Varun Beverages Limited

Q1 CY2017 Earnings Conference Call
May 12, 2017

Moderator Ladies and gentlemen, good day and welcome to the earnings conference call of Varun Beverages Limited. 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 * 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 of CDR India. Thank you and over to you, sir.

Anoop Poojari Thank you. Good evening everyone and thank you for joining us on the earnings conference call of Varun Beverages Limited to discuss its results and developments for the first quarter ended 31st March 2017. We have with us today Mr. Ravi Jaipuria – Chairman, Mr. Varun Jaipuria – Wholetime Director, Mr. Raj Gandhi – Group CFO and Wholetime Director and Mr. Kapil Agarwal – Wholetime Director and Chief Executive Officer of Varun Beverages Limited. Before we begin, I would like to state that some statements made in today's conference call may be forward looking in nature and a detailed statement in this regard is available in the results presentation that was sent to you earlier. I would now request Mr. Ravi Jaipuria to begin the proceedings of this call.

Ravi Jaipuria Good evening, everyone and thank you for joining the call. I hope all of you have had the opportunity to go through our results presentation which provides detail of our operational and financial performance for the quarter ended 31st March 2017.

Let me begin by sharing some of the operational highlights and key developments for the quarter. Mr. Gandhi will later touch upon the financials for the quarter. The year has started on a healthy note. We have reported a net profit of Rs. 30 million in Q1 CY2017 as compared to a loss of Rs. 541 million in Q1 CY2016. The sales volume in the first quarter had been impacted by the extended winter in North India which carried on till the last week of March. The summer has set in since then and the positive news is that we have kicked off our peak season on a strong note recording reasonable numbers in the month of April over a high base last year. The second quarter is crucial for us since majority of our sales and entire profit are realized in this quarter given the seasonal nature of our business. We are confident of sustaining the momentum into the next two months if the summer continues to be strong.

Let me now throw some light on some of the key corporate developments that have taken place this year. We are happy to report the stake increase in our Zambia subsidiary to 90% from 60% in line with our philosophy of consolidating our presence in fast-growing emerging markets beyond India. The acquisition comes at a very reasonable valuation with an attractive payback given growth prospects and promising earnings potential. It will enable VBL to consolidate a higher share of profits from the subsidiary going forward. The company has recorded sales volume of 10.7 million cases and an EBITDA of Rs. 467 million in Zambia in 2016. As far as Mozambique is concerned, we have divested 41% stake in our Mozambique subsidiary in view of limited opportunity to scale up operations to turn around the loss-making operation. The subsidiary contributed only 0.6% to the net revenue in 2016 and recorded a loss of Rs. 99 million in 2016.

We consistently engage with PepsiCo to innovate and launch new products. This year, we have launched Pepsi Black, a zero-calorie carbonated beverage in line with PepsiCo's plan to intensify focus on health and nutrition by reducing sugar contents in beverages. As per PepsiCo India's own statement, they plan to roll out more variants of existing products in zero calories and no-sugar categories every 2-3 months.

In terms of our capex plan, we expect the spend to be largely in line with our depreciation in CY2017 and going ahead to substantially reduce it. During the current quarter, we have set up a new unit for manufacturing of Pepsi range of products in Uttar Pradesh. The commercial operations of the plant have started with effect from May 3rd 2017. The facility is strategically located close to target markets which will reduce time to market and enable optimization of freight and logistic cost aiding margin expansion. We have also consolidated our Goa operations to one large facility from two earlier. This will help better overall control and convenience of one location and will result in substantial saving in overheads going forward.

To conclude, we are optimistic of our growth prospects this year as the summer season sales have started on a strong note. Going forward, we are well placed to strengthen our position as a key player in the beverage industry on the back of our robust business model with end-to-end execution capability and presence across the entire value chain. We have a solid infrastructure and well-entrenched distribution network in place and along with PepsiCo, will constantly innovate to launch new products to stay a tune to the changing consumer preference.

I would now like to invite Mr. Gandhi to provide on the operational and financial performance.

Raj Gandhi

Thank you, Mr. Chairman. Good evening everyone and warm welcome to everyone present for participating in VBL Q1 CY2017 earnings conference call, thank you. Let me provide an overview on the financial performance for the quarter. Before we dwell into the numbers, 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. Revenues and profits follow a bell curve with significant portion accruing in the April-June quarter that is the second quarter for us.

VBL has adopted Ind-AS framework starting Q1 CY2017 and prior period numbers for Q1 CY2016 had been restated in compliance with Ind-AS for a meaningful comparison. Let me spend some time to highlight three key adjustments under Ind-AS, which may constitute more than 90% of the impact of Ind-AS on our financials. The first out of these is very important which is with regard to the interest free deferred consideration to PepsiCo for territory acquisition. As part of Ind-AS, NPV of the outstanding amount payable to PepsiCo towards deferred payment consideration is to be calculated, resulting in two adjustments in the balance sheet. Number one, a reduction in the outstanding deferred liability to its NPV level which is fair value and the corresponding reduction in the fixed assets to that extent. The resultant adjustments to the P&L are in the form of a reduction in depreciation due to decreased asset block and notional provision of interest on the deferred consideration for the period available. Secondly, the franchise rights / trademarks included under intangible assets arising on the acquisition of territories in the past, the life of which is perpetual as per the Ind-AS guidelines, is subject to annual impairment now instead of amortization at a fixed rate. Thirdly, regarding CCDs and CCPS, in fact if you recollect in our accounts prior to IPO, we had CCDs from Standard Chartered PE and CCPS from the promoter group. As per Ind-AS guidelines, any difference due to fair valuation on convertible financials instruments is taken through finance cost in P&L. These instruments have already been converted to the capital in CY2016, before the IPO. Hence, there is no impact in CY2017. The net effect of all these Ind-AS changes will be marginally positive on our accounts in CY2017.

With this background, let me quickly summarize the performance for the quarter ended 31st March 2017. The revenue from operations including excise duty grew 1.8% on YoY in Q1 CY2017 to Rs. 10,509 million as compared to Rs. 10,327 million in Q1 CY2016. Revenue contribution from India stood at 78% in Q1 CY2017. Rest of Indian continent, that is the subsidiaries in Nepal and Sri Lanka contributed additional 13% and Africa contributed balance 9% to net revenue. Total sales volumes in Q1 CY2017 were up 2.3% Y-o-Y to 67.2 million unit cases as compared to 65.7 million unit cases in Q1 CY2016 driven by strong growth in the packaged drinking water segment. India's sales volume grew 2% Y-o-Y while international sales increased by 3.8% Y-o-Y. Q1 is a small contributor to annual numbers and we are confident on a strong performance in the peak second quarter. EBITDA for Q1 CY2017 stood at Rs. 1,372 million as compared to Rs. 1,195 million in Q1 CY2016 representing a growth of 15% Y-o-Y. EBITDA margins have also expanded by 186 basis points year-on-year to 15.6% in Q1 CY2017 as compared to 13.7% in Q1 CY2016. Being a seasonally weak quarter, margins are lower than the annual trend. We recorded EBITDA margins of 20.6% in CY2016 which are relatively higher as compared to peers is a result of our investment in technology and backward integration facility. We have recorded a net profit after tax of Rs. 30 million in Q1 CY2017 as compared to a loss of Rs. 541 million in Q1 CY2016. This is on the back of 48% Y-o-Y reduction in our finance cost. In the previous year, finance cost is adjusted to the interest on CCDs and CCPS as per Ind-AS. Another big positive for us is the CRISIL rating upgrade for our long-term debt facilities to AA- / Stable from A+/Positive. This marks the second upgrade in under six months, testimony to the strength of the operations and cash flow generation. The company had already secured top rating for short-term debt that is CRISIL A1+.

During the quarter gone by, we had raised Rs. 3,000 million by issue of NCDs which had been listed on the wholesale debt market segment of the NSE of India. We have also repaid one installment of Rs. 3,235 million towards interest free deferred consideration payable to PepsiCo during the quarter. The last installment of Rs. 3,000 million is pending which is due on February, 2018.

To conclude, we are on a strong footing as we move into peak summer quarter. We are confident of our ability to drive strong volume growth across all product categories, drive market share gains and deliver a robust performance this year. We have a strong execution track record and the necessary infrastructure and distribution in place to deliver sustainable and profitable growth for years to come. On that note, I come to the end of opening remarks and would like to now ask the moderator to open the lines for Q&A. Thank you.

Moderator Thank you very much sir. Ladies and gentlemen, we will now begin the question and answer session. First question is from the line of Pritesh Chheda from Lucky Investment Managers. Please go ahead.

Pritesh Chheda Sir, I just wanted to understand the margin drivers in the business from the reported 18%-18.5% margin which you have reported last year, what kind of margin drivers reside in the business and if you could also tell margin drivers post the GST implementation if any? So without GST implementation, what are margin drivers and if there are any drivers post GST implementation?

Raj Gandhi Thank you for the question. In fact, last year the margin as already stated was 20.6% and there have been various drivers for increase in margin in the past. One out of that was backward integration, second was economies of the scale, third was the consolidation of the territory and fourth is the scale which is going up in the subsidiaries also and going forward, after the GST definitely it will help because our logistics is going to be much more efficient and the movement of goods will be much smoother and opening of the new plants in every State etc. may not be needed. As you may be aware, we are already having 16 plants when we are operating in 17 states. So at least going forward, we do not have to open new more greenfield plants and all those things may increase our margins but slightly. Actually, we are already, as Chairman pointed out, at very healthy margin. We are sitting on a good margin comparable to our peers. So, we are happy, if we are able to retain what we are already achieving and yes, going forward small improvements there is definitely a scope.

Pritesh Chheda But sir efficiency at the plants by virtue of GST and logistics being one of the bigger costs for you, can there not be substantial gains possible under the GST regime?

Ravi Jaipuria Well there should be, but at the moment, we do not know the numbers of GST, but logistic cost will definitely come down once GST comes in. So, there will be some saving for sure, there is no question about it. The exact quantum we have not been able to quantify as of yet, but there will definitely be good saving because our third largest cost after concentrate and sugar is logistics.

Pritesh Chheda Is that the reason why in the presentation we have written incrementally capex will be equal to depreciation and there is a case for free cash flow generation?

Raj Gandhi In fact, that guidance is for the year CY2017 and in the presentation also stated going forward, it will be much lower. So, then it may come down to 50-60% of the depreciation figure because we may not need opening greenfield plants to that extent.

Ravi Jaipuria It also depends on from where our growth comes, from which territory because we normally like to supply our goods over a radius of 200 km, an optimum radius for us where the product should be supplied from a plant. So in case one territory grows faster than the other territory, then sometimes we need to add capacity on one of the existing plants or if we have run out of capacity there, then sometimes need to add a greenfield. But at the moment, it does not look like that we will be needing too much going forward at least for the next year or 2 years.

Raj Gandhi I would also like to supplement from the presentation. You must have noticed we have rather consolidated our two plants into one in Goa, to attain these efficiencies at the operating level.

Pritesh Chheda So lastly just wanted to check we have a credit rating upgrade, so what was the cost of borrowing earlier. What will be the cost of borrowing in your opinion incrementally now and when I was looking at your P&L for quarter one, there is this drop-in interest expenditure, you made some comments but actually I could not quite catch it, so if you could give us comments again.

Raj Gandhi Sure. Your question has two parts. The first is what was the cost last year and what is the cost at present. Last year, our cost of funds was around 10.25-10.60%, and this year, the cost is ~8.4% on the interest bearing instruments wherein the term loan comes mostly between 8% and 8.5% and the NCD's which are listed are at 7.7% and luckily, last quarter we had advantage of raising CPs at 6.65-6.7%. The second part is that last year, we had CCPS from the promoters which were interest free to the company, but as per Ind-AS, we had to record those at the fair value that means the interest which is although is not debited to the company was not charged as per the instrument and was never paid also, but we had to provide for that notional entry. So, if we compare from the Ind-AS to this, this shows a 48% reduction. Even if we calculate otherwise, reduction is substantial even on the Indian GAAP.

Pritesh Chheda And this revised cost of borrowing has started flowing in through the P&L?

Raj Gandhi Yes. Of course.

Moderator Thank you. Next question is from the line of Saket Kapoor from Kapoor & Company. Please go ahead.

Saket Kapoor Could you share what is our raw material basket all about, various verticals of the raw material, components of the raw material?

Raj Gandhi One is concentrate which is major which we buy from PepsiCo and second is sugar and third is the packaging material which includes pre-form, the crown, corks for the bottle, labels, cartons etc., and then fourth is much smaller, pulp used for Nimbu Masala Soda or Mango Slice.

Saket Kapoor You have spoken about this backward integration part, what are the steps we are taking for backward integration and what are the savings that will be accrued going forward?

Ravi Jaipuria We are a fully backward-integrated company. We produce our own crown caps, shrink films, our crates, our crown corks, our preforms etc. We also blow our own bottles. So, everything which is practically used for packaging is completely backward integrated and we manufacture ourselves because of our scale, which other bottlers cannot afford to do it. So that helps us increasing our margins by at least 3 to 4 percent which is more than a normal bottler would have.

Saket Kapoor We are totally vertically integrated, that is what we are trying to say.

Ravi Jaipuria Totally vertically integrated.

Saket Kapoor Sir coming to the interest part which you were explaining earlier, under the Ind-AS we have booked our interest cost at Rs. 56 crore for the first quarter and as you have told that the majority of the business happens in the second quarter for you. What should be the annualized rate of finance cost to be taken and if you could give some idea?

Raj Gandhi This year, our interest cost we are projecting around Rs. 170 crore on consolidated basis including subsidiaries. This is on Indian GAAP and apart from that, there will be additional charge of about Rs. 35 crore which will be on account of interest free loan taken from PepsiCo and the deferred VAT which we get from the government and both together will be something around additional Rs. 38 crore, so coming to Rs. 208 crore.

Saket Kapoor But the net cash outflow will be around Rs. 170 crore only?

Raj Gandhi Yes, cash outflow will be approx. Rs. 170 crore, that is right. This is the last year of PepsiCo's interest free loan and that will be only for this year.

Saket Kapoor Sir could you explain what is this story about interest free loan from PepsiCo and how is the model derived sir?

Raj Gandhi I will tell you. In 2015 February when we acquired the territory from PepsiCo, we were at that point of time given 4 installments to pay the consideration of Rs. 1,268.5 crore and then distributed Rs. 345 crore upfront, Rs. 300 crore after a year, on annual anniversary, then Rs. 323.5 crore and then Rs. 300 crore. So this is interest free and as per Ind-AS, we have to provide notional interest in the interest cost on this loan and charged to the P&L, so that charge will additionally come to our P&L.

Saket Kapoor Sir, coming to your Zambia acquisition, what was our initial investment for 60% and how much additional we have paid to acquire the 30%?

Raj Gandhi Rs. 175 crore was the initial investment. For the current increase we are paying about Rs. 71 crore (plus PTT) for the balance 30%.

Saket Kapoor That means the valuation has improved considerably, for 60% we have invested Rs. 175 crore. For the remaining 30%, how are we valuing that subsidiary totally sir today?

Raj Gandhi It has not increased. In fact, we have paid lesser, we have paid Rs. 71 crore (plus PTT) for the balance 30%.

Saket Kapoor And what is the total value sir then for remaining 10%?

Raj Gandhi We are having 90% of that, for which we have paid total Rs. 246 crore.

Saket Kapoor So for this quarter we have put the profits also, calculated the profits in the P&L from Zambia acquisition?

Raj Gandhi See, what happens is even in the last year because we had a control, we had 60% and the consolidation level that was consolidated in full. So, there is no change up to that. The only issue was because it was substantially at PAT level making profit for us, last year you must have seen about Rs. 9 crore entry of the minority interest at PAT level, so that won't appear this year.

Saket Kapoor And lastly sir what are the coupon rate for the NCD sir?

Raj Gandhi NCD 7.7%.

Saket Kapoor And what have been the Mozambique sales proceeds?

Raj Gandhi Mozambique actually, it was purchased at some Rs. 1.1 lakh equivalent and at the same price we have sold it and the same person has repurchased. Of course, it had some liabilities about US $700,000, so those liabilities also from our balance sheet will disappear now.

Saket Kapoor Okay and for your Hardoi plant, what will be the incremental capacity that is coming up and how is the order book position that you will be utilizing the plant going forward?

Raj Gandhi See, as Chairman has already stated that capex, we are very tightly monitoring and shall be around the depreciation figure, so that includes the capex for Hardoi expenditure and because this season has just started and this has become operational in this quarter. So more than that, once we are ready, we will provide you the information.

Saket Kapoor No, for the incremental capacity I was speaking. How many cases will be produced here?

Raj Gandhi Capacity?

Saket Kapoor Yes.

Raj Gandhi Presently, we are producing only on the CSD PET line. However, 1,870 bpm shall be additional installed capacity.

Saket Kapoor What will be in percentage terms?

Raj Gandhi Percentage wise around 5%.

Saket Kapoor 5% will be the incremental capacity?

Raj Gandhi That is right.

Saket Kapoor Sir who are our nearest competitors in the country?

Ravi Jaipuria Our competition is basically Coke.

Saket Kapoor And they are doing it directly themselves or they have also hired people?

Ravi Jaipuria No. They have got bottlers as well as themselves. So it is both consolidated, different territories are run by different people.

Saket Kapoor Okay. Now, as you are having 45% of the share for Pepsi, do we have that standard competitor in Coke or…?

Raj Gandhi They do not have that large partners with them, they are segmented smaller and moreover they do about 65% maybe around that themselves and through the company's own bottle operations.

Saket Kapoor Sir today the Chairman on the television channel was also speaking about the logistic cost coming down considerably that the lead time taken by trucks to travel is getting reduced, if you could explain something more in detail, what is the logistic cost as per the percentage of sales and how much are you trying to reduce it. I mean what will be the bottom-line gain out of the logistic costs being going down?

Ravi Jaipuria See, today if you look at anywhere, any borders you see, you see miles long trucks standing in queue waiting for them to be cleared and I have given example of our plant from Greater Noida when our truck has to deliver goods to Delhi which is 30 kms away, sometimes it takes even more than a day for the truck to come back. Now definitely with GST coming in, I expect the time to come down to half if not even less than that. So it is like a 50% time saving. Obviously, it may not necessarily result in reduced cost by 50%. But these are some of the examples and the main cost of trucking is the cost of the equipment more than the just fuel. So, we really expect a substantial reduction in our cost once GST is there and especially when cross border goods are being sold and exact figures will be consolidated and hopefully in the next conference call, we will be able to give it to you. But at the moment, we feel there will be at least 15%-20% reduction in our transportation cost.

Raj Gandhi Here what is the cost in the financial terms when 9 different acts which are monitoring you get subsumed into one. It will reduce lot of paper work and administrative time. See, our industry is a seasonal industry and majority of our business happens in one quarter and any time saved that time helps in better capacity utilization, better asset utilization and then we have to reduce the warehouses which we have to keep at this stage. So, all of those things and as I mentioned, then we can manage 16 manufacturing facilities which are in 17 states. Additionally, opening of the warehouses or the plant in every state, will not be required.

Saket Kapoor Sir, in rupee terms what are our logistic costs for the annual basis?

Raj Gandhi It is around 6% of our revenue.

Saket Kapoor 6% of our sales is the logistics cost and we are expecting that to go down in rupee terms it would be. It will add to the bottom line.

Raj Gandhi See if we have today close to 2,000 trucks and if the time taken is reduced, we may not be required to buy more trucks for some time and then it will have an impact on ROCE. If we don't have to attend to the hearings in the departments of entry tax, or octroi duties, VAT, separate excise duty, so lot of administrative work can get reduced. So that way it would bring efficiency into the system. Moreover, GST has more than the financial and administrative effects, has many more effects, it also provides a level playing field. The compliance in the country, on the tax laws, is going to improve like anything which will take away, fly by night operators primarily in the rural side spurious product markets etc. where to keep that in check, sometimes we have to spend on vigilance so that these spurious products in the market doesn't penetrate. So all those things will improve. There will be improvement in the systems broadly.

Saket Kapoor Now coming sir, my last point is we don't have bottler players like you in the listed space, so for investors what are the parameters on which we should value the company since the seasonality factor is the biggest factor. Most of your revenues will be there in the June quarter for the second quarter for your company. How should now investors look at this business and how should we value it?

Raj Gandhi See, number one you have to see it on annualized basis. Secondly, yes, in India, there is no other listed bottler, but across the globe you will find 6-7 or may be 10 comparables. Then if you adjust it to the India growth, you will have good numbers. Additionally, apart from the beverage industry, you may find comparables from related industries which your teams can identify and as experts in this field I am sure, you can do the benchmarking.

Saket Kapoor Right sir, but my point is that we are reporting our numbers in millions, is there any compulsion for us to be separate, adopting to Rupees in millions or can we look for lakhs and crore also. For the basic understanding, when we talk we used to talk in lakhs or crore, so millions is what we have to go back and do the calculation again -again. So it is just a suggestion.

Raj Gandhi It is a good suggestion. In fact, what happened is you know our main exchange of data, before we were listed, was with the PepsiCo where everything was coming in millions and when you open Excel, automatically the formulation there comes in millions unless you re-adjust it. So, we started with that and now we have become more used to it, but you have a a good suggestion, we may sometime review it.

Moderator Thank you. Next question is from the line of Vivek Maheshwari from CLSA. Please go ahead.

Vivek Maheshwari My first question is, Mr. Jaipuria in his opening remarks mentioned about high base in April. Since you were not listed at that point of time, can we get because this is going to be an important quarter, so is it that the entire quarter has a high base or it was just a comment about April and how should we think about this quarter therefore?

Ravi Jaipuria The quarter April-May-June is our highest quarter. At least close to 50% of our volumes come out of this quarter. So that is why this is such an important quarter and most of our profits come out of this quarter. That is what I have mentioned.

Vivek Maheshwari Sure. But when you mentioned about the base, was that for entire quarter or was that only for the month of April then?

Raj Gandhi It was only for the month of April, Vivek. May-June last year were little subdued.

Ravi Jaipuria April 2016 was a very strong month over April 2015. And this year April has also started well. May and June were not so strong last year, so going forward looks like its going to be a reasonably decent year.

Vivek Maheshwari Okay and again because of seasonality and since we don't have the full four quarter, volume mix and all, is it possible to get first, second, third, fourth quarter, how much each of these quarters is in terms of volume and EBITDA?

Raj Gandhi Vivek, lets firstly break it into H1 and H2 and then we can split it further quarter wise. 65% of our volume happens in H1, which is up to the June for us and the balance 35% of our volume happens in H2 and there is not much of a difference between volume and revenue with a small difference in quarter two where discounting is slightly less and if it is a 65% volume, the revenue may be 66-66.5%. When we split it further, this 65% of volume between these two quarters, so 18-19% volume happens in quarter one and 46-47% kind in quarter two. And the 35% which is in H2 that too in quarter three and four, approx. two-third of that 35% in quarter three and one-third of 35% in quarter four. So that is as far as the volume and revenue are concerned. And on your EBITDA question, approx. 75% of our annual EBITDA happens in H1 and if we have to split that, 20% of H1 EBITDA happens in Q1 and 80% of the H1 EBITDA happens in Q2. I hope I am very clear on this.

Vivek Maheshwari I am following you, yes.

Raj Gandhi So, in other words, 75%, you can say 15% of annual EBITDA in Q1, 60% of annual EBITDA in Q2. And in the H2, we do the balance 25% of EBITDA with 90% of that getting realised in Q3. Means roughly 22.5% of the annual EBITDA is realized in Q3 and balance 2.5% of annual EBITDA happens in Q4. And because depreciation and interest till recently were a very high figure, and for one or two years ahead still may remain little high, will result into Q1 and Q4 in loss situation. But Q1 from this year with the reduction of our interest cost, we have been for the first time made a marginal profit in Q1. And Q2, will continue to contribute anything between 120-

130% of the annual PAT. Q3 will contribute ~20% of annual PAT level and Q4 for another few years will contribute a loss of 40-45% of the annual PAT equivalent. So this is a little different than other businesses however, because we are in business with PepsiCo for 25 years or in beverage industry for 50 years in total, so we have made our systems in such a way so it doesn't affect us with the life throughout the year. We use the lean months for our maintenance or the capacity expansion and the peak months we run the plants, in three shifts. Here also Vivek, when the question is asked, how do you use your capacity; these 3 months, April to June, actually if the plant is run on three shift basis,, so 3 months equal to 9 months production in an industry which works on a single shift basis, we actually do it. But in the balance 9 months, we have to do business equal to 3 months and which makes capacity utilization that way equal to 100% on single shift annualized basis. So that is the way we use our capacity but in a different way. So I think this can provide you at least a good template for understanding the business.

Vivek Maheshwari Sure. This is very helpful. Another bit is on the gross margins in this quarter. So there is a 300 basis point expansion and when I look at raw material head, there is a 5% YoY decline. So could you just elaborate a bit on this?

Raj Gandhi See, our gross margins which have gone up are a factor of few things. One is that the mix of Aquafina as given in our opening remarks has gone up in this quarter and Aquafina, there is no concentrate. So definitely there has been a saving here and Aquafina has royalty which comes below, so one. The second thing is the co-packers which we had. If you remember, in last call we have said in March 2016 we had acquired Phillaur co-packers and in the month of September, we had acquired Sathariya co-packers and till then they were supplying these material to us and when we have acquired them, the margins which they were making from that day has started accruing to us helping us incrementally increase our gross margins**.** And also, to address the market situations and competitive activities, PepsiCo allows concentrate discount from time to time. So all these things together has helped us in increasing the gross margins.

Vivek Maheshwari Okay and no major concern on raw material at this moment or there is some as we head into the next 3 quarters, particularly the second quarter?

Raj Gandhi Sugar, last quarter when it was discussed where we had stated we have already taken the contracts covering us up to May. So that has already covered. The sugar price which in the last two years has gone up, 70% of that increase had happened up to 2016 itself. And in spite of that increase in the sugar price which was substantial, we had been able to maintain our margins in the last year also and rather we had increased because of other operational efficiencies brought in. And this year again small difference we said instead of 20.6%, we have said maybe still around 20% of the margin is visible. So more than that, we do not see any effect and we are already into the season and as far as sugar is concerned, we are quite covered.

Vivek Maheshwari And one last small clarification. When I look at your presentation, your PAT number is let us say Rs. 30 million for this quarter and when I look at your P&L statement, the PAT number comes to Rs. 68.94 million. What am I missing? What is the difference?

Raj Gandhi There are two things. One is under the comprehensive expense on the actuarial loss on gratuity valuation and second is the minority interest for Zambia, so we had provided that and after that, net accruing to Varun Beverages is Rs. 30 million.

Vivek Maheshwari So that has OCI as well in it. Otherwise, net profit is Rs. 69 million basically, right?

Raj Gandhi Yes.

Moderator Thank you. The next question is from the line of Ashish Kacholia from Lucky Investments. Please go ahead.

Ashish Kacholia Would you care to share a little bit about how you managed get these your raw material costs under control for this quarter? You did mention some amount of negotiation with Pepsi on the royalties and all that. Do you feel that this is kind of sustainable going forward?

Raj Gandhi What happens is, the cost for sugar is already explained and regarding the concentrate, the net cost goes above or comes down due to strategic reasons or market competitiveness, if we spend we get the discount. If we are not getting it, then we don't spend. It is as simple as that, it is both sides. So it doesn't affect my P&L.

Ashish Kacholia And overall going forward Pepsi is kind of pushing towards somewhat more healthier kind of a portfolio, health related positive portfolio, so what will be the impact on us out of that repositioning of Pepsi's global strategy?

Raj Gandhi We are important partner for Pepsi in 6 countries and we are happy Pepsi is considering and bringing in a lot of new innovations and one which was introduced last year NMS, Nimbu Masala Soda, is a great success and last month they have already launched Pepsi Black, zero calorie cola, although its contribution is just 0.5% Going forward in next call we shall be sharing with you more product innovations which are in the pipeline.

Ashish Kacholia And my last question sir. Have you articulated your acquisition, financial strategy you mentioned that at some point of time you are going to kind of lay down the policy, any progress on that?

Raj Gandhi In fact we had our Board meeting today and next Board meeting we will be coming out with, we will be discussing with the Board little more homework is to be done on that and we will have a very robust transparent policy for that.

Moderator Thank you. Next question is from the line of Anand Shah from Kotak Securities. Please go ahead.

Anand Shah Sir, one thing was on this jump in the Aquafina. Aquafina volume essentially has gone up 30% this year YoY basis. Is this kind of growth sustainable?

Raj Gandhi See, it is like this. Number one, the territory which we acquired, there the Aquafina sales is more and the second is at Sri Lanka we have launched Aquafina and there we don't have to pay any royalty for establishing this. So we are giving a big push and the third is, the seasonality in case of Aquafina is much lower, than juices and the carbonated drinks and with a lower base of earlier 11% and then 13%. So although in absolute terms number may not be so large, in Aquafina, the increase in percentage terms will look healthier in the first few years.

Anand Shah Okay, but so broadly this 20%-30% kind of growth can be sustainable?

Raj Gandhi Even as per Euromonitor, I think they have stated 18% or similar growth, so water is one area where the growth is there and the improvements in water and other variants of water, Pepsi is working towards, and once we will have little more clarity we will share with you. So that will broad base water portfolio for us.

Anand Shah Perfect. And sir second question, I mean if I look at the realization per case which is your gross divide by the volumes that you reported, so that has been flat. So have you taken any price hikes or is the realization likely to be flat for the year?

Raj Gandhi Actually one factor here Anand as you stated the water mix, the gross mix, water realization is normally lower than this and therefore it is flat in the realization. Price increase normally happens little bit later. Once the mix also will change, the topline also will accordingly grow.

Anand Shah But if I were to exclude let us say water, then would you see positive growth in realization?

Raj Gandhi Yes.

Anand Shah And lastly sir what would be the current net debt level versus let us say CY'16?

Raj Gandhi Including PepsiCo outstanding and the deferred tax loans, etc., the last quarter was about Rs. 2,400 crore or so but that was because the capex was already incurred and with quarter end we should be reducing by another Rs. 300-400 crore coming to a much lower level because what happens I will tell you. In the business, we prepare ourselves with lot of working capital in the beginning of the season and the capex happens in the month of February-March. In April-May-June either the inventory gets liquidated or the capex because when I said 120%-130% of annual PAT happens in this quarter, so that helps March quarter and June quarter the debt figures will be slightly different because March quarter actually is preparation / investment quarter and June is realization quarter.

Anand Shah But for the full year, you should see at least Rs. 300-400 crore kind of a drop in your net debt?

Raj Gandhi Not Rs. 300-400 crore but slightly less, but definitely there will be drop because we have acquired Zambia and depreciation figure definitely has gone, but definitely there will be a drop.

Moderator Thank you. The next question is from the line of Sanjay Singh from Axis Capital. Please go ahead.

Sanjay Singh Just wanted to know do we have the EBITDA numbers for 2016 Ind-AS?

Raj Gandhi No. Sanjay, it is like this. One additional month has been allowed to prepare for Ind-AS for one year which we have not used and are already ready but have prepared the financials for the period for which it is mandatory and Ind-AS prior to that we have not prepared.

Sanjay Singh As we go along the quarter, every quarter you will give the parallel Ind-AS number?

Raj Gandhi Of course, we will be.

Sanjay Singh But logically speaking will the EBITDA number change per se? The topline number could change but the EBITDA number should not change, right?

Raj Gandhi EBITDA number because the change is mostly as I read out in the opening remarks are basically the interest and depreciation. Interest on CCD, CCPS, interest on the PepsiCo's deferred payment consideration and depreciation on assets taking on NPV and adjusting out of the fixed asset block, and on the shifting the franchise rights from the straight-line depreciation to the impairment testing mode. With these few changes, impact basically is on these, apart from other small adjustments which come to the P&L on the other income and expense side on the excise advantage which we have in Zambia or one of our plants for earlier period for Rajasthan.

Sanjay Singh EBITDA, there should not be any difference, right?

Raj Gandhi Not much of difference, that is right.

Sanjay Singh And depreciation, how much it goes up, I mean typically?

Raj Gandhi Depreciation with this actually comes down Sanjay and interest figure goes up and net effect of the two is more or less zero, it gets neutralized.

Sanjay Singh Why does it come down sir?

Raj Gandhi It comes down because of the shifting from the amortization to the impairment testing mode on the franchise rights, number one. Number two, PepsiCo asset which Rs. 1,268.50 crore consideration had to be made in four installments we have taken. As per Ind-AS criteria or standard guidelines, we had to calculate its fair value that means NPV, at the average cost of borrowing for the next year and it could be adjusted out of the block. Therefore, depreciation would be reduced.

Sanjay Singh And given that your June quarter is the most important quarter and we are almost half way through the quarter, can you just give us some sense on how the quarter is looking like?

Ravi Jaipuria So far it is looking pretty good as April is already over. So I think we should have a healthy growth going forward.

Moderator Thank you. Next question is from the line of Keval Lakhani from IIFL. Please go ahead.

Keval Lakhani Sir, we have the sugar cover till the month of May. So could you just tell me at what price we have taken the cover at?

Raj Gandhi My cost for this period is approximately Rs. 37.50 as against last year's average weighted cost of Rs. 36.23.

Keval Lakhani And post that what is the position for sugar?

Ravi Jaipuria Sugar is hovering around that only, so should not be much more than this.

Keval Lakhani Alright and at what percentage the sugar form a part of the total cost?

Raj Gandhi A ball park figure of approx.14%.

Keval Lakhani 14% of the total raw materials?

Raj Gandhi No. 14% of our revenue.

Keval Lakhani Could you elaborate how much discount do we get from PepsiCo on the concentrate purchase?

Raj Gandhi This depends actually. If we pass on we get it, if we don't, we don't get it. So it is not percentage wise. It is not something fixed.

Moderator Thank you. Next question is from the line of Anand Shah from Kotak Securities. Please go ahead.

Anand Shah Sir, on this international sales, if I look at your volume growth was about 4% whereas I mean you indicated in the commentary that Nepal, Sri Lanka, Morocco grew at double digit and you said Zambia has slowed down significantly?

Ravi Jaipuria Zambia there had very heavy rainfall which was unprecedented this year in the first quarter.

Anand Shah But then what would be your guidance let us say on Zambia?

Ravi Jaipuria Going forward it is looking good. It is already coming back. It was just abnormal first quarter.

Raj Gandhi And also Anand, Zambia actually, as against in India when we say, our peak month is May. For Zambia, the peak month is November-December. Like in India January-February-March is not that significant quarter so is for Zambia also and Zambia peak months are November-December.

Anand Shah Rainy season is in last period for Zambia?

Raj Gandhi Here May, comparable there is November.

Anand Shah Okay. Perfect. And sir lastly just one thing, if I do consider that your water segment keeps growing at this rate and hypothetically Pepsi continues to spend and you get that concentrate discount similar to whatever they spend let's say. Then is this kind of a gross margin expansion sustainable for the year?

Raj Gandhi This year, the way we are discussing with PepsiCo, the discount should not be less than the last year, should be maybe higher and it is difficult to say anything at this moment.

Anand Shah Okay. But that was the biggest moving part as to how your gross margins track?

Raj Gandhi But ultimately see, that gets adjusted because the profitability doesn't affect. As I mentioned, if we spend we get it. If we don't spend, we don't get it. That does not affect our margins. At the gross margin level, yes.

Anand Shah So that your realization will go down, your gross margin will go up, that will continue?

Raj Gandhi Yes.

Moderator Thank you. Next question is from the line of Saket Kapoor from Kapoor & Co. Please go ahead.

Saket Kapoor Sir, there is a concept for green MEG also which has been adopted by Coke globally, both Coke and Danone. Is Pepsi also looking for this green MEG part and what is the update if any? Sir, I am talking about the raw material MEG, that goes into the bottling the preform**.** It is a petro based product and worldwide the tilt has been the percentage of this Coke and Danone is purchasing it through the players like India Glycol, the MEG which is prepared from molasses. So just wanted to have the understanding whether Pepsi is also moving towards this green MEG part?

Ravi Jaipuria I am sure they must be working on it, but we don't have information at the moment.

Saket Kapoor Currently it is all the petro based from your side sir?

Ravi Jaipuria Yes, Pepsi has not shifted recently

Saket Kapoor Green MEG part?

Ravi Jaipuria Yeah. Coke has not shifted in India.

Saket Kapoor Right. Sir coming to your working capital requirement also, as you have told that January to June part is the one where the capex is higher-ended and going forward it gets liquidated. So what is our long term borrowing and how much is our working capital requirement?

Raj Gandhi See, working capital we have already improved and come down to 29 days of the annual sales on an annualized basis if I see and with the GST coming in, that should bring in 4-5 days' further improvement and with our scale going up another 3-4 days and that is the maximum we feel we can improve upon.

Saket Kapoor What is the amount sir? How much is the working capital requirement?

Raj Gandhi Annual sale is 29 days or 8.25% of the annual sales.

Saket Kapoor Okay. And sir now, just to have an understanding sir, you told that with GST coming in your trucks will take lesser time to reach the destination, how will that work out sir? The congestion won't go, sir was speaking about that?

Ravi Jaipuria See, what happens is, every border you are crossing, the trucks are just standing waiting for paper work to be done, that time will be reduced drastically. So we expect at least 15%-20% cut in time at least spend by the transport companies which are going across the border especially.

Raj Gandhi There will be one tax, one country and free movement at the borders. We are presuming as the statements are made by the Ministries and once that happens, the free flow will enable savings in time.

Saket Kapoor Sir just to understand the business model a bit deeper, it is only the Pepsi brand that is being used and other than that all raw materials and concentrate and everything has to be done and processed at your end and then the sticker with the Pepsi product goes into the market?

Raj Gandhi For this, you can refer to our quarterly results presentation wherein we have given the model, what Pepsi brings to the table and what we do. There are three things which come from PepsiCo. One is the trademark, we are under franchise agreement which we become entitled to use. Second is the formulation through the concentrate supply which PepsiCo provides to us and the third is the R&D they undertake to broaden the product portfolio and growth of concentrate sales. So these three things come from PepsiCo, which on Page #6 of our presentation on the right hand side is there and the left hand side is rest all starting from the production, visi-coolers, point of sales, marketing, demand delivery, everything is done by us. So this answers the role of two partners in detail.

Saket Kapoor And what is the renewal part sir. When does the agreement get renewed and for how long?

Raj Gandhi After 10 years, it gets automatically renewed. Having said that basically we have to comply with the conditions of the franchise agreement which basically is non-compete or respecting their intellectual property and we have to continue that and if we do that, it gets renewed. If we start playing with their intellectual property with their brand, then of course we are endangering the renewal.

Saket Kapoor When is the renewal due sir next?

Raj Gandhi Last we signed in October 2012, so 2022.

Saket Kapoor Sir what was the net cash earnings for the last year sir?

Raj Gandhi Last year Rs. 795 crore EBITDA and interest figure I mentioned Rs. 213 crore and then tax of less than Rs. 100 crore is to be reduced.

Saket Kapoor Around 400 crore then?

Raj Gandhi So, Rs. 151 crore after minority interest PAT and Rs. 373 crore or something depreciation added to that.

Saket Kapoor No, I was talking about the net cash, you include the depreciation there because it is not..

Raj Gandhi You mean to say the free cash flow.

Saket Kapoor The free cash flow, yes I used the wrong word sir.

Raj Gandhi Free cash flow, in fact we invested in the business in creating capacity. So we ploughed it back.

Saket Kapoor Sir you purchased 30% for the Zambia unit…

Raj Gandhi That we did this year.

Saket Kapoor Yeah, this year and for that we paid Rs. 71 crore. Although sir we were accruing all the benefits as earlier remaining that minority interest which used to be debited, what is our vision for putting this money there sir?

Raj Gandhi As I mentioned consolidation we were able to do, but we also simultaneously had to provide for the minority interest of Rs. 9 crore payable to the other party. Now we have paid total Rs. 71 crore. So one is Rs. 9 crore will not be reduced from PAT this year, second is in that territory we have for 5 years tax benefit and there Rs. 46 crore EBITDA it had generated last year and the rate of interest there was very high and we used our IPO proceeds there and interest cost of around Rs. 10 crore is not going to be there anymore, will flow to the PAT. So all those things will accrue to us and payback will be very quick there.

Saket Kapoor Sir remaining 10% is being held by which entity sir?

Raj Gandhi By the same person, in fact being a local we find useful

Saket Kapoor One of the partner there?

Raj Gandhi Yes.

Moderator Thank you. Next question is from the line of Prashant Kutty from Sundaram Mutual Fund. Please go ahead.

Prashant Kutty Just one thing. What I want to ask you is you just said that obviously packaged water did really well for this quarter, but does that mean that probably the soft drink sales have actually come off quite significantly. Anything structural to worry about over here because the growth rate seems to have come down quite significantly and again to do the math's which you kind of just stated that usually the first quarter is about 20%-22% of the topline. That again does not seem to be happening on this particular quarter. So does that mean that your run-rate for the next quarter actually increases even more substantially.

Raj Gandhi Prashant, the first thing is it is not 22%, the first quarter is 18% of the revenue and the second quarter is more important for us. Every year, if you see, out of the four main months if we are able to catch one or two months we do well. These three months, it was not that large for us and yes the growth in these three months is less and historically it happens in these three months like that only. In India, the basic consumption happens in the summer months on those sides when people are really thirsty. It is still not a lifestyle drink. It is more necessity on when people need instant energy that they consume it.

Prashant Kutty Yeah, but the only reason I was just trying to understand is because, I mean, structurally because I mean even if I compare it on YoY basis, was there anything really there in the last quarter that probably the base was high, anything of that sort. I understand you spoke about the extended winter probably being one of the…

Raj Gandhi That is the only reason.

Prashant Kutty Okay. So ideally one can expect if the next quarter should come back to that normal 8%-9% in terms of the growth rate for the category at least.

Raj Gandhi This is what, the Chairman also said the same.

Prashant Kutty Sure and secondly you also highlighted about the capex probably being equal to depreciation. Just taking out of it, I mean, does it mean that probably we are not looking at any kind of Pepsi plans in this particular year, does it mean towards anything of that sort. Can one extrapolate such a thing then?

Raj Gandhi See this is on organic basis capex. And any those things are out of this assumption.

Moderator Thank you. Ladies and gentlemen, that was the last question for today. I would now like to hand over the floor to the management for the closing comments. Over to you sir.

Raj Gandhi Thank you very much everyone for your interest and support. We will continue to stay engaged. Please be in touch with our Investor Relations Team for any further details or discussions, look forward to interacting very soon. Thank you very much once again for your time. Thank you.

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