investments will mean near-term debt and interest costs will be high, but EBITDA per case improves over the medium term.

## However some key overhangs remain on the stock

Although there are potential catalysts that could help improve profitability over the near to medium term, UNSP also faces some overhangs which may keep the share price performance muted in the near term. We highlight two key overhangs on the stock

**Kingfisher Airlines' woes keep piling up**
As shown below, losses at group company Kingfisher Airlines continue, with the company reporting losses of INR10.3bn for the year ending March 2011. Although this has come down versus the past couple of years, it is still a significant loss. Although there is no direct link between United Spirits and Kingfisher Airlines, except for both having the same promoter group, this may remain as an overhang on the shares in the near term, in our view.

There has been negative news flow in the press regarding non-payment of dues to airport authorities (*Kingfisher owes over INR2bn to AAI, Economic Times*, August 25 2011). There have also been reports of the firm being unable to pay employee salaries on time (*Kingfisher delays salary payment, Business Standard*, August 14, 2011).

**Fig. 10: Kingfisher Airlines – Headline numbers**

| Rs. mn | 31-Mar-08 | 31-Mar-09 | 31-Mar-10 | 31-Mar-11 |
|---|---|---|---|---|
| Net Sales | 14,414 | 52,692 | 50,679 | 63,596 |
| Operating Expenditure | (21,380) | (66,657) | (59,673) | (63,553) |
| **EBITDA** | **(6,966)** | **(13,965)** | **(8,994)** | **43** |
| Other Income | 1,041 | 3,083 | 2,031 | 1,359 |
| Depreciation | (366) | (1,332) | (2,173) | (2,410) |
| **EBIT** | **(6,291)** | **(12,214)** | **(9,135)** | **(1,008)** |
| Interest | (779) | (6,962) | (10,965) | (13,129) |
| **Profit before Tax** | **(7,070)** | **(19,177)** | **(20,100)** | **(14,137)** |
| Tax | 5,055 | 5,464 | 7,707 | 4,934 |
| **Adjusted PAT** | **(2,015)** | **(13,713)** | **(12,393)** | **(9,203)** |
| Extraordinary Items | 135 | (2,375) | (4,079) | (1,071) |
| **Reported PAT** | **(1,880)** | **(16,088)** | **(16,472)** | **(10,274)** |

Source: BSE, Nomura research

### Transfer of funds between group companies

We looked at the annual report of UB Holdings and under the heading of 'related party transactions' UB Holdings had given INR5.75bn to Kingfisher Airlines and made fresh investments of INR6.3bn in FY11. In the United Spirits annual report, there are two transactions with related parties of INR3.69bn and INR3.95bn with the promoter. We have asked the company for clarity on these transactions and have not received a response; hence, we are unable to comment on these transactions.

**Fig. 11: Related company transactions in FY11**

| From | To | Comment | Amount Rs. mn |
|---|---|---|---|
| UBHL * | United Spirits | Amount due from | 3,951 |
| UB Holdings | Kingfisher Airlines | Finance Paid | 5,751 |
| Kingfisher Airlines | UB Holdings | Finance Received | 2,672 |
| UB Holdings ** | Kingfisher Airlines | Investments Made | 6,330 |

Source: Company Annual Reports, Nomura research; Note: * FY11 annual report says repaid in full, but company has not clarified to us. ** Investments made in Kingfisher Airlines in FY11.

Going back a few years, UB Holdings has made a number of 'related party transactions' for which we do not have a full breakdown and in the absence of a response from the company, we are not able to comment on this. We would also highlight the increase in loans and advances in the consolidated numbers for UNSP in FY11, from INR7.8bn to INR16.3bn, which was also not clarified by the company. In the absence of full clarification we would not want to speculate on the nature of these transactions, but at the same time would like to bring it to the notice of investors.

**Fig. 12: Related party transaction of UB Holdings**

| | Kingfisher | | All subsidiaries and associate companies | | | |
|---|---|---|---|---|---|---|
| **Related party transactions UB Holdings** | **FY11** | **FY10** | **FY09** | **FY08** | **FY07** | **FY06** |
| Finance Paid to associates | 5,751 | 2,007 | 580 | 296 | | |
| Finance Received from associates | 2,672 | 1,005 | 328 | 1 | 503 | 574 |
| Investments Made | 6,330 | - | | | | |
| Guarantees and collaterals given | 91,351 | 103,599 | | | | |
| Amount due from Kingfisher Airlines | 1,231 | 3,212 | 1,408 | | | |
| Finance paid to Subsidiaries | | | 4,309 | 5,664 | 7,514 | 4,024 |
| Finance received from Subsidiaries | | | 2,357 | 504 | | |

Source: Company data, Nomura research

### Pressing need to raise cash to sustain Kingfisher Airlines

There have also been recent press reports (Kingfisher Airlines's auditor raises doubts over company's survival, *Economic Times*, September 15, 2011) raising questions as to whether Kingfisher Airlines is a going concern. While the company has clarified that it remains a viable business, it remains a cause of concern. If Kingfisher Airlines were to continually need cash injections to remain viable, there would likely be investor concern

around the potential source of those funds. Importantly, there would be concern if any of the fund raising involved group companies such as UNSP. This is one of the key concerns we have in the near term until the funding situation at Kingfisher Airlines is resolved.

**Kingfisher balance sheet under stress**

Kingfisher Airlines reported debt of INR70.5bn in FY11, down from INR79.2bn in FY10. This was due to part conversion of outstanding debt into equity during the year. The accumulated losses at the end of FY11 stood at INR53.5bn, increasing from INR43.2bn at the end of FY10. The net worth of the company has been completely eroded on account of the sustained losses for the past few years (as per the auditor statement).

As can be seen from the table below, losses at Kingfisher Airlines have only gone up over the years, and in the absence of a major turnaround promoters it appears that will need to infuse more funds into the company during this year as well. This was also mentioned by the auditors in Kingfisher's annual report for FY11.

**Fig. 13: Kingfisher Airlines – key balance sheet items**

| In Rs. mn | FY11 | FY10 | FY09 | FY08 |
|---|---|---|---|---|
| Share Capital | 10,538 | 3,705 | 3,629 | 1,358 |
| Reserves and Surplus | 13,435 | 802 | 802 | 10,207 |
| **Share Holders Equity** | **23,973** | **4,507** | **4,431** | **11,565** |
| | | | | |
| Loans | 70,571 | 79,226 | 56,666 | 9,344 |
| | | | | |
| Profit and Loss A/C | 53,485 | 43,211 | 25,766 | 9,678 |
| Deferred Tax Asset | 29,278 | 24,344 | 16,697 | 4,985 |

Source: Kingfisher Airlines Annual Report FY11, Nomura research

**High level of promoter holdings in UNSP pledged to financial institutions**

Another key overhang on the stock has been the amount of promoter holdings pledged. Promoters hold 28% of the share capital of United Spirits and a significant portion (~88%) of this holding is pledged. We think this will continue to be a dampener on the stock in the near term, until the leverage across the group companies comes down.

## Kingfisher Airlines turnaround strategy as outlined by management

The Board of Kingfisher Airlines at its AGM on 28 September 2011 came up with a variety of solutions to stem the company's losses. In an interview with CNBC TV18, on 29 September, 2011, UB Group President and Chief Finance Officer, Mr Ravi Nedungadi outlined the following measures to improve the profitability as well as raise fresh capital to recapitalise the balance sheet.

**Cut back on first class seats**

The company has seen load factors of only ~50-60% on its first class service across routes. While the company believes there is a significant market for this class of service, in the near term travellers prefer the full-service economy class. The company is now ensuring that they offer more economy class full service tickets, where demand continues to be strong. This should help overall load factors, which should help the company deliver higher profitability. This, the company believes, will allow it to add 10% additional capacity without significant cost attached to it, except the cost of reorganisation.

**Close down operation of its low cost airline Kingfisher Red**

The company also plans to close down its low cost operation Kingfisher Red, which the company believes is not what the consumer wants when they think of flying Kingfisher. Hence, the decision to close down the low cost operations and concentrate on the full service class.

**Infuse equity using internal assets**

Management commented that Kingfisher Airlines owns a number of aircraft and these were taken against financial loans from institutions. But the company has repaid a substantial chunk of these loans over the past five-six years, which in business terms translates into a lot of equity in these aircraft. This gives them the option to sell and lease back these aircraft which would help them infuse funds into the company. This money could be used for operational purposes or to pay down the debt, which stands at INR70bn as at end FY11.

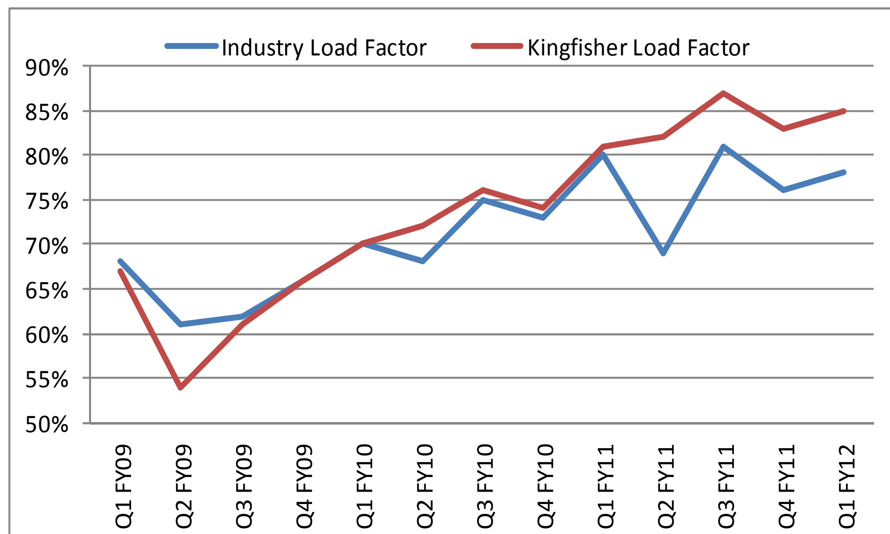
**Sell down other assets owned by Kingfisher Airlines**

The company has also identified other assets which it can sell off, such as assets that are not core to its operations. One example the company cited is Kingfisher House next to the Santacruz airport in Mumbai. It is a property that the company owns, but is not occupied. There is potential to monetise this asset and use the proceeds to either pay down debt or utilise for operations.

**Operational improvement is visible**

Over the past couple of quarters, the company has seen an operational improvement with load factors improving and outperforming the industry. The company also saw FY11 turn a small profit at the EBITDA line. The pace of these improvements is likely to gather pace along with additional infusions of capital for the airline to sustain in the medium term. As highlighted above, management has some turnaround strategies in place, but execution has only just begun, so it will be some time before results are visible.

**Fig. 14: Load factors are showing an improvement for Kingfisher**




Source: Kingfisher Airlines presentation, Nomura research

**Other options to raise capital**

The company has outlined a few plans to raise capital including a GDR issue, which has been put on the backburner for the past few months due to market conditions. The Board has also approved a rights issue to the tune of INR20bn, although the actual amount raised will depend on various factors. In addition, the company also has INR7-7.5bn of optionally convertible debentures which are held by associates of the UB Group. These were short-term debentures and they are due for repayment next year. The company has said it has spoken to these debenture holders to participate in the rights issue.

Considering that the need for Kingfisher Airlines to raise capital is now well established, we see a few scenarios which we believe can happen.

## How does all this impact United Spirits?

UB Holdings owns a 28% stake in United Spirits, of which 88% is pledged to financial institutions. The risk from UNSP's perspective is twofold: 1) what happens if Kingfisher Airlines goes bust? and 2) if the airline survives, then how long can the fund transfer continue? We analyse the situation below:

**Scenario 1 – Kingfisher Airlines survives, debt is rolled over and the transfer of funds (direct and indirect) continues – High probability**

We believe the promoters have a significant interest in Kingfisher Airlines and will seek to ensure that the airline survives this turbulent phase. Management has already spoken of a number of measures that will help turn around the operations of the company. We believe the company will be able to successfully turn around the operations and there are certain visible signs of that already (load factors improving and company making a profit at the EBITDA level in FY11 as well as in Q1FY12). However, this turnaround will be likely a slow and gradual process, which is likely to mean that the overhang of recapitalisation will continue to remain on United Spirits for the foreseeable future. This, we believe, is the most likely scenario and hence, we believe that this overhang on UNSP will remain.

**Scenario 2 – Kingfisher Airlines goes bankrupt and banks offload the shares in the market – Low probability**

As noted above, there have also been recent press reports raising questions as to whether Kingfisher Airlines is a going concern. If Kingfisher Airlines is unable to raise the required capital and defaults on its debt payment obligations, banks have the option of using the UNSP shares which have been pledged as collateral to them. This would mean ~30% of the share capital of UNSP comes into the market at once, which we believe would put considerable pressure on the share price. We see this as a very unlikely

event, as the likelihood of Kingfisher Airlines going bankrupt is relatively low, in our opinion.

**Scenario 3 – Kingfisher Airlines goes bankrupt and banks offload shares to a strategic investor – Low probability**
In the event of Kingfisher Airlines going bankrupt, banks also have the option of pooling together and forming a consortium to sell the shares in UNSP to a strategic investor. This could be an Indian investor or a global company. We also see this as unlikely as knowing these scenarios exist, the current promoters of UNSP will make every effort to find the additional money to recapitalise Kingfisher Airlines. As we have highlighted above, the company is now looking at various options to raise additional cash.

## Key changes to our estimates

We have made a number of adjustments to our estimates and also updated our earnings model for the audited FY11 numbers. The key changes to our estimates are highlighted in the table below.

**Fig. 15: Key changes to headline numbers**

| Rs mn | FY12F | | | FY13F | | |
|---|---|---|---|---|---|---|
| | Old | New | Chg (%) | Old | New | Chg (%) |
| Net Sales | 83,721 | 88,026 | 5% | 96,569 | 102,503 | 6% |
| EBITDA | 16,607 | 13,524 | -19% | 18,300 | 15,499 | -15% |
| Domestic | 13,780 | 10,812 | -22% | 15,023 | 12,625 | -16% |
| W&M | 2,827 | 2,711 | -4% | 3,277 | 2,874 | -12% |
| | | | | | | |
| EBITDA/case | 105 | 84 | -19% | 102 | 89 | -13% |
| | | | | | | |
| Debt | 39,961 | 59,647 | 49% | 36,132 | 59,647 | 65% |
| Interest Cost | 4,564 | 5,611 | 23% | 3,722 | 5,965 | 60% |
| | | | | | | |
| PAT | 7,674 | 5,312 | -31% | 9,946 | 6,395 | -36% |
| | | | | | | |
| EPS | 61.1 | 42.2 | -31% | 79.2 | 50.8 | -36% |

Source: Nomura research

At the headline level, our earnings are cut by >30% for both FY12 and FY13. We highlight two key factors for our earnings cut.

First, our assumption around the profitability of the domestic business is significantly reduced. As we have mentioned above, while there have been expectations by the market and the company of a sharp improvement in profitability in the domestic business, the reality is that EBITDA per case in the domestic business has moved in a very narrow band and over the last three years has largely remained stable. Our earlier expectation was based on an improvement in the profitability on the back of a sharp fall in ENA prices. However, we have now reconciled our expectations in line with the trend over the past three years and do not expect ENA prices to correct in the near term. This leads us to sharply lower our assumptions on EBITDA per case for the domestic business from INR105 earlier to INR84 now. This is largely flat vs. FY11, while for FY13, we expect a slight uptick to INR89, which is also a reduction from our earlier expectation of INR102. This is the most important reason for our earnings cuts.

Second, we had earlier expected the company to pay down debt, which would have resulted in lower interest costs. However, as the company is now focused on improving its backward integration platform by acquiring more distilleries and adding more capacity in-house, we do not expect debt levels to come down significantly in the next couple of years. The company will also see high working capital levels, which will further ensure that debt levels remain high and as a result, interest costs will also remain high.

**Cutting target price from INR1,800 to INR850**

We are cutting our target price from INR1,800 to INR850. Our target price reduction is on account of the following:

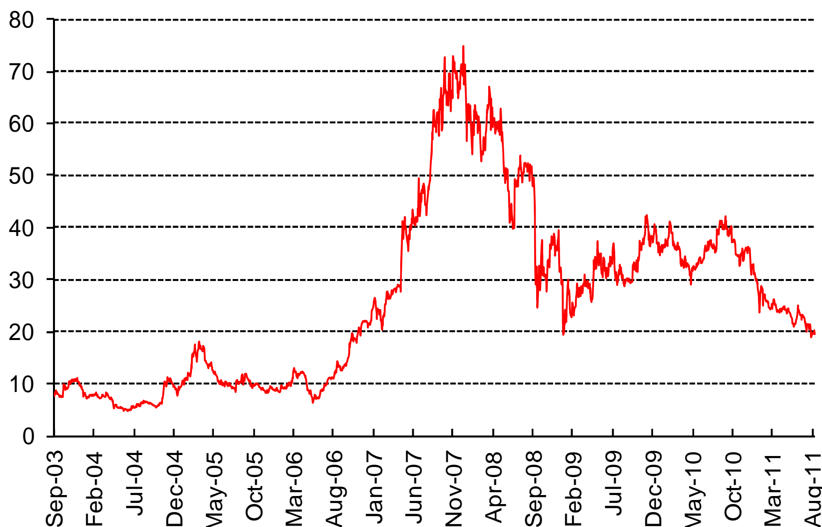
- >30% cut to our earnings for FY12F and FY13F on account of reductions in our profitability estimates, as well as higher interest cost assumptions than before.
- Cutting multiples for the domestic business from 14x EBITDA earlier to 11x now. Our multiple for the W&M business is unchanged at 8x. We believe a reduced multiple is justified as profitability of the domestic business will not see a sharp rise and also the return ratios for the consolidated business are much lower than other consumer companies under our coverage. The new target multiple is almost in-line with global peers, to reflect current concerns.
- Our new target price is based on FY13F EBITDA for both domestic as well as the Whyte & Mackey (W&M) business.

**Why are we downgrading to Neutral and not Reduce?**

While we have highlighted our concerns on the company extensively, we believe there is reasonable scope for domestic business profitability to improve from current levels in the next few quarters. Although visibility on that remains low at this time, if that improvement comes through, we think the stock could possibly see a rerating as current valuations are building in no improvement in the medium term.

Also the overhang on Kingfisher is likely to remain until such time that the company is able to raise funds, but once that issue is resolved, the stock is again likely to see some re-rating back to historical levels, in our view. We acknowledge that both these factors may not play out in the near term; hence, we downgrade our rating to Neutral. But current valuations do not support a Reduce argument, in our view.

**Fig. 16: United Spirits – one year forward P/E**




Source: Nomura research

**Our revised target price reflects the de-rating that the company has seen**

We have cut our multiple for the domestic business from 14x EBITDA earlier to 11x now. Our multiple for the W&M business is largely unchanged at 8x. We believe these valuations reflect the more modest growth rate for the company in the next few years. We believe the stock will continue to remain at depressed valuations in the short term until concerns around the profitability of the domestic business and the shape of the balance sheet remain. We would also argue that as and when profitability in the domestic business improves, the stock could see a strong rerating back towards historical multiples.

### Stock performance has mirrored the concerns over the last year

United Spirits has been one of the worst performing stocks in our coverage universe in the past year. The stock underperformed the Sensex by 27% and the FMCG index by 45%. This has been on the back of the concerns around profitability in the domestic business, reduced guidance during the year on W&M and changes in strategy, overhang around high debt levels, increases in packaging costs and a lack of clear long-term strategy around the W&M business. These issues have held back stock performance vs the sector. While many of these issues continue to remain relevant, we believe this underperformance has meant the stock is trading at a significant discount to the sector as well as towards the lower end of its historical trading band. The current share price is building in minimal expectations for improvement in profitability in the domestic business and offers a reasonable risk reward ratio, we think, although near-term overhangs are a bigger concern at this time.

**Fig. 17: Stock price performance**

| Stock | 3-Oct-11 | 3-Jan-11 | Return YTD |
|---|---|---|---|
| Jubilant Foodw orks | 1,006 | 643 | 56% |
| Marico | 141 | 121 | 17% |
| Titan Industries | 205 | 184 | 11% |
| ITC | 194 | 173 | 12% |
| Colgate Palmolive | 966 | 869 | 11% |
| Nestle India | 4,186 | 3,836 | 9% |
| Asian Paints | 3,145 | 2,875 | 9% |
| Godrej Consumer | 399 | 387 | 3% |
| **FMCG Index** | **3,852** | **3,693** | **4%** |
| Dabur | 103 | 101 | 3% |
| GSK Consumer | 2,385 | 2,266 | 5% |
| Hindustan Unilever | 334 | 313 | 7% |
| **Sensex** | **16,151** | **20,561** | **-21%** |
| **United Spirits** | **775** | **1,469** | **-47%** |

Note: as of close October 3, 2011
Source: Bloomberg, Nomura research

### Reduced valuation in line with global comps

We have reduced our target multiple for UNSP for the domestic business. This is to reflect concerns highlighted above, although over the longer term an attractive business such as UNSP with a significant market share in a growing market should trade at higher multiples, we believe. We have reflected current concerns into our valuation by valuing an emerging market business largely in line with mature spirits businesses in the US and Europe.

**Fig. 18: Global valuation comps**

| Spirits & Wine (millions) | Rating | Price | EV/EBITDA 2011E | EV/EBITDA 2012E | P/E 2011E | P/E 2012E |
|---|---|---|---|---|---|---|
| Brown-Forman ($) | Neutral | 70.14 | 11.8x | 11.4x | 19.2x | 18.0x |
| Campari (€) | Neutral | 5.49 | 11.4x | 10.4x | 18.3x | 16.6x |
| CEDC ($) | Neutral | 7.01 | 9.5x | 8.1x | 13.7x | 9.7x |
| Diageo (pence) | Neutral | 1,232 | 10.8x | 9.9x | 14.6x | 13.2x |
| Pernod Ricard (€) | Buy | 58.83 | 11.5x | 10.6x | 13.6x | 12.3x |
| Remy Cointreau (€) | Neutral | 51.85 | 12.9x | 11.2x | 20.5x | 18.0x |
| ***Mkt cap weighted average*** | | | ***11.2x*** | ***10.3x*** | ***15.3x*** | ***13.9x*** |

| Brewing & Cider (millions) | Rating | Price | EV/EBITDA 2011E | EV/EBITDA 2012E | P/E 2011E | P/E 2012E |
|---|---|---|---|---|---|---|
| AB InBev (€) | Neutral | 39.78 | 9.1x | 8.6x | 14.5x | 14.0x |
| Anadolu Efes (YTL) | Neutral | 21.50 | 9.5x | 8.1x | 19.2x | 15.8x |
| Carlsberg (DK) | Buy | 331 | 6.3x | 5.6x | 9.3x | 8.4x |
| C&C Group (€) | Neutral | 2.83 | 7.1x | 7.0x | 10.4x | 9.9x |
| Heineken (€) | Reduce | 33.54 | 7.1x | 6.7x | 13.0x | 12.1x |
| SABMiller (pence) | Buy | 2,108 | 9.2x | 8.1x | 15.4x | 13.5x |
| ***Beer Mkt cap weighted average*** | | | ***8.7x*** | ***8.0x*** | ***14.4x*** | ***13.3x*** |

Source: Nomura research; Prices as of close October 3, 2011. Ratings from Nomura European Beverages team

## Scenario analysis: What if the US and Europe slip back into recession?

As the markets have been signaling that risks to our baseline forecasts are on the downside, our global economics team have considered a bear case economic scenario, most obviously triggered by a market meltdown, but the fragile state of the advanced economies leaves them vulnerable to unforeseen shocks or policy errors. For details, see Global Weekly Economic Monitor, 12 August 2011, and Global market turbulence: Implications for Asia, 9 August 2011.

The bear case scenario assumes:

–The US and Euro area slip back into recession, with US GDP averaging -1% saar in 2H11 and Euro GDP averaging -3% before recovering to around 2% growth in 2012.

– The CRB commodity price index falls 15% between now and year-end, but starts rising back again through 2012 reaching current levels by end-2012.

## What does this mean for UNSP?

In the above bear-case scenario, we see three factors which are likely to have an impact on the company.

1) Falling ENA prices: If commodity prices correct significantly, on account of a global meltdown, there will be significant benefit for UNSP in terms of lower material costs. If we assume a10% fall in ENA costs, then EBITDA per case in the domestic market would have a positive impact of 9-10%. This will flow through to the bottom line.

2) Falling Interest rates: The company had debt of INR63.8bn as of FY11, a mix of INR and foreign currency denominated debt. If Interest rates were to fall 200bps this could again impact the bottom line by 6-7%.

3) In terms of volume growth, we do not see a major impact even in the case of a recession, but will definitely see some slowdown. Our current numbers assume 15% volume growth, which could be impacted by a couple of percentage points

in case of a severe slowdown. If volume growth slows down by 200bps or so, the impact on earnings would be 7-8%.

Overall, if we combine the impact from all these three key factors, we believe the company is likely to see a positive impact of 9-10% on net profit, although the impact on our TP will be more muted, as our TP is based on FY13 earnings numbers and we are already assigning bottom-of-the-cycle multiples at this time.

**Fig. 19: Sensitivity to of EPS and TP falling RM prices and lower interest rates**

| | Base Case | Bear Case | Upside (%) |
|---|---|---|---|
| FY12 EPS | 42.2 | 46.5 | 10% |
| FY13 EPS | 50.8 | 51.7 | 2% |
| 12 month TP | 850 | 870 | 2% |

Source: Nomura research

# Appendix A-1

## Analyst Certification

I, Manish Jain, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of my compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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**Mentioned companies**

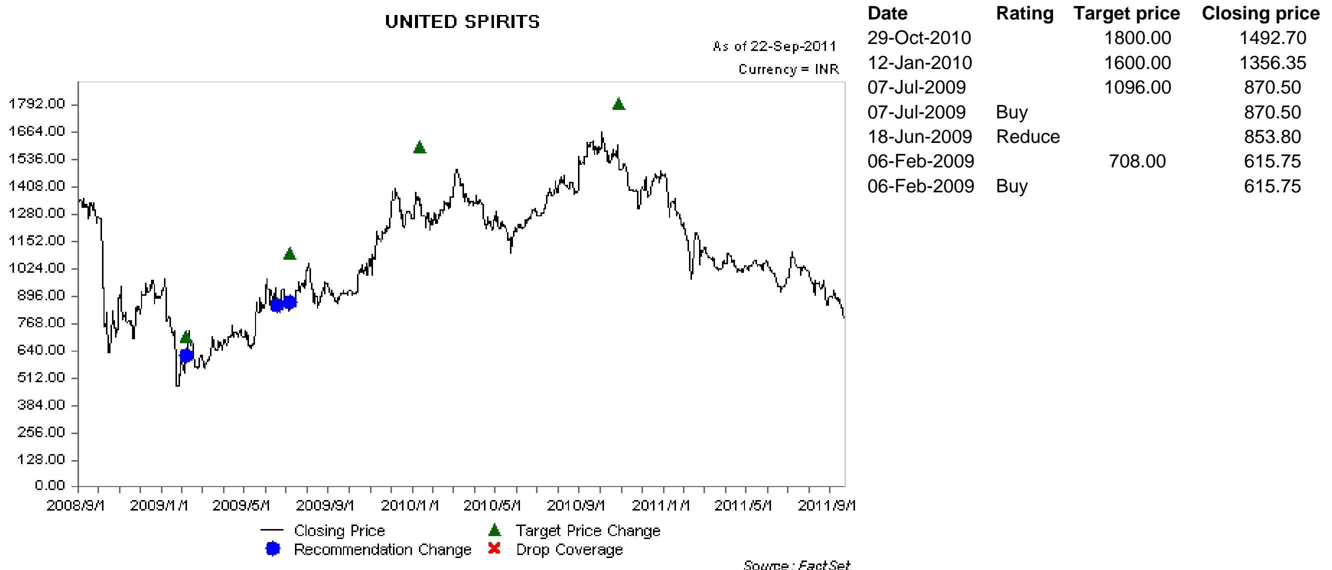
| Issuer name | Ticker | Price | Price date | Stock rating | Sector rating | Disclosures |
|---|---|---|---|---|---|---|
| United Spirits | UNSP IN | INR 779 | 05-Oct-2011 | Neutral | Not rated | |

**Previous Rating**

| Issuer name | Previous Rating | Date of change |
|---|---|---|
| United Spirits | Buy | 06-Oct-2011 |

**United Spirits (UNSP IN)** **INR 779 (05-Oct-2011)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)




| Date | Rating | Target price | Closing price |
|---|---|---|---|
| 29-Oct-2010 | | 1800.00 | 1492.70 |
| 12-Jan-2010 | | 1600.00 | 1356.35 |
| 07-Jul-2009 | | 1096.00 | 870.50 |
| 07-Jul-2009 | Buy | | 870.50 |
| 18-Jun-2009 | Reduce | | 853.80 |
| 06-Feb-2009 | | 708.00 | 615.75 |
| 06-Feb-2009 | Buy | | 615.75 |

For explanation of ratings refer to the stock rating keys located after chart(s)

**Valuation Methodology** We value the domestic business at an EV/EBITDA multiple of 11x and the Whyte & Mackey business at an EV/EBITDA multiple of 8x on FY13 earnings. We arrive at a target price of INR850.

**Risks that may impede the achievement of the target price** Upside risk to our valuation and estimates are 1) Higher than expected improvement in the domestic business profitability and 2)Resolution on fund raising at group company Kingfisher Airlines. Downside risk are 1)Higher than expected increase in glass prices and 2) interest and finance costs being higher than our expectations.

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### Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

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