Equity | India

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India Morning Meeting Notes

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Hindustan Unilever (HUVR IN, Rs274.25, Buy) – Worst-case margin decline fears recede

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(Extract from the report published on 9 September 2010)

HUVR's recent 6% price hike in its detergents portfolio suggests the worst of the price war in the category may be over. While the rises are largely to mitigate cost pressures, we see a positive impact on margins as we expect advertising spend to moderate from current high levels (17% of FMCG sales). Buy.

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue (Rsm)	206,235	177,253	192,048	217,088	241,150
EBITDA (Rsm)	30,402	27,500	28,942	34,863	40,010
Reported net profit (Rsm)	24,964	22,020	21,992	26,254	29,961
Normalised net profit (Rsm)[1]	25,007	21,027	21,792	26,254	29,961
Normalised EPS (Rs)	11.50	9.64	9.99	12.00	13.70
Dividend per share (Rs)	7.50	7.00	8.00	9.00	10.00
Dividend yield (%)	2.73	2.55	2.92	3.28	3.65
Normalised PE (x)	23.90	28.50	27.50	22.80	20.00
EV/EBITDA (x)	19.20	21.10	20.30	16.80	14.90
Price/book value (x)	29.00	23.20	19.70	16.20	13.30
ROIC (%)	214.4	363.4	386.3	174.3	163.1

1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts

year to Mar, fully diluted

Pricing power returns as competitive pressure subsides

Trade sources indicate HUVR has raised prices of its *RIN* detergents (the brand that saw most competition) by 8%, with arch rival P&G having effected a 12% price rise in its competing *TIDE* brand by adjusting freebies and grammage. The moves follow last month's 3-7% hike by HUVR in its soaps portfolio, with Godrej consumer also announcing a plan to raise prices via grammage adjustments. HUVR's weighted average price hike in detergents is now 6%, while that in soaps is 4-5%. We clearly see pricing power returning to HUVR as competition subsides with firms now willing to raise prices to ward off inflationary pressure.

Important disclosures can be found in the Disclosures Appendix.

Volume growth strong, margins can only rise from here

Our channel checks indicate that HUVR is continuing to record double-digit volume growth in 2QFY11. With 10% volume growth for the third quarter in a row, we see clear reason to lower the current high advertising spend in 2HFY11. While the detergent price rises are largely to neutralise the impact of rising raw material costs (soda ash, palm oil and lab prices up 15%, 24% and 6% in the last 10 months), we expect revenue growth to pick up on better realisations. We believe the price rise may kick in only in 2HFY11 (given the time involved in getting products with the new prices on the shelves). We expect EBITDA to remain flat in 2Q11F (vs 4.8% de-growth in 1Q11), but expect it to grow 13% yoy in 2HFY11 and then 20% in FY12. Margins in soaps and detergents will improve from 11% in 1Q11 to 13% in FY12F.

We increase FY12-13F earnings by 3%; reiterate Buy

We raise our FY12-13 earnings estimates by 3% to factor in easing competitive pressure; our EPS forecasts are now 6% above Bloomberg consensus for FY12. This raises our DCF-based target price to Rs312 (from Rs285). With the excellent monsoon in 2010 and HUVR's push on rural distribution, we expect the improving macro environment to raise general volume growth for the sector and, hence, lower competitive intensity. Buy.

Sun Pharmaceutical (SUNP IN, Rs1745.55, Sell) – Taro – respite for Sun's US business

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(Extract from the report published on 10 September 2010)

While Taro is a good strategic fit for Sun's US business and seems to us value accretive, currently we do not attribute any value due to concerns about the credibility of Taro's financials and potential risk of deterioration in Taro's production facilities. We maintain a Sell on rich valuations; raise our TP to Rs1,500.

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue (Rsm)	41,833	38,086	49,241	53,838	61,932
EBITDA (Rsm)	18,639	12,416	17,702	18,682	21,490
Reported net profit (Rsm)	18,177	13,511	15,825	16,460	18,703
Normalised net profit (Rsm)[1]	18,177	14,205	15,825	16,460	18,703
Normalised EPS (Rs)	87.80	68.60	76.40	79.50	90.30
Dividend per share (Rs)	13.80	13.80	13.80	13.80	13.80
Dividend yield (%)	0.79	0.79	0.79	0.79	0.79
Normalised PE (x)	19.90	25.50	22.80	22.00	19.30
EV/EBITDA (x)	18.60	28.80	20.10	18.80	16.10
Price/book value (x)	5.13	4.62	3.98	3.48	3.03
ROIC (%)	28.90	12.50	14.00	12.70	13.30

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts

year to Mar, fully diluted

Taro acquisition getting closer; we consider it a positive

We believe Sun Pharma is finally close to gaining control on Taro (more than three years after the initial offer was made) post the favourable ruling of the Supreme Court of Israel. While there could be some delay in getting control of Taro, as Levitt's (founder promoters) might ask for a review of the judgement, we believe Sun Pharma could gain control by the end of FY11. We also believe Taro would provide a good strategic fit to Sun Pharma due to its presence in derma products in the US. With market concerns over the credibility of Taro's financials due to a lack of audited figures, along with frequent restatements of past financials, we currently do not incorporate financial estimates for Taro. However, we believe Sun's share (54.5% stake post buying out founder promoter's stake and conversion of warrants) in Taro could add upside of Rs55-73/share.

Potential risk of deterioration in Taro's facilities could be a key challenge

While we are cognisant of the impressive track record of Sun's management for turning around smaller companies, we note that potential deterioration in Taro's production facilities due to a lack

of focus and investment by earlier promoters could be challenging to handle. We believe greater disclosure on Sun's management structure would be comforting as the company braces to turn around the sizeable acquisition of Taro (with annual revenues equivalent to about 40%+ of Sun's FY10 revenues). This is needed more than ever, with Sun currently addressing three US FDA warning letters – Caraco (October 2008), Sun Pharma Inc. (August 2010) and now Taro (Feb 2009).

Modest upgrades to core forecasts; raise TP by 6%; maintain Sell

We upgrade our core and reported FY11 EPS estimates by 5% and 16%, respectively, as we build in higher one-offs. We continue to value Sun Pharma's core business on a par with the sector multiple at 22.9x FY11F core EPS (Rs64) and Rs30 for its one-offs, resulting in a 6% increase in our target price to Rs1,500/share. Maintain Sell on rich valuations.

Alert | India – Implications of strong industrial activity

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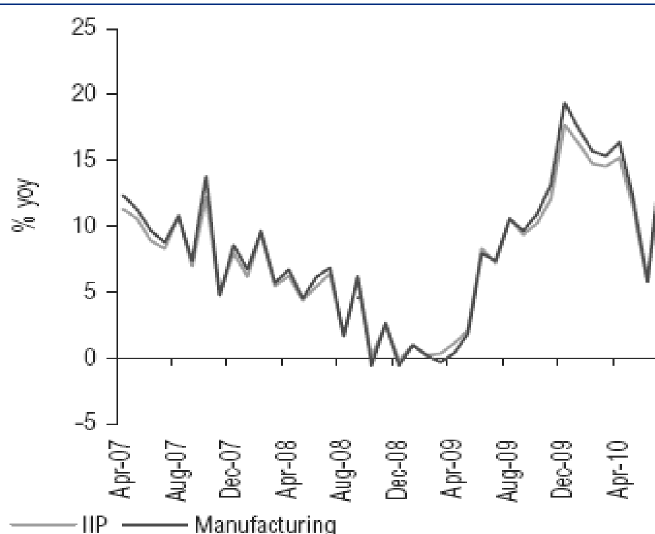
Following the hawkish July policy statement, the combination of global economic uncertainty, slowing to stabilising inflation/manufacturing output and static non-food credit demand had suggested that the RBI would signal a pause after a 25bps repo/reverse repo rate hike on September 16. July's unexpectedly strong industrial production data, however, contradicts a 'pause' in rate hikes beyond September. This rebound coupled with the on-going widening of the trade gap suggests that barring a material worsening of global economic activity, the RBI is unlikely to take its foot off the pedal anytime soon. We continue to think that 100 bps of rate hikes are likely over the next 12 months.

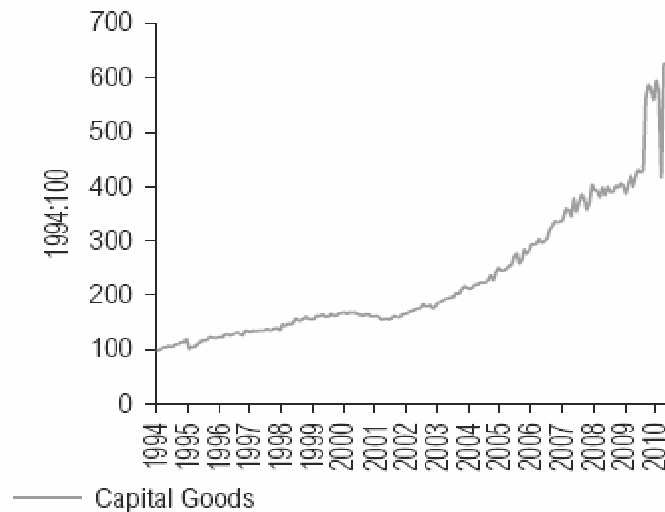
Details: July industrial production expanded 13.8% yoy with the dominant manufacturing component by 15% yoy. In fact, on a seasonally adjustment mom basis, we estimate that the manufacturing sector rebounded 9.3% yoy, snapping a six month phase of negative to flat growth. The breadth of the data was also good with both capital and consumer goods rising sharply. Capital goods output increased 63% yoy during the month while seasonally adjusted index for the series reached a multi-year high. Consumer durables output increased 22% yoy but slipped marginally on a mom basis – this should be temporary considering the on-going strength in various individual product sales such as autos. Overall we find little reason to doubt India's domestic demand story or its independence from activity in the tradables sector.

Figure 1 : Trends in industrial output



Source: CEIC, RBS

Figure 2 : Trends in industrial output

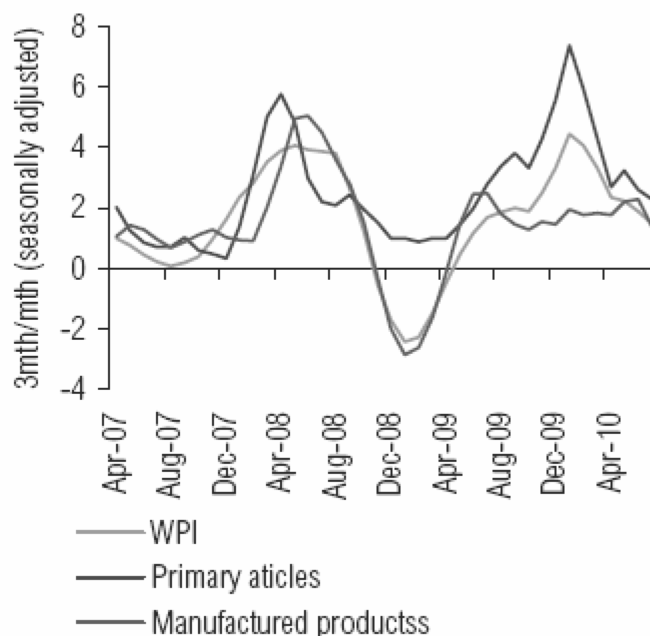


Source: CEIC, RBS

To the extent, the industrial rebound is coming at a time of easing inflationary pressures is a positive This is because the rising trade deficit continues to call for a monetary restraint. In Q1 FY11 (fiscal year development. Even though, yoy readings remain sticky high, the mom momentum is clearly slowing as evident from Figure 3. Non-food credit growth is also showing signs of stabilisation. Unfortunately, this combination is not good enough to revert to a neutral policy stance.

This is because the rising trade deficit continues to call for a monetary restraint. In Q1 FY11 (fiscal year ending March 2011), the monthly trade deficit had jumped to USD11bn from USD12.9bn. Of course, India along with other emerging markets has benefited from low interest rate induced portfolio flows from developed countries but the point to note is that portfolio flows are volatile and have become more so post-Lehman. Moreover, growing policy obstacles to resource sector FDI may well dampen sentiment and sour portfolio flows.

Figure 3 : Momentum in inflation by major component



Source: CEIC, RBS

Accordingly, there is a need for continued rate hikes in India. We continue to expect 100bps of rate hikes over the next 12 months.

Defence and Aerospace: Global vendors demand offset outside defence

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- The Government of India is likely to announce a new Defence Procurement Policy in 2010, which is currently in the drafting stage.
- Global defence vendors (through industry associations and bodies) have sent their suggestions to Defence Minister A. K. Antony:
  1) Raise the FDI limit in defence, currently at 26%, to 74%, to enable technology transfer of some of the best systems.
  2) Offset be allowed outside defence, where vendors can meet their obligation in non-defence, civilian industries as well. The current offset is only direct offsets – ie, offset in defence products itself.
  3) An offset multiplier that would be based on the need for technology transfer, and not the uniform treatment currently in place. For example, if some high-end technology is offered, vendors can offer offset credit, which can be a multiple of the current 30%.
  4) A separate offset authority that would be in charge of offset activities.
  5) Limit financial liabilities in defence contracts.

Our view

- Raising the FDI limit has been debated often, but the Ministry of Defence (MoD) does not appear very inclined to go beyond the current 26%. It is likely to maintain this stance.
- Offset outside defence also may not be viewed well since the MoD is targeting indigenisation and increasing local procurement within defence.
- An offset multiplier might be considered, as it is a bargaining tool to procure higher-end technology.
- A separate offset authority would be positive, as it will streamline activities. Defence contracts (and their offsets) take a long time to process currently.
- Limiting financial liabilities might not be taken up by the ministry, as it does not seem to be a politically viable option based on the government's recent experience with the Nuclear Liability Bill.

In the sector, we recently initiated coverage on Bharat Electronics (BHE IN, Rs1,709.10) with a Buy rating and believe it is the best defence capex play in India. The stock trades at 16x FY11F earnings.

Coal India (Unlisted) : Highlights of meeting with management of Central Coalfields Ltd.

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Mgmt. meeting notes : Central Coalfields Ltd (wholly owned subsidiary of Coal India Ltd.)

We met recently met with the management of Central Coalfields Ltd. (CCL), a wholly owned subsidiary of Coal India Ltd. that operates six coal fields in Bihar and Jharkhand. With 40bn tonnes in total reserves, CCL produced 47mt of coal in FY10 and generated net revenues of Rs66bn.

Key highlights

Significant volume expansion: CCL has various mining projects being implemented, which should take mining capacity from 47mt in FY10 to 78mt by FY12. The company has seven washeries that produced 9mt of washed coal in FY10. The company expects its washery capacity to expand significantly in the coming years.

Wide product mix: The company produces almost all grades of coking and non-coking coal. Its average non-coking coal grade is C-D, with about 40-45% ash content.

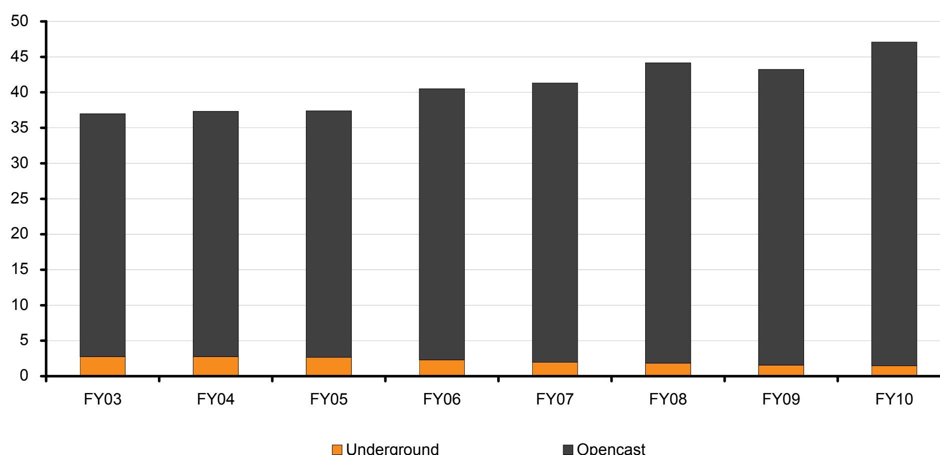
Outsourced production: Of the total production of 47mt in FY10, production of 25mt was outsourced through competitive bidding. Contracts are typically for coal removal, while the overburden is removed by the company itself.

Evacuation: Due to safety concerns, transportation of coal through the night is affected. The company had stock of 16mt of raw coal in FY10, vs 13mt in FY09.

Strong working capital management: The company receives 90% of its payments in advance from customers, the largest ones being NTPC and the state electricity boards of Punjab and Uttar Pradesh. We expect this strong debtor management across Coal India, and it partly explains Coal India's cash balance of US$8bn.

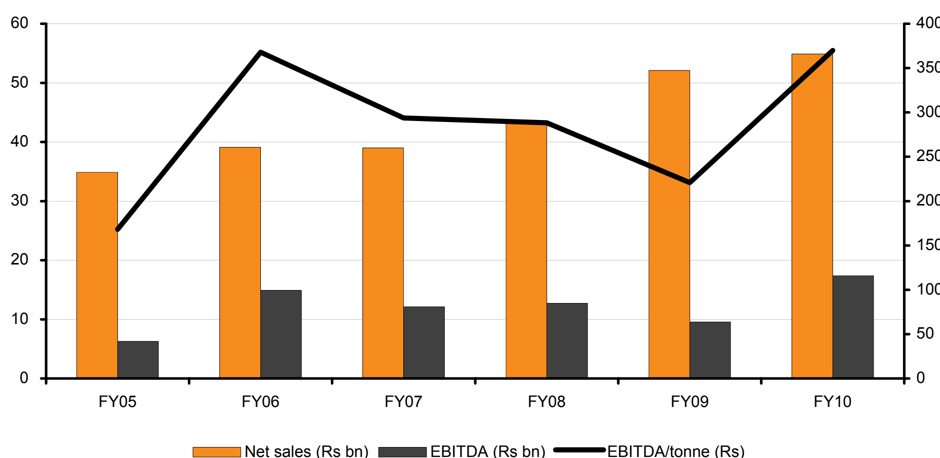
Financials: The company earned EBITDA of Rs17bn in FY10, vs Rs9bn in FY09. Net profit was Rs10bn in FY10, vs Rs5bn in FY09.

Chart 1 : CCL: Coal production volumes by mine type



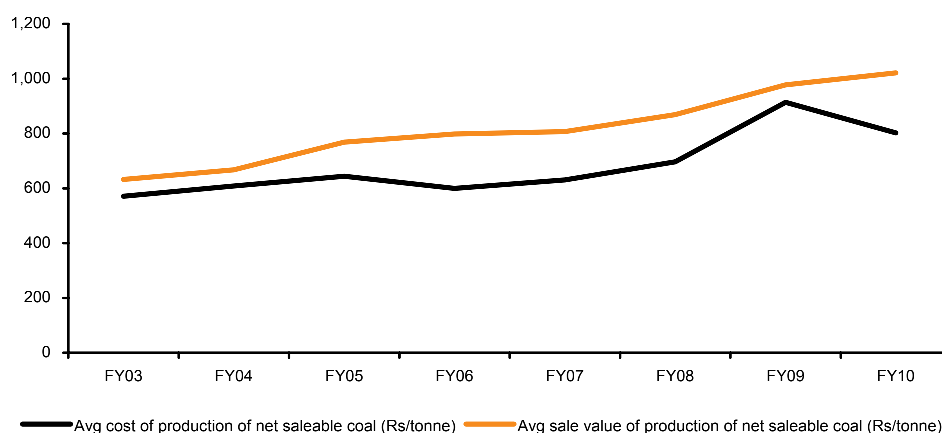
Source: Company data

Chart 2 : CCL: Operational performance



Source: Company data

Chart 3 : CCL: Financial performance



Source: Company data

Tata Steel (TATA IN, Rs593.65, Buy) – Sale of group company shares of US$150m from listed group company holdings of US$900m

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As per recent announcements, Tata Steel sold a portion of its investments in Tata Motors and Tata Power for Rs70bn (US$150m).

This concludes a series of transactions aimed at raising cash. They are as follows:

- 1) issue of shares to promoters – US$230m;
- 2) sale of 27% stake in Southern Steel Berhad – US$70m;
- 3) sale of TCP unit – US$500m; and
- 4) sale of stock of Tata Motors and Tata Power – US$150m,
- **adding to – US$950m**.

This takes care of cash flow needs for the near future. We anticipated a shortfall of US$1bn during the year due to increased working capital requirements stemming from higher raw material prices.

Tata Steel is still holding Rs34.48bn (US$735m) of stock in Tata Motors, Tata Power and Tata Teleservices, which could be divested to meet cash flow requirements. We believe divestment of non-core assets is a positive move for Tata Steel.

We have not considered these investments for our valuations because they were previously considered as part of core holdings and not meant for sale.

This sale would lead to a one-time gain of Rs6.2bn over the cost of sale. These gains would be treated as long-term capital gains, and hence exempt from tax. It would add Rs7 to EPS, but would be an exceptional item.

If the remaining stock of US$750m is sold, it would yield a long-term capital gain of Rs29.36bn (or Rs33/share), or about 40% of the current year's expected PAT, but would be treated as an exceptional item.

We have a Buy rating on Tata Steel, with a target price of Rs725 per share.

Table 1 : Schedule of Investments as of 31 March 2010

	Book value	Number of shares	CMP	Market value	Shares sold	Value of investment sold	Mkt value of investments post sale	Possible future sales
	Rsbn	m	Rs	Rsbn	m	Rsbn	Rsbn	Rsbn
Long-term investments								
Tata Motors	3.0	34	1,039	35.6	4.7	4.9	30.7	30.7
Tata Power	0.6	3	1,288	4.4	1.65	2.1	2.3	2.3
Tata Industries	0.7	6		0.7			0.7	
Tata Teleservices	1.3	63	24	1.5			1.5	1.5
Tinplate Company	1.1	31	77	2.4			2.4	
Dhamra Port	2.5			2.5			2.5	
Tata Bluescope Steel ltd	3.3			3.3			3.3	
Others	5.3			5.3			5.3	
Trade investments:	17.8			55.6		7.0	48.6	34.48
Subsidiary companies								
Millennium Steel	-			-				
Kalamati Investments	0.9			0.9				
Tata Refractories	0.9			0.9				
NatSteel Asia	7.7			7.7				
Hoogly Metcoke & Power	-			-				
Others	5.2			5.2				
Investments in TS holdings	400.1			400.1				
Subsidiary companies	414.8			414.8			414.8	
Current investments	17.2			17.2			17.2	
Standalone investment summary	449.8			487.6			463.41	

Source: Company data, RBS forecasts

Larsen & Toubro (LT IN, Hold, target price Rs1912) – Highlights of meeting with L&T IDPL (infra subsidiary) head

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Summary and view

At a recent analysts' meeting, L&T's head of infra subsidiary, K Venkatesh, made a presentation. L&T IDPL contributes about 5% to our current SOTP target price of Rs1912 per share, valued at 1.5x total equity invested as of June 2010. In the wake of the meeting, we maintain our neutral stance on the company and our Hold rating. The stock currently trades at 26x FY11F, adjusted for subsidiaries. Companies' funding requirements in subsidiaries will continue and this will cap return ratios over the next couple of years and may lead to periodic fund raising. Thus, although we believe the macro outlook for L&T remains exciting in terms of opportunities in the infrastructure space, subdued return ratios could limit valuation upside.

Key takeaways from the presentation

The presentation detailed the scenario and opportunities in India, an overview of IDPL's current portfolio, and the strategy going forward.

Strategy

- L&T IDPL plans to focus on three to four key sectors, such as roads, airports, ports and railways (including metros). Outside these sectors of infrastructure, the company plans to continuously monitor the environment and take up interesting projects that may become available.
- There will not be further real estate projects in IDPL, apart from what is already in the current portfolio.
- The company is now considering a critical ticket size of Rs10bn for projects (up from Rs5bn in previous discussions with the company) in order to have better spread of resources over a larger scale.

- The environment in roads remains challenging in the absence of a regulator and given tardiness in awarding projects.
- Railways was identified as the next big opportunity, since there is limited competition in that space and concession periods are longer, making it attractive for a project developer.

Current portfolio

- The company currently has Rs402bn in assets, and equity investments made so far total Rs33bn. The FY10 turnover was Rs14bn and EBITDA was Rs12bn, including divestment of BIAL, worth Rs7bn.
- The company's current portfolio is as follows:
    - 13 road projects, of which 7 are operational and 8 are under construction, with a total project value of Rs130bn;
    - two port projects – Dhamra and Katupally – valued at Rs53bn;
    - one metro project – Hyderabad Metro– valued at Rs150bn (including interest during construction and consultancy charges); and
    - 19 real estate projects encompassing a total of 28m square feet, of which five are completed. The value is Rs89bn.

Funding

- The company would require an average fund infusion of Rs10bn-12bn per year for the next five years. This includes funding required to buy out private equity funds (JP Morgan and IDFC PE), which hold about 15% in IDPL.
- Buying out the private equity partner is a precursor to a possible IPO, but the company mentioned that it is still two to two-and-a-half years away from an IPO.

Hyderabad Metro

- The Hyderabad Metro project was discussed at length, and the company stated that it has a threshold IRR of 18% as per its internal calculation.
- The project, a 71km stretch with 66 stations, costs Rs150bn, with execution of five years and a concession of 30 years, with an additional 25-year extension.
- The project comes with real estate of 18.5m square feet, which the company plans to roll out in phases over 13 years.
- The long-term mix of revenue is 55% from ticket sales (ridership) and 45% from real estate rentals and advertisements.

News headlines

Corporates

Oil & Gas

- RIL completes deal for 60% stake in Marcellus Shale asset (Economic Times)
- Shale gas auctions by 2nd half of 2011: Sundareshan (Economic Times)
- Govt yet to decide on Cairn-Vedanta deal: Oil Secy (Economic Times)
- ONGC to finalise BP Vietnam asset valuation in few weeks (Economic Times)
- Fire at GAIL plant in Auraiyya; dy manager killed (Economic Times)
- IOC, ONGC divestment by Q4, to fetch Rs190bn: oil secy (Business Standard)

Banks

- RBI-constituted panel proposes new law to make banks more accountable to customers (Economic Times)
- ICICI Bank wins World Finance Awards 2010 in three categories (Economic Times)
- Deutsche Bank to raise euro 9.8bn to buy Postbank (Business Standard)
- Dhanlaxmi aims Rs10bn NRI deposit base by FY11-end (Business Standard)

Pharma

- Rivals may join hands for Paras buy (Economic Times)
- Natco Pharma open to settle cancer drug patent case with US co (Economic Times)
- Elder Health Care to invest Rs1.2bn in next 3 years (Economic Times)
- Dr Reddy's plans to spend Rs16bn for capacity expansion in two years (Business Standard)
- Troikaa Pharma gets patent approval for Dynapar AQ in CIS (Business Standard)

Commodity

- IFGL Refractories buys 2 US cos for Rs590mn (Economic Times)
- Miners may've to share revenues with displaced (Economic Times)
- CIL in talks with Shipping Corp to form JV for coal imports (Economic Times)
- Posco to get land soon for Rs540bn project: Steel Minister (Economic Times)

Retail/ Real Estate

- Hard times over for realty; DLF launching ultra-rich homes (Economic Times)
- Rodium Realty eyes strategic investor, to enter Gujarat (Economic Times)
- DLF's ready-to-occupy luxe apartments in TN (Economic Times)

IT & Telecom

- HCL Technologies to develop IT infra for prisons in New Zealand (Economic Times)
- Telecom and defence ministries to cut spectrum-division deal (Economic Times)
- BSNL to spend Rs450mn for restoring network in Leh (Economic Times)
- Vodafone verdict not to dampen cross-border mergers: E&Y (Economic Times)
- HCL Tech eyes emerging markets for infra deals (Business Standard)
- Mahindra Satyam's new biz model (Business Line)

Power, Engineering & Infrastructure

- BHEL to float non-banking finance firm to fund power projects (Economic Times)
- SC to hear Tata plea on R-Power's coal usage on Monday (Economic Times)

- Nagarjuna Construction may relocate Andhra power project (Economic Times)
- Rowghat mining project in trouble, so is BSP expansion plan (Business Standard)

Automobiles

- Maruti to use high strength steel in its variants by 2012 (Economic Times)
- Car sales soar 33% to record high in August (Economic Times)
- Merc India MD Wilfried Aulbur quits (Business Standard)
- Mahindra working on small petrol engines (Business Standard)

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