

### INITIATING COVERAGE

### Hindustan Lever Limited

Hold

#### Share Data

Market Cap	Rs. 416.65 bn
Price	Rs. 188.8
BSE Sensex	14,487.72
Reuters	HLL.BO
Bloomberg	HLVR IN
Avg. Volume (52 Week)	0.83 mn
52-Week High/Low	Rs. 262.5/166.0
Shares Outstanding	2,206.83 mn

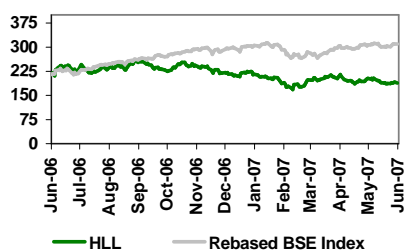
#### Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	8.3	9.4
+/- (%)	22.0%	13.3%
PER (x)	22.7x	20.0x
EV/ Sales (x)	3.0x	2.7x
EV/ EBITDA (x)	18.9x	16.7x

#### Shareholding Pattern (%)

Promoters	51
FII's	12
Institutions	16
Public & Others	20

#### Relative Performance



#### Consumption led growth

Hindustan Lever Limited (HLL), India's largest FMCG company with track record for building large and profitable mass markets has taken a head start in new and growing segments like the water and processed food. HLL's differentiated portfolio, sustained high level of innovations, strong brand equity, and subsidizing new brands will enable the company to increase both penetration into the new markets and rate of consumption. HLL's FMCG business maintained a growth rate of 12.3% during Q1'07, led by high demand in highly competitive laundry and shampoo categories. However, company's deteriorating revenue mix, due to high revenues from low margin segment and low revenues from high margin segments in Q1'07 is a matter of concern.

#### Key Figures

Year to December	CY04	CY05	CY06	CY07E	CY08E	CAGR (%)
(Figures in Rs mn, except per share data) (CY07-08E)						
Net Sales	105,982	115,658	124,110	138,309	154,755	11.7%
EBITDA	16,308	15,914	18,129	21,846	24,758	16.9%
<b>Net Profit</b>	<b>11,645</b>	<b>13,140</b>	<b>15,049</b>	<b>18,366</b>	<b>20,812</b>	<b>17.6%</b>
<b>Margins(%)</b>						
EBITDA	15.2%	13.6%	14.4%	15.5%	15.7%	
NPM	10.9%	11.2%	11.9%	13.0%	13.2%	
<b>Per Share Data (Rs.)</b>						
Normalized EPS	5.3	6.0	6.8	8.3	9.4	17.6%
PER (x)	35.7x	31.6x	27.7x	22.7x	20.0x	

- Taking into account the buoyant Q1 results, we expect the net sales to increase at a CAGR of 11.7% for CY07E and CY08E.
- EBITDA margins are expected to increase by 130 bps over the next two years due to growth in new segments.
- At the current price of Rs. 188.8, the stock is trading at a forward PE of 22.7x CY07E and at 20x CY08E.
- We initiate coverage with a Hold with a twelve month price target of Rs. 207, based on target PE of 25x.

## Investment Rationale

### *Cutting edge distribution network*

HLL's distribution network is recognized as one of its key strengths, which provides a huge competitive advantage in the FMCG sector. This network is capable of managing both traditional and modern trade, and facilitates HLL's market presence and public exposure. The company has a strong marketing network, with direct coverage around 1 mn outlets and total coverage of 6.3 mn outlets. HLL has a market reach of over 166 mn households, which will further increase due to continuous investments in building capability in the area of modern trade and supply chain.

*Versatile distribution network with multi-channel capabilities*

### *Continuous innovations and R&D capabilities*

HLL has a proven track record for developing commercially viable innovations, not only in product development, but also in business processes, packaging, distribution channels, and delivery mechanisms. The company's capability for multi-faceted innovation is core to its seamless service to the each segment of consumer pyramid. HLL has over 380 patents, demonstrating its leading edge in consumer-relevant R&D. HLL's key innovations during Q1'07 were the launches of Ponds "white beauty range", Sunsilk "damage repair and anti dandruff shampoo" and Lux "pinkful"; these innovations enabled the company to deliver value across all segments. Moving forward, HLL will strengthen its portfolio across all categories by leveraging its strong R&D expertise and a deep consumer understanding.

*Targeting the premium end of the market with value added offerings*

### *Increasing focus on growing processed food*

With 200 mn people expected to shift to processed and packaged food by 2010, HLL has identified the nascent branded-processed food market as an area where great opportunity exists. Growing income, changing lifestyle, emerging modern trade, and the branded food market offer enormous potential for HLL. Food processing units also enjoy several tax benefits such as tax holidays and less excise duty. To exploit these immense opportunities, HLL has framed its long term strategy with new launches as the year progress. Although Nestle and ITC are leading players in food sector, HLL's strong brand equity and solid base in tea with Brooke Bond, Annapurna, Kissan, and Knorr will enable it to penetrate market. Results of the focused food portfolio can be

*Ready to eat food segment is expected to grow more than 15% per annum*

seen from 47.9% growth in processed foods and 22.9% growth in overall foods segment during Q1'07 backed by strong growth across all key categories in the food segment.

#### *Entry in water business*

HLL has entered in branded water business in 2005 with launch of 'Pureit' in selective states and company has made substantial investments of Rs. 100 mn to achieve scales in this business. Keeping in view the increased health consciousness of consumers, the company has positioned it as 'as safe as boiled water'. HLL has targeted 'Pureit' not only to the affluent consumer group, but also to medium income group with its low cost (just 20 paisa per litre), which will fetch market share in this segment at an increasing rate. HLL's water tests produced excellent results and provide confidence for a national rollout, commencing during 2007.

*Low cost of 20 paisa per litre*

#### *Rural India: Huge opportunity to drive penetration and consumption*

HLL is deepening its roots in rural Indian market through substantial investments in distribution networks and a broad product portfolio for the low income group. Around 70% of total households reside in rural areas in India, which reveals the huge hidden potential for HLL to increase penetration in these areas. HLL has initiated projects such as 'Project Shakti', to expand rural income and then, to penetrate the market. The company has also taken many initiatives over the decades to create markets in the rural areas by marketing relevant products at affordable prices.

*Deep roots in local culture and markets will enable rural market penetration*

In categories, that are relatively less penetrable, like personal products, rural India offers an even bigger growth opportunity through greater penetration and consumption. As only 3 out of 10 consumers are using shampoo and skin care products in rural market there is huge potential to expand market share for HLL in this segment.

#### *Emerging Retail Format*

The current retail market is estimated at \$330 bn, and, at a conservative y-o-y growth of 12%, it can potentially soar to \$600 bn in next 4-5 years. This highly potential retail market has attracted not only big industrialists like Bharti, Reliance, AV Birla Group etc. but also international retail players like Wal-Mart.

*Big international players such as Tesco and French retailer Carrefour are also planning to enter in Indian retail sector*

The growing organized retail and modern trade will increase shelf space for HLL products and add more customer visibility.

### Risks

#### *Increase in input costs*

HLL has already made substantial increase in prices of several products, and any further increase in costs would not allow the company to raise prices due to competitive pressures. However, on the basis of decline in inflation, which began during mid April we are expecting inflation to stabilise between 4%-4.5% for current year. Any increase in the costs of crude, palm oil and agro based products may put margins under pressure.

#### *Huge ad expenditure and investments may affect margins and profits*

HLL has taken several initiatives to launch new products in the foods portfolio and rollout of water business. The company has already incurred Rs. 100 mn on scaling up its water purification device "Pureit". These new initiatives may demand high marketing expenses, which will increase costs and reduce profit margins.

#### *Lack of cold chain infrastructure*

Lack of a cold chain infrastructure and the underdeveloped processed food industry may hamper HLL's expansion plans. High wastage and value chain loss in the Indian food chain, due to poor storage and transportation infrastructure, may result in low profitability.

### Outlook

Robust economic development, rising incomes, and changing life styles augur the growth of FMCG sector in coming years. The fastest growing \$330 bn Indian retail market will open new markets for FMCG companies. India's huge youth population and increasing per capita income will continue to fuel consumer spending. Hence, we expect HLL to capture these immense opportunities in India with its deep understanding of Indian markets and consumers.

*Advertisement and promotion costs increased by 17.5% in Q1'07*

We expect net sales to increase by 11.4% for CY07E to Rs. 138,309 mn and 11.9% for CY08E to Rs. 154,755 mn. At the current price of Rs. 188.8, the stock is trading at a forward PE of 22.7x CY07E and at 20x CY08E.

We initiate coverage with a Hold with a twelve month price target of Rs. 207, based on target PE of 25x.

### Company Background

HLL is India's largest Fast Moving Consumer Goods (FMCG) company with presence in home care, personal care, food and beverages category. The company caters to two out of every three Indians, with its presence in over 20 distinct categories of consumer products and services.

HLL specializes in offering premium brands to the affluent class, value-for-money brands to middle class, and affordable pricing brands to low income consumers. HLL's key competitive categories are laundry and shampoo and 53% of revenues are driven by six mega brands (Wheel, Rin, Lux, Lifebuoy, F&L and Brooke Bond). An estimated 700 mn consumers use HLL brands everyday, and nine of company's brands are amongst the top twenty most recognized brands in the country.

Headquartered in Mumbai, HLL was incorporated in 1956 from merger of Hindustan Vanaspati Manufacturing Company, Lever Brothers India Ltd. and United Traders Limited. Anglo-Dutch FMCG giant Unilever owns a majority stake in HLL.

HLL has market leadership in personal wash, detergents and personal care with the following market share:

Market Share (%)	
Segments	31 <sup>st</sup> March, 07
Laundry	36.4
Personal Wash	55.3
Hair	46.9
Skin Care	54.8
Oral Care	30

*Leveraging focused portfolio of powerful brands to strengthen leadership in core categories.*

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