



Prabhudas
Lilladher

Fulfilling investors' needs since 1944

Abhijeet Kundu
91-22-6632 2233

Research Analyst
AbhijeetKundu@PLIndia.com

Q4 FY07
Result Update

Kansai Nerolac

Outperformer

Rs 697

May 8, 2007

Inflationary pressure plays spoil sport

Company Details		Result Snapshot	
Market Cap:	Rs 17,783m	<p>Q4FY07 sales posted strong growth of 20.3% to Rs.2852m backed by comprehensive growth across decorative and industrial paints. However input cost inflation in the form of crude derivatives played a spoilsport lowering operating margins by 135bps to 12.7%. Profit after tax grew by 11.1% to Rs.233m.</p> <p>At the CMP of Rs. 697 the stock is trading at 14.0x FY08 earnings and at 12.1x FY09 earnings. On a one-year forward rolling PE, the stock has witnessed a de-rating from about 16.5x in FY06 to the current one-year forward PE of 14x. This we believe is reflective of the lacklustre performance of the company during FY07. However going forward, with KNPL expected to witness 17.1% CAGR in earnings during FY07-FY09, the current valuations are expected to be maintained. We therefore continue to maintain Outperformer on the stock at the current levels with a price target of Rs.810 in a one-year time frame.</p>	
52 Week High/Low:	Rs 960 / 634		
Bloomberg Code:	KNPL@IN		
Reuters Code:	KANE.BO / NS		
Shares O/s:	26m		
Average Volume (3 months):	6,536m		
<th colspan="2">Price Performance</th>			
(%)	1m	3m	12m
Absolute	3.5	(10.7)	(21.0)
Relative to Sensex	(0.9)	(4.6)	(31.0)

Q4 FY07 Result Overview

(Rs m)

Y/e March	Q4FY07	Q4FY06	yoy gr. (%)	Q3FY07	FY06	FY07	yoy gr. (%)
Net Sales	2,852	2,372	20.3	3,091	10,096	12,224	21.1
Raw Mat	1,842	1,392	32.3	1,998	6,110	7,783	27.4
% of NS	64.6	58.7		64.6	60.5	63.7	5.2
Personnel	149	144	3.6	153	559	596	6.5
% of NS	5.2	6.1		5.0	5.5	4.9	(12.0)
Other Expenditure	500	503	(0.7)	530	1,856	2,130	14.8
% of NS	17.5	21.2		17.1	18.4	17.4	(5.2)
Total Expenditure	2,490	2,038	22.1	2,681	8,524	10,509	23.3
OPBDIT	362	333	8.7	411	1,571	1,714	9.1
OP Margin (%)	12.7	14.1		13.3	15.6	14.0	(9.9)
Other Income	92	73	26.3	49	238	241	1.2
PBDIT	454	406	11.9	459	1,809	1,955	8.1
Depreciation	95	93	1.8	88	318	336	5.6
Interest	3	3		2	8	10	23.1
PBT	357	311	14.9	369	1,484	1,610	8.5
Prov for Tax	124	101	22.8	126	456	533	16.8
% of PBT	34.7	32.5		34.0	30.8	33.1	7.7
PAT	233	210	11.1	243	1,027	1,077	4.8
Extraordinary item	-	-		243	359	-	
Reported PAT	233	210	11.1	487	1,386	1,077	(22.3)

(Stock price as on May 8, 2007)



Result Highlights

Q4FY07 sales exceeds expectations grows 20.3%

Kansai Nerolac posted a 20.3% growth in net sales to Rs.2852m exceeding our expectations of a 14.2% growth in sales at Rs.2708m for the quarter. A strong growth across decorative paints and industrial paints has led the strong growth in sales during the quarter.

Operating margins decline 135bps with rise in RM

Operating margins dropped by 135bps to 12.7% during Q4FY07. This was due to 588bps increase in raw material cost to 64.6% of net sales. Rise in prices of solvent based materials, which are crude based and form key raw materials for paints have led to the cost inflation. The increase in raw material cost was higher during the last quarter as against the nine-month increase in raw material cost of 232bps to 63.4% of net sales. This was due to the higher priced raw material used during the quarter as compared to the relatively lower priced raw material inventory carried forward by the company from the previous year (FY06). The company's inventory outstanding days stood at about 53days in FY06 against 41days in FY05. KNPL was unable to pass on the cost inflation to its OEM clients and this in turn impacted KNPL's performance as automotive paints forms approximately about 45-50% of KNPL's total sales. Resultantly operating profit grew at a slower pace of 8.7% to Rs.362m.

Q4 PAT growth in line at 11.1%

Profit before tax grew by 14.9% to Rs.357m primarily led by strong growth in sales. However higher provisioning for tax at 34.7% of PBT in Q4FY07 against 32.5% of PBT in Q4FY06 led to a Profit after tax growth of 11.1% to Rs.233m.

Emulsions and exterior paints drive decorative paints during FY07

Gross sales growth during FY07 has been strong at 26.9% to Rs.1556m. This was driven by a comprehensive growth across decorative paints and Industrial products, which contribute equally to the company's total sales. In decorative paints, emulsions and exterior paints (together accounting 25% of KNPL's sales) have driven growth during the year recording about 25% growth in each of these categories against the industry growth of about 22-23% in each of the respective categories.

Additionally, KNPL has focused on institutional sales to builders to grow its sales. Within decorative paints, re-painting operations contribute about 65% of sales while new constructions contribute about 35% to sales. Further within new construction operations, institutional sales to builders form about 50% of the sales. KNPL's initiatives to tap builders in metros have led to a faster growth in this business during the year.

Strong growth in passenger cars boosts industrial paints sales

In industrial coatings, automotive coatings form the key category for KNPL. This category witnessed strong growth during the year with passenger cars (including utility vehicles) recording higher year on year growth during FY07. Passenger car production (excluding Hyundai Motor India Ltd-KNPL does not supply to Hyundai Motor) during the year grew by 17.3% as compared to 6.7% in FY06. KNPL's key clients like Maruti and Tata Motors have recorded production growth of about 16.6% and 16.8% respectively during the year against 5.9% and 10% growth respectively in FY06. This has boosted automotive coatings growth for KNPL during FY07.



Inability to raise prices of Industrial products impacted margins in FY07

Kansai Nerolac witnessed increased pressure from rising prices of key raw materials during FY07. Raw material cost during the year increased by 316bps to 63.7% of net sales. Cost inflation in decorative paints and industrial products was to the tune of 5.5% and 11% respectively. *This led to a 154bps drop in operating margins to 14% during FY07.* KNPL passed on the cost inflation in decorative paints partly through price hikes averaging at about 2.5%. However in case of industrial paints or automotive paints in particular, the cost price increases were marginal and were unable to provide any respite from rising raw material cost. *Decline in operating margins coupled with increase in effective tax rate at 33.1% against 30.76% in the previous corresponding year led to a marginal growth of 4.8% in profit after tax to Rs.1077m.*

Emulsions and institutional sales to drive growth in decorative

Exterior and interior emulsions backed with installation of colour dispensing machines are expected to drive decorative paint sales in the coming years. Growth in contribution of emulsions to total sales would also improve margins going forward as emulsions enjoy almost double the gross margins over other paints. Further institutional sales to builders in metros will also help as a channel to aid growth.

Focus on product mix in industrial paints to contain pressure on margins

KNPL has been improving its services to OEMs (Original equipment manufacturers) through value engineering and development of newer technologies like 3C-1B system for auto application, including CED for high smoothness, UV cure coatings and low bake ED primer. The company is also working towards strengthening service support at OEMs. Thus this will help KNPL maintain its volumes from its OEM clients. However to maintain its profitability in a scenario of rising raw material cost, KNPL is focusing on selling products which relatively have a better margin profile. Thus the company is focusing on enriching its product mix in industrial paints to maintain its profitability.

Rs.700m capex plans for FY08

KNPL is planning an Rs.700m capex for FY08. The company will be spending about Rs.350m on adding capacity at Bawal (Haryana) and about Rs.200m in Lote (Maharashtra). The company plans to augment its powder coating capacity in bawal through the capex and in Lote, it plans to increase its emulsion manufacturing capacity.

Outlook and Valuation

Going forward, we believe that the growth in sales witnessed during FY07 will slowdown to previous levels of about 15% per annum. In decorative paints, growth would be impacted to the extent of higher interest rates slowing down new housing construction growth. New construction as we earlier stated, contributes about 35% of the total demand for decorative paints. However with income levels still continuing to rise, consumer off-take in the re-painting operations should remain buoyant. In the industrial paints business, demand is expected to slowdown with rising interest rates expected to impact passenger care volumes during FY08. Further industrial products would also continue to constrain margin improvement in the coming quarters as the OEMs are also facing rising pressure from input cost inflation.

We therefore believe that sales would grow by 15% CAGR in the next two years. We expect operating margins to be maintained at the current levels with the rise in input cost expected to lower during FY08. Further better efficiencies and utilization levels would lead to reduction in fixed cost. In view of the higher than expected pressure on margins witnessed in the current quarter and FY07, we have lowered our operating profit estimates for the coming years leading to a downgrading of estimates by 5.1% and 4.1% to Rs.49.7 and Rs.57.9 respectively for FY08 and FY09.



At the CMP of Rs. 697 the stock is trading at 14.0x FY08 earnings and at 12.1x FY09 earnings. On a one-year forward rolling PE, the stock has witnessed a de-rating from about 16.5x in FY06 to the current one-year forward PE of 14x. This we believe is reflective of the lacklustre performance of the company during FY07. However going forward, with KNPL expected to witness 17.1% CAGR in earnings during FY07-FY09, the current valuations are expected to be maintained. We therefore continue to maintain Outperformer on the stock at the current levels with a price target of Rs.810 in a one-year time frame.

Key Figures

Y/e March	FY06	FY07E	FY08E	FY09E
Revenues (Rs m)	10,096	12,224	14,067	16,209
EBITDA (Rs m)	1,571	1,714	1,995	2,305
<i>Margins (%)</i>	<i>15.6</i>	<i>14.0</i>	<i>14.2</i>	<i>14.2</i>
PAT (Rs m)	1,027	1,077	1,267	1,476
EPS (Rs)	40.3	42.2	49.7	57.9
PER (x)	17.3	16.5	14.0	12.1
EV / E (x)	11.9	10.1	8.2	6.5
EV / Sales (x)	1.5	1.1	0.9	0.7
<i>RoCE (%)</i>	<i>22.2</i>	<i>20.0</i>	<i>20.9</i>	<i>21.2</i>
<i>RoE (%)</i>	<i>28.1</i>	<i>24.4</i>	<i>24.5</i>	<i>24.4</i>

This document has been prepared by the Research Division of Prabhudas Lilladher Pvt. Ltd. Mumbai, India (PL) and is meant for use by the recipient only as information and is not for circulation. This document is not to be reported or copied or made available to others without prior permission of PL. It should not be considered or taken as an offer to sell or a solicitation to buy or sell any security. The information contained in this report has been obtained from sources that are considered to be reliable. However, PL has not independently verified the accuracy or completeness of the same. Neither PL nor any of its affiliates, its directors or its employees accept any responsibility of whatsoever nature for the information, statements and opinion given, made available or expressed herein or for any omission therein. Recipients of this report should be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The suitability or otherwise of any investments will depend upon the recipient's particular circumstances and, in case of doubt, advice should be sought from an independent expert/advisor. Either PL or its affiliates or its directors or its employees or its representatives or its clients or their relatives may have position(s), make market, act as principal or engage in transactions of securities of companies referred to in this report and they may have used the research material prior to publication. We may from time to time solicit or perform investment banking or other services for any company mentioned in this document.