

Colgate-Palmolive India

SELL

Downgrade from HOLD

Irrational exuberance

Rs829

Reason for report: Recommendation change

We downgrade Colgate-Palmolive India to SELL as: i) strong double-digit volume growth may not be sustained, ii) EBITDA margin is at an all-time high and further expansion seems difficult, iii) possibility of Procter & Gamble (P&G) entering oral care, which could pose significant risk to margins and iv) expensive valuations – at FY11E P/E of 26.4x, the stock trades at 29% premium to five-year median P/E. We downgrade Colgate to SELL and maintain our 12-month target price of Rs757.

- ▶ **Strong double-digit volume growth unsustainable.** Colgate has posted strong volume CAGR of 11.9% over FY05-10 in toothpastes. This strong volume growth (Chart 2) can be attributed to: i) increase in penetration (toothpaste penetration has increased from 46% in CY04 to 59% in CY09), ii) increase in market share (up 450bps by volume in the past five years) and iii) increase in per capita usage. With market share at a 10-year high and increasing competitive intensity, volume growth due to market share gain appears difficult. Also, due to a high base of penetration, volume growth attributable to increase in penetration will come down. Going forward, we expect Colgate's toothpaste volume growth to be limited to ~9%.
- ▶ **EBITDA margin at an all-time high – Further expansion difficult.** Colgate has continuously improved its gross margins over the past 15 years – increasing from 40% in FY95 to an all-time high of 60.4% in FY10. Also, because of the benign competitive environment, A&P-to-net sales came down to 15.3% in FY10 (lowest in the past five years). This is reflected in the highest-ever EBITDA margin of 24.5% in FY10. With less bandwidth to increase gross margins or lowering advertising spends, we expect EBITDA margin to remain flat in FY11E & FY12E.
- ▶ **Increasing competition & possible entry of P&G could pose risk to margins.** Entry of P&G in oral care has always been a much speculated topic. However, with increased focus of P&G on India, we believe there is a high possibility of P&G entering the category in the medium term. Also, currently Hindustan Unilever is completely focussed on volume growth and is gaining back lost share. In the past, intensifying competition had led to significant spurt in A&P spends (A&P-to-net sales rose from 11.5% in FY97 to 20.8% in FY02). Hence, margin could be under significant risk in case P&G enters the category.
- ▶ **Downgrade to SELL; buyback/open offer speculation unfounded.** The stock has rallied 11% in the past week on speculation that Colgate may opt for a buyback/open offer. Historically, the company has never gone for a buy back/ open offer and as per the management, there are no plans for the same. At FY11E P/E of 26.4x, the stock trades at a 29% premium to its five-year median P/E. Downgrade to SELL with 12-month target price of Rs757 (valuing at FY12E P/E of 21.5x).

Market Cap	Rs113bn/US\$2.4bn	Year to March	FY09	FY10	FY11E	FY12E
Reuters/Bloomberg	COLG.BO/CLGT IN	Net Sales (Rs mn)	16,948	19,625	22,342	25,335
Shares Outstanding (mn)	136	Net Income (Rs mn)	2,806	4,038	4,271	4,788
52-week Range (Rs)	836/482	EPS (Rs)	21.3	31.1	31.4	35.2
Free Float (%)	49.0	% Chg YoY	29.1	43.9	5.8	12.1
FII (%)	15.5	P/E (x)	40.2	27.9	26.4	23.6
Daily Volume (US\$/'000)	1,957	FCF per share (Rs)	20.1	23.4	35.0	37.7
Absolute Return 3m (%)	15.9	EV/E (x)	34.1	21.8	19.5	17.4
Absolute Return 12m (%)	54.8	Dividend Yield (%)	1.8	2.4	2.8	3.1
Sensex Return 3m (%)	(2.8)	RoCE (%)	164.4	157.0	124.2	117.0
Sensex Return 12m (%)	9.9	RoE (%)	148.3	148.9	119.2	112.7

FMCG

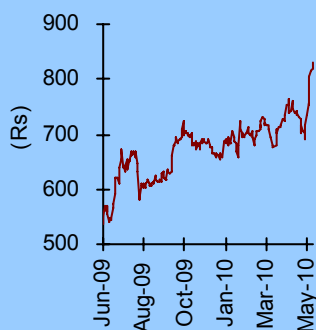
Target price Rs757

Shareholding pattern

	Sep '09	Dec '09	Mar '10
Promoters	51.0	51.0	51.0
Institutional investors	22.2	22.7	22.9
MFs and UTI	2.0	1.4	1.3
Insurance Cos.	5.5	5.6	6.1
FII	14.6	15.7	15.5
Others	26.8	26.3	26.1

Source: www.nseindia.com

Price chart



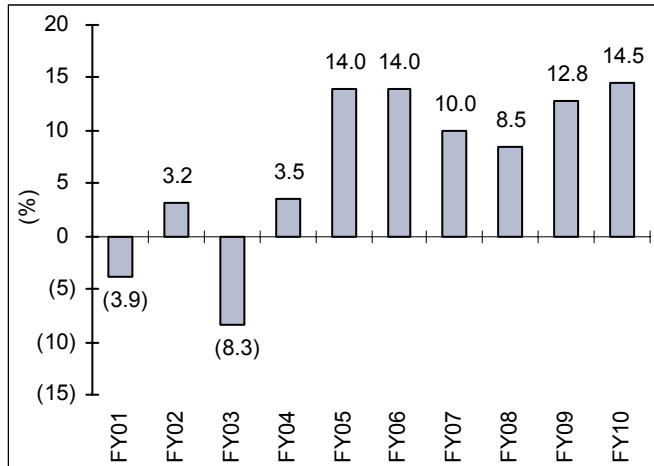
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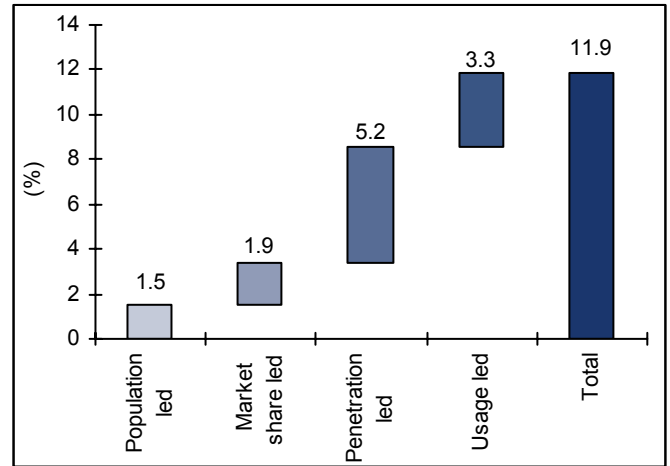
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Chart 1: Toothpaste Volume growth in past 10 years



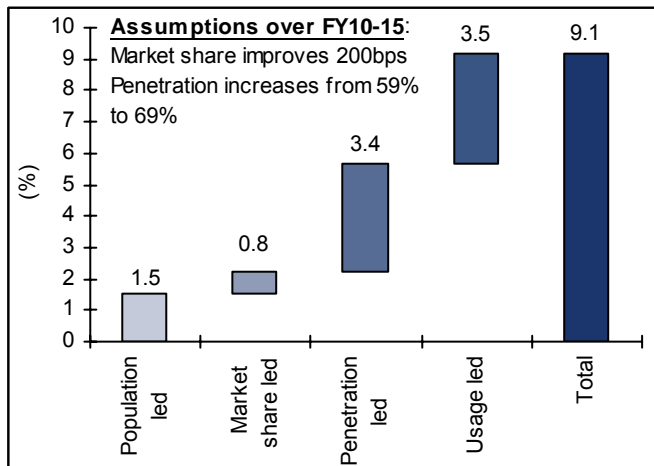
Source: Company data

Chart 2: Volume growth break-up of past five years



Source: I-Sec Research

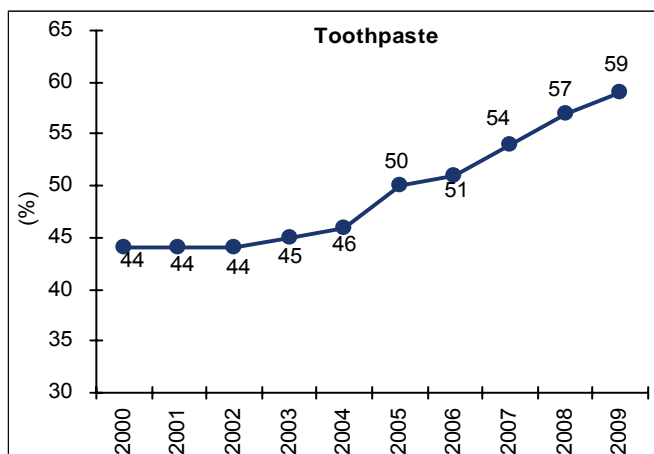
Chart 3: Estimated volume growth in next five years



Source: Company data

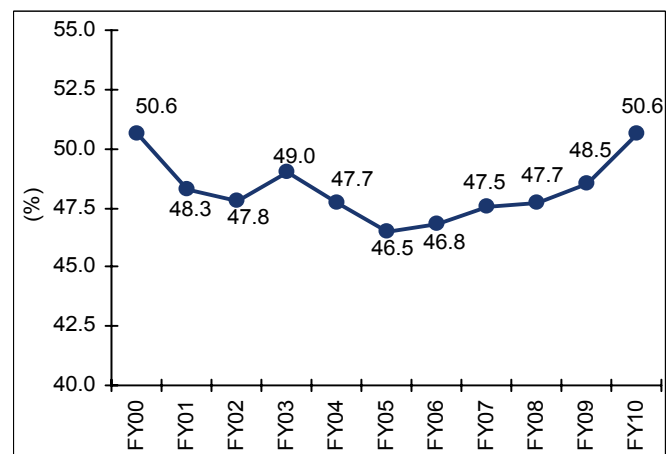
Increase in penetration was the major contributor to volume growth in the past five years. However, due to higher base of penetration, we estimate penetration-led growth to be limited to ~3% annually going forward. Marginal market share gains will contribute ~1% to the overall volume growth. Hence, if Colgate needs to maintain double-digit growth, per capita usage should increase significantly (brushing twice a day), which we believe will not be easy to come by. We estimate volumes to grow at ~9% CAGR over the next five years.

Chart 4: Penetration levels have increased



Source: Company data

Chart 5: Market share gains in Toothpaste

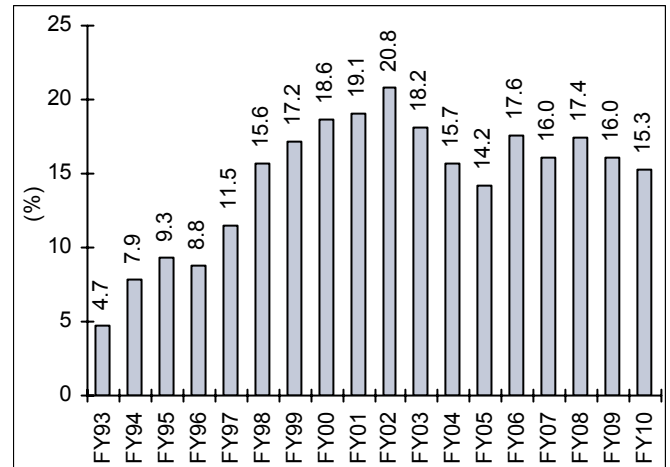
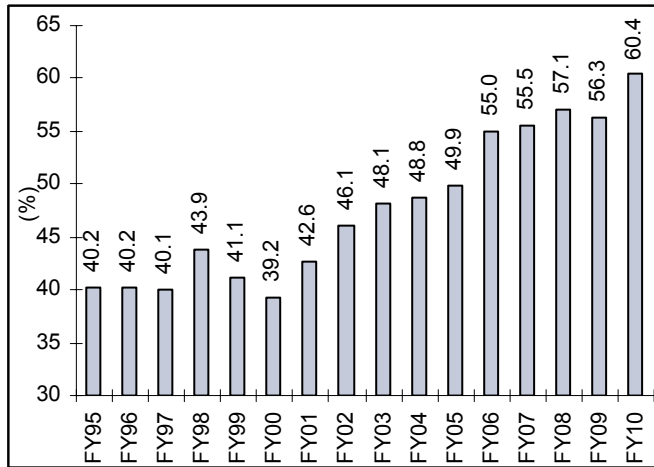


Source: Nielsen

Rising competitive intensity & possible entry of P&G in oral care could lead to market share loss. However, we have not factored P&G's entry in our estimates – we assume market share to improve marginally.

Chart 6: Gross margin has expanded continuously

Chart 7: A&P expenses as percentage of sales



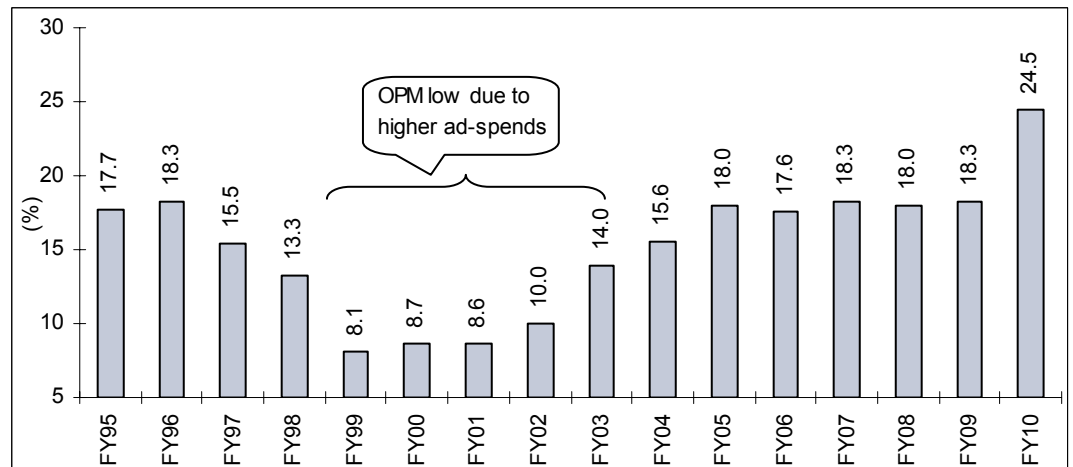
Source: Company data

Source: Company data

Amalgamation of contract manufacturers enabled a significant gross margin expansion in FY10. This has resulted in highest-ever gross margin of 60.4%. Due to increasing competitive intensity, scope of any further gross margin expansion seems limited.

Compared with historical levels, ad expenses-to-sales in FY10 was at a modest 15.3%. High competitive pressure and launch of price-warrior brands by domestic companies such as Ajanta & Anchor resulted in high ad spends during FY00-03. Rise in ad spends to levels of FY00-03 due to entry of P&G can erode margins significantly.

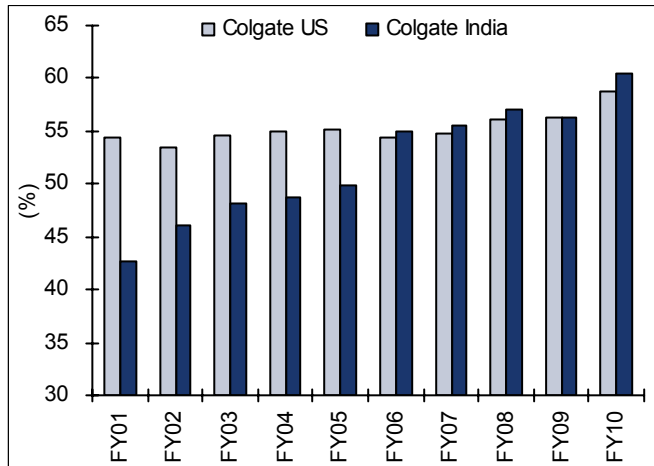
Chart 8: Operating profit margin at an all-time high



Source: Company data

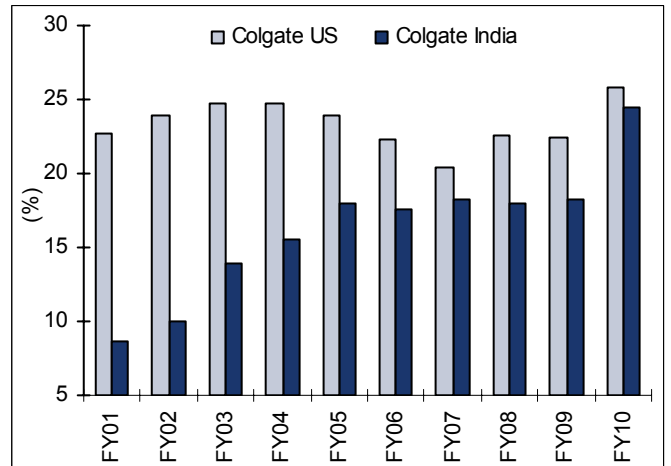
Colgate India versus Colgate US

Chart 9: Gross margin



Source: Company data

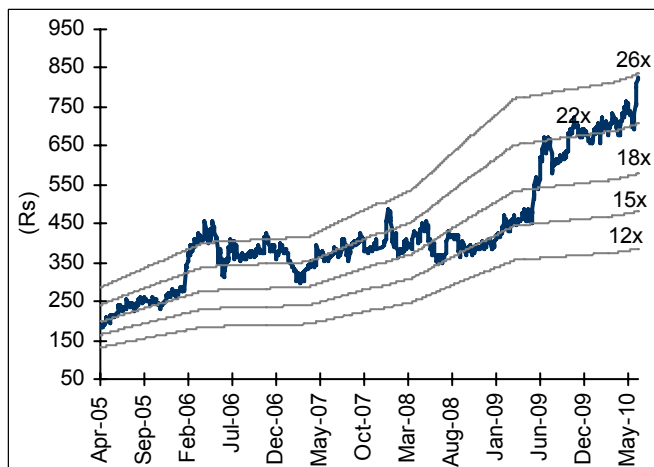
Chart 10: EBITDA margin



Source: Company data

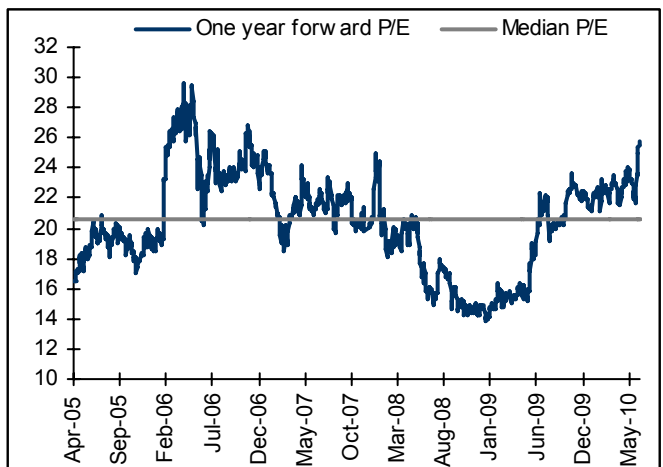
Historically, Colgate India has always lagged behind its parent in terms of gross margins. However, in the past five years it has consistently delivered higher gross margin than its parent. While the parent has stated that it aspires to increase gross margins 500bps in the next five years, we believe the scope for margin expansion is limited for Colgate Palmolive India as it is already higher than the parent. Though EBITDA margin of Indian operations has improved, it continues to be lower than global EBITDA margin, primarily due to higher proportion of ad spends incurred in India.

Chart 11: P/E bands



Source: Company data

Chart 12: One-year forward P/E



Source: Company data

Colgate's EPS CAGR over FY08-FY10 was 36% on the back of strong volume growth and significant margin expansion. However, expiry of tax holiday for its manufacturing unit at Baddi will increase its effective tax rate from 16% in FY09-10 to 23-24% in the next couple of years. Given the limited scope for further margin expansion, we expect EPS CAGR of 9% over FY10-12E.

At FY11E P/E of 26.4x, the stock appears expensive as it trades at 29% premium to its five-year median P/E of 20.6x.

Scenarios – Risks higher than reward

Case	Growth/ Competitive intensity	Costs & margins	FY12E EPS (Rs)	One-yr fwd P/E (x)	Target Price (Rs)
Base	<ul style="list-style-type: none"> • Competition remains unchanged • Marginal market share gains • Volume growth marginally lower than long-term average 	<ul style="list-style-type: none"> • Gross margins remains at FY10 levels • EBITDA margin drops marginally 	35.2	21.5x	757
Bull	<ul style="list-style-type: none"> • P&G does not enter • Marginal market share gains • Volume growth marginally higher than long-term average 	<ul style="list-style-type: none"> • Gross margins improve marginally • EBITDA margin improves further due to decline in ad spends 	38.8	23.0x	892
Bear	<ul style="list-style-type: none"> • P&G enters toothpaste category • Market share contracts marginally • Volume growth moderates 	<ul style="list-style-type: none"> • Gross margin deteriorates marginally • High ad spends pull EBITDA margin further down 	31.2	20.0x	624

Source: I-Sec Research

Financial Summary

Table 1: Profit and Loss statement
(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Net Sales	16,948	19,625	22,342	25,335
<i>of which Exports</i>	180	208	237	269
<i>of which Domestic</i>	16,768	19,416	22,105	25,066
Other operating income	525	727	650	700
Total Revenue	17,473	20,352	22,992	26,035
Raw materials consumed	7,413	7,768	8,825	10,033
Gross Profit	10,060	12,584	14,167	16,002
- <i>Gross Margin (%)</i>	57.6	61.8	61.6	61.5
Other Operating Expenses	6,870	7,599	8,607	9,766
EBITDA	3,190	4,985	5,560	6,236
- <i>growth (%)</i>	16.6	56.3	11.5	12.2
- <i>EBITDA margin (%)</i>	18.3	24.5	24.2	24.0
Depreciation & Amortisation	229	376	416	448
Gross Interest	11	15	10	10
Other Income	388	254	449	564
Recurring PBT	3,337	4,848	5,583	6,342
Add: Extraordinaries	116	195	0	0
Less: Taxes	551	810	1,312	1,554
Net Income (Reported)	2,902	4,233	4,271	4,788
Recurring Net Income	2,806	4,038	4,271	4,788
- <i>growth (%)</i>	29.1	43.9	5.8	12.1
- <i>Net margin (%)</i>	15.7	19.6	18.2	18.0

Source: Company data, I-Sec Research

Table 2: Balance sheet
(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Assets				
Total Current Assets	5,421	5,901	8,067	9,748
- <i>of which cash & cash equivalents</i>	3,533	4,003	5,398	6,810
Current Liab. & Prov.	5,557	5,515	7,132	8,188
Net Current Assets	(136)	387	935	1,560
Investments	383	210	510	810
- <i>of which Strategic</i>	34	0	0	0
- <i>of which Marketable</i>	349	210	510	810
Net Fixed Assets	1,786	2,531	2,316	2,068
- <i>of which intangibles</i>	627	889	813	726
- <i>of which CWIP</i>	47	50	50	50
Total Assets	2,033	3,128	3,761	4,438
Liabilities				
Equity Share Capital	136	136	136	136
Reserves & Surplus*	2,027	3,125	3,768	4,455
Net Worth	2,163	3,261	3,904	4,591
Borrowings	47	46	46	46
Deferred Tax Liability	(177)	(179)	(189)	(199)
Total Liabilities	2,033	3,128	3,761	4,438

Source: Company data, I-Sec Research

Table 5: Quarterly trend
(Rs mn, year ending March 31)

	Jun-09	Sep-09	Dec-09	Mar-10
Net sales	4,680	4,873	4,906	5,166
- <i>% growth (YoY)</i>	14.8	18.1	17.0	13.4
EBITDA	1,226	1,106	1,212	1,441
- <i>EBITDA margin (%)</i>	26.2	22.7	24.7	27.9
Recurring Net profit	1,028	897	1,059	1,055
- <i>% growth (YoY)</i>	42.9	41.3	36.2	30.0
Reported Net Profit	1,028	897	1,164	1,144

Source: Company data, I-Sec Research

Table 3: Cashflow statement
(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Operating Cash flow	2,433	4,150	4,228	4,662
Working Capital Changes	(10)	113	728	669
Capital Commitments	312	(1,087)	(200)	(200)
Free Cash Flow	2,735	3,177	4,756	5,132
Investing Activities	740	887	127	214
Issue of Share Capital	-	0	(0)	-
Inc (Dec) in Borrowings	-	(1)	-	-
Dividend paid	(2,540)	(3,321)	(3,510)	(3,983)
Extraordinary Items	116	195	-	-
Chg. in Cash & Bank balance	1,069	964	1,372	1,362

Source: Company data, I-Sec Research

Table 4: Key ratios
(Year ending March 31)

	FY09	FY10	FY11E	FY12E
Per Share Data (in Rs.)				
Recurring EPS	20.6	29.7	31.4	35.2
Reported EPS	21.3	31.1	31.4	35.2
Dividend per share (DPS)	15.0	20.0	23.0	26.0
Book Value per share (BV)	15.9	24.0	28.7	33.8
FCF per share	20.1	23.4	35.0	37.7

Growth Ratios (%)

Net Sales	15.0	15.8	13.8	13.4
EBITDA	16.6	56.3	11.5	12.2
Recurring Net Income	29.1	43.9	5.8	12.1
Recurring EPS	29.1	43.9	5.8	12.1

Valuation Ratios (x)

P/E	40.2	27.9	26.4	23.6
P/BV	37.2	25.6	24.1	21.5
P/FCF	41.2	35.5	23.7	22.0
EV / EBITDA	34.2	21.9	19.6	17.5
EV / Net Sales	6.4	5.6	4.9	4.3

Operating Ratio

Raw Material/Sales (%)	43.7	39.6	39.5	39.6
SG&A/Sales (%)	18.6	17.9	17.9	18.0
Effective Tax Rate (%)	16.0	16.1	23.5	24.5
NWC / Total Assets (%)	(130.2)	(98.8)	(104.0)	(104.8)
Inventory (days of sales)	17.0	17.9	17.0	17.0
Receivables (days of sales)	2.2	1.9	1.9	1.9
Payables (days of sales)	79.8	76.4	72.6	72.4
D/E Ratio (x)	-	-	-	-

Return/Profitability Ratio (%)

EBITDA Margins	18.3	24.5	24.2	24.0
Rec. Net Income Margins	15.7	19.6	18.2	18.0
RoCE	164.4	157.0	124.2	117.0
RoNW	148.3	148.9	119.2	112.7
Dividend Payout Ratio	82.1	74.5	84.9	85.7
Dividend Yield	1.8	2.4	2.8	3.1

Source: Company data, I-Sec Research

I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

BUY: +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

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