

Company Focus

23 October 2007 | 10 pages

Godrej Consumer Products (GOCP.BO)

Buy: Concerns Overdone; Strong 2QFY08

- Concerns overdone** – We believe GCPL's recent stock underperformance is overdone and exaggerates concerns pertaining to input costs (palm oil) and hair color market share losses. Despite these issues, GCPL's 2QFY08 earnings grew by 20%. We are positive on the steps taken by management to address these issues and believe that at 15x FY09E P/E (lowest amongst our HPC universe) and 3.5% dividend yield, the stock looks attractive.
- Price hikes to cover palm oil cost increases** – Palm oil costs have almost doubled in last 12M. While cost escalation is unlikely to abate anytime soon, GCPL has been consistently taking price hikes. While margins have stabilized, strong product quality and brands have ensured that soaps business volume growth continues to remain robust
- Containing hair color market share losses** – GCP management is expanding its product offering to higher end of the market and is innovating in its existing products, which we believe should help arrest market share declines
- Strong 2QFY08 results** – 2QFY08 consolidated net profits increased 20% yoy driven by 18% sales growth and 120bps EBITDA margin expansion. Margins expanded despite raw material cost pressures and lower profitability of UK's Keyline business. We expect growth to intensify as Keyline turns around and hair care sales pick up. Maintain Buy (1L).

Buy/Low Risk	1L
Price (23 Oct 07)	Rs119.85
Target price	Rs172.00
Expected share price return	43.5%
Expected dividend yield	3.8%
Expected total return	47.3%
Market Cap	Rs27,067M US\$682M

Price Performance (RIC: GOCP.BO, BB: GCPL IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	1,213	5.37	35.7	22.3	34.4	188.8	2.9
2007A	1,342	5.94	10.6	20.2	22.2	133.7	3.1
2008E	1,556	6.89	16.0	17.4	16.1	107.5	3.6
2009E	1,818	8.05	16.8	14.9	12.0	92.6	4.0
2010E	2,052	9.09	12.9	13.2	9.0	77.9	4.2

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	22.3	20.2	17.4	14.9	13.2
EV/EBITDA adjusted (x)	19.2	15.6	13.1	11.1	9.8
P/BV (x)	34.4	22.2	16.1	12.0	9.0
Dividend yield (%)	2.9	3.1	3.6	4.0	4.2
Per Share Data (Rs)					
EPS adjusted	5.37	5.94	6.89	8.05	9.09
EPS reported	5.37	6.38	6.89	8.05	9.09
BVPS	3.48	5.40	7.42	9.97	13.35
DPS	3.50	3.75	4.27	4.83	5.00
Profit & Loss (RsM)					
Net sales	6,997	9,532	11,600	13,459	15,510
Operating expenses	-5,685	-7,877	-9,650	-11,241	-13,044
EBIT	1,313	1,655	1,950	2,218	2,465
Net interest expense	-65	-96	-121	-79	-50
Non-operating/exceptionals	73	26	50	53	55
Pre-tax profit	1,321	1,585	1,879	2,191	2,470
Tax	-113	-243	-323	-373	-418
Extraord./Min.Int./Pref.div.	5	99	0	0	0
Reported net income	1,213	1,440	1,556	1,818	2,052
Adjusted earnings	1,213	1,342	1,556	1,818	2,052
Adjusted EBITDA	1,427	1,797	2,117	2,389	2,642
Growth Rates (%)					
Sales	24.4	36.2	21.7	16.0	15.2
EBIT adjusted	46.1	26.1	17.8	13.7	11.2
EBITDA adjusted	42.1	25.9	17.8	12.9	10.6
EPS adjusted	35.7	10.6	16.0	16.8	12.9
Cash Flow (RsM)					
Operating cash flow	1,298	1,465	2,323	2,115	2,084
Depreciation/amortization	115	142	167	172	177
Net working capital	-30	-118	600	126	-145
Investing cash flow	-812	-1,309	-477	-675	-200
Capital expenditure	0	-1,285	0	-75	-100
Acquisitions/disposals	-861	-24	-800	-600	-100
Financing cash flow	-293	140	-1,732	-1,584	-1,627
Borrowings	626	1,049	-633	-340	-340
Dividends paid	-901	-974	-1,100	-1,244	-1,287
Change in cash	193	296	114	-144	257
Balance Sheet (RsM)					
Total assets	3,425	5,653	6,229	7,002	7,908
Cash & cash equivalent	263	475	589	445	701
Accounts receivable	303	483	493	572	714
Net fixed assets	850	1,992	1,502	1,406	1,329
Total liabilities	2,638	4,433	4,552	4,752	4,892
Accounts payable	1,787	2,520	3,178	3,687	4,207
Total Debt	687	1,736	1,103	763	423
Shareholders' funds	787	1,220	1,677	2,251	3,016
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.4	18.9	18.2	17.8	17.0
ROE adjusted	188.8	133.7	107.5	92.6	77.9
ROIC adjusted	120.6	70.2	75.3	117.8	137.9
Net debt to equity	53.9	103.4	30.7	14.2	-9.2
Total debt to capital	46.6	58.7	39.7	25.3	12.3

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Exaggerated concerns

Figure 1. GCP: Stock Performance

(%)	3M	6M	12M
Absolute	(15.2)	(27.5)	(31.2)
Rel. to .BSESN	(25.1)	(42.8)	(50.3)

Source: Powered by dataCentral

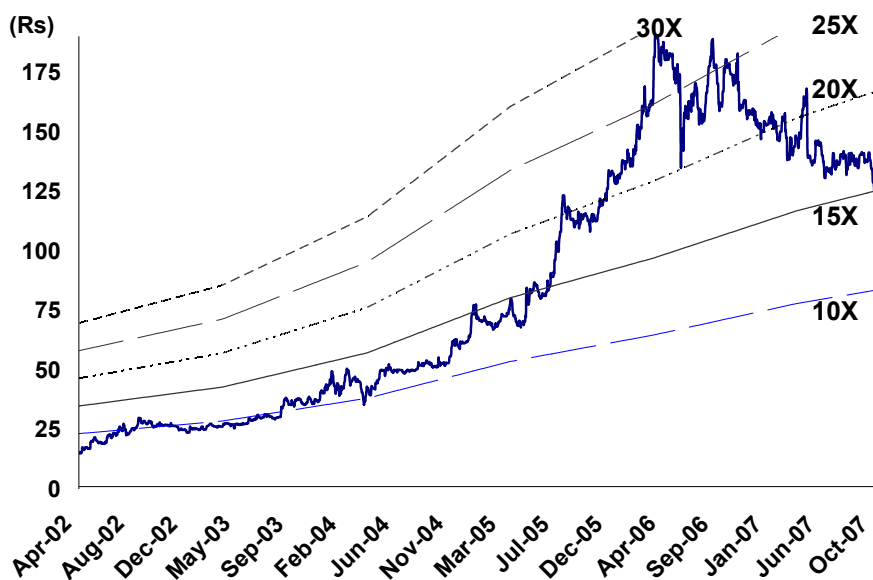
GCP has underperformed the Sensex by 43% in the last six months on the back of concerns pertaining to hair color market share losses and cost escalation in palm oil, which is the key input in soap manufacturing. We believe that these concerns are exaggerated as has been highlighted in the 2QFY08 results. Despite these issues, GCP's 2QFY08 earnings grew by 20% backed by a 120bps EBITDA margin expansion.

Given the demand supply dynamics and increasing demand for bio fuels, palm oil cost escalation is unlikely to abate anytime soon. Palm oil prices have almost doubled in the last year. However, GCP and other soap manufacturers have been consistently taking price hikes without sacrificing volume growth. GCP's margins have stabilized in soaps and its brands and strong product offering have ensured that soaps business volume growth continues to remain robust. Soaps volumes grew by 17% in 2QFY08.

In hair colors, GCP management is expanding its product offering to higher end of the market. It is launching new variants and is innovating in its existing products, which we believe should help arrest market share declines

We are positive on the steps taken by management to address the issues highlighted above. At 15x FY09E P/E, which is the lowest amongst our HPC universe and 3.5% dividend yield, the stock looks attractive.

Figure 2. GCP – P/E Band Chart



Source: Citi Investment Research

2QFY08 results review

GCP reported a 20% growth in 2QFY08 net profit, which was ahead of our estimates, driven by 18% sales growth and 120bps EBITDA expansion. Net profit growth was strong despite (1) higher depreciation (up 50% YoY), (2) higher interest charges (up 23% YoY) and (3) lower other income (down 52% YoY).

Strong margin expansion

GCP's EBITDA margin expanded by 120bps despite a 160bps increase in advertising expenses as the full impact of the price hikes (~6%) taken in last quarter kicked in. Also, GCP benefited due to the rupee appreciation which led to a decline in the imported palm oil costs. Palm oil costs, which have almost doubled in last 12M, however, continue to remain strong.

International business performance - mixed bag

While Rapidol posted a 75% growth in profit in 2QFY08, Keyline's profitability continued to be impacted by poor sales off take of some key brands due to adverse weather conditions. Increase in ad spend also negatively impacted Keyline's profit, which declined by 38%.

Figure 3. Godrej Consumer: 2QFY08 Result Summary (Rupees in Millions, Percent)

	2QFY07	2QFY08	% Change
Net Sales	2,318.3	2,740.2	18.2
Expenditure	-1,921.7	-2,238.8	16.5
EBITDA	396.6	501.4	26.4
<i>EBITDA Margin (%)</i>	<i>17.1</i>	<i>18.3</i>	<i>119 bps</i>
Interest	-25.7	-31.6	23.0
Depreciation	-30.7	-46.1	50.2
Other Income	28.3	13.5	-52.3
Profit Before Tax	368.5	437.2	18.6
Tax	-58.5	-66.6	13.8
<i>Tax Rate (%)</i>	<i>15.9</i>	<i>15.2</i>	<i>-64 bps</i>
Profit After Tax	310.0	370.6	19.5
Net Profit	310.0	370.6	19.5

Source: Company Reports

Figure 4. Godrej Consumer: 2QFY08 Cost Details (Rupees in Millions, Percent)

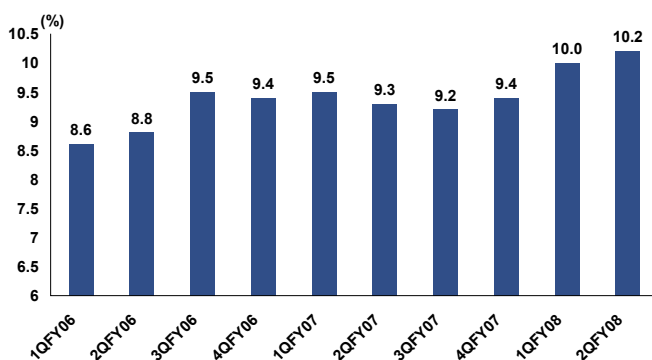
	2QFY07	2QFY08	% Change
(Increase)/decrease in stock in trade	64.5	-92.9	-244.0
Consumption of raw material and purchase of goods	1,118.8	1,433.2	28.1
Total Raw Materials	1,183.3	1,340.3	13.3
-As a % of sales	51.0	48.9	-213 bps
Staff cost	134.0	152.7	14.0
-As a % of sales	5.8	5.6	-21 bps
Advertisement and Publicity	157.8	230.3	45.9
-As a % of sales	6.8	8.4	160 bps
Other expenditure	446.6	515.5	15.4
-As a % of sales	19.3	18.8	-45 bps

Source: Company Reports

Soaps and hair color on different growth paths

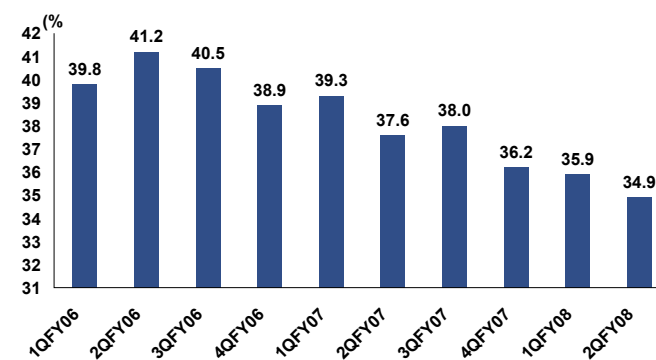
GCP continued market share gains in its soap business (10.2%), as soap revenues grew at 23% compared to industry growth of 10%. Underperformance in hair colors, however, continued with domestic hair color revenues growing by only 4% vs. 12% industry growth.

Figure 5. Soaps Market Share (%)



Source: Company and Citi Investment Research

Figure 6. Hair Color Market Share (%)



Source: Company and Citi Investment Research

Godrej Consumer Products

Company description

GCP is one of the fastest growing companies in India's FMCG sector, with leadership in the hair-color market and a dominant No.2 position in soaps. Its product portfolio also includes toiletries, and household-, baby- and personal-care products. GCP acquired Keyline Products, a manufacturer of cosmetic products and toiletries in the UK, in October 2005. In September 2006 it acquired Rapidol International, a market leader in the South African ethnic

hair-color market. GCP came into being in April 2001 when the consumer division of Godrej Soaps was de-merged. Godrej Soaps then became Godrej Industries and retained the industrial chemicals, medical diagnostics and estate operations. The group has close to 8 decades of manufacturing experience in soaps and personal-care products.

Investment strategy

We rate GCP as Buy/Low Risk (1L). The company has a dominant 38% of India's hair-color market and is the second largest in the soaps segment. GCP's overseas acquisitions complement its product portfolio and give it access to high-growth markets such as South Africa and the UK. The hair-color market is under-penetrated in India, and therefore offers GCP scope for further growth. In soaps, GCP continues to enlarge market share through innovations and value-for-money products. The stock is among the cheapest in our India Household and Personal Care Universe.

Valuation

We use P/E as our primary valuation method because GCP's earnings growth has been steady, and the company is unlikely to face cyclical earnings. Our target price of Rs172 is based on 25x FY08E EPS, pegged at an 8-10% discount to sector leader HLL. Our target multiple is reasonable, in our view, given our positive stance on GCP's core domestic business and its recent international acquisitions. We believe the stock will continue to trade at a historical c.60% premium to the Sensex given its superior profitability ratios and earnings profile.

Risks

We rate GCP as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility, and because the company operates in branded consumer segments. Risks that could impede the stock from reaching our target price include: (1) Intense competition in the hair-color segment, which is undergoing a gradual shift from traditional hair colors to the premium segment, in which GCP has a weak presence; (2) Price inflation in key raw materials such as palm oil; (3) Slowdown in consumer demand; (4) Integration issues after the recent acquisitions, and slower-than-expected growth in the UK and South Africa; and (4) Considering that c20% of the consolidated entity's revenues would be from international markets, earnings growth is exposed to forex risks.

Appendix A-1

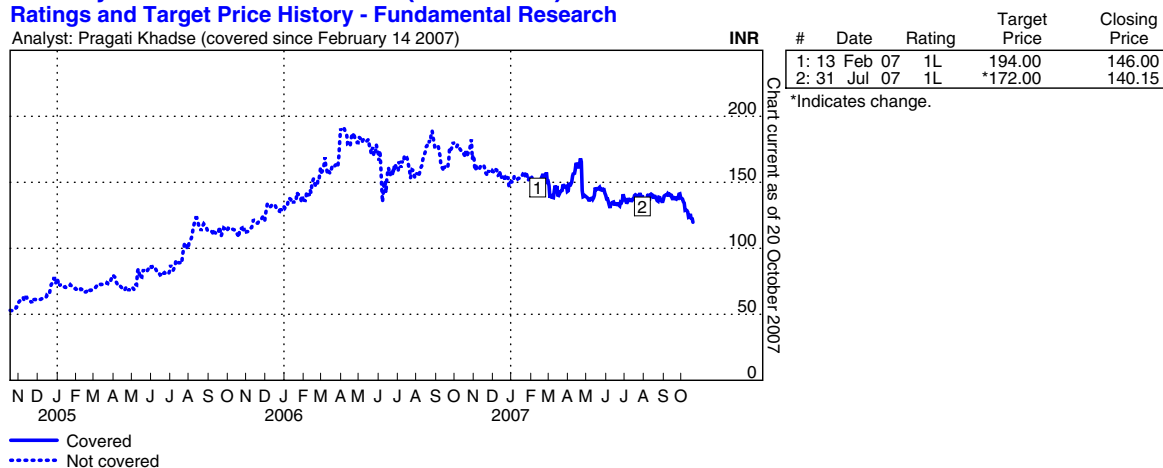
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Analyst: Pragati Khadse (covered since February 14 2007)



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