# Q2 FY2015 Earnings Call Transcript – Nov 7, 2014

**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 second quarter and half year ended 30th September 2014, earnings conference call of Westlife Development Limited. 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 this conference, please signal an operator by pressing "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankit Arora. Thank you and over to you Sir.

**Ankit Arora** Thanks Inba. Welcome everyone and thank you for joining us on Westlife Development Limited second quarter and half year ended September $30^{th}$, 2014 earnings conference call. 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 within 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. Over to you.

**Amit Jatia** Thank you Ankit. Good evening everybody and thanks for joining the call today. Before we discuss the current quarter results, I would like to provide you an overview of our business which will help put our results into better perspective.

The economic environment continues to be challenging, however, we are encouraged by the right steps taken by the government to get GDP growth back in the economy, which are all very positive from business sentiment point of view, although we are yet to see an improvement in the consumer sentiment on the ground. Despite the difficult environment we are confident and well positioned to continue to lead the QSR sector in the days ahead due to strong supply chain, real estate competitive advantage, robust restaurant operations and our people.

As I have explained in previous calls, the Indian market is still in nascent stages of development of the IEO sector and therefore it is critical that WDL's strategic and business imperatives remain strongly aligned with that reality. We will continue to build on the very strong foundation that we have laid down over the last 18 years in India, in building the McDonalds business so as to remain market leaders in the sector in India. It is important to note that within the QSR sector, there are differences in strategic imperatives for each brand as they serve different categories within the eating out market.

Please turn to slide 3 of the earnings presentation. We are sharply focused on our four strategic initiatives mentioned on this slide so that we can operate smarter and faster and continuing to build on our strength. While the current business environment does impact operating results, we continue to build strength in each of the above initiatives during this period which will yield results as it has done in our 18 years journey, thus far.

It is important to understand that globally McDonald's restaurants deliver the highest volumes per restaurant in the food service business. We acquire prime real estate locations of 3,000 to 4,000 square foot so as to cater to high footfalls in this prime location as well as position us to build on each of our brand extensions like breakfast, McCafé, McDelivery, etc., In India, we have built a strong differentiated real-estate portfolio that will play out as market recovers an provide us with long term competitive advantage. A major focus for Westlife is to aggressively grow our base of restaurants by adding between 175-250 restaurants in the next three to five years. Our objective is to build sustainable competitive advantage by securing real estate sites with long terms leases in favorable terms in sync with our business needs and drive-thru locations in high-car traffic zones. We do invest significantly in the sites to improve them and make it relevant for our customers and therefore we look at restaurant development in cycles of two to three years rather than quarters.

We have opened nine restaurants in the first six months and I am happy to say that most of the restaurants to be opened in this fiscal are currently under ground break, we are confident of delivering our planned openings in this financial year while significantly increasing the drive through portfolio of our real-estate.

We continue our focus on development costs, we have maintained our opening cost at between 25 to 30 million in the recent years and we'll continue to do so in the next coming years as well as beating inflationary pressures.

Talking a little bit about building base line sales. In quarter two, we relentlessly focused on reimaging our older restaurants while adding our newest brand extension McCafé for our customers. Customer feedbacks on the new designs have been good and the feedback on our coffee is very encouraging which has led to good results in these restaurants both from a customer experience and sales perspective. We expect to play a significant role in growing the coffee market in the country. McCafé's are already contributing positively to margins and as we scale them we expect positive sales and margin impact to the business.

The reimaging initiative in this quarter led to temporary restaurant closures leading to some sales loss in the quarter as well as some write offs associated with the reimaging. We will continue our efforts to keep our restaurants modern and relevant for the consumer. Through this initiative, by next year a significant portion of our restaurants will be modern and re-imaged, young and energetic for our customers.

Over the last few years, we have intensified our efforts on listening to the customer. Our customer insight team has relentlessly focused on better understanding the needs of today's consumer. We find consumers are now more demanding of what they value in brand choice beyond price and are affected by a growing array of new influencers. We continue to build our everyday value rather than use deep discounting to build short-term sales. In quarter two, we focused on consolidating the brand through building our core menu, reimaging, opening McCafé's and other initiatives involving loyalty and frequency; it does make our task more difficult in the short-term but helps us build the brand and the business on a solid platform.

Moving on to some comments on margin expansion – short-term challenge lies in managing new restaurant growth drag while navigating flat to negative sales in an inflationary environment. As the base of new restaurants keep rising, almost 40% to 45% of our total restaurants base, especially in this difficult operating environment, we have been impacted by higher occupancy and utility costs due to lower absolute sales numbers which have hurt our restaurant operating margins this quarter. In order to maintain brand saliency, we continue to maintain our advertisement spends. Due to higher costs associated with these restaurants we have seen an erosion of a restaurant operating margin. We believe that as sales build back and these new restaurant sales kick in, we will see positive operating leverage leading to higher restaurant operating margin in the coming quarters. We have been through similar cycles in the past as we build the retail network in the country and have seen operating margin kick in previous years as well. Our supply chain continues to be a strong differentiator and we have been able to grow our gross margins without hurting the consumer while maintaining high quality standards for our customers.

I would now like to hand over to Smita, MD of HRPL will take you through the details of the results of the quarters.

**Smita Jatia** Thank you Amit. Good evening everyone. Just to recap on Slide four, in a challenging macro environment, we are happy to say that all our restaurants are under ground-break and we will deliver our planned openings for FY15. Significant investments in our brand extensions of McCafé and McDelivery are giving us dividend. Supply chain economies, product mix, and price changes are enabling gross margin expansion.

Moving into broadening accessibility – currently we are present with 192 restaurants across 20 cities. Mining the future, we have 600 restaurants which we can open in more than 150 cities. WFF is already present which gives us a huge potential in these cities to grow faster and get market share. We continue to open more drive thru's in Tier II cities as well highways, though our lead times become longer due to drive thru's, however, long-term leases of 25 years plus and our deal structure give us the competitive advantage.

Simultaneously, we will continue to grow in our key and crores cities by going into the un-penetrated mini market. We are happy to say that this quarter all of four openings have been in very tough un-penetrated

Mumbai market and have started very well. Hence this two pronged strategy will help us grow market share as well as increase geographical presence.

Today, the biggest challenge what we are seeing is to build customer loyalty in a market which is overflowing with deals. We will build brand differentiation with our first lever which is the menu platform. While we give customers give variety through products like the wraps launch, we will also continue to build our iconic products.

In this quarter, we took the McVeggie and the McChicken which are our great selling products and we added a twist, this helped us not only increase sales of these new variants but also our core burgers giving us better economies of scale, hence influencing product mix positively. The next lever for brand differentiation is through brand extension. In the last quarter we have reimaged 15 restaurants in our older markets of Mumbai, Pune, Gujarat, and have added 27 McCafé's.

On Slide 11, you can see some images of our old restaurants and on the next slide, some pictures of our reimaged contemporary restaurants. We are also happy to announce that on our first year anniversary of McCafé, we have already expanded to Ahmadabad, Pune, and Nasik taking our McCafé count to 27. This will not only help us take advantage of the $250 million coffee market but also the entire beverage platform like shakes, smoothies and iced beverages. McCafé helps us to build a different day part, a different customer need as well as impact gross margin positively. On the McDelivery front, we have seen double-digit comparable for both quarters and our online delivery has been a key lever for growth to our young customer base.

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

**Suresh L** Thank you Smita. Good evening everybody. I will now take you through the financial analysis of the results for Q2 FY15.

As Amit briefly discussed earlier, the macro environment continues to remain weak and coupled with negative comparable sales. However, due to the addition of 24 new restaurants along with the menu innovations that Smita talked about that has helped us post the modest increase in revenues of 1.9% year-on-year.

Moving on to the expense line items – as the base of new restaurants keep moving higher which is currently around 45% of the total restaurant base, the cost associated with those restaurants do impact the restaurant operating margins in the short-term till those restaurants mature and stabilize, which usually takes around three years in our system. Therefore, we have been impacted by higher occupancy and utility cost due to the inflationary environment. Also, there has been an impact of minimum wages in our region year-on-year which has increased the payroll employee cost by more than 30% coupled with increase in royalty this year. However, it is encouraging to note that our focused and sustained efforts around the gross margins continue year-on-year and we have been able to expand our gross margins by approximately 90 bps during the Q2 FY15. Therefore due to the drag of new restaurants and higher costs associated with them, we have seen erosion in the restaurant operating margin and subsequently in the operating margins of the company.

Further, we believe that as volumes and footfalls start to improve, we would benefit significantly from the operating leverage and various other cost optimizations initiatives taken over the last 12 to 18 months.

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

**Amit Jatia** Thank you Suresh. Basically we believe that there is a significant opportunity in the QSR space and WDL through the McDonald's brand is well placed to lead the sector. Western QSRs only represent 1% of the total eating out market in India and is growing at a faster pace than the Indian fast food. Therefore the key for us is to navigate short-term challenges while building for the future. One of our key focus is to increase accessibility of brand McDonald's to the Indian consumer by expanding the restaurant network. We continue to expect to open about 175 to 250 new restaurants in the next three to five years with additional focus on opening new clusters for incremental and profitable growth.

Our current focus has been expanding the retail network in key cities and certain clusters. To say that we operate in only 20 of more than 150 cities in west and south, we are now planning to accelerate our development in these newer markets to capitalize on the customer opportunity in these markets as well. Our past results in many of these markets have been encouraging and we are confident that this will help us accelerate the pace of openings in the future. We expect to continue to invest between Rs.1.3 billion to Rs.1.5 billion each year, for the next three to five years.

WDL will continue to reimage its older restaurants in Mumbai, Pune, and Gujarat to remain relevant to changing consumer needs. Along with reimaging, WDL plans to accelerate the additions of McCafé to its existing restaurant base while opening McCafé with most of the new restaurant openings as well.

In terms of expectation we expect to be between 50 to 75 McCafes by December 2015 and then we intend to double this again in the following two-three years. The current base of the 192 restaurants allows us to ramp this up quickly since the platform is already there. We will continue to look at opportunities to optimize our real-estate portfolio especially in underperforming malls by relocating to better performing locations within the trading area in case the need arise.

Finally, base line sales will be built through new menu platforms like wraps which have worked very well for us, line extensions and limited time offers. In the coming months WDL will focus on building a differentiated brand through menu innovation, brand extension and brand advertising. Digital marketing improved consumer convenience through cashless, free Wi-Fi will drive innovation and improve customer service at McDonalds. So we are pretty confident that as the economy recovers we expect things to start looking up for our sector as well. Thank you.

**Moderator** Thank you. Our first question is from the line of Avi Mehta of IIFL. Please go ahead.

**Avi Mehta** Just wanted to understand two things, now you highlighted that underlying demand per se remains weak, so how do you see same store sales growth trending given that the base kind of becomes even more favorable, you have -10% odd growth in the base now. Do you see SSG still remaining negative or are you seeing any signs of a pickup on a month-on-month basis? Any kind of color if you could give on that sir.

**Amit Jatia** Sure, I mean basically as we have seen in other sectors, as we have seen at the ground level in the malls, footfalls on the street, we still feel that the consumer sentiment is not way back up as we would have liked it be. So at least for the immediate quarter I don't see really much changing at the ground level. In fact, it is hard to predict but I think what we are seeing currently is that the consumer confidence remains quite weak. And yes, we are going against negative comparable sales and that might have a different platform but from a consumer point of view I don't see any changes yet at the ground level.

**Avi Mehta** Okay. And sir if I look at the second quarter employee cost number, this quarter it has been a very high of 23 crores, is there any one off over there and if there is, what would be the sustainable run rate going forward on a quarterly basis?

**Amit Jatia** So there is no one off here, the thing is that last year after this quarter, wages went up and therefore this is the impact of that compared to a base where minimum wages were 30% lower. So I feel this is the way it is going to continue. Obviously we have thoughts around productivity growth, but primarily it is sales driven, because there is a certain minimum staff strength you need at the restaurants to deliver the standards that you expect out of a McDonald's.

**Avi Mehta** Okay. So you think that per say this is whatever probably be somewhere the run rate that we should see going forward?

**Amit Jatia** Yes, but you must factor in for the fact that between September 2013 to 2014 there are 24 new restaurants as well, so this is not a comparable number per say. So just the addition of the 24 new restaurants would have changed this number, and additionally, post last September, there was an impact due to the minimum wage hike.

**Avi Mehta** Okay. So what you are saying is on this 23 crores the only impact would be the new restaurant addition otherwise this is what would be the base number be, that's what I want to clarify?

**Amit Jatia** Yes, what I am saying is that as we continue to add new restaurants, this amount of 23 crore will change, because there are more people coming on the payroll. And the second aspect is whatever minimum wage or inflationary effect comes, that's number two. So those are the two impacts to labor costs.

**Avi Mehta** Sir, last thing, if the way things are looking and probably in FY15 we would see weakness sustaining. But, what I am concerned about is even in FY16 or the next fiscal, due to impact of the depreciation because of these new restaurants and the base that we have, would it mean that we should now start building for FY17 for us to see a very sharp growth in PAT and profitability? I mean I am just trying to get a sense over here sir if you could help us.

**Amit Jatia** We don't get into forward projections but what I can tell you in the past is if you look at our history of 18 years, as we were able to grow sales we kept getting the operating leverage flow through to the bottom line. So the main point being that comparable sales and sales have to start coming back. As the sales start coming back the foundation is already there. The operating leverage shift is quite significant even with every dollar of sales pretty much most of the cost is incurred and therefore the flow through comes pretty well. It is an operating leverage business because it is retail and you keep adding new restaurants. So on one side there are all these new restaurants that drag your performance down, on top of that because of flat comparable or negative comparable sales plus high inflation your existing restaurant are not increasing the contribution and that's a double whammy. And therefore over the 18 years we have seen cycles like that and what we have seen is that when sales come back the flow through picks up very quickly. You can see that in our trend of the last five years as well.

**Avi Mehta** Okay, yes sir, the FY11 to 12 pickup that you are talking about.

**Amit Jatia** From 2009 till 2012, all good years where we did get our margin flow through quite well.

**Avi Mehta** Okay. Unfortunately, those numbers would not be available, if you could share that?

**Amit Jatia** It is on our investor presentation but we will email it to you. Ankit will do that.

**Moderator** Thank you. Our next question is from Hemant Patel of Axis Capital. Please go ahead.

**Hemant Patel** You mentioned that we are maintaining the addition of restaurant base for FY15 and as I see it at the moment I think the net addition of restaurant base is roughly around eight restaurants. Amit could you just highlight to what are we looking at for FY15 and 16 if you can.

**Amit Jatia** Sure. I mean it is a total addition of nine restaurants so far that we have done in this financial year. Pretty much all the restaurants that we need to open are in ground break and what happens is that because these are drive thru's and the lead times go longer which is why we don't look at it from a quarter-to-quarter point of view because the development of the restaurants starts with land acquisition, developing the building and then you go inside and do the interior décor. Basically as far as FY16 and 17 are concerned, we only intend to increase the pace of our growth when it comes to new restaurants and our guidance of 175 to 250 restaurants over next 3-4 years, we are pretty confident of sticking to that.

**Hemant Patel** Okay. If I just prod a little bit more into this, I mean last year we had net additions of 23 restaurants, are we likely to increase that addition this year or be lower than where we are?

**Amit Jatia** Yes, we will increase the additions over last year. Because last year the gross additions were 29 and therefore the net became because of some of relocations and closures, etc., we don't anticipate any of that this year so I think we should be okay.

**Hemant Patel** Okay. You mentioned about reimaging, just wanted to understand I mean out of the 192 restaurants that we have at the moment, what percentage of these really require to go into reimaging and to probably this year and next year, could you give us some sense on that?

**Amit Jatia** Sure. So you know the good news is that a lot of our recent growth is all with new reimaged restaurants which need the new, young, relevant, energetic look that we look for the customer today. So that's the good news. Primarily what we find in markets like Mumbai and Pune some of the restaurants where we need to re-image. So it's a bit case to case per se. But in the last couple of years, we have done over 25 restaurants that have been reimaged and I feel it might be similar number at best over the next couple of years and then we will be pretty current in our outlook to the customer.

**Hemant Patel** Okay. In a given year probably you are talking about a smaller number that is like five or six restaurants, is it?

**Amit Jatia** Re-imaging is about touching only the consumer area where the customers interact with you and you don't need to touch the kitchen. So, you can right now stick to the five to seven per year, although next couple of years it could be a bit higher.

**Hemant Patel** Okay. And wanted to understand the impact of McCafé, because I do understand that we are in 27 restaurants and we are talking about taking it up by December 2015, as per your press release to 50 to 75, but having a look at that I would have assumed that it would have added to the base line sales of the restaurants. Having said so I have not seen much actually coming through on the same store sales numbers, so could you give us some sense of how it has benefited at least for the existing base and what kind of a delta has it given, I mean even on an index basis it is also fine.

**Amit Jatia** Sure, so basically what you've got to understand is that it's 27 on 190 base of restaurants which is a very small number and also of this 27 if you recollect last quarter it was nine, so only in the last two to three months we have taken it from nine to 27 and you continuously see that pace as we are learning and ramping up. The point is that the results we have seen in each of the restaurants where we reimage our McCafé have been quite good and what we noticed is that trends are quite a bit better than what we see in rest of the market. So the return numbers, we don't share individual breakups of business models but the returns are in excess of what we typically expect out of a standalone McDonald's. So it's complementary and contributory to the overall McDonald's business. And other thing is that this is just base line introduction, we haven't even marketed it, it's primarily servicing the customers who are already coming and the more interesting part is that it is building complimentary day parts, like breakfast and afternoon snack part and it is bringing in new base of customers as well. So we find that basically it is nice complimentary business to core McDonald's and therefore it is accretive to margins and to sales both. I hope it gives you some sense.

**Hemant Patel** I was just trying to understand that if in the 27 restaurants where we have introduced it, I know it is too early but has the base line sales improved for just those particular restaurants if I were to do a comparative like-to-like basis?

**Amit Jatia** Absolutely, which is what has encouraged us to move very aggressively on it. We are pushing this harder, because it is giving us the customer experience, the customer connect which is helping us go to the next level.

**Hemant Patel** Okay. I gathered the comments you made about the margin profile of the business and I guess Smita can also add on to this but in terms of restaurant margins I probably think that this quarter was the lowest level I have seen in the last three years, having said so the gross margins are probably at the highest level that we have seen, could you give us some sense of on a like to like basis, are the restaurants probably two or three years of maturity profile, have they held on to margins in the context of increase in gross margins and increase in royalty and labor charges?

**Amit Jatia** Actually what has happened is the absolute sales number has been low in this quarter, so my point to you is that it's not just about comparable sales, it is just one indicator. But in the last quarter, particularly what we learnt is that there was a month where consumers were out there and that month we were all delighted and we were wondering if consumer confidence is coming back. But, what we learnt is that in the next month, the consumers were not out there at all. So because the absolute sales number dropped and our business is about operating leverage and high fixed cost, we immediately took a unprecedented beating in this quarter that I haven't seen in the last five years.

**Hemant Patel** Just two more question, one on delivery business, I know you are not going to give any numbers on it but it's encouraging to see that you are extending it to most of the other restaurants in an aggressive manner, how has this actually changed in the key catchment areas. Is there any metric that you are tracking which gives you confidence that this can become a larger part of your revenue?

**Amit Jatia** Absolutely, because this is a positive comparable business since January and we have been watching a trend of higher and higher comparable sales growth. So obviously it is growing faster than the total business and is it has obviously increased it's percentage sale in totality. We have been very encouraged with it, in fact we recently launched Chennai with McDonalds delivery service. The two things that I have helped us with this is first, we have launched a delivery promise, not a guarantee but a promise that we are saying that we will deliver product to our customers in 29 minutes and it is more an internal operational bench mark for us to ensure that when the customer calls for food at McDonald's we can deliver to them on time and we are finding that what we call as our hit rates of the number of customers who are getting it within that timeframe is getting better and increasing. And the other is the brand connect through online making it easier and more accessible through apps and the hand of the consumer and all of that has built brick-by-brick and month-on-month we are seeing comparable sales in this particular segment growing. So we are really encouraged with this is and we are definitely planning to accelerate this as much as we can in the coming months and quarters.

**Hemant Patel** Sure, this is useful. Could you share what the percentage is delivery and online if you can.

**Amit Jatia** Of our total delivery business, online is about 25% to 30%. So, if we have Rs.100 of delivery sales overall, 30% of that business is coming from online.

**Hemant Patel** Okay. And, if I were to combine these two as a percentage of overall business?

**Amit Jatia** Sorry, we don't share that data.

**Hemant Patel** Just one final question before let you go, we have heard this media news that Burger King is planning an entry strategy into the market especially in the north India. I mean in our sense it could probably lead to a category expansion, at the same time I just wanted your views about their entry strategy in terms of the price points and the menu that you are trying to offer.

**Amit Jatia** See, what I have seen even in the past, most of the times, McDonald's in the burger and the fast food category has remained much ahead of most people. What we saw is even when one of our other competitors was expanding rapidly, as long as the entire category was growing we all did well. I mean if you look at our numbers 2011, around 20% comparable sales on a very strong base of average volume that a McDonald's does over many of it's peers. My view is that firstly it will take some time for any new entrant to scale, I definitely feel it will grow the category because has to access to the customer at the end of the day from a western fast food point of view, which I said is only 1% of the entire eating out market in the country. I have always maintained that 1 billion of western fast food that we see today is going to be 5 to 7 billion may be 5 to 10 years in future and some of the larger players are going to definitely benefit from that. So the only time competition could make a challenging in the medium to short-term if the category does not grow like the frequency of eating out say in Mumbai remains at 8-9 that it has been in the last couple of years and there are more and more people entering and chasing for the same pie. However, if the eating out frequency as it grew from 3 to 8-9 from 2004 to 2012-13, if frequency grows from 8-9 to 12-13, I think everybody is going to do well. So that's pretty much how I see competition. I think in the true sense it is good for the consumer and if it is good for the consumer it will grow the category in totality.

**Moderator** Thank you. Our next question is from Vivek Maheshwari of CLSA. Please go ahead.

**Vivek Maheshwari** On your comment basically about there was a month where consumers were there and you were getting a sense that things were picking up and then you saw unprecedented beating, so I am sure you or your team would have understood this better. What would you attribute that sudden shift, where you were feeling that footfalls were increasing and then it suddenly changed, how do you think about that?

**Amit Jatia** So in a particular month there were end of season sales, there were various celebrations and occasions, etc., so consumer were coming out and we were doing well. The following month after that we suddenly saw that again footfalls started dropping in the malls, so maybe the end of season sale was where the consumers spent their money especially given their current mindset and the confidence. And having spent their money in that particular month I think they did take a step back in that particular month. But, when we talked to our colleagues outside of the QSR in retail, automotive etc., we found that particular month was weak for every single industry. So this is the first time I saw such an unprecedented shift. But outside of that, it gave us learning that as long as consumers come out, the brand McDonald's is still relevant, still current and it gives us the volumes that we need. But if consumers are not coming out because of a broader economic situation, it is going to hurt most of us in the retail industry.

Also, if you link that back to our delivery business, there is not a single month where we have seen our comparable sales in the entire delivery business being negative. And we feel that since consumers were at home instead of going out even in that particular month, we were able to grow the delivery business.

**Vivek Maheshwari** Okay. And on the financial analysis slide, you have mentioned increased base of new restaurants being 45% of the total restaurant base. So 45% essentially I presume will be less than three years restaurant, that's how you classify that?

**Suresh L** Yes, the restaurants which are less than three years old constitute almost 45% of the base of the total restaurants.

**Vivek Maheshwari** Okay. So just to understand this better Amit, when you say three years it takes for a new McDonald's restaurant to ramp up. If we're selecting a property which is in a high footfall area, so had it been a delivery-led model or a number of other retailers that I can think of maybe jewelry where they have installment schemes, I can imagine an entire cycle for them, but for a McDonald's which is very footfall driven model, is it because of the macro that this period has elongated to three years and when things pick up this can be much shorter or this is something that you have seen through the cycle?

**Amit Jatia** No, so basically we have always maintained two to three years in the past, it is not that there are restaurants that open very well from day one as well, it depends on brand development, brand maturity, it depends on the mini market you are going to, there are many-many factors that lead to that. But yes, you are right that it is obviously elongated because what you can see in comparable sales is measurable but in new restaurants there is no measure because it is a new restaurant. And as I have mentioned before new restaurants are opening at a slightly lower level than they used to, in the past because that same comparable sales impact is there for new restaurants as well, so that is number one. Number two, just because McDonald's has opened somewhere does not mean people start building it into their life, what we have learnt is, it takes people some time to start building and recognizing the fact that there is this new McDonald's. If it is a completely underpenetrated market we get a great amount of business, then it settles down and then it starts growing back. So for them to build that into their thinking, they have to keep driving past it, walking past it many times before it gets entrenched into their minds that there is a new McDonald's.

Obviously in a market like Mumbai it is much faster because all our brand extensions are working very well like delivery, McCafé, etc., while in some other market where the brand is developing it takes longer because those customers could have never seen a McDonald's in their life before and even if they access to McDonald's it could have been on their trip to some market and therefore it is a once in a while for them and for it to become a habit takes time.

**Vivek Maheshwari** Okay. And small question on the price hikes, would you have taken any price hikes during the quarter and if you can quantify if you have taken any?

**Amit Jatia** So normally we take 2% to 3%, this quarter there was no price increase.

**Moderator** Thank you. Our next question is from Prasad Deshmukh of Bank of America. Please go ahead.

**Prasad Deshmukh** First of all on employee cost, is the increase just because of the new restaurants and minimum wages going up or there is a pressure building up because of like multiple channels trying for more or less same kind of manpower?

**Amit Jatia** No, absolutely not. It is because of new restaurants and minimum wages hike.

**Suresh L** And the normal increments that would happen on an annual basis.

**Prasad Deshmukh** So are those normal increments like higher versus what they were in the say past couple of years?

**Amit Jatia** No. The other reason from a percentage point of view is also because of lower sales.

**Prasad Deshmukh** Yes, that is understandable. So second question is on the raw material costs, so going forward do we continue to see rather the pressure actually keeps easing off and this bit will also keep driving your gross margins?

**Amit Jatia** No, we have been quite proud of the way we have been able to manage our gross margins while keeping value for the customer. A great example is how we launch the wrap platform which today by the way has become an incremental purchase for the consumer. So the wrap is a snack and is treated as a side and that's added incremental margin to us while it has met our consumer need as well. McCafé's have added incremental margin to all the restaurants where we are doing McCafé. So my point is that, if you can maintain value to the customer because remember in our business in QSR today the average frequency of eating out is still very low and it is about category expansion from our point of view at least. So if we can maintain value, not only does it allow us to get customers back and more often, but through menu innovations and platform if we are able to get our gross margin, I think it becomes a double win. What we have also learnt is that when we keep the pricing right and value, it is not about low prices, we find that in distant markets we are able to penetrate that market deeper and we tend to do quite well in those markets where many of our competitors struggle because their price points are very high for the consumer.

**Prasad Deshmukh** Okay. Just one question on the increase in footfalls and that led to good sale in couple of months, so how many of your restaurants as a percentage of total are in malls?

**Amit Jatia** No, we don't break that up the portfolio but we are evenly balanced.

**Prasad Deshmukh** Was trend same even in the restaurants which are not located in malls?

**Amit Jatia** No, it was not just malls, what I am trying to say is that high streets also had their relevance, important thing is that it was end of season sales, there were reasons for the consumer to be on the ground and that led to good sales. So the fact that as the market recovers the foundation and the as we have continued to expand the base of restaurants, it is going to pay off at that time. And in our cycle of 18 years, we have seen such times and we have seen how the recoveries happened. So that's what gives us the confidence that when footfalls come in, it should help the business.

**Prasad Deshmukh** But you have not seen any pick up in the current quarter? I mean, I am assuming that September would be the month you are talking about.

**Amit Jatia** Yes, I am talking about September and I am not commenting on what happened after that at this time.

**Prasad Deshmukh** Okay. And just one final question, the same store sales growth numbers that you are giving, that also includes for mature restaurants wherever you have opened McCafé those numbers are added there?

**Amit Jatia** No, they include everything. Yes, but remember the base of those total is very-very small because primarily as I mentioned earlier in June quarter we had nine McCafé's.

**Prasad Deshmukh** But those mostly will be in metros right?

**Amit Jatia** Yes, mostly it is Mumbai, Pune, Ahmedabad and one in Nasik as well, these are the four cities where we've opened McCafe's right now.

**Moderator** Thank you. Our next question is from Arnab Mitra of Credit Suisse. Please go ahead.

**Arnab Mitra** Hi Amit, couple of questions. One on your comment that going ahead you would be looking much more aggressively on newer clusters as compared to existing clusters only. What does that do in terms of cost because if you are opening the first McDonald's in some city which is not very large does it mean supply chain cost and those kind of things initially go up much more and also in terms of the capex, is there any kind of lower rollout cost because they are smaller cities?

**Amit Jatia** Firstly we don't intend to lose focus on the key cities we are operating in today. If you recollect Smita mentioned that the four restaurants we opened in the last quarter were all in very tough real-estate market like Mumbai and all have responded extremely well to us and we are very excited about the fact that this worked for us, so that is number one. Number two, you see over the last two or three years we have developed a model based on our learning because we are in smaller cities, we are in Kolhapur, Nasik, Vapi etc. and we have been able to develop a model because we intelligently intend to penetrate new clusters. We are slowly stretching each cluster. So, for example when we opened Rajkot earlier this year in February and we are now in October and we find that those restaurants have performed very well, they still continue to do well, and we continue to do even positive cash flows in those restaurants. So I think that we have a decent model that now will allow us to get into these underpenetrated markets in a smart and intelligent manner and that's what we are now beginning to shift a little bit in that direction. But I want to re-emphasize that that's not at the cost of losing out our current markets, we intend to keep the same focus in our current markets but we intend to add these new cluster openings as well.

**Arnab Mitra** My second question is on the delivery business, the fact that your SSSG or comparable sales has been a little lower than the other QSR chains, is it the only reason that your delivery is not a big part of your business? And secondly, if that is true is there any reason why? Because I know you had said earlier that your delivery is an extension and not the core business but given where India is and other issues there, is it worth going more aggressive on delivery than what you have gone on?

**Amit Jatia** See I just want to reemphasize that when we say it is not our core business the key point here is that we have been and we will continue to be aggressive on delivery but I don't want to leave the wrong impression that delivery is the way forward for us, because consumers do want to go out as well. The first point I want to make is that as you deliver more and more convenience, like with the online app the consumer can now very easily place a McDonald's delivery, I think the convenience helps us quite dramatically in pushing things forward. So to my mind delivery will continue to be a big focus for us as it has been from 2005. We have more than doubled our business today compared to when we started in 2005 and similar is the case with breakfast. So we noticed that as we build scale and as we start talking about it, each of these brand extensions start growing and when I put all the brand extensions together they start working quite well with the in-store business as well and give the same consumer more and more reasons and occasions to use a McDonald's which eventually benefits the brand substantially. So I just want to say that it's a balance, I am not saying that we will not focus on delivery but I am also saying that it is not the core focus of our business as well but it is a brand extension.

**Arnab Mitra** Right. And in terms of just number of restaurants where this is available do you intent to gradually roll it out across the board and will enough resources in terms of man power or bikes etc., there is no constraint on those?

**Amit Jatia** Absolutely not, also I must point out that when you see our numbers, we have always intend to take brand building and we have never intended to focus on sort of deals only to get guest counts from a comparable sales point of view. We prefer to build, like for example the entire focus in the second quarter for us has been the brand and brand does not give you immediate results but at least it helps differentiating McDonald's in the minds of the consumer against competition that may come tomorrow. Also, certain regions where the brand has been around for a long time are already performing far better than the regions where the brand has come in say only two or three years back. So those are the differences that you see in our business and our numbers and as I have always maintained it is a growing country and it is an emerging and evolving category and an evolving brand.

**Moderator** Thank you. Our next question is from Abneesh Roy of Edelweiss. Please go ahead.

**Abneesh Roy** My question is again on Burger King, in the international markets if you could tell us if Burger King has entered in your area of operations where you are already strong, how market share has behaved and in their positioning in India I understand they will do a lot of localization, so are we prepared to respond to that?

**Amit Jatia** I can only talk for India and all I can say is that we are pioneers of localization, we laid the foundation of localization when we introduced

Aloo Tikki in 1997, I think we have written the chapter in the history on Indianization where we have kept our products uniquely McDonald's and yet with an Indian flavor. And if I read out the list of our products that are Indianized, that's how the customer and the brand equity has been built for McDonald's. I feel it is great that other brands and other companies are following the McDonald's lead on Indianization and I feel that's the right thing to do because people have seen the success of localization and bringing relevant taste to the country.

**Abneesh Roy** And currently pizza if you see competitive intensity is quite high because of the slowdown also and new players entering, now slow down will continue at least for the next two quarters in QSR, so in that context isn't there a heightened price war entering finally?

**Amit Jatia** For anybody to impact a market or a player firstly needs to have presence. So now when I read that some competitor is going to open 10 or 12 restaurants in the next few months period, in India we are sitting on a base of 350 to 200 restaurants, opening at least 30 to 50 restaurants a year, my point is that it will come but it will take its time. So I don't think it is about price war or anything today, I think the key players today are the three top brands in the QSR market who all have scale and sell over thousands of products. I think the newer entrants will take their time to get the scale and yes at that point they start becoming relevant. The good news for us is that as they open one restaurant every day, it keeps giving us an insight from a consumer point of view on what are the pros and cons of their offerings and based on what we can learn and adapt.

**Abneesh Roy** Sir, petrol and diesel prices have corrected, any benefit of that to our distribution and delivery cost?

**Amit Jatia** Obviously there will be, but these are minor changes compared to the overall cost structure. So, it is not significant enough, but, it is going to be beneficial.

**Abneesh Roy** In this quarter results if you see Shopper Stop has seen very good volume growth and same store sales growth, if you see the online retailers Flipkart with billion dollar etc., so why customer is spending on these categories but not QSR which is a much lower ticket item, in spite a lot of promotions. Pizza has got one-on-one promotions even today, why there he is not spending?

**Amit Jatia** It is very simple, I can only talk about McDonald's. See, our business is impulse business, you never make a date to go to McDonald's. At best when you think about McDonald's it will be in the morning of that day, so I don't understand the Shoppers Stop category because I am not an expert in that area, whether it is a planned purchase or you think about it, I don't understand that dynamics. In QSR, the whole reason of quick service is because it is an impulse purchase, it is about convenience. As long as there are footfalls on the ground people are going to come in, it is not that people cannot spend Rs. 25. So as they footfalls scale up to a large number, that impacts the QSR, you got to understand the dynamics of what drives QSR.

**Abneesh Roy** I understand this in the in-store dining, but for delivery which is again reasonable portion of you revenues, there it shouldn't be applicable, right?

**Amit Jatia** Well, again at the end of the day delivery has grown double-digit comparable sales since January so I mentioned earlier we have done very well with delivery. But again remember, if you look Euromonitor's data, delivery overall is yet a small part of the consumers consumption. So at the end of the day the impact is not large enough for it to have a significant impact at least on our business because for us it is a brand extension at the end of the day.

**Abneesh Roy** Sir we have done a lot of hard work in the last few quarters like McCafé, wraps and a lot of innovation, so are these also helping expansion of gross margin?

**Amit Jatia** Yes, absolutely.

**Abneesh Roy** Is it moving the needle?

**Amit Jatia** It is moving the needle because if you think about it even though we have had sort of difficulty with sales and absolute sales have been low, we have yet been able to grow our gross margin by almost 100 basis points over last September. Example, we have taken brand Aloo Tikki and we have added a new Chipotle sauce with imported peppers from Mexico, etc., and given the consumer a taste profile that they like in a different platform and a different manner and that's connected with the consumer very well. In our business all you need to do is go to a restaurant and watch the number of people who are eating wraps and the wraps are priced at Rs.45 and therefore it is margin accretive to the business. At McCafé, all our products start at much cheaper than others and as you know beverage gross margins are generally quite decent. So we have seen healthy margin flow through wherever we have launched McCafé's.

**Abneesh Roy** Some of the donut chains this quarter and also in Q3 targeting festive gifting, like Diwali gifting etc. In our McCafé are we trying that or it's too small a format or you don't want to dilute the positioning?

**Amit Jatia** For us right now it is about creating awareness of McCafé and growing the base of McCafé. We believe in a step-by-step approach. For us right now, it is about one getting the scale of McCafé so consumers can feel it and two, it is about trial. So it is about awareness and trials. We feel that once we have scale that is 75-100 McCafé's in place, that's when the real game starts getting played on McCafé from our point of view.

**Abneesh Roy** One follow-up on the coffee retailing space, there is a perception that Starbucks is doing much better than lot of other entrants in the last two three years. So in India if you see where does McCafé start, so why does Indian consumer want to go to McCafé when pricing is not very different from Starbucks? Starbucks stands out in terms of branding majorly because they are specialist in that. For you it is more of a brand extension, so why does an Indian consumer should go to McCafé if he has a Starbucks as an option close by?

**Amit Jatia** Customer does not see it is a brand extension or not, customer sees that McDonald's today is offering great coffee, we already have 170-180 million people coming to McDonald's, previously when you were driving by and you thought of coffee, McDonald's did not come in your consideration set because we never really offered the variety of coffee that we do today. With McCafé coming in and the consumer having already used McDonald's and tried McCafé and the feedback we have is that our coffee has come out very well, today McDonald's starts coming in their consideration set. So today when we see customers enjoying our coffee and with the new reimaged restaurants, it offers our customer a similar experience as that of another coffee chain or coffee shop and McCafé is not new to McDonald's, and if you research globally we have done quite well with brand McCafé. So from our point of view, it is another option of menu for the customer which we are delivering in a slightly coffee environment.

**Abneesh Roy** One last one, premium versus the economy segment for you, which has slowed down more?

**Amit Jatia** I don't see that as a difference, consumers are value conscious that is for sure but we have not seen a drop for example on our premium products. It has been very similar.

**Moderator** Thank you. Our next question is from Nikunj of Bay Capital. Please go ahead.

**Nikunj** just one question, during this period of declining same store sales growth and having some pressure on operating margin, what are the steps that we are taking to improve upon that?

**Amit Jatia** So, the key thing we can do is prepare our restaurant and focus on things that make our foundation stronger that as sales come through the flow through down to the bottom line keeps getting better and better. And one of the best things we have achieved is getting our gross margins right. Remember, lower variable cost per every rupee of new sales help flow through more to the bottom line and therefore covering up fixed cost better, that's number one. Number two, we have constantly kept on evaluating all our fixed cost and example of online delivery with almost 25% to 30% of our delivery business coming from online, it has helped us deal with cost structure of the call center. So, today the platform allows us to grow the delivery business without any incremental cost. We have taken a number of such measures but the primary one has been getting our gross margin in line with where we wanted to be so that as business grows the flow through comes quite strongly down.

**Nikunj** But on gross margin also if we say leave out the product mix change, what are the steps that we would have taken to get the cost right?

**Amit Jatia** As I have mentioned, there are three levers to manage gross margin and it is all about menu pricing, product mix, and raw cost. So we have worked on all of the three things and we have been fortunate that we have got results from product mix.

**Nikunj** Okay. And now again the inflation is coming under control, so do you see that again helping us going forward?

**Amit Jatia** I think it should reduce the pressure a bit, but, we need to wait and watch and see what really happens. But, it is encouraging for sure.

**Moderator** Thank you. Ladies and Gentlemen, that was our last question. I now hand the floor back to Mr. Amit Jatia for closing comments.

**Amit Jatia** Thank you very much for coming on the call and I appreciate you patiently hearing to all our responses as well. If you have any further questions, please do reach out to Ankit who will be happy to respond to any more questions. Thank you again.

**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.