"United Spirits Limited Q2 FY17 Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the United Spirits Limited's Q2 FY17 Conference Call. As a remainder, 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. If you need any assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Anand Kripalu from United Spirits Limited. Thank you and over to you sir.

Anand Kripalu: Thank you and very good evening everyone and a very warm welcome to this call. I am Anand Kripalu and I have with me Sanjeev Churiwala – our CFO. At the outset, I would like to apologise for doing this call late in the evening, I know it is festive season and 7 to 8 pm call is probably not ideal, but it is result season as well, apart from being festive season and we are all kind of back to back. So, I just hope you will understand. Before we open the lines for Q&A, I thought I would give you an overview of our results and I hope each of you have had the opportunity to read the press release that we have sent out a couple of hours ago.

First of all, I want to talk about some of the highlights. You would have seen that we have delivered 8% net sales in the second quarter and an overall 7% net sales growth in the first half. These results in some way continue to demonstrate that we have the right kind of strategy in place which is based on our focus on premiumization coupled with selective participation in popular. So, if we look at Prestige and Above specifically we have grown net sales in the half by 16% and that is on the back of the work that we have done on renovation and premiumization. The Prestige and Above segment now represents 57% to the overall business and we do believe that it is well placed now to outpace growth of the category in times to come.

At the same time our Popular business specifically our brands in the priority states that has grown kind of low single digit in the first half. So, we have had a strong and double digit growth for Prestige and Above and kind of low single digit growth on Popular. If you look at our brand specifically and I am going to focus really on our Prestige brands here. McDowell's No.1 whisky continued to perform well and if I exclude Platinum which is the one part of the architecture that is not yet being renovated.

Net sales was up 13% in the second quarter, so double digit growth and even in the first half McDowell has delivered double digit growth. If I look at just the code variant of McDowell's No.1 whisky which is really the gold variant, now that variant has grown much faster in fact that variant has grown in the 20s in the first half.

Royal Challenge continued to do well in the second quarter and recognised that we are now operating of a base of very strong growth post renovation. Having said that, net sales for Royal Challenge is up 28% in the first half and finally I spoke about the re-launch of Signature last time and I said that we had couple of years of actually decline on Signature. We had growth in quarter 1 on Signature and I am very pleased that growth has continued to build momentum with the results that we have delivered 26% growth on Signature in the second quarter post an action roll out. So as we speak now, we are almost national, just a couple of bits and pieces here and there but we are largely national. So, overall we continue to invest behind our brands and really the step up in our marketing investments by 24% in the first half is I think a critical measure of our confidence in our brands and our willingness to invest in growth. In fact in quarter 2 the increase in marketing is actually very sharp compared to the previous year.

If I moved from brands very quickly to states, UP continues to do very well. It was one of the issues we had in previous year and I think the momentum in UP post the excise duty and therefore consumer price reduction is very encouraging. One of the problems I used to speak about in earlier calls was the problem we had with pricing in Karnataka on Haywards and I am very happy to report that Haywards is absolutely back to growth and we have pretty much recovered almost all of the loss due to that pricing issue that we had.

If I look at cost, we continued to focus on cost in the business and I will come back later about other cost that we have pulled out, but our gross margins in the first half is up by about 80 basis points based on premiumization, but importantly based on also productivity and some of the pricing that we have actually got in the quarter.

In fact, our second quarter reported gross margin was maintained, despite headwinds from input cost particularly on ENA and of course we had a positive benefit from pricing which is largely from Karnataka. If you compare like for like underlying gross margins in the quarter, has improved by about 40 basis points. Yeah, if I were to exclude some of the write back that actually happened in last year's base.

We have continued our journey on corporate citizenship and improved our engagement with states. The pricing in Karnataka was one of the outcomes and the second is that we have now fully taken pricing in the state of Maharashtra to mitigate the impact of LBT, so we are fully compensating for the impact of LBT with pricing.

And finally we have continued to invest in our organization and the shape of our organization, so that we get ready for future growth. These interventions, write-off, reshaping the organization have had one-off impact on staff cost and therefore impacted to an extent our results for the quarter. However, of the benefits from these organizational changes will absolutely flow through in the subsequent quarters and in fact we can see it flowing through even now as we speak and we continue to build kind of systems for the future.

So, finally overall just to summarize, we continue to invest in the future of this business, be it brands or be it, in terms of reshaping the organization. We have had some hits because of local body tax in Maharashtra that was implemented with retrospective effect in fact, but however we have now fully mitigated that and therefore some of these things have impacted the EBITDA for the quarter. If I were to kind of exclude this, at the one-off items so to speak the provision for Bihar, some of the restructured cost and the one-off item in the base then our EBTDA is 11.2% which actually I think puts up, pretty much in-line with where we wanted to be and 11% is really in the zone where we wanted to be in this year. Our performance below EBITDA actually is far stronger. Our focus is both on debt reduction and interest rates and we made a very good progress on both these counts, that resulted in our interest cost coming down by 20% and if you combine that with the lower tax, we have had a 53% increase in PAT in the first half and we are obviously pleased with that. So that really what I wanted to share, I just want to re-create something I have done in the past which is, we do not really manage this business one quarter a time. We are managing this business for the longer term and it is the minimum really on a year- to-year basis and I would like you to just look at our results in the context of that larger journey.

With that I am going to open this up for question.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the question and answer session. We have the first question from the line of Abneesh Roy from Edelweiss. Please go ahead.

Abneesh Roy: Sir, my first question is what is the volume growth in McDowell's, you have given 13% sales growth in first quarter it was quite strong. So has the volume growth slowed down in McDowell?

Anand Kripalu: I will just pull out the volume growth. I think it is not slowed down because growing McDowell's double digit is very encouraging. So if I look at each one, our volume growth on the core variant is up actually 30% in the quarter on volume and McDowell's No.1whisky, if you take everything which includes Platinum and so on which are brands which are going to be renovated in the coming few months, that volume growth is 6%. So, if I remove Platinum which actually we should because that is the way you will get the sense of the underlying momentum, I think it is getting closer to 7% or 8%.

Abneesh Roy: Sir, last quarter you had given 26% as the growth, so, like-to-like number is what there?

Anand Kripalu: Yes, the like-to-like number was 26, is now 33.

Abneesh Roy: So it has inched up?

Anand Kripalu: That is the core variant of McDowell's No.1.

Abneesh Roy: And sir you said 13% sales growth but the volume growth is very different, so how do we look into why the difference is so much?

Anand Kripalu: So, there are several variants right; there is a core variant, there is a luxury variant. In the base, we used to write something called Diet Mate earlier which we have now migrated out of and there is Platinum whisky. We started by renovating the core variant which is the Gold Pack then we started migrating Diet Mate and introducing luxury and then we are going to be renovating Platinum and I think the key message is this, which is as we are renovating we are beginning to see good momentum and that momentum is holding on the variants that we renovating.

Abneesh Roy: Sir, one question was on Royal Challenge you mentioned on the base effect, so I have a question on quarter-on-quarter what is the movement in Royal Challenges because on the overall basis quarter-on-quarter your business is almost flat. So there is not too much of seasonality; so want to understand in Royal Challenge, how quarter-on-quarter movement is there?

Anand Kripalu: So, quarter-on-quarter, I am not sure we want to just give up quarter wise volume, but let me just say this Abneesh, which is I have already said we have had 27% or 28% growth in the half. So, the growth was higher in quarter 1 and a little lower in quarter 2, but there are some other moving pieces here, also our base is beginning to come into effect.

Abneesh Roy: That is the issue sir, Q1 was 48% and Q2 seems to be 9%. So if you do not get quarter-on-quarter we are not able to judge whether the base has really moved so much?

Anand Kripalu: So, 48 and 9, but base meaning, you mean the absolute volume?

Abneesh Roy: Yeah, so, any sense on quarter-on-quarter you get stable, so now the growth will be more like 9% similar to the overall Prestige growth broadly?

Anand Kripalu: Yes, that is right. So I would say it is stable. So there is one issue that I think our competitors have also reported which is the big Royal Challenge market which has been impacted in quarter 2 and that is the big route-to-market change that happened in Punjab. That is in the public domain; it has gone to Supreme Court. Our competitors has reported that their growth have been impacted because of the route-to-market change and we were over index with Royal Challenge, so to speak in the state of Punjab and that is actually hurt us in the quarter. Now we are waiting for that to kind of streamline, business is kind of restarted in Punjab not fully as per what it used to be, but it is certainly getting sorted out. So that is something that has had a bit of an effect Abneesh, on Royal Challenge specifically as a brand.

Abneesh Roy: Sir, one last one, your market share would have expanded because turnover reported around 8% growth. So would you have expanded market share?

Anand Kripalu: The fact is, market share, they have reported 8% growth. We have grown 12% on a like-for-basis quarter-for-quarter. So by definition, yes. Now market shares are not that quick and sensitive, right? So the market share we all look at is Nielsen. Nielsen has a 3 to 6 months lag and Nielsen importantly is based on sample of 30 cities**.** It is not based on census of outlets and volumes. But very simply, we have grown 12**,** they have grown 8. So we have to believe that we have grown share.

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

Arnab Mitra: On the LBT impact in Maharashtra, couple of things I wanted to check with you. One is that, now that you have taken the pricing is it a 10% pricing that you need to take to pass on the LBT and will that have an impact on down trading and the Prestige and volume growths in general and why was there a lag between the LBT coming in and you taking a hike and I mean if you could give any quantification of the kind of margin impact you would have had because of not taking the hike before first of October?

Anand Kripalu: First and foremost, yes the price increase is about the 10%, it obviously varies by SKU and by brand but yes, it is around that. And the intent of that price increase is to fully mitigate the impact of LBT. Now why was the lag effect? Well, the lag effect, what you do if somebody introduces something with retrospective effect, even if you did it immediately there would be a lag, right? And that is how it actually happens, it was announced with retrospective effect as far as we are concerned, we implemented the price increase as quickly as we could and in fact our competitors have all followed, but followed soon after, right? But we were the first because we said there is absolutely no question of not doing it, right? We were not willing to forget our margin in one of our most important state which is the state of Maharashtra. Now with the 10% increase in our portfolio and with the competition also moving, could a 10% increase soften the category, yes of course it could, right? Now having said that if there was one timing I had to choose, we will choose the best time to take a 10% price increase, it would be the run up to the festive season. So, what happens is, we did in summer, we did in off months, I think people would be really cautious about stocking; they will bring down stock, they look for old price stock and even consumers will be probably very sensitive. In the festive season, when there is an optimism, a tendency to premiumize and a tendency for sales and demand to go up, nobody wants to down stock, right? Because nobody wants to be out of stock in these critical days in the run up to the festive season. So if I had to choose a time which was the best time, if I had to just pick it out of my hat, I would have said, this is the best time to take that kind of price increase. So time will tell, but I am optimistic.

Arnab Mitra: And in the quarter, what kind of impact would it have had, would it have straight away knocked off 10% from GM in the state, I mean how would that have played out and how many months did it impact you?

Anand Kripalu: So it impacted us for about 6 weeks because it got effective, I think 15^{th} or 16^{th} of August, right? So impact is 20-25 crores in the quarter, which has come straight off cost for us as far as we are concerned.

Arnab Mitra: And the other question was on this underlying EBITDA margin which have reported 11.6 for this quarter and 11.2 for the first half. So if I just see the difference between the reported number and the underlying there seems to be 28 crores of gap in the 2Q, so if you just quantify what is the one offs there and for the full first half, what is the total amount of one off and what are the main items?

Anand Kripalu: So, I am just going to request Sanjeev to just respond to you.

Sanjeev Churiwala: Let me first come to quarter 2, in terms of what are the one-offs. So as I think in the past we have been telling that we are trying to create the right operating model and asset for the perfect organization, We have been working on this process for a better and a linear organization, in the process in the last quarter we had to let go some of our staffs and in the process we have incurred the severance cost plus some consultancy related to that which is roughly about 30 odd crores and the benefits of this will come in the subsequent quarters and that is one-off for the quarter 2 which is impacting the EBITDA margin. So on a like-to-like basis from a reported EBITDA margin of 10.1% will be standing at 11.6% for the quarter 2. Now coming to H1, besides the severance and the related consultancy cost coming in, in quarter 1 we had the Bihar provisioning coming in. If you remember in the quarter 1 we did discuss because of the Bihar prohibition, on a conservative basis we have taken certain estimates, provisioning about 17 odd crores. So all put together in H1, the total one off cost roughly about 50-55 odd crores which would take our reported EBITDA margin from 9.9% to roughly 11.2%.

Arnab Mitra: And just one last question, anything on input cost because you have mentioned input cost pressures. So if you could just highlight what you are seeing on the input cost side?

Anand Kripalu: Some hardening of input cost. But all I can say is that, we are actually seeing input cost less than what we are anticipated during the course of the year. So, yes there is some seasonality by the way in this input cost as well, right? Overall, I can tell you, we are obviously anticipating some input cost during the course of the year and I think still input costs are a little softer than what we had expected; there is some hardening of ENA, but I think other key input materials like glass and paper and so on are absolutely intact.

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

Latika Chopra: Just continuing from the previous question, any thoughts on the recent regulations regarding any pricing, how would that effect the cost inflation going forward?

Anand Kripalu: So, I will tell you. We have done whatever analysis we can do with the information that is available, right? So it is not deterministic yet; it is probabilistic at this point in time. Now our belief remains that there will be a benefit from this whole thing. Now whether the benefit is 1 crores, 10 cores, 30 crores we do not know still, but we believe there will be a benefit, however; it is yet to play out and that is unfortunately the best answer we can give you at this point in time.

Latika Chopra: Second you mentioned about increased cost focus, is there any sense or any targets that you have in mind from quantum of savings you could target over the next 2 to 3 years?

Anand Kripalu: So, let me put it this way. We believe that having a robust cost saving target every year is fundamental to driving the healthy business and we believe anyway between 1% to 2% cost, we should be able to pull out of the business, every year, right? So if you want to target, that is what it is. Is there a hard plan to deliver that 1 to 2, no? We are evolving that. As far as the current year is concerned, what I can tell you though which is more hard is that whatever we saved in 2015 that is when we started the journey. We saved more than that in 2016 and we going to save much more than that in 2017. So we are building them up and 2017 at the end of H1, I am actually quite pleased with the cost savings that we have actually extracted out of the business. So, I think we will deliver in this fiscal more than we did in the previous one and we will continue to expand to pull out 1% to 2% of cost every year because I believe that is how you run a healthy business.

Latika Chopra: And just lastly a book keeping question on your CAPEX, the first half you mention 119 odd crores for the full year, what should one build in?

Sanjeev Churiwala: Normally, we have our investment plan to roughly invest around 300 to 400 odd crores of CAPEXes and the way we normally invested 60% of our CAPEX investment would normally go into productive gains whether in terms of investing it to technology, investing in terms of better productivity and capacities and remaining 40% as a target we normally would invest in terms of improving on our safety environmental norms and bringing our plants up to the world standards.

Moderator: Thank you. We have the next question from the line of Aditya Soman from Goldman Sachs Asset Management. Please go ahead.

Aditya Soman: My first question is on, you mentioned a 24% increase in marketing investments and a sharp increase in season 2Q. Now this was largely lead by the new launches or was this just additional investments needed to stimulate growth further?

Anand Kripalu: So, I tell you, this is more to do with what is our marketing investment philosophy. So our marketing investment philosophy is, we obviously do a base amount of advertising support on all our brands, but we over index investment when there is no news. So, our marketing investments have been targeted towards new news more, right? Because at the end of the day, I think that is what consumers also receive better. So that is how we have done it. I think it is also about the amount of new news you have it any point in time. So you know we had a recently renovated Royal Challenge, we had recently renovated No. 1 and then we have recently renovated Signature as well and suddenly you have got more brands with new news to support and that is why we have put more money behind it. So we have a quarter where, I have no new news and may decide to spend a bit less rather than just keep throwing money like wallpaper which nobody will notice. So I think that is basically our philosophy and right now we are running through a period of significant new news and therefore we are also supporting that and spending more.

Aditya Soman: Understand. That is useful and if I could just ask further on this, you spent about 300 crores in 1H, where would majority of that spent go in terms of because you obviously cannot advertise directly on television or in print so through would it just be sort of store decorations and stuff like that or where would most of it go?

Anand Kripalu: We obviously put money into store, right? And we have significantly scaled up money in store and I hope when you go to the store and you will see a bit of enhanced presence and we have talked on past call about the concept of perfect stores, where these are stores where we believe that is as close to an ideal visibility of our brand. Apart from that we are spending on media which are really investing behind our brand extension, what we are beginning to call now our brand purpose vehicle. So, if you look at Signature which is recent been introduced, so Signature now we said is all about start up and it is about converting your passion to a pay check and our investment behind Signature is really to bring that alive. So, that is how we do it.

Aditya Soman: Is there a break up you can give in terms of what proportion goes on media and what proportion is on other sources?

Anand Kripalu: No, I do not think we are getting into that level of granularity yet**.**

Moderator: Thank you. We have the next question from the line of Manish Poddar from Religare. Please go ahead.

Manish Poddar: Just wanted to understand when you say priority states, do we include only Maharashtra or Karnataka or are they any other states included in this and are this priority states different for Popular brands?

AnandKripalu: No, so priority states for Prestige and Above is quite different. On Popular yes, Karnataka, Maharashtra are our key priority states. It is not as we do not invest anywhere else, but you probably over index in these, but recognize that we will keep adding and changing this list, depending on how things evolve. So, for instance, of late we have been stepping up our investments in West Bengal and actually finding good momentum over there. So that is a kind of dynamic piece, I think the philosophy is that on Popular will be very choiceful and very selective about where we invest. On Prestige and Above, I think we will be far more expensive because across the geographies, so that is how we are playing the game.

Manish Poddar: And if you do not mind which would be those states, which are the key states for the Prestige and Above brands?

AnandbKripalu: Maharashtra is one of the key states for Prestige and Above; so is Telangana, so is the some of the states in North, Delhi is very big, so there are many state that are big states for Prestige and Above both in terms of current business, but importantly in terms of propensity to grow.

Manish Poddar: And just one more thing, when you say point of sales advertisement is it possible if you could share what will be the total number of those in Maharashtra and Karnataka and what would be our shares versus our competitor when you looking at it from a points of sales, let say the banner at the store or our intensity versus the other brands. I am just trying to understand our relative share of mind in these two key states for us?

Anand Kripalu: Sir, you are trying to ask about our share in store or our presence in store?

Manish Poddar: Yes, presence in store.

Anand Kripalu: No, I am not sure we would want to get into that detailed conversation. I think, see at the end of the day you win in some stores, your competition wins in some stores, over time you are try and win in more and more stores, right? And that is how you increase your total shares of stores presence and that is how we play the game, but I do not think that there is anything more granular than that, we can honestly share with any and make any sense of it at this point in time.

Moderator: Thank you very much. We have the next question from the line of Anand Bhavnani from Sameeksha Capitals. Please go ahead.

Anand Bhavnani: I wanted to know about the employee expenses, they seem to a short of 15% quarter-on-quarter, so can you sir highlight where have we used up this additional money for, is it for additional hiring or is it for voluntary retirements, please elaborate on that?

Anand Kripalu: Sure, Sanjeev is going to help answer your question.

Sanjeev Churiwala: Thanks Anand. So I think if you looking at the numbers for the second quarter, we have spent about 205 odd crores in staff cost as compared to 165 crores in the corresponding previous quarter. The increase is about 40 crores which is about 24% increase and as I said in the past we have incurred about 28 to 30 odd crores in terms of the severance cost for this quarter and that is where the money is spent. If we exclude the severance cost, the overall increase in staff cost is about 9% which is in line with this inflation for salary cost.

Anand Bhavnani: Sir, do we see any further severance cost in quarters coming in Q3, Q4, is there any possibility or is it all done?

Anand Kripalu: Well, no, it is not fully done. There is a little bit more to be done and it is not only about one time project, so we want to continue to look for opportunities to build the right kind of lean organization. Now we have done it in many parts of the business, we have not yet done it in some parts of the business, but in every case I can tell you that the kind of paybacks we are seeing gives us encouragement that is the right thing to do, we should do it because it will pay back in quick time and therefore you might see a bit more, I think the fair amount of heavy lifting has been done, let us put it that way right now. There will be some lighter lifting that might happen in subsequent quarters.

Anand Bhavnani: Sir, can you quantify are we like through 60% of the process in terms of rationalizing your workforce, is it 70% or it just 30%, just wanted to get a sense of how much more severance cost you have might have to bear?

Anand Kripalu: You have to understand that these are sensitive things; I have been upfront to say that we have done the heavy lifting and we have got some lighter lifting left. Now, if I put percentage it will be even more complicated but I have given you an indication.

Anand Bhavnani: Just wanted to understand the LBT hike, you said we have correspondingly the increase our prices, so these prices have been increased, had it been from 15th August or had it been this quarter October 1st?

Anand Kripalu: Well as you understand, the government can put taxes on you retrospectively, you can not increase your prices retrospectively. So obviously we could not do that, but we have done it from in fact 1st October, early October, as early as we could we have done it.

Anand Bhavnani: And the hit is around 30 odd crores because of that?

Anand Kripalu: No, that was the hit in the current quarter that we are talking about and in subsequent quarters, we have mitigated through the price increase.

Anand Bhavnani: So that is what I am confirming. Next quarter we sort of one-off was 30 crores, we got off this LBT, one and a half months that we have to bear?

Anand Kripalu: Yeah, it is not 30, it is a little less than that, but yeah.

Anand Bhavnani: Ballpark?

Anand Kripalu: Yeah.

Moderator: Thank you. We have the next question from the line of Avi Mehta from IIFL. Please go ahead.

Avi Mehta: Just wanted to understand from a balance sheet point of view, a) if you could update us on non-core asset sales, any update over there and b) on working capital you have been able to maintain working capital despite sales growth increase whether that intensity can come off and the second is there any more events second half?

Sanjeev Churiwala: In terms of the non-core asset monetization, we do have a plan in place. As I have indicated in the previous quarters, we do intend to monetize about 2,000 odd crores in the coming years so that plan is still intact and we will continue to do so. Coming back to the discussion on the working capital, if you see with respect to our working capital movement as of 31st of March 2016, we have actually reduced our working capital by close to 175 crores, but the working capital management is quite dynamic in nature, it depends upon market to market in terms of the payment challenges that we might have with the corporation market due to route to market changes. Our intention is to keep on optimizing our working capital and ensure that we maintain a healthy working capital to grow our business.

Avi Mehta: What I meant is, is there any update on that 2000, obviously I understand that 2000 crores, anything further, has there been any movement in that front is what I wanted to understand?

Sanjeev Churiwala: There is a small movement in the last quarter where we have some profits about 20 odd crores coming in and that is a very small amount, we do have bigger monetization plans.

Anand Kripalu: We have much bigger monetization plans and you hopefully see this in subsequent quarters, some big chunks coming in. So this quarter, I think, it has been relatively smaller because we sold many items but unfortunately they were relatively smaller items like cars**.** In subsequent quarters, we are looking at some bigger items. Yeah, you should, we have given you a longer term perspective of our total monetization so you should expect that to start coming through as and when we are able to close the deal.

Avi Mehta: Sir, just and last bit clarification if I understand this quarter, the adjusted number was about 11.6% EBITDA margin and on that, the LBT impact also if I kind of offset which is now longer be there, we are looking at close to 13% EBITDA margin. Would there be any reason to assume that this is not the steady state number, obviously if there are regulatory changes but this is the number on a clean basis which could continue going forward?

Anand Kripalu: So, like I have said that we do not manage this business at one quarter at a time and therefore I do not think we should run away and assume something based on one quarter's numbers. We have given our guidance very clearly to you earlier which is mid-teens margin and the medium term. We left it to you to determine what mid-teens really means and what medium term means, but we have said we want to constantly keep improving our EBITDA margin in a sustainable and a consistent way and we still committed to that, okay. So I think that is what you should take, you might have one quarter which is higher, one quarter little lower but either which way, we do not want to get excited or feel depressed because there is a longer term trajectory that we are trying to follow.

Avi Mehta: Sorry let me clarify sir, so what I meant is that, what the only lever over here which can vary would be the marketing spends or is there anything else is what I wanted to understand? I take your point that this may not be the number to kind of assume, I just wanted to understand what can change in this number, is it the ad spends largely or is there anything else which we may have missed or which I may have missed in doing this calculation?

Sanjeev Churiwala: Yeah, so perhaps we understood your question better now. If you really look at our spend on the A&P run rate would be in the zone of about 8%, this quarter we are still under invested at 6.4%. So we can expect that our run rate in terms of advertisement, promotion spend will go up to the zone of about 8%.

Avi Mehta: And one last question sir the depreciation, is there any one-off, the reason for the increase, it is kind of one-off to 33 crores because have you done any manufacturing addition or any addition over there?

Anand Kripalu: That is because of the higher capitalization that we had in the previous quarter and to that extent, higher depreciation coming in. There is no one-off in this.

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

Nillai Shah: First question is on the gross margins, you have highlighted that you managed to take some pricing in certain parts of the country whereas free pricing, productivity gains, input costs, ENA may have inched up a little bit offsetting it plus you have got the Karnataka big price increase which is 25% of your portfolio and yet your gross margins are flat on a Y-o-Y basis and down sequentially, so how should I think about gross margins, why is there no improvement in gross margins coming to despite product mix improvement, productivity, pricing and Karnataka?

Anand Kripalu: So, our gross margin is up by 80 bps as far as H1 is concerned and really 40 bps in the quarter. Now, there has been some neutralization of some of the positives that you spoke about because there has been inflationary pressure on expense due to spirit in the quarter. So there has been an impact of almost 200 bps of cost inflation this quarter specifically largely driven by extra neutral spirit, so that is how it kind of triangulates.

Nillai Shah: And this 200 basis points, is it more structure because we have not heard of any big increase in alcohol prices given that you are still in the same sugar cycle in this quarter as you were in the earlier parts of this year. So the sugar bit changes only when the new sugar season sets in and that we are expecting a moderation given what the policy is, but just on a sequential basis, how are you seeing 200 basis points increase, is this one-off in it?

Anand Kripalu: So, these are not about sequential. If look at the bps versus last year, last year this quarter was very low in terms of ENA and therefore we are seeing something like a 6%-7% increase in

ENA alone quarter-on-quarter comparison because last year was particularly soft. Now having said that and as I said this earlier in the call today that we are expecting for the year ENA to be less than or equal to what we had planned for right, so it is not going to be any worse. As far as we are concerned, it is not alarming or something that is outside what we planned for.

Nillai Shah: I do not know your plan, so could you help me out to understand because last year also your margins were 42.5, this year also your margins are 42.5 at the gross profit level on Y-o-Y basis I am talking about, and you had all these improvements plus Karnataka, sir not able to understand exactly where this problem is coming from and sequential you had 43.3% gross margin number and so sequentially also that has come down. So Y-o-Y is flat, sequential has come down; I am not able to understand exactly where this problem is, sorry to hop up on this again.

Anand Kripalu: We have tried to explain as possible but may be what we can do is we will help to explain to the extent we can explain this probably offline if you write to Richard, we will set up a call or send you a mail and try and explain this as best as we can. Would that work?

Nillai Shah: That works, thank you. The second question is on the costs, you highlighted that there has been a big push to neutralize cost but if I just look at your cost either on a Y-o-Y basis or over the last 2 or 3 years since you have taken up the rains of USL, really on all line items I am not talking about ad spends because ad spends I can understand that you are building a product portfolio from a long-term perspective, but most of the other line items are not really down in fact they are inflating quite dramatically, so where is this cost optimization really sitting at this point of time and why is it not visible in reported numbers?

Anand Kripalu: So, cost is not just a one way street. So we have pulled out cost particularly to do with cost of different kinds which is to do with not just negotiating harder but to look at product design, look at weight of bottles and stuff like that. Having said that, we have also by the way invested, so for instance, our entire Prestige and Above portfolio today is grain spirit. We have moved, we have reduced the amount of recycling of bottles in states where we believe that a quality bump up could help our brand and brand image. We have improved the offering on some of our brands. So if you look at Royal Challenge, we have improved offering. So the reality is we are not in a situation where we are saving the money and putting it straight into the bottom-line and we have said this in the past that we are saving money, so we can invest in the drivers of growth and that is exactly what we are doing. In my judgement if we are managed to change the trajectory of this business in terms of growth particularly for Prestige and Above, and held gross margin by pulling out cost in wasteful places and putting it back in places that is now helping to drive our growth, I think we are creating a bit of a positive cycle rather than, again where the cost was there but the growth was not there and that is something that we have said. Now we have also invested in new capabilities which are very material to the long term future of this business. I mean for instance, we built a commendable innovation team. We built new capabilities like corporate relations and stuff which are fundamental to succeed in our engagement with the government to overtime unlock pricing and make sure that we do not have any hurdles to doing our business. So I would urge to see the slightly bigger picture of how we are playing this game and trying to shape this business for the longer term and that is why probably you do not see what you are looking for.

Nillai Shah: And this cost optimization plan of pulling out cost to the extent of 1% to 2% that is the net cost which you are targeting may, may not happen but targeting every year for the next few years that is the net number you are targeting, 1%-2% of cost being pulled out every year?

Anand Kripalu: What you mean by net?

Nillai Shah: After all these further investments that you have spoken about to enhance the business?

Anand Kripalu: So the question is what is overall inflation going to be in the next few years' right? There is going to be some underlying inflation. On top of that, we are going to try and save something through our own cost saving efforts and then you might decide to invest something back.

Nillai Shah: And the final question is on the portfolio rationalization which is under way, Popular versus Prestige and Above, I understand it will be an ongoing process but when do you envisage situation where a bulk of it is over in that to say that Popular may not de-grow as dramatically as it is at this point in time so when is the rationalization really a bulk of it over, you have highlighted in the past that 60-40 is what you looking at in terms of revenue contribution between Prestige and Popular?

Anand Kripalu: So Prestige is already 57% as I said earlier right. So that is not a million miles away from 60, but having said that we are currently franchising parts of our Popular business in different parts of the country and I would say the large part of it will be done in month and not years. So exactly how many months, I do not know but it will be in months not years and I think we will reach….

Nillai Shah: Sorry that will optically make the margins look better right, because your revenue capture will not happen at your end fully at least, is that assessment correct?

Anand Kripalu: Yeah, that assessment is correct; I mean it is fairly straight forward, right.

Nillai Shah: Sure, so your mid-teens margin over the medium term that can also factors that part of the shift inside or is it as from now from the current numbers of FY16 you are expecting mid-teens margins so?

Anand Kripalu: We said mid-teens now, how we get to mid-teens will be a combination of various things right? Will this contribute to it? Will other things contribute to it? Yeah, there will be things that might distract from it, but absolutely the direction is to get to mid-teens and there will be different things that will contribute and take away. I just wanted to make it clear that we are not playing a game of just trying to improve our margins optically without any real underlying results improving our margin right? So with the whole improvement happens through offtake rather than through underlying performance, absolutely not. Looking at underlying performance improving it some benefits of offtakes will be there and that is the matter of arithmetic, but that is really how we are looking at it.

Moderator: Thank you. We have the next question from the line of Ashit Desai from SBICAP Securities. Please go ahead.

Ashit Desai: Just on the franchising part, could you give us some idea as to what percentage of your Popular business is currently franchised and where will you reach once this is completed?

Anand Kripalu: I cannot give you specifics, all I can tell you is that there were parts of the country where franchising has already been done. So Tamil Nadu, Andhra Pradesh, Kerala right places where we have done it. Now we are successfully moving some other states where we believe franchising is the better business model or route to market to manage that part of the business and so it is happening. Now, where it will exactly end and what percentage will finally go out, how much will stay, I think we just honestly have to wait for a couple of months till this become completely clear because it is also based not just on our intent, it also based on finding the right franchise partners, executing it, making it happen and so on and so forth. So I think we just have to wait for a couple of months but the direction is what I told you.

Ashit Desai: What percentage of volumes can you get that or?

Anand Kripalu: That is what I said**.** There is no point by telling you because like I said it is not just intent. It is also based on ability to make it happen but it is a material part about bonding, let me put it that way. It is not a rounding of an insignificant part of it. We have done some states already like I said and we are going to do several more and whatever we do, it will be material in terms of the amount of volume that we will aim to franchise out. Now how many million case it will be, so it will be millions of cases by the way. But how many millions of cases will it be, I cannot tell you because we do not know exactly honestly right now.

Ashit Desai: And as I understand for franchising, you will get only a royalty from those volumes but you will not get any margin upside or downside in those states?

Anand Kripalu: Yeah, that is correct; we will get royalty on the franchise volume that is the plan. So it will go off our top-line and it will come into our bottom-line.

Ashit Desai: But if margins improve in those states, you will not get most it.

Anand Kripalu: If margins improve in those states, we won't get the benefit of that. Well that is not true, right? So that will depend on how we make the agreement with those parties and what the logic of future profit sharing and margin sharing is in the contract. So I don't think you can assume that we will not get any share of opportunity that might come out in those deals.

Ashit Desai: And secondly if you can quantify the impact of Punjab, at what percentage it contributes to your volumes?

Anand Kripalu: I don't think we are getting in a discussion of state wise contribution. So Punjab is not one of the biggest states for us, but it did particularly well for Royal Challenge last year and that is why I called it out earlier in the call today, but I think then it is getting a bit too granular.

Ashit Desai: And I have one more last question if I may. In your press release, you have mentioned that underlying EBITDA has declined 3% in the first half. But if I look at the one-offs highlighted by Sanjeev, I mean they are largely 50-55 crores. So your EBITDA seems to have declined by more than 10%, even if I adjust for these 50-55 crores. So what is the difference?

Sanjeev Churiwala: I think it is a combination of various things that you talking about. As I said, in terms of the underlying EBITDA after talking off one-off for the H1, it is 11.2%; this again has to be compared with the last year. In the last year for the similar period, we also had a one-off in terms of certain reversal which has come to negotiation deal of 27 odd crores. So we have to really adjust that as well in the base number, the overall underlying margins last year would come to about 12.6% versus 11.2% norm.

Ashit Desai: Are you including the 20-25 crores of impact of LBT in the 11.2% EBITDA margin this year?

Sanjeev Churiwala: No, we are not including that as an exemption that is part of the normal business as usual.

Ashit Desai: So if we were to adjust for that, it could be higher than 11.2%?

Sanjeev Churiwala: Yeah, if you have to adjust for that but as Anand just said, LBT impact would be largely mitigated to the price increase that we take in early October.

Moderator: Thank you. We have the next question from the line of Chandhrasekhar Sridhar from Fidelity. Please go ahead.

ChAndhrasekhar Sridhar: Could you just draw at any update on discussions which you may be having with government on GST?

Anand Kripalu: So, obviously the discussions are continuing full swing and I think we are getting one more alignment with some of key states, as well as Amit Mitra who has been spoken to sharing the empowered committee as well. And I think the states now absolutely get the issue that is there and they obviously do not want the situation where the center takes away so much more and the business collapses in the states because of the fact that they will have to take that kind of price increase, but equally with some other conversations we are having, I must say that with the slabs that have been coming in that people are talking about, none of these are final yet. I think we believe that cautiously we are feeling more optimistic that the impact is not going to be what we had envisaged and the impact may be far less than that because some of our input material may genuinely come into the lower slabs rather than the higher or the highest slabs. So that is what we are feeling right now. I think we will just have to wait still, I think it is another month, month and a half away before we get final view about those slabs are going to be.

ChAndhrasekhar Sridhar: Secondly, just any information on Telangana price increase, obviously it is being overdue for a very long time, now any sense of where you are in that?

Anand Kripalu: Nowhere in regular touch with the government, the government themselves are losing revenue because they have not got a price increase for themselves either or duty increase. We believe the file is ready, we believe sitting with the Chief Minister, people are following them every day. I have asked for an appointment with the Chief Minister to go along with some of the other CEOs of the industry as part of our industry association, so we were doing all of that but as I said earlier, it will be lying on the table ready as far as I know and the ink must have surely dried by now ready for signing. So I cannot tell you much more on Telangana except that we still remain hopeful. Even yesterday my team was there having conversations and they had very positive conversations about this, but we had positive conversations in the past too. So I think it might just come suddenly and we remain hopeful, but given that it is not come for so long who is to know for sure.

ChAndhrasekhar Sridhar: Just another question if I may, are you carrying any contingent liabilities related to service taxes which you may have to pay on the privilege fees, can you quantify how large this impact is if there is?

Sanjeev Churiwala: So I would not know which service tax you are referring to because service tax on various items of services. So it is very difficult for me to really tell you on exactly which component you are talking about. So if you can drop me a mail or reach at a mail on a specific item you are referring to, we can come back to you.

Moderator: Thank you. We have the last question from the line of Vivek. Please go ahead.

Vivek: Sir my first question is on your release point number 10, it says that the company has received a claim during the quarter from a customer in relation to prices over past several years and you have disputed that, can you tell me which customer you are talking about and what is the quantum that we are talking about?

Anand Kripalu: So what specifically do you want to know?

Vivek: You have mentioned that you have received a claim from a customer, who this customer is and what is the quantum that we are talking about over here?

Anand Kripalu: I could have said that I will send in the release and is not about hiding something. The fact is that these are things that happened constantly right as part of ongoing business and you have disagreements and differences with customers and we have one such disagreement which we are working through and dialoguing and believe that we are going to resolve it with minimal impact and that is why we are not really making any…

Vivek: I understand, but I am saying here you are calling out that it is over the past several years, so that worries me because in United Spirits case, I think the exceptional items are almost recurring every quarter, so what is the quantum that you are talking about, do not tell me the name of the customer but quantum if you can clarify?

Anand Kripalu: So honestly we are not in a position to quantify. If something that was seriously worrying, then we would mostly build into our results which we have not done and not provided for it and the auditors are very comfortable with that and that is the fact. But unfortunately that is all I can tell you now without comprising also the customer in this conversation.

Vivek: Okay, second to an earlier question by Nillai on gross margins sir also and it will be beneficial that if you can clarify in this call, so are you seeing 200 basis point cost inflation in this quarter, the third quarter from second quarter level because I did not understand why are you seeing gross margin expansion at least on the second quarter. On a sequential basis, there is a decline and then you are quantifying it at 200 basis points that is certainly worrying, would be helpful if instead of replying to Nillai one-on-one, if you can clarify on the call for the benefit of everyone.

Sanjeev Churiwala: So let us try and clarify this to the extent possible. I think as Anand has mentioned out, if you look at our first half, our gross margin has increased by 80 basis points and which is a combination of premiumization, productivity and pricing. What Anand was referring was part in terms of the increase in the cost, but a large extent of that is mitigated through productivity. That is why you see an improvement in terms of the gross margins.

Vivek: So basically 42.5 or thereabouts is after absorbing the 200 basis points, it is not going to be an incremental one from this point of time?

Sanjeev Churiwala: Absolutely.

Vivek: And lastly, can I just get the absolute volumes for this quarter, the total volumes that you sold, million cases?

Sanjeev Churiwala: Instead of getting it quarterly by breakup, let me give you the overall for the H1. For the H1, we have sold close to about 44 million cases.

Anand Kripalu: Thank you everybody. Thank you so much for joining in.

Moderator: Thank you very much. Ladies and gentlemen on behalf of United Spirits that concludes this conference call. You may now disconnect your lines.