Q4 FY2016 Earnings Call Transcript – May 6, 2016

CORPORATE PARTICIPANTS

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

Moderator Ladies and gentlemen, good day and welcome to the Westlife Development limited Q4 FY16 earnings conference call. As a reminder, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankit Arora – Senior Manager, Investor Relations. Thank you and over to you Sir.

Ankit Arora Thanks Zaid. Welcome everyone and thank you for joining us on Westlife Development Limited fourth quarter and fiscal ended March 31st 2016 earnings conference call. We are joined here today by Amit Jatia – Vice Chairman, Smita Jatia – Director and Suresh Lakshminarayanan – Chief Financial Officer, 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 a Q&A session.

Before we start, I would like to remind you that some of the statements made or discussed on this call today may be 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 results 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.

Amit Jatia Thank you, Ankit. Good evening and thank you all for joining us on this call today. I am pleased with the progress we have made in FY16 to further strengthen the foundation of brand McDonald's to lead the QSR segment in India.

Against a weak economic backdrop over the last two years we have made solid progress across all our offerings in FY16. We recognized the early signs from the economy in FY14 anticipating low consumer confidence and high inflation and since that time, we have taken decisive steps to address these issues at the grass root level to strengthen the foundation we stand on today and to grow the business over the next three to five years.

With the progress we have made so far, I have no doubt that we will generate significant shareholder value as we continue to execute our plan. The ultimate goal of our plan is to strengthen McDonald's WDL's leadership position and capture the long-term potential of the QSR industry in India.

Through the last two years, we have re-assigned some of our capital expenditures to re-imaging and system upgrades at the restaurant level, this shift should further improve operating efficiencies as we work to provide a modern and progressive restaurant experience to our guests.

Westlife continue to build the foot print for McCafé's taken the total to 75 in a short span of around two years. McCafé's locations have been very successful in creating a different customer experience and optimizing the use of our restaurant at all hours of the operation. We believe the primary benefit of McCafé locations is that they attract new customers by increasing the variety of our product offerings and strengthen our brand image.

Moving on to the brand, we shifted gears and made important investments in building the brand through brand advertising rather than discounting to retain and add new consumers. We continue to open new restaurants with prudent unit economics, acquiring good quality real estate on sustainable, commercial and legal terms while growing the Drive Thru portfolio. The composition of our restaurant portfolio is an important competitive advantage in helping us to weather the challenging environment and it will serve as a backbone for the future growth of our business.

Our effort yielded good results in FY16 with noticeable improvement across all parameters in every quarter starting Q2. We rebuilt the foundation for new restaurant growth by completing our project on unit economics. This project helps us bring down cost pertaining to building new restaurants and restaurant operating cost which helps us in maintaining healthy unit economics as the restaurant base grows.

We diligently worked to enhance the McDonald's experience for the customers through various touch points. We continue to remain relevant amongst our consumers through advancing our digital efforts, re-imaging program, contemporary menu choices and maintaining value through this difficult period. We improved our restaurant operating margin as well as operating EBITDA as we grew our comparable sales and continued to grow gross margins. We remain committed to grow brand McDonald's in a solid but sustainable way to maintain our lead in the QSR segment in India. We hope to continue to make important and meaningful progress in the near-term.

Smita and Suresh, will take you through the specific results for the quarter and the year. I now hand over Smita.

Smita Jatia Thank you, Amit. We continue to build our business through our four strategic levers of broadening accessibility, growing base line sales, margin expansion and growth through people. As Amit mentioned, as a result of the work done in the last 12 months to strengthen the foundation, we are pleased to announced that we have ended the quarter at 8.4% SSG which is the highest growth in 13 quarters and being a third quarter of consecutive positive comparable sales.

We opened 13 restaurants, on the new restaurant operating platform and together with that we are at a 17.6 total sales growth, again being the highest in the three quarters. In addition to this, our gross margin improvement had an expansion of 260 basis points giving a restaurant operating margin expansion by 450 basis points. The biggest driver to achieve this in this quarter was the introduction of the Maharaja Mac along with the traction on MDS and McCafé.

Now coming to FY16 performance, with three out of the four quarters ending in positive SSG we have ended the year at 1.8% giving us a gross margin expansion of 160 basis points and again contributing to restaurant operating margin and operating EBITDA margin expansion by 320 basis points. This has mainly been contributed by our initiative of re-imaging with McCafé giving strong traction around both SSG and margin growth. Delivery continues to grow at a steady 20%+.

Starting with our first lever of broadening accessibility which is to increase brand penetration by driving consumer accessibility, we opened 13 restaurants in this quarter. Some pictures of our new opened restaurants are attached here with. The 13 new restaurants which were based on the new RoP platform have been designed under three main heads, restaurant design, equipment and operating cost. Work has been done to optimize and localize in order to reduce Capex and Opex, design changes and innovation to reduce Opex resulted in 20% to 25% savings in Capex taking it from 25-30 million per restaurant to 23-25 million.

For the year we opened 30 new restaurants across all geographies with four new cities including the new state of Chhattisgarh. Hence, recapping the broadening accessibility lever, we increased accessibility by opening 30 restaurants taking our total restaurant count to 236. 13 of these restaurants were built on the new operating platform which will reduce drag and improve margins.

Market planning is also helping us in better sales estimation thereby also improving margin. Lastly, our Drive Thru's continue to give us competitive advantage.

Moving on to the second strategic – lever of growing base line we have three platforms under that, value, menu and brand extension. Starting with the menu platform, in the quarter we introduced the iconic Maharaja Mac. This was led by a very strong insight of customers feeling that a burger is snacky and wanted a more filling product. On the non-veg side we had the smoky grilled whole muscle chicken accompanied by lettuce, tomatoes, onions and jalapeño adding to the freshness. On the veg side, we introduced for the first time in the history McDonald's, a veg Mac which is with corn and cheese patty.

Through the year menu played a pivotal role in adding to the base line as well as satisfying the consumer need of new news and variety. This was all in the form of limited time offers on our core products like the Indi-Spicy, sides like the Chilli Paneer Pockets, flavors of McFlurry with themed desserts promotions and being contemporary by giving the customer choices of their options of buns for example Focaccia and Masala.

On the value platform, we continue to provide everyday value instead of discounting through sharing packs for all customer segments and occasions. And in this challenging time, we invested marketing dollars in brand campaign thereby giving us differentiation.

Lastly, on growing base line through brand extensions, we added 12 McCafé's in the quarter taking our total McCafé count to 75. In Mumbai, we are the number two player and we will now increase our presence in other cities thereby taking the McCafé foot print to 110 to 130 by FY17 which will again strengthen our position to remain a dominant player in the coffee and beverage market. McCafé for us has helped us to optimize day-part and grow margins across the restaurants. Other than the coffee platform, we have introduced new platforms like Smoothies, Frappe's and Ice Tea. Each quarter had a focus on different flavors and products. Along with McCafé the re-imaging initiative helped us deliver superior customer experience yielding improved restaurant performance and keeping our brand contemporary.

On the delivery front, over the last two years, we have grown the business by more than 60% which has mainly been driven by the mobile and online with continued focus on the evolution of our online platform. Hence, recapping growing base line sales, continuous investment in brand building, innovation and menu providing everyday value, growing McCafé and delivery and continuous investments in keeping our restaurants modern and contemporary have moved our trajectory on base line upwards and at the same time delivered three quarters of positive SSG.

Moving on to margin expansion, for the year we grew our gross margin by ~160 basis points and restaurant operating margins by ~320 basis points. Margin expansion was contributed by positive comparable sales giving strong operating leverage.

Quarter-on-quarter growth on gross margin was contributed by menu work and growth in McCafé and Delivery. And finally, productivity initiatives on labor and utilities yielding expansion on operating margins.

Lastly, going to our last strategic lever of growth through people, we are proud to announce that the great places to work has recognize and awarded us India's Number One Company to work in the retail industry.

In addition, to this four of our McCafé Baristas were among the top six in India in the all India Barista Championship. We also won many awards in the supply chain as well as in advertising.

I will now hand over to Suresh to take us through the financial review.

Suresh L Thank you, Smita. I will now take you through the business performance for the fourth quarter and the fiscal year ended March 31st, 2016.

While on the slide 28, you will notice the reported financials with the exceptional gain which we realized in Q2 FY'16.

May I request you to slide 29, which shows the results for Q4 and a normalized business performance for the fiscal year. As you can see Q4 has been a strong quarter across all key operating parameters namely top-line growth, comparable sales and margin expansion. It is quite heartening to report the highest comparable sales in the last 13 quarters at 8.4%. The trend is encouraging and we expect it to continue in the coming months riding on improving consumer sentiments.

Now on top-line growth, various differentiated brand building strategies which we undertook over the last 12 months yielded strong results which helped us deliver almost 18% growth in our total sales in Q4. The sales growth was 9% when you look at the fiscal 2016 versus fiscal 2015.

Our focused efforts around the four strategic pillars helped us deliver the full year of positive comparable sales of 1.8% after two years of challenging market environment. We also achieved our initial stated target of having 230 to 250 restaurants by FY'16. We saw momentum around restaurant openings during this quarter where we opened 13 restaurants which also help deliver strong revenue growth and thus ended fiscal 2016 with 236 restaurants system wide.

Moving on to gross margins, it is quite heartening to see a consistently healthy growth in the system wide gross margins and the same now stands at 60% for the fiscal ended March 2016. Further we recorded gross margin expansion sequentially in every quarter in the fiscal. All our strategies around the menu innovation, growth in McCafé and judicious price increases over the last 12 months resulted in approximately 260 basis points gross margin expansion in Q4 along with a strong 160 basis points expansion in the full year compared to the corresponding periods in the previous year.

For the first time we introduced a veg variant of Maharaja Mac for our customers during the quarter and a renewed version of the Chicken Maharaja Mac which helped increase the average spends as well as drive better system wide gross margins.

On the restaurant operating margin and operating expenses, our continued focus around monitoring the productivity and expenses at the restaurant level have resulted in strong improvement across our operating margins for Q4 and FY16. Despite the addition of 30 restaurants during the year, we were able to drive a 40 basis points improvement in payroll expenses during the quarter and 30 basis points improvement from a full year perspective as compared to similar period last year.

We also made significant strides across occupancy and other operating expenses through various measures around controlling our utility expense through efficient restaurant operations and design which resulted in approximately 370 basis points improvement in the quarter and about 120 basis points improvement year-over-year in FY16. This coupled with the gross margin expansion resulted in a significant improvement in the restaurant operating margins by 450 basis points during the quarter and 320 basis points for the fiscal year ended March 2016.

These efforts and efficiencies along with stable G&A expenses during the quarter and year let to an operating EBITDA margin expansion of approximately 435 basis points and 320 basis points for Q4 and FY16 respectively.

Overall, we demonstrated strong differentiation this year through our menu innovation, brand building initiatives, brand extensions growth and restaurant openings which led to a significantly improved operating performance over the same period last year. We are committed to drive improvement in our business performance in the coming quarters aided by improving consumer sentiments and our relentless focus on four strategic levers across the system. We believe we are better placed along with the strengthen foundation through our new restaurant operating platform and expect to deliver better business performance for FY17 on the back of improved FY16 results.

With that said, I would now hand over back to Amit who would take you through the outlook for the future and give the closing remarks.

Amit Jatia With respect to the outlook we do expect to see an uptick in the consumer sentiment in the coming quarters and I believe that WDL is well-positioned to capture the opportunity as the next cycle of economic change comes in. We hope to double the current base of 236 restaurants over the next five years to seven years.

In doing so, we will continue to concentrate on the quality of real estate; portfolio or formats with the focus on building Drive Thru's. We will grow our consumer base and therefore, base line sales through menu innovation, aggressive growth of the McCafé portfolio and McDelivery. We will continue to strengthen our affordability platform for our consumers through the Happy Price Menu to bring new consumers into the QSR category to grow the existing base of customers.

Our new restaurant operating platform 2.0 and quick rollout of McCafé will help us improve our margins as new stores turn profitable faster, leading to improved restaurant operating margins in the coming years.

In summary, we remain 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 serve future demand. We are taking necessary steps to meet the short-term challenges and will continue to make important progress towards delivering our long-term targets. We remain confident that our strategic direction aimed at improving operational efficiency and strengthening our balance sheet and the strong foundation built over FY16 will result in significant improvement in shareholders' value in the years to come. Thank you.

We can now open it for question and answers.

Moderator Thank you very much. Ladies and gentlemen, we will now begin the question and answer session. The first question is from the line of Abneesh Roy from Edelweiss. Please proceed.

Abneesh Roy Your SSG is at a 13 quarter high and has consistently improved for the last four quarters - five quarters. So will it be fair to say that you would have gained market share from comparable peers and if I take off the McCafé what will be the same stores growth because I see good linkage between the two so McCafé you have been adding strongly and then same store growth has also come back strongly.

Amit Jatia So while McCafé has played an important role, please remember there is yet only 75 out of 236 restaurant base. So yes, it has helped us but it is not the only driver of comparable sales. As we mentioned, it is delivery, it is menu, a bit of brand, along with the menu and a combination of McCafé. So it is all of the three put together that has yielded the 8.4% result. As far as market share is concerned is concerned, I would let Smita answer that.

Smita Jatia As far as market share is concerned we do not have any syndicated research which kind of maps market share across all competitors so, it will be difficult for us to comment on that.

Abneesh Roy And how have the food delivery apps been doing, food tech companies. Are they doing well in terms of proportion of sales currently?

Amit Jatia: So we currently work primarily with FoodPanda and that has been growing quite well for us although our primary business is still through our app and through our web platform. But the important thing is that the app usage continues to rise because we have also made some enhancements in our app like four months or five months ago, so that has been yielding some result and we continue to make actually quite strong progress on the app side which we think will yield future results as well. So aggregators wise we are currently using only one but we are more than happy to add more people as we go along.

Smita Jatia So the good news is that we are not wholly depended on aggregators, we have our own base of customers also. But aggregators definitely help us in getting more penetration into the online business.

Abneesh Roy In Tamil Nadu, no restaurant addition for last four quarters, what is the reason for that?

Amit Jatia There is no real reason because you know for us it is about sustainable growth in terms of the real estate. So for example, if you look at Hyderabad, suddenly we have added about four or five restaurant in Telangana so, you will see that suddenly one-shot some restaurants might come there in Tamil Nadu as well. So because real estate takes time it is hard to manage it by region. We really do not look at it that way.

Abneesh Roy I had one question on the royalty, it is up 9 bps quarter-on-quarter and 216 bps Y-o-Y, why should it be up quarter-on-quarter and what is the guidance for next year?

Amit Jatia Basically last year in the same quarter there was some gains we had got through tax credit which gave the difference otherwise, primarily between last quarter and this quarter otherwise there is no gain.

Abneesh Roy Sir, last question, McDelivery up 60%. I do not know what is the base it has grown from? How is the ticket price here, is it higher than in-store dining, and, if you could also speak on the margins because here rentals are not there but there is a delivery cost and other things which are quite high. Any comments there.

Amit Jatia So firstly, the base of the delivery for us is pretty strong and if we were to treat that as an independent business it would stack up pretty high in the list of food companies. So as far as we are concerned that has been pretty strong. The average check for delivery is generally much stronger than the in-store.

Abneesh Roy And margin wise, does it work better?

Amit Jatia Yes. In our Investor Day presentation we had mentioned that because remember its incremental business for us. So we look at it as contribution margin and plus there is a Rs. 25 charge per order that actually works quite well for us because it does cover some of our cost for delivery and we don't have any minimum order size. We say that people can order even an Aloo Tikki Burger but as long as they are happy to pay the Rs. 25 we are willing to deliver and if there is Rs. 5,000 order we will deliver with the same Rs. 25.

Moderator Thank you. The next question is from the line of Vincent Heo from Black Horse Capital Fund. Please go ahead.

Vincent Heo I have two questions about the McCafé. My first question is that, in former presentation materials you mentioned the future potential and your sales from McCafé is Rs. 8 million to Rs. 12 million while we see other leading coffee players normally have annual sales around Rs. 8 million. So do you think Rs. 12 million annual sales is achievable target and if yes, how many years will it take a new McCafé to achieve that target?

Amit Jatia So firstly, we had said I mean there are of course stores that range at different volume and we have restaurant that would already do Rs. 12 million but because we are dealing with the basket of say 75 restaurants obviously, it is a range. So we do believe that the McCafé portfolio has tremendous opportunity in terms of more beverages that we can add to the McCafé platform. Also, we have never advertised the McCafé as yet. So really it is the 180 million to 200 million consumers who are coming to see and who are already using the McDonald's who are our customers for McCafé. We feel that as we start advertising a bit more outside that might further help growth the demand. So I think it is over a three years to five years' horizon because the first opportunity is to take the 75 to the 236 restaurants that we already have and the second opportunity is to grow the average sales. You would also notice from our Investor Day presentation that in just five to six quarters we have grown the average volume by 40% for McCafé so it is worth quite well for us.

Vincent Heo And my second question is that apparently coffee and the beverage is more profitable than other products. And the Café Coffee Day has a gross margin of approximately 63%. So is this fair to assume that the McCafé also enjoys the same level of gross margin or even higher?

Amit Jatia So basically we don't share the break outs but yes, beverages do give you a good gross margin so, it would better than a system average right now.

Moderator Thank you. The next question is from the line of Pulkit Singhal from Motilal Oswal Asset Management. Please proceed.

Pulkit Singhal Just on McCafé. I am not sure; do you provide break-up by percentage of sales here?

Amit Jatia No, we do not.

Pulkit Singhal But it is in the 5 million to 8 million per McCafé currently?

Amit Jatia Yes, that is what we have given as an indication.

Pulkit Singhal Okay. And similarly, for the delivery that will be provided as percentage of sales.

Amit Jatia We do not break it out but we have given an indication which stands at sales of INR 5 million to 8 million per restaurant.

Pulkit Singhal Okay. And so therefore, I mean if you see the benefits this year in FY16 versus FY15, these both these seem to be like higher margin businesses even at an EBITDA level, do you think the entire benefit because of these two last year?

Amit Jatia Absolutely, not because you know the base of these stores are still lower especially McCafé and also everything did not open at the beginning of the year, so while we are at 75, out of that 12 opened in the last quarter alone so at least McCafé is not large enough to impact and delivery has been around for many years but growing at 20%+ compounded. So we feel it is also menu and brand that worked for us. So in fact if you look at Q2 FY16, McCafés would be at least about 30 lower than where we are today because that is roughly what we are adding quarter-on-quarter. So it is a combination of everything. Also, if you go back in FY15, not just FY16, you will find that we made good strides on gross margins in that year, which is on account of menu and on account of work around product mix.

Pulkit Singhal Okay. And this current same store sales I mean obviously, it is fairly high and it is very sudden, I mean what is this really driven by? I mean are you thinking that in the next quarter or next to next is going to be good? Is it because of eating out frequency has increased?

Amit Jatia We feel that it is basically a combination of McDonald's strategy around re-imaging and adding McCafé, it is around menu and it is around delivery. So, we feel that as I mentioned the consumer footfalls are still very challenging. However, it is another occasion of use for the consumer when McCafé has been available for example. Similarly, the delivery business overall in the country has been growing quite well and that has helped us grow our delivery business even further. So I think it is a combination of these factors. We do not yet see too much traction in the eating out frequency but I am hopeful that the quarter is coming forward and I had mentioned that we have bottomed out and I am quite hopeful that some signs should start coming around recovery quarter-on-quarter.

Pulkit Singhal All right. And in terms of royalty, what is the rate currently, what is it for next year and is the plan still on for the 8%?

Amit Jatia Yeah, so it goes to 8% by 2020. Currently, it's at 4% and it moves as per the schedule.

Pulkit Singhal So the increase starts next year itself I mean FY17?

Amit Jatia Yeah, that's right.

Moderator Thank you. Next question is from the line of Aditya Joshi from Nirmal Bang. Please proceed.

Aditya Joshi Sir, my question is pertaining to the plastic ban in Bangalore, so Karnataka has banned plastic use in food segment so, will that be materially impacting our business as we have somewhat 50-70 stores in Bangalore.

Amit Jatia It is not just for food I think they have banned plastic across the board it is a short-term challenge because supply chain has not had time to reorganize because it was effectively immediately, so we are working with suppliers to deal with it. I think there would be an impact in the short-term but we are working very hard to manage it.

Aditya Joshi My next question is there is a change in McDonald's parent Chairman will step down and the new Chairman will be elected. So, have they elected the new Chairman and will that impact the Indian business in any way?

Amit Jatia No, the Chairman is a Non-Executive role and but it does not impact us at all, because we are working with the regional people in Asia and that is a Non-Executive position so, it does not matter to us at all.

Moderator Thank you. The next question is from the line of Aasim Bharde from Batlivala & Karani Securities. Please proceed.

Aasim Bharde Sir, I have one question on royalty, earlier in the call you mentioned that there is some royalty relief. Could you throw some more color on that?

Amit Jatia No, that was to do with what we had last year so, if you recollect we had a 1% royalty relief for all of last calendar year. But really if you look at Y-o-Y, in Q4 FY15 it is lower because we had some tax credits which is why it looks lower while in this quarter it was at 4%.

Aasim Bharde So for FY17, would 4% for the entire year would be a fair number to estimate?

Amit Jatia No, in mid-Q1 FY17 it changes. You can connect with Ankit offline for the detailed schedule.

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

Amit Jatia Thank you, everybody for joining us on the call. We really appreciate it. If you have any further questions, please feel free to contact Ankit and he will be happy to address any of the questions. Thank you and have a good weekend.

Moderator Thank you very much members of the management. Ladies and gentlemen, on behalf of Westlife Development Limited, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.