

# Hindustan Unilever

**Rs271**  
**OUTPERFORMER**

## RESULT NOTE

**Mkt Cap: Rs590bn; US\$12.9bn**

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**Result:** Q3FY11  
**Comment:** High on volumes, low on margins!  
**Last Report:** 30 December 2010 (Price Rs294; Recommendation: Outperformer)

### Key Valuation Metrics

| Year to March 31 | Net revenues | yoy chg (%) | Net Profit | EPS  | yoy chg (%) | PER (x) | EV/EBITDA (x) |
|------------------|--------------|-------------|------------|------|-------------|---------|---------------|
| FY10E            | 175,238      | -13.4%      | 21,981     | 9.6  | (16.6)      | 28.2    | 21.2          |
| FY11E            | 195,098      | 11.3%       | 20,929     | 9.6  | (0.3)       | 28.2    | 23.1          |
| FY12E            | 220,001      | 12.8%       | 25,533     | 11.7 | 22.0        | 23.2    | 18.3          |
| FY13E            | 246,612      | 12.1%       | 32,264     | 14.8 | 26.4        | 18.3    | 13.9          |

### Key highlights

- Hindustan Unilever (HUL) has reported revenue growth of 11.6% to Rs50.3bn (our estimate, Rs50.5bn), an EBITDA decline of 13.1% to Rs6.2bn (our estimate, Rs6.4bn) and a PAT decline of 5.2% to Rs5.7bn (our estimate, Rs5.85bn).
- The quarter includes an exceptional gain of Rs643m (profit from sale of properties at Rs492m, profit on sale of long-term trade investments at Rs159m, and restructuring costs of Rs8.5m). Profit post exceptional items stood at Rs 6.4bn.
- The domestic FMCG business grew by 11.5% to Rs46.3bn, exports grew by 9.6% to Rs2.9bn, and others (including the water business) grew by 21% to Rs1.bn.
- HUL reported its third consecutive quarter of strong double-digit volume growth at 13% and ahead of market levels. Impact from price/mix was -1.4%. Almost all categories, including core categories like soaps & detergents and personal products, reported double-digit volume growth. However, double-digit growth in soaps & detergents imply a negative 5% price/mix impact.
- EBITDA margin (before other operational income) has contracted by 360bp to 12.4% (our estimate, 13.3%). Gross margins were down by 200bp to 48.9%, driven by an increase in input prices. ASP spends were higher at Rs 7.4bn (up 70bp to 14.8%), while other expenditure came in higher than estimated at Rs8.6bn (up 90bp to 17%).
- Our sense is that A&P spends in Q3FY11 have been primarily in the emerging categories (Ponds, Dove, Knorr, etc), which gives us comfort that HUL is spending in the right direction. We expect strong A&P spends to sustain given an intense competitive environment and HUL's eagerness to grow the new categories. We believe the increase in other expenditure was due to higher freight costs (higher detergent tonnage and higher freight rates) and from higher royalty payout than last year.
- Other operational income was Rs1.0bn and financial income was Rs770m. Other operational income comes from foreign exchange MTM valuation of open forward contracts and monetary items. Financial income includes interest income, dividend income and net gain on sale of other non trade investments.

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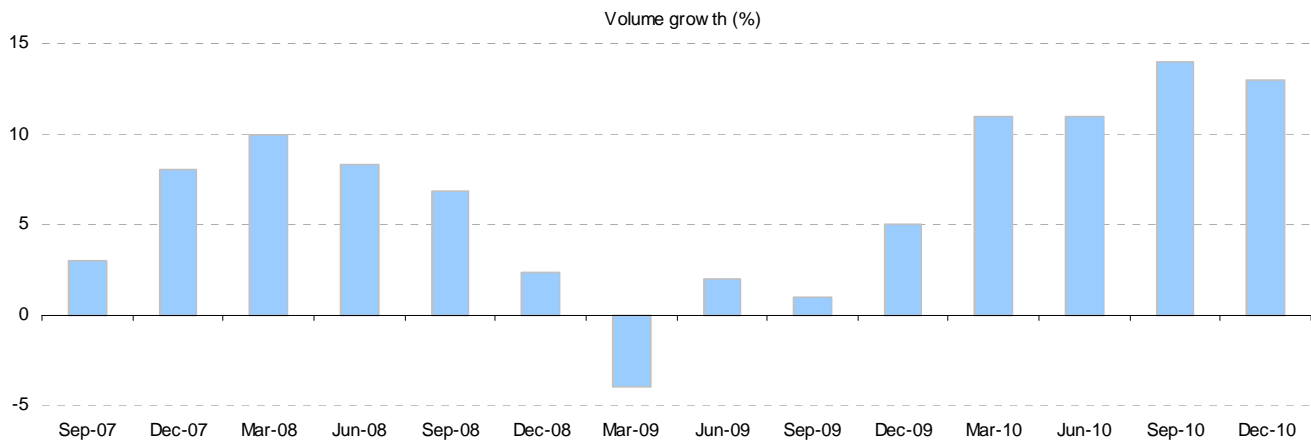
- The soaps & detergents segment has grown by 5.8% to Rs21.9bn, exhibiting strong volume-led growth led by Rin (higher than market volume growth). However, the big surprise was a significant 570bp EBIT margin erosion to 7.7% during the quarter. This erosion marks the lowest ever EBIT margin in soaps and detergents and only 23% contribution to overall EBIT (previous lowest contribution was 35% in December 2009). We believe the drop in margins is due to rising commodity prices (LAB for detergents and palm oil for soaps), increasing share of Rin in the portfolio (lowest profitability in detergents), and lower realization in detergents from the price corrections in February 2010. We believe detergents are at almost zero margins at current input prices.
- The personal products business has reported 20.2% growth to Rs16.6bn – the seventh consecutive quarter of double-digit volume growth. Growth was broad based, but led by skincare. The category reported a 310bp decline in EBIT margin to 28.8% yoy. This is higher than the average margin for the past three quarters (23%) due to high skincare salience. However, the margin was the lowest ever for any December quarter. Our sense is that a significant share of overall media spend has gone into Dove, Ponds Gold Radiance, White Beauty and Vaseline, thereby impacting the EBIT margin of personal products. However, with the significant decline in soaps & detergent margins, the contribution of personal products to overall EBIT was almost two thirds of total EBIT.
- Beverages has grown by 9.3% to Rs6bn and reported a 200bp decline to 16.8%. Processed foods have grown by 19% to Rs 2.2bn. However, margins have been negative in Foods (-7.2% and lowest since Sept 05), which, we believe, is due to high A&P spend on Knorr Soupy Noodles, which has gone national. As the foods business scales up, we see margins improving substantially.
- Ice cream reported strong growth of 31% to Rs481m, with negative margins (-1.2%). Other businesses have grown by 15.9% to Rs1.1bn, driven by growth in the water business.

### Valuations and View

With volume growth and market-share gains taking precedence over profitability, HUL is getting its act together in regaining lost ground in its core categories of soaps, detergents, shampoos, etc. We like the fact that HUL has upped its ante through sustained high ASP spends, new launches and newer price points, thereby showing broad-based volume growth. These are signs of change as HUL transforms from a mass marketer to a mid-top range 'branded retailer'. Further, Polman's new Unilever is creating a stronger and more aggressive HUL, evident in the way HUL has defended categories (Dove's ambush marketing, revival of Rin, claimed product superiority of PureIt, etc) as also launching bigger and better innovations in a cost-effective manner. With mid-tier consumer players (Marico, Dabur, Godrej Consumer) increasing their exposure to international markets, we see limited merit in playing the "Indian consumption story" through these names. We believe that as these mid-tier consumer players further build on the inorganic route (~35% of revenues), de-rating of the overall business would be eventual (as in the case of Tata Global Beverages), and HUL, in this context, is an excellent switch.

However, the margin drop in soaps & detergents is cause for concern. While the company has been achieving strong volume growth, the significant margin deterioration in soaps & detergents has pushed it into a tricky situation of maintaining growth while improving profitability. While we do expect these abysmally low margins to return to normal eventually, we see margin pressure sustaining for the next 1-2 quarters. With rising commodity prices and an intense competition, HUL's ability to manage the profitability issue (via price increases or cost-saving plans) without compromising on growth will be a key monitorable. We downgrade FY11E earnings by 6% and FY12E earnings by 4%, but maintain our Outperformer call on the stock with a price target of Rs340.

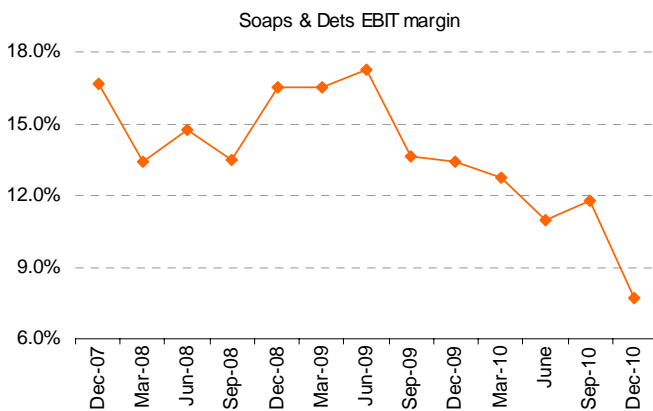
Volume growth



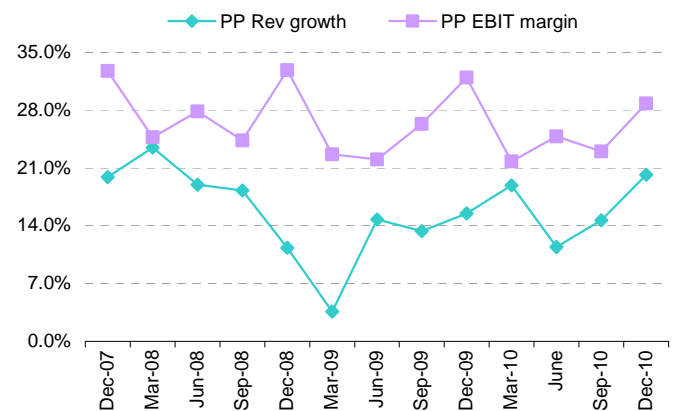
Segmental performance

| Rs m               | Revenues      |               |              | EBIT        |             |                |
|--------------------|---------------|---------------|--------------|-------------|-------------|----------------|
|                    | Q3FY11        | Q3FY10        | % yoy growth | Q3FY11      | Q3FY10      | Chg (bp)       |
| Soaps & Detergents | 21,929        | 20,719        | 5.8          | 7.7         | 13.4        | (571.7)        |
| Personal Products  | 16,547        | 13,770        | 20.2         | 28.8        | 31.9        | (312.9)        |
| Beverages          | 6,022         | 5,511         | 9.3          | 16.8        | 14.8        | 200.5          |
| Processed Foods    | 2,219         | 1,872         | 18.6         | (7.2)       | (0.7)       | (656.8)        |
| Ice Creams         | 481           | 368           | 30.9         | (1.2)       | (10.2)      | 897.1          |
| Exports            | 2,909         | 2,653         | 9.7          | 7.8         | 2.8         | 495.8          |
| Others             | 1,111         | 958           | 15.9         | (16.6)      | (15.6)      | (103.2)        |
| <b>Total</b>       | <b>51,218</b> | <b>45,851</b> | <b>11.7</b>  | <b>14.4</b> | <b>17.2</b> | <b>(282.6)</b> |

Soaps & Detergents: EBIT margin decline



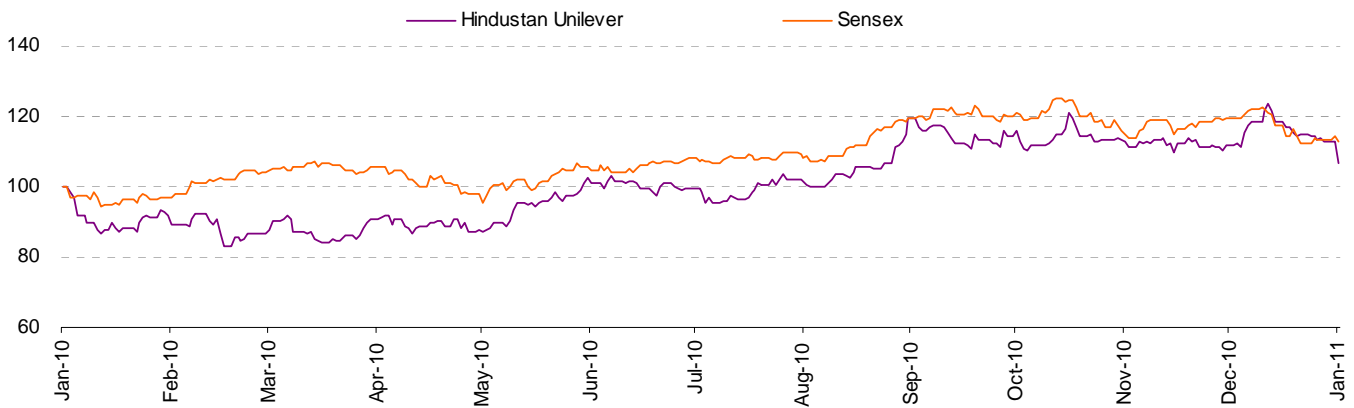
Personal Products: Revenue growth but EBIT margin decline yoy



Quarterly results

| Quarterly results (Rs Mn) | Q3FY10        | Q4FY10        | FY10E          | Q1FY11        | Q2FY11        | Q3FY11        | FY11E          | FY12E          |
|---------------------------|---------------|---------------|----------------|---------------|---------------|---------------|----------------|----------------|
| <b>Net Sales</b>          | <b>45,043</b> | <b>43,158</b> | <b>175,238</b> | <b>47,941</b> | <b>46,808</b> | <b>50,270</b> | <b>195,098</b> | <b>220,001</b> |
| % yoy                     | 4.6           | 8.2           | (13.4)         | 7.1           | 10.7          | 11.6          | 11.3           | 12.8           |
| <b>EBITDA</b>             | <b>7,185</b>  | <b>5,310</b>  | <b>25,445</b>  | <b>5,988</b>  | <b>5,630</b>  | <b>6,243</b>  | <b>24,918</b>  | <b>30,808</b>  |
| EBITDA %                  | 16.0          | 12.3          | 14.5           | 12.5          | 12.0          | 12.4          | 12.8           | 14.0           |
| Net interest              | -             | -             | (2,885)        | -             | -             | -             | (3,309)        | (3,706)        |
| Depreciation              | 450           | 503           | 1,840          | 535           | 554           | 563           | 2,062          | 2,108          |
| Other Income              | 1,079         | 928           | 542            | 1,244         | 1,606         | 1,777         | 846            | 1,050          |
| <b>Profit before Tax</b>  | <b>7,814</b>  | <b>5,735</b>  | <b>27,032</b>  | <b>6,697</b>  | <b>6,682</b>  | <b>7,457</b>  | <b>27,012</b>  | <b>33,457</b>  |
| Tax                       | 1,766         | 1,878         | 6,044          | 1,548         | 1,426         | 1,724         | 6,078          | 7,695          |
| Exceptional items         | 445           | 1,955         | 994            | 185           | 404           | 643           | -              | -              |
| <b>Profit After Tax</b>   | <b>6,493</b>  | <b>5,812</b>  | <b>21,981</b>  | <b>5,334</b>  | <b>5,661</b>  | <b>6,376</b>  | <b>20,934</b>  | <b>25,762</b>  |
| % yoy                     | 5.5           | 47.1          | (16.6)         | (1.1)         | 32.1          | (1.8)         | (0.3)          | 23.1           |

Relative price performance



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2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: Less than 5% to Index

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