Varun Beverages Limited

Earnings Conference Call Transcript
November 06, 2017

Moderator Good Day Ladies and Gentlemen and a Very Warm Welcome to Varun Beverages Limited Earnings Conference Call. As a reminder all participants' lines will be in the listen only mode. 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 '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Anoop Poojari from CDR India. Thank you and over to you.

Anoop Poojari Thank you. Good Evening Everyone and Thank You for joining us on Varun Beverages Q3 and 9M CY2017 Earnings Conference Call. We have with us Mr. Ravi Japuria – Chairman of the company, Mr. Varun Jaipuria – Whole-time Director, Mr. Raj Gandhi – Group CFO and Whole-time Director and Mr. Kapil Agarwal – CEO 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 the question and answer session.

Before we begin, I would like to state that some statements made in today's call maybe 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 their opening remarks.

Ravi Jaipuria Good evening 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 third quarter and nine months ended 30th September, 2017.

We have delivered a strong performance in Q3 CY2017. PAT increased by 160% to Rs 337 million and EBITDA increased by 6.2% to Rs. 1,854 million. In the first nine months of the year, we have recorded a profit growth of 79.2% year-on-year to Rs. 2,861.9 million. EBITDA margins have improved 65 basis points year-on-year to 23.1% driven by the operational efficiencies and consolidation of contiguous territories. After a subdued first half impacted by destocking by the trade ahead of the GST implementation, we have seen a partial recovery in Q3 with uptake in sales volume in India. We believe that the worst is behind us and have successfully navigated the challenges related to demonetization and GST implementation which will bring in enhanced efficiencies, smoothen business operations and will benefit large organized players like us going forward. Our international operations also continue to register healthy growth.

During the quarter we have concluded the acquisition of PepsiCo India's previously franchised territories in the state of Odisha and part of Madhya Pradesh along with two manufacturing units in Bargarh, Odisha and Bhopal (Mandideep), MP, for a consideration of Rs. 1,302 million. The acquisition comes at reasonable valuations and offers healthy growth opportunities going forward given the under-penetration of the market. The acquisition of contiguous territories will further help drive better operational leverage and asset utilization though economies of scale, post this acquisition. Varun Beverages now accounts for 47% of PepsiCo's India beverage sales volume from 45% earlier. We will continue to evaluate strategic acquisitions of new territories which will provide economies of scale.

We constantly engage with PepsiCo to innovate and launch new products in line with the changing consumer preferences. In addition to the launch of Pepsi Black during the summer season we will be launching 'Sting', a new carbonated energy drink from the PepsiCo's stable with a highly competitive price point and with ~50% less sugar than the regular CSD products and 70 calories per 250 ML serving. We expect to roll-out more such new products lines in the quarters to come and diversify the product portfolio.

To conclude this has been a quarter of recovery after the turbulence seen in the first half on account of demonetization and GST. We are encouraged by a positive recovery seen in Q3. Q4 is generally a lean quarter for us given the seasonality in the business. However, we are confident of our prospects going into the next year. We have a robust ecosystem, created and enhanced over decades making it difficult to replicate. We are well-poised to drive growth and garner market share by increasing our penetration further and through the continuous introduction of new product categories, staying in the path of relevance of our customer.

I will now invite Mr. Gandhi to provide highlights of the operations and financial performance. Thank you.

Raj Gandhi

Thank you Mr. Chairman. Good evening everyone and a warm welcome on the investors call. Let me provide an overview of the financial performance for the third quarter and the nine months ending 30th September 2017.

Before we delve into the numbers, I would like to point out that consequent to the introduction of the GST with effect from July 1st, 2017, Central Excise, VAT, etc. have been subsumed into GST. In accordance with Indian Accounting Standard 18 on revenue and Schedule III of the Companies Act, 2013, unlike excise duty, levies like GST, VAT, etc., are not part of revenue anymore. To facilitate comparison, we have provided adjusted revenue calculations on slide #16 of our presentation.

Coming to the performance, we have seen a positive recovery in this quarter. Adjusted revenue from operations has grown 7.4%. Total sales volumes are up 5.4% year-on-year at 66.14 million unit cases as compared to 62.78 million unit cases in Q3 CY2016. Further, we have incurred lower spends on discounts, promotional sales during this quarter. India sales volume grew 4% year on year while international sales volume continued to be healthy at 9.4% year-on-year in Q3 CY2017. EBITDA increased by 6.2% to Rs 1,854 million in Q3 CY2017 from Rs. 1,746 million in Q3 CY2016. We have reported a robust PAT growth of 160% year-on-year in Q3 of 2017 to Rs 337 million as compared to Rs 130 million in Q3 CY2016.

At this point I would once again like to remind everyone that we follow a calendar year of reporting and it is best to monitor the business on an annual basis given the seasonality in the business. evenues and profits follow a bell-curve with significant portion accruing in April to June quarter, i.e. the second quarter for us.

Adjusted revenue from operations grew 1.4% year-on-year during the nine months ended 30th September 2017. As you are already aware overall sales volumes were impacted on account of inventory de-stocking in May and June ahead of the implementation of GST in India. EBITDA has increased by 4.3% to Rs 8,032 million in 9M CY2017 as against Rs 7,398 million in 9M CY2016. EBITDA margins expanded by 65 basis points year-on-year to 23.1% in 9M CY2017 driven by the consolidation of the contiguous territories, new plants, close to demand and solid backward integration infrastructure which has brought in significant cost efficiencies which we are pursuing to sustain going ahead.

The IPO proceeds have been utilized to drive significant debt reduction over the last one year leading to substantial reduction in interest cost. Further, our credit rating upgrades have been used to drive reduction in our borrowing cost. For 9M CY2017, PAT has grown over 79% year-on-year to Rs 2,862 million as against to Rs 1,597 million in 9M CY2016.

To conclude, our well-entrenched distribution network and supply chain is allowing us to deliver profitable growth. We are confident of generating strong free cash flows over the coming years, leveraging existing investments. We are on a strong wicket to deliver ongoing value to all our stakeholders.

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

Moderator Thank you very much. Ladies and gentlemen, we will now begin the question and answer session. We will take the first question from the line of Percy Panthaki from India Infoline. Please go ahead.

Percy Panthaki This is Percy Panthaki here. My question is on the new launches, this new energy drink that you have launched at least in the PPT the photo that I see, it doesn't have any of branding of Pepsi. So just wanted to understand the thought process behind this because as a consumer I don't know it's from the house of Pepsi.

Raj Gandhi Percy thank you very much for asking the question. PepsiCo has this dual brand strategy like for Nimbooz Masala Soda, which is from the house of 7Up but they never say this in the advertisements. Even for Mountain Dew or Mirinda, they don't popularize these brands under Pepsi umbrella rather they do so through separate advertising and brand positioning.

Percy Panthaki Is this priced at similar price points versus other CSD products?

Raj Gandhi No, in fact this is in the category of the energy drinks, the best comparable for this energy drink is Red Bull. I can only say this should be at about 50% discount to its immediate competition.

Ravi Jaipuria Our main competition on this would be Red Bull basically. This product has done remarkably well in our surrounding countries like Pakistan, Vietnam and we have brought it to a level of pricing which is affordable for a common man. It's not highly priced which will be difficult for a common man to have it.

Percy Panthaki My second question is on the gross margins. Do you generally have a seasonality in the gross margins, the reason I'm asking is if I look at CY16, I see that first half of the year gross margins are somewhere around 52% or so and in the second-half of the year they are like 59%? So just wanted to understand if this is a normal seasonality or this is just sort of one thing which happened in CY16 and we should not read too much into this for the future and if it is seasonality then what is the reason is for the same?

Raj Gandhi Percy I am thankful to you. You have answered the question also, which very intelligently you noticed. In fact, this is the first year the company got into the quarterly mode of reporting and last year the fourth quarter was the first time we had drawn the accounts in quarterly format and this quarter (Q3 CY2016) was more was a balancing thing. Having said that in the current year if you see the gross margin, the revenue or the COGS, you will see these are absolutely in line for last full year (CY2016), this quarter (Q3 CY2017) and H1 (H1 CY2017). There are no deviations at all. Yes, you have rightly observed if you compare it in isolation to the Q3 of last year, there is a difference and one reason also let me explain to you why this has happened. PepsiCo from time to time asks us to run certain schemes in the market which they reimburse to us. When we extend discounts and pass on to the market, we account for this by reducing on one-side as a part of revenue and on the other side by reducing the cost of goods sold in the concentrate pricing. So, during last year we had about Rs. 30-40 crore worth of such promotions bundled up in this quarter which this year we have very diligent quarterly allocation. So your answer that we should not read too much between the lines is very correct.

Percy Panthaki So basically whatever we have seen last year it is because of this timing of the promotions otherwise there should be no seasonality apart from this?

Raj Gandhi Absolutely, you are right. And this also gets exhibited in our bottom line, our margins, in spite of gross margins being lower, are intact.

Percy Panthaki If you could give some flavor of how the international business is doing for the 3 or 4 main geographies that you have, each geography if you can give some commentary it will be very helpful.

Ravi Jaipuria Our international markets have been growing at a much faster rate than India. If you look at Nepal for example, it has been growing at close to 20% in the first nine months of CY2017. Sri Lanka has been growing at about 11.4%. Morocco has been growing at about 15%, so most of our markets have been growing at reasonably faster pace and much faster than the Indian geography which got affected by demonetization and then destocking during the GST implementation this year.

Moderator We will take the next question from the line of Vicky Punjabi from JM Financial. Please go ahead.

Vicky Punjabi Again on the gross margin front, actually I understand the fact that there were some higher discounts in the base year which probably got netted-off from sales as well as COGS. And so the gross margin may not be comparable on a percentage basis. But even if we look at the absolute gross margin it has actually declined 1% on a consol basis while the volume has shown a growth of 5%. I believe there should be some pressure in terms of raw materials that should be causing kind of divergence in performance of volumes and gross margins.

Raj Gandhi The reason for this, as in the earlier calls we have drawn everyone's attention, is because of the sugar cost increase this year which was at its all-time peak. The average price for sugar last year was Rs. 36.37, whereas this year has been around Rs. 39. The 1% margin reduction was at the gross profit level because of the sugar cost which we have compensated at the EBITDA level through reduction in the other costs, by realigning the territories when the new plant was put up. We can also add that the cost of sugar as on date is much lower than Rs. 39.77 which is the average price at which sugar was purchased during 9M CY2017.

Vicky Punjabi So does that mean that going forward the margin pressures may not be as stark as seen in this quarter at least on gross margin front?

Raj Gandhi Yes, We hope so.

Vicky Panjabi I believe I heard that the domestic growth is on a recovery trajectory after GST impact in the past quarter.

Ravi Jaipuria That's right.

Vicky Punjabi Is there some kind of an impact of GST in this quarter as well or is it actually reflective of what's happening on the ground, the 4% growth in India?

Ravi Jaipuria We have had a reasonably good last quarter and going forward it's looking pretty stable. We don't see any reason why it should not be growing at the same pace or even better.

Raj Gandhi Just add to what our Chairman said, November 8th last year if you remember, demonetization had happened and this month that way there should not be any surprises. Going forward the introduction of new launches like Pepsi Black which has already been launched and Sting which is expected to happen in this month. The more such launches should strengthen the volume growth for the company.

Vicky Punjabi One more thing was on the juice's front, there the volume appears to be flattish, is there any issue there?

Ravi Jaipuria Juice, so far you are right, the growth has been quite flat. Here the niche for the company definitely has always been the carbonated drinks. However, with new introductions like carbonated juices in the pipeline, as and when in the next couple of quarters are launched, this also should get corrected.

Moderator We will take the next question from the line of Prashant G from Sundaram Mutual Fund. Please go ahead.

Prashant G Just one clarification over here, inherently the water margins are higher than CSD, right?

Raj Gandhi Not exactly Prashant, the margins percentage wise are more or less same. In absolute terms, margins in case of water are lower because the selling price for water is lower. Realization for water is lower than the other products.

Prashant G Because the reason I'm asking is because typically if you look at the EBITDA per case number that hasn't really changed in the last 3-4 quarters so which is why I was referring to and typically if you look at it again the water mix in the volume keeps changing. From the last quarter it's actually improved further, so just wanted to have that clarity on that.

Raj Gandhi This only strengthens our assumption and the calculation that margins between the categories, in percentage terms, are more or less the same. Even if the mix changes, the EBITDA percentage doesn't get affected that much.

Prashant G Second thing with regard to the demand front, when you are referring recovery, if you look at the consolidated number it's about an 8% increase in terms of growth and even the standalone business is about 8.8%. When you mean recovery, are we expecting a higher growth rate going forward or what are we pegging our growth rate at?

Ravi Jaipuria We can't give you ballpark figure but as the recovery starts we believe that going forward it should be as good or better and it should not be worse than this.

Raj Gandhi Prashant, this will be more driven by the speed at which new launches are happening and how the new launches are able to address the consumer preferences. Secondly, of course one thing is pretty sure that the two challenges which in the past came by way of demonetization and GST, those are getting over.

Prashant G What is the market size of the Sting brand which you are referring to? You said that it competes with the Red Bull, what will be the market size that you are looking at over here in terms of cases?

Ravi Jaipuria It should be close to about 2 million cases but currently nobody has put energy drinks at the right pricing which is what we are planning to do. This product will take market from existing energy drinks as well as some of the regular product. So we expect the growth in the volumes of this product if the consumer likes it which we believe they should. But I think it's still to be seen and we hope that it should be a reasonable number for us.

Raj Gandhi The first launch this month will be in the can and followed up with the launch in PET bottles by Feb'18 end. That would give us more flexibility to play with the pricing.

Prashant G You said with regard to juices that you were probably looking at the volume correction should be arrested, is there any new launches expected over there as well in juices?

Raj Gandhi Should be yes.

Ravi Jaipuria We are looking at some new launches going forward in the first quarter of next year.

Moderator The next question is from the line of Bhavesh Shah from CLSA. Please go ahead.

Bhavesh Shah Can you give some comments on your recent acquisition as in what is the EBITDA of the underlying acquired assets?

Raj Gandhi Bhavesh, as we have informed in the past, basically up to the gross margin level there are no changes because the concentrate pricing stays the same, sugar price stays the same and CO_2 and the pulp prices stays the same with marginal quantity discounts on items other than concentrate which we may be entitled to. Then the next thing which comes is with 100% backward integration, we make the operations more efficient and draw another about 4% additional margins from these operations. Then we make improvements similar to how we are running business in our existing sub-territories. To drive that, we transfer the top management out of our existing plants and bring efficiencies in the system. So our experience in the last 20 years in all inorganic acquisitions is that the EBITDA margin, post consolidation, not only stays at the existing margins of the company rather bring in a additional efficiency in the system. The primary reason being the overheads get spread to a larger base and the quantity discounts which we get with economies of scale.

Bhavesh Shah In your experience how much time does it take for you to improve the margin or at least get it in line with what you have, so in your experience typically how much the company has taken to get things back on track?

Ravi Jaipuria **We** think in this case because it is a contiguous territory Bhavesh, it would not take us longer than one quarter and by next year first quarter we will be pretty well on stream. This quarter, which is the last quarter this year would be enough for us to get the territory back on track.

Bhavesh Shah So basically you will be able to take benefit for the upcoming season from this asset?

Ravi Jaipuria For the next year season will be able to get full benefit.

Bhavesh Shah On other expenses, they have declined sharply. So if you could just give some commentary on that?

Raj Gandhi Bhavesh this is in line with in the H1 CY2017. You must have noticed because of realignment of sub-territories in India post setting-up of new plant in Hardoi this year, we have witnessed savings in the freight expenses as the deliveries are now from the plants which are closer to demand centers. So the same trend is continuing in this quarter also although this quarter is not as big as the H1 and this is there to stay.

Moderator We will take the next question from the line of Kaustubh Pawaskar from Sharekhan Ltd. Please go ahead.

Kaustubh Pawaskar With the acquisition of new territory so now you will be accounting about 47% of PepsiCo's India sales, so with this acquisition and the new product addition should we expect the volume growth to get back in low double-digit in CY2018?

Ravi Jaipuria We hope so but this is something we cannot say because ours is a seasonal industry and dependent on the weather and certain other things. But it is looking positive and we can only say that the product additions should help us grow and we should be able to penetrate much deeper than what our predecessors were doing in these new sub-territories.

Kaustubh Pawaskar The non-carbonated beverages, what is your view on how fast it will be growing and becoming one of your key contributors, becoming about 10% of overall sales volume?

Ravi Jaipuria Very close to it already. Non-carbonated, if you look at water and juice, is already close to 20% of the mix. So going forward this will only increase, this is not going to come down and we are planning to launch a lot of non-carbonated beverages.

Kaustubh Pawaskar I'm specifically talking excluding water like juices and other brands.

Ravi Jaipuria Other than water there is only juice which is non-carbonated and it will be growing. But as you know it will be in the range of 5-7% only, it won't be much larger than that for the coming year at least.

Moderator The next question is a follow up question from the line of Percy Panthaki from India Infoline. Please go ahead.

Percy Panthaki After this Hardoi plant now commission, what's your guidance on organic CAPEX over the next three years or so?

Raj Gandhi Percy, last year even with the Hardoi plant whatever we have given the guidance it's around that much only. Going forward as we are saying that for organic part, capex will be around 50% to 60% of our depreciation, still we maintain the same guidance. Any new acquisitions will be over and above this for example MP and Odisha.

Ravi Jaipuria New territories or new countries, anything new would be apart from this. But in our existing territories it would be 50% to 60% of our depreciation.

Percy Panthaki And this 50% to 60% will be mainly brownfield, there is unlikely to be any greenfield CAPEX now for the next, is that understanding correct?

Ravi Jaipuria It will be very close to it unless and until some specific territory where the growth is much more than what our capacities are, so some geographies, some time we might have to but mostly it will be brownfield in this range.

Raj Gandhi And this guidance of 50%-60% will still hold even if it's a new plant.

Percy Panthaki I just wanted to ask tax under GST for different product. I believe now technically speaking any product with at least a 5% fruit content it comes within the 12% bracket. But in practice there seems to be some confusion on that, just wanted to understand what is the status and how are different products taxed currently and do you expect that to change?

Ravi Jaipuria Juice based products are at 12%. Wherever there is some confusion, we are trying to get clarity from the government before using the tax bracket. So the government at the moment is quite clear that juice-based drinks between 5-10% juice content, would be at 12% tax rate and if it is lower than that then it could be at a higher tax rate. So 100% clarity is still not there but we are in the process of getting it and before next year we will have it. So next year, based on the exact clarity of what is happening, our new launches will happen.

Raj Gandhi Here Percy to supplement this answer, our existing product range, the Tropicana Slice is with 15% juice content and is in 12% tax category.

Percy Panthaki My question was actually on the Nimbu Masala Soda only that as per whatever you have said as long as it is 5% technically it should come within the 12% bracket. But right now, it's, you are paying 40%, so is there any possibility that it will come back to the 12% bracket?

Raj Gandhi Yes, in fact small correction, we are paying 12% GST in case of NMS.

Moderator Thank you. As there are no further questions from the participants, I now hand the conference over to the management for their closing comments.

Ravi Jaipuria Thank you very much for joining us on the con-call. We hope that going forward we should next quarter give you better results and everything else is looking positive for the growth of the company. With this additional acquisition we expect that the company should be consolidating further and taking the business forward. Thank you very much.

Moderator

Thank you. Ladies and gentlemen on behalf of Varun Beverages Limited that concludes this conference call for today. Thank you for joining us and you may now disconnect your lines.
