Flashnote

HSBC Global Research

Consumer Brands & Retail
India FMCG
Equity – India

India FMCG

Sector on track for growth

- **Fiscal measures by the RBI unlikely to impair FMCG growth; anti-inflationary measures, could be a positive**
- **The sector continues to offer a unique combination of robust EPS growth (15-20%) and relatively low risk**
- **Our highest conviction calls in the sector are Dabur, Marico, Asian Paints and ITC, all with c12-20% potential return**

Fiscal measures unlikely to impact FMCG outlook: In our view the recent measures and intent of the RBI to tighten liquidity and control inflation are not likely to have a material impact on FMCG companies, as demand for these products are not linked to credit growth. Infact, if the RBI is successful in controlling input cost inflation, it may keep purchasing power intact and may be marginally positive for the sector.

Robust and sustainable growth: FMCG results till now have surprised on the upside. While sales growth has remained robust and volume driven, gross margins have surprised on the upside due to material cost deflation. There is no discernable impact of the weak monsoon on the results, and companies seem confident that demand will remain strong spurred by government spending on the social sector. The higher gross margins have been partly invested in higher A&P spends, (thereby fuelling a virtuous cycle of re-investment and growth), and partly flow through in higher EPS. On the back of these strong results, we have raised EPS forecasts for most of the companies by c5-7%.

In spite of recent rally, potential return exists. Our highest conviction calls: Despite their recent run, we see a 12-20% potential return for FMCG stocks over the next 12 months – we forecast EPS growth at c20% CAGR FY09e-12e and our estimates are above consensus. In the context of this growth outlook, the sector's valuation (trades at c22x 12 months forward) is attractive in our view. Our top picks in the sector are ITC, Dabur, Marico and Asian Paints – for each of these our target prices suggest c12-20% potential return.

FMCG snapshot

Company	Ticker	Market cap (USDm)	Rating	Target price (INR)	Potential total return (%)	Sales CAGR 09e-12e	EPS CAGR 09e-12e	ROE FY10e
Asian paints	APNT IN	3,300	OW	1,850	15.3%	17.1%	29.6%	46.9%
Dabur India	DABUR IN	2,761	OW(V)	180	20.6%	17.9%	21.3%	48.7%
ITC	ITC IN	20,687	OW	290	13.7%	12.2%	17.9%	27.1%
Marico	MRCO IN	1,252	OW	113	16.6%	16.1%	21.3%	45.5%

Price data as on 28-Oct-09 Current prices as of close 39 October: Asian paints INR1593; Dabur India INR154; ITC INR259.3; Marico INR9855
Source: HSBC estimates

29 October 2009

Percy Panthaki*
Analyst
HSBC Securities and Capital Markets (India) Private Limited
+91 22 2268 1240
percypanthaki@hsbc.co.in

Maya Shivani*
Associate
Bangalore

HSBC

Snapshot of 2Q FY10 results

	Asian paints	Dabur India	ITC	Marico Industries
2Q FY10 - Reported				
Revenue	17,239	8,480	42,926	6,922
Y-o-y growth	16.8%	22.7%	14.1%	14.4%
Gross profit y-o-y growth	29.5%	31.6%	16.3%	32.0%
GP margin expansion	424 bp	374 bp	113 bp	703 bp
EBITDA y-o-y growth	54.2%	36.4%	30.8%	28.5%
EBITDA margin expansion	454 bp	215 bp	475 bp	150 bp
Adjusted EPS	22.10	1.60	2.66	1.02
Y-o-y growth	61.2%	29.0%	25.5%	32.5%
2Q FY10 - Estimated				
Revenue	17,187	8,432	40,277	6,940
Y-o-y growth	16.5%	22.0%	7.0%	14.7%
Gross profit y-o-y growth	25.6%	26.7%	*	19.4%
GP margin expansion	307 bp	196 bp	*	187 bp
EBITDA y-o-y growth	37.0%	26.3%	24.4%	23.7%
EBITDA margin expansion	251 bp	67 bp	523 bp	95 bp
Adjusted EPS	18.91	1.47	2.50	0.91
Y-o-y growth	38.0%	18.6%	17.7%	18.7%
Variance over estimates				
Revenue	0.3%	0.6%	6.6%	-0.3%
Gross profit	3.1%	3.9%	*	10.5%
Gross profit margin	116 bp	178 bp	*	516 bp
EBITDA	12.5%	8.1%	5.2%	3.9%
EBITDA margin	203 bp	148 bp	-48 bp	55 bp
Adjusted EPS	16.8%	8.8%	6.6%	11.6%

* We do not estimate gross margins for ITC
Source: Company, HSBC

Asian Paints

For the quarter, Asian Paints reported 16.8% consolidated sales growth. We estimate that volume growth was robust at c20%, along with a good amount of up-trading. Gross profit margin grew 424 bps y-o-y backed by soft commodity costs; though the ones related to crude oil have been showing an upward trend lately. Excluding one-offs, Asian paints closed the quarter with 61.6% y-o-y bottom line growth.

We estimate revenue and EPS CAGR at 17.1% and 29.6% FY09e-12e and gross margins at +42% over the next three years.

Asian Paints is the market leader in the paints industry in India. We believe that Asian Paints has ample scope to grow through: (1) growth in the industry driven by close correlation with GDP growth, low per capita consumption and changing age, income and regional demographics and (2) gaining market share via its strong brands, extensive distribution network, and pricing power to tide over periods of cost inflation. Over last 10 years, Asian Paints has grown market share (market defined as top six players) by 12 percentage points and we believe that there is scope for more gains. We believe that Asian Paints can grow volumes at c15% over the next three years and maintain its margins. With a c45% ROE, near zero debt and sustainable EPS growth of c17-20% in the medium term, we believe that Asian Paints is a low risk way to play the Indian growth story.

Dabur

Sales increased by 22.7%, in line with our estimates. However the main surprise was gross margins higher by 370bps on a y-o-y basis on account of benign raw material costs. Brands were well supported with ad spends going up 54%. Net profit expanded by 29% on y-o-y basis.

Peak gross margins in Q2 FY10 translate into higher margins for the full year. Accordingly we estimate gross margins at 53.1% in FY10e - 220bps y-o-y margin expansion. We estimate revenue and EPS CAGR at 17.9% and 21.3% FY09e-12e

Dabur is a diversified FMCG company in segments such as hair oils, shampoos, oral care, home care, skin care, foods, healthcare, etc. We are positive on the stock for its high sales growth of c20% and also for the quality of growth ie volume led growth with little reliance on price increases. In spite of this we think it manages cost inflation well (in FY09 when cost inflation was at its peak, Dabur still grew EPS by 18%). The company is a play on consumerism in India – with the income pyramid shifting and more consumers coming out of poverty, the consumption of consumer staples products is set for long term and sustainable growth, in our view. The company has strong free cash flows with an ROE of 55% on our estimates.

ITC

The cigarette division reported robust volume growth of 8%, an improvement of 2-3ppts on trend growth, and a 50-60bps increase in market share. Cigarette margins expanded by 134bps as selling price increases on a y-o-y basis were not met with a corresponding tax increase. Except the hotel segment that reported a decline in revenue on a y-o-y basis, largely an industry phenomena, all other businesses reported strong revenue growth (FMCG – 14%, Agri – 19% and Paperboards – 13%).

For FY10e, we estimate 7.5% volume growth in cigarettes (5% previously). On the basis of increased sales and operating leverage in the cigarettes business, we revise our FY10e EPS to INR10.80 (INR10.44 previously). FY11e and FY12e show a sequential upward revision in estimates due to high base effect while assumptions remain unchanged. At the company level, we estimate 12.2% and 17.9% top line and EPS CAGR FY09e-12e.

ITC is the dominant player in the tobacco industry in India, with market share in excess of 80%. India's cigarette market is growing at a c5% rate and seems likely to maintain this pace for several years due to shifts from other forms of tobacco such as bidis and chewing tobacco. This is in contrast to other parts of the world, where volumes are declining, and combined with high EBIT margins of 55% and 100%+ ROE, ITC trades at a higher PE multiple than global peers, we believe. There is empirically proven pricing power for ITC, and it is generally able to manage increases in taxation by increasing prices. In addition to cigarettes, ITC has diverse businesses such as foods, personal products, hotels, commodity trading, and paperboards; while these contribute more than half of net sales, cigarettes contribute 80%+ to company EBIT. We are bullish on the stock due to the scope for growth in cigarettes on volume, price, and margins, improved margins and the return profile on the Agri business, and narrowed FMCG losses.

Marico

Strong growth of 14.4% in Q2 FY10 was largely backed by volumes. The surprise package was the 700bps gross profit margin expansion on a y-o-y basis, reaping benefits of lower commodity costs. Higher cash flows were invested in building the franchise with ad spends up 60% on a y-o-y basis. Marico ended the quarter with 32.3% net profit growth (48% growth excluding excise duty provision).

We believe that for FY10e, gross margin expansion will power growth. In FY11e, we estimate constant gross profit per unit - in line with the company's strategy; and in FY12e, we expect Kaya to boost growth contributing cINR150m to the net profit. We estimate 16.1% and 21.3% top line and EPS CAGR FY09e-12e.

Marico is a player an FMCG player with offerings in coconut hair oils (36% of sales), other hair oils (12% of sales), Saffola edible oils (15% of sales), International business (20% of sales), and Kaya (6% of sales) and the remainder made up of miscellaneous products. It has a dominant position in coconut hair oils with over 50% market share and is a strong number 2 in other hair oils with 21% market share. Saffola has a niche position within edible oils, focussing on cholesterol management and 'good for heart' benefits. It also has an international business in Bangladesh, Middle East, North Africa and South Africa. Marico is also prototyping functional foods under the Saffola brand such as low sodium salt, low GI rice (for diabetics) and healthy snacks. In addition it operates skin treatment clinics under the brand Kaya. The company is a direct beneficiary of trends such as conversion from loose to branded products and a move towards products with health benefits.

Valuation and risks

Asian paints - INR1,850; OW

We value Asian Paints at a PE multiple of 22x (unchanged) on September 2011e EPS, a 5% premium to historical average, justified by our higher earnings growth estimates (please see our 23 October note, *OW: Volume and margin traction positive*). This gives us a target price of INR1,850 per share. Risks to our call are higher cost inflation, more competition and slower demand growth.

Dabur - INR180; OW(V)

We value Dabur at INR180 based on a PE multiple of 24x (10% premium over historical multiples) and also rolled over from Mar'11e to Sep'11e (please see our 26 October note, *OW (V) – strong sales, stronger margins*). We believe that the premium is justified given its broad based growth now, compared to sporadic growth earlier. Downside risks include raw material costs inflation higher than estimated adversely impacting margins; synergies with FCPL not flowing through as estimated, retail losses higher than estimated and a grim macro economic environment impacting consumer spending and volume growth.

ITC – INR290; OW

We value ITC on a sum-of-the-parts (SOTP) basis, and raised our 12-month target price to INR290 from INR264 (please see our 23 October note *OW, raising target price: Solid FQ2 results except for hotels*). We rolled over our valuation horizon from March to September 2011e but kept our multiples unchanged (PEs of 21.0x for cigarettes, 15.0x for hotels, 6.0x for agribusiness, and 5.0x for paperboards; and 1.5x sales for other). Downside risks, in our view, are higher- or faster-than-expected tax increases, a slowdown in consumer spending that reduces volume growth, and PE multiple contraction in the event of a significant economic downturn.

Marico – INR113; OW

We value Marico at a PE of 21x (unchanged), a 10% premium to its historical average of 19x, which we believe is justified given the robust volume growth and potential in its Kaya and functional foods initiatives. We rolled over our multiples from Mar'11e to Sep'11e and changed our target price to INR113 from INR95 while upgrading the stock to Overweight from Neutral (please see our 28 October note *Upgrade to OW: Growing gross margin to invest in growth*). Downside risks include volume growth slowing more than expected; upward pressure on market price for Copra as government announced support prices are higher than current price and Kaya not being able to contribute positively.

Estimates

Estimates - FY10e-12e

	Asian paints	Dabur India	ITC	Marico Industries
FY10e				
Sales	63,358	34,035	178,764	27,133
Sales growth	16.0%	21.3%	9.5%	13.6%
EBITDA	10,268	6,210	62,033	3,873
EBITDA margin	16.2%	18.2%	34.7%	14.3%
EPS	66.58	5.60	10.80	4.08
EPS growth	59.1%	24.1%	22.6%	21.9%
FY11e	74,674	39,627		32,060
Sales	17.9%	16.4%	204,971	18.2%
Sales growth	11,937	7,479	14.7%	4,564
EBITDA	16.0%	18.9%	72,957	14.2%
EBITDA margin	77.73	6.75	35.6%	4.80
EPS	16.7%	20.7%	12.64	17.8%
EPS growth			17.0%	
	87,752	46,009		37,350
FY12e	17.5%	16.1%		16.5%
Sales	13,870	8,924	230,656	5,494
Sales growth	15.8%	19.4%	12.5%	14.7%
EBITDA	91.03	8.05	83,545	5.97
EBITDA margin	17.1%	19.2%	36.2%	24.3%
EPS	63,358	34,035	14.43	27,133
EPS growth	16.0%	21.3%	14.2%	13.6%

Source: HSBC estimates

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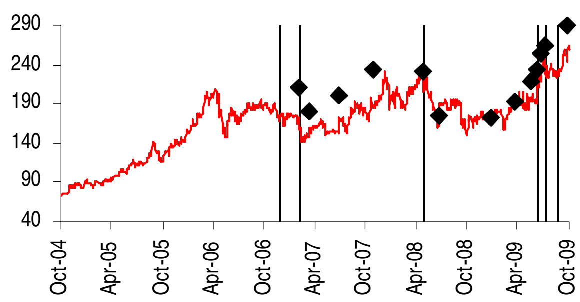
Share price and rating changes for long-term investment opportunities

ITC (ITC.BO) Share Price performance INR Vs HSBC rating history



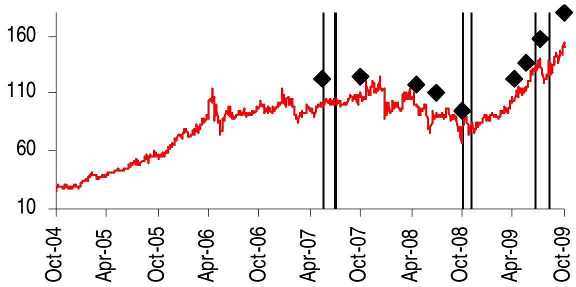
Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	19 December 2006
Neutral	Overweight	01 March 2007
Overweight	Neutral	23 May 2008
Neutral	Overweight	06 July 2009
Overweight	Neutral	05 August 2009
Neutral	Overweight	14 September 2009
Target Price	**Value**	**Date**
Price 1	210.00	01 March 2007
Price 2	180.00	09 April 2007
Price 3	201.00	27 July 2007
Price 4	233.00	26 November 2007
Price 5	231.00	23 May 2008
Price 6	175.00	16 July 2008
Price 7	172.00	20 January 2009
Price 8	193.00	17 April 2009
Price 9	218.00	15 June 2009
Price 10	234.00	06 July 2009
Price 11	254.00	23 July 2009
Price 12	264.00	05 August 2009
Price 13	290.00	23 October 2009

Source: HSBC

Dabur India (DABU.BO) Share Price performance INR Vs HSBC rating history



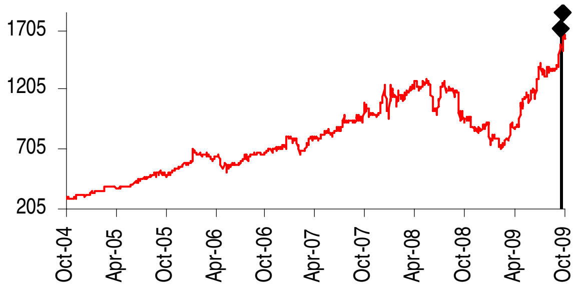
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight (V)	15 June 2007
Overweight (V)	Overweight	24 July 2007
Overweight	Neutral (V)	31 October 2008
Neutral (V)	Overweight (V)	24 November 2008
Overweight (V)	Neutral (V)	13 July 2009
Neutral (V)	Overweight (V)	01 September 2009
Target Price	**Value**	**Date**
Price 1	123.00	15 June 2007
Price 2	125.00	24 October 2007
Price 3	118.00	16 May 2008
Price 4	110.00	29 July 2008
Price 5	94.50	31 October 2008
Price 6	123.00	30 April 2009
Price 7	137.00	15 June 2009
Price 8	158.00	05 August 2009
Price 9	180.00	26 October 2009

Source: HSBC

Asian Paints (ASPN.BO) Share Price performance INR Vs HSBC rating history



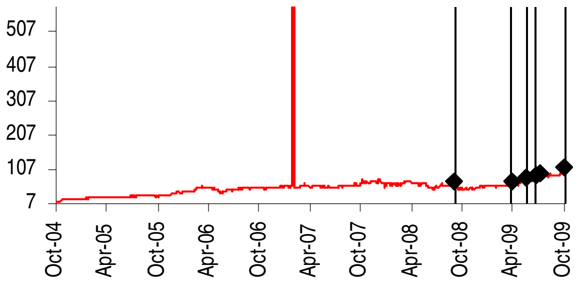
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	12 October 2009
Target Price	**Value**	**Date**
Price 1	1720.00	12 October 2009
Price 2	1850.00	22 October 2009

Source: HSBC

Marico Industries (MRCO.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/R	Overweight (V)	30 September 2008
Overweight (V)	Neutral (V)	22 April 2009
Neutral (V)	Overweight	15 June 2009
Overweight	Neutral	13 July 2009
Neutral	Overweight	28 October 2009
Target Price	**Value**	**Date**
Price 1	72.00	30 September 2008
Price 2	69.40	22 April 2009
Price 3	82.30	15 June 2009
Price 4	90.00	23 July 2009
Price 5	95.00	05 August 2009
Price 6	113.00	28 October 2009

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ITC	ITC.BO	259.10	29-Oct-2009	4, 6

Source: HSBC

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Registered Office
52/60 Mahatma Gandhi Road
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