kotak Institutional Equities

Hindustan Unilever (HUVR)

Consumer products

REDUCE

JUNE 03, 2010

UPDATE

Coverage view: Attractive

Price (Rs): 247

Target price (Rs): 230

BSE-30: 16,742

Light at the end of the tunnel. Yes. However, where is the end? We present why we are (still) not excited by the actions taken by HUL, (1) incubating new businesses—too little, too late? (2) power brand strategy is scrapped. At what cost? (3) markets are likely ignoring the potential 'ITC impact' in personal care (particularly soaps), and (4) consumer uptrading in detergents likely to benefit P&G disproportionately, in our view. Buyback of shares to be ~1.2% of equity; a non-event, in our view. REDUCE.

Company data and valuation summary

Hindustan Unilever

Stock data			
52-week range (Rs) (high,low)			307-218
Market Cap. (Rs bn)			518.2
Shareholding pattern (%)			
Promoters			52.0
FIIs			14.5
MFs			3.2
Price performance (%)	**1M**	**3M**	**12M**
Absolute	1.7	(0.6)	(0.8)
Rel. to BSE-30	5.6	1.0	(11.9)

Forecasts/Valuations	2010	2011E	2012E
EPS (Rs)	9.7	10.4	11.8
EPS growth (%)	1.7	7.3	14.0
P/E (X)	24.6	22.9	20.1
Sales (Rs bn)	175.2	191.4	217.4
Net profits (Rs bn)	21.1	22.6	25.8
EBITDA (Rs bn)	29.0	29.7	34.6
EV/EBITDA (X)	16.4	15.4	12.9
ROE (%)	91.6	82.2	80.8
Div. Yield (%)	3.2	3.6	4.1

Headwinds galore

Consumer uptrading in detergents likely to benefit P&G disproportionately, in our view

Any likely consumer uptrading to mid-segment from mass market (due to price cuts in mid-segment) will likely benefit P&G disproportionately rather than HUL, in our view. Mass market segment accounts for 63% of detergent powder and 71% of detergent bar market. However, P&G predominantly operates in the mid-segment and premium segment and has leading market shares in most of the top-23 cities—typically 1 mn+ population cities—these cities have a higher proportion of mid and premium segment sales, in our view.

Power brand strategy is scrapped. At what cost?

We reiterate that we have limited excitement on the go-again-regional strategy as; (1) HUL needs to invest disproportionately in adspends to win back the consumer franchise, (2) while the brands may have some residual equity in the erstwhile markets, success in weaning away the consumer would depend on the incumbent brand's loyalty score and their ability to invest in adspends and innovations.

Markets are likely ignoring the potential 'ITC impact' in personal care (particularly soaps)

ITC has achieved an exit-March 2010 market share of 5% and 3.5% in soaps and shampoo, respectively—a highly notable achievement in less than 30 months of category entry. We believe this growth in market share was led by product differentiation (Fiama Di Wills gel bathing bar), aggressive trade promotions (buy three get one free in Superia) and focused investment in distribution (~50% of distributors are dedicated distributors for non-cigarette FMCG). Markets are likely ignoring the potential 'ITC impact' in personal care impacting HUL, in our view.

QUICK NUMBERS

- ITC has market share of 5% and 3.5% in soaps and shampoo in ~30 months of category entry
- Consumer uptrading in detergents likely to benefit P&G disproportionately, in our view

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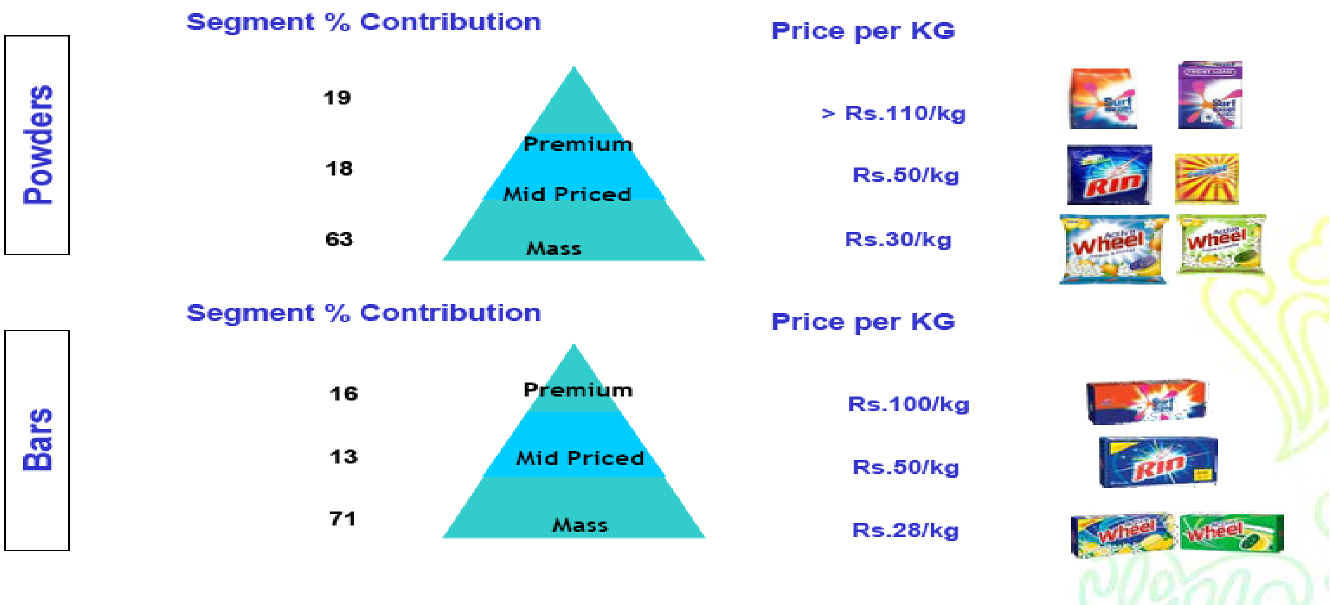
Incubating new businesses—too little, too late?

Considering the size and scale of HUL, it is unlikely that all the new businesses (in aggregate) will contribute materially to HUL's incremental growth in medium term. Most of the new segments and categories (which HUL is investing in) are still nascent in India (which requires significant market development investments—both in terms of consumer education and time). HUL is investing in building a spate of new brands and brand extensions, notably, Comfort fabric conditioner, Dove shampoo and skincare, Ponds top-end skincare range, Vaseline for Men, Knorr soups and cooking aids etc.

Consumer uptrading in detergents likely to benefit P&G disproportionately, in our view

Detergent industry structure



Source: HUL, Kotak Institutional Equities

Buyback of shares to be ~1.2% of equity; a non-event, in our view

The board of HUL will take up the proposal for buyback of its shares in its meeting on June 11, 2010. Under the existing regulations, HUL can spend up to Rs6.5 bn (25% of its net worth) for the buyback. At the current market price of Rs247, HUL can purchase ~26 mn shares or about 1.2% of its outstanding equity shares of 2,182 mn. While the buyback price may provide support to the stock in the interim, unexciting earnings growth during the next two years will likely restrict any re-rating of stock to higher P/E multiple, in our view.

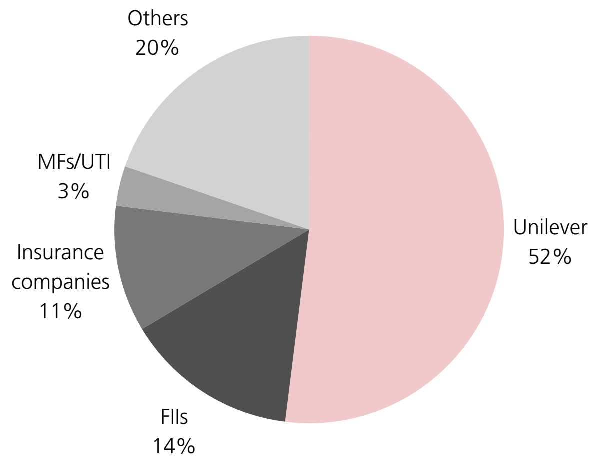
As per the prevailing regulations, the share buyback cannot exceed 25% of the total paid-up capital and free reserves of the company and the buyback in any financial year is restricted to 25% of the total paid-up equity. HUL can undertake a buyback of up to Rs6.5 bn, being 25% of its networth. At the current market price of Rs247/share, HUL can theoretically buy 26 mn shares or about 1.2% of the outstanding shares. We note that HUL has a large floating stock with Unilever group holding only 52% stake, and another 28% owned by MFs/FIs/FIIs. A high buyback price, therefore, will only be able to provide a temporary support to the stock price, in our view.

The exact modalities of the proposed buyback including the price of buyback are yet to be decided. HUL can undertake the buyback by (1) a tender offer through a letter of offer from the holders of shares of the company on a proportionate basis or (2) through purchases in the open market.

Reiterate REDUCE on account of irrational competition in mature categories

We reiterate our REDUCE rating as ~65% of the revenues are from categories which are mature and growing at best at 3% in volumes (where the company also faces irrational competition). Maintain estimates, reiterate REDUCE and target of Rs230. We continue to believe that (1) there is a likelihood of increasing competition in other categories, including personal care, (2) high likelihood of pre-emptive price corrections (by HUL) to align right price/value equation in other categories and (3) gross margin (expansion) comfort prevalent in FY2010 is unlikely to repeat in FY2011E.

HUL can buy back ~1.2% of outstanding equity
HUL's shareholding pattern as of March 31, 2010



Source: BSE, Kotak Institutional Equities

Exhibit 3: HUL: Profit model, balance sheet, cash model, calendar year-ends 2006-07, March fiscal year-ends 2009-12E (Rs mn)

	2006	2007	15 months 2009 (a)	2010E	2011E	2012E
Profit model (Rs mn)						
Net sales	121,034	136,754	202,393	175,238	191,387	217,423
EBITDA	**16621**	**18787**	**26780**	**25484**	**26535**	**31181**
Other income	3,545	4,315	5,678	3,496	5,195	5,765
Interest	(107)	(255)	(253)	(70)	(34)	(54)
Depreciation	(1,302)	(1,384)	(1,953)	(1,840)	(2,144)	(2,476)
Pretax profits	18,757	21,463	30,251	27,071	29,552	34,416
Tax	(3,218)	(4,049)	(5,729)	(5,981)	(6,928)	(8,630)
Net profit	**15539**	**17415**	**24522**	**21090**	**22624**	**25785**
Earnings per share (Rs)	**7.0**	**7.9**	**11.3**	**9.7**	**10.4**	**11.8**
Balance sheet (Rs mn)						
Total equity	27,235	14,392	20,615	25,518	29,613	34,281
Total borrowings	726	885	4,219	4,219	4,219	4,219
Currrent liabilities	45,231	51,110	57,838	51,426	62,771	70,918
Total liabilities and equity	**73191**	**66387**	**82673**	**81163**	**96603**	**109419**
Cash	4,169	2,009	17,773	24,034	33,733	39,448
Current assets	27,527	30,765	38,236	26,794	29,671	33,551
Total fixed assets	15,110	17,081	20,789	24,656	27,701	31,119
Investments	24,139	14,408	3,326	3,326	3,326	3,326
Deferred tax asset	2,245	2,124	2,548	2,352	2,173	1,975
Total assets	**73191**	**66387**	**82673**	**81163**	**96603**	**109419**
Free cash flow (Rs mn)						
Operating cash flow, excl. working capital	20,209	20,674	26,581	23,498	24,947	28,460
Working capital	(471)	3,091	(2,592)	6,199	7,570	3,087
Capital expenditure	(1,576)	(3,355)	(5,660)	(5,708)	(5,188)	(5,894)
Other income	3,545	4,315	5,678	3,496	5,195	5,765
Free cash flow	**21707**	**24725**	**24006**	**27485**	**32524**	**31417**
Key assumptions						
Revenue Growth (%)	9.4	13.0	48.0	(13.6)	9.4	13.6
EBITDA Margin(%)	13.9	13.7	13.2	14.8	13.9	14.3
EPS Growth (%)	18.3	12.1	42.7	(14.0)	7.3	14.0

Note:
(a) 15 month period starting January 1, 2008 to March 31, 2009

Source: Kotak Institutional Equities estimates

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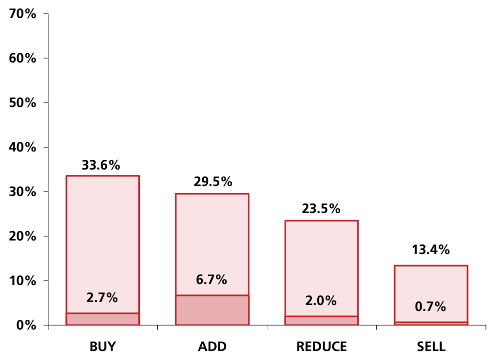

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Source: Kotak Institutional Equities

As of March 31, 2010

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