Equities

22 March 2011 | 11 pages

Asian Paints (ASPN.BO)

Hold: Demand Buoyancy Mitigates Margin Concerns

- Company Update
- Target Price Change
- Estimate Change

- **Management meeting highlights** — Despite multiple price hikes through FY11 (total price increase: ~12.4%; avg increase for the year: ~8%), domestic decorative paints demand continues to remain healthy. Growth rates in non metro markets are ~150-200bps higher than the urban centers – encouragingly, mix seems to be improving across markets – emulsions are now >50% of revenues.
- **Margins under pressure** — Mgmt reiterated that cost inflation remains a key concern – cost index has increased Q/Q and is ~117-118 now vs. 115 in 3Q (on FY10 base of 100). Mgmt expects pressures in TiO_2 (15-18% of material cost) to continue into FY12. Escalating prices of solvents (crude linked) and vegetable oils will also impact margins. ASPN has the ability to push through costs, but these are typically with a lag and may potentially impact demand.
- **International outlook mixed** — International business (~16% of revenues) is likely to be impacted by the MENA political turbulence. Factories in Egypt (~27-28% of int'l revenues) have re-commenced operations, but sales remain weak. Caribbean & South Pacific market growth is lackluster; S. Asia is the silver lining.
- **Capacity expansion under way** — Like other paint companies, ASPN plans to augment capacities - mgmt aims to increase its current capacity of ~590K MT by ~50% by 4QFY13 with the addition of the new greenfield Khandala plant (initial capacity of 300K MT, scalable to 400K MT). Capex guidance for FY11/12/13E is Rs2bn, Rs8-9bn & Rs4-5bn respectively; of which ~Rs10bn is for Khandala. Mgmt noted that ~25-28% of its volumes are sourced through third party manufacturing.
- **Maintain Hold** — We pare our FY12/13E EPS estimates by ~6%/1% as we tweak a) gross margins forecasts, b) international revenues and c) incorporate the higher capex. Our TP is revised to Rs2,763 (from Rs2,803 earlier) as we roll forward to Jun12E from Mar12E at our 25x target P/E multiple. Cyclical pressures given sticky cost pressures are likely to negatively impact margins. This, coupled with valuations at 24x one year fwd P/E cap upside potential in our view.

Hold/Low Risk	2L
Price (22 Mar 11)	Rs2,527.10
Target price	Rs2,763.00
from Rs2,803.00	
Expected share price return	9.3%
Expected dividend yield	1.5%
Expected total return	**10.8%**
Market Cap	Rs242,399M
	US$5,387M

Price Performance (RIC: ASPN.BO, BB: APNT IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	4,014	41.84	-3.9	60.4	20.1	36.7	0.7
2010A	7,720	80.48	92.3	31.4	14.2	53.0	1.1
2011E	8,990	93.72	16.4	27.0	11.1	46.1	1.5
2012E	10,157	105.89	13.0	23.9	8.9	41.3	1.7
2013E	11,937	124.44	17.5	20.3	7.2	39.1	2.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	60.4	31.4	27.0	23.9	20.3
EV/EBITDA adjusted (x)	36.5	19.8	17.1	15.4	13.1
P/BV (x)	20.1	14.2	11.1	8.9	7.2
Dividend yield (%)	0.7	1.1	1.5	1.7	2.0
Per Share Data (Rs)					
EPS adjusted	41.84	80.48	93.72	105.89	124.44
EPS reported	41.48	87.12	93.72	105.89	124.44
BVPS	125.43	178.27	228.24	284.70	351.06
DPS	17.50	27.00	37.49	42.36	49.78
Profit & Loss (RsM)					
Net sales	54,639	66,809	79,649	93,626	107,060
Operating expenses	-48,682	-55,369	-66,839	-79,227	-90,182
EBIT	**5,957**	**11,441**	**12,811**	**14,399**	**16,879**
Net interest expense	-263	-285	-215	-184	-179
Non-operating/exceptionals	510	778	854	962	1,087
Pre-tax profit	**6,204**	**11,934**	**13,449**	**15,177**	**17,787**
Tax	-1,974	-3,731	-4,035	-4,553	-5,336
Extraord./Min.Int./Pref.div.	-252	154	-425	-467	-514
Reported net income	**3,978**	**8,356**	**8,990**	**10,157**	**11,937**
Adjusted earnings	4,014	7,720	8,990	10,157	11,937
Adjusted EBITDA	6,701	12,276	13,993	15,544	18,296
Growth Rates (%)					
Sales	24.0	22.3	19.2	17.5	14.3
EBIT adjusted	-1.0	92.1	12.0	12.4	17.2
EBITDA adjusted	1.4	83.2	14.0	11.1	17.7
EPS adjusted	-3.9	92.3	16.4	13.0	17.5
Cash Flow (RsM)					
Operating cash flow	**3,363**	**12,442**	**10,318**	**10,853**	**13,076**
Depreciation/amortization	744	836	1,182	1,145	1,417
Net working capital	-1,656	3,530	-278	-916	-792
Investing cash flow	**-895**	**-10,042**	**-2,750**	**-8,500**	**-4,000**
Capital expenditure	-2,878	-4,585	-1,750	-8,500	-4,000
Acquisitions/disposals	1,983	-5,457	-1,000	0	0
Financing cash flow	**-1,436**	**-4,082**	**-4,685**	**-4,841**	**-5,572**
Borrowings	334	-794	-489	-100	0
Dividends paid	-1,967	-3,023	-4,196	-4,741	-5,572
Change in cash	**997**	**-1,045**	**2,883**	**-2,488**	**3,504**
Balance Sheet (RsM)					
Total assets	**28,328**	**37,846**	**44,278**	**52,966**	**62,714**
Cash & cash equivalent	2,104	1,058	3,941	1,453	4,957
Accounts receivable	5,719	5,425	6,547	7,695	8,799
Net fixed assets	9,051	12,801	13,369	20,724	23,307
Total liabilities	**15,541**	**19,802**	**21,015**	**23,821**	**26,691**
Accounts payable	5,542	7,183	8,095	9,627	10,944
Total Debt	3,086	2,292	1,804	1,704	1,704
Shareholders' funds	**12,787**	**18,044**	**23,262**	**29,145**	**36,024**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	12.3	18.4	17.6	16.6	17.1
ROE adjusted	36.7	53.0	46.1	41.3	39.1
ROIC adjusted	29.8	48.1	51.0	44.8	40.9
Net debt to equity	7.7	6.8	-9.2	0.9	-9.0
Total debt to capital	19.4	11.3	7.2	5.5	4.5

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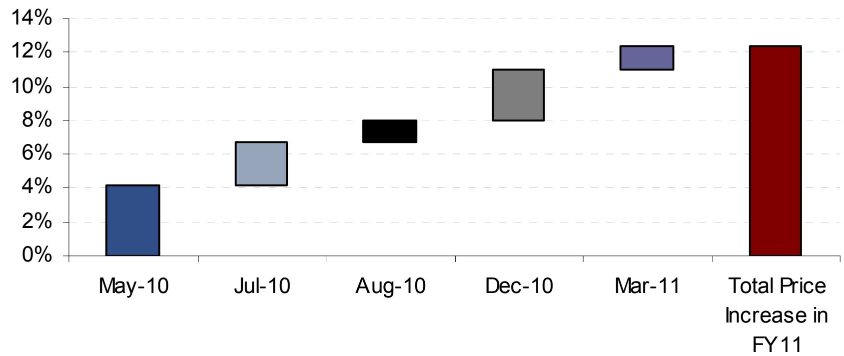
Management Meeting Highlights

1) Domestic decorative paints demand remains healthy

- Mgmt has taken a total price hike of ~12.4% in FY11, with the latest 1% increase in March. Despite the multiple increases in pricing, domestic demand has been steady – mgmt notes that the volumes traction of the festive quarter (3Q) is sustained into 4Q.
- Overall, price hikes for the industry have been of similar magnitude. There was no meaningful inventory build-up post 3QFY11.
- Non-urban markets (now ~40-50% of sales) are growing at a faster rate (by ~150-200bps) as compared to urban markets.
- Volume growth rate for the industry is estimated to increase by ~1.7-2x GDP growth; implying ~14-16% Y/Y increase in sales.

Figure 1. Staggered Price Hikes in the Domestic Business



Source: Company Reports

2) Mix improvement across geographies

- Mgmt noted that there have been no signs of downtrading as mix continues to improve – emulsions are now more than 50% of revenues. Encouragingly, there is no meaningful variation in mix between sales from urban and non-urban markets.
- Industry volume growth for emulsions is strong at ~20%+. Growth in enamels is ~10%+ while distempers are growing at much lower rates (single digit growth). This does support margins to some extent as emulsions have the highest margins, followed by distempers and enamels.

3) Distribution initiatives continue

A key competitive strength of ASPN is its unmatched distribution with around 27,000 dealers including 17,000-18,000 Color Worlds. Mgmt mentioned that it plans on adding 1,500-2,000 dealers annually. It believes that the competition is also expanding its distribution in proportion of their market share.

With the recent expansion drive, ASPN's geographic split of sales is now more evenly balanced – it traditionally was more dominant in West and South India.

4) Organized segment garners share; ASPN does better than peers

Mgmt believes the company has increased its domestic market share YTD within the top players. Also, a high input cost environment makes business for the unorganized players unviable and these lose share to the larger organized players.

5) Input cost pressures increase

- Input cost inflation remains a key concern – mgmt noted that its cost index has increased sequentially and is ~117-118 now (vs. 115 in 3QFY11, 112 in 2QFY11 and 106 in 1QFY11 on FY10 average cost base of 100).
- Mgmt expects pressures in TiO_2 (15-18% of material cost) to continue for at least another year as global supply normalizes.
- Further, cost pressures on solvents and vegetable oils are also likely to negatively impact margins.
- Historically, in times of high input cost pressures, ASPN's gross profit growth has lagged that of revenue growth – we have seen evidence of this in 2/3Q FY11, and believe this could be the start of a longer trend.

Figure 2. Asian Paints: Revenue vs. Gross Profit Growth (%)

	FY06	FY07	FY08	FY09	FY10	FY11YTD
Revenue growth	18.0%	21.5%	20.1%	24.0%	22.3%	19.5%
Gross profit growth	14.7%	19.7%	24.4%	14.4%	39.6%	15.6%
EBITDA growth	16.9%	22.1%	38.2%	1.4%	83.2%	11.7%

Source: Company Reports and CIRA

- While we believe ASPN has the ability to partially push through costs, these are typically with a lag and may potentially impact demand.

Figure 3. Asian Paints (Parent): Per Liter Analysis

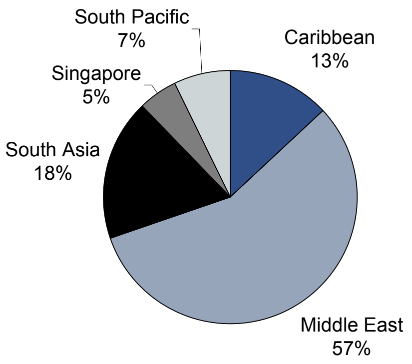
	FY07	FY08	FY09	FY10
Paints sold (Rs m)	32185	39062	48642	56032
Net sales (est)	28097	34101	43102	51942
Quantity (m litres)	369	433	491	572
Revenue / L (on gross)	87	90	99	98
Revenue / L (on net)	76	79	88	91
Total Material Cost	12,874	14,911	25,303	28,394
Total Gross Profit (GP)	15,223	19,190	17,799	23,549
Cost / litre of paint sold	35	34	51	50
Revenue / litre	76	79	88	91
GP / litre	41	44	36	41

Source: Company Reports and CIRA Estimates

6) International business outlook mixed

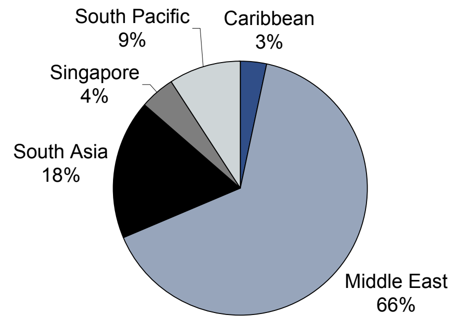
- International business (~16% of consolidated revenues) is likely to be impacted by the MENA political turbulence. Growth in the Middle East was slow and the crisis has further impacted growth rates. Factories in Egypt (~27-28% of international revenues) have re-commenced operations, but sales remain weak.
- The Caribbean & South Pacific markets' revenue growth is lackluster; however these remain profitable.
- Mgmt remained upbeat on the performance of South Asia (~18% of international revenues).
- Over the long term, it remains positive on the international opportunity – believes EBIT margins can improve from ~12% currently as scale benefits kick in and investments bear fruit. Exits from loss-making geographies bode well for future profitability. Mgmt mentioned that its focus is on emerging markets.

Figure 4. International Revenue Mix* (%)



Source: Company Reports; * Based on 1HFY11

Figure 5. International EBIT Mix* (%)



Source: Company Reports; * Based on 1HFY11

7) Aggressive capex plans

- Like most other paint companies, the market leader, ASPN also plans to augment capacities for future growth - mgmt aims to increase its current capacity of ~590K MT by ~50% to ~890K MT with the addition of the new greenfield Khandala plant (initial capacity of 300K MT, scalable to 400K MT) by Jan-Mar 201. Capex for the Khandala facility is expected to be ~Rs10bn - mgmt mentioned that most of the new capacity is for emulsions.
- Currently, overall capacity utilisation is ~85-90%. A part of the domestic volumes are met by outside processing centers (OPCs) - mgmt noted that ~25-28% of its volumes are sourced through third party manufacturing.
- Overall, capex guidance for FY11/12/13E is ~Rs2bn, ~Rs8-9bn & ~Rs4-5bn respectively.

Tweaking Earnings, Target Price to Rs2,763 – Maintain Hold

We pare our EPS estimates by ~1-6% over FY12-13E driven by a reduction in our gross margin forecasts and as we tweak our international business revenues. We think that margins have peaked in FY10; we forecast gross margins to dip 350bps over FY10-12E. Net net, we forecast ~16% and ~14% revenue and EBITDA CAGR over FY11-13E.

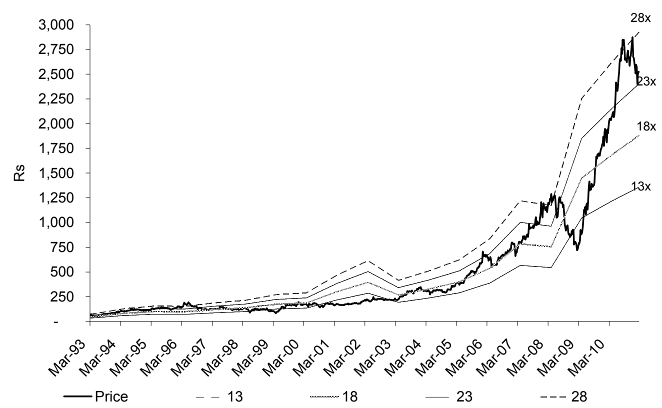
Figure 6. Asian Paints (Consolidated): Earnings Revision Summary

Year to 31-Mar	2012E			2013E		
	Old	New	% Chg	Old	New	% Chg
Sales (Rs Mils.)	94,229	93,626	-1%	108,235	107,060	-1%
EBITDA (Rs Mils.)	16,469	15,544	-6%	18,312	18,296	0%
EBITDA Margin (%)	17.5%	16.6%		16.9%	17.1%	
Net Profit (Rs Mils.)	10,756	10,157	-6%	12,060	11,937	-1%
Diluted EPS (Rs)	112.1	105.9	-6%	125.7	124.4	-1%
Dividend Per Share (Rs)	44.9	42.4	-6%	50.3	49.8	-1%

Source: Citi Investment Research and Analysis estimates

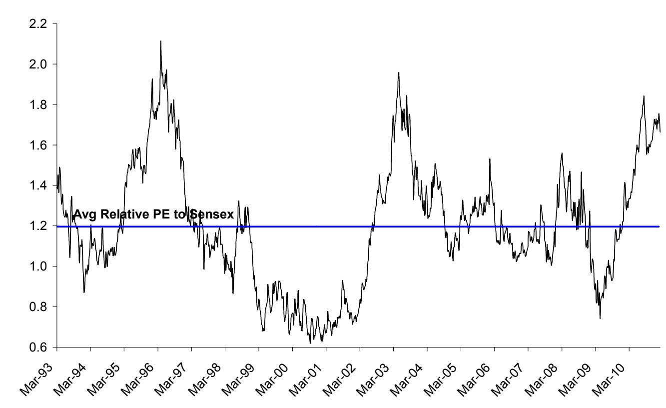
Our TP is revised to Rs2,763 from Rs2,803 earlier as we roll forward to Jun12E from Mar12E, maintaining our 25x target P/E multiple on our revised EPS. ASPN currently trades at a multiple of around ~24x one-year forward EPS, at the higher end of its current trading band (though not at previous peak levels of ~28-29x). From a relative perspective, the stock is trading at a relative P/E of ~1.6-1.7x the broad market. Margin of safety from a valuation perspective seems inadequate, and we maintain our Hold recommendation.

Figure 7. Asian Paints: One Year Forward P/E Band Chart



Source: DataStream, Company Reports and Citi Investment Research and Analysis

Figure 8. Asian Paints: Relative P/E Band to Sensex



Source: DataStream, Company Reports and Citi Investment Research and Analysis

Asian Paints

Valuation

Over the last two years, the stock re-rated as the domestic decorative paints demand increased at a healthy pace, after a sharp decline in FY09. However, we believe margins have peaked - given the rising input cost pressures. The company has the ability to push through cost pressures, but these will typically be staggered and with some lag, and could potentially impact overall demand. There is limited comfort on valuations – ASPN trades at ~24x one-year forward P/E, higher than the last 5-year mean of ~20x, however, far lower than its peak forward P/E of around 28-29x.

Our target price of Rs2,763 is based on 25x Jun12E consolidated EPS, around a 25% premium to its average multiple of the past three years. We are comfortable ascribing this premium given ASPN's healthy revenue growth trajectory (~16% CAGR over FY11-13E). However, we expect earnings growth to be lower, due to a contraction in gross margins going forward. At our target price, ASPN's relative multiple (vs. broad market) is ~1.7x.

Risks

We rate Asian Paints shares as Low Risk based on our quantitative risk-rating system, which tracks historical share price volatility. The main downside risks to our target price include: (1) If economic growth decelerates further, it would affect demand for paints; (2) Inability to respond to the rising competition could result in loss of market share to the organized and unorganized segments. Key upside risks include: (1) Sharp correction in input costs (primarily linked to global petrochemical prices) should support margins; (2) currency fluctuations impact profitability – directionally, an appreciating rupee should also help profit growth, as ~25% of inputs are imported.

Appendix A-1

Analyst Certification

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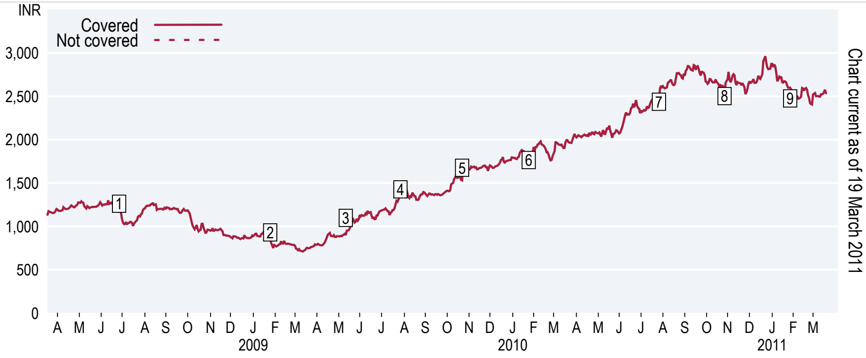
Asian Paints (ASPN.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Jamshed Dadabhoy
Covered since May 6 2008



	Date	Rating	Target Price	Closing Price
1	26-Jun-08	*3L	*1,098.00	1,179.90
2	26-Jan-09	3L	*801.00	922.60
3	12-May-09	*1L	*1,090.00	898.40
4	28-Jul-09	1L	*1,562.00	1,385.90
5	22-Oct-09	1L	*1,762.00	1,530.20
6	24-Jan-10	1L	*2,092.00	1,766.90
7	27-Jul-10	1L	*2,772.00	2,437.75
8	27-Oct-10	1L	*2,903.00	2,502.90
9	27-Jan-11	*2L	*2,803.00	2,600.30

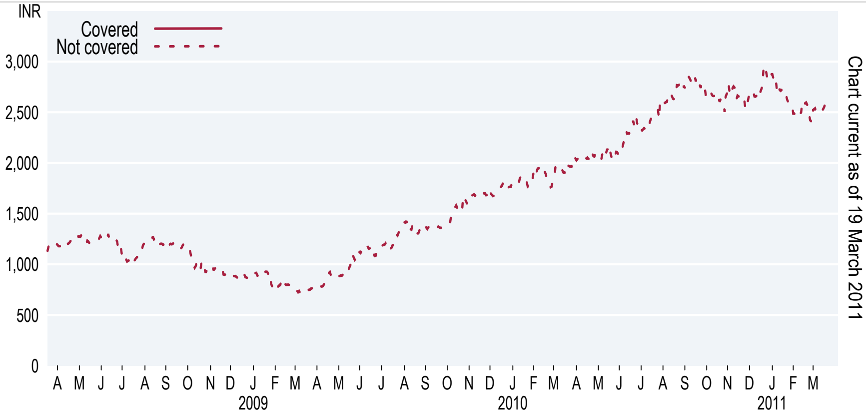
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Asian Paints (ASPN.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Jamshed Dadabhoy
Covered since May 6 2008



* Indicates change

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	12 Month Rating			*Relative Rating*		
Data current as of 31 Dec 2010	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	52%	37%	11%	0%	100%	0%
% of companies in each rating category that are investment banking clients	45%	44%	40%	0%	44%	0%

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