Prabhudas Lilladher

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Consumer

Poised for long term growth

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(Prices as on 3rd April 2006)

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Executive Summary

- Strong GDP growth and rising income levels have been boosting demand in India. Robust growth in organized retailing, too, is providing a fillip to urban markets while favorable agricultural growth and lower per capita consumption is improving rural demand for consumer goods, leading to accelerated growth in overall consumer demand.

- Dependence of agriculture on the monsoons still remains a concern while higher crude oil prices pose a threat to input costs. Nevertheless, higher input prices are expected to be offset by price hikes as, with revived demand, pricing power is expected to have returned to the sector.

- Those with strong cash flows are strengthening their position by making acquisitions to complement their present product range and also making a foray into less penetrated categories.

- In view of the expected continuing economic growth, the Sector should grow by 9% a year.

- **Top picks**- ITC, HLL, Nestle and Dabur

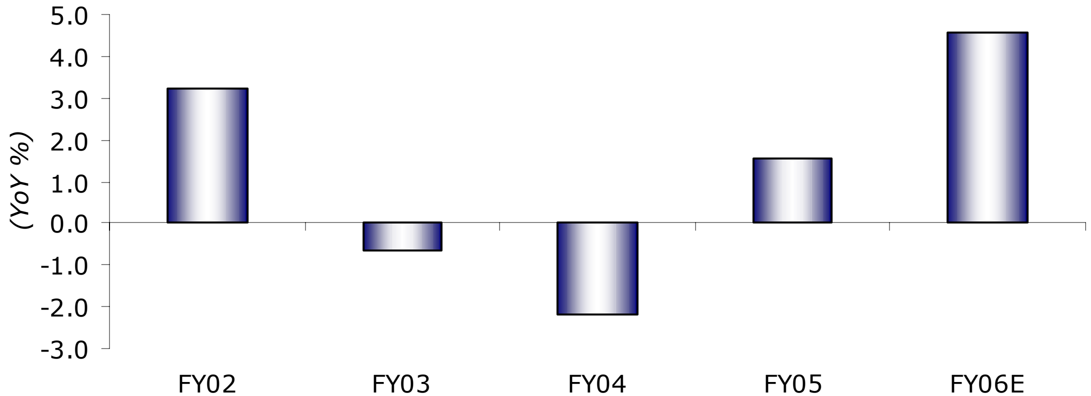
FMCG Growth Trend

- After two years of decline, in FY2005 the Sector has seen demand growing. Growth had been led primarily by volumes.

- Reversal in low demand continued during FY2006, with value growth following volume growth.

- During FY2003 and FY2004, FMCG demand had slid, leading to “downtrading” in consumer goods and a strengthening of regional players.

Chart 1: 5-year FMCG Value Growth (HLL Categories)

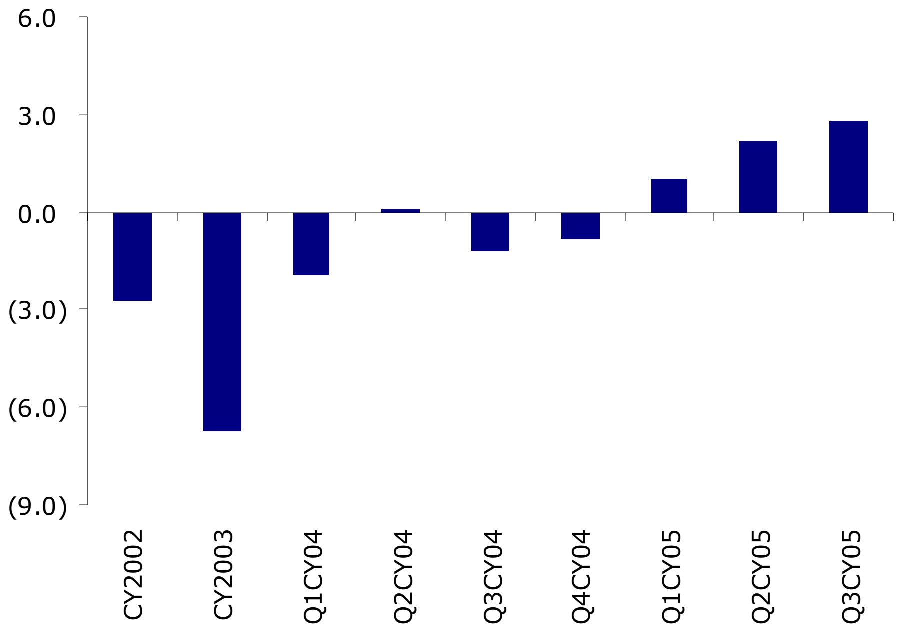


Source: Company

Urban and Rural Demand Trends

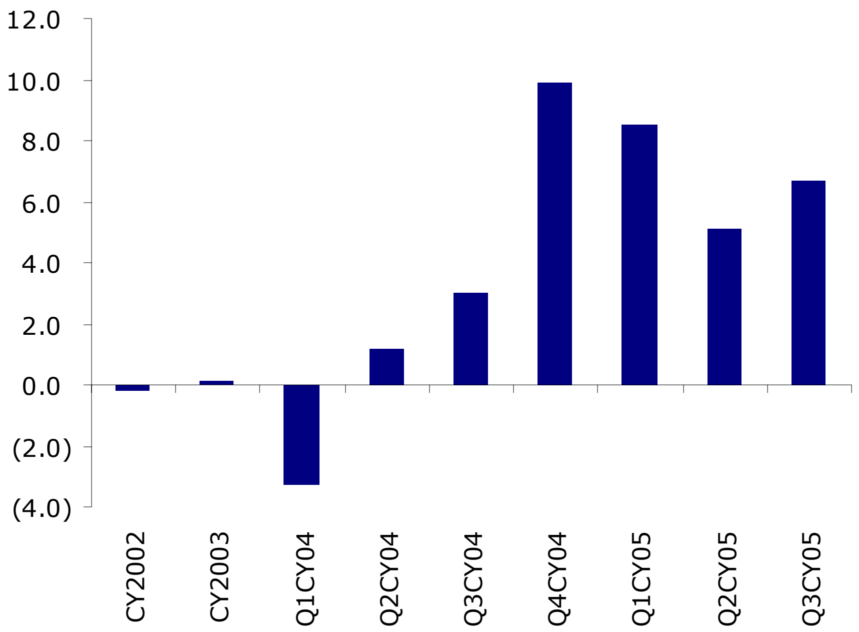
- Growth during CY2004 (FY2005) mainly led by urban markets.
- During CY2005 (FY2006), after two years of decline rural markets initially saw revived demand

Chart 2: Rural FMCG Market Value Growth % (HLL Categories)



Source: Company

Chart 3: Urban FMCG Market Value Growth % (HLL Categories)



Source: Company

Growth across Categories

- During FY2006, major FMCG categories, like soaps and detergents, which had seen low or negative growth in the two years earlier, saw accelerated growth.
- Greater use led by rising income levels and product innovations have driven sales in these already highly penetrated categories.
- Penetration and greater usage have driven sales in less-penetrated categories such as Shampoo, Skin cream and Household cleaners.

Table 1: Category value growth trends (5 years)

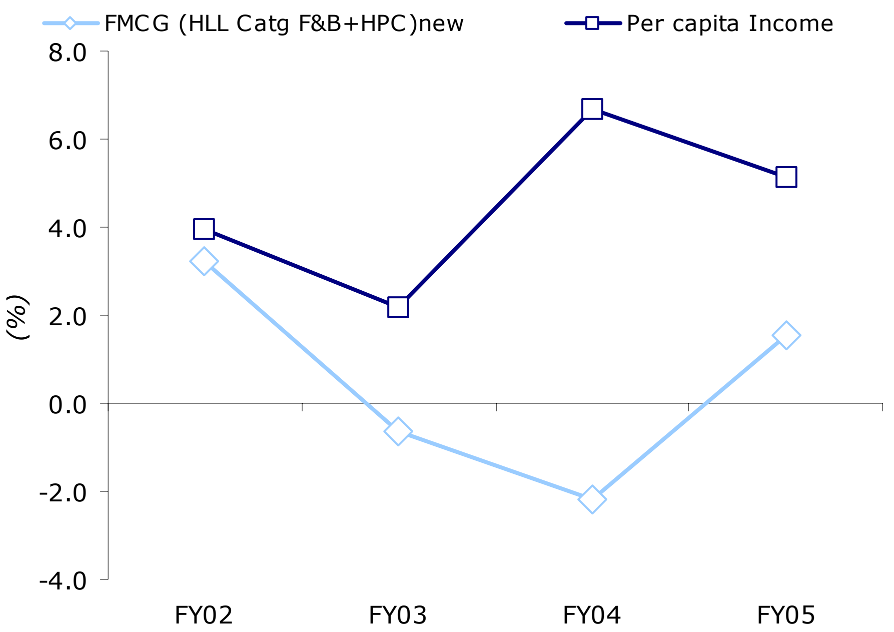
Category YoY (%)	2001	2002	2003	2004	2005
Toilet Soap	(4.6)	(1.8)	2.6	1.1	3.6
Detergent Powder	7.3	2.2	0.08	1.9	9.8
Detergent Bars	(1.6)	2.1	(4.1)	(2.3)	0.4
Household Cleaners	3.3	31.3	16.8	25.0	24.4
Shampoo	17.0	9.1	(3.0)	8.5	17.4
Tooth Paste	7.2	(6.3)	(9.6)	(0.7)	3.6
Skin Cream	7.3	5.1	2.6	2.7	7.5
Hair Oil	3.0	3.4	2.5	4.5	10.7
Packaged Tea	2.1	(8.4)	(10.2)	0.0	(3.2)
Instant Coffee	16.0	8.1	0.1	8.3	15.1

Source: Industry, PL Research

Factors Influencing Demand

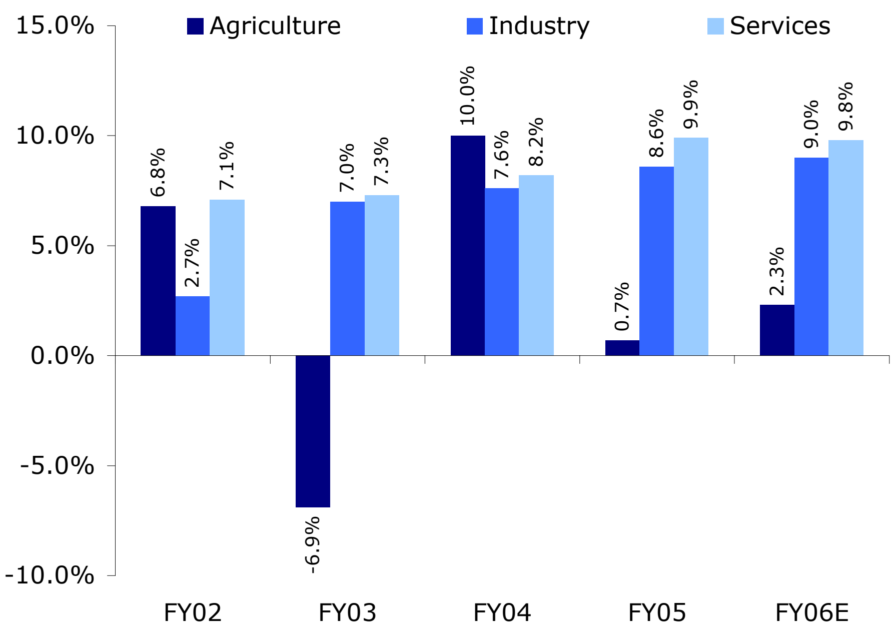
- During FY2003, growth slowed down due to lower growth in per capita income following a decline in agricultural growth.
- During FY2004, growth slipped further despite a rise in incomes mainly due to greater investments in other avenues (consumer durables, vehicles, housing) in view of lower interest rates and a shift in consumer aspirations.

Chart 4: FMCG & Per Capita Income trend



Source: Company & CrisInfac

Chart 5: GDP growth rates



Source: CrisInfac

Contd…

- During FY2005, revival in the sector was led by continuing growth in per capita income, which shifted back to higher consumption of consumer non-durables.

- Growth in FY2005 was primarily driven by urban demand, as agricultural growth was lower.

- Urban growth in turn was led by growth in organized retailing and consistent growth in incomes arising from growth in services and industrial production.

- During FY2006, growth continued as rural demand also started participating in the overall sector growth on the back of favorable agricultural growth.

Better Demand spurs positive price trend

- In the last two years, prices were reduced in order to cope with competition and to spur demand.
- Price reductions dented Hindustan Lever's margins by 450-500 basis points.
- During FY06, rising demand has enabled companies to raise product prices.
- During February and November 2005, prices of detergents were raised by an average 8%.
- Price hikes mainly resulted from rising input costs.

Table 2: Price Trend

Category	Range of price changes	Trend	Period
Toothpaste	15-17%	Reduction	2003
Detergent Powder	25%	Reduction	2004
Shampoo	20%	Reduction	2004
Detergent Powder	4-6%	Increase	2005
Detergent Bar	3%	Increase	2005
Toothpaste	5%	Increase	2005
Skin cream	4-6%	Increase	2005
Noodles	20%	Increase	2005

Source: Industry, PL Research

Pressure from Rising Input Costs

- Prices of key raw materials (LAB and soda ash), constituting 30-35% and 20-22% of detergent sales, respectively, have squeezed margins of detergent manufacturers.

- Prices of LAB climbed by around 15-16% while those of soda ash rose by about 11%.

- Prices of polymer-based packaging (polyethylene and polypropylene) averaged a 15% increase.

- Sugar prices were up by about 12-15%.

- Lower palm oil prices facilitated margins of soap manufacturers.

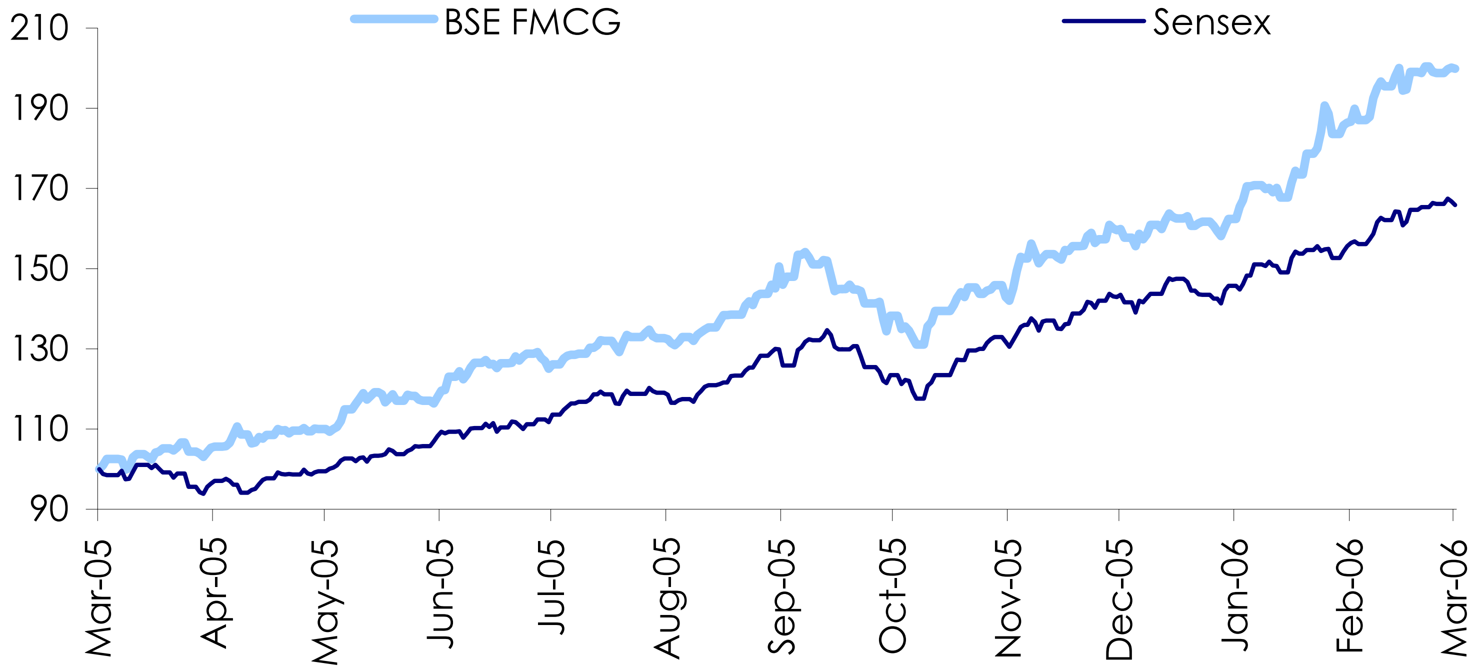
- Decline in Copra prices raised the margins of coconut hair-oil manufacturers.

Budget proposals Neutral for the Sector

- Excise duty reduction (from 16% to nil) on Pasta, Condensed milk and Ice cream would improve volumes and aid margins. Positive for Nestle.
- Excise duty reduced from 16% to 8% on Ready-to-eat packaged foods, and on Instant food mixes. Marginally positive for ITC
- Reduction in peak customs duty (from 15% to 12.5%) is expected to reduce prices of LAB.
- Customs duty on non-edible-grade oils used in soaps reduced from 20% to 12.5%. Positive for soap manufacturers: Hindustan Lever and Godrej Consumer Products.
- Reduction of FBT (Fringe benefit tax) on Tours and Travels (from 20% to 5%) and exemption from FBT of expenditure on brand promotions through celebrity endorsements would reduce this tax by about 15-16%.
- Increase in the Minimum Alternate Tax (MAT) rate (from 7.5% to 10%) is expected to raise the present tax incidence of companies under MAT like Dabur and Godrej Consumer Products by 2%.
- The hike in specific rates of excise duty on Cigarettes by 5% would not affect ITC. The increase is expected to be successfully passed on to consumers through average price rises of 3%.

Outperformance of the Sector

- **The Sector outperformed the benchmark index due to**
  - Growth in both urban and rural markets
  - The return of pricing power



The Road Ahead – Demand Drivers

- Growth in per capita income aided by continuing 8% GDP growth is expected to fuel growth in demand for FMCGs. Per capita income growth expected to be 6-7% in the next eight to ten years.

- Growth in household incomes to drive demand, and should improve value growth.

Classification (annual household income)	**Number of Households (mn)**		
	1994-95	**1999-2000**	**2006-2007**
Very Rich (above INR 215000)	1	3	5
Consuming (INR 45,000 - 215,000)	29	55	76
Climbers (INR 22000 - 45000)	48	66	82
Aspirants (INR 16000 - 22000)	48	32	20
Destitutes (less than INR 16000)	35	24	17

Source: Industry, PL Research

- Low levels of per capita consumption coupled with rising income levels to drive volume growth

Per Capita Consumption (US $)	**India**	**China**	**Indonesia**
Fabric wash	1.2	1.7	2
Toothpaste	0.4	0.8	1.1
Shampoo	0.6	1.1	1.2

Source: Industry, PL Research

Contd....

- With 45% of the Indian population estimated to be below 20 years of age, willing to spend more with rising disposable incomes, growth in consumer demand is expected to accelerate.
- Rise in income levels and improving literacy rates (from 52% to 66%) from 1991 to 2004 are expected to raise demand for "branded" products.
- Urban demand to be driven by the growth in the share of organized retailing (from 3% in 2004 to 10% in 2010). Retail sales expected to grow 8.3% a year from 2003 to 2008 (against 7% in from 1999 to 2002). This should fuel value growth in FMCG due to the better product mix. Additionally growing urbanization (from 17% to 28% in FY05) and rising aspirations would aid growth in FMCGs.

Country	Share of organised retail
US	85%
Malaysia	55%
Thailand	40%
Brazil	36%
Indonesia	30%
China	20%
India	3%

Source: Industry, PL Research

- FMCG market estimated to grow 9% a year (from $11.6bn in 2003 to $27.8bn in 2013).

Taking the Inorganic Route to Growth

- **Earlier growth strategies have been**
  - Greater penetration by widening distribution.
  - More capacity additions in backward areas, leading to tax concessions, aiding margin expansions.
  - Innovations and fresh introductions.
- **With rising cash flows, FMCG companies have resorted to inorganic growth**
- **Prominent acquisitions have been**
  - Acquisition of Balsara by Dabur
  - Acquisition of Keyline brands by Godrej Consumer Products
  - Acquisition of Nihar
- **Further acquisitions are expected from ITC, Dabur, Marico and Godrej Consumer Products**

Risks

- Dependence of agriculture on the monsoon due to lack of widespread irrigation
- Lower agricultural growth might affect demand and might lead to higher commodity prices, thus affecting margins
- Volatility in prices of crude oil may squeeze margins of detergent manufacturers.

Long term expected

With the expected 9% per annum growth in consumer demand, we are optimistic about the long-term growth prospects of the Sector

We believe that the following factors would decide the winners

- Acquisitions strengthening market share and providing entry into less penetrated categories
- Presence in less penetrated segments like Personal products and Foods
- Strong presence in the modern format retail stores
- Strong distribution network in rural markets
- Product innovations creating a distinctive positioning by improvising existing strengths.

Our Top Picks

HLL

To capitalise on its domination in the modern retail format and on its wide rural reach

ITC

To see a re-rating, led by strong growth in Cigarettes and by multiple growth drivers

Nestle

Excise duty cut to boost sales of Noodles as well as profitability while the new plant would improve profitability

Dabur

Premium valuations within the sector coupled with continuing earnings growth warrant further upside in the stock

Comparative Valuations (FY07)

Name of the Company	Rating	M/Cap *(Rs m)*	EPS *(Rs.)*	PE *(x)*	EV/Sales *(x)*	EV/EBTIDA *(x)*	RoCE *(%)*	RoE *(%)*
Britannia	OP	453,914	66.1	28.7	2.3	19.4	25.7	26.2
Dabur India	OP	71,999	4.3	29.3	3.2	20.7	39.5	51.5
GCPL	OP	43,071	25.8	29.6	4.7	23.4	86.9	124.5
Hindustan Lever	OP	599,222	7.5	37.4	4.9	34.0	61.6	69.8
ITC	OP	747,648	6.9	28.7	3.8	18.9	24.9	26.5
Marico	MP	32,231	18.0	30.8	2.5	18.3	24.0	34.3
Nestle India	OP	116,663	40.2	30.1	3.9	19.0	69.0	108.9

Top Picks : HLL, ITC, Nestle & Dabur

Britannia Industries Outperformer Rs 1,900

- Greater utilization at its backward area unit is expected to save excise of approx. Rs 180m in FY07 and Rs 190m the following year. Additionally, income tax saved is expected to be about Rs 525m in FY07 and Rs 562m the year after.
- Expected 10-12% growth in Biscuits should lead to a 10% growth for Britannia in the next two years.
- We expect sales to grow by 9% in the next two years.
- Operating margins are expected to improve by 52bp due to a 90-bp drop in raw material costs from more in-sourcing. However, adspend is expected to increase due to mounting competition.
- Profit after tax is expected to grow 19.3% yoy to Rs 1.58bn in FY07 and 25.5% yoy the year after to Rs 1.98bn.

Key Figures *(Rs m)*

Y/e March	**FY05**	**FY06E**	**FY07E**	**FY08E**
Net Sales	15,876	17,552	19,139	20,699
EBIDTA	1,839	2,007	2,288	2,720
PAT	1,706	1,323	1,579	1,982
PAT growth (%)	*30.5*	*(22.4)*	*19.3*	*25.5*
EPS *(Rs)*	71.4	55.4	66.1	83.0

Key Ratios (%)

EBIDTA	11.6	11.4	12.0	13.1
RoCE	36.1	26.2	25.7	27.1
RoE	39.1	26.7	26.2	27.7

Valuations (x)

PER	26.6	34.3	28.7	22.9
EV / Sales	2.8	2.5	2.3	2.1
EV / EBIDTA	24.6	22.0	19.4	16.3
MCap / Sales	2.8	2.5	2.3	2.2

Dabur India Outperformer Rs 126

- The Consumer care division (10% yoy growth) and international sales (20%-25%yoy growth) to be key growth drivers.
- Revival in sales of oral care (at 5-6%) and consistent growth in health supplements (of about 10%) to drive the consumer care division.
- Incremental sales from Pakistan, Bangladesh and Nigeria to fuel International sales.
- Balsara to see accelerated growth of 25%-30%, with focus on home-care products
- Expected rise in input prices would be nullified by the planned rise in product prices (of 5% to 10% in FY07).
- Net sales to record a 19% CAGR from FY05 to FY08; Net profit a 23% CAGR.

Key Figures *(Rs m)*

Y/e March	**FY05**	**FY06E**	**FY07E**	**FY08E**
Net Sales	15,370	19,113	21,985	25,230
EBIDTA	2,088	2,902	3,403	3,918
PAT	1,558	2,188	2,458	2,879
PAT growth (%)	*46.3*	*40.4*	*12.3*	*17.1*
EPS *(Rs)*	2.7	3.8	4.3	5.0

Key Ratios *(%)*

EBIDTA	14.0	15.3	15.7	15.7
RoCE	34.7	40.5	39.5	39.0
RoE	47.9	55.1	51.5	48.3

Valuations (x)

PER	46.2	32.9	29.3	25.0
EV / Sales	2.4	3.8	3.2	2.7
EV / EBIDTA	17.9	24.8	20.7	17.4
MCap / Sales	2.3	3.8	3.3	2.9

Godrej Consumer Products Outperformer Rs 763

- The growth rate in Soaps to slip to 14% due to revived competition from HLL and up-trading in Soaps.
- Hair color is expected to grow at about 20% following 20-25% industry growth.
- Toiletry expected to record 25% CAGR in the next two years, due tp the low base.
- Keyline brands expected to add 18% to GCPL's sales in FY07 and likely to grow by 15% during FY08.
- Consolidated sales expected to grow by 33.1% yoy to Rs 9.19bn in FY07 and 15.9% yoy to Rs 10.65bn in FY08.
- In FY2008, margins expected to improve from savings in excise of Rs 202m.

Key Numbers *(Rs m)*

Y/e March	FY05	FY06E	FY07E	FY08E
Net Sales	5,627	6,960	9,187	10,521
EBIDTA	1,005	1,366	1,855	2,272
PAT	861	1,212	1,455	1,837
PAT growth (%)	*32.7*	*40.8*	*20.1*	*26.2*
EPS *(Rs)*	15.2	21.5	25.8	32.5

Key Ratios *(%)*

EBIDTA	17.9	19.6	20.2	21.6
RoCE	128.2	110.5	86.9	101.6
RoE	186.7	176.5	124.5	114.4

Valuations *(x)*

PER	50.2	35.5	29.6	23.4
EV / Sales	7.7	6.3	4.7	4.1
EV / EBIDTA	43.0	32.0	23.4	18.8
MCap / Sales	7.7	6.2	4.7	4.1

Hindustan Lever — Outperformer — Rs 279

- With demand revival in rural markets and growth of the modern retail format, HLL expected to outperform consumer growth.
- Strong 17% growth in Personal products and revived 10% growth in Soaps and Detergents expected to drive sales
- Revived performances in Skin cream, Toothpaste and Soap expected to aid growth
- Better profitability in Processed foods is expected to facilitate margins
- Pressure on margins in Detergents to continue due to pricing pressure in the segment
- Sales expected to have an 11% CAGR during CY05-07 (against 4% CAGR in CY03-CY05). Profits expected to have a 19% CAGR in CY05-07,

Key Figures *(Rs m)*

Y/e December	**CY04**	**CY05**	**CY06E**	**CY07E**
Net Sales	99,269	110,606	123,761	136,349
EBIDTA	14,374	14,433	17,702	20,589
PAT	11,993	13,545	16,440	19,060
PAT growth (%)	*(33.5)*	*12.9*	*21.4*	*15.9*
EPS *(Rs)*	5.4	6.2	7.5	8.7

Key Ratios *(%)*

EBIDTA	14.5	13.0	14.3	15.1
RoCE	34.7	44.4	61.6	59.3
RoE	56.7	63.7	69.8	66.1

Valuations *(x)*

PER	51.3	45.4	37.4	32.3
EV / Sales	6.3	5.5	4.9	4.4
EV / EBIDTA	43.2	42.1	34.0	29.4
MCap / Sales	5.6	5.1	4.5	4.1

ITC

Outperformer

Rs 199

- Cigarettes to see a re-rating backed by an 11.3% CAGR in FY05-08, led by consistent growth and strong pricing power.
- Hotels and Paperboards and Paper to record 22.7% and 16.7% CAGR during FY05-08.
- Non-cigarette FMCGs expected to have a 60.2% CAGR during FY05-FY08 driven by the continuing ramp-up of operations.
- Lifestyle Retailing (Wills Lifestyle) and Rural Retailing (*choupal sagars*) to trigger re-rating. The *Choupal* initiative to record sales of Rs 1.12bn in FY07 and Rs 1.69bn in FY08.
- Net sales to have a 22% CAGR in FY05-08. Net profit expected to have a 19% CAGR.
- Sum-of-parts valuation gives a fair value of Rs 225 per share over a 12 to 18-month horizon.

Key Figures *(Rs m)*

Y/e March	FY05	FY06E	FY07E	FY08E
Net Sales	76,395	97,223	118,715	139,132
EBIDTA	27,926	32,892	38,750	46,021
PAT	18,371	22,052	26,031	31,125
PAT growth (%)	*15.3*	*20.0*	*18.0*	*19.6*
EPS (Rs)	4.9	5.9	6.9	8.3

Key Ratios (%)

EBIDTA	36.6	33.8	32.6	33.1
RoCE	24.7	24.2	24.9	25.7
RoE	25.7	26.0	26.5	27.4

Valuations (x)

PER	40.7	33.9	28.7	24.0
EV/Sales	3.7	4.6	3.8	3.3
EV/EBIDTA	17.9	22.5	18.9	15.6
MCap / Sales	3.7	4.7	3.9	3.4

Marico Market Performer Rs 556

- Marico has exercised its pricing power after forming a strong brand in Hair oil. This has led to improved margins and a re-rating of the stock to "branded" play.
- The recent acquisition of Nihar from HLL has added to its dominance in Hair oil.
- Kaya's breakeven during FY07 would further raise margins.
- Main drivers of future growth would be Hair oil, International sales and Kaya.
- Interest cost expected to grow due to the debt of Rs 2bn to acquire Nihar.
- Effective tax rate is expected to grow to about 17.5% by FY08 due to the expiry of tax benefits from backward-area units
- Net Profit expected to have a 23.6% CAGR during FY06-08, primarily backed by an 18% CAGR in sales.

Key Figures *(Rs m)*

Y/e March	**FY05**	**FY06E**	**FY07E**	**FY08E**
Net Sales	10,128	11,455	14,255	15,967
EBIDTA	882	1,443	1,832	2,132
PAT	681	833	1,047	1,284
PAT growth (%)	*15.5*	*22.4*	*25.6*	*22.6*
EPS (Rs)	11.7	14.4	18.0	22.1

Key Ratios (%)

EBIDTA	8.7	12.6	12.9	13.4
RoCE	29.1	22.5	24.0	28.1
RoE	33.9	34.3	34.3	32.9

Valuations (x)

PER	47.3	38.7	30.8	25.1
EV/Sales	3.3	3.1	2.5	2.1
EV/EBIDTA	36.8	23.6	18.3	15.2
MCap / Sales	3.2	2.9	2.4	2.1

Nestle India — Outperformer — Rs 1,210

- Milk products to grow by 10% per annum while Beverages to grow at 6% due to a decline in instant coffee exports to Russia. Chocolate and Confectionary to grow at 10-11%.
- Prepared dishes and cooking aids to be key growth drivers with reduced duty on Pasta (from 16% to nil) and the addition to capacity in Uttaranchal by end-CY06.
- Nestle to partially pass on the reduced excise duty in order to gain volumes. Excise savings from reduced excise duty on noodles at around Rs 335m in CY06 and Rs 402m in CY07.
- Income tax savings from sales from backward-area units at Rs 300m.
- Operating margins to see pressure from rising prices of key raw material -- milk.
- Net Sales to record a 12.8% CAGR during CY2005-07. Adjusted Net Profit to seea 23.0% CAGR.

Key Figures *(Rs m)*

Y/e Dec	**CY04**	**CY05**	**CY06E**	**CY07E**
Net Sales	22,276	24,769	28,186	31,512
EBIDTA	4,510	5,221	6,046	7,131
PAT	2,809	3,293	3,878	4,982
PAT growth (%)	*(2.5)*	*17.2*	*17.8*	*28.5*
EPS (Rs)	29.1	34.1	40.2	51.7

Key Ratios (%)

EBIDTA	20.2	21.1	21.5	22.6
RoCE	56.3	65.0	69.0	79.1
RoE	85.9	99.5	108.9	128.7

Valuations (x)

PER	41.5	35.4	30.1	23.4
EV/Sales	4.9	4.4	3.9	3.4
EV/EBIDTA	25.9	22.1	19.0	15.9
MCap / Sales	5.1	4.9	4.4	4.0

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PL's Recommendation Scale

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer**	:	5 to 15% Outperformance to Sensex
Market Performer	:	-5 to 5% of Sensex Movement	**Underperformer**	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			

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