Hindustan Lever (HLL.BO)

Buy: An Unjustified De-rating on an Improving Trajectory

- Recent de-rating unjustified — HLL's current valuations seem to be building in the worst-case scenario, and we see the recent stock de-rating as unjustified. The stock has been unduly de-rated post a disappointing 4Q, which we believe was a one-off. Fundamentals are on an improving trajectory, and its operating parameters are looking up.

- Fundamentals are improving — Sales growth has picked up and margins have been improving despite cost pressures. HLL has also started to gain ground on market share in its key segments of late. HLL is investing behind new products in the high-margin cosmetics segment, benefits of which will accrue. It is also likely to aggressively expand its foods business in 2007.

- Positive surprises likely — HLL's margins could surprise positively; HLL had increased its ad-spend in 20006, which could be curtailed in 2007. HLL still makes no money on its detergents portfolio (20% of sales). Easing of competitive pressures here could see an uptick in margins. We do not rule out an acquisition in the foods segment to kick-start HLL's stated expansion in foods.

- Valuations at near historical lows — Current valuations are near historical lows and are disconnected to fundamentals. The stock is trading at 17.9x08E P/E, offers 2-year EPS CAGR of 20.5% and its capital efficiency ratios are among the best in the sector (78% ROE), and improving. In addition, the stock offers a dividend yield of 4%, which should support the stock price

Buy/Low Risk	**1L**
Price (09 Mar 07)	Rs181.95
Target price	Rs253.00
Expected share price return	39.0%
Expected dividend yield	4.0%
Expected total return	**43.1%**
Market Cap	Rs401,525M
	US$9,084M

Price Performance (RIC: HLL.BO, BB: HLVR IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	14,082	6.40	17.6	28.4	17.4	64.0	3.0
2006A	18,554	8.43	31.8	21.6	16.3	78.0	3.7
2007E	18,837	8.56	1.5	21.3	15.8	75.6	4.0
2008E	22,375	10.16	18.8	17.9	15.3	86.9	4.7
2009E	25,856	11.75	15.6	15.5	14.7	96.7	5.5

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	28.4	21.6	21.3	17.9	15.5
EV/EBITDA adjusted (x)	26.4	22.8	18.8	15.5	13.2
P/BV (x)	17.4	16.3	15.8	15.3	14.7
Dividend yield (%)	3.0	3.7	4.0	4.7	5.5
Per Share Data (Rs)					
EPS adjusted	6.40	8.43	8.56	10.16	11.75
EPS reported	6.40	8.43	8.56	10.16	11.75
BVPS	10.47	11.15	11.50	11.91	12.39
DPS	5.39	6.74	7.27	8.64	9.98
Profit & Loss (RsM)					
Net sales	110,605	121,034	135,406	150,816	166,166
Operating expenses	-97,416	-105,855	-116,965	-128,409	-139,869
EBIT	**13,189**	**15,179**	**18,441**	**22,407**	**26,297**
Net interest expense	-192	-107	-54	-54	-54
Non-operating/exceptionals	3,048	3,545	3,722	3,909	4,104
Pre-tax profit	**16,046**	**18,617**	**22,109**	**26,262**	**30,347**
Tax	-2,500	-3,220	-3,272	-3,887	-4,491
Extraord./Min.Int./Pref.div.	536	3,157	0	0	0
Reported net income	**14,082**	**18,554**	**18,837**	**22,375**	**25,856**
Adjusted earnings	14,082	18,554	18,837	22,375	25,856
Adjusted EBITDA	14,434	16,481	19,811	23,845	27,803
Growth Rates (%)					
Sales	11.4	9.4	11.9	11.4	10.2
EBIT adjusted	0.2	15.1	21.5	21.5	17.4
EBITDA adjusted	0.4	14.2	20.2	20.4	16.6
EPS adjusted	17.6	31.8	1.5	18.8	15.6
Cash Flow (RsM)					
Operating cash flow	**24,786**	**17,756**	**21,418**	**26,328**	**29,921**
Depreciation/amortization	1,245	1,302	1,370	1,438	1,506
Net working capital	9,460	-2,099	1,211	2,515	2,559
Investing cash flow	**1,509**	**-714**	**-3,349**	**-4,865**	**-5,119**
Capital expenditure	-645	-1,000	-1,000	-1,000	-1,000
Acquisitions/disposals	2,154	286	-2,349	-3,865	-4,119
Financing cash flow	**-27,530**	**-16,720**	**-18,069**	**-21,462**	**-24,801**
Borrowings	-14,142	31	0	0	0
Dividends paid	-13,388	-16,750	-18,069	-21,462	-24,801
Change in cash	**-1,235**	**323**	**0**	**0**	**0**
Balance Sheet (RsM)					
Total assets	**64,809**	**70,265**	**75,527**	**82,237**	**89,147**
Cash & cash equivalent	3,550	6,000	6,000	6,001	6,001
Accounts receivable	10,623	13,027	14,498	16,079	17,673
Net fixed assets	14,835	14,534	14,164	13,726	13,221
Total liabilities	**41,752**	**45,728**	**50,222**	**56,020**	**61,876**
Accounts payable	29,594	31,383	34,734	38,332	41,956
Total Debt	569	600	600	600	600
Shareholders' funds	**23,056**	**24,537**	**25,305**	**26,217**	**27,271**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	13.0	13.6	14.6	15.8	16.7
ROE adjusted	64.0	78.0	75.6	86.9	96.7
ROIC adjusted	nm	na	na	na	na
Net debt to equity	-12.9	-22.0	-21.3	-20.6	-19.8
Total debt to capital	2.4	2.4	2.3	2.2	2.2

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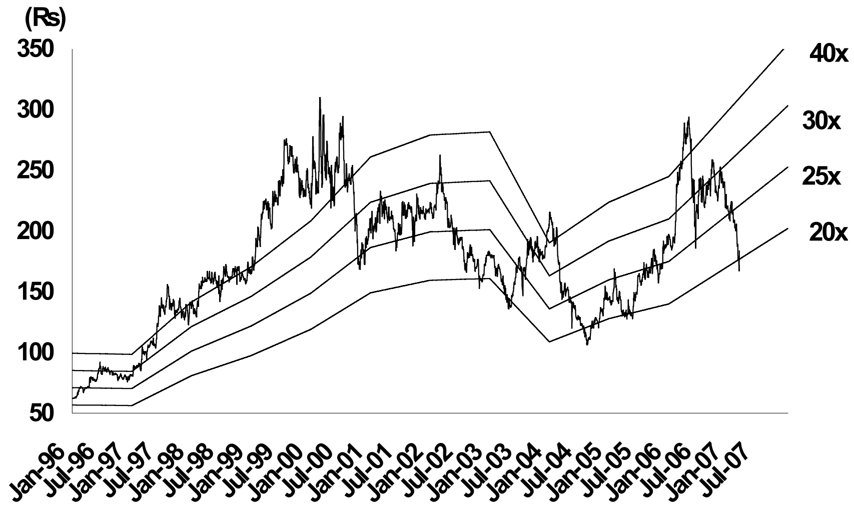
Stock de-rating unjustified; Buy into recent weakness

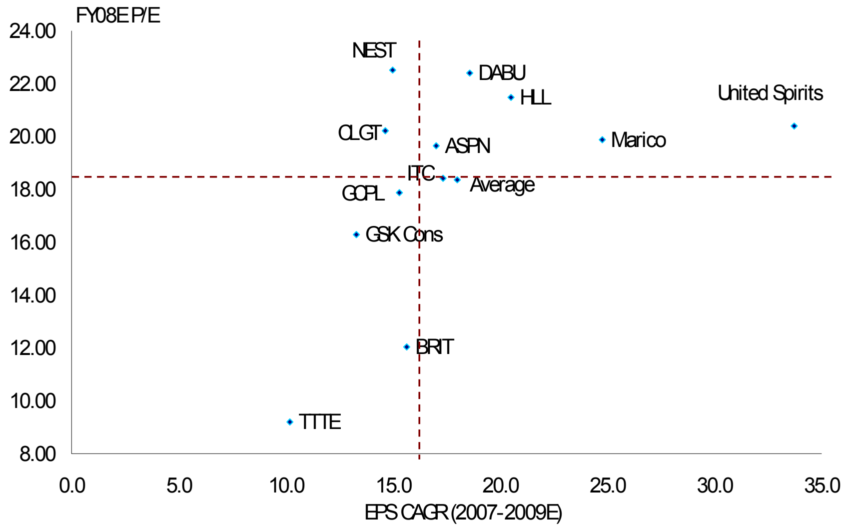
We believe that HLL's recent de-rating is unjustified. The stock is currently trading near its historical low valuations on a forward P/E basis. Only once in the last 10 years has HLL stock traded below 20x forward P/E. The last time HLL stock breached its base valuation of 20xP/E was in 2004, following the pricing war with P&G on detergents, which resulted in sharp margin erosion. However fundamentals have improved since then, and we do not see the recent de-rating as justified. The stock has corrected sharply recently following disappointing 4Q results, which we believe was a one-off. We believe that the street has taken an overly pessimistic view and expect growth to pick up. HLL stock trades at 17.9x08E P/E, against our estimated EPS growth CAGR of 20.5%. We believe that there are ample chances of positive earnings surprises and the risk-reward seems favorable at current valuations. The stock also offers a 4% dividend yield, which should provide downside protection to the stock. We maintain our Buy/Low Risk rating and price target of Rs253.

Figure 1. HLL P/E Bands Chart



Source: Citigroup Investment Research

Figure 2. Indian Consumer Universe – FY08E P/E v/s FY07E-FY08E EPS CAGR



Source: Citigroup Investment Research

Fundamentals are improving

Fundamentals for HLL have started to look up. The company struggled with sales growth during 2001-2004, on account of a sluggish consumer non-durables sector and weak agriculture sector demand. In addition, new products like mobile telephones, automobiles and real estate (propelled by sharp decline in interest rate on mortgages) significantly increased share of the consumer wallet, at the expense of consumer non-durables. In addition, HLL's sales growth was also tempered on account of its power brand strategy, resulting in HLL curtailing it brand portfolio. HLL also lost market share during this period in some of its key segments, as competitive activity picked up. However, the worst is behind HLL now. Its sales growth is picking up and more important, the quality of sales is improving, with high-margin businesses growing faster. Over the last two years, HLL's sales and profit growth have picked up strongly, following an aggressive price-led market share battle with P&G in 2004. HLL's operating parameters now fare much better than 5 years back.

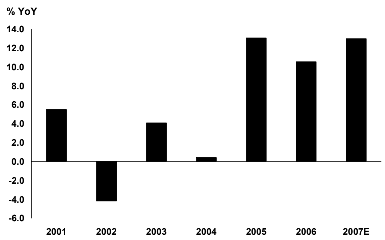
Figure 3. HLL – Key Operating Parameters

	6 year CAGR	3 year CAGR	2 Year CAGR	1 year Growth
Overall Sales	2.2	6.1	10.4	9.4
FMCG Business Sales	4.7	7.9	11.8	10.6
EBITDA	2.0	-5.9	7.1	14.2
Net Profits	2.7	-5.2	13.3	22.3

Source: Citigroup Investment Research

Sales

Figure 4. HLL – FMCG Sales Growth Trend (% YoY)



Source: Citigroup Investment Research

FMCG sales growth has picked up to double digits over the last two years, and we expect the trend to continue. HLL has been aggressive behind its brand building and has rolled out many new product variants across segments to continue to create excitement behind its brands. In 2006, HLL rolled out variants across segments, including soaps (new variants for Lux, a reformulated Lifebuoy), skin care (new variants in Fair & Lovely like Menz Active) as well as rolled out its high-end cosmetics portfolio under the Ponds brand. We believe that the rollout of the cosmetics portfolio at the top-end addresses a segment in which HLL had little presence earlier. The top end of the income pyramid, though small in size in terms of volumes, is growing rapidly and could be highly profitable.

As the next leg of growth, HLL is looking toward expanding its foods portfolio. Management has indicated that HLL would be looking at aggressively expanding its foods portfolio in 2007, not ruling out the possibility of acquisitions. HLL is likely to focus on high value added segments of foods and is unlikely to expand on the lower margins (staples) side of the packaged foods business.

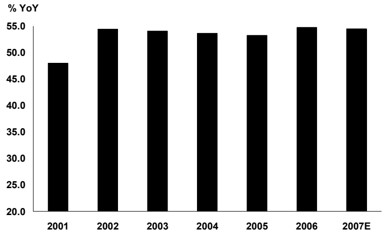
While globally, food & beverages contribute over 50% to HLL's sales, in India their contribution to sales is less than 20%. One of the impediments of growing the foods business in India has been lack of a cold chain infrastructure, as well as sourcing bottlenecks. We believe that expansion of modern retail is set to change that, and modern retail will play a significant role in growing the branded foods market in India. We believe that there are three options that HLL has to aggressively grow its foods portfolio:

1. Tap international foods brands, which have relevance to India
2. Expand the product offerings under the current brands
3. Acquire foods companies, brands in India

We believe that HLL is likely to follow a combination of all the three options. Within the existing brands in India, we expect HLL to expand to more food categories that could be tailored to Indian tastes. Among the international brands not already in India, we see limited choices, but nevertheless some of the brands/products could be introduced in the Indian market.

Margins

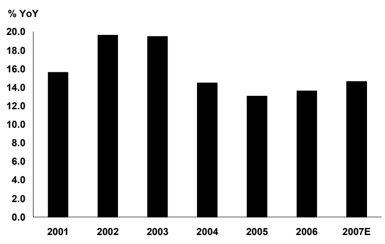
Figure 5. HLL Gross Margin Trend (%)



Source: Citigroup Investment Research

One of the key concerns on HLL has been the margin pressure on account of rising raw material costs (palm oil etc.). Despite the recent cost pressures, HLL's gross margins have only expanded, driven by selective price hikes and improving product mix. HLL management has not ruled out further price hikes if cost pressures persist. Consumer companies across the board have been affecting price hikes over the last few quarters to mitigate cost pressures. Even in the pricing war between P&G and HLL, HLL's gross margins did not decline significantly, given that its product mix had undergone a structural change post the implementation of the power brand strategy. We expect EBITDA margins to continue to expand, driven by improvement in the product mix. We are building in about 100bps margin expansion in 2007 into our estimates though we believe there could be further positive surprises on account of:

Figure 6. HLL – EBITDA Margin Trend (%)



Source: Citigroup Investment Research

1. Potential Detergent price hikes: HLL, by its own admission, makes no margins on its detergents portfolio, which is almost 20% of its overall sales. In the event of P&G increasing prices, HLL could see significant improvement in its margin profile. We estimate that historical operating margins for HLL's detergents portfolio were about 20%-25%. Even if HLL were to see margins recover to 10%, it would add almost 200bps to the overall margins for the company

2. Scale-back in ad expenses: HLL increases its advertising budgets significantly in 2006. Part of this was to invest behind its nascent Ponds cosmetics portfolio, which would pay back only going forward, as it scaled up. In addition, HLL had significant numbers of product re-launches and brand extensions, which stretched the ad budget. Ad expenses averaged 10.5% of sales in 2006, up 150bps over last year. We believe that chances of a scale-back in 2007 are fairly high.

Market Share

Over the years, HLL has lost market share to competition in most of the key segments it operates in. However, over the last 3 quarters, its market share in most key segments has started to improve. Given that HLL is a No. 1 or strong No. 2 player in most of its segments, improving market share is a difficult task. In its high-margin skin care segment, HLL has continued to gain market share since 2001.

Figure 7. HLL Recent Market Share Trend (%)

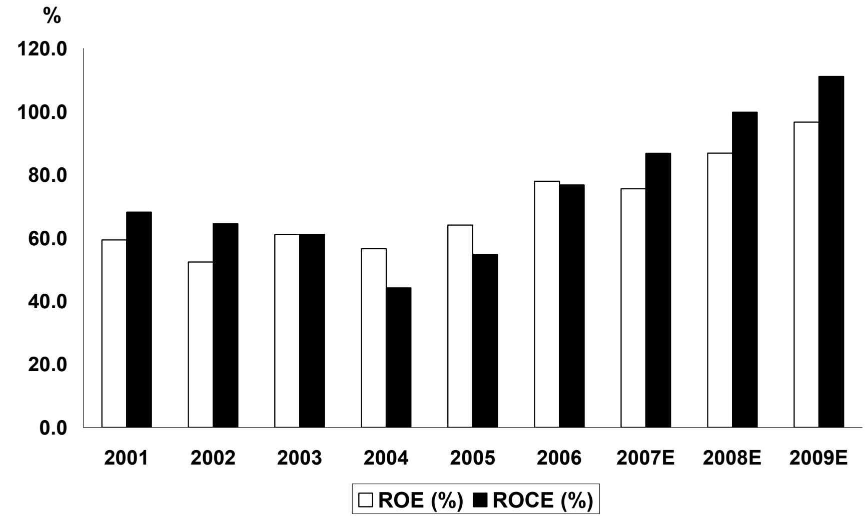
	Jan-06	Feb-06	Mar-06	Apr-06	May-06	Jun-06	Jul-06	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06
Soaps	55.5	55.9	56.2	55.4	54.8	53.6	53.6	54.4	54.4	55.4	55.2	55.4
Fabric wash	35.7	35.0	35.5	35.9	36.3	36.4	36.2	35.9	35.7	36.1	36.0	36.3
Shampoos	47.2	47.8	47.9	47.7	47.9	48.3	48.4	49.3	49.2	49.1	48.9	47.5
Toothpaste	31.1	30.4	29.7	30.0	30.1	30.5	30.7	30.8	30.5	30.9	30.5	30.0
Toothbrush	15.4	15.8	16.5	16.3	16.2	15.8	16.0	16.5	16.3	15.4	16.3	16.1
Skin Care	53.1	52.9	53.1	53.7	54.6	54.5	54.7	56.5	57.1	56.7	55.9	54.4
Tea	25.0	25.9	26.0	25.6	25.1	25.8	25.8	26.5	25.1	25.3	25.0	24.3
Coffee	43.4	43.6	44.7	47.0	47.9	49.4	49.0	49.4	48.2	46.6	44.5	43.1
Ketchup	24.5	24.8	24.1	23.1	24.2	26.4	26.4	27.6	28.0	27.1	26.6	28.1

Source: AC Nielson; Company Presentations

Capital Efficiency

HLL continues to have the highest capital efficiency ratios in our Indian consumer universe. We expect its capital efficiency ratios to continue to improve.

Figure 8. HLL – ROE and ROCE Trend (%)



Source: Citigroup Investment Research

Hindustan Lever

Company description

HLL is the largest consumer non-durables company in Asia. 51%-owned by the Unilever Group, HLL has one of the best-managed businesses in India, in our view, and a record of steady growth spanning decades. It has a diversified product portfolio, including fabric wash, personal care, tea, coffee and staple foods. Some of the strongest brands in India such as Lifebuoy, Lux, Surf, Wheel, Lakme, Ponds and Lipton are from the HLL stable.

Investment thesis

We have a Buy/Low Risk (1L) rating on the stock. HLL's valuations look attractive after the recent sell-off. The stock is trading at the lower end of its historical trading range and offers downside protection. HLL's fundamentals are looking up, with a significant pick-up in growth on improving demand from the urban as well as rural segments, especially in the rural areas. Management has increased its focus on market-share gains and as a result investment in brands has picked up. The company has been aggressively launching new product variants and has also undertaken product re-launches, which we believe will continue. With the high-end personal-care segment growing faster, the product mix is also improving. We believe margins could also surprise on the upside, driven by price hikes and declines in commodity prices. Margins have been under pressure in the past few quarters, and we believe they have bottomed.

Valuation

HLL's fairly steady stream of earnings makes P/E a good tool to value the stock. Our target price of Rs253 is based on what we think is a conservative multiple of 27x Jun08E P/E, at the lower end of the stock's historical trading band. We use a P/E of 27x, as we believe that a re-rating for HLL is warranted on the back of strong sales momentum. At 27x P/E, HLL would trade at a 40% premium to the

Sensex. The company has historically enjoyed more than a 100% premium to the Sensex owing to its high capital-efficiency ratios and consistent earnings growth. However, we do not expect the stock to re-trace to its historical high premium, given that the company now operates in a different competitive landscape, with higher competitive intensity and a lower margin profile. On EV/EBITDA, we believe the stock should trade at 24x Jun08E EV/EBITDA, which gives a fair value of close to Rs248. The stock's trading band has been 20-30x over the past three years.

Risk

We rate HLL as Low Risk because the company operates in branded consumer products and has a diversified product portfolio. The most significant risk to our target price is the possibility of a prolonged battle for market share with other MNC peers as well as Indian companies. HLL is leveraged equally to the rural and the urban economies and, as such, any dislocation would affect the company's performance. Although the company's brands have strong pricing power, in a challenging external environment price increases are limited. PG is aggressively seeking to increase its market share in detergents, shampoos and some other categories. Other downside risks include higher-than-expected raw-material costs and the company's inability to deliver on top-line growth.

Appendix A-1

Analyst Certification

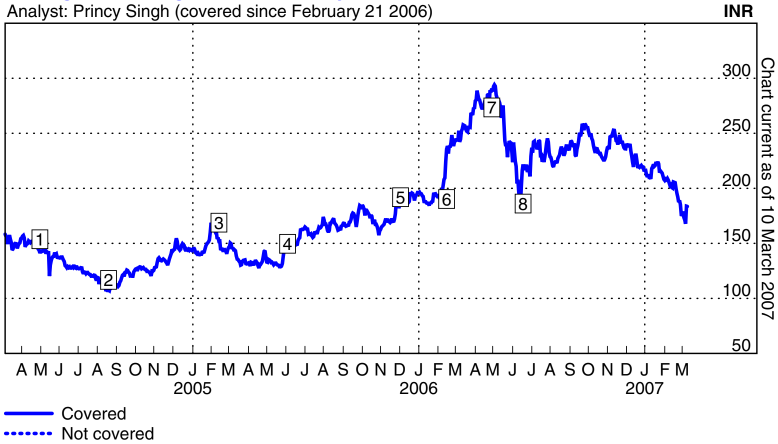
I, Princy Singh, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Hindustan Lever Ltd. (HLL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since February 21 2006)



#	Date	Rating	Target Price	Closing Price
1:	30 Apr 04	3L	*120.00	141.20
2:	19 Aug 04	3L	*104.00	107.70
3:	14 Feb 05	3L	*106.00	151.90
4:	3 Jun 05	3L	*104.00	146.75
5:	2 Dec 05	3L	*129.00	184.50
6:	15 Feb 06	3L	*150.00	235.70
7:	28 Apr 06	3L	*200.00	290.65
8:	19 Jun 06	*1L	*253.00	221.75

*Indicates change.

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Data current as of 31 December 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3106)	43%	41%	15%
% of companies in each rating category that are investment banking clients	45%	41%	34%
India -- Asia Pacific (118)	58%	14%	28%
% of companies in each rating category that are investment banking clients	48%	50%	39%

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