Q1 FY2022 Earnings Call Transcript – Aug 6, 2021

CORPORATE PARTICIPANTS

- Kulin Lalbhai – Non-Executive Director
- Shailesh Chaturvedi – Managing Director & CEO
- Pramod Gupta – Chief Financial Officer
- Ankit Arora – Head, Investor Relations and Treasury

Moderator: Ladies and gentlemen, good day, and welcome to Arvind Fashions Limited Q1 FY22 Earnings Conference Call. As a reminder, all participant lines will be in listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing * then 0 on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankit Arora – Head, Investor Relations & Treasury at Arvind Fashions Limited. Thank you, and over to you, sir.

Ankit Arora Thanks Zaid. Hello, welcome everyone and thank you for joining us on Arvind Fashions Limited earnings conference call for the first quarter ended June 30th, 2021. I am joined here today by Kulin Lalbhai – Non-Executive Director, Shailesh Chaturvedi – Managing Director & CEO, Pramod Gupta – Chief Financial Officer. Please note that results, press release and earnings presentation had been mailed across to you earlier and these shall also be available on our website www.arvindfashions.com. I hope you had opportunity to browse through the highlights of our performance. We'll commence the call with Kulin providing his key thoughts about our strategy and financial performance for the first quarter and fiscal ended June 30th, 2021. He will be followed by Shailesh who will share his key thoughts. At the end of the management discussion, we will have a Q&A session.

Before we start, I would like to remind you that some of the statements made or discussed on this call today maybe forward-looking in nature and must be viewed in conjunction with risks and uncertainties we face. A detailed statement of these risks is available in this quarter's earnings presentation. The company does not undertake to update these forward-looking statements publicly. With that said, I would now turn the call over to Kulin to share his views. Thank you.

Kulin Lalbhai Thanks Ankit. Very good evening to you all. Thank you for joining us for our Q1 results. The last quarter has been a very challenging one due to the severity of the second COVID wave. The quarter saw widespread lockdowns and also was very challenging on the health front. We as a company did all that we could to ensure the safety of our employees through this difficult period. While the second wave was much bigger than the first wave, our business has been much more resilient and has performed far better this time around. This has been possible due to the corrections we have made the year before, strong cost measures that we have been able to bring in, the scale of our digital sales, as well as the strength of our portfolio of brands.

Sales for the quarter was significantly higher than the comparable quarter last year with more than 340% year-on-year growth. The reported EBITDA is better than the previous year even though we have booked lower future rental savings this year. Q1 FY21 included 26 crores rental savings for future quarters as against savings considered in Q1 FY22 is only 6 crores. Adjusted for that the underlying improvement in the bottom line of the business is better than Q1 FY21 by close to 30 crores. This quarter saw much stronger offline sales compared to last year. The offline recovery compared to pre-COVID stands at 30% vis-à-vis 5% in Quarter 1 of last year. Sales growth was further driven by the online channel which grew four times year-on-year. Digital sales accounted for more than 60% of the total sales for Q1. This large sale of online revenue was made possible by the strong consumer pull of our brand on the digital platform, a rapidly scaling direct to consumer strategy and the category expansion into new categories like comfort wear, footwear and women's wear. Our efforts on digital transformation should continue to bear fruits and ensure that our business is less vulnerable to demand shocks in the offline side of the business.

The overall recovery is gathering momentum and the recovery was nearly 80% in July'21. We expect business performance to significantly improve moving forward and expect our EBITDA post rental to be positive in Q2. Over the past few years, we had made significant progress in reducing the losses of our value format Unlimited. However, we face the challenge of scaling up the business to create long-term value. In order to best realize value for our shareholders we have decided to exit the value retail business by selling the Unlimited retail network to V-Mart. Through this transaction we will realize 100% of the net asset value of the network which includes the store fixtures and the inventory.

Most of this value will be realized upfront for a cash consideration of close to 150 crores. We also expect to earn an additional 30 to 40 crores through an earn-out based on performance of the retail stores over the next few years. This transaction allows us to exit the value business in an orderly fashion and will lead to a reduction in overall debt and losses. We are very happy to have found the right home for the business as well as the employees that are a part of it. With this transaction we have almost completed the strategic reset that we set out to achieve over the past 18 months. We expect the GAP business to fully transition out in Q2. While we cannot fully size the exit costs, we expect Q2 losses on the GAP business and overall discontinue businesses to be slightly lower than that of Q1. From Q3 onwards, no further losses will be reported under discontinued operation.

A lot of efforts have gone into reducing costs this quarter. Our overall fixed costs were reduced by 70 crores compared to our comparable pre-COVID quarter. This large reduction in fixed costs has come from reduction in rentals, optimizing supply chain costs and significantly reducing overheads in store running costs. The rental costs were reduced in line with the fallen sales and we expect some savings on rental in Q2 and Q3 as well. This cost focus has allowed us to minimize our cash losses for the quarter. With the exit from Unlimited, the cost base itself will be lower going forward and we will continue to drive structural savings on the retained cost base of the business. In spite of a large drop in sales we were able to manage our working capital efficiency and reduce gross working capital by over 30 crores as compared to March'21. We have been able to keep our inwards in line with the lower sales so that the overall working capital remains balanced as we move into Q2. As we enter the autumn winter season the fresh inwards will significantly enhance the overall freshness and support the business growth and better productivity. We continue to reduce our leverage quarter-on-quarter and the gross debt at the end of Q1 stands at 913 crores.

We have the following priorities for the current year – exit all non-core businesses by H1 of the current year, significantly scale up the focus brands through better productivity and by opening more than 150 stores for the year, continue a strong momentum on the digital side and exit the year with a 1000 crores annual run rate on digital sale, optimize inventory turns and freshness and take the overall inventory turns to greater than four times, achieve a much stronger profitability in the second half of this year. We hope to achieve these milestones as long as we do not have a very large impact from any potential third wave in the future. With a focus portfolio of market leading profitable brands, strong growth levers in both online and offline channels, the exit of loss-making businesses, the leaner cost structure and the healthier and fresher inventory, we expect the business to see much better performance going forward. I would like to now hand it over to Shailesh Chaturvedi to talk about the brand level highlights, market recovery and plans moving forward.

Shailesh Chaturvedi Thanks Kulin. Good evening everyone, Shailesh here. While Q1 has been COVID impacted quarter, I'm happy to share that recovery has been faster post unlock this time around with nearly 2x recovery than last year. For example, if a channel in a particular month last year had X% recovery that recovery is 2X%. This time the recovery is much faster and double the percentage of last year. In July we saw business recovery of 80% and in power brands this recovery was 90%. We are hoping that by September right in time for festival season, recovery could be inching towards the near normal mark. Just to add, this recovery of 90% in power brand has been done without Maharashtra malls, Bombay and Pune malls opening. Once they open, we hope to reach near normal mark very soon. We are encouraged by the fact that our power brands portfolio is very suitably placed for post-COVID work from home time where consumers are preferring our brand that has casual and relaxed appeal.

A severe onset of COVID Wave 2 and subsequent lockdown required a focused work on cost control and cashflow management. Our team did a fantastic job on inventory control which otherwise tend to swell during such lockdown with very low revenues. We had built in sharper processes on inventory buys last year and that playbook came in handy in our response to second wave this year. We reduced the inwards of inventory in line with reduced sales so that the inventory levels at end June were only marginally higher as compared to March'21 and they were sharply lower than June'20 by over 300 crores.

Continuing our stronger focus on collection from the market during this quarter our debtors reduced by 77 crores over March'21. With inventory control and debtor's management, our gross working capital reduced by more than 30 crores compared to March'21 even though there were large drop in sales. Hence, our debt levels continued to show declining trend as we have seen in last several quarters. Kulin did mention that we've been very focused on cost control and the cost base itself will be lower going forward. I will also add that here with the receipt of final call of rights issue of 94 crores in this quarter and with reduction in GWC of more than 30 crores, we've been able to fund COVID time losses in this quarter. At the channel level, we saw online grow over four times business over last year Quarter 1 and it was 60% higher than the normal quarter which was the Quarter 1 of FY20. This impressive growth in digital business has been enabled by strengthening of several capabilities at the backend. We connected additional 100 stores with omni tech-pack and now we have nearly 600 omni enable stores across the country. This has resulted in contribution of omni-channel increasing to mid-teens of store sales in this quarter. We also increased the number of B2C warehouses helping us fulfill marketplace orders efficiently and quickly. In order to strengthen marketplace business, we have now connected with all major portals and that has significantly helped grow this business. We continue to support online business with several merchandise assortment that are exclusively made for online. Going forward, we wish to build further on our leadership position in online business and enable channel to drive growth and profitability significantly.

Just to add a point; we increased this quarter revenue by additional 250 crores. Out of that additional 250 crores we got 150 crores from the online channel, so a significant part of the growth has come through online channels. Overall July saw 80% recovery in business with 90% recovery in our power brands. We are awaiting further opening in Maharashtra and Kerala which is expected to drive higher recovery. With faster recovery this time we are moving towards post rental EBITDA breakeven in Q2 with six high conviction brands. With divestment of Unlimited retail business our focus on six high conviction brand is getting sharpened further. Our strategies to unlock the full potential of these brands and drive profitable growth moving forward. With rapid recovery seen in market this time, we expect rest of the quarter to deliver healthy profitability except for a fear of any potential third wave. With improvement in momentum in Quarter 2 and the festival season thereafter we looked forward to significantly improve sales and profitability during H2 FY22. With that we conclude our opening remarks and open it up for the questions.

Moderator: Thank you sir. Ladies and gentlemen, we will now begin the question-and-answer session. First question is from the line of Akshay Satija from Alpha Invesco.

Akshay Satija: What would be our release from the Unlimited business in terms of capital employed?

Shailesh: We will get close to 150 crores from sale of Unlimited and this should happen by early September.

Akshay Satija: Approximately what capital employed would be released from GAP business and how do we plan to use these funds? Will we be repaying our debt or will this be going into further growth expansion?

Shailesh: As far as GAP is concerned, we will plan in Quarter 2. We will have to wait and we can confirm the exact details of the capital that will get released in Quarter 2 in GAP. But Unlimited would be 150 crores of capital release.

Akshay Satija: That would go towards debt reduction or further expansion?

Shailesh: A significant part of that will be to reduce our debt further and part of that will be for funding of the growth.

Akshay Satija: Also, if you could give an approximate number in terms of GAP maybe what amount of capital employed is currently stuck in GAP and we understand the number could be 20%-30% here and there?

Shailesh: The total capital employed is about 70 crores and we expect a good amount of that getting released in Q2 itself.

Akshay Satija: If you could help us what were the number of own stores versus franchised and how much of them were making money pre-COVID levels?

Shailesh: In the wave first last year, we had corrected our store network very sharply and most of the loss-making stores were already shut down last year. On that cleaned up base, this year, we didn't need to close down too many stores and if I remember a small number between 30 to 40 stores is what we plan to close which also happens on a regular basis. The number of stores that we shut down now was less and our understanding is that post-COVID with the normalcy restoring, most of our store network will be profitable.

Akshay Satija: What would the number of own stores versus franchisee?

Shailesh: I can tell you that our store network is largely franchisee led and going forward will be I can use the word entirely franchisee led like 95% of our store openings will be franchisee led.

Moderator: Next question is from the line of Nishit Rathi from CWC.

Nishit Rathi: As you mentioned Q1 is generally when we see higher purchases done before the festivals and this is second time in a row that we have pushed out our purchases. Just two questions on that – does this in any way affect our ability to grow once the demand is back and how does this affect our terms of trade with the vendors when again things come back to normal?

Would love to get your thoughts on that. I have a couple of follow-ups after this.

Shailesh: As we stand today in July, our goods were as per our plan what we wanted to bring in into our system and send to the market. We are on track after all the modification and improvisation that we did in the inventory for Q1 COVID time. For this quarter I don't anticipate any issue with our ability to service the inventory to the market. We are extremely well-poised on that and we will be able to fill orders in time for the season ahead.

Nishit Rathi: So, Shailesh the question here is we were doing things a little differently, let's say 2 years back and you are saying that we have changed the way we are doing it now. Does that mean that going forward we are going to become more just-in-time in terms of doing it and or was their inventory that was stocked-up that were able to supply? I am just trying to understand that.

Shailesh: There are two parts to your question. One is on the discipline on how inventory is billed and second thing is on the response time, agility that's what you use right, just-in-time. What we did is that we in the last year in our playbook we tightened the discipline and we ensured that we were bringing it at the right time in the right quantities. So, lot of internal check and balance and discipline, also we played safe with the MBO channel because that channel used to throw up lot of surprises on inventory. That's a structural discipline that will help us going forward as long as we maintain and improve upon that. Second part is on the agility side. We do a very large volume of production and we have a partnership with back-end with lot of good vendors in India and then we have worked with them on many methods to reduce the lead time of production. And we will be able to get goods on time in season because of the reduced lead time that we are working on currently.

Nishit Rathi: Just to follow-up on that, let's say if historically you used to do two drops, three drops a year. Are you saying that you have reduced your order quantity and you will do multiple drops – you will do maybe four-five drops? Is that the way the new supply chain is kind of geared up? Is my understanding correct?

Shailesh: One thing is we bring in the goods right in time for the season launch. What is early in the season we call it drop zero and then we have multiple drops or the collections coming every 2 months into the market. We are working with the vendors so that the lead time required for producing these goods in different multiple cuts also is reduced. Also, we are a leader as Arvind as a group on the flexible manufacturing and there are lot of new techniques of flexible manufacturing, like digital printing or dry method, finishing on denim on five pocket jeans. We have invested a lot on the flexible manufacturing where the lead times could be as low as 30 days versus traditional 90 days to 100 days lead time. There's a lot happening at the back end to be more agile and flexible.

Nishit Rathi: The second question is, if I understand it right almost 60 crores of your sales in this quarter were D2C sales. So, I just wanted to know what is driving this D2C sales? Is it because the stores are shut, you are getting more D2C sales from brand like U. S. Polo which any which ways have very strong demand or is it primarily driven by brands like Flying Machine or smaller brands which are bound to be more online and which you intend to make it more online? So, would love to get some color there.

Shailesh: The online traction that we have seen is across the brands. It is definitely in U.S. Polo, surely in Flying Machine led by the special relationship with the

Flipkart group. It's also in Tommy Hilfiger, Calvin Klein and Arrow online business has picked up in this quarter. So, it is not specific to a brand it's an overall drive, we are a leader in online business in the country, our current run-rate is going to be 1000 crores annual business going forward. We have a large business which is spread across all brands. And it is not just because of the COVID and I mentioned that we have built lot of capabilities at the backend to support our brands. Right from linking more stores and those stores 100 odd stores that we have added now in this quarter are spread across all our brands from Flying Machine to U.S. Polo to Arrow to every other brand. Also, we have linked up with portals like Myntra and the Ajio and the Amazon and we are doing very large business with them. Our own website NNNOW it's growing well. We have lot of repeat customers in NNNow.com. Through that and through other market places we are able to reach many customers, we have increased the inventory levels in our marketplace model so that we can service more, we can give a larger assortment to our customers. If you really see the whole retailing of business on online through our own NNNow.com and also through the marketplaces through all the portals and we have a higher number of D2C warehouses so that we can fulfill faster, more efficiently. So, it is a strategic and very structural capabilities that we are building that will help us even post-COVID. So, for example we mentioned that our omni-business in this quarter was in mid-teens of the store business, so entire store team is now getting used to servicing an omni order from the store. There are lot of these structural changes that have happened that will help us to continue to grow on our leadership position in the digital and in large size of almost 1000 crores even as the market recovers fully in the time beyond COVID.

Kulin Lalbhai: I will just add, if you kind of distill this there are three broad transformations that are going on in the digital strategy. One transformation is that this business used to be an old good selling business, what you call OSM which used to be sold on discount largely online. The new model is to actually create products which are attuned to online and they have much better sell-throughs, lower discounting and a much better cash conversion cycle. One big transformation going on is that the business is moving from what used to be these old goods to what we call specially made units. Units made for the online channel with deep analytics and flexible supply chain, so that is one transformation going on. The second transformation is that this used to be a wholesale business where you used to sell and then forget and it's moving to a retail business which is both our own channel NNNow.com and what we call the marketplace model where we set up the listing and control the pricing, promotion and delivery of the products that we sell on third-party marketplaces like Myntra, Flipkart and Ajio. In a sense we are building muscle as a company to do direct retailing and that is very powerful because you get customer connect, you get to control the quality and the way in which your product is sold. We have every as we go on, right now it's in the mid-thirties but we expect our direct retailing to keep increasing and that will make the business even more robust. And the third transformation is how do stores not just remain physical stores but we digitize our store. So, as Shailesh was saying we are in the mid-teens as the online contribution to store revenue but as we keep connecting more and more marketplaces and building more and more omni-channel journey, I think the store will also keep enabling the digital sales more and more. I think these are all three of the transformations are at work and that is why the online business is scaling up the way we are seeing.

Moderator: Next question is from the line of Vaishnavi Mandhaniya from Anand Rathi.

Vaishnavi: What is our net debt as of the first quarter?

Pramod Gupta: Gross debt is 913 crores at the end of first quarter.

Vaishnavi: This is the gross debt number?

Pramod Gupta: Net debt will be around 20 crores less than that. So will be around 900 crores.

Vaishnavi: Also on the online channel, in terms of the current run rate that we have what exactly is the profitability of the channel and what exactly the current run rate of quarterly sales in terms of online and how do we see this moving forward with stores opening up and offline also picking up in the rest of the years?

Shailesh: If you look at this quarter, we did nearly 200 crores online business in Quarter 1 and even online business was impacted in the second half of April and only in the first week of May, they started going back to the normal business in online. This business also would have been slightly higher if the online was not also impacted by the COVID lockdown and warehousing etc. This is a current rate. The way our order flow is currently we are at 1000 crores annual run rate and the growth is faster. I told you that this quarter, online contributed more than 60% of revenues. Now lot of capabilities that we mentioned and Kulin added in the previous question; all those capabilities have a significant impact and our brands are also very suitably placed for the online business. All casual, relaxed feel brands at different price points from Flying Machine which is value, to Calvin Klein which is super premium. So, we have brands of casual appeal at different price points and different product categories. Those categories are doing better on online channel for the kind of consumers who are coming and shopping there. So, we are quite bullish. We are feeling that the business will continue to grow at a very good rate going forward and even the profitability of this business is fairly good.

Kulin Lalbhai: Actually, just coming in here, the profitability of the online channel is actually higher than that of the retail channel. It's historically been one of the most profitable channels.

Moderator: Next question is from the line of Nishid Shah from Ambika Fincap.

Nishid Shah: My question is on overall company's direction. If you look at the two categories which are relatively large in India. One is the innerwear category, there are companies with a significantly larger operations like Page Industries and all. What is our strategy in this area?

Shailesh: As far as the innerwear business is concerned, 2 years back we put investment behind that business and set up a separate unit, separate team, dedicated for innerwear and that business has really scaled up both online and through the multi-brand innerwear stores. We do that business largely with U.S. Polo which is a very strong brand and we have added some youth wear, loungewear recently which has also received very good feedback both offline and online. Our plan now is to keep adding new categories on the innerwear. Also, we will going forward add innerwear in other brands. For example, Flying Machine there is a requirement from the online channel, as it's a very digital first brand. In addition, we do very successful premium innerwear business in Calvin Klein and if you notice most of the celebrities in India wear Calvin Klein innerwear and CK is one of the strongest innerwear brand in the world. In addition, we have innerwear brand in Tommy Hilfiger also. Slowly, you will see us expand our innerwear portfolio across our brands.

Nishid Shah: What about the beauty and fashion. You would have seen one of the companies going public recently has got a valuation of more than 30,000 crores. You have a tie-up with one of the best in the world brand platforms.

Yet we are not able to capitalize on it. Could you elaborate what is our plan on this?

Kulin Lalbhai: Sephora is a very exciting format. I think there is no question about it. It's one of the world's most successful luxury cosmetic player and in the Indian context also the franchise has been very successful. The one thing though that one has to understand is that it is a super-premium kind of a price point and positioning where the average ASPs of the products are typically above Rs. 2,500. There is a certain of course market for that product and it is rapidly growing. We are excited to be able to scale up that business. In fact, on the retail side the productivity of Sephora in any mall that you will see, is by far the highest. We have a measure called PSFPD which is the sales per square foot per day and Sephora sets the benchmark of productivity in the country. But because of the mix, there is a certain set of malls in India which can support the format of Sephora. And as the affluence goes up, we believe we will be able to keep opening more and more stores. So, this year we will open more than 6-7 stores of Sephora. Even in the first quarter the Sephora stores have really bounced back extremely well. I think as far as physical retail is concerned, it's a very successful format but it is going to be growing in line with the distribution. Now coming to online, definitely we see the opportunity to be bigger. Again, here the price points are different. You mentioned another player but Sephora plays in the prestige part of the market. Within that we are definitely scaling up our digital presence significantly. We have been consistently growing and the lever there for us there is to keep expanding the offering. In the next 12 to 18 months, there are more than 12 brands which we will be launching, exclusive luxury brands which will be coming into the country. As the offering keeps growing it will help us bring a step change and also, we are working with the global team to see if we can bring in the Sephora store front on the digital side as well. Globally, it has done very well. We have to work to bring that alignment into India and to capitalize on that. I think the opportunity for Sephora is exciting. We have to work within the segment that Sephora is in and really capitalize on it. We are working with the partners to ensure that in the rapidly changing environment, Sephora continues to have its pride of place in the customer's mind.

Moderator: Next question is from the line of Devanshu Bansal from Emkay Global Financial Services.

Devanshu Bansal: Online has seen robust traction for us. So just wanted to check if you could provide profitability comparison versus last year for this channel be it in terms of quantitative or qualitative terms? This is basically to understand whether the new D2C and own website initiative that we are doing are helping us on the profitability front?

Kulin Lalbhai: As I mentioned overall profitability in digital is higher than that of physical and between last year and this year, actually the profitability is holding up. In fact, for our NNNOW.com also it is a positive unit economic model with a healthy unit economics as we speak. And the wholesale part of it obviously has always been strong on unit economics. There is no deterioration in the channel level profitability in online between last year and this year.

Devanshu Bansal: Secondly, you indicated D2C gaining traction and currently if I heard it correctly 30% of online sales. What is the steady state mix between B2B and D2C sales that you foresee down the line?

Kulin Lalbhai: Just a little clarification. When we are saying direct to consumer, we are meaning it more direct to retail which is our own website plus what we call marketplace where we control the sales process on even third-party, that put together is in the thirties. Right now, it looks like it will remain in this range for some time as the market evolves. It is really tough to say whether the direct to retail can significantly go up from this. But we are going to play both sides – the wholesale side and the direct retailing side and ensure that both are maximized and as the market evolves, we will be able to see how the split will change.

Devanshu Bansal: Lastly any benefits out of preponement of end of season sales like the major platform Myntra during this quarter?

Shailesh: If you really look at EORS and the events they were a little late this year than last year. This year it was in early July which typically happens in June mid. So, the big event in online world were later this year. But since the lot of places the opening up had not happened so they wanted to give some time and we participate with the portal dates because they pull in the customer, they do the marketing events and we work with them and partner them to get benefit from the traffic that they bring in through the special event.

Devanshu Bansal: We should see a benefit of this in Q2 as well as in because of postponement of these sales or the B2B sales have already happened for the results?

Shailesh: The discounted sale or the end of season sale happened in July this year and the big days also happened. So, we got the online business filling in June and in July. And this year's this quarter results will cover and this is as per the plan. There is no major change of the quarterly profitability as we speak.

Moderator: Next question is from the line of Sagar Parekh from Deep Financial.

Sagar Parekh: Firstly, with this Unlimited sale what is the fixed cost base that will go away from our books?

Kulin Lalbhai: I think the way to look at it should be to look at what kind of PBT losses on average go away and of course last year was a COVID impacted year where the PBT losses of Unlimited were high. As the business was getting close to EBITDA break-even, I think one can say that around 50-60 crores of the bottom-line weight would go away in a normal year.

Sagar Parekh: Assuming EBITDA break-even, so that was I think happening at around 650 crores kind of top-line number?

Kulin Lalbhai: No, I think we had significantly reduced the break-even point, so at much lower revenue we were break-even. In fact the second part of last year also we were broadly break-even at a much lower revenue point.

Sagar Parekh: My second question would be that with all the restructuring done, what would be the break-even point for us now going forward for the existing continuing brands?

Pramod Gupta: It would be between 600 to 700 crores.

Sagar Parekh: And any plans for debt reduction in the current financial year or we should be broadly similar?

Shailesh: From the proceeds from the Unlimited of around 150 crores, some amount of that will go to reduce the debt further.

Sagar Parekh: So that is assuming that there would be the recovery happens. If there's like a third wave and further lockdowns then it could possibly go into loss funding as well, right?

Shailesh: See if there's a third wave then the whole calculation will change. I mean the focus will then be on managing the wave than on debt reduction, but in case there is no third wave or it's not like a strong third wave, then we anticipate further reduction in debt.

Sagar Parekh: 120-130 crores is the reasonable debt reduction estimated?

Shailesh: I mean out of that 150 Crores, a good amount of that should go into debt reduction if there's no third wave.

Sagar Parekh: And for FY22, do we still anticipate like cash profits from the internal accruals like to happen or it will possibly happen in FY23 now?

Pramod Gupta: You have to break it up between H1 and H2. I mean the Q1 is already there out there and as we said, Q2 will be EBITDA break-even and likely to further improve from Q2 to H2. So we are really positive about what we will be able to do in H2 barring third wave.

Sagar Parekh: Working capital is sustainable at the current levels in absolute terms or with the sales growth working capital absolute number should also increase?

Shailesh: In working capital, on the inventory side, we are on a major drive for improving our stock-turns. Directionally, we have to go close to 4 and in the second half of the year we should be reaching that mark and our efforts would be to look at moving towards stock-turn of 5 post that. There's a lot of strategic focus on that and we are very committed to take up that objective. Now, assuming a situation where stock-turns are closer to 5 and we have no COVID third wave likely and we have also removed a large amount of loss-making businesses, this results into six high conviction brands throwing up a decent amount of cash. That will have its positive impact on debt and working capital. So as the scale will go up we will still add lot more efficiency to our working capital as the remaining six brands that we have, we want to focus hard and invest behind growing them profitably and you will see our working capital needs will reduce significantly structurally.

Moderator: The next question is from the line of Priyank Chheda from Standard Chartered Securities.

Priyank Chheda: My question is with respect to gross margins, now we are done with the portfolio restructuring, what can be a steady state gross margin that we can safely assume going ahead?

Shailesh: Our gross margins for this quarter were close to 42% and Q4 of last year was around 41%. There is seasonality in the Quarter 4 which includes impact of EOSS. This quarter despite COVID and despite all the issues linked to COVID our gross margins have remained steady from 41% to 42% range. In a normal quarter where the Covid impact subsides and malls open up leading to better full-price sales, our gross margins can potentially reach around 45%.

Priyank Chheda: The other part of the question is on the expenses, so want to understand at this current state with these six brands, can our fixed costs be the quarterly run rate of that reported in Q1, going ahead?

Shailesh: If you look at fixed costs as a percentage of NSV then there's a lot of improvement possible, because the top-line will come back strongly if there's no wave three and good season time. But if you look at the absolute numbers as the business normalizes then some of the costs will also normalize. We have already achieved structural cost savings of more than 100 crores last year across supply chain, manpower, shutting of loss making stores etc. So, we are at a very efficient level right now and a lot of these structural advantages will be there going forward, however, when the business grows and post COVID top-line is likely to grow very fast then we'll have a support it with slightly higher absolute value fixed costs. But as a percentage of the NSV, we will remain very efficient because likely NSV growth should be higher than the lightly increase in fixed costs.

Priyank Chheda: And just to squeeze in further on the rental expenses, so now in the current quarter it has been 30 crores that have been reported for Q1 and we have achieved a significant savings versus previous quarter. Is that a permanent one or is that when the stores get open, we are likely to see a slightly higher rental expense?

Shailesh: These are rental for COVID times and lot of hard negotiation but once the typical arrangement with the landlord is that when your business becomes close to a 100% then we'll have to pay the normal rent also and they're partners in the business and it's a win-win for both of us they have to survive, we have to survive, it's a partnership. Once the business become normal and when we start growing over 2019 numbers, our rent will also normalize.

Kulin Lalbhai: I think Quarter 4 was broadly a normalize rent maybe it was little maybe 95% of what a normal rent would look like.

Moderator: The next question is from the line of Suhrid Deorah from Paladin Capital.

Suhrid Deorah: I have a question on the margin and I'm not sure if you already talked about it before on today's call. On your slide 10 emerging brands showing higher loss this quarter was comparing last year despite higher turnover. I was wondering what that was due to.

Shailesh: See in the emerging brands we've done a minor reclassification because of Sephora. Earlier, we used to be to have two buckets – Emerging brands and specialty retail, but in the specialty retail we had GAP, Unlimited and Sephora. Now with GAP and Unlimited exit there's only Sephora left, so what we have done is that Sephora has been clubbed with emerging brands and what has happened in this quarter that with Sephora being a pure physical retail and very low online business, the losses are higher in that bucket due to this reclassification led by Sephora. To give you additional insights, 25% of Sephora business comes from Maharashtra and the Maharashtra malls have not even opened. It's a temporary issue and when the market will open up, the losses will reduce significantly. We are not able to reduce all the fixed costs in the same proportion of the drop in the sale. So, the losses happened in Sephora has seen those losses and that's where the emerging losses are looking higher right now.

Suhrid Deorah: No but if I compare to Q1 FY21, I'm assuming the market is same but the sales have tripled. Wouldn't that also apply the same for the last year?

Shailesh: Also, there are these rent adjustments, as we discussed earlier that in Q1 rental savings booked for future quarters is only 6 crores versus 26 crores in same quarter last year, so some of those things are impacting the number right now.

Suhrid Deorah: Can you help us understand your long-term margin aspirations for the company as a whole? So just directionally I mean let's assume COVID is gone by the year end and after losses of Unlimited going away and all the non-core brands being sold? How should we look to margin aspiration?

Shailesh: See if you look at our portfolio post GAP and Unlimited, we have these six high conviction brands that have fundamentally established decent scale and profitable brands structurally. Once we get out of the COVID times and get rid of the discontinued brands, in the second half of this year we will have a portfolio of very strong brands with fairly high potential for margins. Most of these brands in near term if I have to say like next 2 years should be significantly close to double digit EBITDA margin and some of them like in the power brands, we have US Polo which has higher margin potential. There are very few brands like US Polo and that brand with its own strong appeal and the likely scale and a lot of new categories that we could add-in, we could have an even a higher EBITDA margin. So, our intent is to unlock the potential of these brands in the near term and reach this kind of margin that we are talking about and on that you add the stock-turns that we are talking about going from 4 this year to maybe 5 after that and what it can do to the ROCE could be very dramatically positive but we don't want to go too much into the future forecasting at this stage. I mean there is we still need to see whether wave three happens or not. We still need to close the discontinued brands in Quarter 2, but I think the way we see is that in H2 of this year itself, things will look very encouraging except wave 3. With execution on stock-turns etc., situation can be very good in terms of margin and return matrix.

Suhrid Deorah: Last very small question is when if the country reopens all the growth that you've been seeing from online sales will some of that get cannibalized by offline?

Shailesh: Interestingly, if you really see the market share of any big brand in India, the size of the market is huge. The way the online is penetrating into new zip codes with new consumers, the whole conversion from unorganized to organize and organized getting upgraded, its very exciting. There is a lot of tailwinds in our industry, I think both can continue to grow significantly from here. Online will grow at higher pace and offline can grow through new categories and through distribution to new towns and omni-channel. So I don't think we have reached the point where it's like a zero sum game between the two channels. Of course in COVID times the percentage of online channel to total sales was more than 60%, that % will not stay at those levels and expect to stabilize around 25% mark. So, I think there is enough probability of both the channels growing side by side.

Kulin Lalbhai: In fact, in Quarter 1 itself I think is COVID was not there the absolute scale of the online business would have been even higher because during shutdown, usage occasion of apparels goes down. So irrespective of channels, I don't think Quarter 1 absolute online business was due to offline not being there or any level of cannibalization. In fact we see no structural reason why digital and also our brands shouldn't gain traction on the online sites. I don't think there is any danger of businesses moving from online to offline, both are going to be independently scaled.

Moderator: The next question is from the line of Deepak Poddar from Sapphire Capital.

Deepak Poddar: I just wanted to understand like maybe from a 2-year perspective do we aspire basically to reach pre COVID kind of revenue level 4500 to 5000 crores?

Shailesh: I don't know how far can we predict but I would like to say that second half of this year would be much higher to reach closer to pre COVID year which was FY20. So even in very near term we see it reaching for our continuing brands. There are enough growth drivers which can take us to the scale and beyond, like, digitalization, addition of adjacent categories, so US Polo now has kids, footwear and innerwear. For Flying Machine, online first mindset is adding a lot of new categories with Flipkart group partnership. Also, we are going in aggressively into smaller towns and this year our plan to add 150 stores. These stores will not be pure vanilla offline stores. They will be all omni-enabled and not just Tier-II, Tier-III but even much smaller towns. We have a model called FMX in Flying Machine which is for small town and our target is to reach towns with 50,000 to 2 lakhs population. We have opened 50 stores and our target is to reach 100 stores soon.

We're still modeling it and the potential of that FMX model alone will be very large, all digitally enabled stores. So, if I just summarize, all these growth drivers from digitalization to adjacent category to small town's expansion through omni-enabled stores. We see a lot of opportunity for growing and revitalizing the growth of our top brands.

Deepak Poddar: And you did mention that the second half of FY22 adjusting for discontinued brands, versus a second half of FY20, you can outperform, right?

Shailesh: Even last year second half we did better than the second half of the FY20 period, when unlock happened. Like we see in July our power brands are only at 90% recovery even though Maharashtra is not open, Kerala is not fully operational. So, our brands are very well placed for the times we live in work from home casual relaxed. We have a very strong portfolio which is very right for our times – casual jeans, open footwear, athleisure, inner-wear, kidswear. So, we are very confident that with these strong brands already profitable, we can grow rapidly.

Moderator: Thank you. Ladies and gentlemen that was the question due to time constrain, I now hand over the meeting to Mr. Ankit Arora for closing comments.

Ankit Arora: Thank you everybody for joining us on the call today. If any of you have more questions, please feel free to reach out to me and I would be happy to answer them offline. Thanks for your time.

Moderator: Thank you very much members of management. Ladies and gentlemen on behalf of Arvind Fashions Limited that concludes today's conference call.