Q3 FY2023 Earnings Call Transcript – Feb 15, 2023

Corporate Participants

- Kulin Lalbhai – Vice Chairman & Non-Executive Director
- Shailesh Chaturvedi – Managing Director & CEO
- Girdhar Chitlangia – Chief Financial Officer
- Ankit Arora – Head, Investor Relations and Treasury

Moderator: Ladies and gentlemen, good day, and welcome to Arvind Fashions Limited Q3 FY23 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: Thank you, Mike. Welcome everyone and thank you for joining us on Arvind Fashions Limited earnings conference call for the third quarter and nine months ended Dec 31st 2022. I am joined here today by Kulin Lalbhai – Vice Chairman & Non-Executive Director, Shailesh Chaturvedi – Managing Director and CEO and Girdhar Chitlangia, Chief Financial Officer. Please note that results, press release and earnings presentation had been mailed across to you yesterday and these are also available on our website www.arvindfashions.com. I hope you had opportunity to browse through the highlights of our performance. We will commence the call today with Kulin providing his key highlights of our performance for the third quarter. He shall be followed by Shailesh who will share insights into business and financial performance. 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: A very good afternoon to you all. Thank you for joining us for the Q3 results. Q3 was a very strong quarter for AFL, where we saw industry-leading growth and an improvement in profitability. Revenues grew 17% year-on-year with strong like-for-like growth of more than 12% in the retail channel and a more than 40% growth in the department store channel. Better full price sell-throughs led to lower discounting, which improved our gross margins and led to a lift in our EBITDA margin by 110 basis points year-on-year.

I would like to also especially mention the great work that is happening on the supply chain transformation, which was initiated last year. It has yielded strong results and our stock turns continue to sustainably stay beyond 4 and along with that, we see the improvement in gross working capital, which has led to cash flow generation and a quarter-on-quarter reduction in our debt. This is the second consecutive quarter where our annualized return on capital employed is at 15%, and we look forward to further improving this in the years to come.

We entered quarter 4 with a re-energized brand portfolio and look forward to continuing momentum in the business. I would like to now hand it over to Shailesh to take us through the specifics and more details on our financial performance.

Shailesh Chaturvedi: Thanks, Kulin. Good afternoon, everyone. Let me start with welcoming Girdhar Chitlangia, our new CFO, who is joining AFL investor call for the first time.

Girdhar Chitlangia: Good afternoon, everyone.

Shailesh Chaturvedi: AFL continues as part of decisive focus revitalizing performance of our exciting brand portfolio and making our brands bigger, really large and more profitable and making AFL a much stronger company. With no distraction, we continued our focus in Q3 FY '23 on execution, more focus on sell-through improvements, full price like-for-like growth, reduction in discounting, all leading to increase in GP margin and better EBITDA.

With nearly INR 1,200 crores top-line, we saw the highest ever quarter, similar to quarter 2, with EBITDA of INR 136 crores. The growth in the offline is 17% and much higher growth in EBITDA at 30%. Fall holiday '22 season saw continued good performance on our brands on sell-through with industry-leading full price sell-through that was healthy 12% like-for-like growth in our retail and expansion of gross margin by 160 basis points.

EBITDA percent also has gone up by 110 bps with 60 basis points gain coming from lower discounting in retail channel and 50 basis point gain coming from scale leverage linked to efficiency in employee costs. The increase in power brand EBITDA is 140 bps.

At the end of December, in the 9 months of this financial year, AFL has reached nearly INR 3,300 crores top-line with 53% growth over last year. The EBITDA at December end is nearly INR 370 crores, is more than double of last year and there's an improvement of 400 basis points in EBITDA percentage at end December over last year. This fall holiday season spanned out very interestingly with equal business in Q2 and Q3.

With early Puja and Diwali dates, we completed majority of our wholesale billing for the season in Q2 itself, and Q2 saw 100% growth in MBO trade channel. Online B2B wholesale business also saw robust business in Q2 with more online tower events, which were lined up towards end September and early October.

While Diwali retailing started by end September, majority of the Diwali retailing happened in October and the contribution of retail channel increased by a huge 10% in our revenue mix in Q3 over Q2. And this was an increase of INR 110 crores in retail channel value in Q3 over Q2.

With wholesale peaking in Q2, we realized a large part of our margin in Q2 and our EBITDA grew by 19% in Q2. Subsequently, the wholesaling in our revenue mix dipped in Q3, as expected, with MBO trade delivering single-digit growth in Q3 because it has already shipped out goods in Q2 in time for the festival season. But then retail channel did very well in Q3 and our like-to-like retail sales grew by an impressive 12%+ in Q3.

Two big quarters, Q2 and Q3. Q2 saw a larger growth in EBITDA of 19% due to early Diwali billings and Q2 also reached the same level of highest ever revenue and EBITDA value of the same INR 136 crores because of healthy margin gain from retail channel.

There was a slowdown in onset of winter season this year, winter started late, because of which the normal repeat orders of winter goods that we typically get in Q3 did not happen this year. Fortunately, winter finally arrived in January and all our brands eventually saw very healthy sell-throughs of winter wear by end January.

We resisted the temptation of going early with EOSS in December because we were witnessing good sell-throughs. We consciously decided to postpone EOSS, which helped us lower discounting in Q3, because of which we got additional 0.6% EBITDA. Thus, we have this unique situation of both Q2 and Q3 being similar level of top-line and EBITDA. If winter had set in at normal time and we had not consciously decided to postpone EOSS, Q3 would have been even bigger in both revenue and EBITDA value.

We continue to focus sharply on balance sheet, deleverage and we are ensuring tight control on working capital. Very happy to see reduction of further 3 days in GWC with gains coming from reduction in debtor days. We saw a reduction of nearly INR 200 crores of inventory value in Q3 as compared to Q2 end and the inventory levels remained healthy at 88 days with stock turns at 4.2, in line with our guidance of taking stock turns above 4.

Receivables also came down by nearly INR 100 crores as our partners paid their dues as per credit norms with good consumption of inventory in the season. There was also a sharp reduction of nearly INR 300 crores in payable, and this was done as per the payment terms with our vendors. Post supplies in Q2, these payments were due in Q3 and we made payments to reduce payables by nearly 19 days over the last Q3. Overall, good control on working capital on all aspects.

With increase in EBITDA and sharp control on working capital, we saw continued good performance on capital efficiency and we delivered a ROCE - annualized ROCE of 15%. We continue to focus on our goal of improving profitability towards double-digit EBITDA for our power brands in the next year.

We remain confident of this journey because we are seeing higher efficiency in our reduced execution. There's a reduction in discount coming from higher sell-through. There's improvement in some of our brands' profitability, especially Arrow. And with power brands EBITDA of 12.5% in cumulative in the 9 months of this year, we are very close to that double-digit pre-IndAS EBITDA objective for our power brands and we are confident that we are moving in the right direction.

With our portfolio of very strong brand and continued momentum in our growth engines, we remain optimistic about our guidance of 12% to 15% CAGR. The key growth engines include robust like-to-like growth through superb execution of store experience, we delivered industry-leading 12% like-to-like growth in Q3.

The growth engines include store expansion and we added nearly 60 new stores in Q3, in line with our guidance of opening 200 new stores annually. The growth engines include leadership in digital opportunity. And in Q3, online business got a very healthy 23% mix of our revenue.

The growth engines also include build-up of adjacent categories and we have seen more than 45% growth this year in kids' wear and footwear. The revenue contribution of adjacent category in our key brand USPA is in mid-teens percentage and we continue to focus on developing adjacent category in each of our brands.

With presence of strong brands like USPA in our portfolio, which is likely to reach close to INR 1,800 crores NSV this financial year, AFL is poised to deliver revenue growth of close to INR 1,200 crores this year versus last year, surpassing INR 4,000 crores NSV mark in this financial year.

AFL also poised to deliver an increase in EBITDA of more than INR 225 crores in this financial year, versus last year. And the focus remains singularly on reaching double-digit pre-IndAS EBITDA in power brands next year. We have seen continued momentum in Jan due to winter season and Pongal festival in south and also the energy of USS.

There are good retail days ahead with wedding season in south in February and March. Then there is Eid festival coming up in mid-April, for which the business will gain energy from mid-March. Hence, we remain optimistic about momentum going forward. With this, I hand over the mic to Ankit.

Ankit Arora: We can open it up now to Q&A.

Moderator: We have the first question from the line of Pritesh Chheda from Lucky Investments.

Pritesh Chheda: Sir, what is the operating cash flow that you would have generated for the 9 months that has gone by?

Shailesh Chaturvedi: Pritesh, the operating cash flow will be close to INR 150 crores.

Pritesh Chheda: This INR 150 crores is after working capital, right?

Shailesh Chaturvedi: Yes, yes, Pritesh.

Pritesh Chheda: And what is the gross debt and the net debt now we have as of 9 months?

Ankit Arora: Pritesh, Ankit here. We have a net debt of INR 372 crores as of December end and a gross debt of closer to about INR 570 crores.

Pritesh Chheda: So has this increased Q-o-Q, the gross debt number?

Ankit Arora: No, the gross debt number would have come down by about INR 20 crores Q-on-Q.

Pritesh Chheda: I was trying to locate the pre-IndAS number or margin that we would have done now for the 9 months and the quarter 3. But I think your presentation doesn't tend to report it. So if you could share what will be the pre-IndAS margin that you would have done in the 9 months and the quarter 3?

Ankit Arora: So Pritesh, we have guided to the Street in the past and I'm sure as what you would be aware, there is a 400 bps difference between post-IndAS reporting and pre-IndAS reporting. And that is something which is what stays constant or around the similar levels and that would have been there for 9 months as well and Q3 also. So Q3, we reported 11.6% EBITDA margin. You can subtract about 400 bps from there to arrive at pre-IndAS number and similarly for 9 months numbers as well.

Pritesh Chheda: Lastly on margins, so versus pre-Covid where you used to do about 8% pre-IndAS at about INR 800 crores of business. And now you have already moved closer to about INR 1,200 crores, INR 1,180 crores of business, but the pre-IndAS margin hasn't changed. So on a 9-month basis, if you could help us understand this performance of ours from the margin perspective of pre-IndAS, considering that the scale of operations have obviously gone up?

Shailesh Chaturvedi: See, Pritesh, if you really look at for the 9 months, if I look at the post-IndAS EBITDA, there is a 400 basis point increase in the EBITDA. And typically, the way the improvements are happening now and the EBITDA percentage improvements are likely to happen in the future are on two, three grounds.

One is, there is an execution where we are focusing on full price sell-through. For this quarter, we received 1.1% EBITDA gain, 0.6% gain has come from lower discounting from retail channel. So that's one focus that we want to continue to focus on full price sell-through and reduce discounting.

Second point is that there is a scale leverage coming in. So in this quarter also, we received 50 basis points improvement in our EBITDA margin coming from scale leverage on the employee cost. So as the scales are going up, and if you look at last two quarters, our employee cost has remained flat and there is a 0.5% additional EBITDA going up, which is adding up to 1.1%.

Third reason of this 400 basis point increase in last 9 months is that couple of our brands, for example, Arrow, has turned around. So compared to past, Arrow sell-throughs today are very good. We started having positive EBITDA. Still it's in the low-single-digits, last three quarters, Arrow has been EBITDA positive. For some of the brands – profitability is going up. And also in power brands also, as the business scales up, the profitability is coming up.

So through efficiency, through better performance of the brands there, our profitability is a little suppressed and it's improving like Arrow. And through scale leverage, we want to take this -- the cumulative power brand, for example, we are at 12.5% post-IndAS and to reach 14% or so where it becomes double-digit, and that's what the focus has been, Pritesh, now.

Pritesh Chheda: Shailesh, but from INR 2,800 crores of business going to INR 4,000 crores of business already, let's say, on an annual run rate or let's say on a quarterly basis, from INR 700 crores to now INR 1,000, the pre-IndAS margin has actually not moved. You were making pre-IndAS 8%, now you're making pre-IndAS 6% or 8% number if I take Ankit’s guidance from 12%, which is including the other income and minus 4% then it is 6%. So Shailesh, the question is, has the discounting increased because of which the margin is not coming in?

Shailesh Chaturvedi: No, no. There are two ways, Pritesh. Margins are coming in. In 9-months period, there is 4% increase in EBITDA margins post-IndAS and that shows in pre-IndAS also. So, there's a significant margin increase, Pritesh. That's point #1. Point #2, like I said earlier in this call, that discounting has come down in quarter 3 by 0.6% and that's leading to higher EBITDA. So definitely, there is a decrease in EBITDA and there is a reduction in discounting as well.

Pritesh Chheda: My question was actually pre-COVID numbers. So what you were comparing is last year's number. I was actually trying to compare the business margin pre-COVID at INR 2,800 crores of sales.

Shailesh Chaturvedi: Pritesh, what happens is that they were – in pre-COVID time there was a large amount of rent waiver sometimes. And quarter-to-quarter, the losses would have been different. This year, there's no rent waver. And our profitability has definitely gone up by 400 basis points compared to last year. So if I look at steady growth in our business, we are far more profitable than we have ever been, Pritesh.

Also, if you look at our PBT performance, you can see quarter-by-quarter from second half of last year onwards, we started delivering PBT positive. And that trend has continued to grow. And today, in these 9 months of this year and look at the overall. I'm saying, in this year, our post-IndAS EBITDA will go up by almost like INR 225 crores increase in EBITDA.

Kulin Lalbhai: Pritesh, I'd add one point here. One difference between many years ago when you might be comparing to today is that our retail mix has significantly gone up. And wholesale versus retail mix changing, changes the percentage EBITDA somewhat.

But at an absolute level, our EBITDA is going up, which shows generally how much the profitability of the business is improving over time. So the kind of absolute EBITDA you are seeing are amongst the highest the business has ever delivered. The percentage EBITDA had changed because in that the channel mix four, five years ago was a little different from what it is today.

Pritesh Chheda: Has the retail increased in the channel mix and your own COCO stores increased?

Kulin Lalbhai: It's a 47% retail, which is the highest it has been and we generally have a FOFO model.

Shailesh Chaturvedi: Pritesh, I'll give you another data point. If you look at the PBT swing in these 9 months over last year, the swing is INR 212 crores. See, look at a little broad numbers. We are talking about more than INR 1,000-odd crores increase this year. We are talking about INR 225 crores additional EBITDA.

Look at our – the way our debt levels have come down, the cash has been generated. So I don't know which part of the business, we are looking at differently.

Moderator: We have the next question from the line of Shreyans from Svan Investments.

Shreyans: Sir, just wanted to understand one thing. If I look at your Q-o-Q other expenses, your revenues are largely flat, but we see about 8% increase in your other expenses. So could you just explain what has driven this increase in the other expenses?

Shailesh Chaturvedi: So on other expense, I'll take a little time to explain it more elaborately because this is a point that is being discussed regularly. So look at quarter 3, the other expenses are value which is INR 370.8 crores. Now what constitutes this other expense? Now 2/3 of this other expense is linked to the sales.

Basically, it is largely related to retail sales like commission to the franchisee, royalty that we pay on the sales, the marketing cost that's really 3.5-3.7% of sales, there's activity on warehouse and freight linked to the sales. So a large part of this INR 370 crores, 2/3 is linked to increase in sales.

So as the sales will keep growing up, this expense – other expense will also grow. And as the retail part of the business grows, the other expenses will grow further because almost like 26% to 30% of our sales, we pay as franchisee commission. And so every INR 100 crores increase in our retail sales, there will be, let's say, INR 28 crores increase in other expenses.

Now I'll give you quarter-by-quarter number on other expense. Look at quarter 1, this other expense was at INR 297 crores, which was 31% of our NSV. This in the current quarter, Q3 is INR 370 crores, which is also 31% of our NSV. Now wherever the retail sales are high, so like quarter 1 had high retail contribution of 46%, Q3 had a higher retail contribution of 47%, in these two quarters with very high retail sales, the other expenses remain around 31% of NSV.

Now look at quarter 2, which is a more wholesale-driven quarter, where the retail mix was only 37% versus 47% in Q3, the other expense came down from average 31% to 29% because retail contribution was less. So in quarter 1, the other expense is 31%; quarter 2 – 29%; quarter 3 – 31%. At a 9-month average, this NSV – this other expense is 31% of overall sales. And as the sales grow up and as the retail sales grow up, the other expenses will keep coming up. The other 1/3 is where we will strive for leverage.

Now I'll give you another example of Q2 versus Q3. In Q2, our other expenses were at INR 342 crores. And in Q3, our other expenses were at INR 370 crores. And the retail sales in Q3 was higher than Q2 by INR 110 crores. Now if I take on this additional INR 110 crores of retail sales and if I take our weighted average 28% commission, then it comes down to INR 30 crores of additional commission.

And that is precisely the difference between the Q2 other expense of INR 342 crores with Q3 other expense of INR 370 crores. So there is a clear trend of close to 31% of NSV and it covers things like commissions, royalty, marketing expenses, freight and warehouse and the retail staff cost and department store, etc.

Whenever the retail contribution comes down, like in Q2, it comes down to things like 29% of sales. When the retail is high, like in quarter 1 and quarter 2, it goes up to 31%. The delta is 2%. And Q2 to Q3, the entire delta is because of higher INR 110 crores of retail sales, which in terms of commission is higher by INR 30 crores.

It's only going up in line with sales and there's no other reason of other expenses going up. As the business grows, the royalty will go up, franchisee commission will go up, marketing investment at 3.5% of sales will continue to go up. So it's a part of the business that will show growth as the top-line and as the retail sales are growing up.

Shreyans: So sir, if I have to think about the future as you grow your retail business, so should we build in like a 29% to 30% of other expenses that will continue to be there? So the 1/3 that you're talking about, the leverage that will come in, how will you drive that? Because those expenses are basic office expenses where there's no room for a lot of leverage to come in. So just wanted to understand what will drive the operating leverage in the business?

Shailesh Chaturvedi: So that's a very interesting question. If you look at 1/3 -- in YTD Q3, our other expenses are at INR 1,000 crores roughly. So the 1/3 of that is INR 330 crores. And if we strive for even 5% efficiency there, which is possible, you'll see a lot of leverage coming in. So our entire focus – if you look at this year's – this quarter's results also, our employee costs, which don't come in other expenses, it's a separate row item, we have saved 0.5% of EBITDA coming from the people side.

If you look at our marketing cost, which used to be close to 4%, now we are at 3.5%, while we are actually spending more dollars or rupees of marketing. But since the scale is coming up, we are saving. We almost got a 0.5% saving on marketing costs currently. Also, as the scale goes up on warehousing, on transportation, we are able to negotiate better with our partners. So there is almost like 2/3 is a variable component, but the other 1/3, which is large value, 9 months itself is INR 330-odd crores, we will strive to gain as much of leverage and efficiency there as possible.

Shreyans: Sir, my second question is, if I go back three years, I'm looking at Q3 FY '20 where we used to do about – so you've given in the presentation that we've grown about 40%-odd versus Q3 FY '20. So if I just go back in time and look at your profitability then, and this is after adjusting for IndAS.

So at that point in time, our operating profit excluding other income was INR 113 crores. And this number, sir, includes your Unlimited losses. And whereas you look at Q3 FY '23, our numbers are ex of Unlimited. So what I'm trying to really understand is, even after selling of Unlimited, we haven't been able to see a lot of the leverage what you've been saying in the past, those numbers don't seem to come through. So question is, how is this going to change? And when is it going to change?

Shailesh Chaturvedi: See, if I again repeat what I just said some time back, this year, we are looking at, at least like an INR 225 crores additional EBITDA over last year in this financial year. In 9 months, the swing in our PBT is INR 212 crores. And every quarter, we have improved our EBITDA. These 9 months over last year 9 months, our EBITDA has gone up by 400 basis points. So look at our scale of our brands, the way our top-line gesture will cross INR 4,000 crores. There are efficiencies kicking in, every day in our business.

So I'm not able to visualize minus Unlimited. But if I look at existing businesses, the existing portfolio of power brands and the emerging brands, the overall portfolio, we are far healthy. Our stock turns are first time crossing 4. Our working capital – I mean, there is an improvement of more than 10 days in our business, therefore, tight on working capital.

Our interest costs are – net debt levels are at below INR 400 crores. That used to be more than – at point of times was close to INR 1,400 crores. So all around, this business is very healthy, efficient and bigger and more profitable. So I'm not able to imagine a situation what you are looking as to what I'm looking at.

Shreyans: So I'll just explain, sir. We did about INR 830 crores or INR 836 crores in Q3 FY '20 ex of Unlimited. Now from INR 836 crores, you've reached about INR 1,200-odd crores. So that's almost a delta of about INR 400 crores in top-line. Now when I look at your operating profit, excluding other income, you used to do INR 113 crores, including Unlimited losses. Now ex of those losses, we are at INR 120 crores. So your profits have not really changed.

Kulin Lalbhai: I don't know which numbers you are referring to, but most of our numbers have been re-stated to make them like-to-like. So the number you are talking before would also possibly not have Unlimited.

Shreyans: I'll take that offline. And the last question is, so if I just look at your profitability for our parent, we've done about INR 8 crores of profit this quarter. Now if you see the minority interest is INR 14-odd crores, so broadly, that gives you INR 28 crores of profit from the CK and the Tommy subsidiary.

So INR 28 crores profit. And if you look at the PAT before minority interest, it's about INR 22-odd crores. So there's a INR 6 crores loss that you've done in the other businesses. And if you look at this Q-o-Q, it is almost a INR 14 crores delta that has come in. So what is really happening in the other subsidiaries?

Shailesh Chaturvedi: So let's look at PAT number for the cumulative 9 months. Now if I look at the PAT number, which is close to INR 60 crores, and it's more or less an equal split between the PVH business and the all other brands of AFL. So it's a healthy sort of a 50-50 split between the two sets. In quarter 3, PVH brands, Tommy, CK, and I've been running those businesses for 16 years, I know that they are pure retail businesses.

So they tend to do better in the retail quarters of quarter 3. Also, this quarter 3, when it's a winter season, the winter was late, but then still, sale was coming through in October, November. The Tommy and CK do much better in winter business than the other brands of Arvind and also the industry.

So if I really look at the sum total of their strengths in winter season and also the fact that it's a pure largely a retail business compared to our brands, which have a very healthy wholesale business, which had peaked in quarter 2, like I said in my opening comments, if I generally look at normalizing, it's more or less equal split. And I'm looking at quarter 4 now. I think quarter 4, you will see normalization again. And on a full year basis, it will be a kind of an equal split, not the kind of skew you are seeing in the quarter 3 season.

Moderator: We have the next question from the line of Jatin Sangwan from Burman Capital.

Jatin Sangwan: If I look at quarter-on-quarter basis, your EBITDA has remained same, but there has been a lot of difference at the PBT level. So could you please explain why that has happened?

Shailesh Chaturvedi: See, if you look at items below EBITDA, basically, it is the interest costs and the depreciation. Now when I look at last year – last quarter interest rate, there is an 85 basis point increase in interest rates since there was an announcement in September end and then there was a recent announcement. So the interest rates have gone up by 0.85%. And that's the main reason why the below EBITDA, the interest component has gone up.

And actually, if you look at pre-IndAS, the operating expense, the interest rates are not very different. It is almost like an INR 2.5 crores difference. Post-IndAS, a lot of entries come, so that is as per the accounting policy. But if you really look at our gross debt, it's more or less the same number given the size of the business. And the impact of higher repo rate of 0.85% is coming into the interest, and that's what is making the difference.

Depreciation, also if I look at the quarter 2 to now, it's gone up slightly. In terms of operating depreciation of the real business, actually it's slightly lower. But with IndAS entry is looking slightly higher from INR 59 crores going to INR 63-odd crores. So the sum total of these two things, that is the interest and depreciation, is what is leading to a slightly more minus over EBITDA.

Jatin Sangwan: And sir, according to me, gross debt would be around INR 500 crores. And you have mentioned that interest has increased by 85 bps. So that would explain the difference of INR 1 crores in interest expenses. But if I look at overall interest expenses, they have gone by more than INR 6 crores.

Shailesh Chaturvedi: If you really see, we're also taking over close to 23 stores of PVH. We are buying back from the franchisee in order to improve our margins. So there is IndAS 116 impact on account of that. So actually, if you really see the real interest cost, it's not going up. Also, there are some other costs which what you call as finance charges. So there is a security deposit of the franchisee that we pay also. That, and then there are some commissions also come in. So it's not just the block, but there are other expenses also in the finance charges.

Jatin Sangwan: And sir, what would be the break-up of this depreciation of INR 63 crores into amortization of ROU assets and depreciation of PP?

Ankit Arora: So you are basically asking the break-up of interest on lease liability and normal interest. Is that your question?

Jatin Sangwan: Yes. And the same break-up for depreciation.

Ankit Arora: So, the normal interest cost is close to about INR 21 crores and normal depreciation is about INR 20 crores and the rest is on account of interest on lease liability and depreciation on ROU assets.

Moderator: We have the next question from the end of Mythili Balakrishnan from Alchemy Capital Management.

Mythili Balakrishnan: So I just wanted to check with you on this other income. What is the components of it?

Shailesh Chaturvedi: So if you look at the quarter three number, the total amount of other income is INR 15.9 crores. INR 8 crores out of that is what we call as the provision no longer required. So we had, for example, security deposit with the franchisee, which in the past, we had written-off and we had some money lying with the landlord, which we had made provision in the past.

And we've got a genuine recovery of those money in the deposit. So, no more of those provisions are required. So the bulk of this from INR 16 crores, INR 8 crores is the provision that is not required.

Second component of that other income is, we have interest coming on some of our bank deposits. So we have INR 3.3 crores of interest income from the deposit that we have made. And there's also a rent recovery of INR 2.5 crores. So what happens, in some of our businesses, we pay the rent to the mall and this goes as rental expense in our books, and then we recover from the franchisee later. So that recovery is at INR 2.5 crores where accounting-wise it comes as other income. But it is not other income, but the way the accounting is done that we make the payment to the mall first and then we recover from the franchisee. So these are the main heads. Then there is some re-assessment of lease and fair valuation of security deposits, which is around INR 2 crores.

So if I really make a summary of this, there is INR 16 crores of other income out of which INR 8 crores is largely the provision that we don't require. There is a rent recovery of INR 2.5 crores, there is an interest income on our deposits with the bank of INR 3.3 crores. And then there is INR 2 crores on re-assessment of lease and fair valuation of security deposits.

Mythili Balakrishnan: But on a more recurring basis, then it is probably – this number would be INR 3 crores to INR 5 crores on a quarterly basis?

Shailesh Chaturvedi: Currently, if I see, it's more close to like INR 10 crores than like INR 3 crores to INR 4 crores. Last quarter was a little higher because there was some gain on write-back of provision. But I think around INR 10 crores of this kind of entry would be normal for the scale of our business.

Mythili Balakrishnan: In terms of the raw material prices, are you seeing any pass-through in terms of lower cost inventory coming to us?

Shailesh Chaturvedi: Sorry, lower cost? You mean reduction in the cost of goods?

Mythili Balakrishnan: Yes, yes. I meant from the perspective of the cotton prices coming off.

Shailesh Chaturvedi: Let me first answer the first part and then I'll come to your point. See, our world, in this current quarter 3, we have never seen the kind of cost push we ever saw. The cotton prices went INR 1 lakh per candy, the China import shipment costs went up, the dollar depreciated, we had to take higher costs in imports. There are a lot of things in Q3 that are at a higher level and we're still able to improve our EBITDA by 1.1%.

Now as I look forward, the kind of lead times we work on, our spring/summer goods were good where there was slight softening, not full softening. But after that, the cotton prices have come down to maybe INR 65,000 from the peak of INR 1 lakh. So most of this reduction is likely to happen by fall holiday '23 goods, which we are booking right now with the market, the road shows are on. So the lower cost structure likely to become material in our books from fall holiday deliveries, which will start from July onwards.

Mythili Balakrishnan: Also I wanted to check with you on the state of Arrow. You mentioned the fact that it's got a low-single-digit EBITDA margin. I wanted to check with you on the trajectory that you see there, the quality of sales? What do you see as the more steady state for this business?

Shailesh Chaturvedi: In fact, we are very pleased with the progress on Arrow and where Arrow is sitting today. Today, we have seen three quarters of positive EBITDA in Arrow. COVID was very tough for a formal brand like Arrow. And it's a larger retail business, so it got impacted more. But in the last three quarters, the brand has come out very strongly.

Now we did a lot of things, and I don't want to go back again, but I just want to say that we re-invented the brand, improved the product quality, and logoized it. We got a new retail entity done. We improved the sports line which is a little more work from home or casual side.

We got Hrithik Roshan, a new brand ambassador. And we did many things which we have been talking about. And the results of that have started to come in now. This year, full year pre-IndAS, the delta in EBITDA of Arrow would be close to INR 65 crores to INR 70 crores from losses of last year to positive almost low-single-digit EBITDA.

The swing is very significant. And that swing is happening because in fall holiday, Arrow saw the highest improvement in sell-through. So the sell-through went up by like 7% to 8% and the discounting came down because of that significantly.

So today, if you go to the market and talk to any big trade customer, Arrow is a strong brand and everybody will acknowledge saying that Arrow has turned around doing really well. The throughputs are good, sell-throughs are good. So a lot of changes were made. We're seeing the results for the last three quarters. This quarter, it had the highest improvement in full price sell-through.

The delta and EBITDA this year will be very, very material for the company going forward. And from this place where this brand now has crossed more than INR 500 crores business and it's reached low-single-digit EBITDA, the interesting part is what we do with it going forward. And how do we now take it forward to the desired double-digit EBITDA in, let's say, two years or three years.

So I think the whole game in Arrow now is that in some part of Arrow it's sub scale. So for example, number of stores that Arrow had close to 200 compared to its competition, we are sub scale. And the most important thing in Arrow now is to how to open 100 good stores going forward. The earlier we can open those 100 stores, the better it will be for Arrow.

It might take us one and a half years to do that. But that's the journey that now all the efficiency and the aesthetic sides are in place, now we need to ramp up. We need to accelerate the expansion of Arrow fast. And wherever there is a sub scale nature of the business, we need to bring the scale back. And that's what we are doing. We are increasing the product lines from suits and blazer to former trouser doing really well. To the channel side where we believe, we should open 200 more stores in the next two years or three years. So get to the scale that is required.

So we feel very confident of what we have done with Arrow in the last two-odd years. And the recent performance has been very, very encouraging. And we will now focus on increasing the scale in the right way for Arrow and take the journey to double-digit. Next year, I feel it should hit the mid-single-digit EBITDA. And that would, again, be a very large swing in EBITDA for Arrow to help AFL, improve its overall profitability.

So Arrow is sitting on a very good wicket. And we just launched a premium line of Arrow, called ‘1851’, that's got very good response and it improves the revenue per square foot in stores. So a lot of good things going for Arrow right now. And our job now – having done the job of turning around, we need to now scale-up profitability, to reach 5%-odd, 6% EBITDA soon and then to double-digit EBITDA journey. That's the game plan on Arrow.

Mythili Balakrishnan: Coming back to the margin question, which, at some level, we are all looking at. I just wanted to understand that, in your view, what would be a more steady state sort of EBITDA margins that one should look at for a business of our size and scale? And like by when do you think you can sort of like get there?

Shailesh Chaturvedi: So I think we've been really obsessed with that guidance ourselves. We are saying we need to hit double-digit EBITDA pre-IndAS, in our power brands. And we used to say 18 months, now we're talking 12 months, now we're saying next year, because we have gone through the journey. Our EBITDA at the company level has gone up by 4%. And in power brands also, the EBITDA has gone up this year by 4%. Now we are at 12.5% post-IndAS. And if we were close to 14%, we will be where we want to reach at 10% double-digit EBITDA.

So our game plan now, first step is to reach 14%-odd post-IndAS EBITDA in power brands, which we believe we should reach next financial year. And that's the first stage of improvement. And then every year in our guidance on revenue is between 12% to 15%, as we keep growing the revenue and keep turning around the brands like Arrow and make Flying Machine big brands, higher scales towards INR 1,000 crores revenue, we will get additional EBITDA.

So those are the some of the things that we have to deliver; power brand, double-digit EBITDA, scaling up of the brands and it will give us scale advantage. We will start getting leverage, like in this quarter we got 0.5% additional EBITDA because of people costs. So there are a lot of such opportunities will keep coming as we keep growing the branding at 12% to 15%.

Moderator: We have the next question from the line of Sagar Parekh from One-Up Financial Consultants.

Sagar Parekh: Congratulations for a decent set of numbers. Actually my question was on Arrow only, which you answered it quite elaborately. Just on this Arrow thing, at peak, I think INR 700-750 crores kind of top-line versus you mentioned that we will end the year this year at around INR 500 crores. So when do you think we'll probably reach the peak again? And once we reach the peak, do you think that we can like go to double-digit kind of pre-IndAS EBITDA margins in Arrow?

Shailesh Chaturvedi: See, next year, we should reach the highest ever revenue in FY '24. And the double-digit EBITDA should be a journey one year later. So we are at a low-single-digit EBITDA, we should hit 5%, 6% EBITDA and then towards 10% EBITDA. So it will be like a 2-2.5 years game from now.

Sagar Parekh: So what will drive this margin expansion from single-digits? So apart from scale, anything else?

Shailesh Chaturvedi: Scale is very important, also in terms of our channel mix. So what happens is that there is a certain revenue that's coming from retail, which is a little higher. And some of the other channels are low, we need to increase the revenue of that. Also, the kind of brand Arrow is and the kind of prices on suit, blazer and '1851', the retail profitability also can go up.

So a couple of things we have to do. First, scale up. Second, channel mix to be a little more balanced. Third, the retail productivity, it has to go up. And overall, the way we are doing for all other brands, the discounting also has to come down in Arrow. Like most of other brands, we are looking at full price sell-through focus which should deliver lower discounting.

Sagar Parekh: The overall full price sell-throughs for different brands, how would that be different from, let's say, Arrow versus US Polo?

Shailesh Chaturvedi: Arrow is not competitive. Arrow is now a good sell-through. It's really in the last two seasons caught up with the remaining brands. So it's now a healthy sell-through. But all brands can improve sell-through and reduce discounting, and that's what our focus will be. Also, when we're talking about the kind of scale in next two years Arrow should get, I think there will be a lot of leverage on cost will come from better employee costs, marketing costs as a percentage of sale will come down.

So I clearly see advantage on higher channel margin in Arrow scale, better scale, bringing in some more efficiency on leverage and higher EBITDA coming from there. So those are the things Arrow will have to do. And we are very confident, because you see all the metrics, the KPIs we work on, full price sell-through, discounting, growth of business, it's passing the test. Now we need to scale up. We need to accelerate the expansion of this brand.

Sagar Parekh: When you say channel mix, you mentioned – you were trying to say that more of retail channels rather than online?

Shailesh Chaturvedi: Yes. So for example, a competitor will be having close to 350 stores, Arrow has 200. So we need to add those 150 stores. And what happens in our business that when you open more right stores, you could theoretically reduce the advertising cost because store becomes the brand advertisement. Also, Arrow could do a little more on online. So we're building marketplace model for online business. We're linking all the Arrow stores with omni-linkages which will further improve the visibility of the Arrow inventory online. So there are many things that we are doing to take Arrow forward.

Sagar Parekh: So if I have to look at your overall portfolio of brands, let's say, by next financial year, you will reach – obviously, Arrow was an outlier, but you gave a very broad elaborate answer to Arrow. But apart from that, the other two laggards are basically Sephora and this Flying Machine in terms of margins at least. If I have to look at the overall portfolio in double-digits, we need to scale up these two – the margins of these two brands as well, right? So where are we in that journey?

Shailesh Chaturvedi: So I think your point is very valid that – let me leave Sephora aside, but I would say, first talk about Arrow and FM. And both the journey – FM also is close to INR 500 crores business. And in our business, if we really want to be a double-digit EBITDA on a sustainable basis, we need to be much bigger and we just did a strategy where we are looking at FM as a INR 1,000 crores brand. And at that scale, FM also, like Arrow at INR 1,000 crores, will deliver kind of EBITDA, because there is a huge scale leverage in our business.

Also, to do that in – for example, in Flying Machine, we are looking at channel modification and the product modification. So on the product side, we are looking at adjacent category like what we have done really well in US Polo. So we've just right now launched the first line of footwear in Flying Machine, selling online fairly well. We are encouraged by that. We are looking at inner wear, we are looking at women's wear, probably kids' wear. So there are lot of discussions going on with our partners to see how we can leverage new categories and we are committed to that idea of making our brand bigger and more profitable through adjacent category. And FM will also follow that strategy.

Also in channel, FM is slightly weak in a couple of regions. So we are putting disproportionate energy in some of the regions. I don't want to mention the regions for confidentiality and competitive positioning in the call. But we know some areas where there are regional gaps in Flying Machine. We are filling those regional gaps. Also, some channels are relatively weak. For example, retail stores. We've done some work on a new store identity for Flying Machine and opened the first few stores and we want to now ramp up the store network for Flying Machine.

So in Flying Machine also, the whole opportunity for new categories, opportunity on regions side, opportunity on channel side that we can take it forward. This is our own brand. And this is where the opportunity to scale up in a sub-premium segment are enormous.

And jeans is such a large segment in India that Flying Machine as an export on jeans gets a premium pricing. It's very good opportunity. And now we are going to try to exploit that opportunity for Flying Machine. So Arrow and Flying Machine – a clear game plan for us to push it towards higher profitability and bigger scale.

Sagar Parekh: Sephora?

Shailesh Chaturvedi: So Sephora is a more niche high price business and it's offline. So that's how the brand is worldwide. It has an offline appeal with women consumer in a more prestige segment. And we have 26 stores in big cities and those stores do really well. If you go to any mall and ask which brand has the highest sales density, Sephora would come in the top brand for any mall in the big city.

Now we are in dialogue with the principal to take it to the logical profitability in India. We'll have to see how we can expand into slightly smaller cities in India. And also add channels like online where we are currently not playing the game with Sephora. We don't have the online rights.

And we are in negotiation with the license for principal. So that's a game where we have to sort of sit down and influence the principal. So that will take more time. In Arrow and Flying Machine, it's a different ease to move forward. And here, we are actively in dialogue and we'll see what comes out of those dialogues with the principal.

Sagar Parekh: Are we profitable at EBITDA level in Sephora?

Shailesh Chaturvedi: It's a small, very low-single-digit profitability. It is growing well. Like-to-like store growth is good. It's growing good in those 26 stores. But it needs to be redefined completely if it's online with smaller town expansion, etc., to reach a certain scale. That's where we are engaged with the principal. Let's see what comes out of it.

Sagar Parekh: I mean, we have been engaging with the principal since a long time now, but nothing is coming out of it. And since it's been a while, till what timeframe are you looking at probably engaging further before taking a call on what you did with other brands, which were not performing?

Shailesh Chaturvedi: So we see value in this engagement because it's a powerful brand and we'll indeed put in the harder work of engagement and time has not come from our side to look at like that.

Sagar Parekh: Some time away then before you take your call on that?

Shailesh Chaturvedi: Yes. I mean, we are in active engagement. So that's what I can say right now.

Moderator: We have the next question from the line of Jatin Sangwan from Burman Capital.

Jatin Sangwan: Sir, during this time, there was a delay in winter and EOSS was also pushed to Q4. So should we expect Q4 similar to Q3?

Shailesh Chaturvedi: No. Q3, Diwali is the highest and the biggest quarter of the year. And in the quarter 4, EOSS has a big impact. So January and till middle of Feb, EOSS takes place. So you cannot compare quarter – in our business, sequential quarter-to-quarter this is very difficult. In fact, right way we always do it, to look at even high seasonality, you compare with last year. So if you say compared to last year, quarter 4, how do you see the performance, I can say. But if you compare a Diwali quarter with the EOSS quarter, it will not be really correct to compare the two quarters.

Jatin Sangwan: And sir, just one data-keeping question. What was the actual amount of rent that we paid in this quarter and for the 9 months FY '23?

Shailesh Chaturvedi: Let me just check.

Ankit Arora: Jatin, we don't have the exact number right now. I will probably will be able to connect it back offline.

Moderator: We have the last question from the line of Gautam Rathi from CWC.

Nishit: This is Nishit. Just one question. I was just doing the math. If you said roughly this year should be INR 1,200 crores higher than last year which was roughly INR 4,200 crores, INR 4,300 crores of revenue. And you said both Arrow and Flying Machine are around INR 500 crores brand.

And if I just work back of the envelope, if I just think about Sephora, mostly around INR 300 crores brand. The point I'm trying to make is roughly INR

3,000 crores worth of brands that we have are more than double-digit EBITDA and the balance brands are all single-digit EBITDA, right? Is my understanding right?

Shailesh Chaturvedi: See, if you look at power brands, Nishit, we said we are at 9 months 12.5% post-IndAS EBITDA, right? So clearly, Tommy Hilfiger, US Polo, that zone is clearly is double-digit pre-IndAS and it remains and growing in that base. But that's how I would read the data.

Nishit: Correct. But broadly, the only brand left out there is CK, right, which is also doing really well broadly, from whatever we see from the PVH balance sheet. The combined PVH brands are double-digit. So the point I'm trying to make, Shailesh, out here is that broadly if you see INR 3,000 crores is 10% plus EBITDA and INR 1,300 crores is low-single-digit EBITDA, so if I just do the math, it should roughly work out to be around INR 300 crores, INR 350 crores around that EBITDA on the pre-IndAS side, whereas we are at INR 225 crores for the 9 months.

It's impossible that we're going to do INR 100 crores EBITDA in the last quarter, which is the only reason I'm just trying to understand there is something which I'm not able to understand in this, right? There is something which is not fitting into the math out there.

Shailesh Chaturvedi: So what happens is that this year, Arrow is a very low kind of EBITDA and you're comparing with an expectation of 10%. So there is a big drag and similar with Flying Machine.

Nishit: No, no, I'm not taking Arrow into that account at all. I'm saying INR 4,200 crores which you mentioned, I'm taking out the INR 500 crores Arrow, I'm taking out the INR 500 crores Flying Machine, I'm taking out the INR 300 crores Sephora. I'm saying all of them INR 1,300 crores put together is a 2% EBITDA, INR 25 crores at best.

And I'm saying the INR 3,000 crores EBITDA, the balance brands are only the Tommy, CK and US Polo, right, which are all 10% plus EBITDA. So if I do the math, it should be better than INR 25 crores, unless there is a loss somewhere which I'm not able to understand.

Shailesh Chaturvedi: I'll explain you that what is the missing piece here. See, we have in our business, couple of brands which are now not active. We have shut down the operations. So that's brand like Ed Hardy, there's a brand IZOD, there's a brand Aeropostale. Now till last year, we were doing small business and we used to get small GP and we are paying minimum guarantee royalties. This year, we have stopped that also. We were being focused on our efforts only on the six brands.

We still have a royalty minimum guarantee, which is around INR 5-odd crores royalty payment, roughly around INR 20 crores a year on these brands over the next couple of years. So that is a missing piece. And as we grow the business to much higher EBITDA going forward, like every quarter we're increasing, then this around INR 20 crores EBITDA loss will become a smaller percentage of our overall – this is not going to grow and this will go away from our life in couple of years. So that's the only missing piece. Maybe that's what you are looking for.

Nishit: Which is fair, which explains my point. So when do you think -- when should we put a sunset date for these payments going out, whether by FY '25, FY '26? When do they become zero?

Shailesh Chaturvedi: Two to three year horizon on this. And it's a legal commitment, so we'll have to honour. And we are actively in partnership with all these brands.

And if there is a way to sunset in some model earlier or so, we will explore that option. But currently, this is a reality we are living with.

Nishit: And one last question. I know you guys are trying hard and trying to figure this out and there has been a lot of press about Sephora even we're hearing – we're reading a lot of articles. How should we think about it in our mind? Is there some kind of a timeframe that can be provided or it's just too vague?

Shailesh Chaturvedi: See, we can't respond to speculations. This is our business. We continue to focus on running the business. And like I said, we run these 26 stores quite well with the best productivity. This is our access to women consumers, beauty segment. So we continue to run. We don't want to respond to market speculation. And if and when on any of our brand, something comes up, we'll always engage with our investors. So right now, I have nothing much to add, Nishit.

Nishit: No, no, I was just trying to understand that since the good part is we are hearing that that speculation has been put to an end. So the question I'm trying to understand is, for us to get some kind of a response to take the brand to a logical conclusion, can we expect anything in the near-term or is it still uncertain? That's the question I'm trying to understand.

Could you get some kind of an assurance from the brand to take it to a logical conclusion in the next three to six months or is it very uncertain? That's the question.

Shailesh Chaturvedi: We are in active engagement with all principal, including with this brand. We're always trying to better our business, deliver better profitability for our portfolio of brands, at AFL level. So we are in active engagement with all our principals. So that is what I can say. Sometimes discussions on way forward takes time, but I can't comment more on that on speculation. We are running the business and my focus is on running the business.

Moderator: I would now like to hand it over to Mr. Ankit Arora for closing comments.

Ankit Arora: Thank you everybody for joining us on the call today. If any of your questions have been unanswered, please feel free to reach out to me separately, and I'll be happy to answer them offline. Thank you, and have a good day.

Moderator: Thank you. That concludes the conference on behalf of Arvind Fashions Limited. Thank you for joining us. And you may now disconnect your lines.