UNITED SPIRITS

A DIAGEO Group Company

3C CAPITALS

expertise you can trust

Game Changer

Undergoing Metamorphosis

Date: 20th June, 2021 (CMP = 673)

Inside the Report

Metamorphosis

Metamorphosis is the process by which the young form of insects, frogs, etc., develops into the adult form. Metamorphosis also means a complete change of character, appearance, or condition.

Our latest Game Changer recommendation **'United Spirits Ltd (USL)'** has been going through a metamorphosis in our opinion.

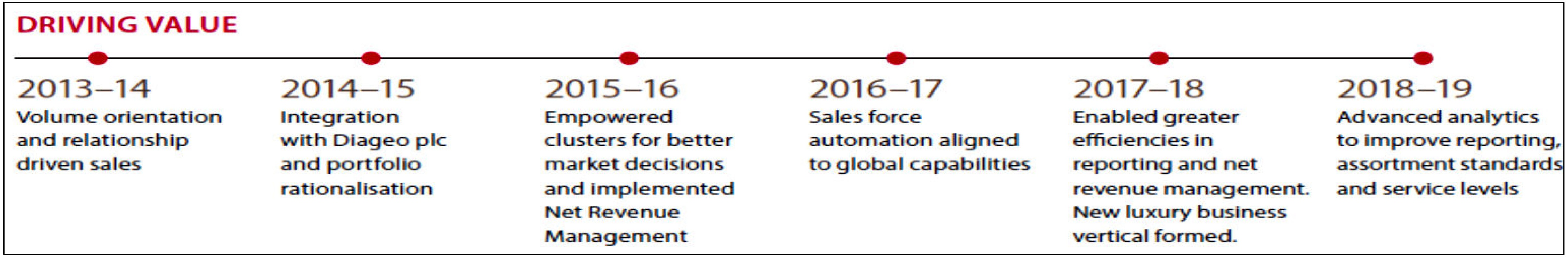
The 'Ugly Caterpillar' Phase: United Spirits Ltd, which was a UB group company, was inherited by Vijay Mallya. Vijay Mallya went around the country picking up the No1 or No2 brands in each geography and this brought in huge economies of scale of national brands.

However, along with the no of brands, debt was also increasing in the company's books. Focus on volumes rather than margins and subsequent corporate governance issues eventually led to the ousting of Mallya from the chairmanship.

The almost Butterfly Phase: In 2013, Diageo Plc finally completed its takeover of USL. Diageo decided to have a slow and patient approach, in line with its history of acquisitions, in turning around USL. **The focus was brought back to margins, high-priced brands and improving cost efficiency.**

They also brought in new management to oversee the turnaround. Over the next few years, the new management has brought down the huge debt and implemented initiatives to improve margins and profitability.

The management is clearly walking the talk, however we believe there is more to come.



Company Snapshot

Total Weightage % in Portfolio = 6% (CMP 673)

Two Phase Buying Strategy = Buy 3% around CMP 673 & average down further buying 3% between 525-575 range.

Price Target = Rs 1000+ in 12 months; 2000+ in next 3 years. Expect 20-25% CAGR over the period of 5-10 years.

Current Market Price (INR) – 673.00	**Market Cap (INR Cr.) – 48,885.00**
BSE – 532432	**52 Week High / Low – 679.00 / 494.00**
NSE – MCDOWELL-N	**Promoter's Holding – 56.8%**
Bloomberg Code – UNSP:IN	**Pledged Percentage – 1.19%**

Business : USL, a subsidiary of global spirits leader Diageo, manufactures, sells and distributes a portfolio of premium brands. With sales volumes of 79.7 million cases during FY2020, the company is the largest player in the domestic spirits industry.

Management : Post its acquisition, Diageo brought in new management to run the operations. Over the next few years, the management has been able to turnaround the business by focusing on the premium brands, cost-cutting initiatives and riding the preimmunization trend. Diageo's association brought in business synergies, financial flexibility and strengthened governance.

Valuation : USL has historically been trading at high PEs due to its market leadership position and portfolio of iconic brands. Post the debacle of Vijay Mallya and subsequent entry of Diageo, the company has not gone anywhere in terms of price. We believe the company is in a sweet spot in terms of bringing more growth by focusing on super brands and implementing cost efficiency initiatives. While the management has not been able to achieve everything that they set out to, we expect that as the operations gets more leaner and profitable, USL is a prime candidate for re-rating.

Risks : Exposure to regulatory changes, Volatility in input prices & Intense competition

Business Overview & History

United Spirits (USL) has been undergoing a remarkable transformation post its acquisition by Diageo, a global leader in alcohol beverage nearly seven years ago.

The company manufactures, sells and distributes an outstanding collection of premium brands such as Johnnie Walker, Black Dog, Black & White, Vat 69, Antiquity, Signature, Royal Challenge, McDowell's No. 1, Smirnoff and Captain Morgan.

USL was the spirits division of the UB Group. It was originally incorporated as McDowell & Co. in 1999. On the amalgamation of eight spirit companies into the company including Herbertsons, Triumph Distillers & Vintnersgot, and Shaw Wallace, the company got its current name in 2005.

Diageo Acquisition Timeline

- 27 May 2013 – Diageo acquired 10% stake
- 4 July 2013 – Bought an additional 14.98%
- 2014 – share holdings rose to 54.8% after buying out stake from United Breweries (Holdings) Ltd (UBHL), the holding company of the UB Group, and other promoter companies.

Investment Rationale

Continued consumer push towards premium products

Growing Young Population

Opportunities to expand into other categories (White Spirits)

Strengthening Balance Sheet by reducing debt

Increased focus on Prestige & Above Brands

Portfolio of Iconic Brands

Backing of Diageo – one of the world's largest producers of spirits and beers

Premiumization – The Key Growth Driver

- The Indian spirits industry has been growing at more than 12% CAGR for the decade starting 2001 making it one of the fastest growing markets in the world.
- Similar to food and personal care categories, premiumization is a fairly large trend even in the Indian spirits category.
- Characterized by an increased focus on flavor, high-quality ingredients and more appealing packaging, there has been a growing consumer trend towards ‘premium products’. Consumers are likely to spend extra given the rise in budget options making premium products more appealing.
- The addition of millennial consumers, who are guided by health and sensorial experience, is also driving growth for the more prestigious and premium brands.
- The rise in premiumization is clearly reflective in the increased focus of the big players on semi-premium and Premium categories with an increase in launches and increased marketing of these categories.
- However the pandemic induced lockdown has slowed down this premiumization trend. Countries hard-hit by the economic impact of Covid-19, consumers are most likely to choose to down-trade as they focus on value-for-money options.
- **Two key sub-trends that we believe will further push the premiumization trend are rise of ecommerce and innovation.**
- The pandemic forced the country to experiment with alcohol ecommerce. We believe this could lay the groundwork for a permanent new sales channel in the world’s second-largest spirits consumption market.
- In India, the alco-bev category is highly under-penetrated and has amongst the lowest per-capita consumption compared to other developing countries around the world.
- The growing socializing and celebration of occasions has got consumer patterns undergoing a metamorphosis. This paradigm shift is a great opportunity for brands to innovate with their offerings.

Portfolio of Iconic Brands

- The company has a comprehensive brand portfolio with over about 120 brands of Scotch whisky, IMFL whisky, brandy, rum, vodka and gin.
- 13 of these brands sell more than a million cases annually.
- 4 brands sell more than 10 million cases each annually
- Almost 1 in every 2 branded spirits bottles being sold in India coming from the Company's portfolio.
- The company's brands are consistently among the top alcohol beverages brands in the country.
- The company also boasts of pan-India manufacturing presence with 50+ facilities and robust distribution network of more than 65,000 outlets, which provide access to vendors, suppliers and distributors.

ALCOHOLIC BEVERAGES

RANK	BTR 2020 RANK	BRAND NAME	CATEGORY
1	258	KINGFISHER	BEER
2	495	ROYAL STAG	WHISKEY
3	634	BUDWEISER	BEER
4	663	SMIRNOFF	VODKA
5	670	McDOWELL'S	WHISKEY
6	701	TUBORG	BEER
7	998	TEACHER'S	SCOTCH WHISKEY
8	999	BLENDERS PRIDE	WHISKEY
9	1000	SIGNATURE	WHISKEY

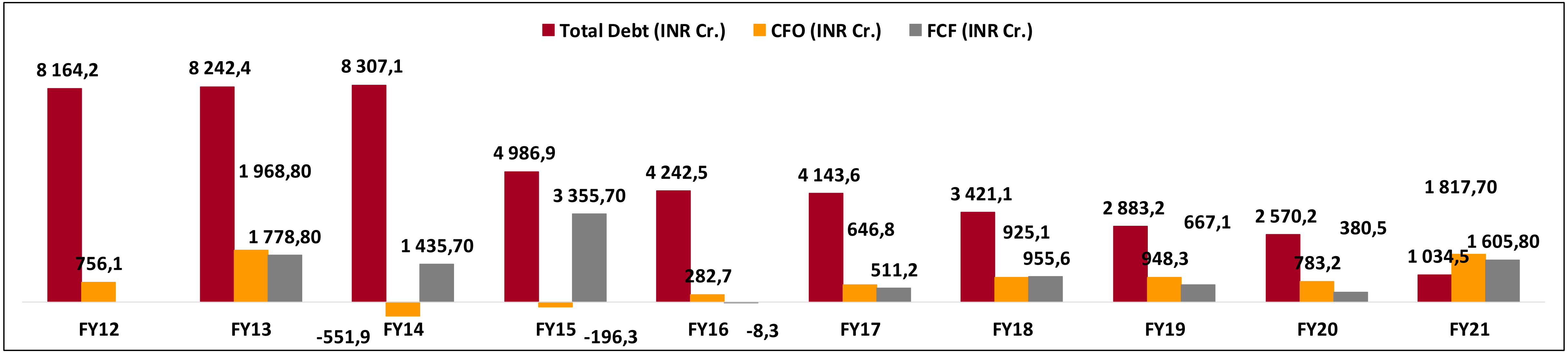
Unloading Deadweight

- Diageo started to tidy up everything - books, the brands, the people, the distribution channel, the disinvestment and incentives – all at once. Since all these systems and processes are interconnected, it is impossible to fix things in isolation.
- One of the major task in front of the new management was to reduce the huge debt in the books. They also started by getting rid of non-core assets.
- The below graph clearly shows the impact of the management's clean up process on both debt and cash flows.
- The management also leveraged improving profitability to strengthen balance sheet by improving credit rating and reducing interest cost further and deleveraging debt further.
- Diageo's takeover brought in business synergies, financial flexibility and strengthened governance.

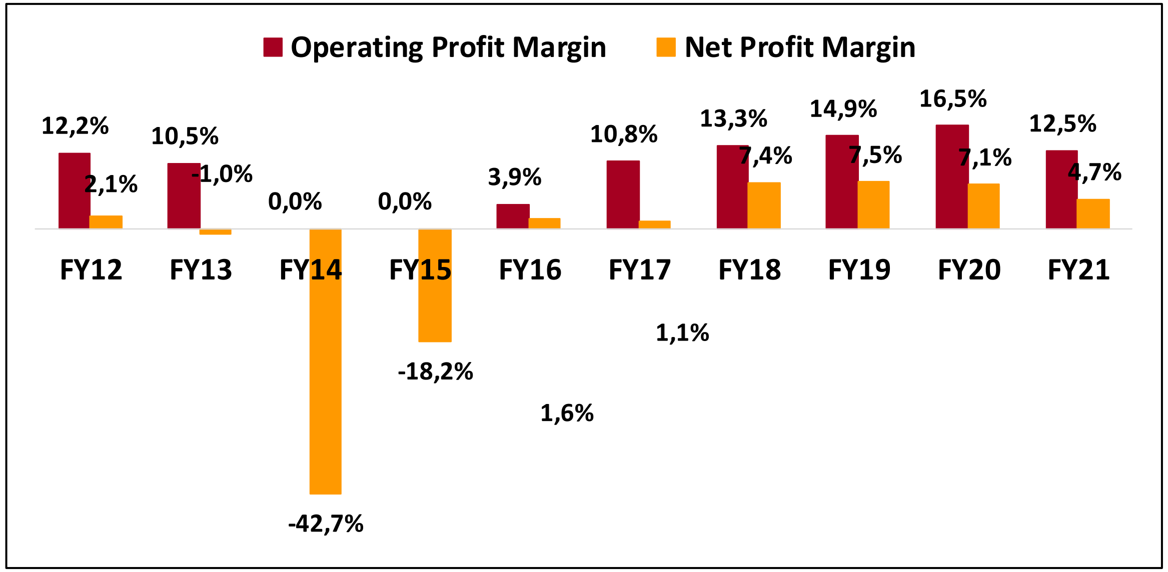
Credit Ratings

ICRA: Feb 2021 – Reaffirmed

Crisil: Dec 2020 - Reaffirmed



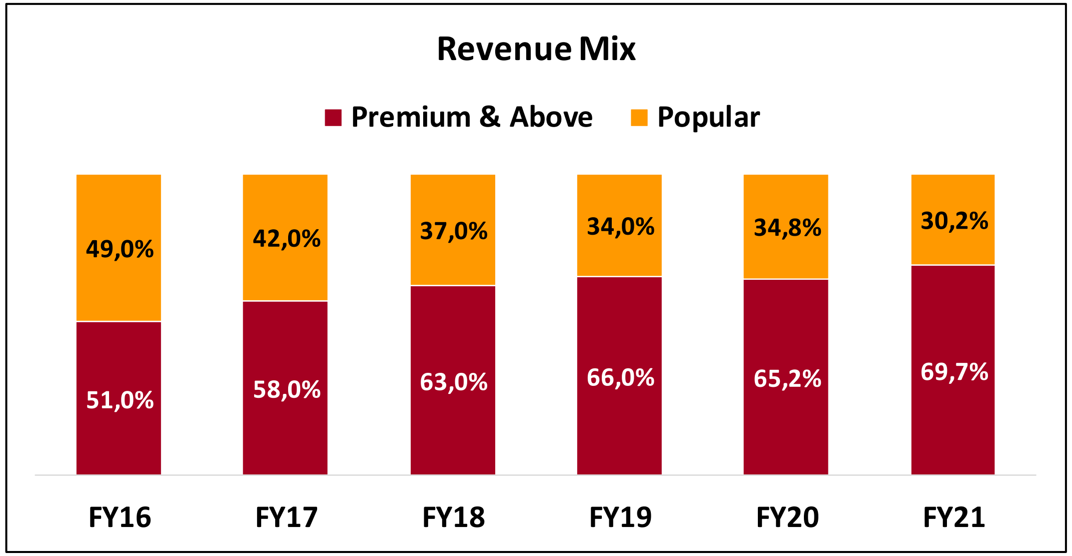
Being Cost-Efficient

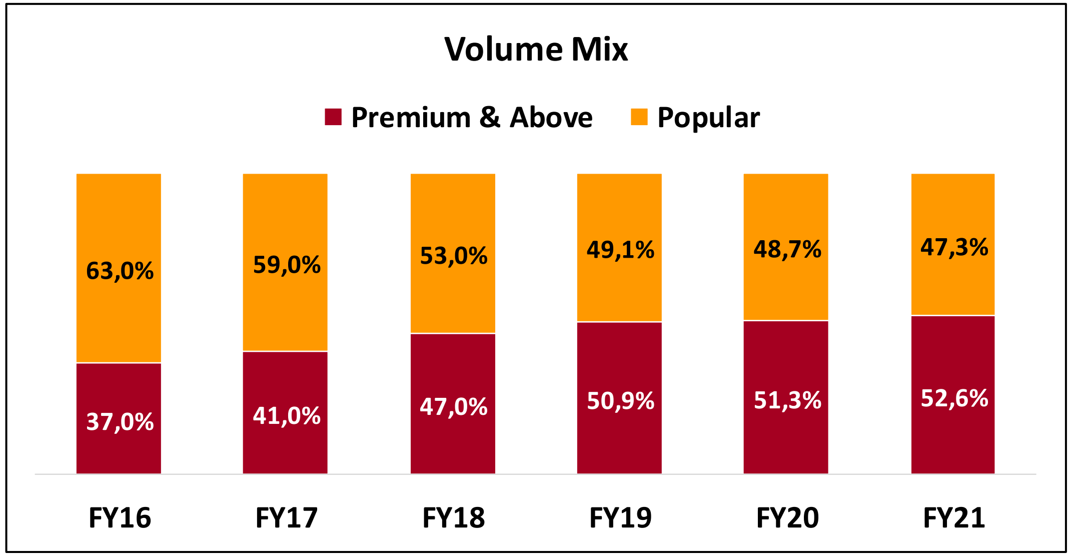


- Along with the premiumization strategy, the management adopted a stringent cost-efficiency model, which involved shutting down unviable manufacturing facilities and franchising some mass brands. The management has brought down the no of factories to 47, down from 94.
- Being closer to market was important for an alcohol company to avoid taxation imposed by each state. For a Rs 100 product, an alcohol company generally ends up paying Rs 75 as taxes. The company also has to pay an export pass fee to the state where it manufactures, an import tax fee in the state where it sells and a transit fee to states through which its trucks pass.
- Winning at the point of purchase is fairly critical, considering that distribution is restricted to only about 80,000-90,000 stores.
- The management has also implemented 'Perfect Store' and 'Net revenue management' initiatives to further boost its margins. They are also trying to do away with the push-sales strategy which is a major cause of compliance lapses. With systems and checks in place, the management has been able to reduce the bureaucratic interference to some extend which also lead to lower working capital days.
- Liquor in India is highly regulated and duty hikes (both excise duty and VAT) has been used for maintaining fiscal balance of the country as well as for political reasons. Therefore, there has always been an extremely uncertain environment with respect to liquor taxation in India. Taxes in India are much higher than in other countries, making it unaffordable for the larger audience.
- Prices of key raw materials like molasses, extra-neutral alcohol (ENA) and glass are beyond the control of USL.
- As the premium portfolio is growing, the dependence on molasses has declined as most premium whisky brands are grain- based.
- Despite taxation and raw material cost fluctuations, there has been a continuous improvement in the margins of the company.

Focus on P&A Segment paying off

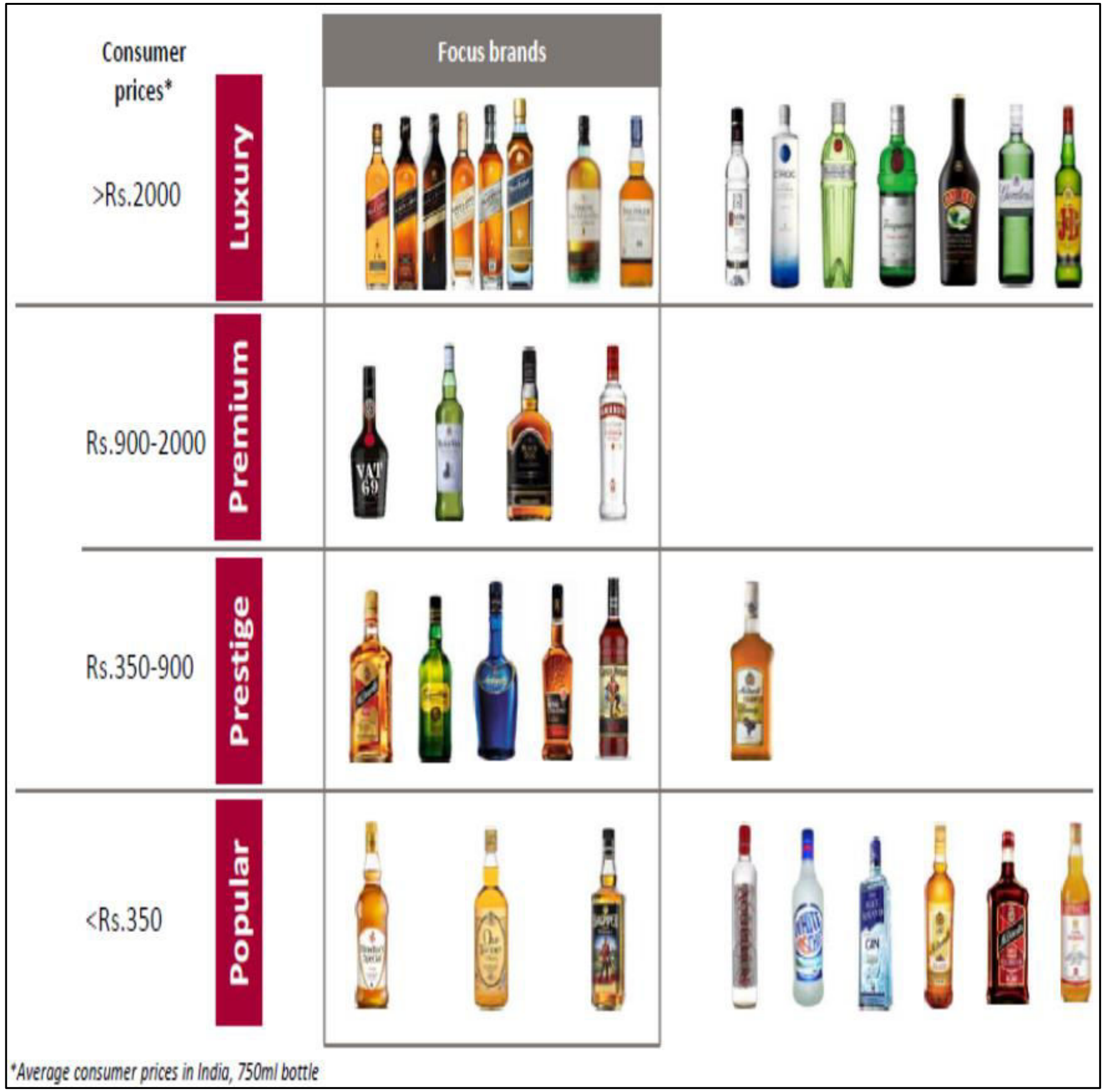
- Post the USL – Diageo integration, the management has been following an FMCG power brand strategy. Through this, the focus is on selling brands that cost more than INR 400 a bottle and franchise or sell rights for brands that sell less than INR 400 a bottle.
- Ad spends are expected to return to 8- 9% of revenues as the situation normalizes and the company will continue to spend more on prestige and above segment to drive its premiumization strategy over the longer term.
- The management has been undertaking a strategic review of the 'Popular' segment encompassing reviews of geography, franchise agreements to bring a higher focus on Prestige and Above (P&A).
- USL's popular portfolio comprises around 30 brands and the strategic review will focus on approximately half of this portfolio by volume. This review will not include the McDowell's or Director's Special trademarks.
- The management is looking to retain the 'Popular' segment in certain states and franchising in other states.
- The strategic review is expected to be completed by the end of the 2021 calendar year.
- Bengaluru-based alco-bev firm John Distilleries, the maker of top selling Popular segment whiskey 'Original Choice' and premium brand 'Paul John Single Malt' whiskey, and global private equity giants KKR and TPG Capital are in the fray to purchase some of the popular or mass-priced brands.





Market expansion opportunities

- Sales of Indian Made Foreign Liquor (IMFL) declined 12% year-on-year in FY21 due to the pandemic-induced lockdown and increase in taxes, according to the Confederation of Indian Alcoholic Beverage Companies (CIABC), the representative body of leading Indian alcohol beverage companies.
- Indian alcobev industry holds huge growth potential given the low per capita consumption and the demographics and aspirations of the growing younger population.
- Even though India is one of the largest producers and consumers of spirits globally, the country is still popular as a whiskey market. Nearly one in every two bottles of whisky bought around the world is now sold in India, and seven of the top ten global whisky brands are Indian.
- According to IWSR figures, 93% of all whisky traded in India falls into the 'value' segment, and that leaves plenty of scope to develop the higher end segments.
- The organized players stand to benefit from steady growth in the conversion from country liquor to IMFL given increasing health concerns associated with consumption of country liquor.
- Scotch forms almost 20–25% of USL's P&A NSV. In the Scotch portfolio, Bottled in India (BII) is bigger than Bottled in Origin (BIO). Scotch grew faster than IMFL as consumers have become less price sensitive. BIO has grown faster than BII in the last five years.



Financial Analysis

	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
Revenues (INR Cr.)	9,138.7	10,378.1	10,507.8	9,253.9	8,494.9	8,817.5	8,590.6	9,340.8	9,325.4	8,131.3
Operating Profit (INR Cr.)	1,111.2	1,090.8	-3,368.4	-365.5	333.3	954.9	1,145.1	1,391.4	1,540.7	1,018.1
Operating Profit Margin	12.2%	10.5%	0.0%	0.0%	3.9%	10.8%	13.3%	14.9%	16.5%	12.5%
Net profit	187.9	-101.2	-4,489.1	-1,687.7	138.3	100.1	633.8	700.2	658.9	383.6
Net Profit Margin	2.1%	-1.0%	-42.7%	-18.2%	1.6%	1.1%	7.4%	7.5%	7.1%	4.7%
Cash from Operating Activity (CFO) (INR Cr.)	756.1	1,968.8	-551.9	-196.3	282.7	646.8	925.1	948.3	783.2	1,817.7
Free Cash Flow (FCF) (INR Cr.)		1,778.8	1,435.7	3,355.7	-8.3	511.2	955.6	667.1	380.5	1,605.8
Debt to Equity ratio (D/E)	1.8	1.7	2.7	7.6	2.6	2.3	1.3	0.9	0.7	0.3
ROE		-2.1%	-114.8%	-91.4%	12.1%	5.9%	29.3%	24.4%	18.7%	9.6%
ROCE	9.4%	8.1%	-25.5%	-16.8%	14.0%	9.1%	20.0%	20.5%	21.4%	14.1%
Receivables days		73.7	81.3	79.2	87.1	108.8	120.3	102.6	94.4	100.3
Inventory Days		92.6	94.6	92.6	79.7	80.3	81.7	75.3	75.6	89.3

- Post its acquisition by Diageo in 2014, United Spirits has seen significant improvements in the operations of the company.
- While its revenues have been volatile, the management has been able to turn around the company's profitability. Both operating and net profit margins have been continuously improving. The impact of the management's clean up process is also clearly seen in the company's positive cash flow from operating activities and free cash flows.
- With the management's continued focus on P&A segment and power brands, we expect the margins and profitability to improve further.
- Even though the management has been able to reduce its debts substantially, current level of debt is still high. As on March 31st, the company had a total debt of INR 1,034. 5 Cr. against a cash balance of INR 83.9 Cr.

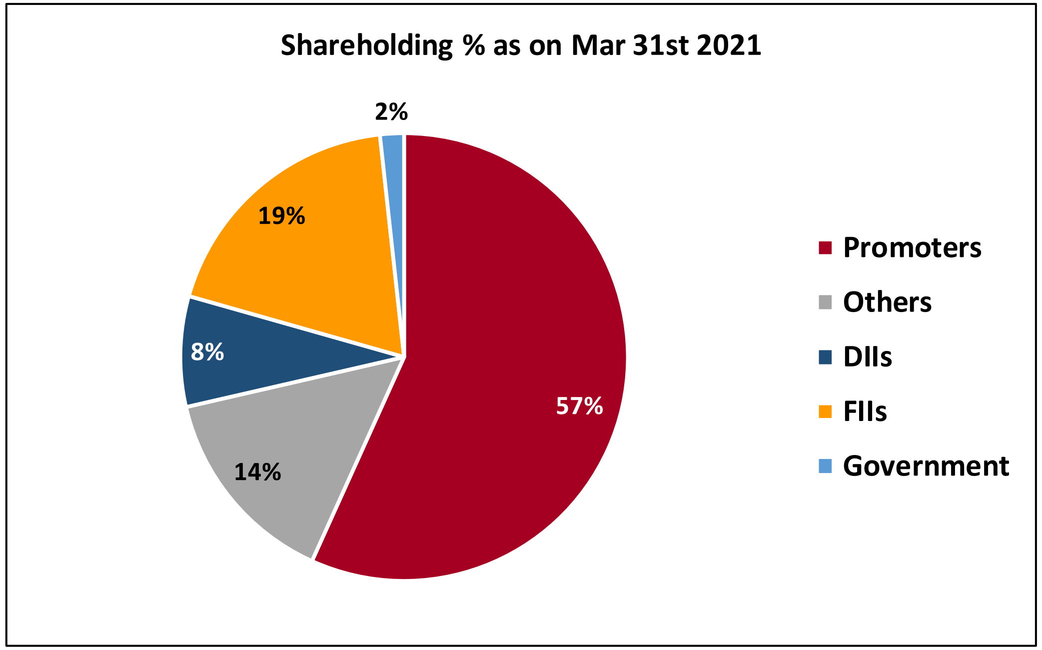
Management Analysis & Shareholding %

Mr. Anand Kripalu, former head of chocolate maker Cadbury India Ltd, took charge of USL on 1 October 2013 as CEO. Along with turning around the business from a debt ridden loss making company to a double margin brand focused business, Anand also played an role in transforming the compliance mechanisms in the company.

Anand will step down as CEO and managing director, on June 30, 2021, ending an eight-year association with USL.

Mrs. Hina Nagarajan was named as the next Managing Director and Chief Executive Officer succeeding Anand on December 10, 2020. She is set to become the first woman to lead USL and also the first woman leading a liquor company of such a large scale in the country.

Hina is currently the managing director, Africa Regional Markets (ARM) at Diageo, USL's parent company.



Promoter Shareholding : Current shareholding of promoters in the company is 56.76% as on March 31st, 2021. None of the senior management officials hold any stake in the company.

Management compensation: Management compensation has been in line with the ceiling limits of 10% of net profits.

Capital allocation record: In an industry where pricing is controlled by state governments, we believe the management has done a tremendous job in making the company profitable again. The management has a clear action plan as to where to invest money and cut down expenses where they believe they have no advantage.

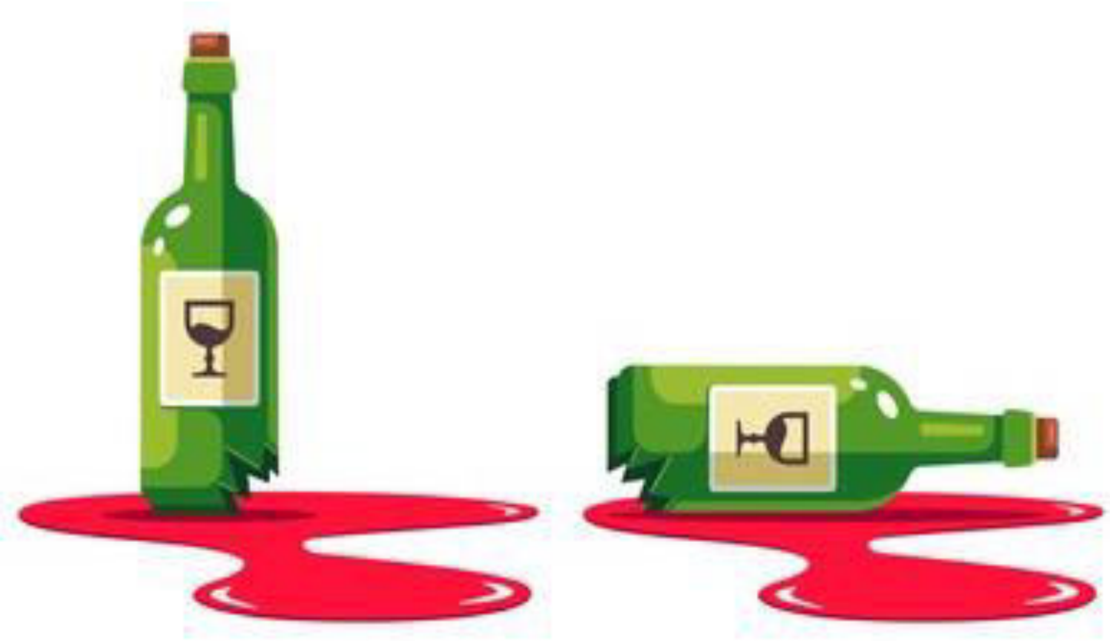
Shareholder communication: Adequate

Pledged Shares: 1.19% of promoters holdings are pledged.

Sources of Risks

Exposure to regulatory changes

USL is exposed to a plethora of stringent regulations and rapid regulatory changes, including state control on pricing. The industry has witnessed excise hikes in several states in FY2020 and FY2021 which has increased the consumer prices in turn impacting the volumes to a certain extent.



Volatility in input costs

USL's margins are expected to remain sensitive to input price trends of major raw materials like molasses, extra-neutral alcohol (ENA) and glass in the absence of corresponding pricing flexibility with consumers. This is primarily because pricing is controlled by state corporations for majority of the company's revenues.

High competitive intensity

USL's revenues will continue to be impacted by increasing competitive intensity in the domestic market from global players and start ups particularly in the premium segment.

Future Outlook

Building a profitable business in Indian alcohol is certainly an uphill task, thanks to innumerable taxes. Profitability in India comes with scale. With consumers getting more globalized, there is huge scope for better brands.

The willingness to spend created an opportunity for value growth, which USL capitalized upon. India for the longest time was the world's largest whisky market by volume, but the lowest per capita consumption in value terms.

However the biggest hurdle in front of liquor makers is the taboo surrounding it. While in the recent years, this taboo is gradually fading away. This attitudinal change actually lowered barriers to ensure increased consumption.

Industry experts believe that growth opportunity depends on sanitizing the image of liquor. They also believe that once the narrative around alcohol in India is changed, the flow-on effects will be enormous.

The management sees the COVID impact is unlike last year's but still significant. However, growth is sustained by premiumization trend and growing mix of P&A segments in the revenue. E-commerce and innovation are two major trends that is still trying to find its footing in the industry.

Compared to the global scenario, Indian companies had faced manifold challenges and growth was hampered for quite some time. However, considering the market penetration potential and positive consumption environment, these companies bounced back on every downfall, outperforming the broader indices and adding significant value to shareholders' wealth.

While in the short to medium term, uncertainty continues to remain over the evolving situation in the on-trade channels and pickup in the home consumption, the longer-term growth aspiration and continued premiumization trends remain key positives for the liquor sector and USL.

Statutory Disclosure

SEBI Research Analyst Registration No. : INH200006451

1. At the time of writing this article, **the analyst have position in the stock** covered by this report.
2. The analyst has not traded in the recommended stock in the last 30 days.
3. The research analyst does not have any material conflict of interest at the time of publication of the research report.
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