

April 20, 2007

Stock Rating  
**Overweight**

Industry View  
**Attractive**

## Hindustan Lever

### Annual Report Analysis

**What does its annual report say?** HLL recently released in C2006 annual report. Amongst other things, the annual talks about the simplification in organization structure by appointment of a single committee to manage the business. It also discusses the potential move into new corporate office in C2008 and the potential positive cash flow impact on account of this move.

**Soaps volume recovers, but tea declines:** HLL witnessed the highest volume growth of 5% in its soaps business during the last 10 years in C2006. However, its tea business volumes continue to decline, witnessing a 10% volume decline in C2006. Surprisingly, detergents is the fastest growing category within the HPC segment, growing at 16%. Ice creams have grown 39%, albeit from a low base. Detergent realizations have improved for the second consecutive year, despite the price war with P&G, by 8% following a 4% improvement in realizations in C2005 (Exhibit 3).

**Working capital improves:** Its capital expenditure in C2006 at Rs13bn was marginally lower than Rs14.4bn incurred in C2005. Interestingly, HLL's C2006 capital expenditure was in line with its provision for depreciation during the year (Exhibit 1). HLL's working capital management continued to improve in C2006.

**Maintain Overweight rating:** The stock is trading at 24.2 and 20.7x C2007E and C2008E earnings, respectively. Recovery in earnings growth momentum is likely to be the key trigger for the stock, in our view. HLL is expected to report its Q1C2007 performance on 30th April; we expect the company to deliver 12% domestic FMCG revenue growth and 20% earnings growth.

#### Key Ratios and Statistics

Reuters: HLL.BO Bloomberg: HLVR IN  
India Consumer

Price target	Rs245.00
Shr price, close (Apr 20, 2007)	Rs205.50
Mkt cap, curr (mn)	Rs452,218
52-Week Range	Rs295.85-166.00
Sh out, basic, curr (mn)	2,200.6
EV, curr (mn)	Rs433,146
Net debt/cap (06e) (%)	(610.6)
ROE (06e) (%)	66.8
Shrs out, basic, per-end (06e) (mn)	2,201
S'hldr eqty (06e) (mn)	Rs23,561
RNOA (06e) (%)	244.7

e = Morgan Stanley Research estimates

Fiscal Year (Dec)	2005	2006e	2007e	2008e
ModelWare EPS (Rs)*	5.96	6.99	8.48	9.95
Prior ModelWare EPS (Rs)	-	-	-	-
EPS, basic, rpt'd (Rs)	6.40	6.99	8.48	9.95
Prior EPS, basic, rpt'd (Rs)	-	-	-	-
Revenue, net (Rs mn)	110,605	121,034	137,073	154,650
ModelWare net inc (Rs mn)	13,105	15,392	18,669	21,888
P/E	33.1	29.4	24.2	20.7
P/BV	18.8	19.2	18.2	17.6
EV/EBITDA	28.8	26.2	21.5	18.4
Div yld (%)	2.5	2.9	3.4	4.1

\* = Please see explanation of Morgan Stanley ModelWare later in this note.  
e = Morgan Stanley Research estimates

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**Move to new corporate office cash flow positive:** According to HLL's annual report, they are likely to move into a new corporate office in Andheri, Mumbai, which will be built on the company's 12.6 acre site to be completed by C2008 and will cost around Rs3.75bn. The company's Foods & Beverages, Home and Personal Care businesses and Finance, HR, Sales and Customer development, supply chain, legal and training centres will work together at the proposed campus. According to management, the new campus is being built to create an inspiring work environment. Interestingly, the move to the new campus is likely to be cash flow positive, as it will release valuable real estate in Bangalore and Mumbai for disposal, which is expected to yield higher realization than the proposed investment in new corporate office.

**Organization structure simplified:** HLL has simplified the organization structure by doing away with two divisional management committees for HPC and Foods. The structure is replaced by appointing a single management committee. The new ventures structure has also been discontinued. Shakti is being fully integrated with customer and sales function to harness the synergies in the rural areas, and HLL Network and Ayush (Consumer Health Care) businesses have been incorporated with HPC. However, Water will continue to be run as an independent business.

**Gearing up for organized retail:** HLL has invested in equipping itself to face the changing dynamics, be it building a seamless supply chain with reduced response time or building a knowledge base to operate in an organized retail environment. The company is also helping the general trade to adapt to the changing business environment by partnering with them. HLL believes that the investments in general have ensured that it is significantly ahead of the competition in delivering customer satisfaction.

**Water likely to be rolled out in C2007:** The company's in-home drinking water purification system, Pureit, was test-launched in a few cities in Tamil Nadu in C2005. Encouraged by the initial response, the company built its overall capability to manufacture and distribute in C2006. It is likely to be rolled out in more states in C2007.

**Project Shakti to cover 600 mn consumers in 2010:** Shakti has more than doubled the company's rural reach, with 30,800 Shakti entrepreneurs covering 100,000 villages in 15 states. Shakti entrepreneurs sell to 3 mn rural households every month, creating a distinctive rural direct to home distribution channel. It has aimed to reach 600 mn consumers in 500,000 villages through 100,000 entrepreneurs by 2010. Effective

February 2007, the Shakti channel has been aligned with the mainstream sales and customer development function.

**Ayush Therapy centres increased from 15 to 40:** The company has built a technological foundation for ayurvedic product development and safety clearance protocols along with sourcing and testing of herbs. According to management, this would be leveraged to develop Ayush range of products for the future. The business is being developed on two legs, direct selling and health & wellness services, through a franchisee route. Revenues have doubled in this business for the second consecutive year. It has expanded operations into 11 cities from 7 earlier and the number of centres from 15 to 40. It has also launched five new products in the Health & Wellness area.

Exhibit 1

**HLL: Segment capital expenditure**

Capital expenditure	2006	2005	% change
Soaps and detergents	671	776	-14%
Personal products	258	320	-19%
Beverages	168	44	282%
Foods	41	28	49%
Ice-creams	85	73	16%
Exports	50	167	-70%
Other operations	31	30	1%

Source: Company data, Morgan Stanley Research

**Company Description**

Hindustan Lever, a 51%-owned subsidiary of Anglo Dutch giant Unilever, is the largest consumer company in India, with an annual turnover of US\$2.2 billion. Its business portfolio includes detergents, soaps, personal and oral care products and processed foods and beverages. The company is the market leader in most of its product categories.

**India Consumer**

**Industry View: Attractive**

The industry outlook remains attractive, with most consumer companies witnessing significant revenue growth. While input cost pressures remain severe, we have seen alleviation of some of these costs over the past 2-3 months. If this trend continues, consumer companies in India could witness steady gross margin expansion over the next few quarters.

**MSCI Country: India**

Asia Strategist's Recommended Weight: 1.6%  
MSCI Asia/Pac All Country Ex Jp Weight: 6.3%

Exhibit 2

**HLL: Trend in working capital management**

YE December 31	2002	2003	2004	2005	2006
Inventories % of sales	12.8	13.7	14.8	11.9	12.8
Debtors % of sales	3.7	4.6	4.9	4.7	3.6
Sundry Creditors % of sales	24.1	24.1	24.9	26.3	26.0
Net Working capital % of sales	-7.5	-5.7	-5.2	-9.6	-9.6

Rs mn

YE December 31	2002	2003	2004	2005	2006
Inventories	12787	13926	14704	13217	15477
Creditors	3678	4709	4893	5228	4404
Sundry Creditors	23965	24389	24766	29056	31466
Net working capital	(7500)	(5754)	(5169)	(10611)	(11585)

Source: Company data, Morgan Stanley Research

Exhibit 3

**HLL: Trend in Growth Metrics for Various Categories**

Y/E December (Rs m)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Soaps</b>											
Volume Growth (%)	9%	3%	-2%	2%	1%	-2%	-1%	-2%	-1%	1%	5%
Realization Growth (%)	21%	10%	4%	5%	-2%	-2%	11%	6%	3%	5%	5%
% of sales	26%	25%	21%	21%	20%	19%	23%	23%	24%	23%	23%
Value Growth (%)	32%	13%	2%	7%	-2%	-3%	10%	4%	2%	7%	10%
<b>Synthetic detergents</b>											
Volume Growth (%)	103%	1%	7%	8%	5%	7%	1%	-1%	4%	11%	7%
Realization Growth (%)	-13%	16%	4%	4%	1%	-4%	0%	-3%	-3%	4%	8%
% of sales	18%	18%	16%	17%	18%	18%	19%	18%	19%	20%	21%
Value Growth (%)	76%	17%	11%	12%	6%	3%	1%	-4%	1%	16%	16%
<b>Personal products</b>											
Volume Growth (%)	105%	63%	45%	23%	17%	18%	-3%	41%	12%	25%	21%
Value Growth (%)	54%	47%	73%	16%	4%	14.3%	-0.3%	14.5%	2.9%	21.7%	15%
<b>Tea</b>											
Volume Growth (%)		7%	-8%	-13%	19%	-8%	-17%	19%	-11%	2%	-10%
Realization Growth (%)	26%	10%	29%	-4%	8%	3%	1%	-12%	12%	0%	9%
% of sales	17%	17%	17%	13%	16%	15%	14%	14%	14%	13%	12%
Value Growth (%)		17%	18%	-16%	29%	-5%	-16%	4%	0%	2%	-2%
<b>Coffee</b>											
Volume Growth (%)		8%	4%	28%	18%	23%	14%	1%	-14%	1%	1%
Realization Growth (%)		13%	3%	-10%	-7%	-13%	-9%	5%	19%	12%	10%
% of sales	3%	3%	2%	3%	3%	3%	3%	3%	3%	3%	3%
Value Growth (%)		21%	7%	15%	9%	7%	4%	6%	3%	12%	11%
<b>Frozen Deserts and Ice-creams</b>											
Volume Growth (%)		7%	n.a	-4%	0%	0%	-42%	-14%	-8%	36%	0%
Realization Growth (%)		6%	n.a	14%	-4%	-13%	27%	1%	0%	0%	0%
% of sales	2%	2%	2%	2%	2%	1%	1%	1%	1%	1%	1%
Value Growth (%)		13%	2%	10%	-4%	-13%	-26%	-13%	-4%	11%	39%
<b>Processed triglycerides/hydrogenated oils/vanaspati</b>											
Volume Growth (%)	93%	4%	1%	2%	-1%	-2%	-21%	-34%	-42%	13%	-57%
Realization Growth (%)	80%	1%	19%	-8%	0%	-3%	8%	7%	-9%	-3%	2%
% of sales	8%	7%	7%	6%	6%	5%	5%	3%	2%	2%	1%
Value Growth (%)	247%	6%	20%	-6%	-1%	-5%	-14%	-30%	-47%	9%	-57%

Source: Company data, Morgan Stanley Research

Exhibit 4

**HLL: Brand Performance**

Categories/Brands	Activity during the year	Comments/Outlook
Detergents	Clocked double digit sales growth. Judicious price increase and aggressive cost effectiveness measures to neutralize inflation.	Profit margins continue to be challenge given the intensity of competition
Surf Excel	Surf Excel was relaunched with significantly improved packaging and formulations	Plans to extend Surf Excel Bar to all geographies in C2007
Wheel	Wheel gained 50 bps market share	
Vim	Introduced Vim dishwash liquid	Plans to extend it to larger geographies
Soaps	Demonstrated volume and value growth, however competition from local and regional players continues	Vegetable oil prices which were stable in C2006 have started firming up towards the end of the year requiring price increases to offset input cost inflation
Lifebuoy	Relaunch with improved formulation and packaging	
Lux	Variants such as White Glow, Uplifting Firm, Aqua sparkle and Chocolate Seduction were launched	Brand celebrated 75th year. Celebrations were used to strengthen the brand. Lux boyd wash rolled out
Dove	New variants rolled our	Dove body wash rolled out. Focusing on upgrading consumers and driving value growth
Breeze	Relaunched in H2C2006	Expected to arrest volume decline
Personal Products		
Hair	All leading brands witnessed double digit growth	
Sunsilk	Sunsilk Gang of Girls, Color Shine and Hair Expert launched	Sunsilk brand transforming from hair wash to hair care positioning
Clinic Plus	Sachets continue to be the key driver for penetration and consumption	Consolidated market leadership
Clinic All Clear	Ice Cool and Hair Fall Defense variants launched	
Skin	Allround performance in creams, lotions and talc	
Fair & Lovely	Menz Activ, FAL Skin Clarity launched	Variants under FAL strengthened
Pond's	Introduced new top end products. Pond's cold cream relaunched and Pond's facial wash launched	Top end products to address anti-ageing, moisturizing and skin lightening needs
Lakme and Vaseline	Vaseline witnessed strong double digit growth and Lakme skin continues to grow strongly	
Lakme Color cosmetics	Lakme Fashion platform, twice a year to give the brand vibrant and contemporary image	88 Lakme Salons in major metros
Toothpastes		
Close-up	Milk Calcium variant launched	Grew ahead of the market
Personal Products	10 teeth and gum problems" campaign	Helped the brand grow in C2006
Deodorants	Rexona Deo Roll launched, Axe variant Click met with tremendous response	
Exports	HPC exports grew 24%	Buoyancy in HPC exports is expected to be sustained
Foods	Business continued to drive operation efficiencies and cost synergies for growing profitably	
Processed Foods	Knorr international quality soups launched	With strong growth momentum behind brands and categories hopes for a good and exciting C2007
Tea	Extremely competitive market environment. Focus on Lipton with Out of Home consumption	Tea prices have begun to firm up towards the later part of the year
Coffee	Another excellent year led by instant coffee	Perceptible trend of consumers shifting from roast and ground coffee to instant coffee
Ice-cream	A massive availability expansion plan modeled on Unilever success put in place	a new manufacturing unit in the North. Business is well poised to sustain performance into the future

Source: Company data, Morgan Stanley Research



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(as of March 31, 2007)

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<b>Underweight/Sell</b>	<b>364</b>	<b>17%</b>	<b>95</b>	<b>14%</b>	<b>26%</b>
<b>Total</b>	<b>2,198</b>		<b>671</b>		

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**Hong Kong**  
Tel: +852 2848 5200

**Industry Coverage:India Consumer**

<b>Company (Ticker)</b>	<b>Rating (as of)</b>	<b>Price (04/20/2007)</b>
<b>Hozefa Topiwalla</b>		
Colgate-Palmolive India (COLG.BO)	O (01/10/2005)	Rs344.85
Dabur India (DABU.BO)	O (10/18/2006)	Rs97.1
Godrej Consumer Products Limited (GOCP.BO)	O (07/24/2006)	Rs163.9
Hindustan Lever (HLL.BO)	O (08/01/2005)	Rs205.5
ITC Ltd. (ITC.BO)	E (03/12/2007)	Rs160.6
Marico Limited (MRCO.BO)	U (04/10/2007)	Rs56.7
Nestle India (NEST.BO)	O (05/02/2002)	Rs995.75
Tata Tea (TTTE.BO)	E (09/04/2006)	Rs676.45

Stock Ratings are subject to change. Please see latest research for each company.