HDFC securities

INSTITUTIONAL RESEARCH

COMPANY UPDATE | 04 OCT 2017

United Spirits

SELL

INDUSTRY	**FMCG**
CMP *(as on 4 Oct 2017)*	**Rs 2,400**
Target Price	**Rs 2,060**
Nifty	9,915
Sensex	31,672

KEY STOCK DATA	
Bloomberg	UNSP IN
No. of Shares (mn)	145
MCap (Rs bn) / ($ mn)	349/5,359
6m avg traded value (Rs mn)	1,386

STOCK PERFORMANCE (%)

52 Week high / low **Rs 2,774/1,773**

	3M	6M	12M
Absolute (%)	(5.0)	17.2	(5.9)
Relative (%)	(6.4)	11.3	(17.6)

SHAREHOLDING PATTERN (%)	
Promoters	58.5
FIs & Local MFs	4.8
FPIs	23.3
Public & Others	13.4

Source : BSE

Himanshu Shah
himanshu.shah@hdfcsec.com
+91-22-6171-7315

Persistent hangover…

United Spirits (UNSP) is the undisputed liquor leader in India. Long term investors in India's consumption story have been motivated by the transformation of UNSP under Diageo. Mgt has pushed for premiumisation, cost control, de-leveraging and has franchised out low-end brands. This has fuelled investor aspirations of sustainably better margins and falling debt.

While we are believers in most of the repair work at UNSP (as well as the broader Indian consumption story), we are skeptical on stock return hereon. Our thesis is premised on three important factors, namely (1) We see persistent structural hurdles for liquor branding, distribution and pricing power in India, despite broader reforms in the nation's policy mix. Liquor is a whipping boy for state governments across the political spectrum (2) GST has added to costs, and (3) Competition is sniping at UNSP's heels.

UNSP's stock is up 24% YTD (36% from its 52-week low) as states have denotified certain highway stretches in an effort to circumvent the Supreme Court's ban on retail sales along highways. In view of the longer term challenges, UNSP's currently rich valuations (43x FY20E EPS) offer a decent EXIT point. This is a great business, but we suspect the hangover is persistent. SELL, with a TP of Rs 2,060 (40x Sep-19E EPS).

Why is UNSP a SELL?

- The Indian liquor industry's volume growth slowed from 13% CAGR over FY10-12 to 3.5% over FY13-16. It is running negative in FY18 YTD. The liquor ban along highways is only one instance of an unrelenting hostile environment. Distribution and pricing continue to be mired in complex, state-specific regulations. UNSP has not manufactured liquor in Tamil Nadu (18% of India's liquor volume) after exiting this market in 2013.
- Profit margins for brand owners are falling, especially in the economy segment. Indirect taxes have risen to 66% (FY17) from 42% in FY10 for UNSP. We expect states to continue milking the industry. Meanwhile, premiumisation is difficult. Liquor is a 'media dark' industry. Also, UNSP faces strong challenges from Pernod Ricard in premium segment.
- Rising taxes on input materials (under GST) will hit margins, as no set-offs are available (liquor is outside GST). Regulatory delays and hurdles will hit pricing resets, not to mention some demand elasticity too!

Consolidated Financial Summary

(Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Net Sales	84,949	88,175	80,979	92,411	99,965
EBITDA	9,646	9,892	8,785	14,257	16,685
APAT	1,708	4,611	2,781	6,614	8,354
Diluted EPS (Rs)	11.8	31.7	19.1	45.5	57.5
P/E (x)	204.6	75.8	125.7	52.8	41.8
EV / EBITDA (x)	40.0	39.1	43.5	26.7	22.5
RoE (%)	14.9	27.0	14.4	27.6	26.6

Source: Company, HDFC sec Inst Research

Indian Alcohol Industry Overview

IMFL, IMIL (Country liquor) and Beer contribute broadly equally to country's ~900mn cases p.a. liquor market

Contribution to state exchequer remains highest of IMFL and IMIL the lowest

Ban on country liquor (especially illicit) by states and gradual shift to IMFL is a potential trigger. However in recent years, share of IMIL has been on rise led by improved quality and packaging and exit by larger players from lower end IMFL

Contrary to India, globally beer remains the most preferred drink owing to low AbV



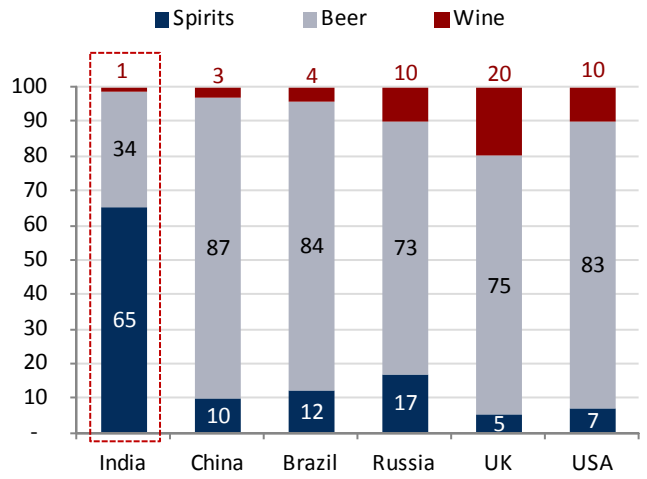
Source : Crisil, HDFC Sec Inst Research

- The Indian alcohol market (beer, spirits and wine) is valued at ~Rs 400-420bn (excluding IMIL), with volumes at ~890-900mn cases (One case is equivalent to 9 litres, and comprises 12 bottles of 750 ml each). Of this, the IMFL segment accounts for ~Rs 280bn of revenues and 35% of volumes. Volumes in FY17 and FY18 are estimated to be lower by ~20-30%, owing to demonetisation and ban of liquor sales near highways.
- **Demand drivers:** Rise in the drinking age population (~18-20mn additions p.a.), growing acceptance of alcohol consumption in society, and a gradual shift to Indian-made foreign liquor (IMFL) from country liquor will support consumption. However, the steep rise in taxes, prohibitions and restrictions in various states dampen growth.
- **Opportunity in shift from country liquor to IMFL:** Country liquor is a cheaper alternative to IMFL, and contributes a smaller amount to state excise. The primary difference between IMIL (Indian Made Indian Liquor) and IMFL is that the former is less refined as it undergoes fewer rounds of distillation, and is thus considered harmful. Country liquor is banned in Southern states.
- Consumers were gradually shifting to lower-end IMFL products from IMIL. This remains a long-term growth opportunity for IMFL The northern states (especially UP) are important markets for IMIL. During the elections, sales of IMIL are higher. Even in Maharashtra (second-largest market for UNSP), the share of IMIL is ~38% vs. 22% for IMFL and 40% for beer.
- However, the shift is not expected to be aggressive. IMIL sales, which had dipped a few years ago when players upgraded to IMFL brands, have been on the rise in recent times, thanks to improved quality and packaging of IMIL brands. Rising prices and an increased price differential with IMFL brands owing to taxes and exit by large players from the lower-end non-profitable IMFL segment have also supported growth for IMIL.
- **Shift from IMFL to beer is a risk:** Globally, a majority of countries outside India recognise the essential differences between high alcohol content drinks like spirits (Alcohol By Volume (ABV) of 42.8%) and lower alcohol content drinks like beer (ABV 6-8%). Spirits are taxed at a significantly higher rate than beer, as hard liquor has greater negative consequences on health. Globally, thus, the share of beer in overall liquor consumption is notably higher than India.

Change in taxation structure in India to AbV may impose risk to liquor consumption owing to steep rise in taxes

Prohibition on liquor by states even if lifted subsequently hampers growth

India Vs. Global: Spirits vs. Beer Consumption Trend



Source : All India Brewers Association, HDFC Sec Inst Research

- **Shift in tax structure to ABV can be a dampener:** With the ratio of excise duty adjusted for alcoholic content, IMFL appears to be more affordable than beer, as it exhibits a higher 'alcohol/price' ratio. Over time, this could act as a trigger for the government to increase taxes on IMFL, driving consumers to switch to beer. Excise duty for IMFL in India stands at ~60% vs. ~50% for beer, despite a significant difference in ABV. However, Kerala is an exception, as it follows global standards. Excise duty on beer is ~11% vs. 60% for IMFL in Kerala. We are not factoring in any potential changes in the tax structure, and thus adverse impact on IMFL remains a risk.

Liquor ban dampens business

- States have been regularly announcing prohibition on liquor consumption owing to health hazards, and the directive principles of state policy in the Constitution of India (article 47) which states, "....the State shall endeavour to bring about prohibition of the consumption except for medicinal purposes of intoxicating drinks and of drugs which are injurious to health". In Apr-17, Madhya Pradesh became the fourth Indian state (after Kerala, Bihar and Tamil Nadu) in the last two years to announce a ban on liquor. Alcohol prohibition is in force in Gujarat, Bihar, Manipur, Mizoram, Nagaland and Union Territory of Lakshadweep.
  - **Apr-15:** Kerala has implemented gradual prohibition on alcohol over 10 years, except for beer and wine
  - **Apr-16:** Bihar has banned all alcoholic beverages
  - **Apr-16:** Tamil Nadu announces prohibition, starts shutting down first batch of outlets
  - **Apr-17:** MP announces gradual prohibition, starts closing first batch of outlets
- We note that (1) Liquor prohibition has not lasted longer than a couple of years in any Indian state except Gujarat. This may be primarily because alcohol contributes 25-40% of the state governments' revenues (2) Prohibition is partial (3) Volume contribution of states where alcohol is banned is lower, especially for UNSP.
- In our view, it is unlikely that the largest liquor-consuming states like Karnataka, Maharashtra etc will implement prohibition. More recently, Pune Municipal Corporation proposed a state-wide ban on liquor, though peers felt the idea is not very practical.
- In our view, even as the recent weak performance can be seen as transient owing to demonetisation, other factors like the ban of liquor sales near highways and in states like Bihar, and also the very nature of the business exposes it to disruptions from time to time.

UNSP: Dominant player, established footprint

- UNSP is the largest spirits player in India, with sales of ~80mn cases per annum (IMFL industry at ~270-300mn cases in FY17/18).
- UNSP has a strong product portfolio, where sales of 15 of its 140 brands are more than a million cases.
- A distinguishing characteristic of UNSP is its established product portfolio across segments and price points.
- We provide a line-by-line financial analysis of UNSP, Pernod Ricard, ABD and Radico Khaitan in the subsequent section.

A distinguishing characteristic of UNSP is its extensive product portfolio - across segments and price points.

Currently, Prestige and above accounts for ~40% of UNSP's product portfolio (volumes) and ~60% of its revenues

Segment-wise Key Brands

Customer Segment*	Price Point**	Segment***	Whisky	Brandy	Vodka
Affluent	> Rs2,000	Luxury	Red , Black, Blue label		Ketel One
(> Rs 10 lacs)			Gold Label		Ciroc
			Glenfiddich		
			Singleton		
			Talisker		
Middle	Rs 1,000 – 2,000	Premium	VAT 69		Smirnoff & Variants
(Rs 2-10 lacs)			Black & White		
			Black Dog		
Middle	Rs 400 – 850	Prestige	McDowell's No.1 Original	McDowell's VSOP	Romanov Red
(Rs 2-10 lacs)			McDowell's No.1 Platinum		
			McDowell's No.1 Luxury		
			Royal Challenge		
			Signature		
			Antiquity		
Aspiring	< Rs 400	Popular or	Director's Special	McDowell's	Romanov
(Rs 1-2 lacs)		Regular	Old Tavern		White Mischief
			Bagpiper		
			Haywards Fine		

Source: Company, HDFC sec Inst Research * Basis annual income per households **Average consumer prices for 750ml bottle *** *from reporting perspective, UNSP reports only two segments viz. Popular/Regular and Prestige & Above (P&A)*

UNSP leads in terms of volume & value market share

Pernod leads in P&A segment with 45% value share and has seen robust growth in last couple of years

Allied Blender operates primarily in the popular segment

Player-Wise And Segment-Wise Annual Volumes

Mn Cases	Prestige & Above	Popular	Total
United Spirits	36.8	53.3	90.1
Pernod Ricard	43.0		43.0
Allied Blenders		35.7	35.7
Radico Khaitan	4.7	13.4	18.1
Total	84.5	102.4	186.9

Source: Company, Media articles, HDFC sec Inst Research

The Top 10 Best-Selling Indian Whisky Brands

Company	Brand	FY16	FY17	% chg YoY
Allied Blenders	Officer's choice	32.90	32.85	-0.2%
United Spirits	McDowell's No 1	24.60	25.50	3.7%
Pernod Ricard	Imperial Blue	17.50	18.01	2.9%
Pernod Ricard	Royal Stag	17.28	17.99	4.1%
John Distilleries	Original Choice	10.70	10.11	-5.5%
United Spirits	Old Tavern	9.40	8.80	-6.4%
United Spirits	Hayward's Fine	7.40	8.50	14.9%
United Spirits	Bagpiper	7.20	7.00	-2.8%
Pernod Ricard	Blender's Pride	5.58	6.19	10.9%
Radico Khaitan	8PM	4.10	5.65	7.9%
		136.7	**140.6**	**2.0%**

Source: www.thespiritsbusiness.com, HDFC sec Inst Research

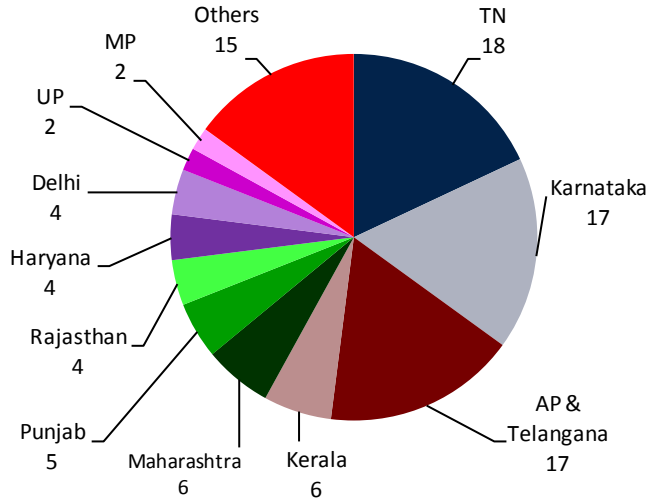
Owing to severe state control, UNSP operates in the TN (since 2013) and Kerala (Jan-17) through franchisee route only

UNSP volumes in Kerala hover around 5.5-6.5mn cases p.a. (~6-7% of total)

IMFL choice varies starkly across states

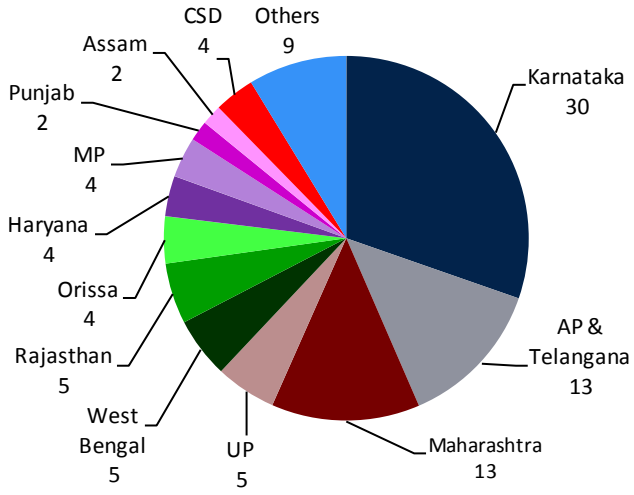
- IMFL consumption in India varies across states, in line with differences in regulations, taxes, prices, brand preferences, etc. Preference for IMFL variants also differ. Southern states account for about 60% of total IMFL consumption. Ban on country liquor has translated into higher consumption of IMFL.
- Brandy and rum are the preferred IMFL products in Tamil Nadu and Kerala. Whisky, followed by brandy, is the most popular choice in Andhra Pradesh, Telangana and Karnataka. Whisky and vodka are preferred drinks in North and West India. UNSP, Pernod Ricard, Allied Blenders and Distillers (ABD) and Radico are the top players in IMFL.

State-Wise Consumption Mix Of IMFL



Source: Crisil, HDFC sec Inst Research

State-wise Consumption Mix Of IMFL For UNSP*



Source: Company discussions, HDFC sec Inst Research
* excluding Kerala

UNSP: Karnataka and Maharashtra key states

Karnataka accounts for ~30% of UNSP volumes

UNSP enjoys a healthy 50% market share in large market of Karnataka with ~4mn IMFL cases per month market

John Distilleries enjoy 28% volume share

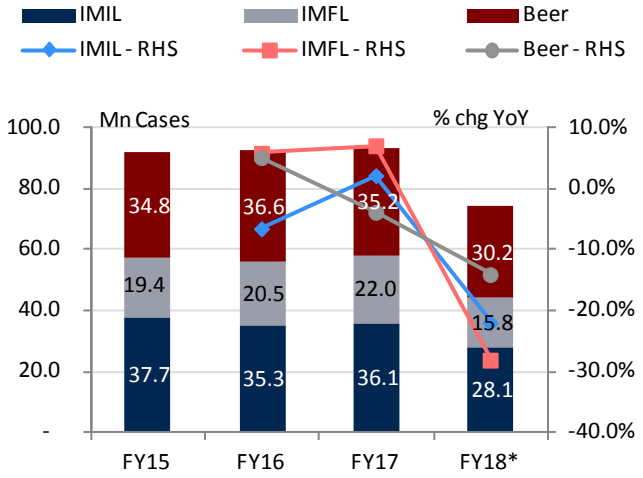
Haywards, Old Tavern, McDowell No 1 and Bagpiper are the key brands of UNSP in order of volume share

- Karnataka, Maharashtra, and AP/Telangana are key markets for UNSP. Karnataka and Maharashtra contributes 40-45% to overall volumes of UNSP.

Maharashtra YTD-Aug IMFL volumes down 28%

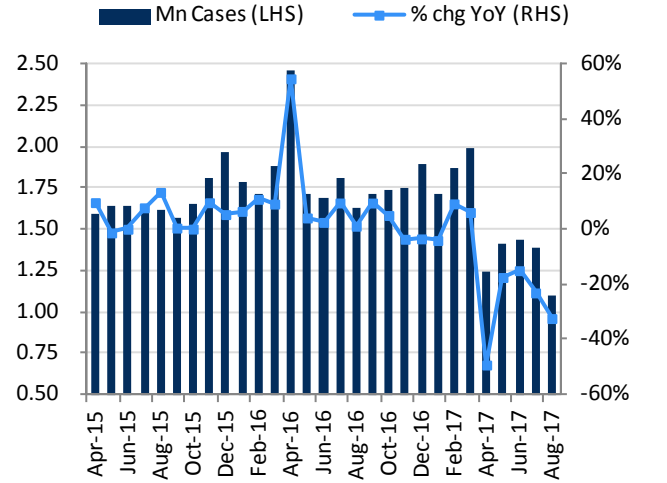
- In December 2016, the Supreme Court banned the sale of liquor in outlets within 500 metres of highways across the country, with the aim to prevent drunken driving.
- Demonetisation and a Supreme Court ruling have severely impacted industry volumes by 10-30%. Volumes in Maharashtra in FY18 YTD are down 28% for IMFL (22% for IMIL and 11% for beer).
- UNSP enjoys a dominant share at ~50%, with 10-11mn cases p.a., in a ~22mn cases market (pre demonetisation / highway ban). Around 50% of the 15,000 stores are open, and 40% of the 6,000 stores in Karnataka remain closed.

IMFL Volumes In Maharashtra Under Pressure



Source: State Excise, HDFC sec Inst Research

Maharastra IMFL Volumes Down 28% upto Aug

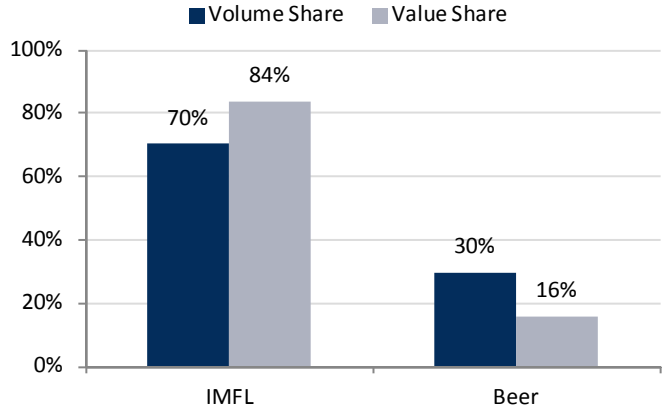


Source: State Excise, HDFC sec Inst Research

Karnataka: UNSP enjoys a lion's share

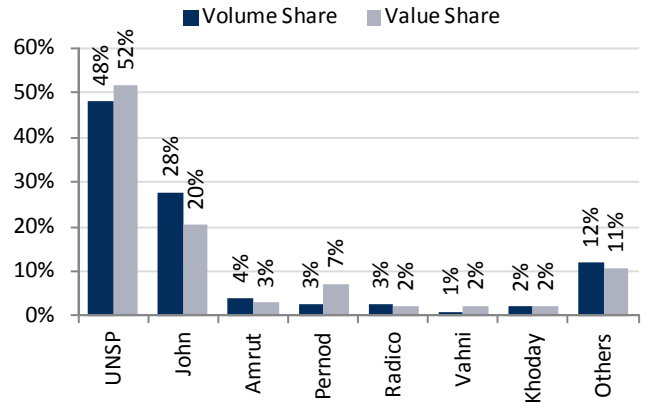
- UNSP enjoys a dominant 48% volume and 52% value share in one of the largest liquor-consuming states of India viz. Karnataka. Monthly volumes for IMFL, beer and wines are around 6-6.5mn cases, with gross revenue at Rs 16-17bn. Our industry check reveals a drop of 5-10% sales YoY in Karnataka.

Karnataka: Volume And Value Share



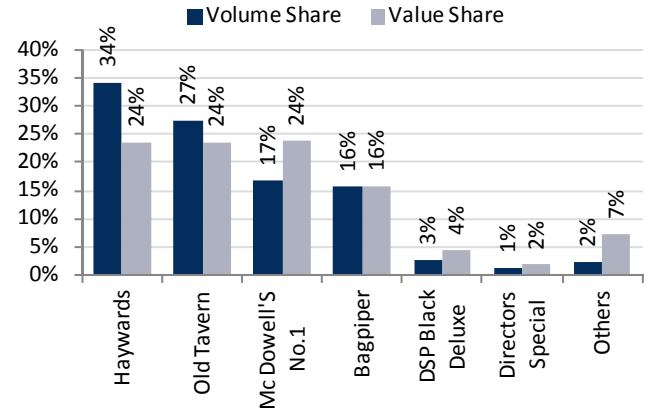
Source: KSBCL, HDFC sec Inst Research

IMFL Karnataka: Player-wise Volume And Value Share



Source: KSBCL, HDFC sec Inst Research

UNSP: Brand-wise Volume And Value Market Share



Source: KSBCL, HDFC sec Inst Research

- The Supreme Court, post the highway ban announcement in Dec-16 (to be effective from Apr-17), in subsequent clarifications, has allowed states to denotify highways as municipal roads passing through city limits. This has helped certain states to denotify highways and re-open trade outlets. Hope is also pinned on a gradual shift in consumption to the remaining stores. Nevertheless, the industry estimates a permanent loss of ~5-10% in volumes.
- A leadership share in the key markets of Karnataka and Maharashtra leaves limited scope for further improvement in volume market share. Premiumisation thus remains the only strategic option to outpace industry growth.

Key levers: Premiumisation and cost control

Embarking on the premiumisation strategy, UNSP's prestige and above segment is expected to contribute ~50% to volumes and ~66% to value by FY20E from current 41/57% respectively

The company has upgraded key brands from the regular segment to that of Prestige and above, namely McDowell's, Royal Challenge and Signature whiskey

- UNSP has highlighted premiumisation as a key strategy to strengthen its business model through:
  1) Focus on prestige and above (P&A) brands
  2) Upgrade select regular brands to the P&A category
  3) Franchise the regular portfolio (select brands in select states)
  4) Strengthen go-to-market marketing skills.

Besides premiumisation, cost control is another strategic priority for the company

Premiumisation: The 'only' magic wand

Low pricing flexibility forcing players to push premium products

- In many regulated markets (~60% of industry volumes), where the government controls alcohol prices, players have been unable to hike prices in line with the rise in taxes and input costs. Therefore, selling low-end products has become unviable, especially for larger players, as they incur high selling and distribution costs. Therefore, to expand operating margins, players are focussing on premium products.

Pernod Ricard enjoys a lion's share in P&A segment

- Pernod, with its focussed approach on the premium segment, has witnessed stellar growth in the last couple of years. This is despite the company selling ~44mn cases in the P&A segment vs. 90mn for UNSP (34mn in P&A segment). UNSP is trying to replicate market leader Pernod Ricard's model. Pernod has 45% value share in the P&A segment.

We appreciate USL's strategy of premiumisation. However, we remain cynical on its success in the near/medium-term, led by industry headwinds.

Media dark: Both a boon and curse

- The Indian alcohol market is a media-dark industry, where advertising is restricted. Stringent state-wise regulations and restrictions on advertising pose challenges for new players to enter the market, and create a loyal customer base for their products. These aspects act as a strong entry-barrier. Shifting consumer preferences to premium brands in a 'media dark' industry is also counter-productive to UNSP's premiumisation strategy.

Franchising: Relieves bandwidth, upside capped

- With a view to focus on its P&A brands and downsize its non-profitable regular portfolio, UNSP has franchised its regular brands in certain states on a fixed fee basis, starting Jan-17. Franchised brands account for ~1/4th of UNSP's regular portfolio viz. ~ 10mn cases and revenues worth Rs 7bn in FY17. Management indicated the total royalty income to be in the range of Rs 1.4to 1.6bn in FY18E, with marginal annual escalation. This structure is locked for 3 to 5 years.

- Through franchising, management does not foresee a significant accretion to the P&L. UNSP would not participate in any upside from the franchised portfolio, even if the franchisee is able to deliver a meaningful turnaround on the portfolio's economics. Nevertheless, a section of the street recognises royalty income as a source of incremental EBITDA.

Contrary to street expectations, franchise model is expected to be earnings neutral for UNSP with both upside/downside potentials capped

But would relieve management bandwidth to focus on Premium segment

UNSP's Franchise Arrangement

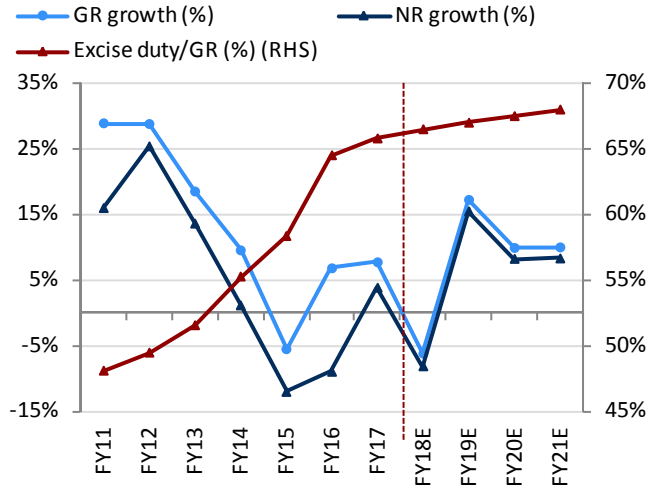
State	Brands	w.e.f
Andhra Pradesh	Popular	1-Jan-17
Goa	Popular	1-Jan-17
Kerala	All	1-Jan-17
Puducherry	Popular	1-Apr-17
Andaman & Nicobar	Popular	1-Apr-17
Chandigarh	Popular	1-Apr-17
Rajasthan	Popular	1-Apr-17
Madhya Pradesh	Popular	1-May-17
Himachal Pradesh	Popular	1-May-17
Jammu & Kashmir	Popular	1-May-17
Delhi	Popular	1-May-17
Sikkim	Popular	1-Jun-17
Uttar Pradesh	Popular	1-Jun-17

Source: Company, HDFC sec Inst Research

Growth opportunity: UNSP or state governments?

- The bull thesis on UNSP at current valuations (still high at a PE of 55X FY19E) rests primarily on the positive view on the underlying growth opportunity. We share the positive view on growth potential - in terms of growth in consumer spends. Our cautious view is from the uncertainty surrounding value capture for the industry from this strong growth of consumer spends.
- For example, this value capture has been trending downward as reflected in the increasing excise/gross revenues ratio for UNSP. Excise/GR stood at 66% in FY17 versus 42% in FY10, with consistent increase through this time-frame.
- Industry dynamics are unlikely to improve in the near term in the backdrop of GST. Given that alcohol is now amongst the very few items for states from a tax revenue perspective, we expect a consistent increase in the gap between gross and net revenue growth for companies.

Excise As % Of Gross Revenues Has Consistently Risen



Source: Company, HDFC sec Inst Research

Cost control : effective?

Costs structure of UNSP is inferior to peers and provides significant head-room for improvements

- Diageo is now the promoter of UNSP, and holds ~55% share in the company. Since Diageo assumed control, it has undertaken numerous rationalisation and restructuring initiatives. Key points are listed below:
  1) Sale of Whyte & Mackay, the scotch-making subsidiary of UNSP in 2014. This has resulted in rationalisation of costs and working capital (particularly inventory), as well as debt reduction.
  2) Made provisions for doubtful debts and advances, including loans and advances to related parties. These provisions were reflected in UNSP's financials of FY14 and FY15.
  3) Divestment of non-core assets, such as sale of shares of United Breweries Ltd. UNSP plans to further monetise its non-core assets (to the tune of Rs 20bn) over the next few years. The impact of this has not been factored in our financials.

Going ahead, UNSP plans to further monetise ~Rs 20bn of non-core assets in the coming years. The impact of this has not been factored in our financials

- Management reiterates its stringent focus on costs and opportunities for rationalisation. A comparison of UNSP's costs structure with peers **(refer table below)** highlights dramatic scope for improvement, especially on the employee and other operating costs.

Employee costs

- Despite rationalisation efforts, employee cost at ~Rs 6.8bn p.a. for UNSP is significantly elevated (~25% higher than the combined costs of the next three players).

  Management foresees scope for modest reduction in employee costs. We have however assumed a reduction of Rs 500mn each year over FY18-20. In the absence of efficiencies, our numbers could disappoint.

Miscellaneous expenses

- Miscellaneous expenses at ~Rs 5.7-5.9bn p.a. for UNSP are notably higher than peers.
- This includes costs towards legal and professional charges (Rs 1.8bn), rent (Rs 2.1bn), repairs and maintenance, bad debts, IT & communications and other administrative costs.
- We thus foresee a potential saving of Rs 1.5-2.5bn each in employee and other operating costs (Rs 3-5bn total) for UNSP in the medium term.
- UNSP is constantly optimization to bring costs and operational efficiencies through sustainable initiatives like integrated supply chain, faster-decision making, besides greater focus on productivity. As per UNSP's annual report, these initiatives have led to Rs 1.6bn cost savings in FY16 and Rs 2bn in FY17.
- The savings being portrayed by the management are not being reflected in the financials, as costs in FY17 is still at par with FY16.

Profitability of Pernod is significantly higher than UNSP. This is despite just 15% higher volume in P&A segment for Pernod (at 43mn) vs. UNSP (37mn), leave apart the robust 53mn cases done by UNSP in Popular segment

Employee cost at ~Rs 6.8bn p.a. for UNSP is ~25% higher than the combined costs of next three players

Miscellaneous expenses at ~Rs 5.7-5.9bn p.a. for UNSP are notably higher than peers

Financial Comparison Of Key Industry Players

Rs Mn	UNSP		Pernod Ricard		Radico Khaitan		Allied Blenders	
	FY16	FY17	FY15	FY16	FY16	FY17	FY15	FY16
Gross revenue	**237,860**	**255,954**	**94,962**	**114,566**	**42,711**	**48,680**	**20,215**	**29,005**
(-) Excise duty	154,260	169,393	40,406	52,525	26,193	31,881	7,163	12,133
Net revenue	**83,600**	**86,561**	**54,556**	**62,041**	**16,518**	**16,799**	**13,052**	**16,872**
NR as % of GR	**35.1%**	**33.8%**	**57.4%**	**54.2%**	**38.7%**	**34.5%**	**64.6%**	**58.2%**
Raw Material Costs	47,572	49,297	26,932	30,215	8,938	9,214	5,353	7,660
Gross Profit	**36,028**	**37,264**	**27,623**	**31,826**	**7,580**	**7,585**	**7,699**	**9,211**
GP as % of Net revenue	**43.1%**	**43.0%**	**50.6%**	**51.3%**	**45.9%**	**45.2%**	**59.0%**	**54.6%**
Power and fuel	360	348	138	129	286	278	33	42
Other Mfg Exps	1,526	1,610	1,680	2,133	791	726	1,238	1,574
Contribution	**34,142**	**35,306**	**25,806**	**29,564**	**6,503**	**6,581**	**6,428**	**7,596**
Contribution %	**40.8%**	**40.8%**	**47.3%**	**47.7%**	**39.4%**	**39.2%**	**49.2%**	**45.0%**
Employee costs	6,800	6,882	2,289	2,440	1,283	1,403	1,241	1,566
Rates and taxes	2,198	2,314	1,300	2,309	457	445	57	128
Sales and Marketing	7,464	8,065	3,860	4,463	1,010	1,176	2,909	3,184
Travel/Transportation	2,595	2,813	2,746	2,980	879	924	183	235
Miscellaneous expenses	5,705	5,877	1,357	2,060	1,283	789	431	605
Other Operating Costs	**24,762**	**25,951**	**11,553**	**14,251**	**4,911**	**4,737**	**4,821**	**5,718**
EBITDA	**9,380**	**9,355**	**14,253**	**15,313**	**1,591**	**1,844**	**1,607**	**1,879**
EBITDA Margin %	**11.2%**	**10.8%**	**26.1%**	**24.7%**	**9.6%**	**11.0%**	**12.3%**	**11.1%**
Costs as % of Net revenue								
Raw Material Costs	56.9%	57.0%	49.4%	48.7%	54.1%	54.8%	41.0%	45.4%
Power and fuel	0.4%	0.4%	0.3%	0.2%	1.7%	1.7%	0.3%	0.2%
Other Mfg Exps	1.8%	1.9%	3.1%	3.4%	4.8%	4.3%	9.5%	9.3%
Employee costs	8.1%	8.0%	4.2%	3.9%	7.8%	8.4%	9.5%	9.3%
Rates and taxes	2.6%	2.7%	2.4%	3.7%	2.8%	2.6%	0.4%	0.8%
Advertising	8.9%	9.3%	7.1%	7.2%	6.1%	7.0%	22.3%	18.9%
Transportation	3.1%	3.2%	5.0%	4.8%	5.3%	5.5%	1.4%	1.4%
Misc exps	6.8%	6.8%	2.5%	3.3%	7.8%	4.7%	3.3%	3.6%
Total Operating Costs	**88.8%**	**89.2%**	**73.9%**	**75.3%**	**90.4%**	**89.0%**	**87.7%**	**88.9%**
Volume (Mn cases)	93.1	90.1	43.9	42.9	18.3	18.2	32.0	35.7
- Prestige & above	34.2	36.8			4.4	4.7		
- Popular	58.9	53.3			13.9	13.4		
Net realization/bottle (Rs)	74.8	80.1	103.5	120.5	75.4	76.9	34.0	39.4
EBITDA/bottle (Rs)	8.4	8.7	27.0	29.7	7.3	8.4	4.2	4.4

Source: Company, HDFC Sec Inst Research

Alcohol is outside GST ambit, whereas inputs materials as part of GST have witnessed steep increase in taxes; thus impacting gross margin of players

Increase in RM costs to offset gains from premiumisation and/or cost controls

Rising RM costs to offset premiumisation gains

- Alcohol has been kept out of GST, but raw materials and packaging products are included in the new tax regime. This implies that liquor firms will incur higher costs, but won't be eligible for output credit. Therefore, they won't be able to offset the cost increase like other sectors.
- Raw materials such as molasses used to produce ENA (Extra Neutral Alcohol) have been taxed at 28%, i.e. an increase of ~12% compared to the pre-GST tax structure. A majority of dry packaging goods (primarily glass bottles) have been taxed at 18%, i.e. an increase of 3.5% to 5.5%. The third major cost item is freight, where service tax has been increased from 15% to 18%.

  Note: The Extra Neutral Alcohol or ENA is a high distillated alcohol without any impurities and used for production of alcoholic beverages. Ethanol, also called alcohol, ethyl alcohol, and drinking alcohol is mostly produced by the fermentation of sugars by yeasts, or by petrochemical processes.

- Margin impact on account of GST implementation remains uncertain at this point, with management shying away from any quantification. Our back-of-the- envelope calculations implya potential impact of Rs 2-3bn (~300bps margin impact at midpoint). The company is still working with state governments to seek clarity on certain state-specific taxes, and is also approaching them for price hikes. Overall, it expects to mitigate the GST impact fully over the next two to three years, through a combination of price hikes and cost controls.

Our assumptions are optimistic with (a) healthy 10% revenue CAGR over FY18-22 equally split between volume and price increase. This is against negative revenue CAGR in recent past (b) expansion in margin from FY19 led by price increase and (c) reduction in employee costs & other opex

Key Model Assumptions

	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	CAGR FY18-22	Remarks
Volumes (Mn Cases)	**90.1**	**76.5**	**82.1**	**85.7**	**89.5**	**93.6**	**5.2%**	Highway ban to impact 1HFY18. We factor 10% volume growth in FY19 and 7% from FY20-22 in P&A.
- P&A	36.8	35.7	39.3	42.0	45.0	48.1	7.7%	
- Popular	53.3	40.8	42.8	43.7	44.6	45.5	2.7%	
Realization/bottle	**78.9**	**83.6**	**89.0**	**92.4**	**95.9**	**99.6**	**4.5%**	To offset the GST and highway ban impact we factor pricing to improve by 6% in FY19 and 3% from FY20-22
- P&A	110.5	112.8	119.5	123.1	126.8	130.6	3.7%	
- Popular	57.0	58.2	61.1	62.9	64.8	66.7	3.5%	
Revenue	**86,560**	**79,252**	**90,563**	**97,988**	**106,082**	**114,911**	**9.7%**	
- P&A	48,814	48,302	56,321	62,071	68,408	75,393		
- Popular	36,476	28,480	31,400	32,988	34,658	36,411		
- Other operating income	1,269	2,469	2,843	2,928	3,016	3,107		Royalty from third party franchising to boost operating income in FY18
Contribution Margin	**42.2%**	**40.8%**	**41.2%**	**41.5%**	**41.9%**	**42.2%**		Contribution margin to be impacted in FY18 owing to increase in tax rate on input materials post GST
- P&A	46.5%	44.5%	44.8%	45.0%	45.3%	45.5%		
- Popular	36.5%	34.5%	34.8%	35.0%	35.3%	35.5%		
Contribution (Rs Mn)	**37,282**	**33,789**	**38,958**	**42,406**	**46,188**	**50,336**		
- P&A	22,699	21,495	25,203	27,932	30,955	34,304		
- Popular	13,314	9,826	10,911	11,546	12,217	12,926		
- Other operating income	1,269	2,469	2,843	2,928	3,016	3,107		
Other Mfg Exps	1,958	2,056	2,200	2,354	2,519	2,695		
% of revenue	2.3%	2.6%	2.4%	2.4%	2.4%	2.3%		
Employee costs	6,882	6,382	5,882	5,382	5,651	5,934	-1.8%	We estimate Rs 500mn synergy in employee costs over FY18-20 though potential remains high
% of revenue	8.0%	8.1%	6.5%	5.5%	5.3%	5.2%		
Other operating expenses	19,069	17,162	17,505	18,906	20,418	22,052	6.5%	We estimate absolute reduction of 10% in FY18 in other operating expenses led by efficiencies and franchising
% of revenue	22.0%	21.7%	19.3%	19.3%	19.2%	19.2%		

	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	CAGR FY18-22	Remarks
Total operating expenses	27,909	25,600	25,587	26,642	28,588	30,680	4.6%	
% of revenue	32.2%	32.3%	28.3%	27.2%	26.9%	26.7%		
EBITDA	**9,373**	**8,189**	**13,371**	**15,765**	**17,600**	**19,656**	**24.5%**	
% of revenue	10.8%	10.3%	14.8%	16.1%	16.6%	17.1%		
IPL Revenue	**1,614**	**1,727**	**1,848**	**1,977**	**2,116**	**2,264**		Revenue share payable to BCCI to reduce from FY19
IPL operating costs	1,077	1,131	961	1,057	1,163	1,279		
IPL EBITDA	**537**	**596**	**887**	**920**	**953**	**984**		
Consolidated								
Revenue	88,174	80,979	92,411	99,965	108,198	117,175	**9.7%**	
EBITDA	9,910	8,785	14,257	16,685	18,552	20,641	**23.8%**	
Margin %	**11.2%**	**10.8%**	**15.4%**	**16.7%**	**17.1%**	**17.6%**		
Depreciation	1,886	2,098	2,251	2,403	2,556	2,708		
Interest Costs	3,751	3,397	3,159	2,922	2,542	2,138		
Other Income	1,053	875	1,040	1,110	1,180	1,250		
PBT	**5,326**	**4,165**	**9,887**	**12,469**	**14,635**	**17,044**	**42.2%**	
Tax	697	1,375	3,263	4,115	4,829	5,624		
PAT	**4,629**	**2,791**	**6,624**	**8,354**	**9,805**	**11,419**	**42.2%**	
O/s shares	145	145	145	145	145	145		
EPS	31.9	19.2	45.6	57.5	67.5	78.6	**42.2%**	

Source: Company, HDFC Sec Inst Research

Upbeat assumptions and rich valuations leave limited room for complacency

Sell with TP of Rs 2,060

Valuation and view

- At CMP, UNSP is trading at 54x FY19E and 43x FY20E EPS. Though we foresee strong earnings CAGR of 57% over FY18-22, led by recovery in volumes, price increase and improvement in mix with P&A to contribute 50%+ vs. 41% currently, and reduction in operating expenses (on an absolute basis vs. FY17, especially for employee costs).

- Optimistic assumptions, though plausible, are fraught with risk. Rich valuations and persistent regulatory adversity associated with the business leave limited room for upsides hereon. We await a better entry-point. SELL with a TP of Rs 2,060 @ 40x Sep-19E EPS.

Sensitivity Of TP At Various EPS And Multiples

Multiple (x)	EPS FY19	EPS FY20	EPS FY21
	43.8	55.6	65.5
30	1,368	1,725	2,024
35	1,596	2,012	2,362
40	1,824	2,300	2,699
45	2,052	2,587	3,037
50	2,280	2,875	3,374

Valuation Matrix / Peer Comparison

FMCG companies	Mcap (Rs bn)	CMP (Rs)	Rating	TP (Rs)	P/Sales (Rs)			P/E (x)			P/BV (x)			EPS CAGR (%) (FY17-19E)
					FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	
HUVR IN	2,568	1,186	BUY	1,363	59.4	49.5	40.6	37.9	36.1	30.9	64.8	74.8	82.0	20.9
ITC IN	3,175	261	BUY	353	30.3	27.2	24.3	6.8	6.4	5.9	23.5	24.2	25.3	11.8
JUBI IN	93	1,416	BUY	1,405	138.6	70.2	48.0	11.2	9.9	8.4	8.4	14.9	18.9	70.0
DABUR IN	549	312	BUY	352	43.0	37.9	32.1	11.1	9.5	8.3	28.0	27.0	27.5	15.6
CLGT IN	289	1,062	NEU	1,062	50.1	40.8	35.4	22.4	18.3	15.1	49.8	49.3	46.6	18.8
MRCO IN	398	308	NEU	340	49.0	40.8	33.1	17.1	15.1	13.2	37.3	39.3	42.5	21.6
RDCK IN*	22	167	NR	-	27.6	24.0	19.5	2.2	2.0	1.8	8.1	8.6	9.7	19.1
UBBL IN*	222	840	NR	-	96.7	74.4	57.7	9.5	8.5	7.5	10.2	12.9	12.2	29.4
UNSP IN	**349**	**2,400**	**SELL**	**2,060**	**77.2**	**128.0**	**53.8**	**19.9**	**17.3**	**13.1**	**27.0**	**14.4**	**27.6**	**19.8**

Source: Bloomberg, HDFC Sec Inst Research *Bloomberg estimates

Financials

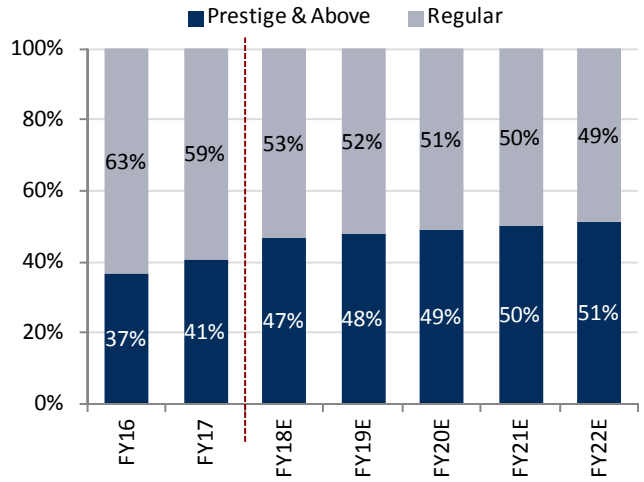
Premiumisation strategy to play out - contribution of the P&A segment to UNSP's volumes and revenue to increase

P&A to contribute to 65% to UNSP's revenue and 46% to volumes by FY19E

Volumes of P&A to grow at 7% CAGR, while regular volumes at 3%

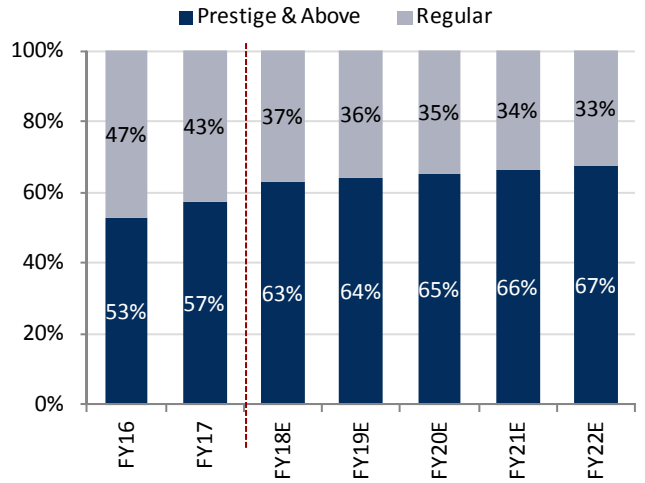
Gross margins to improve on the back of acceleration of premiumisation and price increases

Volume Break-up: Prestige Vs. Regular (%)



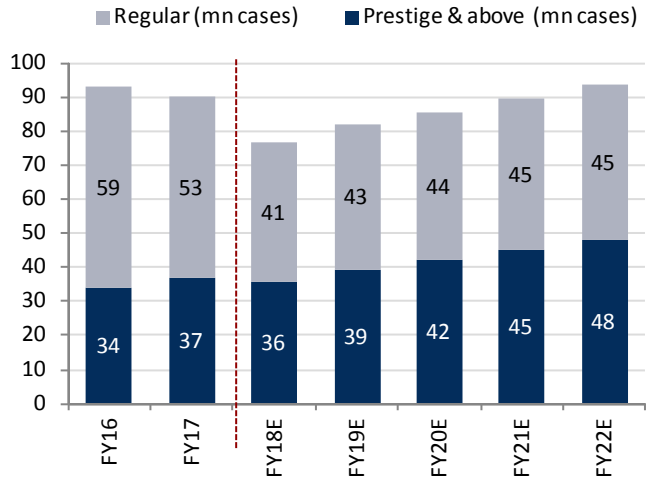
Source: Company, HDFC sec Inst Research

Value Break-up: Prestige Vs. Regular (%)



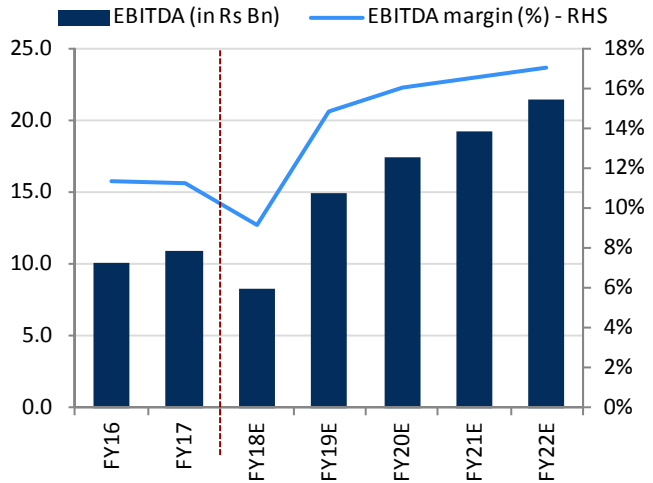
Source: Company, HDFC sec Inst Research

UNSP's Regular And Premium Volumes (Mn Cases)



Source: Company, HDFC sec Inst Research

Trend In EBITDA (Core) And Margins



Source: Company, HDFC sec Inst Research

Company background

Vijay Mallya was appointed Chairman of the company in 1983

Diageo has made two open offers to UNSP shareholders – the second in 2014 being more successful

Currently, Diageo is UNSP's promoter, with a ~55% stake

Diageo has driven various rationalisation initiatives in UNSP, after assuming control in 2013-14

- UNSP was acquired by Vithal Mallya in 1951. Post his demise, Vijay Mallya was appointed Chairman in 1983.
- In 2013, Diageo Plc, the UK-based spirits company, acquired ~25% in UNSP for Rs 1,440 per share through three routes viz (1) Acquiring 14.98% stake by entering into a share purchase agreement with five companies (UBHL, Kingfisher Finvest India Ltd., SWEW Benefit Company, Palmer investment Group Ltd. and UB Sports Management Overseas Ltd., (2) 10% by preferential allotment agreement and (3) 0.04% through an open offer made to public shareholders
- Post this, in 2014, Diageo again made an open offer to UNSP shareholders of Rs 3,030 per share. Moreover, Diageo acquired 3.76% by way of on-market purchases in 2013-14. Currently, Diageo is the promoter and holds ~55% stake in UNSP. The cumulative investment for this stake is ~USD 3bn.
- Currently, Anand Kripalu is the MD and CEO of UNSP, and Sanjay Churiwala is the CFO.

United Spirits: The Story So Far..

Year	Key Milestone
1951	Vithal Mallya acquired McDowell's
1968	McDowell's No.1 Whiskey launched.
1973	Vijay Mallya inducted as Director in McDowell & Co.
1983	Company board unanimously appoints Vijay Mallya as the Chairman of McDowell's, after the demise of Vithal Mallya
2005	McDowell's completes acquisition of Shaw Wallace & Company - brands Royal Challenge, Antiquity, Director's Special, White Mischief amongst others become part of the company portfolio.
2006	United Spirits Ltd, is created through the merger of McDowell & Co Ltd, Herbertsons Ltd, Triumph Distillers and Vintners Private Ltd, Baramati Grape Industries India Ltd, Shaw Wallace Distilleries Ltd and four other companies. UNSP acquires Bouvet Ladubay, subsidiary of France-based Taittinger.
2007	UNSP acquires Whyte & Mackay, UK's scotch whiskey distiller, for GBP 595 mn
2013-14	Diageo plc acquires ~55% shareholding in United Spirits. Currently, UNSP is a subsidiary of Diageo plc
2014	In September 2014, UNSP's board of directors directed an enquiry into certain matters referred to in company's financial statements and auditor's report for FY14. This enquiry was headed by the MD and CEO of UNSP and covered various matters, including certain doubtful debts, receivables, advances, deposits etc.
2015	Sale of Whyte & Mackay to Emperador, for a consideration of GBP 430 mn In April 2015, UNSP board discussed and considered the outcome of this inquiry. Subsequently, UNSP made provisions for doubtful debtors, loan and advances to UBHL, etc., which were reflected in financials of FY14 and FY15 Renovation of key regular brands such as McDowell No.1 and Royal Challenge completed
2015-16	UNSP continued to implement rationalisation initiatives, such as sale of select non-core assets
2016	USL entered into a settlement agreement with Vijay Mallya pursuant to which he resigned from his positions as a director and chairman of UNSP and of the boards of its subsidiaries

Source: Company, HDFC sec Inst Research

Income Statement (Consolidated)

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Net Revenues	**84,949**	**88,175**	**80,979**	**92,411**	**99,965**
Growth (%)	***(9.0)***	***3.8***	***(8.2)***	***14.1***	***8.2***
Material Expenses	47,572	49,297	45,462	51,605	55,581
Power & Fuel expenses	360	348	343	392	424
Employee Expenses	6,800	6,882	6,382	5,882	5,382
Other Operating Expenses	20,571	21,756	20,006	20,275	21,893
EBITDA	**9,646**	**9,892**	**8,785**	**14,257**	**16,685**
EBITDA Margin (%)	***11.4***	***11.2***	***10.8***	***15.4***	***16.7***
EBITDA Growth (%)	***2,819.5***	***2.6***	***(11.2)***	***62.3***	***17.0***
Depreciation	1,572	1,886	2,098	2,251	2,403
EBIT	**8,074**	**8,006**	**6,687**	**12,007**	**14,281**
Other Income (Including EO Items)	162	(2,628)	875	1,040	1,110
Interest	4,574	3,751	3,397	3,159	2,922
PBT	**3,662**	**1,627**	**4,165**	**9,887**	**12,469**
Tax (Incl Deferred)	2,228	697	1,375	3,263	4,115
Minority Interest & Profit/loss from associates	-	-	10	10	-
RPAT	**1,434**	**930**	**2,781**	**6,614**	**8,354**
EO (Loss) / Profit (Net Of Tax)	(274)	(3,681)	-	-	-
APAT	**1,708**	**4,611**	**2,781**	**6,614**	**8,354**
APAT Growth (%)	***n.a***	***170.0***	***(39.7)***	***137.9***	***26.3***
Adjusted EPS (Rs)	**11.8**	**31.7**	**19.1**	**45.5**	**57.5**
EPS Growth (%)	***n.a***	***170.0***	***(39.7)***	***137.9***	***26.3***

Source: Company, HDFC sec Inst Research

Balance Sheet (Consolidated)

As at March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
SOURCES OF FUNDS					
Share Capital - Equity	1,453	1,453	1,453	1,453	1,453
Reserves	14,894	16,403	19,184	25,798	34,153
Total Shareholders Funds	**16,347**	**17,856**	**20,637**	**27,251**	**35,606**
Minority Interest	56	(25)	10	10	-
Secured loans	7,305	8,697	7,697	7,197	6,197
Unsecured loans	29,969	29,069	26,069	25,569	22,569
Total Debt	**37,274**	**37,766**	**33,766**	**32,766**	**28,766**
Net Deferred Taxes	1,579	1,536	1,558	1,547	1,552
Long Term Provisions & Others	1,075	442	500	600	600
TOTAL SOURCES OF FUNDS	**56,331**	**57,575**	**56,470**	**62,174**	**66,524**
APPLICATION OF FUNDS					
Net Block (excluding goodwill)	18,415	18,486	18,888	19,137	19,234
CWIP	2,821	1,993	1,830	2,089	2,259
Goodwill	1,125	680	680	680	680
Investments	9	1	5	5	5
Other non-current assets	6,156	8,528	8,699	8,873	9,050
Total Non-current Assets	**28,526**	**29,688**	**30,102**	**30,783**	**31,228**
Inventories	19,519	19,276	18,314	19,961	21,305
Debtors	23,032	29,534	27,690	32,077	35,233
Loans and advances	8,948	7,808	6,883	7,855	8,497
Cash & Equivalents	1,368	872	1,325	2,033	2,638
Total Current Assets	**52,867**	**57,490**	**54,212**	**61,926**	**67,672**
Creditors	10,189	12,247	10,519	11,593	12,306
Other Current Liabilities & Provns	14,873	17,356	17,324	18,942	20,071
Total Current Liabilities	**25,062**	**29,603**	**27,844**	**30,536**	**32,377**
Net Current Assets	**27,805**	**27,887**	**26,369**	**31,391**	**35,296**
TOTAL APPLICATION OF FUNDS	**56,331**	**57,575**	**56,470**	**62,174**	**66,524**

Source: Company, HDFC sec Inst Research

Cash Flow

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Reported PBT	3,662	1,627	4,165	9,887	12,469
Interest expenses	4,506	3,751	3,397	3,159	2,922
Depreciation	1,577	1,886	2,098	2,251	2,403
Working Capital Change	(6,455)	(2,993)	1,822	(4,499)	(3,472)
Tax Paid	(1,900)	(697)	(1,375)	(3,263)	(4,115)
Others	997	(1,053)	(885)	(1,050)	(1,110)
OPERATING CASH FLOW (a)	**2,386**	**2,521**	**9,223**	**6,486**	**9,098**
Capex	(2,329)	(1,129)	(2,337)	(2,758)	(2,671)
Free cash flow (FCF)	*58*	*1,392*	*6,886*	*3,727*	*6,427*
Investments	8,686	8	(4)	-	-
Non-operating Income	1,705	4,734	875	1,040	1,100
INVESTING CASH FLOW (b)	**8,063**	**3,613**	**(1,466)**	**(1,718)**	**(1,571)**
Debt Issuance/(Repaid)	(1,417)	492	(4,000)	(1,000)	(4,000)
Interest Expenses	(4,612)	(3,751)	(3,397)	(3,159)	(2,922)
FCFE	*(5,971)*	*(1,867)*	*(511)*	*(432)*	*(495)*
Share Capital Issuance	-	-	-	-	-
Dividend	(3)	-	-	-	-
Others	(6,678)	(3,372)	93	100	-
FINANCING CASH FLOW (c)	**(12,710)**	**(6,631)**	**(7,304)**	**(4,059)**	**(6,922)**
NET CASH FLOW (a+b+c)	**(2,261)**	**(497)**	**453**	**708**	**605**
Opening bal of Cash & Cash Equ	3,629	1,369	872	1,325	2,033
Closing Cash & Equivalents	1,369	872	1,325	2,033	2,638

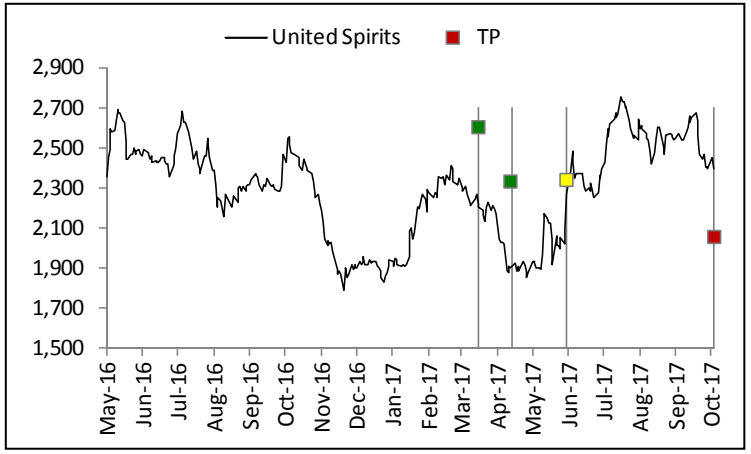
Source: Company, HDFC sec Inst Research

Key Ratios

	FY16	FY17	FY18E	FY19E	FY20E
PROFITABILITY (%)					
GPM	44.0	44.1	43.9	44.2	44.4
EBITDA Margin	11.4	11.2	10.8	15.4	16.7
APAT Margin	2.0	5.2	3.4	7.2	8.4
RoE	14.9	27.0	14.4	27.6	26.6
RoIC (or Core RoCE)	5.6	10.8	7.0	12.8	14.3
RoCE	6.1	11.9	8.9	14.7	16.0
EFFICIENCY					
Tax Rate (%)	60.8	42.8	33.0	33.0	33.0
Fixed Asset Turnover (x)	4.6	4.8	4.3	4.9	5.2
Inventory (days)	*83.9*	*79.8*	*82.5*	*78.8*	*77.8*
Debtors (days)	*99.0*	*122.3*	*124.8*	*126.7*	*128.6*
Other Current Assets (days)	*38.4*	*32.3*	*31.0*	*31.0*	*31.0*
Payables (days)	*43.8*	*50.7*	*47.4*	*45.8*	*44.9*
Other Current Liab & Provns (days)	*63.9*	*71.8*	*78.1*	*74.8*	*73.3*
Cash Conversion Cycle (days)	113.6	111.8	112.9	116.0	119.2
Debt/EBITDA (x)	3.9	3.8	3.8	2.3	1.7
Net D/E (x)	2.2	2.1	1.6	1.1	0.7
Interest Coverage (x)	1.8	2.1	2.0	3.8	4.9
PER SHARE DATA (Rs)					
EPS	11.8	31.7	19.1	45.5	57.5
CEPS	20.7	19.4	33.6	61.0	74.0
Dividend	-	-	-	-	-
Book Value	112.5	122.9	142.0	187.6	245.0
VALUATION					
P/E (x)	204.6	75.8	125.7	52.8	41.8
P/BV (x)	21.4	19.6	16.9	12.8	9.8
EV/EBITDA (x)	40.0	39.1	43.5	26.7	22.5
EV/Revenues (x)	4.5	4.4	4.7	4.1	3.8
OCF/EV (%)	0.6	0.7	2.4	1.7	2.4
FCF/EV (%)	0.0	0.4	1.8	1.0	1.7
FCFE/Mkt Cap (%)	(1.7)	(0.5)	(0.1)	(0.1)	(0.1)
Dividend Yield (%)	-	-	-	-	-

Source: Company, HDFC sec Inst Research

RECOMMENDATION HISTORY



Date	CMP	Reco	Target
17-Mar-17	2,217	BUY	2,600
14-Apr-17	1,906	BUY	2,330
31-May-17	2,265	NEU	2,340
4-Oct-17	2,400	SELL	2,060

Rating Definitions

BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period
NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period
SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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HDFC securities
Institutional Equities
Unit No. 1602, 16th Floor, Tower A, Peninsula Business Park,
Senapati Bapat Marg, Lower Parel, Mumbai - 400 013
Board : +91-22-6171-7330 www.hdfcsec.com