



Q3 FY2017 Earnings Call Transcript – Feb 3, 2017

CORPORATE PARTICIPANTS

- Amit Jatia – Vice Chairman
- Smita Jatia – Director
- Suresh Lakshminarayanan – Chief Financial Officer
- Ankit Arora – Senior Manager, Investor Relations

Moderator

Good day ladies and gentlemen, good day and welcome to the Westlife Development Limited Q3 FY17 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode, and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during this conference call, please signal for an operator by pressing “*” then “0” on your touchtone phone. I now hand the conference over to Mr. Ankit Arora – Senior Manager, Investor Relations. Thank you and over to you, sir.

Ankit Arora

Thanks, Margaret. Welcome everyone, and thank you for joining us on Westlife Development Limited earnings conference call for the third quarter and nine months ended December 31st, 2016. We are joined here today by Amit Jatia – Vice Chairman, Smita Jatia – Director and Suresh Lakshminarayanan – Chief Financial Officer of Westlife Development Limited.

Please note that results, press release and investor presentation had been mailed across to you earlier, and these are also available on our website www.westlife.co.in. I hope you had the opportunity to browse through the highlights of the performance. We shall commence today's call with key thoughts from Amit, who will provide the strategic overview, which shall be followed by Smita to take you through the key business initiatives, and Suresh will cover analysis of the financial performance and highlights during the review period. At the end of the Management discussion, we will have Q&A session.

Before we start, I would like to remind you that some of the statements made or discussed on this call today maybe forward-looking in nature and must be viewed in conjunction with risks and uncertainties we face. A detailed statement and explanation of these risks is available in this quarter's press release and investor presentation and in our annual report

which is available on our website. The company does not undertake to update these forward-looking statements publicly.

With that said, I would now turn the call over to Amit to share his views. Thank you.

Amit Jatia

Thank you Ankit. Good evening everyone and thank you for joining us on this call today. In line with our vision 2022 that we had communicated in March last year, we had focused on the business drivers that we can most influence. We have invested significant time and effort in further strengthening the foundation of brand McDonald's in India. Our results demonstrate the progress that we are making each day against our plan. Within a challenging operating environment, we are delivering solid sales performance, capturing efficiencies in our restaurants and tight G&A discipline. Turning to the third quarter, I am pleased to share that we reported 6th consecutive quarters of positive comparable sales of 5.1% while maintaining a strong double digit revenue growth of 14.6% in the quarter ended December 2016. Despite the economic uncertainty and sporadic slowdowns in the market, our bold actions have differentiated brand McDonald's in the minds of consumer across the QSR segment. We have increased our addressable market through brand extensions including opening of 100 McCafé's in within a short period of 30 months and aggressively expanding the delivery business. We carefully looked at our entire business model and reset the foundation for new restaurant growth by innovating and implementing ROP 2.0 thereby reducing development cost and improving margins for the new openings. I am pleased to share that the basket of restaurants opened from January 2016 are contributing positively to operating cash flow. In November, post the government's announcement of demonetization, discretionary consumption saw some impact as consumers with a liquidity crunch were cautious on where they spend. We do saw a short term dip of ~8%-10% in the revenues largely due to the liquidity crisis across the country due to

demonetization. However, our substantial investments behind cashless technology helped us recovery quickly. We saw an overnight jump in the cashless transactions from a 22% to 75%, which has now stabilized at 50% week-on-week. We quickly built back our business leading to strong positive comparable sales in December, backed by a strong October and therefore an overall strong quarter. Continuous focus on building branding extensions, our branded menu platforms like McAloo Tikki and Fries and constantly expanding the McDelivery platform are driving more customer occasions to visit and use brand McDonalds, in turn driving strong comparable sales growth. Each of these platforms has added a phenomenal dimension to brand McDonald's with strong consumer connect, evolving the McDonald's experience and adding more occasions to visit the restaurants. McDonald's is well positioned to lead the QSR segment and these steps and investments will go a long way in delivering our vision of 2022. I would now like to handover to Smita to talk specifically on quarter three.

Smita Jatia

Thank you Amit and good evening everybody. Our financial performance of quarter three reflects a strong brand positioning despite uncertain macro headwinds in the country. Comparable sales at 5.1% with a strong traction for the 6th consecutive quarter with positive SSG. Our total restaurants stand at 252 with 7 new additions in the quarter and a total revenue growth of 14.6%. With this we ended the quarter with a restaurant operating margin at 12% and operating EBITDA at 5.8%. Highlights of the quarter were a 20-year celebration brand campaign along with McCafé and Delivery also driving strong growth. Under broadening accessibility, we continue to increase our footprint. We opened 7 new restaurants in the quarter with the new city opening. In the last 12 months, we opened 29 new restaurants, taking our restaurant counts to 252. A major presence still continues to be in Maharashtra followed by Karnataka and Gujarat, while we continue to increase our presence in the

other states. Our new restaurants opened on the new ROP 2.0 platform are delivering strong results thereby reducing drag on margins.

Coming to growing baseline sales, under value, menu and brand extensions, we started the quarter with a 20-year celebration with a brand film on air. This helped in winning share of heart and creating brand loyalty. Bouncing back with strong sales in December straight after demonetization is a testimony to our brand connect. We continued with our Aloo Tikki festival with the Mexican and Lebanese flavors in addition to the loaded Mexican fries thereby strengthening our core menu offering. Coming to brand extensions, we strengthened our position as a dominant player in the coffee & beverage market. We have opened 104 McCafé's and new products under this platform continue to drive sales and create differentiation. In this quarter we also launched our new mobile app with refreshed and a contemporary interface. The delivery platform continues to deliver strong sales and through the web and app platform providing convenience to our customers contributing to 55% of total delivery sales. As a result, our baseline continues to get stronger with product innovation, core and value platform, brand extensions like MDS and McCafé and of course the customer experience. All these levers help us in sustainably delivering our 6th quarter of positive comps sales with no dependence on discounting and offers. On margin expansion, our gross margins remained flat. Restaurants built on the new ROP platform reduced drag on margins. However, muted sales in November due to demonetization resulted in higher fixed cost leading to a decline by 100 basis points in restaurant operating margins. I now handover to Suresh, who will go into detail on the financial performance.

Suresh L

Thank you Smita and good evening everybody. I will now take you through the business performance for the third quarter and nine months ended 31st December, 2016. Overall the financial performance is very encouraging despite the demonetization headwind in the month of

November where we were impacted by around 8%-10% as mentioned by Amit in his opening remarks. We are delighted to see remarkable recovery in December coupled with strong October on account of festive season which has led to this 6th consecutive quarter of positive comparable sales of 5.1% compared to 3.1% in Q3 FY16. This has contributed to the significant top line growth this quarter as well. This clearly demonstrates good response by our loyal customers to the brand. We launched the brand campaign in conjunction with the completion of 20 years of our existence along with the differentiated menu offerings of Aloo Tikki and cheesy fries and coupled with the addition of new restaurants has helped us deliver 14.6% growth in our total sales in Q3 and YTD sales growth of 13.7% in FY17. While we maintained our gross margins year-on-year, our restaurant operating margins saw a dip of approximately 100 basis points largely on account of impact on sales during the month of November coupled with brand related as well as payroll and employee costs in the quarter.

As mentioned by Smita earlier it is quite heartening to note that the new restaurants opened on the ROP 2.0 platforms are performing in line with our expectations and are expected to contribute to profitability significantly in future. Upfront investments are required to provide a better customer experience to help keep the brand modern and relevant and also to augment the expansion of brand extensions. This has led to higher G&A expense Y-o-Y which resulted in operating EBITDA margins for the quarter at 5.8%.

Lastly, we shall continue to build on strategic initiatives across the system and as consumer sentiments are advancing slowly and becoming positive, we believe we have strengthened our foundation due to strategic investments in the brand and customer offerings and it should help us deliver profitable growth in future. With that said, I would now handover

back to Amit who would take you through the outlook and give the closing remarks.

Amit Jatia

Thank you Suresh. From a broader perspective, we see the overall uptick in the consumer sentiment. Our focused efforts on menu and brand advertisement have resonated well with our customers helping us create brand affinity. I'm confident of our menu strategy and our product line up which has been robust in the recent times. We remained committed to being the most accessible brand to consumers and we will focus on bringing more customers to our existing base while opening new restaurants to service future demand. We are focused on acquiring good quality real estate to stay on track to take our restaurant footprint to 450 to 500 by 2022. This will be aided by efficient unit economics for new restaurant openings yielding strong results in the future. We are determined to keep our focus on strengthening our brand by catering to local preferences and providing our guest with a relevant McDonald experience, driving sales and tightening up our cost structure. To conclude, our pipeline for growth is strong and we have various initiatives under test for future growth to ensure we remain connected and relevant with the fast-evolving consumer. We believe our consistent and long term approach will help us accelerate momentum and position us to deliver significant profitable growth in the future for our shareholders.

Thank you very much. I now open it up for question and answers.

Moderator

Thank you. Ladies and gentlemen, we will now begin with the question and answer session. The first question is from the line of Sameer Gupta from India Infoline. Please go ahead.

Sameer Gupta

Sir, the first question from my side, you mentioned about these expenses going up because of your brand related investments. Could you just elaborate on what exactly have been these investments?

Amit Jatia Basically see, overall what happened is that obviously the November aspect was not anticipated and essentially we had a brand campaign running at that time which was 20 year advertisement that Smita talked about. So essentially, we could not cut all those expenses in the short term while it yielded no result in terms of top line growth for November. As we were not able to cut all our costs very quickly which led to a bit of a higher cost structure in this particular quarter.

Sameer Gupta Sir my understanding is that, this event wouldn't have happened, still you would have seen this 33% jump in the G&A expenses, am I right on this?

Suresh L If you are referring to G&A, let me just clarify this I will clarify it in 3 parts. Demonetization in November and its effects from the top line has had an impact on the percentage, firstly. Secondly, as mentioned earlier by me certain upfront investments have been made to keep the brand modern and relevant as also to augment expansion of our brand extensions. So there are some costs associated with that. And last but the most important aspect is that, we see this to be within our normal range on an annualized basis and definitely giving us leverage in FY'17 over FY'16. So on a quarter basis you may see a skew, but on an annualized basis we are well within our accepted range of what it ought to be.

Sameer Gupta So sir my question again would be, if the demonetization wouldn't have happened you still would have seen a 30%-33% increase, right?

Suresh L Yes, on a rupee wise basis but as a percentage it would have been lower.

Sameer Gupta Are there any offers or promotional offers that you had given because of which this number is looking higher?

Amit Jatia No, it doesn't go into G&A. Those costs go into food and paper cost, so you would have seen that. There is no such thing as promotion cost in G&A. So like Suresh mentioned to you, over the full year the number will

normalize. So it is not going to be higher than what you have normally seen in the past.

Sameer Gupta Got it sir. Second question would be, could you just give a sense of the monthly trend of SSSG in this quarter?

Amit Jatia We won't be able to share absolute numbers but obviously November was extremely difficult, in fact it trended towards negative, but as you can obviously sense that October and December were absolutely fantastic, which is why we got the 5.1% in the quarter. So normally we do not share monthly numbers but just to give you perspective, October and December really made up for the impact we had in November.

Sameer Gupta So sir, did December like reach back to the October levels or it was very strong but lower than October?

Amit Jatia No, I would not be able to respond to that quantitatively, but what I am just saying is that remember if I have given you the indication that November was kind of in the negative territory. So basically both months were absolutely rock solid for us to be able to do 5% comps for the quarter.

Sameer Gupta And sir how was January been, if you could give a sense on that?

Amit Jatia No, I cannot unfortunately. Next quarter I will surely talk about January, but right now I cannot.

Sameer Gupta Sir just one last question. If you could just give you the cashless contribution before the demonetization and currently?

Amit Jatia Sure. We were at about 22%. Currently, we are trending at ~50%.

Sameer Gupta And you said you saw a spike to about 75% in the first week.

Amit Jatia Correct. We did.

Moderator Thank you. The next question from the line of Manjeet Buaria from Solidarity Advisors. Please go ahead.

Manjeet Buaria Sir I wanted to understand how does the advertising structure work for McDonald's in India? Since there are two master franchisees do you commit like a certain percent of revenues which goes to the national pool and then the decision is taken or it is your own standalone decision?

Amit Jatia Primarily given the current issue that is going on in North India, we are making our own call, as you would have noticed that our advertising spends are between 5.3% to 5.6% percent of sales on a full year basis and we are continuing with that trend.

Manjeet Buaria Sir, so what I wanted to understand was I am not aware of how aggressively McCafé's are being expanded into North and East India but if we were to advertise for just McCafé since they are reaching some critical mass, how do you look at it?

Amit Jatia Firstly, there are zero McCafé's are North India but we got very good scale in West & South with 104, and without any advertising it has been doing extremely well. I mean this is the power of $1+1+1=5$. So what happens is that we already have 185 million customers coming to McDonald's on an annual basis in West and South and this is the point I have been making over the 3 years, that as we expand our offering we do not even need to go and look outside for new customers. These customers who are already brand loyal, they find new opportunities to visit McDonald's and what we found is again if the McCafé sales were Rs. 100 in a specific restaurant, today the average volume has gone up quite dramatically and trending extremely strong without any advertisement. So the whole advantage has been, one, the customers who are already coming to us. Two, the way we expanded the menu in McCafé. We started only with Ice Tea, Frappes, hot coffee etc., while today we have smoothies, we have our ice coolers, we have done the share shakes and we continue to play with more and more

menu items. So, we feel when the time is right, we will not shy away from advertising around McCafé, but currently we feel the word of mouth is doing that job. Also, I feel the products have come up really well and the fact that we have such a strong customer base already has really worked for us.

Manjeet Buaria Sir, one final question around this is, so when we see, advertisements on National Television, so that is completely funded by you right now?

Amit Jatia Not necessarily. In the past, national television was always a shared national expense and even today there is some sharing that takes place. So it not only our cost, there is contribution from North India into the contribution of advertising as well.

Moderator Thank you. The next question is from the line of Aditya Joshi from Religare Capital. Please go ahead.

Aditya Joshi Sir my question is pertaining to gross margins. We maintained a gross margin which was 60.4% in this quarter, given the perishable commodity prices like the vegetables, etc., seeing us very sharp drop post demonetization, however, our gross margins didn't move much so any thoughts on that?

Amit Jatia See, we do not do purchasing month-on-month or week on week, so when Demonetization happened on November 8, given that in India McDonald runs 400+ restaurants. Thankfully we were not buying for the next month or week, so it has no bearing on the quarter for sure. But if demonetization has brought inflation down, that benefit will surely help in the quarters to come.

Aditya Joshi But sir, the raw material that goes in our food preparation that we have a contract manufacturing and it is pertaining to the current market prices, isn't it or do we have a fixed pricing policy with our supply chain.

Amit Jatia

See, is very simple if you want French fries in restaurant, I do not buy potatoes on 9th of November, so that I can have French fries in the restaurant on 10th of November, it just doesn't work like that. So, obviously there is a full supply chain factor in there and any event that happens, it takes a few months or few quarters before the impact actually starts coming into the P&L. So there is a full supply chain which operates from farm to fork and inventory management is done for a longer timeframe. So if the trend of inflation continues to be in the right direction and it remains low, obviously the benefit will come into gross margin at some point in time.

Suresh L

So both ways do not impact us, that is the point that we are trying to make because these are long term arrangements and we have a fairly robust supply chain in place, so spike do not really impact us. Whatever happens over a long period of time, you will see the effect of that in our P&L.

Aditya Joshi

Sir next question is regarding to our employee cost. We have seen a 20% hike. Your thoughts on that?

Amit Jatia

See, during the Diwali period it is obviously festivity and business goes up quite well. So we were all geared up for that, basically we were ready to deal with customer volumes. Now business dropped substantially as we have given indication of 8%-10% in November, which is substantial impact on our P&L given our sales run rate for the month. So we do not sack people tomorrow if business has gone down. So we had to carry that cost and in fact the reason it has come out quite well is because of great October and December. Other than that there are 29 new stores that came into the system as well on Y-o-Y basis. My point is like I have always maintained that, our business is also sensitive, if something happens and the impact comes instantly in a month or week. The fact is that it is a high operating leverage business and there is fixed cost and we are not running this business for a quarter or a month. We have to take long term calls, so

that we continue to build the equity with our employees, with our customers and so on. The margin impact has largely been attributed to the impact of business we had, in fact we felt that without demonetization it would have been a good quarter, even from a margin point of view.

Aditya Joshi Sir next question is regarding to the McDelivery segment of ours. How have we seen the business performing pre and post demonetization? We know that it has been growing at a steady pace, but this quarter has it been a bit different post the demonetization?

Amit Jatia No, other than the normal impact, again remember that if you were to deliver 5% comps with one month being quite week, all the engines have to be running quite well, so I must say that both McCafé and Delivery have contributed as they have always contributed to deliver sales growth as well as comps growth we have seen in the quarter.

Aditya Joshi Sir, next question is regarding to the McCafé itself. So sir we have opened 11 this quarter, correct?

Amit Jatia Correct.

Aditya Joshi So going forward will we maintain a similar run rate, or it will be getting more aggressive on opening McCafé's?

Amit Jatia See, we feel we have been very aggressive with McCafé's, but remember to do it right you need Barista training and that there is a human element plus we like to change the look of the restaurant along with the launch of McCafé in our older restaurants, because we feel that gives us the best results. If you visit any of the McCafé stores you will find that it is a very modern restaurant with a wonderful look and feel and which is working very well for us. So firstly we will meet our guidance of having between 110 to 130 McCafé's by the end of the year. Additionally we will continue to maintain the same focus. We believe that every single restaurant that we

have on hand which are 252 can actually take a McCafé. So, over time we are going to catch up with the backlog of the current restaurant base plus new restaurants will also open with McCafé. We have given in our vision 2022 that we expect to be 300-350 McCafé's in the next 5 years and we will be a significant player with significant revenues coming from McCafé, like I said not only are the number of McCafé's growing but the average volume per unit of McCafé is also growing extremely well. So we are going to continue to step on the gas on McCafé.

Aditya Joshi

Sir, next question is regarding newly introduced Breakfast menu. Has it seen a good performance, any thoughts on that?

Amit Jatia

It is done well. I will give you more flavor by the next quarter because it is early days. We launched it only 20 days ago, but generally a lot of products have caught the fancy of consumers and we feel there are certain products in there that are the Aloo Tikki of Breakfast in our view and consumer feedback has been generally positive. So we feel like McCafé it became a driver for our business over the last 30 months. We feel over the next 2-3 years, breakfast is going to continue to be a similar driver. If you look at our strategies, we always think 2-3 years ahead and if we want to continue to maintain the growth of same store sales and top line we got to keep coming up with new brand & product line extensions, and that is what you will find with McDonald's. It is not going to be just around discounting. It will be around value, it will be around brand and it will be around brand extensions etc.

Aditya Joshi

And sir currently, offerings of different variants of McAloo Tikki, will that be continuing, or it was a limited period offer that we will discontinue any time soon.

Amit Jatia

The Mexican variant is there and it is still on. So we expect it to continue. The response from the consumer has been excellent.

Aditya Joshi Yes, Mexican McAlloo Tikki is much better than the Lebanese.

Amit Jatia So your wish is fulfilled and it is on the menu, so please do visit McDonald's often.

Aditya Joshi Sure sir, one last question. Any aggressive plans on Goa expansion, because as a territory it sees a lot of international travelers and you just have one store there right now?

Amit Jatia We believe in sustainable growth. So once we enter a city we like to own it. So you will continuously see us opening restaurants in Goa as it makes business sense. So, yes you will see more restaurants come up soon, but we believe in aggressive but sustainable expansion. So that is the best I can say at this point.

Moderator Thank you. We will move to the next question which is from the line of Avinash Nahata from Aditya Birla Money. Please go ahead.

Avinash Nahata My question is regarding lease rentals we are almost three months into demonetization, are we approaching differently as far as the properties we were chasing for opening new stores or has the environment been more conducive to us in terms of structuring our lease agreements? Is it happening faster? How are we approaching this?

Amit Jatia I am not seeing the marked change in the way we are approaching it, maybe it is too early at this point in time because it is effectively three months post the demonetization. I am sorry I don't have much flavor on that at this point in time but I am not seeing a major difference.

Avinash Nahata So how do you see this rental inflation panning out for your incremental stores?

Amit Jatia I think through the cycles of ups and downs, what happens for good properties in a downturn is actually the landlord is willing to talk to us and

they are willing to do a long-term deal with us. So we look at that as an opportunity. So I feel if the inflation is low it does help us because then the yield that the landlord gets, he finds it attractive and therefore, I feel inflation being low is going to help the business for sure. Also, we feel that if the property that you want in vicinity and there is always a shortage of 1000% locations. So recently we have opened a new restaurant in South Mumbai and there are two locations around that area that you can negotiate with. But since the availability of real-estate is poor, your negotiating power is sort of low but when the market is down it helps us to that extent.

Moderator Thank you. The next question is follow up from the line of Manjeet Buaria from Solidarity Advisors. Please go ahead.

Manjeet Buaria One thing which I observed in the last quarter was the promotions around the McDelivery was stepped up quite a bit whether in terms of the messages or mails I got or even on the website. So I wanted to understand that your gross margin has remained stable despite that. So where were we seeing gross margin expansion which was being ploughed back in to the system for this promotional offers?

Amit Jatia As we have always maintained, our promotions and discounting are negligible and therefore they have no impact on our gross margin by and large. You may see like Friday offer on delivery but in the big picture it is a very small number. So therefore, it does not bother us that much; I feel we are quite balanced between giving consumer an offer to make it value for him versus management of our gross margins.

Moderator Thank you. As there are no further questions, with that we conclude today's conference call. I now hand the conference over to the management for their closing comments.

Amit Jatia

Thank you very much for joining us on the call today. Really appreciate your time and the questions. If you have any additional questions or queries, please do direct them to Ankit Arora, his details are on the website and I am sure he will be happy to address them. Thank you once again and have a great weekend.

Moderator

Thank you. On behalf of Westlife Development Limited, that concludes this conference. Thank you for joining us and you may now disconnect your lines.