8 October 2010 (No. of pages: 53)

Fast Moving Consumer Goods (FMCG) Sector

Positive

Household & personal products: India

We expect strong long-term growth to support valuations

Summary

- **Long-term and short-term growth drivers look intact.** We expect India's FMCG industry to benefit from a number of revenue-growth drivers in the future, namely low per-capita consumption in most FCMG categories, low penetration levels for all categories (except for the personal-wash and fabric-wash categories), favourable age and income demographics, increasing literacy, hygiene awareness, and the influence of the media on consumer awareness and buying behaviour. Strong agricultural production growth as a result of this year's monsoon rains being considered normal should boost farm incomes, which should in turn lift demand in the rural markets for FMCGs. We believe increased farm production would also lead to reductions in agri-commodity prices and improvements in profitability for food and beverage (F&B) companies, while receding inflation would be beneficial for consumers and FMCG companies.

- **Positive sector rating; we would buy the leaders.** Unlike in prior years, when India's FMCG sector and the Sensex moved in opposite directions, they have moved in tandem over the past year. While most FMCG companies are trading currently at near their peak valuations, we believe these are supported by what we see as the favourable outlook for sales volume and value growth. We favour those companies with category leadership and what we see as high sales- and earnings-growth potential. We maintain our **1** *(Buy)* rating for ITC. We initiate coverage of Colgate Palmolive India (Colgate) with a **1** *(Buy)* rating, GlaxoSmithKline Consumer Healthcare (GSKCH) with a **2** (*Outperform*) rating, and Nestle India (Nestle) with a **4** (*Underperform*) rating. We have downgraded our rating for Hindustan Unilever (HUL) to **3** (*Hold*) from 2 *(Outperform)*.

FMCG sector: valuation summary

Company name	Bloomberg code	Share price 6-Oct-10 (local curr.)	Rating	Target price (local curr.)	+/- (%)	Year end	PER (x)				EV/EBITDA (x)				Dividend yield (%)			
							2010	2011E	2012E	2013E	2010	2011E	2012E	2013E	2010	2011E	2012E	2013E
ITC	ITC IN	172.90	1	201.00	16.3	Mar	32.5	28.2	24.4	21.4	20.8	17.9	15.2	12.9	2.9	1.4	1.7	2.0
HUL	HUVR IN	301.15	2 → 3	309.00	2.6	Mar	31.5	27.3	24.3	22.0	24.5	22.1	19.5	17.4	2.2	2.5	3.3	3.8
Nestle	NEST IN	3,212.00	4	2,981.00	(7.2)	Dec	38.1	32.3	27.6	n.a.	25.2	21.5	18.4	n.a.	2.0	2.4	2.8	n.a.
Colgate	CLGT IN	871.20	1	995.00	14.2	Mar	28.0	24.3	21.0	18.5	27.0	20.6	17.4	15.0	2.3	2.9	3.4	4.0
GSKCH	SKB IN	2,035.00	2	2,117.00	4.0	Dec	27.4	23.1	19.7	n.a.	18.7	15.4	12.7	n.a.	1.2	1.5	1.7	n.a.

Source: Companies, Daiwa forecasts

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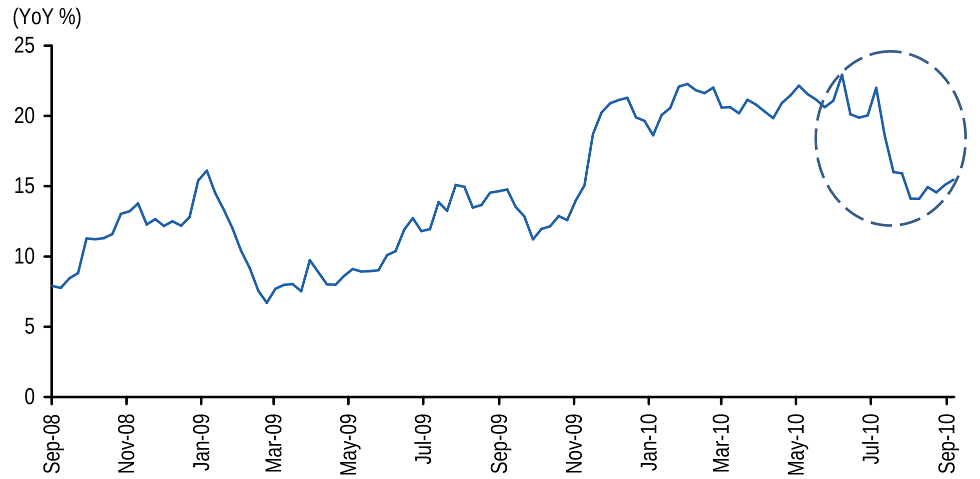
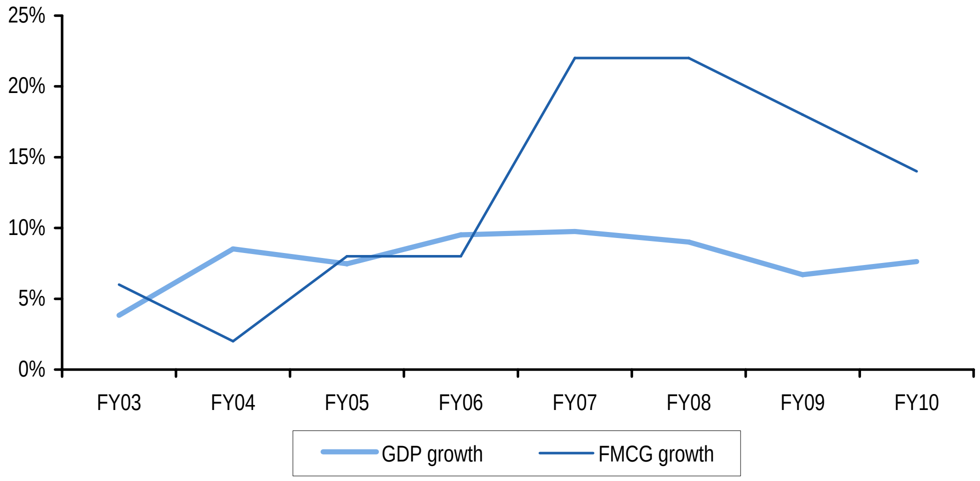
The three most important charts in this report ...

India: change in wholesale food prices



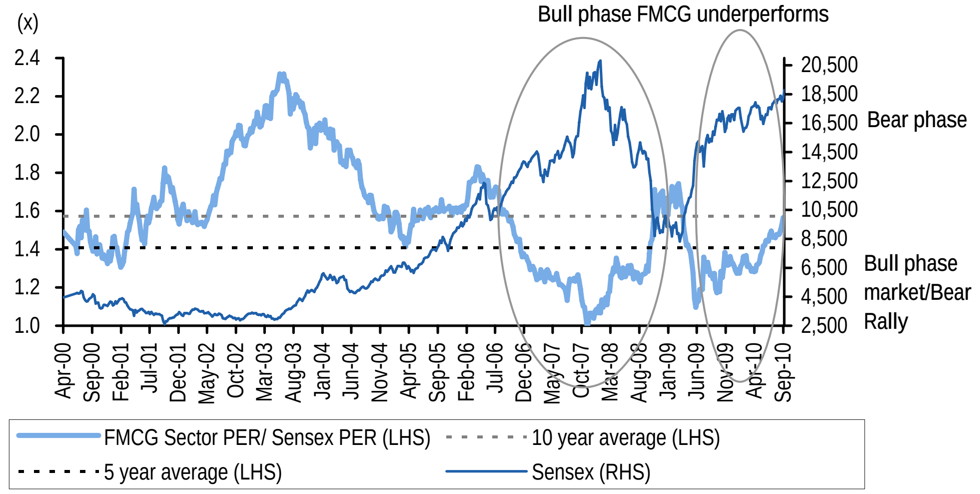
Source: Bloomberg, Daiwa

India: GDP growth vs. FMCG sector's sales growth (YoY)



Source: Bloomberg, Company, Daiwa
Note: GDP – Y/E is March, FMCG – Y/E is December

One-year-forward PER – FMCG sector vs. Sensex



Source: Bloomberg, Daiwa forecasts

Executive summary

Strong scope for penetration levels and per-capita consumption should increase

India has one of the world's lowest per-capita consumption rates for FMCGs, even for products with high penetration levels

Penetration levels for FMCGs in India are low still for almost all product categories, except the mass-consumption personal-wash and fabric-wash categories. Per-capita consumption of FMCGs in India is among the lowest in the world, and in particular in the developing economies, even for the highly penetrated personal- and fabric-wash categories. As such, we see strong potential for sustainable long-term sales-volume growth for the India's FMCG sector.

India's robust GDP growth is driving the consumption boom

According to MGI, India's per capita income is forecast to increase nearly fourfold over the 2008-30 period

According to McKinsey Global Institute, India's GDP is likely to rise at a CAGR of 7.4% over the 2008-30 period, while its per-capita income is expected to increase nearly fourfold over this period. India is poised to become the world's fifth-largest consuming country by 2025, from its current position of 12^{th}, while India's FMCG market should triple by 2018 compared with 2008 (source: *The Marketing Whitebook 2010-2011*).

Rising consumer awareness

Rising literacy levels have boosted hygiene awareness and media exposure has increased product awareness

Increasing literacy levels and government measures have boosted hygiene awareness, and consumers' increasing exposure to the media has raised product awareness. We believe the government's increased focus on education, along with the media's influence over consumers' decisions, appears promising for packaged products (compared with loose products), products based on health platforms and high-end personal hygiene products, such as hand wash, sanitizers, etc.

F&B companies should benefit from potential reductions in raw-material prices

We expect raw-material prices to soften, supporting FMCG companies' EBITDA margins

We believe F&B companies should be the biggest beneficiaries among the entire FMCG space of this year's normal monsoon rains and a potential decline in food inflation. We expect the normal monsoon rains to boost agricultural production, which should provide a much needed respite to consumers and FMCG companies. It should boost farm incomes and therefore rural consumption too, while reducing agri-related raw-material prices, and hence lead to an improvement in profitability for F&B companies.

We prefer PER-based valuations for the sector

We have valued the companies based on target PERs to reflect our view of the stability of the FMCG business

Over the past three-to-five years, FMCG businesses have recorded stable earnings growth, with few fluctuations in profitability. However, raw materials like crude-oil derivatives and palm oil have a direct impact on the profitability of these companies. As such, given the FMCG companies' stable earnings profiles, we prefer PER-based valuations, applied to our FY12 EPS forecasts (2011 for Nestle and GSKCH), to set our six-month target prices for the companies that we cover.

We maintain our 1 (*Buy*) rating for ITC, initiate coverage of Colgate with a 1 rating, GSKCH with a 2 (*Outperform*) rating, and Nestle with a 4 (*Underperform*) rating; We have downgraded our rating for HUL to 3 (*Hold*)

In our sum-of-the-parts (SOTP) valuation for ITC (**1** [*Buy*] rating), we now apply a FY12 target PER of 25x for the cigarette business to reach our new target price of Rs201. We value Colgate (initiated with a **1** [*Buy*] rating) at a target PER of 24x to reach our target price of Rs995, taking into consideration what we see as Colgate's increasing market share and improving profitability despite intense competition. For GSKCH (initiated with a **2** [*Outperform*]), we apply a 24x PER to reach our target price of Rs2,117, as we believe GSKCH deserves a higher multiple than its peers given its broader product portfolio, stronger pricing power and increasing customer base. For HUL (downgraded to **3** [*Hold*]), we now apply a target PER of 25x to reach our new target price of Rs309. We believe Nestle is the best play on India's packaged-foods industry and that its premium valuation to its peers looks justified by its strong sales and earnings visibility. However, we believe the share price factors in the positives, and hence initiate coverage with a **4** (*Underperform*) rating. We value Nestle at a target PER of 30x to reach our target price of Rs2,981.

Favourable macro factors

FMCGs have low penetration and per-capita consumption

We think low per-capita consumption should drive sales-volume growth for FMCGs, even for categories with high penetration

Penetration levels of FMCGs in India remain low for almost all product categories except the mass-consumption personal-wash and fabric-wash categories. The per-capita consumption level of FMCGs is one of the lowest worldwide and among the developing economies, even for the highly-penetrated personal- and fabric-wash categories. We believe this reflects primarily low levels of affordability of personal-care products among the Indian population, along with the use of low-cost home-made or natural substitutes like neem sticks for oral care, ash or soil for dish-washing products, and soap seeds for shampoos.

Sachets and smaller SKUs should drive up penetration

However, the availability of products in small sachets and effective advertising has helped to boost the penetration rates of FMCGs in both urban and rural areas since past couple of years. We believe the current trend among FMCG companies of introducing single-use packs (for instance, a Rs10 pack of *Chocos* by Kelloggs India [Not listed] and smaller stock keeping units (SKU) (for instance, *Maggi* Instant Noodles at Rs5 per packet) should help drive up penetration of other categories of FMCGs generally. In addition, as products become more widely available and consumers' affordability levels increase, so per-capita consumption of FMCGs should increase in the long term.

Per capita consumption (US$)

Category	India	China	Indonesia	Brazil	USA
Detergents	1.4	2.2	1.9	12.1	22.9
Shampoo	0.3	1.0	1.1	6.0	6.7
Ice-cream	0.2	2.8	0.9	5.9	49.4
Skin care	0.3	3.2	0.8	12.2	26.9
Personal wash (bars)	1.0	0.5	0.7	6.7	4.3
Oral care	0.6	1.4	1.5	10.0	18.9
Coffee	0.2	0.2	1.0	15.0	22.9
Tea	0.8	0.4	2.4	1.0	5.5

Source: *The Marketing Whitebook 2010-2011*, Daiwa

Category penetration in India (%)

Categories	All India	Urban	Rural
Toilet soap	91.5	97.4	88.9
Detergent bar	88.6	91.4	87.4
Washing powder	86.1	90.7	84.1
Toothpaste	48.6	74.9	37.6
Shampoo	38.0	52.1	31.9
Utensil cleaner	28.0	59.9	14.6
Skin cream	22.0	31.5	17.8
Instant coffee	6.6	15.5	2.8
Deodorants	2.1	5.5	0.6

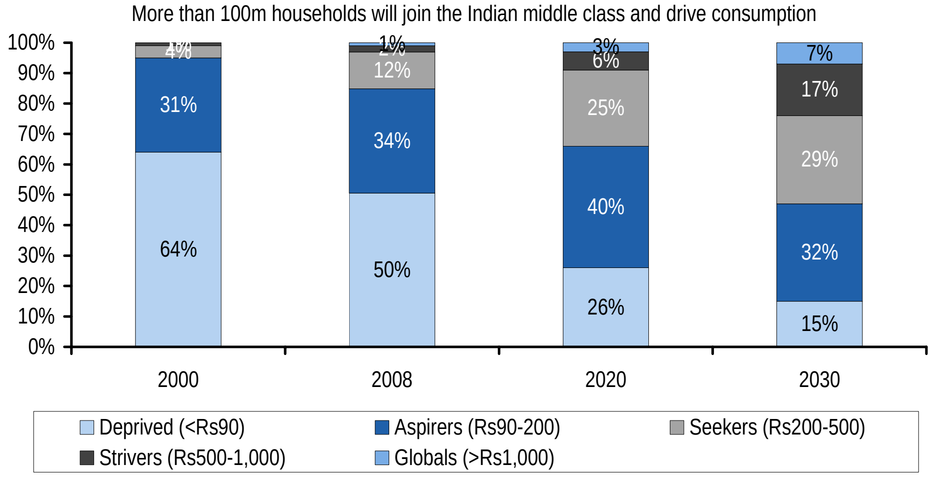
Source: *The Marketing Whitebook 2010-2011*, Daiwa

India's robust GDP growth is driving its consumption boom

The size of the FCMG market is expected to triple during the 2008-18 period

According to McKinsey Global Institute, India's GDP is likely to rise at a CAGR of 7.4% over the 2008-30 period, while its per-capita income is expected to increase nearly fourfold over this period. India is poised to become the world's fifth-largest consuming country by 2025, from its current position of 12th, while India's FMCG market should triple by 2018 compared with 2008 (source: *The Marketing Whitebook 2010-2011*).

India’s population split by income bracket



Source: MGI, Daiwa
Note: All India households by income (Rs ’000) for the period 2000-30; percentages of million households; prices as at 2000; middle class = seekers and strivers.

Rural India: the next growth driver for the FMCG industry

India’s rural population accounts for 70% of its total population and 50% of FMCG sales

Rural India has 720m consumers currently, resident across 627,000 villages. Although the rural Indian population represents 70% of India’s population, it accounted for only 50% of sales of the country’s FMCG industry (Source: *The Marketing Whitebook 2010-2011*), due to the rural population’s lower purchasing power, lower exposure to education and the media, and limited choice and availability of goods compared with those for the population in urban areas. As incomes, education and media exposure increase, and distribution networks are expanded in the rural areas, we believe these areas offer a huge opportunity for FMCG companies in India.

Rural consumption-growth drivers

Drivers	Details
Government’s thrust on developing agriculture.	Agricultural GDP forms 17.5% of total GDP and the attainment of high production growth in agriculture would supplement the already-high GDP growth rates of the services and manufacturing sectors. Various government measures for rural development, in both agriculture and non-agriculture, such as increasing the minimum support price (MSP) to promote more sowing, improve farm productivity (by providing and subsidising irrigation, better-quality seeds and fertilisers) and the development of rural infrastructure (for the transport and storage of farm produce) have led to an increase in rural incomes generally over the past few years
Creation of multiple employment opportunities through employment generation programmes like the National Rural Employment Guarantee Act (NREGA) and development of rural infrastructure.	Improving the infrastructure in rural areas is one of the India Government’s top priorities; it plans to spend US$80.82bn out of the total projected investment of US$283.83bn earmarked in its *11th Five-Year Plan* (2007-12).

Source: National Sample Survey Office (NSSO), Daiwa

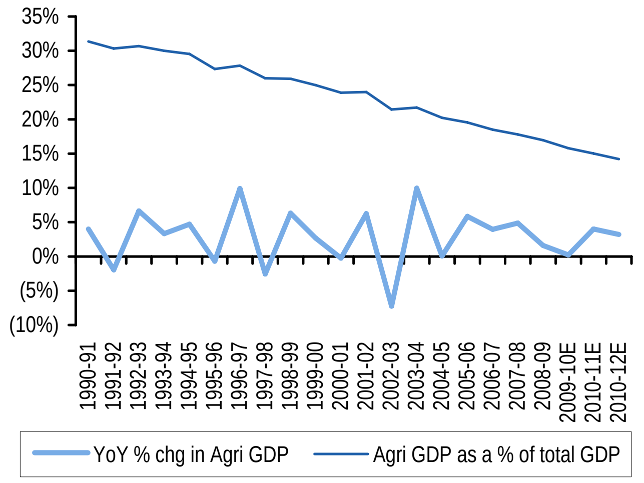
We see rural India offering substantial opportunities for FMCG companies

Given this backdrop, FMCG companies that market goods to lower-socio-economic classes and that have established their presence in the rural markets look well-placed to us to exploit the rural opportunity as penetration levels increase across FMCGs.

Increasing disposable incomes should boost consumption of FMCGs

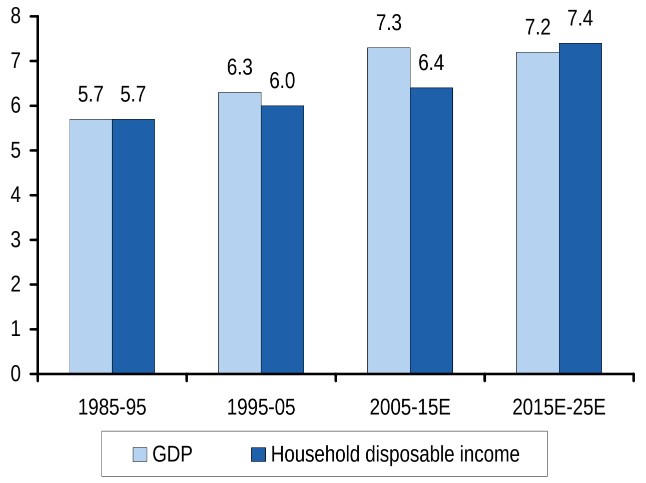
In our view, increasing household disposable incomes, especially among rural consumers and urban middle-class consumers, should boost the consumption of FMCGs. Initially, we believe increased income is likely to be diverted to necessities like housing, healthcare and education.

India: agricultural GDP as a % of total GDP and YoY % change in agricultural GDP



Source: Bloomberg, Daiwa

India: household disposable incomes and GDP (CAGR %)



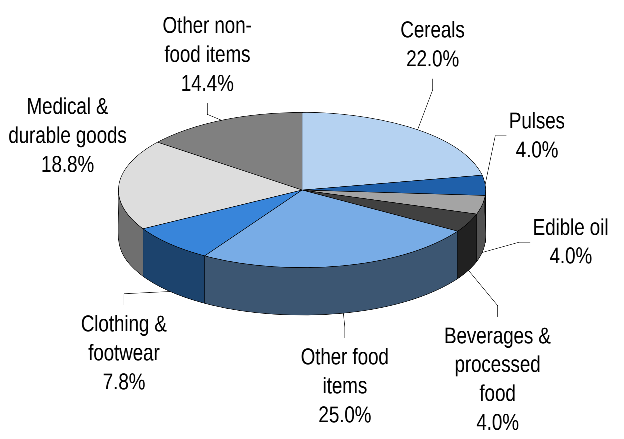
Source: McKinsey Global Institute, Daiwa

We expect per capita consumption of FMCGs to increase as consumer expenditure rises

However, once necessities are taken care of, we believe that households are likely to spend most of their increased disposable incomes on consumer goods. This should lead to a rise in per capita consumption of FMCGs, through either increasing usage, or a shift to purchases of higher-value items within categories with high penetration levels already (eg, shifting from bidis to cigarettes, or from unfiltered to filtered cigarettes).

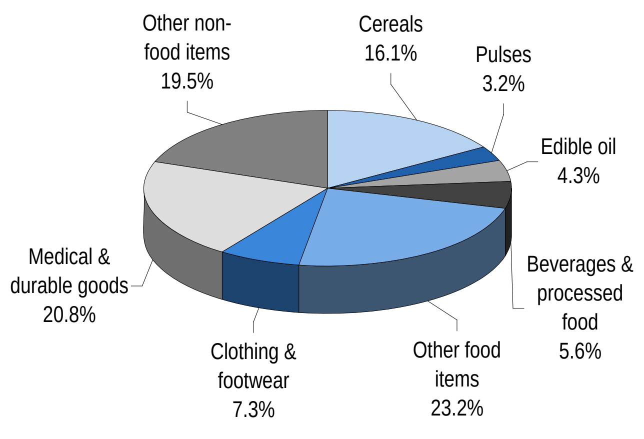
Even if FMCG consumption were to remain unchanged as a percentage of India's total consumer expenditure in the future, we believe per capita consumption of FMCGs would increase, as the country's income base would rise in absolute terms.

India: rural consumption expenditure (1997)



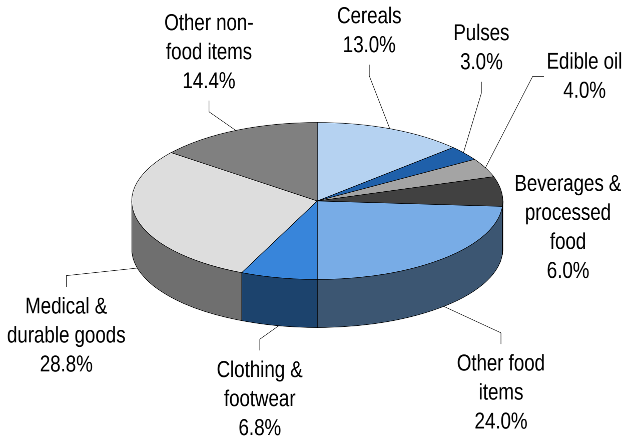
Source: NSSO, Daiwa

India: rural consumption expenditure (2008)



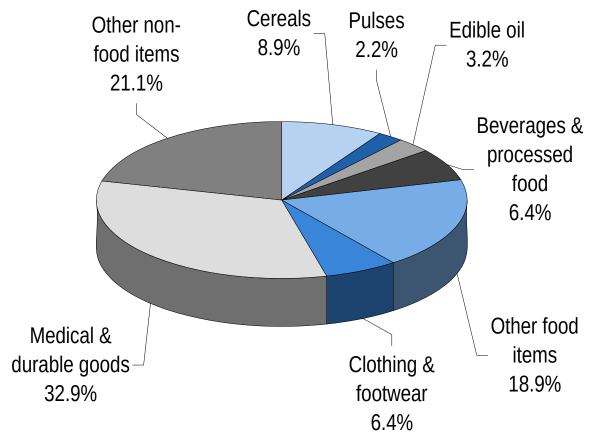
Source: NSSO, Daiwa

India: urban consumption expenditure (1997)



Source: NSSO, Daiwa

India: urban consumption expenditure (2008)



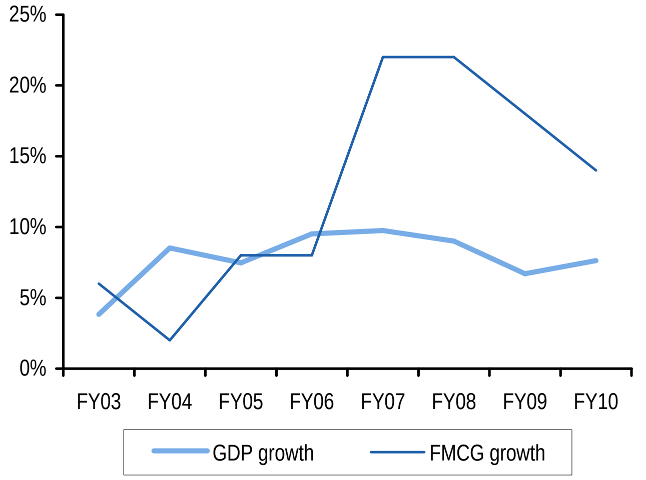
Source: NSSO, Daiwa

FMCG market forecast to triple by 2018 on rising incomes

India's FMCG market to triple to US$74bn by 2018 versus 2008

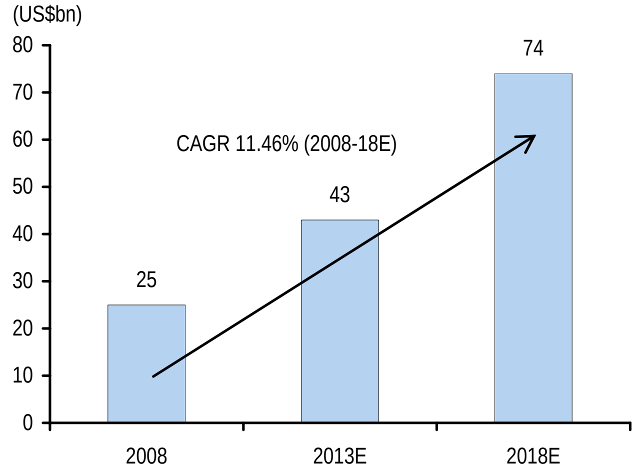
We expect broad-based economic growth encompassing the manufacturing, services and agriculture sectors to continue to fuel India's consumption boom. The size of the India FMCG industry is forecast to triple from sales of US$25bn for 2008 to US$74bn by 2018, representing a CAGR of 11.5% (Source: *The Marketing Whitebook 2010-2011).*

India: GDP growth vs. FMCG sector sales growth



Source: Bloomberg, Company, Daiwa
Note: Financial year for GDP, calendar year for FMCG sector growth

Projected size of India's FMCG market



Source: *The Marketing Whitebook 2010-2011*, Daiwa

Access to education, media exposure: key drivers in rural markets

Media exposure helps increase penetration levels of FMCGs

Improvements in access to education have increased hygiene awareness among consumers, while exposure to the media has enhanced their awareness of the wide range of consumer goods available now. Exposure to the media has contributed to increasing literacy levels too, by communicating the importance of education. Access to higher education has also increased employment opportunities, and in turn raised some consumers' income levels. As such, we would expect increasing literacy, especially among homemakers, along with rising exposure to television, to help raise penetration of consumer goods in rural markets.

Education level of homemakers vs. product penetration % (2008)

Product	Illiterate	Literate but below 10th grade	Above 10th grade	Graduate
Toothpaste	29.8	60.1	76.8	90.2
Shampoo	64.2	72.9	79.8	85.7
Utensil cleaner	6.4	22.8	43.3	57.4
Toilet cleaner	1.4	9	21.8	40.6
Floor cleaner	0.8	4.1	10.9	23.1
Packaged edible oil	8.2	17.9	32.5	41.5

Source: *The Marketing Whitebook 2010-2011*, Daiwa

Exposure to TV, cable & satellite (C&S) vs. FMCG penetration % (2008)

Product	No TV	TV but no C&S	C&S
Toothpaste	30.9	67.5	78.9
Shampoo	63.9	76.2	81.4
Utensil cleaner	6.5	27.6	42.1
Toilet cleaner	1.5	11.1	21.2
Floor cleaner	0.7	5.4	10.5
Packaged edible oil	8.5	19.9	30.9

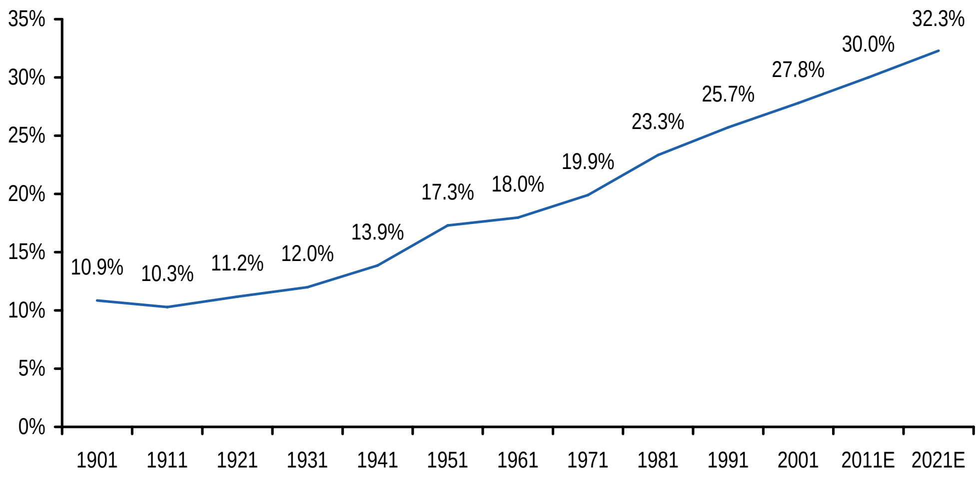
Source: *The Marketing Whitebook 2010-2011*, Daiwa

Rising urbanisation: 75m consumers to migrate to cities by 2015

The rural population near urban centres has higher monthly incomes generally than those in distant rural areas

As noted, 70% of India's population resides in rural India currently. However, improvements in urban-rural transport connections, increasing education levels among the rural population, and better employment opportunities than in past years, are driving more people toward the urban areas. In addition, people who live close to cities benefit from increasing urbanisation as they have better access to jobs, markets and other urban infrastructure, compared to those in distant rural areas. According to estimates by McKinsey, monthly incomes among the rural population adjacent to large urban centres are 10-20% higher than the rural average. People who migrate to urban areas tend to buy FMCGs both for themselves and for their families in rural India. As such, increasing urbanisation raises the population's exposure to branded and packaged products, so should continue to support growth in sales for FMCG companies in India.

Urbanization in India (% of total population)



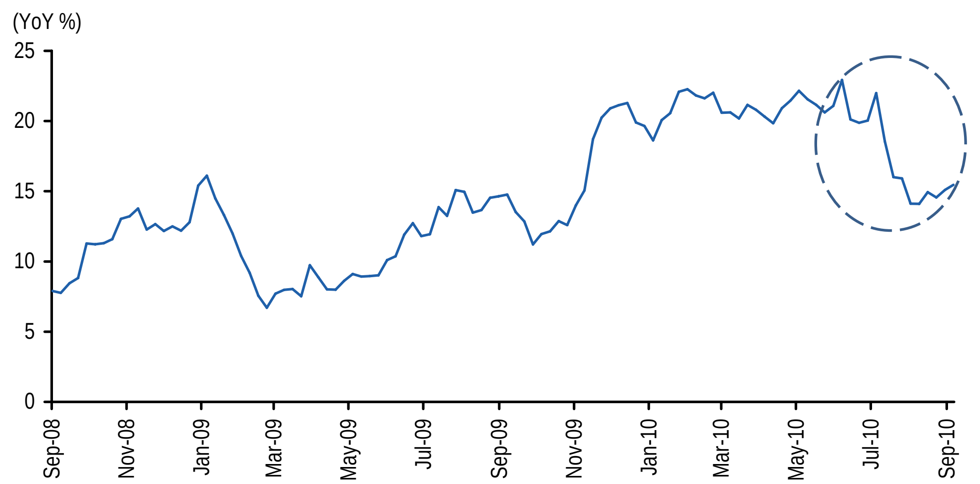
Source: industry, Daiwa

Normal monsoon and receding inflation benefit F&B sector more than personal-products

Purchasing power affected by high inflation

High inflation (in excess of 10%) over the past 16 months has adversely affected the purchasing power of lower middle-class and lower-income consumers. These consumers' expenditure on basic necessities has increased, leaving them with less disposable income to spend on other discretionary products. The effect has been the most severe on consumers at the lowest income strata for whom food and related products occupy more than 60% of their wallet. With inflation running at 20% (from November to around July this year), this ratio shot up to 72%, leaving only a small amount for other discretionary products. As a result, the highly penetrated non-discretionary categories, namely personal and fabric-wash categories, saw significant downtrading (ie, consumers trading down to cheaper products). However, receding inflation since July has provided some respite for consumers by leaving them a little more income on hand to spend on other consumer goods.

Receding food inflation (change in wholesale food prices)



Source: Bloomberg, Daiwa

The normal monsoon rains should benefit both consumers and FMCG companies

We believe the normal monsoon rains this year will benefit consumers and FMCG companies equally. While consumers should get respite from the hitherto high food inflation, consumer-goods companies using agri-commodities should see a reduction in their raw-material costs on the back of the resulting good harvest. This effect will be generally felt the most by companies whose key raw materials are sugar and wheat. The healthy monsoon will, to a certain extent, lead to a softening of fodder prices and as a result, should benefit milk and skimmed milk prices as well. This would be beneficial for GSKCH (milk and skimmed milk powder accounts for 37% of its total raw-material costs) and Nestle (milk and skimmed milk powder account for 43% of its total raw-material costs). This is evident from Nestle's recent reduction in its milk procurement prices and we expect to be followed by other companies also.

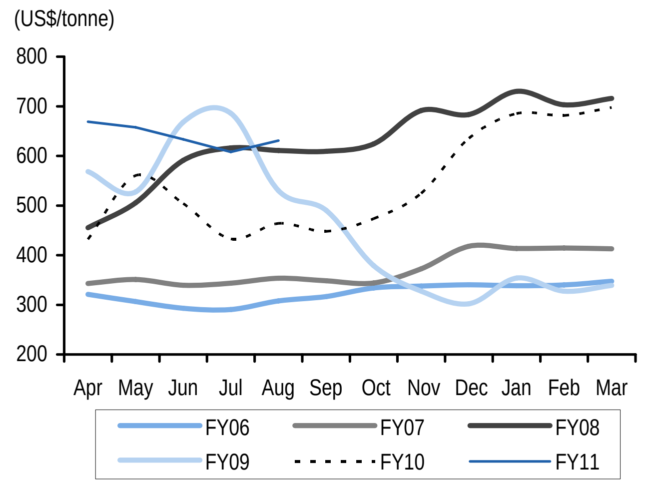
To summarise, receding food-price inflation and this year's normal monsoon rains, leading to a normal level of agricultural production (compared with last year), should in turn boost demand for FMCG products, thereby:

- Boosting demand from urban and non-agricultural rural consumers due to lower inflation giving them a higher amount to spend on other discretionary consumer goods.
- Improving the profitability of the FMCG companies as a result of the lower cost of agri-related raw materials.

We do not expect non-food companies to benefit much from the normal monsoon

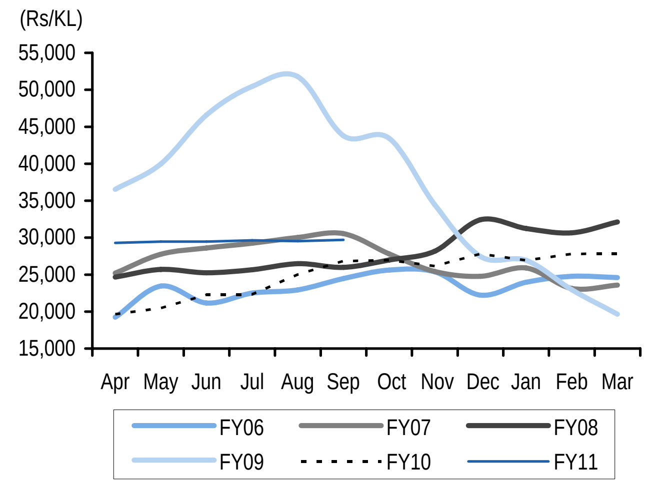
We believe non-food companies whose major raw materials are crude-oil derivatives and vegetable oils will not see a major impact on their EBITDA margins from the normal monsoon rains. However, receding inflation could arrest further downtrading by consumers in the highly penetrated categories.

Raw-material prices: palm oil



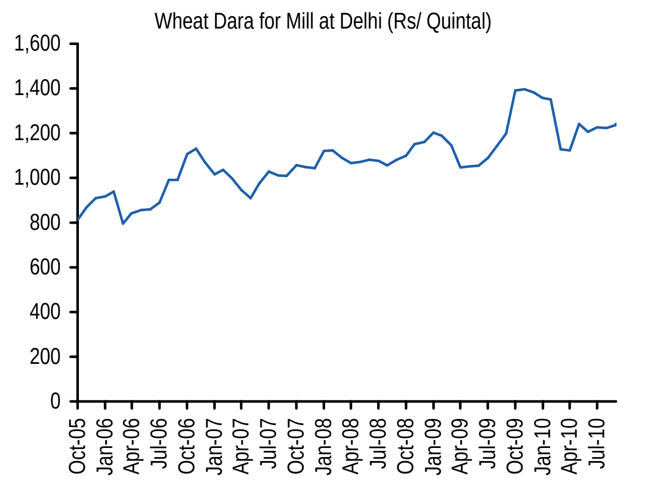
Source: MPOB, Daiwa

Raw-material prices: linear alkyl benzene



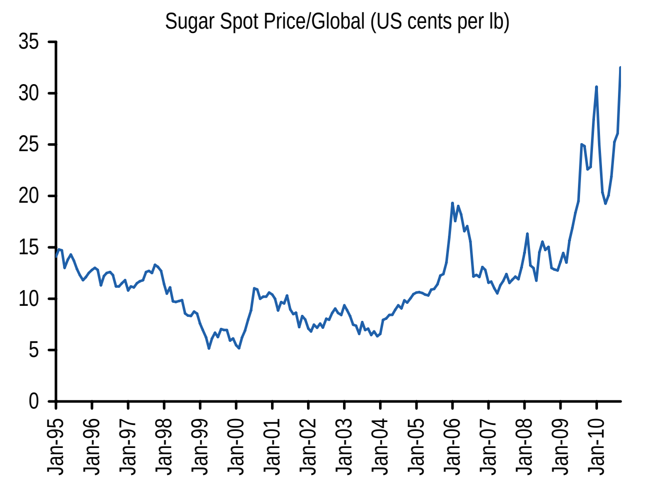
Source: Bloomberg, Daiwa

Raw-material prices: wheat



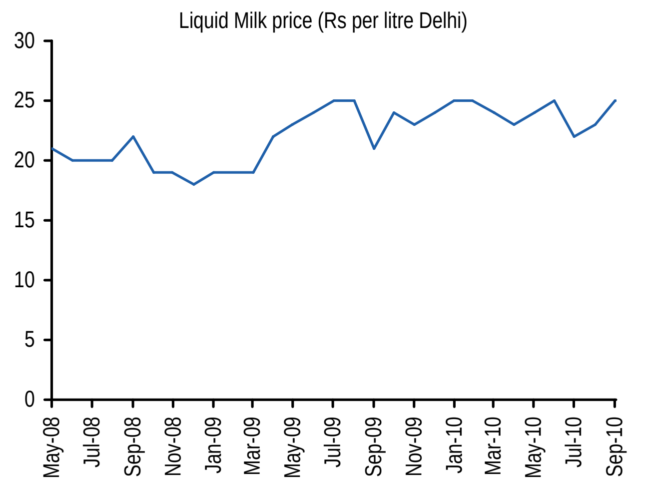
Source: Bloomberg, Daiwa

Raw-material prices: sugar



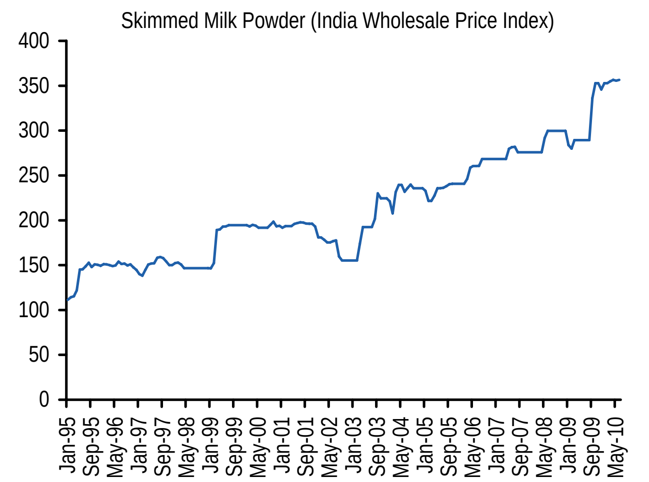
Source: Bloomberg, Daiwa

Raw-material prices: liquid milk



Source: Bloomberg, Daiwa

India Wholesale Price Index for skim milk powder



Source: Bloomberg, Daiwa

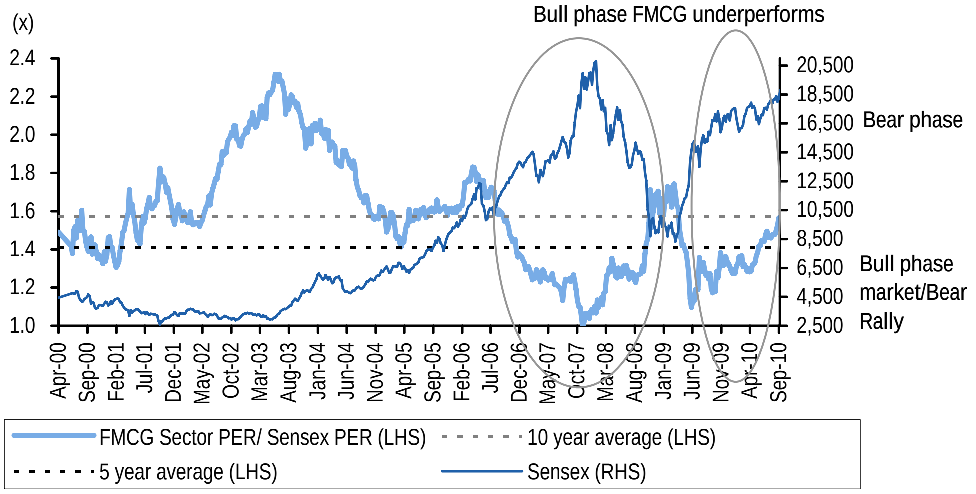
Sector valuation and rating: Positive, we would buy leaders

Significant re-rating in the past year

Unlike in the past when the FMCG sector and the Sensex have moved in opposite directions, over the past year both have moved in tandem. The sector has seen a significant re-rating over the past year due we believe to:

- Strong resilient demand witnessed across categories.
- The robust outlook for the resurgent economy.
- The return of pricing power due to receding inflation and rising disposable income.

One-year-forward PER – FMCG sector vs. the Sensex



Source: Bloomberg, Daiwa

We believe volume and value growth will support current valuations

Most of the companies in the FMCG sector are trading near their peak valuations. However, we believe sales volume growth accompanied by value growth will support existing valuations. We expect those companies with strong sales and earnings-growth potential to outperform the sector and deliver a good return on investment. We maintain our **1** (*Buy*) rating for ITC, have downgraded our rating for HUL to **3** (*Hold*) from 2 (*Outperform*), and initiate coverage of Colgate with a **1** (*Buy*) rating, GSKCH with a **2** (*Outperform*) rating, and Nestle with a **4** (*Underperform*) rating. We favour those companies with category leadership and what we see as high revenue-growth potential.

FMCG sector PER and rating update

	Rating		PER (x)		
Company Name	New	Old	New	Old	Comments
ITC	1 (*Buy*)	1 (*Buy*)	25	21	Same as HUL for ITC's cigarette business.
Hindustan Unilever	3 (*Hold*)	2 (*Outperform*)	25	21	Two-year high historical PER of 25x factors in most of the positives, in our view.
Nestle India	4 (*Underperform*)	n.a.	30	n.a.	Has traded at a higher PER in the past due to under-penetration of its product portfolio.
Colgate	1 (*Buy*)	n.a.	24	n.a.	Target PER is at a marginal discount to HUL due to HUL's wider portfolio.
GSKCH	2 (*Outperform*)	n.a.	24	n.a.	Target PER is at a marginal discount to HUL due to HUL's wider portfolio.

Source: Daiwa forecasts

FMCG valuations

Company name	Bloomberg code	Y/E	Price (US$)	M'cap (US$bn)	Sales (US$m) 2009	Sales CAGR (%) 2009-12E	EBITDA (%) 2009	EBITDA (%) 2010E	EBITDA (%) 2011E	EBITDA (%) 2012E	PAT (US$m) 2009	PAT CAGR (%) 2009-12E	ROE (%) 2010E	ROE (%) 2011E	ROE (%) 2012E	ROCE (%) 2009	PER (x) 2010E	PER (x) 2011E	PER (x) 2012E
ITC	ITC IN	Mar	172.90	30	182	14.9	33.2	33.2	33.8	34.3	41	15.0	31	30	30	39	28.2	24.4	21.4
Hindustan Unilever	HUVR IN	Mar	301.15	15	175	10.6	14.5	14.5	14.6	14.6	21	12.7	81	74	72	93	27.3	24.3	22.0
Nestle India	NEST IN	Dec	3,197.60	7	51	17.4	19.5	20.1	20.0	20.0	7	19.6	131	135	139	167	38.1	32.3	27.6
Colgate-Pamolive India	CLGT IN	Mar	871.20	3	20	16.0	21.7	24.0	24.0	24.0	4	14.8	131	123	117	141	24.3	21.0	18.5
GlaxoSmithKline Consumer Healthcare	SKB IN	Dec	2,027.75	2	19	18.0	16.2	18.1	18.3	18.3	2	23.1	31	31	30	32	27.4	23.1	19.7

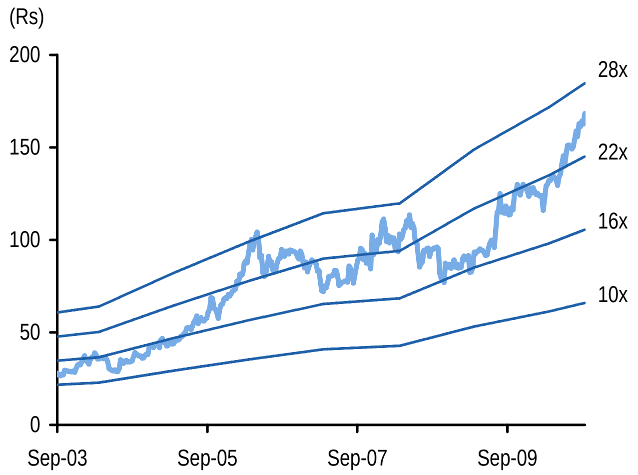
Source: Bloomberg, Daiwa forecasts
Note: data is based on closing share prices as of 6 October 2010.

We prefer a PER-based valuation for the sector

Due to consistent sales and earnings growth, we prefer a PER-based valuation for the sector

In our view, a PER-based valuation is the most appropriate approach to value the FMCG companies due to their consistent sales and profit growth. Over the past three-to-five years, FMCG companies have recorded stable earnings growth, with relatively few fluctuations in profitability. Most of their sales are domestic in nature, and thus are not affected much by foreign-exchange movements; although some raw-material prices are based on crude-linked derivatives.

ITC: one-year forward PER bands



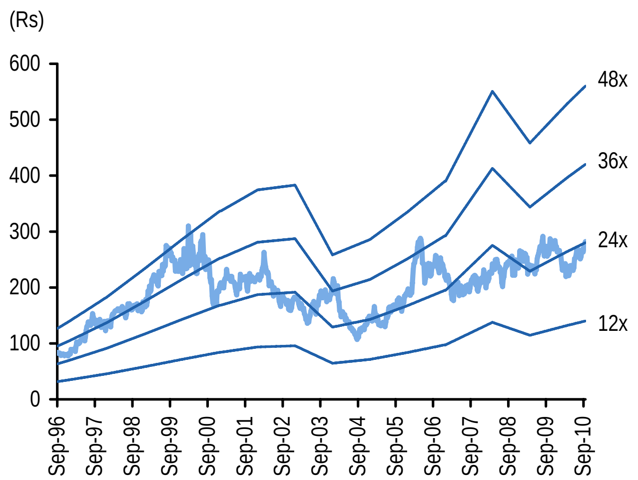
Source: Company, Daiwa forecasts

Rationale for PER and target price

ITC has traded within a PER band of about 16-26x over the past three years. In our view, its recent fluctuations within this band are more to do with news flow related to the cigarette business. We believe the company's cigarette business should be valued at a 25x PER (compared with 21x previously), in line with our revised target PER for HUL of 25x. We arrive at our six-month target price for ITC using the SOTP methodology to value the different parts of the company's business. We maintain our **1** (*Buy*) rating for the stock and have raised our six-month target price to Rs201 from Rs170.

Source: Company, Daiwa forecasts

HUL: one-year forward PER bands



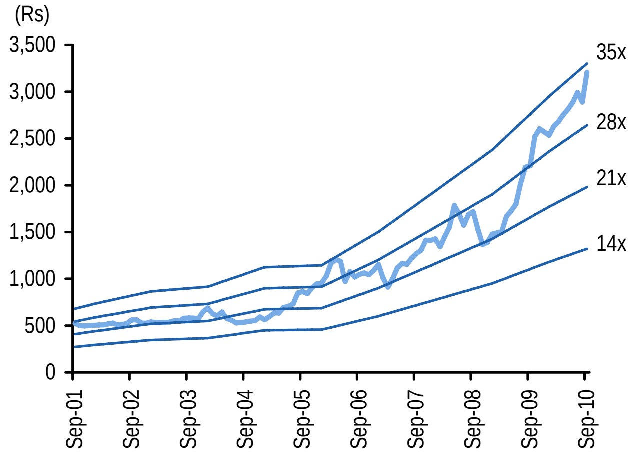
Source: Company, Daiwa forecasts

Rationale for PER and target price

HUL has traded within a PER band of 21-25x over the past two years, lower than its past-five-year band of 20-36x. We attribute the lower PER band mainly to increasing competition in HUL's main FMCG business of soap and detergents. Also, HUL's volume growth has started to increase from 4Q FY10, due mainly to a reversal of consumers trading down to cheaper products. We believe that concerns in the market about HUL's volume growth have lessened and will cap its PER in the 21-26x band. Hence, to arrive at our new six-month target price of Rs309, we now use a two-year high historical PER of 25x (from 21x previously). However, at the current share price, we believe that most of the positives of volume and price rises are factored in, and hence have downgraded our rating to **3** (*Hold*) from 2 (*Outperform*).

Source: Company, Daiwa forecasts

Nestle: one-year forward PER bands



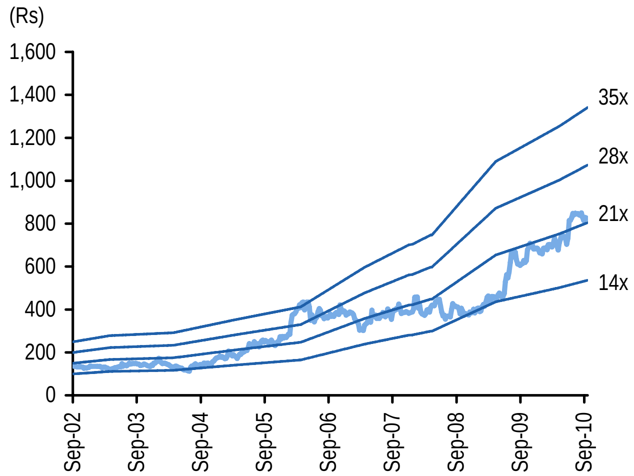
Source: Company, Daiwa forecasts

Rationale for PER and target price

Nestle has traded within a PER band of 18-34x over the past 10 years, and at an average PER of 25x over that period However, over FY08-10 it moved up in the PER bands to trade at an average PER of 27x, and in the past year has traded at 30x. Nestle, like other FMCG companies, has been re-rated significantly since May 2009. The stock is trading currently above its 10-year average PER and we believe the premium is justified considering what we see as the strong demand outlook and likely improvement in its EBITDA margin from a potential decline in agri-based raw-materials prices and the company's strong pricing power. However, considering the likely headwinds in the form of intensifying competition from existing and new players, we believe a further appreciation in the valuation multiple would be restricted. In our view, the current share price fully factors in the positives. We initiate coverage of the stock with a **4** (*Underperform*) rating and six-month target price of Rs2,981, equivalent to a 30x PER on our 2011 EPS forecast.

Source: Company, Daiwa forecasts

Colgate: one-year forward PER bands



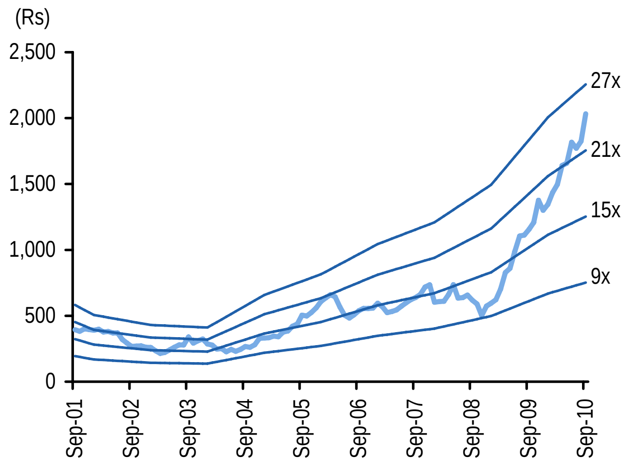
Source: Company, Daiwa forecasts

Rationale for PER and target price

The company has traded within a PER band of about 13-23x and at an average of 18x over the past three years. We believe its dominant market position in the oral-care segment with likely continued double-digit-percentage growth across key segments will lead to the stock trading at the higher end of its historical PER band. Colgate is a steady cash-generating company, and hence we value it on a PER basis. It has increased its market share over past four years in a highly penetrated market and improved its EBITDA margin. We believe that despite increasing competition, Colgate will be able to maintain its leadership position and profitability due to its strong brand equity and pricing power. Hence, we expect the stock to trade at a slightly higher PER band in the future. Accordingly, we have used a target PER of 24x based on our FY12 forecasts (compared with 25x for HUL) and arrive at a six-month target price of Rs995. We initiate coverage of Colgate with a **1** (*Buy*) rating.

Source: Company, Daiwa forecasts

GSKCH: one-year forward PER bands



Source: Company, Daiwa forecasts

Rationale for PER and target price

GSKCH has traded within a one-year forward PER band of 9-25x and at an average PER of 16x over the past 10 years. The relatively lower multiple compared with other FMCG companies like HUL is on account of GSKCH's single-product image, in our view. However, the stock has been rerated post its aggressive innovation. As a result, it traded at an average PER of 17x for FY09-10, and at an average PER of 20.7x over the past year. In our view, the company's broadening portfolio, low penetration and strong pricing power are its key business strengths. We believe these factors will lead to the stock trading at a higher PER band in the future and hence initiate coverage with a **2** (*Outperform*) rating and six-month target price of Rs2,117, equivalent to a 24x PER based on our 2011 EPS forecast.

Source: Company, Daiwa forecasts

ITC
(ITC IN)

Food, beverage & tobacco: India

6-mth rating: 1

Target price: Rs170.00 → Rs201.00

Share price: Rs172.90 (6 Oct)

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Cigarette business supported by improving FMCG business

1 (*Buy*) rating maintained

- We forecast ITC's FY10-13 total sales and earnings to increase at CAGRs of 14.9% and 15%, respectively.

- We maintain our **1** (*Buy*) rating, and have raised our six-month target price to Rs201 (from Rs170), based on our SOTP valuation (Rs155/share [a PER of 25x (from 21x) based on our FY12 EPS forecast] for the cigarette business, Rs39/share for the other businesses, and Rs7/share for cash and cash equivalent).

- ITC remains our top pick in the sector, supported by its strong stable cigarette business, which continues to have more than an 80% share of the India market.

Non-cigarette FMCG segment losses narrow

- Losses for non-cigarette FMCG segment have continued to narrow over the past few quarters. In our view, this has been due mainly to improvements to the product mix and the sourcing of raw materials, and increased supply-chain efficiency.

Revival at the hotels business

- After a slowdown in the first half of FY10 for the hotels division, occupancy rates and average room rates (ARRs) have picked up since 3Q FY10. We expect ITC's hotel business to improve the company's overall profitability.

Reuters code		ITC.NS

Market data

SENSEX Index		20,543.08
Market cap	(US$bn)	29.66
EV	(US$bn; 11E)	28.09
3-mth avg daily T/O	(US$m)	27.45
Shares outstanding	(m)	7,636
Free float	(%)	74.0
Major shareholder		Tobacco Manufacturers India Ltd (26.0%)
Exchange rate	Rs/US$	44.515

Performance (%)*	1M	3M	6M
Absolute	4.3	14.2	29.9
Relative	(6.4)	(2.5)	15.4

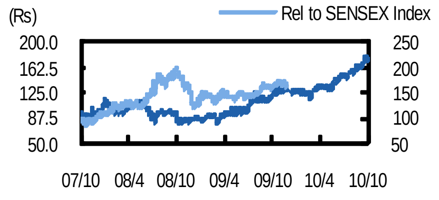
Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2011E	2012E	2013E
PER	(x)	28.2	24.4	21.4
PCFR	(x)	30.8	22.8	19.9
EV/EBITDA	(x)	17.9	15.2	12.9
PBR	(x)	8.0	6.9	5.9
Dividend yield	(%)	1.4	1.7	2.0
ROE	(%)	30.6	30.3	29.7
ROA	(%)	19.4	20.1	20.3
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

Year to 31 Mar	Revenue (Rs m)	(%)	EBITDA (Rs m)	(%)	Net profit (Rs m)	(%)	EPS (Rs)	(%)	CFPS (Rs)	DPS (Rs)
2009	153,881	*10.3*	48,402	*9.6*	32,636	*4.6*	4.274	*4.6*	4.882	1.829
2010	181,532	*18.0*	60,206	*24.4*	40,610	*24.4*	5.318	*24.4*	10.553	5.000
2011E	210,335	*15.9*	69,914	*16.1*	46,831	*15.3*	6.133	*15.3*	5.621	2.500
2012E	240,820	*14.5*	81,437	*16.5*	54,187	*15.7*	7.096	*15.7*	7.576	3.000
2013E	275,566	*14.4*	94,572	*16.1*	61,709	*13.9*	8.081	*13.9*	8.671	3.500

Source: Company, Daiwa forecasts

Company background

ITC was incorporated in 1910 as Imperial Tobacco Company of India Ltd. as a pure cigarette and tobacco-leaf business. Currently, it has a diversified presence across a number of product ranges under various basic segments including other FMCG, hotels, agri-business, and paper and packaging. Its core competencies lie with its distribution reach and effective supply-chain management.

ITC – financial summary

Profit and loss (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Cigarettes	75,568	93,212	111,224	125,136	141,769
Other FMCG	30,056	36,339	41,490	49,717	59,575
Others	48,256	51,981	57,622	65,968	74,222
Total revenue	153,881	181,532	210,335	240,820	275,566
Other income	0	0	0	0	0
COGS	(66,587)	(76,591)	(88,646)	(100,616)	(114,259)
SG&A	(8,144)	(9,367)	(10,842)	(12,306)	(13,974)
Other op. expenses	(36,242)	(41,455)	(48,069)	(54,812)	(62,221)
EBIT	42,908	54,119	62,779	73,086	85,112
Net-interest inc./(exp.)	0	0	0	0	0
Assoc/forex/extraord./others	5,349	6,034	6,600	7,190	7,683
Pre-tax profit	48,257	60,153	69,379	80,276	92,795
Tax	(15,622)	(19,543)	(22,548)	(26,090)	(31,086)
Min. int./pref. div./others	0	0	0	0	0
Net profit (reported)	32,636	40,610	46,831	54,187	61,709
Net profit (adj.)	32,636	40,610	46,831	54,187	61,709
EPS (reported) (Rs)	4.274	5.318	6.133	7.096	8.081
EPS (adj.) (Rs)	4.274	5.318	6.133	7.096	8.081
DPS (Rs)	1.829	5.000	2.500	3.000	3.500
EBIT (adj.)	42,908	54,119	62,779	73,086	85,112
EBITDA (adj.)	48,402	60,206	69,914	81,437	94,572

Balance sheet (Rs m)

As at 31 Mar	2009	2010	2011E	2012E	2013E
Cash & short-term investment	38,701	68,532	71,025	83,980	100,833
Inventory	45,997	45,491	52,360	58,486	65,329
Accounts receivable	6,687	8,588	9,951	11,393	13,037
Other current assets	18,603	15,929	17,495	19,248	21,212
Total current assets	109,989	138,540	150,831	173,107	200,410
Fixed assets	84,860	91,514	102,476	112,220	120,856
Goodwill & intangibles	0	0	0	0	0
Other non-current assets	0	0	0	0	0
Total assets	194,848	230,053	253,306	285,327	321,266
Short-term debt	0	0	0	0	0
Accounts payable	31,612	40,870	39,628	44,264	49,764
Other current liabilities	15,438	39,613	39,613	39,613	39,613
Total current liabilities	47,050	80,482	79,240	83,877	89,377
Long-term debt	1,776	1,077	1,077	1,077	1,077
Other non-current liabilities	8,672	7,850	7,850	7,850	7,850
Total liabilities	57,498	89,410	88,167	92,804	98,304
Share capital	3,774	3,818	7,636	7,636	7,636
Reserves/R.E./others	133,576	136,826	157,503	184,886	215,326
Shareholders' equity	137,351	140,644	165,139	192,523	222,962
Minority interests	0	0	0	0	0
Total equity & liabilities	194,848	230,053	253,306	285,327	321,266
Net debt/(cash)	(36,926)	(67,454)	(69,948)	(82,903)	(99,756)

Cash flow (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Profit before tax	48,257	60,153	69,379	80,276	92,795
Depreciation and amortisation	5,494	6,087	7,135	8,350	9,459
Tax paid	(12,400)	(20,365)	(22,548)	(26,090)	(31,086)
Change in working capital	(4,070)	34,712	(11,039)	(4,685)	(4,950)
Other operational CF items	0	0	0	0	0
Cash flow from operations	37,281	80,587	42,926	57,852	66,218
Capex	(17,397)	(12,741)	(18,097)	(18,095)	(18,095)
Net (acquisitions)/disposal	0	0	0	0	0
Other investing CF items	968	(28,891)	0	0	0
Cash flow from investing	(16,429)	(41,633)	(18,097)	(18,095)	(18,095)
Change in debt	(369)	(698)	0	0	0
Net share issues/(repurchases)	6	44	3,818	0	0
Dividends paid	(16,299)	(44,517)	(22,336)	(26,803)	(31,270)
Other financing CF items	431	7,157	(3,818)	0	0
Cash flow from financing	(16,231)	(38,015)	(22,336)	(26,803)	(31,270)
Forex effect/others	(968)	28,891	0	0	0
Change in cash	3,653	29,830	2,494	12,954	16,854

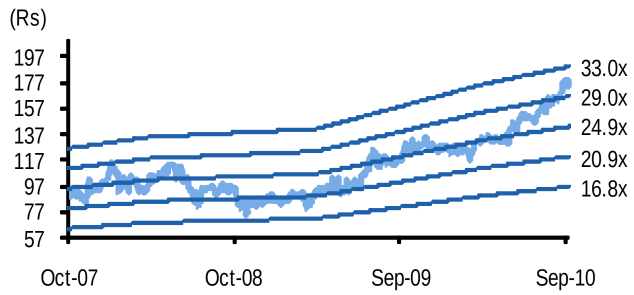
Key ratios

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Sales – YoY %	10.3	18.0	15.9	14.5	14.4
EBITDA (adj.) – YoY %	9.6	24.4	16.1	16.5	16.1
Net profit (adj.) – YoY %	4.6	24.4	15.3	15.7	13.9
EPS (adj.) – YoY %	4.6	24.4	15.3	15.7	13.9
EBITDA margin % (adj.)	31.5	33.2	33.2	33.8	34.3
EBIT margin % (adj.)	27.9	29.8	29.8	30.3	30.9
Net-profit margin % (adj.)	21.2	22.4	22.3	22.5	22.4
ROAE (%)	25.3	29.2	30.6	30.3	29.7
ROAA (%)	17.8	19.1	19.4	20.1	20.3
ROCE (%)	32.8	38.5	40.8	40.6	40.8
ROIC (%)	28.7	38.4	46.0	44.7	45.5
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Effective tax rate (%)	32.4	32.5	32.5	32.5	33.5
Accounts receivable (days)	16.7	15.4	16.1	16.2	16.2
Payables (days)	72.8	72.9	69.8	63.6	62.3
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout (%)	42.8	94.0	40.8	42.3	43.3

Key assumptions

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Cigarette growth (%)	13.9	23.3	19.3	12.5	13.3

PER bands



Source: Company, Daiwa forecasts

Earnings outlook

Cigarettes continue to drive profit

We expect the EBITDA margin to remain at around 33-34% over the next three years

We forecast gross sales for the cigarette segment to increase at a CAGR of 12.6% between FY10 and FY13, and the company's overall EBITDA margin to remain at around 33-34% over the same timeframe, due mainly to our expectation of a stable gross-sales CAGR for the cigarette business. We forecast the cigarette business to contribute 81.3% of ITC's PBIT for FY13, and for this to increase at CAGR of 16.4% over the FY10-13 period.

Continue market leadership in cigarettes

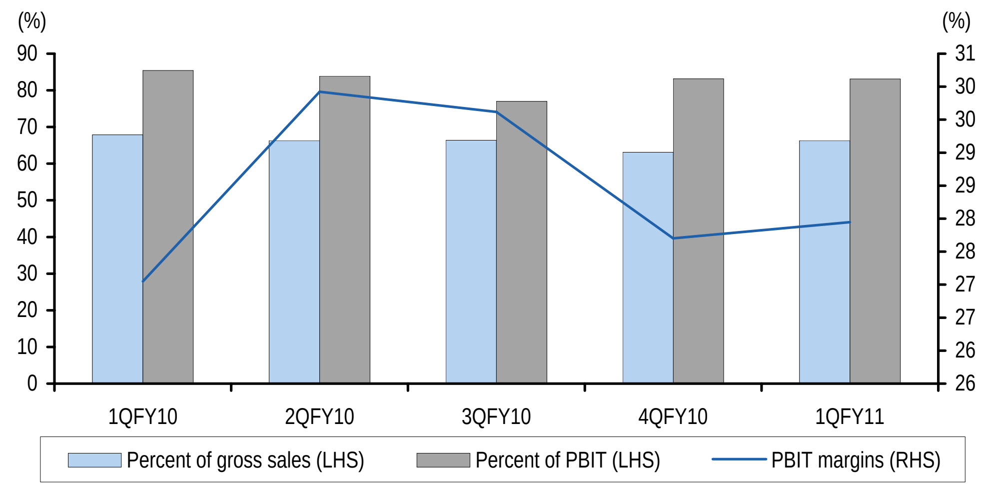
The cigarette division contributed 65.8% of FY10 gross revenue. ITC retained its leading overall market position and improved its standing within certain segments of the cigarettes market in FY10. However, the company experienced pressure on sales volume and pricing due to the ban on smoking in public places, the requirement that graphic health warnings be placed on tobacco products, an increase in VAT rates on cigarettes, and its exit from the popular low-priced micros and plain non-filtered cigarettes segments.

ITC: gross sales mix and EBITDA margin (%)

	FY09	FY10	FY11E	FY12E	FY13E	Sales CAGR FY10-13E
Cigarettes	65.3	65.8	66.0	65.0	64.3	12.6
Other FMCG	13.0	13.9	13.9	14.7	15.6	17.9
Hotels	4.4	3.5	3.3	3.2	3.1	9.2
Agri business	16.6	14.7	12.5	12.2	11.3	4.1
Paperboards	12.2	12.3	9.9	10.4	11.0	9.3
Total	111.6	110.2	105.6	105.6	105.3	11.8
Less inter segment revenue	11.6	10.2	5.6	5.6	5.3	(8.8)
Gross sales	100.0	100.0	100.0	100.0	100.0	13.5
EBITDA margin	31.5	33.2	33.2	33.8	34.3	

Source: Company, Daiwa forecasts
Note: slight discrepancies are due to rounding

ITC: cigarettes' quarterly contribution to gross sales and PBIT, and PBIT margins



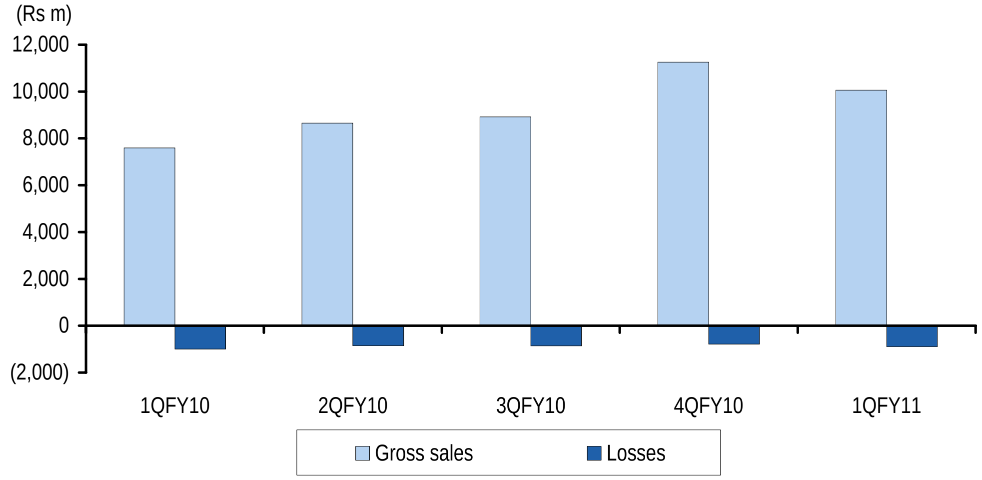
Source: Company, Daiwa

Non-cigarette FMCG segment losses narrow

Improvements in non-cigarette segment

Losses for non-cigarette FMCG segment have continued to narrow over the past few quarters. In our view, this has been due mainly to improvements to the product mix and the sourcing of raw materials, and increased supply-chain efficiency.

ITC: non-cigarette FMCG segment sales and losses



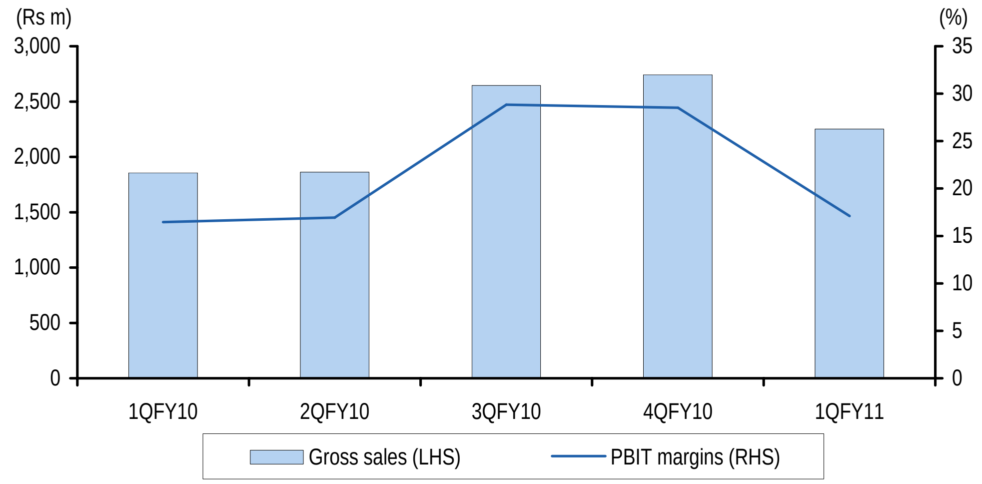
Source: Company

Recovery at the hotels business

Turnaround at the hotels business since 3Q FY10

Due to the economic slowdown, a drop-off in domestic air travel, and a slowdown in inbound tourism, the hotels business saw its occupancy rates and ARRs drop in FY10. However, this trend reversed in 3Q FY10. In 1Q FY11, the division accounted for 3.2% of the company's gross revenue (up from 3.0% for 1Q FY10).

ITC: hotel segment – gross sales and PBIT margins



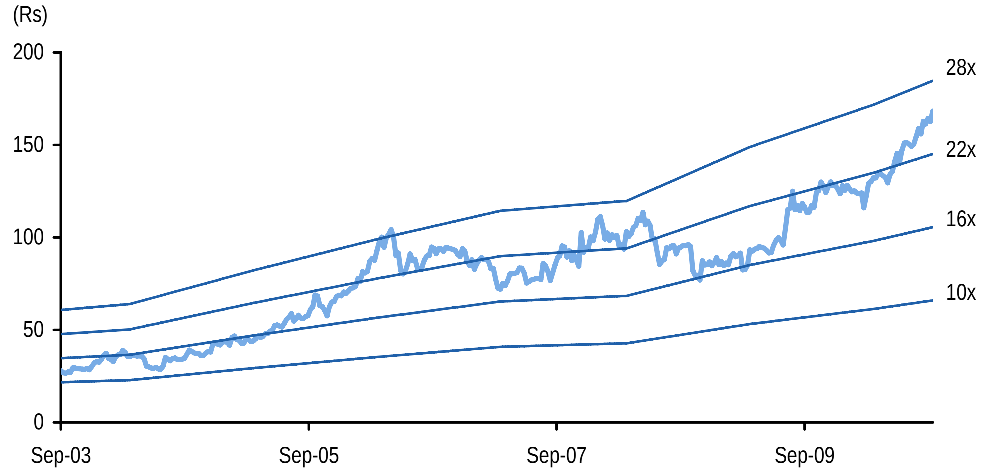
Source: Company, Daiwa

Valuation and target price

Over the past three years, ITC has traded in a PER range of about 16-26x

Over the past three years, the stock has traded within a PER range of about 16-26x. In our view, its recent fluctuations within this band have more to do with news flow related to the levies on cigarette business. We believe the company's cigarette business deserves to be valued at a PER of 25x, especially on account of its continued strong share of the cigarette market.

ITC: one-year forward PER bands



Source: Company, Daiwa forecasts

We use an SOTP method to arrive at our six-month target price

We use an SOTP method to value the different parts of the company's business (see the following table for a breakdown). We maintain our **1** (*Buy*) rating, with a six-month target price of Rs201 (raised from Rs170), based on our SOTP valuation (Rs155/share [a PER of 25x (revised from 21x) based on our FY12 EPS forecast] for the cigarette business, Rs40/share for the other businesses, and Rs7/share for cash and cash equivalent).

ITC: SOTP valuation

Segment	Rs	Methodology	Multiple (x)	Remarks
Cigarettes	155	PER	25.0	Upper end of the past-two-year PER range of 21-25x of Hindustan Unilever (HUVR IN, Rs309, 3)
FMCG	20	EV/sales	3.0	Discount to Nestle India (NEST IN, Rs2,981, 4)
Hotels	4	EV/EBITDA	12.0	In line with Indian Hotels (Not rated)
Agri business	8	EV/EBITDA	12.0	FY11-13 EBITDA growth of over 20%
Paperboards	8	EV/EBITDA	8.0	FY11-13 EBITDA growth of around 15%
Net cash	7			
Total	**201**			

Source: Daiwa forecasts

Downside risks

Slower-than-expected narrowing of losses of FMCG division

We see the main downside risks to our view as a slower-than-expected narrowing of losses for the FMCG division, and potential increases in the various taxes imposed by the government on cigarettes.

Hindustan Unilever (HUVR IN)

Household & personal products: India

6-mth rating: 2 → 3

Target price: Rs260.00 → Rs309.00

Share price: Rs301.15 (6 Oct)

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Most of the price- and volume-led positives appear priced in already

Rating downgraded to *Hold*

- We forecast HUL's FY10-13 total sales and earnings to increase at CAGRs of 10.6% and 12.7%, respectively. We believe that concerns in the market about HUL's volume growth have lessened and that this would cap its PER to within a 21-26x band. Hence, to arrive at our six-month target price of Rs309, we use a past-two-year PER high of 25x (21x earlier) on our FY12 EPS forecast. However, we believe that most of the positives relating to volume and price rises have already been factored into the share price. Hence, we have downgraded our rating to **3** (*Hold*) from 2 (*Outperform*)

Trading down in mass-market segments has stopped

- For the first three quarters of FY10, HUL observed consumers trading down in the mass-market laundry segment. However, in 4Q FY10, the company witnessed strong sales-volume growth for its soaps and detergents. We believe the intensity of price competition in the mass-market segments, especially in the laundry segment, has eased, helping larger players like HUL record volume gains after almost a year of volume declines.

Gaining market share remains the focus

- To improve its market share, HUL continues to strengthen the competitiveness of its portfolio and brands. This should be well supported by increased advertisement spending and entering newer categories and segments.

Reuters code		HLL.NS

Market data

SENSEX Index		20,543.08
Market cap	(US$bn)	14.76
EV	(US$bn; 11E)	13.84
3-mth avg daily T/O	(US$m)	14.58
Shares outstanding	(m)	2,182
Free float	(%)	48.0
Major shareholder		Unilever Group (52.0%)
Exchange rate	Rs/US$	44.515

Performance (%)*	1M	3M	6M
Absolute	10.9	12.6	31.0
Relative	0.2	(4.0)	16.5

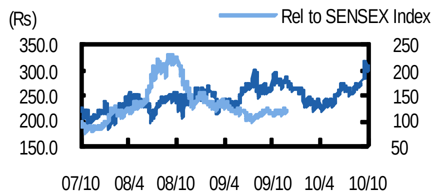
Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2011E	2012E	2013E
PER	(x)	27.3	24.3	22.0
PCFR	(x)	23.8	21.2	19.2
EV/EBITDA	(x)	22.1	19.5	17.4
PBR	(x)	19.5	16.9	15.1
Dividend yield	(%)	2.5	3.3	3.8
ROE	(%)	80.8	74.4	72.3
ROA	(%)	24.3	24.5	24.7
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

Year to 31 Mar	Revenue (Rs m)	(%)	EBITDA (Rs m)	(%)	Net profit (Rs m)	(%)	EPS (Rs)	(%)	CFPS (Rs)	DPS (Rs)
2009	202,393	*n.a.*	26,780	*n.a.*	25,007	*n.a.*	11.472	*n.a.*	11.813	5.999
2010	175,238	*8.2*	25,484	*19.0*	20,831	*4.1*	9.548	*4.0*	16.911	6.499
2011E	192,045	*9.6*	27,886	*9.4*	24,038	*15.4*	11.018	*15.4*	12.649	7.500
2012E	213,413	*11.1*	31,159	*11.7*	26,996	*12.3*	12.374	*12.3*	14.213	10.000
2013E	237,100	*11.1*	34,617	*11.1*	29,825	*10.5*	13.671	*10.5*	15.654	11.500

Source: Company, Daiwa forecasts

Company background

Hindustan Unilever was incorporated in 1933. It is the largest FMCG conglomerate in India, with brands spanning 20 consumer categories. The company enjoys strong brand equity, as most of its brands are market leaders (in value terms) in the laundry-wash, personal-wash, hair-care, skin-care, beverage, jam and talcum-powder segments. It manufactures in over 71 locations, serving more than 700m Indians.

Hindustan Unilever – financial summary

Profit and loss (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Soaps and Detergents	92,104	76,365	80,965	87,105	93,761
Personal Products	56,161	51,073	57,202	66,354	76,971
Others	54,128	47,800	53,878	59,954	66,368
Total revenue	202,393	175,238	192,045	213,413	237,100
Other income	0	0	0	0	0
COGS	(108,525)	(92,544)	(101,446)	(112,628)	(125,129)
SG&A	0	0	0	0	0
Other op. expenses	(69,042)	(59,050)	(64,777)	(71,806)	(79,650)
EBIT	24,827	23,644	25,822	28,979	32,321
Net-interest inc./(exp.)	(253)	(70)	(70)	(70)	(70)
Assoc/forex/extraord./others	5,678	3,301	4,294	4,836	5,031
Pre-tax profit	30,251	26,875	30,047	33,745	37,282
Tax	(5,244)	(6,044)	(6,009)	(6,749)	(7,456)
Min. int./pref. div./others	(43)	1,189	185	0	0
Net profit (reported)	24,965	22,020	24,223	26,996	29,825
Net profit (adj.)	25,007	20,831	24,038	26,996	29,825
EPS (reported) (Rs)	11.452	10.093	11.103	12.374	13.671
EPS (adj.) (Rs)	11.472	9.548	11.018	12.374	13.671
DPS (Rs)	5.999	6.499	7.500	10.000	11.500
EBIT (adj.)	24,827	23,644	25,822	28,979	32,321
EBITDA (adj.)	26,780	25,484	27,886	31,159	34,617

Balance sheet (Rs m)

As at 31 Mar	2009	2010	2011E	2012E	2013E
Cash & short-term investment	21,100	31,563	40,797	47,988	55,050
Inventory	25,289	21,799	23,748	26,390	29,319
Accounts receivable	5,369	6,784	7,435	8,262	9,179
Other current assets	7,579	6,172	6,172	6,172	6,172
Total current assets	59,336	66,318	78,151	88,812	99,721
Fixed assets	20,789	24,361	24,297	24,117	23,820
Goodwill & intangibles	0	0	0	0	0
Other non-current assets	2,548	2,488	2,488	2,488	2,488
Total assets	82,673	93,167	104,936	115,417	126,029
Short-term debt	0	0	0	0	0
Accounts payable	33,050	43,737	47,646	52,948	58,824
Other current liabilities	24,788	23,595	23,595	23,595	23,595
Total current liabilities	57,838	67,332	71,241	76,543	82,419
Long-term debt	4,219	0	0	0	0
Other non-current liabilities	0	0	0	0	0
Total liabilities	62,058	67,332	71,241	76,543	82,419
Share capital	2,180	2,182	2,182	2,182	2,182
Reserves/R.E./others	18,435	23,654	31,513	36,692	41,428
Shareholders' equity	20,615	25,835	33,695	38,874	43,610
Minority interests	0	0	0	0	0
Total equity & liabilities	82,673	93,167	104,936	115,417	126,029
Net debt/(cash)	(16,880)	(31,563)	(40,797)	(47,988)	(55,050)

Cash flow (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Profit before tax	30,251	26,875	30,047	33,745	37,282
Depreciation and amortisation	1,953	1,840	2,064	2,180	2,296
Tax paid	(5,669)	(5,984)	(6,009)	(6,749)	(7,456)
Change in working capital	(742)	12,975	1,310	1,832	2,031
Other operational CF items	(43)	1,189	185	0	0
Cash flow from operations	25,751	36,895	27,597	31,008	34,152
Capex	(5,660)	(5,413)	(2,000)	(2,000)	(2,000)
Net (acquisitions)/disposal	0	0	0	0	0
Other investing CF items	11,082	(9,315)	0	0	0
Cash flow from investing	5,422	(14,727)	(2,000)	(2,000)	(2,000)
Change in debt	3,334	(4,219)	0	0	0
Net share issues/(repurchases)	2	2	0	0	0
Dividends paid	(19,123)	(16,560)	(19,144)	(25,525)	(29,354)
Other financing CF items	378	(242)	2,781	3,708	4,264
Cash flow from financing	(15,408)	(21,020)	(16,363)	(21,817)	(25,090)
Forex effect/others	(11,105)	9,417	0	0	0
Change in cash	4,660	10,565	9,234	7,191	7,063

Key ratios

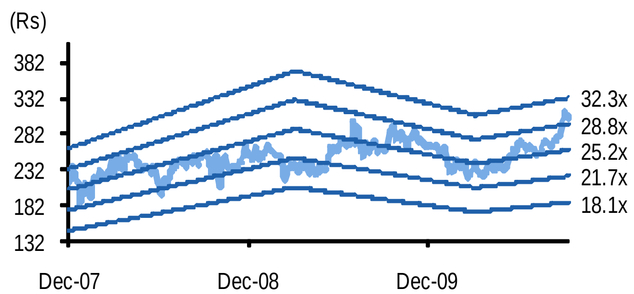
Year to 31 Mar	2009	2010	2011E	2012E	2013E
Sales – YoY %	n.a.	8.2	9.6	11.1	11.1
EBITDA (adj.) – YoY %	n.a.	19.0	9.4	11.7	11.1
Net profit (adj.) – YoY %	n.a.	4.1	15.4	12.3	10.5
EPS (adj.) – YoY %	n.a.	4.0	15.4	12.3	10.5
EBITDA margin % (adj.)	13.2	14.5	14.5	14.6	14.6
EBIT margin % (adj.)	12.3	13.5	13.4	13.6	13.6
Net-profit margin % (adj.)	12.4	11.9	12.5	12.6	12.6
ROAE (%)	n.m.	89.7	80.8	74.4	72.3
ROAA (%)	33.6	23.7	24.3	24.5	24.7
ROCE (%)	n.m.	93.3	86.8	79.9	78.4
ROIC (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Effective tax rate (%)	17.3	22.5	20.0	20.0	20.0
Accounts receivable (days)	8.8	12.7	13.5	13.4	13.4
Payables (days)	55.8	80.0	86.8	86.0	86.0
Net interest cover (x)	98.0	338.7	369.9	415.2	463.0
Net dividend payout (%)	52.4	64.4	67.6	80.8	84.1

Key assumptions

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Soaps and Detergents sales growth (YoY %)	n.a.	3.6	6.0	7.6	7.6
Personal Products sales growth (YoY %)	n.a.	13.7	12.0	16.0	16.0

2009 is not comparable as it was a 15-month period

PER bands



Source: Company, Daiwa forecasts

Earnings outlook

We expect soap and detergent to continue to dominate the product mix

We expect soap and detergent to remain the key contributors

We expect the soap and detergent segment to remain the main contributor to HUL's total FMCG sales over the next three years. We believe that any reduction in the proportion of relatively high-margin personal products in product mix would have a negative impact on the company's overall PBIT growth.

HUL: sales mix and EBITDA margins (%)

Segments	FY09	FY10	FY11E	FY12E	FY13E	Sales CAGR FY10-13E
Soap and detergent	48.2	46.5	46.1	45.0	43.8	9.5
Personal products	26.2	28.4	28.5	29.2	29.9	13.7
Beverages	11.2	12.1	12.2	12.5	12.8	14.0
Foods	4.0	4.1	4.3	4.5	4.6	16.3
Ice cream	1.1	1.3	1.4	1.5	1.6	20.0
Exports	7.7	5.7	5.2	4.7	4.2	1.5
Others	1.8	2.0	2.3	2.7	3.1	30.0
Net Sales	**100**	**100**	**100**	**100**	**100**	**10.6**
EBITDA margin	*13.2*	*14.5*	*14.5*	*14.6*	*14.6*	

Source: Company, Daiwa forecasts
Notes: slight discrepancies are due to rounding. For the four quarters to 31 March 2008.

Downtrading in the mass-market segment for detergents declines

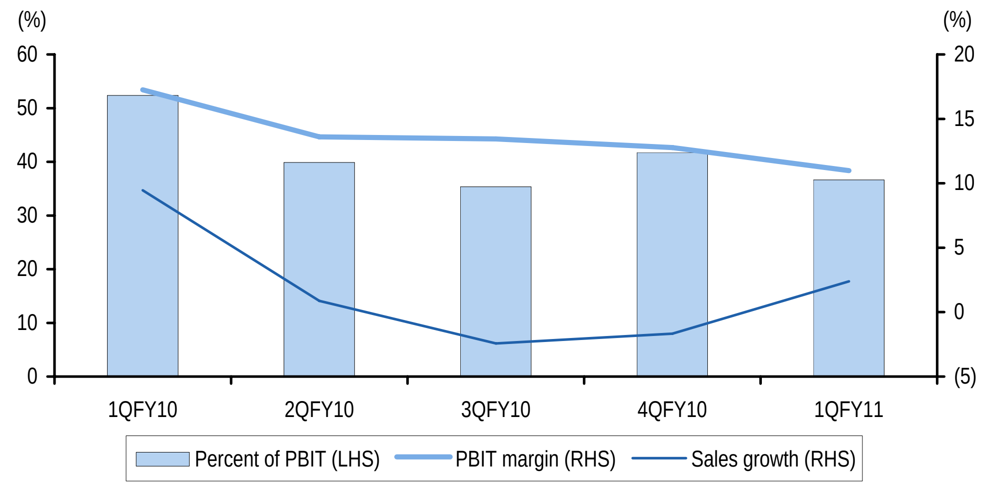
Sales growth improves with increasing volume

The contribution from the soap and detergent segment to total PBIT has been declining over the past five quarters. We attribute this to a slowdown in volume growth, which in the recent past was offset by price hikes. In our opinion, the company's overall sales growth would suffer unless the sales-volume growth of the soap and detergent segment improves.

Downtrading in mass-segment detergents declining

Constant pressure as a result of consumers trading down in mass-market segments had a negative effect on revenue growth for the soap and detergent segment for the first three quarters of FY10. However, we believe the intensity of price competition in the mass-market segments, especially in the soap and detergent segment, has now eased, helping larger players like HUL record volume gains after almost a year. However, the overall steps undertaken by the company during FY10 – such as various product relaunches, launching brands at different price points, improvements in competitiveness, etc – have helped reverse this falling trend for its soap and detergents division, which contributed 46.5% of its FY10 revenue.

HUL: soaps and detergents



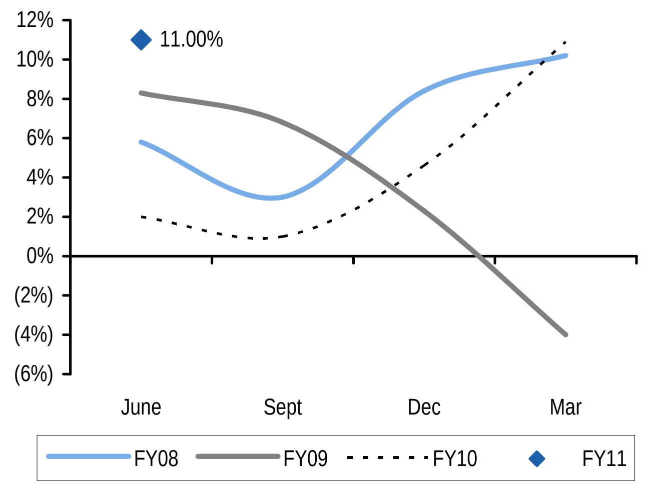
Source: Company, compiled by Daiwa

Revenue growth driven by volume

Highest volume growth and lowest price-led growth over the past 16 quarters

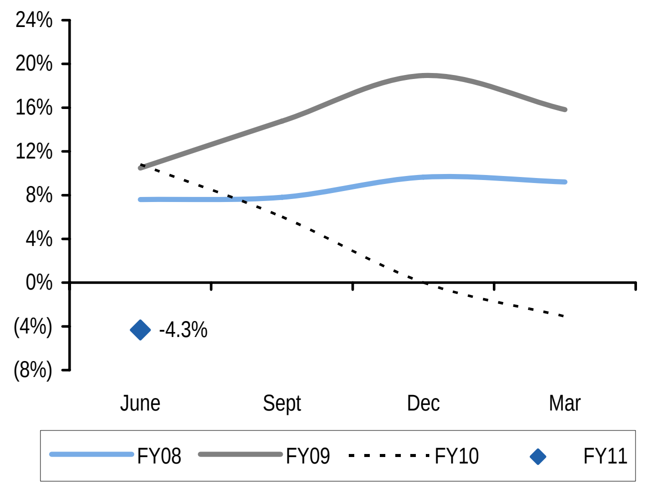
HUL's volume growth has been strong since 4Q FY10, accelerating by 11% YoY for 1Q FY11, and stronger than the overall industry's growth. HUL is focused on strengthening its leadership position in the detergents and personal-care segments. Volume growth has started to increase from 4Q FY10, due mainly to a reversal of downtrading by consumers to cheaper products. From the following charts, one can see that price-led growth has also been declining, and hit its lowest level over the past 16 quarters in 1Q FY11.

HUL: YoY volume growth



Source: Company, Daiwa

HUL: YoY price-led growth



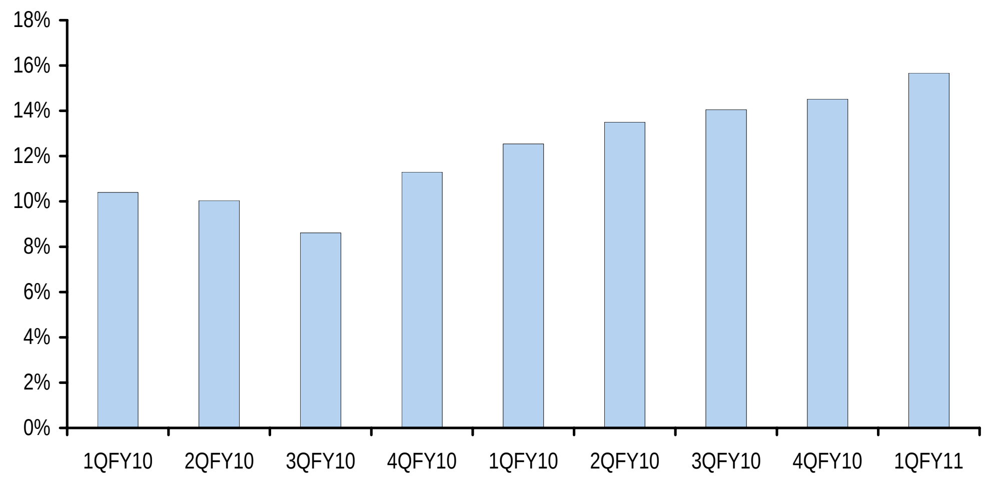
Source: Company, Daiwa

Increased spending on marketing across the industry

Marketing spending increasing across the industry

The overall investment in marketing undertaken by various FMCG companies in India is on the rise due to the intensified competitive environment. Improving the product mix and focusing on investing in and developing its various brands have resulted in an increase in HUL's overall spending on advertising and promotion (A&P) over the past few quarters. For 1Q FY11, HUL's A&P expenses increased to 15.7% of net sales, up from 12.5% for 1Q FY10.

HUL: A&P as a percentage of sales



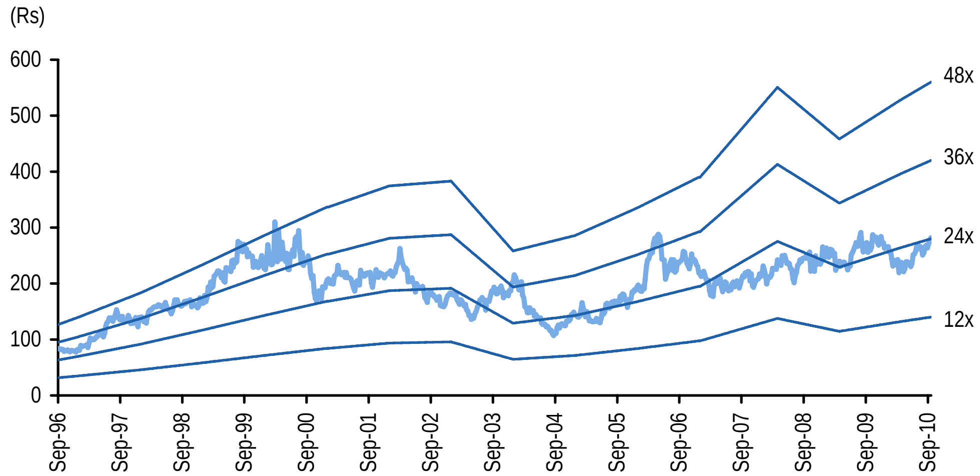
Source: Company, Daiwa

Valuation and target price

HUL has traded within a PER band of about 20-36x over the past five years

HUL has traded within a PER band of 21-25x over the past two years, lower than its past-five-year PER band of 20-36x. We attribute the lower PER band mainly to increasing competition in HUL's main FMCG business of soap and detergents. However, HUL's volume growth started to increase from 4Q FY10, due mainly to a reversal of downtrading by consumers to cheaper products.

HUL: one-year-forward PER bands



Source: Company, Daiwa forecasts

Our six-month target price for HUL is based on a target PER of 25x on our FY12 EPS forecast

We believe that concerns in the market about HUL's volume growth have lessened and that this would cap its PER to within a band of 21-26x. Hence, to arrive at our six-month target price of Rs309, we use a past-two-year PER high of 25x (21x earlier) on our FY12 EPS forecast. However, we believe that most of the positives relating to volume and price rises have already been factored into the share price. Hence, we have downgraded our rating to **3** (*Hold*) from 2 (*Outperform*).

Risk factors

Faster-than-expected increase in market share for HUL

We see a faster-than-expected increase in market share for HUL as the key upside risk to our earnings forecasts and rating.

Nestle India (NEST IN)

6-mth rating: 4

Target price: Rs2,981.00

Share price: Rs3,212.00 (6 Oct)

Food, beverage & tobacco: India

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Initiation of coverage: potential positives already in the price, in our view

Strong earnings-growth potential likely factored in

- Nestle is a leading F&B company, with a strong presence in categories with high revenue-growth potential. We forecast Nestle's sales to rise at a CAGR of 17.4% over the 2009-12 period, driven by demand for prepared dishes, chocolates, milk products and beverages. We forecast Nestle's earnings to increase at a 19.6% CAGR over the 2009-12 period, driven by cost efficiencies, pricing power and lower commodity prices.

- In our view, the share price already factors in these positives. Hence we initiate coverage with a **4** (*Underperform*) rating and target price of Rs2,981, based on a target PER of 30x on our 2011 EPS forecast.

Pure play on rising incomes and consumer aspirations

- Nestle is one of the fastest-growing FMCG companies in India. We believe demand for infant nutrition will be driven by rising income levels and the number of working women, whereas milk-powder sales will be driven by increasing awareness about hygiene and improving affordability. We expect the chocolate and instant-noodles markets to expand as a result of the entry of new players that we believe would help to expand the category size.

Normal monsoon could boost sales and profit growth

- Besides reducing raw-material prices and thereby food-price inflation, a normal monsoon would also increase agricultural output and therefore agri-incomes. It would also reduce raw-material costs for F&B companies and improve their profit margins.

Reuters code		NEST.NS

Market data

SENSEX Index		20,543.08
Market cap	(US$bn)	6.96
EV	(US$bn; 10E)	6.93
3-mth avg daily T/O	(US$m)	3.55
Shares outstanding	(m)	96
Free float	(%)	38.2
Major shareholder		Nestlé S.A (61.9%)
Exchange rate	Rs/US$	44.515

Performance (%)*	1M	3M	6M
Absolute	0.1	3.9	16.4
Relative	(10.6)	(12.7)	1.9

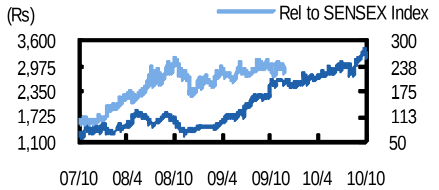
Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2010E	2011E	2012E
PER	(x)	38.1	32.3	27.6
PCFR	(x)	31.6	28.9	24.7
EV/EBITDA	(x)	25.2	21.5	18.4
PBR	(x)	n.m.	n.m.	n.m.
Dividend yield	(%)	2.0	2.4	2.8
ROE	(%)	n.m.	n.m.	n.m.
ROA	(%)	37.8	40.4	43.2
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

Year to 31 Dec	Revenue (Rs m)	(%)	EBITDA (Rs m)	(%)	Net profit (Rs m)	(%)	EPS (Rs)	(%)	CFPS (Rs)	DPS (Rs)
2008	43,242	*23.4*	8,333	*22.5*	5,341	*29.1*	55.394	*29.1*	75.078	42.500
2009	51,294	*18.6*	10,022	*20.3*	6,550	*22.6*	67.935	*22.6*	97.310	48.500
2010E	60,862	*18.7*	12,241	*22.1*	8,129	*24.1*	84.312	*24.1*	102	65.000
2011E	71,551	*17.6*	14,310	*16.9*	9,581	*17.9*	99.375	*17.9*	111	77.000
2012E	82,945	*15.9*	16,589	*15.9*	11,213	*17.0*	116	*17.0*	130	90.000

Source: Company, Daiwa forecasts

Company background

Nestlé India, a 61.85%-owned subsidiary of Nestlé S.A. of Switzerland, is a leading processed-food company in India, with leading positions in almost all categories where it is present. The company manufactures and markets milk and infant-nutrition products, prepared dishes and cooking aids, beverages, and chocolate and confectionary.

Nestle India – financial summary

Profit and loss (Rs m)

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Milk Products and Nutrition	19,388	23,113	27,439	31,692	36,605
Beverages	8,009	8,042	8,866	9,775	10,777
Others	15,846	20,139	24,557	30,084	35,563
Total revenue	43,242	51,294	60,862	71,551	82,945
Other income	0	0	0	0	0
COGS	(21,041)	(24,484)	(29,637)	(34,345)	(39,814)
SG&A	(1,944)	(2,675)	0	0	0
Other op. expenses	(12,852)	(15,329)	(20,233)	(24,270)	(27,985)
EBIT	7,406	8,806	10,992	12,937	15,147
Net-interest inc./(exp.)	(16)	(14)	(19)	(19)	(19)
Assoc/forex/extraord./others	339	378	420	482	555
Pre-tax profit	7,728	9,170	11,393	13,400	15,683
Tax	(2,387)	(2,620)	(3,264)	(3,819)	(4,470)
Min. int./pref. div./others	0	0	0	0	0
Net profit (reported)	5,341	6,550	8,129	9,581	11,213
Net profit (adj.)	5,341	6,550	8,129	9,581	11,213
EPS (reported) (Rs)	55.394	67.935	84.312	99.375	116
EPS (adj.) (Rs)	55.394	67.935	84.312	99.375	116
DPS (Rs)	42.500	48.500	65.000	77.000	90.000
EBIT (adj.)	7,406	8,806	10,992	12,937	15,147
EBITDA (adj.)	8,333	10,022	12,241	14,310	16,589

Balance sheet (Rs m)

As at 31 Dec	2008	2009	2010E	2011E	2012E
Cash & short-term investment	1,937	1,556	1,002	2,281	3,907
Inventory	4,349	4,987	5,465	6,424	7,430
Accounts receivable	456	642	834	980	1,136
Other current assets	1,238	1,380	1,826	2,147	2,488
Total current assets	7,980	8,566	9,127	11,831	14,961
Fixed assets	8,622	9,758	11,510	10,886	10,194
Goodwill & intangibles	0	0	0	0	0
Other non-current assets	349	2,033	2,033	2,033	2,033
Total assets	16,950	20,356	22,669	24,750	27,187
Short-term debt	0	0	0	0	0
Accounts payable	5,075	5,876	7,382	8,554	9,916
Other current liabilities	6,773	8,348	8,348	8,348	8,348
Total current liabilities	11,848	14,224	15,730	16,902	18,264
Long-term debt	0	0	0	0	0
Other non-current liabilities	369	320	320	320	320
Total liabilities	12,217	14,544	16,049	17,222	18,584
Share capital	964	964	964	964	964
Reserves/R.E./others	3,769	4,848	5,656	6,564	7,639
Shareholders' equity	4,734	5,813	6,620	7,528	8,603
Minority interests	0	0	0	0	0
Total equity & liabilities	16,950	20,356	22,669	24,750	27,187
Net debt/(cash)	(1,937)	(1,556)	(1,002)	(2,281)	(3,907)

Cash flow (Rs m)

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Profit before tax	7,728	9,170	11,393	13,400	15,683
Depreciation and amortisation	927	1,216	1,249	1,374	1,442
Tax paid	(2,023)	(2,693)	(3,264)	(3,819)	(4,470)
Change in working capital	549	1,544	391	(253)	(142)
Other operational CF items	58	145	19	19	19
Cash flow from operations	7,239	9,382	9,787	10,721	12,532
Capex	(2,550)	(2,565)	(3,000)	(750)	(750)
Net (acquisitions)/disposal	31	12	0	0	0
Other investing CF items	0	0	0	0	0
Cash flow from investing	(2,519)	(2,552)	(3,000)	(750)	(750)
Change in debt	(21)	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0
Dividends paid	(3,177)	(4,624)	(6,267)	(7,424)	(8,677)
Other financing CF items	(555)	(801)	(1,073)	(1,268)	(1,479)
Cash flow from financing	(3,752)	(5,424)	(7,340)	(8,692)	(10,156)
Forex effect/others	592	(1,787)	0	0	0
Change in cash	1,559	(381)	(553)	1,279	1,626

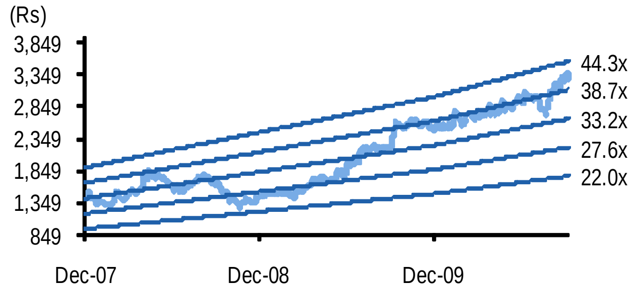
Key ratios

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Sales – YoY %	23.4	18.6	18.7	17.6	15.9
EBITDA (adj.) – YoY %	22.5	20.3	22.1	16.9	15.9
Net profit (adj.) – YoY %	29.1	22.6	24.1	17.9	17.0
EPS (adj.) – YoY %	29.1	22.6	24.1	17.9	17.0
EBITDA margin % (adj.)	19.3	19.5	20.1	20.0	20.0
EBIT margin % (adj.)	17.1	17.2	18.1	18.1	18.3
Net-profit margin % (adj.)	12.4	12.8	13.4	13.4	13.5
ROAE (%)	n.m.	n.m.	n.m.	n.m.	n.m.
ROAA (%)	34.4	35.1	37.8	40.4	43.2
ROCE (%)	n.m.	n.m.	n.m.	n.m.	n.m.
ROIC (%)	n.m.	n.m.	n.m.	n.m.	n.m.
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Effective tax rate (%)	30.9	28.6	28.6	28.5	28.5
Accounts receivable (days)	4.2	3.9	4.4	4.6	4.7
Payables (days)	40.8	39.0	39.8	40.6	40.6
Net interest cover (x)	450.8	629.7	591.0	695.5	814.3
Net dividend payout (%)	76.7	71.4	77.1	77.5	77.4

Key assumptions

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Milk Products (YoY % chg in volumes)	10.1	13.1	12.0	10.0	10.0
Beverages (YoY % chg in volumes)	0.0	(3.1)	5.0	5.0	5.0
Chocolates (YoY % chg in volumes)	12.4	9.7	12.5	12.5	10.0
Prepared Dishes and Cooking Aids(YoY % chg in volumes)	30.1	21.7	20.0	20.0	15.0

PER bands



Source: Company, Daiwa forecasts

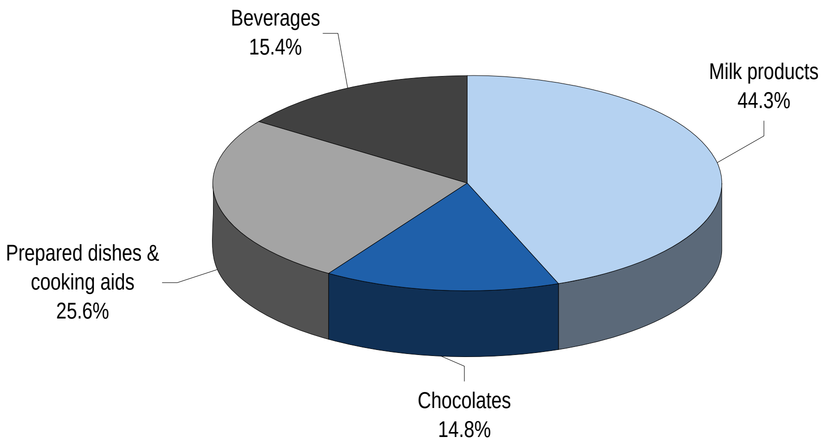
Business background

Pure play on rising incomes and consumer aspirations

Strong presence in fast-expanding categories

Nestle is a leading F&B company, with a presence in four high-margin categories that we believe have good sales-growth potential: 1) milk products and infant nutrition, 2) chocolate and confectionary, 3) prepared dishes and cooking aids, and 4) beverages. All of the product categories where Nestle has a presence are still at a nascent stage, but we believe that they offer significant potential to sustain a strong revenue-growth rate over the long term.

Nestle: sales mix (2009)



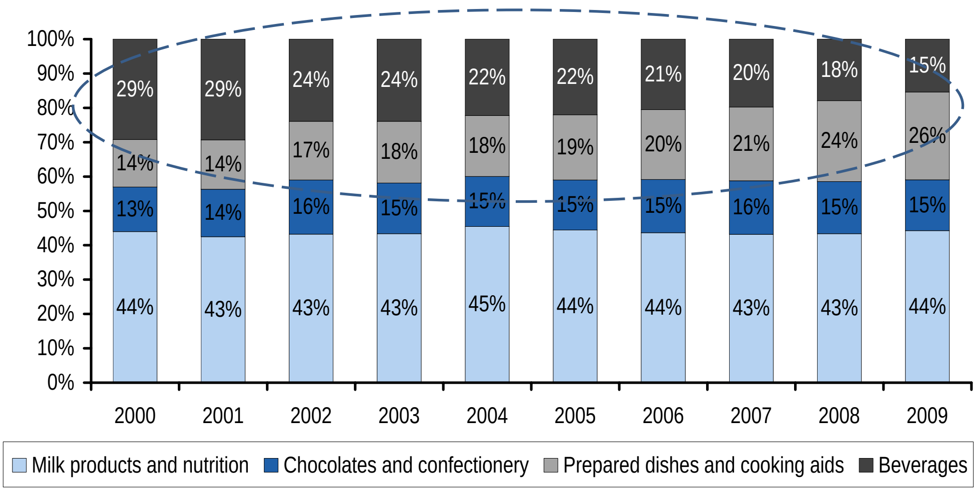
Source: Company, compiled by Daiwa

Prepared dishes is the fastest-growing segment

While the milk products and infant nutrition, and chocolate and confectionery segments have maintained their contributions to the company's overall revenue over the past 10 years, fast sales growth for prepared dishes and cooking aids has resulted in their share of total revenue increasing at the expense of beverages.

Sales mix changing in favour of prepared dishes and cooking aids

Nestle: changes to the sales mix over the past decade



Source: Company, Daiwa forecasts

Smaller SKUs are likely to drive penetration

Smaller pack sizes account for about 30% of Nestle's sales

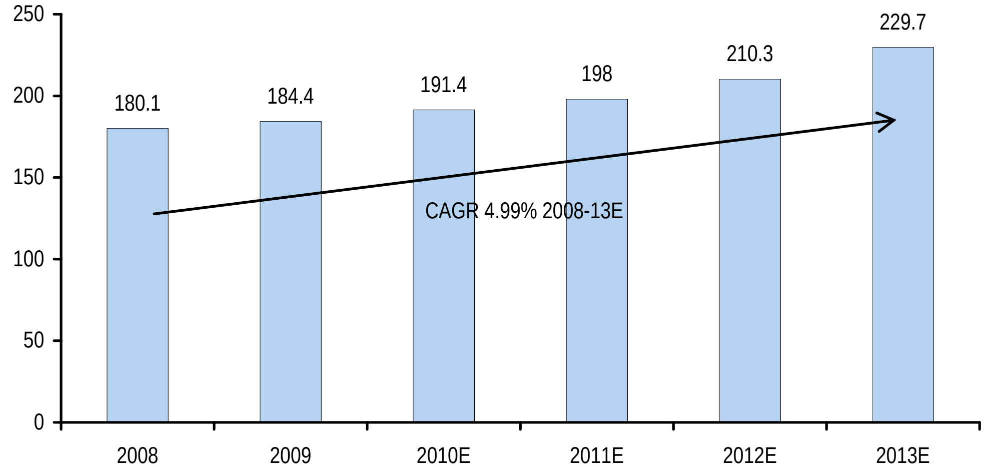
In order to drive penetration among rural consumers (as well as lower- to middle-income urban consumers), Nestle has launched several small-sized packs for most of its products. Currently, such smaller SKUs account for almost 30% of the company's total sales. Although there have been some concerns in the market about a third of Nestle's revenue coming from smaller SKUs, which are exposed to coinage risk, we believe Nestle's pricing power and upbeat consumer demand would enable the company to maintain medium to long-term volume and profit growth in these segments.

F&B – good opportunity as all product segments at nascent stage

F&B is the largest category of consumer spending in India

F&B represents a good opportunity in India, since it is the largest category of consumer spending in India, and it is expected to retain this position in the future. Food consumption is expected to rise at a 4.99% CAGR over the 2008-13 period, exceeding annual population growth of 1.44% over the period, due mainly to increases in income levels, leading to an increase in per-capita consumption of food products (Source: *The Marketing Whitebook 2010-2011*).

Food consumption in India (US$bn)

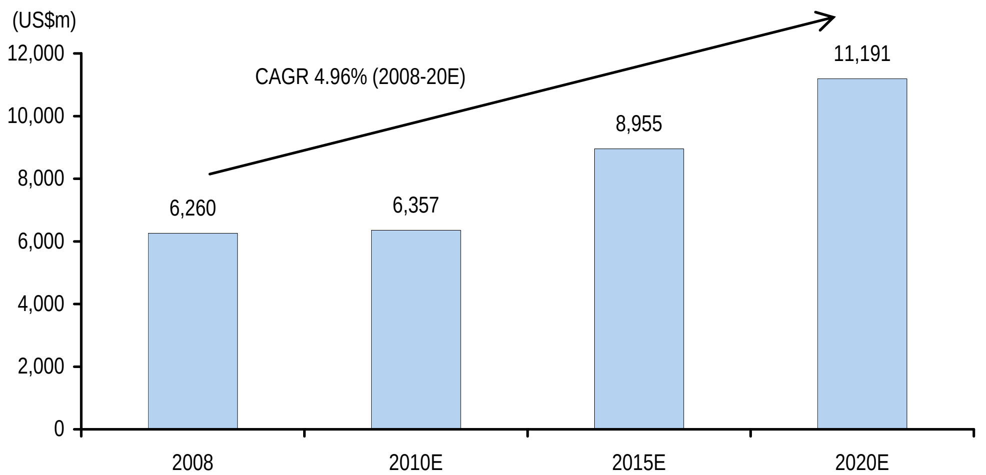


Source: The *Marketing Whitebook 2010-2011*, Daiwa

Dairy products are expected to reach US$61bn by 2020 (US$34bn in 2008) (Source: The Marketing Whitebook 2010-2011)

Dairy products are one of the largest categories in India's food-processing industry, and has very good business-growth potential. The organised sector of the dairy industry is expanding faster than the unorganised sector due to lower base and increasing preference for packaged and branded dairy products. Milk and milk products are expected (Source: The *Marketing Whitebook 2010-2011*) to see their share of total consumption increase from 18.88% in 2008 to 19.27% and reach US$61bn by 2020 due to increasing preferences for branded offerings over traditional khoya, cottage cheese, yoghurt, etc. This implies tremendous potential for Nestle's dairy products (other than infant nutrition). Nestle's packaged liquid milk faces competition from dairy co-operatives, and hence it focuses on other niche healthy-milk variants, such as low-fat milk.

India: spending on milk and milk products

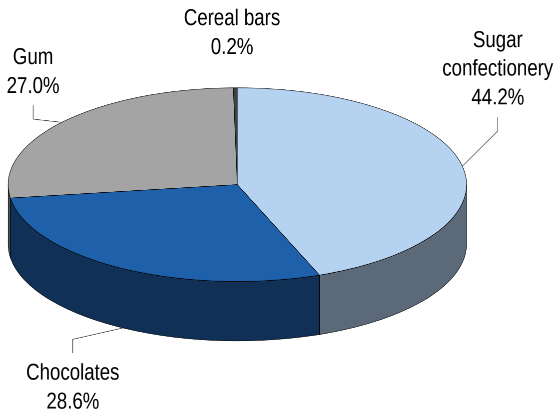


Source: *The Marketing Whitebook 2010-2011*, Daiwa

Confectionery sales are expected to expand at a 7.3% CAGR over the 2008-11 period (source: The Marketing Whitebook 2010-2011)

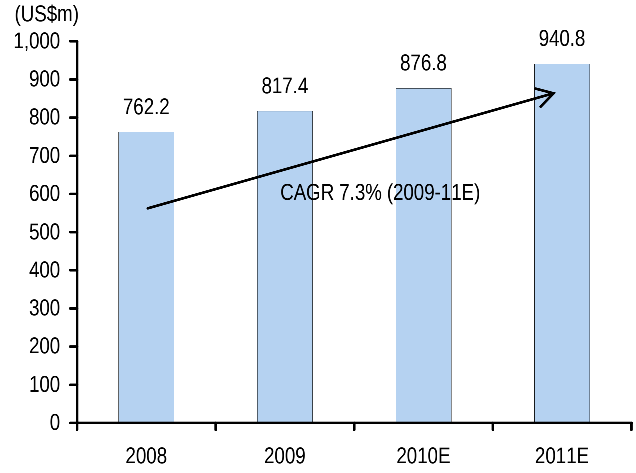
Indian's confectionery industry is made up of various segments: chocolate, sugar confectionery, gums and cereal bars. The sugar confectionery category is further segmented into hard-boiled sweets, gums and jellies, medicated confectionery, caramel and toffee, regular mints, and other sugar confectionery and power mints.

Confectionary market breakdown by sales (2009)



Source: *The Marketing Whitebook 2010-2011*, Daiwa

Confectionery market size (by value)

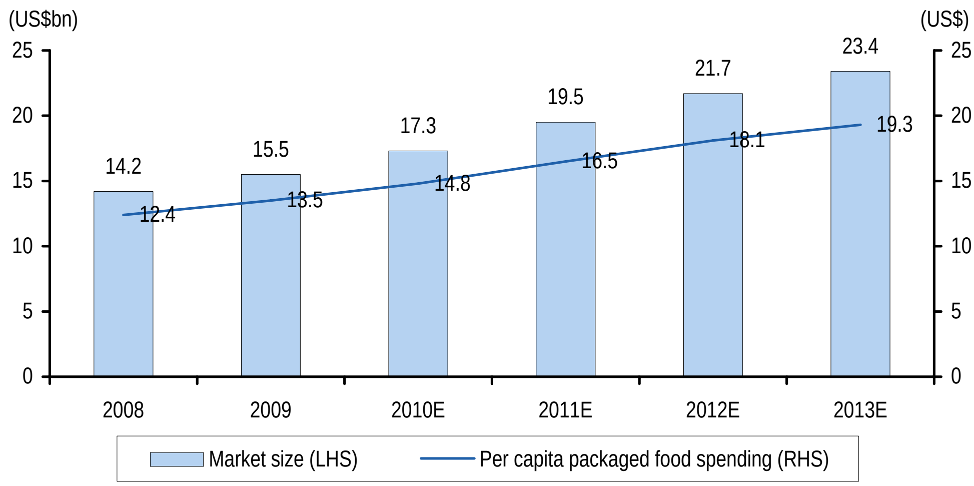


Source: *The Marketing Whitebook 2010-2011*, Daiwa

The instant-noodle market expanded by 20%, pasta 14.1% and soup 16.1% over the 2003-08 period

The packaged-food market is being driven by lifestyle changes, eating and cooking habits, and a young population. The market for packaged foods is expected to expand from US$14.2bn in 2008 to US$23.4bn in 2013, equating to a CAGR of 10.51% (Source: The *Marketing Whitebook 2010-2011*). Over the 2003-08 period, the instant-noodle market expanded by 20%, while the pasta and soup markets increased by 14.1% and 16.1%, respectively.

Packaged-food industry: market size and per-capita packaged-food spending



Source: *The Marketing Whitebook 2010-2011*, Daiwa

Earnings outlook

Demand resilience and receding inflation to drive sales growth

We expect volume-driven double-digit-percentage annual sales growth to continue

Nestle's leadership and near monopoly in infant nutrition, condensed milk, instant noodles, and chocolate, gives its strong pricing power. Its well-established beverage brands should enable it to benefit from increasing demand for packaged beverages. We believe strong beverage brands will also enable Nestle to take advantage of increasing out-of-home consumption opportunities through the installation of vending machines in corporate and educational set-ups, and public transportation (ie, railway stations, airports, and bus depots).

We forecast a sales CAGR of 17.4% for the 2009-12 period

We forecast Nestle's sales to rise at a CAGR of 17.4% over the 2009-12 period, driven by sales-volume growth for prepared dishes, beverages, milk products and chocolates. We believe prepared dishes and cooking aids will see rising demand from urban consumers and an increasing number of semi-urban consumers. We forecast double-digit sales-volume growth over the 2009-12 period for the chocolate business, due mainly to the rationalisation of its portfolio. We expect milk products to increase in terms of volume as a result of increasing affordability and awareness about hygiene, which is driving demand for packaged dairy products.

Nestle: sales mix (Rs m) and EBITDA margin (%)

Segments	2008	2009	2010E	2011E	2012E	CAGR 09-12E
Milk products and infant nutrition	43.4	44.3	44.1	43.3	43.2	16.6
Chocolate and confectionery	15.2	14.8	14.6	14.4	14.0	15.4
Prepared dishes and cooking aids	23.5	25.6	27.0	29.0	30.2	24.2
Beverages	17.9	15.4	14.2	13.4	12.7	10.3
Gross sales	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	
EBITDA margin (%)	*19.3*	*19.5*	*20.1*	*20.0*	*20.0*	

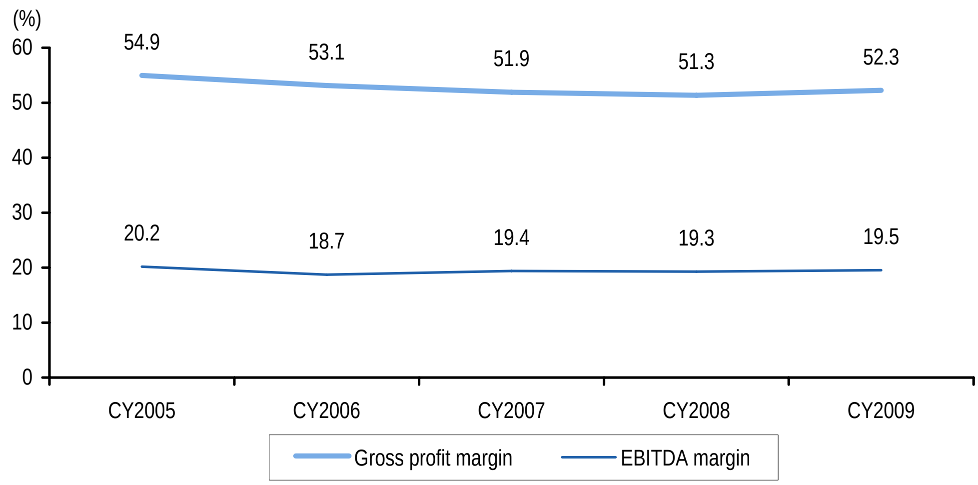
Source: Company, Daiwa forecasts

Easing raw-material prices and improving pricing power should drive earnings growth

We forecast Nestle's earnings to rise at a 19.6% CAGR over the 2009-12 period

We forecast Nestle's earnings to increase at a 19.6% CAGR over the 2009-12 period, driven by our expectations of lower raw-material costs and a return of its pricing power. The normal monsoon in 2010 will lead to an increase in agricultural production and softer commodity prices, including fodder prices.

Nestle: gross-profit and EBITDA margins



Source: Company, Daiwa

What could go wrong?

New players in the instant-noodles category likely to expand the market size

The high volume-growth rate of instant noodles has attracted other multinational corporations to enter the category, namely GSKCH with its *Horlicks Foodles* brand, HUL with its *Knorr Soupy Noodles* brand, and ITC with its *Sunfeast Yippee* brand. However, we believe increasing competition in a growing category would help to expand the size of the instant-noodles category, as happened in the case of the biscuits category with entry of ITC. Also, the former two new entrants have positioned their products in two niche areas: healthy nutrition in case of *Horlicks Foodles* and noodles-cum-soup in case of *Knorr Soupy Noodles*. We believe the niche segmentation by competitors and strong brand equity of *Maggi* in core instant-noodles category will also enable Nestle to maintain its strong volume in the future.

Kraft's early entry could intensify competition and increase A&P

Cadbury India's takeover by Kraft Foods makes the entry of the latter certain and faster than expected earlier, since now it can leverage Cadbury India's deeply entrenched distribution network to launch its food products. Although greater competition could widen the category size, intensified competition could lead to increased spending on A&P, restrict pricing power, and thereby affect the profitability of F&B companies. However, we do not expect this to happen for the foreseeable future, since the packaged-foods category is highly underpenetrated.

Balance sheet and cash flow

Investing Rs3.7bn in increasing its processed-foods capacity

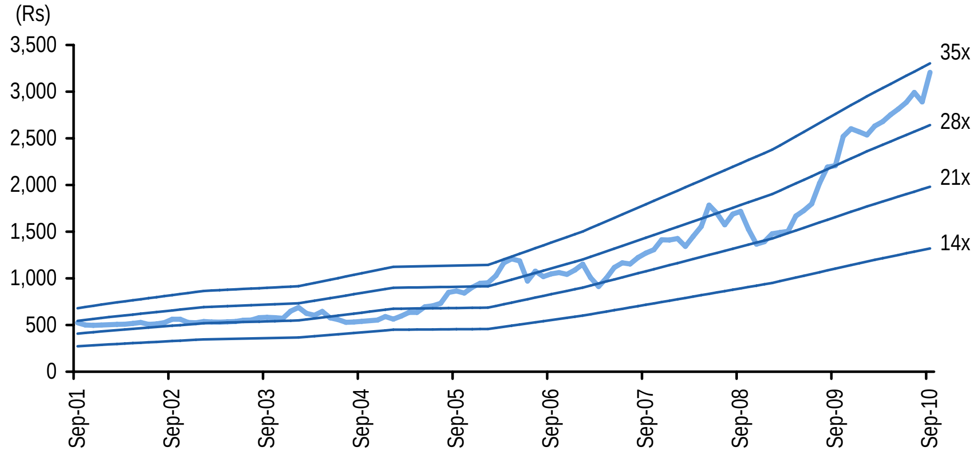
Nestle is a debt-free company that generates healthy cash from operations and has negative working capital. It plans to invest a total of about Rs3.7bn in 2010 and 2011 in increasing its processed-food capacity. With limited fresh capex requirements, and a strategy focusing on organic growth (through innovation and renovation) rather than inorganic growth (acquisitions), Nestle has been distributing healthy cash generated from operations to its shareholders in the form of good dividends, and we expect the company to maintain its liberal dividend-distribution policy in the future.

Valuation and target price

We believe a premium valuation is justified

Over the past 10 years, Nestle's stock has traded at an average one-year-forward PER of 25x, and within the 18-34x range. Over the past three years, it has traded at an average PER of 27x, and at an average of PER 30x over the past year. Like other FMCG companies, Nestle has been rerated significantly since May 2009. The stock is trading currently at a higher PER than its past-10-year average, but we believe this premium is justified considering what we see as the strong demand outlook and likely improvement in profit margins from declining agri-based raw-material prices and the company's strong pricing power.

Nestle: one-year-forward PER bands



Source: Company, Daiwa forecasts

However, considering the likely headwinds from intensifying competition from existing and new players, we believe further upside potential for its valuation multiples would be limited. In our view, the current share price factors in the positives fully. We initiate coverage of Nestle with a **4** (*Underperform*) rating and six-month target price of Rs2,981, based on a target PER of 30x on our 2011 EPS forecast.

Upside risks

Faster-than-expected market-share growth

We see faster-than-expected market-share growth for Nestle in the processed-food segment as an upside risk to our rating.

Colgate-Palmolive India (CLGT IN)

Household & personal products: India

6-mth rating: 1
Target price: Rs995.00
Share price: Rs871.20 (6 Oct)

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Initiation of coverage: bite into this!

Healthy volume-growth trajectory should continue

- Colgate is the main player in India's oral-care market, expanding its market share and improving its profitability despite increasing competition. We forecast FY10-13 net sales and earnings CAGRs of 16% and 14.8%, respectively, driven by a forecast double-digit percentage sales-volume growth for its toothpaste operation (over the period) and its dominant position in the oral-care market, as well as its pricing power and operating efficiencies.

- We initiate coverage with a **1** (*Buy*) rating and six-month target price of Rs995, based on a target PER of 24x on our FY12 EPS forecast.

Consistently increasing its market share

- Colgate's three-pronged strategy of covering all three segments, namely product, price and consumers in all income brackets, has enabled the company to expand its share of the oral-care category over the past four years, gaining market share from its major competitor, HUL.

Rural opportunities should drive healthy sales growth

- As there is a low per-capita consumption of toothpaste in India's rural areas (only one-third of Colgate's revenue comes from these areas), we believe the company could maintain volume growth of about 10% YoY for the foreseeable future. Colgate would also benefit from consumers trading up as a result of their increased spending power and aspirations, its ties with the medical sector, and its strong brands in the oral-therapeutic market.

Reuters code		COLG.NS

Market data

SENSEX Index		20,543.08
Market cap	(US$bn)	2.66
EV	(US$bn; 11E)	2.54
3-mth avg daily T/O	(US$m)	2.68
Shares outstanding	(m)	136
Free float	(%)	49.0
Major shareholder		Colgate-Palmolive Company, U.S.A. (51.0%)
Exchange rate	Rs/US$	44.515

Performance (%)*	1M	3M	6M
Absolute	5.7	3.5	25.9
Relative	(5.0)	(13.1)	11.4

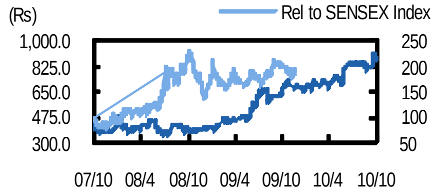
Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2011E	2012E	2013E
PER	(x)	24.3	21.0	18.5
PCFR	(x)	19.1	18.3	16.4
EV/EBITDA	(x)	20.6	17.4	15.0
PBR	(x)	28.5	23.5	20.2
Dividend yield	(%)	2.9	3.4	4.0
ROE	(%)	n.m.	n.m.	n.m.
ROA	(%)	49.2	47.3	46.7
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

Year to 31 Mar	Revenue (Rs m)	(%)	EBITDA (Rs m)	(%)	Net profit (Rs m)	(%)	EPS (Rs)	(%)	CFPS (Rs)	DPS (Rs)
2009	16,948	*15.0*	2,616	*14.5*	2,902	*25.3*	21.341	*25.3*	23.485	15.000
2010	19,625	*15.8*	4,254	*62.6*	4,233	*45.8*	31.124	*45.8*	29.219	20.000
2011E	22,915	*16.8*	5,500	*29.3*	4,872	*15.1*	35.825	*15.1*	45.535	25.000
2012E	26,758	*16.8*	6,422	*16.8*	5,637	*15.7*	41.448	*15.7*	47.687	30.000
2013E	30,626	*14.5*	7,350	*14.5*	6,398	*13.5*	47.044	*13.5*	53.224	35.000

Source: Company, Daiwa forecasts

Company background

Colgate-Palmolive India (Colgate) is a leading oral-care company with a 50.2% volume share of the toothpaste market, 38.7% of the toothbrush market, and 44.8% of the toothpowder market. It also markets a range of personal-care products, such as shower gels, shaving creams and dishwashing paste. It markets oral-care products under the *Colgate* brand, a specialised range of dental therapies under the banner of Colgate Oral Pharmaceuticals, and personal-care products under the *Palmolive* brand.

Colgate-Palmolive India – financial summary

Profit and loss (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Cosmetics and Toilet Preparations	14,924	17,466	20,435	23,909	27,352
Toothbrushes and Shave Brushes	2,002	2,134	2,454	2,822	3,245
Others	22	25	26	28	29
Total revenue	16,948	19,625	22,915	26,758	30,626
Other income	0	0	0	0	0
COGS	(7,413)	(7,768)	(8,665)	(10,168)	(11,638)
SG&A	(2,717)	(2,994)	(3,457)	(4,014)	(4,594)
Other op. expenses	(4,431)	(4,983)	(5,602)	(6,479)	(7,385)
EBIT	2,386	3,878	5,191	6,097	7,009
Net-interest inc./(exp.)	(11)	(15)	(14)	(14)	(14)
Assoc/forex/extraord./others	1,078	985	1,076	1,237	1,423
Pre-tax profit	3,453	4,848	6,253	7,321	8,418
Tax	(551)	(615)	(1,381)	(1,684)	(2,020)
Min. int./pref. div./others	0	0	0	0	0
Net profit (reported)	2,902	4,233	4,872	5,637	6,398
Net profit (adj.)	2,902	4,233	4,872	5,637	6,398
EPS (reported) (Rs)	21.341	31.124	35.825	41.448	47.044
EPS (adj.) (Rs)	21.341	31.124	35.825	41.448	47.044
DPS (Rs)	15.000	20.000	25.000	30.000	35.000
EBIT (adj.)	2,386	3,878	5,191	6,097	7,009
EBITDA (adj.)	2,616	4,254	5,500	6,422	7,350

Balance sheet (Rs m)

As at 31 Mar	2009	2010	2011E	2012E	2013E
Cash & short-term investment	2,511	3,476	5,432	6,887	8,151
Inventory	824	1,106	971	1,132	1,294
Accounts receivable	111	98	126	147	168
Other current assets	1,974	1,222	1,604	1,873	2,144
Total current assets	5,421	5,901	8,133	10,039	11,756
Fixed assets	1,786	2,531	2,472	2,397	2,457
Goodwill & intangibles	0	0	0	0	0
Other non-current assets	560	389	389	389	389
Total assets	7,767	8,822	10,994	12,826	14,602
Short-term debt	0	0	0	0	0
Accounts payable	3,945	4,267	5,539	6,500	7,440
Other current liabilities	1,612	1,248	1,248	1,248	1,248
Total current liabilities	5,557	5,515	6,787	7,748	8,688
Long-term debt	47	46	46	46	46
Other non-current liabilities	0	0	0	0	0
Total liabilities	5,604	5,561	6,833	7,794	8,734
Share capital	136	136	136	136	136
Reserves/R.E./others	2,027	3,125	4,025	4,895	5,732
Shareholders' equity	2,163	3,261	4,161	5,031	5,868
Minority interests	0	0	0	0	0
Total equity & liabilities	7,767	8,822	10,994	12,826	14,602
Net debt/(cash)	(2,465)	(3,430)	(5,387)	(6,842)	(8,105)

Cash flow (Rs m)

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Profit before tax	3,453	4,848	6,253	7,321	8,418
Depreciation and amortisation	229	376	309	325	341
Tax paid	(482)	(765)	(1,381)	(1,684)	(2,020)
Change in working capital	350	(209)	997	510	486
Other operational CF items	(357)	(276)	14	14	14
Cash flow from operations	3,194	3,974	6,193	6,485	7,238
Capex	(24)	(355)	(250)	(250)	(400)
Net (acquisitions)/disposal	97	439	0	0	0
Other investing CF items	354	282	0	0	0
Cash flow from investing	426	365	(250)	(250)	(400)
Change in debt	0	(1)	0	0	0
Net share issues/(repurchases)	0	0	0	0	0
Dividends paid	(2,540)	(3,359)	(3,972)	(4,767)	(5,561)
Other financing CF items	(11)	(15)	(14)	(14)	(14)
Cash flow from financing	(2,551)	(3,375)	(3,986)	(4,781)	(5,575)
Forex effect/others	0	0	0	0	0
Change in cash	1,069	964	1,957	1,455	1,263

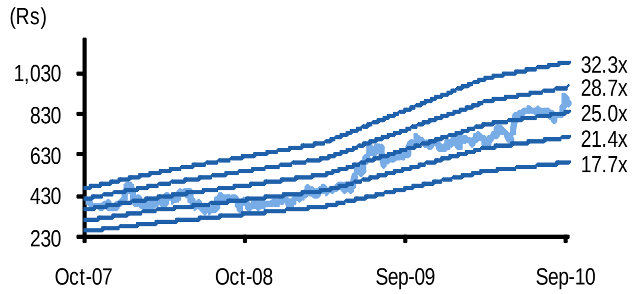
Key ratios

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Sales – YoY %	15.0	15.8	16.8	16.8	14.5
EBITDA (adj.) – YoY %	14.5	62.6	29.3	16.8	14.5
Net profit (adj.) – YoY %	25.3	45.8	15.1	15.7	13.5
EPS (adj.) – YoY %	25.3	45.8	15.1	15.7	13.5
EBITDA margin % (adj.)	15.4	21.7	24.0	24.0	24.0
EBIT margin % (adj.)	14.1	19.8	22.7	22.8	22.9
Net-profit margin % (adj.)	17.1	21.6	21.3	21.1	20.9
ROAE (%)	n.m.	n.m.	n.m.	n.m.	n.m.
ROAA (%)	39.3	51.0	49.2	47.3	46.7
ROCE (%)	n.m.	n.m.	n.m.	n.m.	n.m.
ROIC (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Effective tax rate (%)	16.0	12.7	22.1	23.0	24.0
Accounts receivable (days)	2.2	1.9	1.8	1.9	1.9
Payables (days)	79.8	76.4	78.1	82.1	83.1
Net interest cover (x)	216.9	257.8	373.5	438.7	504.3
Net dividend payout (%)	70.3	64.3	69.8	72.4	74.4

Key assumptions

Year to 31 Mar	2009	2010	2011E	2012E	2013E
Cosmetics and Toilet Preparations (YoY % chg in vol)	12.8	13.5	12.5	12.5	10.0

PER bands



Source: Company, Daiwa forecasts

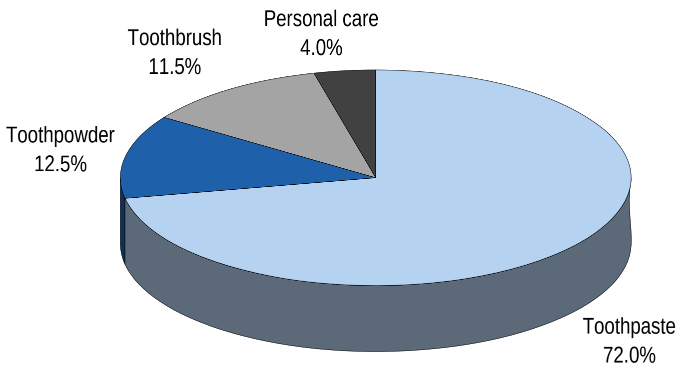
Business background

Market leader; outperforming the oral-care market; gaining market share

Market leader in the oral-care market, with a 50.2% share of the toothpaste market

Colgate, a 51%-owned subsidiary of the US-based Colgate-Palmolive Company is a leader in the oral-care product market in India. Its products are available in almost 4.3m stores across the country. It derives more than 96% of its sales from oral-care products, with toothpaste sales accounting for 72% of sales, and about 12% each from sales of toothbrushes and toothpowder. Colgate has the biggest share of the oral-care market, and has a 50.2% share of the toothpaste market.

Colgate: sales mix (FY10)



Source: Company, Daiwa

Firm presence across various price points

Colgate has been gaining market share consistently over the past four years from competitor HUL, as well as from some of the other regional players. HUL and Dabur (Not Rated) have been aggressive in increasing their presence in the oral-care market by launching new products and smaller SKUs, as well as increasing advertising and promotional expenditure in an effort to expand their sales and regain their lost market shares. However, we believe Colgate will continue to increase its sales volume at a healthy double-digit percentage on a year-on-year basis, mainly because Dabur's products are positioned in the niche herbal market, and HUL lacks presence in the mass-market segment (where Colgate has a firm presence), which is being driven by increasing demand from low-income and rural consumers. Although HUL has launched smaller SKUs to gain back some of its lost market share, we believe Colgate's strong brand positioning and competitive pricing would enable it to maintain its current market share.

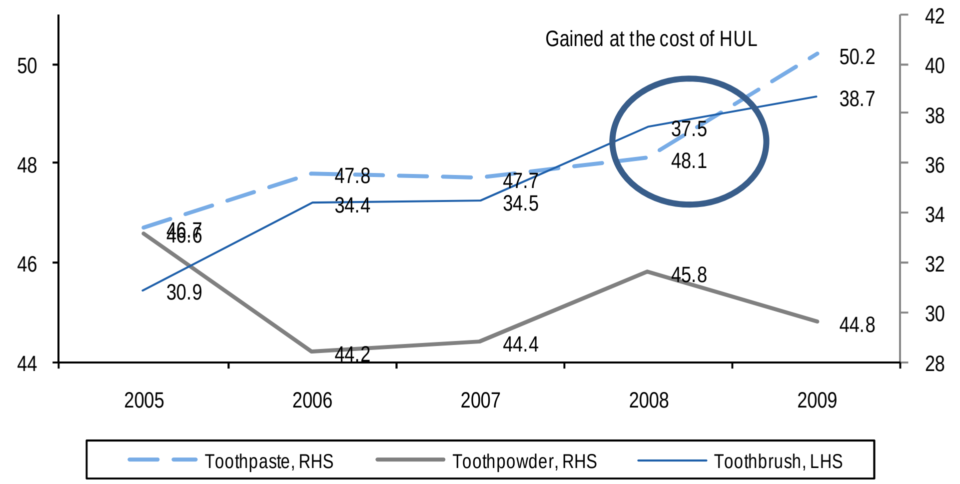
Outperforming the oral-care market consistently

Colgate vs. category growth (%)

Particulars	Toothpaste 2009	Toothpaste 3-year CAGR	Toothbrushes 2009	Toothbrushes 3-year CAGR
Market	6.9	10.7	10.7	8.7
Colgate	11.4	13.6	14.4	15.2

Source: Company, Daiwa

Colgate: Trend in market share (%)



Source: Company, Daiwa

Three-pronged strategy should sustain healthy volume growth

Colgate's strategy focuses on all product segments, price points and consumers

We believe Colgate has benefited from its three-pronged segmentation strategy, namely: 1) products (premium and therapeutic, family, and mass-market), 2) price (family packs for existing users, and smaller SKUs to attract first-time users and drive market penetration), and 3) consumers (upper, middle, and lower income).

Colgate: Segmentation Strategy

Segments	Brands/pack sizes
Product	
Premium	*Colgate Gel, Herbal, Total*
Therapeutic	*Colgate Sensitive, Plax Mouthwash*
Family	*Colgate Dental Cream, Active Salt, Kids*
Low-price points (LPP)	*Cibaca Plain White*
Price	
Family packs	150 grams and 200 grams
Low-unit packs (LUP)	50 grams
Consumer	
Upper & middle-income earners	*Colgate*
Lower-income earners	*Cibaca*

Source: Company, Daiwa

Low-per-capita consumption but awareness is increasing

The per-capita consumption of oral-care products in India is less than half of that in China

India's per-capita consumption of dentifrice is low, due to low affordability and the use of natural substitutes such as *neem* sticks. However, an increasing awareness of dental hygiene and increased spending power have led to an increase in consumption. Furthermore, an expanded distribution network and the availability of products in smaller packets, as well as effective advertising, have helped to boost the company's penetration rates in both urban and rural areas. We believe the current trend of introducing one-time user packs and smaller SKUs (Rs10 for toothpaste and a free toothbrush) will help to drive penetration in these categories and, in turn, Colgate's sales of toothpaste and toothbrushes.

Per capita consumption of dentifrice (2009)

Country	Grams/year	US$
USA	542	18.9
China	255	1.4
India	115	0.6

Source: Company, Daiwa

We see India's oral-care market as a big opportunity

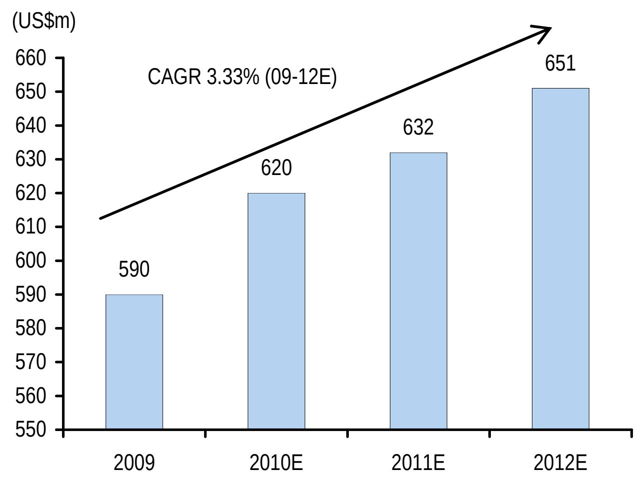
India's dentist-population ratio is one of the lowest in the world

We believe India's lack of dental-care infrastructure and one of the lowest dentist-population ratios in the world will benefit toothpaste manufacturers such as Colgate, which has positioned its products as being necessary for 'preventative' reasons. India's dentist-population ratio is one of the lowest in the world. While in urban areas, the ratio is one dentist to 10,000 people; in rural India it is one dentist to 250,000 people (Source: *The Marketing Whitebook 2010-2011*).

We forecast India's toothpaste market to expand to US$651m by 2012

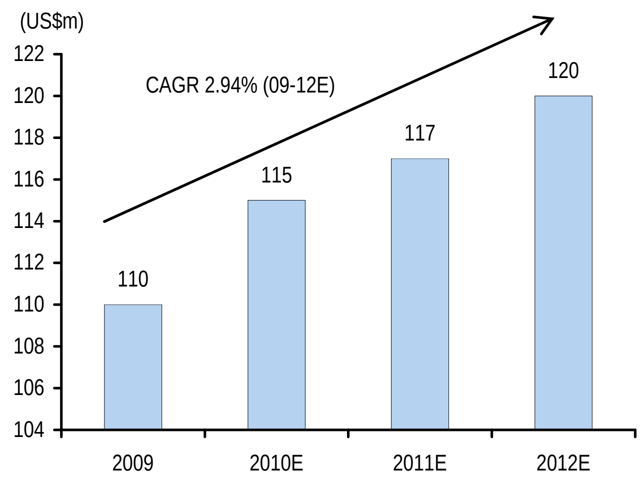
Accordingly, India's toothpaste market is expected to expand from US$590m for 2009 to US$651m by 2012, driven by: products being more available and affordable, an increase in dental-hygiene awareness, and consumers upgrading from substitutes like neem sticks. Toothbrush sales are driven mainly by toothpaste sales, and hence sales of toothbrushes are expected to show a similar growth trend in the future (Source: *The Marketing Whitebook 2010-2011*).

India: toothpaste market



Source: *The Marketing Whitebook 2010-2011*, Daiwa

India: toothbrush market



Source: *The Marketing Whitebook 2010-2011*, Daiwa

Education and media exposure – drivers in the rural markets

Exposure to the media and education is increasing the market penetration for oral-care products

Access to education in India has led to an increase in oral-hygiene awareness, and exposure to the media has made consumers more aware of the wide range of products available. Furthermore, an increase in the number of people gaining a higher education has increased employment opportunities, leading to a rise in average income levels. The increase in literacy, especially among homemakers, and exposure to the television are expected to aid the market penetration of consumer goods in rural areas.

Education level of homemaker vs. product penetration level (%)

Product	Illiterate	Literate but below 10th grade	Above 10th grade	Graduate
Toothpaste	29.8	60.1	76.8	90.2
Shampoo	64.2	72.9	79.8	85.7
Utensil cleaner	6.4	22.8	43.3	57.4
Toilet cleaner	1.4	9	21.8	40.6
Floor cleaner	0.8	4.1	10.9	23.1
Packaged edible oil	8.2	17.9	32.5	41.5

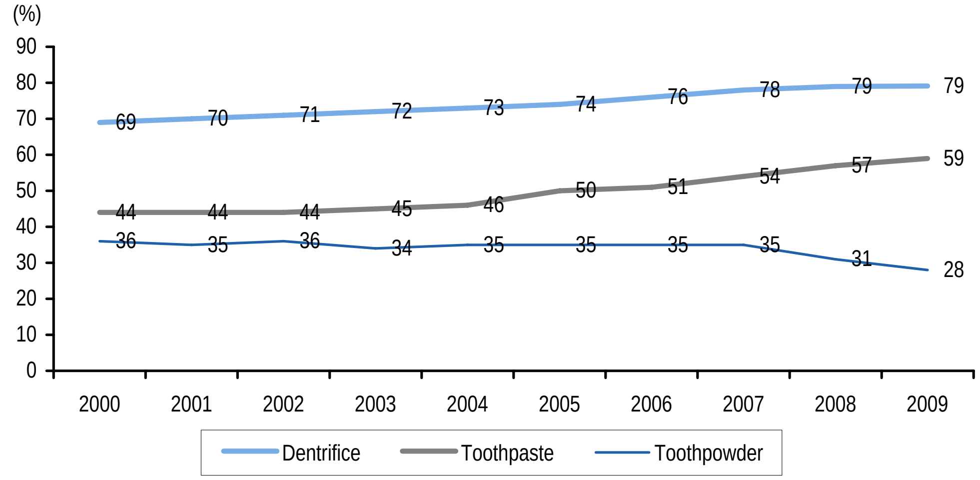
Source: *The Marketing Whitebook 2010-2011*, Daiwa

Exposure to TV, Cable & Satellite (C&S) vs. FMCG penetration level (%)

Product	No TV	TV but no C&S	C&S
Toothpaste	30.9	67.5	78.9
Shampoo	63.9	76.2	81.4
Utensil cleaner	6.5	27.6	42.1
Toilet cleaner	1.5	11.1	21.2
Floor cleaner	0.7	5.4	10.5
Packaged edible oil	8.5	19.9	30.9

Source: *The Marketing Whitebook 2010-2011*, Daiwa

India: Oral care penetration level in India (%)



Source: Company, Daiwa
Note: dentifrice refers to either toothpaste or toothpowder

Rural India offers a huge opportunity, in our view

Higher income and literacy levels are driving demand for oral-care products

Increases in incomes and literacy levels in rural areas, leading to greater oral-hygiene awareness among rural consumers, have driven demand for various consumer goods including oral-care products. While 70% of India's population resides in rural India, Colgate earns only 37% of its revenues from these markets. We believe this offers huge potential for Colgate to increase its business from rural India, considering its wide distribution network, strong brands in the mass-market segment, and presence across sales points to drive market penetration. As well as the opportunity to expand its rural business, we believe the next phase of business growth will come from high-income earners switching from plain white toothpaste to gels and therapeutic oral-care products, such as mouthwash.

Colgate: trend in urban: rural sales mix (%)

Market	2006	2007	2008	2009
Urban	67	66	63	63
Rural	33	34	37	37

Source: Company, Daiwa

Earnings outlook

Short term boosted by the monsoon season; long term driven by the sales volume

Benign raw-material costs, increased pricing power, and improved operating efficiencies should enable Colgate to maintain a healthy EBITDA margin in the future

In the short term, we believe Colgate will benefit from receding inflation and a good monsoon season, which has kept raw-material prices under check and improved the company's EBITDA margin (this was also evident in Colgate's 1Q FY11 financial results). As well as providing comfort on the cost front, receding inflation will also release more disposable income into the hands of lower-income earners, which could be spent on other relatively discretionary consumer goods, such as oral-care products.

Colgate: 1QFY10 results at a glance (Rs m)

	June 2010	June 2009	% chg	Mar 2010	% chg
Net sales	5,288	4,680	*13.0*	5,166	*2.4*
EBITDA	1,389	1,052	*32.1*	1,247	*11.4*
Other income	263	260	*1.2*	222	*18.5*
PBIDT	1,652	1,312	*26.0*	1,469	*12.5*
Depreciation	79	56	*41.0*	206	*(61.5)*
Interest	3	5	*(24.4)*	4	*(15.0)*
PBT	1,569	1,251	*25.5*	1,259	*24.6*
Tax	350	223	*57.2*	115	*204.4*
Adjusted PAT	1,219	1,028	*18.6*	1,144	*6.5*
EBITDA margin (%)	26.3	22.5		24.1	
PBIDT margin (%)	29.8	26.5		27.3	

Source: Company, Daiwa

Increase in market penetration rate should drive sales-volume growth, in our view

In the long term, we believe an increase in sales volume will lead to operating efficiencies and that pricing power will improve once the economy returns to normal. This along with consumers trading up to more sophisticated products will improve Colgate's EBITDA margin, in our view.

Colgate: sales mix (Rs m) and EBTIDA margin (%)

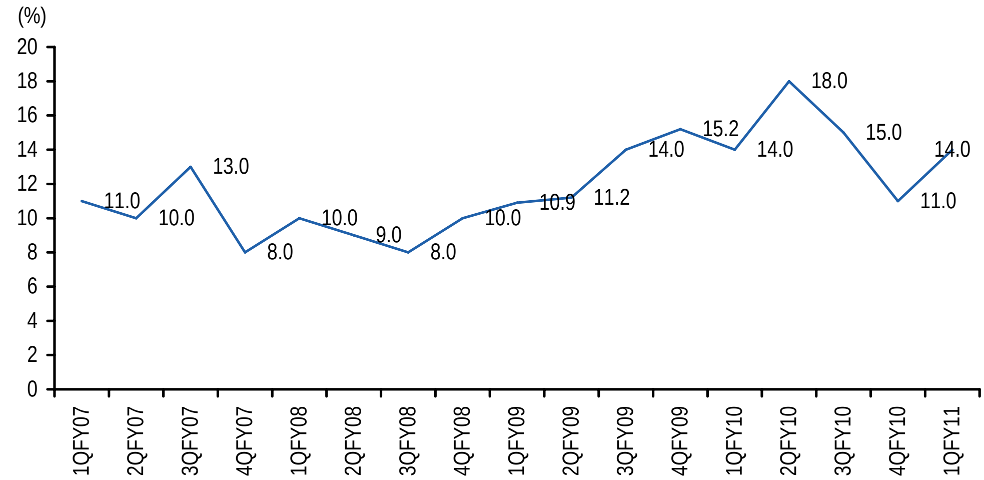
Sales mix	FY09	FY10	FY11E	FY12E	FY13E	Sales CAGR FY10-13E
Cosmetics and toilet preparations	88.1	89.0	89.2	89.4	89.3	16.1
Toothbrushes and shaving brushes	11.8	10.9	10.7	10.5	10.6	15.0
Others	0.1	0.1	0.1	0.1	0.1	5.0
Net sales	100	100	100	100	100	16.0
EBITDA margin (%)	15.4	21.7	24.0	24.0	24.0	

Source: Company, Daiwa forecasts

The sales volume of toothpaste continues to expand by a double-digit percentage on a year-on-year basis

Colgate's toothpaste sales volume has expanded by a low-to-middle double-digit percentage year-on-year for at least the past 17 quarters (8% YoY on only two occasions). This rate of expansion, which is higher than sales-growth rate for the industry, has helped Colgate to increase its market share.

Colgate: Toothpaste volume growth (%)



Source: Company, Daiwa

We expect volume-driven sales growth to continue in the future

We forecast a FY10-13 revenue CAGR of 16%, driven mainly by an expansion in the sales volume. We forecast an EBITDA CAGR of 20% for this period, driven by better efficiencies, pricing power and customers switching to more sophisticated products. We forecast a lower earnings CAGR of 14.8% for this period, due to increase in effective tax rates.

What could go wrong?

More intense competition could limit market-share gains and increase A&P

Increasing opportunities in the rural and mass-markets, and the switching to more sophisticated products by upmarket consumers have attracted competition in many consumer categories, and oral care is no exception. Existing players such as HUL and Dabur have upped their ante to regain some of their lost market shares, while new entrant Procter & Gamble Home Products (P&GHP) (Not listed) is planning to launch its *Oral-B* toothpaste in India, and GSKCH is test-marketing its *Sensodyne* toothpaste brand in southern India. Thus, aggressive innovation and marketing activities by existing players, as well as the entry of new players, could lead to more intense competition, which in turn could restrict further market-share gains for Colgate limiting sales-volume growth on the one hand, and pushing up A&P expenses on the other hand.

Balance sheet and cash flow

Colgate is a debt-free company

Colgate is debt-free and generates strong cash balances from its operations. It recently expanded its capacity on a large scale, and we do not expect major cash outflow for other than maintenance activities, which would be funded by internal accruals. According to the company, the current capacity will be sufficient until the end of FY12, after which it might plan to increase capacity, either by augmenting its current facilities or by building a new plant.

We expect Colgate to maintain its high-dividend payout policy

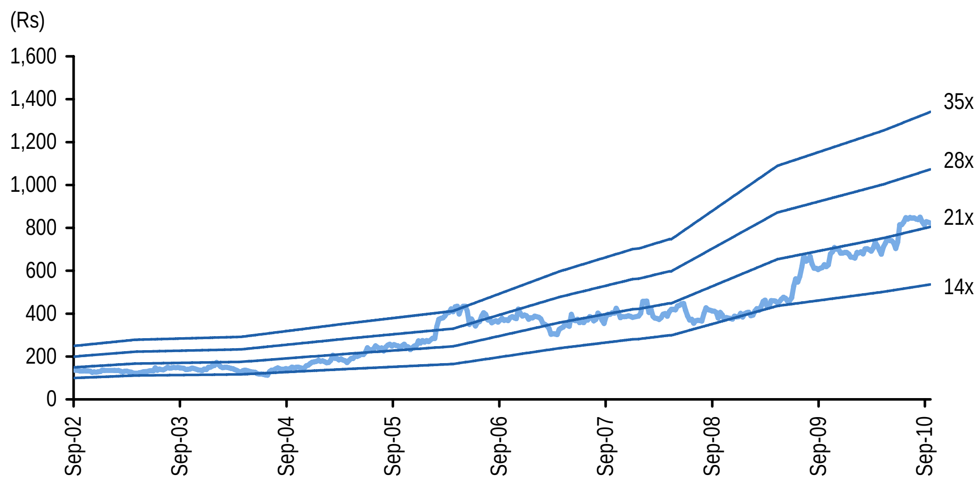
As the company plans to focus purely on India's oral-care market and there are limited acquisition opportunities available, we do not expect any substantial cash outflow for acquisitions in the near future. Hence, we expect the company to continue its high-dividend payout policy in the future.

Valuation and target price

Colgate has traded at a three-year average PER of 18x

The company has traded within a PER band of about 13-23x and at an average PER of 18x over the past three years. We believe the company's dominant position in the oral-care market, and our expectations of continued double-digit percentage sales-volume growth across key segments, will lead to the stock to trade at the higher end of its past years' PER band.

Colgate: one-year forward PER bands



Source: Company, Daiwa forecasts

We value Colgate at a PER of 24x on our FY12 EPS forecast, and have a six-month target price of Rs995

Colgate generates a steady cash flow and hence we value it on a PER basis. It has increased its share of a well-penetrated market and improved its EBITDA margin. We believe that, despite increasing competition, Colgate will be able to maintain its leadership position and profitability due to its strong brand equity and pricing power. As such, we believe the stock should trade at a slightly higher PER in the future. Accordingly, we have applied a target PER of 24x on our FY12 EPS forecast (compared with a target PER of 25x on our FY12 EPS forecast for HUL) and arrived at our six-month target price of Rs995. We initiate coverage with a **1** (*Buy*) rating.

Risks

We see the risks to our target price and rating as a lower-than-expect uptake of goods in the rural markets, an increase in competitive activity that is more aggressive than we would expect, and unfavourable changes in raw-material prices.

GlaxoSmithKline Consumer Healthcare (SKB IN)

Food, beverage & tobacco: India

6-mth rating: 2

Target price: Rs2,117.00

Share price: Rs2,035.00 (6 Oct)

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Initiation of coverage: food for thought

Tapping into the malted-food-and-drink (MFD) market

- GSKCH has a 70% share of the MFD market, where the penetration rate can be as low as 20%. We forecast an FY09-12 revenue CAGR of 18%, driven by a healthy increase in sales volume in main *Horlicks,* other *Horlicks* varieties, and its other MFD brands. We forecast an FY09-12 earnings CAGR of 23.1%, due to GSKCH's pricing power and receding raw-material price inflation. We initiate coverage with a **2** (*Outperform*) rating and target price of Rs2,117, based on a target PER of 24x on our FY11 EPS forecast.

Aggressive innovation should drive sales

- GSKCH has leveraged on the equity of its flagship brand *Horlicks* to launch new varieties of Horlicks targeted at niche customers such as working women, consumers in rural markets and low-income urban consumers. It has also entered the specialist-nutrition market and the high-volume growth noodle and biscuit markets. With a product portfolio targeting all classes of consumer, we believe GSKCH is on a high business growth path.

Normal monsoon season should improve profitability

- We expect the current 'normal' monsoon season to lower food-price inflation, thereby increasing the amount available to spend on relatively discretionary consumer goods. A normal monsoon season would also reduce the high prices of agricultural commodities and milk, which are GSKCH's main raw materials, thereby improving its profitability.

Reuters code		GLSM.NS

Market data

SENSEX Index		20,543.08
Market cap	(US$bn)	1.92
EV	(US$bn; 10E)	1.74
3-mth avg daily T/O	(US$k)	927.31
Shares outstanding	(m)	42
Free float	(%)	56.8
Major shareholder		Horlicks Ltd (43.2%)
Exchange rate	Rs/US$	44.515

Performance (%)*	1M	3M	6M
Absolute	13.5	12.5	32.8
Relative	2.8	(4.2)	18.3

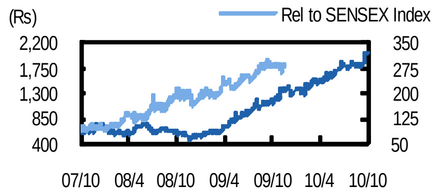
Source: Daiwa
Note: *Relative to SENSEX Index

Investment indicators

		2010E	2011E	2012E
PER	(x)	27.4	23.1	19.7
PCFR	(x)	51.3	23.3	19.5
EV/EBITDA	(x)	18.7	15.4	12.7
PBR	(x)	7.8	6.5	5.4
Dividend yield	(%)	1.2	1.5	1.7
ROE	(%)	31.2	30.8	30.0
ROA	(%)	20.4	20.6	20.3
Net debt equity	(%)	net cash	net cash	net cash

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

	Revenue		EBITDA		Net profit		EPS		CFPS	DPS
Year to 31 Dec	(Rs m)	*(%)*	(Rs m)	*(%)*	(Rs m)	*(%)*	(Rs)	*(%)*	(Rs)	(Rs)
2008	15,418	*11.4*	2,375	*(28.1)*	1,883	*(29.9)*	44.782	*(29.9)*	32.033	15.000
2009	19,215	*24.6*	3,108	*30.9*	2,328	*23.6*	55.351	*23.6*	95.168	18.000
2010E	22,893	*19.1*	4,138	*33.1*	3,125	*34.2*	74.296	*34.2*	39.655	25.000
2011E	27,019	*18.0*	4,942	*19.4*	3,710	*18.7*	88.224	*18.7*	87.419	30.000
2012E	31,571	*16.8*	5,772	*16.8*	4,346	*17.1*	103	*17.1*	105	35.000

Source: Company, Daiwa forecasts

Company background

GlaxoSmithKline Consumer Healthcare is a leader in the Indian Health Food Drink industry through its four brands namely, *Horlicks*, *Boost*, *Viva* and *Maltova*; *Horlicks* being the flagship brand. GSKCH has leveraged on the brand equity of *Horlicks* to launch new malted food variants and other products to create new niche categories and tap existing niche categories in India which offer huge potential to drive future growth.

GlaxoSmithKline Consumer Healthcare – financial summary

Profit and loss (Rs m)

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Malt Based Food	16,318	19,237	22,824	26,841	31,284
Biscuits	602	771	1,005	1,281	1,568
Others	(1,503)	(793)	(936)	(1,103)	(1,280)
Total revenue	15,418	19,215	22,893	27,019	31,571
Other income	0	0	0	0	0
COGS	(5,859)	(7,106)	(8,669)	(10,132)	(11,966)
SG&A	(1,940)	(3,021)	(3,386)	(4,053)	(4,736)
Other op. expenses	(5,663)	(6,400)	(7,124)	(8,399)	(9,655)
EBIT	1,956	2,688	3,713	4,435	5,215
Net-interest inc./(exp.)	(53)	(43)	(31)	(31)	(31)
Assoc/forex/extraord./others	955	893	1,037	1,189	1,367
Pre-tax profit	2,857	3,539	4,719	5,593	6,551
Tax	(974)	(1,211)	(1,595)	(1,883)	(2,205)
Min. int./pref. div./others	0	0	0	0	0
Net profit (reported)	1,883	2,328	3,125	3,710	4,346
Net profit (adj.)	1,883	2,328	3,125	3,710	4,346
EPS (reported) (Rs)	44.782	55.351	74.296	88.224	103
EPS (adj.) (Rs)	44.782	55.351	74.296	88.224	103
DPS (Rs)	15.000	18.000	25.000	30.000	35.000
EBIT (adj.)	1,956	2,688	3,713	4,435	5,215
EBITDA (adj.)	2,375	3,108	4,138	4,942	5,772

Balance sheet (Rs m)

As at 31 Dec	2008	2009	2010E	2011E	2012E
Cash & short-term investment	4,710	8,198	8,193	9,552	12,467
Inventory	2,772	2,660	3,678	4,331	5,055
Accounts receivable	433	314	627	740	865
Other current assets	620	557	916	1,081	1,263
Total current assets	8,534	11,729	13,414	15,704	19,650
Fixed assets	2,261	2,323	2,920	3,763	3,506
Goodwill & intangibles	0	0	0	0	0
Other non-current assets	0	110	110	110	110
Total assets	10,795	14,162	16,444	19,577	23,265
Short-term debt	0	0	0	0	0
Accounts payable	3,120	5,111	5,497	6,394	7,456
Other current liabilities	0	0	0	0	0
Total current liabilities	3,120	5,111	5,497	6,394	7,456
Long-term debt	0	0	0	0	0
Other non-current liabilities	66	0	0	0	0
Total liabilities	3,186	5,111	5,497	6,394	7,456
Share capital	421	421	421	421	421
Reserves/R.E./others	7,188	8,630	10,527	12,763	15,389
Shareholders' equity	7,609	9,051	10,947	13,184	15,810
Minority interests	0	0	0	0	0
Total equity & liabilities	10,795	14,162	16,444	19,577	23,265
Net debt/(cash)	(4,710)	(8,198)	(8,193)	(9,552)	(12,467)

Cash flow (Rs m)

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Profit before tax	2,857	3,539	4,719	5,593	6,551
Depreciation and amortisation	420	420	424	507	558
Tax paid	(1,041)	(1,398)	(1,595)	(1,883)	(2,205)
Change in working capital	(571)	1,688	(1,647)	(280)	(214)
Other operational CF items	(317)	(246)	(235)	(261)	(290)
Cash flow from operations	1,347	4,002	1,668	3,676	4,399
Capex	(307)	(463)	(1,022)	(1,350)	(300)
Net (acquisitions)/disposal	237	10	0	0	0
Other investing CF items	264	237	266	292	321
Cash flow from investing	193	(216)	(757)	(1,058)	21
Change in debt	0	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0
Dividends paid	(492)	(248)	(886)	(1,228)	(1,474)
Other financing CF items	(54)	(50)	(31)	(31)	(31)
Cash flow from financing	(546)	(298)	(917)	(1,259)	(1,505)
Forex effect/others	0	0	0	0	0
Change in cash	995	3,488	(5)	1,359	2,915

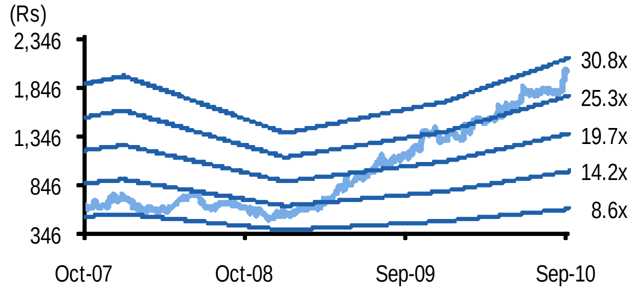
Key ratios

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Sales – YoY %	11.4	24.6	19.1	18.0	16.8
EBITDA (adj.) – YoY %	(28.1)	30.9	33.1	19.4	16.8
Net profit (adj.) – YoY %	(29.9)	23.6	34.2	18.7	17.1
EPS (adj.) – YoY %	(29.9)	23.6	34.2	18.7	17.1
EBITDA margin % (adj.)	15.4	16.2	18.1	18.3	18.3
EBIT margin % (adj.)	12.7	14.0	16.2	16.4	16.5
Net-profit margin % (adj.)	12.2	12.1	13.6	13.7	13.8
ROAE (%)	26.8	27.9	31.2	30.8	30.0
ROAA (%)	18.9	18.7	20.4	20.6	20.3
ROCE (%)	27.8	32.3	37.1	36.8	36.0
ROIC (%)	30.6	94.3	n.m.	92.1	99.2
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Effective tax rate (%)	34.1	34.2	33.8	33.7	33.7
Accounts receivable (days)	8.4	7.1	7.5	9.2	9.3
Payables (days)	66.4	78.2	84.6	80.3	80.1
Net interest cover (x)	36.6	62.9	120.2	143.5	168.8
Net dividend payout (%)	33.5	32.5	33.6	34.0	33.9

Key assumptions

Year to 31 Dec	2008	2009	2010E	2011E	2012E
Malted Food (YoY volume growth %)	16.2	10.0	13.0	12.0	11.0

PER bands



Source: Company, Daiwa forecasts

Business background

Leader in malted food drinks

No longer a single-product company

GSKCH, a subsidiary of Britain-based GSK Plc, is a leader in India's MFD market and a niche player in the value-added biscuit and instant-noodle markets. Over the past two years, it has undergone a complete image makeover from being a single-product-single-brand company, to becoming an aggressive innovator launching new products and product varieties, which has led to it being re-rated significantly in the recent past. The company, with its four brands *Horlicks*, *Boost*, *Viva* and *Maltova*, has a 70% share of the MFD market; *Horlicks* is the flagship brand and also the leader in the MFD market.

MFD players in India: brand comparison

Company	White MFD	Brown MFD	Market share (%)
GSKCH	*Horlicks*	*Boost, Viva, Maltova*	70
Cadbury's India		*Bournvita*	14
Heinz India	*Complan*		-
Dabur India		*Chyawan Junior*	-
Nestle India		*Milo*	-

Source: Company, Daiwa
Note: white MFD is milk-powder-based and brown MFD is largely malt-based

Products for all consumer segments

Leveraging on the equity of its flagship brand *Horlicks*, GSKCH has launched several new varieties and products targeting niche customers. Besides introducing various flavours for its *Horlicks* brands, it has launched *Women's Horlicks*, to target upmarket working women, and *Mother's Horlicks*, for pregnant women and new mothers. It has also targeted the niche adult-and-health-conscious market with *Horlicks Lite*, and *Sugar Free* for diabetics.

GSKCH has a presence across different price points

The company has a presence across different price points and target consumers. Its strategy of targeting niche categories has been successful as seen from the successful acceptance of all its launches in the recent past.

GSKCH: product profile

Product category	Brands
Malted food and drinks	*Boost, Viva, Maltova* and *Horlicks*^
Biscuits	*Horlicks Regular, Cookies, Cream*
Specialist nutrition	*Acti base, Acti grow, Pro Height*
Snackbars	*Nutribar*
Flavoured milk	*Horlicks Chill Doodh*
Instant noodles	*Horlicks Foodles*

Source: Company, Daiwa
^*Horlicks* varieties: *Regular, Junior, Women, Asha, Mother, Adults and Diabetics*

Tapping the expanding middle-class market

Horlicks Asha *is targeted at the mass-market consumer segment*

In the past, the MFD market has been a single-digit growth category, due to its relatively discretionary nature and premium positioning for upmarket consumers. However, to take advantage of the potential demand from a growing number of urban middle-class consumers and rural consumers, GSKCH has launched smaller packets and a new brand *Horlicks Asha*.

Differentiated marketing for different products and consumers

Medically-promoted specialist-nutrition products have been well-accepted by consumers

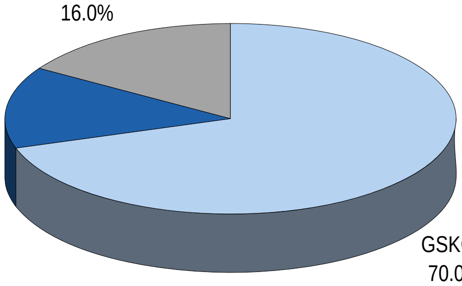
Also, it has adopted a different promotional strategy for each product category. While the existing MFDs are promoted through traditional forms of advertising, the specialist-nutrition products are promoted through medical channels. Such promotion has led to slower sales-growth in the past compared with sales promoted in other ways, although it has resulted in better acceptance by consumers, according to the company.

Market share maintained despite increasing competition

Strong brands have enabled GSKCH to maintain its market share despite increasing competition

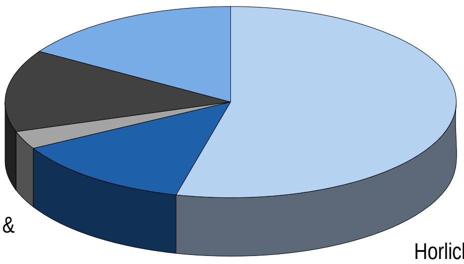
GSKCH has maintained its market share despite increasing competition from existing and new players; this has been despite consistent price hikes every year. The strong brand equity of *Horlicks* and *Boost* has enabled the company to pass on raw-material price inflation. It has also enabled GSKCH to widen its consumer base through renovation and innovation.

MFD market: key players' market shares (as at 2009)



Source: Company

GSKCH: market share per brand (as at 2009)



Source: Company

New revenue growth drivers

MFD accounts for 95% of GSKCH's revenue currently

Currently, MFD accounts for almost 95% of GSKCH's annual revenue, while biscuits, noodles, snackbars, and other food items account for the remainder. The company expects these other food categories to account for about 15% of its annual revenue over the next three-to-five years. To achieve this, the company has increased its distribution network and brand investment.

India's biscuit industry is worth Rs120bn currently

Biscuits: GSKCH has ventured into the biscuit industry by leveraging on the equity of its *Horlicks* brand. Although biscuits are a low profit-margin business in India, where there is severe national and regional competition, GSKCH has entered this market for the following strategic reasons such as:

- **A huge and expanding market:** the biscuit market is a Rs120bn industry that is expanding by 15-20% YoY. Therefore, even having a market share of a mid-single-digit percentage would add to GSKCH's top line. GSKCH expects its biscuit business to expand by 30% YoY, due to its present small scale and aggressive marketing efforts.
- **Exposure to north and east India:** biscuits are consumed largely in north and west India, which together account for 60% of the country's total demand. Entering these regions would enable GSKCH to explore these markets for other potentially lucrative products for its MFD business. These regions combined account for only 15% of the company's total revenue.
- **Serves a dual purpose:** launching biscuit products under its *Horlicks* brand will serve a dual purpose, namely: 1) it will provide an easy launch pad for biscuits by leveraging on the equity of the *Horlicks* brand, which is associated with healthy food, and 2) it will increase awareness of its *Horlicks* brand in these markets, which will lead to increased awareness of its MFD brands in north and west India.
- **Creates a platform for other launches:** GSKCH can take advantage of the increased awareness of *Horlicks* and its other brands, as well as its expanded distribution network, to launch other products in these markets.

Noodles and other snack options are rapidly expanding markets

Noodles, cereal bars, sports drink, and flavoured milk: in line with its plan to become a complete health-food company, GSKCH has entered other niche but expanding markets such as instant noodles, cereal bars, sport drinks and flavoured milk. GSKCH has entered these small, but rapidly expanding, categories by leveraging on its *Horlicks* brand to position itself in the health market.

- Although the noodle market is largely dominated by Nestle India, this market has seen many new entrants, both domestic and multinational corporations, struggling to garner a share of one of the fastest expanding food categories in India.
- Cereal bars that are positioned as a healthy snack option are a new and niche, but fast-expanding, category among the health-conscious population.
- Flavoured milk is fast becoming a healthy out-and-about option for young people.
- Recently in India, the company launched a sports drink from its parent's portfolio, *Lucozade Sport*. The sports-drink market, although still small, is expanding rapidly and is dominated by PepsiCo's *Gatorade*. According to industry estimates, India's sports-drink market is valued at about Rs1.5bn and is expected to more than double to Rs4bn over the next year.

Earnings outlook

Healthy sales-volume growth and margin improvements should continue

Low market-penetration rate should ensure at least 10% YoY sales-volume growth, in our view

With the rate of market penetration as low as 20% and frequency of use as low as four times a year, we believe the MFD market has the potential to expand by at least 10% YoY in sales-volume terms over the foreseeable future. Therefore, we believe the low-per-capita consumption, ample untapped opportunities in the semi-urban and rural areas, and exposure to the mass population offer huge potential for the market to expand by a low-double-digit percentage on a sustainable basis over the long term. This is also evident from the company's plan to expand its production capacity by 20% during 2010 and 2011.

Sales of new products could double every year

GSKCH expects main *Horlicks* sales to double every five years, while the *Horlicks* varieties for adults, women and children could double every three years, and the specialist-nutrition, nutrition bars, flavoured milk, and noodles could double every year due to its small scale and high business-growth potential.

GSKCH: sales mix (Rs m) and EBITDA margin (%)

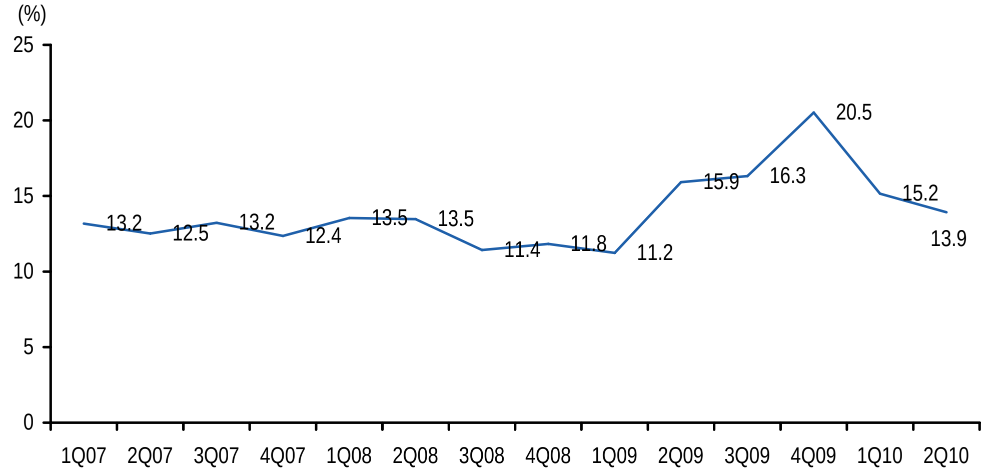
Segments	2008	2009	2010E	2011E	2012E	CAGR FY09-12E (%)
Malt-based food sales	96.0	95.0	94.2	93.9	93.6	17.6
Biscuits sales	3.5	3.8	4.1	4.5	4.7	26.7
Others (includes excise duty)	0.5	1.2	1.6	1.6	1.7	31.8
Gross sales	**100**	**100**	**100**	**100**	**100**	**18.2**
EBITDA margin (%)	*15.4*	*16.2*	*18.1*	*18.3*	*18.3*	-

Source: Company, Daiwa forecasts

We forecast an FY09-12 earnings CAGR of 23.1%

Backed by the company's potentially aggressive innovation, marketing and distribution activities, we expect GSKCH's MFD sales volume to expand by a low-double-digit percentage year-on-year and the biscuit sales volume to rise by 25% YoY. We forecast an FY09-12 revenue CAGR of 18% for the company, driven by healthy sales-volume growth in its core business, as well as the launches of new products. We forecast an FY09-12 earnings CAGR of 23.1%, driven by improvements in the company's raw-material price scenario, and in its pricing power and operational efficiencies.

GSKCH: A&P to sales ratio



Source: Company, Daiwa

New OTC product launches would increase the company's supplementary income

GSKCH earns supplementary income from GSK Asia Private Ltd (GSK) (Not listed) by marketing its over-the-counter (OTC) drugs namely, *IODEX*, *CROCIN*, and *ENO*. GSKCH is now test-marketing *Breathe Right* nasal strips and *Sensodyne* toothpaste. We believe the successful launch of the new products and the continued good performance of OTC products should increase GSKCH's supplementary income in the future. However, we believe the overall impact of this side business on GSKCH's total revenue and earnings would be modest, given the niche market of these products, and that the marketing of these products accounts for a low single-digit percentage of GSKCH's total income.

What could go wrong?

Potentially aggressive tactics by multinational corporations could have a negative impact on GSKCH's new product launches

GSKCH has launched several new products in new categories, some of which are dominated by multinational corporations. The success of these products will depend on its promotional and positioning strategies, as well as how the competition reacts to the launches. Any aggressive tactics by existing market leaders could affect the new launches.

Balance sheet and cash flow

A 20% hike in capacity due to an expected increase in demand for MFD

GSKCH is debt-free. In line with the company's healthy sales-volume growth in the past couple of years and in anticipation of the same going ahead, GSKCH is expanding its production capacity by 20% by investing Rs2.5bn during 2010 and 2011. The capex will be funded from the company's internal accruals. Despite its business operations generating healthy cash balances, GSKCH has a low dividend-payout ratio, mainly because the company has been using up funds for its aggressive innovation and renovation plans, and to increase its production capacity, as well as creating a war chest for possible health-and-nutrition acquisitions in India.

Returning cash to shareholders

Probability of higher payout or share buyback

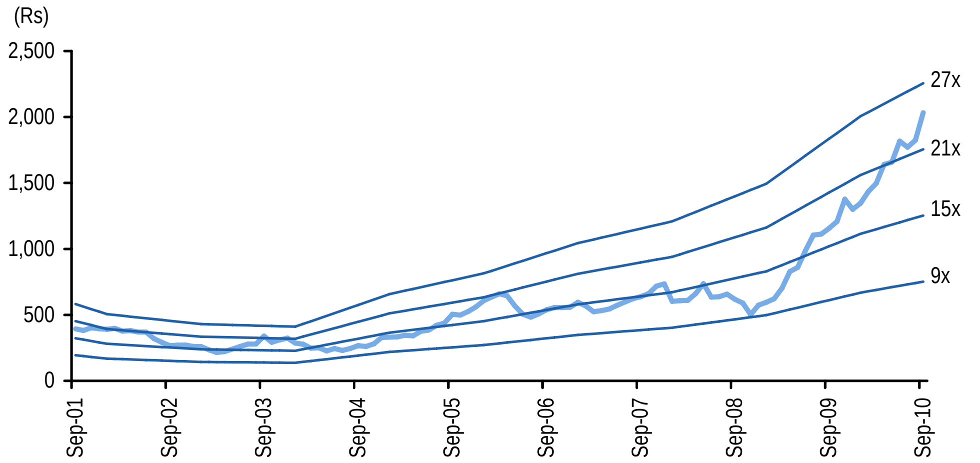
As a result of the healthy cash flow from its business operations, its current manufacturing capacity and low working-capital requirements, GSKCH has accumulated healthy cash reserves over the years; Rs8.2bn or Rs195 cash per share as at the end of 2009. However, it has maintained a low-dividend-payout ratio in order to build a war chest to pay for its inorganic growth. We believe a lack of suitable acquisition opportunities in the domestic market and the company's aggressive organic business-growth plans will limit the company's fund requirements in the future, except for the Rs2.5bn required to increase its manufacturing capacity by 20% over the 2010-11 period. We believe the company could return excess cash to shareholders either in the form of a higher dividend or a share buyback.

Valuation and target price

Rerated due to its expanding product portfolio

GSKCH has traded within a one-year forward PER band of 9-25x, and at an average PER of 16x over the past 10 years. The relatively lower PER multiple, compared with other FMCG companies such as HUL, was due to GSKCH's single-product image. However, since the company's aggressive innovation phase over the past two years, the stock has been rerated. As a result, the average past-two-year PER was 17x and the past-one-year PER was 20.7x.

GSKCH: one-year forward PER bands



Source: Company, Daiwa forecasts

We value GSKCH at a PER of 24x on our 2011 EPS forecast

We see GSKCH's key business strengths as: its broader portfolio, low market penetration rate, and pricing power. We believe these factors will enable the company to trade at a higher PER, and hence initiate coverage with a **2** (*Outperform*) rating and a six-month target price of Rs2,117 (based on a PER of 24x on our 2011 EPS forecast).

Risks

Adverse changes in agri-commodity prices could affect the company's profitability

We have factored into our share price and rating any potential margin improvements from receding agri-based raw-material price inflation and operational efficiencies from any new planned production capacity. Any change in the outlook for agricultural produce could affect commodity prices and, in turn, our earnings forecasts and rating for the stock. However, we believe GSKCH should be able to maintain its earnings-growth momentum through efficient cost-control measures and the strong pricing power enjoyed by its leading brands.

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