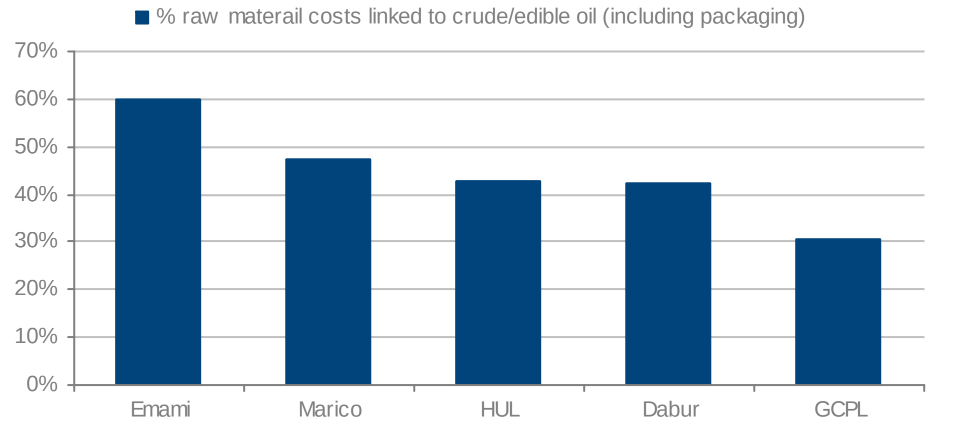
Who gains if RM cost reduction sustains?

Costs of commodities, especially crude oil and palm oil, have corrected meaningfully in the past few weeks. We would wait for the corrections to sustain before factoring them into our estimates. However, if there is a sustained reduction, the key beneficiaries would be home and personal-care companies that have high pricing power and would not need to undertake price cuts. In our recent detailed FMCG sector report, *The hyper-competition threat,* we highlighted the following home and personal-care companies with high pricing power: Emami, Godrej Consumer and Marico. These companies could see sustained margin gains if commodity costs settle lower. Hindustan Unilever (HUL) would also gain in the near term, though intensified competition in detergents and soaps would force price cuts and higher marketing spends.

Crude, palm oil prices come off significantly: The c15% fall in crude prices over the past few weeks would reflect in crude derivative prices if crude prices remain at the current level. Prices of key FMCG derivative inputs, LAB and liquid paraffin, rose significantly, by 25-40%, in the past six months. Prices of packaging material did not rise as fast, increasing only 5-15% in this period, despite it being a crude derivative. Palm oil is also down c16% from the March quarter 2011 average; this would put downward pressure on other edible oils and copra.

Home and personal-care companies could gain – Emami, Marico, HUL key beneficiaries: Crude derivatives or oils form a significant portion of raw material for all home and personal-care categories; their prices increased significantly over the past six months. These commodities contribute the most to raw material costs of soaps, detergents and hair-oil categories. Packaging costs did not rise substantially over the six-month period and hence, price correction could be smaller than that for other crude derivatives. We expect the soaps, detergents and hair-oil categories to benefit the most from easing of commodity costs. Emami, Marico and HUL have the highest share of crude linked commodity costs at 40-60% of their total raw material mix.

Figure 1: Proportion of crude and vegetable oil linked raw material costs, including packaging costs, is the highest for Emami, Marico and HUL



Source: Companies, IIFL Research

High pricing power key to sustained margin gains – Emami, Marico, GCPL best positioned: Companies with high pricing power would not need to pass on price cuts in line with reduction in costs; hence, in the event of fall in commodity prices, margin gains would sustain. Emami, Marico, Colgate and Godrej Consumer, with relatively higher pricing power, would be able to sustain their margin gains if commodity prices remain low.

HUL would gain in the near term, but benefits unlikely to sustain, owing to competitive intensity: Proportion of crude-linked raw material cost is one of the highest for HUL. Thus, it would gain in the near term if these costs fall. However, in the soap and detergent categories, competition would intensify from aggressive

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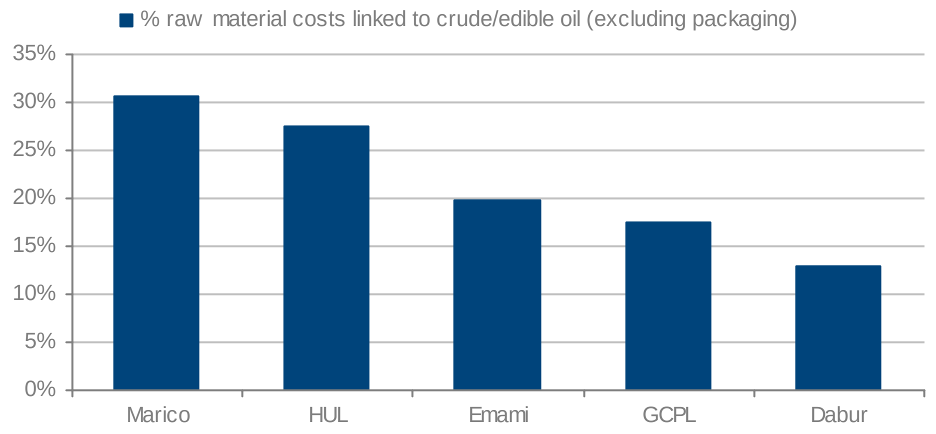
competitors such as P&G and ITC and unorganised players that typically halt operations in a scenario of higher commodity prices. Thus, HUL would need to pass on most of the correction in the form of price cuts. It would also need to increase advertising and promotion spend. HUL was able to lower advertising and promotion spend in the past two quarters, with competitors' spend also being lower.

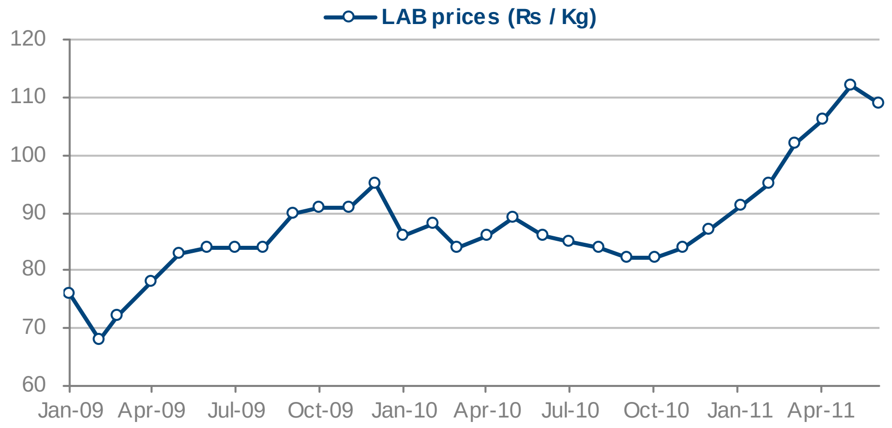
Figure 2: Marico, HUL, Emami and GCPL have substantial share of crude and vegetable oil linked raw materials whose prices have increased substantially in the past six months



Source: Companies, IIFL Research

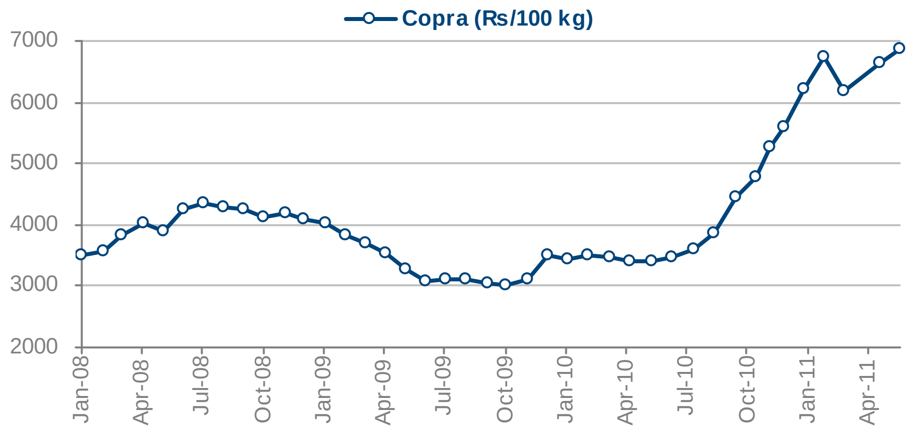
Correction to reflect in P&L with lag of at least a few months: Even a sustained fall in costs will take at least 2-3 months to reflect in P&Ls, as most companies have minimum forward covers of that duration. Most companies have indicated that they are not carrying larger-than-normal inventory or forward covers.

Figure 3: LAB prices moved up significantly in the past six months



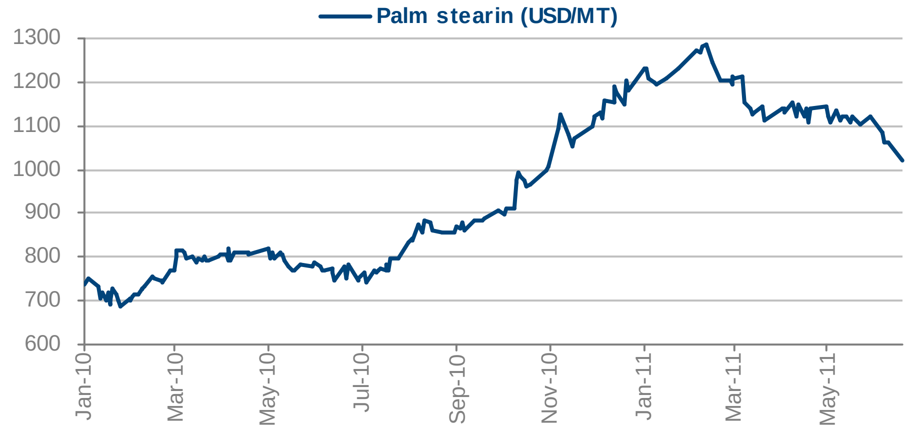
Source: Industry sources, IIFL Research

Figure 4: Copra prices continue to be at peak levels



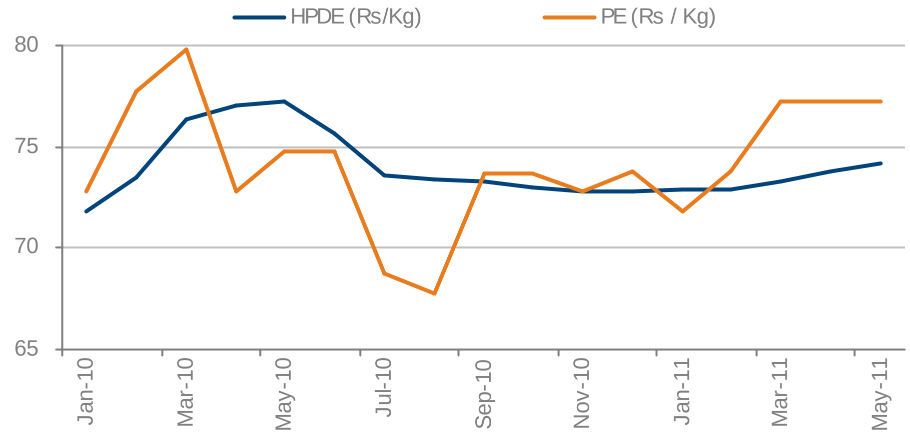
Source: Industry sources, IIFL Research

Figure 5: Palm oil corrected c16% in the past three months



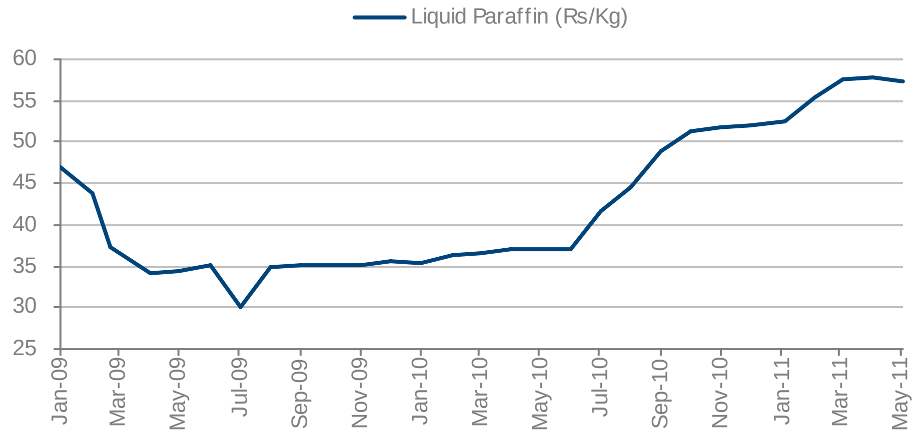
Source: Industry sources, IIFL Research

Figure 7: Cost of packaging did not rise significantly, despite it being a crude derivative



Source: Industry sources, IIFL Research

Figure 6: Liquid paraffin prices are at peak levels



Source: Industry sources, IIFL Research

Figure 8: Details of inflation in key commodity costs in home and personal care companies

Company	Raw material	% of consol sales	% of consol RM costs	Price change in May 2011 (YoY)	Used in
HUL	Palm Oil	6.9%	13.5%	40%	Soap
	LAB	7.1%	14.0%	27%	Detergent
	Packaging	7.7%	15.1%	5-15%	All
Dabur	Vegetable oil	3.1%	6.0%	15%	Hair Oil
	Liquid paraffin	3.6%	6.9%	35%	Hair Oil
	Packaging	15.3%	29.4%	5-15%	All
Marico	Copra	15.6%	30.6%	50%	Coconut Oil
	Packaging	8.6%	16.9%	5-15%	All
Emami	Liquid paraffin	4.4%	11.0%	35%	Hair Oil
	Menthol	3.5%	8.8%	80%	Hair Oil, Balm
	Packaging	16.0%	40.0%	5-15%	All
GCPL	Palm Oil	8.8%	17.6%	40%	Soap

Source: Company, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
