United Spirits Limited

Want to become a millionaire? All you need to do is to invest a billion dollars in the airline industry. To complicate it further fund the investment by taking a lot of debt. This is what Vijay Mallya did when he started Kingfisher Airlines in 2003. What is the result?

United Spirits (USL)	2015	2012
USL total shares outstanding	145,327,743	130,794,968
United Breweries (Holdings) Limited	4,208,556	23,577,293
Relay B V (subsidiary of Diageo Plc)	79,612,346	0
% shares of USL held by UB Holdings	2.90%	18.03%
% shares of USL held by Diageo Plc	54.78%	0%

From 2005 to 2012 Kingfisher Airlines generated cash flow from operations of negative 6,000 crore rupees. The airlines went bankrupt in 2012. In the process, Mallya had to sell his major stake in United Spirits Limited (USL) to Diageo Plc. In February 2016, Mallya resigned as the chairman of USL and he is moving to England to be closer with his children.

What would Warren Buffett tell if he reads the story of Vijay Mallya? He would tell that — “To make the money they didn’t have and they didn’t need, they risked what they did have and did need that’s foolish, that’s just plain foolish. If you risk something that is important to you for something that is unimportant to you, it just does not make any sense. I don’t care whether the odds are 100 to 1 that you succeed, or 1,000 to 1 that you succeed.”

Business

United Spirits Limited (USL), is an Indian alcoholic beverages company and a subsidiary of Diageo, is the second largest spirit company in the world by volume. USL originated as a trading company called McDowell and Company. It was founded in India in 1826 to import liquor to the British people stationed in India. In 1951, Vittal Mallya’s run United Breweries Group bought McDowell and Company. After the death of Vittal Mallya in 1983 his son Vijay Mallya took over the chairmanship of UB Group and McDowell.

From 1983 to 2012, under Vijay Mallya’s leadership, the number of liquor cases sold by USL went up from 3 to 120 million cases. This translates to an annual compounded volume growth rate of 13 percent for 30 years. A case has 9 litres [12 bottles * 750 ml] of alcohol. During

Mallya's tenure USL maintained the top spot by volume with an overall market share of 41 percent in 2012. This is a commendable job and Vijay Mallya deserves some credit for this.

India is one of the most attractive markets for the alcohol industry with growth expected to be around 8 to 10 percent per year. It accounts for 10 percent of global volumes. In 2015, the industry sold around 892 million cases. Indian market can be broadly categorized into beer, spirits, and wine segments. From the image given below we can see that Indians prefer spirits over beer and wine due to higher alcohol content in spirits.

Spirits market can be divided into several segments — Indian Made Foreign Liquor (IMFL), Indian Made Indian Liquor (IMIL), Foreign Liquor Bottled In India (BII), Foreign Liquor Bottled In Origin (BIO), and Illegally Brewed (Hooch). The IMFL pie is organized and it's growing faster than all the other segments. Products sold by USL belongs to the IMFL category.

The IMFL market has two segments — Brown and White spirits. Whisky, Brandy, and Rum are called as brown spirits and they account for 95 percent of the market. Gin and Vodka are called as white spirits. From 2005 to 2015, the total number of cases sold by the IMFL industry grew from 135 to 312 million cases. This represents a compounded annual volume growth rate of around 9 percent.

In 2015, USL sold 117 million cases which represents around 38 percent of total industry volumes. It's McDowell's No.1 franchise, with a presence across whisky, brandy and rum, sold over 52 million cases. This represents around 45 percent of USL total volumes. The image above and the table below shows different kinds of spirits and brands sold by USL.

Type	USL and Diageo Brands
Scotch	Black Dog, Johnnie Walker, and Singleton
Whisky	Antiquity, Bagpiper, McDowell's No.1, Royal Challenge, Signature, DSP Black, and McDowell's No.1 Platinum.
Brandy	McDowell's VSOP
Rum	Celebration Rum
Vodka & Gin	Romanov, White Mischief, and Ciroc
Wine	Four Seasons

USL categorizes its products into four broad price segments — Luxury, Premium, Prestige, and Popular. Its popular brand is targeted for mass market, priced low, and it generates low profit margins. Prestige and above brands are targeted for affluent, middle, and aspiring consumer segments. They are priced higher and it generates high profit margins. From the table given below we can see that USL is aggressively growing its premium offerings. Also, it's degrowing its popular offerings. Why does USL premiumize its offerings?

	United Spirits Limited				
	2015	2014	2013	2012	2011
No of cases sold in millions	117	121	124	120	112
No of prestige and above cases in millions	35	33	29	27	23
No of popular cases in millions	82	88	95	93	89
% prestige and above cases sold	30%	27%	23%	22%	21%
% popular cases sold	70%	73%	77%	78%	79%

> The consumer landscape in India has traditionally been described as a classic “pyramid”, with a large number of households with low incomes forming the base, and a small number of households with large incomes at the pinnacle. With growth being fuelled by both, the economic development and the demographic dividend, India has seen this classic pyramid morph into a diamond shape with the emergence of a rapidly growing “middle class” and the consumer landscape segmenting into three distinct groups, Affluent, Middle and Aspiring, each with distinct consumption drivers and needs. This shifting shape of the consumer landscape and associated changes in consumer preferences, attitudes and behaviours, will not only drive an overall expansion in TBA volumes, but will also drive a shift in the shape of the TBA pool, **with growth in higher margin more premium products projected to exceed that of lower margin “popular” brands, resulting in an overall “premiumisation” of india’s TBA, and overall value growth ahead of volume growth.** - Annual Report; 2015

Before discussing more about the business of USL it is important to know how alcohol is made. To learn about this, I read the book The Science Of Booze. It is an excellent read and the author did a fantastic job in explaining it through the vantage points of physics, chemistry, biology, and metallurgy. Manufacturing alcohol involves three important steps — Malting, Fermentation, and Distillation. Given below are some excerpts from the book which explains these steps in detail. Before reading the excerpts spend some time looking at the illustration [source].

Excerpts from the book [Proof: The Science of Booze]

What is Fermentation?

Yeast was the first eukaryote— that is, the first creature with cells and nuclei— to have its genome sequenced. The miracle of yeast is awesome enough to strain credulity. It's a fungus, a naturally occurring nanotechnological machine that converts sugar to the alcohol we drink. It breeds pretty much everywhere and is one of the organisms on which scientists have built much of our knowledge of how life works.

Fermentation isn't an accident, or a byproduct. It's the way yeasts convert what they eat to energy. That's metabolism, a long sequence of chemical reactions, nipping away atoms here and adding them there, attaching and detaching electrons, all in the service of creating a molecule called ATP, adenosine triphosphate. Inside a living thing, ATP is energetic currency, the stuff that keeps the lights on.

In short, yeast eat sugar, eliminate alcohol from the intestinal tract and CO2 from the urinary organs. A magical tiny creature that pees carbon dioxide and poops out beer?

What is Malting?

Malting is how people turn barley's starch into sugar, which they can turn into beer and booze. Brewers and whisky makers use barley because it's easy. Other grains are maltable, but wheat, for example, produces less starch-breaking enzyme. Oats have too much protein and fat. Corn needs too much heat to untangle the starches before malting, and the oils tend to turn rancid. Barley is the way to go.

Barley, like all grains, is a grass, and the part that we humans eat is its seed. A seed is a bomb of life, an embryo packaged with all the nutrition it will need to be born and a biochemical engine for growth and development. Drop that bomb into water and air and dirt, and it detonates into a plant. But if we're interested in alcohol, we're interested not in the payload— the rootlets and embryo that turn into a plant— but in the packaging. Those seeds are full of starch.

A barleycorn is as streamlined as a tuna. It grows with its "head" pointing inward, toward the stalk, and at the tip where the tuna's brain would be is the barley embryo, a packed bundle of rootlets. Behind that is a wall called a scutellum, which is what turns into leaves. And behind that, taking up almost the entire space of the corn, is the starchy endosperm, food for the embryo (just as the yolk of an egg provides nutrition to a developing bird). Wrapped around that are three layers of enzyme-making cells, the aleuron, and the whole thing is encased in a hard cellulose husk.

All that handling of barley, getting it soaking-wet and then air-drying it, tricks the barley embryo into thinking that it's time to start growing. It triggers a chemical cascade, starting with the production of a hormone called gibberellic acid, which then courses through the aleuron layer. That's a signal to those cells that they should start making enzymes— amylases that can break down starches and proteases that can break down the protein coatings around those starches. Those amylases can break down not just the starch in the barley but in anything— maize (the main component of American-style bourbon whiskies), sweet potato, and even the rice used as an adjunct grain in some beer.

What is Distillation?

A distillery is a factory, an industrial processing plant for fermenting grain and distilling the result into whisky. We distill knowledge to its essence the same way we distill fruit wine to brandy, beer to whisky, fermented sugarcane juice to rum. Fermentation is a natural process, as close to a miracle as a science-minded type like me would ever acknowledge. Over human history we've learned to harness and adapt it. We domesticated the microorganisms that make it possible, designed containers friendlier to it, created businesses around it. But a winemaker taking credit for fermentation is like a beekeeper taking credit for honey. Fermentation would happen whether men and women were here on earth or not.

Distillation, though, is technology. Human beings invented it; we came up with the process and developed the equipment. It requires the ability to boil a liquid and reliably collect the resulting vapors, which sounds simple. But to do it, you have to learn a lot of other skills first. You have to be able to control fire, work metal, heat things and cool them, make airtight, pressurized vessels. You need a big brain with a wrinkled cortex, maybe some opposable thumbs. But most of all you need a desire to change your environment instead of just live with what you have. Distillation takes intelligence and will. To distill, literally or metaphorically, requires the hubris to believe you can change the world.

Water, for example, has a boiling point of 212°F. It has a lower vapor pressure than ethanol, which boils at 173°F. Ethanol is the more volatile molecule. This is the key to distilling booze. The interesting stuff vaporizes and comes out; the water stays behind. Because ethanol is more volatile than water at every temperature, distilling will eventually pull all the ethanol out of a solution— to a point. At 95.57 percent alcohol, the vapor has the same ethanol concentration as the liquid, and you can't squeeze any more out. It's called the azeotropic limit, and it's the upper bound on how potent any spirit can ever be.

USL has a portfolio of 140 brands with 18 millionaire brands, selling more than one million cases in an year. It exports its products to 37 countries and 15 percent of its revenue comes from exports. It has 88 manufacturing facilities that are owned, leased, and contracted. A curious reader should ask why does USL need so many manufacturing facilities? Alcohol industry in India is highly regulated by the state government.

Separate licenses from each state is required for production, bottling, and distribution of alcohol. Tax laws are complicated and it's different in each state. Also, states heavily taxes the inter-state movement of alcohol, which makes it unviable to manufacture in few locations and distribute it across India. This prevents alcoholic beverage companies like USL to achieve economies of scale.

Take a look at the table given below. What do you see? Taxes on alcohol form a significant source of revenue for the state governments. In 2015, USL paid 59 percent of its gross sales as excise duty to the state governments. In less than five years, excise duty went up by 900 basis points. USL passed on the excise duty hike to its customers. This resulted in the slowdown of consumer demand which resulted in low growth in sales. If USL passed on the excise duty hike to its customers then why did the gross margin come down from 48 to 44 percent?

	2015	2014	2013	2012	2011
Net sales (in crores)	₹9,241	₹10,524	₹10,624	₹9,159	₹7,355
Excise duty	59%	56%	51%	50%	50%
USL market share	38%	39%	41%	41%	41%
Gross margin	44%	45%	44%	45%	48%

It happened because of two reasons. Extra neutral alcohol (ENA) accounts for about 40 percent of the total cost of good sold. In order to support the cash-starved sugar mills the Indian government has asked the oil marketing companies to boost ethanol blending with petrol by 10 percent. This resulted in increasing the demand for ENA and its price went up from 27 to 49 rupees per bulk litre. You can read about this news here.

In the last four years, Indian currency depreciated by over 40 percent against the dollar. This resulted in increasing the cost of major components such as glass and other key raw materials. Why did USL not pass on this price increase to its customers? Alcohol price increases are regulated by the state. The companies need to negotiate with the state before increasing the price. For example in states like Tamil Nadu it took six years before the price got increased.

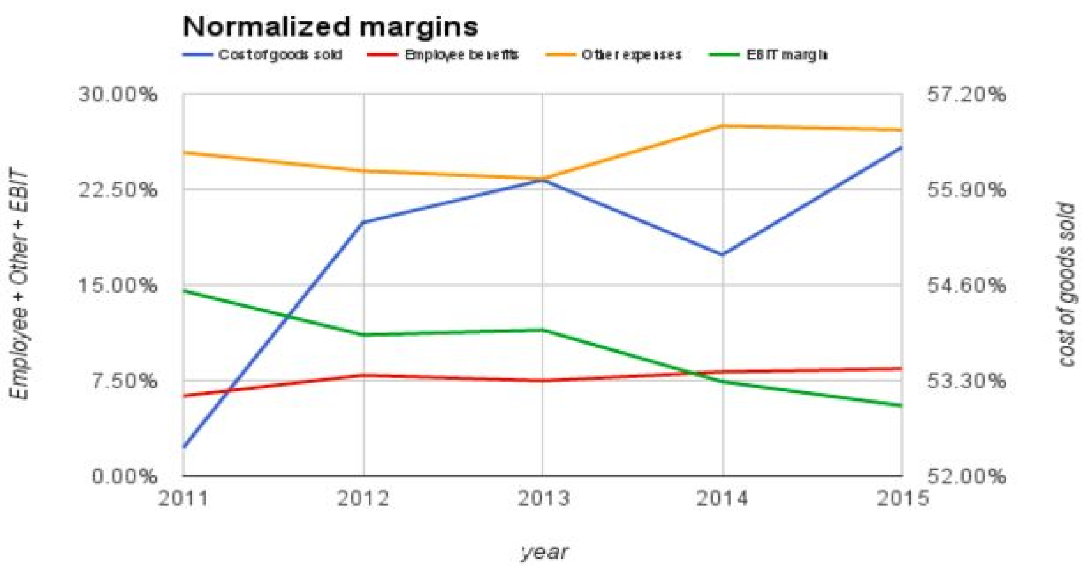
> **In a scenario where nearly three out of every four cases are sold by the Company to para-statal organisations, price increases are not easy to come by.** However, your Company continues to be in the forefront of discussions with these agencies to push through price increases. Notwithstanding this, your Company has managed price increases in various states through a mix of upgraded product launches at higher price points and judicious price corrections in certain markets as also through reduced trade spends. - Annual Report; 2013

USL is aggressively increasing its premium offerings and reducing its presence on mass market segments. This is another reason why net sales went down in 2015. And this is the reason why USL market share went down from 41 to 38 percent in less than five years. USL's previous management focused too much on gaining market share and compromised on the profitability. The present management is focusing on 14 power brands and emphasising premiumisation to earn more profit per case sold.

Take a look at the table given below showing the financial snapshot before and after Diageo's took over USL. What do you see? A cursory glance at the table would make you feel that Diageo screwed up the whole thing. Both sales and EBIT have declined since Diageo took over USL. On top of that the equity capital of USL almost got wiped out. What is going on? Sales declined due to **(1)** excise duty hike and weak consumer demand **(2)** purposefully reduce volumes on low margin popular segments **(3)** divestiture of subsidiaries including the sale of Whyte & Mackay (bulk scotch seller).

(in crores)	2015	2014	2013	2012	2011
			After Diageo	Before Diageo	
Net sales	₹9,241	₹10,524	₹10,624	₹9,159	₹7,355
Expenses	₹8,731	₹9,745	₹9,405	₹8,144	₹6,285
EBIT	₹510	₹779	₹1,218	₹1,015	₹1,070
Invested capital	₹4,567	₹6,508	₹4,663	₹5,429	₹6,288
Fixed Assets	₹1,973	₹2,908	₹2,796	₹2,821	₹2,069
Working capital	₹2,594	₹3,600	₹1,868	₹2,608	₹4,219
Equity	₹660	₹3,032	₹4,787	₹4,662	₹4,179
Debt	₹4,771	₹8,036	₹7,089	₹7,292	₹6,381
Goodwill	₹62	₹2,902	₹5,205	₹5,167	₹4,432

From 2011 to 2015, EBIT margin, excluding extraordinary and other currency exchange related items, came down from 14.54 to 5.52 percent. Half of that decline was explained already by the increase in cost of goods sold. The other half is explained by the increase in employee and other expenses operating on a lower sales base. Both these factors resulted in EBIT margins coming down by 900 basis points.



Will EBIT margin improve in future? Hold on to this question for some more time. I will discuss it in the next few pages. In 2007, USL acquired Whyte and Mackay (W&M), primary supplier of bulk scotch to global liquor companies, by paying GBP 595 million. After Diageo acquired a major stake in USL it sold W&M to Emperador in 2014 for GBP 400 million. The sale proceeds were used to pay down USL overseas debt. In the process, USL had to incur a loss and it wrote down the goodwill associated with W&M. This is clearly reflected in the above table with the reduction of debt and goodwill. Why did USL venture into this transaction?

> USL bought W&M with an eye to ensure long-term scotch supplies for the India business and gradually build W&M's branded business in India and international markets. However, this was a very challenging task as the developed markets have strong incumbents in the segments where W&M operates and USL lacks any scale in these markets. USL was struggling to build the branded business of W&M in developed markets. **Diageo clearly stated in its investor call post the deal with USL that W&M was not core for the company and it could look to sell the business if there are regulatory issues in the UK.** - Credit Suisse Report

Under the Sick Industrial Companies Act (SICA), if the accumulated losses of a company, at the end of any fiscal year have resulted in the erosion of 50 percent or more of its peak net worth during the preceding four fiscal years such a firm is mandated to report to Board Of Industrial and Financial Reconstruction (BIFR). You can read more about BIFR here. As of 31-Mar-2015, USL accumulated losses touched 86 percent of its peak net worth. After getting the shareholders approval, USL reported itself sick to BIFR. The table given below shows why the BIFR trigger got fired.

(in crores)	2011	2012	2013	2014	2015
Peak net worth	₹5,262	₹5,567	₹5,850	₹2,808	₹846
Accumulated Losses				(₹3,079)	(₹5,045)
Accumulated Losses as % of peak net worth			Peak net worth	-52.6%	-86.2%

Several items including provision on advances to UB Holdings of Rs 995 crores and diminution in the value of long-term investments-loans-and-advances to subsidiaries of Rs 716 crores increased the accumulated losses to hit the BIFR limit. This is the reason why shareholder's equity of USL went down over the years. Does this mean that USL is in trouble? The company is not in any trouble and USL believes that the provisioning mentioned above is mainly due to exceptional factors and it does not reflect upon the long term prospects of its business. Diageo plan for USL can be clearly seen from the commentary [emphasis mine] of Anand Kripalu, who is the new CEO of USL.

> Robust performance in the quarter and we continue to build confidence in our strategy behind our **power brands** and our prioritized geographical participation strategy. The Diageo brand portfolio integration positively impacting both top line and operating margins. Our focus on **reducing debt** continues with a 27% reduction in our net debt in the nine month period (circa Rs. 1,400 Crore), driven by our **non-core asset divestment** strategy and the continued **positive cash flow from operations**. Our premiumisation strategy and the benefit of the full integration of the Diageo brands

into our portfolio driving the **"Prestige and Above"** segment growth of 25% in the nine months and 41% in the quarter. Our **renovations strategy** continues on our core brands with continued momentum from our Royal Challenge brand post its re-launch (58% volume growth in the last nine months) and the new look McDowell's No.1 re-launch that is underway with early signs of positive consumer and trade response. - Anand Kripalu; [Third quarter 2016]

Moat

Bruce Greenwald once said that — As a first rule of thumb, if you can't count the top firms in an industry on the fingers of one hand, the chances are good that there are no barriers to entry. Such a simple and powerful idea to see how the competitive forces affects an industry. Take a look at the table given below. In India, top 3 organized players control 61 percent of the market share. This clearly tells that the barriers to enter into the alcoholic beverage industry is very high.

Companies	Market Share
United spirits	38
Pernod Ricard	15
Allied Blenders and Distillers	8
Others	39

Why is it very hard for a new player to enter into the Indian alcohol industry? Alcohol is a state subject in India. Each state has its own rules and tax structures. Also, states heavily taxes the inter-state movement of alcohol, which makes it unviable to manufacture in few locations and distribute it across India. To achieve pan-India presence a new player need to set up factories in at least 15 states. In states that contribute over 65 percent of volumes in India, the distribution of beverage alcohol is controlled entirely by the government.

Segment	Range	Competitors	Competitor Brands
Premium	High end	Pernod Ricard	Royal Stag, Seagram's Imperial Blue, Blenders Pride, and 100 Pipers scotch.
Prestige	Mid range	Allied Blenders and Distillers	Officers Choice and Jolly Roger Rum.
Popular	Low end	Radico Khaitan, Jagajit Industries, Tilaknagar Industries and John Distilleries	Several low end brands.

Even large global companies such as Diageo struggled to get distribution when it was operating as a separate company. On top of all this, advertising of alcohol is banned on mass media like television [surrogate advertising is allowed]. This makes life much harder for a new entrant to create brand awareness and loyalty. If a new entrant can neither achieve economies of scale nor create customer captivity then he doesn't have any incentives to enter the game. This allows the incumbents to maintain and grow their market share over time.

As shown in the above table there is heavy competition among incumbents from popular to premium segments. Take a look at the EBITDA per case made by different players in the industry. Pernod Ricard operates only in the prestige and above segments. It generates mouth watering EBITDA margins of 25 percent. Pernod Ricard margins are 1400 basis points higher than that of United Spirits and Radico Khaitan. What does this tell you?

	Pernod Ricard	United Spirits	Radico Khaitan
EBITDA margin	25%	11.6%	11%
EBITDA per case	₹425	₹100	₹97
Notes	Estimates from Credit Suisse.	USL's EBITDA during the first nine months of 2016 is 11.6 percent.	Five year average EBITDA is 11 percent.

As USL is pushing hard to move towards selling more premium brands there is a lot of room for its EBITDA margins to improve. Roughly 10 percent of USL's current EBITDA comes from Diageo's premium brands like Johnnie Walker. If USL can execute successfully on its strategy to premiumize then I wouldn't be surprised if its EBITDA reaches 18 percent levels. One of the key invariant that an investor of USL should use to measure its progress is EBITDA per case.

Valuation

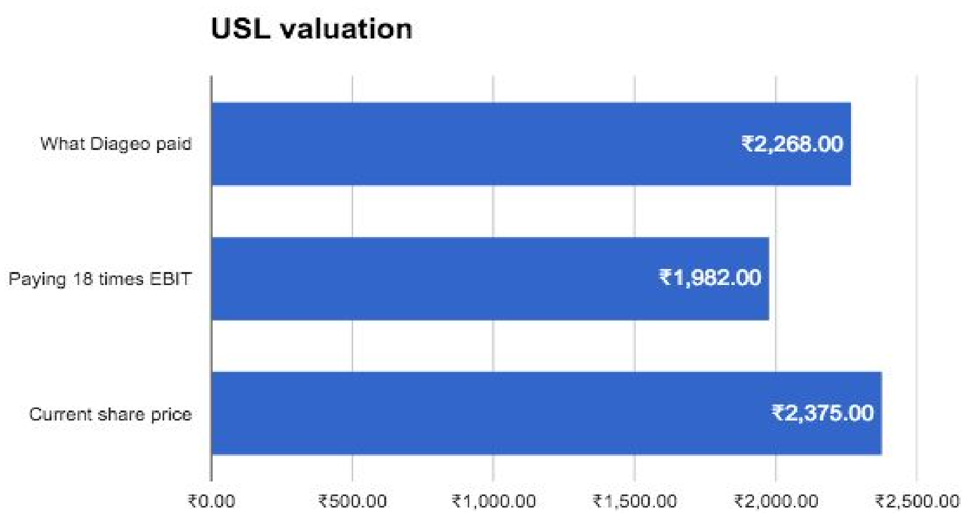
One of my favorite value investing teacher is Bruce Greenwald. According to Bruce, for an investor to be on the right side of the trade, he needs to be a specialist. In one interview he tells that — If I'm a specialist in South Texas Gulf Coast onshore oil leases and that's all I do, and you fly down from New York and buy an oil lease from me based on a vague idea of peak oil, guess who made money in that transaction? I did.

Diageo's stake in USL				
Year	No of shares	Price per share	Total value (in crores)	% of USL shares
2013	36,359,192	₹1,440.00	₹5,235.72	25%
2014	5,526,608	₹2,500.00	₹1,381.65	4%
2014	37,785,214	₹3,030.00	₹11,448.92	26%
	Weighted share price	₹2,268.00		

For a moment let's assume that Diageo, like the oil dealer in South Texas, knows the fair value of USL and paid the fair price for its stock. How much did Diageo pay for a share of USL? From the table given above we can see that it paid around 2,268 rupees per share. I am going to keep this as the floor price for the stock. This price doesn't include all the writeoffs it did and the parting fee of 515 crore rupees it paid to Vijay Mallya. This is what Diageo wrote when it acquired an initial stake in the business — This represents a 18x multiple of USL's EBITDA for the year ended 31 March 2013 and the transaction is expected to be eps accretive in year 2 and economic profit positive in year 5 assuming a 12% WACC [source].

Let's assume that USL on a steady state is going to generate net sales of Rs 10,000 crores. If USL can execute well on its strategy then generating a 16 percent EBIT margins seems very reasonable. For a business with **(1)** leading market share of almost 40 percent **(2)** world class brands **(3)** growth protected by moats **(4)** under able Diageo's management, paying 18 times EBIT is reasonable. This means that each share of USL should be worth 1,982 rupees. The current share price of Rs 2,375 doesn't appear expensive.

> With 18% growth in sales, India turned in an excellent performance, and I'd like to hail the work of our staff there. India is a fascinating market with sizable potential: more than 22 million people reach the legal age of alcohol consumption each year. That's 220 million people over the course of a decade. - Pernod Ricard; Annual Report



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Disclaimer: As of this writing, I don't own any shares of United Spirits Limited. This is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the company and the industry. I am sharing it so that you can learn something from this.

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