

Industry In-Depth

19 August 2007 | 9 pages

Indian Consumer

Unduly De-rated; Revisiting the Drawing Board

- Stellar 1Q, but ignored** — Markets have continued to ignore the significant pick-up in the growth profile of Indian consumer companies – 1QFY08 was a stellar quarter, with all companies beating our (& Street) estimates handsomely (for HUL, Apr-Jun07 earnings grew fastest in last six years). Competition has become more rational, allowing for pricing power; margins are improving despite cost pressures.
- Valuations have shrunk, focus on earnings quality** — Sector absolute and relative valuations are near historic lows, and while the sector de-rating was quick following irrational competition (P&G, HLL price war) and growth slowdown, the market has been slow to reward a turn in fundamentals. Quality of earnings (pick-up in core businesses, corporate governance, ROE) seem to have been largely ignored.
- Free cash flow, dividend yield support** — Sector offers average free cash yield of 5% and avg div yield of ~3%. Most companies offer free cash yield of 6%-8%.
- Outlook remains robust** — We polled consumer company managements recently – the growth outlook remains strong, the margins outlook is selectively improving, more price hikes are not ruled out and earnings windfalls await in the event of input commodity prices cool off.
- Top picks** — 1) HUL: Earnings picking up, share buybacks support, attractive valuations; 2) ITC: Cigarette volumes and margins look to surprise positively, attractive valuations; 3) Tata Tea: Net cash of Rs200 per share (30% of market cap), core business available at 9x FY08 P/E; 4) United Spirits: 41% 3-year EPS CAGR, potential positive earnings surprises.

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Figure 1. Indian Consumer Top Picks Valuation Summary

Company	RIC		Mkt Cap (USD M)	Price Target (Rs)	P/E (x)		EV/EBITDA (x)	Div. Yld. (%)		RoE (%)	
	Code	Rating			FY08E	FY09E		FY08E	FY08E	FY08E	FY09E
Hindustan Unilever	HLL.BO	1L	10,305	254	20.9	18.0	17.9	4.1%	80.7%	83.6%	
ITC	ITC.BO	1L	14,015	195	19.5	16.3	12.4	2.2%	27.2%	24.7%	
United Spirits	UNSP.BO	1L	3,086	1,463	31.4	22.3	19.7	0.0%	17.1%	10.7%	
Tata Tea	TTTE.BO	1L	954	1,045	11.8	8.3	4.2	2.3%	52.9%	8.1%	

Source: Company Reports and Citigroup Investment Research estimates

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

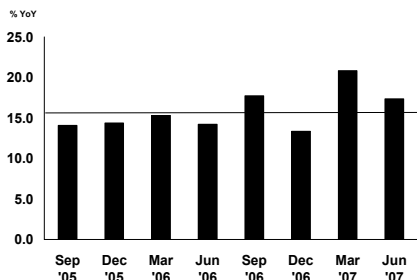
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Sector sales growth over the last eight quarters has remained over 15%. Despite raw material cost pressures, margins have been stable, aided by price hikes. Apr-Jun07 saw the strongest EBITDA and net profit growth for the sector over last eight quarters. Most companies surprised positively, reporting growth ahead of our and Street estimates

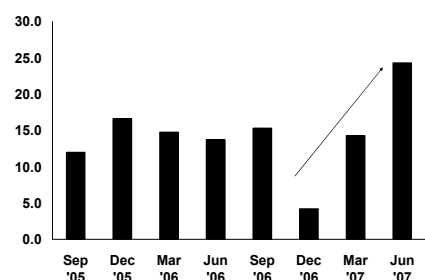
Fundamentals are improving.....

Figure 2. CIR Consumer Universe Sales Growth (% YoY)



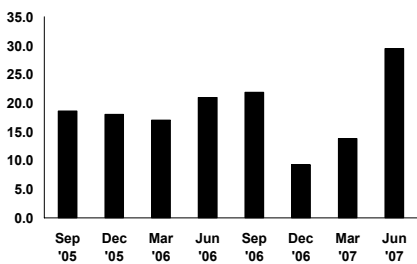
Source: Company Reports and CIR estimates

Figure 3. CIR Consumer Universe EBITDA Growth (% YoY)



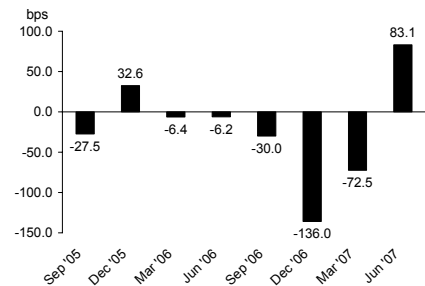
Source: Company Reports and CIR estimates

Figure 4. CIR Consumer Universe PAT Growth (% YoY)



Source: Company Reports and CIR estimates

Figure 5. CIR Consumer Universe Change in EBIT Margins (bps YoY)

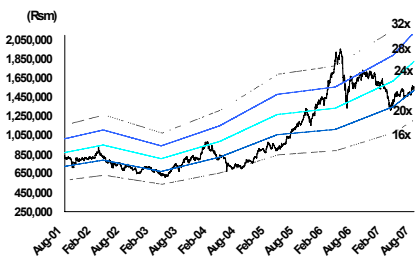


Source: Company Reports and CIR estimates

.....but valuations have remained depressed

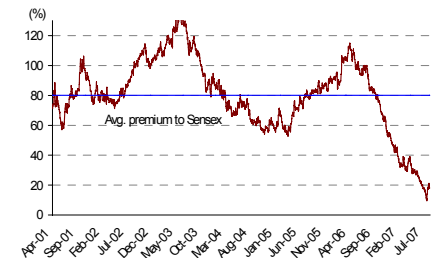
Sector valuations are near historic lows, both on absolute basis and relative to Sensex. While the market was quick to de-rate the sector following slow growth and irrational competition, a turnaround over the last few quarters has not seen any improvement in valuations. We believe that there is undue pessimism and the Street is ignoring the quality of earnings growth that the sector offers

Figure 6. Consumer Sector P/E Bands



Source: Citigroup Investment Research

Figure 7. Consumer Sector P/E Relative to Sensex P/E (%)



Source: Citigroup Investment Research

Figure 8. Indian Consumer Sector Valuation Summary

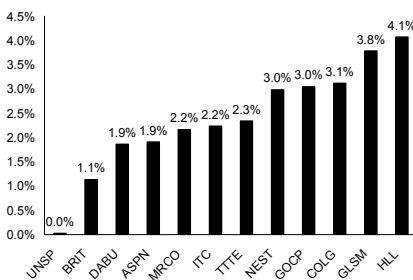
Company	RIC Code	Rating	Mkt Cap (USD M)	Target Price	P/E (x)		EV/EBITDA (x)		Dividend Yield (%)		RoE (%)	RoCE (%)
					FY08E	FY09E	FY08E	FY09E	FY08E	FY08E	FY08E	
Asian Paints	ASPN.BO	1L	2,171.0	1,028	26.8	23.5	16.6	14.2	1.9%	41.5%	75.5%	
Britannia Industries	BRIT.BO	1L	925.7	1,825	20.3	15.2	15.7	11.1	1.1%	27.3%	42.3%	
Colgate Palmolive (India)	COLG.BO	1L	1,222.8	482	19.7	17.2	18.2	15.2	3.1%	82.6%	NC	
Dabur India	DABU.BO	1L	2,060.1	125	24.3	19.7	19.1	17.0	1.9%	71.7%	47.5%	
Godrej Consumer	GOCP.BO	1L	755.2	172	20.3	17.4	15.2	13.0	3.0%	107.5%	63.6%	
GSK Consumer	GLSM.BO	1L	610.9	770	14.7	13.6	8.7	7.5	3.8%	27.1%	22.4%	
Hindustan Unilever	HLL.BO	1L	10,305.0	254	20.9	18.0	17.9	15.2	4.1%	80.7%	83.6%	
ITC	ITC.BO	1L	14,015.2	195	19.5	16.3	12.4	10.0	2.2%	27.2%	24.7%	
United Spirits	UNSP.BO	1L	3,086.1	1,463	31.4	22.3	19.7	15.0	0.0%	17.1%	10.7%	
Marico	MRCO.BO	1L	847.0	74	23.3	19.3	13.8	11.5	2.2%	65.4%	36.7%	
Nestle India	NEST.BO	1L	2,758.1	1,244	22.0	18.8	13.4	11.3	3.0%	102.2%	253.8%	
Tata Tea	TTTE.BO	1L	954.3	1,045	11.8	8.3	4.2	3.0	2.3%	52.9%	8.1%	
Average					21.3	17.5	14.6	12.0	2.4%	58.6%	92.0%	

Source: Company Reports and Citigroup Investment Research estimates

Indian Consumer sector offers strong free cash and dividend yield support. Companies like Colgate, Nestle and HUL offer dividend yields of almost 3%-4%, while sector free cash yields for most companies are between 5%-8%

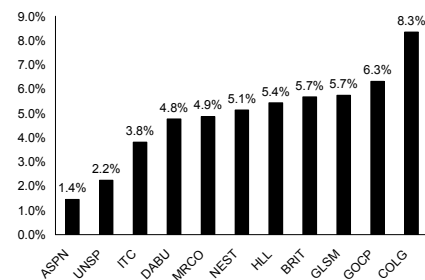
Free cash yield and dividend support

Figure 9. Indian Consumer Stocks Dividend Yield (%)



Source: Company Reports and CIR estimates

Figure 10. Indian Consumer Stocks Free Cash Yield (%)



Source: Company Reports and CIR estimates

We recently polled managements of key consumer companies. Growth outlook remains robust across the board, while companies selectively expect margins to improve going forward

Management outlook remains robust

Figure 11. Summary of Consumer Company Management Meetings / Polls

Company	Recent Management Comments
Asian Paints	Expect to grow over 15%. Margins may improve as some raw material prices have cooled off and operating leverage from international business
Dabur	Expect sales growth of 18%-20% and stable to improving margins. Strong growth across all key segments
GSK Consumer	Sales growth to remain robust, 7%-8% volume growth and 4%-5% price hikes to 12%-13% sales growth. Price hikes to mitigate raw material cost pressures, margins to remain stable
Marico	Sales growing close to 20%, underlying volume growth of 14%. Can take price hikes easily, not just to pass on cost pressures but also to improve margins
Godrej Consumer	Sales growth to remain strong – re-launch and re-positioning of high end hair color brand revive to curb market share losses. Margins likely to expand going forward
HUL	Sales growth momentum remains strong, company gaining market share in key segments. Will mitigate raw material costs through further price hikes

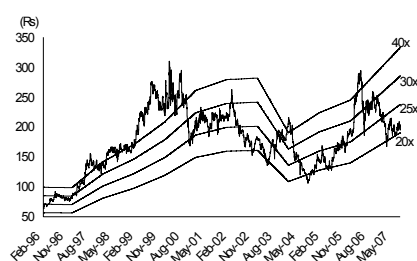
Source: Company Reports

Top Picks

Hindustan Unilever

- **Growth turning around:** Sales and earnings growth momentum is picking up. EBITDA profits in Apr-Jun07 quarter grew 23.5%, highest in the last six years. After significant investment behind brands, HUL seems to be now in a position to scale back its ad spend (already coming off a high base), which should aid margins further.
- **Valuations seem attractive:** Valuations have abated and the stock trades near historical lows. Premium to Sensex has shrunk to only 25%, against historical average of about 80%-100%.
- **Stock buyback support:** Company has announced a share buyback from the market up to Rs230 per share, which should provide downside support to the stock. We have a price target of Rs254.

Figure 12. HLL P/E Bands



Source: Bloomberg; CIR estimates

Figure 13. HLL Stock Price Performance

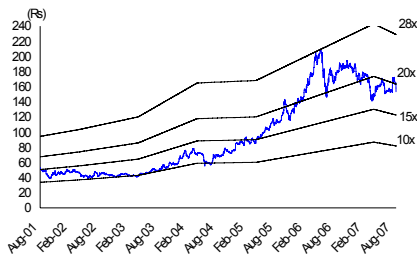
(%)	3M	6M	12M
Absolute	(0.6)	(4.6)	(14.9)
Rel. to Sensex	(2.2)	(4.7)	(32.1)

Source: Powered by dataCentral

ITC

- **Expect positive volume and margin surprises:** ITC's cigarette volumes surprised positively in 1QFY08E, which we believe set an undertone for the full year. We also expect cigarette EBIT margins to surprise positively, given that cigarette price hikes are heavily loaded in favor of the mid segment which is almost 65% of volumes.
- **Foods business break even to aid margins:** Foods business losses are declining and ITC management expect it to break even by end FY08E. This should be a major milestone for the company and would boost sentiment.
- **Valuations look attractive:** Stock price has declined by almost 14% over last four weeks following strong 1Q results, providing a good entry opportunity, in our view. Stock is currently trading at P/E of 16.3x FY09E. We have a price target of Rs195.

Figure 14. ITC P/E Bands



Source: Bloomberg; CIR estimates

Figure 15. ITC Stock Price Performance

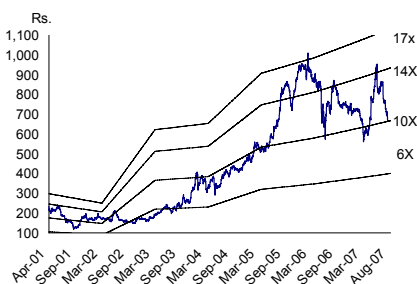
(%)	3M	6M	12M
Absolute	(3.1)	(9.1)	(12.5)
Rel. to Sensex	(4.6)	(9.1)	(30.3)

Source: Powered by dataCentral

Tata Tea

- Cash of Rs200 per share:** Tata Tea will have net cash of about Rs200 per share (net of debt) once money from its Glaceu stake sale to Coke flows in around Oct-Nov 2007. This cash represents almost 30% of company's market cap. While Tata Tea may not retire debt, earnings growth should accelerate, aided by yield on excess cash.
- Chances of a potential leveraged acquisition diminishing:** With the current global credit environment, we believe that chances of Tata Tea making a potentially large leveraged acquisition in the international market have diminished. This should improve sentiment and lift a potential overhang on the stock.
- Attractively Valued:** The stock looks attractively valued at a P/E of 8.3x FY09E, the lowest amongst our consumer universe and near its historic lows. We have a price target of Rs1,045.

Figure 16. Tata Tea P/E Bands



Source: Bloomberg; CIR estimates

Figure 17. Tata Tea Stock Price Performance

(%)	3M	6M	12M
Absolute	(16.7)	0.4	(20.9)
Rel. to .BSESN	(18.0)	0.3	(36.9)

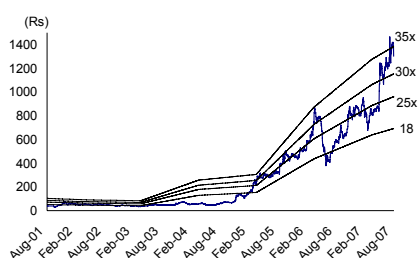
Source: Powered by dataCentral

United Spirits

- Solid earnings growth profile:** United Spirits is amongst the best leveraged stock to Indian consumption growth and young population profile. We expect strong demand for branded liquor and improving margins to drive 41% EPS CAGR over FY07-FY10E.

- **Positive earnings surprises:** UNSP has historically surprised positively on earnings, and we believe that there are ample levers in place for the company to further surprise positively. Key positive surprise is likely on earnings of Whyte & Mackay (acquired recently) – management has guided at GBP50m EBITDA for FY08E, which we believe could be beaten materially given that scotch prices have continued to increase post the acquisition.
- **Potential treasury stock sale to prepay debt:** Management has indicated that they are likely to pre-pay debt raised for the Whyte & Mackay acquisition. This could happen through a combination of sale of treasury stock and raising funds through a potential listing of Whyte & Mackay. An earlier-than-anticipated debt pay-down would boost earnings and the stock price. We have a price target of Rs1,463.

Figure 18. United Spirits P/E Bands



Source: Bloomberg; CIR estimates

Figure 19. United Spirits Stock Price Performance

(%)	3M	6M	12M
Absolute	45.5	53.4	118.7
Rel. to Sensex	43.1	53.3	74.3

Source: Powered by dataCentral

Appendix A-1

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