Flashnote

HSBC Global Research

Consumer Brands & Retail
India Consumer
Equity – India

Indian FMCG

Sales slow slightly, margins surprise

- **Trends from FMCG results indicate a slowdown in sales as realisation gains are absent, and food inflation hits demand**
- **HPC gross margins were healthy due to sales mix and the last of low-cost inventory; foods margin impacted by cost inflation**
- **We think the earnings upgrade story is nearing the end for most FMCG stocks – we prefer ITC, an exception to this rule**

Results validate our cautious stance: FMCG Q4 FY10 results to date (Dabur, Marico, Nestle, GCPL) support our cautious stance on the sector. Sales growth is slowing due to high food cost inflation, competitive pressures and lack of price increases. While gross margins were higher than estimated due to some low-cost inventory, product mix changes, and promotional activity, we believe that companies may find it difficult to continue to expand margins any further.

Near-term upside limited, but long-term fundamentals intact: Overall, we believe that the EPS upgrade story in the sector, which has been going on over the last 9-12 months, is now nearing an end. With valuations for most stocks above historical averages, and a lack of earnings upside surprises, we view any near-term upside as unlikely. However, longer-term demand trends are intact on the back of government spending in the social sector, an increase in frequency of usage, and up-trading.

ITC is our top pick. We prefer ITC (ITC IN, OW, INR265, TP INR315) as it is relatively unaffected by commodity price inflation and competition, the two major risks in the FMCG sector currently. We believe that price increases taken on cigarettes are ahead of those necessary to offset tax increases, resulting in 18% EBIT growth and 21% EPS growth in cigarettes. Our EPS forecast is the highest on the Street and we believe that ITC is an exception to our thesis that the earnings upgrade story for FMCG is nearing its end.

Also like Asian Paints and Nestle. In addition to ITC, we also like (1) Asian Paints (APNT IN, OW, INR2,075, TP INR2,380) as we think it will be a beneficiary of the uptick in consumer discretionary spends and up-trading, while operating in a relatively benign competitive environment; and (2) Nestle (NEST IN, OW, INR2,761, TP INR3,110) as we believe it will be the main beneficiary of the growth in the underpenetrated and fast-growing F&B sector in India, again with relatively low competition. While near-term upside on these stocks may be limited, we are positive on the longer-term potential on the back of strong growth.

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Trends from recent results

Sales

Top line growth was slightly muted and below our estimates. This was on account of a lack of price increases vs Q4 FY09 and some impact on demand due to food inflation. For Dabur, while sales growth was 16%, organic sales growth was c12%, mostly via volume. While GCPL posted 48% sales growth, in line with estimates, the standalone company reported sales growth of just 2%, below expectations, due to tough comps last year and a pipeline inventory correction. Nestle was impacted as price increases did not happen as expected, and here too most of the growth was volume-led. Marico suffered from a net realisation decline due to input cost deflation being passed onto consumer.

Sales growth y-o-y %

	Dabur	GCPL	Marico	Nestle
Estimated Mar 10	17.0%	50.0%	10.0%	20.0%
Actual Mar 10	16.0%	48.1%	6.4%	16.9%
Dec 09	18.9%	53.1%	7.8%	25.3%
Sep 09	22.7%	65.4%	14.4%	17.6%
Jun 09	23.0%	21.4%	16.8%	16.8%
Mar 09	18.8%	26.1%	20.5%	16.0%

Source: Company, HSBC

Gross margins

Gross margins were higher than estimated for most companies. For GCPL, mix change (less of low margin soaps) led to an expansion. For Marico, some promotional spends included in COGS in previous quarters were not present this quarter, bumping up the margins. For Nestle, however, margins were lower as food input costs went up sooner than for home and personal care companies, and price increases are being taken in a phased manner.

Gross profit margins

	Dabur	Godrej	Marico	Nestle
Estimated Mar 10	54.4%	52.3%	50.7%	51.0%
Actual Mar 10	54.7%	55.5%	56.1%	50.2%
Dec 09	54.6%	52.5%	52.7%	51.8%
Sep 09	55.0%	52.8%	52.9%	52.2%
Jun 09	52.5%	53.9%	49.7%	52.4%
Mar 09	50.9%	49.1%	49.2%	52.8%

Source: Company, HSBC

Overheads

There was no clear trend for overheads for the quarter (overheads consist of employee costs, A&P costs, and other expenditures). While this metric was lower than expected for Dabur and GCPL, it was higher than anticipated for Marico and Nestle.

Overheads growth yoy

	Dabur	Godrej	Marico	Nestle
Estimated Mar 10	19.3%	79.2%	19.1%	15.5%
Actual Mar 10	16.4%	71.0%	23.0%	22.2%
Dec 09	29.9%	81.1%	-21.4%	38.0%
Sep 09	26.8%	75.9%	-24.9%	20.8%
Jun 09	25.3%	31.6%	-20.9%	13.5%
Mar 09	14.6%	0.9%	-6.0%	11.4%

Source: HSBC, Company

A&P percentage sales

We have seen that, on average, A&P has been in line with expectations, remaining at a high level, as was the case with the previous three quarters of this year, but showing a big jump on a yoy basis and vs FY09. This is on the back of increased competitive activity and because, as gross margins have expanded, all players are investing in ad spends to grow the market.

A&P % sales

	Dabur	Godrej	Marico	Nestle
Estimated Mar 10	14.0%	8.5%	12.8%	NA
Actual Mar 10	13.6%	6.8%	14.8%	NA
Dec 09	14.6%	8.4%	12.8%	NA
Sep 09	14.2%	8.9%	13.2%	NA
Jun 09	15.3%	9.9%	12.2%	NA
Mar 09	12.2%	4.5%	10.1%	NA

Source: HSBC, Company. Note Nestle does not report A&P on quarterly basis

EBITDA margins

EBITDA margins have, on average, been higher than estimated, as a result of higher gross margins as mentioned before.

EBITDA margins

	Dabur	Godrej	Marico	Nestle
Estimated Mar 10	18.7%	16.8%	14.3%	24.1%
Actual Mar 10	20.2%	21.1%	14.1%	20.9%
Dec 09	19.6%	19.7%	14.8%	15.1%
Sep 09	21.4%	19.6%	13.7%	20.7%
Jun 09	16.5%	19.9%	13.8%	22.1%
Mar 09	17.7%	19.3%	13.1%	24.9%

Source: HSBC, Company.

EPS growth

EPS growth has also been higher than estimated due to higher EBITDA and gross margins, as described above. However, growth has come down substantially vs previous quarters due to tough comps on input costs.

EPS growth y-o-y

	Dabur	Godrej	Marico	Nestle
Estimated Mar 10	12.9%	1.6%	1.1%	22.0%
Actual Mar 10	27.9%	30.4%	4.6%	2.3%
Dec 09	28.2%	78.1%	29.2%	-7.0%
Sep 09	29.9%	123.7%	50.1%	38.7%
Jun 09	28.2%	67.3%	29.8%	33.8%
Mar 09	17.1%	26.2%	97.1%	23.2%

Source: HSBC, Company.

Valuation and risks

ITC (OW): We value ITC on a SOTP basis at INR315 per share. We value the cigarettes business, which is the major part of the valuation, at 21x PE, in line with global peers, adjusting for higher growth rates and better ROEs.

ITC: SOTP valuation (INR)

Basis	Business	Multiple	Per share (Dec'11)	Price
EPS	Cigarettes	21.0x	12.0	252
	Hotels	15.0x	0.7	10
	Agribusiness	6.0x	1.0	6
	Paperboards	5.0x	1.8	9
Sales	FMCG - Others	1.5x	13.5	20
Cash	Cash per share			17
Target price				**315**

Source: HSBC

Downside risks include volume backlash to price increases being higher than estimated; a slowdown in consumer spending that reduces volume growth; increased losses on the FMCG business; and PE multiple contraction in the event of a significant economic downturn.

Asian Paints (OW): We value Asian Paints at INR2,380 based on 23x EPS (5% premium to average multiples to account for accelerated sales growth).

Downside risks to our call are margin contraction being higher than expected due to cost inflation; the demand scenario worsening; and competitive intensity increasing.

Nestle (OW): We value Nestlé India at INR3,110 at 28x EPS. Nestlé shares have traded at an average multiple of 24.4x over the past three years. However, given the company's robust volume growth and improved ROE, we believe the stock deserves a 15% premium to its historical average.

Downside risks include declining exports to Russia and the potential inability of Nestlé to make up for this; premium pricing of new launches; pressure on margins more than anticipated if commodity costs increase beyond our expectations; increased competition from Indian FMCG giants and global players; and low liquidity in the stock.

Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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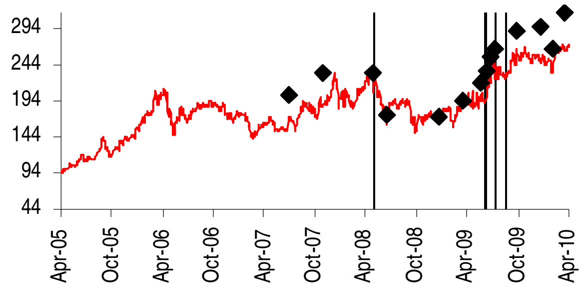
Overweight (Buy)	48%	(12% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(11% of these provided with Investment Banking Services)
Underweight (Sell)	14%	(10% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

ITC (ITC.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

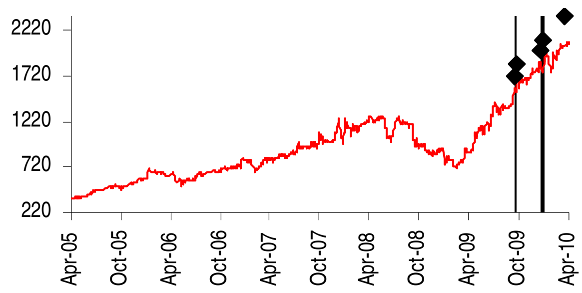
Recommendation & price target history

From	To	Date
Overweight	Neutral	23 May 2008
Neutral	Overweight	06 July 2009
Overweight	Neutral	05 August 2009
Neutral	Overweight	14 September 2009

Target Price	Value	Date
Price 1	201.00	27 July 2007
Price 2	233.00	26 November 2007
Price 3	231.00	23 May 2008
Price 4	175.00	16 July 2008
Price 5	172.00	20 January 2009
Price 6	193.00	17 April 2009
Price 7	218.00	15 June 2009
Price 8	234.00	06 July 2009
Price 9	254.00	23 July 2009
Price 10	264.00	05 August 2009
Price 11	290.00	23 October 2009
Price 12	295.00	18 January 2010
Price 13	265.00	01 March 2010
Price 14	315.00	16 April 2010

Source: HSBC

Asian Paints (ASPN.BO) Share Price performance INR Vs HSBC rating history



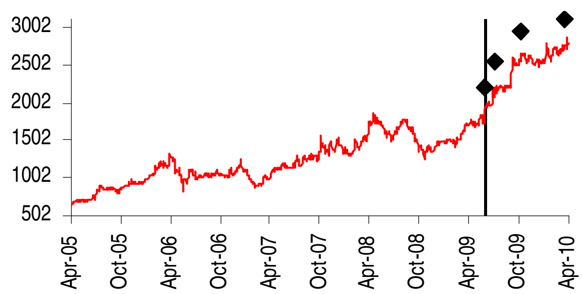
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	12 October 2009
Overweight	Neutral	18 January 2010
Neutral	Overweight	24 January 2010
Target Price	**Value**	**Date**
Price 1	1720.00	12 October 2009
Price 2	1850.00	22 October 2009
Price 3	2015.00	18 January 2010
Price 4	2125.00	24 January 2010
Price 5	2380.00	16 April 2010

Source: HSBC

Nestle India (NEST.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/R	Overweight	29 June 2009
Target Price	**Value**	**Date**
Price 1	2210.00	29 June 2009
Price 2	2550.00	31 July 2009
Price 3	2950.00	02 November 2009
Price 4	3110.00	16 April 2010

Source: HSBC

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Company	Ticker	Recent price	Price Date	Disclosure
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Source: HSBC

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