Edelweiss
Ideas create, values protect

FMCG

Ten reasons why we currently prefer ITC over HUL

Abneesh Roy

+91-22-6620 3141

abneesh.roy@edelcap.com

Ajay Thakur

+91-22-6620 3031

ajay.thakur@edelcap.com

January 12, 2009

ITC likely to outperform HUL

Edelweiss
Ideas create, values protect

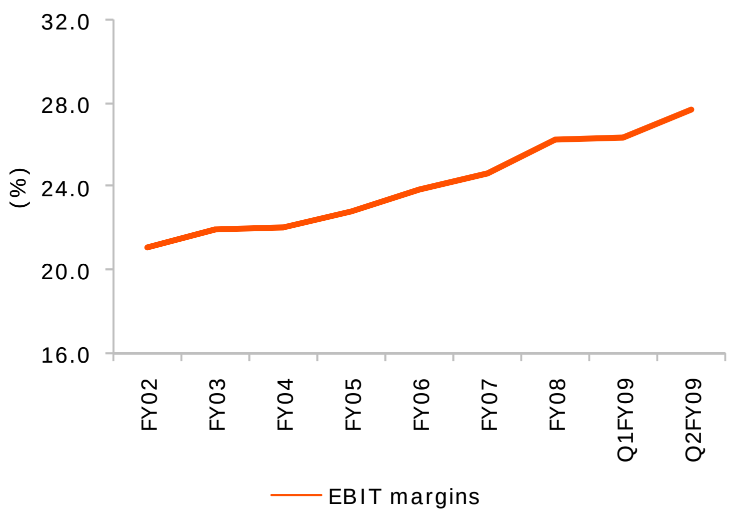
- We continue to remain positive on both HUL and ITC in the FMCG sector over the long term and expect them to outperform broader markets.
- We believe strong rural demand (largely inelastic demand), strong pipeline of innovations targeting the upper end of the urban consumer, and sharp fall in raw material prices will continue to be strong growth drivers for both.
- However, over the medium term, we expect ITC to outperform HUL:
  - **HUL unlikely to re-rate:** HUL outperformed Sensex by ~70% over the past one year, and is trading near its peak at over 150% premium over Sensex. Factors like imminent price cuts/promotions by Procter & Gamble (P&G) and regional players, slowing volume growth for HUL, loss of market share in key categories, and a less harsh winter (HUL's personal care growth is likely to take a hit in Dec quarter) are likely to cap any significant upsides to HUL from current levels on an absolute basis.
  - **ITC likely to re-rate:** ITC has been trading at lower end of its trading band at 17x one year forward P/E and has underperformed HUL by ~40% over the past one year. We expect ITC to re-rate from current levels as good performance in cigarettes gets rewarded, supplemented with the likelihood of a soft budget for cigarettes (in June/July) and easing of FMCG losses , coupled with gains in market share in soaps and shampoo (already at ~2.5%; up from ~1.5%, a quarter back).

Reason #1 - Pricing power comes to the fore

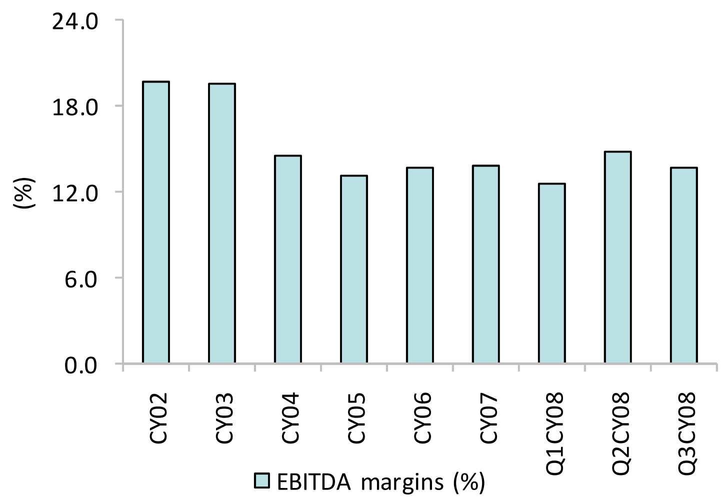
Edelweiss
Ideas create, values protect

- Pricing power of ITC is stronger than HUL, given relatively in-elastic demand profile of cigarettes and ITC's ~80% market share. This translates into increasing margins for ITC.
- We expect HUL to face pressure as both P&G and regional players like Ghadi, Cavin Care will resort to price cuts/promotions in order to gain market share (it has already started in the soaps). HUL has already cut prices of Lifebuoy.

ITC – Cigarette-EBIT margins



HUL –EBITDA margins

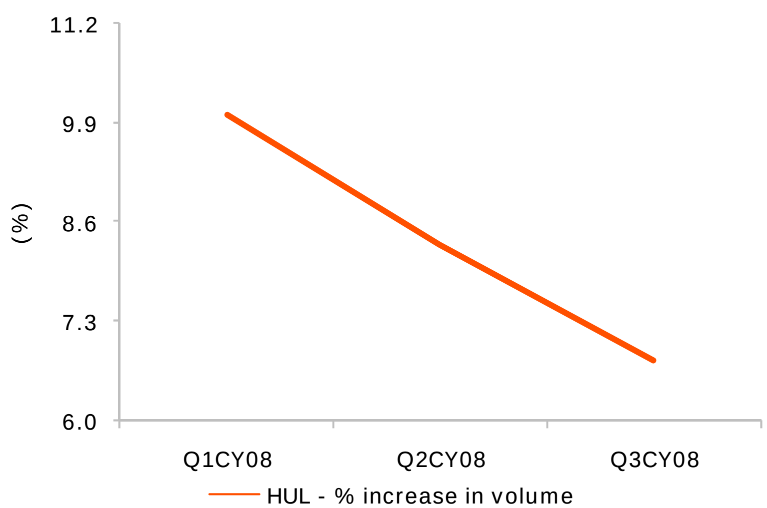


Source: Edelweiss research, Company

Reason #2 – Volume game

- ITC's price hikes in its bread and butter cigarettes segment (contributes ~80% of ITC's EBIT) hasn't affected volumes in a significant manner.
  - ~1% volume decline in FY08 (as against consensus expectations of 5-7%).
  - ~3% volume decline expected in FY09 (as against consensus expectations of 8-10% initially).
  - Ban on public smoking had a negligible impact in the first three months.
  - HUL is facing pressure on volumes post price hikes in various categories.

HUL - % volume growth – CY08



Volume growth for key catagories for HUL

Category	CY05	CY06	CY07
Soaps	1.0	5.8	1.5
Detergents	*10.6*	*7.5*	*6.5*
Personal Care	26.0	21.7	10.0
Tea	*11.5*	*(7.3)*	*(6.5)*
Coffee	0.6	0.8	(7.6)

Source: Edelweiss research, Company

Reason #3 - Creator of new brands/ new product

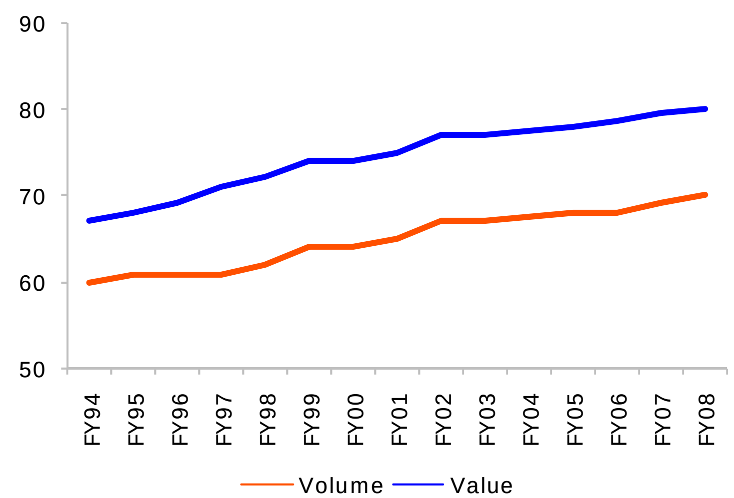
Edelweiss
Ideas create, values protect

- ITC has clearly been the best FMCG company in terms of creation of new brands and successful entry in new categories.
- Key successes of ITC: Salty snacks (*Bingo* has sales of ~INR 3 bn with a ~13% market share), Confectionaries (*Candyman* and *Minto* are market leaders with sales of INR 2 bn), Biscuits (*Sunfeast* is the number three player with sales of ~INR 10 bn), staples (*Aashirwad* has more than 50% market share with sales of INR 9 bn).
- It has already gained ~2.5% market share in soaps within 1 year of launch and plans to reach ~3.5% market share within the next two quarters.
- ITC has done this by the right product mix, aggressive ad budgets and innovative distribution strategy.
- We like the aggressiveness of ITC in gaining market share.
- Entry of HUL into malted beverages and nutrition-based snack foods by '*Amaze*' brand is yet to be successful and has remained in the test marketing phase for more than nine months.

Reason #4 - Increasing market share

- ITC's value market share has risen from 67% in FY1994 to ~80% in FY08 and volume market share has risen from 60% in FY1994 to ~70% in FY08.
- HUL has reported loss of market share across most of its categories.

ITC – cigarettes market share



Declining market share for HUL – risk further increases in a soft raw material scenario

HUL -Market shares	Sep-08 Qtr	Jun-08 Qtr	Q-o-Q Change (bps)	Sep-07 Qtr	Y-o-Y Change (bps)
Laundry	37.9	38.3	(40.0)	37.0	90.0
Personal Wash	50.3	52.7	(240.0)	53.2	(290.0)
Hair	46.1	46.5	(40.0)	47.7	(160.0)
Skin Care *	52.7	53.4	(70.0)	55.0	(230.0)
Toothpaste	29.6	30.0	(40.0)	30.0	(40.0)
Tea	23.3	23.2	10.0	23.4	(10.0)
Instant Coffee	47.1	46.9	20.0	46.5	60.0

Source: Edelweiss research, Company

Reason #5 - We like the aggression of ITC

Edelweiss
Ideas create, values protect

* In terms of advertising, ITC was the number four advertiser in CY08 and the second most aggressive in terms of jump in yearly ranking after Vodafone.
* What is heartening to see is that this aggressiveness is actually working for ITC in terms of gains in market share. HUL has maintained its number one slot.

Top 10 advertisers on TV - Jan - Sep-CY07

Company	Rank in CY08	Rank in CY07	Change
HUL	1	1	0
Reckitt Benckiser	2	2	0
Pepsi	3	6	3
ITC	4	11	7
Vodafone	5	24	19
Bharti Airtel	6	10	4
Coca Cola	7	3	(4)
Smithkline Beecham	8	7	(1)
Colgate	9	8	(1)
P&G	10	12	2

Source: TAM Adex, Edelweiss research

Reason #6 - Higher competitive intensity from P&G

Edelweiss
Ideas create, values protect

- P&G (USD 83.5 bn FMCG behemoth) COO, Robert McDonald in his visit to India last month has clearly stated that India is one of the most important countries in P&G's expansion strategy.
- In India, P&G is present in merely eight different categories, as opposed to 21 categories in the US. We expect P&G to enter new categories.
- P&G COO expects that in the next 3-to-5 years, the Indian business of P&G can be the size of its business in Russia and China. This can be a significant risk factor for HUL as it has very large market share in most of the categories.

HUL's market share could be at further risk due to P&G	Sep-08 Qtr
Laundry	37.9
Personal Wash	50.3
Hair	46.1
Skin Care (12 mth MAT)	52.7
Toothpaste	29.6
Tea	23.3
Instant Coffee	47.1

Source: Edelweiss research, Company

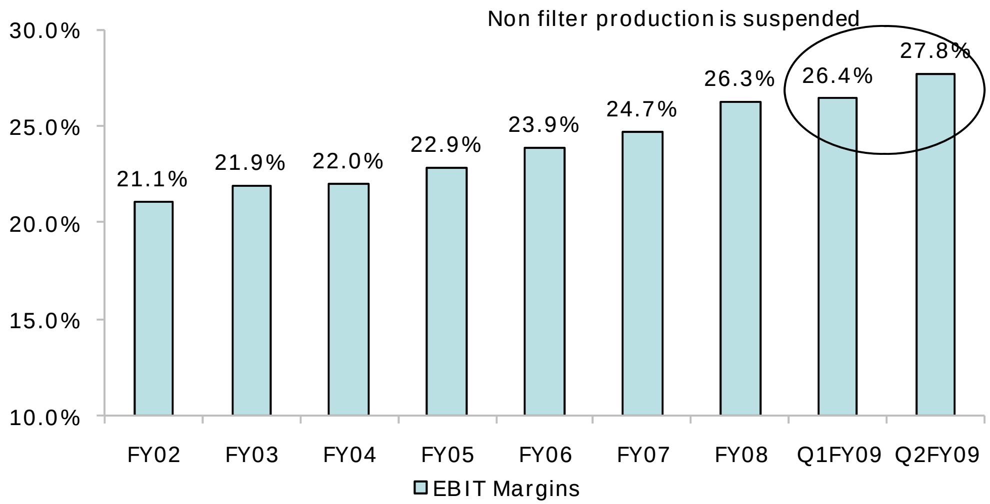
Reason #7 - Low regulatory risk in cigarettes in FY10

Edelweiss
Ideas create, values protect

- We see a low probability of an adverse budget for cigarettes in FY10.
- The first budget after elections has traditionally been a soft budget. The likelihood of soft budget is even higher for the tobacco sector due to the electorally important tobacco farmer community.
- ITC contributes close to ~6% to the central exchequer.
- The Government is unlikely to take an adverse stand for three years in a row as Government also suffers as volumes take a hit and some migration happens to other forms of tobacco which are highly inefficient in terms of excise (like Bidis).

- ITC's resilience came to the fore even in FY08 and FY09.
- FY09 budget was in fact a blessing in disguise as the low margin non-filter has been stopped and ~65-70% conversion to filter has happened which has much higher margins.
- ITC with its dominant market share, superior distribution and strong brands will be the main beneficiary of filterisation of cigarettes.
- In Q2FY09, cigarette margins expanded by 135 bps and EBIT from cigarettes actually increased by a healthy 16.6% YoY.

ITC – cigarettes EBIT margins



Source: Edelweiss research, Company

Reason #9 - FMCG losses for ITC to reduce in FY10

Edelweiss
Ideas create, values protect

* We expect FY09 to be the peak year in terms of FMCG losses. We expect losses to be to the tune of INR ~4.5 bn in FY09 and reduce thereafter. This reduction will be due to four factors:

* **Break even - Biscuits in FY10 and Bingo in FY11.**

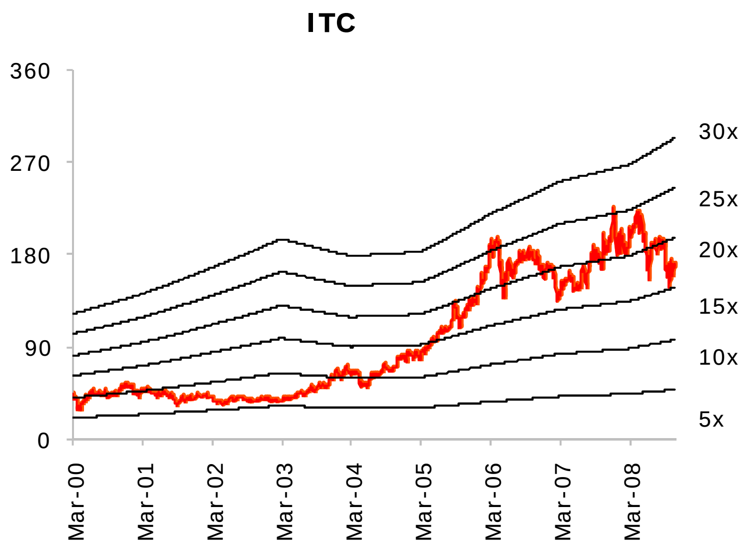
* **Raw material prices like palm oil have corrected sharply.**

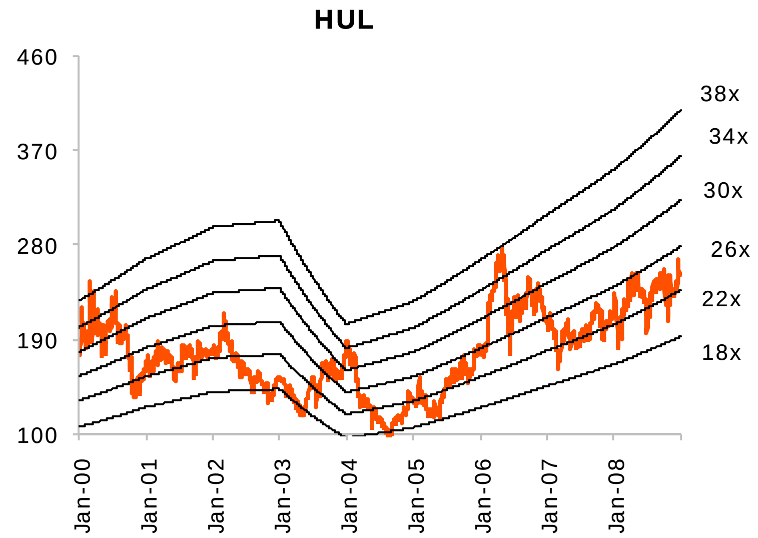
* **Initial period of launch:** FY09 being the initial period of launch for soaps and shampoo, the marketing costs as a % of sales were very high.

* **Ad rates to remain benign:** In FY10 we expect ad rates to remain benign and fragmentation in Hindi General entertainment channels to reduce.

- ITC is currently near the lower end of its trading band at 17x one year forward earnings. We expect it to re-rate.
- On the other hand HUL still trades at the higher end of its trading band.

1 Yr forward P/E





Source: Edelweiss research, Company

Upgrading ITC target price

Edelweiss
Ideas create, values protect

- We upgrade our SOTP-based price target for ITC to INR 200 factoring a higher 18x P/E for cigarettes business and lower 10x P/E multiple for hotels business.
- Our price target for HUL stands at INR 270 per share (25x CY09E earnings).

SOTP based one year forward price target for ITC

Division	Multiple	EPS	Value per Share
Cigarettes	18	8.3	150
Hotels	10	0.6	6
Paper	10	1.1	11
Agri Business	6	0.3	2
	EV/Sales	**Sales per Share**	**Value per Share**
FMCG Others	2	11.1	22
Cash			8
Total			**200**

Source: Edelweiss research

Key Risks

Key risks to our call

Edelweiss
Ideas create, values protect

- Slowdown in Hotel business: ITC's hotel business has been impacted by the downturn in the economy and the terror attacks in Mumbai. It is worthwhile to note that the Hotel business contributed ~8% of net revenues and ~11% of EBIT for ITC in FY08.
- FMCG losses for ITC exceed our expectations by significant margin.
- HUL's volumes improve drastically despite price hikes across the board.
- Price wars from P&G/ regional players does not happen.
- FY10 budget is harsh on cigarettes.

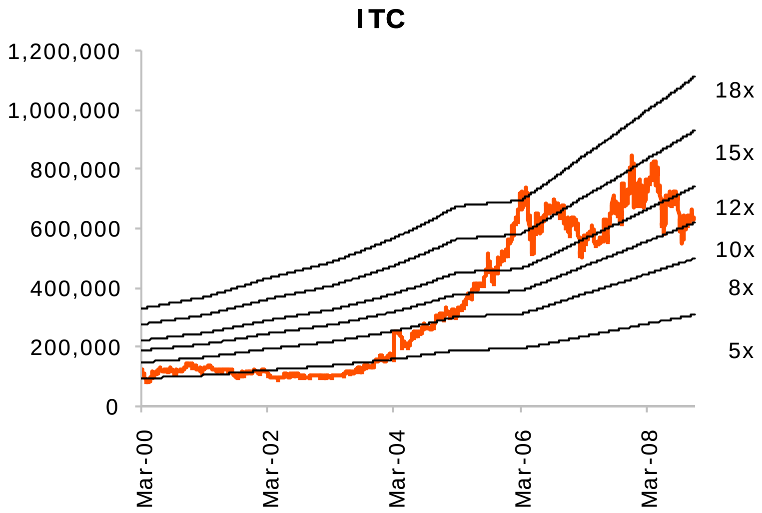
Triggers for ITC

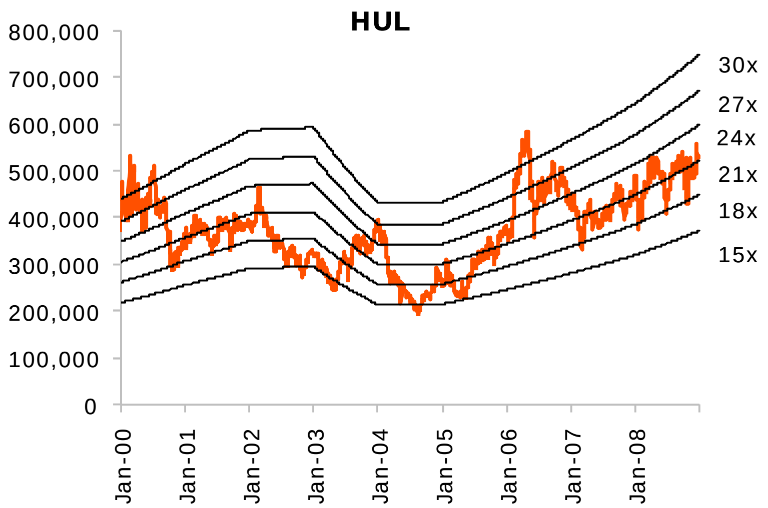
Edelweiss
Ideas create, values protect

- Moderate taxation regime in FY10 budget (budget is likely in June/July 2009 instead of Feb).
- Market share gains in personal care business.
- Biscuit segment turns profitable in FY10.
- Decreasing losses in FMCG business.

	1 month	3 month	1 year	1 year relative return (%)
Sensex	(2.6)	(10.7)	(54.3)	
Hindustan Lever	7.6	18.7	15.2	69.5
ITC	(0.6)	3.5	(22.8)	31.5

1 Yr forward EV/EBITDA





Source: Edelweiss research, Company

Disclaimer

Edelweiss
Ideas create, values protect