Arvind Fashions

Q4 FY2023 Earnings Call Transcript – May 31, 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 Q4 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, Zico. Welcome everyone and thank you for joining us on Arvind Fashions Limited earnings conference call for the fourth quarter and fiscal year ended Mar 31st 2023. 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 fourth 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: Thanks, Ankit. A very good afternoon to you all. Thank you for joining us for the Q4 results. We are very pleased with the strong operational performance this quarter. Despite tough market conditions, the company was able to register a growth of 24% in revenues and 45% in EBITDA. This was made possible by strong like-for-like growth and sell-thru's, which led to a significant GP expansion.

Over the past two years, we have focused extensively on reenergizing our brand franchises and those efforts are now clearly bearing fruit. FY23 has been an exceptional year for AFL. Our sales grew by 45%, adding more than INR 1,350 crores to the top line. Growth in EBITDA was far higher at 100%.

Overall, EBITDA margins increased by 330 basis points. The key drivers for this significant expansion in EBITDA are increased sell-thru's and productivity in our retail channel, the turnaround in Arrow profitability and operating leverage due to a much larger scale.

As we exit the year, we feel confident that we will continue to see a significant expansion in our EBITDA margins moving forward. A very significant milestone for us is achieving a return on capital employed of close to 15%. We had stated a medium-term objective of reaching return on capital employed of 20% and that objective is now well within reach.

Our North Star at AFL will be to achieve a high return on capital employed and strong operating cash flows. And hence, all the decisions we have taken in the past many years are towards achieving this objective. We exited unprofitable businesses, reduced asset intensity by increasing the share of franchising in our business, significantly improved our gross margins through better full price sell-thru and dramatically reduced our gross working capital days.

Strong controls on inventory have improved our inventory turns to more than 4x. And by pivoting to a consignment model in our franchise network rather than the buy-and-sell model, we have optimized our receivable days as well. We could have had an even higher EBITDA had we not made these business model changes, but these changes have resulted in a more robust business model, where we have full control over our inventory in the franchisee stores and hence much better turns and lower receivables and therefore, higher return on capital employed.

Our gross working capital days are the lowest in the company's history and have gone down by 22 days over the last year. This strategy of investing strongly behind our power brands and scaling them up in this asset-light consignment driven business model in retail, will ensure strong growth with strong operating cash flows in the years to come.

The customer demand remains soft, but we believe we have many growth drivers to scale up our business. We will increase our retail penetration with a healthy store opening plan. Our direct-to-consumer online business is showing great promise and our new category expansion into footwear, kidswear and innerwear is gaining momentum.

Our percentage EBITDA should continue to improve, driven by better productivity and sell-thru’s, improvement in profitability of brands like Arrow and higher operating leverage. While we enter the new-year with cautious optimism, we remain confident with the strength of our brands and our execution capabilities to navigate this environment.

I would like to now hand it over to Shailesh to take us through the specifics and more details about the financial performance.

Shailesh Chaturvedi: Thanks a lot, Kulin, and good afternoon, friends. Two years back during the COVID pandemic, AFL went on a path of decisive focus to put our entire weight behind reenergizing profitable growth. We've built one of its kind and very powerful portfolio of market-leading brands like US Polo Association, Tommy Hilfiger, Calvin Klein, Arrow and Flying Machine. With this decisive focus, AFL has doubled its revenue in the last two years, going from nearly INR 1,900 crores to now nearly INR 4,500 crores, it's a swing of INR 2,500 crores in two years.

In these two years, the growth in EBITDA has been even higher. In the previous year FY22, AFL saw INR 140 crores swing in EBITDA. And now in just completed FY23, AFL EBITDA went up by another INR260 crores. AFL EBITDA has doubled in FY23 with gain in EBITDA percentage margin of 330 basis points.

The growth in EBITDA in the last two years INR 400 crores. Power brand EBITDA is at a healthy place at 12.6% at end FY23, delivering PBT swing at AFL of nearly INR 240 crores and a PAT swing of nearly INR 300 crores.

Q4 saw good results, starting with January, which finally saw the onset of peak winter. And with our strength in winter wear, we saw a very good full price sell-thru of winter goods that time and for the entire full season of fall holiday '22. Q4 revenue at INR 1,140 crores meant a growth of 24%, aided by like-to-like growth in retail of 17%. Department store grew 60%+, and MBO channel grew by 50%+. USPA in the whole year grew by nearly INR 600 crores in NSV. Arrow also is a sharpen avatar now and with an impressive swing in EBITDA, which is based on healthy full price sell-thru's and strong like-to-like growths.

Tommy and CK have continued their path of excellence and has crossed revenue scale of INR 1,000 crores in this JV with extremely healthy margins. These brands lead the industry in retail experience and business KPIs. Flying Machine saw launch of a new brand logo and a new brand architecture, and we are leaving no stone unturned to take FM scale to the desired ambitious levels in the next few years.

Footwear business is showing very encouraging traction with its market-leading position and growth in 40% to 50% range with very healthy margins. We are also premiumizing all our brands and have touch points in order to offer a differentiated brand experience to consumers. In addition to very profitable growth of brands, we have kept a keen eye on working capital that resulted in 10 days improvement in inventory and 12 days improvement in debtors in quarter 4.

The supply chain initiative of last two-odd years, including focused project on core line has started to pay early dividends. In the current market conditions, we'll continue to keep a keen eye on execution and operational rigor so that we continue to gain profitability through better retailing standards and higher full price sell-thru.

We see large growth potential in our brands, and we'll continue to grow scale and gain scale leverage and make our brands more profitable. In our build versus buy strategy, capital efficiency will remain the key priority. Thank you.

Ankit Arora: Zico, we can open it up now for Q&A.

Moderator: Thank you, sir. Our first question is from the line of Nishid Shah from Ambika FinCap. Please go ahead.

Nishid Shah: Congratulations on a very, very good set of numbers. My first question is relating to the Sephora. On the online side, I think one year back, we discussed about it that we should be seeing some initiative. So, can you elaborate on this? Now what's the situation? And how do we see it going forward?

Shailesh Chaturvedi: The situation on Sephora is – there is a status quo there. And we don't have anything incremental to add and it remains currently a very prestigious offline business selling masstige brands to women consumers. We haven't sort of launched a new online initiative as yet.

Nishid Shah: The experience at the store is excellent. In fact, it is much better than shopping at any of the international airport's duty-free shops. So I was just wondering what is stopping us from launching Sephora online in India? It is there on NNNOW.com. But if you have it as Sephora, it makes a whole lot of a difference. And there is a competition catching up with Nykaa and Reliance also launching on to it. I'm sure that it must be on the mind and you are working on it.

Kulin Lalbhai: We had stated this earlier as well, and this is one of the discussion points which we have with our partners. As Shailesh mentioned, we don't have an update on that yet, but of course, it is an area which we are in constant discussions with, with the global Sephora team.

Nishid Shah: My second question is relating to the overall size and the direction, you are right now at about INR 4,400 crores going by the normal growth rate that you would expect to achieve over the next three years, you will be almost $1 billion or maybe $1 billion-plus. Would you like to elaborate on that?

Shailesh Chaturvedi: We won't sort of comment on that. What our current strategy is to grow the brand's profitability and we don't see any change of that strategy. We'll continue to grow our business at 12% to 15% CAGR, that's our guidance to the market. And we stick to that guidance that in the medium term, all our growth engines are still firing be it on store expansion, be it on marketplace capability online, also continue to focus on sell-thru and grow the like-to-like growth of our store. Our adjacent categories are doing well. So we will continue to grow the way we have grown in the last two years and wherever it takes, it takes but we will stick to our strategy.

Nishid Shah: Kulin, 12% to 15%, actually, 12% is the nominal GDP growth. If you look at 7% inflation and 6% to 7% growth, real growth, then we are talking about 13% to 14% nominal GDP growth. So if you say 12%, then you are going to actually be losing out on the market share. And you talked about so many initiatives, so many new category additions and all, then we should be at least aiming for at least 18% to 22% kind of a growth. Isn't it?

Kulin Lalbhai: No, what you are saying is fair. I mean, if you look at our last few years, we have been growing fast, even adjusted for COVID and no decision we will take in the company which will not maximize the growth potential. The only thing we will always do is we are wanting profitable growth where growth gets converted into very healthy operating cash flows. And you have been seeing how we have been delivering on that. So as long as we are able to grow with the healthy opportunity, there won't be a stone unturned that the company will use every means possible to grow in a healthy fashion. Now with 15% as being our kind of median projection over the next 3 years, whether it is plus some percent points or minus percent points, depends on market conditions at that given point.

But I think even the numbers which you have said, if the markets are very responsive even we have been growing at 18% in the past. I think what we want to be very clear about is that we want healthy growth in the company, and we will not take decisions to accelerate growth at the cost of strong bottom line and operating cash flows.

Moderator: Thank you. Our next question is from the line of Darshil Jhaveri from Crown Capital. Please go ahead.

Darshil Jhaveri: Firstly, sir, congratulations on a great set of results. Sir, with respect to our margins, now you finally consistent double-digit margin, so what kind of further leverage that we can see? Because we have a good portfolio of premium brands. So what would be our take in terms of our margins? Like we said you want to do it better, but some kind of a range that our target is maybe over the next two, three years?

Shailesh Chaturvedi: Yes. So on the margin side, I will say, first, the -- what are the inputs that will drive our margins and then we can talk about some percentage. So if you look at, a lot of our focus is on the operational rigor, efficiency. So we look at both the product side and the retail side margin improvement, so on the product side, improving full price sell-thru, reducing discounting, buying better, a lot more focus on that side.

And we see an opportunity to grow our margin on the product side. Also on the channel mix, we are looking at getting higher business from more profitable channels, and we're also trying to reduce our discounting. So overall, the efficiency, the product rigor and the retail rigor offline/online, both is likely to give us some uptick in the gross margin. In addition to that, we have the second bucket of turning around profitability of some brands even more.

So happy that Arrow has turned around in FY23 and has a very large EBITDA swing from FY22. So that's helping grow the GP for AFL. And we see that both Arrow and Flying Machine need to be higher scale, they're a little soft scale currently. And as they go in their journey for bigger scale, we will also get more margin coming from that.

And the third side on the margin is the operating leverage. As we grow the scale like we have doubled our business in the last to years, and we continue to hopefully grow at market-leading growth rate, that will also flow into our additional margin EBITDA. So these are the broad sort of direction where the EBITDA is flowing.

Now I talk to the specific guidance. See, we have a guidance for company that we need to grow our EBITDA close to 1.5% to 2% on an annual basis, that's a minimum sort of guidance from our side. And we see that we will be able to continue to grow that space and if the markets are better, even at a higher pace.

Also in power brands, we will need to achieve double-digit EBITDA soon, and we are working very hard to that, and we have internal goals to reach that quickly. So those are the guidance that every year, we need to take the EBITDA at least 1.5% to 2% in that zone, I think more like 1.5% expansion, and that will lead to the level that we'll be happy with in next one to two years.

Darshil Jhaveri: Okay, sir. So sir, with respect to, I think we've mentioned we might see some softening of demand. So would that -- how are we seeing now in two months in this year. So what is the consumer sentiment that we could see, what are we expecting? Is the demand issue that is why we are maybe focusing on 12% to 15% growth because we've been growing at a very substantial rate. Could you just help me understand how the environment is currently?

Shailesh Chaturvedi: See, I would say the current market conditions are soft. And I would say despite the market condition, given the strength of our brand and our confidence in our ability to execute strongly, we are likely to deliver fairly competitive growth going forward. And as the market sort of improves which, likely to be from festival time, the growth rate still likely to go up further.

So we will stay focused on our growth drivers, like I said, store expansion, building online marketplace, improving like-to-like growth in our store, growing adjacent category like footwear and kidswear, etc. So we will continue to fire on all of cylinders. We want to build these brands to mega brands and we will continue to focus on growing these businesses.

Darshil Jhaveri: Okay. So that helps. And if I may, sir, one more question. I just wanted to understand about our tax rate. So will we -- because of our prior losses will that help in our taxation or how would that just happen?

Girdhar Chitlangia: This is Girdhar here. Yes, you're right. There are still accumulated losses which will help us in our taxes in the future.

Darshil Jhaveri: So going forward, what would be the effective tax rate? Because I think this year, we've still shown as 30%.

Girdhar Chitlangia: So there are two things there. One is the tax regime and whether it's ultimately, we pay our tax. Two different questions here. So we are currently in the current tax regime only. And in the future, I mean, we keep evaluating. As and when we get an opportunity to move to a new regime, we will. Of course, we have the option of continuously utilizing our past losses.

Darshil Jhaveri: Okay, sir. So like if I can understand that we're not paying out cash taxes, it is just a book entry currently, if I could that could make sense?

Girdhar Chitlangia: Yes.

Moderator: Thank you. Our next question is from the line of Ankit Kedia from Phillip Capital. Please go ahead.

Ankit Kedia: Sir, my first question is regarding the working capital. I think excellent work on the inventory days and collection period. Just wanted to understand, have you changed accounting with the franchisee owners or wholesalers to reduce the inventory or status quo on that front?

Shailesh Chaturvedi: See, there's nothing dramatically done in last 1 quarter, but over the last two, three years, we've been gradually changing the model to maximize ROCE and capital conversion. So we used to do a lot more outright billing in the past. But now we have moved – like the industry has also moved, to a consignment model. It's been done gradually. It's not like a one-off in quarter 4.

And we believe that's the right model because the cash collection is faster there, our ability to manage the assortment of merchandise and drive the full price thru store in a more scientific automatic – automated way is better. So we like in this we've also made some changes, but they have been very gradual on this.

Ankit Kedia: Sir, so in this, the inventory is on our books or on the franchisee books? And, accounting and practical could be two different things, right? So if you can explain the buy-and-sell model historically and now consignment model, how is it different on paper and actually?

Shailesh Chaturvedi: Yes. So in the past, then the outright model, the inventory gets transferred at the time of billing to the franchisees. And then that franchise is supposed to pay back to us as per the terms we have with the party.

Now after that, the whole experience and the whole scientific rigor of ensuring very healthy sell-thru is with the franchisee. All the tools get transferred to the franchisee, we don't even have visibility of level detailing.

The industry, and we have moved to a consignment model where the goods – the title remains with us, with the company. And based on the sale, every day the sale gets collected, it's transferred back to us. And at a pre-decided margin commission, we pay them on a monthly basis, the commission.

Ankit Kedia: So the inventory which is reduced is sitting on our books and despite that the inventory days have come down. Is that the right way to look at it?

Shailesh Chaturvedi: That's right – also, what happens is that you're right that with all this back-end being a little more scientifically handled, automated replenishment, the throughput of the inventory gets to us in our way, and it's a scientific knowledge and now machines are doing it. So we need the whole inventory pool to be guided by the machine learning.

Second part is that when the inventory is with us, it also gives the opportunity for us to do the omni business because we have a clear visibility of omni, then through the omni method gets exposed to the consumers online.

And then we push the full price sell-thru to the omni conversion also. And in lot of our stores, the omni contribution is in high single digits. So that's a further push into full-price business. So you're right in a way that despite the inventory being on our books, we are seeing much faster turns in our business. And like we mentioned, the stock turn have crossed 4 now.

Ankit Kedia: And sir, because of that from a revenue recognition perspective, now we are looking at full revenue and the expenses the franchisee commission comes as expenses because of this accounting. So that way, over three years, if the transition has happened over the last two, three years, the revenue has bumped up by that percentage of the franchisee commission?

Shailesh Chaturvedi: Yes, gross margin and the revenues do get slightly increased. And, also the franchisee commission will come below the GP as an other expenses and profitability comes. So percentage EBITDA comes down in this model because the revenue recognition is at the MRP-ish level, whereas the margins are after reducing the expenses. So while the denominator goes up, but overall we see in the medium term, our ability to sell full price with lower discounting, goes up. So that's why overall EBITDA goes up.

So basically, this is a model which is optimizing return on capital employed. So, ROCE is the north star and this method gives us opportunity to do faster stock turn and improve ROCE.

Ankit Kedia: Sure. Sir, in Channel-wise, can you just help us with channel-wise margins on a ballpark basis, what they would be? And how are we looking at the mix here – online, MBO and retail business now?

Shailesh Chaturvedi: Yes. So let me first give you a sense of channels. See, we are fortunate that we have multiple very well-developed channels, be retail, department store, trade, online. And within online, we have both wholesale as well as our own marketplace. So at an annualized level, our retail contribution now is around 43%, which has gone up by 4% in last year.

Department store is at that 12% to 13%. That’s also because the department store took some more time to recover. So this year, we'll see further continuing growth in department store percentage, and they are now at around 13%. Trade tends to be on an average at 15%, we are at around 17%. But between department store and trade that we get around 30%. Then we have a healthy online, we are the leader in the online space where our contribution has been between 20% to 25%. And then we have small other channels like export or liquidation, which is like 4% to 5% of the business.

So this is the whole sort of a channel mix and our entire effort is to drive channels, which give us better opportunity to give experience so be it the retail channel, be it the online marketplace model. We prefer where we have a larger say on things like consumer experience, product assortment, discounting and faster stock turns. So that's where our philosophy on the channel is currently.

Ankit Kedia: So from a margin perspective, then retail would give you the full control end-to-end. So is it fair to assume that the retail is the highest margin, while trade would be the least. But actually, I believe trade still gives the best margin, right, where you still don't have control. So if you can just help us...

Shailesh Chaturvedi: See, every channel has its own dynamics on margin and expenses. So it will not be fair to answer that question. But our priority is to focus on experience right now.

Ankit Kedia: And on online – own website versus third-party marketplace and a lot of there, we are seeing companies shifting to omni and not outright. How is that movement in online happening? And how does that impact margins?

Shailesh Chaturvedi: But that's a major strategy for us to divert the online demand for our exciting brands to marketplace model. And in this quarter, our marketplace business grew by 75%. What happens is that in marketplace, the whole assortment of inventory, we do it very scientifically. We create a lot of exclusives and very strong linkages with our stores on omni side. So overall, we are building this marketplace model very strongly, and we're putting a lot of resources and energy behind that.

Ankit Kedia: So today it would be 50%?

Kulin Lalbhai: Let me come in and explain this model simplistically. In the older buy-and-sell model in online, you would sell actual inventory to the partners. And then the control of how they sell it, at what price they sell it, it's with them. And it also meant that your inventory then is in different places with different partners. In a marketplace model, the inventory all is with us, in our warehouses and our stores. And because the inventory is centralized and all the demand comes to one centralized pool of inventory, we not only control the pricing in the presentation, but the same inventory pool is catering to all the demand.

So it is a much more efficient way to even get inventory sell-thru's to happen. So I think the pivot towards marketplace is a very strategic one. It means our company has to also obviously developed capabilities around not only fulfilling the orders, from our stores and warehouses, but also maintaining the listing, creating demand. These are all now very scientific new age capabilities, and those capabilities have been built by the company over the last two years.

So we are pivoting even our online business from a buy and sell to more of a marketplace model, where we take full control. So that is the strategic significance of the shift we are making.

Ankit Kedia: Sure. If I can ask one last question? This quarter, there is some discontinued operations around INR 1 crore loss. Any brand like Ed Hardy, Aeropostale getting the license go, is it to do with those businesses?

Ankit Arora: So Ankit, just to clarify, we had some old inventory for the discontinued businesses, which we had done over the last 2 years. We have completely cleaned that in this quarter. And it's just a minor loss, which is coming on account of that and there is nothing else apart from that.

Moderator: Thank you. Our next question is from the line of Pritesh Chheda from Lucky Investment Managers. Please go ahead.

Pritesh Chheda: Congratulations for the growth and the balance sheet inventory turns. I'm still unable to understand what is the pre-IndAS margin that we would have at this scale of business vis-à-vis the scale of business that we had pre-Covid. If you could give those two numbers, it would be very helpful to understand your margin movement?

Shailesh Chaturvedi: See, the post-IndAS result that we declared, typically, the pre-IndAS numbers are – there's a gap of -- the difference of around 4%. And you can calculate that yourself. And if I look at the last two years our EBITDA growth, we have done really well. I mean we've doubled in the last financial year itself. And in terms of our ROCE, debt level, EBITDA level, we've been probably at the healthiest we have seen. From pre-COVID to now, we have seen major changes.

We have driven some of those changes ourselves in terms of change of model from outright to a consignment model. And a lot of those things have changed now. And if you look at last two, three years, we've been really focused on increasing our EBITDA. Last year itself, our EBITDA has gone up by 330 basis points. So we are on a healthy trajectory, and we expect that our drivers of margin improvement will continue to go forward.

In that sense, we're ahead of the pre-COVID EBITDA, and you look at our company results overall on our debt level on inventory levels, stock turn level, EBITDA level, we are moving forward.

Pritesh Chheda: So if your pre-IndAS margin of 6%, you reported is 10% minus 4%, 6%, for a scale of business of INR 4,500 crores, we have competing players who have a fairly higher pre-IndAS margin. So what all steps are still needed? Or if you could tell us the bridge, why are the margins still single digit?

Shailesh Chaturvedi: See, our EBITDA for the full year is 11.4%. You can calculate the pre-IndAS number, and we've really moved forward. Yes, there may be some players who have a higher EBITDA margins than us, and we will continue to improve further.

A couple of dynamics, it could be in terms of royalty payments, it could also be a need for us to turn around Arrow's profitability further, to scale up Flying Machine further. So there are a lot of levers and job for us to do. We focus on that, and we are very confident and working hard towards improving our EBITDA further every year.

Pritesh Chheda: What is the drag which comes from Arrow and Flying Machine and the emerging businesses in your EBITDA, if you could give us that it would be very helpful for us to understand what is the EBITDA margin on the residual business?

Shailesh Chaturvedi: So let's see Arrow as a brand. COVID was really tough for the formal brands and that business, a very largely retail-driven business went into losses. And what we have done now is that by making a lot of changes to Arrow, which we have spoken a lot in our past investor calls, we've turned around this brand. And this FY23 end, it is now in low single digits. It used to be loss making earlier, there's a large swing in Arrow. Many of our brands are at a pre-IndAS double-digit EBITDA already. You look at our power brand portfolio EBITDA in quarter 4 itself, you see is at 13.1% post IndAS. So you can calculate where it is.

And Tommy Hilfiger, Calvin Klein, US Polo, footwear, I mean, overall, US Polo is all in double-digit EBITDA already. The brand like Arrow, we have turned around, we are happy about it, but there is a journey ahead to improve it scale further and improve its profitability further.

Pritesh Chheda: Okay. And the emerging brand, what is a drag now from the emerging brand to our EBITDA?

Shailesh Chaturvedi: So if you really see the full year, the emerging brand EBITDA has gone up from 2% earlier to this year is around 5.9%. The emerging brands have improved, and that's largely coming from Calvin Klein. The other brands in that group are Sephora, where the EBITDA margins have remained stable. And discontinued brands like Ed Hardy, IZOD and Aeropostale where we have a INR 5 crores to INR 7 crores royalty hit for next 1 to 2 years, and that's the drag that we have currently.

Pritesh Chheda: So basically, when you report 6% in your PPT in emerging brands, minus 4%, so basically emerging brand is at about 2% pre-IndAS margin. And in power brands, if you say your pre-IndAS double digit, is it right that you are pre-IndAS double-digit margin in US Polo and Tommy and you're losing some money in, let's say, Flying Machine and Arrow. Is that the interpretation?

Shailesh Chaturvedi: I would say the interpretation is that Tommy, Calvin Klein, US Polo or double-digit pre-IndAS. Arrow and Flying Machine are at a stage where there are low profitability. And we believe they're sub-scale, once we improve the scale of these brands, they will also become higher profitable.

Moderator: Thank you. Our next question is from the line of Shreyans Jain from Svan Investments. Please go ahead.

Shreyans J: Yes. Congrats on a great set of numbers. Sir, my first question is last quarter when we had done the call, you had told us about how operating leverage will now start kicking in. But now if you just look at your gross margin and EBITDA margins, you obviously EBITDA margins have improved, but the kind of leverage that we were expecting has not actually come through. So one is on the other expenses bit. And I think last quarter, you had also mentioned that as retail grows, other expenses also tend to grow.

But just wanted some more granularity in the sense that quarter-on-quarter, last four quarters, we see this number from INR 300 crores is now at INR 400-odd crores. And when I look at some other companies like Aditya Birla, their percentage of other expenses to sales is not as high as ours, so just wanted some fundamental understanding of what is driving this increase in other expenses?

Shailesh Chaturvedi: Yes. So let's see, let's start with GP to EBITDA and other expenses, we'll cover in that. So first point is that we are getting a healthy scale leverage already. In the full year, we've seen more than 2%, 200 basis point improvement in EBITDA margin coming from scale leverage in FY23.

Even in the quarter 4, we've seen out of our growth in EBITDA of 1.9%, 190 basis points, 0.5% improvement in EBITDA out of that has come from scale leverage. So scale average is kicking in and it will continue to grow. That's the 1 sort of statement of fact. Now if you look at our GP for quarter 4, our GP has gone up by 7%. Now out of that, 2% is because of a technical model change in Tommy Hilfiger where we went from an outright to consignment. And that happened early April, and this is the last quarter where from year-to-year comparison, you will see that change in other expenses because almost INR 25 crores of that expense has come as higher GP and then it's coming as higher operating expense also.

So 2% out of that 7% is one-off technical. I mean, we changed this in April, and now it will continue and in comparison from last year will not come from the quarter 1. So that's 1 technical reason that 7% actually is a 5% GP growth, which is, in a way, as per target healthy growth. Now if you look at 5% GP increase. Out of that, close to 2% has flown into EBITDA. Now the balance 3%, what has happened is that as the sale is increasing, and we have grown like really at a healthy pace of 45%, then other expenses are also growing because a lot of franchisee commissions, royalty, supply chain costs like warehousing and freight, etc. come below that.

So out of that 3%, 2% is going as variable. A lot of it is basically commission 1%, 0.5% is sellex. So out of the 3%, 2% comes as variable. We have scale leverage coming in from lower manpower cost, which is around 0.5%. And we had, in this quarter, slightly lower other income than in the past. And because of that, there was little bit drop of EBITDA. So out of that 5%, 3% is flowing in, then there are some expenses and then there is a scale average of 0.5%, which actually leads to 1.9% EBITDA increase.

Now coming specifically to other expenses, I will just give you a little more colour on the other expenses of quarter 4 versus quarter 3, but one reason clearly is because of the sales increase, and there's a one-off technical reason of Tommy Hilfiger around INR 25 crores when we moved from outright to consignment model early this year. Girdhar, our CFO, will explain a little more about the other expenses.

Girdhar Chitlangia: So you see quarter-on-quarter, the other expenses have gone up largely because our department store sales have gone up, in which corresponding higher increase in commission expenses. Also in Q4, last year, we were a little subdued on our expenses, and most of our expenses are now back to normal levels. So that has also impacted slightly our expenses.

Shailesh Chaturvedi: Because last January was COVID, so most of the retail everything was shut, right? So the retail sellex also was lower on that basis. But now this year, we have grown on January because of COVID not there, but then our other expense has also grown in proportion to the sales.

Shreyans J: Okay. So sir, just coming back to this. So when we guide for about 12% to 15-odd percent top line growth, so is it a fair understanding that we should build in 10% to 12% growth in your other expenses component as well?

Shailesh Chaturvedi: Yes. So in the channel where the commission comes in. So for example, a lot of our mono brand store is retail and marketplace also has a commission. So in terms – in line with the sales, but a slightly lower percentage of that will come as other expense.

Girdhar Chitlangia: Not all our expenses are variable in nature, but we'll surely get some leverage on this account.

Shreyans J: No. But higher the channel sales than higher the commission and brokerage, right?

Girdhar Chitlangia: Yes. Understand. So that is, of course, variable. But what I'm saying is of all the other expenses, not everything is variable in nature. There are other fixed expenses, which we will surely get leverage on.

Shreyans J: All right. All right. And sir, somewhere in the call, you mentioned that Arrow has now turned profitable. And now just looking at your profit for the full year, so we've done about INR 50-odd crores profit in the Tommy, CK JV. So that in itself would have been INR 100-odd crores because 50% is our share. And when I look at your profit before minority interest for the full year, it's at about INR 87-odd crores. So is there a INR 13 crores loss that is still sitting that you've done in this year? I mean is that from Flying Machine? Is that understanding correct?

Ankit Arora: Ankit here. So what you are seeing is the swing in from negative INR 267 crores to plus INR 36 crores in PAT after minority interest. You are right, as to what Shailesh earlier explained is we have brands like Arrow and Flying Machine which are low on profitability. And of course, the drag on account of our discontinued brands, where there is a fixed cost. So that does have a drag on PAT for FY23. But as to what you can see there is a significant stride, which is what we have made from FY22 to FY23, and we expect this momentum to continue in the years to come, and you will see that in FY24 as well.

Shreyans J: Okay. All right. And just last question on the debt bit, sir. I see in your cash flow, we've increased debt by about INR 130-odd crores. So I just wanted some clarity on that because I think we were on the debt reducing spree, but all of a sudden we've gone ahead and increased debt?

Girdhar Chitlangia: You see largely our endeavour is to reduce debt, and we expect it to have a downward trajectory. FCF for the year will be used to pay down our debt. This is what is going to be our priority.

Shailesh Chaturvedi: See, our debt levels, if you look at in FY23 ending close to INR 600 crores, it's gone up by INR100 crores. For a sale growth is so much higher. And if you look at our working capital days have come down. So this increase in debt is largely linked to the increase of scale and our inventory levels are healthier and we've dropped 10 days in inventory, we are higher by almost

INR 100 crores because the kind of growth, 45% growth we have seen in that the value of inventory has gone up by almost INR 100 crores and our debt levels have also gone up by close to INR 100 crores because of that.

But if you look at the scale of operation that has gone up, our overall -- the inventory days have come down significantly. Our GWC and NWC turns have become better. And we think that we will grow our capex etc., from our internal accruals, and we don't have any organic plan. So our debt levels are to be very similar or maybe a little lower as we go along.

Moderator: Thank you. Our next question is from the line of Jatin Sangwan from Berman Capital. Please go ahead.

Jatin Sangwan: Congrats for the amazing set of results. I noticed that in your balance sheet you're right of use assets have increased substantially from March'22 levels and even from September'22 levels. So what's the reason behind this? And would it have any effect on the depreciation in the interest component that will come in FY'24?

Girdhar Chitlangia: So you see, we have opened 39 stores, and which is basically a leading us to this higher number on the balance sheet, but I don't see any increase in interest outgo on account of this. Of course, I mean, the IndAS accounting will have to happen for these newly leased properties. But apart from that, there is no cash of flow on this.

Shailesh Chaturvedi: See, if you look at Tommy Hilfiger business, it's a very high cash generating business, growing really well and profitability growing even higher. Now as a part of our capital allocation strategy, we see takeover stores because we're sitting on cash in the bank, it's a very good because the IRR you get in the Tommy store is very, very high. So it's very prudent from a capital allocation strategy to use that cash lying in the bank to build stores and get a higher return on that investment into the stores.

Jatin Sangwan: Okay. Got it. And how many stores of Tommy Hilfiger currently on COCO model? And what is your target rate?

Shailesh Chaturvedi: Around close to 35 stores. See, Tommy has more than 100-odd stores, out of which 35 around we have done now to convert COCO stores.

Jatin Sangwan: And what's the target for FY24 and FY25?

Shailesh Chaturvedi: We will wait and watch. We will evaluate it. So I don't have a ready answer to give you, but we will explore opportunity to increase our profitability by every other means.

Jatin Sangwan: Okay, sure. And also, I noticed that employee expenses have increased around 10% Q-o-Q. So is it because the retail – share of retail channel has increased or it was some part of onetime bonus payment? And second question is on what's the steady level of employee spends we should look at?

Girdhar Chitlangia: You see the Q4 expenses have gone up, as you rightly picked up because of the bonus and variable payout in Q4.

Ankit Arora: Jatin, Ankit here. Just to clarify, you should look at employee cost on a year-on-year basis, it has gone up from INR 237 crores to INR 268 crores. It will increase in line with inflation. So you should probably build around 10% of increase in employee costs for FY24.

Moderator: Thank you. Our next question is from the line of Ankit Kedia from PhillipCapital. Please go ahead.

Ankit Kedia: Sir, what is the overall store opening guidance across brands for the next two years? Because if I also look at the city count in US Polo, you have present been around 175-odd cities; Tommy for the last five years, we're present in sub-40 cities; CK is sub-32 cities; Arrow, the store count is on a reduction, city count is also on a reduction; Flying Machine also now you're planning to relaunch the brand; Sephora, there has been no store addition. How should we look at this over the next two years now and which model each of these brands on the store front?

Shailesh Chaturvedi: So store expansion is a key growth driver for our brands. All our brands are we see huge opportunity and untapped potential to expand in the big city and the suburb of big city as well in the smaller tier towns. Now our guidance is to open close to 200 stores, that's our guidance for FY24 as well that we opened close to 175 stores in last year. And we will continue to focus on that because our traction in our store is good.

Our share of revenue coming from our EBO channel is going up. It's doing good business for us. So we see opportunity to grow in these brands. And as we stand today, the numbers that city you -- you're giving our numbers are really gone higher. And just to clarify that US Polo has now crossed 200 towns. Tommy is available in now 70 towns. So the city count also has gone up. So the numbers from the last time, the data you've seen our numbers have gone higher, and we continue to grow sensibly our store count.

Ankit Kedia: And sir, what is the capex guidance? Because if I look at the math, debt has gone up. And if you suggested that from a free cash flow, we plan to pare our debt. So if the capex of 200 stores, assuming 60%, 70% would be on FOFO model and not 20%, 25% could be on COCO model, still there will be substantial capex in the business. So how much debt over the next two years can be pay down with 200 store expansion every year?

Girdhar Chitlangia: We are we are expecting our capex for next year to be around INR100 crores, a large part going towards refurbishing some of the stores. And also, we are spending some money on upgrading our IT systems. But all this, we are expecting to do with our internal accruals. And I don't expect any further debt to be taken on account of this.

Ankit Kedia: Yes. Sir, but debt reduction is also important. So do you see debt reduction happening if not debt increasing?

Girdhar Chitlangia: So we earlier answered that question, and we said any further FCF will actually go towards reduction of debt. Shailesh just mentioned that largely, we are hoping that our debt will remain very, very consistent. And if at all, it will actually go down.

Ankit Kedia: So over the next two years, we are looking to maintain these debt levels or marginally reduced if you generate free cash flow?

Shailesh Chaturvedi: We are quite confident of cash generation from our business and our capex are for specific need. So there's no major because our expansion is asset-light through partners. So in stable market condition, we're very confident of our debt level going down in the next two years because we are very confident of generating further cash from our operations.

Ankit Kedia: Sure. And one last question. What is the pre-IndAS rental we would have paid this year?

Ankit Arora: Ankit, that number would be somewhere in the range of about INR180 crores to INR200 crores.

Ankit Kedia: Which is lower than last year's absolute rental number?

Ankit Arora: I will have to check that. It would have gone up in my assessment, probably on account of because FY22 was impacted by COVID. And of course, we have opened a lot more stores and the retail expenses coming back, my assessment is the rental would have gone up from FY22 to FY23.

Ankit Kedia: Sure, I'll take this offline. So ex the other income or onetime rental benefit, I believe the rentals would have come down, but I can take it offline.

Ankit Arora: Sure, we will do that.

Moderator: Thank you. Our next question is from the line of Dhviti from Molecule Ventures. Please go ahead.

Dhviti: Congratulations on a good set of numbers. So my first question is regarding USPA. In the PPT, we have mentioned about doing INR 2,000 crores of NSV. So what has it been in FY23? And what will be the delta in the brand going forward?

Shailesh Chaturvedi: USPA has done really well in terms of growth. Delta this year in FY23 over previous year is close to INR 600 crores. So it's almost like size of a big brand that we added in 1 year. It's still not reached INR 2,000 crores, let me clarify that, but it's in a journey, it should hit INR 2,000 crores top line very soon. And it is a leading player in the men casual segment in the country, and we'll continue to dominate that segment.

Dhviti: Okay. And sir, the adjacent categories, if you could give annual revenue breakup for each of your kidswear, footwear, innerwear?

Shailesh Chaturvedi: See, we will be in the brands where we have big adjacent category like US Polo, Tommy Hilfiger, the number, we will hit close to double-digit revenue share very soon. The growth rates in these brands in this segment is very high. Footwear is growing at 40% to 50%. Kidswear has been growing at around 25%. And we continue to pilot some new categories in the background, doing some small piloting all the time. So these categories will continue to grow at a very rapid pace.

Dhviti: Okay. Also, sir, USPA, can we assume that it has done around INR 1,800-odd crores in FY23?

Shailesh Chaturvedi: Very close to that. I mean give and take some crores here or there, but you are very close to that number.

Dhviti: Okay. So next question is regarding Arrow. So last few quarters, we have been talking about the brand turning EBITDA positive. So what will be the EBITDA margin for FY23? And how do you look those going forward?

Shailesh Chaturvedi: See, like I said, COVID was harsh to this category. This year, we did a large swing in EBITDA, very, very large and it's turned EBITDA positive. But still, the EBITDA margin in Arrow in FY23 is low single digits. And the idea is to take it to mid-single digit very, very quickly because once our model is working and the consumers are buying that model with newer categories like super premium '1851' or new smart casual line called 'Arrow Sport'. So a lot of things are trending really well. The like-for-like growth and sell-through in Arrow are very, very healthy.

We've also done updation of retail and we are opening more and more stores so with that identity and the energy that Arrow has, we are gunning for fairly high growth and with that scale, we are also gaining leverage along with the efficiency. So the next milestone is to hit mid-single-digit EBITDA in Arrow in near future.

Dhviti Shah: Okay. Sir, if you could give the OPM for current quarter in Arrow.

Shailesh Chaturvedi: We don't give brand-specific details.

Moderator: Thank you Due to time constraints, our last question is from the line of Gautam Rathi from CWC. Please go ahead.

Nishit: This is Nishit Am I audible?

Shailesh Chaturvedi: Hi, Nishit, you're audible.

Nishit: Great set of numbers, guys. Just a question. I just wanted to clarify, I could not understand the debt comment actually made by the CFO. Actually, because in my understanding, you guys have done a very decent OCF this year despite INR 130-odd crores that was used in working capital, right? And you're guiding for EBITDA margin expansion going forward on the overall revenues, which will basically give you even further ammunition.

And your working capital may not increase at the same level because you may not add the same amount of absolute revenue that you are talking about. So am I missing something? It doesn't tie up, right? I can't see any reason why we shouldn't be reducing debt substantially every year, right?

And even this year, right, we accrued cash, right, our net debt is flat. Our gross debt has increased for some reason, but our net debt is flat, right? So going forward, shouldn't we be accruing at least INR 100 crores of FCF, if not more?

Kulin Lalbhai: This is Kulin here. You are very right that with the increase in profitability and now last year was a onetime where we saw almost a 50% revenue growth because of a COVID base, but now with a normalised natural growth rate and a much improved profitability and a small capex amount, the business will be generating free cash flow. So let me be very clear in stating that. But the environment is a little uncertain. So we are kind of being a little cautious in our guidance, but definitely, debt will be going down, it has a downward bias. And every year, we believe the amount of FCF the company will be generating will be going up significantly.

Nishit: Yes, Kulin, I fully understand. So basically, what you're saying is, if your other guidance is held, which is improved profitability and steady growth rate then you will generate this. Now the only scenario in which you don't generate FCF is, let's say, the environment deteriorates sharply. Even there, the growth will slow down, the working capital will get controlled and you will control the capex and/or the growth goes through the roof wherein you again consume some working capital, but again, you will generate much better profitability, right? So most of the scenarios going forward from here, your guidance for better ROCE which we will be getting much better OCF/FCF -- better CF conversion, right?

Kulin Lalbhai: No, you are right. I mean there is no scenario where we see debt going up. And in terms of its downward bias, it will -- as you explained or as you mentioned, it will be a function of how the scenarios play out, in a scenario where the markets are good, which we do believe that the market are going to pick up in the next few quarters. We do believe that the free cash flow generation in the company should be healthy and thereby, debt should go down.

Nishit: And Kulin, in your assessment, and I'm not holding you for it, but you guys are taking to become a debt-free company sometime, right? Where would you be -- you say that is it two years, three years, where will you be disappointed not getting to that number?

Kulin Lalbhai: No, I think that is the stated objective that we are going to generate very healthy cash flows. And as per a 3-year kind of vision, definitely, we can be very close to being net debt 0.

Nishit: That is very, very positive. I think you guys have done a really good job from where we were to generating very healthy OCF. Just another – this is something that keeps coming up, and I really want to appreciate the fact that now you're looking at your PAT excluding the minority interest, right?

It's very stark, right, because somehow it appears that Tommy, CK is already a INR 100 crores PAT business, right? Is it fair to assume that US Polo will be in a similar kind of range if not better?

Kulin Lalbhai: Yes. US Polo, as Shailesh also mentioned is double-digit pre-IndAS profitability. So it's in a very healthy profitability and also an extremely healthy return on capital employed.

Nishit: Yes. It is very, very, very heartening to hear again because then basically because whenever we look at the stand-alone numbers, excluding the subsidiary numbers, the profitability somehow doesn't show up but that you're saying there are two components. One is partially the drag of some of the brands which are discontinued and partially as some of your brands like Arrow scale up then the true profitability of US Polo at some point of time starts showing up, right?

Kulin Lalbhai: Yes, definitely. I mean, we're already seeing it. I mean 190 bps increase in Q4 and every quarter, you should expect to see the operating leverage continue.

Nishit: No. I think this year, with the balance sheet and the cash flow and managing all of that, the discipline to manage the growth was great. Looking forward to next year, I hope the only thing now left to see is healthy, healthy FCF generation.

Kulin Lalbhai: Thank you.

Moderator: Thank you. That was the last question of a question-and-answer session. I would now like to hand the conference over to the management for closing comments.

Ankit Arora: Thanks, 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. Thanks for your time and look forward to again interacting with you in the next quarter.

Moderator: Thank you. On behalf of Arvind Fashions Limited, that concludes this conference. Thank you for joining us, and you may now disconnect your lines.