



# “United Spirits Limited Q3 FY17 Earnings Conference Call”

**January 23, 2017**



**MANAGEMENT: MR. ANAND KRIPALU – CEO, UNITED SPIRITS LIMITED**  
**MR. SANJEEV CHURIWALA – CFO, UNITED SPIRITS LIMITED**

**Moderator:** Ladies and Gentlemen, good day and welcome to the United Spirits Limited Q3 FY17 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '\*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Anand Kripalu – Chief Executive Officer from United Spirits Limited. Thank you and over to you, Sir.

**Anand Kripalu:** Thank you very much and very good morning everybody, thank you for joining this call. I am Anand Kripalu and I am joined by our CFO – Mr. Sanjeev Churiwala and between the two of us, we will also take your questions after I have done a brief introduction which is what I typically do. First and foremost, let me start by saying that we are reasonably pleased with the results that we have delivered to date and especially so over the last three months, and everybody knows that the last three months has been challenging in the backdrop of demonetization, which has led to a bit of a subdued economic environment, so in that context, I think we are pleased. Having said that, I do want to underscore something that I have underscored in the past, that we do not manage this business purely on a quarter-to-quarter basis, we manage this on a slightly longer-term basis which is at least one year at a time. Now, as you would have seen from our results, we have continued to grow the top line despite this environment with a 3% net sales growth in the third quarter and then overall growth of 6% in the nine months' year to-date. Although we have been impacted by the effects of demonetization, we believe that we have managed through this period better than what we initially thought we would be able to do. The results, I think in some ways also demonstrate that we have the right strategy in place and our big focus on premiumization coupled with selective participation in the popular segment, I think this strategy seems to have worked for us particularly during this difficult period.

Specifically, in this period, our Prestige and above business, which is really No. 1 whisky and above grew 12% net sales in the quarter and 16% in the nine months' period, and this has been hugely enabled by our renovation strategy as well as premiumization strategy. The Prestige and above segment now represents almost 60% of the overall business, so we have made huge progress in making Prestige and above much richer part of our total business, and this has been enabled like I said by renovation, but also some new interactions which I will touch upon. At the heart of Prestige and above is McDowell No. 1 whisky. We have renovated the core variant about a year ago, and it is the biggest brand really in our family and it grew at 19%, so the core variant of McDowell No. 1 whisky grew at 19%. In the past quarters, I had mentioned the re-launch of Signature and I must say I am very pleased to see that Signature has grown 50% this quarter and almost 30% in the nine months so far.

In terms of new interactions in the Prestige and above segment, we introduced McDowell No. 1 Silk, which is the first Indian whisky with honey flavor, Royal Challenge Bolt which is an espresso-based Royal Challenge whisky. We introduced Captain Morgan Dark Rum into West Bengal, and during the festive period, we introduced gift packs for some of our premium brands, which include Royal Challenge, Black Dog whisky, Black and White whisky and VAT 69, and I must say I am very pleased with the ability of consumers to pay a premium for a highly giftable pack. From a comparative standpoint, in the last quarter I had mentioned that we had grown faster than the category and grown share, given how we perform this quarter, I am actually quite confident that we would have again grown faster than the category and grown market share.

If you move from Prestige and above to Popular, Popular in our priority states have actually grown by 6% in these nine months' period. Finally, we had shared with you earlier that we were looking at franchising out part of our Popular business particularly in space where we believe we do not see a great opportunity for growth in the future and opportunity for profitability, and I am happy to report that we have started progressing franchise agreements and many of these will be effective from January 2017. In addition to growing our top line, we have continued to focus on improving margins and that has been driven through premiumization as well as productivity combined with pricing, which we have managed to get in certain select states. As a result of this, our gross margin has improved by about 150 basis points in the nine-month period. Now, I must add that inflation has been somewhat subdued in the period, but more recently, we have seen some firming of input costs particularly towards the end of the quarter on ENA. Overall, input cost inflation has remained around the 2-3% mark over the nine months, which we have largely mitigated through our cost-saving initiatives. Importantly during this period, we have continued to do what we believe is right for the future of this business, which is to make investments in our organization, in brands and our investment behind core

brands is 16% as well as investing in new capabilities as well as internal systems and processes, so as we are taking this business forward, we continue to invest now so as to shape this businesses and make it ready for the future.

At the EBITDA level, we have improved margins of the quarter with reported 11.8% enabled by improved gross margins and lower staff cost. Our underlying EBITDA is 11.6% in the nine months' period and really is in line with the expectations we have for the business. This includes increased investment behind our brand of about 60 basis points. We have also continued to focus on the business below EBITDA, both in terms of reducing debt as well as reducing interest costs. As a result of that, our overall interest costs are down by about 20%, so this together with lower tax cost and the exceptional items have led to 129% increase in profit after tax in the nine-month period. As we look ahead, I expect that some impact of demonetization will continue into Quarter-4 though I think it is at a decreased level. However, there is a recent supreme court judgment on liquor outlets near national state highways and I think that is going to be a key variable for the forward period and it is something that we are watching very closely, so despite these headwinds that will be there in the coming quarter, we will continue to focus on our core strategies which we believe is working and make sure that we shape our operating model as well as our business to exploit the biggest growth opportunities in times to come, so with that introduction, I will now open the line for questions.

**Moderator:** Thank you. Ladies and Gentlemen, we will now begin with the question and answer session. We take the first question from the line of Avi Mehta from IIFL. Please go ahead.

**Avi Mehta:** Just wanting to kind of understand this gross margin expansion a little bit, could you kind of highlight is this completely just a premiumization because the cost inflation you indicated and just trying to understand that or is there is a RM deflation that has happened, if you could share some light on that as well?

**Anand Kripalu:** I am going to request Sanjeev to actually give you a full flavor of the gross margin because I am sure that is in the minds of many people on the call today.

**Sanjeev Churiwala:** Avi has a great question to begin the call today, so instead of talking about the quarterly performance and margin expansion, I will talk about the first nine-month thing and if you see the reported numbers, the first nine months, we had reported a 150-basis points improvement and expansion in the GM margins. Now, as you are aware that we had this LBT coming in Maharashtra in the month of August, as a result of which we have increased the prices in Maharashtra and the entire LBT cost have been passed toward for price increase, so effectively if you really see there is an impact of roughly about 50 basis points of LBT and the way it is reported, the increase in the price is reported in the net sales whereas the LBT increase has reported as the other overheads, so in effect basically the underlying performance in terms of the GM margin improvement about 100 basis points, and the where it is coming from as Anand has alluded that the overall inflation for a nine month stands is about 2-3%. A large part of this inflation increase has been mitigated through productivity improvements, so basically if you really see inflation has been taken care, bioproductivity has been utilized, so all the margin expansions basically largely comes through a pricing and positive mix increase, which is a great nine months' performance in terms of GM margin improvement, so hopefully that answers the question, Avi.

**Avi Mehta:** Yes, so it basically means that this level should sustain, obviously, the other expenses will also sustain are okay. Just the second question Sir, was any update that you could give on, A, if there is any pricing related discussion or pricing increase expected in any of the few states and whether the increase that we have seen in Telangana and West Bengal, I am not sure if that was in the entire part of 3Q or is there some benefit that is yet to flow through, this is my last question?

**Anand Kripalu:** I will tell you what has happened, in Telangana, there will be no price increase just to put it clearly, it has been eluding us, through the quarter this year we have been in touch with the state government, but it has not happened. What happened during the course of this fiscal is an increase in Karnataka from the July 1<sup>st</sup> last year and that has enabled us. We have taken prices up in Maharashtra which has more than compensated for the LBT increase, so we have got a little bit more than the LBT increase over there and we have also taken our prices in West Bengal which is a free-pricing market to again, the basis on a equal to the excise increase that

has happened in the state of West Bengal. Apart from this, we have had price increases which are much smaller in nature in some of the other states and a few of the other states, but that is really the pricing story.

**Avi Mehta:** Ok sir, let me rephrase, I am just trying to understand the pricing strategy, because as I see there is a lot of free-market price increase that you have taken and you are now trying to kind of pass on more of the cost, in fact, move up margins if I read your comment correctly and is that the strategy that we are trying to looking forward and while focusing obviously on states to come through and I hope I am able to explain?

**Anand Kripalu:** The strategy is not to just keep pushing the free pricing markets and become unaffordable for consumers, that is not the case. We have taken the prices up in those states because there has been a clear trigger in terms of taxes and cost, both in case of Maharashtra and in the case of West Bengal. I think we remain absolutely focused on trying to get price increase some space like we managed to get in the case of Karnataka, we have got something in Delhi, so we remain focused on that. Obviously, that is a much tougher nut to crack, but we remain committed to doing that.

**Moderator:** Thank you. We take the next question from the line of Latika Chopra from JP Morgan. Please go ahead.

**Latika Chopra:** You talked about this risk of this Supreme Court judgment, could you share your initial thoughts in your assessment on what could be the likely impact from closure of liquor stores near highways and from a mix perspective, would not you be less impacted considering this could hit the lower-end brands more?

**Anand Kripalu:** I am not saying that this is a recent judgment and we are trying to get our heads and hands around this issue as we speak. I do not have complete clarity on what the impact could be. Now obviously, liquor stores need to be closed on highways and move 500 meters from that highway that is something that absolute is the state government's and the retailers would be wanting to do in order to protect their own business and states to protect their revenue. That is something that they will be doing. I think the critical part is going to be how we manage this transition period so that the ball does not rock during this transition period, but honestly at this stage, there is very little more that I can tell you on this. The devil is in the detail, you need to solve that is almost outlet by outlet, an outlet that is going to close, which is the outlet that is going to pick it up or where is this new outlet going to be relocated, the devil is in the detail. You need to kind of micro-analyze and build a mitigation plan and our teams are focused on trying to make sure we have that clarity before April 1 happens.

**Latika Chopra:** My second question is on, we did see the demonetization-related impact on volumes, but what is the sense you picked up in some of the markets where you took price increases particularly Maharashtra, did it affect the volumes at least over the month of October or the data is too cluttered to make any analysis here?

**Anand Kripalu:** I think your lateral point is absolutely right, Latika, because there are just so many moving parts in today's market place that is very hard to isolate cause and effect from one of them because we have had demonetization. We had a big price increase because of LBT, so these are large increases. I think there is some subdued volume numbers in Maharashtra, slightly subdued, not very huge, but I will tell you from our experience from price increases from other state is, when there has been a material price increase in any state, you typically see some softness for the first three-four months, and historically the volumes have always kind of bounced back and I think that is what we should expect in this case as well.

**Moderator:** Thank you. We take the next question from the line of Arnab Mitra from Credit Suisse. Please go ahead.

**Arnab Mitra:** On the franchising part, so you have given about an estimate of about 100 crores on a 480 crore top line as your contribution, so just wanted to understand is this pretty much the current contribution that you get from these brands, is it a drop on that level, and secondly, given that Popular is a tough segment to make money in, how would the franchisee actually make money with 20% being given to you as a royalty or a franchisee fee?

**Anand Kripalu:** First of all, you are right. We are looking at about 100 crores from this round of franchising that we have done so far, this does not represent the end-game still, it is still work in progress. Just to set back for a minute, the purpose of which we are doing franchising is on a state-to-state basis, we have looked at our Popular business, we have looked at opportunities to grow that business and opportunities to make profit in that business, and generally speaking, if we have felt that there is a growth opportunity and profit opportunity, we are keeping that business, right, so we are not franchising out everything that is popular. Now, in space where we believe that there is a real constraint on margin of growth opportunity, I think quite clearly the simplest source of advantage is cost leadership and we believe that a franchisee will be able to operate at a much lower cost, both in terms of manufacturing and particularly in terms of overhead than we as USL will be able to operate, so therefore, if anybody is able to make a margin in that segment, it is going to be a franchisee with a really low cost model, but we will ensure that the basic quality requirements of the brand are met, so that is our philosophy. I would say we are probably half the way through in this journey or about third of the way through in this journey and over the next six months, nine months, we will get to the destination that we want to get to on franchising, but I think what is really important for us is, one is that we are securitizing on a fixed-fee basis, on a fixed-fee basis, the franchise margins that we are going to get and we are trying to securitize within the zone of gross profit that we currently make. It could be plus or minus 10-15%, but within the zone of the gross profit that we make, so the idea is to retain the gross profit as we make now. From our perspective, this is a declining gross profit trend because these are space and segments where volumes have actually been slipping and by ensuring that we have a fixed fee, which is an increasing fixed fee, we more than compensate for anything that we could have ever done ourselves, so we feel that it is actually a win-win because biggest win for us is that as a management team and as USL, we can really focus all our attention on Prestige and above and as you can see from these results as well as the last nine months and beyond, the Prestige and above is what is really driving this business for growth and profitability and therefore, we will be able to double up our efforts behind that.

**Arnab Mitra:** Couple of questions related to that, does the working capital link to these brands also go away completely from you or this popular segments in these states, and do all the variable cost link to manufacturing or selling into market, do all of that also go away from your P&L and this fixed fee, so it is not a percentage of sales or something, it is a fixed quantum that you are looking at?

**Anand Kripalu:** The answer is yes to everything you asked, if it is working capital or whether it is manufacturing cost, distribution cost, everything is yes, because it is the franchisee's business after that. It is the franchisee's business and you are absolutely right, the fixed fee means it is not into volume, so which means that the franchisee has to deliver a certain base volume but there is also huge incentive for the franchisee to drive volume even harder knowing that they do not have to pay a margin from the enhanced volume, so we believe we will incentivize the franchisee to actually do the best they can.

**Arnab Mitra:** One last question, on this excise changes in West Bengal and Telangana, do you foresee a major impact in the fourth quarter because of these two things?

**Anand Kripalu:** Excise changes in West Bengal has already been mitigated to price increase so that is done. Telangana what happened is, they converted VAT to excise, so there is some implication on working capital for the business, but no immediate impact on margin.

**Moderator:** Thank you. We take the next question from the line of Nillai Shah from Morgan Stanley. Please go ahead.

**Nillai Shah:** My first question is on the fixed asset which you are going to sell off, the non-core assets, what is the update on that and by when do you see that going through?

**Sanjeev Churiwala:** As we have been mentioning in our previous calls, we plan to monetize about 2000 crores of non-core assets in the coming years. The monetization plan have already kicked in and as you can see in the first nine months of the performance, we have other income of 26 crores already delivered through monetization and this journey will continue in the next couple of years and as we have mentioned, the large chunk of commercial and residential assets that we have that we tend to monetize, so our plan is on a target and we will continue to deliver that.

**Nilai Shah:** The second question is basically in this press release you mentioned about 100 crores of additional levies that affected your EBITDA for the nine months, now in the last quarter release you had mentioned 25 crores was an account of the impact of LBT, with retrospective effect in state of Maharashtra, so what is the remaining 75 crores that you have had in the nine months, if you just throw some light?

**Sanjeev Churiwala:** If you remember, Anand was just mentioning about that we have the full impact of the Local Body Tax coming in this quarter, and if you really see the first nine months, the total LBT impact is about 61 crores. In addition to that, we have some service tax, additional levies and inter-tax levies which is again close to 40 odd crores, so both of these combined makes it about 100 odd crores.

**Nilai Shah:** These are not one off, these are recurring expenses?

**Sanjeev Churiwala:** These are recurring expenses and the LBT has been fully passed on in terms of price increases.

**Nilai Shah:** Final question, your other income has gone up quite dramatically last two quarters, part of it is reversals of provisions, what is the full breakdown of this other income?

**Sanjeev Churiwala:** As we have reported, if you really see the other income including FX as compared to last year, we had 16 odd crores, we are now sitting at roughly about 85-odd crores up by roughly about 65-odd crores, and the breakup is, the first part is basically income coming because of monetization of assets roughly about 26-odd crores, besides that we have some dividend coming from subsidy of 5 odd crores. We had one off interest that we received in terms of deposit that we had made in a court litigation and we have received interest of 15-odd crores and this was reported earlier in the earlier quarter as well, and we have about 12-odd crores coming through a tax reversal because of a favorable court judgment.

**Moderator:** Thank you. We take the next question from the line of Aditya Soman from Goldman Sachs. Please go ahead.

**Aditya Soman:** My first question is again on the franchise agreement, where we are looking at the franchises making about 20% EBITDA margin, what would be the reason their costs are significantly lower than USLs?

**Anand Kripalu:** I am just saying that if USL than in terms of manufacturing and overheads, there are certain costs that you incur by being part of USL, our salaries would be much higher than what a franchisee would need to pay in terms of salaries. We would need to pay much above minimum wages, they might just pay minimum wages, and for supervisory staff and sales staff, they would obviously pay less. I would say that is the main reason. Also, what happens is they will be focusing their business really in a small geography and on one segment of the market, so it is a very simple focus operation versus our operations which tend to be a little more fragmented and little more diverse.

**Aditya Soman:** You are basically saying that they would focus more on the brand which they are getting from you than what you would have done, clearly because they are non-focused on you?

**Anand Kripalu:** Clearly, I mean we are very clear which are our focus brand and brands may not be big enough for us to focus on are absolutely big enough for those guys because for them they become head brands rather than tail brands.

**Aditya Soman:** In terms of your employee cost, here again we have seen a significant reduction in terms of a proportion of sales, is this again to do with maybe, I know there was some restructuring and also is this linked to this whole franchise move towards a franchising operation?

**Sanjeev Churiwala:** You are absolutely right on the first count. We have in the previous quarter did announce certain severance package and we have taken a hit of about 26 odd crores. The whole idea was that we get the payback of this severance cost within one year. As a result of this, you see a benefit coming into this current quarter, and hopefully, in the next subsequent quarters, you will see the benefit

ruling in, and of course, the franchise benefit have still not kicked in, the franchisee agreement that we have done is signed off with effect from January 1<sup>st</sup>, so as of December 31<sup>st</sup>, we do not see the benefit coming in the top line.

**Aditya Soman:** Just one follow up on that, so a 6.5%-7% sales should be a steady state sort of assumption in terms of employee costs, or you think it could come down even further with this franchisee thing?

**Sanjeev Churiwala:** I think that the trend that we have seen in the first nine months looks like a reasonable trend to follow going forward.

**Moderator:** Thank you. We take the next question from the line of Vivek from CLSA. Please go ahead.

**Vivek:** First question is on the ENA prices that you mentioned, from the quarter average, where are the exit ENA prices right now and any inflation in the glass bottle prices?

**Anand Kripalu:** We will see what specifics we can give you on that here, because I did mention to you as part of the opening was some hardening of ENA prices more recently towards the end of the quarter, so what are we seeing. We saw about 2.5% to 3% in Quarter-1. Quarter-2 is higher at about 6%-7%. Quarter-3 has again come down to 3% and we believe it to remain around that level as we go into Quarter-4 about 3%.

**Vivek:** Second, Sir, on Supreme Court judgment, I was reading one of the articles which says that almost 40% of the outlets get impacted, so the Supreme Court judgment on liquor ban or stores 500 meters from highway, does that also include five star hotels and pubs and everything?

**Anand Kripalu:** We think so, but there are lots of things that are not completely clear yet, so for instance as an example, nobody knows whether 500 meters is as crow flies or as the road goes, so there are some variables and I think states are also looking at getting more clarification and clarity so that they can then implement it appropriately, that is why I said, it is very hard to say anything more right now because it is just evolving honestly as we speak.

**Vivek:** In this case, I am sure it is just not only the interest of liquor industry, there will be state interest also because of the taxation plus the hotel, even the five star properties which get impacted in places like Mumbai on Western Express Highways, there will be a bunch of hotels which get impacted, so is there is a representation which is being made to the government and in all probability this will only benefit the informal sector, so is government looking receptive and who is the authority that the industry would be engaging with over here?

**Anand Kripalu:** Our industry is not involved with this at all because we are no locus standi to get involved. The state government and the retail associations are doing whatever they need to do to get clarity, and to protect their business, and I think that is where it stands.

**Vivek:** One more if I may, on the GST bit, any more clarity, last quarter you were sounding a little more positive and I think the same experience with United Breweries as well, has there been any more clarity on GST bit?

**Anand Kripalu:** No, I would only say this that everyone knows what is in the public domain in terms of the date now being July 1<sup>st</sup> and the slabs that have been emerged between 0 and 28%. Now, we are still not clear exactly in which slabs our key input materials will go and that is the key input that we need. Having said that, we still remain positive about the fact that the worst case that we had envisaged about six-nine months ago that worst case is looking a little better today, but again these are based on assumptions because there is no complete clarity and we are not in a position to quantify beyond that. I just think that directionally it seems to be little better than the worse that we had expected, that is all.

**Vivek:** Directionally, how do you get a sense, is it because of the fact that the states are listening to your concern or understanding your concern, how do you get that confidence that this is better than what you faired six months back?

- Anand Kripalu:** States are definitely understanding our concern, also I think when we are internally looked at what is the worst case scenario, we had made certain assumption and we are increasingly getting clarity that the assumptions may not be as bad as what we had originally assumed, but honestly this is a very blurred area and I do not want to get more specific than I have already done only because nobody knows for sure anything right now. These are all more I would say rough and back of the onlooker kind of calculations, which are driving sentiment and thinking at this stage. I think we will have to wait for another two-three months now again till we get full clarity.
- Moderator:** Thank you. We take the next question from the line of Prasad Padala from Investec Capital. Please go ahead.
- Prasad Padala:** Just few more questions on the franchisee part, we are expecting around 20% of the net sales from the franchisee outlet, but is it not much higher than what we are getting from Tamil Nadu, what is the basis for expecting 20% number?
- Anand Kripalu:** The numbers that we have now excludes Tamil Nadu. Tamil Nadu was something that was done some time ago and Tamil Nadu is on a variable fee model and based on our experiences there, we decided this time that as we expand we will go into a fixed fee model. We believe that securitizes the company far-far better because at the end of the day, this is a model which is a kind of eyes-on hands-off model. We are completely hands-off from this model and this kind of securitizes our ongoing profitability far better and that is why we have done it this way.
- Prasad Padala:** Even you will be going to the franchisees, you will be selling it or leasing it, what would happen, to your distilleries and bottling unit in this case?
- Anand Kripalu:** We already have a lot of our volumes which are third party, and absolutely we are not going to retain manufacturing capacity more than what we need, so where there are third parties, the third party is made them, as you become franchisee, the third party may start supplying to the franchisee but obviously we are not going to keep more capacity than what we need.
- Prasad Padala:** The existing owned unit in these states, so you would be selling them to franchisees or what you would do?
- Anand Kripalu:** Own unit we may or may not be selling, in some cases, we could be selling to the franchisees as well and there are couple of cases where that might actually happen but we are in parallel with the whole franchisee model also looking at our own manufacturing footprint and we might be shutting a few factories like indeed we shut half of factories in Bihar for obvious reasons. So we may be shutting factories, we may be keeping them if we are seeing the demand coming in those factories or we may be selling it to the franchisee, so that is something that the matter of detail, but obviously something that we are looking at closely to make sure that we do not have a residual model that is inefficient.
- Prasad Padala:** About Kerala, you have franchised all the brands including P&A, so may I know what is the strategy because in the other state you only franchised the popular brand mainly, so why in Kerala all the brands?
- Anand Kripalu:** Actually that is an exception to our overall strategy to be clear and that is because many of the brands in Kerala make little or no margin. I think Kerala there has been no price increase for 8 to 10 years maybe, I do not know, so it is impossible for us to be doing business and did not make sense for us to be doing that business, so in Kerala case alone, that is what we have done. However, in the foreseeable future, we reserve the right to take some of things back as and when the environment improves.
- Prasad Padala:** One final question, I mean the price increase in Maharashtra, I understand it must have happened in the second half of last quarter, so what about the price increases you mentioned in West Bengal and some of the other states, did they happen this quarter or in the last?
- Anand Kripalu:** West Bengal happened this quarter. I forget the date right now, but it happened this quarter and there was a significant price increase on the back of an excise increase and West Bengal has taken up excise duty after three to four years for the first time, so we have done that. Most of the other states, I think happened maybe in the previous quarter. Karnataka definitely happened on



July 1<sup>st</sup> and the other one, Delhi, there was some price increase which might have been somewhere between the two quarters, but it was small, so it is not hugely material to the total numbers.

**Prasad Padala:** The reason I asked is all the triggers for gross margin improvement this quarter, they have been same in the last quarter as well, so what is the delta this quarter, it is just because LBT?

**Anand Kripalu:** In the previous quarter, we took the hit of LBT with no price increase because LBT came with retrospective effect. This quarter, we have managed to take the price increase in Maharashtra actually to more than compensate for the LBT.

**Moderator:** Thank you. We take the next question from the line of Ankit Panchmatia from ICICI Securities. Please go ahead.

**Ankit Panchmatia:** Again asking about regarding the franchisee business, so have we kind of some of the internal targets that how many distilleries we are targeting to close down and do we kind of have a plan on it?

**Anand Kripalu:** We are obviously looking at what is our optimal destination footprint. Hence, we are obviously going to trim down our destination footprint from where we are today. So there are two big interventions that are influencing what the destination will be. One is the franchising and to what extent we franchisee out our business on a state-by-state basis and the second is GST. GST could have a material impact on what will be the most optimal destination footprint. Now, obviously GST is not completely clear yet, but all I can tell you is that we have already reduced our number of manufacturing units in the last two-and-a-half years from 93-94 to now 75-76, so that is a huge reduction in the number of sites, already that has been happening. We are not making a big noise about this, but we are just doing this in an evolutionary way on a state-by-state, case-by-case basis. You also know that in this industry, you have to have at least one factory in every state, so that defines the theoretical max cost destination. We will be somewhere between where we are today and that theoretical max cost and that is it.

**Ankit Panchmatia:** Regarding the price increase in Karnataka and Maharashtra, just a sense that what would that volumes be in the total overall basket or how much does Karnataka or Maharashtra contribute to our total top line?

**Anand Kripalu:** In terms of volume, Karnataka plus Maharashtra would be probably about third of our volumes, maybe more.

**Ankit Panchmatia:** One-third of the volumes, I did not get you, Sir?

**Anand Kripalu:** One-third to 40% of our volumes, Karnataka and Maharashtra.

**Ankit Panchmatia:** West Bengal price hike has been taken in this quarter?

**Anand Kripalu:** The previous quarter, yes.

**Ankit Panchmatia:** What does West Bengal contribute to our volumes?

**Anand Kripalu:** West Bengal would be 3-4%.

**Ankit Panchmatia:** Regarding the gift pack which has been introduced in the current quarter, so I assume the response of the sales would be quite phenomenal, but just to understand that what are the new product launches are yet there in to our basket which are expected to roll out in the rest of the year if I want to understand?

**Anand Kripalu:** We cannot share that, but all I can tell you is this, that our strategy of renovation on the one hand and innovation the other has been fundamental to our Prestige and above performance. We have talked of the renovation, I mean No. 1 has done well, the Royal Challenge has done well, Signature is doing really well, and on innovation, what we are doing is in some cases, we are in test market, we are testing how the market is, which we have done on brands like No. 1 Silk and on Bolt and gifting and you will

see this gold-colored packs because I am not sure if you know but one of the top desired gifts of men is to receive a bottle of whisky and that is what is the insight that we are trying to service with this offer.

**Ankit Panchmatia:** Just getting a sense that majority of our core branch are already been renovated, so now there would be innovation which would be kicking in and bringing in the higher delta, is my understanding right?

**Anand Kripalu:** I think what you have to understand is that renovation and innovation in a business has to be part of the rhythm of the business. It is not that you have renovated your branch today and you never need to do it again. You have to have a rhythm in a cycle for renovating because consumers evolve, when consumers need new offering every now and then, so you have a rhythm and similarly for new products, you will introduce a certain number of new products, all of them may not succeed, so you will withdraw those when you will introduce something more, but that is part of the overall rhythm of the business. Innovation and renovation has to be at the heart of the business rhythm and that is what we are aiming to do, it is not a one-off activity.

**Ankit Panchmatia:** Just on the employee expenses part, are we through with all the restructuring or is there some more thing which we can expect from the same?

**Anand Kripalu:** Organizational restructuring?

**Ankit Panchmatia:** Yes sir.

**Anand Kripalu:** We have done a piece of restructuring which we have shared. I think beyond this, there will always be continuous improvement and constant evolution of the organization and that is what we will be continuing to do at all times so that we stay efficient.

**Moderator:** Thank you. We take the next question from the line of Manoj Menon from Deutsche Bank. Please go ahead.

**Manoj Menon:** Excellent performance given the headwind. Sir, couple of small ones – one for Anand, on this franchising bit, if I am to understand essentially then you will have two separate sales systems, you will have your own and franchisee will have his own?

**Anand Kripalu:** Yes, the franchisee will do his own manufacturing, his own selling, it is an independent operation. Ours will be our own in states where we are retaining Popular, we may choose to have a separate sales force to just focus on Popular, so that the focus on Prestige and above is not compromised and where the franchisee is running the operation, he will run his operation, absolutely.

**Manoj Menon:** Understood, so as it stands today, is it that we have two separate sales piece and so to that extent, there is no disruption?

**Anand Kripalu:** In some states, we have a separate sales force for Popular, and if you are retaining those states, that model will stay. In other states, Popular by definition is smaller and has been shrinking, but is handled by a common sales force, so what happens is we take that smaller and shrinking part away and give it to the franchisee. We will look at seeing if there is some opportunity to optimize our headcount in sales and so on, but I think it could be small, the bigger opportunity is that the time released from sales force from focusing on Popular, will be focused on Prestige and above, so that we can drive the improved performance there.

**Manoj Menon:** Just from again a business continuity point of view, will it be fair to say that most of the franchisees are existing businessmen in the same line of business so there is no disruption from your side?

**Anand Kripalu:** Not universally, generally yes. Generally, they will be in this line of business and are familiar, but there could be cases of some entrepreneurs in some states wanting to enter this industry and this sector and we believe that they have the right competencies and capability to do this kind of work, we might consider giving it to them as well.

**Manoj Menon:** Secondly, on the comments about price hikes which are being implemented in the so-called free states, just trying to get around, for example, earlier about a year back or so, there has been heightened competitive activity particularly in terms of pricing in

Maharashtra and Karnataka from competition, probably bordering on the lines of irrational competition, so how are you seeing the relative competitive activity at this point in time?

**Anand Kripalu:** Competition is always fierce and is to be respected, but from a pricing standpoint, I have seen more rationality in recent quarters than I had seen maybe a year ago.

**Manoj Menon:** This comment is specifically on just pricing and what would you attribute that to, given that input costs are still probably range bound?

**Anand Kripalu:** If you look at the price increases that have happened more recently, they are all based on significant cost increases, which are tax increases and I think players selectively took that decision, but realized they cannot absorb and just to be clear both LBT and West Bengal, the tax increases are very material. They are not small. I mean the consumer prices have had to go up by 15-20%. It is almost impossible for anyone to absorb that kind of tax increase, so I think therefore, people have taken a decision to pass this on and that is why I said more rationality rather than just undercutting and destroying category value and eroding margin.

**Manoj Menon:** My question was largely related to one comment, if I heard it correctly earlier that the price hike has actually been slightly ahead of let us say the excise hike particularly in Bengal, so that is what I was alluding that to, so there is a bit of a leeway which is feasible today versus let us say what it was six months or one year back?

**Anand Kripalu:** Yes, so I think in Maharashtra it has been a little more than the tax increase and Bengal it has not been so much more than the tax increase. So, I think each player has decided what they want to do and others have either followed or done something in the zone and slightly different, that is all.

**Manoj Menon:** Lastly, on one of your comments about the lingering effects of demonetization in the fourth quarter also, is it a material thing which you are calling out because given that you had a great performance which looks pretty much like there is no demo-impact on your business at all in 3Q, a bit surprised about is cautious comment about 4Q?

**Anand Kripalu:** What we do know is that there is not complete normalcy as far as monetization is concerned, as far as money availability is concerned particularly when you go beyond the metros and large stuff, the cash supply is still not completely adequate, and therefore, we see some risk. I do not expect this to be huge material, however, we have this other Supreme Court issue now, and between the two, we are still not clear how much will be the impact of that.

**Moderator:** Thank you. We take the next question from the line of Pulkit Singhal from Motilal Oswal. Please go ahead.

**Pulkit Singhal:** This is from IR Management team, just a question again the franchisee side, is this going to be gross profit neutral the 100 crores?

**Anand Kripalu:** Yes, so that is the intent. Like I said, it will be in the zone, it will not be half of current gross profit or twice of current gross profit, it will be in the zone.

**Pulkit Singhal:** If I look at the business, almost 30% of your sales is employee, advertisement and other expenditure, so for this particular 500 crores of revenues, if I were just to translate it, it is almost 150 cr, so what happens to that cost?

**Anand Kripalu:** By the way on our Popular business, our advertising and promotion is very small. All our advertisement and promotion money are actually going behind Prestige and above, so therefore, you do not get anything from transferring out the Popular business. We only spend a small amount in the priority states on Popular, which you are retaining anyway.

**Pulkit Singhal:** There would still be if not 30%, may be 10-15% of sales so may be out of 500 is 75 crores being spent, so what happens to that cost?

- Anand Kripalu:** Your talking about advertising spends?
- Pulkit Singhal:** I am talking about your employee expenditure, advertisement, and promotion and other expenditure that is all your operating costs are roughly 30% of sales for an overall company wide basis, for this 500 crores that you franchisee out, maybe it is a much lower percent, maybe it is close to 15% instead of the 30%?
- Anand Kripalu:** Just to be clear. I think the AMCs will be pretty much negligible wherever we are franchising it out anyway. As far as sales force costs are concerned, we will largely be retaining the sales force to focus on Prestige and above, there may be some trimming which I said earlier, so that will be small and nominal and not very material. That is the way it really is.
- Pulkit Singhal:** Other expenditure, is there any benefit you will get, I mean whatever you report on the other expenditure line?
- Anand Kripalu:** We have already done whatever we wanted to do in terms of our organizational effectiveness of work and severances and so on earlier and we have kept in mind the fact that we are going to be doing this franchising, so wherever there were obvious superfluous roles those have been eliminated as part of the overall org effectiveness of work, which is completed now.
- Pulkit Singhal:** EBITDA wise impact would be broadly the same as well as the gross profit impact?
- Anand Kripalu:** The percentage may look a little better because your net value will go down, but the absolute EBITDA will not be very different for franchising, in that way intent that we are aiming towards.
- Pulkit Singhal:** How do you take care of the quality, the impact on the brand because if we do not leave enough money on the table, he may try to cut corners to kind of sell the product so how do you mitigate the impact on the quality and the brand by this franchisee role?
- Anand Kripalu:** We are very clearly keeping control on brand governance and brand and quality, so he cannot change the labels and packs and stuff like that on his own, equally he cannot change the liquid and we are going to be supplying the IP of the liquid, so there we will have proper checks and balances in place to make sure that is not eroded because those are our brands at the end of the day and he has been given those brands for a finite period of time.
- Moderator:** Thank you. We take the last question from the line of Chandra Shekhar Sridhar from Fidelity Investment. Please go ahead.
- Chandra Sridhar:** Just wanted to clarify, so the EBITDA of the case as per my own understanding that from most of the economy brand must have been in the region of about Rs. 15-20, Rs 25 per case, the royalty which you are getting now per case effectively looks to be about Rs. 135 to Rs. 140 per case, so roughly on the EBITDA level, you still would be making about Rs. 15-20 per case, is that a fair assessment?
- Anand Kripalu:** Actually, we are not looking at this on a margin per case basis. The way we have done this to be transparent is we have looked at what is the GP we were making in the previous year and this year from the sales on those volume and our intent has been to try and protect and have an increasing trend of GP rather than decreasing trend of total GP. Now, whether the franchisee sells half the volume or retains the volume, he will have to pay us the fixed fee and that is all that is important, so we are looking at the protecting this at a GP level not at a GP or an EBITDA per case level.
- Chandra Sridhar:** What about, you had about 3500 odd people in manufacturing, I presume a lot of these people would be basically supervising a third party bottle, do these people eventually move off roles?
- Anand Kripalu:** Wherever you have third party manufacturers, third parties may or may not move to the franchise itself and I spoke earlier about the fact that we had cribbed the number of our manufacturing sites, we are continuing to do that and every time by doing that, we are looking at closing select sites that are either not relevant in the future definition model or are too expensive, and when that

happens, obviously then we will close the site and then leave the people. In terms of the supervisory staff that is overseeing third party manufactures, again there may be some trimming, but it will not be very large and material.

**Chandra Sridhar:** As per my understanding on this is some of the profits which were made in this business were effectively cross subsidizing the Prestige business in terms of the A&P spends, this was sort of a source for subsidizing the A&P for festies, now will you still be making sufficient profits such as the pool which we make it and subsidize the A&P in the Prestige and above?

**Anand Kripalu:** I do not know what you mean by subsidizing on A&P, there is a certain total amount of A&P that is being spent, and as I said earlier, apart from small investments in our priority stake on Popular, all of it is going behind Prestige and above. That total spend, our aim is to not only protect, but increase overtime, so therefore, at the end of day that is what we are going to be doing. Now the A&P as a percentage may look a little higher because the net sales comes down when the franchise volumes goes away, but at the end of the day, like I said we are trying to protect GP, so it will not have an impact as you go down the line.

**Chandra Sridhar:** Lastly, is there a plan to roll this out nationally almost everywhere eventually overtime?

**Anand Kripalu:** Like I said, it is selective participation and selective franchisee, so there are some states which we will definitely keep because we believe it is profitable and there is a growth opportunity, some states we will definitely give out and some states that are in the middle and that will depend on have we found the right franchisee partner, are we able to negotiate the right franchisee fee from that partner, etc., so that is how we are evolving it. We have done one phase now and as we speak over the next month or two, we will be doing a few more where we have got complete clarity and then still some in the grey zone where we are not certain whether we want to do it, whether we found the right partner, whether the partner is offering us the best terms, so we will not do this to destroy value, I think is the simple message I want to give. We will do it when we believe we are going to create value for the enterprise.

I just want to thank everybody on the call for the time that you have taken to get on to this call and for the very insightful and engaging questions that you have posed to us. We look forward to staying in touch.

**Moderator:** Thank you. Ladies and Gentlemen, on behalf of United Spirits Limited, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.