

UBS Investment Research

Asia On The Ground: India Consumer

India

Consumer, Non-Cyclical

Sector Comment

Potential for staples still substantial

■ We met distributors and consumers in a rural ‘bazaar’

We met with a consumer staples distributor in Pune primarily catering to rural India. The distributor caters to ~800 outlets, but only 2-3 of those are organised outlets, the rest being ‘mom-and-pop’ outlets. We also interacted with consumers at a ‘weekly bazaar’ in a rural market in the outskirts of Pune in rural Maharashtra.

■ Key objectives: to get a sense of the products sold in rural India

We wanted to understand: 1) consumer up-take of premium (higher-priced per unit volume) products; 2) sales of sachets vs. larger packs; 3) sales of national vs. regional brands; 4) an increase in direct reach vs. indirect reach; 5) general consumer sentiment; and 6) the changed approach of consumer companies.

■ Findings: higher growth in premium products and smaller packs

1) Consumers continue to upgrade and premium products sell faster than others; 2) Smaller packs continue to grow at a faster pace due to convenience of usage; 3) Regional brands continue to give tough competition to national brands, but rural consumers have now started recognising national brands; 4) Consumer companies now try to reach retailers directly through distributors (direct reach); 5) Overall consumer sentiment is upbeat with the monsoons revving up now; 6) Consumer companies now take a more pragmatic view of consumer demand for brands.

■ UBS top picks

ITC remains our top pick in the consumer space, regardless of the “noise”. We believe volume growth is the key catalyst for Nestle. Marico and Godrej Consumer Products (GCPL) continue to enjoy resilient domestic growth and higher growth expectations in new businesses.

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Table 1: Indian consumer companies valuation comparables

Company	Price,	Mcap	PT	Rating	PE, x		EPS gr	EV/EBITDA, x		EBITDA gr	ROE, %		P/BV	
	Rs				FY13E	FY14E	CAGR	FY13E	FY14E	FY12-14E	FY13E	FY14E	FY13E	FY14E
ITC	269	37,946	300	Buy	28.7	23.7	19.8%	18.6	15.1	22.1%	36.1	37.8	9.64	8.35
HUL	540	21,364	500	Neutral	38.2	32.8	17.1%	29.9	25.6	17.4%	85.5	66.8	24.82	20.03
Nestle	4,569	7,986	5,500	Buy	31.0	25.9	19.8%	19.2	16.0	20.5%	76.5	72.7	21.16	18.53
Asian Paints	3,846	6,686	4,450	Buy	30.6	25.1	21.8%	20.0	16.3	22.5%	38.0	37.7	10.24	8.84
Dabur	129	4,052	NA	NA	28.9	24.3	19.5%	21.8	18.3	20.3%	39.4	36.4	10.11	7.90
GCPL	658	3,858	725	Buy	27.2	22.4	29.9%	19.2	16.0	27.7%	25.3	25.4	6.25	5.16
Titan	238	3,831	250	Neutral	29.5	23.8	21.6%	21.5	17.3	22.3%	42.4	39.9	10.91	8.41
Colgate- India	1,238	3,053	1,400	Buy	32.6	27.9	16.2%	24.3	20.6	17.8%	111.9	116.7	34.58	30.77
UBL	557	2,660	650	Buy	56.3	35.9	68.9%	27.4	19.3	39.0%	18.6	24.3	9.71	7.90
Marico	205	2,265	235	Buy	30.9	25.6	23.2%	20.7	16.9	26.6%	27.2	23.3	6.60	5.44
USL	916	2,084	850	Neutral	31.2	22.8	59.5%	13.0	10.9	28.9%	7.7	9.8	2.33	2.16
TGBL	135	1,509	120	Sell	22.2	19.9	9.4%	14.0	12.3	16.0%	8.1	8.7	1.76	1.70
Pantaloon	151	594	250	Buy	15.1	9.2	53.6%	6.5	5.3	20.8%	5.0	7.7	0.74	0.69

Source: Reuters, UBS estimates

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Meeting with staples distributor and visit to rural 'bazaar'

We met with a consumer staples distributor in Pune primarily catering to rural India. The distributor caters to ~800 outlets, but only 2-3 of them are organised. We also interacted with consumers at a 'weekly bazaar' in a rural market in Pune.

The objective: to get a sense of the products sold in rural India

We met the distributor of a consumer company catering to rural India to gauge:

- Consumer up-take of premium products;
- The sales of sachets vs. larger packs as sachets contribute to a larger proportion of sales volumes for FMCG companies;
- The competition of regional vs. national brands;
- Distribution channels in rural India—whether companies are increasingly using the wholesaler channel or looking at distributors for reaching out to retailers.
- To gauge the general consumer sentiment following concern over delayed monsoons.
- To understand the changed approach of consumer companies towards sales and distribution in rural India.

Our findings: premiumisation continues, albeit in small sachets

Our key findings suggest: 1) consumers continue to upgrade and value-added premium products are selling faster than others; 2) smaller packs continue to grow at a faster pace due to convenience of usage and purchasing power; 3) regional brands continue to give tough competition to the national brands, but rural consumers have now started showing signs of being brand loyal; 4) consumer companies now try to reach retailers directly; 5) overall consumer sentiment is upbeat with the monsoons revving up; and 6) consumer companies now take a more pragmatic view of consumer demand for brands.

UBS view and action

We remain positive on the secular volume growth and the ongoing premiumisation. This is a trend seen even in rural India. Growth of premium products in sachets is extremely strong across the hinterland. Also, the brand loyalty and awareness of the difference in quality between regional and national brands emerging among rural consumers were new to us. We continue to believe companies will keep their innovation channel open to launch new 'value for money' products, especially for rural consumers. Some consumer companies mentioned during the UBS India CEO/CFO Forum held from 5-6 September that they are looking at new product developments specific to rural India, which should result in faster growth for these companies in these markets.

Rural markets are evolving faster; we went into the interiors of Maharashtra to get a sense of this change

Consumers find value in better brands—at affordable prices, as bigger brands are also available in smaller sachets

We believe consumers are ready to upgrade to better products; we expect growth for national-level brands to be higher than the underlying growth in consumption

Our top picks are:

- ITC: It remains our top pick in the consumer space, regardless of the “noise” due to regulatory issues. We believe volumes can bounce back after the initial impact of price increases. We derive our price target of Rs300 from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS’s VCAM tool (assuming an 11.2% WACC).
- Nestle: We believe volume growth will be the key catalyst for Nestle India. We derive our price target of Rs5,500 from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS’s VCAM tool. We assume a WACC of 10.3%.
- Marico/GCPL: We believe they will continue to enjoy resilient domestic growth due to higher growth expectations in new businesses. We derive our price target of Rs235 for Marico from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS’s VCAM tool (assuming a 10.7 % WACC). Our price target of Rs725 for GCPL uses a sum-of-the-parts analysis of its businesses.

Key takeaways from the ground

■ **Premiumisation:** The distributor believes that the ‘new rich’ in rural areas i.e. those who sell their land, are the ones that have made a move to premium products. HUL’s skin cream *Fair & Lovely* remains a favourite of rural consumers, but there is a clear switch by consumers to premium products like *Dove*. The existence of modern trade (due to the opening up of malls) has also influenced the purchase decisions of consumers and helped them upgrade. There is a trend of premiumisation even in the smaller packs.

■ **Sachet revolution:** The best selling units for the distributor are the smaller packs priced at Re1 in shampoos and Rs5, 10, and 20 in soaps. The Re1 packs of shampoo account for ~60-70% of the total sales of the distributor. The distributor attributes the primary reason for the popularity of smaller packs to the fact that he services the rural areas, which he defines as population majorly dependent on agriculture. He believes the monthly spend of a family of four on consumer products is roughly Rs700-Rs800. Conversations with some rural consumers also helped us understand that they are now looking for convenience, which is primarily the reason for their purchase of sachets, which are easy to use and throw.

Elasticity of demand not very high at lower price points: A move from the Re1 price point to say a Rs1.50 price point did not make a big impact on volumes. This was seen by some of the FMCG majors in the rural markets of India. While consumption may slow on price increases for sometime, in a month or two, most of the original consumers come back to the fold.

In fact, the key resistance to increasing price points comes from retailers, because of the inconvenience of returning small change to consumers. They prefer price points rising by Re1 rather than a gradual increase.

Fair & Lovely is still the #1 brand on the ‘vanity’ list of the rural consumer

In low-to-medium income households, consumers could spend Rs700-800 per family per month on consumer staples

Elasticity of demand not very high at lower price points

Figure 1: Sachets



Source: UBS (*note the *Dove* sachets to the right of the toothbrushes)

■ **Fierce competition from regional brands:** Local brands have a strong presence in rural India. Their strong presence has made a difference to the product offering from national brands.

National brands face competition from regional brands

A conversation with a local vendor in the rural ‘bazaar’ indicated that local brands sell very well in the rural markets. One of the vendors stated that he sells ~5-6 cartons (with ~40 pieces in each carton) of local brand soaps a week. Some rural consumers also stated that they do not compromise on the quality of the product and prefer national brands to regional brands.

Rural consumers are now associating with brand names

Figure 2: Regional brands vs. national brands



Source: UBS (*while dishwash and laundry bar soaps are for different need bases, note the visible extra length of the national brand vs. the block-like shape of the regional brand)

Figure 3: Regional brands in the rural markets



Source: UBS (*regional brands are sold alongside with national level brands)

■ **Increase in reach through distributors in rural India:** There is a trend of retailers being reached directly by the distributors vs. the wholesalers. FMCG distributors are reaching out to retailers directly and hence, ensure that the shelves are full and all products stocked. Frequent service by distributors also ensures that the retailers do not have to lock up funds in inventory, so they prefer direct servicing as well.

■ **No slowdown witnessed:** In line with the comments from the consumer companies, our on-the-ground visit to the distributor also indicated that there is no slowdown in consumer pick-up and business remains as usual for the distributors. Certain categories of products continue to grow at high growth rates.

■ **Education making a difference:** Youngsters are making purchase decisions and are now demanding from retailers products driven by their aspirations. Information Technology (IT) parks set up in certain cities such as Pune are helping youngsters upgrade to premium products as well.

The distributor believes retailers continue to remain influential and play an important role in influencing purchase decisions in certain parts of the country.

■ **Change in approach of FMCG companies:** Companies are now giving specific targets to distributors as opposed to just selling the products earlier. They have now adopted a secondary target approach vs. a primary target approach, which entailed sale of products of certain value without a follow-up of actual sales of brands by the distributors. In addition, companies are aggressively launching products to keep the consumer engaged.

■ **Existence of copycat brands:** Copycat (legal) brands continue to appear in rural markets (see images given below). However, hope remains in education, which we believe will help consumers differentiate between original products and others.

Figure 4: Copycat brand of Marico's *Parachute*



Source: UBS (* similarities include: 1. blue colour bottle, 2. palm fringes above the brand, 3. the broken coconuts below, and 4. 100% natural coconut oil at the bottom)

FMCG companies now increasing their direct reach

It is business as usual in these markets

Younger consumers have started making purchasing decisions for the family

Retailers play an important role in influencing purchase decisions in some areas

Secondary sales rather than primary sales are now becoming important for companies

Rural markets still see copycat brands

Figure 5: Copycat brands alongside national brands



Source: UBS (*personal care products sold alongside household products; packaged food is still not that prevalent)

Pictures from the villages

Figure 6: Vendor at work



Source: UBS (*mix of branded and unbranded goods, sold together)

Figure 8: Footwear in the "bazaar"



Source: UBS (*highly unbranded, localised consumption categories)

Figure 7: Fresh food sold in the rural bazaar



Source: UBS (* fresh, localised taste, affordable and no inventory issues)

Figure 9: Distributor at work



Source: UBS (*distributor carrying inventory to sell to 'mom-and-pop' stores)

■ **Statement of Risk**

The key risks that could affect the sector include continued upward movement of downstream petrochemical products and higher agri-commodity based raw material costs and the inability of branded consumer companies to be able to pass on price increases in an increasingly competitive market.

Higher excise duty on cigarettes and state taxes on liquor could delay the uptrading in cigarettes and to better quality ENA-based spirits.

The sector enjoys low corporate tax rates because of factory locations in areas that are designated as tax benefit zones; any change in this law could affect earnings.

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	55%	33%
Neutral	Hold/Neutral	37%	31%
Sell	Sell	8%	16%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	less than 1%	0%
Sell	Sell	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 June 2012.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

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Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

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UBS Securities India Private Ltd: Sunita Sachdev.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Godrej Consumer Products	GOCP.BO	Buy	N/A	Rs657.80	12 Sep 2012
ITC	ITC.BO	Buy	N/A	Rs269.40	12 Sep 2012
Marico Ltd	MRCO.BO	Buy	N/A	Rs205.20	12 Sep 2012
Nestle India Ltd. ²²	NEST.BO	Buy	N/A	Rs4,569.40	12 Sep 2012

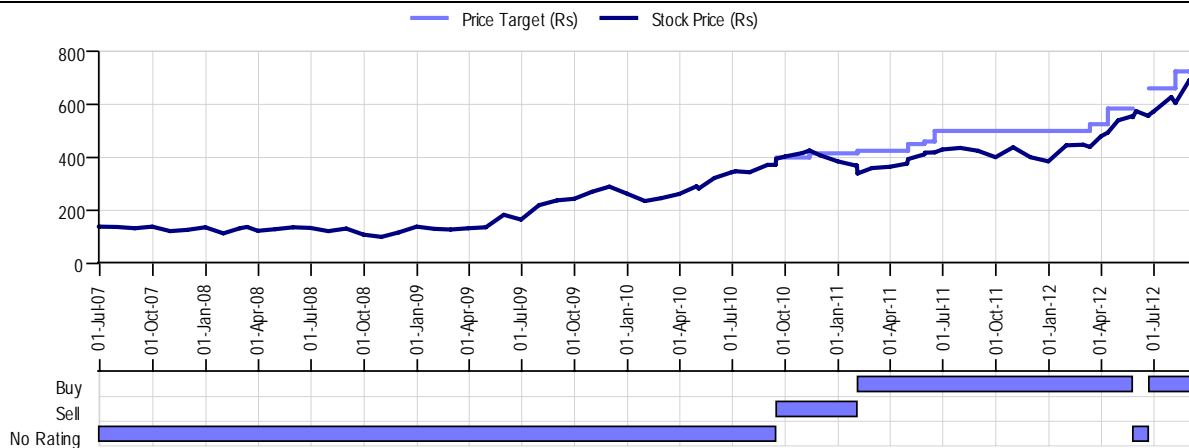
Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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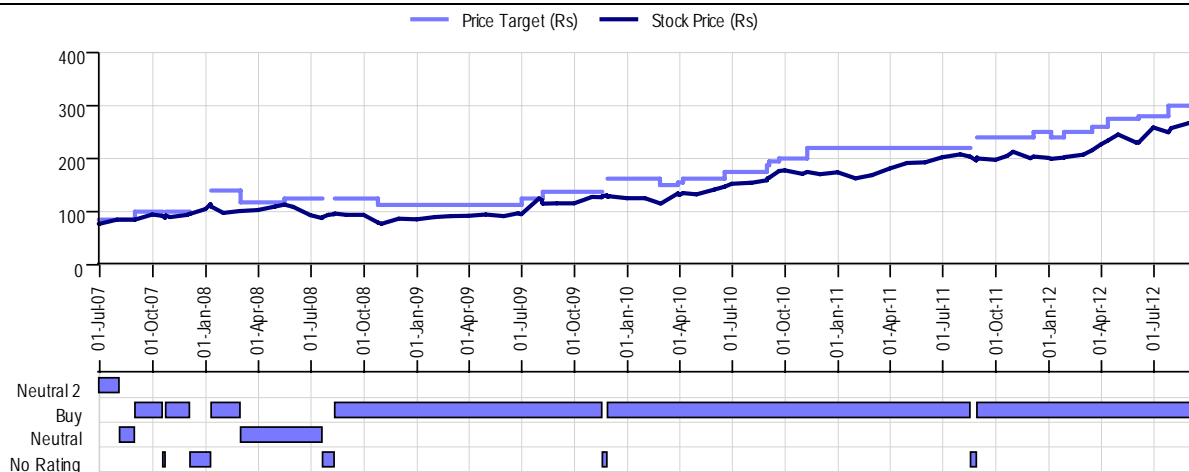
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Godrej Consumer Products (Rs)



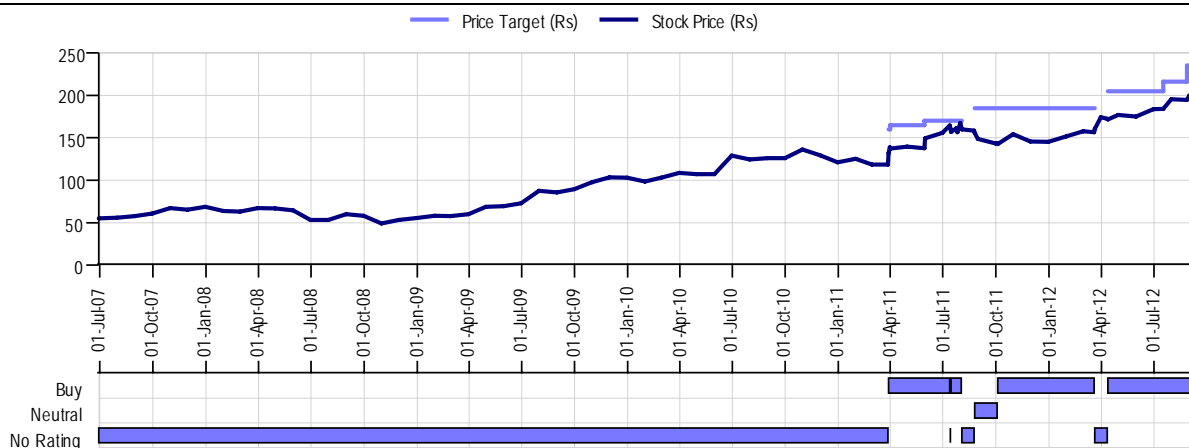
Source: UBS; as of 12 Sep 2012

ITC (Rs)



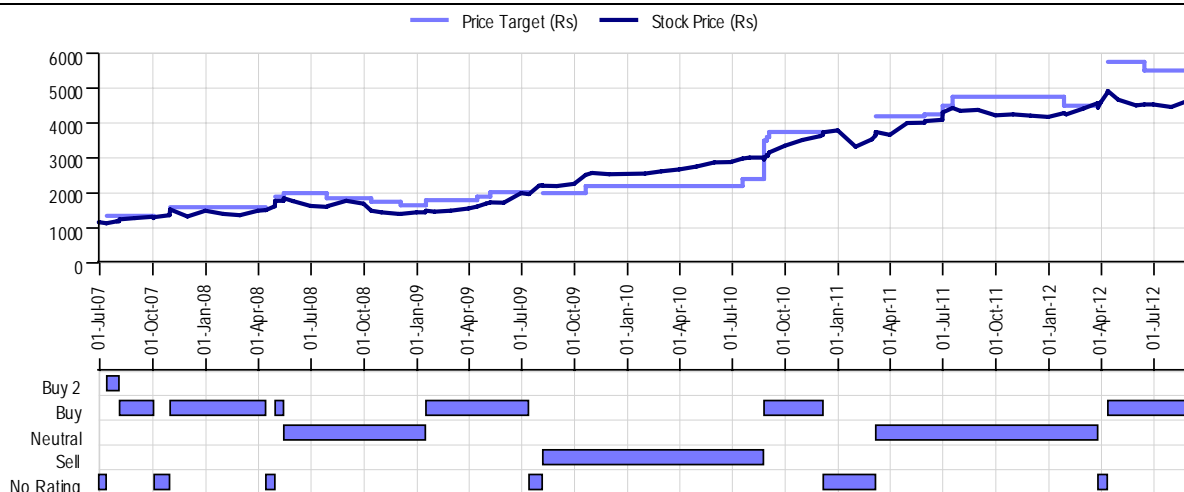
Source: UBS; as of 12 Sep 2012

Marico Ltd (Rs)



Source: UBS; as of 12 Sep 2012

Nestle India Ltd. (Rs)



Source: UBS; as of 12 Sep 2012

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Additional Prices: Asian Paints Ltd., Rs3,845.65 (12 Sep 2012); Colgate-Palmolive India, Rs1,238.40 (12 Sep 2012); Dabur India Ltd., Rs128.65 (12 Sep 2012); Hindustan Unilever, Rs540.25 (12 Sep 2012); Pantaloon Retail (India) Ltd., Rs150.95 (12 Sep 2012); Tata Global Beverages, Rs134.60 (12 Sep 2012); Titan Industries, Rs238.05 (12 Sep 2012); United Breweries, Rs556.60 (12 Sep 2012); United Spirits Ltd, Rs915.65 (12 Sep 2012); Source: UBS. All prices as of local market close.

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