# Varun Beverages Limited

## Earnings Conference Call Transcript
## August 9, 2018

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**Moderator:** Ladies and gentlemen good day and welcome to the Varun Beverages Limited 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 would now like to hand the conference over to Mr. Anoop Poojari from CDR India. Thank you and over to you sir.

**Anoop Poojari:** Thank you. Good evening everyone and thank you for joining us on Varun Beverages' Q2 & H1 2018 Earnings Conference Call. We have with us Mr. Ravi Jaipuria - Chairman of the company, Mr. Varun Jaipuria – Whole time Director, Mr. Raj Gandhi – Group CFO and Whole time Director, Mr. Kapil Agarwal – CEO and Whole time Director and Mr. Kamlesh Jain – CFO and Whole time Director of the company.

We will initiate the call with opening remarks from the management following which we will have the forum open for a question and answer session.

Before we begin, I would like to point out that some statements made in today's call may be forward looking in nature and a detailed statement in this regard is available in the results presentation shared with you earlier.

I would now request Mr. Ravi Jaipuria to make the opening remarks.

**Ravi Jaipuria:** Good afternoon everybody and thank you for joining the call. I hope all of you had the opportunity to go through our results presentation which provides details of our operational and financial performance for the second quarter and half year ended 30$^{th}$ June, 2018.

We are pleased to announce a strong performance in the second quarter on the back of good peak season sales. We have delivered a strong top line growth of 26.1% year-on-year and net profit growth of 24.9% year-on-year. What is encouraging is the organic volume growth has reverted to double digits in line with historical trends of the last 25 years, after being impacted last year on account of GST implementation. Organic volume growth in India was robust at 12.6% in Q2 2018. Further the introduction of new product categories like Tropicana and Sting has resulted in better portfolio mix and improved our realizations during the quarter.

Over the last 12 months, we have undertaken several business strengthening initiatives including value accretive acquisition of 5 new sub-territories in India, set up a new plant in Nepal, had a very successful foray into Zimbabwe recording strong volumes and have laid the foundation for long term sustainable growth. All these have been achieved while maintaining a strong balance sheet position. In fact, we have been able to drive a reduction in our overall debt levels and improvement in our working capital cycle on the back of robust cash flows.

Despite the robust volume growth, our capacity utilization during the peak month has remained under 70% providing significant scope for growth on existing investments. Further, the territories acquired are highly under-penetrated and provide huge opportunity for increasing volumes and gaining market share. We have enhanced our portfolio mix over the last few months with new products additions with ethnic flavors in the fast-growing juice segment. We will leverage our existing distribution network and chilling infrastructure to help expand volumes in the Tropicana juice business in the North and East regions by growing its availability in these regions. These initiatives augur well for our long-term growth prospects and also will reduce seasonality, enhance profitability and augment return ratios.

In line with the guidelines of our dividend policy, the Board of Director's have recommended an interim dividend of Rs. 2.50 per share.

We are focused on strengthening our reach and increasing availability in line with customer preferences. We are well-poised to capture the enormous opportunities on the back of our robust business model, strong end to end execution capabilities and customer centric approach. We are confident that the efficient execution of our strategy will translate into profitable, sustainable and responsible growth.

I would now invite Mr. Gandhi to provide highlights of the operational and financial performance, thank you very much.

**Raj Gandhi:** Thank you Mr. Chairman. Good afternoon and a warm welcome to everyone for joining the investors' call. Let me provide an overview of the financial performance for the second quarter ended 30th June 2018. Revenue from operations adjusted for Excise/GST grew 26.1% year-on-year in Q2 2018 to Rs. 20,591 million on the back of strong summer season sales. Total sales volumes were up 21.3% year-on-year at 136.4 million cases in Q2 2018 as compared to 112.5 million unit cases in Q2 2017. Further the introduction of higher realization products, price hikes in select SKUs and re-classification of freight cost (instead of netting off from revenue) has resulted in ~4.8% value growth during the quarter.

Growth momentum continued in India with strong organic volume growth of 12.6% in Q2 2018, organic volume growth on a consolidated basis was 9.8% year-on-year for the quarter. CSD constituted 78%, Juice constituted 8% while Packaged Drinking Water 14% of the total sales volume in Q2 2018.

Gross margins expanded 137 basis points year-on-year to 53.4% during the quarter on account of benefits realized from reduction in sugar prices which was partially offset by increase in resin prices. EBITDA increased by 19.6% to Rs. 5,749 million in Q2 2018 from Rs. 4,805 million in Q2 2017. Underlying margins have improved in existing as well as recently acquired territories on the back of operational efficiencies, increase in organic volumes and consolidation of contiguous territories. However, blended EBITDA margins reduced by 150 basis points year-on-year to 27.9% due to sub-optimal volumes / margins in acquired sub-territories and contribution from the Tropicana juice portfolio where at present we have only a supply and distribution arrangement and are not manufacturing the product in-house. The robust volume growth in India and strong volumes in Zimbabwe have resulted in 24.9% increase in PAT to Rs. 3,068 million in Q2 2018 from Rs. 2,456 million in Q2 2017.

In terms of the half yearly numbers, revenue from operation adjusted for Excise / GST grew 25.5% y-o-y in H1 2018 to Rs. 31,539 million. EBITDA grew 21% to Rs. 7,476 million while net profit expanded 29.3% to Rs. 3,265 million.

Coming to the balance sheet position, as Chairman pointed out, despite making significant investments to the tune of Rs. 7,600 million over the last year, we have been able to drive a Rs. 1,278 million reduction in our net debt position to the level of Rs. 20,947 million as on 30th June, 2018. Simultaneously, debt equity ratio stood at 1x, working capital cycle has come down to 13 days as on 30th June 2018 on account of efficient working capital management even after the consolidation of 5 new sub-territories during the period, testimony to our robust execution capabilities. Given the strong visibility of improvement in cash flows driven by operational efficiencies brought in by the recently acquired contiguous sub-territories, CRISIL has re-affirmed its credit rating for long term debt as CRISIL AA- and for short term debt as CRISIL A1+.

To conclude this has been a strong quarter. We are on a strong footing and are confident of sustaining our growth momentum in the years ahead on the back of our robust ecosystem, enhanced product portfolio and ability to drive growth and garner market share.

On that note, I come to an end of the opening remarks and would like to now ask the moderator to open the lines for the Q&A. thank you very much.

**Moderator:** Thank you very much. We take the first question from the line of Kaustubh Pawaskar from Sharekhan. Please go ahead.

**Kaustubh Pawaskar:** My question is on the volume growth. On a consolidated basis we have seen an organic volume growth of 9.8%, while domestic volume growth stood at 12.6%, so this concludes that there has been problem with the international organic volumes, I guess they must have declined, so can you explain this?

**Ravi Jaipuria:** Sales volume got impacted due to Ramadan in Morocco. Also, Sri Lanka has increased taxes on sugary drinks because of which the industry has de-grown in Sri Lanka. So, these are the only two reasons. Otherwise, Zambia has grown at 26% during H1 2018 and our new market which we have entered this year - Zimbabwe is doing extremely well for us. Overall, I think going forward, international territories should also be performing as well as India or even better.

**Kaustubh Pawaskar:** So, Morocco I can consider it to be a one-time but Sri Lanka we have been hearing that there has been continuous problem because for past two quarters we have seen that?

**Ravi Jaipuria:** Yes, because it was only last year when the government introduced sugar tax which has certainly affected our volumes. We are taking corrective measures in our product portfolio such as introducing sugar free variants and it might take another quarter before the results start showing up.

**Kaustubh Pawaskar:** And in presentation you have mentioned that the current capacity utilization is under 70% which provides you the scope to expand, so once the recent acquisition attains certain scale, what kind of capacity utilization you are expecting?

**Ravi Jaipuria:** We have enough capacity as of now and we do not have to add capacity till another 10-20% growth., Once we reach about 90% utilization then we can look to start adding capacity. Moreover, the new acquisitions which we have done have enough capacity and they are being under-utilized. We expect double digit growths in these territories because they are very under-penetrated at the moment. We have just got these territories only 3-4 months back and it takes about 6 months to actually understand the full territory and take it forward. We have been able to demonstrate results because these are contiguous territories and we are doing quite well with them. So, again, going forward gradually you will see a visible change in the new territories' performance.

**Kaustubh Pawaskar:** So, then, do we expect capacity utilization to improve to about 80-85%, over the next 2 years?

**Ravi Jaipuria:** We definitely hope in the next 2 years, if we can do double digit growth there is no reason why we cannot reach that level.

**Raj Gandhi:** Let's calculate it, if the capacity utilization today is 70%, with the 10% organic growth it will reach to the level of 77%, with 20% growth it will go to 84%. It is only a matter of time we will be able to use it fully, so the objective of highlighting this is, that we are well-capitalized company wherein the growth level of 30-40% will not require additional CAPEX and our leverage position has shown a tremendous improvement in the last 12 months, so a lot of upside is left for this.

**Kaustubh Pawaskar:** Right sir, my following question was on that only because where I was coming to is like for next 2 years you might not require any substantial organic CAPEX, so whatever operating cash flows you would be generating from the existing business you can utilize further it to reduce your debt, so is it the right understanding?

**Ravi Jaipuria:** Absolutely except that we would have to put up a facility to manufacture Tropicana Juices which we are right now buying and that is why our EBITDA margins are affected. So this is the only major CAPEX which will come, so that we can produce juices in-house.

**Kaustubh Pawaskar:** Right Sir, and one last one. I will squeeze in. Do we expect our margins to come under pressure because whatever acquisition of territories we have done for the operation or those territories to become fully optimized, you might incur certain cost, so till then should we expect some kind of impact on the margins in the near term?

**Raj Gandhi:** When we acquired these new sub-territories, margins were something to the tune of 7-8%, we have already more than doubled these margins, although our margins came down 150 basis point on blended basis as these territories have still left 60-70% increase to match our existing margins. Yes, the entire 60-70% increase may not come in the next two quarters, but gradually every territory is getting merged on an overall basis, similar to what we have demonstrated time and again over last few years when we acquired PepsiCo territories or even before that.

**Ravi Jaipuria:** I think fundamentally by next year it should merge into our original territory and the same level of EBITDA margins should start flowing in. It takes minimum 6-9 months to completely merge the territories and since these are contiguous, we will be able to bring them to our profitability levels within 9 months and by next year we expect the same profitability from these sub-territories.

**Moderator:** Thank you. We take the next question from the line of Percy Panthaki from IIFL. Please go ahead.

**Percy Panthaki:** If you could just give us an idea what is the domestic as well as international CAPEX that you would incur in FY19 as well as in FY20?

**Raj Gandhi:** In India, the CAPEX is going to be, as Chairman was just saying, only for the introduction of the new products and in the last call also we said that the new line for Tropicana, Gatorade and the Quaker Oats for which we will be putting up new facility at Pathankot, the Board will be taking it up after seeing the current year's results.

**Ravi Jaipuria:** Approximately Rs. 450 crore is going to be spent in the new plant which is coming up at Pathankot.

**Raj Gandhi:** So, Rs. 450 crore for Pathankot and our guidance on organic capex at the level of ~ 50% of the depreciation stands. We may have to incur Rs. 50-60 crore on the capacity enhancement at Zimbabwe which we will be keen to undertake because that territory is doing really well for us. Sales volume of 4 million cases was the budget for Zimbabwe for 2018 which has already been achieved by 30th June 2018 and we have already acquired 35% of the market share. Otherwise we are absolutely on our guidance on CAPEX of ~ 50% of the depreciation figure.

**Percy Panthaki:** So, if I can just summarize this Sir; if I take FY19 and FY20 put together, you will have Rs. 450 crore on Tropicana plant, you would have again for the 2 years put together somewhere around what Rs. 300 crore of maintenance CAPEX and Rs. 50 crore on Zimbabwe?

**Raj Gandhi:** Our depreciation for a year is ~ Rs. 380 crore, so Rs. 380 crore to Rs. 400 crore; under Rs. 400 crore we can say, Percy.

**Percy Panthaki:** Okay, so somewhere in the region of about Rs. 800-900 crore over the next 2 years.

**Raj Gandhi:** That is right. If there is any inorganic opportunity that will be over and above it, like in the past.

**Percy Panthaki:** And Sir this Tropicana and Quaker Oats and all that, I mean the CAPEX of Rs. 450 crore that you are doing, theoretically at full capacity assuming normal seasonality, what would be the top line that you could generate out of that?

**Raj Gandhi:** We have anticipated in our projections close to 2x of the CAPEX as the top line and on the margins we will be able to give you the visibility maybe in next one or two quarters. Only thing is whether this will be equivalent to our existing margins or maybe slightly lower, I think we will have more clarity in next two quarters as we are working on this with Pepsi on the concentrate price and other raw materials, etc.

**Ravi Jaipuria:** So, 2x is what you should look at.

**Percy Panthaki:** Understood but as of now, I mean the size of the business in your regions is only about 1x right, is that understanding correct?

**Ravi Jaipuria:** Little more than 1x but as you know PepsiCo was distributing at a very small number of outlets and that is why they have given it to us and once we produce it and we expand, we are looking to expand the distribution by about 500% for Tropicana. So, we definitely expect the volumes to at least double, if not more.

**Raj Gandhi:** Percy, this was there in a news report six months back from PepsiCo wherein they have said that they expect Tropicana volume to double in the next two years, let us keep the fingers crossed and as Chairman also said if that happens, so then again, we will be discussing for the capacity enhancement.

**Percy Panthaki:** Right but I assume that would be brownfield and incremental asset turns would be higher, right?

**Ravi Jaipuria:** It could be but then it depends you know because for Tropicana we will have only one plant, so it might make more sense to put it in another far away location, so to save freight cost. But depends, if we are able to achieve our 2x then it makes sense to put up a plant, say anywhere.

**Moderator:** Thank you. We take the next question from the line of Vicky Punjabi from JM Financial. Please go ahead.

**Vicky Punjabi:** I just wanted to know on the volume growth side which you have clocked double digit in this quarter, how sustainable is this because I think this is coming up on a very weak base?

**Ravi Jaipuria:** Not really. If you look at, we have done double digit growth for the first half, so this is not only this quarter and going forward this is looking pretty positive because half of the third quarter is already over.

**Raj Gandhi:** Barring last 2-3 years, we had always been witnessing growth more than this. This year also, when you say it is coming on a very weak base, that is true only for the month of June and contribution of June to overall volumes is lower than April / May. Also this year, as you know, April was also not that good. So, that way it looks quite feasible, double digit should be possible.

**Vicky Punjabi:** And Sir, just on this Tropicana bit, are the contours of the arrangement finalized out here because I thought initially you were looking at distribution and only once there are clear terms on margins is when we will go for the CAPEX here?

**Ravi Jaipuria:** It has not been finalized yet but we will have reasonably close margins to what we already have, give or take one or two points up or down. So, that is what our understanding is, only on that basis we have gone ahead and put the CAPEX.

**Vicky Punjabi:** And just on this front, again this organic CAPEX at Rs. 200 crore for this last 12 months, I mean generally our depreciation is around Rs. 300-350 crore. It used to be around Rs. 150-175 crore, right; the incremental that we have incurred over last one year?

**Raj Gandhi:** Our depreciation is going to be around Rs. 375-380 crore.

**Ravi Jaipuria:** CAPEX is about 50% of our depreciation and our depreciation has been at this level for the last year or two years.

**Vicky Punjabi:** Just to add on to this, now if our CAPEX is around 50% of depreciation, is our policy of write-off in terms of depreciation is too aggressive?

**Raj Gandhi:** Actually this policy was adopted after the introduction of the new Companies Act of 2013 and we decided to continue with the same. So, once we started with it, from a consistency point of view, I think it is better to maintain that.

**Vicky Punjabi:** And Sir, this second one I wanted to ask again on the CAPEX front, so I remember last year we had a Rs. 400 crore of CAPEX on this Hardoi plant, if I am not missing anything but was there any organic CAPEX last year as well apart from this?

**Raj Gandhi:** Total organic CAPEX for CY17 was ~ Rs. 390 crore which included setting up of Hardoi plant. Also, there was some in-organic CAPEX which we are accounting in this year which was actually incurred last year for the acquisition of new sub-territories out of these 5 new sub-territories and a plant in Zimbabwe and Nepal.

**Moderator:** Thank you. Next question is from the line of Bhavesh Shah from CLSA. Please go ahead.

**Bhavesh Shah:** So, basically, if you can share some perspective on this double digit volume growth which you have reported in this quarter, especially in the context of unseasonal rainfall which we saw in the regions of North and East during the start of the season, so is there any one-off here, either on the positive side or a negative side that you would like to give some more thoughts on volume growth? I am just trying to understand the volume growth number for this particular quarter.

**Ravi Jaipuria:** Fundamentally we are correcting our go-to-market strategy every day, we are putting more chilling equipment and moreover the economy is turning around. We have had one or two bad years, you know we used to have double-digit growth consistently for the last 25 years, it is only the last one or two years when the excise had gone up significantly, destocking ahead of GST transition and demonetization had affected the growth. So, it is not only this quarter, if you look at the first half we have double-digit growth.

**Bhavesh Shah:** And was there any impact of unseasonal rainfall in any of the month?

**Ravi Jaipuria:** We have a large territory now, sometime North is more rainy, sometime East is more rainy so you cannot correlate each territory. There is something happening all the time. So, I don't think it impacts us much now unless and until something really drastic happens.

**Bhavesh Shah:** What was the contribution of Tropicana portfolio in terms of volumes during the quarter?

**Raj Gandhi:** We got this portfolio at the fag-end of the Q1 so most of the volumes have accrued in Q2, whichi is ~ 2.3 million cases.

**Bhavesh Shah:** And sir adjusting for this Tropicana base portfolio, ex-Tropicana, Gatorade**,** and Quaker Oats, the base portfolio margins, how did the margins move for the portfolio which was there say last versus this year?

**Bhavesh Shah:** I am trying to understand the underlying margins excluding the Tropicana impact during the quarter because obviously Tropicana would have a come at a lower margin since we have only distribution and supply agreement so if you strip-off the Tropicana volumes from the revenue part as well as from the EBITDA part, what was the underlying EBITDA margins, if you can share some thoughts on that?

**Raj Gandhi:** EBITDA margins were slightly higher than the last year and there is some improvement. In the presentation we have clearly stated that margins have improved at both levels at gross margins and at EBITDA level in our existing sub-territories as well as acquired sub-territories. Now what has happened is when we see at the blended level with the mix of five new sub-territories, the margins which were may be 7% to 8% when we acquired and even in spite of doubling that the base was so slow and Tropicana virtually nil margins, the blended margins about 150 basis have come down but otherwise in our existing territories margins has gone up.

**Bhavesh Shah:** And just one more clarification on this freight adjustment, is my understanding correct that this could have also impacted the EBITDA margins optically because your revenue base would have gone up but its EBITDA would have more or less remained same so this also would have optically impacted the margins, is my understanding correct here?

**Raj Gandhi:** The depiction of the EBITDA margins is 100% correct. When the base of revenue is going up instead of netting-off and EBITDA margins are lower by 150 basis points, we can say ~ 0.5% lower is because of grossing up of freight with the revenue.

**Bhavesh Shah:** Sir any one-off in the employee cost during this quarter, is it because of the new territories that you have added or anything to call out there?

**Raj Gandhi:** Essentially because of three factors – one - new sub-territories, second - the freight grossing up and lastly – trading of Tropicana portfolio.

**Bhavesh Shah:** My last question on input inflation especially how you are seeing sugar commodity prices as well as PET prices as we move into the next couple of quarters, any thoughts on how should we look at the gross margins for the next two quarters?

**Ravi Jaipuria:** Sugar, we cannot really answer because it depends what the government policy is going to be. Technically, the sugar prices should be much lower, the amount of stocks which are available in this country and if you look at the international prices, but we don't know what the policy is going to be of the government and till we know that it is very difficult to predict anything. As far as the resin prices are concerned, I think they will be very close to where they are today. Petroleum is already at a reasonably high level, so I don't see any major impact coming. So, I don't see any major impact coming to us even if the commodity prices are slightly up or down.

**Bhavesh Shah:** Finally, you have taken some MRP increase in select SKUs so any thoughts on this what will be the impact on the volumes or how much price hike you have taken and in which parts of the portfolio? Can you share some more details on this?

**Ravi Jaipuria:** If you see we have got a value growth of about 4.8% however that is not all pricing increase which we have taken. It is also on account of change in the product mix and adding some of the higher priced products like Tropicana, Sting and Gatorade to the portfolio. So very slight tweaking of pricing has been done otherwise it is basically mix change which has given us the value addition.

**Moderator:** Thank you. That seems to be the last question for today. I would now like to hand the conference over to the management for their closing comments.

**Raj Gandhi:** On behalf of the management, I thank all the participants for sparing time to know more about our company. Thank you very much and we will stay in touch with more details from time-to-time. Thank you very much.

**Moderator** Thank you very much. Ladies and gentlemen, on behalf of Varun Beverages Limited we conclude today's conference. Thank you all for joining us and you may disconnect your lines now.

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