MOTILAL OSWAL

2QCY06 Results Update
SECTOR: FMCG

Hindustan Lever

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,813	HLVR IN
	REUTERS CODE
S&P CNX: 3,151	HLL.BO

Equity Shares (m)	2,201.2
52-Week Range	296/156
1,6,12 Rel. Perf. (%)	-11/4/-6
M.Cap. (Rs b)	483.1
M.Cap. (US$ b)	10.4

7 August 2006 **Buy**

Previous Recommendation: Buy Rs219

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
12/05A	110,605	14,081	6.0	10.6	36.9	21.0	56.8	68.7	4.2	31.9
12/06E	122,535	17,193	7.2	21.3	30.4	18.3	60.1	73.7	3.7	25.9
12/07E	135,870	19,716	9.0	24.1	24.5	15.5	63.4	77.5	3.3	20.7

- 2QCY06 results were below our expectations with 8.7% sales growth compared with our expectation of 11%. Adjusted PAT grew 26.2% versus our estimate of 33.2% YoY. EBITDA increased by 19.9% as EBITDA margin increased 120bp, despite 110bp increase in advertising expenditure. PAT increased by 26.2% as the tax rate declined by 450bp, due to increased outsourcing from own units in backward areas.
- HLL achieved volume and value growth of 8% and 12.1% on its FMCG portfolio. Despite broadbased growth, performance of Personal Care was sub par with just 13.3% sales value growth. Soaps and Detergents (13.1%), Processed Foods (24.2%) and Ice Creams (34.3%) posted double-digit value growth, Beverages reported declining sales (-3.7%).
- We expect HLL to be one of the largest beneficiaries of the strong upsurge in demand growth (10.2% growth in the June quarter, up from 7.7% in the March quarter) due to wide product portfolio covering all price points and segments. While we are bullish on the long term demand potential, we are reducing CY06 and CY07 profit estimates by 5% and 6% respectively due to lower growth rate in Personal Care (15% volume growth as against 20% earlier), higher advertising spend (100bp) and cost pressures due to freight fuel and crude based raw materials.
- We have revised our EPS estimates for CY06 to Rs7.2 and for CY07 to Rs9 respectively. The stock is trading at 30.4x CY06 and 24.5x CY07 earnings. We maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E DECEMBER	CY05				CY06				CY05	CY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales (incl service inc)	**25,064**	**28,363**	**27,315**	**29,743**	**27,981**	**30,832**	**30,320**	**33,402**	**110,605**	**122,535**
YoY Change (%)	*6.5*	*10.3*	*13.8*	*14.4*	*11.6*	*8.7*	*11.0*	*12.3*	*11.4*	*10.8*
Total Expenditure	22,629	24,906	23,872	24,925	24,675	26,686	26,015	27,498	96,172	104,874
EBITDA	**2,435**	**3,457**	**3,444**	**4,818**	**3,306**	**4,146**	**4,305**	**5,904**	**14,433**	**17,660**
YoY Change (%)	*-32.4*	*8.4*	*1.7*	*14.7*	*35.8*	*19.9*	*25.0*	*22.5*	*0.4*	*22.4*
Margins (%)	*9.7*	*12.2*	*12.6*	*16.2*	*11.8*	*13.4*	*14.2*	*17.7*	*13.0*	*14.4*
Depreciation	-310	-318	-325	-316	-339	-301	-335	-345	-1,245	-1,320
Interest	-46	-56	-48	-36	-21	-34	-35	10	-192	-80
Other Income	746	794	849	642	694	814	875	761	3,048	3,143
PBT	**2,826**	**3,877**	**3,920**	**5,108**	**3,640**	**4,625**	**4,810**	**6,328**	**16,045**	**19,404**
Tax	-606	-872	-666	-796	-655	-833	-890	-1,133	-2,940	-3,511
Rate (%)	*21.4*	*22.5*	*17.0*	*15.6*	*18.0*	*18.5*	*18.5*	*17.9*	*18.3*	*18.1*
Adjusted PAT	**2,220**	**3,005**	**3,254**	**4,312**	**2,985**	**3,793**	**3,921**	**5,195**	**13,105**	**15,893**
YoY Change (%)	*-22.7*	*17.2*	*15.2*	*20.3*	*34.5*	*26.2*	*20.5*	*20.5*	*10.6*	*21.3*
Extraordinary Inc/(Exp)	283	-188	6	897	1,444	13	0	-157	976	1,300
Reported Profit	**2,503**	**2,817**	**3,260**	**5,209**	**4,429**	**3,806**	**3,921**	**5,038**	**14,081**	**17,193**
YoY Change (%)	*-17.4*	*15.2*	*0.5*	*56.1*	*77.0*	*35.1*	*20.3*	*-3.3*	*17.6*	*22.1*

E: MOSt Estimates

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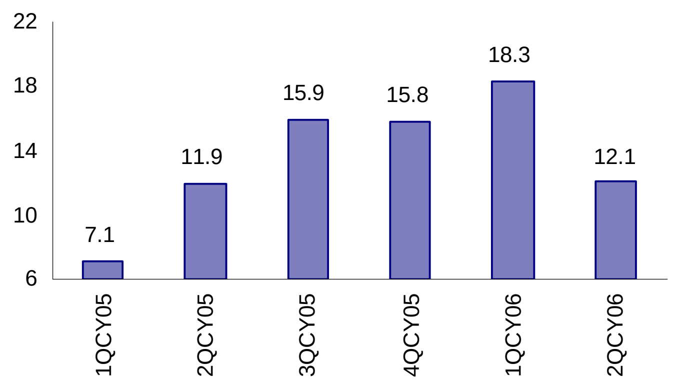
2QCY06 topline growth at 8.7% was below our expectations, while continuing businesses grew at 10% (impact of Nihar and tea plantations). FMCG sales growth at 12.1% showed a sharp de-acceleration after a continuous increase during the past four quarters, partly due to the base effect. HLL's FMCG growth rate at 12.1% was ahead of FMCG sector growth rate at 10.2%. It appears management is confident of taking growth ahead of the market on the basis of strong product and brand innovations across categories.

SALES GROWTH (%)



Source: Company/Motilal Oswal Securities

Cost pressures continue; selective price increases not ruled out

Cost pressures continued to be intense with crude-based raw material, agri-commodities, fuel, freight and advertising on an upswing. HLL has been able to expand margins during the current quarter by effecting a 4% average price increase and higher inhouse production in backward areas. Strong demand has enabled the company to undertake selective price increases without impacting demand significantly.

We are revising our estimates to factor in some of the rising costs — we have increased advertising costs by 100bp; raised freight, power and fuel costs to give effect to the likely inflationary tendencies. Management has not ruled out future price increases to protect margins should cost pressures sustain. We believe there is a possibility for further price increases given strong demand growth in the FMCG sector.

SEGMENT WISE REVENUES (RS M)

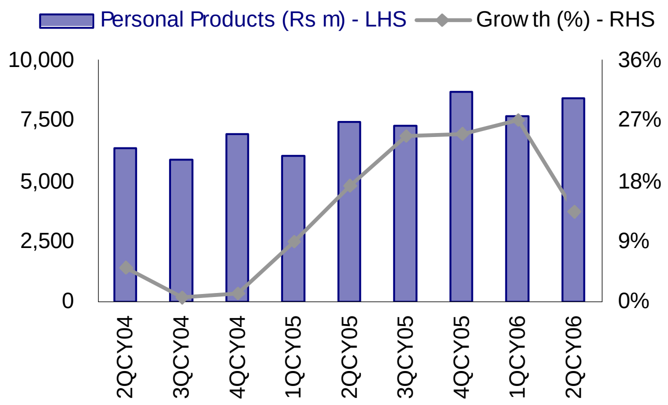
	2QCY05	2QCY06	CHG.(%)	1H05	1H06	CHG.(%)
Net Sales						
Soaps & Det.	12,876	14,559	13.1	24,240	27,745	14.5
Personal Prod.	7,474	8,467	13.3	13,516	16,126	19.3
Beverages	3,122	3,006	-3.7	6,146	6,182	0.6
Proc. Foods	783	973	24.2	1,457	1,855	27.3
Ice Creams	376	505	34.0	580	770	33.0
Exports	3,225	3,287	2.0	6,646	6,042	-9.0
Others	786	379	-52.0	1,478	719	-51.0
EBIT						
Soaps & Det.	1,712	2,084	22.0	3,032	3,608	19.0
Personal Prod.	2,073	2,414	16.0	3,545	4,282	21.0
Beverages	539	407	-25.0	1,179	1,027	-13.0
Proc. Foods	-45	42	193.0	-66	45	-169.0
Ice Creams	51	109	115.0	20	117	495.0
Exports	23	156	593.0	83	236	186.0
Others	-132	-192	45.0	-213	-243	14.0
EBIT Margin (%)						
Soaps & Det.	13.3	14.3		12.5	13.0	
Personal Prod.	27.7	28.5		26.2	26.6	
Beverages	17.3	13.5		19.2	16.6	
Proc. Foods	-5.8	4.3		-	-	
Ice Creams	13.5	21.5		3.4	15.2	
Exports	0.7	4.7		1.2	3.9	
Others	-16.8	-50.7		-14.4	-33.8	

Source: Company/Motilal Oswal Securities

Personal Care products – sharp deceleration in growth rates

Personal Care recorded 13.3% increase in sales and 16% increase in EBIT as the margins expanded by 80bp. All the key segments in Personal Care namely Shampoos, Skin Care, Toothpaste grew during the quarter. Excluding the impact of Nihar, sales growth was 15.1%. The company lost YoY share in Skin Care and Toothpaste but gained market share in shampoos. Clinic All Clear gained 270bp share in the last one year. The company launched Pepsodent Complete, Clinic All Clear Variant, Fair & Lovely Ayurvedic, Fair & Lovely Menz variant during the period. Fair & Lovely grew well but the other skin care portfolio posted retarded growth. We believe the growth rates in the segments will attract new players, so the dominant players will find it hard to protect their market shares. However, sustaining growth is the key. Growth rates of this division have come off very sharply during the quarter, which the management cites is due to high base effect. We are reducing volume growth estimates for Personal Care to 15% in CY06 and CY07 versus our earlier estimates of 20%.

PERSONAL PRODUCTS

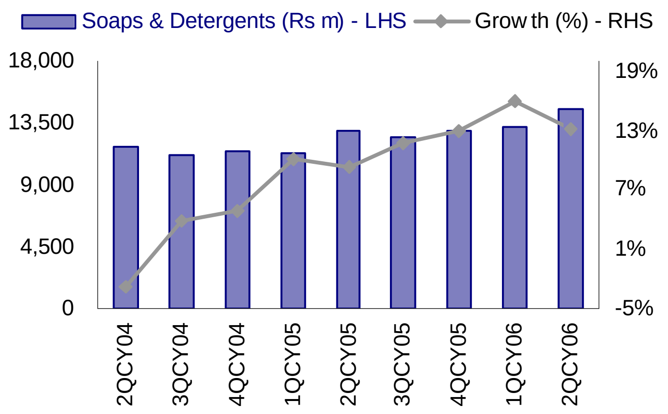


Source: Company/Motilal Oswal Securities

Soaps and Detergents – the party continues

Soaps and Detergents continued to be the star performer with 13.1% higher sales and 22% increase in EBIT as margins expanded by 100bp. Both detergents and toilet soaps maintained strong growth momentum. Lux gained 280bp share in the last 12 months since its re-launch. Launch of Lifebuoy during the quarter was successful, although the product was priced 9.1% higher. Margin expansion in this division is particularly heartening as it has been facing the brunt of increase in crude-based raw material prices.

SOAP & DETERGENTS



Source: Company/Motilal Oswal Securities

We expect cost pressures to remain high in this division, in the coming quarters. We expect the manufacturers to undertake selective price increase due to strong raw material prices and the fact that the major competitor is losing money with lower incremental market share gain. We expect this division to be a major growth driver for HLL as Toilet Soap category growth has accelerated during the last quarter to 8%. Additionally, we expect detergents to grow in high single digits. We expect HLL to benefit in the long term as the only player which has a presence in all segments of the detergents business.

Sluggish tea market impacts beverages performance

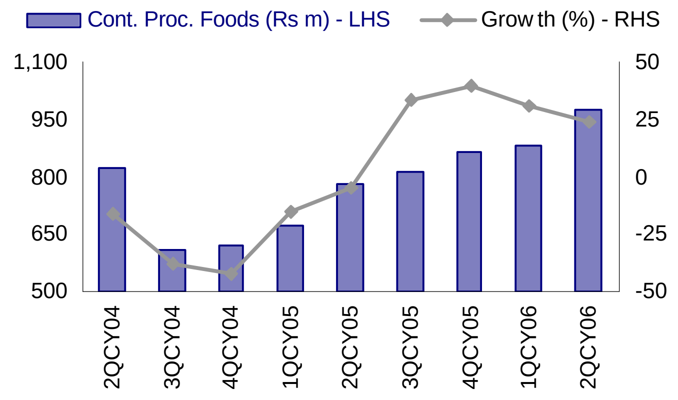
Beverages reported 3.7% decline in sales and 25% decline in EBIT as margins expanded by 380bp. Sluggish market conditions impacted sales growth. Management has cited that the regional players have been able to gain some ground in a market which has been sluggish from time to time. This market has started growing recently but the category is mature. To gain from the turnaround in category growth, HLL has re-launched its premium brand Brooke Bond Taj Mahal, which impacted its margins.

HLL's long term strategy is to target the premium end of the market with valued-added offerings. The coffee business continued the growth momentum with strong 160bp share gains on a YoY basis. We expect the business to be low growth in the medium term.

Processed Foods and Ice Creams post strong growth and turnaround

A continuous stream of Processed Foods led to strong 24.2% sales growth with turnaround in EBIT. HLL achieved EBIT of Rs42m in 2QCY06 v/s losses of Rs45m in 2QCY05. All key brands like Annapurna, Knorr and Kissan contributed to growth. Ice Cream grew 34.5% during the quarter with PBIT increasing 115%, the high growth driven by the impulse category. EBIT margin jumped to 21.5%, highest ever for the category. HLL continues to invest in products and variants in this segment, which we believe will result in this category continuing its double-digit growth on a small base.

CONTINUING PROCESSED FOODS



Source: Company/Motilal Oswal Securities

HLL gaining confidence – water project to be rolled out

HLL is gaining confidence in sustaining its growth, indicated by greater number of new product and variants launches. HLL has extended its water purifier to 15 cities in Tamil Nadu and parts of Karnataka. The company plans to extend the launch to more states in the coming quarters. We believe the product has immense long term potential as it does not require running water, plumbing and electricity. So the product is well suited for rural areas and areas, which do not have availability of good quality, clean drinking water. However this product segment will require a long time to breakeven, as it is a semi-consumer durable. We have not factored in any benefits from the potential scaling up of this product segment in our estimates.

Valuation and view

While we are bullish on the long term demand potential, we are reducing profit estimates for CY06 by 5% and for CY07 by 6% respectively due to lower growth rate in Personal Care (15% volume growth v/s 20% earlier), higher advertising spend (100bp) and cost pressures due to freight, fuel and crude-based raw materials. We have revised EPS estimates for CY06 to Rs7.2 and for CY07 toRs9 respectively. The stock is trading at 30.4x CY06 and 24.5x CY07 earnings. We maintain **Buy**.

Hindustan Lever: an investment profile

Company description

HLL is the largest company in the FMCG industry, with market leadership in soaps, detergents and personal care categories.

It has a wide distribution network with direct reach of over1m retail outlets. The company is a subsidiary of Unileverthe Anglo Dutch FMCG giant.

Key investment arguments

- 2QCY06 FMCG sales growth of 12.1%, is higher than FMCG industry growth of 10.2%.
- Favorable change in sales mix as higher margin, personal care and toilet soaps record strong volume growth.
- Longer term prospects bright due to expected pick up in consumer demand.

Key investment risks

- Competitive pressure could intensify with more companies entering personal care and toilet soaps which account for more than 50% of HLL sales.
- Failure of monsoons could dampen rural demand pickup.
- High crude prices would increase material costs.

Recent developments

- Sale of Nihar brand of coconut hair oils to Marico Indus. for Rs2.17b.
- Relaunch of Sunsilk, Clinic All clear black and Lifebouy soaps.
- Entry into new segments with Surf Excel liquid detergent and Fair and Lovely menz active.

Valuation and view

- We expect an earnings CAGR of 26% over CY06-08E.
- The stock is trading at 30.4x CY06 and 24.5x CY07 earnings. We maintain **Buy**.

Sector view

- We are positive on the sector. The sector is showing strong volume growth across product categories with improving pricing power for leading players.
- Companies with low competitive pressures and brought product portfolios will be able to better with stand any slowdown in a particular segment.
- Longer term prospects bright, given rising incomes and low penetration.

COMPARATIVE VALUATIONS

		HLL	ITC	NESTLE
P/E (x)	CY06E	30.4	22.4	27.2
	CY07E	24.5	19.1	22.4
EV/EBITDA (x)	CY06E	25.9	14.7	21.0
	CY07E	20.7	12.4	17.7
EV/Sales (x)	CY06E	3.7	5.0	4.2
	CY07E	3.3	4.2	3.8
P/BV	CY06E	18.3	5.9	18.4
	CY07E	15.5	5.0	16.1

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	51.5	51.6	51.6
Domestic Institutions	15.5	14.9	13.9
FIIs/FDIs	13.9	14.5	14.4
Others	19.1	19.0	20.1

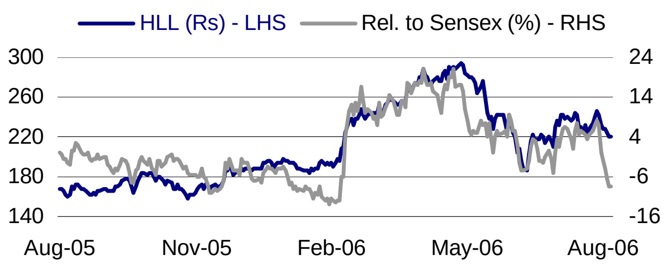
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
CY06	7.2	7.4	-2.3
CY07	9.0	8.9	1.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
219	288	31.2	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(RS MILLION)
Y/E DECEMBER	**2004**	**2005**	**2006**	**2007E**	**2008E**
Net Sales	**99,269**	**110,605**	**122,535**	**135,870**	**150,317**
Change (%)	*-2.1*	*11.4*	*10.8*	*10.9*	*10.6*
Total Expenditure	-84,896	-96,172	-104,874	-114,172	-124,067
EBITDA	**14,374**	**14,433**	**17,660**	**21,698**	**26,251**
Change (%)	*-27.3*	*0.4*	*22.4*	*22.9*	*21.0*
Margin (%)	*14.5*	*13.0*	*14.4*	*16.0*	*17.5*
Depreciation	-1,209	-1,245	-1,320	-1,370	-1,420
Int. and Fin. Charges	-1,300	-192	-80	-80	-80
Other Income - Recurring	3,188	3,048	3,143	3,766	4,715
Profit before Taxes	**15,053**	**16,045**	**19,404**	**24,014**	**29,467**
Change (%)	*-32.9*	*6.6*	*20.9*	*23.8*	*22.7*
Margin (%)	*15.2*	*14.5*	*15.8*	*17.7*	*19.6*
Tax	-2,660	-2,530	-3,026	-3,698	-4,488
Deferred Tax	-547	-410	-485	-600	-737
Tax Rate (%)	*-21.3*	*-18.3*	*-18.1*	*-17.9*	*-17.7*
Profit after Taxes	**11,846**	**13,105**	**15,893**	**19,716**	**24,242**
Change (%)	*-32.6*	*10.6*	*21.3*	*24.1*	*23.0*
Margin (%)	*11.9*	*11.8*	*13.0*	*14.5*	*16.1*
Non-rec. (Exp)/Income	128	976	1,300	0	0
Reported PAT	**11,973**	**14,081**	**17,193**	**19,716**	**24,242**

BALANCE SHEET					(RS MILLION)
Y/E DECEMBER	**2004**	**2005E**	**2006**	**2007E**	**2008E**
Share Capital	2,201	2,201	2,201	2,201	2,201
Reserves	18,726	20,855	24,246	28,906	36,837
Net Worth	**20,927**	**23,056**	**26,447**	**31,107**	**39,038**
Loans	14,711	569	0	0	0
Capital Employed	**35,638**	**23,626**	**26,447**	**31,107**	**39,038**
Gross Block	23,142	23,751	25,251	26,251	27,251
Less: Accum. Depn.	-8,911	-9,896	-11,216	-12,585	-14,005
Net Fixed Assets	**14,231**	**13,855**	**14,035**	**13,666**	**13,246**
Capital WIP	944	980	980	980	980
Investments	22,296	20,142	22,521	31,231	42,342
Deferred Charges	2,260	2,201	2,142	2,167	2,193
Curr. Assets, L&A	**33,050**	**27,630**	**29,747**	**30,753**	**32,225**
Inventory	14,704	13,218	15,317	16,469	17,684
Account Receivables	4,893	5,228	5,371	5,584	5,766
Cash and Bank Balance	6,980	3,550	3,839	3,633	3,849
Others	6,472	5,634	5,219	5,067	4,926
Curr. Liab. and Prov.	**37,143**	**41,183**	**42,979**	**47,690**	**51,949**
Account Payables	20,292	23,450	25,170	27,972	30,396
Other Liabilities	10,773	11,572	11,604	12,255	12,804
Provisions	6,077	6,162	6,205	7,463	8,749
Net Current Assets	**-4,093**	**-13,553**	**-13,232**	**-16,937**	**-19,724**
Application of Funds	**35,638**	**23,626**	**26,447**	**31,107**	**39,038**

E: MOSt Estimates

RATIOS					
Y/E DECEMBER	**2004**	**2005**	**2006**	**2007E**	**2008E**
Basic (Rs)					
EPS	**5.4**	**6.0**	**7.2**	**9.0**	**11.0**
Cash EPS	5.9	6.5	7.8	9.6	11.7
BV/Share	9.5	10.5	12.0	14.1	17.7
DPS	5.0	5.0	5.5	6.0	6.5
Payout %	92.9	84.0	76.2	67.0	59.0
Valuation (x)					
P/E		36.9	30.4	24.5	19.9
Cash P/E		33.7	28.1	22.9	18.8
EV/Sales		4.2	3.7	3.3	-0.3
EV/EBITDA		31.9	25.9	20.7	16.6
P/BV		21.0	18.3	15.5	12.4
Dividend Yield (%)		2.3	2.5	2.7	3.0
Return Ratios (%)					
RoE	56.6	56.8	60.1	63.4	62.1
RoCE	45.9	68.7	73.7	77.5	75.7
Working Capital Ratios					
Debtor (Days)	18	17	16	15	14
Asset Turnover (x)	2.8	4.7	4.6	4.4	3.9
Leverage Ratio					
Debt/Equity (x)	0.7	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					(RS MILLION)
Y/E DECEMBER	**2004**	**2005E**	**2006**	**2007E**	**2008E**
OP/(loss) before Tax	13,165	13,189	16,341	20,328	24,831
Int./Div. Received	3,188	3,048	3,143	3,766	4,715
Depreciation and Amort.	1,209	1,245	1,320	1,370	1,420
Interest Paid	-1,300	-192	-80	-80	-80
Direct Taxes Paid	-2,660	-2,530	-3,026	-3,698	-4,488
(Incr)/Decr in WC	-679	6,030	-32	3,499	3,003
CF from Operations	**12,923**	**20,789**	**17,665**	**25,185**	**29,401**
Extraordinary Items	128	976	1,300	0	0
(Incr)/Decr in FA	-1,931	-645	-1,500	-1,000	-1,000
(Pur)/Sale of Investments	3,454	2,154	-2,379	-8,710	-11,111
CF from Invest.	**1,650**	**2,485**	**-2,579**	**-9,710**	**-12,111**
Issue of Shares	0	0	0	0	0
(Incr)/Decr in Debt	-2,332	-14,141	-569	0	0
Dividend Paid	-11,006	-11,006	-13,802	-15,057	-16,311
Others	-2,320	-1,557	-426	-625	-763
CF from Fin. Activity	**-15,659**	**-26,704**	**-14,797**	**-15,682**	**-17,074**
Incr/Decr of Cash	**-1,085**	**-3,430**	**289**	**-206**	**216**
Add: Opening Balance	8,065	6,980	3,550	3,839	3,633
Closing Balance	**6,980**	**3,550**	**3,839**	**3,633**	**3,849**

NOTES

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Disclosure of Interest Statement	Hindustan Lever
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No