Q2 FY2014 Earnings Call Transcript – November 08, 2013

CORPORATE PARTICIPANTS:

- Mr. Amit Jatia – Vice Chairman, Westlife Development Limited
- Ms. Smita Jatia – Director, Westlife Development Limited
- Suresh Lakshminarayanan – Chief Financial Officer, Hardcastle Restaurants Pvt. Ltd.
- Ankit Arora – Manager, Investor Relations, Hardcastle Restaurants Pvt. Ltd.

Moderator Ladies and gentlemen good day and welcome to the Westlife Development Limited conference call to discuss the results for the second quarter and half year ended 30th September 2013. As a reminder, all participants' lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference, please signal an operator by pressing '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankit Arora – Manager, Investor Relations. Thank you and over to you sir.

Ankit Arora Welcome everyone and thank you for joining us on Westlife Development Limited second quarter and half year ended September 30th 2013 earnings conference call. We are joined here today by Amit Jatia – Vice Chairman, Smita Jatia – Director, Westlife Development Limited and Suresh Lakshminarayanan – Chief Financial Officer, Hardcastle Restaurants Private Limited.

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

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

Amit Jatia Thanks Ankit. Hi everybody and welcome to the call. We really appreciate you taking the time to be with us here today. Basically we continued to focus on building our restaurant network in South and West India while navigating tough really economic environment in the country. In Q2 FY14, essentially we grown revenues by about 11% year-on-year. This was primarily driven by new store openings. While we opened about 9 new restaurants in the quarter, we ended the period with a total number of restaurants at 174. Year-on-year, we have added about 36 new restaurants. So between October 2012 to September 2013, we have added about 36 new restaurants compared to 26 for a similar period in the previous year. Comparable sales were negative at about 5% versus about 10% positive in the previous quarter in FY13. This clearly reflects a very weak consumer sentiment while we have actually almost doubled same stores sales over the last 5 years, this is the first time over a decade where we faced a full quarter as a negative comparable sales period. Despite that, we are happy to say that the restaurant operating margins (RoM) of course improved by 130 basis points from last quarter, but despite adding 36 new restaurants between the year and as you know new restaurants mature over a 2-3 year period, we are happy to state that our RoM we have lost only about 90 basis points between last year until this year. So pretty much at the store operating level, our margins have remained quite alright. We are also pleased to say that our gross margin which is one of the areas that we have been striving to improve over the last few years, we have been able to make a pretty good delta and we have been able to expand our gross margin by about 165 basis points year-on-year.

In terms of key growth drivers, essentially of course new restaurants remained our number one growth driver. While reinvigorated value platforms and our popular Happy Meal properties while offering compelling limited time menu choices have been important for us and later on in the presentation we will take you through that. I now hand over to Suresh, our CFO to take you through the financial section.

Suresh Thank you Amit and good evening everybody. I will now take you through the financial results for Q2FY14. So if you are on slide #5, you will notice that the revenues have increased by about 11% over the corresponding quarter of the last year and this has been primarily due to the opening of 36 new restaurants in the intervening period and we have also introduced new products like the Masala Grill range, the Veggie Pops, the Piri-Piri McNuggets and the same has also been complemented with limited term offers like the McFloat twisters. If you will go on to the next slide and look at the restaurant operating margins, I would like to mention here that through very concerted efforts put in by the supply chain and the menu management team, we have been able to drive significant efficiencies in product management which coupled with prudent menu pricing has helped us improve our gross margin significantly around 165 basis points over the corresponding quarter of the last year, but what is also needs to be noted is that during this period, we have invested in almost over 36 new restaurants and as you will appreciate it takes almost about 2-3 years for a new restaurant to stabilize completely and the initial years do result in a higher occupancy and utility cost and despite the tough economic scenario, the inflationary headwinds and significantly large new restaurant openings, we have managed to hold the reduction in the restaurant operating margins to around 95 basis points over the corresponding quarter of the last year.

And as we move onto the EBITDA front, you will notice that we are in the investment mode and Smita will talk about it in the subsequent slide as we go along and all this requires very significant investment on talent acquisition, talent management and development. We have made those considered investments and therefore while the general and administrative expenses would take the impact in the short term, we believe that this investment is very critical to help us grow and expand our network profitably and thus cater to our long-term objectives. Resultantly we are seeing a dip in the EBITDA margin by about 205 basis points over the corresponding quarter of the last year; however, what needs to be noted is that as compared to Q1 of this fiscal year, we have had an improvement of about 140 basis points on the EBITDA margin and this is despite increased store openings in this quarter and a lower comparable store sales as compared to the previous quarter. Finally as we get onto the PAT, you will notice that due to depreciation on the new restaurants that we have opened and an also extraordinary item which pertains to the scheme of arrangement of Westlife Development Limited, the Q2 FY14 PAT is lower as compared to the Q2 PAT of the last year and now with this, I would like to hand it over to Smita who would take us through what our development plans are.

Smita Jatia Thank you Suresh and good evening everybody. So I am going to briefly talk to you about what our pillars of growth have been. I will start with broadening accessibility which is increasing our store network and as you have heard from Amit that this is our biggest focus. In spite of a very challenging economic environment, we continue our focus of opening new restaurants. We have opened 36 restaurants in the last year taking us to account to 174 and in this quarter itself we have opened 9 restaurants which are evenly spread between West and South. You can see two pictures of our newly opened restaurants. These are Drive Thru's**.** Our focus on Drive Thru's continue and we will be opening more of these Drive Thru's as we move forward.

The next slide just shows that our presence is again equally divided between West and South or we have 57% of our restaurants in West and the remaining which are opening in South and Bangalore having a huge chunk at 24% of the restaurants.

Moving onto the next pillar which is food image – both Amit and Suresh talked about that we have improved our gross margins by 165 basis points and this has been done with work on menu which is impacting our product mix positively. We have introduced new products in our offerings which is what you can see the Veg Pops. Though not mentioned here, in the first quarter we introduced the Masala Grill and this is also showing a lot of positive impact in quarter 2. Also, we introduced limited time offers like McFloats as well as our Piri-Piri fries and nuggets.

Moving onto the third pillar which is modernizing the experience – We are very happy to announce that we have launched our first McCafe at the SoBo Central Mall. The initial results are very encouraging. Not only they have helped increase the store sales in the restaurant; however, they have also helped attract a completely new segment of customers and a new customer need is what we all being able to fulfill through the beverage offering. Another positive impact what it had was it's good impact on our gross margins. So we can again say confidently that as we expand our McCafes and our projections are to open about 75-100 in the next 3 to 5 years. It will again help improve gross margins to a significant level. From here on, I would like to again hand over to Amit to take us to the end of the presentation.

Amit Jatia Thank you Smita. As far as the QSR market is concerned, we do believe that it is yet in nascent stages in India and will grow substantially in the next 10 to 20 years. McDonald's is a global leader by far and with the phenomenal infrastructure and brand that we have built in India, we do believe that we have a huge advantage.

In terms of the outlook of the future, we do believe that the external environment continues to remain tough for us. We believe that the consumer sentiment is weak, but along with that there are high inflationary pressures which make it a bit more challenging especially in the area of utilities. However, we are confident that we will open the 75-100 new restaurants that we have talked about by FY15. We also hope to launch about 75-150 McCafé over the next 3-5 years. This has helped us attract a new customer and also a new occasion and allowed us to play in the growing café business in India and we are quite excited about the opportunity for McCafé moving forward.

Thirdly, we do intend to remain value leader in the QSR space. However, given the challenging environment and pressures on margins, it will largely be through menu innovation and intelligence supply chain management. As a company, our philosophy is that we do not discount, but we rather build loyalty through getting customers engaged with the brand and we working on our McSmile cards which provide loyalty benefits and we continue to maintain everyday value through our happy price menu. So these will be the sort of hallmarks for us as we move along. Finally to summarize on the last slide, it is the tough environment, but we continued to put our focus on growing a profitable network of restaurants. We are quite happy with the delta we have been able to make in the gross margins and as a dominant brand; we do believe that we are well placed to capture the QSR market in India. With this, I now open up for questions.

Moderator Thank you very much sir. Ladies and gentlemen we will now begin the question and answer session. Our first question is from Hemant Patel of Axis Capital. Please go ahead.

Hemant Patel Couple of questions over here. Amit I just think the takeoff on the same store sales growth which is at negative 5%. Wanted to try understanding this a little bit more carefully that from a quarter-on-quarter basis, the decline is relatively a little bit more sharper than some of the other peers. Is this decline partly attributable to certain amount of value offering which has been done by the competing brands in the market and another reason which I can probably think of is at the same time, the level of competitive intensity in the Tier-I cities where we are present, Maharashtra and Bangalore, has that actually moved up a little bit more than what consumers can take in those micro markets?

Amit Jatia Hemant, basically our view is that pretty much everybody in the industry is facing a similar challenge. As far as McDonalds is concerned, our belief is that we believe in everyday value for our customers and we believe in working with loyalty programs rather than offering sort of deep discounts to bring customers back into our fold. So while of course competition is increasing through different times, if I go back 2 or 3 years earlier, what we had realized while competition was low, but so was the market size in terms of the frequency of eating out. So as the frequency of eating out has grown while competition intensity is there, I feel that in the previous period, all our competitors grew well together. While in this period, all of us are facing challenges but at different levels. So I think that it is an issue of external environment thing where consumer sentiment is weak and I think this might sustain for the next quarter or so, but then we do believe it is coming back and lastly this is on account of very strong 10 years of continuous positive comparable sales growth and same quarter last year we had got about 10%. So based on that, we had a bit of a beating. Also as a market leader, our share has generally been amongst the highest and therefore to some extent, we have taken a bigger beating also because of that.

Hemant Patel If I look at the Maharashtra and Karnataka region, is the impact similar in regional markets?

Smita Jatia Hemant there could be a little bit variation here and there, but I would say generally it is comparable and I would not say that it is only in one city or in one region that there is a sharp decline or stabilization. So the feeling of this downturn is being felt across all markets. In fact in South, I would say we may be a little better because the decline was not as sharp as what we saw because Mumbai has always led the pack in terms of comparable sales.

Hemant Patel Few more questions. One on the gross margins, you mentioned that there was a 165 basis points improvement and this is partly attributable to mix pricing and food and paper cost. Can you just give me a sort of an attribution analysis, how much of a price hike have we affected in the first half?

Amit Jatia So in the first half, Hemant it has been about 2% price increase, but lot of work on the menu is definitely yielded very good results for us. So for example all the new products like the veg pops, the floats which is a beverage option, they have all helped the margin profile quite well for us and we continue to expect menu to play a role in improving gross margin as we move along.

Hemant Patel And food and paper cost declined because of the economies of scales that we have consistently seen. Is that playing out?

Amit Jatia Not really. Currently commodity cost pressure continues and if one commodity does better, so for example in the recent past, onions, and tomatoes have really played havoc. So what we are finding is that while scale does help us, at least at this point because of huge commodity cost increases that is kind of evening out, but primarily we have seen the benefit of product mix improvements through menu innovation and some impact of the price increase that we took earlier this year.

Hemant Patel And just one final question on McCafé. Could you give us some details or inclinations as to the kind of investment that is likely to go in, the space likely to be occupied and what kind of a more of financial what you call cash on cash returns. Can I expect something on this? I do not know whether you track it on that basis, but just wanted to understand on a financial basis how this would pan out?

Amit Jatia So briefly the investment is typically between 30-35 lakhs per McCafé and sometimes this accompanies a reimaging as well. So in that case it could become higher. Of course we are working on localizing various aspects of that, so we expect it over time in terms of investment cost to come down. The benefit has been that it establishes McDonald's as a beverage destination and that has a tremendous benefit on our gross margins particularly. We do not share individual brand extension return on investments and so on. So therefore I am sorry I would not be able to comment on that as much, but clearly we are seeing that the results have been very encouraging. What is most exciting for us is that we are seeing a different set of customers who are visiting McDonald's now on top of our previous customers plus we are seeing us being able to attract a new day part and a new occasion and we believe that this really adds to what we already have and it is sort of a building block approach that we feel that over the next 3-5 years, will really place the brand as a very young, energetic brand that connects with a certain type of consumer.

Hemant Patel On McCafé, the foot falls that you would experience and since it is barely open I think a month, would the foot falls in McCafé be relatively or close to similar to some of the competing brands which are 500-1000 square feet.

Amit Jatia Actually it is very hard to judge on that because we already have a strong customer base that is coming in and it is too early to determine that. However, we normally within a month do get a decent sense as to how the start has been and sometimes starts up sort of average, but we find that McCafé has been quite encouraging and the feedback that we have got from a qualitative point of view from customers has been quite good actually and in terms of product quality. So it is very hard at this point for us to tell you on foot falls to separate that out, but all I can say is that the particular store we launched, we can see its performance really rise above the others in the same environment. So that clearly differentiates and tells us where we stand.

Moderator Thank you. Our next question is from Aditya Soman of Goldman Sachs. Please go ahead.

Aditya Soman Firstly congratulations on opening out so many new restaurants. My question was regarding your expansion going forward. So you have a significant expansion plan. Two questions on this. Firstly will you be financing this, what will be the route of financing this entire expansion going forward and what will be the requirement in terms of the backend support that you need to set up all these new restaurants?

Amit Jatia: So in terms of the backend, we are quite well placed. We generally have a 5-year forward strategy on supply chain and we recently in the last 2-3 years, I would say intelligently added capacity in most of our suppliers. You got to recognize that if you are not smart in adding capacity and you extended too much or too little, both can bite you quite negatively if it is not managed right. So, we are quite happy with the way it is all panned out so far. So that is not really an issue, but it is a challenge that we need to manage. In terms of financing, if you notice that our cash accruals are alright even in this difficult environment, primarily of course the impact has been because of higher depreciations of new restaurants. So we believe that one with the cash we had raised earlier with debt being quite low on the balance sheet and with some internal accruals, we are quite confident that the next 2-3 years will be able to manage internally and finance that quite easily.

Aditya Soman And in terms of new restaurants, what is the payback period or the return that you sort of expect from new store or target when you open?

Amit Jatia Typically as we stated before that when we invest a new store, the investment is about Rs. 25-30 million to set it up. Typically we shoot for between 22%-25% cash ROI by the third year and the payback is generally about 4 years or so.

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

Abneesh Roy My first question is if I see your store location, two states are accounting for almost 75% of the restaurants and if you see Tamil Nadu especially if you see the opportunity in most cases in terms of consumer seems to be similar to Karnataka if not more and similarly Andhra. So if you could tell us Andhra and Tamil Nadu why we have much lower number of restaurants and if you could tell us how you open restaurants. What is the thought process behind that?

Amit Jatia Sure Abneesh, so that is a great question. As we stated before, our focus has always been to go into a market and own it. So in the early years, we concentrated on West India. We started with Mumbai and rather than dilute our focus to be built a very strong platform in Mumbai in the early years and some of the real estate we have been able to get is only because of that focus. In 2005, we planted our first flag in South India in Bangalore and in the initial years, I refused to let my team go outside of Karnataka and focus hard on owning the Bangalore market and once we built a very strong nucleus in Bangalore and set up the base, the office, the talent etc., then we started moving out into AP and Tamil Nadu. So Tamil Nadu we have entered only a couple of 2 or 3 years ago. So obviously it takes time to scale up because for us it is about doing the right thing and building the right quality of portfolio. However you will notice that in the recent past particularly, we have been able to grow our restaurant base in Tamil Nadu quite well and therefore you will continue to see this growth in Tamil Nadu and Andhra Pradesh both over the next 3 to 5 years. So it is just a structured approach. We feel that a restaurant network rollout has to be done smartly and eventually the market is always there, but finally you have to deliver value and a good quality product that serves well to the consumer and to do that you need to ensure that your infrastructure is built quite well before you just keep spreading yourself into hundred cities and diluting your focus. So that has been our thinking and you will continue to see progress in both Tamil Nadu and Andhra Pradesh in the future.

Aditya Soman So most of the openings for restaurants in next 2-3 years are they going to happen in these states and because you have come late in these states, how is the competitive scenario there. Is it much adverse versus say Maharashtra, Karnataka or it is similar in terms of the competitive intensity?

Amit Jatia Firstly we obviously cannot neglect the markets like Mumbai, Bangalore and other markets as well. So it is not that, either one or the other and this is primarily how as we open clusters, our ability to open more restaurants also increases. So in summary, first and foremost you will see more openings in Andhra Pradesh and Tamil Nadu, but you will not see a decline in store openings in Karnataka and Maharashtra etc. There is no doubt that because we started in West, at least from our point of view in West and south, we have a very dominant position in West. Also in Karnataka, we have been able to, we were 5 or 7 years behind our competition in Karnataka and therefore it has taken us time to build our base, but the good news is that with our efforts over the last 5 years, we are pretty much about there. So typically we are not allowing now for some of our competitors to get too far ahead in important markets. Yet at the same time, we are not as focused on Tier-III market as much as a Tier-I and Tier-II. So obviously the competitive intensity we have been able to manage in most markets quite well, but in Tamil Nadu, yes we are little behind than where we want and there has been an extra focus to try and get us to where we want to be over the next 2-3 years.

Aditya Soman Sir my next question is on the same store growth. If you see you mentioned initially that you want to be an everyday value proposition rather than discount led. So globally is there a policy that we cannot do discounts. Why I am asking this if you see listed Pizza Company in Q1 and Q2, their SSG largely the trend has remained similar. So what was the growth rate in the previous quarter if you can say and what is the policy on these discounts?

Amit Jatia There is no global policy on discounts, but we have always maintained that for us it is about the long term and it is about building the brand connect and we believe that discounting is a short term measure and McDonald's philosophy that is at least our philosophy in West and South is always to sort of do things that are more sustainable and build brand loyalty rather than people coming to us for a offer and then somebody else gives a bigger offer and then they go there the next day. So that is not really what our effort has been. The other important thing you got to note that our average store sales are very much higher than most of the pizza players particularly because we operate on an all-day dining opportunity which includes breakfast until dinner with a very strong snack day part as well. So therefore our comparable sales percentage in itself is not reflective of our actual dollar value that we bring in through driving comparable sales. If you look at our investor presentation, you will see trends that we provided over the last 4 or 5 years and you see that the trends have been very healthy and therefore when you face a very difficult environment right on a base that where we have taken say 100 customers in 2007 and

2008 which have become almost 200 in 2012. So on that base, tough environment we believe that as long as you can continue to even maintain that customer base we are alright. So particularly we found that after August when all the deals in malls went away, we found foot falls to have sort of slowdown on the retail side which is where we took a bit of a beating. So I do not know about how pizza companies do things because I cannot comment on that, but as far as we are concerned, we have the confidence that markets go up, markets go down and as long as we say do sustainable things and as long as we provide value to our customers and differentiate ourselves, we believe that as the economy bounces back, we will be among the first ones to benefit from that. Our last quarter we were minus 5% comparable sales and again in the previous year in the same quarter, we were about 10% positive comparable sales.

Aditya Soman Sir my last question is gross margins you have done really well, 165 bps. I failed to understand because if you see food, paper and even the distribution cost diesel etc. there has been a huge inflation and price growth, is it only 2%. So is there a big growth coming because of mix improvement. So it seems very good improvement, but difficult to understand.

Amit Jatia So globally McDonald's does a very good job in managing product mix, menu outside of just prices. So we managed to keep dollar menu for a while in the more matured markets, but coming to India, if you look at products that we launched like the Veg Pops, so the whole idea in the design of the product is such that it gives us better margins and some of our products that are already in the market place and also beverages help dramatically. So when you see float festival, the whole idea is to ensure that our floats that already do well if we offer more variety to customers, they do tend to tend towards that which helps us make better margin. So we are generally quite good at it and we believe that pro-mix management is more intelligent way than just raising prices. So we tried to balance the two quite well and especially in this period has worked well for us.

Moderator Thank you. We will take the next question from Vivek Maheshwari of CLSA. Please go ahead.

Vivek Maheshwari My first question is on same store sales growth again. You mentioned that there has been a mix improvement in this quarter which has pulled up gross margins, but is not it counterintuitive at the time when market is slowing down. Why should mix improve rather I would have imagine that value part of the portfolio should have grown higher than the top end.

Amit Jatia No, it is not like that. In fact in the last few years while we maintained our value; as I have said before, our premium portfolio has done extremely well also because at different day parts, the consumer needs value in different things. So you are going to also compare it to the outside basket. So for example when somebody is coming in for lunch and they are hungry and if they can eat a meal at Rs. 150 versus going somewhere else and eating a meal at Rs. 250 that is value for them as well as long as they like the product and the taste is filling. Now I can give you an example of the Veg Pops, the Pops were at Rs. 25, but they gave us a better gross margin and for the customer it was a variety factor and again the whole idea of doing sides is that sides adds a lot of value for the customer because they order that along with the meal and for us it is value because it does give us a better gross margin as well. So our general philosophy has been that you use number of levers to manage your gross margin and while one of course is menu prices, but that is not the only lever we want to use. We focus very hard and worked very hard on pro-mix management and pro-mix management is not just about higher or more expensive products, you just design the product better so that at the same Rs. 25, you get a better margin. So I hope this answers your question in some ways.

Vivek Maheshwari Yes it does and second on McCafé 75 to 150 in next 3-5 years, two things; one is it possible to get broadly what would be the payback and second is I have seen the one at SoBo Central, is it going to be pretty much at the similar sites across India that you have or there will be standalone McCafé as well?

Amit Jatia There will be no standalone McCafé as such because our McDonalds model is to have, when all aspects of the brand work together in the same location, we get far more synergies and economies of scale, then spreading that through different models being outside. So that is the first part. The second part is yes, it would be largely around Cross Roads, but there could be places where we do not have the same amount of space. Many times we use the brand McCafé in a slightly different way. So largely it will be like Cross Roads, but there could be a slightly different play as well which we will play out in the next 3-6 months and you will see that as we do that and on your first question, we do not necessarily share individual brand extension breakups in terms of payback and return. So I am sorry, I might not be able to answer that.

Vivek Maheshwari Not a problem and one small question if I may which is McFloat Twisters. Why is it that it is a limited time offer? Just was curious if you could provide your inputs there.

Smita Jatia There is no particular reason why it is a limited time offer. What we do continuously is depending upon the season we introduce new flavors. So these were the flavors we introduced at this time and shortly we may also introduce other flavors again in the right season. So it is just about kind of rotating products in order to provide the choice and variety to the consumer and new news as well.

Moderator Thank you. We will take the next question from Arnab Mitra of Credit Suisse. Please go ahead.

Arnab Mitra Amit, first question again on the same store sales growth part, if you could just help me understand is the decline more because of lesser number of people or lesser number of bills getting cut or are you seeing the bill size itself coming down because of the market environment and is there an element of cannibalization given the large number of new store openings that you have done?

Amit Jatia Arnab all good questions. So this is not the first time where we are opening large number of restaurants and for example in the past when we were focused on Bangalore and we took the Bangalore base from 0 to 30-40 restaurants today. Yet we deliver very high comparable sales as a system. So while in the short term sometimes it does cannibalize because it takes customer's time to recognize a new store has come in the trading area. So while that impact is not very large and normally it does build back. What we are seeing is a resistance from customers to spend more basically. So if the customer was spending Rs. 100 in the past, they do not want to spend more than Rs. 100 today. So what happened in April, first and foremost there was a new service tax that increased the customer's cost by 5% or so. On top of that, when we increased our menu prices by about 2% or so as I mentioned earlier, what happens is that the customer then starts trading down in an environment like this where they find that the whole sentiment is very weak and they do not want to increase the discretionary spend budget. It is very hard to say if it is only foot falls or if it is average cheque, but generally when we do a qualitative work because a lot of this comes back from the qualitative side, we are finding resistance to spending more than what they had originally planned and therefore they are adjusting their spend accordingly and we are seeing that for example after the sales season in August, we found that foot falls in malls, etc., all slowed down. People were not going out and shopping as much. They were deferring their big purchase items and that all impacted in the total negative comparable sales growth.

Arnab Mitra Right and just one more question is on the margin side given the tough environment, what are really the cost levers that the business has other than the product mix thing that you spoke about because what I see for example is staff cost increases very muted despite such a big addition in space. So are there any cost levers at all other than the menu part which you can be worked on and if you could also help me just understand how the restaurant operating margin is calculated. Does it on existing restaurants or on the entire base of restaurants?

Amit Jatia No, it is on entire base of restaurants. So the numbers we are giving you it includes new restaurants as well and basically the numbers that we have released and it is on our website as well. If you go up to the occupancy line item and total that that is basically the restaurant operating margin that we are talking about. So before G&A, all the expenses relate to the store. So this includes new restaurants and old restaurants. In fact if you look at our restaurants that remember that we open 36 in the last one year between last September to this September and we open 26 before that and normally it takes us to about 2-3 years to mature. So pretty much 50% of our base of restaurants, are less than 2-3 years old and that definitely has an impact on margins, but our play is not about managing today's margins. As long as store operating margins are remaining good that means that all the new restaurants we are opening is the right thing to do. In terms of the margin profile and other cost levers, clearly it is about the new restaurants taking shape and maturing as we go along over the 3 years to give us the cash on cash return that I talked about earlier and as that happens, the margin profile will change automatically, but meanwhile we will continue to open new restaurants at a more aggressive pace and therefore in the short term for the next 3-5 years, the margin profile will have its ups and downs. The primary way margins are going to continue to improve is through the scale and comparable sales growth and clearly comparable sales growth is an important factor to improve margins in our business and the economy is not going to remain soft for all its life. So while it is remaining soft, we are working very hard on cost optimization and it is a good thing to do. When everything was going up, then the focus always remains on that side, but when tough times come, you shift your focus to ensure that your cost structure is also innovated and worked upon as well. So we believe as the winds start changing and as things start getting better, we hope that that growth will give us far more margins contribution to the bottom line than it has in the past. Largely, the lever is around growth of same store sales, it is around food and paper cost because it is on the higher side in India at this point in time and it is also about the investment in a store. So for example rent, depreciation, interest, that is all fixed. So as your new store base matures, automatically all that flows through to the bottom line.

Arnab Mitra Right and staff cost increase is lower, is it more because of incentives not getting done because just a 10% increase looks very low considering the space addition?

Amit Jatia No, so at the store level you see the administrative expenses is about the corporate office. So that is a different subject, but at the store level there are incentives, but it is not primarily driven by that.

Smita Jatia And there is productivity initiative. So even if there is a salary increase, we heavily focused on productivity so as to ensure that the staff cost in the restaurants does not increase faster than what the sales increase are.

Amit Jatia Lastly you will see the same trend over 3 years if you look at our P&L over 3 years, you will find that we have been able to manage the payroll cost at the store level even in good years and even in the difficult times and largely it is because of productivity, improvements at the store level.

Moderator Thank you. Our next question is from Harit Kapoor of IDFC Securities. Please go ahead.

Harit Kapoor Sir I had a couple of questions. Firstly just wanted to understand you spoke about that the expansion will be more in the Drive Thru format. Just wanted to know how are the economics different from normal store for McDonald's?

Amit Jatia Sure. So we do not share individual breakup details of each of our portfolio restaurants, but typically what happens with the Drive Thru is that it does we believe give us long-term competitive advantage because as car ownership in India continues to grow, the added convenience of being able to drive through the store gives us tremendous incremental business and that actually takes our average store volume much higher than what you would see in other type of restaurants. Also the convenience of being able to park right upfront in the store, so your ability to in and out of the store becomes very valuable because finally we are a convenience driven business and impulse is a very large part of our business as well. So while drive thru take a little bit longer to breakeven because the investment is much higher upfront, but we believe that in the longer term, the returns that it provides, the comparable sales growth that it provides far offset that initial cost.

Harit Kapoor Fair enough. Just one more question, just wanted to understand the G&A expenses have just increased significantly. Would the royalty also be part of the G&A?

Amit Jatia No, royalty is a separate line item and it is in the statements that you might have or you can download from our website. So G&A is everything to do with the corporate office. There has been initiative to separate store operating cost from the corporate office and clearly when you are in the growth mood for example McCafé. So McCafé launch does not happen because you decide one month earlier. We have been working on McCafé for over a year and you got to get the taste right, you do work on products. So you build a team and secondly as we roll out McCafé that team continues to stay on. Similarly Breakfast, Breakfast is a business we have invested in 2 years ago like McCafé and today we have Breakfast in over 100 restaurants, but where we want to take Breakfast is at a completely different level from where it is today and therefore you need to invest in people to be able to do that. Plus if we want to take our store openings to a next higher level, again you are going to start working with people today, you need strategic planners to be hired today so that they can become productive 2 years later. So if you ask me in a growing company with the way we manage G&A for the last 3 to 4 years, it has been quite alright. That is not my worry point. My worry point is how do we ensure that our new restaurants even in this tough economic environment come up to speed at the time we normally like them to.

Harit Kapoor And just one maintenance question. The same stores sales growth that you calculate the comparable growth, would that be on 138 restaurants?

Amit Jatia That would be on any store that is open for more than 12 months.

Moderator Thank you. Our next question is from Vikash Mantri of ICICI Securities. Please go ahead.

Vikash Mantri Just one question on the same store sales growth. Can you break it up into increase in foot falls versus decrease in bill payouts or orders?

Amit Jatia No, we do not that because remember that foot fall measuring is a very difficult thing and we do not want to give a number out that is not absolutely accurate because the number of people that come inside the restaurant and the number of people who actually order are different.

Vikash Mantri So you will have the number of bills and the order sizes?

Amit Jatia But that is not reflective of the number of customers who are actually coming in and if you go back to place another order just because you want to order for dessert etc. So that is not very reflective of reality and hence we do not really share that. We feel comparable sales reflect what best we feel at this point in time; however, average cheque is something that overtime we do want to share with the market and we will come back on that in the coming quarters.

Vikash Mantri Another question sir you said your gross margins improved because of product mix. Can I get a broad idea of how better can they get by changing in product mix? What could be the highest gross margins they can deliver?

Amit Jatia I feel the correct way to look at this is that we have stated very clearly that long-term within 5-7 years, we clearly see our gross margins to go to about 60% and that is not uncommon. In fact you will see that our gross margins clearly have opportunity and we feel that we have a very good understanding of how we can manage that. Typically in products that are Rs. 25 we can manage good gross margins. Sometimes when the product is a premium product, you might not get percentage, but you get rupee contribution. So it is hard to answer that question from a product by product point of view, but there are products where we have very high gross margin and there are products where we have much lower gross margins. So the important thing is we have a very good understanding of how this all plays out and we work quite well in order to be able to take gross margins to about 60%, but it will be a mix of three things as I have said before. It will be a mix of managing our raw cost coming into the store, it is a mix of managing menu more intelligently and it is a mix of menu prices. If we manage the three right, I think it works as a win-win for the customer and the brand.

Vikash Mantri And sir can you share with us what would be the store level margins for your mature restaurants just to get a better idea of the business?

Amit Jatia Again we do not break the restaurants up between new restaurants and mature restaurants, but what I can say is that primarily the margins you see include quite a reasonable drag from our new restaurants. It could give you an indication that obviously if we do not open new restaurants, the margins on their own account will get better quite well over time. So we do not break it up, but the margins you see have a significant track from new restaurants.

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

Prasad Deshmukh Sir in your opening remarks, you said you expect recovery in same store sales growth in couple of quarters. So what is this confidence based on? Are there any macro level indicators that you look at which gives you this confidence or is there something just specific to the company which is giving you this confidence?

Amit Jatia No, currently the environment continues to remain tough. So I do not see anything that is happening right at this moment, but what I am able to see economically there are lot of decisions that I feel that is being taken place. So for example if you look at foreign currency, finally after about 6 to 8 weeks of difficult times, we are now seeing some stability. We are seeing some good policies that are coming out. I am hopeful that in 6 to 9 months, things will start looking up because the economy has already seen about 2 years of slightly tougher times. So this is more on what I perceive in the external environment that might help customer sentiment. So it is not anything more than that. So thanks for asking that clarifying question though.

Prasad Deshmukh Second question is on the supply chain that you have to develop whenever you enter a new market given the product as such is a pretty standardized product and especially the agriculture supply chain that you may have to develop may be different in different states. So as far as your markets are concerned, are you seeing any challenges regionally, supplying of raw material you need in Maharashtra versus that in South India?

Amit Jatia No, it is not to do with that. I will tell you what are the main challenges in fresh produce particularly. So anything that has got a short shelf life like take lettuce. Lettuce you know 5 days ago from when you eat at a McDonald's is being grown on a field. So if I open a new store and every 3 days I need to replenish lettuce there. The cost of just moving lettuce for one store given that it is refrigerated is just too high and the impact on the gross margin could be quite substantial that impacts our ability to be value in that market. So therefore when we open a cluster, we like to think about 10-25 restaurants to be opened within a period of 3-5 years which is where when we start investing in building the fresh produced supply chain in that particular market. So that is the reason why we have to think about it intelligently, but it is not just about supply chain. It is about equipment servicing and spare parts, it is about management bandwidth, it is about marketing because if you go to a city and open one restaurant, the cost of getting coverage or the consumer to have our brand as top of mind is very high for one store and you need a multiple number of restaurants to really get that advantage. So we believe that intelligently trading that in a cluster approach is a better way and that is what works for us quite well.

Prasad Deshmukh So just to summarize, so you are saying there is not much of difference in terms of the challenges that you face in Western India versus Southern Indian market.

Amit Jatia In terms of supply chain and in terms of availability, but it takes time to build it because of the scale required to build supply chain.

Prasad Deshmukh Just one follow up question on that. The part of cold chain which is needed for this. Is it like own by your company or you look for partners there?

Amit Jatia In McDonald's, it is about a three-legged stool theory and suppliers are the third leg of the stool and therefore we work with our supply chain partners. McDonald's does not own any part of the supply chain. It is all own by our supplier partners and the supplier partners are integrated with us and they work with us as we build our network. So they would have a view on where we are going and they would have a 5-year plan on how we want to build capacities and increase growing acreage of farms and so on and so forth.

Moderator Thank you. Ladies and gentlemen due to time constraints, we just have time for just one more question that is from Shariq Merchant of Ambit Capital. Please go ahead.

Shariq Merchant Two questions from my side. Firstly can you help us understand longer term movements on how the average order size has grown as well as how the number of orders have grown at the same store level? Suppose you take a 5-year view there?

Amit Jatia Basically while we do not break it out, all I can tell you is that when we think about our comparable sales, there are three or four components that help comparable sales grow. So first and foremost by maintaining value, we bring in new users into the restaurants who now try McDonalds for the first time and we bring existing users more often because they find value in what we offer to them. The second way we grow our comparable sales is by offering things like sides. For example take Chicken McNuggets; by offering Chicken McNuggets or take McFlurry that we started as a dessert option. So when consumers come, now they are able to have a dessert that they like as well and therefore incrementally from a meal they are able to buy a dessert which increases our average check which increases our comparable sales growth and the third thing is by making new occasions of use. So for example when we launched our spicy chicken and spicy paneer, it became an instant hit because the product was filling and very tasty for our customers and we became a lunch destination and a dinner destination as well because it was a filling option and because the price points of these products are much higher, we obviously were able to grow comparable sales quite well too. So while we do not give a breakout, these are the three major ways in which we are able to grow our comparable sales which includes a mix of growing the bill size, getting customers more often and getting new customers as well.

Shariq Merchant And sir on your expansion plans, you said you planned to open 75 to 100 new restaurants. How many of these would be in Tier-I cities?

Amit Jatia About 65%-70% will be in existing markets. So we do not really define it as Tier-I, Tier-II. So for example we are already even in a city like Kolhapur in a city like Vapi, yet at the same time we just open Cochin around a year ago. So the way we see at is 60%-70% of our growth will come from the cities we are already present in and the balance will come from newer cities which are largely going to be Tier-II and Tier-III.

Shariq Merchant So sir when you are looking at opening a new restaurant, you obviously do a survey of the population or the number of households there. So what number would be an ideal number to open a McDonald's outlet that can service these many number of households in a particular geography?

Amit Jatia It is actually on our investor presentation if you can download that from our website, it gives you I think about 1.32 restaurants per 100,000 people.

Shariq Merchant And one last question on the competitive intensity side, so Burger King recently announced its plans for India. So just wanted to understand firstly how this would affect your strategy and secondly obviously it will take time for them to scale up to a decent level. How long do you think it takes for a chain to scale up to a significant size enough to challenge McDonald's?

Amit Jatia As leaders, we have to look ahead and of course while there are new people coming in, the critical thing for us is how do we differentiate ourselves continuously with our customers and build a stronger connection where consumers love McDonald's as a brand and say "I'm lovin it" every time and therefore competition is continue to become intense in our market that is growing and globally we compete with everybody. So we are not new to this competition. However, if you think about the infrastructure we built in terms of many things starting with supply chain, you see in order for us to be able to give a quality product even over price consistently to the customer from all the way from North down South, it is not very easy when you are dealing with a short shelf life product like food and we believe that is a huge competitive advantage we have. The other competitive advantage we have is the base of around 330 restaurants that we have in the country and that base is growing. It is not going to remain static. The real estate advantage that we have, the Drive Thru's we have, and the connect with the consumer for the last 15 years, these are not easy things for somebody to wipe out and fact of the matter is we are not a brand that is fledging. We are a brand that is growing. A brand that is staying connected with our consumers through Breakfast, delivery, doing McCafé, reimaging our store, offering WiFi, at the same time being very affordable. So I think we will pose a formidable challenge for everybody to come into the market place, but in summary leaders have to look ahead and if leaders start looking behind, then they lose their leadership. So as McDonald's, we have confidence in what works for us globally. We have confidence of what works for us in India and we will continue to forge our path ahead and hopefully that will keep us differentiated and successful in India.

Moderator: Thank you. I would like to turn the call over to Mr. Jatia for closing remarks.

Amit Jatia I would like to thank you all for joining on this call. We hope it gave you some insight to our business and performance. I really appreciate and thank you for tracking us and engaging with us and we value your continued interest and support. If you have any further questions or would like any clarifications, please do not hesitate to contact us. Ankit from Investor Relations is always available and we will do our best to try and respond you as soon as we can. Finally, thank you and look forward to speaking to you again. Thank you.

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