Man Financial

FMCG results preview: Still a growth story

***Shishir Manuj** (shishir.manuj@manfinancial.in) +91 22 5667 9759*

We expect the aggregate sector sales to grow by 16.2% yoy and net recurring earnings to grow by 25.5%. The demand growth for the sector has come at a good time, as its ability to hike product prices has helped maintain operating margins despite lower gross margins for most, except for a few like Dabur and Marico. Besides, fiscal benefits from investments in backward area and improvement in operating efficiencies have also supported margin expansion. We expect some of the leftover benefits of investment in backward areas and subsequent ramp up of production to trickle in for a few more quarters.

However, we would like to caution that earnings growth could be under pressure if demand slows down and the inflation threat persists for some more time, as upsides from excise and tax savings as well as price hikes would be insufficient to cover margins.

Quarterly snapshot

(Rs mn)	Sales		chng	PBDIT		chng	PAT		chng	EPS, Rs		chng
	JQ06	JQ05	(%)	JQ06	JQ05	(%)	JQ06	JQ05	(%)	JQ06	JQ05	(%)
Dabur*	4,927	4,147	*18.8*	615	492	*25.1*	453	349	*29.9*	0.8	0.6	*29.9*
ITC	27,997	22,669	*23.5*	10,327	8,268	*24.9*	6,671	5,315	*25.5*	1.8	1.4	*25.5*
Asian Paints*	7,546	6,631	*13.8*	941	814	*15.7*	509	436	*16.8*	5.3	4.5	*16.8*
Goodlass	2,617	2,266	*15.5*	431	370	*16.6*	234	217	*8.0*	9.2	8.5	*8.0*
HLL	31,773	28,363	*12.0*	4,759	3,769	*26.3*	3,952	3,005	*31.5*	1.8	1.4	*31.5*
Nestle	6,739	6,158	*9.4*	1,533	1,380	*11.1*	966	864	*11.9*	10.1	9.0	*11.9*

*Consolidated basis. Source: Company, Man Financial Research Estimates

No growth slowdown as yet

We expect aggregate sales for JQ06 to grow 16.2% yoy (consolidated basis for Dabur and Asian Paints), a tad lower than the 17.6% yoy growth registered in JQ05. Nevertheless, all companies, barring Nestle, are expected to register double-digit growth. This growth rate is also in line with the 18.7% growth registered in MQ06. Sales in JQ05 were accentuated by the impact of VAT implementation where a part of the previous quarter sales were registered in that quarter.

Paints companies were one of the most affected due to VAT, as sales tax rates for paints in the important South Indian markets were higher than the proposed VAT rates. Therefore, we are not witnessing any slowdown yet compared with last year, which was relatively good. However, the interplay between slowdown in economic growth and product price hikes could lower expected growth towards the end of the year.

Sales growth: No signs of deceleration yet

(Rs mn)	JQ06	JQ05	*YoY chng (%)*	MQ06	QoQ chng (%)
Dabur*	4,927	4,147	*18.8*	4,799	*2.7*
ITC	27,997	22,669	*23.5*	27,845	*0.5*
Asian Paints*	7,546	6,631	*13.8*	7,650	*(1.4)*
Goodlass	2,617	2,266	*15.5*	2,372	*10.3*
HLL	31,773	28,363	*12.0*	27,981	*13.6*
Nestle	6,739	6,158	*9.4*	6,759	*(0.3)*
Aggregate	**81,599**	**70,234**	***16.2***	**77,406**	***5.4***

*Consolidated basis. Source: Company, Man Financial Research Estimates

Margin expansion: Delayed contribution from HLL to lead margin expansion

A delayed contribution from HLL would finally help aggregate operating margins improve 130bps yoy in JQ06. We expect operating margins to rise to 22.8% in the quarter, with all six companies seeing margin expansion. Price hikes, an indication of both inflationary pressure as well as robust demand in many products, have not spooked growth yet. The paints segment will see minimum margin expansion, as it took price hikes with a lag. Besides, these price hikes have been insufficient to cover the rise in cost of solvents. We expect another round of paints price hike to protect margins, although this could be deferred due to the shorter pre-festive (*Diwali*) paint season.

Operating margin: Moving up

(%)	JQ06	JQ05	*YoY chng (bps)*	MQ06	*QoQ chng (bps)*
Dabur*	12.5	11.9	*62*	16.3	*(380)*
ITC	36.9	36.5	*41*	28.8	*810*
Asian Paints*	12.5	12.3	*20*	12.0	*50*
Goodlass	16.5	16.3	*15*	14.0	*250*
HLL	15.0	13.3	*169*	13.1	*190*
Nestle	22.8	22.4	*34*	20.2	*260*
Aggregate	**22.8**	**21.5**	***131***	**19.5**	***330***

*Consolidated basis

Source: Company, Man Financial Research Estimates

We expect a 25.5% jump in aggregate net profit (recurring) contributed primarily by HLL's and Dabur's profit growth. Net margins will improve 120bps, with HLL reporting highest improvement in net margins.

Net profits: Gaining from HLL

(Rs mn)	JQ06	JQ05	*YoY chng (%)*	MQ06	*QoQ chng (%)*
Dabur*	453	349	*29.9*	614	*(26.2)*
ITC	6,671	5,315	*25.5*	5,675	*17.6*
Asian Paints*	509	436	*16.8*	492	*3.5*
Goodlass	234	217	*8.0*	210	*11.4*
HLL	3,952	3,005	*31.5*	2,985	*32.4*
Nestle	966	864	*11.9*	805	*20.0*
Aggregate	**12,785**	**10,186**	***25.5***	**10,781**	***18.6***

*Consolidated basis

Source: Company, Man Financial Research Estimates

Companies: Key highlights

Dabur: Balsara to see margin improvement; raw material and foods margin could be under pressure

We saw a sharp improvement in the consolidated gross margin for Dabur in FY06 driven by improved profitability of foods, lower key raw material prices, as well as improvement in the Balsara portfolio's profitability. The management has guided for a further upside from Balsara's gross margin profile, although the raw material and foods profitability over the next few quarters can be under downside risk. With foods contribution to gross consolidated sales estimated to move up 300bps to 16%, increasing competition from new players (*PriyaGold, Mohan Meakin*, etc.) could pose a threat to both growth and margins. For the year, we do not see any significant improvement in margins.

ITC: Hotels and paperboards to slowdown due to capacity constraints, agri faces a tough base

We are accounting for an 8.0% increase in cigarette volume growth for the year, lower than the 8.4% increase in FY06, due to a hike in cigarette prices and tightening marketing controls. Since there would not be any meaningful capacity addition in hotels and paperboards until FY08, we see growth coming mostly from realisation improvement.

We expect ITC to probably show the maximum deviation from our expectation, as the same quarter last year had a big movement in the agri-product sales, which not only skewed the growth, but also margins.

HLL: Margin expansion with low single-digit topline growth

After three quarters of robust mid-to-high teens growth, we expect the base effect to catch up with domestic FMCG growth in JQ06. However, we still expect low double-digit growth of 12.4% yoy, while exports, benefiting from a benevolent base, could see a 10% growth. Despite inflationary pressure on key raw material inputs like LAB and increased freight charges, we expect operating margins to improve around 170bps to 14.8%. This would be led by price hikes in key categories including toilet soaps, detergents, personal care (shampoos, toothpaste, skin cream, etc.), as well as higher margin products growing better compared with last year.

Asian Paints: Growth unchecked, margins unchanged

Despite interest rate hikes, we do not see any major threat to growth expectations for the year ahead for decorative paints. However, there could be some slowdown in automotive paint sales due to interest rate and fuel price hikes. Even so, the company would be relatively shielded compared with other automotive paints players who supply predominantly to four-wheeler manufacturers, as the slowdown is expected to hit this segment the worst. Margins could be under pressure due to higher raw material costs as well as freight hikes. After a spate of price hikes to pass on these inflationary pressures, we see some reluctance for further price hikes, particularly with the shorter pre-*Diwali* season in 2006.

Goodlass Nerolac: Upside from consolidation not yet factored in

In line with the overall paints segment, we see robust topline growth, although margins could be under pressure. The company carried higher inventory levels at the end of FY06 and hence underlying margins in JQ06 could be obscured. Goodlass Nerolac should report a slight decline in net margin due to higher yoy depreciation charges for its Bawal plant. We have not yet factored any contribution from the consolidation of Polycoat Powders, which is due to be completed in the ongoing quarter. Q1FY07 could see some non-recurring charges due to fire at one of its plants.

Gangadhara Kini	**Head – Institutional Equities**	**91-22-5667 9752**	**gangadhara.kini@manfinancial.in**
Vasudeo Joshi	**Head – Institutional Equity Research**	**91-22-5667 9754**	**vasudeo.joshi@manfinancial.in**
Jignesh Shah	**Head – Equity Derivatives**	**91-22-5667 9735**	**jignesh.shah@manfinancial.in**

Equity Research

Abhijeet Dakshikar	Engineering, Construction & Power	91-22-5667 9963	abhijeet.dakshikar@manfinancial.in
Jatinder Agarwal	Financial Services	91-22-5667 9986	jatinder.agarwal@manfinancial.in
Mandar Pawar	Oil & Gas	91-22-5667 9987	mandar.pawar@manfinancial.in
Nimesh Mistry	IT Services	91-22-5667 9768	nimesh.mistry@manfinancial.in
Rahul Jain	Metals	91-22-5667 9758	rahul.jain@manfinancial.in
Shishir Manuj	FMCG, Retail & Textiles	91-22-5667 9759	shishir.manuj@manfinancial.in
Vikas Sonawale	Pharmaceuticals	91-22-5667 9762	vikas.sonawale@manfinancial.in
Vivek Pandey	Auto, Auto Ancillaries & Logistics	91-22-5667 9766	vivek.pandey@manfinancial.in
Parthapratim Gupta	Research Associate	91-22-5667 9962	parthapratim.gupta@manfinancial.in
Prachi Kulkarni	Research Associate	91-22-5667 9966	prachi.kulkarni@manfinancial.in
Rupesh Sonawale	Research Associate	91-22-5667 9769	rupesh.sonawale@manfinancial.in
Shridatta Bhandwaldar	Research Associate	91-22-5667 9965	shridatta.bhandwaldar@manfinancial.in
Vaibhav Agarwal	Research Associate	91-22-5667 9967	vaibhav.agarwal@manfinancial.in
Pankaj Kadu	Database Analyst	91-22-5667 9756	pankaj.kadu@manfinancial.in
Roshan Sony	Editor	91-22-5667 9964	roshan.sony@manfinancial.in
Ganesh Deorukhkar	Production	91-22-5667 9756	ganesh.deorukhkar@manfinancial.in

Institutional Sales

Sajid Khalid	Equity – Sales Trading	91-22-5667 9745	sajid.khalid@manfinancial.in
Suketu Parekh	Equity – Sales Trading	91-22-5667 9746	suketu.parekh@manfinancial.in
Sweta Ganguly	Equity – Sales	91-22-6667 9973	sweta.ganguly@manfinancial.in
Vijay Baoney	Equity – Sales	91-22-5667 9753	vijay.baoney@manfinancial.in

Institutional Dealing

Chetan Babaria	Equity	91-22-5667 9749	chetan.babaria@manfinancial.in
Rajesh Ashar	Equity	91-22-5667 9748	rajesh.ashar@manfinancial.in

Man Financial-Sify Securities India Pvt. Ltd.,
2ND floor, 'C' Block, Modern Centre, Mahalaxmi, Mumbai-400 011, India. Tel: 91 22 2300 2999