Company Focus

30 May 2008 | 10 pages

# Colgate Palmolive (India) (COLG.BO)

## Buy: Sedate 4Q, Revising Target Price to Rs466

Target price change ☑
Estimate change ☑
Results ☑
Analyst meeting ☑

- **Reduce target price to Rs466 –** Our target price is based on 21x Sept09e EPS. We pare our earnings multiple to 21x (from 23x) to reflect the deceleration in forecast earnings growth and also roll forward to Sept09e EPS.
- **Revising earnings downward –** We reduce earnings by c8% over both FY09/10e, reflecting a confluence of higher input costs and greater advertising spends on the backdrop of a competitive industry scenario (which restricts COLG's pricing ability). We have pared EBITDA margins by c230-320 bps over FY09/10e.
- **Sedate 4Q** — PAT rose 12%Y/Y, below expectations, as margins contracted c2.7% driven by advertising costs, power and fuel expenses and also a slight uptick in raw material costs. Overall volume growth was 9% in the quarter, with toothpaste and toothbrushes recording 10% and 20% growth respectively.
- **Market share remains stable, despite competition intensity** — Colgate continues to dominate across key segments – toothpastes, toothbrushes and toothpowder – with market shares of c48%, 35% and 44% respectively. Pricing, however, could remain constrained, given the competitive nature of the industry and the relatively elastic demand (especially in categories like toothpowder).
- **Defensive appeal continues** — Risk reward ratio has declined, given robust outperformance against the broader market. We believe defensive appeal persists, given the current volatile environment. Healthy dividend yield should provide downside support at around Rs380-400 levels. Maintain Buy (1L).

| **Buy/Low Risk** | **1L** |
|---|---|
| Price (30 May 08) | Rs416.00 |
| Target price | Rs466.00 |
| *from Rs482.00* | |
| Expected share price return | 12.0% |
| Expected dividend yield | 4.0% |
| **Expected total return** | **16.0%** |
| Market Cap | Rs56,573M |
| | US$1,342M |

**Price Performance (RIC: COLG.BO, BB: CLGT IN)**


**Statistical Abstract**

| Year to 31 Mar | Net Profit (RsM) | Diluted EPS (Rs) | EPS growth (%) | P/E (x) | P/B (x) | ROE (%) | Yield (%) |
|---|---|---|---|---|---|---|---|
| 2006A | 1,376 | 10.12 | 18.4 | 41.1 | 20.9 | 52.8 | 1.8 |
| 2007A | 2,182 | 16.04 | 58.6 | 25.9 | 20.2 | 79.1 | 2.3 |
| 2008E | 2,327 | 17.11 | 6.7 | 24.3 | 30.3 | 99.6 | 3.1 |
| 2009E | 2,799 | 20.58 | 20.3 | 20.2 | 27.1 | 141.5 | 4.0 |
| 2010E | 3,237 | 23.80 | 15.7 | 17.5 | 24.1 | 145.9 | 4.6 |

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.



[1]Citigroup Global Markets India Private Limited

| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| **Valuation Ratios** | | | | | |
| P/E adjusted (x) | 41.1 | 25.9 | 24.3 | 20.2 | 17.5 |
| EV/EBITDA adjusted (x) | 31.7 | 26.3 | 23.9 | 19.3 | 16.5 |
| P/BV (x) | 20.9 | 20.2 | 30.3 | 27.1 | 24.1 |
| Dividend yield (%) | 1.8 | 2.3 | 3.1 | 4.0 | 4.6 |
| **Per Share Data (Rs)** | | | | | |
| EPS adjusted | 10.12 | 16.04 | 17.11 | 20.58 | 23.80 |
| EPS reported | 10.12 | 11.78 | 17.04 | 20.58 | 23.80 |
| BVPS | 19.93 | 20.63 | 13.72 | 15.36 | 17.27 |
| DPS | 7.50 | 9.50 | 13.00 | 16.46 | 19.04 |
| **Profit & Loss (RsM)** | | | | | |
| Net sales | 11,242 | 12,951 | 14,734 | 16,938 | 19,474 |
| Operating expenses | -9,818 | -11,015 | -12,637 | -14,337 | -16,450 |
| **EBIT** | **1,424** | **1,936** | **2,097** | **2,601** | **3,024** |
| Net interest expense | -6 | -10 | -14 | -16 | -17 |
| Non-operating/exceptionals | 461 | 670 | 848 | 870 | 990 |
| **Pre-tax profit** | **1,879** | **2,596** | **2,930** | **3,455** | **3,997** |
| Tax | -503 | -414 | -603 | -657 | -759 |
| Extraord./Min.Int./Pref.div. | 0 | -580 | -10 | 0 | 0 |
| **Reported net income** | **1,376** | **1,602** | **2,317** | **2,799** | **3,237** |
| Adjusted earnings | 1,376 | 2,182 | 2,327 | 2,799 | 3,237 |
| Adjusted EBITDA | 1,738 | 2,089 | 2,295 | 2,816 | 3,249 |
| **Growth Rates (%)** | | | | | |
| Sales | 16.6 | 15.2 | 13.8 | 15.0 | 15.0 |
| EBIT adjusted | -4.1 | 36.0 | 8.3 | 24.0 | 16.3 |
| EBITDA adjusted | 1.8 | 20.2 | 9.9 | 22.7 | 15.4 |
| EPS adjusted | 18.4 | 58.6 | 6.7 | 20.3 | 15.7 |
| **Cash Flow (RsM)** | | | | | |
| **Operating cash flow** | **1,874** | **2,554** | **4,462** | **3,815** | **4,198** |
| Depreciation/amortization | 314 | 153 | 198 | 215 | 225 |
| Net working capital | 174 | 400 | 1,937 | 801 | 736 |
| **Investing cash flow** | **-397** | **-228** | **-96** | **-45** | **-45** |
| Capital expenditure | -533 | -382 | -45 | -45 | -45 |
| Acquisitions/disposals | 137 | 154 | -51 | 0 | 0 |
| **Financing cash flow** | **-1,159** | **-1,508** | **-3,250** | **-2,575** | **-2,978** |
| Borrowings | 4 | -1 | 7 | 0 | 0 |
| Dividends paid | -1,163 | -1,481 | -2,033 | -2,575 | -2,978 |
| **Change in cash** | **318** | **238** | **1,107** | **1,195** | **1,174** |
| **Balance Sheet (RsM)** | | | | | |
| **Total assets** | **6,265** | **7,074** | **7,450** | **8,638** | **9,820** |
| Cash & cash equivalent | 880 | 1,117 | 2,224 | 3,419 | 4,593 |
| Accounts receivable | 65 | 93 | 121 | 139 | 160 |
| Net fixed assets | 1,691 | 1,920 | 1,767 | 1,597 | 1,417 |
| **Total liabilities** | **3,555** | **4,269** | **5,585** | **6,549** | **7,472** |
| Accounts payable | 2,095 | 2,428 | 2,897 | 3,289 | 3,778 |
| Total Debt | 44 | 43 | 50 | 50 | 50 |
| **Shareholders' funds** | **2,711** | **2,805** | **1,865** | **2,089** | **2,348** |
| **Profitability/Solvency Ratios (%)** | | | | | |
| EBITDA margin adjusted | 15.5 | 16.1 | 15.6 | 16.6 | 16.7 |
| ROE adjusted | 52.8 | 79.1 | 99.6 | 141.5 | 145.9 |
| ROIC adjusted | 85.3 | 142.8 | nm | na | na |
| Net debt to equity | -30.8 | -38.3 | -116.5 | -161.2 | -193.5 |
| Total debt to capital | 1.6 | 1.5 | 2.6 | 2.3 | 2.1 |

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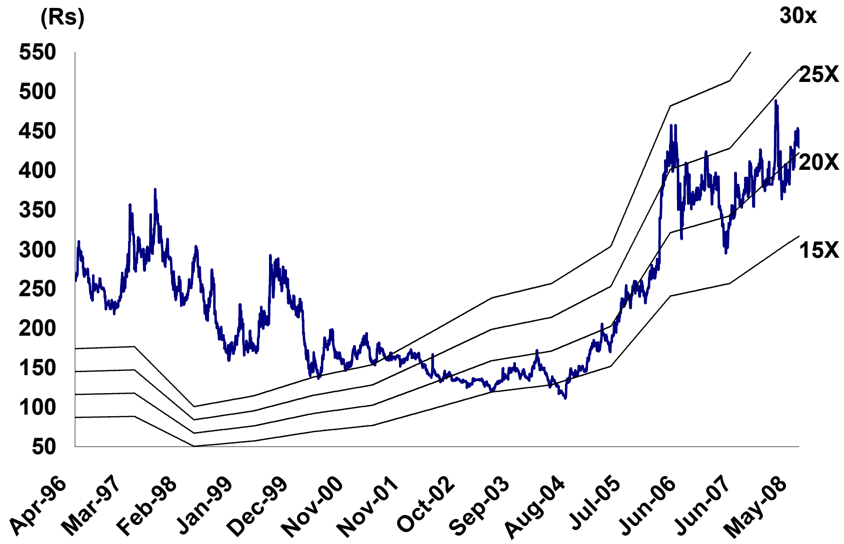
## Revise Target Price to Rs466

Our target price of Rs466 (previously Rs482) is based on 21x Sept09E earnings. Our target multiple has been pared to 21x from 23x to reflect deceleration in forecast earnings growth (earnings CAGR of 18% over FY08-10e, vs. c23% previously). We have also rolled forward to Sept09E EPS.

Our target P/E multiple of 21x is at the mid range of the historical trading range, which we believe is appropriate given Colgate's strong brand equity which will likely help the company maintain its premium rating despite increasing competition. The stock has traded between 15-28x (average c21x) over the last five years. It has typically found support around 18-19x, which also coincides with a fairly healthy dividend yield of 4-5%.

**Figure 1. Colgate – P/E Band Chart (x)**




Source: Citi Investment Research forecasts, Bloomberg

## Earnings Revision

**Figure 2. Colgate – Earnings Revision**

| Year to 31-Mar | Net Profit (Rs Mils.) | | | Diluted EPS (Rs) | | | Dividend Per Share (Rs) | | |
|---|---|---|---|---|---|---|---|---|---|
| | Old | New | % Chg | Old | New | % Chg | Old | New | % Chg |
| 2009E | 3,041 | 2,799 | -8.0% | 22.36 | 20.58 | -8.0% | 14.0 | 16.5 | 17.6% |
| 2010E | 3,506 | 3,237 | -7.7% | 25.78 | 23.80 | -7.7% | 16.0 | 19.0 | 19.0% |

Source: Citi Investment Research forecasts

Our downward revision in earnings is based on our view that EBITDA margins will remain fairly range bound (we forecast margins of c16.6-16.7% over the next two years, vs. earlier forecasts of around 19-20%), on account of i) escalating input costs, ii) higher advertising spends, and iii) higher costs like power and fuel, packaging etc (oil based derivatives).

Overall revenue growth is forecast to grow at around 14-15% CAGR, driven by around 12-13% in volumes, and another 2% price increase. We believe the price hikes should be sufficient to pass on cost hikes (but not the margin).

At the 4Q analyst meeting, management indicated that Colgate's market share gains continue, but also indicated that the competitive environment remains challenging. Given these factors and the relatively limited differentiation within products like toothpaste and toothbrushes, we believe that pricing will remain constrained over the medium term.

There could be some upside risk to our estimates depending on the extent of tax savings at the Baddi facility (accounts for c50% of overall production at present), but we believe that the market will focus on both volume growth and the quality of core earnings, rather than these benefits.

**Figure 3. Colgate – Market Share (%)**

| | CY06 | CY07 | 1QCY08 |
|---|---|---|---|
| Toothpaste | 47.8 | 48.4 | 48.3 |
| Toothpowder | 44.2 | 44.3 | 45.5 |
| Toothbrush | 34.4 | 34.9 | 37.2 |

Source: Company Reports, AC Nielsen

# 4QFY08 Results Review

**Figure 4. 4QFY08 Results Summary (Rupees in Million, Percent)**

| | 4QFY07 | 4QFY08 | % Change |
|---|---|---|---|
| **Net Sales** | **3,432.5** | **3,913.3** | **14.0** |
| Expenditure | -2,897.1 | -3,407.7 | 17.6 |
| **EBITDA** | **535.4** | **505.6** | **-5.6** |
| *EBITDA Margin (%)* | *15.6* | *12.9* | *-268 bps* |
| Interest | -2.5 | -3.6 | 44.0 |
| Depreciation & Amortisation | -36.5 | -54.5 | 49.3 |
| Other Income | 173.5 | 214.0 | 23.3 |
| **PBT** | **669.9** | **661.5** | **-1.3** |
| Tax | -171.8 | -105.3 | -38.7 |
| *Tax Rate (%)* | *25.6* | *15.9* | *-973 bps* |
| **PAT** | **498.1** | **556.2** | **11.7** |
| Exceptional items | 7.8 | 0.0 | nm |
| **PAT after Exceptionals** | **505.9** | **556.2** | **9.9** |
| No of shares | 136.0 | 136.0 | |
| **EPS** | **3.7** | **4.1** | **11.7** |
| **Cost Details** | | | |
| Total Raw Material Cost | 1,538.8 | 1,768.0 | 14.9 |
| *% of Sales* | *44.8* | *45.2* | *35 bps* |
| Employee/Staff Cost | 250.9 | 307.4 | 22.5 |
| *% of Sales* | *7.3* | *7.9* | *55 bps* |
| Advertising Cost | 639.3 | 734.5 | 14.9 |
| *% of Sales* | *18.6* | *18.8* | *14 bps* |
| Other Expenditure | 468.1 | 597.8 | 27.7 |
| *% of Sales* | *13.6* | *15.3* | *164 bps* |

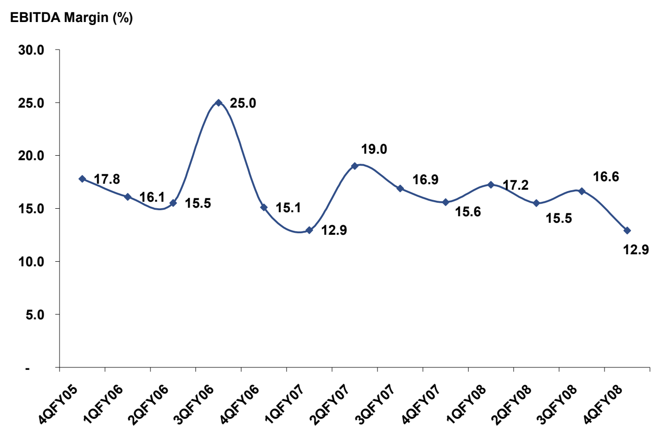
Source: Company Reports

Colgate revenue growth moderated to 14% YoY, declining from the c15-25% levels evidenced over the past two years on a combination of a higher base, and stable (rather than rapidly increasing) market share.

EBITDA margins declined primarily due to an increase in other expenditure and rising staff costs. Management indicated that these are addressable, but raw material costs, and power & fuel expenditure are an area of concern. We believe that all petro-based products (polypropylene, polyethylene, packaging materials, etc) will continue to impact profitability.

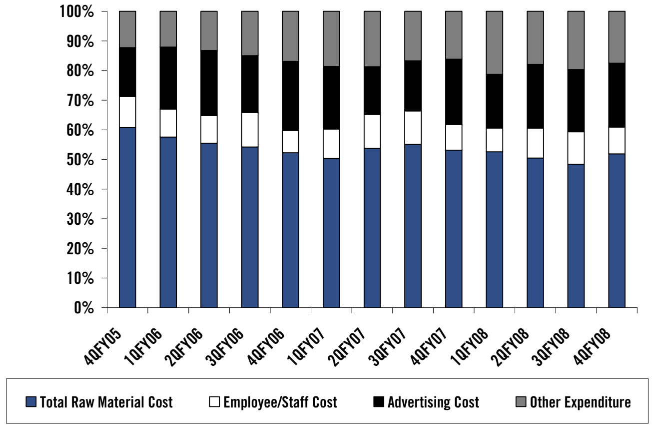
Overall PAT growth was c11.7% Y/Y, reflecting the benefits of other income, and also a lower tax incidence (the Baddi plant which accounts for c50% of production enjoys both an excise and an income tax holiday). PBT and EBIT declined c.1% and 10% respectively.

**Figure 5. EBITDA Margin Trends (%)**




Source: Company

**Figure 6. Cost Mix Trends(%)**




Source: Company

# Colgate Palmolive (India)

## Company description

Palmolive has been a leader in India's oral-care market for more than 30 years. The group's portfolio is heavily skewed toward oral-care products, which account for more than 90% of sales. Of late it has been exposed to rivalry from Hindustan Unilever and others. The company has a presence in the personal-care category through its Palmolive brand in products such as shaving creams and soaps, as well as higher-end shower gels and hand washes. Colgate Inc. has a 51% stake in the company.

## Investment strategy

We rate Colgate as Buy/Low Risk. Colgate is the market leader in the oral-care market with more than 49% market share. The company has invested significantly in its brands and, even with its strong leadership position, has been growing ahead of the market. In the past two years, it has gained market share in the semi-urban/rural markets by pushing its ‘Cibaca' brand. It has also launched innovative variants catering to the urban markets, which has significantly enhanced its growth profile.

## Valuation

Our target price of Rs466 is based on 21x Sept09E earnings. We have pared our target multiple to 21x from 23x, driven by the deceleration forecast in earnings growth (earnings CAGR of 18% over FY08-10e, vs. c23% previously), and have also rolled forward to Sept09E.

Our target P/E multiple of 21x is at the mid range of the historical trading range, which we believe is appropriate given Colgate's strong brand equity which will likely help the company maintain its premium rating despite increasing competition. The stock has traded between 15-28x (average c21x) over the last five years. It has typically found support around 18-19x, which also coincides with a fairly healthy dividend yield of 4-5%.

## Risks

We rate the stock as Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to the stock reaching our target price include: 1) The biggest risk to Colgate emanates from increased competition by HUVR and P&G; 2) Oral care market has seen all major players introduce discount brands but only some have been successful. In case there is cannibalization of the flagship brands, there is a threat that although volumes may not decline, the overall size (value) of the oral care market may not increase but rather contract if the brands and the perceived value equation are not communicated in an effective manner; and 3) If rural demand slackens (on sub-normal monsoon), volume growth could decelerate.

# Appendix A-1

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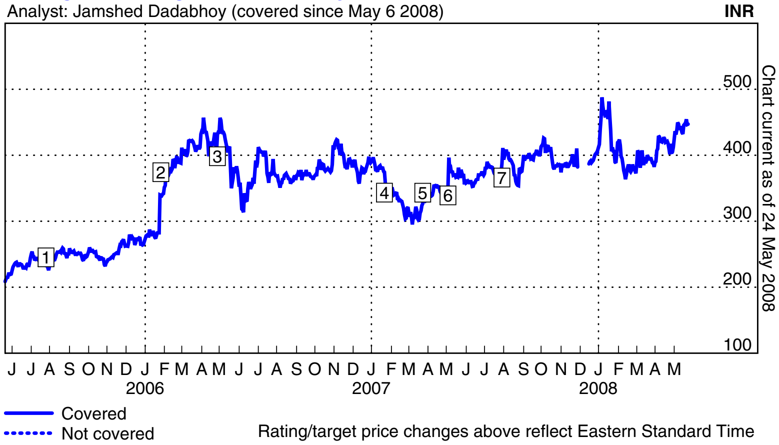
**Ratings and Target Price History - Fundamental Research**
Analyst: Jamshed Dadabhoy (covered since May 6 2008)




| # | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1: | 26 Jul 05 | 3L | *164.00 | 233.35 |
| 2: | 26 Jan 06 | 3L | *200.00 | NA |
| 3: | 27 Apr 06 | 3L | *270.00 | 431.10 |
| 4: | 22 Jan 07 | 3L | *302.00 | 374.35 |
| 5: | 23 Mar 07 | *1L | *413.00 | 326.75 |
| 6: | 3 May 07 | 1L | *445.00 | 351.80 |
| 7: | 29 Jul 07 | 1L | *482.00 | 386.85 |

*Indicates change.

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|---|---|---|---|
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