Q3 FY2015 Earnings Call Transcript – Feb 6, 2015

CORPORATE PARTICIPANTS

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

Moderator Ladies and gentlemen, good day and welcome to the Westlife Development limited Q3 FY15 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 – Manager, Investor Relations. Thank you and over to you Sir.

Ankit Arora Thanks Shyma. 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, 2014. 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 will 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 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 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. Thank you.

Amit Jatia Thanks, Ankit. Good evening, everybody and thank you for taking the time to join us on the earnings call today. I would request you to please turn to page 3 of the earnings presentation.

As mentioned in my previous calls, the Indian eating-out market is still in its nascent stages of development leading to huge growth opportunities for WDL over the medium to long term. It is critical that WDL's strategic and business imperatives remains strongly aligned with this reality while intelligently navigating the current challenges in the Indian economy but without getting distracted by the same. In the past, as the eating-out frequency grew in West and South India, our basket of comparable restaurants almost doubled their same store sales over this period, reflecting the McDonald's brand connect with its consumer. Even as the economy revives, a key task for WDL is to continue to open restaurants in the vast underpenetrated geography opening up significant growth opportunities for the company. While we need to have an aggressive approach to growth, it is imperative and it is a sustainable plan so that these new restaurants build strong long-term competitive advantage in our site locations through favorable commercial and legal terms, differentiated design, and especially a well-diversified portfolio. A testimony to this is the fact how McDonald's has managed its risk in location selection in malls which has minimized the impact of various issues malls are facing. In order to grow sales, we need to keep the brand energized, fresh, and relevant for today's consumers. To that end, we focused on reimaging our older restaurants, adding McCafés and providing menu options that strengthen our offering to the consumer.

The addition of online ordering option to the delivery business has seen the delivery business explode with strong double digit same-store sales in the delivery business month-on-month for the entire 9-month period. McCafé addition is the first strategic step towards laying the foundation of making McDonald's the beverage destination for consumers, opening up the $250 million market for coffee which in turn is growing at over 25% a year. Results from basket of restaurants where we have combined reimaging and McCafé have been positive and consumer feedback is very favorable. We currently have 30 McCafés with 15 new McCafés added in the last quarter alone. Based on these results, we will continue reimaging our older restaurants and add McCafé and we expect to see positive impact on brand McDonald's in the coming quarters. As the portfolio of such stores increase, we expect to add favorably to comparable sales as well. We believe that this will help us grow average volume per restaurant which is important to grow our operating margins.

Listening to our consumers, we have constantly innovated our menu offerings to make them more relevant to our consumers. Along with menu variety, we continue to increase wholesome and healthy options on our menu. Over the last few years, we have added the McEgg burger, grilled chicken and grilled vegetarian options. This is in addition to our wholesome breakfast offerings which are grilled. Our menu team has worked with suppliers across a range of products to ensure a reduction in sodium levels. Since June 2013, McDonald's has consistently reduced sodium across its various products by 10%-20%. Our dairy products such as popular soft serve, they have less than 3% fat. Additionally, we have successfully reformulated our sauces to reduce 40% fat and calorie content across sauces. We continue to work on our menu to provide variety and excitement through limited time offers in the coming years.

I am happy to say that our efforts have paid off and we have ended this quarter with flat comparable sales, a total of 202 restaurants and 30 McCafés. It is important to note that McDonald's across its 360+ restaurants in India serves over 320 million consumers annually. This is a strong base of customers and as we implement many of our strategies, we expect them to visit us more often, use our restaurant on more occasions and day-parts including ordering through our delivery platform. Through our breakfast, McCafé drive through an increased penetration, not only do we expect to get more customers per year, we do hope to serve our existing customers better and generate incremental sales from them. We have also been able to further improve our gross margins in this quarter while maintaining value for our customers. As previously explained, our short-term challenge lies in managing new restaurant operating margin drag. As the base of new restaurants keeps rising, which is about 46% of our comparable base as mentioned earlier as well, we see an impact on occupancy and utility cost in the short term, as sales do take a few years to build.

We believe that as the economy builds back, we expect our sales to build back too, and we expect to see positive operating leverage leading to higher restaurant operating margin in the coming quarters. We have been through a similar cycle in the past and our past results show improvements in margins pretty quickly on the back of positive same-store sales. I now hand over to Smita, Managing Director of Hardcastle Restaurants, who will take you through the business highlights of the quarter.

Smita Jatia

Thank you, Amit and good evening everybody. Taking from Amit's strategic framework, here are some highlights. At present, we stand at 202 restaurants with 11 openings for this quarter. We have added 25 gross openings and we are on track for our restaurant openings for the year. We are happy to say that after 5 quarters of negative comparable sales, we ended the quarter at flat comps and I will take you on some of the drivers which helped us do so. McCafé continues to expand. We opened 15 McCafés in this quarter taking the total to 30 McCafés and our delivery business consistently gave us double digit comps sales. Our continued focus on gross margin by efficient product mix, menu pricing, and raw cost reduction helped improve gross margin by 110 basis points.

Our highest number of restaurants continues to be in Maharashtra followed by Karnataka, while we grow in the other clusters. We also continue to build our competitive advantage by opening more drive thru's and in order to expand our presence, we not only opened our restaurants in our key cities but also opened 4 new cities – Aurangabad, Belagavi, Mangaluru and Nadiad. In quarter 3, we also focused on building the baseline by building on our core menu. We took our hero burgers and made some variations in the bread and sauces to give our customers new news. This builds loyalty with our customers towards our core menu and at the same time help improve gross margin. In the South, we leveraged a key customer insight that customers like spices and help create brand relevance and brand awareness through our world famous fries.

Moving on to brand extension, on the McCafé platform our footprint now extends across Mumbai, Ahmedabad, Pune, Nasik and our new city addition was Aurangabad. We opened 15 in the quarter taking the total count to 30 McCafés. These McCafés along with the reimaging are driving better comps sales as well as margins. And more importantly, they are driving a new occasion for our customers to visit us. Convenience through delivery continues to grow. Through the web and online delivery platform, we continue to deliver double digit comparable sales. I now hand over to Suresh who will take us through our financial analysis.

Suresh L Thank you Smita. Good evening, everybody. I will now take you through the financial analysis of results for Q3 FY2015. While the overall consumer sentiment continues to remain sluggish, the addition of 25 new restaurants and 27 new McCafés during the last 12 months, resulted in flat comparable sales after a gap of 5 quarters and we posted a 9% increase in our revenues year-on-year. Revenues were also helped by a better festival season and new introductions on our menu by working on our strategy of building the core products where we continued our limited-time offer through Classics with a Twist which included the new variants of McVeggie and McChicken as Smita mentioned earlier.

On the expense line items, as we have indicated earlier that as the base of new restaurants keep moving higher which currently is at around 46% of the total restaurant base, costs associated with those restaurants do impact the restaurant operating margins in the short to medium term. Resultantly, we have been impacted by higher occupancy costs which relate to opening of new restaurants and higher utility costs as well. Also, there has been a significant impact of minimum wages which has resulted in increase of our payroll expenses by around 34% year-on-year in Q3FY15. However, it is extremely encouraging and satisfying to note that our strategy around driving gross margins in the upward trajectory continues to yield results and we were able to expand our gross margins by ~110 basis points during Q3 and around ~130 basis points for the 9-month period ended December 2014. Hence due to the drive of new restaurants and higher costs associated therewith, we have seen erosion in the restaurant operating margin and subsequently in the operating margins of the company. However, we believe that as the consumer sentiments improve consistently, we would significantly benefit from the higher operating leverage and various other initiatives that are being driven across the organization. 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. Western fast food represents only 1% of the total eating-out market and is growing at a faster pace than Indian fast food, therefore the key for WDL is to navigate short-term challenges while building for the future. Our goal is to increase the accessibility of brand McDonald's to the Indian consumer through expanding the restaurant network. We continue to expect to open 175 to 250 new stores in the next 5 years with a sharper focus on opening in new clusters for incremental and profitable growth. We are accelerating our restaurant development in newer markets and cities to capitalize on the customer opportunity in these markets. Our past results in such markets have been encouraging. We will invest about Rs. 1.3 to Rs. 1.5 billion each year for the next 3 to 5 years for restaurant expansion. WDL will continue to reimage its older restaurants in Mumbai, Pune and Gujarat to remain relevant to changing consumer needs. Along with the reimaging, WDL will accelerate the opening of McCafés to its existing restaurant base while opening a new McCafé with the new restaurant openings as well. We expect to have about 50 to 75 McCafés by December 2015 and then double again in the following 2 years. The current base of 202 restaurants allows us to ramp up pretty quickly.

Further, I am happy to announce that considering the prevailing muted consumer sentiment in India, McDonald's Corporation has reaffirmed its commitment in WDL and provided a one-time relief of 1% in its royalty for calendar year 2015. We will look at opportunities to optimize the real estate portfolio specially in underperforming malls by relocating to better performing locations within the trading area in case the need arises. Many of these older malls are now under stress due to newer and bigger malls. Our risk management and favorable location and commercial turns put us in a good position to manage this effectively and put our assets to better use. Baseline sales will be built through new menu platforms, line extensions, and limited-time offers. WDL will focus on building a differentiated brand through menu innovation, brand extension, and brand advertising. Digital marketing and improved customer convenience through cashless services, free Wi-Fi will drive innovation and improved customer service at McDonald's. With that said, I would like to open it up for Q&A.

Moderator Thank you sir. Ladies and gentlemen, we will now begin with the question and answer session. We have the first question from the line of Avi Mehta from IIFL. Please go ahead.

Avi Mehta Sir, I wanted to understand first on the demand front, we have seen flattish SSSG in this quarter. Does that kind of give you some signs of pickup in demand or is it primarily because of some offers that you did? How would you describe this and would you say that from here on things would probably go upwards. Could you give any sense on the demand front?

Amit Jatia Sure. So first and foremost, you see I had mentioned this before that we generally do not like to do deep discounting to win customers because we believe that is a short-term strategy. We believe that our consistent work like for example reimaging, McCafé and other things that I talked about earlier are the ones that we need to work on to retain customers, bring them more often. Having said that, I must say that the demand situation still continues to be quiet weak. I do not think that I can say yet that the demand is sort of picking up. We do see certain weekends that do really well, certain weekends that are still sort of average, but I think it is a bit of a wait and watch. In my opinion, it will still take another 3-6 months for us to figure out where it is going.

Avi Mehta Sir, would you say that it has possibly bottomed out or is it too difficult to even call that. How would you read this situation?

Amit Jatia I mean one could say that yes, it is definitely towards the end of the cycle is the way I see it.

Avi Mehta Sir, the other thing was on the EBITDA margin trend. Now you have seen an expansion, I mean an improvement from the last quarter's levels. Just wanted to understand if we see same-store sales growth roughly remaining at the similar levels possibly 100-200 bps up and down, would it be fair to estimate that margins would remain where they're or could we see some improvements from here on? How one should project the current numbers, if you could give some clarity on that part as well.

Amit Jatia I mean see as I mentioned before, we are in the growth mode of this particular sector and category. The difference is that as far as McDonald's is concerned, our investment for restaurant is Rs. 25 - 30 million. We go into prime real estate, we acquire a large real estate area, and then we build the business; once we start with the baseline we add delivery, we add breakfast, we add McCafé and all that helps us continuously grow our business. My point is that if I were to go steady state, a lot of things would become different. Our G&A for example is built to open 30 to 50 stores a year, is built to grow the McCafé business, is built to take the Breakfast business to a different platform and so on. So I feel that it is not really an area that is really comparable because given that the impact of new stores is hard to determine, I think we are going to live with the impact of new stores for the next few years if we continue to expand like that. However, what is interesting is that we have been able to make good delta on gross margins. The reason that is material is that the minute comparable sales start coming up, the flow through to the bottom-line is pretty solid. Also I have mentioned this before that when we do our rent deals in our new restaurants, we try to keep our breakeven sales at a very low number. So the minute again sales start coming up, there is flow through to the bottom line. So in other words, yes, as comparable sales come, we do expect some margin improvements to come and of course new stores will continue to drag for the next few years. So it is a balance between the two.

Avi Mehta Just two more questions. One is on what you highlighted that McDonald's has decided to give a relief of 1% in royalty. So how would this work?

Amit Jatia Basically it is only for calendar year 2015 where from January onwards, there is a 1% lower than it was; if we were running at 4%, so it will become

3% and then it was supposed to rise to 5% after May where it will remain at 4%.

Avi Mehta And after that, how would it work for the next year?

Amit Jatia As I mentioned this is only for 2015.

Avi Mehta And, lastly a book keeping question, the other income has seen a very sharp increase in the third quarter. Could you explain the reason for that?

Amit Jatia We have always mentioned that we have had our cash balance in our books and this is all the other income that we have accrued from there. We have always tried to maximize that, so our investments were such that they were maturing after 1 year.

Avi Mehta So, the trend going forward would be similar to the 9 months level average?

Amit Jatia Yes, it would.

Moderator Thank you. Our next question is from the line of Latika Chopra from JP Morgan. Please go ahead.

Latika Chopra My first question is, if you could provide some sense of what could have been the contributions from McCafés and Delivery sales which could have aided this recovery in SSG and second question is, were there any store closures in the quarter and you did mention that you are reviewing your portfolio in underperforming malls. So could this lead to any near-term disruption going forward?

Amit Jatia I will take the last one first. What happens is as malls age, one example is center one mall in Mumbai where we have been operating quite well for a long time and the mall is now closing down; however, it was a food court and we have got our return and we will be relocating from there. So there is no disruption at all. The whole idea is to ensure that you have a diversified portfolio and the ability to manage your risks when you do the real estate deals when we go into the malls, we ensure that a lot the fixed costs are done by the mall operator so that in case the mall faces any disruptions, we can move without any difficulty. But this is the constant revaluation of our portfolio, so I do not think it will cause any disruption to our business. Only one store was what we closed in this particular quarter, which answers your other question. Now, for delivery and McCafé, we do not break up the number of sales for Delivery and McCafé but the good news is that both of them have been growing extremely well and obviously that has contributed to the flat comps on top of whatever our in-store business has done, each one has played its part but these are brand extensions for us. So I can take each one but particularly if I take McCafé, what we find interesting is that it is building different day-parts from our regular lunch and dinner business. So it is a very complementary business to our current base of customers. Also, it attracts a different kind of customer as well. So we find that it is very complementary. Similarly we find Delivery very complementary because if people are not able to make it to the restaurant, by adding convenience of online by giving them the mobile app, what it does is makes it very convenient for them to order at McDonald's and we now have a 29-minute promise and having kept the operations pretty strong and tight, we have seen very good response in results for the Delivery business. We expect both of these businesses to continue to grow quite well in the coming months.

Moderator Thank you. Next question is from the line of Arnab Mitra from Credit Suisse. Please go ahead.

Arnab Mitra Just going back to the demand situation, what would you basically look for in terms of a recovery? Is it more footfalls that you look for in terms of number of people coming in or is it more of bill sizes and you said that you had a mixed bag of weekends being good or bad, but is the last two-three quarters suggesting that things are not getting worse from where they were?

Amit Jatia Definitely I feel that if you look at our own trends of results we have given, they have constantly been getting better, which is the fact. Is the consumer sentiment changed? I do not think so as yet. I personally feel that there have to be footfalls in malls on high street, there has to be a feel good factor from the consumer, their income levels has to start going up and when all of these things start happening, the sentiment on the consumer spends starts getting positive and all brands that have good reach and that has good consumer connect will start seeing that benefit. And I think even from the last quarter, we have already felt a little bit of that through flat comps. So I feel that as consumer sentiment changes, as customer's income levels rise, as they start going into malls, they start shopping again, they start coming on to the high street, and we will start feeling that benefit. Now from a long-term point of view, as I mentioned the eating-out frequency in India is still very nascent. We in our own life cycle have seen it grow from 3 times in Mumbai to about 8 times in Mumbai in the last 7 or 8 years. The real game changer will be when the 8 times starts moving to 10-12 times in the coming years and coming months and as that happens, I think we are all going to see tremendous benefits. At this point in time, I think all brands need to see both footfall increases as well as average check and spend increases per customer. I think both are going to remain constant for the next 5 years given the small size of the market at this point.

Arnab Mitra Right. And in terms of the cost environment, we have been hearing of course that food inflation is down although selectively in some places, also that we have seen reduction in diesel, petrol prices. So overall how is the cost scenario looking? I know wage cost is completely different which is related to the minimum wages, but other than wages are you seeing a relatively benign situation as compared to the past 2-3 years?

Amit Jatia Yes, I would say that in the past we would think a lot about inflation and cost. Currently, it is definitely much better than before, there is no doubt that. Labor has been a big challenge for us. Secondly, utilities have continued to be a big challenge for us. So we have not seen utility rates come down at all, but we continuously have the pressure of utility rates going up. So, on the food side I can see less pressure but let us see how wages pan out and what kind of decisions the government make on that and similarly let us see if all these crude oil reductions lead to some reductions in utilities as well, we have not seen that as yet.

Arnab Mitra And on wages, in your key states basically Maharashtra, Karnataka, what is the kind of increase in minimum wages that has happened from the government's side?

Amit Jatia It was around 30-40% last year. So otherwise we were not involved with minimum wages, but with the 40% increase it definitely hit us at that particular point.

Arnab Mitra Right. And just one question, the market still continues to be very soft on real estate especially commercial real estate. Are you seeing it easier or you getting better deals there and because you are still very underpenetrated even in the larger cities like Mumbai, there are lot of catchments where you are not there. So is that actually happening that it is easier to get real estate than in the past?

Amit Jatia See it is not cheaper for sure because good quality retail locations are still in short supply. Also when you want size, for example we look for minimum 3,000 square feet carpet area, both of these become a bit of barrier. However, we have developed models that have allowed us to penetrate pretty aggressively. So we made a lot of strides in Mumbai in the last 12 months. So even when we talk of 25 stores year-on-year, what of course people miss to watch is where have those stores opened? And we are very happy to say that for example in Mumbai, our penetration has been consistently increasing quite well and these are absolutely marquee locations. So in the current scenario, the advantage we have is that the mindset of the owner is to do the deal. So I hope you are able to appreciate what I am saying that the prices do not go down but the owner is more inclined to do the deal with good brands that they know will pay them on time.

Arnab Mitra Right and if I could just add one more question, is there given the constraint of high quality real estate of that size, are there models that you are looking at in India where at least in the bigger cities you could work in lesser spaces or is that kind of a non-negotiable from a McDonald's perspective that, that kind of size is necessary for a store?

Amit Jatia No, we are very flexible. I mean we have not got to 202 restaurants without being flexible, but we are very smart about what works in what location. I personally feel that in the long term, what matters is the quality of your real estate and smart people who deal with the real estate structure right are the brands that are going to really emerge victorious in the long term. We can see this in tough times, we can see it when malls sometimes do not work out, that is the time when your deal structure starts working out. So my view is we adapt, we adjust and we accommodate because the crux is to grow. But yet at the same time if you do not provide the customer experience, then there is no point in doing a restaurant where the brand takes the beating. So the key is Arnab, it is a very tight balance. If you look at our 200 sites, you will see that we have got all kinds of options and we have learnt a lot about what works and what does not. So we are very adaptive and we will not allow that to become a constraint.

Moderator Thank you. Our next question is from the line of Mohammed Ali-Reda from Dark Horse Capital. Please go ahead.

Mohammed Amit, I have a few questions that follow up to the McCafé. You mentioned that the type of customers that are coming in are different. Can you share more on what is the difference in those types of customers and what are they buying in terms of the top three categories of products, the sales from McCafé?

Amit Jatia I can give you general trend, for example we see that the breakfast day-part is good for McCafé. Even after breakfast that is till lunch time, we see customers who are enjoying a McCafé product. So typically it would be a Cappuccino, a Latte, it would be some of the Muffins, it would be some of our flavored products, the Frappes are doing extremely well too. So it is a variety of products across the range of offerings that we have in McCafé. But the interesting part is that it is pre-lunch and it is post-lunch and post-dinner. So the occasion basically is to catch up with a friend, to just come and chit chat at McDonald's which we find very interesting rather than just to refuel during lunch and dinner. And we see a lot of women customers as well who have coffee. So these are some of the shifts that we are seeing which is excellent because outside of lunch and dinner business, we are able to fill in other day-parts that make the business very complementary.

Mohammed Interesting, are you seeing any changes in the average ticket price or volume, so are the frequencies increasing in the number of items that people are buying increasing?

Amit Jatia No, that is something that we have done over the last many years. My best example is, as we have added our chicken nuggets, McFlurry which provides a customer option to have a side-item and dessert after the meal. The other thing with coffee is definitely people now consider McDonald's as a destination for coffee as they are experiencing our product and the customer experience we are able to provide. So all that is making the customer do two thing – one is on the same visit they are buying more which is helping us get more from the customer on that visit. The other thing is we are giving them more and more occasions to come and visit us. I mean the best example I can give you is McDelivery. When we started

Delivery in 2005 and currently, we are 2.5 times of that business and it is continuing to grow at that rapid pace. So, as I have explained before, when we initiate each of our brand extensions and as the consumer start recognizing what that brand extension stands for, it helps as a building block to grow our average volume.

Mohammed Do you have any numbers to help quantify let us say the trend that you have been seeing and if it is also continuing in this quarter?

Amit Jatia I can give you, it is in our investor presentation and Ankit can help you with that later as well but essentially in 2003, if a restaurant was doing say Rs. 100, by 2012 that restaurant almost doubled its same-store sales. So all of these activities have helped us grow our average store volume by almost 100% in a span of 7 or 8 years. So that is the kind of gain we have seen in the past but quarterly we do not sort of break that up.

Mohammed What is the average sale per restaurant on that note currently?

Amit Jatia It is Rs. 40 – Rs. 50 million is what we do at an average level and as the store continues to mature, it continues to grow the sales.

Mohammed So if we took out the new restaurants from the operating margins, would the operating margins be flat, positive or still negative because I know that that was part of the reason why operating margins are also negative.

Amit Jatia Primarily if you look at stores that have aged, they do generally much better margins than others. Again we do not break up the details, so I am sorry I would not be able to share that with you. But, to help you understand better, if our current margins are at a certain %, it is the new stores that drag us down. As we have shared this before that it takes 2-3 years for a new store to start generating a level of return that we desire.

Mohammed My last question is we have seen some changes at McDonald's Headquarters with the CEO changes. How is that going to affect the business in terms of the direction that McDonald's wants to go in and even though India is still very early in the game, things like healthier menus are a concern. Can you share with us any information on the direction that might change for McDonald's in India?

Amit Jatia I mean even in the past as CEOs have changed, it has never sort of impacted us. As you can see, Steve Easterbrook has been with McDonald's and his direction is something that has been around. So I do not see anything changing at least for us in India. We feel that it is basically the brand stands for what it is. Our "plan to win" strategy is really what the guiding force and we expect that to continue.

Moderator We have the next follow-up question from the line of Avi Mehta from IIFL. Please go ahead.

Avi Mehta You mentioned at the start that for the new store additions, we are focusing primarily on new clusters. I just wanted to kind of understand that would do you mean that, if I would just split, if you are say adding 10 stores, 5 of them would be in existing geographies, 5 would be in new geographies. Is that the way you see it and because you are going into new clusters, does that mean that the impact from new stores is actually much more than probably opening a store if the share was more in the existing geographies?

Amit Jatia See, it is not about geographies. So the whole idea is, for example last quarter we opened in a market called Vasai, which is a suburb of Mumbai and we never had a restaurant in that area. So what I mean by underpenetrated is the areas where the customer is not able to access a McDonald's and whenever we have done things like that, our general response to the restaurant and initial sales have been pretty good. So we are saying that at this point in time when the consumer sentiment is a bit low, we want to use the opportunity to go more in underpenetrated markets. So it could mean existing cities, number one and definitely we have taken a very focused approach towards growth in McDonald's. Our approach is always a 10 to 20 year view and therefore we open our restaurants in clusters. So obviously we are only in about 24 cities in West and South while we have about 190 cities that are available to us and many of our peers are operating in many of these cities. We see that as an opportunity and we see it that opportunity as a fact that we can now capture that in the next 3 to 5 years. So yes, you will see us going into underpenetrated cities but in a smart and intelligent manner through our cluster approach plus you will see us open in our current cities in underpenetrated areas that our customers are not able to reach a McDonald's within a certain time and certain distance.

Avi Mehta The second question is on the Delivery bit. You said Delivery has seen double digit SSS growth for the entire period in this quarter and given that kind of trajectory, do you internally have a percentage salience of Delivery that you want to restrict given what the brand stands or no there is no such plans?

Amit Jatia No, because I feel the opportunity is huge as yet and we do not see that as a barrier today. We think that we are at a very nascent stage of even brand development in India as yet. We see our in-store business, our Delivery business, our McCafé business, Kiosk, Breakfast, Drive-Thru, we see all of them going up. We have seen that happen in the last 10 years and we feel that as soon as the consumer sentiment changes, we see each aspect to start moving. As I have explained before, I call it 1+1+1=5. So each of these brand extensions when they work together, the impact of that is far greater than the sum of parts. So we feel that there is tremendous opportunity in each of these areas and we do not see that we have hit a barrier or a peak as yet.

Avi Mehta So would you be able to share any percentage contribution by McDelivery?

Amit Jatia No, we do not break that up at all.

Moderator Thank you. Our next question is from the line of Gautam Duggad from Motilal Oswal Securities. Please go ahead.

Gautam Duggad Just two questions on royalty bit. One is, is there precedence for this royalty relief in the past? When you witnessed weak consumer sentiment, has that been lowered earlier and second in terms of the specifics, the 4% royalty will be 3% for which year and after that when does it go back to the earlier levels?

Amit Jatia I can talk about is the future. Basically it is a tremendous support that we have got given the weak consumer sentiment and the environment. It is basically 3% till May and then it remains at 4% instead of going to 5% as per the earlier discussion.

Gautam Duggad So in the past it has not happened?

Amit Jatia I mean like I said it has, because that is how we actually came to the level we are at today and the whole idea is it steps up from 3% all the way up to 8%. That is all available in the documentation in the past. The important thing is that given the environment and the situation in India, they have supported us with this benefit that is helping us reinvest back in the business, open stores and do the right things for the market place.

Moderator Thank you. We have the next follow-up question from the line of Mohammed Ali-Reda from Dark Horse Capital. Please go ahead.

Mohammed I just had a clarifying question. There was a jump in the other income. Could you just explain what that is related to?

Amit Jatia Yes, as I had mentioned earlier, so we have a cash reserve of Rs. 1.7 – Rs. 1.8 billion. This is the income that is accrued from there basically.

Mohammed So it is cash deposit related income?

Amit Jatia Correct.

Moderator Thank you. We have the next question from the line of Naveen Kulkarni from Phillip Capital. Please go ahead.

Naveen Kulkarni Just wanted to understand the investment required for McCafé and what kind of return on investment and payback period that you look at for this format?

Amit Jatia So again, we do not breakup our models and talk about that. Bulk of the investment is made when the restaurant opens. So we will take the 3,000 sq. ft. area, we will do the décor etc., and at the right time we bring different brand extensions. Many new restaurants start with McCafé from day 1 because it is an incremental model, it really supports us tremendously both, from a margin point of view because gross margin on beverages are pretty good and the other aspect is that it gives us incremental volume without increasing cost structure too much because the cost has already been incurred for the current restaurant business that we are in. For addition of McCafé in a restaurant where it was not there earlier, it's an incremental investment of about 30-40 lacs.

Moderator Thank you. Our next question is from the line of Krishnan Sambamoorthy from Nirmal Bang. Please go ahead.

Krishnan Do you have any rewards programme for your regular customers and what proportion of your regular customers is the proportion of existing revenues. How do you see that potentially playing out?

Amit Jatia We played a different game. We do not have a loyalty program per se, but we have had smile cards. So what happens is that when people come in, we give them a card. This is at different times, what happens is that every time you visit, you get rewarded. I mentioned this before that when others were doing deep discounting, we were using frequency driver through the smile card which is more a loyalty builder than actually giving discounts and free products. So the idea was to reward every incremental visit to McDonald's. We have not run any other loyalty program at this point in time.

Krishnan Do you see that happening sometime in the future?

Amit Jatia Absolutely. There are lots of things around customer relation management, tons of things that are going on. We have a number of things that are being done at different restaurants and yes in the long term, you will see all of that come together.

Krishnan Any data on how large this loyalty programs are in the global markets of McDonald's?

Amit Jatia No, I do not have that information.

Moderator Thank you. Next question is from the line of Bhavesh Shah from CLSA. Please go ahead.

Bhavesh My question is on McCafé. Considering the tremendous success that we have got by having McCafé in the existing stores, what really limits you to not aggressively push this offering to other stores because if I just look at your guidance going forward, it continues to remain somewhere around 50 to 75 till December 2015 and then probably doubling over the next 2-3 years. So do you really see the scope of expanding this much more rapidly considering the real estate is not a limiting factor here?

Amit Jatia It is a good question. I mean the thing is that you see just because we open a McCafé, it does not mean that the customer knows that McDonald's has a McCafé. It has got to be done in an intelligent manner. We have a master plan and essentially we would like to do this along with reimaging and plus many of the new restaurants are opening with McCafé. It involves Barista training because we want the experience to be right. It involves marketing etc. We feel finally at the end of the day, it has to be a win for the consumer, it has got to be a win for McDonald's as well. So essentially we feel that having between 50 to 75 McCafés by the end of the year, we will be amongst the largest sort of coffee players in that sense in the market place and then if you double that again to 150, we may have the most easy access of coffee to our consumers. Also you see, we serve about 180 million people in a year and even to those consumers it becomes accessible. So we feel that we are taking quite an aggressive view around McCafé and growing it as aggressively as we think is right for the market place.

Bhavesh Fair point. My second question is on your breakfast offering. How are you really seeing the ramp up in this offering? Has this particular brand extension as good as what you have seen inside Delivery or say McCafé or you are still seeing this ramp up and deliver the way the other two has delivered?

Amit Jatia Breakfast is in my view a different ball game because it involves habit changes in the market place as well. We feel that being the first mover gives us certain advantages, so therefore we stayed with Breakfast. We have continuously seen Breakfast grow quite well. Actually Breakfast is also in that sense positively growing in sales. We are getting more and more customers and actually along with McCafé, Breakfast becomes even more powerful because we are seeing coffee and the breakfast offering together is connecting quite well with our consumers. The key is that again Breakfast because its habit changing will take its time and is doing alright.

Moderator Thank you. Next question is from the line of Tanmay Sharma from Edelweiss. Please go ahead.

Tanmay Sharma I only have one question from my side. A new burger chain has also come into the city. I want to know have you seen any impact of the same to your stores. As of today, it may not be relevant but going forward they also have some aggressive plans of expanding their stores. Can you throw some light on this?

Amit Jatia See I think basically it is too small because if you take 2 or 3 restaurants compared to us where we have in Mumbai 70+ restaurants, I think once they get scale then we will really know the impact. In my view, there are 3 or 4 brands that will do well. From our point of view, our connect with the consumer has been excellent, we have a very strong happy price menu, our products have been around for a while so each of our products have become a brand. If you think about a McVeggie or McChicken or McAloo Tikki, we do not just call them burgers. Each one of them has a following, each one of them has a taste profile and consumers have been using that for 15 to 20 years. So we feel that we have a very strong position, a very strong connect and as we take our base of 70 restaurants to a much stronger level in Mumbai and other markets as well, I feel we will continue to gain this customer connect. I feel it is too small and too early to talk about any impact at this point.

Moderator Thank you. We have the next question from the line of Rajasa from Jeffries. Please go ahead.

Rajasa My question is regarding the Indian fast food segment which you mentioned is growing slower than the Western fast food. Just want to understand what all kind of formats are considered as part of the Indian fast food segment. Would you say the recent home grown brands are also part of that?

Amit Jatia Yes, of course. Udupi's, Dakshini's are the big example around Indian fast food. All local branded and non-branded are example of Indian fast food.

Rajasa Right and how would you see is the competitive intensity from those players in recent years. Have you seen a very significant increase on that?

Amit Jatia No. Like I mentioned, we are a different occasion for eating out. So McDonald's is all about burgers and fries while others is Indian fast food. What we feel is that the consumer makes his choice upfront. If they have decided to go Indian fast food, their consideration set is different. Now, for example if consumer has now thought about say between burgers and pizzas, they make their choice first. Once they have decided burgers, then we come into the consideration set and that is when the next move is made which is why I say that in food you cannot say that everybody is competing against each other, but primarily if you think about real competitors, in burgers it would be within the burger category, in pizza it would be within the pizza category. So I feel that the Indian fast food is a different market segment and while they do take a part of the total eating-out market, they do not really directly compete with us.

Moderator As there are no further questions, I hand the floor back to Mr. Amit Jatia for closing comments. Thank you and over to you sir.

Amit Jatia Thank you very much for participating in today's call. We really appreciate that. If you have any further questions or clarifications, please contact Ankit Arora at Investor Relations and we would be happy to answer any further queries if you may have. Thank you very much.

Moderator Thank you. Ladies and gentlemen, with that we conclude this conference call. Thank you for joining us. You may now disconnect your lines.