Q4 FY2014 Earnings Call Transcript – May 9, 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 Fourth Quarter and full year ended March 31, 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 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 Mr. Arora.

Ankit Arora Thanks Mallika. Welcome everyone and thank you for joining us on Westlife Development Limited's fourth quarter and year ended March 31st, 2014 Earnings Conference Call. We are joined here today by Amit Jatia – Vice Chairman, Smita Jatia – Director and Suresh Lakshminarayanan – Chief Financial Officer, Westlife Development Limited.

Please note that the results, press release and investor presentation has 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 the analysis of financial performance and highlights during the review period. At the end of the management discussion we will have a Q&A session. Before we start I would like to remind you that some of the statements made or discussed on this call today may be forward-looking in nature and must be viewed in conjunction with risk and uncertainties we face. A detailed statement and explanation of these risks is available in the quarter's results press release and investor presentation and in our subsequent annual report which is available on our website. The company does not undertake to update these forward looking statements publicly. With that said, I would now turn the call over to Amit to share his views.

Amit Jatia Thanks Ankit and thanks to everybody for joining us on the call today. We basically continue to invest in building the McDonald's brand and business in India. While the IEO category particularly in FY14 has remained flat, Westlife has made good strides in each of the four strategic pillars of the McDonald's business.

With respect to broadening accessibility, we have basically been able to open new restaurants and by continuing to provide value to our customers. With respect to food image, we have offered relevant and modern choices to our customers through some things that we will share with you later in the presentation, modernizing the experience by making the customer experience at the restaurant more relevant keeping in times with the changing needs of the consumer particularly using modern designs in technology and with respect to energizing crew, the idea is to provide a friendly experience to our customers. We are also pleased to be able to build a platform for beverage options through the launch of McCafé in October 2014 that forms as a solid foundation to build on particularly the beverage business in the future. More specifically on FY14 performance and highlights, with respect to restaurant expansion we were able to add 29 new restaurants to drive long term growth for the business with a particular emphasis on Drive Thru's. Some of the new markets that we opened were Rajkot in Gujarat and Palakkad in Kerala. What we are particularly happy that we have been able to enter both these markets through Drive Thru restaurants that provide us long term competitive advantage. We have also had a hard look at our portfolio as we do every year and essentially as mini markets change in an emerging and developing markets, we have actually relocated and closed 6 of our restaurants in FY14.

With respect to revenue growth we have been able to get a revenue growth of about 8.2% year on year. Largely, FY14 has been a year where consumer confidence has been pretty muted. What we found is that while the first couple of quarters were alright it has been extremely difficult in the last two quarters. We have been able to keep our comparable sales in the year down to minus 6.4% against a positive comparable growth in the previous year at 6.2%. In line with expectations we have been able to grow the gross margin by about 200 basis points. We are particularly happy to say that this has been achieved through combination of product mix work along with some menu pricing which has actually strengthened the portfolio of offering pretty substantially.

Finally we have been able to deliver cash profit of almost Rs. 490 million in FY14. Let me hand you over to Smita to take you through some of the details.

Smita Jatia Thank you Amit. What I am going to do is take you through some of the highlights across the four pillars which Amit just talked about. So going on to broadening accessibility, we opened 29 restaurants which is a ~20% unit growth. We continued our focus on Drive Thru thereby increasing our Drive Thru portfolio as well as gaining competitive differentiation. In the last quarter, we opened 5 restaurants, 3 being in Karnataka and 2 being in Gujarat. This makes our presence across west and south to be at 184 restaurants with the highest number of restaurants in Maharashtra followed by Karnataka and then Gujarat. On the food image pillar, FY14 saw a lot of new products news. This did not only give consumer new news but also helped us improve our gross margin through the product mix shift which Amit just talked about. Through product introduction across every quarter as you can see through the Masala Grill in quarter 1, Quarter 4 saw the saucy chipotle wrap and the premium products, we were able to offer menu choices across day part and thereby positively impacting margins by 200 basis points. To put this whole together and to celebrate our food we launched a new brand campaign which was called *Aaj Menu Mein Kya Hai*, which help us drive the brand connect across our consumer growth. To continue to drive guest counts (GCs) across our restaurants we used loyalty card programs and occasion driven promotion. Adding excitement, we also had limited time of offers across all quarters. Moving forward to increase our operating leverage and also to sweat our assets further we continue to build on our new business channels. Some of the highlights I would like to talk about in doing so is about our McCafé deliver business. We launched our new web delivery platform as well as our 29-minutes delivery guarantee and we are very happy to say that starting January we have seen good growth in our delivery business. The second highlight is our McCafé footprint which we had started in October, 2013. Today we stand at 7 McCafes and doing well both in terms of attracting a new customer segment as well as helping gross margin improvement.

From now I hand it over to Suresh who will take us through the financial results.

Suresh L Thank you Smita. Now I will take you through the financial analysis of the results for Q4 and FY14.

So if we move onto Slide #15, as Amit mentioned you will notice that the revenues have increased by almost 8.2% over the corresponding quarter of the last year and this is primarily driven by the opening of 29 new restaurants. And as Smita also mentioned during the intervening period the last financial year we have had various product introductions be it the Masala Grill in Q1 or the Chipotle Wraps and the Premium Burgers in Q4 and this along with various other initiatives that she also talked about, have contributed to the positive sales growth during the year. However, the sales for Q4 have largely been flat. If you move onto Slide #16 and let us talk a little about our restaurant operating margins, so as we had also mentioned in the earlier quarter our focus continues on the operating margins at the restaurant level and this slew of initiatives and measures that we have introduced, be it at our supply chain and also managing our product mix and also working optimally on the price changes etc., we have been able to drive significant efficiencies and this has helped us improve our gross margins around 195 basis points during the financial year FY14 over FY13 and around 265 basis points when we look at Q4 FY14 over the corresponding quarter of the last year. We have made significant investments in 29 new restaurants over the last 12 months ending March 14. However, as these restaurants are new and they take time to stabilize it has a significant drag on our restaurant operating margins. We are conscious of that and at the same time, as far as the investment in the restaurant goes we are very clear and keen to take ahead our plan of opening about 250 restaurants by 2015. We have been taking various initiatives to bring down utility cost in the restaurant which has been impacting us over the last 12 to 18 months. However due to the tough economic scenario, inflationary headwinds and around wages and utilities we have seen a dip in our restaurant operating margins by 170 basis points. However, I would like to mention that almost 50% of our restaurants are probably around 3-year period and therefore that is the kind of time that a restaurant takes to mature and therefore we see some drag on the restaurant operating margin. So if we move onto the operating EBITDA front, we are currently in the investment mode and this requires significant investment on talent, acquisition, management, and development also. Corporate, general, admin expenses if I look at the entire year as compared to the FY13 there has been a growth of almost 20%. But if I look at the Q4 FY14 versus a Q4 FY13 they largely remained flat but we believed that this investment is critical to help us drive profitable business growth over the long term. So therefore largely due to this, we are seeing a dip in the operating EBITDA margin by about 240 basis in FY14 compared to FY13. And let me talk briefly about when we look at our balance sheet on the consolidated basis we have a network as of

March 31, 2014 of almost Rs. 520 crores and a cash & cash equivalence of almost Rs. 170 crores and we continue to remain a net cash company as at the fiscal year end. 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 our belief is that we are still at the nascent stages of the development of the QSR industry in India. As per Euromonitor the total size of QSR is about $15 billion and therefore if you take a view over a long-term horizon we continue to invest in building new restaurants and we continue to maintain an outlook of 230 to 250 restaurants till 2015. As Smita mentioned operating leverage is given by doing our basic average to our sales and we believe that McCafé is a good foundation for us especially making a beverage platform pretty strong. We expect to launch about 75 to 150 McCafé over the next 3 to 5 years. One of the big focuses we have in the coming years is to really start penetrating in newer markets as well. So while we focused hard on our 6 key cities and we continue to do that we intend to increase our focus on newer markets based on the results we have seen in Rajkot and Palakkad. Re-imaging of our older restaurants has also yielded positive results for us in the last year. Recently, we have re-imaged Colaba, we re-imaged Phoenix and we opened both the stores with McCafé and our customers have given us very good reviews around that. And we intend to continue reimaging our older restaurants to provide a modern experience to our customers. With respect to menu, we expect it to continue to play a huge role in both providing variety and options for our customer and helping us continuously improve our gross margins as we move along. With respect to profitability we have made good strides on gross margin in the last year and we hope to continue making strides on gross margins in the next 2 to 3 years. We have been very focused on driving unit economics and even with the dollar depreciating by almost 30% to 40% we worked hard to ensure that our cost of developing the restaurant has yet remained in the range of Rs. 25 million to Rs. 30 million per restaurant and finally we continue to focus very hard on optimizing our assets by looking at the restaurant portfolio regularly. Basically we are quite excited about the future and we have used this period to really build the foundation and we hope to continue to do so in the coming years. With this I open it up for question and answer.

Moderator Thank you very much sir. Ladies & gentlemen, we will now begin the question and answer session. The first question is from line of Avi Mehta from IIFL. Please go ahead.

Avi Mehta I had a few questions more on the future and just on the demand environment if I may. First I just wanted to check with you is there any guidance that you can share for FY15 on gross margin expansion and also on the store addition plans for next year.

Amit Jatia We do not really provide guidance specifically for a year. However with respect to new stores we continue to maintain that we will open between 70 to 100 stores every 2 years. That is the range we will continue to grow in the coming years. As far as gross margin is concerned the endeavor is to continuously improve gross margins further.

Avi Mehta The next question is on demand. If you look at this quarter it has come at (-10.5%). I understand that there is some base element also to it but all said and done, Yum! has seen some improvement in SSSG. So is there any sign of competitive intensity? Are we kind of facing some market share pressures and are you seeing any signs of probably improvement or even bottoming out if you could share?

Amit Jatia See as far as McDonalds is concerned we believe in building our customer base in a healthy and a strong manner because we want to build a strong foundation for the company and therefore we do not offer deep discounts to our customers but we focus rather on building loyalty and that is where the big difference of our comparable sales and numbers versus anybody else. So for example, we have launched loyalty cards and loyalty cards basically reward frequency. So what it means is that when customers come more often to McDonalds they get rewarded and we prefer building those kinds of transactions and customers rather than other types. So that is primarily been our focus. With respect to demand my point is that it is very hard to say, all we find is that particularly in the last six months we have clearly seen consumer confidence has been impacted and I see this across category. So you have got to recognize that QSR is yet at a very nascent stage and as I had explained last time that we are in impulse business and especially McDonald's focuses on a very large base of customers and we provide affordable prices. So what happens is when consumers are not buying homes or consumers are not out buying white goods and they are not visiting shopping malls, that impulse visit of the customer is lost and that is where we see some loss in terms of sales and comparable sales. We believe that as the economy picks up, clearly QSR demand will come back because we are yet a very smaller frequency driver in the entire informal eating out market. So I feel that as consumers start coming back out into the market, as the confidence level of the consumer keeps moving up I feel we will all sort of come back.

Avi Mehta So if I look at it on a pure base, I am just doing a very simplistic analysis but just adding the last year's number, the base kind of becomes very-very favorable going forward. I am just trying to get a sense, would you see the demand as of now what you see in April or May demand is more or less at the same levels or do you see it is very difficult to take a call on whether it is deteriorating further or any kind of comment on that front which you could help us with?

Amit Jatia All I can tell you is that basically the sentiment of the consumer has been difficult I feel that it will take some time before that starts changing. What you must also recognize that we had all 10 years of phenomenal double-digit comparable sales growth, so if 10 years ago a restaurant was at 100, today that same restaurant is trading around 200. If you look at Q4 FY13 results, we were at 7.2 percent comparable sales, quite different from rest of the industry and therefore I feel that what we have done in 2014 is continuously build our foundation and we believe that our job in the next 12 months is to continue to build on the foundation because as the consumer sentiment starts changing we feel that that allows us to really be at the forefront of taking advantage of that swing.

Avi Mehta Lastly, is there any re-statement that has been done in the prior period with the consolidated numbers?

Suresh L No, there is no restatement.

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

Latika Chopra My question was on operating margins – restaurant operating margins have come down. I understand the environment is very uncertain but any sense on would you expect the margins have bottomed out or there could be levers which could probably contain margins at these levels because much of the increase in cost is coming from employee and other operating expenses. So any thoughts there?

Amit Jatia What I would like to say here is quarterly numbers are hard to focus on. I personally feel that a full year number in a business that is being built is a better base to kind of discuss and if you look at our full year numbers, the primary impact has come because of new restaurant openings. So with sort of flat to minus comparable sales growth with little bit of cost pressure on both utilities and labor and especially with the impact of new restaurants I think personally that we have done alright with 180 basis points of reduction and particularly what I am happy about is to get about 200 basis points improvement on gross margin because that remains forever. What I feel is that by building that as the economy stabilizes and as business starts growing in the coming months that will add good incremental margins to us in the future. So I feel that it is primarily on account of utilities and occupancy cost relating to new restaurants.

Latika Chopra Second question is on the royalty payout, it is about 3% for FY14, what is the expectation for FY15, is there going to be any increase there?

Amit Jatia It goes up by 1%.

Moderator Next question is from the line of Abneesh Roy from Edelweiss. Please go ahead.

Abneesh My first question is on the smaller markets, can you talk about Rajkot and Palakkad stores? How consumption habits are different here and are we tweaking our business model in these smaller towns and what is the plan going ahead in terms of entering new smaller cities in FY15 and FY16?

Amit Jatia Basically we are pretty consistent with the way we want to grow in the coming years. As we have said before that about 60-70% of our growth would be in existing cities which we are saying and while new markets would be 30-40%, so we continue to maintain that. What we have learned though is that when we build free-standing Drive Thru's, in markets like Rajkot the consumer experience has been pretty good. So for example, we have 30 car parks consumers have tremendous convenience in just parking and straight entering into the restaurant, it is a good 3,500-4,000 sq. ft. restaurant. So the consumer experience has been great and we have been rewarded quite well with the customer experience and business in those markets. However at the end of the day a city like Rajkot can take may be one restaurant. I have mentioned this before that we continue to grow in clusters. As we have done in Gujarat in the past, we first opened Ahmedabad then Baroda then Surat and then slowly we entered markets around there and now we have increased our circle by adding Rajkot, all the cities that come in that circle now become sort of fair game for us. So particularly we find that using the Drive Thru model has worked well for us.

Abneesh Next question is on your other initiatives like Online Web Delivery and McCafé, if you see the delivery model of the pizza companies they are offering specific promotions to popularize that. So 1+1 pizza is offered in the web delivery model and not in store dining. So in your case are you offering any specific online promotions?

Smita Jatia Yes absolutely, I talked about with the whole new Web Delivery platform and us being able to increase our business through that we are offering online offers. At the same time we also have bill back offers which you can redeem in your next purchase and the other part is the 29-minute guarantee, so if you do not get your order in 29 minutes you again have a free offer in that. So there are regular promotions which continuously happen on the delivery platform.

Amit Jatia So basically by combining operational efficiency and giving the customer a commitment on the delivery along with ease of ordering through the web system, it has yielded good results for us and we continue to sort of build on that moving forward.

Abneesh And these promotions are communicated to consumers through micro targeting because in pizza we see the online ads etc which are mass ads. In your case how is it communicated to the consumer?

Smita Jatia Absolutely what you mentioned is through micro targeting on the website as well as the cookies which enable to see the offers to the right target audience.

Abneesh And online is expected to increase your ARPU, in the sense that in pizza we see that because we see more graphics, etc., more options, the average revenue per user does increase. In your case also in other markets of

McDonald's have you seen similar trends and currently what is the target you are expecting in the next three years from the delivery model?

Amit Jatia Firstly any time you allow the consumer to place the order on their own the order size does go up because they can do that at their own convenience and it is easy to use. So we see a similar situation when it comes to our platform. While we do not give future numbers, we have seen very strong double-digit growth in the online ordering model. And we expect this to grow to a substantial level in the coming years.

Smita Jatia It is also going to change as the media patterns are changing with the target audience. So, as more and more internet usage is happening and as more and more companies are going on digital platform, you will see growth coming from the digital platform.

Amit Jatia However I must point out that we are in in-store business largely and delivery really is a brand extension for us providing us with another opportunity to serve the customer. So, we do not want to lose our in store focus.

Abneesh My next question is on the competitive intensity, now pizza companies are also coming out with option wherein they give a free toy along with the dish and your USP and one of the major attraction points has been the toy which is given out. So are you seeing this as a risk and in other markets do pizza companies do this and do they impact your business in other markets?

Amit Jatia See, when brands like McDonald's build a platform, the platform is built in such a way that it provides competitive advantage to us in the long term. So just because somebody offers a toy does not put something at risk. But fact is for example, if you look at our global breakfast business, you look at our global Happy Meal business, it has remained a foundation for us through the years. And it is not that other competitors have not tried to offer but what is unique about McDonald's is its global strength and leverage and partnerships with global brands that bring toys that are relevant to the consumer and the children. So these are programs that are current with a movie that is playing, these are programs that is current with the games that children are playing online and we believe that it is a global strength that we bring to the table. So, competition will always be there in every category and it is important for brands like us to keep staying ahead and to keep re-energizing ourselves and we are very confident of the platform that we have.

Abneesh When you say a successful launch of McCafé brand, what exactly you mean? What is the internal benchmark and in the other mature markets how big is the McCafé and in India in the light of already lot of players who are having specific experience in that they are also entering the market. How you are seeing this grow-up in India in the next few years? I am not asking in terms of guidance but directionally how much does it change in India kind of market?

Amit Jatia See as far as we are concerned my first benchmark always is what the consumer is saying. Is the product with its price value equation establishing well with the consumer and so far we have had very encouraging results in all of this and good news with the retail business is all you need to do is go to the restaurant and see it for yourself. And therefore we are quite pleased with the feedback and the way the consumers have responded to our McCafé offering. Now coming to McDonald's you see the difference between us and how people do it, as far as we are concerned it is another offering within the McDonald's platform, so we do not do independent McCafé and therefore when people are coming into McDonald's it is another option of having great coffee and great beverages available along with your food purchases. And slowly in the consumers' mind they start thinking of McDonald's as a beverage option and a beverage platform as well. So we feel that in the long term it will open up an opportunity for us to build McDonald's as a beverage destination and McCafé is the first step in that direction. And based on the customer feedback it has given us encouraging results basically.

Abneesh My last question is on the El Nino thing which is going to up, how worried are you for this because some of your raw materials could see a sharp spike and in current challenging demand scenario, are you seeing a substantial risk to your gross margins this year?

Amit Jatia See basically in India having been around for 17 years depending on agriculture we have built a lot of things where our supply chain focus is hard and on being an assured supplier. So for example a lot of our farms are irrigated and we built an irrigation platform because we want such effects to not impact our business and our food & paper & commodity costs. So you will see trends of our food & paper cost across the last 10-15 years, you will find that we have managed it quite well and we are quite confident. It is hard to predict, I do not want to speculate on some report that is going on that monsoon might be good or not, but it is always better as McDonald's always does is to build fundamental strength in the supply chain that can address such issues through irrigation etc. E.g., we do not rely on any one area say for all our lettuce. So what we have done is we have leveraged the geography of India to grow lettuce across the whole country and even if one area has a bit of an issue we are very confident that our assured supply program will ensure that at least at McDonald's you will get lettuce for sure.

Moderator The next question is from the line of Avi Mehta from IIFL. Please go ahead.

Avi Mehta I missed the net cash number and gross debt number, if you could share that. In the occupancy cost, the increase is almost about 18% versus 12% last year despite this store edition being lower. So I just wanted to know if there is one off occupancy cost. And similarly in the employee cost, probably one-off in the sense that you might have brought an employee for this store edition which is likely to happen in 1,000 FY15 or so, I mean is there is anything of that sort as well?

Suresh L On the employee cost, if you look at, what has happened is that there have been some wage revisions across the states, so this quarter will not give you the right picture because it comes along with some arrears, etc., which have all been paid in this quarter and therefore to that extent it is there. So you need to look at the annual number to get a sense. So if you look at how it moved annually that will give you a better sense of how it is and that is how the trend we see going forward as well.

And, nothing extraordinary in occupancy costs. What is also there is we also have a slew of openings around the end of the calendar year so therefore, new restaurants which have kicked off on the last day of previous quarter comes into this quarter as well. So therefore to that extent you will see slightly higher numbers. But, if we look at the kind of a near average, it has basically moved up from 29.2% to 32.3% and obviously there are some inflationary impacts as well because there are other expenses there where we have had inflationary trends, particularly on the utilities, etc., and also with the new stores. So it is an impact of that what you see. So the increase is generally at that level.

Amit Jatia So for example in the last quarter there is quarter 3, we added I think 10 restaurants, on top of that we added another 5. So the impact of the entire 15 largely comes on this particular quarter. Also what happens is that our advertising expenses vary. So if you are launching a product, sometimes the advertising expenses go up, although across the year it is flattened at between 5% to 5.5%. So therefore I said that quarterly numbers are very hard to look at. But in terms of trends I do not see it very different from what you see in the year-end and the full financial year numbers.

Suresh L So you would also want to know what the net cash position is, so basically as at 31st March we have a net cash of Rs. 110 crores. So there is cash and cash equivalents of Rs. 170 crores and we have borrowings of about roughly Rs. 60 crores as of March end. So that leaves is with net cash of around Rs. 110 crores.

Avi Mehta And one last thing, you recently highlighted that you have opened two stores in Tier-2, Tier-3 towns, just trying to understand in terms of revenue per store and in terms of profitability per stores how do these compare with the Tier-1 stores both in margins as well as absolute value if you could shed any colors on that?

Amit Jatia We do not break up our numbers by new cities etc. but I just want to point out that this is not the first new city we have opened. We have been operating in Kolhapur for the last 6-7 years. We have been in Nasik for 5 years. When we opened in Baroda many years ago it was considered a small city. So, we have good experiences between both bigger cities and the smaller cities. Both have their pros and cons. So like a Mumbai might have much higher volumes, so while the volumes in a smaller city might be lower but then the cost structure is also lower. So, while we do not break it up that is the best I can share for you at the moment. The good news is that we have good dynamics and understanding of how both the markets work and when we set up the store, we set it up with that structure in mind and that allows us to get the best from both markets.

Avi Mehta Okay. Sorry on that, I was not looking for a quantitative number but just a qualitative commentary on the profitability is what I was looking. Would you be able to share that?

Amit Jatia All I can is you know it varies. There are some markets that respond extremely well. There are some markets that take time but all I am trying to say is that on a return basis we are able to manage both markets quite well. So sometimes a new store in a small city opens well and we get great returns but there are examples of stores that could be lower than the market average and it takes time to build the brand there. So it is not one specific answer that I can give you.

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

Bhavesh Shah My question is actually on McCafé. I wanted to know how much time does it take to get a McCafé to contribute positively to a particular in-store margin, I mean does it also take say three years as to what you benchmark for a standard McDonald's restaurant?

Amit Jatia No, no, fortunately McCafes do quite well from day 1 because there is already a trading traffic that comes into the restaurant and because there are already a whole bunch of customers that are coming in. So McCafé contribute immediately to particular restaurants and also the margin profile of a McCafé is pretty decent and therefore it overall improves the store performance quite well.

Bhavesh Shah Okay, so considering the incremental capex that you would spend and the margin which eventually McCafé would contribute, qualitatively say down a year, so it is basically less than 3 years effectively you are saying as compared to what a matured McDonald's store would do.

Amit Jatia All I would like to say is that McCafé contributes positively to a store because one, it adds to the offering of the beverages and therefore consumers. So for example, you have done a meal now and you can have a Frappé or a coffee after the meal. So that is an incremental purchase. And secondly as consumers realize there is a McCafé they come at different day parts, so they could come in the afternoon day part and they could come in the breakfast or just post breakfast day part. So it gives us these two benefits primarily and therefore they contribute quite positively to the return from the store pretty much from the beginning itself.

Bhavesh Shah Understood. My second question is on considering say price hikes, I mean I do understand that the gross margin expansion that has been extremely superb for Westlife, but do you think it makes more sense to even consider say price hike to protect your restaurant margins or is it that the demand pressures are very high to risk it?

Amit Jatia No, we have always said that we believe that when you are thinking about gross margins, there are basically three or four ways to think about it. Obviously, we have to deal with menu prices given that there is significant inflation in the Indian market. The second thing is that we constantly endeavor to work very hard on the supply chain to keep getting benefits, for example at the farm level to increase the yield per acre, at the factory to improve the yield or reduce our cost, etc. And the third thing is of course the product mix shifts. So, for example when we introduce a category like beverages that offers us a slightly better margin that allows us to improve the margin profile of the whole restaurant. So we believe that all these three levers together should yield margin improvements rather than just focusing on menu price hikes, yet at the same time we obviously have to look at menu price increases as well because the three together that we feel gives us the best results.

Bhavesh Shah Understood. My final question is on your breakfast offering, would you like to share some thoughts on how the offering is growing or how is it, in which scale of development it is, is it still very early stage or if you could just share some thoughts on it?

Amit Jatia Sure, I mean one we have been expanding the breakfast offering across restaurants so today we have more than 100 restaurants that offer breakfasts so that is something that we believe we continue to want to invest in. Secondly, we did for example National Breakfast Day in March and National Breakfast Day is a phenomenal opportunity for us to expose to the consumers the breakfast offerings of McDonald's. So this happens across the Asia Pacific restaurants where we offer across 9,000 restaurants consumers to come in and get about 500 to 1000 muffins free and the whole idea is like a sampling exercise. So we do things like this to continuously sort of build brick by brick the breakfast business. We believe that when we started the McDonald's business 17 years ago we build the burger business in the same manner and it took time for consumers to understand what this means for them and therefore I believe that breakfast is in its nascent stages and I think that it is going to be built across over the coming years.

Moderator The next question is from the line of Pulkit Singhal from Treeline. Please go ahead.

Pulkit Singhal On McCafé, I understand we started in October last year and we are just opening around 7 McCafé and I think even the plan is around 75 to 150 in 3 to 5 years as you mentioned, but I am just trying to understand what is the challenge in opening McCafé. You already have 184 restaurants and what is the challenge in opening all of them much faster than at the pace that you are opening?

Amit Jatia We believe that we want to keep a balance between our growth of new stores because we yet believe that with only 184 stores, we want to ensure that the platform and the accessibility of our restaurants continues to grow for our customers. Please remember that at the end of the day McCafé is a brand extension for us. Secondly, whenever McDonald's launches anything we like to take its time to settle down, get customer feedback, ensure that the product offerings are solid, get the supply chain in place and then go aggressively in the future. So all I would like to say is that we are as aggressive as we feel we should be and we believe that again this business is something that has got to be built over time and we believe that we will do justice to this brand as it needs. We also need to think about a certain way in which it works better than others and we want to work through all of that because doing it right is more important than just spreading it without results.

Pulkit Singhal Okay, so my takeaway is that the supply chain is currently in all place for you to expand more aggressively. So in that sense you are saying that our supply chain would very much be in place, say 3 years or so for us to be able to expand it fast.

Amit Jatia See let me explain, as I had explained before we are enabling our restaurants to be McCafé enabled, not let me explain what I mean by that. So every new restaurant that we are building has already factored McCafé footprint, the McCafé design and the entire ecosystem that is required to build a McCafé. So what that means is that the day I decide I want to move fast I can because then it is already there. I do not need to change anything in the design. So please recognize that it is already happening and that will give us the pace and the skill that we need. Meanwhile when you launch a brand you first want to get consumer feedback, you want to ensure that you get all of that right and then you want to take it to the next level, which is the phase we are in today and as we did with our restaurants where in the first 10 years and this is just more an example that in the early years we built a certain number of restaurants then in the last 3 years we built more than what we did in the last 10 years. And I feel that that is the same phase that is going to happen with McCafé but only faster.

Smita Jatia Just to add to it what I would also like to put here is while we are understanding consumer feedback, we are also spending time to operationalize the entire McCafé platform because only when we are confident that this platform is ready for the scale up that is when we are going to accelerate and get the McCafé in all our restaurants and as what Amit has said we are already providing the space and whatever is required.

So once we have got the model right, we have operationalized it completely, that is when the scale up will happen.

Pulkit Singhal So if I understand it correct all your 184 restaurants already have a space of McCafé. So there is no renegotiation of rental contract or getting some extra space etc. Is that understanding correct?

Amit Jatia Absolutely. I mean obviously the newer restaurants have the space built in but the older restaurants have the space but in the design it may have to be altered. Substantially pretty much across the board, we do not need to renegotiate rents, and if you see our investor presentation we have talked about that that bulk of our cost structures incurred when we opened the store but as the breakfast business builds, as the McCafé business builds that is when our volume keeps growing. Of course in food courts, we do not have the opportunity to add a McCafé because all we have is a food counter. So, that is the only exception to the rule.

Pulkit Singhal My concern stems from the fact that lot of these coffee joints in India are expanding pretty fast. I mean you have the CCD, Starbucks etc., so while I appreciate your quick expand there also a concern on whether someone is already taking that space.

Amit Jatia My only point is that it does not completely work like that. That is our sense at least. As far as we are concerned, we already have a customer base that is coming to us and we are providing them more convenience and options by offering beverages as well. So I feel that we add a different dimension to it but I hear your point on the consumer. We are quite conscious of the fact that it is going to be consumer driven, not internal driven but at the same time you got to give the right experience to the consumer. So there is a balance. And I will sort of close it by saying that the foundation is built in every restaurant and we will not leave any opportunity to grow it if we have to.

Pulkit Singhal Got it, and lastly having operated 7 McCafes how does it kind of impact the average sales per store? I mean does it bump it up by 10, 15 or 20%? I mean what is the kind of impact does it have on the sales?

Amit Jatia We do not breakup our business models and how much they contribute to the store. So I am sorry I would not be able to answer that. More importantly it's building a foundation for our customers on different day part and is building the menu platform on beverages for McDonald's.

Pulkit Singhal Right, but it would at least improve the margin profile as you mentioned beverage is high margins.

Amit Jatia Definitely.

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

Arnab Mitra My first question is on new store additions and clearly with the kind of slowdown in the macro and as you pointed out in your presentation that probably sentiments will remain low for another year or so, does it in any way change the calibration of restaurant addition because you do have a target for the next two years. So do you at all think about the near term when you are planning the next one year or is it completely driven by the long term and you would not really worry about the next 6 to 12 months slowdown in terms of adding new stores especially in the top 10 cities I would say.

Amit Jatia We have always built our business outside of the environment. You have to adapt to the environment, however, when it comes to new stores the answer is that we will continue to build the 70 to 100 restaurants within two years for the foreseeable future. So we are not slowing down or changing our strategy around new restaurant openings based on the current environment.

Arnab Mitra Right. And you did point out to some store closure if I recall, if you could just tell us is it like a continuous process of re-evaluation or is it like it has happened for the first time or it happens very rarely and what were the reasons for that?

Amit Jatia We have had a pretty good track record of restaurant openings but also it is important that as the size of the portfolio grows you have got to constantly look at what a restaurant is offering to you. Now to give you a great example so let us assume that we look at things as a mini market and in the mini market, India is an emerging market. So a lot of things happen. So let us say a mall was built many years ago and the mall was built on a certain size and obviously when we think about a mall and the way we operate, we take a call where we manage our risks quite alright. But over 10 years, let us assume the dynamics of the trading area has changed and while we have done well in the mall we have got a good return, we have got our pay back, we feel that currently the sales in this market are not going to grow and not going to contribute positively to our return. That is the point of time when we think that may be if we move the same store to another part of the mini market we can capture more sales and generate more returns while catering to the same consumer. So it is a well thought process and while I do not anticipate too much of this but I do anticipate us thinking about such situations in the next 5 years because the market is dynamic in India and as the mini markets shift we are going to be prudent about our return and our investment in a particular mall or a particular store.

Arnab Mitra Right. And just couple of other questions, in terms of price increases if you could just give us a sense how much year on year is the menu pricing on an average up now?

Amit Jatia Typically, we look at about 5-6% in a year just ensuring that we stay sort of with inflation or slightly behind it.

Arnab Mitra Right. And just lastly on the demand side, is there any way you track absolute footfalls into your store and has that declined more than the 10% kind of comparable sales decline that you have seen? So I am just trying to figure out whether it is lesser people dropping in or is it the absolute purchase which is the problem?

Amit Jatia We get thousands of people and basically you cannot have a ticket counter guy, so, the number of footfalls is very hard to measure in terms of footfalls into the restaurant but what we can tell you is from what we have seen is that we are seeing lower footfalls on high-streets and we are seeing, when there is a sale offer, there are times in India now where it is a sales period, we see mall footfalls go up during the sale period and immediately after the sale we see footfalls in malls drop. So, because we are an impulse business we immediately see the impact back onto our business as well which is why we follow a balanced portfolio approach where we like to have our presence on high street malls, Drive Thru's, transit points so that we have a diversified basis of capturing customer visits rather than being dependent on any one type. Footfalls on the high street we are seeing it go down a bit. Footfalls in malls depends on the season and the sale but we are seeing pressure on that in these two areas.

Moderator Next question is from the line of Pritesh Chedda from Emkay Global. Please go ahead.

Pritesh Chedda Couple of questions, in pay back period for investments in Tier-1 and Tier-2 would it be similar? And my second question is what would be the payback currently based on the current restaurant operating matrix which we saw in quarter 4 or which we saw in fiscal 2014?

Amit Jatia See restaurants that we open are on a 20-25 year horizon and therefore we do not look at today's environment to base our decisions around restaurants especially quarterly results as I explained to you numbers vary so we have launched the product, advertising could be way off that impact the quarter numbers. So I would first focus on the full year numbers to really get a sense of what is going on. Point #2, payback is not dependent on Tier-1 or Tier-2 but it is more dependent on how developed market it is versus how underdeveloped the market it is for the brand. So if the brand is new the early results are great and then the store settles down, right. While in a developed market the brand is already known so when you open the store the store the results could be pretty encouraging. So in a normal business unit economics, our sales are anywhere between Rs. 40 to 50 million by year 3 and typically payback is around 4 years. That is roughly the way we sort of look at it.

Pritesh Chedda And would it have increased, so let us say in the current environment would it have increased the payback and if has increased then what it would have increased?

Amit Jatia Like I said that obviously given that comparable sales are muted, obviously new store openings are also opening at a slightly lower volume. But at the same time we have seen that when things turn around the comparable sales that you are able to get and the way the store gets built up again is also pretty high. So, it is hard for me to tell you if anything has changed. We are going by the basis that we have normally been able to do because we have also got a history of about 16-17 years now and we have seen many of the cycles play out exactly as I mentioned to you. So, when the economy stabilizes the uplift that we are able to get makes up for some of the times when it opens slower. So I maintain that the payback of 4 to 5 years is pretty much how we see it currently.

Pritesh Chedda Putting forward that question again, so let us say we have opened a store in Palakkad, which is a smaller town, what would be your expectation on payback there?

Amit Jatia Like I mentioned it is the same, we do not breakup our paybacks by towns, etc. It does differ by business models but we do not break that up. So for example a food court would be different from a Drive Thru but we do not breakup our thing and we do not really share those details.

Moderator Next question is from the line of Pratik Biyani from Standard Chartered. Please go ahead.

Pratik Biyani While you will not share the gross margin trend, do you have any target in mind or if you can share what are the gross margins of McDonald's system in other emerging countries or developed markets and could that number be your target for gross margins here in India as well?

Amit Jatia As far as we are concerned, we have made a 200 basis points delta and over the next 3 to 5 years, I have said that in the past that our aspiration is to move towards the 60% number.

Pratik Biyani Even in your previous call you mentioned about down-trading happening and I think that must have impacted you in this quarter as well. In some other QSR player within the portfolio some people have witnessed down trading to low end products or low margin products. However, in our case product mix for us has been favorable. Any particular reason for that and will you attribute it to significant amount of new launches that has happened in FY14?

Amit Jatia No, see down traders is not just around the menu. So I will tell you down trades happen in 2 or 3 different ways. So firstly when you think about eating out, down trade happens to road-side vendors, down-trade happens to clubs and canteens, etc., where people are trying to spend less by going to these options. So that is one level of down trade that happens and we have seen that happen in FY14, which is why the QSR category then takes a bit of a hit. Secondly what we see is that if a consumer was spending Rs. 100 in the past and they still want to spend the Rs. 100. So for example the service tax came in that increased their cost by Rs. 5 which is when they either down trade or buy one thing less. So, we see that as well. However, for example just by offering Shake-Shake Fries, the consumer likes the spice and now along with the fries has bought the Piri Piri spice as well which helps us increase the spend from the consumer at the same time helps our margin profile as well. Same example goes with beverages, so now the consumer is buying a cup of coffee as well and that helps us with our margin profile also. So that is when I talk about product mix, that is what I mean in terms of improvement in margin profile.

Pratik Biyani But these would be new launches and hence there could be excitement around new launches, are you seeing within your new launches some repeat purchases happening at a brisk pace.

Amit Jatia Obviously I mean it is not just around new launches, there are food festivals that we do that we keep coming back with different offers. For example, we have done our doubles offer for the last 2 to 3 years and every time we have done our doubles offer the consumer has responded extremely well. Similarly, Piri Piri fries has now been on the menu for a while and as consumers get more used to it, it automatically keeps building volumes. So all I want to caution you is that it is not just about new products. It is about variety, it is about new news. It is about going back and talking to the consumer about the same delicious McVeggie that we have had on the menu for a while and reminding customers that they can buy that as well. So it's a bunch of all of this.

Pratik Biyani And what is the margin differential between your new store and a mature store which is more than 3 years old if you can share some data.

Amit Jatia We do not break that up, I am so sorry about that.

Pratik Biyani Couple of book-keeping questions more. You talked about re-imaging some of your older restaurants so after how long do you feel the need of re-imaging that older restaurants, after how many years and what is the cost that you incur in re-imaging them?

Amit Jatia Basically, it depends on the store, it depends on the profile, and it depends on many factors. It is a hard question to answer. But typically we like to keep refreshing the store at least every 5 years and a refresh is very different from sort of a reimage and there are different elements that go into that. So all I can say is a 5 to 10 year horizon for a refresh to a reimage.

Pratik Biyani How many stores did we close in FY14?

Amit Jatia We kind of relocated/close about 6 stores. And in our entire history over the last 15 years we have done about 10 to 12.

Moderator Ladies & gentlemen due to paucity of time we will be taking last question from Sunny Agarwal of Aditya Birla Money. Please go ahead.

Sunny Agarwal My question pertains to our strategy on new product launches. I mean what is our strategy with regards to new products? How many products usually we aim to launch every year and in continuation with that, is there any plan to launch new product based on health base platform which comes with a higher price point and higher margin? And, again is it possible to launch a region specific product like for north and south, depending looking at different taste preferences?

Amit Jatia Basically in terms of new products there is no number that every year we need to launch these many products. First and foremost, when we think about even the health platform in the last one year we particularly added a number of grilled products on the menu and they have kind of resonated very well with our consumer. Again for example, we launched a couple of years ago, our Egg Burger and it is a steamed product and that again has resonated very well. So the whole idea is to offer options on the menu that resonate with different customer needs and occasions. There are times when consumers want to indulge and want a filling meal and we need to have options for that and there are times when the consumer wants a light burger or a light product for a certain day part. So that is how we build our menu strategy. It is sometimes about just romancing your old products that have done extremely well and that are anchors today. So for example, you take McDonald's Fries. You know our Mac Fries have been around for 17 years and they continue to build day on day and year-on-year. What we do sometime is add excitement by basically adding say the Piri Piri Spice and recently we have added a Cheese Spice. So the idea was for the consumer to play around with the Cheese Spice and that is in some ways engaging and giving new news to the costumer. So we do think about the menu over a 2-3 year horizon and basically it depends on the need of the hour, it depends on the market, depends on the consumer and many other factors.

Sunny Agarwal My question was with regards to the increased competitive intensity as far as new product launches from other QSR players are concerned. So in that regard, I mean looking at a current downturn so as to excite the consumer are we fastening our process of new product launch?

Amit Jatia No, all I am trying to say is that it is not just about new products when you are thinking from a competition point of view as well. If you look back at the presentation and the work we have done on menu both in terms of menu additions as well as the LTOs, food festival etc. So, we will continue to work towards this by giving excitement and fun to our consumers based on our understanding of the need for McDonald's.

Sunny Agarwal And is it possible to launch region specific product or it will be only a pan India kind of thing?

Amit Jatia Take an example of Aloo Tikki, it has got an universal appeal across all regions and it is today a brand across the country. Take our Mac Fries, it is a brand across the country. So we will do what is needed from a consumer's point of view but we do not find today the need to be very regional in terms of our product offerings.

Moderator Thank you. I now hand the conference over to Mr. Amit Jatia for his closing comments.

Amit Jatia I just want to thank you for taking the time to be on the call today and for patiently listening to our responses as well. Hope and look forward to your participation on the next call in Q1 FY15. Thank you and have a good weekend.

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