India - Mid-caps

IIFL
Institutional Equities

The Chosen Eight

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Bottom-up investment ideas

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Eight bottom-up investment ideas

Inflation concerns, infrastructure project delays, commodity price increases and governance issues have put the brakes on the thesis of a secular bull market in India. In our view, bottom-up stock-picking assumes increased significance in such an environment. We have picked eight such ideas on the basis of their pricing power, visibility of revenues, strong management execution track record and balance-sheet strength on the face of a liquidity squeeze/hardening rates. The eight companies that we recommend are Amara Raja Batteries, Bajaj Electricals, Bajaj Finance, Emami, Havells India, HT Media, Indraprastha Gas and Pidilite.

A time for stock-picking: In the Indian stock markets, macro and systemic risks have taken centre stage recently, but our exploratory study suggests serious value in successful mid-cap stock-picking, as return distribution has a fat right tail - the probability estimate of a >30% annualised return is 17.9% in mid-caps versus 5.1% in large-caps, based on our study. The mid-cap space has borne the brunt of the current correction, with the CNX Midcap Index down 22.8% from its peak, while the Nifty is down 14.1%.

Consumption theme remains strong: We believe that consumption growth in India is likely to sustain in the 14-18% band achieved in the last five years versus 5-10% achieved earlier. This will continue to be driven by faster income growth across the segments of the income pyramid, the demographic dividend, increasing media penetration and a significant uptick in rural consumption empowered by government schemes like NREGS (National Rural Employment Guarantee Scheme).

Criteria-based stock selection: We believe that the key differentiating factors for successful stock-picking in an uncertain environment are: 1) resilient demand scenario; 2) pricing power to combat margin pressures from commodity inflation; and 3) strong competitive positioning that would allow healthy capital return ratios even in periods of vulnerability. Based on the consumption theme, our picks are Bajaj Electricals, Bajaj Finance, Emami, Havells India, HT Media, and Pidilite. We also pick Amara Raja Batteries and Indraprastha Gas. While these stocks are also vulnerable to a sharp correction in the markets, we expect healthy absolute returns over the next 12 months.

Figure 1: Valuation table

	Bberg	CMP (Rs)	12-month upside (%)	Mkt Cap (US$m)	P/E (x) (FY12)	EPS CAGR FY10-13ii	EV/ EBITDA (x) (FY12)	P/B (x) (FY12)	RoE (%) FY12
Amara Raja Batteries	AMRJ IN	171	64%	323	9.0	6.0	5.1	1.9	20.6
Bajaj Electricals	BJE IN	228	23%	491	11.5	21.6	6.6	2.8	24.7
Bajaj Finance	BAF IN	660	59%	534	7.3	69.7	NA	1.6	23.0
Emami	HMN IN	357	37%	1,197	18.3	26.2	15.5	5.6	33.8
Havells India	HAVL IN	348	36%	958	11.8	NA	7.9	4.8	48.2
HT Media	HTML IN	135	27%	705	14.2	28.0	5.9	2.0	14.3
Indraprastha Gas	IGL IN	305	31%	943	14.8	17.7	7.7	3.6	24.2
Pidilite	PIDI IN	136	25%	1,525	17.9	20.3	12.2	4.9	29.8

Source: Company, IIFL Research

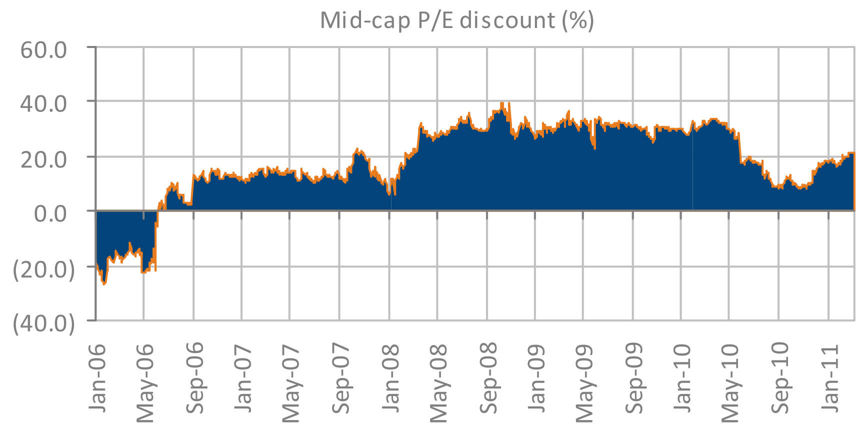
A time for stock-picking

Mid-caps have corrected more than large-caps

Mid-cap valuation discount far from its highs despite correction

The CNX Midcap Index has corrected 22.8% from its peak, while the Nifty has corrected 14.1%. The CNX Midcap Index is trading at 16.7x TTM P/E versus 21.04x TTM P/E for the Nifty. The valuation discount of mid-caps to large-caps at 20.7% is rather far off from the peak of 40% witnessed in the past five years. This means that while mid-caps have been sold down compared to larger peers in the current fall, the discount does not yet justify any basket buying, as absolute levels are not near a historical rock bottom. It will be beneficial to cherry-pick, in our opinion.

Figure 2: Discount to large-cap P/E remains high



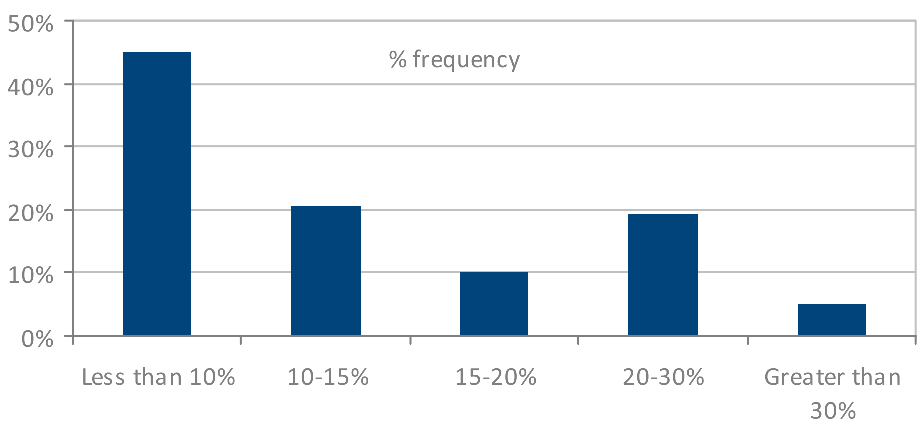
Source: Company, IIFL Research

Historical study suggests value in mid-cap stock picking

Value in bottom-up stock-picking

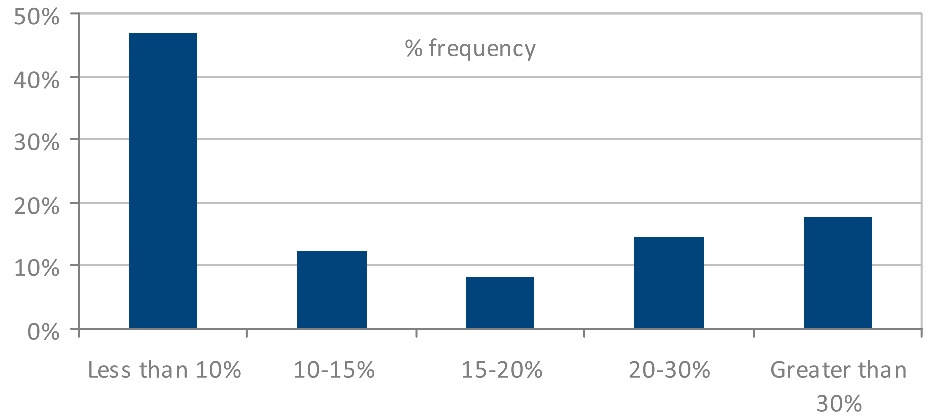
The Indian market has rewarded successful stock-picking in mid-caps handsomely through cyclical downturns (admittedly adjusting for survivorship bias). To understand this phenomenon, we study the 5-year (2006-2011) annualised return histograms of current BSE500 stocks with a market cap of more than Rs50bn in February 2006 versus stocks with a smaller market cap.

Figure 3: 5-year annualised return distribution of large-caps (2006 market cap >Rs50bn) (Sample size – 78 stocks)



Source: Company, IIFL Research

Figure 4: 5-year annualised return distribution of midcaps (2006 market cap <Rs50bn) (Sample size – 280 stocks)



Source: Company, IIFL Research

Mid-cap return distribution is more right skewed

From the above charts it is evident that the right skew (probability of asymmetric positive return) appears higher in the mid-cap group. This puts a premium on stock-picking in the mid-cap space. Also chances of a sub-10% return (which one can define as failure in the investment context) are remarkably similar across both groups.

Large success stories have common features

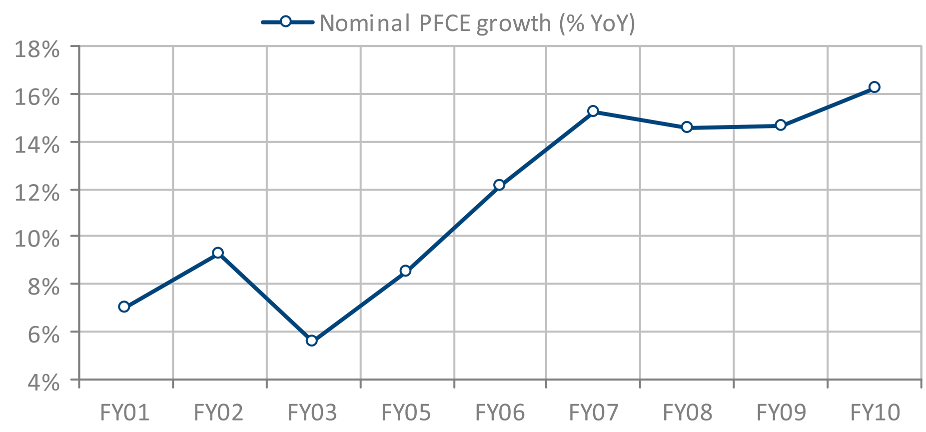
As far as success stories go, consider the examples of Shriram Transport Finance and Titan Industries that have delivered annualised returns of 47.5% and 34.2% over the last five years vs 13.1% for the Nifty Index. It is worthwhile to note that most such success stories have been dominant players in large opportunity spaces with a business model that has been profitable through cycles. They have also been typically entrepreneurial organisations.

Consumption unbound – a structural shift

Consumption growth to sustain at current trajectory

We believe that consumption growth in India is likely to sustain in the 14-18% band achieved in the last five years versus 5-10% achieved earlier. This will continue to be driven by faster income growth across the segments of the income pyramid, the demographic dividend, increasing media penetration and a significant uptick in rural consumption empowered by government schemes like NREGS.

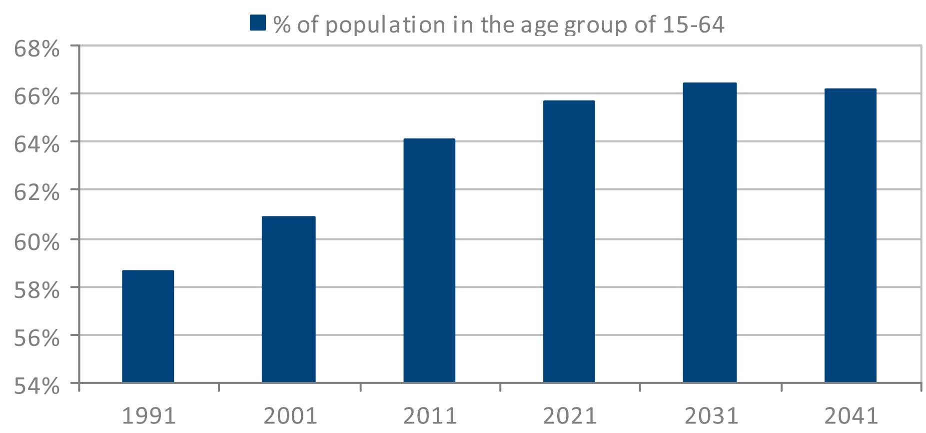
Figure 5: Nominal PFCE growth has sustained in the past 4-5 years



Source: Company, IIFL Research

India is a beneficiary of rising income levels across categories and a larger consuming class

Figure 6: India's population in the working age group is moving up

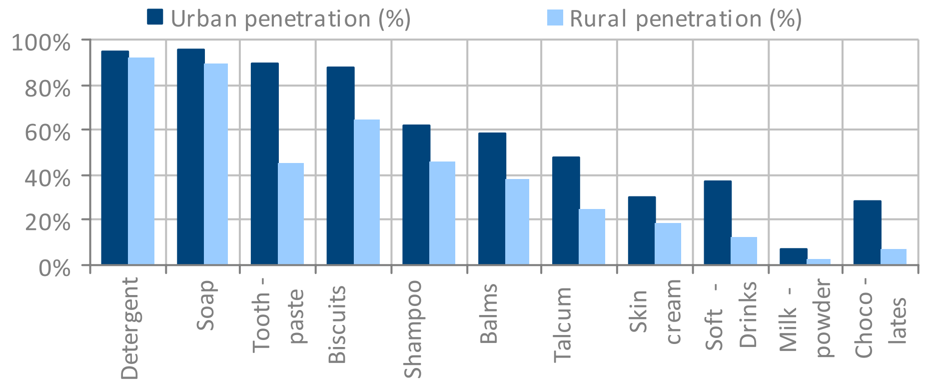


Source: Company, IIFL Research

Indian market has massive untapped potential

While the drivers for consumption growth are very strong, penetration and per capita consumption in India are very low in most personal care and foods categories. In most personal care categories, over 50% of Indians are yet to enter the consumption basket, and over 80% of Indians are yet to enter the foods categories. Even among present users, per capita consumption is very low when compared to other emerging markets. Skin care per capita consumption in India is 1/25th that of Thailand and 1/10th that of China. This gap in penetration and consumption will lead to the high growth opportunity in India over the next decade.

Figure 7: Penetration levels in personal care and foods are very low



Source: Company, IIFL Research

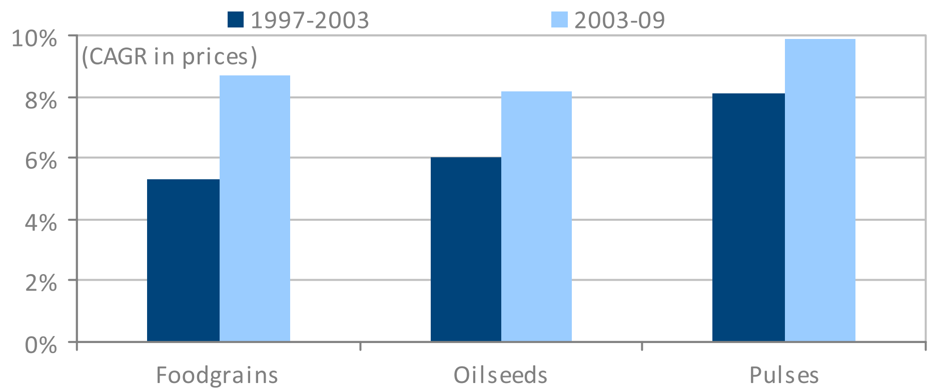
Rural market has been the key growth driver and will remain so

Rural markets are now a key contributor

The key driver for the shift in consumption growth has been the rural market, which forms c70% of India's population. Rural markets, which were earlier a laggard to urban market growth, have actually outgrown the urban markets in the past three years. The key factors that have led to this growth are: 1) strong price increases of agri commodities; 2) sustained investment by the government in rural income generation programmes like the National Rural Employment Guarantee Act (NREGA) and rural infrastructure; and 3) the increasing media reach in rural areas, which have created awareness. Consumer companies have also done their bit by bringing out low unit packs to generate trials among rural consumers and expanding rural distribution. We feel that the policy focus on such rural schemes is here to stay and there is much more capacity available in the distribution framework that consumer companies have created. These drivers should sustain the buoyancy in the rural economy.

Government schemes have helped rural prosperity

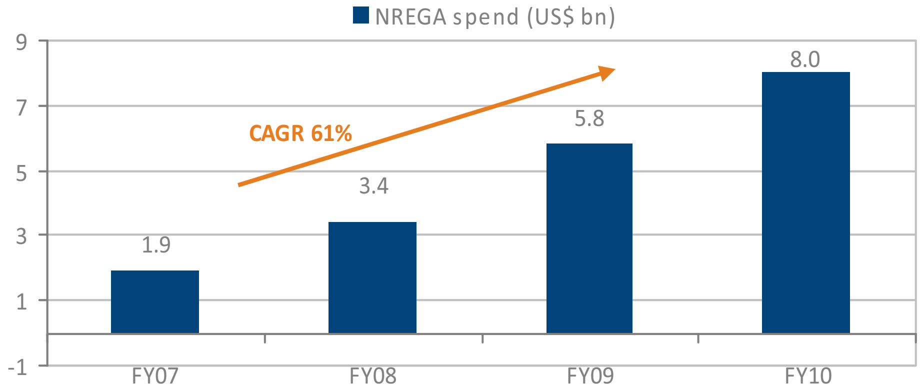
Figure 8: Agri commodity prices have risen much more in the past six years as compared to the previous 6-year period



Source: Company, IIFL Research

NREGA has been a growth driver

Figure 9: NREGA has been a driver for income growth in rural areas



Source: Company, IIFL Research

Eight investment ideas – criteria-based selection

Stocks selected based on their performance across the key criteria chosen

We highlight eight bottom-up stock ideas with a strong thematic opportunity, on the basis of our exploratory study on the BSE500 stocks that suggest serious value in successful mid-cap stock-picking**.** All our recommended companies in this report have the following factors in common:

- They represent a thematic opportunity that is sizable, and within that space, they have a dominant and profitable presence.
- They do not have stretched balance-sheets that are vulnerable to a liquidity squeeze.
- The manufacturing companies have significant pricing power to manage demand profitably in an inflationary environment.
- These are well-managed companies with the management bandwidth to make the most of the opportunity.

Stock picks suited to uncertain times

Key issues facing Indian equity markets today are:

- Interest rate hikes targeted at reining in inflation, thereby adversely affecting the indigenous demand environment.
- Worsening of corporate balance-sheets through a stretched receivables cycle, as liquidity worsens and it becomes more difficult to obtain debt.
- Squeeze on manufacturing margins from commodity price hikes that cannot be passed on fully.
- Worsening of fiscal deficit from a further rise in oil subsidies, as oil prices rise.
- Corporate governance issues coming to the forefront for multiple Indian companies.
- Slowing down on infrastructure orders from the government leading to margin destruction for existing projects.
- Possible stress on the banking system from the non-viability of various infrastructure projects.
- Clear slowdown in the investment cycle with industrials order flow slowing down.

Picks suited to the current uncertain environment

In spite of these uncertainties, we have recommended eight investment ideas that are smaller companies, as we believe these companies have business models that although not entirely immune to these stress points are strong enough to withstand the headwinds creditably.

Figure 10: Vulnerability evaluation matrix

	Demand slowdown risk	Leverage and vulnerability to rate hikes	Possible margin pressure risk
Amara Raja Batteries	Medium	Low	Medium
Bajaj Electricals	Low	Low	Medium
Bajaj Finance	Medium	Medium	Medium
Emami	Low	Low	Medium
Havells India	Low	Medium	Medium
HT Media	Low	Low	Medium
Indraprastha Gas	Low	Low	Medium
Pidilite	Low	Low	Medium

Source: Company, IIFL Research

Multiple examples of demonstrated pricing power

Pricing power should aid margin defence

Figure 11:Pricing power – few examples

Companies	Example
Amara Raja Batteries	Lead, which is the key raw material, is a pass through for Amara Raja in the auto OEM and industrial segments (which accounts for 80% of revenues for Amara Raja). In the remaining 20% (auto replacement) market there is a duopoly with both Exide and Amara Raja passing on raw-material inflation to customers (Amara Raja though typically increases prices only after Exide, which is the dominant player with a 70% share).
Bajaj Electricals	During 3QFY11, the consumer segment margins expanded 190bps YoY, despite 15-20% increase in raw-material costs.
Bajaj Finance	The latest rate hikes have been passed on (on the back of a 250bps hike in borrowing costs, the company has raised lending rates by about 200bps).
Emami	Raised prices in Fair & Handsome's sachet by 40% from Rs5 to Rs7 in 1QFY10 and yet saw volumes grow 15-20% in the segment. Dropped grammage in Navratna sachets from 3.5ml to 3ml in 4QFY09 and yet saw 15% volume growth in the next few quarters.
Havells India	The company has taken 15-20% price increases across categories in 3QFY11, as prices of key raw materials, copper and aluminum, hardened.
Indraprastha Gas	In 1QFY11, IGL hiked CNG prices by 26% post the government doubling the prices of domestic natural gas.
Pidilite	The company has taken 6-8% price increases in industrial chemicals and 3-4% in consumer and bazaar products as VAM (Vinyl Acetate Monomer, key raw material) prices inflated 20% YoY.

Source: Company, IIFL Research

Demand visibility a key selection criteria

Figure 12: Demand resilience – key arguments

Companies	Argument
Amara Raja Batteries	Given the healthy volume growth witnessed in the last five years, the replacement battery market will see continued traction for the next few years giving good viability on volumes from this segment. Even OE volumes are expected to remain strong, given the healthy growth in incomes and low penetration. Bulk of the telecom tower additions happened in FY07-08 and hence demand from this segment too should be healthy.
Bajaj Electricals	Since rural and semi-urban markets are the main drivers of demand growth for the company, with agricultural incomes remaining strong, we anticipate little dip in the volume offtake for appliances in these regions. Additionally, with the government having pulled its act together in semi-urban towns (if not in rural areas) in improving their access to electricity, infrastructure supporting the demand growth for appliance products should also support resilience in demand for their products.
Bajaj Finance	Demand for consumer financial services is driven by consumption growth and rising income levels. Both these remain as key drivers of the broader economy and hence demand for consumer lending should remain robust.
Emami	Emami's key segments draw c50% revenues from rural areas, where income growth has been very strong helped by rising agri commodity prices and government spending.
Havells India	Just as in the case of Bajaj Electricals, the company is a beneficiary of the electrification drive in rural areas and smaller towns.
HT Media	We expect ad-spend in the country to remain robust driven by strong consumption growth in the country. Further ad-spend of large categories like education and services among others will not be significantly impacted by external factors.
Indraprastha Gas	Cost economics for CNG as compared to liquid fuels (65% cheaper to petrol and 25% cheaper to diesel) makes it a natural choice for fuel, resulting in more demand for gas. Also penetration in new markets will result in higher demand. Availability of R-LNG to meet this demand along with the pricing power gives us enough comfort that IGL can meet our earning estimate of 18% pa over FY11-13ii.
Pidilite	Pidilite's key categories are consumer staples and quasi-discretionary whose demand is not likely to be significantly affected by a slowdown.

Source: Company, IIFL Research

Figure 13: Balance-sheet highlights – robust position

	Gross debt to equity (FY11)	Net debt to equity (FY11)	RoCE (%) FY11	RoE (%) FY11
Amara Raja Batteries	0.1	0.1	25.9	27.6
Bajaj Electricals	0.2	0.1	10.8	23.7
Bajaj Finance	5.3	5.2	5.1	19.0
Emami	0.1	-0.1	34.4	32.9
Havells India	1.9	1.6	26.6	50.0
HT Media	0.1	-0.4	17.0	12.5
Indraprastha Gas	0.3	0.2	23.3	25.1
Pidilite	0.3	0.1	29.9	31.3

Source: Company, IIFL Research

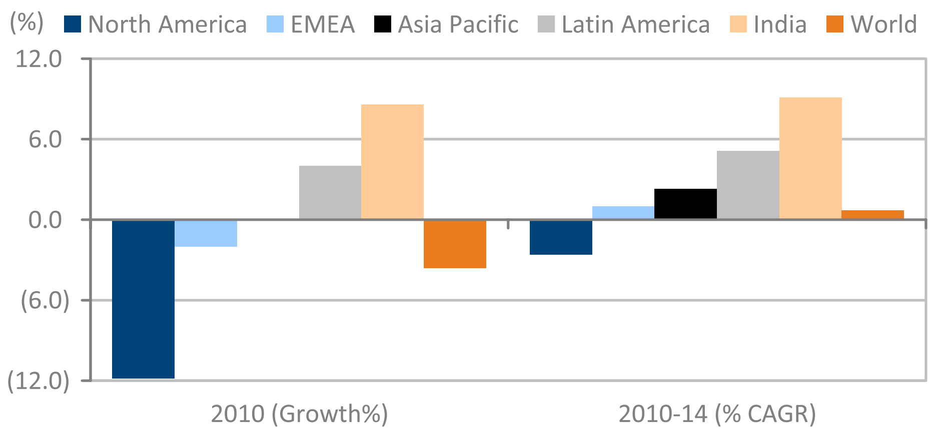
Other important trends we choose to ride

Robust print media expansion

Indian print media growth - a strong theme

The Indian print media industry is set for sustained growth and is likely to easily outshine the global print space over the next few years. A combination of social sector spending, employment schemes and the trickle-down effect of strong economic growth in urban India has buoyed semi-urban and rural economies. This has brought into the fold new advertisers in the form of small-scale and regional enterprises, and also resulted in more local content in newspapers. This new class of advertisers now accounts for more than 50% of advertisements in print media. Meanwhile, overall ad spends, at 0.41% of GDP, remains one of the lowest globally, and offers great scope for growth. This, combined with an uptick in print penetration from the current ~38% and rising literacy rates, sets the stage for Indian print media's multi-year growth story. We expect the regional print ad markets to maintain at least high-teen growth rates outpacing the 8-10% growth in English print.

Figure 14: Print media - across geographies



Source: Company, IIFL Research

Urban gas distribution

Gas outlook – supply boosted

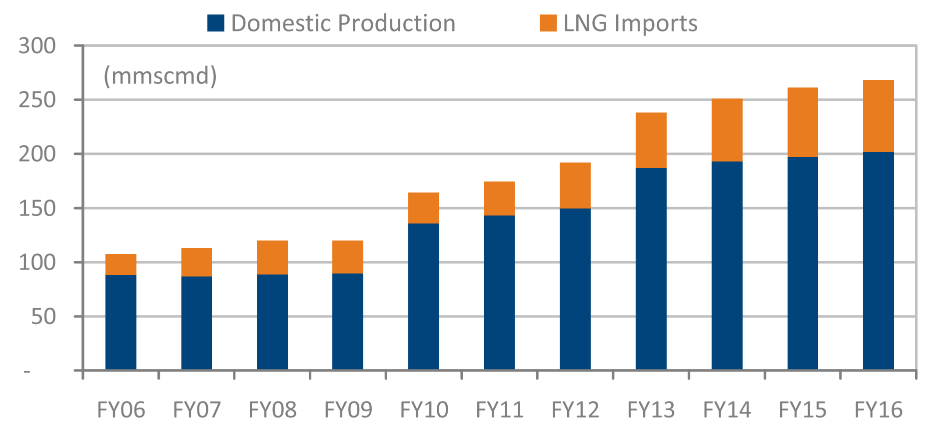
Gas consumption in India is set for structural growth, on the back of increasing supplies, an evolving gas pipeline network, and pricing reforms. New gas discoveries such as RIL's KG-D6 and GSPC's Deendayal fields have significantly improved India's gas supply outlook. Based on published development schedules, domestic gas availability is expected to increase at 7% annually over FY10–16. Including gas imports through LNG terminals of Petronet, Shell and

RGPPL, gas availability could increase to 270mmscmd by FY16 from 165mmscmd in FY10. A regulatory framework that defines expected return ratios for infrastructure developers has attracted investments from GAIL, RIL, GSPL and others—and this would quadruple India's gas transmission pipeline network from the current ~6,100km through FY16-17. This, clubbed with pricing reforms, should improve gas penetration among sectors other than power and fertilisers, which currently account for 60% of India's gas consumption.

City gas likely to be a significant demand kicker

Furthermore, the government's thrust on developing city gas distribution (CGD) will significantly expand the user base. Government plans to appoint 201 new operators through competitive bidding across India by 2015. Expansion of CGD networks will bring new users into the fold, such as small and medium industries, households, and vehicle owners. We also think that since CGD strikes a balance between economic and environmental imperatives, the government would continue to extend its support for a pan-India rollout. Average consumption of 0.20mmscmd per area by 2015 would lead to 40mmscmd additional demand from CGD operations, which is 25-30% of present consumption.

Figure 15: Gas availability to increase at 9% CAGR over FY10-16



Source: Company, IIFL Research

Consumer lending – a large opportunity

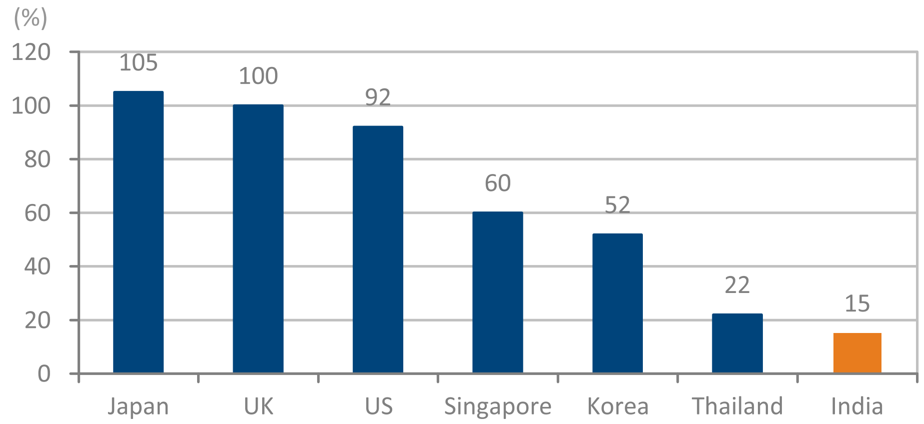
Unleveraged household balance-sheets

Consumer lending would remain an attractive segment given the low penetration of such lending. Consumer loans/GDP (excluding mortgages) at 7% suggests low leverage of households' balance-sheet. Consumer lending other than mortgages has been confined mostly to secured loans. Penetration of unsecured lending is low and offers huge potential, in our view. With consumption being a key growth driver for the economy, rising income levels and increasing sophistication of households would drive demand for consumer lending robustly over the long term. Ease of access to consumer finance, innovation and multitude of channels for distribution would enable lenders to capitalise on the evolving opportunity, in our view.

While the market opportunity is large, lenders have faced two key challenges in consumer lending: 1) achieving higher economies of scale; and 2) very large deviation in credit losses during cyclical downturn. Many lenders withdrew from the market as a result of negative operating leverage from declining volume and large credit losses impairing the profitability significantly during the previous downturn. Key to success includes creating strong technology platform for loan origination and administration, product diversification and strong credit culture within the organisation.

Consumer lending is still underpenetrated

Figure 16: Consumer loan penetration



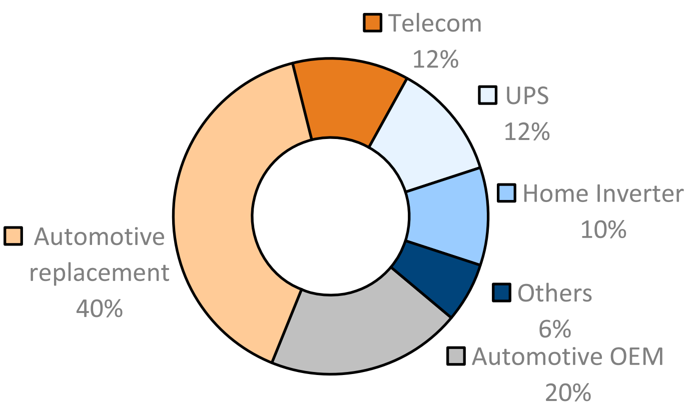
Source: Company, IIFL Research

A growing battery market

Battery market to report 12-15% CAGR over the next five years

The Indian battery market is estimated at Rs65bn and will register 12-15% CAGR over the next five years. Low vehicle penetration and rising incomes would drive healthy double-digit growth across segments in the auto industry. Meanwhile, the high-margin replacement segment is set for a surge, as strong growth in vehicle sales in the last few years (12% CAGR in five years) translates to replacement demand for batteries, and users increasingly opt for branded batteries. Margin expansion in the medium term would be driven mainly by a shift in market share in the replacement segment from unorganised battery manufacturers to organised ones. This shift will help expand battery manufacturers' margins for two reasons: 1) margins in the replacement segment are intrinsically higher than in the OEM segment; and 2) raw-material costs will fall as prices of scrap batteries come down.

Figure 17: Battery market break-up



Source: Company, IIFL Research

Summary of investment theses

Play on the growing battery market

Amara Raja (The Challenger): Amara Raja Batteries Ltd (ARBL) is the second-largest manufacturer of lead-acid batteries in India, with ~23% share by volume of the organised battery market. We estimate an earnings CAGR of ~30% over the next two years, driven by capacity expansion in the automotive and two-wheeler segments. In our view, concerns over its high exposure to the telecom sector are overdone, and ignore the company's strong performance in the automotive and UPS segments. On the telecom side too, there are initial signs of bottoming; we expect substantial improvement in this segment's revenues and margins in FY12. Valuations, at 9x FY12ii EPS, are attractive for a branded consumer company.

Consumer appliances major

Bajaj Electricals (Resilient rural growth play): Bajaj Electricals (BJE) is a leading player in consumer appliances, fans and lighting products, which together account for 55% of its revenues. The company enjoys an established brand franchise in India, with a market share of 20-30% in most of the consumer-durable categories in which it operates. It is well-placed to benefit from the potential 25%+ volume growth in consumer durables, driven by under-penetrated semi-urban markets. With the government's focus on rural infrastructure also remaining high, growth in sales of its industrial products too should stay high at over 20%+ annually. The stock is trading at 11.5x FY12ii EPS, and we reckon the 1-year-forward multiple should re-rate to 14x, given BJE's leadership position in a fast-growing market. We recommend BUY with a target price of Rs280.

Consumer finance and SME lending play

Bajaj Finance (Primed for a new phase): Bajaj Finance (BFL) is a play on the consumer and small business lending opportunities in India. Positioned initially as a consumer finance company, BFL expanded its scope to include opportunities in small businesses as well. BFL's competitive advantage includes strong parentage, favourable funding position, and an experienced senior management team. High asset growth, improving efficiency and a renewed focus on asset quality would drive 70% CAGR in earnings during FY10-13ii. Strong and sustainable earnings growth, rising ROE and an inexpensive valuation (P/B of 1.6x on FY12ii) makes BFL an attractive play, in our view.

Niche FMCG company; robust brands

Emami (The niche advantage): Emami is one of India's fastest-growing FMCG companies, with a unique product mix of leadership positions in niche segments such as 'cooling oils', pain balms and antiseptic creams. With minimal competition from large companies, Emami commands high pricing power, which would help it tide over commodity inflation. Growth in low-penetration core categories, product innovation and expansion in the international business will drive 24% earnings CAGR over FY10-13. Margin pressures and an expensive bid for Paras Pharmaceuticals have led to a correction of 24% in the past six months, which we believe is an attractive entry point into the stock.

Strong presence in electrical consumer goods

Havells India (Charged up): Electrical consumer-goods major Havells is a beneficiary of robust demand growth based on upgrading consumer preferences and increased construction activity in its key verticals—switchgears, lighting fixtures, consumer durables (fans) and cables/wires. Strong brands built through aggressive advertising strategy and extensive distribution networks are sustainable growth drivers. Consolidated leverage is set to decline, with its European lighting-fixtures acquisition Sylvania looking to breakeven in FY12, post restructuring. The stock's current P/E of 11.8 on FY12ii is reasonable, in our view, and our target price of Rs475 (ascribing zero equity value to Sylvania) indicates 36% upside. We retain BUY.

Well-entrenched print media house

HT Media (A 'fine' print): HT Media, a leading print media conglomerate, boasts of a strong product portfolio catering to the lucrative English and Hindi print markets. Well-entrenched leadership of its flagship dailies, *Hindustan Times* in English and *Hindustan* in Hindi in their respective legacy markets would enable it to capitalise on ad-spend strength. In the new markets, namely *Hindustan Times* in Mumbai and *Hindustan* in Uttar Pradesh we expect, its ad-revenues to surge, as its readership market share is nearing inflection. Having made peak investments in these markets, a strong operating leverage would come into play, leading to 34% earnings CAGR over FY11-13ii.

Play on urban gas distribution

Indraprastha Gas (Quality play on gas retailing): Indraprastha Gas (IGL), the sole distributor of gas in the National Capital Region (NCR), has extensive network penetration. This, we reckon, will enable it to maintain its monopoly in Delhi and pass on any increase in input prices, as reflected in the 32% increase in CNG prices since June 2010. IGL plans to replicate its network in markets adjoining Delhi—Noida, Greater Noida and Ghaziabad—where demand for gas remains strong. This, we reckon, will translate into a volume CAGR of 23% and earnings CAGR of 18% over FY11-13ii. Trading at 15x FY12ii EPS, IGL offers a quality play on gas retailing in India.

Strong brands in niche categories

Pidilite (Niche innovator): Pidilite Industries is a niche consumer and specialty chemicals player in India. It has pioneered multiple brands of national top-of-the-mind recall like Fevicol and M-Seal. Construction chemicals (primarily retail consumption) is the company's new growth driver, as legacy strengths remain in place for now mature categories like adhesives and sealants. This should drive ~16% revenue CAGR leading to 20.3% EPS CAGR over FY10-13ii. The stock is valued at 17.9x FY12ii P/E and offers 12-month upside of 25%. We recommend BUY.

Key risks

1. Generally the market position and dominance of smaller players is weaker than their larger peers. However, most of our featured stocks are dominant in their own niches. For example, Emami has over 65% market share in pain balms.

2. Pricing power and ability to negotiate with suppliers is generally higher in a large company than in a generic mid-cap. However, there are exceptions to this rule as each market niche has it own dynamics.

3. The bargaining power that the smaller companies enjoy in institutional and wholesale debt markets is lower and the vulnerability to a liquidity squeeze is higher (in terms of both cost and availability of debt).

4. Mid-cap companies often tend to be promoter-driven entities, where the number of highly qualified professionals is lower. This could prove to be a serious impediment to gaining and managing scale. A key criterion in our choice of investment recommendations is if the management is keen or not on divesting authority to a carefully chosen team that can take the company forward. In the case of Emami, for example, although outside managers are not in abundance, promoter managers themselves are qualified professionals.

Liquidity is an inherent risk

5. The biggest risk from the investment point of view in mid-caps is possibly liquidity risk. Typically the companies do not have adequate free-float and liquidity generally dwindles in a bear market as risk appetite falls. The key to investment in mid-caps is a long enough investment horizon to overcome the need for immediate liquidity in a distress situation.

Lower levels of disclosures

6. The level of disclosures in most mid-caps is lower compared to large-caps. Given the sporadic model of information dissemination, earnings shocks are more likely.

Figure 18: Valuation table

	CMP (Rs)	Mkt Cap (US$m)	Daily Volume (US$m)	P/E (x)		EPS CAGR (%) FY10-13ii	EV/ EBITDA (x)		P/B (x)		RoE (%)	
				FY11	FY12		FY11	FY12	FY11	FY12	FY11	FY12
Amara Raja Batteries	171	323	0.8	11.0	9.0	6.0	6.3	5.1	2.2	1.9	20.2	20.6
Bajaj Electricals	228	491	1.0	15.1	11.5	21.6	8.7	6.6	3.6	2.8	23.7	24.7
Bajaj Finance	660	534	1.0	10.3	7.3	69.7	NA	NA	1.8	1.6	19.0	23.0
Emami	357	1,197	2.0	23.3	18.3	26.2	20.3	15.5	6.9	5.6	32.9	33.8
Havells India	348	958	2.0	17.2	11.8	NA	10.0	7.9	7.1	4.8	50.0	48.2
HT Media	135	705	0.4	18.8	14.2	28.0	8.1	5.9	2.4	2.0	12.5	14.3
Indraprastha Gas	305	943	2.0	16.9	14.8	17.7	9.1	7.7	4.2	3.6	25.1	24.2
Pidilite	136	1,525	0.7	21.8	17.9	20.3	14.8	12.2	5.9	4.9	31.3	29.8

Source: Company, IIFL Research

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Companies

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CMP	**Rs171**
Target 12m	**Rs280 (64%)**
Market cap (US$ m)	**323**
Bloomberg	**AMRJ IN**
Sector	**Autos**

14 March 2011

52Wk High/Low (Rs)	226/138
Shares o/s (m)	85
Daily volume (US$ m)	0.8
Dividend yield FY11ii (%)	1.4
Free float (%)	47.9

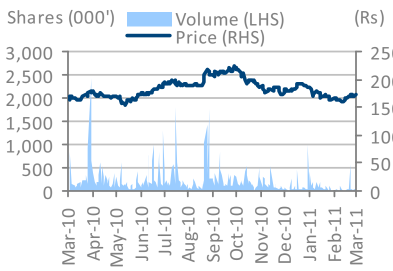
Shareholding pattern (%)

Galla and family	52.1
FIIs	2.4
DIIs	19.4
Public	26.1

Price performance (%)

	1M	3M	1Y
Amara Raja	5.5	0.1	5.2
Rel. to Sensex	3.0	6.9	-0.6
HBL Power	10.3	-18.2	-42.0
Exide	3.5	-18.0	19.0

Stock movement



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Amara Raja BUY

The Challenger

Amara Raja Batteries Ltd (ARBL) is the second-largest manufacturer of lead-acid batteries in India, with ~23% share by volume of the organised battery market. We estimate an earnings CAGR of ~30% over the next two years, driven by capacity expansion in the automotive and two-wheeler segments. In our view, concerns over its high exposure to the telecom sector are overdone, and ignore the company's strong performance in the automotive and UPS segments. On the telecom side too, there are initial signs of bottoming; we expect substantial improvement in this segment's revenues and margins in FY12. Valuations, at 9x FY12ii EPS, are attractive for a branded consumer company.

Capacity expansion will drive growth in the auto segment: Low penetration and rising incomes would drive healthy double-digit growth across segments in the auto industry. Meanwhile, the high-margin replacement segment is set for a surge, as the last few years' strong growth in vehicle sales translates to replacement demand for batteries. ARBL, which plans to increase its annual battery capacity for 4-wheelers from 4.2m batteries to 6m, and for 2-wheelers from 1.8m to 5m by October 2011, should be a key beneficiary.

Telecom segment on its way up: The telecom segment, which forms >20% of revenues for ARBL, after a sharp decline in the previous few quarters, is now improving on increased demand from replacement of telecom batteries. ARBL is running at full capacity on improved demand, and pricing too has bottomed out; the segment should witness a healthy 15% growth in FY12. ARBL is also planning to develop new markets outside India, especially in Africa.

Battery business holds great promise: The Indian battery market is set for strong volume growth and margins for the next 5-6 years. Margin expansion in the medium term would be driven mainly by a shift in market share in the replacement segment from unorganised battery manufacturers to organised ones. This shift will help expand battery manufacturers' margins for two reasons: 1) margins in the replacement segment are intrinsically higher than in the OEM segment; and 2) raw-material costs will fall as prices of scrap batteries come down.

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	13,330	14,730	16,973	20,939	24,521
EBITDA Margins (%)	12.5	20.3	14.2	14.2	14.6
Pre-Exceptional PAT (Rs m)	801	1,670	1,321	1,619	1,968
Reported PAT (Rs m)	801	1,670	1,321	1,619	1,968
EPS (Rs)	9.4	19.6	15.5	19.0	23.0
Growth (%)	-40.3	108.5	-20.9	22.5	21.6
IIFL vs consensus (%)			-0.2	-0.2	0.2
PER (x)	**18.2**	**8.8**	**11.1**	**9.0**	**7.4**
ROE (%)	21.7	35.2	22.1	22.5	22.7
Debt/Equity (x)	0.7	0.2	0.1	0.1	0.1
EV/EBITDA (x)	**11.4**	**5.7**	**7.3**	**5.9**	**4.7**
Price/Book (x)	3.6	2.7	2.2	1.9	1.5

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

Amara Raja Batteries Ltd (ARBL) is the second-largest manufacturer of lead acid batteries in India, with ~23% share of the organised battery market. Its association with Johnson Controls, the global leader in lead acid batteries, has made ARBL technologically advanced and thus enabled it to steadily increase its market share.

Capacity expansion at ARBL will drive growth

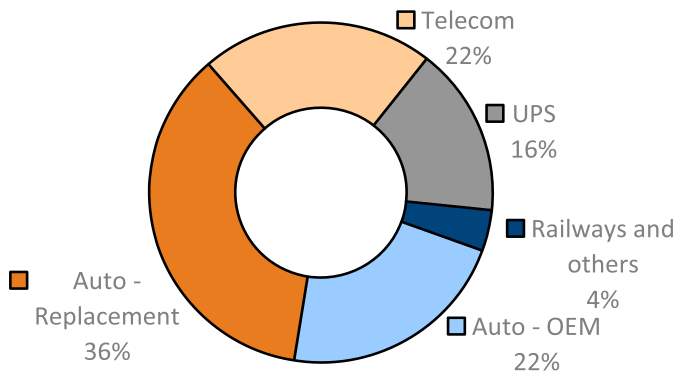
By the end of FY11, the company will have invested Rs220m on increasing four-wheeler battery production to 5.05m units per annum (from 4.2m), and Rs350m to increase two-wheeler battery production to 3.6m units per annum (from 1.8m units). In the second phase of expansion, to be completed by September 2011, the firm will invest Rs470m to raise its four-wheeler battery production capacity to 6m units annually and that of two-wheeler to 5m units.

Background

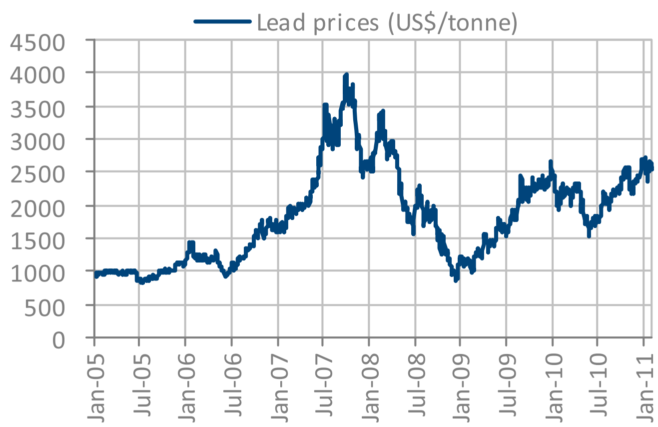
The company is a JV between Johnson Controls and the Galla family

Amara Raja started producing industrial batteries in 1992 after a technology transfer deal with GNB. It entered the automotive segment in 2000, after a tie-up with Johnson Controls in 1995. Furthermore, the automotive segment's contribution to ARBL's revenues has increased from zero in FY2000 to 30% in FY05, and further to 50% in FY10. Johnson Controls Inc (JCI) and the Galla family are joint promoters, each owning 26% of ARBL. JCI was first issued 23.8% shares in 1997, and increased its stake to 26% in 2001, via a preferential issue.

Amara Raja revenue break-up



Lead is the key raw material for Amara Raja



Management

Name	Designation	Remarks / management description
Dr Ramchandra Galla	Chairman	Electrical engineer from SV University, Tirupati. Has a master's degree in applied electronics (from Roorkee, India) and systems sciences (from Michigan State University, USA).
Jayadev Galla	Managing Director	Has a bachelor's degree from University of Illinois.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Volume growth (%)	22.04	28.75	18.00	18.00	15.00
Realisation change (%)	-4.14	-16.84	0.71	4.56	1.82
Gross margins	33.39	39.63	35.34	33.71	33.70

Source: Company data, IIFL Research

Capacity expansion to drive growth in auto batteries

ARBL, which started making automotive batteries in 2000, has garnered a share of ~25% by volume in both aftermarket and OEM batteries for passenger cars. The automotive segment's share of ARBL's revenues increased from zero in FY2000 to 30% in FY05 to 50% in FY10, and rose further to ~58% as at end-1HFY11.

Amara Raja offers batteries with higher power and higher warranty life at the same prices as Exide's

ARBL has positioned itself directly against market leader Exide, by offering batteries with higher power and higher warranty life at the same prices as Exide's batteries. Apart from its Amaron brand, ARBL sells aftermarket batteries to private-label manufacturers such as Bosch, Lucas and AC Delco.

As of March 2011, ARBL's annual production capacity for four-wheeler batteries: 5.1m units; two-wheeler batteries: 3.6m units

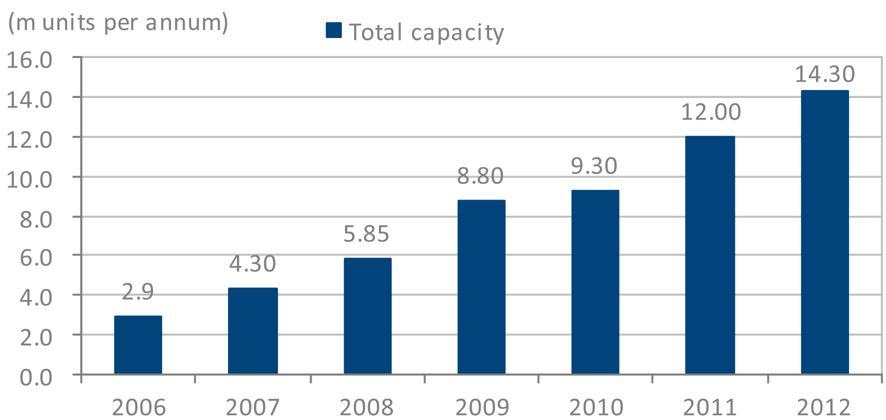
The company's annual production capacity is 4.2m four-wheeler batteries and 1.8m two-wheeler batteries. In March 2011, its annual production capacity for four-wheeler batteries will increase from 4.2m units to 5.1m units and for two-wheeler batteries from 1.8m units to 3.6m units. By September 2011, annual production capacity will increase further to 6m four-wheeler batteries and 5m two-wheeler batteries. The company's capacity utilisation for both classes of batteries is currently running at over 90%.

ARBL sells only VRLA batteries for two-wheelers. As OEMs are often reluctant to adopt new technology, which is often relatively expensive, ARBL sells its entire output of 1.8m units in the replacement market. The two-wheeler battery replacement market has seen a strong surge in demand in the last 2-3 years, thanks to the advent of self-start vehicles. Earlier, two-wheeler batteries were used to power only the lights and horn, so batteries were often not replaced even after they had died down.

ARBL will supply batteries to Honda and Bajaj Auto in 2011-12

ARBL's 3.6m-unit capacity will also be used solely to cater to the replacement market. In addition, the company is developing a two-wheeler VRLA battery for Honda, to be used for its vehicles in India as well as abroad; capacity beyond 3.6m units will be used to make batteries for Honda. ARBL will start supplying batteries to Honda in 2012. It will also start supplying batteries for Bajaj Auto's high-end bikes (KTM brand) by end-2011.

Figure 19: Significant capacity expansion planned



Source: Company, IIFL Research

Duopoly structure results in pricing power for both players

Exide and Amara Raja together account for ~95% of the organised automotive battery market. As the large presence of the unorganised segment indicates, automotive batteries are not very technologically demanding to make. The barrier to entry in this business is brand franchise, and ARBL has worked hard to build the Amaron brand in the last ten years.

Exide and ARBL have by and large refrained from aggressive price competition…

Whilst Exide is clearly the market leader, ARBL, through its positioning as a "technology leader" has established a strong brand franchise. ARBL has emerged as the second-largest player in the segment, and has garnered 30% share in both the auto OEM and replacement market. Both players have by and large refrained from aggressive price competition, because the market is virtually a duopoly.

… However, capacity constraints led Exide to make price cuts in January 2011

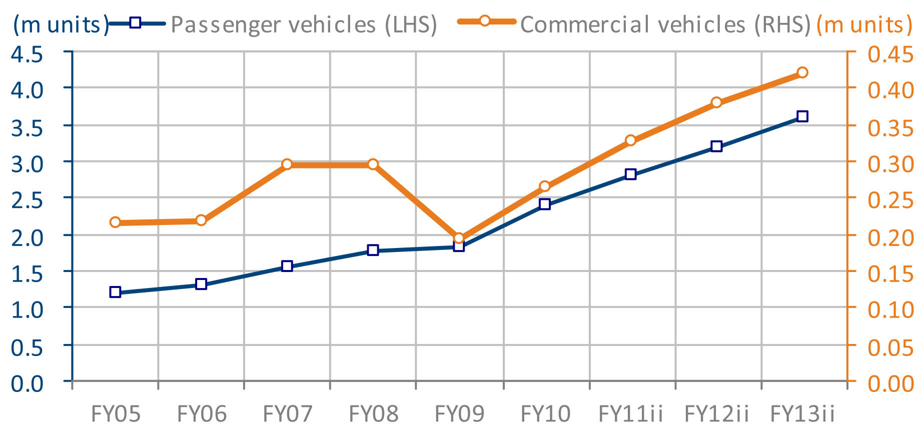
This duopoly was temporarily disrupted in January 2011, when Exide cut prices of its batteries by 4%, in spite of an increase in lead prices. Exide's price cut was prompted by a need to stem the previous few quarters' market share losses in the replacement segment caused by capacity constraints. Normalcy has since been restored, with Exide increasing prices by 5% from mid-February 2011. Exide's dominant position in the market makes it not only the price-setter, but also makes it the most susceptible to any excessively aggressive pricing by competitors.

Low penetration and rising income levels augur well for growth in auto sector

Healthy volume growth in the auto sector augurs well for ARBL

With India emerging as a small-car production hub, passenger-car production in India is set to increase at over 15% annually in the next five years. Robust growth in the rural economy will drive a >12% CAGR in two-wheeler sales as well. As such, we expect volume growth in the OEM segment to remain healthy. Whilst Exide is the dominant player with OEMs, most of them want to diversify their vendor bases. Hero Honda's production was adversely affected recently when Exide, which is currently the company's sole supplier of batteries, had a strike. Hero Honda is therefore likely to appoint ARBL as a second supplier.

Figure 20: India is emerging as a hub for small-car production in the region



Source: SIAM, IIFL Research

Based on last few years' record, we expect low double-digit growth in replacement demand in the coming years. Growth would be further boosted by a shift in volumes from the unorganised segment to the organised segment. Unorganised players' market share in the replacement segment is ~90% in commercial vehicles (CVs), 50% in two-wheelers and ~10% in passenger cars.

Improved distribution to drive further growth

Whilst Exide follows a direct distribution strategy—it has around 3,000 direct dealers and 3,500 indirect dealers—ARBL uses a franchisee model. ARBL has 200 franchisees who service 18,000 retail outlets. This was a good model to follow in the initial phase, as it enabled ARBL to expand quickly while extending credit to only about 200 franchisees and not to over 5,000 dealers (this made the task of collecting money easy). Going forward, ARBL plans to use the direct dealer model in some cases where the franchisee model has not been effective.

ARBL plans to tie-up with new franchisees in the north, west and south of India

Also, the eastern part of the country, which is a stronghold for Exide (since it is based in Kolkata), is weak in terms of distribution and is a focus area for ARBL. It also plans to tie-up with new franchisees in the north, west and south, as some of its current franchisees are now constrained by credit and hence are unable to scale up the business as well as ARBL would like them to. The new franchisees would help ARBL penetrate deeper into the existing territories.

Johnson Controls gives ARBL the technology edge

The tie-up with Johnson Controls gives ARBL access to the latest battery technology

Johnson Controls, which owns 26% in ARBL (in which it also holds board seats), is the global leader in lead acid batteries for passenger cars, light trucks and utility vehicles, in addition to being the leading independent supplier of hybrid systems. ARBL has been a technology leader in the Indian market, having introduced VRLA batteries for the first time for industrial applications and two-wheelers. In the automotive segment too, ARBL was the first to introduce batteries with 5-year warranties. The tie-up with Johnson Controls gives ARBL access to the latest battery technology. Furthermore, Johnson's eminence in the hybrid space would be an asset for ARBL as and when this technology picks up in India. The presence of Johnson Controls also gives comfort on the various related-party transactions that ARBL has with its sister companies, as Johnson Controls carries out a quarterly internal audit.

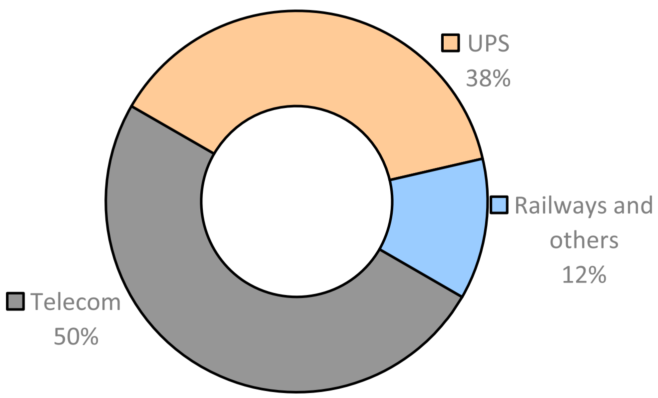
Telecom, a sore point in the industrial space, is bottoming out

Telecom's share of ARBL's revenues will fall to 45% in FY11 (from 65% 18 months ago), given the slowdown in the telecom segment

ARBL made its entry into the industrial segment with batteries for telecom towers. It was the first to introduce VRLA (valve-regulated lead acid) batteries in the Indian market. The telecom segment's share of ARBL's revenue has fallen from 65% 18 months ago to 50% now. We expect it to fall to 45% in FY11, given the slowdown in the telecom segment and robust growth in the automotive segment.

ARBL makes three kinds of batteries for the industrial market: large VRLA batteries that form essential infrastructure for telecom companies and railways, etc; and medium VRLA batteries used in UPSes.

Figure 21: Mix of the industrial segment



Source: Company, IIFL Research

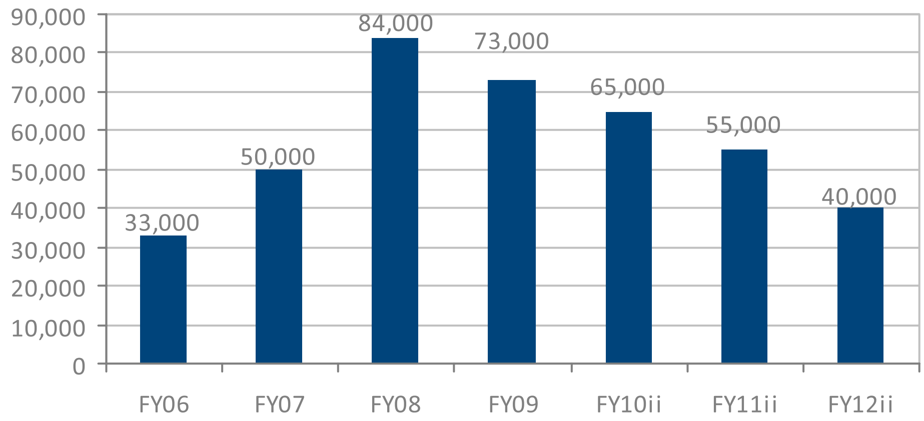
Demand having bottomed out, has started to pick up, with an increase in capex for 3G

Telecom segment is close to bottoming out: Demand from telecom towers, which account for 30% of the industrial segment's demand, has moderated in the last few quarters. About a year ago, demand was for 2,000m Ah (ampere hours), and the company set up a 2,500m Ah production capacity in view of the demand growth outlook. But demand has shrunk to 1,400m Ah, and the resultant supply excess caused a sharp fall in prices of batteries. In 1HFY11, battery prices declined by ~15% (adjusted for fluctuations in lead prices), but pricing has been improving from 3Q onwards. Demand too has now bottomed out, and has started to pick up, with capex for 3G beginning to rise. With 3G capex set to increase, demand should increase further. Moreover, replacement demand for towers should also pick-up in FY12, as tower additions had accelerated 3-4 years ago.

Management expects 15% growth in telecom revenues in FY12

It seems there is a base being set for prices. In a recent tender by a large tower company, none of the established players in the telecom batteries segment bid, as reserve prices were unacceptably low. ARBL had not bid in any tenders in the previous quarter either, and hence had a sharp fall in telecom revenues. But with some pricing discipline beginning to set in, the company will start bidding for orders now, so telecom segment revenues should improve from 4Q onwards. Management expects 15% growth in telecom revenues in FY12, as it expects demand to increase in the months ahead on account of an increase in replacement demand in addition to an increase in telecom capex on account of 3G. Management also said that another reason for a slowdown in telecom demand has been tower-sharing, but with efficiencies from sharing towers now largely fructified, tower companies will have to add more towers.

Figure 22: Telecom tower additions



Source: Company, IIFL Research

We expect margins to start improving from 3QFY11

In addition, production capacity set up for telecom batteries can be modified at a modest expense to produce UPS batteries, for which demand is strong. With some capacity conversion, demand-supply equilibrium could be established faster than expected. Weakness in the telecom segment has resulted in margin pressures for ARBL in the last 2-3 quarters. With the pick-up in demand and some capacity conversion, we expect 2QFY11 to mark a bottoming-out in the telecom segment, and margins to start improving from 3QFY11.

UPS demand remains healthy; we expect ~20% growth

UPS batteries are primarily sold to OEMs, to be placed in UPS systems for home and industrial use. End-users of UPS systems include banks, companies, governments and individuals. The primary function of a UPS system is to provide uninterrupted flow of power to electronic equipment such as computers, and to minimise the impact of power surges and power outages.

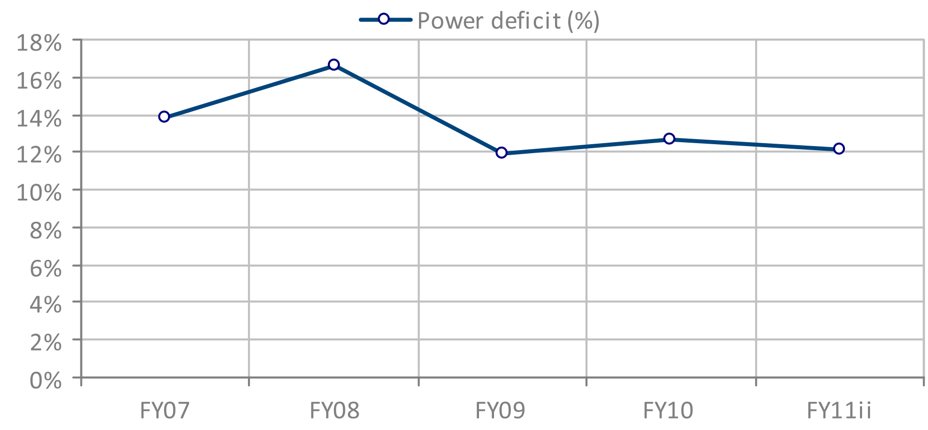
UPS battery demand grew at 15% annually in the last five years

Large-scale computerisation of banking networks and government departments, strong growth in the IT sector, and increasing demand for data services catalysed UPS sales. Hence, battery demand in this segment grew at 15% annually in the last five years. Demand for UPS batteries will continue to be driven by addition of high-powered data centres in telecom, IT, BFSI and government sectors, continued growth in the number of ATMs, and massive government-funded projects such as Accelerated Power Development and Reform Program (APDRP), and National e-Governance Plan (NeGP).

Demand for inverters has increased owing to continued power shortages and lack of reliable power

Inverters are used as back-up power supply systems by both residential users and industrial plants. Unlike UPS batteries, inverters are used standalone by end-users. Inverters are similar to UPS systems, but need lead time to begin supplying power. Continued power shortages and lack of reliable power in the country have led to a surge in demand for inverters.

Figure 23: Power deficit remains high



Source: IIFL Research

Margins in the home inverter segment have dropped owing to increased competition

ARBL is not a big player in the home inverter segment

The other large segment in industrial batteries is the home inverter segment, in which too, Exide is the dominant player. The home inverter business is a seasonal one, in which demand peaks during the summer months (March-June). Margins in this business were very high a few years ago, but have since dropped sharply with the emergence of competitors such as Su-kam and Luminous. Furthermore, demand growth has slowed down as availability of grid power has improved across the country. Exide reported weak results in 3QFY11, owing to a decline in demand and margin contraction.

Structural drivers for replacement segment growth in place

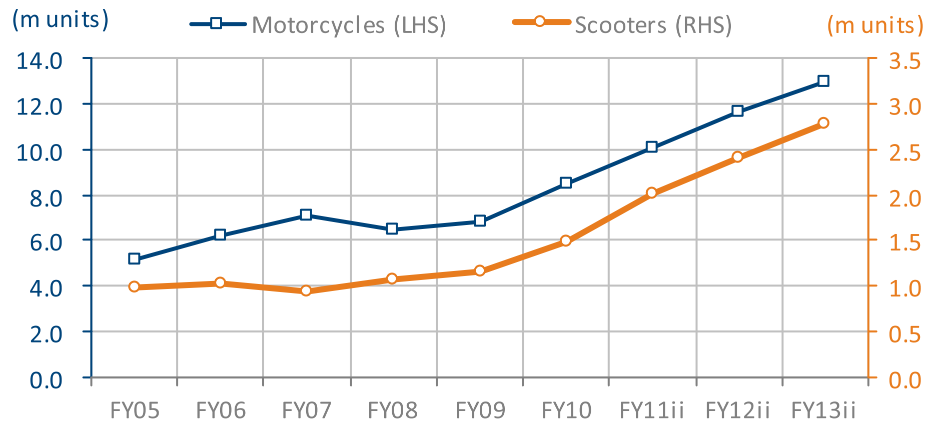
Demand for high-quality batteries is driving a shift from unorganised manufacturers to the organised segment

Advent of self-start vehicles is boosting a shift in the two-wheeler segment: The advent of self-start two-wheelers has boosted demand for high-quality batteries, which unorganised manufacturers are unable to produce. This is driving a shift in the replacement segment from unorganised manufacturers to the organised segment.

Increasing sales growth in scooters and motorcycles will be beneficial for the replacement segment

Growth in sales of ungeared scooters has accelerated in the past couple of years, as increased employment among women has spurred demand for unisex vehicles. Sales of ungeared scooters have risen at 33% annually in the last two years—faster than sales of motorcycles. In motorcycles too, the mix has shifted from entry-level models to the 'executive' segment, in which most models have the self-start feature and the 'premium' segment, in which models with higher cc engines and more features need better batteries.

Figure 24: Sales of motorcycles and scooters are set for continued growth



Source: SIAM, IIFL Research

ABRL and Exide are focussed on gaining market share from the unorganised segment

Eliminating franchisees in the distribution network is helping battery manufacturers compete with the unorganised segment: In the replacement market, which offers the highest margins, both ABRL and Exide are focussed on gaining market share from the unorganised segment rather than competing with each other on price. This is true especially in the CV segment, where the unorganised players have 90% share. Batteries in the four-wheeler and two-wheeler segment are sold to franchisees, who in turn distribute them to over 18,000 retailers, who stock several brands.

Companies are directly selling to dealers and are passing on the savings to the customers

Now, both Exide and ABRL are trying to eliminate franchisees from their CV battery distribution networks. Companies are directly selling to dealers, who set up exclusive shops and sell directly to customers. By eliminating franchisees from the distribution chain, they save the 12-13% margin that would otherwise accrue to the franchisees. This saving is passed on to customers, and helps these companies compete effectively against the unorganised segment. Though the cost structure of the organised segment is superior to that of the unorganised segment, unorganised players' avoidance of excise and sales tax enables them to sell their batteries at a cheaper price.

Amara Raja's exclusive outlets, branded 'Powerzone' stores, are used mainly to sell batteries for use in CVs and tractors. With the company's expanding product range, it should be useful for two-wheeler batteries and inverter batteries as well.

Garnering share from unorganised segment will lower raw-material costs as well: The unorganised sector is a big demand driver for scrap batteries. Although the Government of India, via the Batteries (Management and Handling) Rules 2001, has made it mandatory for dealers to obtain old batteries from customers when they sell new batteries and to maintain proper records and file half-yearly returns, implementation of these rules remains loose. Dealers continue to sell scrap batteries to unorganised manufacturers, who readily pay higher prices for the batteries, as that is their only source of raw material.

We expect scrap-battery prices to fall in the medium term, leading to a fall in prices of recycled lead

This results in higher scrap battery prices, and increases the price of recycled lead. Globally, scrap batteries are sold at junk prices, and hence recycled lead is significantly cheaper, and accounts for ~85% of the battery industry's lead usage. In India, the share is significantly lower, but with the two largest players focussed on increasing their market share from the unorganised segment and increasing use of recycled lead (Exide, for one, has recently acquired two lead smelters), we reckon scrap-battery prices will fall in the medium term, leading to a fall in prices of recycled lead.

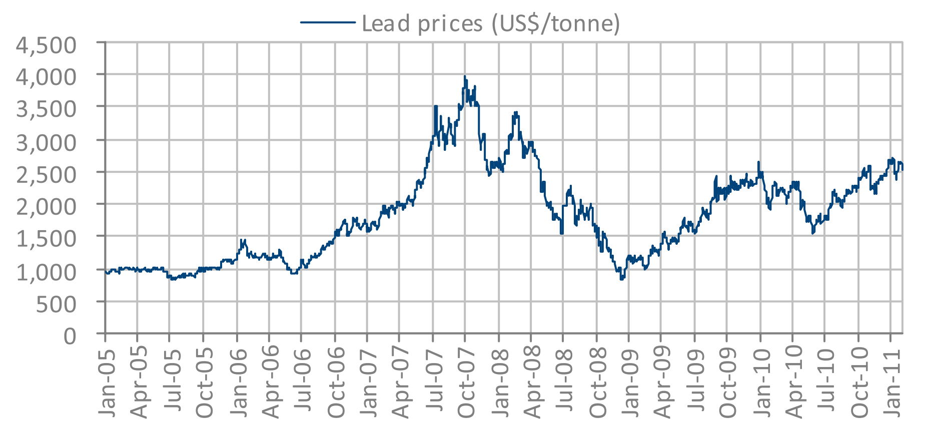
Risks

Prices of lead, a key raw material, are volatile
Lead accounts for ~75% of ARBL's total cost of production and ~65% of its net sales. The company sources 15–20% of its lead from third-party smelters, 30% from domestic lead suppliers and imports 55% of its lead requirement, largely from Australia and Korea. Its imports are dollar-denominated and the company hedges 50% of its currency risk.

Lead prices reached a peak of US$3,890/tonne in October 2007 and then fell to below US$1,000/tonne in January 2009

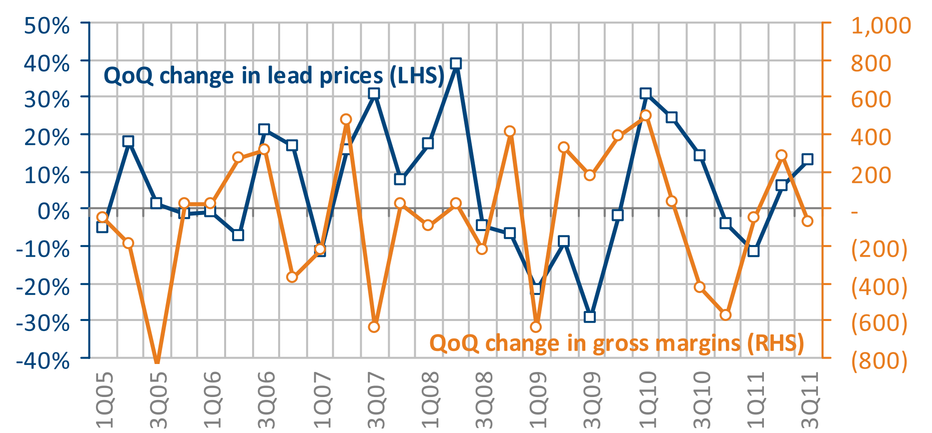
The company has built-in clauses in its contracts to pass through any lead-price fluctuations to its OEM customers and large corporate industrial customers. For auto OEM customers, increases in cost of lead are passed on with a one-quarter lag. In sales to industrial retail customers and replacement sales, on the other hand, the company bears the raw-material risk. Lead prices have been very volatile in the past few years, reaching a peak of US$3,890/tonne in October 2007 and then falling to below US$1,000/tonne in January 2009.

Figure 25: Lead prices are in a comfortable zone for battery manufacturers



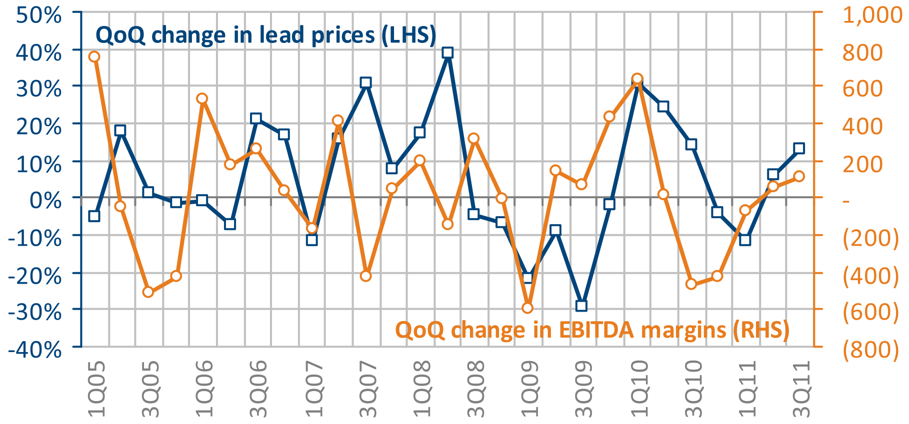
Source: Bloomberg, IIFL Research

Figure 26: Lead prices and gross margins



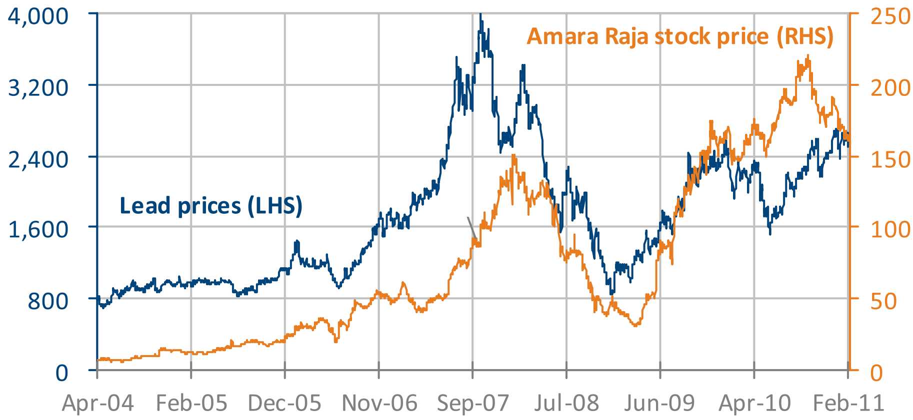
Source: Company, IIFL Research

Figure 27: Lead prices and EBITDA margins



Source: Company, IIFL Research

Figure 28: Lead price and ARBL stock



Source: Company, IIFL Research

Lead sourced from smelters is 5–6% cheaper than that sourced from outside

ARBL currently sources 20–25% of its requirement from smelters

Lead smelters can help reduce volatility

ARBL's margins are more sensitive to lead prices than Exide's margins, as Exide now sources ~50% of its raw-material requirement from its own smelters. Exide has acquired a couple of lead smelters, and after expansion in those smelters, it sources 50% of its lead requirements from its captive smelters. Lead sourced from smelters is 5–6% cheaper than that sourced from outside; besides, lead scrap prices are stickier when compared to LME lead prices.

Lead-smelting operations in India are not as safe and environment-friendly as global standards require them to be. Hence, Johnson Controls, which is on ARBL's board, is not keen on ARBL acquiring smelters in India. But ARBL is in the process of increasing its collection of scrap batteries and is tying up with smelters for sourcing more of its own needs from these smelters. It currently sources 20–25% of its requirement from smelters.

Increased competition

Increased competition has already resulted in a sharp decline in margins in the telecom segment, where new players such as HBL Power have sharply cut prices to maintain their market share. But the automotive segment is not as easy to enter as the industrial segment—in the OEM automotive space, margins are very thin, and OEMs are wary of trying new players. Hence, any new player has to start with the replacement segment, where the highest barrier to entry is brand franchise. Any new player would have to invest time and money to make a mark in this segment.

Figure 29: The battery space could get very competitive in the future; there are a number of players who want to emerge as a credible number 3 in the next 2-3 years

Competitor	Segments	Comments
AMCO	Two-wheelers, four-wheelers	Strong in the two-wheeler segment. Market leader in the OEM two-wheeler space. Also has a presence in the four-wheeler replacement market for batteries.
HBL Power	Industrial	HBL is a very competitive player in the industrial battery segment, especially the telecom segment. The company plans to enter the automotive segment in the next two years.
Minda	Two-wheelers, four-wheelers	Minda has tied-up with Italian firm Fiamm SpA to sell batteries in India. The company plans to leverage on its automotive relations to gain a foothold in the market.
Tata Autocomp	Four-wheelers	50:50 JV with GS Yuasa International, which started production in December 2006. Currently catering only to the replacement market. Once the planned capacity expansion in December 2008 comes on stream, they could start supplying to Tata Motors, to which Exide is currently the sole supplier for a number of products.

Source: Company, IIFL Research

Attractive valuations — BUY

ARBL is currently trading at a one-year forward PE of 9x as against Exide's 16x

ARBL is currently trading at a one-year forward PE of 9x. For comparison, Exide is trading at a one-year forward PE of 16x, a >50% premium to ARBL. In the last five years (FY05-10), ARBL's revenues have grown at 44% annually, driving an 81% CAGR in profit. During the same period, Exide's revenues have grown at 26% annually, driving a 48% CAGR in profit.

Our target price on Amara Raja is set at 12x one-year-forward PE (FY13 EPS of Rs23), which translates into a PE of 14.8x on FY12ii EPS of Rs19.

Figure 30: We expect the discount between Amara Raja and Exide to narrow

Source: Bloomberg, IIFL Research

Appendix

Jayadev Galla

Enterprising India 2 - Excerpts from IIFL's interview with Jayadev Galla, MD, Amara Raja Batteries

Jayadev Galla knows a thing or two about batteries, and he wants to make sure they don't just sit there under the hood, unsung and uncelebrated. Batteries are a "low–involvement" category, but Mr Galla's Amara Raja is changing that through its witty advertising, technological innovations and smart distribution. Amara Raja has done what some of the largest global battery players were unable to do—shake off Exide's monopoly to garner 25% market share in the automotive battery business. The result: Amara Raja's revenues have grown at 40% annually and profits at 80% annually over the last five years.

Mr Galla joined his father's firm, Amara Raja Batteries, in 1992, after completing his studies in the US and learning the ropes of the battery business through a two-year stint with GNB Technologies (technology partner in his father's firm). He was instrumental in getting Johnson Controls on board, and masterminded the company's entry into the automotive business.

He believes Amara Raja can grow annual revenues to US$1bn in the next five years, as growth in the automotive segment will be supplemented by growth in UPS, two-wheelers (an area the company has recently entered) and entry into home inverters.

You started with the telecom segment; any particular reason?
We pioneered VRLA technology in the country. We saw telecom as a segment with huge volumes; it was also a segment where internationally it was proven that VRLA batteries were better suited. So we started with the telecom segment, we introduced this system to the Department of Telecommunications (DoT). Apart from dealing with the bureaucratic mindset, we had to provide a lot of service and technical capabilities to ensure the success of the product. We worked with them in defining the specifications for these batteries, testing samples etc, before they came out with tenders.

How did the JV with Johnson Controls materialise?
We had grown to about Rs2 billion in revenues on the industrial side, and with growth stabilising, we were getting restless. At the same time, we saw Exide entering the industrial VRLA space, so we made the decision that to continue growing, we will have to enter the automotive space. We looked at various partners and decided that Johnson Controls, which was the leader in the automotive space, was the best partner for us. Having worked with a technology-licensing arrangement with GNB, we were clear that we needed somebody who was willing to look at this as an owner, and hence we got them as an equity partner in our company.

What is the arrangement with Johnson Controls for technology; do you pay them a royalty or a one-time fee?
There is no royalty or a long-term fee. On the industrial side of the business, we were big players even before their entry, so there is no royalty; but on the automotive side, we had some royalty for a period, not a large amount (there is no royalty now). They have an equal representation on our board; we have two family members, two members from JCI and five independent directors. They review

all inter-group transactions on a monthly basis to ensure that they are fair.

How did you break Exide's dominance in the Indian market?
We realised that there were a number of players who came in with better technology than Exide but still could not succeed because they failed in distribution. When I say distribution I mean collections—people were not able to collect money, as Exide would start giving huge credits to these distributors, who would demand the same from the new entrants, who were not able to do that. So we decided to adopt a different distribution strategy. Exide has some 4,500 direct dealers and about 3,000 indirect dealers, so they have 7,500 dealers. But we have only 200 franchisees who service 18,000 retailers. On our part, we deal with only 200 franchisees who give credit in the retail market, and that is how we were able to survive.

You were the first player to really focus on building a brand.
Again, we knew Exide's other big strength was its brand, and we needed a brand to compete against a brand. It may take us some more years to become a stronger brand than Exide, but our brand recall right now is pretty good.

Given that margins in the replacement market are so much higher, why do the OEM business at all?
Globally, the OEM business has lower margins and the difference in India is much more stark and similar to Japan. This is not surprising, given the influence of Japanese manufacturers in India. But given that this is a low-involvement category, the replacement buyer usually goes with the battery that is already under the hood, so one has to be present in the OEM business as well. This buying behaviour is gradually declining as more and more brands have started to advertise.

What is your outlook on the telecom segment?
The telecom-batteries business globally is a cyclical business—and in India, the cycle is pretty close to its bottom. Demand should recover on upgradation in technology and replacement of old batteries. One big reason for this slump has been the sharing of telecom infrastructure, but with most of that efficiency being realised, I believe the worst is behind us, and demand should recover soon. Margins have to improve because current margin levels are just not sustainable. We are also looking at making some of our telecom capacity more flexible so that it can be used for other segments.

What's your strategy against the unorganised segment?
Our strategy has always been to launch products that nobody else has and thereby create a unique positioning in the market. To compete against the unorganised segment, we have launched Powerzone outlets; these are not franchises, but exclusive retail outlets. We have opened around 700 such outlets in tier II and tier III towns, and we plan to expand these to 1,200 outlets by 2012. We save on the franchisee margins in this model and that helps us compete on price against the unorganised segment.

Where do you see the company in the next five years?
I think India itself is a huge growth story, so we would like to expand our footprint in India both in terms of getting into new types of batteries and new applications, but we would also like to expand our global footprint. We would then like to benchmark ourselves against a different set of peers rather than benchmarking ourselves against only the domestic players. I would like to scale the US$1bn revenue mark in the next five years.

Financial summary

Revival in telecom segment will boost revenue in FY12

Capex to go up as the company aggressively expands capacity

Higher exposure to replacement market will help EBITDA margins

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**13,330**	**14,730**	**16,973**	**20,939**	**24,521**
EBITDA	1,673	2,991	2,414	2,979	3,570
EBIT	1,327	2,561	1,979	2,423	2,935
Interest expense	-196	-68	-46	-46	-36
Others items	92	53	68	75	83
Profit before tax	**1,223**	**2,546**	**2,002**	**2,453**	**2,982**
Tax expense	-422	-876	-681	-834	-1,014
Net Profit	**801**	**1,670**	**1,321**	**1,619**	**1,968**

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	1,327	2,561	1,979	2,423	2,935
Depreciation & Amortization	346	430	435	556	636
Tax paid	-714	-410	-841	-681	-834
Working capital change	1,002	-423	-487	-882	-794
Operating Cash-flow	1,961	2,158	1,086	1,416	1,942
Capital expenditure	-1,009	-504	-1,150	-1,150	-1,150
Free cash flow	**951**	**1,654**	**-64**	**266**	**792**
Equity raised	4	0	0	0	0
Investments	-309	310	0	0	0
Dividends paid	-47	-80	-290	-232	-284
Net change in Cash & cash equivalents	495	1,869	-331	64	555

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	703	625	293	157	513
Sundry debtors	2,079	2,423	2,790	3,442	4,031
Trade Inventories	1,608	2,176	2,706	3,423	4,009
Other current assets	870	1,087	1,196	1,316	1,447
Fixed assets	3,209	3,284	4,000	4,594	5,108
Other assets	471	161	161	161	161
Total assets	**8,940**	**9,756**	**11,146**	**13,093**	**15,269**
Sundry creditors	957	1,390	1,818	2,296	2,687
Other current liabilities	887	1,801	1,674	2,008	2,370
Long-term debt/Convertibles	2,859	912	912	712	512
Other long-term liabilities	183	216	216	216	216
Networth	4,056	5,436	6,526	7,861	9,483
Total liabilities & equity	**8,940**	**9,756**	**11,146**	**13,093**	**15,269**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	21.3	10.5	15.2	23.4	17.1
Core EBITDA growth (%)	-4.9	78.8	-19.3	23.4	19.8
Core EBIT growth (%)	-12.3	93.0	-22.7	22.4	21.1
Core EBITDA margin (%)	12.5	20.3	14.2	14.2	14.6
Core EBIT margin (%)	10.0	17.4	11.7	11.6	12.0
Net profit margin (%)	6.0	11.3	7.8	7.7	8.0
Dividend payout ratio (%)	10.0	17.4	17.5	17.6	17.6
Tax rate (%)	34.5	34.4	34.0	34.0	34.0
Net Debt/Equity (%)	87.8	28.3	18.5	11.1	10.8
Return on Equity (%)	21.7	35.2	22.1	22.5	22.7

Source: Company data, IIFL Research

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CMP	**Rs228**
Target 12m	**Rs280 (23%)**
Market cap (US$ m)	**491**
Bloomberg	**BJE IN**
Sector	**Mid-caps**

14 March 2011

52Wk High/Low (Rs)	347/188
Shares o/s (m)	99
Daily volume (US$ m)	1
Dividend yield FY11ii (%)	1.0
Free float (%)	35.1

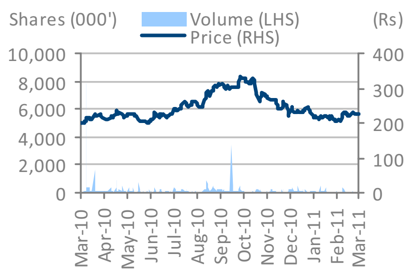
Shareholding pattern (%)

Shekhar Bajaj & family	64.9
FIIs	8.3
DIIs	11.7
Others	15.1

Price performance (%)

	1M	3M	1Y
Bajaj Electricals	10.3	0.1	14.1
Rel. to Sensex	7.8	6.9	8.3
Havells India	15.0	-6.5	27.2
Kalpat. Power	-16.6	-34.8	-46.5

Stock movement



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Bajaj Electricals BUY

Resilient rural growth play

Bajaj Electricals (BJE) is a leading player in consumer appliances, fans and lighting products, which together account for 55% of its revenues. The company enjoys an established brand franchise in India, with a market share of 20-30% in most of the consumer-durable categories in which it operates. It is well-placed to benefit from the potential 25%+ volume growth in consumer durables, driven by under-penetrated semi-urban markets. With the government's focus on rural infrastructure also remaining high, growth in sales of its industrial products too should stay high at over 20%+ annually. The stock is trading at 11.5x FY12ii EPS, and we reckon the 1-year-forward multiple should re-rate to 14x, given BJE's leadership position in a fast-growing market. We recommend BUY with a target price of Rs280.

Strong brand name cum distribution to keep consumer growth high: In consumer appliances, fans and lighting products, BJE is primarily a marketing company and outsources most of its manufacturing, which mitigates risk of competition from lower-cost regional producers and Chinese exporters. The company plans to launch new products (such as pressure cookers), which are under-penetrated in rural areas. In these products, competition from other incumbents is unlikely, as they would have to incur distribution costs, whereas BJE already has an established network in rural markets.

Robust growth from government's infrastructure programme: The company derives 45% of its revenues from projects won under various infrastructure development schemes (including transmission tower development under the Accelerated Power Development and Reform Programme, APDRP), on which spends are growing at 20% annually.

Pricing power to partly offset cost pressure: BJE's pricing power enabled it to contain EBITDA margin losses at just 30bps during the commodity inflation cycle of FY08–09. The company's pricing power is supported by a rational competitive environment both in its consumer and engineering segments.

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	17,657	22,286	27,241	32,657	38,810
EBITDA Margins (%)	10.2	10.9	9.5	10.4	10.5
Pre-Exceptional PAT (Rs m)	893	1,304	1,468	1,937	2,358
Reported PAT (Rs m)	893	1,254	1,468	1,937	2,358
EPS (Rs)	10.3	13.4	15.1	19.9	24.2
Growth (%)	22.2	29.3	12.6	31.9	21.7
IIFL vs consensus (%)			1.4	2.2	-0.6
PER (x)	**22.1**	**17.1**	**15.1**	**11.5**	**9.4**
ROE (%)	36.5	26.4	23.7	24.7	24.0
Debt/Equity (x)	0.7	0.2	0.1	0.0	-0.1
EV/EBITDA (x)	**12.6**	**9.3**	**8.7**	**6.6**	**5.6**
Price/Book (x)	8.0	4.5	3.6	2.8	2.3

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

BJE's position in its key segments

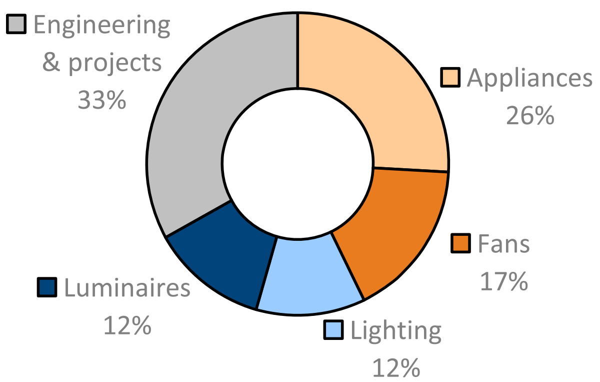
Segment	Market share	Rank
Appliances	15%	No. 1
Fans	17%	No. 2
CFL lamps	7%	No. 3
Lighting	8%	No. 3
Luminaires	17%	No. 2

Source: Company, IIFL Research

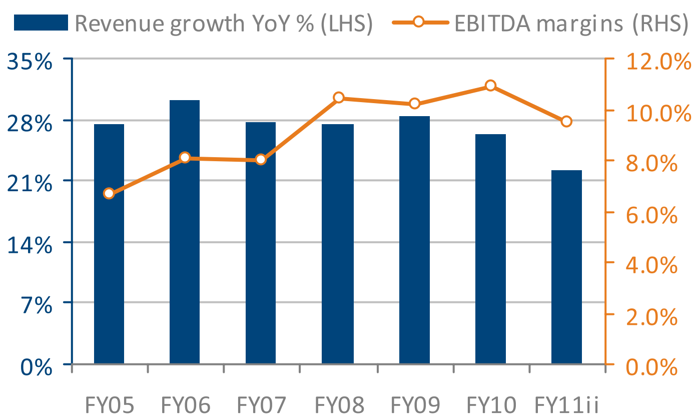
Bajaj Electricals (BJE) was incorporated in 1938 as Radio Lamp Works Ltd and was renamed Bajaj Electricals in 1960. It was started as a marketing company for consumer durables (India's regulations restricted the manufacture of certain appliances to the small-scale sector). Subsequently, the company diversified into engineering projects to parlay its presence in the lighting segment to take advantage of the growing infrastructure spending in India. The company derives 55% of its revenues from consumer products (appliances, fans and lighting). The remaining 45% comes from industrial and infrastructure segments: engineering and projects (projects under power development, transmission towers and private-sector plant projects), and luminaires (for airports, dockyards, etc).

Following a turnaround in FY04 (the company had incurred losses after its venture in die-casting turned sour), the company's earnings have grown at 55% annually during FY05-10. Management focussed on topline growth by launching new models developed in-house, as well as increasing penetration in the premium segments by entering into marketing tie-ups with foreign brands. To reduce costs, it stepped up outsourcing from vendors in China and India.

FY10 revenue mix



Despite commodity price volatility, margins have remained within 9-10.5% in the last three years



Management

Name	Designation	Remarks / management description
Shekhar Bajaj	Chairman	Joined the company in 1980 ; active role in setting corporate strategy
R Ramakrishnan	Executive Director	Former Head of Sales at Asian Paints; joined BJE in 1999; responsible for the consumer segment
Anant Bajaj	Executive Director	Responsible for the engineering & projects division

Assumptions

Y/e 31 Mar (%)	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Appliances revenue growth	28	25	25	23	20
Fans revenue growth	22	27	25	22	20
Lighting revenue growth	19	25	22	20	20
Luminaires revenue growth	23	-2	25	10	10
Engineering & projects revenue growth	44	41	18	20	20

Source: Company data, IIFL Research

Brand and distribution key to growth in the consumer segment

Bajaj caters to the lower-end consumer segment through outsourced production

BJE has a strong brand franchise in small home appliances. It sells a range of appliances, including irons, mixers, water heaters, room coolers, grinders, food processors and home UPSes. Until FY03, the company sold primarily to the mass segment. To extend its presence to higher-priced segments, it signed a technical collaboration and brand licensing agreement with Morphy Richards, UK, in FY03 for the sales and marketing of electrical appliances under the brand name 'Morphy Richards' in India. In FY09, the company tied up with Nardi of Italy, to enter the growing premium kitchen appliance market in India. With this tie-up, the company targets 25% market share of the premium gas hobs/chimney market in India.

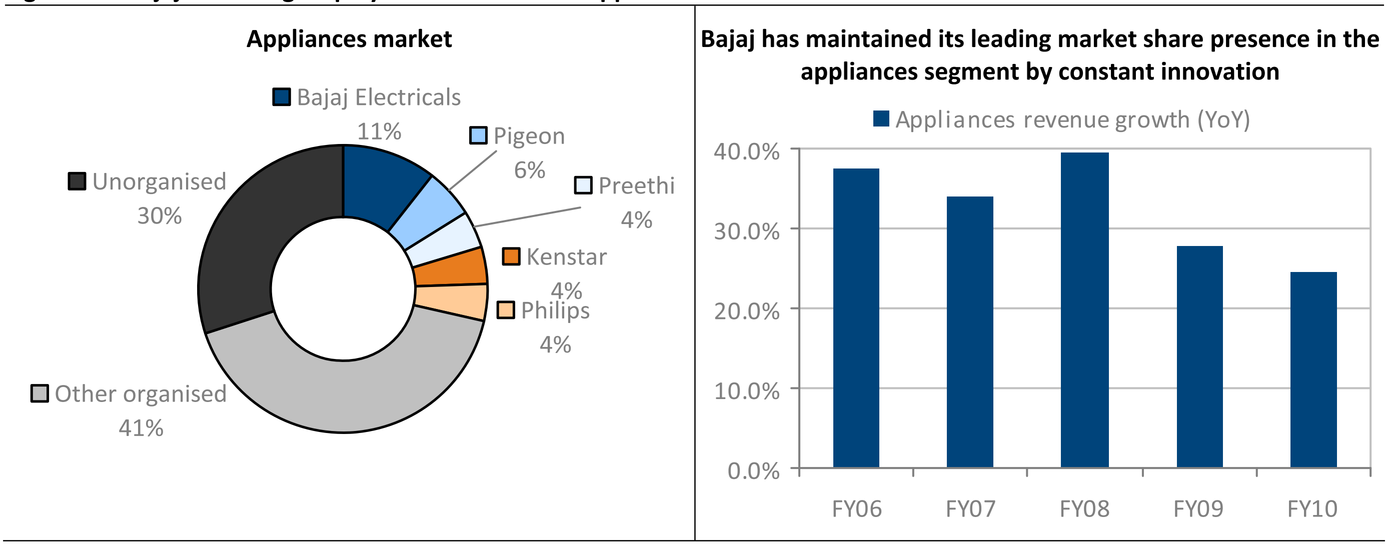
Consumer appliance market: Well-entrenched *Bajaj* brand keeps the growth momentum high

BJE's management pegs the domestic appliance market at ~Rs60bn, of which ~70% is in the hands of organised players. The company estimates that it is largest player in the domestic appliance market, with a ~15% share amongst organised players (or ~10% of the market). In the premium segment, foreign brands dominate the Indian market. Key competitors for the Morphy Richards brand in India are Philips, Black & Decker and Braun.

In the premium segment, Bajaj is present through tie-ups with foreign brands

Thanks to its distribution network for appliances that reaches out to over 25,000 retail outlets in India, and frequent introduction of new models, BJE's revenues from appliances have grown at ~31% annually during FY06-10. We estimate this segment's revenues will grow at ~25% annually over the next 2-3 years, driven by: 1) increase in distribution reach to penetrate semi-urban/rural markets; 2) increase in market share of premium segments of its brands Bajaj Platini, Nardi and Morphy Richards; and 3) entry into promising new segments (mainly water purifiers).

Figure 31: Bajaj is the largest player in the domestic appliance market



Source: Company, IIFL Research

Rural penetration will be a major driver of growth for the fans segment

Fans: Innovation and imports key to driving growth

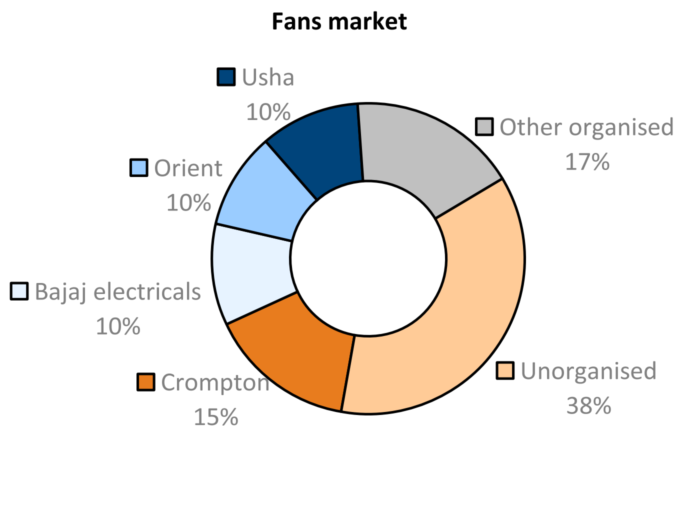
BJE estimates the fans market in India—comprising ceiling fans, pedestal fans, wall-mounted and exhaust fans (industrial & domestic) and air circulators—at ~Rs20bn. Through a combination of its tie-up with China's Midea, and its own in-house development and manufacturing facilities, Bajaj Electricals sells both lower-priced and premium products. In the premium segment, BJE has driven growth mainly through introduction of novel products such as decorative fans, remote-controlled fans, and models for children, with Disney characters.

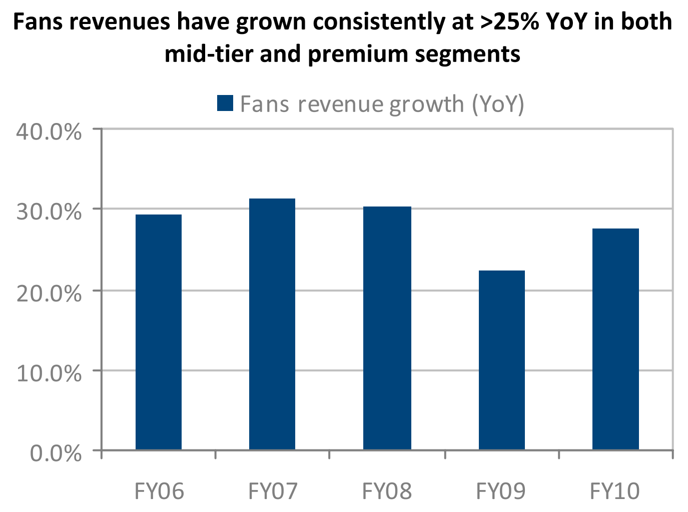
BJE's plans to ramp-up presence in industrial fans and motors is well-timed

The fans segment has maintained a robust revenue CAGR of 28% during FY06-10, and we estimate its revenues will grow at 22% annually over the next three years, driven by:

- increase in rural penetration of existing products especially in the low-to-mid-tier segments;
- increased presence in the industrial fans, and motors segment; and
- continued innovation in the premium segment both through in-house R&D and alliances with international brands.

Figure 32: Through its tie-up with China's Midea and its own premium brands, BJE remains a dominant player in this segment





Source: Company, IIFL Research

Lighting: CFL is the way to grow

Through acquisition of Starlite, BJE entered the high-growth CFL market

BJE has had a presence in lighting for many decades, through GLS lamps, fluorescent tube-lights, domestic luminaires and ballasts & starters. To tap the growing market for energy-efficient lighting, the company entered the CFL segment, through the acquisition of a 32% stake in Starlite Lighting Ltd (which has a CFL manufacturing unit). The company estimates the CFL market at ~Rs20bn and the rest of the lighting market at Rs36bn. BJE has maintained a leading presence in this market with its entry into the CFL market, and is well-poised to benefit from strong growth in this market.

BJE's revenues from this segment grew at 25% annually during FY06-10, and we estimate a 20% CAGR over the next three years, driven by: a) strong growth in CFLs; b) expansion of distribution both to *kirana* stores and modern retail formats; and c) rural electrification and increase in power availability in remote areas.

Figure 33: BJE has a strong presence both in CFLs and general lamps

CFLs		Rest of lighting	
Player	Market share within the organised segment	Player	Market share within the organised segment
Philips	20%	Philips	26%
Surya	8%	Surya	12%
Bajaj electricals	7%	Bajaj Electricals	8%
Oreva	6%	Crompton	5%
Havells	6%		

Source: Company, IIFL Research

Both in the staid GLS as well as fast-growth CFL market, BJE is a leader

Marketing and distribution strength are critical support factors

Thanks to a large distribution reach, BJE will benefit the most from semi-urban and rural growth

BJE's key strength is its ability to build strong brands through marketing efforts and the fact that it has among the widest distribution reaches amongst consumer-durable companies in India. Ad spends account for ~3% of the company's sales and the proportion is likely to remain at these levels, as the 'Bajaj' brand is well-entrenched in the minds of both urban and rural consumers.

BJE's established supply-chain network will make them highly price competitive in small towns

Currently, BJE reaches over 300,000 retail outlets in India through 5,000+ dealers and 600+ distributors. Since after-sales service is key to consumer appliance products (especially for the premium brands), the company will also focus on widening its reach beyond the 240 service centres that it already has. Distribution costs, which account for ~2.5% of sales, could see some increase, as the company seeks to increase its presence in semi-urban and rural markets as well.

Figure 34: BJE reaches out to more than 300,000 outlets in India – one of the largest distribution presence amongst consumer durable companies

Source: Company, IIFL Research

Figure 35: Most of the products are outsourced from dedicated vendors, in the consumer category

Appliances	Vendors in Himachal, Noida and imports from China
Fans	Own factory at Chakan
	Vendors in Hyderabad, Himachal, imports from China
CFL lamps	Own factory of associate company Starlite, Nasik
Electrical lamps, tubes	Own factory of associate company Hind Lamps, UP
Luminaires	Vendors in Daman, Himachal, imports from China
High masts, poles, towers	Own factory at Ranjangaon and Chakan

Source: Company, IIFL Research

The company is scouting for acquisitions, which are small in size that are good fits with its existing product boutique

Consumer segment: Inorganic growth will not increase leverage significantly

Management indicated that it would likely pursue inorganic growth by:

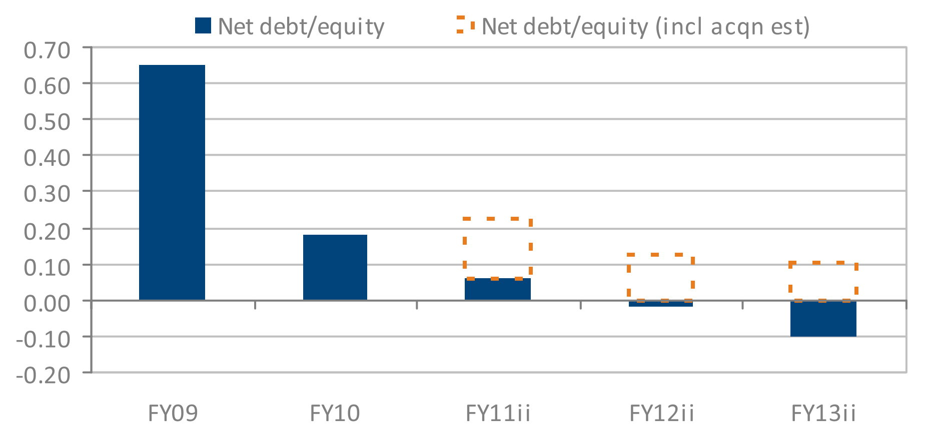
(a) buying brands (rather than manufacturing facilities) in the consumer appliance space. The company will consider buying brands that have strong penetration in geographies where BJE's brands are weak, or brands that could allow BJE to enter new product categories, complementary to its existing product suite; and

(b) acquiring companies with technological know-how/contracting experience in the engineering & projects segment.

The company has no plans to make large acquisitions (that is, with annual revenue of over Rs1bn). Given its comfortable gearing position (net debt/equity of 0.2x), the company will not need to raise any equity for these acquisitions. If the acquisitions were to be funded entirely by debt (assuming acquisition consideration of 12-15x PE), net debt/equity will rise to only about ~0.4x.

Acquisitions unlikely to increase leverage materially

Figure 36: Even if inorganic growth (estimated at Rs1bn) is funded entirely by debt, leverage will increase to only ~0.4x



Source: Company, IIFL Research

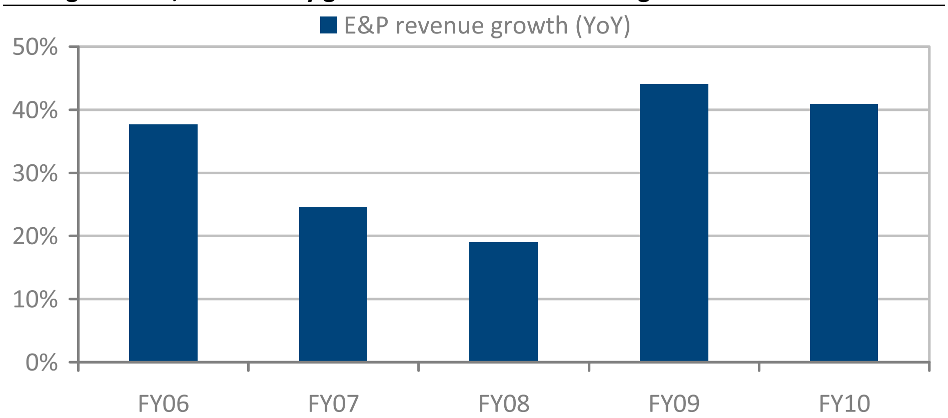
Sustained growth in infra spending to drive engineering segment

The engineering segment caters mainly to rural and urban infrastructure projects of governments and quasi-government bodies

The Engineering & Projects division has three main sub-divisions:

- **High masts and poles:** involves setting up streetlights (customers include municipal corporations, infrastructure players, govt spending under Jawaharlal Nehru National Urban Renewal Mission), high masts/poles for factories/facilities of corporates, and signages (customers include HPCL, BPCL and Reliance).
- **Towers:** covers manufacture and setting up of transmission towers. The key driver for this segment is capacity expansion by companies such as Power Grid Corporation.
- **Special projects:** mainly involves project execution under the government's rural electrification programme (Rajiv Gandhi Grameen Vidyutikaran Yojana), and lighting projects (for power plants, factories, sports stadiums, etc).

Figure 37: Transmission towers revenues, which registered 73% revenue CAGR during FY06-10, was the key growth driver for the E&P segment

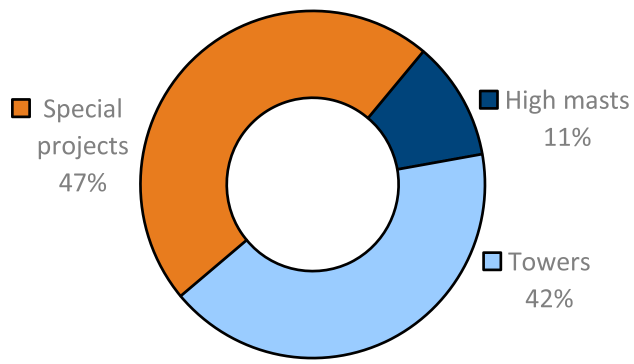


Source: Company, IIFL Research

Industrial capex by power companies also a key driver of growth

The E&P segment's revenues grew at 32% annually during FY06-10. Growth was driven mainly by the transmission tower segment, owing to rapid expansion by telecom companies, and power capacities. The company currently has a Rs1.8bn order book, and is well-placed for orders worth Rs1.25bn. Coupled with the 14-18 month average gestation period for projects gives us visibility for ~20% YoY revenue growth in this segment during the next year.

Figure 38: Order book dominated by transmission towers and govt infra schemes



Source: Company, IIFL Research

Given the government's continued thrust on infrastructure schemes (both rural and urban) and the recent fillip in industrial capacity expansion, we expect BJE's E&P revenues to grow at ~20% annually during the next three years.

Near-term growth to be led by investment in rural infrastructure

Figure 39: Rs450bn demand potential for E&P should comfortably support ~20% CAGR estimate for revenue growth over 2-3 years

Segment	Growth driver
Towers	Rs200bn demand from power transfer capacity increase (from 9000MW to 30,000 MW)
High Masts and Poles	Rs125bn spending under JNNURM over five years
Special projects	Rs120bn spending under rural electrification projects; 25 non-metro airport development

Source: Company, IIFL Research

FY11 margins in the E&P segment affected by one-off factors in 2QFY11

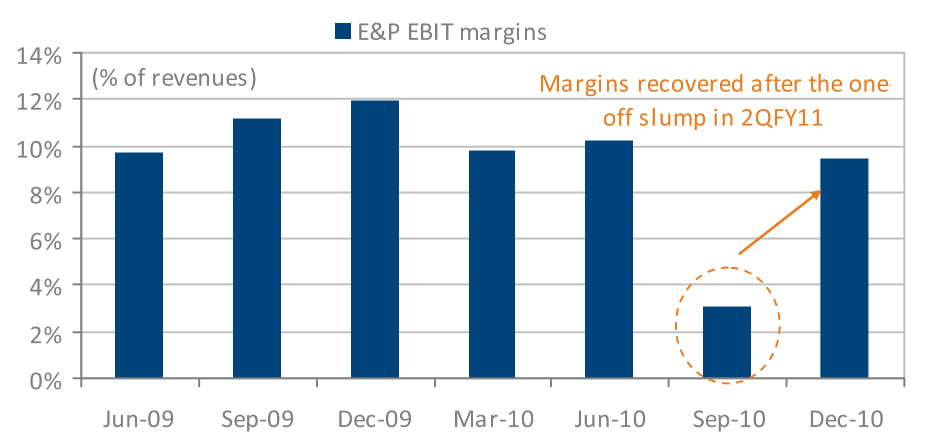
The share of 'product execution' vs 'products' in the E&P business was skewed significantly during 2QFY11 in favour of 'product execution', which intrinsically has very low margins, since this part of the business involves mainly costs incurred in erection and commissioning of projects.

This was mainly driven by the rush in project execution ahead of the Commonwealth Games in Delhi, which accounted for the largest share of projects executed during the quarter, thus putting most other projects in abeyance for 2HFY11. Additionally, the higher-margin transmission-tower business was affected by a slowdown during 2QFY11, owing to the heavier-than-normal monsoon this year.

Focus also in engineering segment shifted to better execution to improve margins

In-line with management's guidance, EBITDA margin in the E&P business rebounded in 3QFY11 to 9.4% after the disappointing performance in 2QFY11 (when margin was down to 3%).

Figure 40: E&P margins rebounded after the 2QFY11 disappointment



Source: Company, IIFL Research

Luminaires: order flow has regained strength

The luminaires segment caters mainly to industrial applications, flood lighting and street lights. This market is pegged at Rs25bn (according to company estimates), of which ~40% is in the hands of unorganised players. BJE is a leading player (2nd largest after Philips) amongst organised players, thanks to both its strong product portfolio and technical tie-ups with global leaders in the space.

In FY05, the company entered into a distribution agreement with Trilux Lenze of Germany for high-end technical lighting. BJE has since supplied luminaires for a number of large projects, among them the Indira Gandhi Stadium, Jawaharlal Nehru Stadium, and TCS's green-building projects in Chennai.

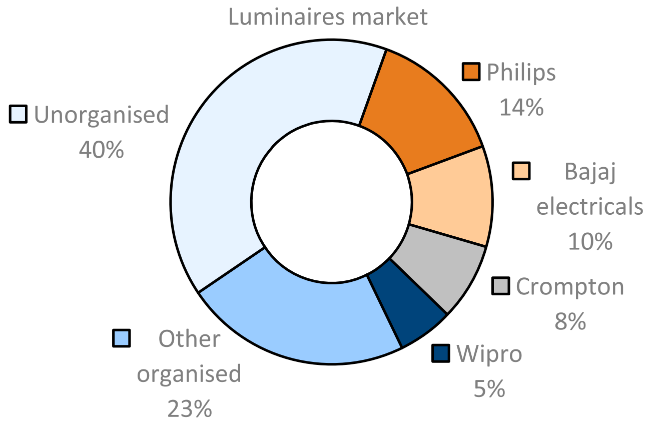
In the luminaires segment, BJE to enter building management systems market

BJE has also entered into a tie-up with Securiton of Switzerland for fire-alarm and security systems, and with Delta Controls for HVAC controls, access and building management systems (BMS). This enables the company to offer integrated BMSes, which is targeted mainly at new IT, BPO and retailing projects.

Revenues in the luminaires segment has picked-up due to investments in sports facilities

A slump in industrial activity caused this segment's revenues to fall by 2.5% YoY during FY10. According to the management, order flow has since revived (1QFY11 revenues from luminaires were up 78% YoY). We estimate this segment's revenue growth at ~15% annually over the next three years as it trends towards historical growth rates (revenues registered 21% CAGR during FY06-09).

Figure 41: Technical excellence through tie-ups with global leaders support BJE's leadership in luminaires

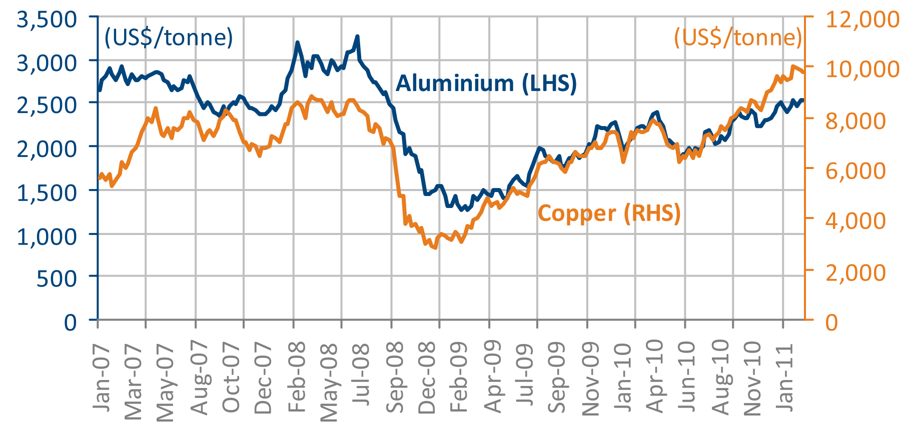


Source: Company, IIFL Research

Pricing power to partly offset cost pressure

Copper, aluminium and steel are key raw materials in both consumer and engineering segments. Commodity price inflation continues to be a cause for concern—raw-material prices for BJE were up 25-50% YoY in 3QFY11 and show no signs of declining.

Figure 42: Raw-material inflation already running high for BJE



Source: Company, IIFL Research

Rational competitive environment and strong brand should help BJE pass on cost increases in a staggered fashion

BJE has demonstrated strong pricing power during previous commodity inflation cycles, especially in its consumer product segments. During FY08-09, for instance, when commodity prices were 10-30% above current levels, BJE was able to pass on a substantial part of the cost increases, though in a staggered fashion, thus protecting its margins (consumer segment EBITDA margins declined just 30bps YoY during FY09 and subsequently expanded 250bps YoY in FY10 once commodity prices corrected).

We expect BJE to continue to be able to pass on cost increases in the current environment too. However, there may be some time lag, as consumer acceptance for a price rise is better secured through steady increases rather than sudden jolts. As a result, we currently expect margins to decline 40bps YoY during FY10-12, assuming modest inflation in commodity prices from current levels. However, any unforeseen shocks to commodity prices will pose downside risk to our current margin estimates for the consumer segment.

E&P segment faces both margin and receivables risk

Government finances pose some risk to receivables for the engineering segment

As BJE's bids in the E&P segment are in relatively low-tech areas, there are no entry barriers to speak of. This is attracting an increasing number of smaller players to the business. As such, BJE's EBITDA margins in this business, which are currently at 10-12%, will come under further pressure in the years ahead. We estimate 200-300bps margin erosion over the next two years in this segment.

For the near term, we are building in a ~100bps decline in margins in this segment to factor in cost inflation. While the segment is highly competitive, the wafer-thin margins already prevalent in the segment should temper price competition (at least a part of the cost increases will be passed on by most players).

On the other hand, we expect some strain on working-capital requirements of the segment, given that government orders constitute the largest share of the engineering segment's orders. With government finances remaining under strain, the receivables period could also come under risk.

Bear-case assessment implies 18% downside to our earnings estimate

At mid-cycle levels of previous downturn, margins could compress a further 100bps from our estimates

In our estimate, if margins in both consumer and engineering segments approach the mid-cycle levels of the previous downturn, an incremental 100bps risk to our current margin estimate, or ~10% downside to our current earnings estimate is possible. Also assuming receivables days stretch by a further 15% from current levels (current receivable days are already comparable to the mid-cycle levels of the previous down-cycle), earnings would decline by a further 8%.

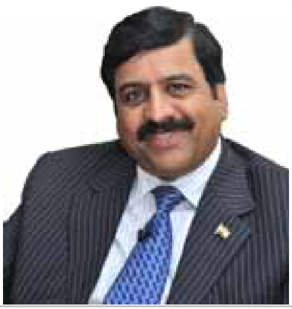
Overall, our bear-case assessment indicates ~18% downside to our current earnings estimate.

Appendix

Enterprising India 2: Excerpts from IIFL's interview with Shekhar Bajaj, Chairman & MD; Ramakrishnan, ED; and Anant Bajaj, ED; Bajaj Electricals


Shekhar Bajaj

When India opened its markets in the early part of this decade in deference to WTO norms, Shekhar Bajaj was one of the first to identify value in importing good quality products at an affordable price for the Indian consumer. He found significant value in retaining the 'marketing company' business model of Bajaj Electricals for all such products where there wasn't much high-tech know-how involved. He finds outsourcing sensible since Indian entrepreneurs maintain strong control over costs and importing from places like China offer scale efficiencies. Thanks to this, Bajaj Electricals has been a pioneer in offering quality at an affordable price to Indian consumers.


Ramakrishnan

Bajaj Electricals is a fairly old company, established in the 1930s, but has seen meaningful growth only in the last decade or so. What were the key growth drivers?
Shekhar Bajaj: The market for consumer durables opened up only after 2000, when India had to allow imports of consumer products as per the new WTO rules. Bajaj Electricals was also the very first company to use this opportunity; we explored the option of importing goods from China, where they have greater scale advantages. We also brought foreign brands to India, including Morphy Richards.

Do you see India's explosive growth in consumption spending continuing?
Ramakrishnan: I would not be surprised if it accelerates, because when rural demand grows, it means about 70% of India's population would be a base from which we should see consumption growth. Virtually every category today is under-penetrated. Thanks to agriculture doing well, rural employment generation gaining steam and infrastructure being built, we could witness a further spurt in the buying power of rural India. Greater employment and greater aspiration are a very potent combination. At the same time, even urban consumption will continue to grow, amongst the lower and lower-middle classes, driven by the same factors. So, on the whole, I am even more bullish about the next 15 years.


Anant Bajaj

How do you see the E&P segment growing?
Anant Bajaj: Our market share in the E&P space is still very small. As we gain experience in implementing larger projects and a wider variety of projects, I see our E&P segment attracting a greater share of the order flow. Currently, we target not only domestic orders, but also international orders. Recently, we won orders for turnkey projects for the cricket and football stadiums in Dubai, in addition to lighting projects in Africa. These projects have helped us improve our expertise and quality control, and enable us to be more competitive in the domestic market by offering greater quality at affordable cost.

Where do you see your company ten years from now?
Shekhar Bajaj: I see us reaching Rs250 billion in revenues by 2020. While this will substantially be led by organic growth, we will be happy to explore any suitable acquisition opportunities.

Ramakrishnan: In the medium term, I see our annual revenues hitting Rs50 billion in three years and Rs100 billion in three years after that. About 80% of this growth would be organic, and the rest by diversification and acquisitions. Our strategy is simple—strong growth in categories in which we are already present, and even stronger growth in those that we plan to enter soon. We are entering the water business, gas appliances, pressure cookers, LED lanterns for rural areas, DG sets for small applications and industrial exhaust fans and air circulators. We might get into non-stick utensils and pumps.

Anant Bajaj: Specifically within segments, I think we'll be a leading player in luminaires in the next three years. We are not far behind the leader today, and I think we can bridge that gap fairly soon, thanks to our focus on quality control. I think we'll be a leader in the lighting segment in the next six to seven years, driven by new products such as CFL. In the E&P space, we will be among the top 5 players in India and among the top 20 in the world, within five years.

How will your new products that are rural oriented impact your margins?
Ramakrishnan: Today's rural consumer is brand-aware; if he has a choice between buying unbranded product vs a brand that assures him high quality, he is willing to pay a premium. At the same time, their incomes are also growing—agriculture is doing well, and financial inclusion is gaining momentum. The rural consumption story for any consumer company will be a function of three things: 1) product innovation—offering the right product at the right price point; 2) rural distribution—how you can offer products through channels which the rural consumer can reach easily; and 3) consumer connect—a differentiated value proposition. Bajaj Electricals is focussing on all these aspects, and I think will be ahead of the race. So I don't really see any risk to our consumer margins.

What can go wrong that may prevent you from meeting your targets?
Shekhar Bajaj: We need to keep in mind that Bajaj Electricals has a very low break-even, since our share of own manufacturing is very low. Hence, a change in the demand growth trajectory should have no major impact on our profitability. However, margins could come under pressure in the event of any under-cutting by new players.

Ramakrishnan: It's important to have a ready second line of leadership. Not just at the top, but at every step within the organisation. Secondly, as we grow in size, scale and complexity, we will be faced with the challenge of retaining the entrepreneurial and innovative spirit of the organisation.

Financial summary

Revenue growth during FY12 to be driven equally by consumer and engineering segments

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**17,657**	**22,286**	**27,241**	**32,657**	**38,810**
EBITDA	1,798	2,434	2,591	3,410	4,057
EBIT	1,713	2,343	2,490	3,301	3,938
Interest expense	-370	-314	-324	-449	-474
Others	57	29	25	39	55
Profit before tax	**1,400**	**2,057**	**2,191**	**2,891**	**3,519**
Taxes	-507	-754	-723	-954	-1,161
Extra-ordinary items	0	-50	0	0	0
Net profit	**893**	**1,254**	**1,468**	**1,937**	**2,358**

Working capital requirement is mainly driven by high receivables in the engineering segment

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	1,713	2,343	2,490	3,301	3,938
Depreciation & Amortization	85	91	100	109	118
Tax paid	-542	-912	-723	-954	-1,161
Working capital change	55	-1,564	-674	-1,054	-1,085
Other operating items	99	55	0	0	0
Operating Cash-flow	1,411	14	1,194	1,402	1,811
Capital expenditure	-148	-147	-150	-180	-180
Free cash flow	**1,263**	**-133**	**1,044**	**1,222**	**1,631**
Equity raised	0	1,634	0	0	0
Investments	-92	-50	0	0	0
Debt financing/disposal	-228	-620	-319	204	77
Dividends paid	-161	-201	-220	-291	-354
Other items	-562	-504	-299	-411	-419
Net change in Cash & cash equivalents	**219**	**125**	**205**	**725**	**935**

Fixed asset addition modest since their business model relies mainly on outsourcing

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	538	612	817	1,542	2,477
Sundry debtors	5,592	7,507	9,031	11,094	13,291
Trade Inventories	1,777	2,094	2,586	2,934	3,408
Other current assets	1,131	1,777	1,642	1,789	2,127
Fixed assets	971	1,017	1,066	1,137	1,199
Other assets	316	366	366	366	366
Total assets	**10,324**	**13,373**	**15,507**	**18,863**	**22,867**
Short-term debt	908	574	319	482	544
Sundry creditors	5,704	6,911	8,117	9,622	11,545
Long-term debt	1,261	945	881	922	937
Networth	2,450	4,944	6,192	7,838	9,842
Total liabilities and equity	**10,324**	**13,373**	**15,507**	**18,863**	**22,867**

EBITDA margins for FY11 impacted mainly by a steep dip in 2QFY11 (engineering segment); excluding this one-off impact, FY12 margins dip ~60bps YoY

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	28.5	26.2	22.2	19.9	18.8
Core EBITDA growth (%)	25.6	35.3	6.4	31.6	19.0
Core EBIT growth (%)	26.1	36.8	6.3	32.6	19.3
Core EBITDA margin (%)	10.2	10.9	9.5	10.4	10.5
Core EBIT margin (%)	9.7	10.5	9.1	10.1	10.1
Net profit margin (%)	5.1	5.6	5.4	5.9	6.1
Tax rate (%)	36.2	36.6	33.0	33.0	33.0
Net Debt/Equity (%)	65.3	18.3	6.2	-1.8	-10.1
Return on Equity (%)	36.5	26.4	23.7	24.7	24.0
Return on Assets (%)	8.7	9.4	9.5	10.3	10.3

Source: Company data, IIFL Research

Bajaj Finance Ltd BUY

CMP	Rs660
Target 12m	Rs1,050 (59%)
Market cap (US$ m)	534
Bloomberg	BAF IN
Sector	Financial Services

14 March 2011

52Wk High/Low (Rs)	839/295
Shares o/s (m)	37
Daily volume (US$ m)	1
Dividend yield FY11ii (%)	2.4
Free float (%)	44.5

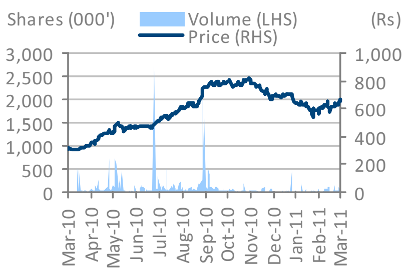
Shareholding pattern (%)

Bajaj FinServ	55.5
FIIs	6.1
DIIs	12.9
Others	25.5

Price performance (%)

	1M	3M	1Y
Bajaj Finance Ltd	9.9	-4.1	111.0
Rel. to Sensex	7.4	2.8	105.1
Shriram City Union	-4.3	-21.3	9.6
M & M Fin	4.5	-4.7	81.0

Stock movement



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Primed for a new phase

Bajaj Finance (BFL) is a play on the consumer and small business lending opportunities in India. Positioned initially as a consumer finance company, BFL expanded its scope to include opportunities in small businesses as well. BFL's competitive advantage includes strong parentage, favourable funding position, and an experienced senior management team. High asset growth, improving efficiency and a renewed focus on asset quality would drive 70% CAGR in earnings during FY10-13ii. Strong and sustainable earnings growth, rising ROE and an inexpensive valuation (P/B of 1.6x on FY12ii) makes BFL an attractive play, in our view.

Niche player in financial services: Consumer finance and small-business loans continue to be undertapped segments, largely because access to finance has been a constraint. This is evidenced by the declining share of bank financing to these segments over time, while aggregate loans of banks continue to grow at a rapid clip. We believe BFL is well-positioned to capitalise on this opportunity, with an established distribution network, strong parentage, and an experienced management. We forecast a CAGR of 47% and 70% in BFL's loans and earnings, respectively, driven by the market opportunity and BFL's well-established position in its key businesses.

Higher economies of scale in lending, a key re-rating factor for BFL over the medium term: The key challenge that non-banking finance companies (NBFC) such as BFL face is achieving higher economies of scale in their businesses, while keeping operating costs and credit quality under check. We believe this would be a key factor for a re-rating in BFL's valuation over the medium term. New product introduction and focus on improving process efficiencies would keep operating cost under check, while an increase in secured assets' share of loans should keep credit quality robust.

Robust growth outlook and ROE uplift to drive valuations: Strong volume growth, improved efficiency and decline in risk profile of assets would drive earnings performance. Increasing leverage and higher ROA would drive ROE uplift further through FY13. Strong and sustainable earnings growth, rising ROE and inexpensive valuation makes BFL an attractive play in the financial-services space.

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Pre prov. operating inc. (Rs m)	2,146	3,949	5,941	7,477	9,803
Net profit (Rs m)	339	894	2,348	3,299	4,373
EPS (Rs)	9.3	24.4	64.1	90.1	119.5
Growth (%)	68.6	163.6	162.6	40.5	32.6
IIFL vs consensus (%)			1.3	8.4	5.1
PER (x)	71.2	27.0	10.3	7.3	5.5
Book value (Rs)	297	315	360	424	509
PB (x)	**2.2**	**2.1**	**1.8**	**1.6**	**1.3**
CAR (%)	38.4	26.0	15.3	14.0	13.3
ROA (%)	1.0	2.3	3.4	3.3	3.4
ROE (%)	**3.2**	**8.0**	**19.0**	**23.0**	**25.6**
Dividend yield (%)	0.3	0.9	2.4	3.4	4.5

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

Bajaj Finance Ltd (BFL) provides financing for two-wheelers, consumer durables, housing, and small businesses. The company has also recently begun financing construction equipment, and plans to gradually scale up this business.

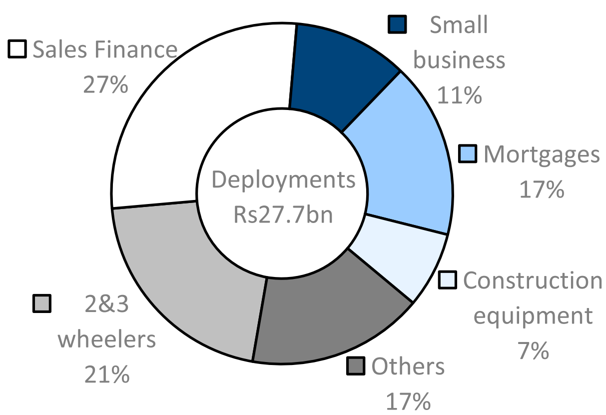
BFL undertook business and organisational restructuring in FY08 and identified small business loans and consumer financing as key niches. While the legacy problems in BFL's 2-wheeler and consumer-durable financing portfolios continued to adversely affect financial performance, new initiatives began delivering tangible results in FY10, with 164% net profit growth. BFL further built on this performance with strong 113% and 174% growth in disbursements and profits, respectively, in 9MFY11.

Background

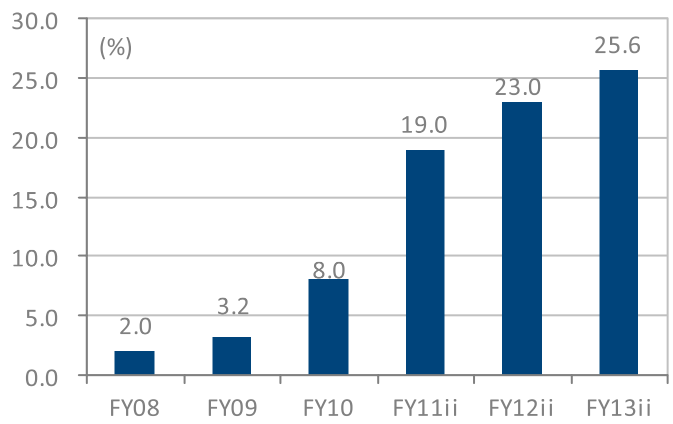
Bajaj Finance Ltd (BFL), formerly known as Bajaj Auto Finance, was incorporated in March 1987. BFL was promoted by the erstwhile Bajaj Auto Ltd and Bajaj Auto Holdings Ltd. BFL was subsequently listed in 1994. When the Bajaj Group was restructured in 2008, the shareholding of Bajaj Auto Limited in BFL was transferred to Bajaj FinServ Ltd. As of September 2010, the company was renamed from Bajaj Auto Finance Ltd to Bajaj Finance Ltd.

BFL is present across 375 Bajaj Auto dealerships and over 2,000 consumer-durable outlets across the country. Small business lending is carried out through 63 branches spread across 16 cities.

Deployment mix – 3QFY11



Return on equity



Management

Name	Designation	Remarks / management description
Rajeev Jain	CEO	Has over 18 years of experience in the consumer lending industry, having worked in the past with AIG, General Electric and American Express.
Pankaj Thadani	CFO	Has over 28 years of experience, having previously worked in Bajaj Auto Limited, Eicher, Mico Bosch and Corporate Database.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Disbursement growth (%)	-19.3	87.1	98.1	24.0	23.6
New NPL accrual rate (%)	5.3	1.4	2.5	1.7	1.5

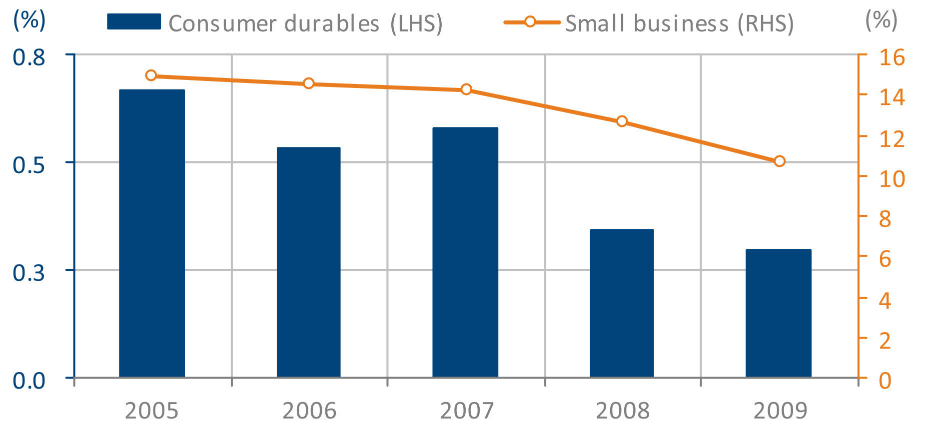
Source: Company data, IIFL Research

Favourable environment, competitive edge

Large opportunity due to inadequate bank funding for retail banking

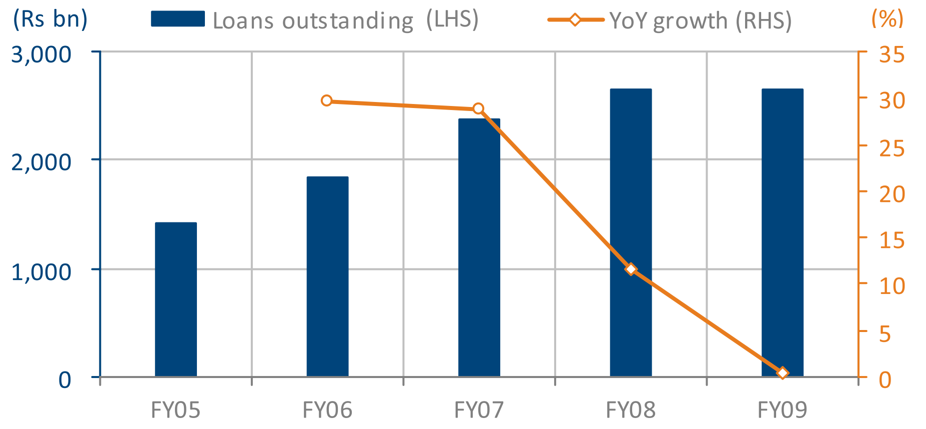
Huge untapped potential in small business and consumer lending: Access to finance for small businesses and consumer segments has long been a constraint, as evidenced by the decline in the share of credit from banks to these segments. These segments' share of bank credit has declined because of banks': 1) preference to lend to the government and the corporate sector; and 2) lack of focus and skills on originating and managing these assets. We believe inadequate access to finance from the banking sector has enabled non-banking financial companies (NBFC), including BFL, to carve a niche in small-business and consumer lending.

Figure 43: Share of bank credit to consumer durables and small business



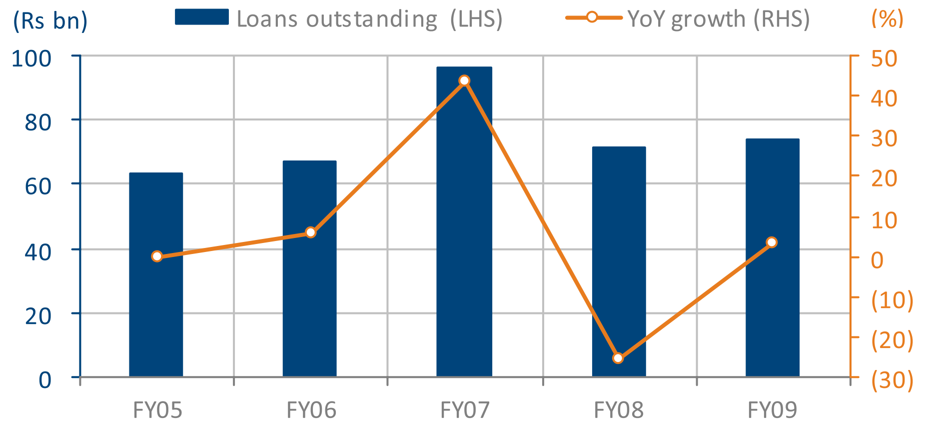
Source: RBI, IIFL Research

Figure 44: Banking sector loans to small business have been growing at below the system growth rate



Source: RBI, IIFL Research

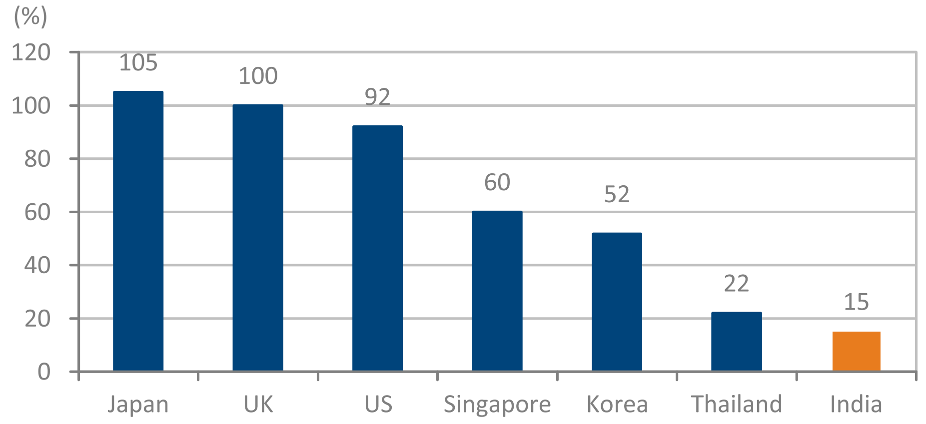
Figure 45: Banking sector loans for consumer-durable purchases have remained stagnant over the years



Source: RBI, IIFL Research

Low consumer lending penetration provides large growth opportunity

Figure 46: Consumer loans/GDP ratio - cross-country comparison



Source: Company, IIFL Research

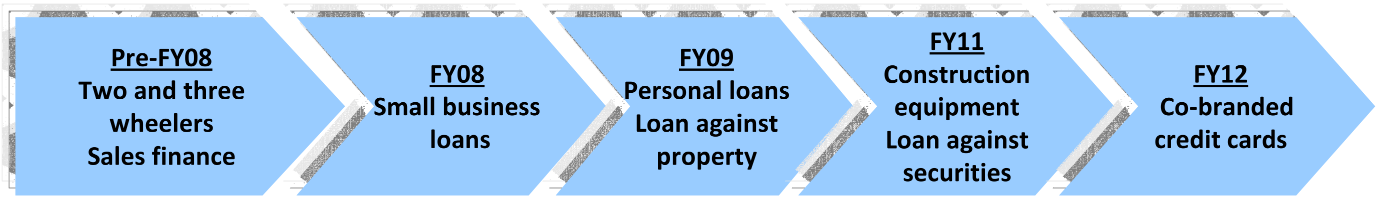
Low competitive intensity allowed BFL time to diversify its loan book

BFL scaled-up in FY10 post consolidation

BFL – carving a niche

BFL re-organised its business in 2008 and broad-based its customer focus to include consumer and small-business lending. BFL's investment in new initiatives could not have had a more opportune time. Lenders, including well-established NBFCs such as CitiFinancial Consumer Finance and GE Money and banks such as HDFC Bank, Kotak Mahindra Bank and Standard Chartered Bank, were withdrawing from small business and consumer lending, owing to rising delinquencies and a worsening lending environment in FY08. In our view, competitive intensity had ebbed significantly by FY10, leaving the opportunity entirely to a handful of players. This afforded BFL the time to invest in processes and systems for credit administration and management. BFL made a beginning in small business loans and consumer financing in FY09 and began scaling-up in FY10, while at the same time withdrawing from its legacy businesses.

Figure 47: Product evolution



Source: Company, IIFL Research

BFL has large distribution reach

Focus on improving customer value proposition

BFL has enhanced its value proposition

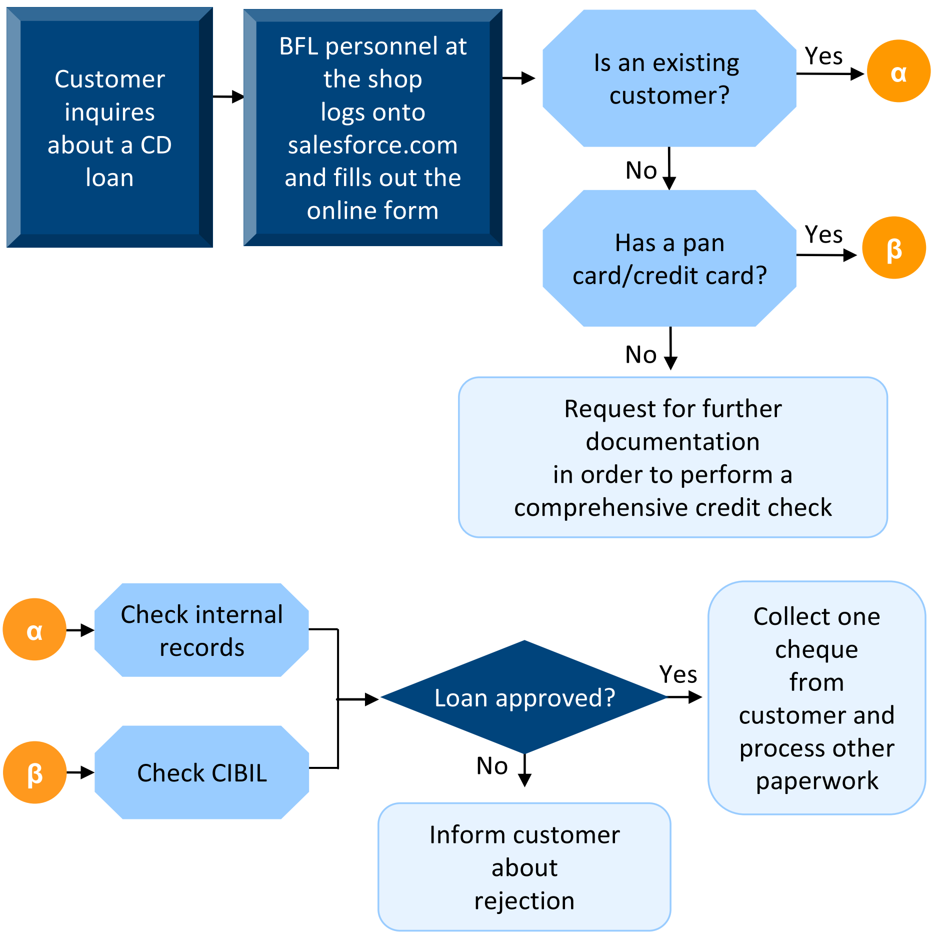
Competitive edge from distribution, focus on customer value proposition and well-experienced team

Wide distribution, cost efficiency and strong customer value propositions are the key factors needed to compete in consumer and small-business lending. Banks have a natural advantage in distribution, but not necessarily in other factors. BFL has large distribution reach, thanks to its long-standing two-wheeler and consumer-durable loans. Furthermore, the bank has built a strong team that is well-experienced in consumer and small-business lending. The company has invested in building a strong value proposition (see text box and Figure 48 below).

Unique customer proposition in consumer durables: In the consumer-durable segment, BFL finances only high-value items such as LCD TVs, refrigerators, and air-conditioners—assets that are usually financed by credit cards. BFL has invested considerable resources to bring down the turnaround time for loan applications, from a few hours to 15 minutes, thus allowing it to compete with credit cards in this segment. This reduction in the turnaround time owes much to better data availability with the Credit Information Bureau (India) Limited (CIBIL).

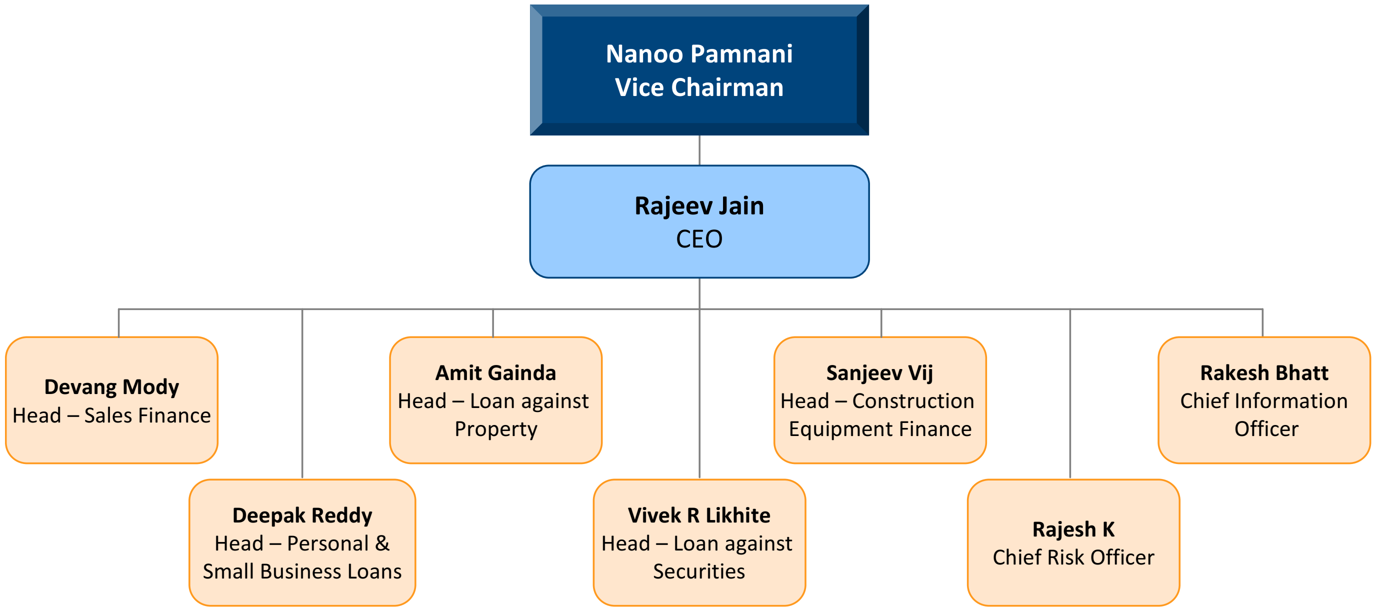
A customer taking a consumer-durable loan from BFL pays 0% interest on the loan, which has a duration of eight months, and is required to make 30% down payment for the product. This is in contrast to a credit-card purchase, where the consumer would end up paying interest at 25-35% pa for the same purchase, but with no down payment. BFL earns its entire spread from the manufacturer, who sub-vents the consumer's purchase.

Figure 48: Standardised and technologically advanced processes allow BFL to approve/reject a consumer-durable loan within 15 minutes



Source: Company, IIFL Research

Figure 49: Organisation chart



Source: Company, IIFL Research

BFL resumed growth in FY10 after a period of consolidation

Larger scale and new products to drive strong growth in assets over the medium term: Deployments (loan disbursements) grew at a rapid clip between FY10 and the current year. BFL began to expand its book in FY10 after downsizing risk between FY08 and FY09; growth in the loan book in FY10 was a reflection of the low base. In FY11, the company began to sweat its investments, again accelerating asset growth.

Increasing wallet share in consumer financing through cross-selling

For consumer finance, BFL's focus is on tapping opportunities in major urban markets, with a specific emphasis on large retail chains/outlets. With a presence already in 71 cities, BFL would likely push for rationalisation of its distribution network and look to increase its share of wallet with large retailers. Personal loans are originated through cross-selling from the customer base of durable finance. The origination process would be largely technology-driven, as the company is likely to rely on its customer relationship management tools.

Widening footprint in small business locations to drive growth

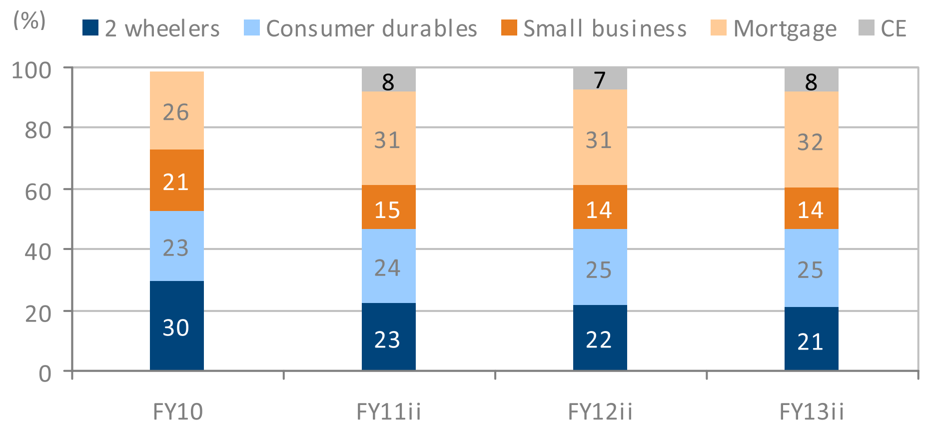
Small-business lending would likely see expansion into new markets to sustain volume growth, apart from scaling up volumes in existing locations. Currently, BFL operates from 16 cities, and the company plans to expand its coverage to over 25 cities over the medium term.

We forecast 25% CAGR in disbursements during FY11ii-13ii, driven by expansion of its share of consumers' wallet in existing locations and through a selective push into new geographies. In FY11, the company launched its construction equipment (CE) financing business. CE financing is part of Bajaj Finserv's entry into infrastructure financing; Bajaj Finserv will use BFL as the vehicle for this business. As the business scales up, it would be carved into an infrastructure finance company proposed to be incorporated at a later period. Until then, CE financing would remain part of BFL. Given the small base, CE financing would likely grow at a rapid clip. However, its contribution to the overall business mix would likely remain insignificant.

We expect receivables under finance to grow at 29% annually during FY11ii-13ii, led by CE financing, consumer-durable financing and mortgage lending, in that order. Growth rate and share of 2-wheeler financing in receivables under financing would likely moderate, as volume growth in this business would remain linked to Bajaj Auto's sales. Our auto analyst forecasts double-digit volume growth and higher realisations. This, along with an increase in penetration of financing to Bajaj Auto products, would likely drive a CAGR of 24% in receivables from this segment.

CE, consumer durable and mortgage financing to drive growth

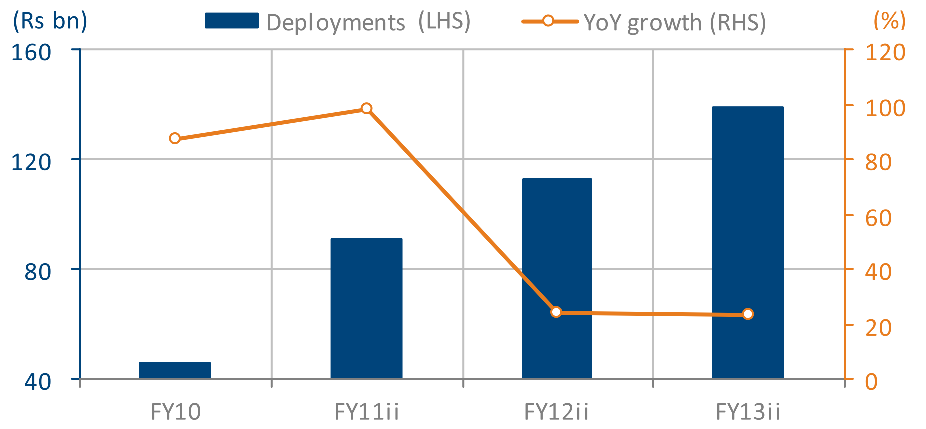
Figure 50: Expected deployment mix



Source: Company, IIFL Research

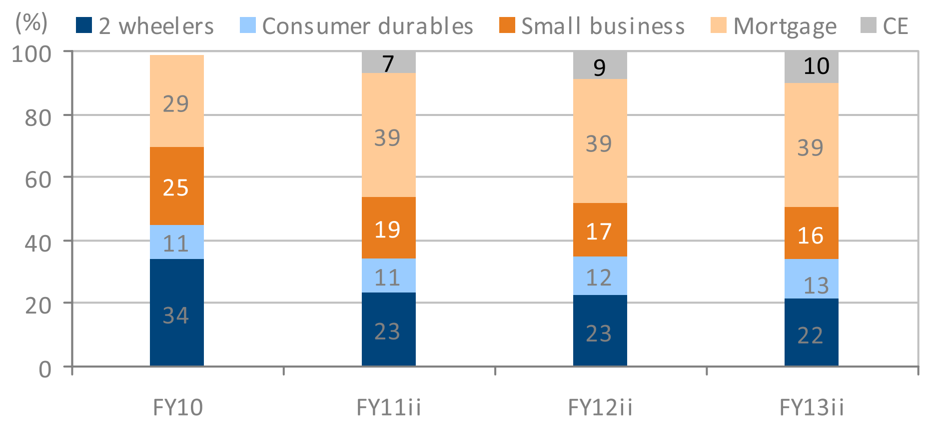
We estimate 25% CAGR in disbursements over FY11-13ii

Figure 51: Deployments set to grow at a rapid pace



Source: Company, IIFL Research

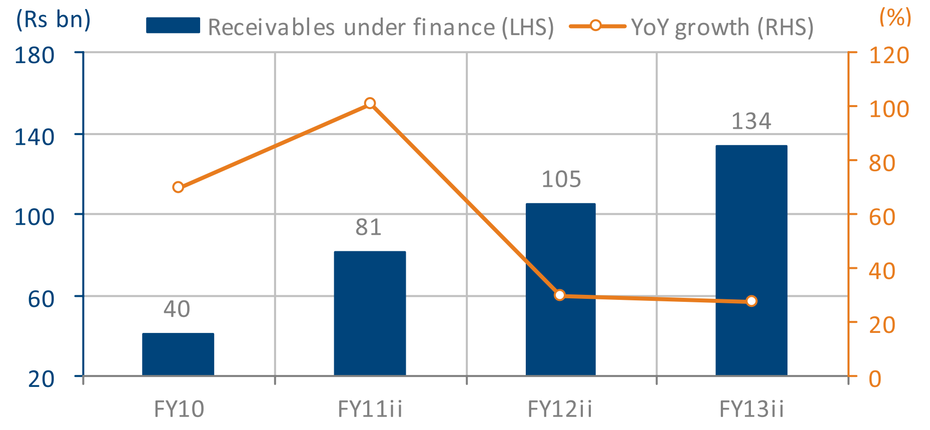
Figure 52: Receivables under finance mix



Source: Company, IIFL Research

We estimate 29% CAGR in receivables under finance over FY11ii-13ii

Figure 53: We forecast 49% CAGR (FY10-FY13ii) in receivables under finance



Source: Company, IIFL Research

Competition likely to intensify as banks' risk appetite returns

Competitive intensity is low, but is likely to rise over the medium term: With many key players withdrawing from small-business lending and consumer financing, competitive intensity remains low. Given BFL's head-start, it is likely to derive significant pricing power and ability to cherry-pick assets. However, competition would likely intensify as banks' risk appetite returns. There is some evidence of new entrants, particularly new-generation private-sector banks such as IndusInd Bank and Yes Bank. In general, banks' prime focus continues to be on secured lending products. Given the gap in financing needs, new competition may not pose a threat to BFL's pricing power. As banks' risk appetite increases and they expand into unsecured products, BFL's pricing power would likely wane. Cognisant of the threat to its pricing power, BFL continues to invest in process improvements to drive down costs.

Focus is on improving cost efficiencies

Figure 54: Key product features and competition landscape for consumer loans

	Consumer loans		
Products offered	Two wheeler loan	Consumer durable loan	Personal loan
Minimum loan size (Rs)		7,500	20,000
Maximum loan size (Rs)	50,000	500,000	2,000,000
Average loan size (Rs)	37,000	20,000	50,000
Maximum duration of loan (months)	24	8	12-48
Key competitors	All banks, lead by HDFC Bank	All banks through credit cards, SCUF	All banks

Source: IIFL Research

Figure 55: Key product features and competition landscape for small-business loans

	Business loans		
Products offered	Small business loans	Loan against property	Construction equipment financing
Minimum loan size (Rs)	300,000	2,000,000	-
Maximum loan size (Rs)	3,000,000	125,000,000	500,000,000
Average loan size (Rs)	1,700,000	14,000,000	-
Maximum duration of loan (months)	12-36	180	48
Key competitors	All banks (primarily HDFC Bank, SCB, Kotak), SCUF	All banks, India Bulls Financials, SCUF	All banks, SREI Finance

Source: IIFL Research

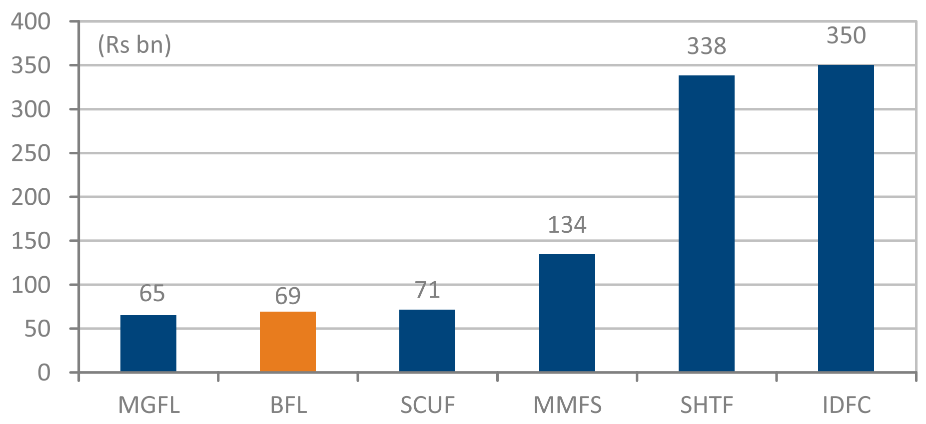
Key re-rating drivers: Scale economies, improving risk profile

Lack of scale remains key issue for NBFC

The key issue for NBFCs such as BFL is achieving higher economies of scale while keeping operating costs and credit quality under check. Although BFL is a significant player in its niche, it is disadvantaged by lack of scale. Furthermore, it is yet to be tested on its asset quality performance over a longer time horizon and on a larger scale. We believe BFL's stock will see a re-rating if the company were to establish strong performance metrics (operating efficiency and asset quality) with larger scale over the medium term.

Improvement in operating efficiencies and asset quality are key re-rating factors

Figure 56: Asset base compared to other NBFCs



Source: Company, IIFL Research; MGFL – Mannapuram Finance, SCUF – Shriram City Union Finance, MMFS – M&M Financial, SHTF – Shriram Transport Finance;

De-layering organisation and increasing cross-selling to drive efficiency in consumer lending

Higher scale likely to drive cost efficiency for BFL

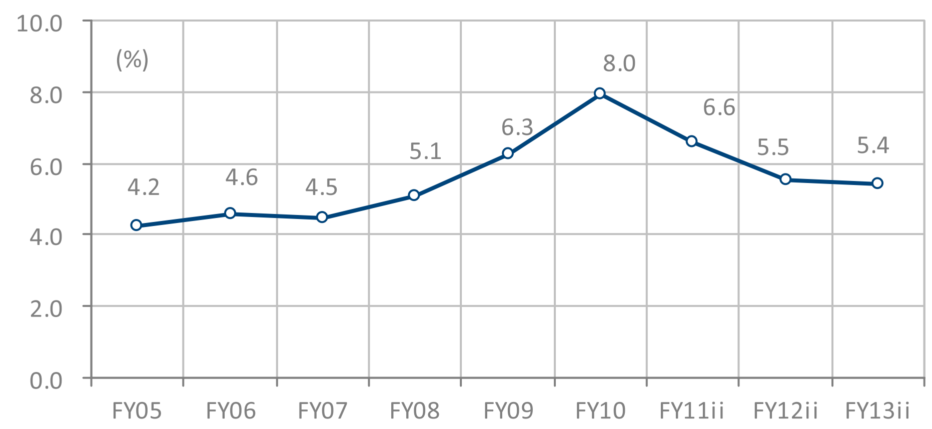
BFL is likely to introduce new products and expand its footprint into new geographies in FY12 and FY13. In consumer lending, BFL already has a large footprint, and BFL would likely rationalise geographies and dealership network through which it originates loans. In consumer finance, the company is likely to launch new products, chiefly credit cards. BFL is likely to launch a co-branded credit card with a commercial bank to leverage its large client base in consumer finance (it has acquired ~1.5m new customers in FY11 between sales financing and two-wheeler financing). Given that BFL is seeking to leverage its customer base, the current infrastructure should be adequate. The company's key focus remains on improving process efficiencies in consumer lending. This includes reducing the turnaround time involved in origination and administration processes, de-layering the organisation and increasing cross-selling opportunities.

In small-business lending, BFL is likely to expand into new geographies. This would require an increase in distribution infrastructure for loan origination, underwriting and recovery. However, cost increases on account of a larger distribution set-up are unlikely to be significant, given the large ticket sizes in small-business lending.

We believe expansion of the distribution network and inflation will increase BFL's costs by 25% annually during FY11ii-13ii. Revenue growth would likely outpace cost growth, as deployments and assets are likely to grow at the same pace as cost. Growth could be faster if market opportunities remain robust, and would drive efficiency gains, in our view.

We estimate 25% CAGR in operating expenses over FY11ii-13ii

Figure 57: Operating expenses as proportion of average assets



Source: Company, IIFL Research

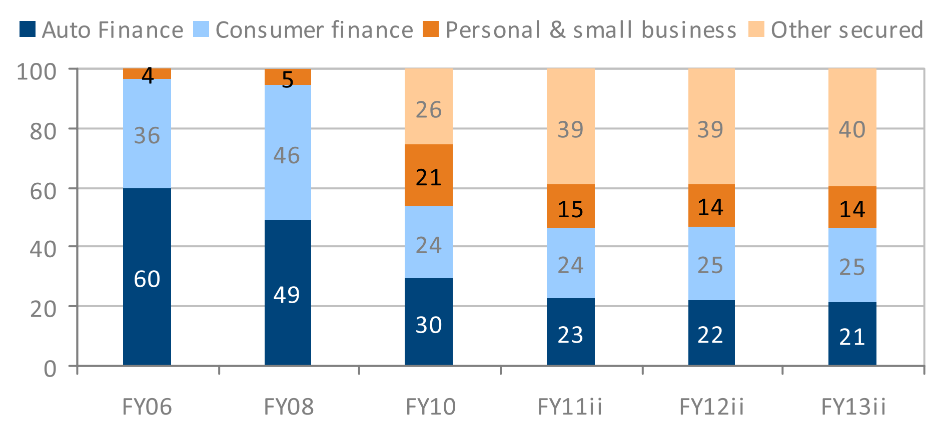
Comfort on asset quality due to change in mix of assets; management preference for quality over quantity

Strong credit culture – key to sustained performance

Small businesses and consumer lending are more vulnerable to downturns/distress in the economy. BFL's entry into small-business and consumer finance coincided with the trough in economic activity in FY09. With the economy on the upswing since then, BFL has experienced a favourable tailwind. In our view, there are two other key considerations when evaluating the asset quality outlook for BFL:

1. Focus on secured assets to cushion against sharp rise in credit cost: BFL's thrust would be mainly on secured loans for small businesses, which will help lengthen the duration of assets while providing protection against significant increase in credit costs. BFL would not have the leverage of using foreclosure as a disincentive against default; nevertheless, secured loans would provide significant downside protection.

Figure 58: Trend in deployments – share of auto finance has declined since FY08

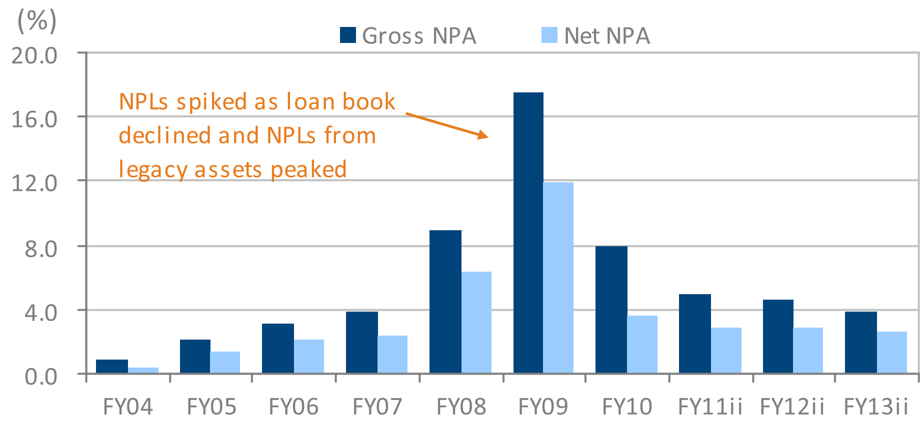


Source: Company , IIFL Research

2. A strong credit culture: BFL's asset quality also benefits from its strong credit culture. The management's considerable experience in the business equips it to navigate through various business and economic cycles. The key shareholders too have a demonstrated track record of choosing quality over rate of growth.

Improving asset quality performance as NPL from legacy assets peaked

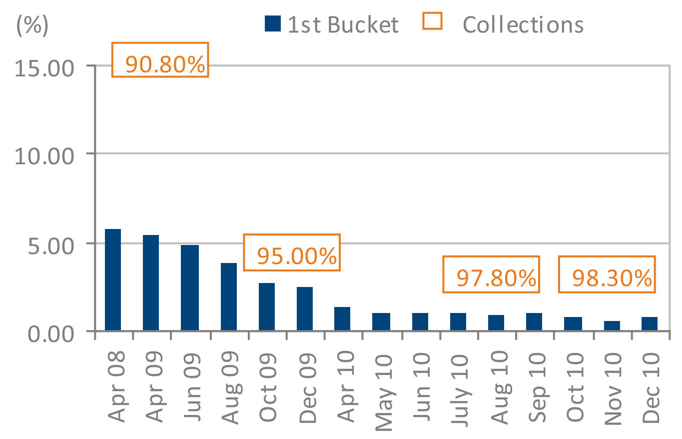
Figure 59: Asset quality trend



Source: Company , IIFL Research

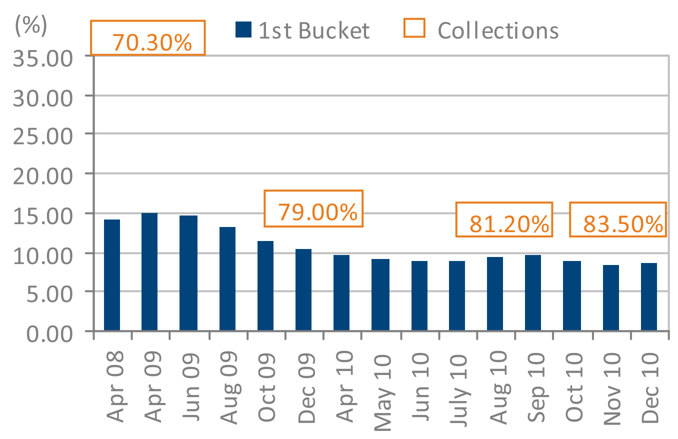
Management has put in considerable efforts into strengthening its risk management processes. The delinquency performance over time bears out the robustness of BFL's processes.

Figure 60: Consumer durable delinquencies



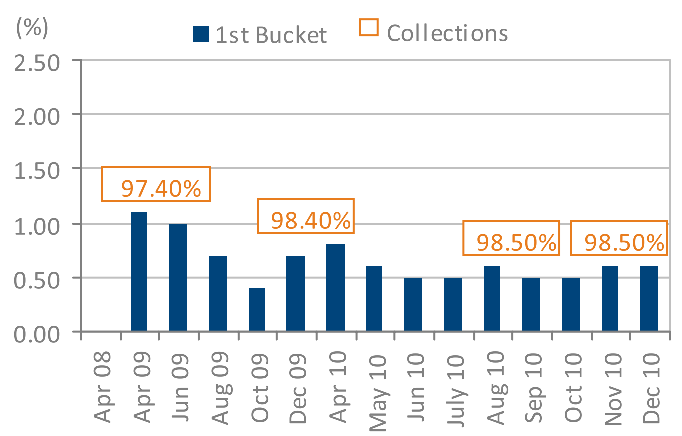
Source: Company, IIFL Research

Figure 61: Two wheeler delinquencies



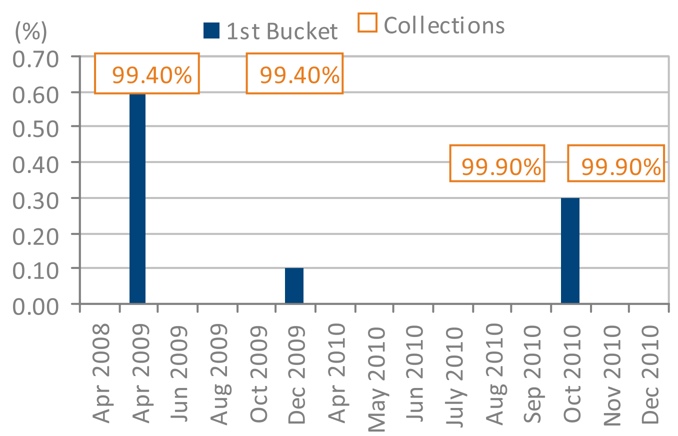
Source: Company, IIFL Research

Figure 62: Personal & small-business loan delinquencies



Source: Company, IIFL Research

Figure 63: Loan against property delinquencies



Source: Company, IIFL Research

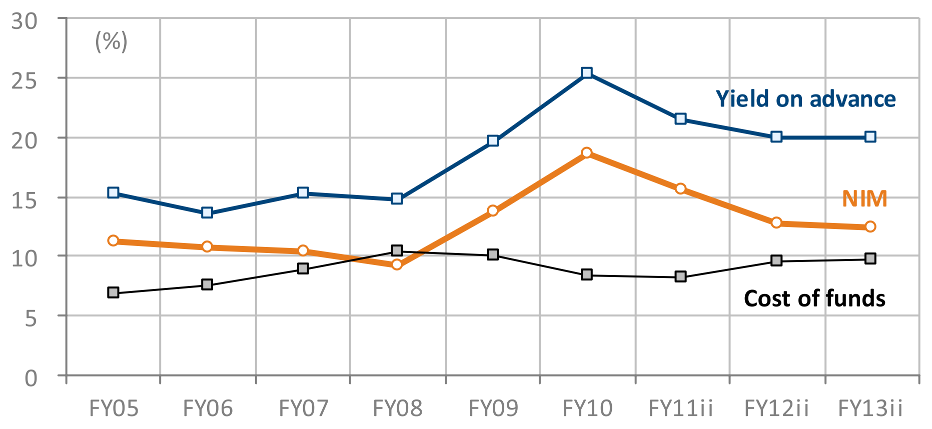
Key catalysts: Robust earnings growth, significant ROE uplift, inexpensive valuation

We forecast over 600bps NIM decline over FY10-13ii due to change in asset mix, rising cost of funds

NIM to moderate going forward

We expect BFL's NIM to moderate from 18.6% in FY10 to 12.4% by FY13ii, as credit growth would come largely from loans against property and small-business loans, putting pressure on overall NIM. Furthermore, BFL benefited from a relatively benign interest rate environment over the past year, which kept cost of funds low despite rapid growth in borrowings. Going ahead, we expect the change in loan mix along with an increase in cost of funds to put pressure on NIMs. Nevertheless, rapid growth in assets should help BFL register strong earnings growth.

Figure 64: NIM to moderate owing to change in asset mix and rising cost of funds



Source: Company , IIFL Research

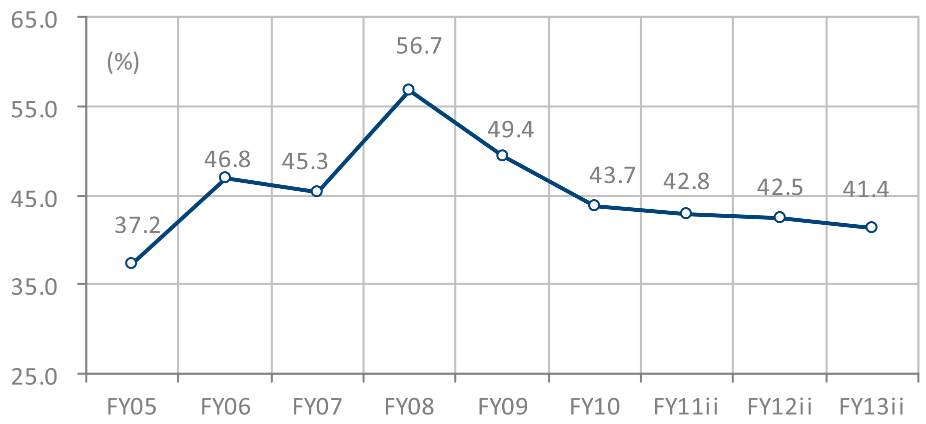
31% operating cost CAGR and 33% revenue CAGR over FY10-13ii

200bps improvement in cost-income ratios over FY10-13ii

Cost/income to moderate

BFL has been aggressively investing in building its presence across consumer retailing chains for consumer-durables financing, and in the top 16 cities for small-business lending. As such, the company will see only limited geographical expansion from hereon, primarily in small-business lending. Furthermore, commissions paid to direct marketing agents (DMA) and staff for sourcing loans is broadly in-line with loan processing fees charged to customers, and this arrangement provides for variable payouts. This, we believe, should enable BFL to keep cost growth under check, although the company is set to witness robust growth in disbursements. We expect operating costs to register 31% CAGR over FY10-13ii, with total income growing at 33% annually over the same period. Thus, we expect the cost/income ratio to improve by over 200bps to 41.4% by FY13ii.

Figure 65: Trend in cost/income ratio



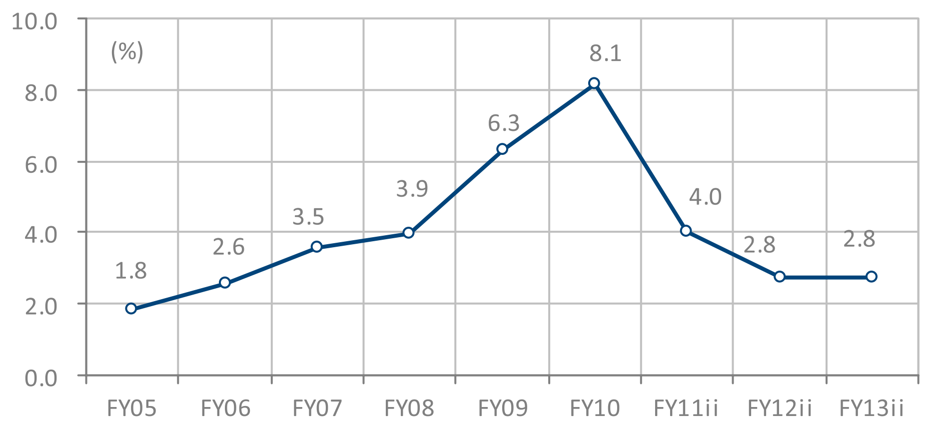
Source: Company , IIFL Research

Normalisation in credit costs to provide additional kicker to earnings growth

Provision charges set to normalise

Weak asset quality in FY09 and FY10 caused its provision charges as a proportion of average loans to rise to 8.15% in FY10. Provision charges are likely to stay high in FY11ii, as BFL would have to write-off more legacy loans to bring down gross NPA. However, with the peak in gross NPAs having already passed in FY09, we expect provision charges to drop to 400bps in FY11ii before normalising between 250-300bps. This would provide a substantial kicker to earnings, as provision charges on legacy issues made up 66% of PPoP in FY10. We estimate this will effectively fall to 30-35% of PPoP by FY13ii.

Figure 66: Fall in provision charges due to declining risk profile of assets to aid earnings growth



Source: Company , IIFL Research

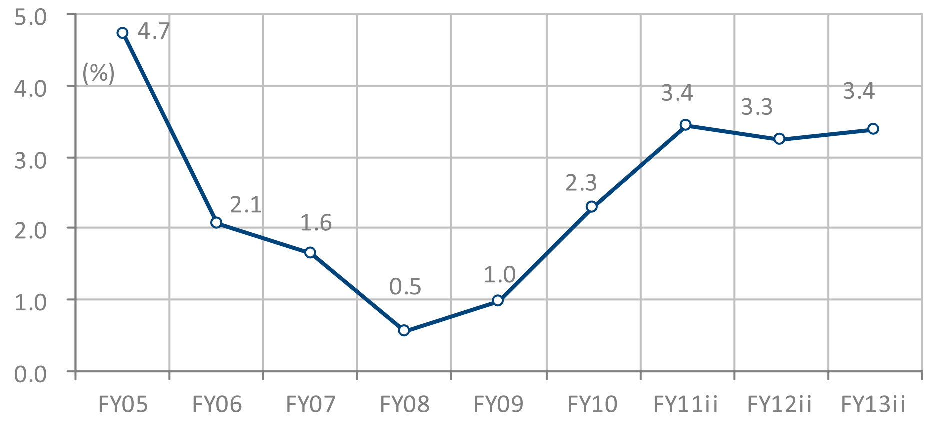
Significant improvement in ROE likely

We expect BFL's RoA to rise by 110bps to 3.4% during FY10-13ii, thanks mainly to improving cost efficiency and falling provisions. We believe BFL would likely sustain above-average RoA, as credit costs are likely to fall short of our estimates in the early phase of growth in secured loans (mainly loans against property). Consequently, we expect RoE to show substantial improvement in FY11ii and rise to 19%, from 8% in FY10. We expect RoE to improve further to 23% by end-FY12ii, on the back of an increase in leverage. However, higher leverage may not be sustainable, requiring BFL to raise additional capital in FY12ii. We believe BFL's sustainable RoE will be 21-22%. Normalisation of credit costs would likely drive RoA closer to 3%;

regulatory and other market-driven discipline would likely require BFL to maintain a leverage of 7x; hence, we expect a sustainable RoE of 21–22%.

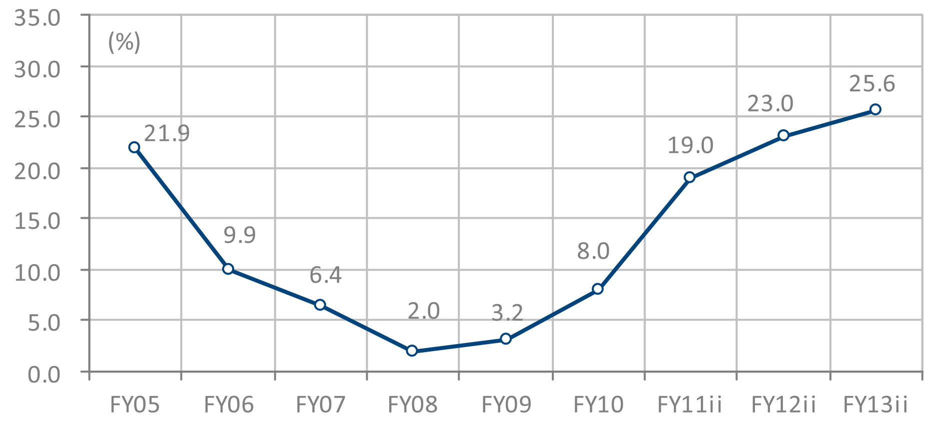
Sustainable ROA and ROE for BFL to be 3% and 21%, respectively

Figure 67: RoA to improve owing to operating leverage and falling provision charges



Source: Company , IIFL Research

Figure 68: RoE to improve due to increase in RoA and leverage



Source: Company , IIFL Research

Strong and sustainable earnings growth to drive up ROE through FY13

Robust growth outlook and ROE uplift to drive valuations: Strong volume growth, improved efficiency and a decline in risk profile of assets would drive earnings performance. Increasing leverage and higher ROA would drive ROE uplift further through FY13. Strong and sustainable earnings growth and rising ROE makes BFL an attractive play in the financial-services space.

Figure 69: BFL's P/B

Source: Bloomberg, IIFL Research

Figure 70: Peer comparison

Company	FY11ii			FY12ii			EPS CAGR
	P/E	P/B	RoE (%)	P/E	P/B	RoE (%)	FY10-FY13ii
Bajaj Finance	**10.3**	**1.8**	**19.0**	**7.4**	**1.6**	**23.0**	**69.7**
M&M Financial	13.9	2.7	23.2	11.2	2.3	22.6	25.6
Shriram City Union	10.5	2.1	21.3	8.0	1.7	23.1	27.4
Shriram Transport	14.1	3.6	28.5	11.8	2.8	26.7	27.3

Source: Bloomberg , IIFL Research

Asset quality, interest rate and regulatory changes are risks to BFL's valuation

Key risks include unfavourable lending environment, rapid increase in interest rates, a less-than-proven track record in new business segments and increase in risk weights.

Asset quality risk from an unfavourable lending environment remains a prominent concern. The management, though less proven in the current set-up, brings a wealth of experience in the chosen business segments from various multinational organisations. This should help mitigate risk.

Rapid increase in interest rates and hence its adverse impact on NIM would likely continue to be a concern, in our view. We are factoring in a moderation in NIMs owing to rise in rates, but a sharp rise could lead to greater-than-anticipated impact on NIMs and loan growth.

An increase in risk weight on loans could be a key risk if the Reserve Bank of India (RBI) sees rapid credit growth in the entire system. Increase in risk weight could constrain BFL's growth rate, but could be mitigated through capital augmentation. Higher capitalisation would likely depress RoE, but this would be partly offset by an increase in RoA.

Financial summary

We expect 70% earnings CAGR over FY10-13ii

We expect 47% loan book CAGR over FY10-13ii

Sharp uplift to ROE driven by strong loan growth and declining credit costs

We expect loan loss provisioning to decline even from current levels

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Net interest income	4,139	6,545	9,900	12,088	15,092
Others	212	600	660	1,113	1,860
Non-interest income	212	600	660	1,113	1,860
Total operating income	4,350	7,145	10,560	13,201	16,952
Total operating expenses	2,204	3,196	4,619	5,724	7,149
Pre provision operating profit	**2,146**	**3,949**	**5,941**	**7,477**	**9,803**
Provisions for loan losses	1,636	2,606	2,422	2,553	3,277
Profit before tax	**510**	**1,343**	**3,520**	**4,924**	**6,526**
Taxes	171	449	1,172	1,625	2,154
Net profit	**339**	**894**	**2,348**	**3,299**	**4,373**

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Net loans & advances	26,075	43,539	84,935	109,787	139,337
Cash & equivalents	418	225	498	506	422
Other interest-earning assets	2,739	3,018	1,660	1,826	2,009
Total interest-earning assets	**29,456**	**47,029**	**87,414**	**112,535**	**142,309**
Fixed assets	202	505	732	878	1,053
Other assets	506	692	692	692	692
Total assets	**30,164**	**48,226**	**88,838**	**114,106**	**144,055**
Other interest-bearing liabilities	16,114	32,268	69,698	90,956	115,650
Total interest-bearing liabilities	16,114	32,268	69,698	90,956	115,650
Non-interest-bearing liabilities	3,162	4,433	5,953	7,629	9,791
Total liabilities	**19,276**	**36,700**	**75,651**	**98,585**	**125,441**
Total Shareholder's equity	**10,887**	**11,525**	**13,186**	**15,520**	**18,614**
Total liabilities & equity	**30,164**	**48,226**	**88,838**	**114,106**	**144,055**

Ratio analysis - I

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Balance Sheet Structure Ratios (%)					
Loan Growth	-19.9	67.0	95.1	29.3	26.9
Growth in Total Assets (%)	-21.6	59.9	84.2	28.4	26.2
Profitability Ratios					
Net Interest Margin	13.7	18.6	15.7	12.7	12.4
Return on Average Assets	1.0	2.3	3.4	3.3	3.4
Return on Average Equity	3.2	8.0	19.0	23.0	25.6
Non-Interest Income as % of Total	4.9	8.4	6.3	5.5	4.7
Net Profit Growth	68.6	163.6	162.6	40.5	32.6
FDEPS Growth	68.6	163.6	162.6	40.5	32.6
Efficiency Ratios (%)					
Cost to Income Ratio	50.7	44.7	43.7	43.4	42.2
Salaries as % of Non-Interest costs	33.1	31.1	30.1	30.4	30.4

Ratio analysis - II

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	17.6	7.9	5.0	4.6	3.9
NPL coverage ratio	32.1	55.0	43.4	36.7	34.0
Total provision charges as % avg loans	6.3	8.1	4.0	2.8	2.8
Net NPLs as % of net loans	11.9	3.6	2.8	2.9	2.6
Capital Adequacy Ratios (%)					
Total CAR	38.4	26.0	15.3	14.0	13.3
Tier I capital ratio	38.4	26.0	15.3	14.0	13.3

Source: Company data, IIFL Research

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CMP	**Rs357**
Target 12m	**Rs490 (37%)**
Market cap (US$ m)	**1,197**
Bloomberg	**HMN IN**
Sector	**FMCG**

14 March 2011

52Wk High/Low (Rs)	519/267
Shares o/s (m)	151
Daily volume (US$ m)	2
Dividend yield FY11ii (%)	1.3
Free float (%)	24.0

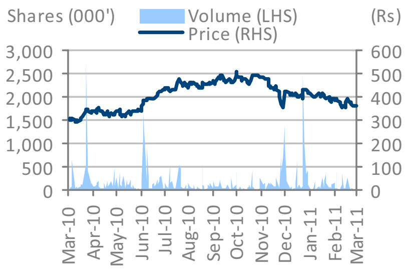
Shareholding pattern (%)

Agrawals, Goenka +	72.7
FIIs	14.8
DIIs	3.4
Others	9.1

Price performance (%)

	1M	3M	1Y
Emami	-8.5	0.8	17.8
Rel. to Sensex	**-11.0**	**7.6**	**12.0**
Colgate	2.6	0.7	16.9
Dabur	5.4	0.2	13.8
Marico	13.7	10.6	23.7

Stock movement



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Emami **BUY**

The niche advantage

Emami is one of India's fastest-growing FMCG companies, with a unique product mix of leadership positions in niche segments such as 'cooling oils', pain balms and antiseptic creams. With minimal competition from large companies, Emami commands high pricing power, which would help it tide over commodity inflation. Growth in low-penetration core categories, product innovation and expansion in the international business will drive 24% earnings CAGR over FY10-13. Margin pressures and an expensive bid for Paras Pharmaceuticals have led to a correction of 24% in the past six months, which we believe is an attractive entry point into the stock.

Niche product portfolio will see high growth with no meaningful increase in competition: Emami operates in niche, low-penetration categories (skin-care, pain balms) and in those categories where consumer adoption is increasing ('cooling oils' and 'cooling talcum powder'). We expect volume growth in Emami's product categories to sustain at 15-20% annually. As these are small product segments, they are unlikely to attract MNC competition. This should also help Emami maintain or strengthen its market position.

New product pipeline, international business will add to growth: Emami continues to churn out new products that are either in niche segments or occupy differentiated positions within large categories. The company is now ramping up a number of new launches that it has done in the past 12-24 months, such as cooling talcum powders, body lotions, cold creams and glycerin soaps. It is also seriously expanding its international business with new manufacturing locations in Egypt and Bangladesh, which could drive 25% revenue CAGR for that business over the next three years.

Pricing power in most segments; margin decline likely to reverse in FY12: Emami enjoys pricing power in most of its segments, thanks to minimal competition from companies and dominant market share. Emami has faced steep inflation in a few inputs such as menthol and liquid paraffin. The company has initiated prices hikes of 6–7%, which should help EBITDA margins to recover from their fall seen in the past two quarters without adversely affecting revenue growth.

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	7,489	10,217	12,241	14,486	17,001
EBITDA Margins (%)	17.2	24.1	21.6	22.9	24.1
Pre-Exceptional PAT (Rs m)	820	798	2,337	2,957	3,416
Reported PAT (Rs m)	820	676	2,337	2,957	3,418
Adj. EPS (Rs)	6.2	5.3	15.4	19.5	22.6
Growth (%)	-13.4	-15.6	192.9	26.6	15.5
IIFL vs consensus (%)			-0.8	0.4	-1.4
PER (x)	**58.6**	**69.4**	**23.7**	**18.7**	**16.2**
ROE (%)	27.9	17.2	33.3	33.9	31.9
Debt/Equity (x)	1.5	0.4	0.1	0.1	0.0
Price/Book (x)	16.0	8.9	7.1	5.7	4.7

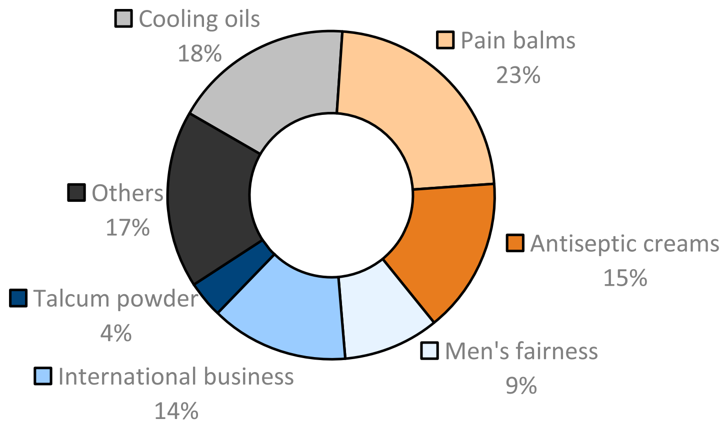
Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

Emami operates mainly in niche segments which have low competitive intensity

The Emami Group is one of India's leading consumer-goods companies, with a presence in niche categories such as 'cooling oils', pain balms and antiseptic creams, with no competition from MNCs so far. The company also markets men's fairness creams and ayurvedic OTC medicines. As a result, competition for Emami's brands has been relatively low, which has enabled superior margins for the business (63% FY10 gross margins, ahead of the 48-53% range for the personal care peer group).

Emami's FY10 revenue mix



Source: Company, IIFL Research

Emami's key brands

Key category	Brand	Comments
Cooling oil	Navratna	• Revenue share of c50% in the Rs5.8bn category • CAGR of 14% over FY05-10 • Large players like Dabur and Marico failed to successfully enter this segment • Fastest-growing segment in hair oils, growing at over 20% in the past three years
Antiseptic cream	Boro Plus	• Revenue CAGR of 18% over the last five years • Third-largest skin-care brand in India • Increased market share from 64% to 75% over the last five years in boro-creams
Men's fairness creams	Fair And Handsome	• This brand, launched in 2005, was the first fairness cream targeted at men • Crossed Rs1bn in revenues in FY11, 60% market share
Pain balm	Zandu, Mentho Plus	• Revenue CAGR of 21% over the last five years in Mentho Plus • Acquired Zandu in 2008. The brand has grown c25% in FY11 • Holds 65% share in this category, the only national player

Source: Company, IIFL Research

The Emami group has presence in FMCG, newsprint, real estate, healthcare and refined edible oils

Background

The Emami Group was co-founded by two childhood friends, RS Agarwal and RS Goenka in 1974. From the beginning, the company launched differentiated products from the established brands. Outside the listed entity Emami Ltd, the group now has a presence in newsprint, healthcare, refined edible oil and real estate, and is likely to enter the cement business in the near future.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cooling oils (YoY growth)	-5%	12%	16%	16%	16%
Pain balms (YoY growth)	-2%	6%	20%	14%	14%
Winter skin creams (YoY growth)	11%	18%	12%	18%	15%

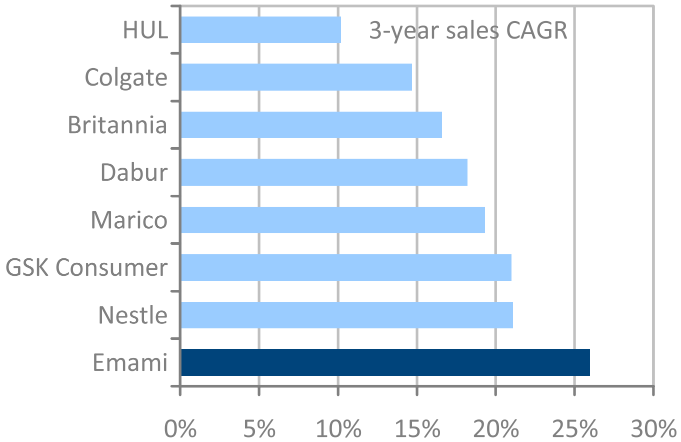
Source: Company data, IIFL Research

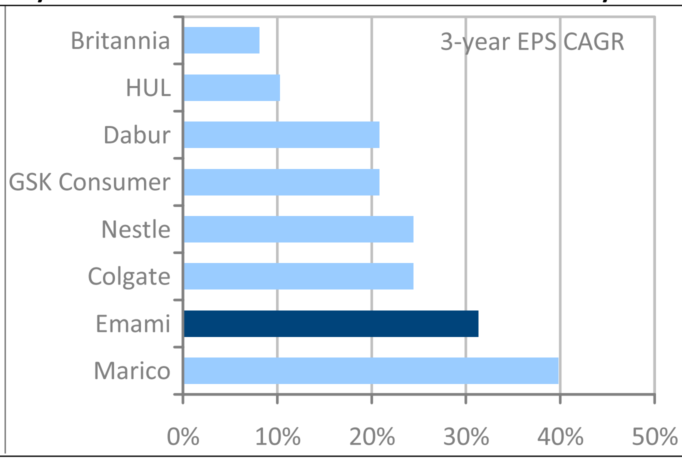
Niche product portfolio will see high growth and little escalation in competition

One of India's fastest-growing FMCG companies

Through a number of product innovations and the acquisition of Zandu, Emami has recorded a sales and EPS CAGR of 26% and 32%, respectively over FY07-10, making it one of the fastest-growing consumer companies in India during this period.

Figure 71: Emami's revenue and earnings growth in the last three years has been one of the best in the FMCG industry





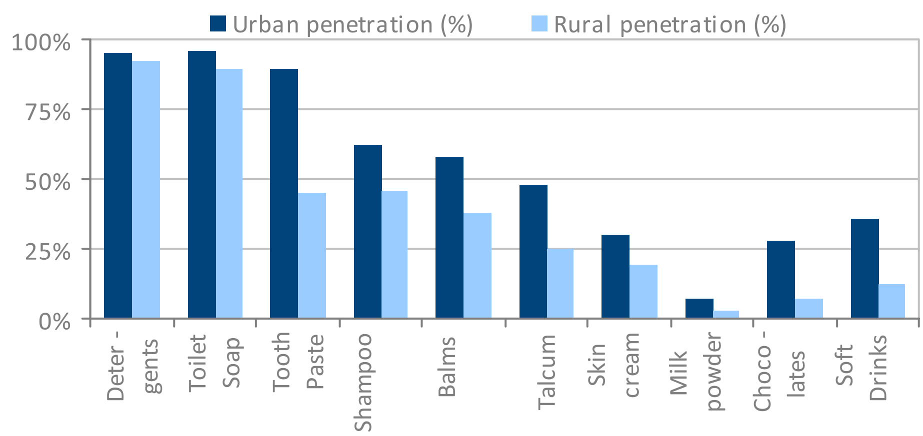
Source: Industry, IIFL Research

Under-penetration/consumption gaps and presence of large unorganised sector points to strong long-term growth potential

Most of the categories where Emami operates have low penetration levels

Penetration levels for categories such as skin creams, which account for c30% of Emami's domestic sales, are very low in India, at c24%. Per-capita consumption of skin-care products in India is very low when compared to other emerging markets such as Indonesia, China and Thailand. India's per-capita consumption of skin-care products is one-eighth that of China and one-twenty-fifth that of Thailand. Penetration rates of talcum powder and pain balms are also low.

Figure 72: Emami's skin-care and balm categories have low penetration



Source: Company, IIFL Research

Cooling oils is one of the fastest growing categories with revenue CAGR of 28% over three years

On the other hand, 'cooling hair oil', which accounts for 25% of the company's sales, is a completely new category that was pioneered by Emami itself over the past decade. Thus, there is a large segment of consumers who are yet to even try the product. The product has witnessed strong sales, as it offers a unique way of satisfying the consumer's need to beat the heat in Indian weather conditions. This is reflected in the category's sales CAGR of 28% over the last three years. We expect consumer penetration of the product to increase further.

Most of Emami's categories are natural/ayurvedic and are small in size, which is not attractive for MNCs

Non-MNC categories make for relatively low competition

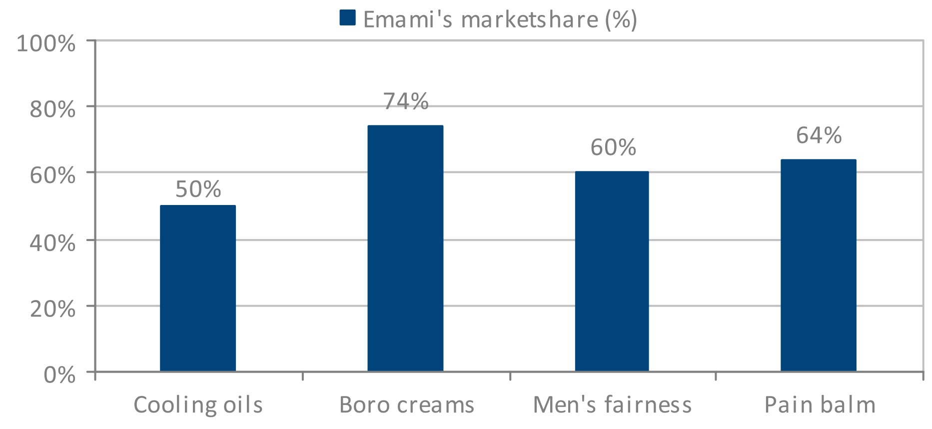
Emami draws c70% of its domestic turnover from niche categories such as 'cooling oils', boro antiseptic creams and pain balms, in which it commands market leadership. Attributes such as relatively smaller category sizes and 'natural'/ayurvedic positioning of these products make the categories relatively unattractive to large MNCs. This, we believe, explains the absence of MNCs in these segments. Barring categories such as men's fairness cream—where Emami faces a formidable competitor in Hindustan Unilever—Emami's other large categories are niche, where competition is less intense, in our view.

Figure 73: Emami faces little competition from MNCs in most segments

Category	Key competitors
Cooling oil	- Local players in north India - Hemgange, Himtaj, Banfool - Marico (in prototype stage) in Andhra Pradesh
Pain balms	Amrutanjan - local player in Tamil Nadu and Kerala
Antiseptic creams	Boroline (GD Pharmaceuticals) – player in East India
Men's fairness cream	HUL, L'Oreal
Cooling talcum powder	Paras Pharmaceuticals (now Reckitt Benckiser) , Heinz

Source: Company, IIFL Research

Figure 74: Emami has dominant market share in niche categories



Source: IIFL Research. Note: Balms market share includes Zandu

Even large Indian companies do not directly compete with Emami in most categories

Among Indian FMCG companies, Dabur and Marico operate in the hair-oils segments and have made attempts to enter the 'cooling hair-oil' segment in the past, but have failed to make a mark. While Dabur has clearly given up its ambitions in this category, Marico has modified its goals from taking a large share in the segment to playing on the nourishment platform within cooling oils to avoid taking Emami head-on. Emami's brand franchise has been built through a decade of advertising involving some of India's biggest movie stars.

Rural areas contribute 45% to Emami's revenues

Rural exposure adds resilience to revenues

Emami derives c45% of its revenues from rural areas, which we reckon will stay resilient to the consumer price inflation that India is witnessing. Agri incomes continue to increase on the back of increases in prices of agri commodities, while government social programmes like NREGA continue to augment income at the bottom of the pyramid. Products such as *Navratna* 'cooling oil' and *Fair and Handsome* are positioned to appeal to the masses. The company has focussed on making products affordable to rural consumers through smaller SKUs and price points. About 40% of Emami's overall sales come from SKUs priced at less than Rs10. So, while *Navratna* oil is available in sachets of Rs1, *Boro Plus* antiseptic cream and *Fair and Handsome* are sold at Rs5. The company has recently introduced Zandu balm in a Rs2 pack.

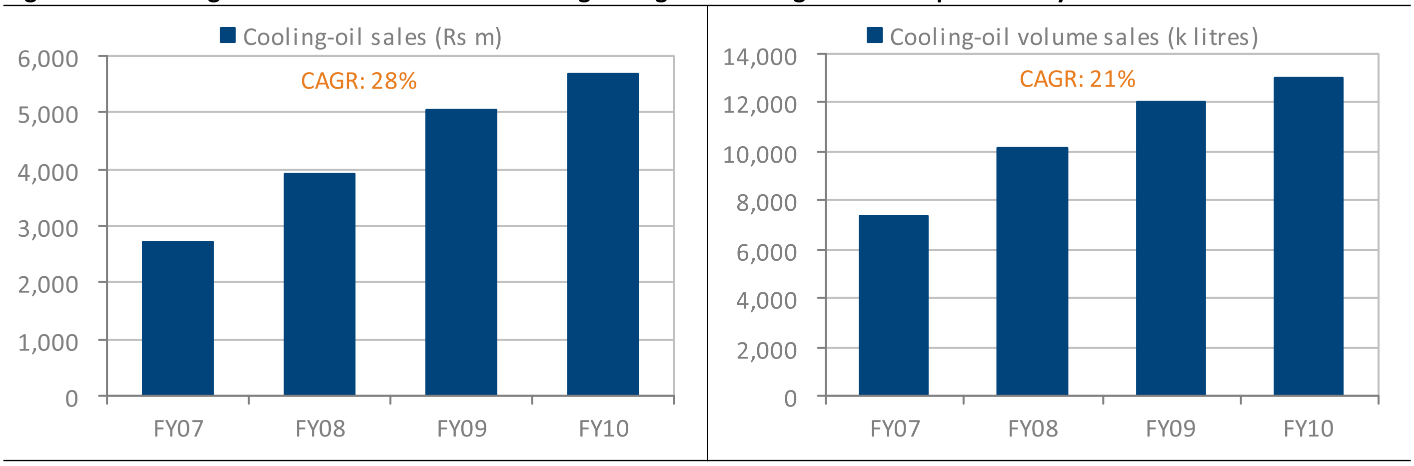
Navratna Oil (18% of sales)

Source: Company

Growth driver # 1: Navratna Hair Oil—created the 'cooling oil' category

Navratna is positioned as a 'therapeutic cooling oil', a stress-reliever and relaxant. This category's sales have grown from virtually nil a decade back to Rs5.8bn in FY10. It has been one of the fastest-growing FMCG categories, with a 3-year revenue CAGR of 28%. This is a unique case of new category creation, as the need gap for a 'cooling oil' was not identified until a decade ago. Emami, through a high-decibel advertising campaign with top movie actors, played the lead role in creating the category, with the result that its brand 'Navratna' is now synonymous with the category. The category's penetration, at c10%, is quite low compared to the over 80% penetration of all hair oils. This, we believe, gives the category ample scope for growth.

Figure 75: Cooling oils has been one of the fastest-growing FMCG categories in the past three years

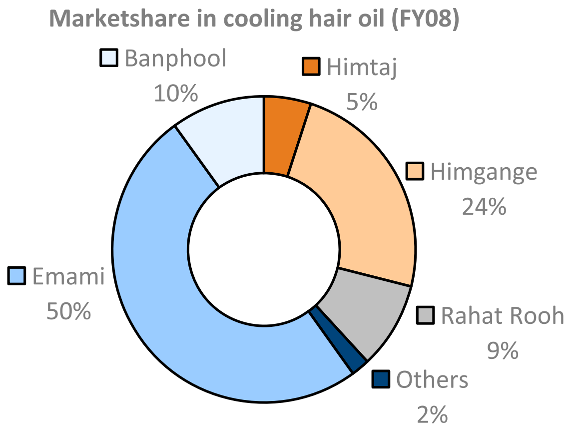


Source: Industry, IIFL Research

Emami's competitors in cooling oils are regional players

Other brands in the category include Himgange, Himtaj and Banphool, all from local players. Himgange is strong in the northern states of Uttar Pradesh, Bihar and Jharkhand, while Navratna is sold all over the country. Marico ventured into the cooling-oil category twice in the last four years (last with *Maha Thanda* in 2008), but withdrew both times because of poor consumer response. Dabur's foray (*Dabur Super Thanda*) faced the same fate. Marico is now prototyping a 'nourishing cooling oil', which could take a niche positioning within the category. We do not expect any major competitive pressure in this category.

Figure 76: Emami is the market leader in cooling hair oils, with a c50% share



Source: Company, IIFL Research

Emami has launched variants to take on *Hemgange*, a strong local player in North India

Emami is now also growing the brand through brand extensions. It has launched two major line extensions of Navratna this year in select markets—*Navratna Lite Oil* to cater to consumers who want a non-sticky form of the oil, and *Navratna Extra Thanda Oil* to counter competitor Hemgange, whose USP is that it has significantly higher menthol content than Emami's Navratna.

***Boro Plus* (15% of sales)**

Source: Company

Growth driver # 2: Boro Plus—one of India's largest-selling skin creams

Boro Plus antiseptic cream is positioned as both a curative antiseptic cream and a winter cream that protects the skin against harsh winters. It is the third-largest skin-care brand in India after Fair & Lovely and Pond's. In 2009, Emami extended the brand to other categories such as lotions and fairness creams, which are categories with combined revenues of over Rs25bn.

Boro Plus has been gaining share in the Rs1.9bn antiseptic boro brand market. Boro Plus has a market share of 75%. Competitors such as Boroline (GD Pharmaceuticals), which was a dominant leader in the category till the 1990s, and Borosoft (Paras Pharmaceuticals) have lost share, as they could not match Emami's advertising investments.

***Boro Plus* franchise's growth to be driven by extensions like lotions and fairness creams**

The 'boro creams' category has seen stable double-digit revenue growth over the past three years. The skin-care category is seeing c20% revenue growth driven by low penetration of 24% and very high growth in the top-end segment, as aspirations continue to rise among Indian consumers. We expect Boro Plus's revenues to grow in-line with the market's growth rate of 15-20%. Brand extensions, especially in the fast-expanding body-lotions category, will aid this growth.

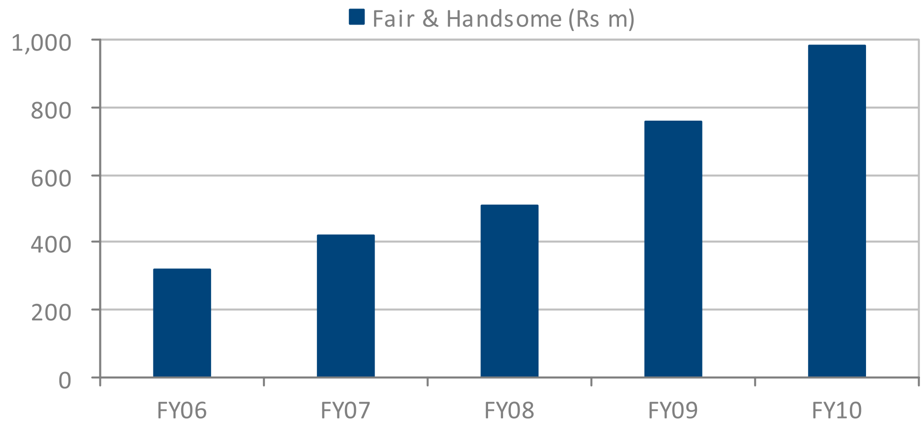
***Fair And Handsome* (9% of sales)**

Source: Company

Growth driver # 3: *Fair and Handsome*—early-mover advantage

Emami established itself within India's Rs20bn fairness-cream market in 2006 through the innovative launch of a fairness cream targeted at men. Marketers have long known that there is a market for fairness creams targeted at men: market research showed that 30% of the fairness creams sold in India was actually used by men, as there were no separate fairness creams positioned for them. Emami was one of the first to spot this opportunity, and its early-mover head-start has given it a market share of 60% in the category.

Figure 77: Fair and Handsome has rapidly ramped up sales



Source: Company, IIFL Research

Hindustan Unilever launched its men's fairness cream two years after Emami's launch. The initial launch was not a success—the company was unable to garner a share of more than 10%. However, HUL's recent re-launch of the brand has been more successful, which has led to Emami's volumes remaining flat YoY in 3QFY11. While larger packs have seen YoY growth for Emami, the sachets, which account for 50% of Emami's volumes, have seen a decline in 3QFY11. The reason for this slowdown remains unclear.

The category growth will be driven by more men shifting to male-specific fairness creams from general fairness creams

We expect sales in the men's fairness cream category to grow at an annualised rate of 20-25% over the next 3-5 years, driven by rising male grooming needs of an increasingly appearance-conscious generation. Men account for 30% of India's Rs20bn market for fairness-creams, and this segment can potentially be converted to a specialised men's fairness cream market. As fairness creams targeted at men currently form a relatively small market—about Rs2.5bn annually—there is significant scope for growth.

***Zandu & Mentho Plus* Balm (23% of sales)**

Source: Company

Growth driver # 4: Zandu Balm and Mentho Plus Balm—growth boost through advertising investments

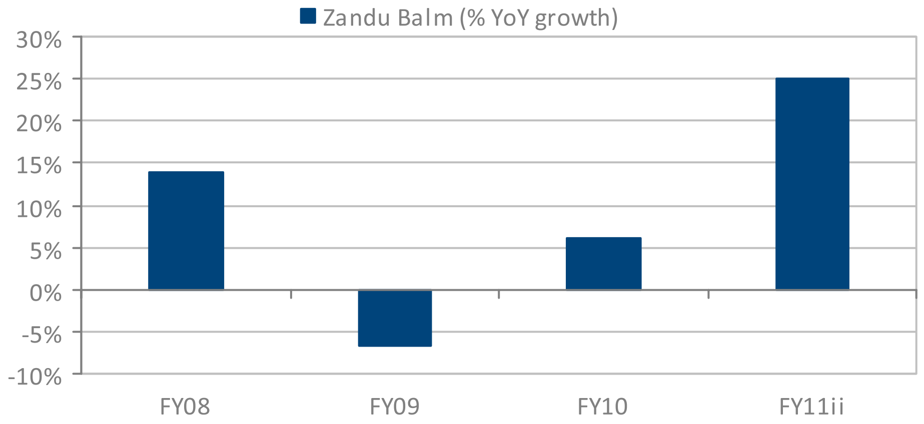
Zandu balm was acquired by Emami in FY09 after a hostile takeover, which took Emami's market share in this category to over 60%. The management concentrated on extracting cost synergies in FY10, primarily by shifting manufacturing to tax-exempt areas, reducing trade margins and merging distribution and supply chain with Emami. As a result, Zandu's PAT jumped four-fold from Rs150m in FY08 to Rs600m in FY10. The management started aggressively investing in the Zandu brand in 2HFY10 by getting top cricket players to endorse the brand, and more recently, placing the brand in popular movies. This has spurred the brand's sales, which are up c25% in FY11, as compared to the 10-12% growth seen in the past 4-5 years. The brand was advertised for the first time in over five years. The only serious competition to Emami is Amrutanjan, a Rs1bn-a-year brand, which is strong in the two southern states of Tamil Nadu and Andhra Pradesh.

Emami targets the entire pain management category of Rs30bn with Zandu Balm as opposed to only the Rs5bn pain balm market

Being the market leader, Emami is looking to grow the category. The management sees the category as a Rs30bn pain management category, including Rs15bn worth of pain tablets. To target this one-at-a-time use consumer need, Emami has just launched a Rs2 SKU of Zandu Balm.

Emami 's aggressive marketing inputs have led to an acceleration in Zandu Balm's growth rates

Figure 78: Zandu Balm's sales have risen strongly after its takeover by Emami



Source: Company, IIFL Research

New product pipeline, international business will add to growth

Emami is ramping up a number of launches done in FY10 and FY11

Emami continues to churn out new growth drivers

Emami continues to draw revenue growth from products launched in the past 1-2 years. A number of launches done in FY11 are in ramp-up mode, and revenues from them would likely grow much faster than those from other established products, helping Emami maintain the 18-20% revenue growth it has historically delivered on an organic basis. These launches done in FY10 are already contributing 10-12% to overall revenues, and would see a further ramp-up in FY12. As in the past, Emami's new launches are either in niche segments or have a clearly differentiated positioning in larger categories such as skin-care.

Figure 79: Emami's key product launches in the past two years already contribute 10-12% of overall revenues

Product	Category	Category size	Product proposition and market position
 Malai Kesar Cold Cream	Cold cream	Rs2bn	Contains 'malai' (milk cream), which is traditionally used as a skin cream in the winter. The brand has taken 8-9% market share in the cold cream category in 24 months from its launch.
 Navratna Cool Talc	Cooling talcum powder	Rs3.2bn	Launched in FY09 and grew over 100% YoY in FY10. Now has 13% market share in the category. The company plans to ramp it up significantly in FY12.
 Malai Kesar Cold Cream	Petroleum Jelly	Rs2bn category	A petroleum jelly advertised to have natural ingredients. Petroleum jelly is used in India to protect skin from winter dryness. It is seen as a cheaper alternative to body creams and lotions. HUL is the dominant market leader with its brand Vaseline, but has not invested in any new innovations or variants in this segment. The product was launched in FY11, but as winter was delayed, ad spend on it was rather low.
 Malai Kesar Cold Cream	Cream glycerine soap	Rs2bn	Glycerine soaps form a niche segment in the Rs90bn soap market. HUL's Pears is the market leader in this segment. This segment is growing strongly and is seen as a premium soap. The product was launched a few months ago.
 Boro Plus Body Lotion	Body lotion	Rs4bn	This all-season moisturising lotion draws on the *Boro Plus* franchise. The category's annual sales are Rs4bn, and HUL's Pond's is the market leader. Emami also launched separate winter and summer body lotions. The products achieved sales of Rs160m in FY10.

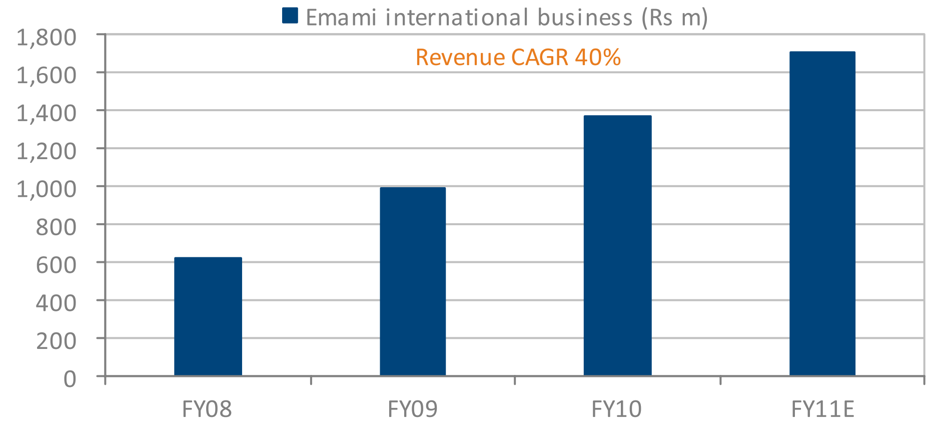
Source: Company, IIFL Research

Emami's international business is small, relative to other Indian FMCG players

International business will be a key growth driver

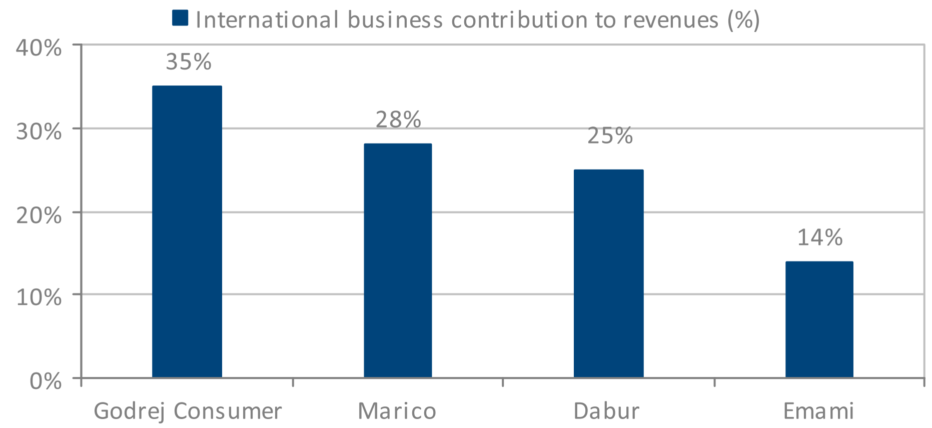
Emami currently draws 14% of consolidated revenues from its international business. The business has delivered a CAGR of 30% over the past three years. Emami's international business comprises its business in the Middle East, North Africa and the CIS nations, where the company was largely exporting products from India. Despite the high growth, Emami's share of international business is significantly lower than other large Indian FMCG companies, which range from 24-35%. Emami has organically built its international business by initially exporting and then setting up its own distribution network.

Figure 80: Emami's international business has seen revenue CAGR of 40%



Source: Company, IIFL Research

Figure 81: Emami draws much lower % contribution from international business



Source: Company, IIFL Research

Emami is setting up manufacturing in Egypt and Bangladesh, which will be new growth geographies over the next 2-3 years

Emami is now moving to the next level of setting up local manufacturing, marketing and product development for these markets. The company has recently enhanced its distribution system in the CIS and has acquired manufacturing assets in Egypt to serve the Middle East and North Africa. FY12 will also mark Emami's entry into Bangladesh, where it is setting up local manufacturing for its cooling oils, balms and skin creams.

Figure 82: Emami is starting manufacturing in new geographies in FY12

Product	Product proposition and market position
Bangladesh	• Emami setting up manufacturing unit for pain balms, skin creams and hair oils, which would commission in FY12 • All of Emami's categories are relevant for the market, as consumer behaviour is very similar to East India, which is a big market for Emami • Initial response from products that Emami exports and distributes to Bangladesh has been very encouraging despite them being at a very high price due to high import duties. These duties would now go and products would be priced at significantly more affordable rates
Egypt	• Emami has bought a manufacturing asset in a Free Trade Zone, which is exempt from direct and indirect taxation • Egypt will be the manufacturing hub for the Middle East and North Africa, which are covered in a free trade agreement • Emami currently pays 5% import duty for the products it sells in the Middle East, which would not be there any more • Greater expansion into North Africa would lead to faster growth in this region

Emami plans to take up the share of international business in overall revenues from 14% now to c20% in three years

We expect Bangladesh and North Africa to be an important growth driver for Emami's international business over the next 3-5 years. Overall, we expect the contribution of international business to move up from 14% currently to 18-20% over the next five years, as this business is expected to grow at 25%+ over this duration.

Pricing power in most segments; margin decline will likely reverse in FY12

Menthol and liquid paraffin are the main raw materials that are seeing very high cost inflation

Emami has witnessed very high inflation in key raw materials

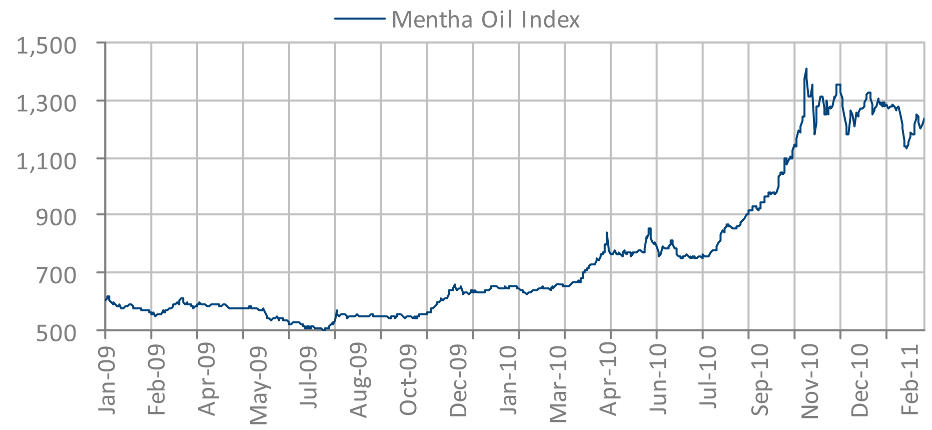
Some of Emami's key raw materials have seen steep and unexpected cost increases in the past six months. Menthol, which is a key input for cooling oils and pain balms, has seen a price increase of over 90% YoY and is now well above its all-time peak. Another key input for cooling hair-oils, light liquid paraffin, has seen a price increase of 40% YoY. All packaging materials for personal-care brands are crude derivatives and are likely to see YoY inflation in the quarters ahead, as the lagged impact of the increase in crude prices flows through.

Figure 83: A number of key raw materials have seen steep inflation

Raw material	% of raw material	% price rise YoY	Remarks/outlook
Packaging material	45%	5%	Prices of crude derivatives such as polyethylene and HDPE are likely to rise as the impact of rising crude would hit with a 2-3-month lag.
Light liquid paraffin	8%	45%	Crude derivatives have risen as domestic capacities have not ramped up in-line with demand growth. Rising crude prices would put further pressure.
Menthol	11%	90%	An agri commodity which rose 100% and now has stabilised at marginally lower levels. The new crop in April could cool down prices.

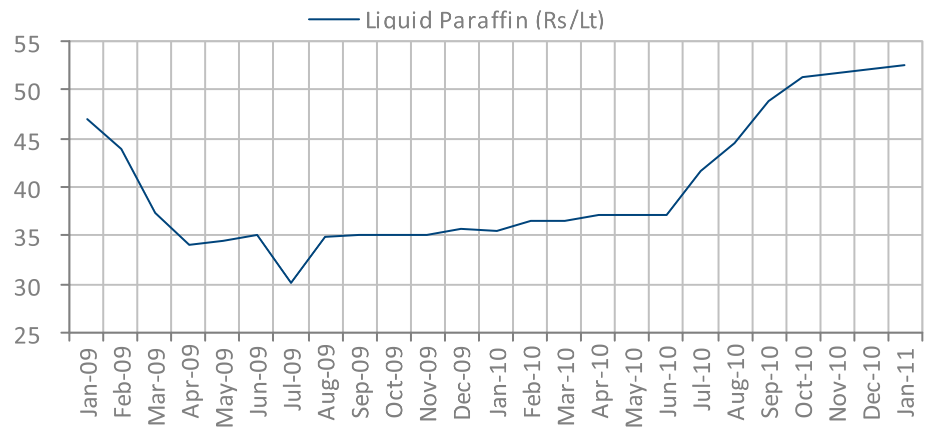
Source: Company, IIFL Research

Figure 84: Mentha oil has risen over 90% YoY, though it has now stabilised



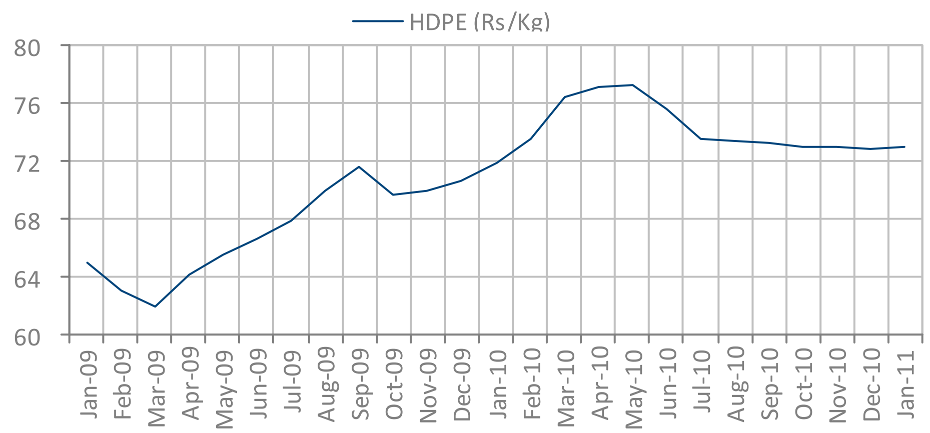
Source: Company, IIFL Research

Figure 85: Liquid paraffin has risen 45% YoY on capacity shortages



Source: Company, IIFL Research

Figure 86: Packaging material prices would pick up with a lag to crude prices



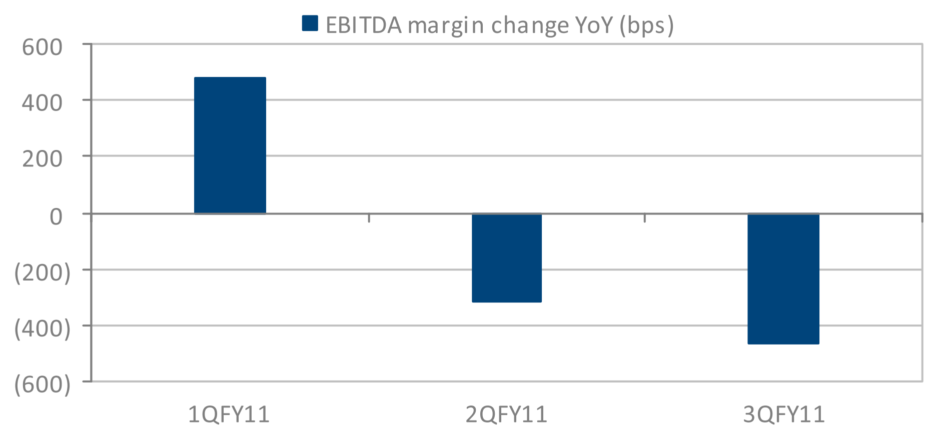
Source: Company, IIFL Research

Emami's margins have fallen on account of the lag in taking price hikes

There was a 3-4 month lag between commodity costs moving up and Emami taking price hikes

Emami's EBITDA margin fell 460bps YoY in 3QFY10, led by a 550bps YoY drop in gross margin. As inflation in commodities such as menthol and liquid paraffin was unexpected, the management waited to see if the high prices would sustain before initiating price increases. The 3-4-month lag between commodity inflation and price hikes led to a fall in margins.

Figure 87: Emami's EBITDA margins have declined YoY in the last two quarters



Source: Company, IIFL Research

Emami has pricing power in almost all categories due to benign competition or very high growth

Emami has pricing power in most categories; margins likely to recover in FY12

As discussed, Emami draws over 75% of revenues from segments in which it has no competition from major MNCs or large Indian FMCG companies. Emami is a market leader in almost all its segments, and its challengers in cooling oils, pain balms and boro creams are largely players who operate in their chosen states. Meanwhile, in categories where Emami does have competition—mainly skin-care—its major competitors such as Hindustan Unilever have taken price hikes in the recent past, and as such there is no price competition. Thus, Emami has faced no difficulty in raising prices in segments like men's fairness creams, cold creams and lotions, despite having strong MNC competition.

Figure 88: Emami has initiated a number of price hikes post November 2010

Brand	% contribution to revenue	Price hike
Zandu balm and Mentho Plus	24%	10%
Boro Plus	16%	5-7%
Fair & Handsome	9%	8-25%
Navratna large packs	9%	8-10%
Fast Relief, Chyawanprash	5%	8-10%
Overall portfolio		6-7%

Source: Company, IIFL Research

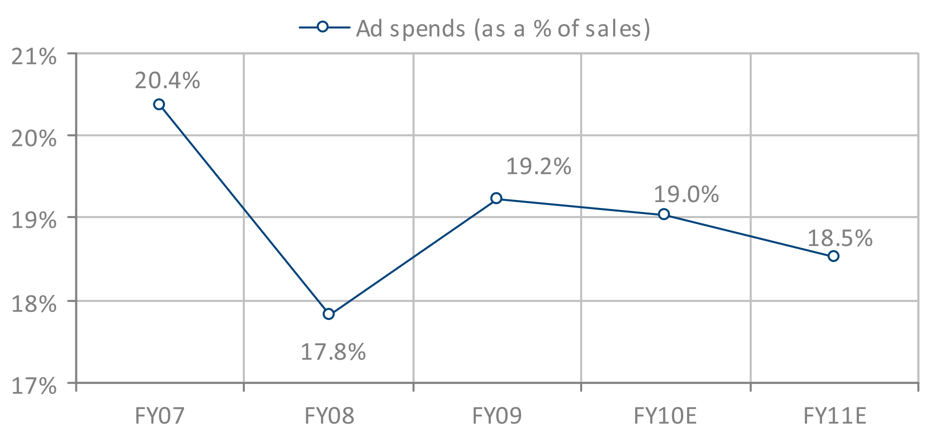
At the aggregate level, Emami raised prices by 6–7% in November–December 2010. We do not expect volumes to be adversely affected except for initial trade stocking issues. We expect margins to start recovering in 4QFY11 and see further recovery in FY12.

Ad spends could be used as a last resort if commodity inflation accelerates further from current levels

Ad spends are a margin lever, though the management would use it as a last resort

Emami's ad spend as a proportion of revenues is among the highest in the Indian FMCG industry, though the proportion has been declining gradually as Emami's lead brands mature into larger size. That said, the company has maintained the momentum with new launches, which has kept the total ad spend from falling sharply. Thus, the company could use ad spend as a margin lever in the short term to go slow on new segments. However, the management is likely to use this only as a last resort, as it believes in investing consistently and adequately to support new products.

Figure 89: Emami's ad spends are gradually declining as a proportion of revenues



Source: Company, IIFL Research

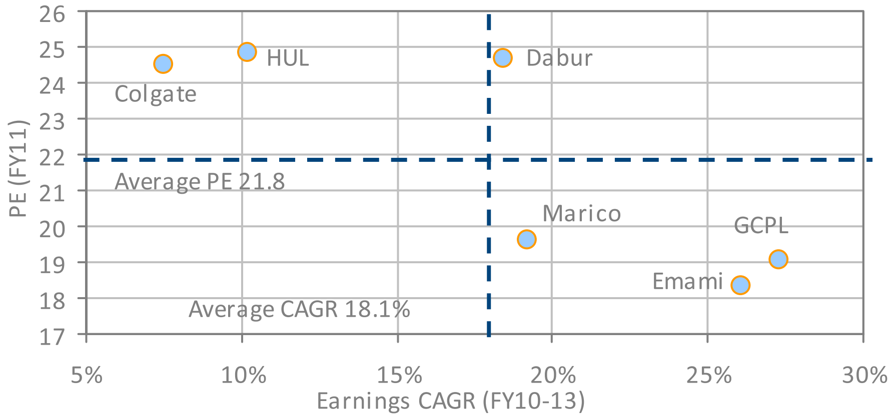
Valuations

Stock correction owing to near-term margin pressures and an expensive bid for Paras Pharma

Emami's stock has corrected 24% over the past six months largely due to an earnings downgrade for FY11, owing to lower-than-expected margins in 2HFY11 given the sharp spike in some raw materials like menthol and liquid paraffin. Also, the management's bid for Paras Pharma, at over 30x 1-year forward earnings, was seen as a risk. However, we believe Emami has pricing power to mitigate cost pressures. Thus, we see the current stock correction as an opportunity to buy the stock.

Emami lies in the favourable quadrant of the valuation growth matrix

Figure 90: Emami lies in a favourable position on growth-valuation matrix



Source: Company, IIFL Research

Key risks

Further commodity inflation will force more price hikes and hence, hurt volume growth momentum: If commodity inflation further intensifies, Emami would need to take further price hikes to protect margins. However, steep price hikes could adversely affect the strong double-digit volume growth that Emami is witnessing. However, given the low penetration of most of Emami's key categories, we believe any slowdown in volume growth would be short lived.

Marico's continued attempts to enter the cooling oil market would need to be monitored

Large companies entering Emami's niche segments: Emami has till now faced little competition from large companies in categories like cooling oils, pain balms and antiseptic creams. However, companies like Marico continue to attempt an entry into the cooling oil segment despite a couple of failures. Similarly, skin care players are looking to enter antiseptic skin creams. If any of the larger players are able to get a strong foothold in these categories, it would pose a risk to Emami's pricing power. However, Emami's strong innovation record, diversified revenue stream and high market growth in its categories significantly mitigates any major risk to earnings growth.

Emami's bid for Paras Pharmaceuticals was stretched, as the acquisition size was almost half of Emami's market cap

Management going in for a large acquisition: In the past, Emami's management has made acquisitions that are beyond the comfortable scale for Emami's size. Emami acquired Zandu in FY08 paying c35% of its market cap at that time. Similarly, the company bid for Paras Pharmaceuticals recently for a price that would have been 35-40% of its market cap. While the company has been very successful in extracting significant value from large acquisitions like Zandu through aggressive cost cutting and marketing inputs, such moves create near-term uncertainty, as the acquisition size warrants equity issuance. However, we do not see any acquisition near the scale of Paras on the horizon in the Indian personal care space.

Appendix

RS Agarwal
RS Goenka

Enterprising India 2: Excerpts from IIFL's interview with the founders of Emami, RS Agarwal and RS Goenka

We met the co-founders of Emami in Kolkata. They discussed the beginnings of Emami and how the company has used product differentiation as the central pillar of their strategy. They also outlined their approach towards organisation building and implementing systems and processes as the company looks to transform to a much larger scale.

Tell us about the beginnings of Emami.
RS Agarwal: We used to study in the same school and became very close friends. After graduation, we used to meet almost every day and started thinking about what we could do together, and decided to start a small business together. That is how the journey started. With an initial investment of Rs20,000, we started our business from a 60-sq-ft space in the godown. Our first big success came in 1974, we launched the Emami brand name and launched talcum powders and vanishing creams under the brand name. Both products were hugely successful—so much so that in talcum powder, we became the second-largest player in the country and in vanishing cream, we actually became the market leader, beating established MNC brands.

How did you go about the key marketing tasks—branding, product design, etc?
RS Agarwal: Right from the start, our mantra has been distinctiveness, differentiation and innovation. We studied the gaps in portfolios of the top FMCG companies, and we tried to use these gaps to position our brands. When all other established brands were selling skin creams in tin containers, Emami was the first to come up with plastic packaging, which was a refreshing change and looked significantly better. While all established brands were using cheaper perfume, we came with French perfume in our talcum powder and creams. If you ask consumers who bought these products around the 1970s, they still remember the perfume of Emami talcum powder—it was so distinctive. We have followed the same mantra of distinctiveness, differentiation and innovation in creating Boro Plus, Navratna Oil and Fair & Handsome. Ours is the first company to have come up with advertising in Hindi movies, a medium that was probably the only form of entertainment for most people in the 1970s. So there was distinctiveness even in our style of advertising.

Were there failures in new products?
RS Goenka: Whenever the company faced any difficulty in any new product launch, we were very fast to take decisions and withdraw before any major loss was incurred. Our feedback mechanism and MIS has been very strong from the very beginning, and this has been the biggest reason we have managed to avoid major failures.

What has been your approach towards systems & processes?
RS Goenka: Our experience of having worked in the corporate world stood us in good stead. For instance, from the very beginning, we put in place a strong MIS for all parts of our business, be it sales, purchase, manufacturing or supply chain. As early as 2003, we

introduced ERP in our company, when even many of the large MNC FMCG companies in India were operating on far inferior IT systems. We have a large internal audit team with over 60 persons who constantly audit operations, including forensic audit. Beyond this, whenever we need to look at improvements in our operations, we appoint best-in-class consultants to give us the advice.

Emami group has very large businesses outside of FMCG.
RS Goenka: We are today one of the largest business groups in eastern India. We are the India's largest player in newsprint. In hospitals, we are the biggest private sector player in the eastern zone. We have a pharmacy chain, which is the biggest in the eastern zone, and probably the biggest in the country after Apollo. In real estate, what we have built in Bengal would be a matter of pride for anyone.

There is a perception that Emami is a family-run business and hence professionals do not work in the senior.
RS Agarwal: There is a big difference between owners running a company and professional owners managing a company. We are professional owners. Both Goenkaji and I have strong higher education backgrounds and we have worked in the corporate world in important positions. If I am a chartered accountant, MCom, LLB, FCS, am I not a professional myself? Today, we have around 140 MBAs and around 100 CAs working in our group.

Emami has a diverse set of business and a number of family members are involved in running the businesses. What are the key aspects of managing such a structure?
RS Agarwal: To begin with, each of the companies in our group is a completely separate entity. None of our companies can fund another within the group. In each company, one member of the second generation from each of the two families is involved. Either Goenkaji or I is chairman of each company. We have very well-defined and documented rules for all family members. The rules cover a large number of aspects—owning fixed assets, making investments, personal expenses, and so on. Independent directors on our board include the former chairman of Ernst & Young India, Mr K N Memani; former governor of West Bengal Mr Viren J Shah; and eminent lawyer Mr Y P Trivedi.

How do you evaluate acquisitions?
RS Goenka: Way back in 1982, we took over Himani, which was a sick business in Kolkata. We launched Boro Plus cream in 1983 and followed it up with Navratna oil under the Himani brand name. We acquired Zandu for a price that many analysts then thought was too high, but it was based on a very thorough and highly detailed internal analysis of potential returns. We were clear that Zandu was a valuable franchise, and would generate very high returns after cost rationalisation. Sure enough, profits multiplied 4x within 1-2 years after we took over the company. The Zandu brand's revenues, which were growing at less than 10% annually, are today growing higher than 30%, thanks to our innovative marketing strategy. The same rigorous process of evaluation was done for Paras Pharmaceuticals when we bid for the company. The evaluation was done for every product in the Paras portfolio, looking at possible synergies and opportunities for growth. We know the value of money as we started very small and are very careful when we use our resources.

Financial summary

Revenue growth will be led by volumes and will be aided by new launches

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**7,489**	**10,217**	**12,241**	**14,486**	**17,001**
EBITDA	1,290	2,465	2,601	3,307	4,078
EBIT	1,207	2,310	2,433	3,126	3,883
Net Interest expense	-227	-210	93	180	207
Other Income	79	70	88	96	120
Profit before tax	**1,059**	**2,171**	**2,614**	**3,402**	**4,210**
Taxes	-141	-352	-307	-456	-800
Exceptional items	-1	-121	0	0	2
Net profit	**916**	**1,697**	**2,307**	**2,946**	**3,412**

No major capex is needed to maintain the 15%+ volume growth

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Profit before tax	1,059	2,171	2,614	3,402	4,210
Depr. & amortization	180	154	168	181	195
Tax paid	-141	-352	-307	-456	-800
Working capital Δ	1,485	-532	-103	-158	-65
Other operating items	-6	-121	0	0	2
Operating cashflow	2,577	1,319	2,372	2,969	3,542
Capital expenditure	-5,752	667	404	-200	-200
Free cash flow	**-3,175**	**1,987**	**2,776**	**2,769**	**3,342**
Equity raised	-372	2,075	0	0	0
Investments	756	-176	0	0	0
Debt financing/disposal	3,224	-1,892	-1,600	-500	0
Dividends paid	-398	-531	-810	-1,034	-1,397
Other items	40	10	-9	0	0
Net change in cash	**75**	**1,473**	**357**	**1,235**	**1,945**

Emami paid down its Zandu acquisition debt in just over two years

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & equivalents	141	1,614	1,971	3,206	5,151
Sundry debtors	710	755	904	1,070	1,256
Inventories - trade	738	826	990	1,172	1,375
Other current assets	808	1,065	1,276	1,510	1,772
Fixed assets	**6,495**	**5,673**	**5,101**	**5,120**	**5,125**
Other term assets	426	602	602	602	602
Total assets	**9,318**	**10,536**	**10,845**	**12,680**	**15,281**
Short-term debt	752	1,098	498	498	498
Sundry creditors	1,269	927	1,066	1,262	1,481
Other current liabs	494	695	976	1,204	1,571
Long-term debt/CBs	3,731	1,492	492	-8	-8
Other long-term liabs	60	70	60	60	60
Net worth	**3,013**	**6,254**	**7,751**	**9,663**	**11,678**
Total liabs & equity	**9,318**	**10,536**	**10,845**	**12,680**	**15,281**

EBITDA margin would recover in FY12 mainly due to price increases

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue growth (%)	29.4	36.4	19.8	18.3	17.4
Op Ebitda growth (%)	35.6	91.0	5.5	27.2	23.3
Op Ebitda margin (%)	17.2	24.1	21.2	22.8	24.0
Op Ebit margin (%)	16.1	22.6	19.9	21.6	22.8
Net profit margin (%)	12.2	16.6	18.8	20.3	20.1
Dividend payout (%)	43.5	31.3	35.1	35.1	40.9
Tax rate (%)	13.3	16.2	11.7	13.4	19.0
Return on equity (%)	31.2	36.6	32.9	33.8	32.0

Source: Company data, IIFL Research

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CMP	**Rs348**
Target 12m	**Rs475 (36%)**
Market cap (US$ m)	**958**
Bloomberg	**HAVL IN**
Sector	**Mid-caps**

14 March 2011

52Wk High/Low (Rs)	447/258
Shares o/s (m)	125
Daily volume (US$ m)	2
Dividend yield FY11ii (%)	1.5
Free float (%)	38.4

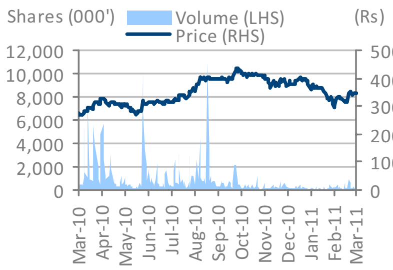
Shareholding pattern (%)

Qimat Rai Gupta & family	61.6
FIIs	16.3
DIIs	2.4
Foreign corporate bodies	10.7

Price performance (%)

	1M	3M	1Y
Havells India	15.0	-6.5	27.2
Rel. to Sensex	12.5	0.4	21.3
Bajaj Electricals	10.3	0.1	14.1
Siemens	1.6	12.2	16.7

Stock movement



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Havells India — BUY

Charged up

Electrical consumer-goods major Havells is a beneficiary of robust demand growth based on upgrading consumer preferences and increased construction activity in its key verticals—switchgears, lighting fixtures, consumer durables (fans) and cables/wires. Strong brands built through aggressive advertising strategy and extensive distribution networks are sustainable growth drivers. Consolidated leverage is set to decline, with its European lighting-fixtures acquisition Sylvania looking to breakeven in FY12, post restructuring. The stock's current P/E of 11.8 on FY12ii is reasonable, in our view, and our target price of Rs475 (ascribing zero equity value to Sylvania) indicates 36% upside. We retain BUY.

Domestic business is a good play on the consumption theme: Havells's consumer businesses such as fans, lighting fixtures, and CFLs (compact fluorescent lamps) are its fastest-growing domestic businesses (growing at over 30% annually). We assume 14.4% CAGR in standalone revenues over FY10-13ii, driven by higher growth rates in consumer businesses. The company spends ~2-4% of its revenues on advertising, and has about 2,000 distributors in India who in turn reach out to ~25,000 retail points.

Significant progress at Sylvania: Havells India acquired Sylvania for an EV of €227m in April 2007 (€200m debt, €27m pension liability). According to the company, restructuring efforts through 'Operation Phoenix' and 'Parakram' at an estimated cost of €32m would generate annual savings of €39m (mainly in manpower costs), and would be fully visible in FY12, when the company should breakeven. In our estimate of Sylvania's turnaround, we do not assume any growth spurt or gross margin improvement in the entity.

Pricing power helps margin defence, improved financials, attractive valuations: With medium competitive intensity in all segments, except cables and wires, price increases to manage raw-material inflation is par for the course. With the breakeven in Sylvania and strong cash flows of the domestic business, leverage should reduce to about 1.1x. Our target price of Rs475 is based on 19x FY12ii EPS (standalone). Key risks are a delay in Sylvania's breakeven and raw-material inflation.

Financial summary (Rs m)

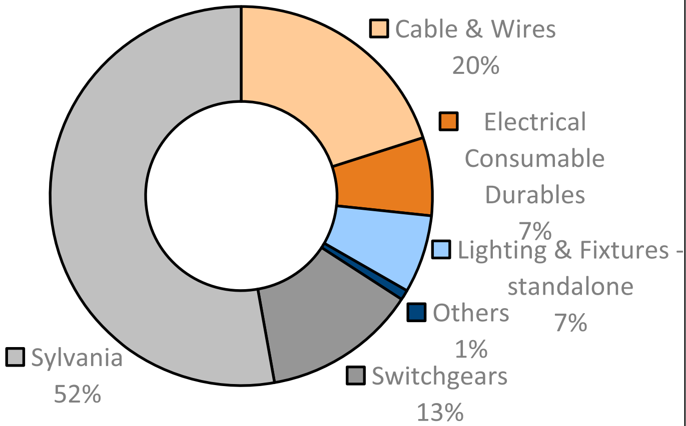
Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	54,775	53,569	55,802	60,652	66,184
EBITDA Margins (%)	5.3	5.4	8.8	9.9	10.6
Pre-Exceptional PAT (Rs m)	385	372	2,434	3,536	4,327
Reported PAT (Rs m)	-1,601	-2,384	2,434	3,536	4,327
EPS (Rs)	3.2	3.1	20.2	29.4	36.0
Growth (%)	-77.0	-3.3	554.0	45.3	22.3
IIFL vs consensus (%)			-5.8	-2.9	2.6
PER (x)	**108.9**	**112.6**	**17.2**	**11.8**	**9.7**
ROE (%)	5.9	7.5	50.0	48.2	41.3
Debt/Equity (x)	2.0	2.8	1.9	1.1	0.6
EV/EBITDA (x)	**17.2**	**16.9**	**10.0**	**7.9**	**6.4**
Price/Book (x)	6.8	11.0	7.1	4.8	3.4

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

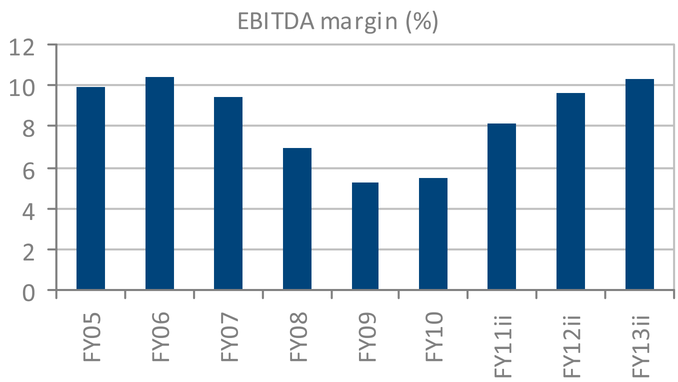
Company snapshot

Havells India, incorporated in 1983, makes a wide range of low-voltage electrical equipment. The company is dominant across a wide spectrum of products and services—industrial and domestic protection switchgears, cables and wires, motors, fans, power capacitors, CFLs, luminaires for domestic and industrial applications, modular switches, and energy meters such as static and electromechanical meters. The company acquired global lighting fixtures major Sylvania in April 2007 for an EV consideration of €227m, funded through debt of €200m. Of this amount, €120m was with recourse to Havells, and there was a residual pension liability of €27m. Havells owns some prestigious global brands, among them Crabtree, Concord and Luminance, and has 91 branches and representatives offices with over 8,000 staff in 50 countries. The company has 11 manufacturing plants in India, located at Haridwar, Baddi, Samepur Badli, Noida, Sahibabad, Faridabad, Alwar and Neemrana. Sylvania has eight manufacturing plants across Europe, Latin America and Africa.

FY10 revenue break-up



EBITDA margins set to expand



Management

Name	Designation	Remarks / management description
Qimat Rai Gupta	CMD	Chairman and group founder. Roots in trading of electrical goods.
Anil Gupta	Joint MD	Graduated in economics from Sriram College of Commerce, Delhi University. MBA (Marketing and Finance) from Wake University, North Carolina.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Standalone revenue growth (%)	4.2	10.7	19.4	13.5	13.6
Cable & Wires growth (%)	4.0	-1.1	20.0	10.0	10.0
Consumable Durables growth (%)	15.4	30.9	29.0	20.0	20.0
Lighting & Fixtures growth (%)	-3.1	33.5	24.0	20.0	20.0
Others growth (%)	-36.0	-32.1	5.0	5.0	5.0
Standalone gross margins (%)	35.9	40.2	39.0	38.0	38.0
Standalone EBITDA margins (%)	9.2	12.6	12.0	11.6	12.4
Sylvania constant curr growth (%)	-2.1	-14.7	-2.1	3.3	3.5
EUR-INR	65.0	67.1	62.0	62.0	62.0
Sylvania EBITDA margin (%)	2.6	-0.7	5.2	7.8	8.1

Source: Company data, IIFL Research

Domestic business plays strongly into consumption theme

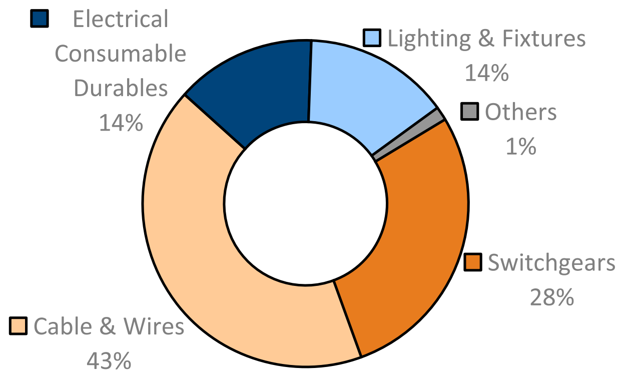
Four key segments

The company has four main segments in its standalone domestic business:

- electrical consumer durables;
- lighting and fixtures;
- switchgear; and
- cables and wires

In all of these businesses, the proportion of industrial buying is small, and almost all of them are driven by domestic consumer demand. As buyers become ever more quality-conscious and the market becomes more broad-based (thanks to increasing prosperity of tier-2 and tier-3 cities), the size of opportunity for a player like Havells, with nationwide distribution and well-known brands, is large. In the smaller industrial buying business component, the company is a beneficiary of India's construction theme and industrial capex, including power capacity and T&D infrastructure augmentation.

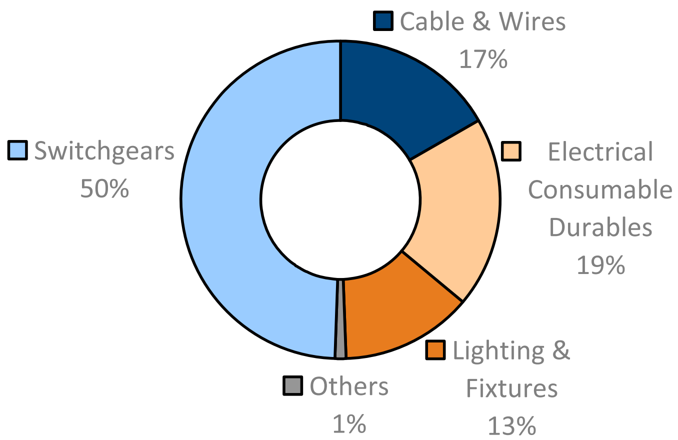
Figure 91: Break-up of domestic revenue pie – FY10



Source: Company, IIFL Research

Figure 92: Breakup of domestic profit contribution pie - FY10

Switchgear is the largest contributor of profits



Source: Company, IIFL Research

Switchgears – highest-value-added segment

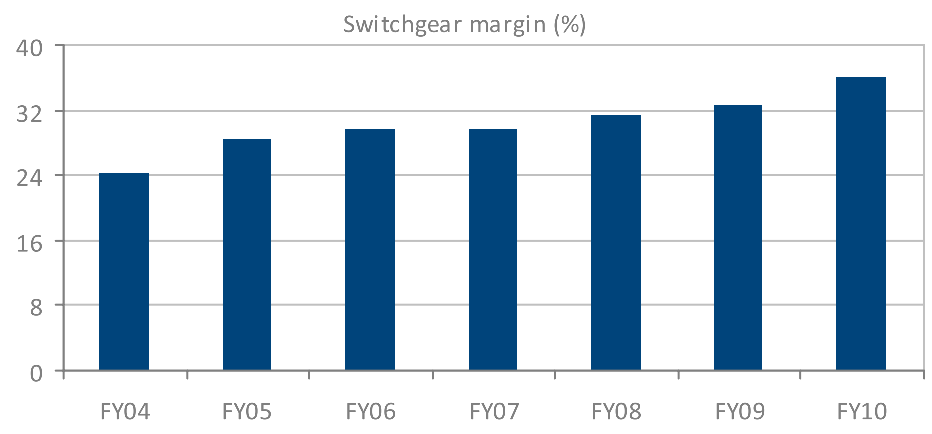
Havells is a leading name in circuit protection devices in India. This market is dominated by big-name multinationals with significant pricing discipline, which makes the segment very lucrative. It is the largest manufacturer of MCBs (miniature circuit breakers) in India, and among the top ten in the world. The company manufactures a wide range of products, including MCBs, mini MCBs, RCCB (residual current circuit breaker), RCBO (residual current breaker with overload protection), switches, sockets, regulators, MCCBs (moulded case circuit breakers), rewirable switches, off-load changeovers, on-load changeovers and SDFs (switch disconnector fuse).

Havells manufactures these products in Baddi (Himachal Pradesh) and Faridabad (Haryana). Havells has exclusive rights to market the Crabtree brand in India and sells modular plate switches under this brand name. These switches are aimed at the upper end of the consumer market. In FY10, the brand recorded revenues of about Rs1.5bn. The brand is number 2 in terms of market share, which has increased from 5% in 2006 to 15% in FY10 (an estimated Rs10bn market).

Competition is margin focused in switchgears

In the Rs20bn industrial switchgear market (based on FY10 revenue), Havells has a market share of about 8%. Switchgears, given the critical safety they offer against short circuits, have remained a quality-sensitive category—consumers prefer to pay a premium for quality rather than cutting corners. This is further helped by competitors in the segment, such as L&T (largely industrials focussed business), Siemens and Schneider, who are value-conscious incumbents and respect the need for pricing discipline. Contribution margins in the segment have risen substantially in the last few years (see chart below), reflecting the market's quality consciousness.

Figure 93: Switchgears – contribution margins have risen over the years



Source: Company, IIFL Research

Domestic lighting and fixtures – rapid growth, expanding margins

Domestic lighting – a quasi-discretionary consumption play

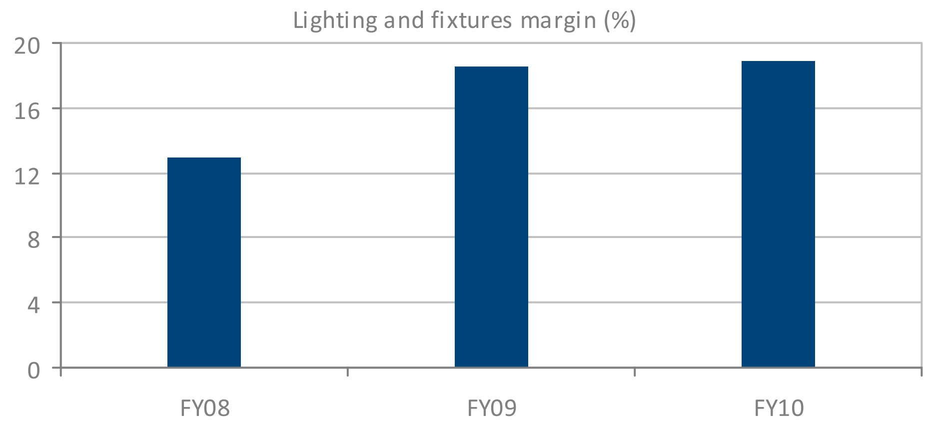
Havells' domestic lighting and fixtures business is positioned at the higher end of the CFL market. The bottom end of the market faces significant competition from unorganised players and cheap Chinese imports. At the totally-commoditised bottom-end of the price pyramid, manufacturing for almost all players is outsourced to China. But in the higher price bands, a preference for high quality has stayed ever since the first incursion of Chinese-built products ten years ago.

In the Rs12bn CFL market, Havells is the second-largest player (after Philips), with a market share of 10%. In the Rs20bn luminaires segment, its market share is again 10%, with Philips and Bajaj Electricals being other leading players. The company's Neemrana facility meets its global demand for CFL units (including Sylvania).

Stays away from Chinese goods dominated low price points

The company's policy of staying out of the mass market is reflected in the contribution margins it earns in the segment. With Sylvania's products likely to be introduced in this segment in India soon, we expect acceleration in revenue growth and margin expansion in the medium term (on an annual basis), as the cross-sold products are likely to be at the top-end of the price pyramid.

Figure 94: Stable and healthy contribution from lighting and fixtures



Source: Company, IIFL Research

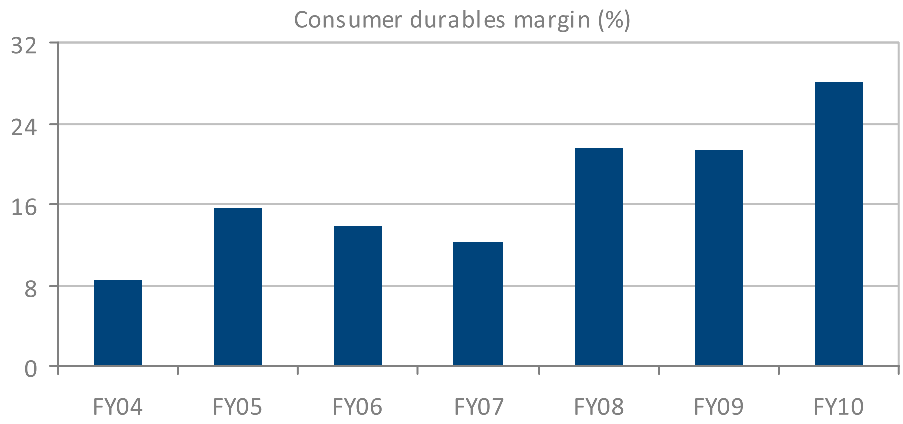
Consumer durables – expanding from single product presence

Havells avoids the low price sub-segment within ceiling fans

Havells's presence in the consumer-durables segment has so far been confined to fans. The company's fan factory in Haridwar is the largest such facility in India. In fans, the table-top and portable fans segments are overwhelmingly dominated by Chinese imports, and even the lower-value ceiling–fan segment is intensely price-competitive. Havells has chosen to be present in only the Rs1,000+ price category, thereby maintaining healthy margins. Outlook for this business remains strong, given broad-based consumption growth in India. The company is now moving into other parts of the consumer-durables business, with new categories such as water storage geysers and other home implements.

The fans market in India is estimated at Rs20bn, and Havells currently has about 18% market share—a rapid scale-up from its FY06 market share of 6%. The leading players are Crompton Greaves and Orient Fans, followed by Bajaj Electricals. Smaller players such as Polar and Khaitan are also forces to reckon with in their own geographies.

Figure 95: Healthy consumer durable margins



Source: Company, IIFL Research

Cables and wires – lowest-margin business

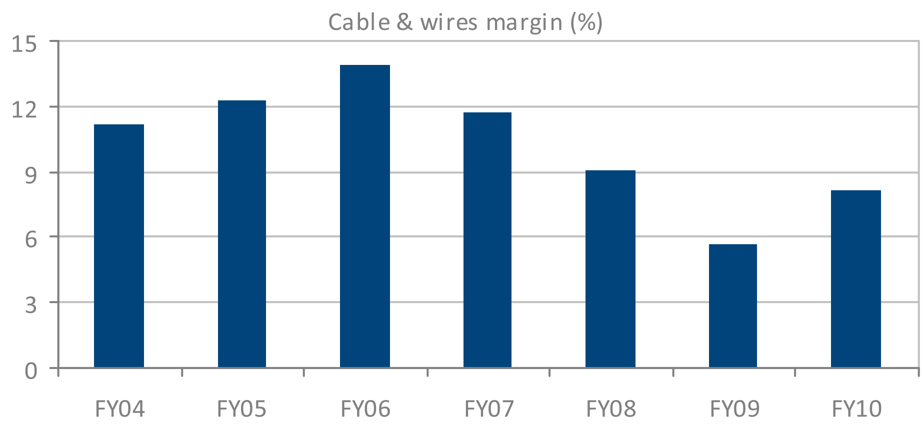
Cable and wire – commodity business with little bargaining power

The company manufactures a complete range of low- and high-voltage PVC and XLPE cables, besides domestic FR/FRLS wires, co-axial TV and telephone cables. The manufacturing unit is in Alwar, Rajasthan, and is equipped to handle cables up to voltages of 66KV. This business accounts for 43% of Havells's standalone revenues, but only 17% of its contribution profit. The key competition in this segment is from Finolex Cables, Polycab, and KEI Industries. Torrent Cables also has a significant presence, but mostly in the higher-value high-voltage segment. Havells has about 9% market share in a Rs120bn annual revenue pie.

Profitability not very high

Cables and wires is the least profitable business for Havells India. Prices of cables track those of copper, although with some lag. Contribution margins are a modest 5-10%, and can turn negative for short periods in case of sudden inventory pile-up due to sudden demand slowdown. There is little value addition in this business, and it is not a major focus area for future growth. Nevertheless, the company does advertise this business on national television, mainly to build the Havells brand rather than to build revenue momentum in the category. Furthermore, the consumer end of the business is more profitable and less working-capital-intensive (no credit), and is a preferred sub-segment for Havells. In FY11, much of the revenue growth in the segment will come from hardening copper prices that are being passed through; Havells has been singularly aggressive in this respect.

Figure 96: Margins consistent for a conversion business



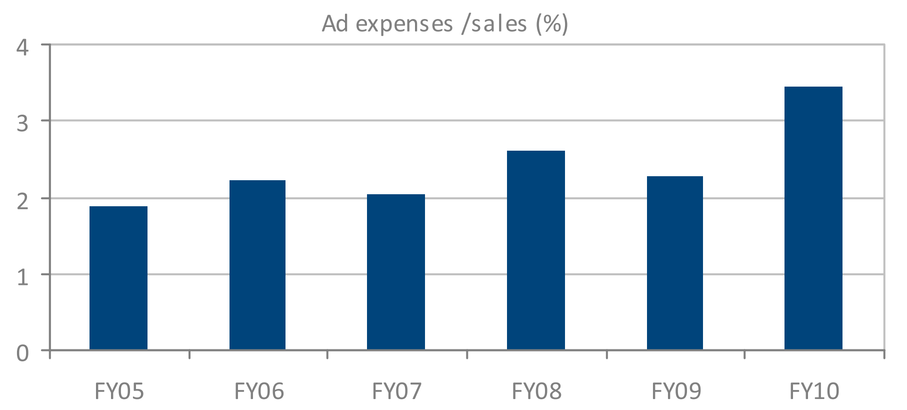
Source: Company, IIFL Research

High branding spend appropriate for a consumer business

Reasonable ad spends for brand development

Havells spends 2-4% of its annual revenues on advertising, which compares favourably with other consumer companies. Through branding initiatives, the company has been able to create high visibility for a number of its brands.

Figure 97: Ad expenses to sales ratio



Source: Company, IIFL Research

Wide distribution network – a pillar of Havells's business model

Distribution – a key strength

Advertising helps build visibility, but an even bigger growth driver in the domestic market is Havells's distribution network. Havells has about 2,000 distributors in India, and each of these reaches out to about 25,000 retail points of sale. Havells's success in distribution can be attributed to the following factors:

- Distributors prefer to stock brands that maximise churn of their own capital. This translates to a preference for fast-moving categories, as it is difficult for manufacturers to differentiate much on commissions and credit terms. Havells's portfolio of fast-moving brands makes it a favourite among distributors, as these products generate higher RoIs for dealers.
- Havells straddles a significant portion of the electrical-goods value chain, and for the dealer, a single relationship helps with multiple SKUs.
- Dealers are often short on organised credit and are sometimes stuck with inventories in downturns. In such times, small adjustments from manufacturers help dealers (price discounts, etc) and builds long-term relationships and credibility.
- A dealer's reputation is also linked to the final quality of the product, an area where Havells has delivered.

We assume 14.4% CAGR in standalone revenues.

Consumer businesses should drive growth

Figure 98: Revenue model

(Rs m)	FY09	FY10	FY11ii	FY12ii	FY13ii
Standalone revenues	23,414	25,928	30,113	34,170	38,831
Cable & Wires	11,066	10,949	12,591	13,850	15,235
Electrical Consumable Durables	2,769	3,625	4,531	5,437	6,525
Lighting & Fixtures	2,805	3,743	4,492	5,390	6,469
Others	541	367	385	404	425
Switchgears	6,234	7,244	8,114	9,087	10,178
Standalone revenues growth (%)	4.2	10.7	16.1	13.5	13.6
Cable & Wires	4.0	-1.1	15.0	10.0	10.0
Electrical Consumable Durables	15.4	30.9	25.0	20.0	20.0
Lighting & Fixtures	-3.1	33.5	20.0	20.0	20.0
Others	-36.0	-32.1	5.0	5.0	5.0
Switchgears	9.7	16.2	12.0	12.0	12.0

Source: Company, IIFL Research

Significant progress at Sylvania

Acquisition made in 2007

Sylvania acquisition was a strategic deal

Havells India acquired Sylvania from a private equity player in April 2007, for a total consideration of €227m. Sylvania is a global major, with a 100-year history. The deal was financed entirely through debt of €200m, out of which €80m was with recourse to Havells. There was €27m worth of pension liabilities on Sylvania's books.

Sylvania has a strong presence in Europe and Latin America, with some presence in select Asian geographies. It is one of the top three or four brands in each country in which it has a presence. The acquisition of Sylvania gave Havells an entry into potentially lucrative overseas markets. Furthermore, Sylvania's international expertise added significantly to Havells's product development capabilities and design bank.

Recession hit Sylvania hard – obligations reworked

In the FY ended 2008, Sylvania's EBITDA was at €27m. This pegged the entry valuation at an EV/EBITDA of 8.4x on FY08—not cheap, but not unreasonably high in the context of long-term strategy. But FY09 was a very bad year, with losses mounting to €47m, as a slowdown in consumption and construction severely hit revenues in key geographies. This made bankers nervous, and compelled Havells to restructure its debt obligations. Sylvania breached the covenants of the funding agreement with its banking consortium, and a new agreement was reached in August 2009, wherein repayment was deferred to April 2013. Havells infused equity of €12m into the business as per the new agreement. On 26 November 2007, Havells India Limited had issued 4,160,000 equity shares to Seacrest Investment Ltd (a Warburg Pincus Group company) at an issue price of Rs625 per share, aggregating Rs2.6bn. The proceeds received were used to repay the €50m bridge loan taken to fund the acquisition of Sylvania.

Acquisition enterprise value of €227m including pension liabilities

Business operations restructured extensively

After the acquisition, Havells had retained most of the incumbent management. In FY09, post the new agreement with lenders, the company decided to remove the CEO and three other top executives. With plants running at close to 50% capacity utilisation, layoffs in the developed markets were central to sustainable health of the entity. Havells divided the entire process into two phases, 'Operation Phoenix' and 'Operation Parakram'. The former is over, with a one-time cost of €12.23m, and the latter is almost complete, with the one-time cost estimated at €20m. Annual savings targeted through these two restructuring initiatives amount to about €17m and €22m, respectively.

Figure 99: Restructuring outline

Phoenix (Phase 1)	Parakram (Phase 2)
Started in 1QCY09	Started in 4QCY09
Operational details - Close 8 warehouses, 3 plants and lay off 1,300 staff	Operational details - Lay off 400 staff and start outsourcing from China/India
One time cost of €12.23m	Estimated cost of €20m
Annual savings expected -€17m	Annual savings expected -€22m
Completed - savings ramping up	Almost completed by end-CY10

Source: Company, IIFL Research

Sylvania operationally much stronger

Figure 100: Sylvania P&L (Rs m)

	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	% YoY	% QoQ
Revenue	8,022	6,864	6,302	7,061	7,636	-4.8	8.1
EBITDA	(490)	339	281	334	257	-152.4	-23.1
EBITDA margin (%)	-6.1	4.9	4.5	4.7	3.4		
Depreciation	144	131	122	126	125	-13.2	-0.8
Interest	56	304	168	132	163	191.1	23.5
Other income	84	0	79	76	124	47.6	63.2
PBT before exceptionals	(606)	(96)	70	152	93		
Exceptional items	1,734	423	37	0	66		
PBT	(2,340)	(519)	33	152	27		
Tax	26	332	57	71	45		
PAT	(2,366)	(851)	(24)	81	(18)		

Source: Company, IIFL Research

Sylvania could not sustain the PAT breakeven attained in 2QFY11, but was profitable at pre-tax levels (as well as adjusted for exceptional items).

Sylvania showing signs of restructuring benefit

Asia and Americas business strong

Figure 101: Region-wise revenues (€ m)

	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	% YoY	% QoQ
Net revenue	106.47	108.56	103.89	109.61	115.91	8.9	5.7
Europe	77.33	76.83	67.02	65.59	74.10	-4.2	13.0
Americas	27.53	29.04	32.67	37.56	35.60	29.3	-5.2
Asia	2.88	4.04	5.47	5.88	4.62	60.4	-21.4
Other/elimination	(1.27)	(1.35)	(1.27)	0.58	1.59	-225.2	174.1

Source: Company, IIFL Research

Asia and the Americas lead the way in revenue growth, while Europe declined YoY.

Figure 102: Debt in Sylvania (€ m) – deleveraging in progress

	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11
Total net debt (in Euros m)	138.5	143.4	155.1	166.6	147.5
With recourse to Havells	16.7	16.7	13.3	13.3	10.0
Acquisition debt	16.7	16.7	13.3	13.3	10.0
Other debt	0.0	0.0	0.0	0.0	0.0
Without recourse to Havells	134.6	139.4	150.2	161.7	150.1
Less: Cash	12.8	12.6	8.4	8.4	12.6

Source: Company, IIFL Research

Figure 103: Havells' exposure to Sylvania (€ m)

	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11
Initial equity investment (A)	NA	50	50	50	50
Debt with recourse to Havells (B)	NA	54	54	45	45
Recourse debt repaid	NA	13	17	17	20
Recourse debt to be repaid till 2012	NA	17	13	13	10
Estimated interest paid/payable	NA	10	10	10	10
Addl WC debt guaranteed by Havells	NA	14	14	5	5
Total initial exposure (A) + (B)	NA	104	104	95	95
Additional equity invested	12	12	12	26	35
Total exposure of Havells to Sylvania	NA	116	116	121	130

Source: Company, IIFL Research

Total exposure of Havells is €130m

Havells's exposure to Sylvania has gone up, but this is on account of additional equity invested for the restructuring.

We do not expect any major ramp-up in revenues yet

We expect Sylvania's revenues from Europe to decline this year before stabilising. Revenue growth outlook in the Americas and Asia remains robust.

No aggressive business turnaround assumptions for Sylvania

Figure 104: Sylvania assumptions

Sylvania geographical break up (€ m)	FY10	FY11ii	FY12ii	FY13ii
Net revenue	406.6	398.1	411.0	425.3
Europe	290.3	270.0	270.0	270.0
Americas	105.4	115.9	127.5	140.3
Asia	13.5	14.8	16.3	17.9
Other/elimination	(2.5)	(2.6)	(2.7)	(2.9)
Sylvania geographical growth rates (%)	**FY10**	**FY11ii**	**FY12ii**	**FY13ii**
Net revenue	(14.1)	(2.1)	3.3	3.5
Europe	(13.2)	(7.0)	0.0	0.0
Americas	(16.6)	10.0	10.0	10.0
Asia	(38.8)	10.0	10.0	10.0
Other/elimination	(74.4)	5.0	5.0	5.0

Source: Company, IIFL Research

Sylvania P&L projections – the real change is manpower costs

The key assumptions to note for Sylvania are:

Business growth revival not assumed

- No major traction in revenues is assumed
- Gross margins not assumed to shift drastically
- No improvement assumed in selling and distribution costs and administrative overheads
- No improvement assumed in other manufacturing expenses
- Interest costs not assumed to fall although de-leveraging has started

Entire profitability improvement is due to reduced manpower costs

- Almost the entire shift in operating profits is from manpower cost reduction in which there is visibility because of the re-structuring

Figure 105: We expect a breakeven in FY12

Sylvania (P&L) (in € m)	FY08	FY09	FY10	FY11ii	FY12ii	FY13ii
Gross sales	**514**	**504**	**430**	**421**	**435**	**450**
Excise duty	(0)	0	0	**0**	**0**	**0**
Net sales	**514**	**504**	**430**	**421**	**435**	**450**
Expenditure:						
Purchase of FG	101	120	121	**110**	**108**	**105**
Raw Material Consumed	153	122	81	**89**	**98**	**108**
(Increase)/ Decrease in stock	(10)	3	10	**5**	**5**	**5**
Excise duty on chg in FG	0	0	0	**0**	**0**	**0**
Material cost	**244**	**246**	**212**	**204**	**211**	**218**
Gross profit	**269**	**258**	**217**	**217**	**224**	**232**
Gross profit margin (%)	*52.5*	*51.3*	*50.5*	**51.5**	**51.5**	**51.5**
Personnel Expenses	120	117	101	**75**	**68**	**71**
Selling and distribution	68	71	67	**66**	**68**	**70**
Manufacturing expenses	25	21	23	**22**	**22**	**22**
Other expenses	29	36	30	**32**	**32**	**32**
Total Cost	**486**	**491**	**433**	**399**	**401**	**414**
Op EBITDA	**27**	**13**	**(3)**	**22**	**34**	**36**
Other Income	2	0	1	**1**	**1**	**1**
Depreciation	10	11	9	**8**	**8**	**8**
Op EBIT	17	2	(12)	**14**	**26**	**28**
EBIT	19	2	(11)	**15**	**27**	**29**
Interest	14	15	13	**13**	**13**	**13**
PBT (pre- exceptional)	6	(13)	(24)	**2**	**14**	**16**
Exceptional items	0	31	41	**5**	**0**	**0**
PBT (post- exceptional)	6	(44)	(65)	**(3)**	**14**	**16**
Tax	2	3	1	**3**	**3**	**3**
FBT	0	0	0	**0**	**0**	**0**
Deferred tax	1	(0)	3	**0**	**0**	**0**
Wealth tax	0	0	0	**0**	**0**	**0**
PAT before minority interest	3	(47)	(69)	**(6)**	**11**	**13**
Extraordinary Items	0	0	0	**0**	**0**	**0**
Adjusted PAT	**3**	**(47)**	**(69)**	**(6)**	**11**	**13**

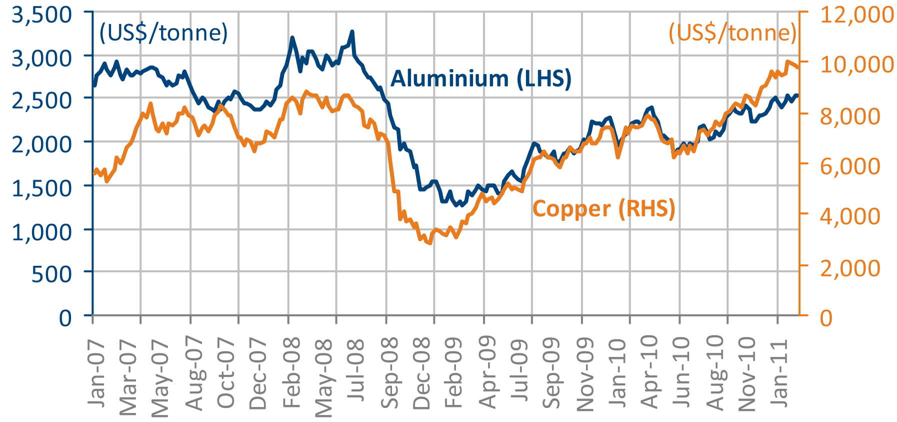
Source: Company, IIFL Research

Pricing power helps margin defence, improved financials, attractive valuations

Copper and aluminium are key raw materials

Havells's key raw materials are copper and aluminium. Prices of both have been up 25-50% in 3QFY11 and show no signs of abating. These two commodities are 50% of the raw-material book.

Figure 106: Raw-material inflation already running high



Source: Company, IIFL Research

Price leader in many segments

The company, however, is fortunate enough to function in segments where competition is generally not margin destructive. In switchgears, the company competes with multinationals like Siemens, Schneider, etc. In consumer durables (fans), the company has no product under the Rs1,000 price point, and hence has no competition from product versions (table top and portable), which is dominated by Chinese products. In lighting, the company has an established brand and enjoys pricing power. Only in the cables & wires segment, the company has no control over pricing.

Figure 107: Pricing power map

Category	% of contribution profits	Competitive landscape	Pricing power
Switchgears	50%	The most profitable segment for Havells due to safety-first brand discriminatory attitude of consumers. The competitive peer group is small and profit focus is primary for all players.	High
Consumer durables (fans)	13%	Presence at the higher price points ensures freedom from the scramble for margins at the bottom end of the price spectrum	Medium
Domestic lighting	19%	Havells brand is established and can price itself at a premium to regional brands without demand destruction	Medium
Cables & wires	17%	The least protected category in margin terms for Havells. Highly competitive commodity conversion business.	Low

Source: Company, IIFL Research

We believe that the company will be able to pass on moderate inflation without facing any impact on volume growth in the medium term. The company has taken a price increase of 15-20% in the current financial year across product categories.

Financial situation improving

Figure 108: Consolidated ratios

Key Ratios					
Year to March	FY09	FY10	FY11ii	FY12ii	FY13ii
Growth (%):					
Net Sales	9.5	(2.2)	3.9	8.6	9.0
Net Sales	7.9	(0.8)	2.2	6.6	8.2
Gross Profit	(16.7)	(0.4)	61.7	28.4	16.1
Op EBITDA	(65.6)	147.3	(22.5)	30.3	23.3
Other Income	(28.5)	4.7	88.0	33.2	17.9
Op EBIT	NA	NA	NA	61.6	23.1
APAT	NA	NA	NA	61.6	23.1
Profitability (%)					
Gross margin	45.1	45.7	45.0	44.2	43.9
Op EBITDA margin	5.3	5.4	8.4	10.0	10.6
Op EBIT margin	3.6	3.9	7.0	8.6	9.3
APAT margin	-2.9	-4.5	3.9	5.8	6.5
Material costs/ Sales	54.9	54.3	55.0	55.8	56.1
Personnel expenses/Sales	15.5	14.1	10.6	8.8	8.4
Non-employee overheads/ Sales	24.4	26.2	26.0	25.4	24.8
Tax rate	52.6	71.6	30.4	21.3	20.5
Asset Efficiency					
Inventory (Days of Sales)	53	55	55	55	55
Debtor (Days of Sales)	50	47	50	50	50
NWC (Days of Sales)-Net of cash	23	7	22	22	22
Fixed Asset Turnover (Sales/ Fixed Assets)	6.2	6.0	6.0	6.0	6.0
Sales to Capital Employed	3.0	3.6	3.2	3.2	3.2
Capital Structure					
Gross Debt-Equity ratio	2.0	2.8	2.1	1.1	0.6
Net Debt-Equity ratio	1.6	2.4	1.7	0.9	0.4
Interest Coverage (EBIT/ Interest)	1.6	2.3	4.2	5.5	6.5
Return ratios					
RoACE (%)	10.8	13.8	25.2	29.7	32.5
RoAE (%)	(24.9)	(48.0)	45.5	48.2	40.0
Incremental Capital Deployment metric					
Payout Ratio (%)	(9)	(9)	13	9	9

Source: Company, IIFL Research

We assume no improvement in gross margins

Tax rates fall on account of Sylvania

Debt equity comfortable FY12 onwards

Sylvania – zero equity value ascribed, but upside possible

We estimate Sylvania's FY12ii EBITDA at €30m. Ascribing a 5x EV/EBITDA multiple to this profit estimate gives an EV of €150m, which is close to the debt that Sylvania carries on its books. As such, we ascribe zero equity value to Sylvania.

Sylvania equity valued at zero

If Sylvania's revenues actually grow at about 10% annually post FY12 (we have assumed ~3.5%), its revenue will be €500m in FY13—which is possible, given the extensions into growth geographies such as Asia and Latin America. With about the resultant €50m in EBITDA, the valuation multiple we have used would value Sylvania at €250m. With the debt almost paid back by then, almost the entire amount could be treated as value of equity, adjusted for pension liabilities. This potential boost equates to 25-30% of current market capitalisation.

Target price of Rs475

36% 12-month upside

The standalone business is poised to deliver an EPS CAGR of 17.2% over FY10-13ii (starting off on a high base in FY10, owing to higher-than-usual gross margins in 1HFY10, a legacy of low-cost raw-material inventory) and a medium-term sustainable EPS CAGR of 18-19%. As the domestic standalone business is driven mainly by consumer spending, a PEG multiple of 1x is not unreasonable, in our view. Accordingly, our target of Rs475 is based on 19x FY12ii EPS (standalone), which is 16.4x FY12ii on a consolidated basis. This indicates an upside of 36% on a 12-month basis.

Key risks

Sylvania turnaround and raw-material costs are key risks

Sylvania turnaround issues: A prolonged recession in the EU will severely restrict the company's chances to grow its business. While we do not build in much revenue traction, any significant decline in revenues post-FY12 might necessitate further restructuring. Also, gains of the restructuring are yet to flow through fully, and delays will further push back an eventual breakeven. Finally, the company needs to generate significant cash by FY13 to avoid any further breaches of debt covenants. On balance, though, we believe the worst is over for Sylvania, and we expect a breakeven by FY12.

Raw-material price risks: Raw-material prices pose a short-term risk to margins, especially in the cables & wires business, which accounts for 43% of Havells's revenues, but only 17% of its standalone profits.

Slowdown in domestic consumption: Any slowdown in domestic consumption—unlikely as it is—will adversely affect the revenue traction of the standalone business.

Appendix

Enterprising India 2: Excerpts from IIFL's interview with Anil Gupta, Joint MD & Qimat Rai Gupta, Chairman & MD, Havells

Qimat Rai Gupta

Anil Gupta

Anil Gupta, the MD of Havells India is a man with a mission: to cover the entire gamut of Indian consumers' electrical needs through his company. He graduated in economics from Sriram College of Commerce, Delhi University and obtained an MBA from Wake University, North Carolina. But the best of his education came during his apprenticeship under his father, when he joined the senior Mr Gupta's business at the age of 24.

A health enthusiast Mr Gupta spends religiously spends an hour daily in the gym keeping fit. His consuming passion outside work is music and he is a vocalist by training and continues to train in Hindustani classical music. He feels strongly about causes like education and child hunger and has been active through Havells in giving back to society. At his behest, Havells is expanding its program of providing daily mid-day meals to 15,000 students to 50,000 daily in order to even better serve the community.

Mr Gupta lists the integration of Sylvania as the biggest challenge and learning opportunity he has faced in his life. He takes great pride in the Havells brand and channel strengths and feels that those are the biggest entry barriers for an incumbent.

Qimat Rai Gupta started his business selling electrical wires and cables from a small shop in Delhi. Fifty years on, at 84, he is just as enthusiastic about his business as the day he started. Even today his motto in life is "Business, Business and Business". A through and through family man he also retains a healthy interest in Cricket and movies. Having started at the age of 21 as an electrical items trader in Delhi in 1958, Mr Gupta acquired the Havells brand name in 1971 and formally incorporated in 1983. As the business becomes world scale, the entire management team looks up to him as a mentor. The current MD Anil Gupta is his son, who believes his father is the principal influence in his life and attributes most of his business learning to him.

A firm believer in "one step at a time" he stops short of setting numerical benchmarks for his company's aspirations and feels that the focus on basics like customer satisfaction that has served the company so well will be pointers to future course of strategic choices for the company.

What are the key barriers to entry in your business?
Anil Gupta: The key barriers are brand and channel. In the categories in which we operate, brand franchise and trust are of utmost importance. It takes a number of years for a consumer to change his preference from one brand to another. The second key factor is product availability, in which distribution channels plays a very important role.

What are the key risks in your business and how do you manage them?
Anil Gupta: The biggest risk is competition—the market is moving very fast in terms of technology, product range, costs, branding, reach… you name it. As Andy Grove of Intel said, only the paranoid survive. No one can say they are comfortable, as everyone is always at risk in one aspect or another.
Qimat Rai Gupta: We need to be ever watchful, so we have formed a core thinking group to keep abreast of changes in market and competition trends to take corrective action as needed from time to time.

If you were to correct one mistake in your career, what would that be?
Anil Gupta: The way we managed Sylvania was the biggest mistake we made. We did not integrate the two companies for the first one and half years after our acquisition; if I had the power, I would go back to 2007 and change that. We lost two years in that, and that meant we were caught unprepared when Europe was struck by a recession in 2008. I think the company lost money because of that. We also lost credibility. But it was a big learning exercise; if it were not for that bad patch, maybe we would not even have learnt how to manage in a crisis, because in India in the last 20 years of my career, we had never seen a crisis.

What was the thinking behind the Sylvania acquisition? Does the rationale for that acquisition still hold?
Anil Gupta: Ten yeas ago, when multinationals in our field started arriving in India, we decided that we had to invest in our manufacturing practices, make them world-scale as well as world-class in technology. So in 2000, we started investing heavily into our manufacturing setup and product quality, to protect our standing in the Indian market. When we started doing that, we realised that we had to make products comparable with international standards. As our quality improved, overseas companies with major brands started outsourcing their manufacturing to us. As we did that, our aspirations rose: if we could manufacture for someone else, why not for our own brand? In 2003-4, we started putting in a lot of investment into expanding into export markets, putting up offices in various locations, but we knew that not having a big brand was a limitation. With Sylvania, the biggest advantage was that it was an established brand. Plus, it had a distribution channel across 50 countries, and this clinched it for us; otherwise, we would have had to acquire multiple companies across countries. Sylvania was one company which was available at a price, but with access to various markets—very strong European markets, in addition to the fast-growing LatAm market. So we decided to use this channel, brand-new as it was, to sell more of Havells products. That rationale still holds true and now that is bringing success because we have integrated the companies. Earlier, we were treating them as two separate companies, as though Sylvania was more of a financial investment, whereas Havells was our own company. I think that changed in the last two years. That was our biggest learning: any company that you acquire should be properly integrated, and that comes with experience.

Qimat Rai Gupta: When we first ventured into exports, we realised that an established brand with top-of-mind recall in its country is key to penetrating foreign markets. This was the key attraction in Sylvania.

Financial summary

Healthy EBITDA growth

Sturdy operating cash flow

Leverage set to reduce

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**54,775**	**53,569**	**55,802**	**60,652**	**66,184**
EBITDA	2,886	2,898	4,926	6,022	6,993
EBIT	1,981	2,073	4,140	5,197	6,123
Interest expense	-1,253	-973	-956	-971	-996
Exceptional items	0	0	0	0	0
Others items	86	213	162	212	262
Profit before tax	**814**	**1,313**	**3,346**	**4,438**	**5,389**
Tax expense	-429	-941	-912	-902	-1,062
Extraordinary items	-1,986	-2,756	0	0	0
Net Profit	**-1,601**	**-2,384**	**2,434**	**3,536**	**4,327**

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	1,981	2,073	4,140	5,197	6,123
Depreciation & Amortization	905	825	786	825	870
Tax paid	-429	-941	-912	-902	-1,062
Working capital change	2,224	2,334	-2,264	-292	-333
Other operating items	-233	367	0	0	0
Operating Cash-flow	4,448	4,659	1,750	4,828	5,597
Capital expenditure	-1,424	-935	-1,135	-1,633	-1,792
Free cash flow	**3,024**	**3,723**	**616**	**3,195**	**3,805**
Equity raised	1,022	586	301	0	0
Investments	32	0	0	0	0
Debt financing/disposal	-684	-1,669	645	-1,552	-2,111
Dividends paid	-176	-528	-634	-704	-880
Other items	-22	376	120	120	120
Net change in Cash & cash equivalents	2,030	1,729	254	300	200

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	2,473	1,446	1,700	2,000	2,200
Sundry debtors	7,573	6,885	7,644	8,308	9,066
Trade Inventories	7,947	8,130	8,409	9,139	9,973
Other current assets	2,414	2,141	2,355	2,590	2,849
Fixed assets	8,842	8,952	9,300	10,109	11,031
Intangible assets	3,579	3,212	3,212	3,212	3,212
Total assets	**32,830**	**30,766**	**32,620**	**35,359**	**38,331**
Sundry creditors	14,501	16,056	15,044	16,382	17,899
Long-term debt/Convertibles	12,278	10,610	11,254	9,702	7,591
Other long-term liabilities	-97	279	399	519	639
Minorities/other Equity	0	2	2	2	2
Networth	**6,147**	**3,819**	**5,921**	**8,753**	**12,200**
Total liabilities & equity	**32,830**	**30,766**	**32,620**	**35,359**	**38,331**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	9.5	-2.2	4.2	8.7	9.1
Core EBITDA growth (%)	-16.7	0.4	70.0	22.3	16.1
Core EBIT growth (%)	-28.5	4.7	99.7	25.5	17.8
Core EBITDA margin (%)	5.3	5.4	8.8	9.9	10.6
Core EBIT margin (%)	3.6	3.9	7.4	8.6	9.3
Net profit margin (%)	0.7	0.7	4.4	5.8	6.5
Dividend payout ratio (%)	45.7	141.9	26.0	19.9	20.3
Tax rate (%)	52.7	71.6	27.2	20.3	19.7
Net Debt/Equity (%)	160.1	239.9	161.4	88.0	44.2
Return on Equity (%)	5.9	7.5	50.0	48.2	41.3
Return on Assets (%)	1.1	1.2	7.7	10.4	11.7

Source: Company data, IIFL Research

CMP	**Rs135**
Target 12m	**Rs171 (27%)**
Market cap (US$ m)	**705**
Bloomberg	**HTML IN**
Sector	**Media**

14 March 2011

52Wk High/Low (Rs)	186/125
Shares o/s (m)	235
Daily volume (US$ m)	0
Dividend yield FY11ii (%)	0.2
Free float (%)	31.2

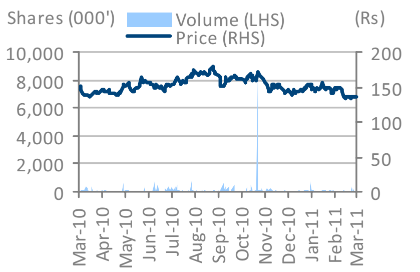
Shareholding pattern (%)

K. K. Birla group	68.8
FIIs	12.3
DIIs	13.6
Others	5.3

Price performance (%)

	1M	3M	1Y
HT Media	-3.8	-4.7	-3.9
Rel. to Sensex	-6.3	2.1	-9.8
Jagran Prakashan	1.8	-10.8	-2.7
D B Corp	1.5	-3.8	0.6
Deccan Chronicles	-17.0	-28.8	-58.0

Stock movement



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HT Media Limited BUY

A 'fine' print

HT Media, a leading print media conglomerate, boasts of a strong product portfolio catering to the lucrative English and Hindi print markets. Well-entrenched leadership of its flagship dailies, *Hindustan Times* in English and *Hindustan* in Hindi in their respective legacy markets would enable it to capitalise on ad-spend strength. In the new markets, namely *Hindustan Times* in Mumbai and *Hindustan* in Uttar Pradesh we expect, its ad-revenues to surge, as its readership market share is nearing inflection. Having made peak investments in these markets, a strong operating leverage would come into play, leading to 34% earnings CAGR over FY11-13ii.

English - Mumbai at inflection point, while Delhi reaps tailwinds: On the strength of a continued recovery in English print media ad spends, we expect ~10% growth in FY12. HT Mumbai's readership has risen 18% since the paper's re-launch in July 2009, and it is now the second-most-popular daily in Mumbai. HT is now better-placed to tap the lucrative Mumbai market, with strong ad-spend growth in Delhi and funding needs in the Hindi markets being met by proceeds of the recent IPO. At margin, competition has also reduced. As *HT*'s readership has already reached 40% of that of the leader, *Times of India*, further gains in readership would lead to disproportionate gains in advertising revenues in Mumbai.

Hindi - strong growth ahead: Regional print media remain on a stronger footing, driven by consumption growth in Tier II and Tier III cities and the large contribution of local advertisements. *Hindustan,* with its well-entrenched leadership in Bihar and Jharkhand, is well-placed to benefit from the same. The daily is making rapid progress in UP and has seen a 47% increase in readership over the past 18 months. Sustenance of trend in readership could result in a disproportionate increase in ad revenues from UP.

Attractive valuations, robust earnings growth; BUY: We forecast HT's ad revenue stream to report 12% CAGR over FY11-13ii. As operating leverage comes into play in the new markets, margins are set to improve, translating into a 24% EPS CAGR Successful ramp-ups in the two key markets of Mumbai and UP could drive substantial earnings growth beyond FY12. The stock is attractive at 14.1x FY12ii P/E, in our view. We reiterate BUY.

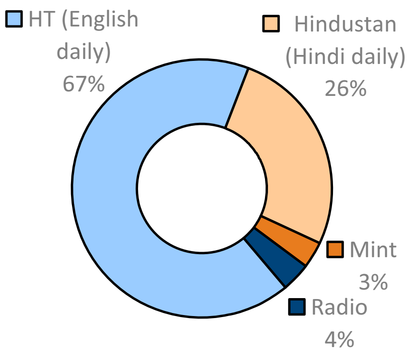
Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	13,591	14,378	17,396	19,829	22,007
EBITDA Margins (%)	7.4	19.5	19.2	21.2	24.2
Pre-Exceptional PAT (Rs m)	199	1,438	1,686	2,232	3,013
Reported PAT (Rs m)	9	1,362	1,686	2,232	3,013
Adjusted EPS (Rs)	0.8	6.1	7.2	9.5	12.9
Growth (%)	-80.4	624.3	17.3	32.4	35.0
PER (x)	**NA**	**21.8**	**18.6**	**14.1**	**10.4**
ROE (%)	0.1	14.0	12.5	14.3	16.2
EV/EBITDA (x)	**34.3**	**11.9**	**8.0**	**5.8**	**4.1**
Price/Book (x)	3.7	3.2	2.3	2.0	1.7

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

Break-down of revenues



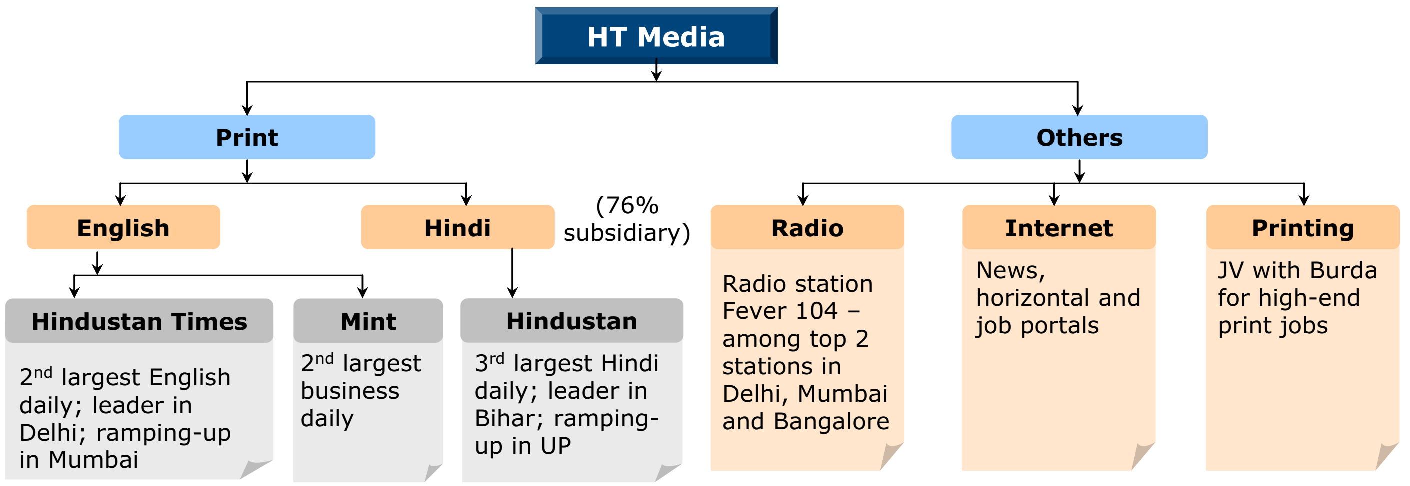
Source: Company, IIFL Research

HT Media is one of India's oldest diversified media conglomerates. HT's English daily, *Hindustan Times*, enjoys an average issue readership of 3.3m, second only to *Times of India*. Its Hindi news business has been hived off into a separate company, which has recently raised money through an IPO. HT's Hindi daily, *Hindustan*, leads the readership ranking in Bihar and Jharkhand, and is third in Uttar Pradesh, with an all-India readership base of 9m. HT's English business daily, *Mint,* is number two in its segment.

Background

HT Media (formerly known as Hindustan Times) was founded in 1924 and has its roots in India's independence movement. It has had many eminent names among its editors, including Devdas Gandhi (a son of Mahatma Gandhi) and renowned author Khushwant Singh. HT Media is now part of the KK Birla group, which owns 69% of the company. The KK Birla group owns diverse businesses, among them sugar and furniture, in addition to running schools and colleges. HT Media is currently headed by Shobhana Bhartia, daughter of KK Birla. Ms Bhartia has also been a member of the Rajya Sabha, the upper house of parliament, where she was nominated by the ruling United Progressive Alliance.

Key business and markets



Source: IIFL Research

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Ad-revenue growth (%)	12%	1%	21%	14%	11%
Circulation revenue growth (%)	3%	19%	5%	5%	5%
Newsprint costs (Rs/t)	34,334	30,912	31,839	33,750	33,750
EBITDA margins (%)	7.4	19.5	19.2	21.2	24.2

Source: Company data, IIFL Research

English: Inflection ahead in Mumbai; Delhi riding on tailwinds

HT's English print business enjoys a strong franchise in Delhi; ramping-up in Mumbai

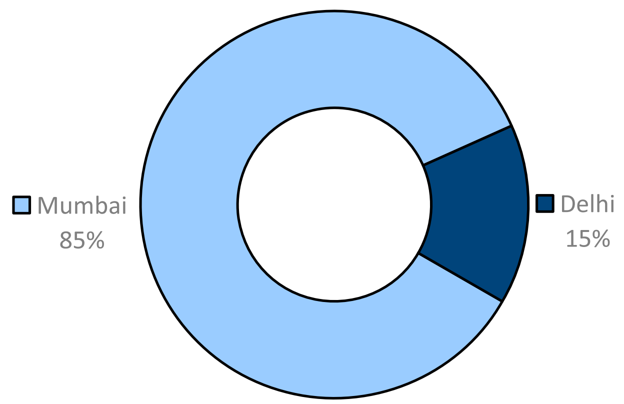
Hindustan Times (HT), HT Media's flagship daily, enjoys an average issue readership (AIR) of 3.5m, making it the second-largest English daily in India. It has six editions selling in nine Indian cities. The company, which has enjoyed a strong franchise in Delhi for several years, launched its Mumbai edition in 2005, and has till date garnered a readership of ~0.6m. *HT*, which accounts for ~60% of HT Media's consolidated revenues, is primarily dependent on the Delhi market. As per the most recent Indian Readership Survey (IRS), it has gained number 2 position in Delhi, dislodging *DNA.* Its large readership base in Delhi gives it a formidable competitive advantage that is difficult to replicate and also enables it to cross–sell advertising space for its Mumbai edition.

Figure 109: HT's readership break-down and market position

Market	AIR - IRS 2010 Q3 ('000 readers)	Market position
Delhi	1,914	1
NCR	222	2
Bihar / Jharkhand	160	2
Uttar Pradesh/Uttarakhand	264	2
Mumbai	592	2
Kolkata	38	4
Others	327	
Total	**3,517**	
Delhi + NCR as % of total	60.7	
Mumbai + Delhi NCR as % of total	77.6	

Source: Company, IRS, IIFL Research

Figure 110: Delhi contributes the lion's share of HT's total revenues



Source: Industry, IIFL Research

The Delhi English print market is essentially a duopoly between *HT* and *ToI*

Delhi: strong readership base; market to remain a duopoly

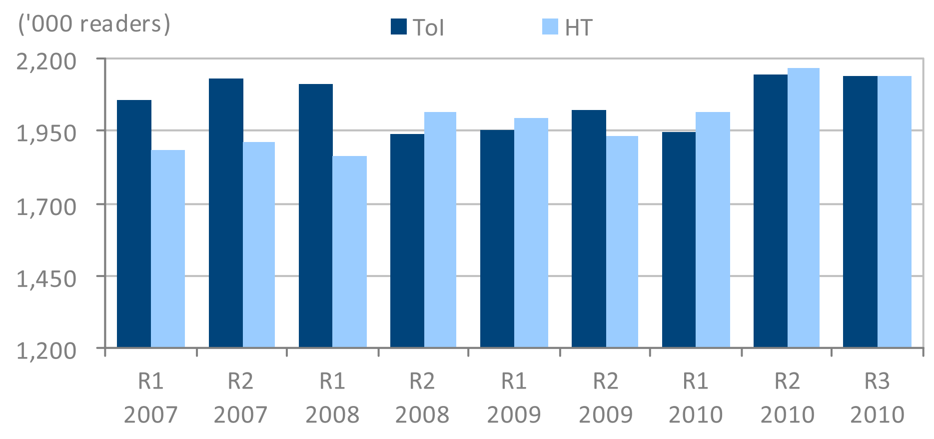
HT is the second most-read daily newspaper in Delhi NCR. The fight for leadership in the Delhi market has been close—readership of the leading daily, *The Times of India,* is just ~0.1% ahead of that of *HT.* The market is essentially a duopoly, with leadership remaining with either of these dailies. Presence of two strong incumbents, coupled with huge initial cash-burn for launch, would prevent any new launches, and the market is likely to remain a duopoly.

Delhi expected to post low double-digit growth in the next couple of years

Delhi business expected to grow at low double-digit rates

Delhi's English print market size is estimated at Rs13bn (as of FY10), growing at ~10% annually. The company has initiated efforts to separately monetise its readership in the NCR region, which now accounts for 12% of total readership in the Delhi NCR market. Over the medium term, these efforts are likely to give a fillip to ad-revenue growth in the market. However, HT, with ~50% revenue market share, is expected to grow in-line with the market in the near term. We expect the competitive landscape to remain stable, so revenue growth will further improve the profitability of the franchise.

Figure 111: HT and ToI remain locked in a tussle for leadership in Delhi



Source: Company, IRS, IIFL Research

HT has smartly climbed up to the second position in the competitive Mumbai market

Mumbai: highly competitive; HT gained number 2 position

HT Media launched the Mumbai edition of *HT* in July 2005. Mumbai is the largest English print media market in India, with an estimated size of ~Rs14bn per annum. This market has always been *ToI*'s stronghold. The other main competitor to *HT* in this market is *DNA*, a joint venture between DB Corp and Subhash Chandra's Essel Group. In the Mumbai market, broadsheets also compete with two key tabloids, *Mumbai Mirror* and *Mid-Day*, for local advertisements. Additionally, Mumbai has a large proportion of English business news readers. As per the most recent IRS, the company has already overtaken DNA and has attained number two position.

Figure 112: Mumbai English newspaper market

Newspaper	AIR - IRS 2010 Round 1 ('000 readers)
The Times of India	1,559
DNA	575
Mumbai Mirror	740
Hindustan Times	592
Mid-Day	387
Indian Express	49

Source: Company, IRS, IIFL Research

Is Mumbai at an inflection point?

Since the launch of *HT* in Mumbai, the paper has remained in an incubation phase. Of late, the company has had some success in building a readership base in Mumbai, but its market share by revenue remains low. We believe the company is set to see a surge in its ad revenues in Mumbai in the next couple of years, driven by the following two factors:

- **Best-placed to focus on building Mumbai property:** *HT*'s launch in Mumbai coincided with that of *DNA*. To ward off competition from these two papers, *TOI* launched the tabloid *Mumbai Mirror* and distributed it free with the broadsheet *ToI*, making the Mumbai market very competitive. At the same time, HT Media was building its Hindi business in Uttar Pradesh, and this made it difficult to put in large upfront investments in both the markets. This period also coincided with a sharp rise in prices of newsprint, followed by a sharp drop in ad spend for two years (2008 and 2009). This confluence of adverse factors compelled HT to put all expansion plans on the backburner.

  HT media is in a better position to focus on Mumbai property as compared to the past

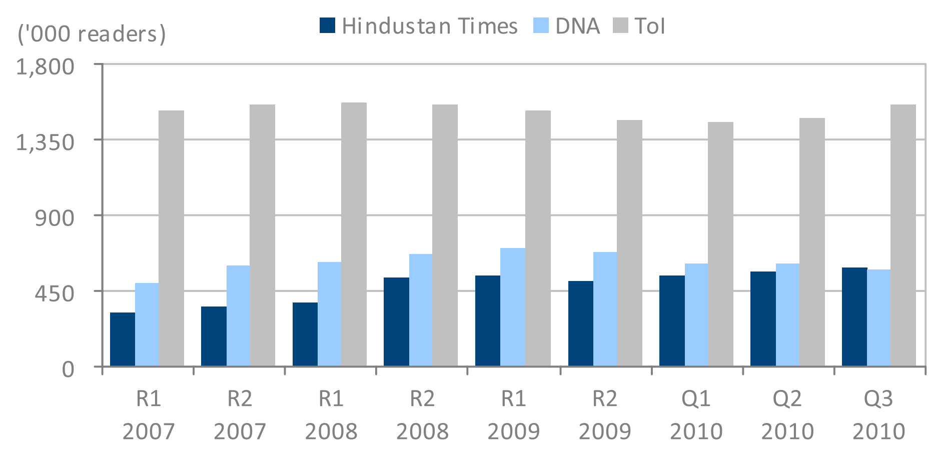
  Now, HT is much better-placed to focus on building Mumbai property, as: 1) post IPO of the Hindi business, it is well-placed to meet its funding requirements; 2) losses in Mumbai can be easily absorbed, as the Delhi business enjoys continued strong momentum in ad spend; 3) competitive intensity is easing.

- **Competition is reducing at margin:** Meanwhile, readership of *DNA*, the third player, is declining. It has incurred significant losses since its launch and its ability to increase circulation is limited. Unlike *HT* and *ToI, DNA* is not a national newspaper, which further limits its ability to make investments.

Investments starting to pay off

HT Mumbai was re-launched in July 2009 and its readership has grown 18% since then. In the previous readership survey it surpassed DNA in terms of readership though the lead is marginal at present.

Figure 113: HT and ToI remain locked in a tussle for leadership in Delhi



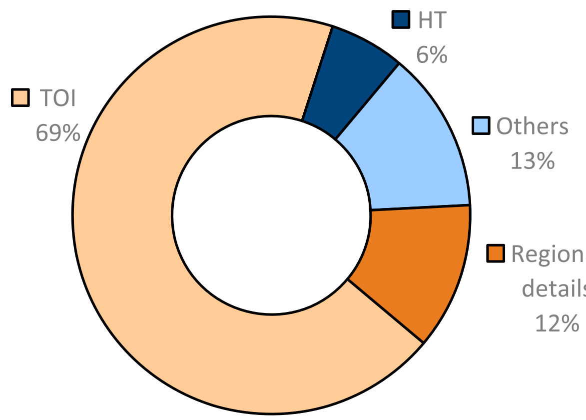
Source: Company, IRS, IIFL Research

Mumbai - a large opportunity, if traction continues

HT's readership in Mumbai is now ~40% of TOI but its revenues are only 10% of *TOI*

HT's readership in Mumbai is already more than a third of that of *ToI*. *HT* has continued to aggressively push circulation, and results of this will be visible in the forthcoming readership surveys. With its readership at ~40% of that of the market leader, HT has already attained critical mass, in our view. Its revenues, on the other hand, are less than 10% of those of *ToI* despite ~40% of TOI's readership. In our view, monetisation of readership will improve significantly if *HT* can take its readership to 50–60% of *TOI*'s readership. As it happens, revenues of *HT's* Mumbai edition have been growing at over 30% YoY in recent quarters. The growth in HT's readership is likely to continue as push in circulation over the past year translates into readership in forthcoming readership surveys.

Figure 114: TOI has dominant market share in Mumbai



Source: Company, IRS, IIFL Research

Figure 115: HT has made necessary investments in Mumbai; monetisation to follow

	TOI- Mumbai	HT- Mumbai	HT as % of TOI
Revenues (Rs m)	11,000	1,000	9%
Circulation ('000)	550	365	66%
Readership ('000)	1,559	592	38%
RPC (x)	2.8	1.6	58%
Revenue/reader (Rs)	7,056	1,689	24%
Revenue/copy (Rs)	20,000	2,740	14%

Source: Company, IRS, IIFL Research

We are factoring in break-even in Mumbai in FY13; guidance is for 4QFY12

Peak investments done; Mumbai set to breakeven in FY12-13

HT's Mumbai circulation has increased from 280,000 copies a year ago to 365,000 currently, and the company aims to increase it to 400,000 copies in the next six months. This will take its circulation to 75% of that of the leader. An increase in circulation from thereon is unlikely, and the company would wait for readership per copy (RPC) to increase to ~2-2.25x (1.6x at present) before further increasing the print order. Annual revenues of HT's Mumbai edition are estimated at Rs1bn and growing at 25% annually. Growth in revenues will more than offset the expected increase in cost on higher circulation. In this scenario, the Mumbai edition may well breakeven in FY12-13, as per management's projection.

We expect no major forays into other English print markets in the medium term

Expansion in other markets unlikely in the near term

HT has no meaningful presence in the other large English daily markets—Kolkata, Chennai and Bangalore. We believe it might eventually expand in these markets, especially Chennai (Tamil Nadu). However, we do not expect any such expansion initiatives in the near term, given: 1) presence of a strong incumbent in each of these markets; 2) higher start-up costs involved in starting an English edition; and 3) management's current focus on gaining market share in Mumbai. This, along with the fact that the English print market is likely to remain confined to the top 20 cities in the medium term, shows that HT has few avenues left for expansion in the English print-media business.

Hindi: Strong growth ahead

***Hindustan*, HT Media's Hindi daily is likely to be the growth engine**

Hindustan the *third*-largest newspaper in India

HT Media enjoys a significant presence in the Hindi belt through its Hindi daily, *Hindustan*. *Hindustan* is the leader by far in Bihar and Jharkhand, and is a close second in Delhi/ NCR. *Hindustan* is also present in the important UP market, where it made its entry in 2004 and subsequently ramped up presence in 2006. The Hindi-daily business currently contributes 31% of HT Media's overall ad revenues, but is gradually assuming greater importance, thanks to the overall buoyancy in the regional print-media space. *Hindustan* will be the key driver for the company's print business in the foreseeable future.

Figure 116: *Hindustan*'s readership break-down and market position

Market	AIR IRS R3 2010 ('000 readers)	Market position
Delhi	1,321	2
Bihar	4,515	1
Jharkhand	1,630	1
UP	3,189	3
Uttarakhand	222	3
Others	68	
Total	10,839	

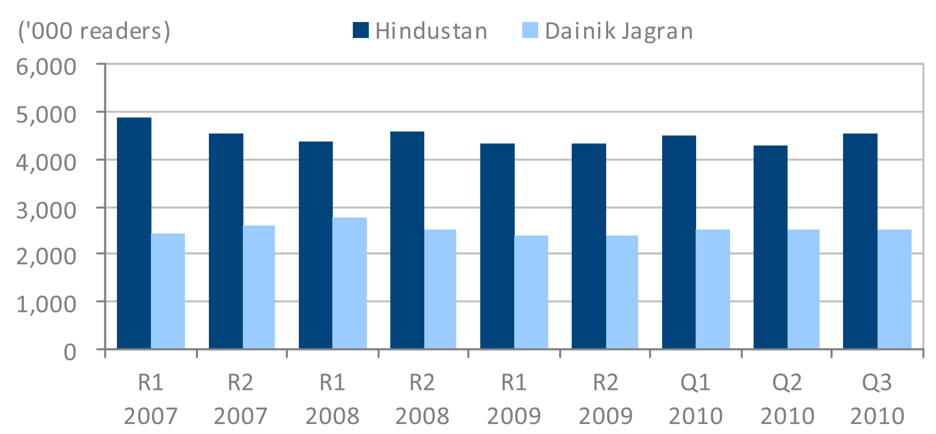
Source: Company, IRS, IIFL Research

***Hindustan* dominant in Bihar; leader in Jharkhand**

Bihar, Jharkhand: HT's papers lead in readership, by far

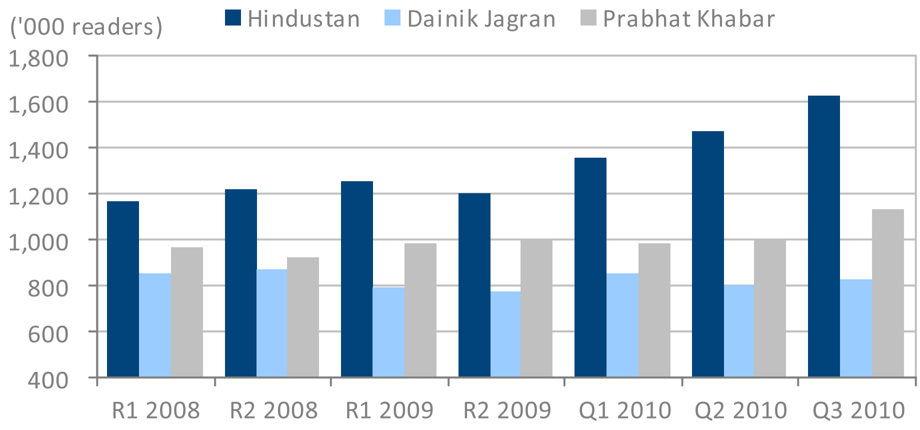
The Bihar and Jharkhand (BJH) markets together have an aggregate readership of ~9.5m and an estimated print advertisement market of Rs2.7bn (FY10 estimate). *Hindustan* is the most popular Hindi daily in Bihar and Jharkhand, being read by ~65% and ~50% of readers, respectively. In Bihar, *Hindustan* enjoys a lead of 78% over its nearest competitor, *Jagran*. The smaller Jharkhand market remains more competitive, with *Hindustan* more closely contested by *Jagran* and a local newspaper, *Prabhat Khabar*. Jharkhand also witnessed entry of new player, *Dainik Bhaskar,* in the recent past.

Figure 117: Bihar market – HT enjoys 75% lead over nearest competitor, *Jagran*



Source: Company, IRS, IIFL Research.

Figure 118: Jharkhand market – HT enjoys 40% lead over nearest competitor, *Jagran*



Source: Company, IRS, IIFL Research.

Deferral of DB's Bihar launch is a positive – will also moderate the impact of launch in Jharkhand state

Dainik Bhaskar enters Jharkhand; Bihar launch deferred

DB Corp completed its launch in the state of Jharkhand in December. According to DB Corp's management, its paper has been well received in the market, though its numbers are yet to be reflected in the readership survey. The company has deferred its entry in the Bihar market by at least a year, which is positive for *Hindustan*. Deferment of the Bihar launch will significantly dilute the impact of the Jharkhand launch as national advertisers (accounting for ~50% of total ad-spend in state) buy ad-space for both Bihar and Jharkhand together. We do not expect DB's expansion in Jharkhand to have any material impact on the market till the time it is complemented with a launch in Bihar.

No major threat from DB's entry into *Hindustan*'s stronghold

DB has established a formidable record of success in new launches, but we are not overly worried about its impact on *Hindustan,* for two reasons. Firstly, print-media penetration in these markets is pretty low, and has tremendous scope for growth. This, we believe, gives ample scope to accommodate one more player in the market. DB's previous launches have resulted in expansion of the relevant markets. Secondly, *Hindustan* enjoys a strong lead over its competitors in both the markets. DB's primary goal would be to gain second position in the market, which in our view will have limited impact on *Hindustan*'s revenues.

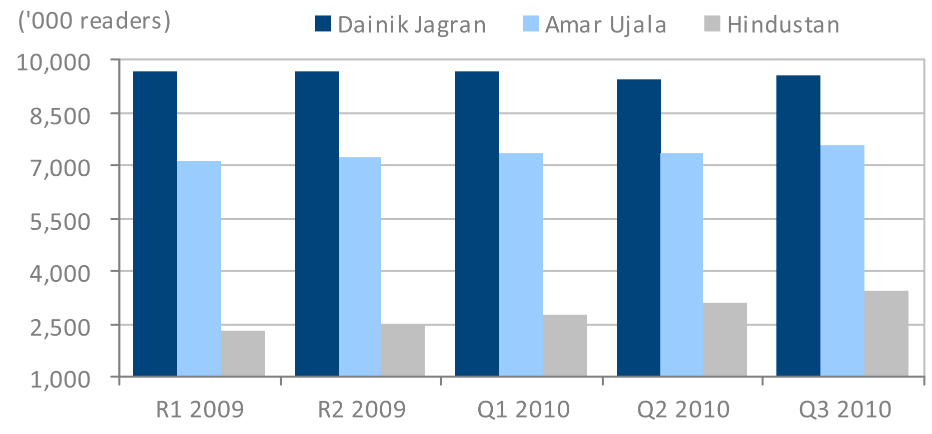
We see no major downside to subscription revenues from hereon, as cover price in Jharkhand was cut just a few months ago. Cover prices of *Prabhat Khabar* were also cut in a few cities in Bihar.

***Hindustan* ramping up in UP; earnings from this market could inflect**

UP — a significant opportunity; time to reap benefits

UP is the largest Hindi print-media market, with a readership that is more than 50% larger than that of any other Hindi market. The combined UP and Uttarakhand ad revenue market is estimated at Rs7bn. *Hindustan* had a minor presence in the important UP market for a long time, but the company enhanced its presence with three new editions in 2006. *Jagran Prakashan* has traditionally been the most popular daily in this market, and enjoys a comfortable lead, with its readership at ~1.5x and ~3x as much as those of its closest competitors, *Amar Ujala* and *Hindustan,* respectively. Management's first priority after the IPO would be to use the proceeds to ramp up circulation and readership in UP.

Figure 119: Traction in UP improving



Source: Company, IRS, IIFL Research.

Hindustan at an inflection point in UP; ad revenues could surprise positively

Hindustan's readership is 35% of Jagran's in UP; but ad-rates would be less than 20%

Hindustan's presence in UP presents an immense opportunity, not only in terms of the number of readers, but also ad rates. Here, the company's first target would be to displace the No. 2 player in the market, *Amar Ujala*. The recently-concluded IPO of the Hindi business will lend ammunition to increase circulation as well as readership in the UP market. Success on this front, we believe, would lead to a substantial improvement in *Hindustan*'s ad rates, which at present are about a fifth of *Jagran*'s in this market.

Figure 120: Hindustan needs to scale up manifold to displace Jagran in UP

	Hindustan	Jagran	Ramp-up to be achieved
Readership ('000 readers)	3,411	9,531	2.7x
Yields	0.2x	x	5x

Source: Company, IIFL Research

UP the focus—becoming No. 2 is the first priority

As we highlighted earlier, *Hindustan*'s climb in UP remains a steep one. The company has invested over Rs1bn in the UP market over the past six years. It continues to increase its circulation, which has increased from less than 600,000 to ~1m over the past 18 months. This is aptly reflected in its readership, which grew by ~60% in the same period. The full impact of the circulation push in the past six months will be evident in forthcoming readership surveys. We reckon the company's immediate target for *Hindustan* in UP would be to displace *Amar Ujala* as the second-most-read daily in the state. We expect Hindustan's improved readership momentum in UP to sustain, which we believe will strengthen investors' conviction on Hindustan's potential in the Hindi market.

Opportunity in Hindi remains significant: several markets untouched

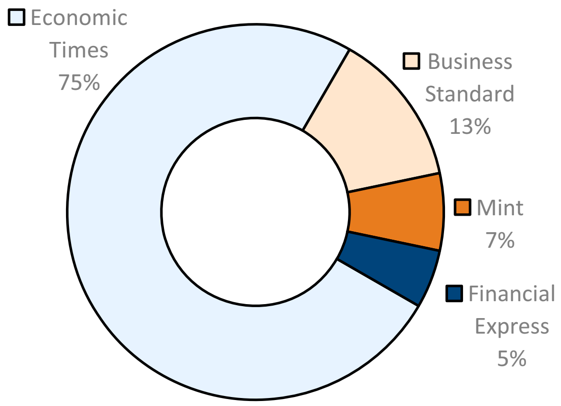
Among the major Hindi dailies, Hindustan has the greatest potential for expansion in terms of untapped markets. The company's top priority will be to ramp-up in Uttar Pradesh, while at the same time defend its traditional strongholds. In addition, there are several large markets—Madhya Pradesh, Rajasthan, Punjab and Haryana—where Hindustan has no presence and might look to enter over a period of time. Successful execution in these markets could enable Hindustan to graduate to the next level of growth and achieve scale comparable to that of DB Corp or Jagran.

Mint: a promising entry in the business space; but a small opportunity

***Mint* has become the second-largest business daily in less than five years**

HT's foray into the Rs6bn business news market was through a business daily, *Mint*. This market has traditionally been dominated by the Times of India Group's business daily, *Economic Times,* which has 62% of the segment's readership and commands 75% of the segment's ad revenues.

Figure 121: Business news segment dominated by *Economic Times*



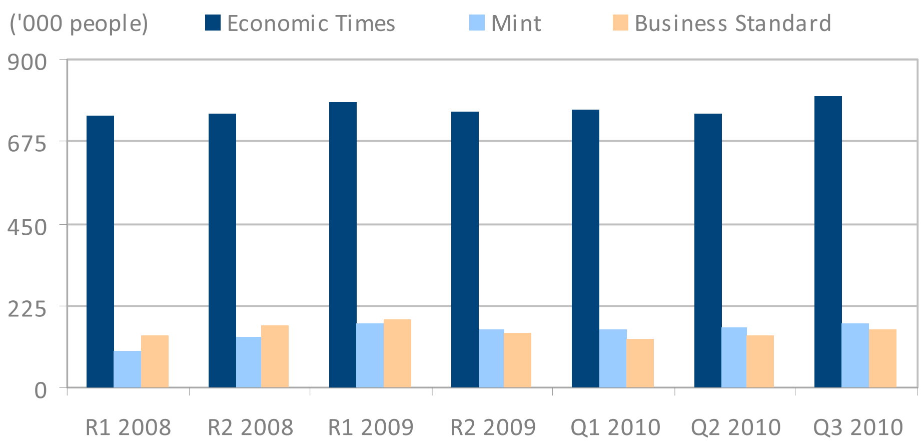
Source: Company, IIFL Research

After initial success in Delhi, Mint is expanding its franchise in Bangalore, Kolkata and Chennai

Mint's readership skewed towards Delhi

Mint's initial tie-up with *Wall Street Journal* gave it access to premium international content. Originally launched in just Mumbai and Delhi, *Mint* quickly became the second-most-popular business daily in these markets. *Mint*'s readership, however, remains skewed towards the Delhi market, which is 5x its readership in Mumbai. In the Delhi market, *Mint* benefits from HT's strong franchise, whereas in Mumbai, *ToI*'s franchise has acted as a barrier to *Mint* gaining significant ground. Recently, *Mint* has also been launched in Bangalore, Kolkata and Chennai.

Figure 122: Mint – a strong start, but a long way to go



Source: Company, IRS, IIFL Research.

Mint achieved break-even at EBITDA level; inflection ahead

In FY10, *Mint* recorded an EBITDA loss of Rs150m on revenues of Rs410m. The paper achieved EBITDA break-even in 4QFY10. The company has given an aggressive push to circulation in the recent past, and this should translate into readership gains in FY12. As the company is not looking to launch *Mint* in any new markets, we expect a sharp inflection in its earnings in the years ahead. We forecast ad revenues from Mint will grow at an annualised rate of 20% over FY11-13ii.

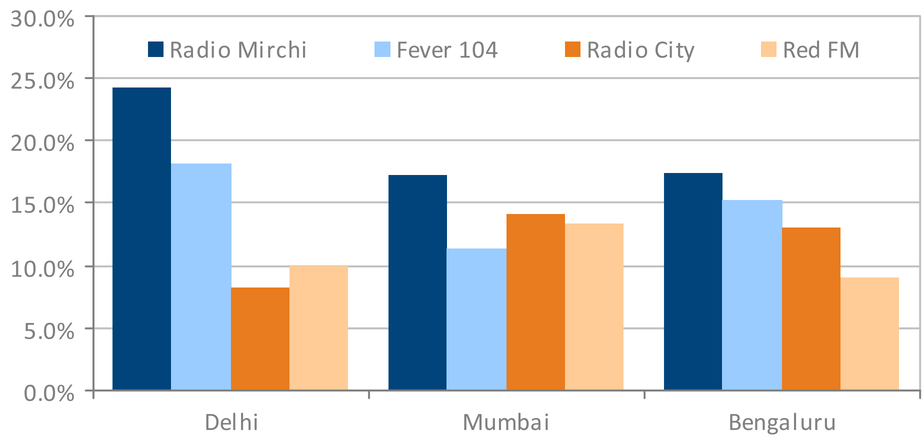
Other businesses: promising start, but contribution remains insignificant

Radio channel *Fever 104* is the second most popular station in Delhi and Bangalore

Radio business: good start, but too small to make a difference

HT's foray into the Rs4bn radio industry was part of the company's strategic goal of gaining at least a toehold in all segments of the media business. It currently runs a radio channel only in four metro cities—Delhi, Mumbai, Bangalore and Kolkata. Its channel *Fever 104* has achieved moderate success since its launch.

Figure 123: *Fever* 104 enjoys decent market share in radio business

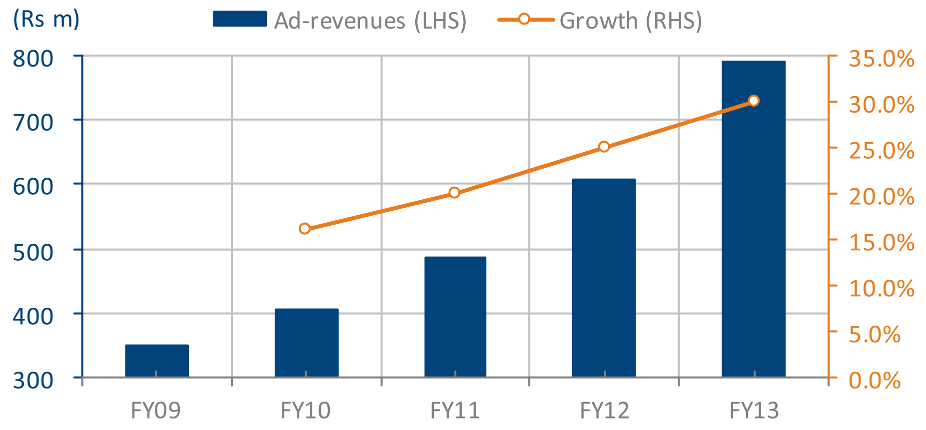


Source: Company, IIFL Research

Forecast moderate growth in radio; bet is on deregulation

After several years of losses at the EBITDA level, the radio business achieved EBITDA break-even in 2HFY10. As the company is not expanding beyond the four metros, its growth is likely to be moderate. For FY11, management has guided for Rs450m-500m of revenues, which we reckon would translate to an EBITDA of Rs50m. PAT break-even is still some time away. Management indicated that it is waiting for Phase III (the next phase of license auctioning in the Indian radio industry), before it resumes expansion of this business.

Figure 124: Radio business offers moderate growth in revenues



Source: Company, IIFL Research

HT has entered into a JV with German company, Burda, for high-end printing jobs

JV with Burda – entry into high-end publishing

HT has entered into a JV with German print group Hubert Burda for high-end printing jobs such as catalogues for brands such as *Vogue* and *IKEA*. HT's stake in this JV amounts to 51% for an initial investment of Rs400m. Burda's owned printing facility in Germany has been transferred to Noida on a fully depreciated basis as part of this JV. HT is in charge of setting up the infrastructure, and so the facility accrues to HT at a marginal cost. Management expects this venture to achieve break-even in 1HFY21. As utilisation ramps up to 100% over the next few years, its revenues are likely to increase to Rs2.5bn-3bn and will account for ~10-15% of total revenues. Given the low operating costs involved, this business is likely to generate significantly higher margins than the print business. We will wait for a ramp-up before building in strong improvement in utilisation rates of the plant.

Job portal shine.com has more than 4m registered users

Building presence on the Internet; to restrict its annual losses to Rs250m

HT has again attempted to achieve a diversified presence on the Internet through: a) its web-based portals hindustantimes.com, livemint.com and hindustandainik.com; b) job portal, shine.com; and c) newly acquired community portal, desimartini.com. The job portal shine.com has registered strong growth in its user base, with 3.3m registrations in 18 months. The management had guided that it will restrict its losses to Rs250m a year.

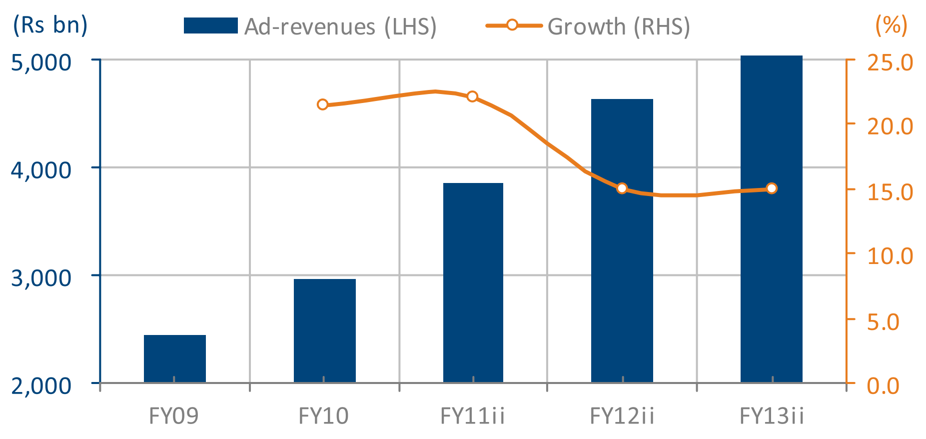
Attractive valuations, robust earnings growth

Multiple drivers for earnings growth

Ramp-up in Mumbai and UP likely to drive ad-revenue growth beyond our forecast period

Hindi ad revenues to benefit from continued buoyancy; improved traction in UP
Hindustan's ad revenue stream has grown at ~37% annually over FY08-10, benefitting from the regional focus of national advertisers and *Hindustan*'s strong franchise in the important Bihar and Jharkhand markets. We expect ad spends in regional markets to remain buoyant, driven by further localisation of advertisements. *Hindustan*'s improving traction in the important UP market is also likely to sustain. Further market share gains in this market in the coming quarters could result in a disproportionate increase in ad revenues from this market. This lends a possible upside to our ad revenue CAGR assumptions of 15% over FY10-13ii for *Hindustan*.

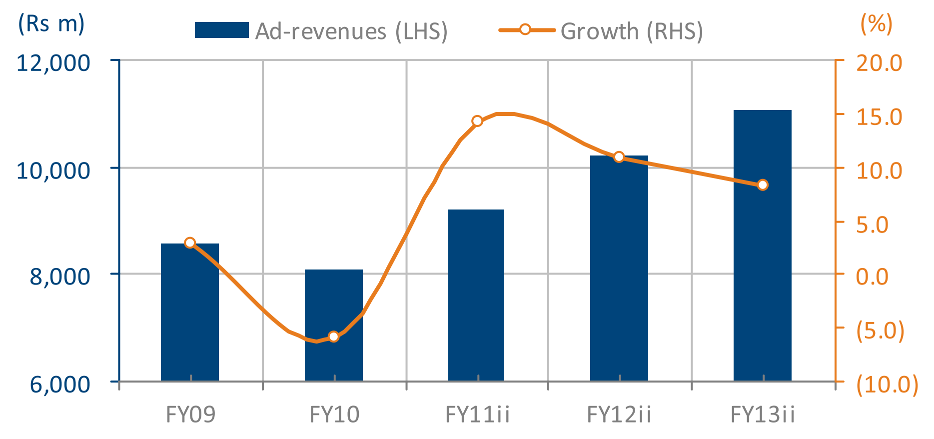
Figure 125: Hindustan's ad-revenue growth to remain robust, but taper off on higher base; market share gain in UP offers potential upside



Source: Company, IIFL Research

Improving ad spends in English print; market share gain in Mumbai to drive HT's ad revenues
Ad spends in English print media have seen an uptick in ad volumes after a sharp decline during the financial crisis of 2008. HT, by virtue of its leadership position in the Delhi market, is well-poised to benefit from this uptick. Moreover, its Mumbai edition has seen improved traction following a re-launch in Mumbai. Further improvement in readership in this market will accelerate growth in the Mumbai business, creating potential upsides to our CAGR assumption of 15% over FY10-13ii in HT's ad revenues.

Figure 126: Sharp swing ahead in HT's ad-revenues



Source: Company, IIFL Research

Hindustan's margins inferior to other Hindi print majors; significant room for upside

***Hindustan's* margins are significantly lower than peers owing to large investments in UP**

A successful ramp-up in UP would not only translate into a re-rating in Hindustan's ad revenues, but also act as a trigger for *Hindustan* to achieve scale similar to that of DB Corp or Dainik Jagran. This is likely to translate into a significant improvement in *Hindustan*'s EBITDA margin, which at the present level of ~20% is around 800bps lower than those of leaders in the Hindi print space.

Valuations attractive—BUY

Valuations attractive given best-in-class earnings growth

We expect HT's earnings to register a CAGR of 34% over FY11-13ii. A faster-than-expected ramp-up in readership in UP and Mumbai would result in substantial earnings growth beyond FY12, and also offer upside to our earnings estimates. The stock is currently trading at a PER of 18.6x and 14.1x on FY11ii and FY12ii, respectively. Given the industry-leading growth outlook and earnings visibility beyond two years, we expect multiples to re-rate in the quarters ahead. Our target multiple of 18x on FY12ii EPS, which translates into a target price of Rs171, is conservative, in our view. At the current market price, the stock offers upside of 27%. We reiterate BUY.

Key issues

Competition resorting to excessively aggressive price competition: Competition in the Hindi print media space is likely to escalate, as incumbent players expand beyond their core markets. The first casualty of this increasing competition would be cover prices, with steep cuts hitting subscription revenues. In a bid to retain their share of readership, incumbents may increase print orders, which would mean higher costs. If a new entrant manages to raise its readership close to that of the leader in its respective market, it could put pressure on advertising rates in that market. On the other hand, we think steep cuts in advertising rates are unlikely in the medium term.

Widening losses in the portal business: HT Media's portal business registered EBITDA-level losses of Rs350m in FY10. The company plans to expand its job-search portal platform to other verticals. Expansion along these lines would make it difficult for the management to contain the portal business's losses at management's guidance of FY10 levels.

Newsprint mix improving, but expect marginal uptick in newsprint costs

Increase in newsprint costs to be offset by revenue growth

Newsprint cost remains a key margin lever for HT Media, as for all other publishing companies. We estimate that a US$50/tonne increase in blended newsprint costs will adversely affect HT Media's FY11 EPS by ~10%. Newsprint prices have cooled significantly from their highs in FY09, and this has been an important driver for margins improving by 1,200bps over FY09-10. Margins have also been aided by an increase in proportion of domestically produced newsprint, which costs about US$100 less per tonne than imported newsprint. Going forward, we expect a marginal uptick in HT Media's newsprint cost, but the adverse impact of this would be largely offset by robust revenue growth. We forecast HT Media's consolidated margins will expand by ~170bps over FY10-12ii.

Figure 127: Our newsprint cost assumptions

	FY08A	FY09A	FY10ii	FY11ii	FY12ii	FY13ii
Consumption (tonnes)	153,447	147,104	142,000	174,720	189,616	198,918
Per-tonne costs (Rs)	27,598	34,334	30,912	31,839	33,750	33,756
Newsprint costs (Rs m)	4,235	5,051	4,390	5,563	6,399	6,713

Source: Company, IIFL Research

Appendix

Shobhana Bhartia

Enterprising India 2: Excerpts from IIFL's interview with Shobhana Bhartia, Chairperson, HT Media

We met the chairperson of HT Media, Shobhana Bhartia in Delhi. She discussed the transition of Hindustan Times from a paper was started to promote the freedom struggle to being a more consumer-led business. She argues for a strong business case for English newspapers with a strong franchise, while expecting growth in regional print to outpace Hindi. In a decade she expects the education business to contribute equally.

It has been a very rich and interesting journey for HT. How has the company evolved since its inception to its current stature?
Hindustan Times was started to promote the freedom struggle, at the behest of Gandhiji, and was not meant to be a profit-driven enterprise. HT was started for a cause, and its change to a profit-driven enterprise started in the 1990s, when liberalisation started throwing up new opportunities. Everything started changing—we adopted a more reader-friendly format and better-quality presses for printing, and put in a real effort connect with the readers. We also started some of our Hindi offerings—Lucknow and Bhopal. Our English paper for Mumbai also came on the drawing board for the first time in the mid 1990s, as there was a greater focus on growing the business.

What is your outlook for the Indian print media space?
I think Indian print industry is in a far better position vis-à-vis the rest. Although English papers should see healthy growth, Indian language papers should see much stronger growth. Growth may not be at the galloping double-digit rates that we saw in the 80s or the 90s, as increasing penetration of broadband causes a shift in the younger generation's reading habits. Furthermore, in India, linguistic variations have acted as a driver for print media, and will continue to do so. Another driver is the rising literacy rate, which offers enough headroom. Newspapers are still the first point of conversion for an illiterate person who moves to the literate pool, which is why I foresee enormous growth in the Indian languages space.

HT launched its Mumbai edition five years ago. What is your assessment of the performance of the Mumbai edition and how soon do you expect it to break even?
We are satisfied with our growth in Mumbai, not just in terms of circulation, but also in terms of readership—we are now the Number 2 paper in the city. We are happy about our progress so far. I constantly ask people for feedback, which I think is the best way to assess how we are doing—and I gather that HT Mumbai is creating a buzz and has now been accepted as a Mumbai newspaper. It has taken up a number of local causes and initiated some great campaigns, and the paper is now making headway in Mumbai. Revenues are also increasing, and we hope to break even within two years. Regardless of what people plan or say, the gestation period for a new paper is typically four to five years; it may even take seven to eight years. Even if there is brand recognition, it takes a while for that to translate into increased profitability. I see the

Mumbai edition breaking even in less than two years—and that remains our primary focus for the English business for the medium-term.

How serious and urgent is the threat of migration to digital media?
The migration has started, but I do not see it assuming a significant proportion in the near future. It's a relatively small proportion of consumers that is migrating, and ad spend on digital media is also increasing. At present, digital media is still a small niche; majority of the population still prefers the hard-copy. In the long term, the migration will become widespread, so we are also building up our presence in digital media. In English, I think the number 1 and number 2 players have a strong business case in this country. But over the long term, the trend of declining circulation—as has been seen in other parts of the world—will affect India too. So the scope for a #3 player becomes even smaller going forward, but for the #1 and #2 players, I think opportunities will remain.

Competition has been intensifying. Going forward, how do you see this playing out?
It is always difficult to comment on competition, but yes, given how attractive the print space is now, the major players might not be content with merely occupying their current territories, and will try and expand into newer geographies. In the English-language market, I don't see any signs of predatory pricing, as the existing players have found a pricing level at which value is no longer being destroyed. On the other hand, competition in the Hindi market has increased, but it has done so in quite a predictable manner. In a sense, Hindustan has also been a challenger in Uttar Pradesh. Going forward, I think competition will increase, but I don't think that the pricing bloodbath of the 1990s is likely to happen again.

What are the group's plans for businesses other than print and radio, in which you already have a presence?
We are very excited about education; it will be a good fit for the group. In fact, when I met Ms Graham in the 1980s, even at that stage, 30% of her group's revenues came from Kaplan (a Washington Post subsidiary which provides higher education programmes). I remember asking her why a newspaper company would be in the education business. What she said still rings true: the greatest strength of a newspaper company is credibility, and that is the first inherent quality you look for when you put your child through education. So I think the field of education offers the best possible leverage for a print media company. In the 1980s and 1990s, media itself had such a long way to go and we also had a lot on our hands. But now education is one area which we are looking at very closely.

So what is your vision for the Group five or ten years down the road?
First of all, businesses which would have crossed their gestation periods will generate immense value for shareholders. The digital business would have established itself in a much bigger market and would no longer be a fringe business. I also see education being a big part of our business; we have just started off with tutorials, but in ten years, I hope to be sitting and discussing both the education and media businesses on equal terms.

Financial summary

13% revenue CAGR over FY11-13ii

34% CAGR in consolidated profits over FY11-13ii

Robust free cash generation

Cash balance to surge

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	13,591	14,378	17,396	19,829	22,007
EBITDA	1,003	2,803	3,339	4,198	5,333
EBIT	**315**	**2,099**	**2,508**	**3,297**	**4,361**
Interest expense	323	295	220	200	130
Exceptional items	-189	-76	0	0	0
Others items	206	159	250	301	357
Profit before tax	**9**	**1,888**	**2,538**	**3,398**	**4,589**
Tax expense	125	537	736	985	1,331
Extraordinary items	125	11	-116	-181	-245
Net Profit	**9**	**1,362**	**1,686**	**2,232**	**3,013**

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	9	1,888	2,538	3,398	4,589
Depreciation & Amortization	688	704	831	901	971
Tax paid	-39	-508	-736	-985	-1,331
Working capital change	750	1,897	-40	-249	-877
Other operating items	84	153	163	0	0
Operating Cash-flow	1,491	4,134	2,755	3,065	3,352
Capital expenditure	-2,576	-1,393	-900	-850	-900
Free cash flow	**-1,084**	**2,741**	**1,855**	**2,215**	**2,452**
Equity raised	2	0	2,698	0	0
Investments	-379	-1,720	2,255	0	0
Debt financing/disposal	1,476	-581	-2,040	0	0
Dividends paid	-82	-58	-58	-58	-58
Net change in Cash & cash equivalents	**-68**	**381**	**4,709**	**2,156**	**2,394**

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	705	1,087	5,796	7,952	10,346
Sundry debtors	2,199	2,423	2,931	3,341	3,708
Trade Inventories	1,756	1,200	1,498	1,714	1,798
Other current assets	2,315	2,007	2,600	3,100	4,100
Fixed assets	**6,717**	**7,494**	**7,663**	**7,724**	**7,776**
Intangible assets	1,000	912	813	701	577
Other assets	3,035	4,777	2,522	2,522	2,522
Total assets	**17,728**	**19,901**	**23,823**	**27,054**	**30,828**
Short-term debt	8	0	0	0	0
Sundry creditors	5,227	6,377	7,744	8,611	9,186
Other current liabilities	172	279	270	280	280
Long-term debt/Convertibles	3,699	3,125	1,085	1,085	1,085
Other long-term liabilities	207	178	178	178	178
Minorities/other Equity	-69	218	1,094	1,275	1,520
Networth	**8,486**	**9,725**	**13,452**	**15,625**	**18,579**
Total liabilities & equity	**17,728**	**19,901**	**23,823**	**27,054**	**30,828**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	12.9	5.8	21.0	14.0	11.0
Core EBITDA growth (%)	-40.9	179.3	19.1	25.7	27.0
Core EBIT growth (%)	-72.1	565.6	19.5	31.5	32.3
Core EBITDA margin (%)	7.4	19.5	19.2	21.2	24.2
Core EBIT margin (%)	2.3	14.6	14.4	16.6	19.8
Net profit margin (%)	1.5	10.0	9.7	11.3	13.7
Dividend payout ratio (%)	NA	4.3	3.5	2.6	1.9
Tax rate (%)	NA	28.4	29.0	29.0	29.0
Net Debt/Equity (%)	35.4	21.0	-35.0	-44.0	-49.8
Return on Equity (%)	0.1	14.0	12.5	14.3	16.2
Return on Assets (%)	1.3	7.6	7.7	8.8	10.4

Source: Company data, IIFL Research

CMP	**Rs305**
Target 12m	**Rs400 (31%)**
Market cap (US$ m)	**943**
Bloomberg	**IGL IN**
Sector	**Utilities**

14 March 2011

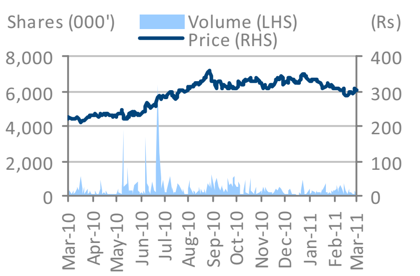
52Wk High/Low (Rs)	374/209
Shares o/s (m)	140
Daily volume (US$ m)	2
Dividend yield FY11ii (%)	2.2
Free float (%)	55.0

Shareholding pattern (%)	
BPCL	22.5
Gail India	22.5
FIIs	17.0
DIIs	17.4
Others	15.6

Price performance (%)

	1M	3M	1Y
Indraprastha Gas	-0.4	-5.1	38.2
Rel. to Sensex	-2.9	1.8	32.3
Gujarat Gas	20.3	3.6	52.4

Stock movement



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Indraprastha Gas BUY

Quality play on gas retailing

Indraprastha Gas (IGL), the sole distributor of gas in the National Capital Region (NCR), has extensive network penetration. This, we reckon, will enable it to maintain its monopoly in Delhi and pass on any increase in input prices, as reflected in the 32% increase in CNG prices since June 2010. IGL plans to replicate its network in markets adjoining Delhi—Noida, Greater Noida and Ghaziabad—where demand for gas remains strong. This, we reckon, will translate into a volume CAGR of 23% and earnings CAGR of 18% over FY11-13ii. Trading at 15x FY12ii EPS, IGL offers a quality play on gas retailing in India.

Monopoly in the high-growth Delhi market: IGL's gas distribution network in Delhi (2,300km of pipelines + 241 CNG stations), is hard to replicate, and is thus unlikely to face competition in the near future. Given that CNG is much cheaper than liquid fuels, we expect demand to remain firm, and forecast a volume CAGR of 13% through FY11-13ii. Furthermore, launch of CNG variants by leading car-makers (Maruti, Hyundai, etc) could increase the monthly rate of CNG-using private vehicles from ~4,000 in 1QFY11. This presents an upside risk to our estimate of volume growth.

Growth beyond Delhi would support further volume growth: IGL plans to replicate its gas retailing network in Noida, Greater Noida and Ghaziabad, where latent demand remains strong (we estimate it at 2-3mmscmd). Such sales could grow at an exponential rate and account for 24% of sales by FY13ii and 28% by FY15ii. Over the next few years, the government plans to appoint CGD (city gas distribution) operators across 200 cities through a bidding process, which presents a further growth opportunity to IGL.

Play on emerging gas retailing business in India—BUY: Our estimate of 18% earnings CAGR for IGL through FY11-13ii builds in 23% volume CAGR, and assumes continuance of pricing power, which is demonstrated in the series of price hikes taken by IGL in FY11 (CNG prices up 32% YoY). IGL's valuation of 15x FY12ii EPS is attractive, in our view, and is at a discount to regional peers' multiple of 15x-20x one-year-forward earnings. IGL offers a long-term play on the emerging gas-retailing business in India, which we believe is set for a massive take-off. We retain BUY with a target price of Rs400.

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	8,528	10,781	18,461	25,515	32,587
EBITDA Margins (%)	36.0	36.0	27.0	24.0	23.0
Reported PAT (Rs m)	1,725	2,155	2,531	2,876	3,516
EPS (Rs)	12.3	15.4	18.1	20.5	25.1
Growth (%)	-0.8	24.9	17.5	13.6	22.2
IIFL vs consensus (%)			-3.5	-4.6	4.2
PER (x)	**24.8**	**19.8**	**16.9**	**14.8**	**12.1**
ROE (%)	24.5	25.4	25.1	24.2	24.9
Debt/Equity (x)	0.0	0.1	0.3	0.3	0.3
EV/EBITDA (x)	**13.6**	**10.9**	**9.1**	**7.7**	**6.3**
Price/Book (x)	6.1	5.0	4.2	3.6	3.0

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

Company snapshot

Indraprastha Gas was incorporated in 1998 as a JV between GAIL and Bharat Petroleum. The company later took over the Delhi gas distribution project from GAIL. This project envisaged providing consumers in Delhi with natural gas through a network of pipelines. As of date, IGL's gas distribution network is spread across Delhi and Noida & Greater Noida. The company is also setting up its network in Ghaziabad. It supplies compressed natural gas (CNG) to the auto sector, piped natural gas (PNG) to households and commercial enterprises, and R-LNG (regassified LNG) to industrial users.

SWOT analysis

Strengths	Weaknesses
• Parentage – GAIL and BPCL; regulatory monopoly providing marketing exclusivity till January 2012 and network exclusivity till 2035 • Huge initial capex requirement makes an existing network a strong barrier to entry	• Highly regulated sector prone to government interference • Cross-subsidy of end-level tariff to enable recovery of initial network capex
Opportunities	**Threats**
• Huge untapped markets that are dependent on LPG/ LNG for gas requirements	• Revenue model susceptible to gas price increases

IGL receives natural gas through the Hazira-Bijaipur-Jagdishpur (HBJ) pipeline, which is managed by the state-owned GAIL (formerly known as the Gas Authority of India Ltd). Pipeline tariff for the HBJ pipeline is determined by the government. In addition to the HBJ pipeline, IGL uses sections of GAIL-owned pipelines within Delhi to transport gas to its own network. This tapped natural gas is distributed via a network of pipelines to CNG stations and PNG consumers. To meet the growing demand for gas, the government has allocated gas to IGL from RIL's KG D6 field. In addition, it has signed an agreement with BPCL to source R-LNG for its industrial consumers.

Promoter / Management background

Name	Designation	Remarks / management description
S Radhakrishnan	Chairman	More than 30 years experience in the oil & gas sector. Ex-member of Oil Co-ordination Committee under the Ministry of Petroleum. Ex-Managing Director of Bharat Shell. Prior experience with BPCL.
Rajesh Vedvyas	Managing Director	More than 30 years experience in oil & gas sector. Prior experience in Indian Oil and GAIL India across projects, marketing and operations.
Manmohan Singh	Director (Commercial)	Experience in diverse fields. Currently, independent director of Kilburn Industries. Prior experience in marketing at BPCL.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Volumes (mscm)	660	782	969	1,200	1,461
Gross Spreads (Rs/scm)	6.70	7.75	7.97	8.05	8.15
Capex (Rs bn)	1.6	3.4	7.0	6.1	5.7

Source: Company data, IIFL Research

Investment thesis

Monopoly in the high-growth Delhi market

Thanks to the regulatory push—mandatory conversion of all public transport vehicles to compressed natural gas (CNG) from liquid fuels, and rapid penetration of CNG-dispensing stations across Delhi—almost ~0.4m vehicles (private + public) currently ply on CNG. Conversion of vehicles to CNG has also been spurred by attractive pricing against traditional liquid fuels. For instance, per-km cost of running a CNG vehicle is 63% and 23% lower than that of a comparable passenger vehicle running on petrol or diesel, respectively.

Running cost per km on CNG is 63% cheaper as compared to petrol

Figure 128: CNG is sold at 63% discount to petrol on energy-equivalent terms

	CNG	Petrol	Diesel
Fuel price (Rs/litre)		58.4	37.7
Energy-equivalent price (Rs/scm)	22.1	59.4	35.3
Discounted CNG price in Delhi		63%	38%

Source: Company, IIFL Research

Figure 129: Cost per km of CNG is substantially lower than that of liquid fuels

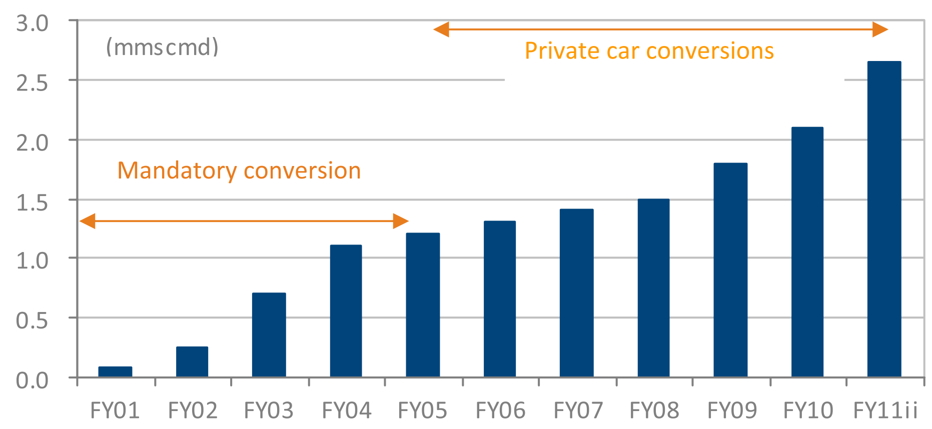
(Rs/km)	CNG	Petrol	Diesel
Auto	0.8	2.3	-
Bus	8.3	-	10.8
Private vehicle s	1.8	4.9	2.4

Source: Company, IIFL Research

Mandatory conversion of public transport vehicle and private car conversion led to higher demand for gas historically

Delhi has a total vehicular population of approximately 4m (as of end-FY10), of which only ~0.4m operate on CNG. Thus, even after a decade since the introduction of city gas operations, the Delhi market remains relatively under-penetrated. While all public transport vehicles run on CNG, a large proportion of private vehicles—aggregating more than 3m—continue to run on liquid fuels. We believe that a majority of these vehicles will convert to CNG over a period of time, given CNG's compelling cost advantage over liquid fuels. Similarly, there is a huge untapped market for piped natural gas (PNG): as of end-FY10, IGL supplies PNG to only ~0.17m households in Delhi, whereas 4.3m use LPG; these households can potentially switch to PNG, which is safer and more convenient.

Figure 130: IGL's volumes have registered a CAGR of 40% over the last decade



Source: Company, IIFL Research

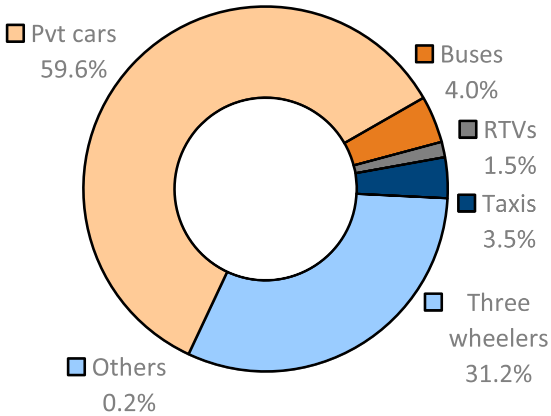
Overall volumes in Delhi is estimated to grow at 13% CAGR

We reckon this large-scale conversion to CNG and PNG will drive a volume CAGR of 12% and 24%, respectively, in these fuels over FY11-13ii. Thus, we expect IGL's aggregate volumes in Delhi to register a CAGR of 13% through FY11-13ii.

- **Pick-up in private-car conversion:** Frequent increases in prices of liquid fuels (especially petrol, following the deregulation) have increased the attractiveness of CNG, and this is spurring voluntary conversion of private vehicles at a much faster pace. According to IGL's management, the number of private cars being converted to run on CNG has almost doubled, from ~2,000 a month in FY08 to 5,000 in recent months. Despite the ~32% increase in CNG prices in FY11, it remains a considerably cheaper fuel than liquid fuels (see Figure 129). As such, we expect a pick-up in the conversion rate from FY12 onwards. This would be supported by rapid addition of CNG stations across Delhi, which has resulted in lower queuing time at supply stations. We therefore expect car conversions to average at 5,000-5,500 per month in FY12/FY13. Launch of CNG variants of vehicles by leading manufacturers should further support CNG volume growth.

More than 3m vehicles in Delhi ply on liquid fuels, presenting a huge growth potential

Figure 131: Private cars account for 60% of CNG vehicles in Delhi



Source: Company, IIFL Research

The initial cost of the CNG kit for a taxi can be recovered in less than three months

Figure 132: Economics of CNG conversion

	Taxi (Petrol)	Auto (Petrol)	Bus (Diesel)
Cost of CNG kit (Rs m)	0.04	0.02	0.40
Price of liquid fuel (Delhi-Rs/ltr)	58.4	58.4	37.7
Mileage/ltr (km)	12.0	25.0	3.5
Running cost on liquid fuel (Rs/km)	4.9	2.3	10.8
Mileage on CNG (km)	12.0	25.0	3.5
Cost of CNG (Rs/kg)	21.5	21.5	21.5
Running cost on CNG (Rs/km)	1.8	0.9	6.1
Daily running (km)	150	75	200
Savings by operating on CNG (Rs m)	0.17	0.04	0.34
Payback (years)	0.2	0.4	1.2

Source: IIFL Research

- **DTC bus fleet growth of 20%:** Delhi Transport Corporation (DTC) had ordered 3,500 new passenger buses to handle the increase in traffic during the Commonwealth Games. It also plans to phase out approximately 1,000 old buses, resulting in net addition of 2,500 to DTC's bus fleet and translating to an increase

20% increase in DTC bus fleet to result in higher CNG demand

of 20%. This in itself would add to CNG volumes from 2HFY11 onwards. IGL has signed a long-term contract with DTC, whereby IGL would be the exclusive supplier of CNG to all DTC buses for ten years.

- **Rapid increase in radio taxis:** The Delhi government introduced the first batch of "radio taxis" (call-a-cab service) in the capital in 2006. The service has been gaining popularity among business and leisure travellers. Since its launch in 2008, the fleet has grown to ~3,000. This fleet is likely to be expanded by 2,500 cabs in FY11, and by a further 2,500 in FY12, in response to the growing popularity of these cabs. This bodes well for CNG volumes.

- **Mandatory conversion of LCVs to CNG:** The Delhi government has mandated all LCVs registered and plying in Delhi to operate on CNG. As of March 2010, Delhi had about 20,000 registered LCVs, which can potentially operate on CNG. However, since the mandate excludes carriers with national permits (which form a large chunk of the overall population), we do not think these conversions will result in a significant pick-up in the CNG population, and assume ~200 conversions a year.

With further penetration in the domestic market - PNG volumes are estimated to register 24% CAGR

- **Rapid growth in PNG connections:** Although IGL has a presence in 55 of the 77 charge areas in Delhi, its network remains under-utilised. The company currently supplies PNG to only ~0.2m households, though it is equipped to supply to 0.6m households. This is partly because the company has so far concentrated on growing its CNG business, in which it enjoys better pricing power.

  However, with intensifying competition, IGL plans to improve utilisation of its existing network by offering more connections to domestic consumers. Over the next three years, IGL plans to double its PNG connections from 0.2m to 0.4m.

  In addition, IGL is focussing on the industrial and commercial segment, where it expects an annual growth of 15% for the next three years. The company has recently signed contracts to supply gas to Hotel Leela for its new property at Chanakyapuri. In addition, it will also supply almost 0.03mscmd gas to a 3.5MW power plant at Thyagaraj Stadium, one of the venues of the Commonwealth Games that were concluded in October 2010. The plant may continue to operate after the Games thereby supplying power to the neighbourhood.

Deregulation of petrol prices has increased the cost differential – will lead to higher conversion

- **Deregulation of administered petroleum products prices to also drive volume growth:** Complete deregulation of petrol prices and partial deregulation of diesel (complete deregulation is expected in phases) has resulted in a 22% increase in petrol prices in Delhi. This increase in motor fuel prices has further increased the per-km price difference between these liquid fuels and CNG, making CNG conversion an even more economically compelling choice.

  Also, post the 12% increase in LPG prices, IGL too has increased its PNG prices. The company has introduced differential pricing to offset the impact of higher prices on low-gas-consuming domestic consumers. IGL has increased prices of domestic piped gas by ~19% (Rs18.95/scm) to consumers that consume 90scm (equivalent to ~4 cylinders), in four months. And for consumers that consume more than four cylinders in four months, the applicable price increase is 23% (Rs26/scm).

Competition unlikely to shake IGL's bastion in Delhi

Since its incorporation in 1998, IGL has enjoyed a monopoly. Prospects of this monopoly continuing undisturbed came under a cloud in 2006, when the government set up the Petroleum and Natural Gas Regulatory Board (PNGRB) to steer development of CGD (city gas distribution) operations across India. The primary objectives of the board are to establish a regulatory framework, regulate pipeline tariffs, introduce competition, and develop the market. The board's guidelines are applicable to PNG operations, but CNG operations remain out of the regulatory ambit.

IGL enjoys marketing exclusivity in Delhi till 2012 and network exclusivity till 2025

PNGRB has allowed a period of exclusivity for the companies that were functional prior to its incorporation. Once the exclusivity period ends, these areas would be open to competition.

The board has given IGL marketing exclusivity in PNG till January 2012, and network exclusivity till 2025. Thus, IGL will remain the sole distributor of PNG in Delhi till 2012. Thereafter, other players will be able to market PNG using IGL's infrastructure, for which IGL would receive a fixed charge (network exclusivity). The new entrants will be allowed to develop their network only in areas where IGL does not have its infrastructure in place.

This coupled with wide distribution network and low set-up cost makes IGL's model immune to competition

In our view, IGL's operations would remain unaffected by such competition, as: 1) it has established a wide network in Delhi that is hard to replicate; 2) it has set up this network at costs that are substantially below the current setup costs; and 3) stringent regulations that disallow duplication of the network will significantly reduce operational flexibility for any new entrant.

IGL's network reaches almost 75% of Delhi

Over the past ten years of its operations, IGL has built a pipeline network spanning 2,300km across Delhi. The network covers 55 of the 77 charge areas (as defined in the Delhi Master Plan). With an aggregate compression capacity of 2.91m kg/day, IGL has the second-largest CGD network in India. In addition to its widespread network, IGL has the highest number of CNG dispensing stations in India (241 as of FY10).

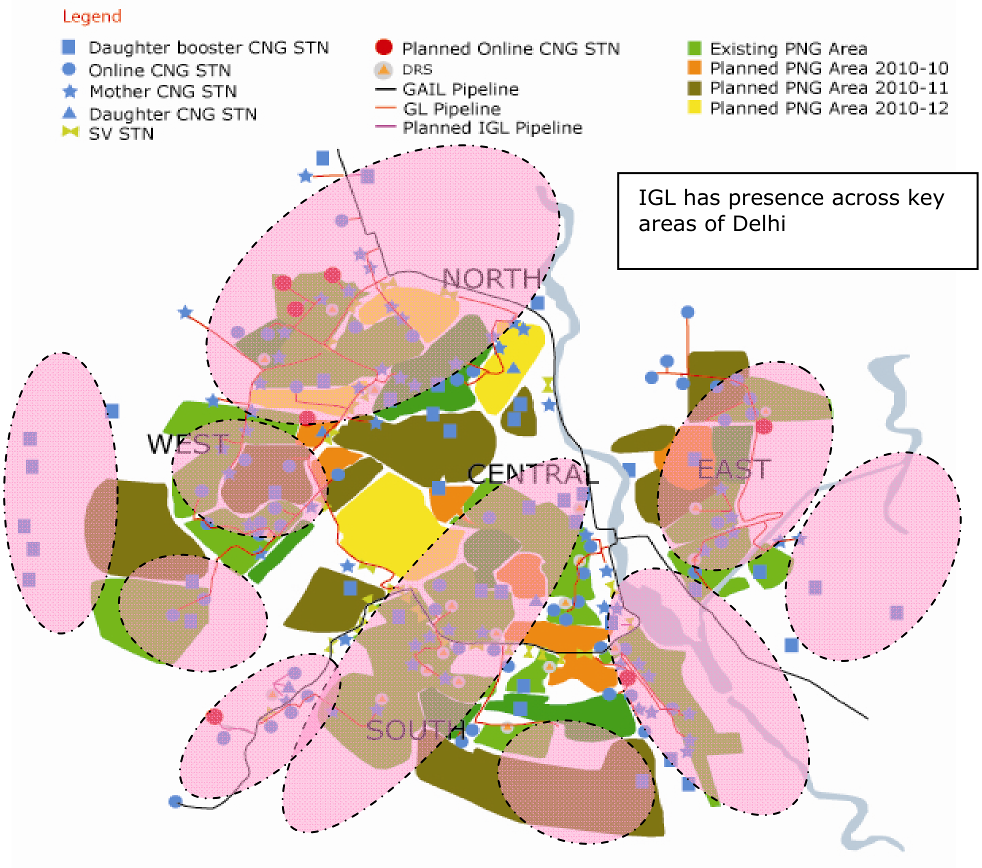
PNG retailing requires widespread penetration of the pipeline, while the CNG business demands presence in key city locations. IGL has a widespread pipeline network, and its 241 CNG stations across Delhi are at locations where traffic density is high. The Delhi government, one of the promoters of IGL (5% equity stake), has played a key role in infrastructure development. It has not only provided the necessary approvals for laying pipelines, but also extended land at key areas on long-term leases (99 years).

In the next two years, IGL plans to further spread its network to cover 100% of Delhi

Moreover, over the next 24 months, IGL plans to further strengthen its network across Delhi, to cover all the 77 charge areas. Thus, by 2012, when IGL's marketing exclusivity ends, its pipeline network would cover almost all of Delhi, thereby giving it a significant advantage over its competitors.

Currently IGL operations cover 75% of Delhi

Figure 133: Few places in Delhi are still not covered by IGL

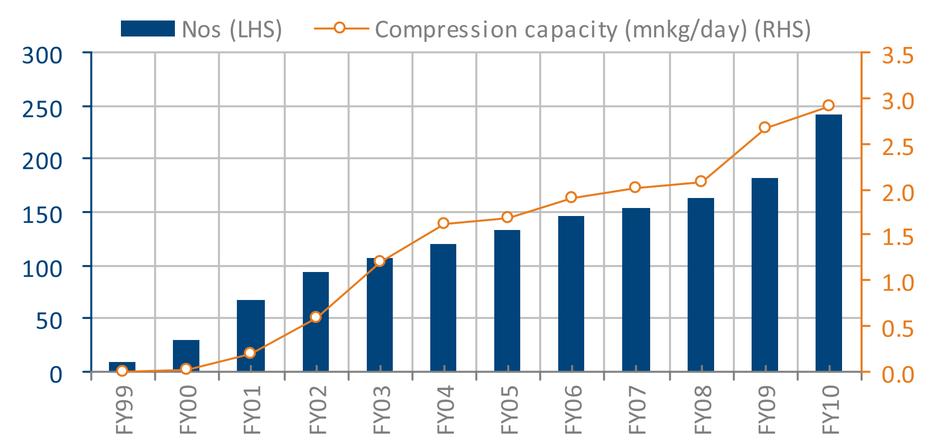


Source: IGL

IGL is in the process of locking in its high-volume customers by signing long-term contracts to mitigate the risk of cherry-picking beyond 2012

The regulations allow new players to access IGL's pipelines to sell PNG (by paying a fixed charge determined by the regulator). Hence, there remains a possibility of "cherry-picking" of high-volume consumers. *To counter such cherry-picking, IGL has started: 1) locking in these high-volume customers on long-term contracts spanning more than five years; and 2) minimising the spare capacity on its network, thereby eliminating scope for open access to new players.* While the PNG business remains susceptible to competition, the CNG business has strong entry barriers, given IGL's presence across premium locations. Hence, we think risk to the CNG business remains relatively low.

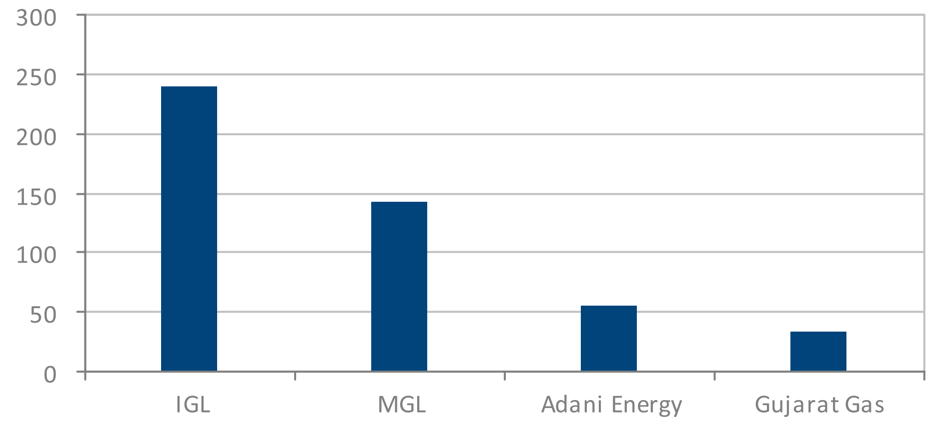
Figure 134: IGL has 241 CNG stations with 2.9m kg/day compression capacity



Source: IIFL Research

CNG has the highest number of dispensing stations across the country

Figure 135: IGL has the highest CNG dispensing stations among its peers



Source: IIFL Research

Replacement costs for any new entrant would be almost 2x that of IGL's average setup costs

Replacement costs almost 2x that of IGL's setup costs

Moreover, IGL has developed its infrastructure over the past ten years, and thus the weighted average cost of its network would be lower than the current replacement costs. Till date, IGL has invested close to Rs6bn in its CNG stations (implying a setup cost of Rs26m/station) that have compression capacity of 2.9mkg/day. A new player, we reckon, would have to spend at least 75–80% more to replicate such infrastructure. Higher setup costs would mean either a higher breakeven point or lower RoI for any new player, if it could match IGL's price points (see table below). This calculation assumes that both players source gas at similar prices.

Figure 136: IGL has significant advantage over the new player beyond FY12

	IGL	New entrant
Investment in CGD (Rs m)	10,000	17,500
Sales (mscm)	769	769
Gross margins (Rs m)	5,961	5,961
(-) Fixed costs (Rs m)	2,002	2,402
(-) Depreciation (Rs m)	800	1,400
EBIT (Rs m)	3,159	2,159
RoI (%)	32%	12%

Source: IIFL Research

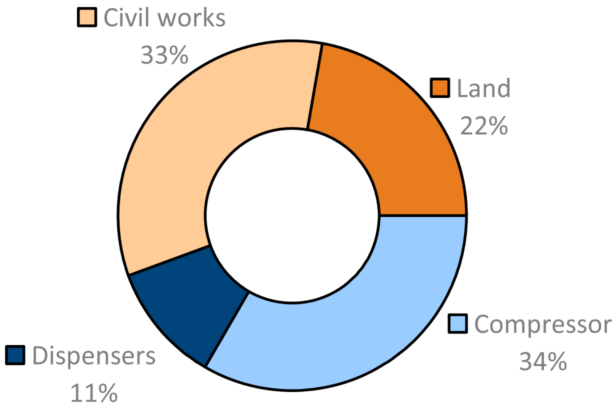
Restriction on installation of compressors would confine economies of scale in operations

Regulations limit operational flexibility of new entrants

Regulations have been framed with an intention to eventually introduce competition—but in their present form, they impair the operational flexibility of any new entrant, in our view. For instance, while a new player can sell CNG by installing its own dispensing stations, it is not allowed to install the compressors, and has to use the compressors of the incumbent utility for payment of a fixed charge determined by the regulator.

While non-installation of compressors would mean lower capital costs, it would also restrict the scale of dispensing stations, and perhaps curtail economies of scale in operations.

Figure 137: A compressor accounts for a third of the cost of a CNG station



Source: IGL, IIFL Research

Diversifying operations in areas adjoining Delhi

We expect Noida, Greater Noida and Ghaziabad to contribute ~20% of FY13 gas volumes

IGL has begun its network expansion beyond NCR of Delhi to Noida, Greater Noida, and Ghaziabad. Growth potential in these areas remains promising, given the development of small and medium industrial establishments, which can quickly switch over to PNG. While industrial consumers would be the key demand drivers, CNG and PNG would also generate healthy volume growth, given the rapid urbanisation in these areas. *By FY13, we reckon, IGL could sell ~0.8mscmd gas in these three geographies—almost 30% of its present sales from Delhi.*

IGL has also bid for a CGD license for Ludhiana and Jalandhar; if won it will result in upside risk to our volume assumptions

Other than this, IGL has also bid in the third round for Ludhiana and Jalandhar (both in Punjab) held by PNGRB in July 2010. We expect companies to bid for more cities in the future, as PNGRB expects to authorise CGD operations in 200 cities by 2015. Any new area would present further upside to our estimates. The company has also increased its earmarked capex plans to Rs19bn to be spent over FY11-13 as against Rs12bn earlier.

Noida and Greater Noida: industrial consumers drive demand growth

IGL started its operations in Noida and Greater Noida in 2009. In these areas, IGL has established 11 CNG stations and tied up ~3,500 PNG consumers. In addition, it has a number of industrial consumers to whom it sells ~0.06mscmd of R-LNG. Strategically, IGL is focussing on tying up long-term contracts with these bulk consumers. Simultaneously, the company is developing CNG and PNG infrastructure for other classes of consumers. From 0.05mscmd sales as of end-FY10, IGL is aiming for sales of ~0.2mscmd in FY11, and ~0.5mscmd by FY13.

Industrial consumer would drive demand in Noida and Greater Noida

To meet its gas requirements, the government has allocated IGL 0.2mscmd APM gas, which it can sell only to its CNG and domestic PNG consumers. To meet the needs of industrial and commercial consumers, it has signed a contract for 0.24mscmd R-LNG with GAIL and BPCL. Improved gas availability would also allow IGL to buy gas from other sources, if current supply arrangements fall short of demand.

Ghaziabad: operations have just begun amid uncertainty…
IGL has also begun operations in Ghaziabad. At present, it sells CNG through three stations, and sells a very small quantity of PNG. Over the next few quarters, IGL plans to complete construction of the main steel pipeline in Ghaziabad, which would enable it to sell gas to small and medium industrial consumers.

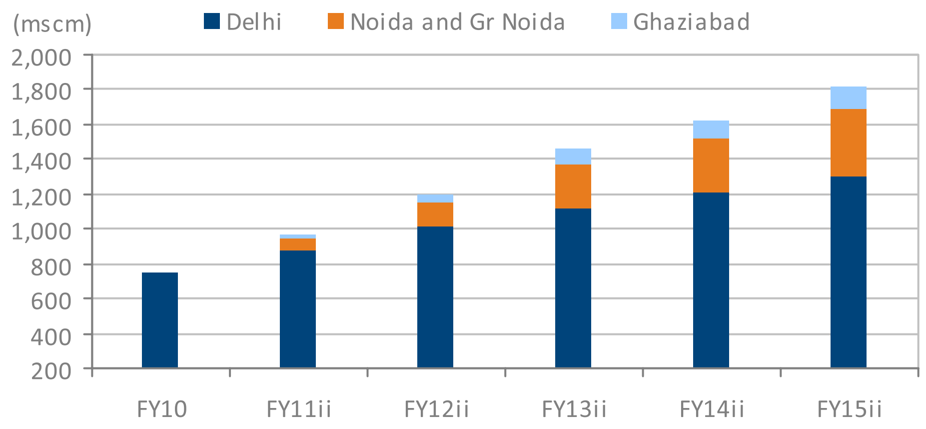
Demand from industrial consumers in Ghaziabad is almost 1.25-1.5mmscmd (equivalent to 50-60% Delhi volumes)

Ghaziabad has no gas distribution network at present, so there is a large latent demand from industrial consumers. According to IGL's management, demand from industrial consumers is almost 1.25-1.5mmscmd (equivalent to 50-60% Delhi volumes), and the company is therefore accelerating construction of its network. By FY13, we think sales from Ghaziabad could reach almost ~0.3mscmd.

By FY13, new geographies to contribute ~20% of IGL's gas volumes…
By FY13, we estimate IGL's volumes from new geographies will be around 0.8mscmd. At this run rate of sales, by FY13, new geographies would account for 20% of IGL's sales volumes (equating to ~30% of FY10 sales). Further, we forecast that by FY15ii, such sales could potentially reach 1mscmd, or ~50% of IGL's volumes in FY10. In our analysis, we assume that IGL's Ghaziabad operations remain unaffected.

By FY15ii gas volumes from new geographies is estimated to be 1mscmd, or ~50% of IGL's FY10 volumes

Figure 138: IGL well-poised to double gas sales by FY15ii



Source: IIFL Research

… **but geographical diversification has risks**
IGL's geographical diversification has significant regulatory risks. In case of an unfavourable order in the Supreme Court, IGL would lose a substantial growth opportunity in Ghaziabad, and additionally, may have to take a write-down for investments made till date.

Regulatory risk relating to geographical diversification can lead to downside earnings risk

Similarly, while IGL was directed by the Supreme Court to develop the CGD network in Noida and Greater Noida, Adani Energy (AEL) has started to develop a parallel network without any authorisation. As AEL does not have a definitive gas-supply contract, its assets (although relatively smaller) remain unutilised. Meanwhile, it has applied to the PNGRB to authorise its network and grant exclusivity. IGL may have to battle such competition, even though it has all the necessary approvals. This may adversely affect utilisation of its network, and hence volume growth.

SC allowed Adani to sell gas in Faridabad in public interest

The Government of India has authorised IGL as a CGD operator in Faridabad (Haryana), and allocated APM gas for the operations. Notwithstanding this authorisation and gas allocation, the state government appointed Adani Energy as the CGD operator in Faridabad.

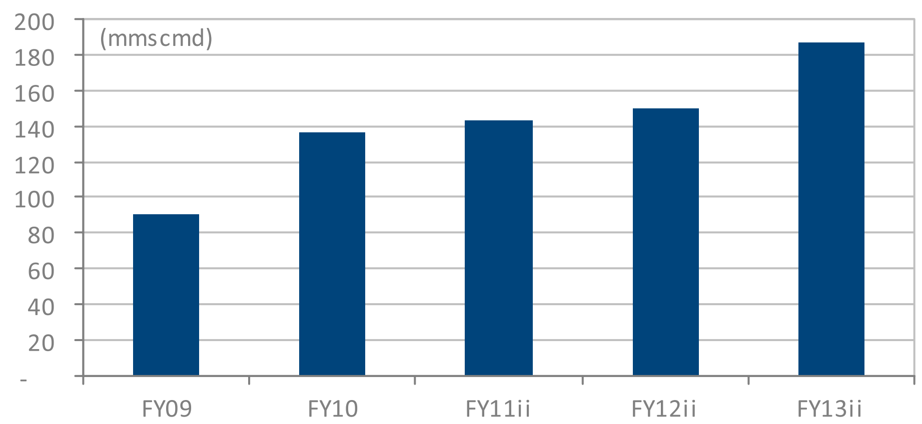
While AEL was constructing its network, IGL challenged the State Government's decision. The case is pending in the Supreme Court. Meanwhile, SC issued an interim order that allowed AEL to launch gas distribution services. The court also asked IGL to supply the earmarked gas to Adani in "public interest" till the case is resolved.

Pick-up in domestic gas supplies bodes well for IGL

Gas supplies are estimated to deliver 13% CAGR, which bodes well for IGL's volume growth

Currently, IGL has a firm allocation of 2.5mscmd from the government for its Delhi (2.3mscmd) and Noida/Greater Noida operations (0.2mscmd), comprising APM and RIL gas. In addition, it has signed two long-term agreements aggregating 0.44mscmd for sourcing R-LNG for its industrial and commercial consumers, with GAIL and BPCL at Delhi, Noida and Greater Noida. By FY13ii, we estimate IGL's gas requirement will increase to 4mscmd (2.3mscmd as of FY10). Although supply contracts currently in force would fall short of demand projected for FY13, we do not think it will be difficult for IGL to secure new supplies over the next few years to meet demand, given the outlook on gas supplies (set to register 13% CAGR through FY11-13ii—see chart below), and strong parentage (GAIL, BPCL).

Figure 139: New discoveries from NELP fields support supply growth



Source: IIFL Research

Earnings CAGR: 18% through FY11-13ii

IGL's earnings is estimated to deliver 18% CAGR over FY11-13ii

IGL's earnings are leveraged to: 1) growth in volumes; and 2) its ability to pass on input-cost escalations as measured by gross margin per unit of gas.

IGL's volume growth is a function of: 1) private-car conversions and pick-up in domestic PNG; 2) successful foray in Noida and Greater Noida; and 3) favourable verdict from the Supreme Court in Ghaziabad. Its spreads, on the other hand, hinge on its gas sourcing strategy and pricing of end-products.

Gas requirement beyond APM sources will be sourced through R-LNG market

So far, IGL has sourced most of its gas requirements through the low-priced APM gas (Administered Pricing Mechanism). Any gas requirement beyond APM sources will be bought at market prices, which would affect margins. That said, note that the gap between market and APM prices has narrowed considerably after the 100% increase in APM gas prices (US$4.2/mmbtu).

As a result of the skewed tax structure for petroleum products (taxes + duties = 50% of retail prices), which inflates retail prices, **CNG continues to be cheaper on a per-km basis even after the steep 32% price hike**. This gap in cost and IGL's retail franchise, in our view, should allow substantial scope to maintain margins.

In the PNG business—particularly domestic PNG, where gas is priced at a 5% discount to the tightly regulated prices of LPG cylinders—IGL may not be able to pass on frequent changes in input costs. On the other hand, if crude-oil prices firm up, IGL would retain pricing power for supplies to industrial and commercial segments and be able to pass on any cost increases. On balance, we reckon IGL would be able to maintain its gross margin per unit of gas sold.

IGL's gas sales to grow at 23% over FY11-13ii

We forecast IGL's earnings will register a CAGR of 18% through FY11-13ii, backed by strong 23% volume growth. Our earnings estimate also builds in capex of Rs4bn-5bn pa through FY11-13ii, which IGL would spend to grow in new centres; benefits of such expansion will accrue over a period of time. Given IGL's low D/E (<0.1x) and strong internal cash flows, we believe IGL can comfortably fund its ambitious capex plans.

Play on emerging gas retailing sector in India, BUY

We think the gas retailing business in India is set for a massive take-off. Over the next few years, we believe the government will award at least 200 new distribution circles through a bidding process. Any wins in such bidding would allow IGL to grow its business much faster than in the three centres that are currently driving its medium-term growth. As such, IGL offers a play on the emerging business of gas retailing in India.

IGL is trading at 15x FY12ii EPS, lower than the average PE of regional players

IGL's regional peers trade at an average P/E of ~20x on a 12-month forward basis as against IGL, which is trading at 15x FY12ii EPS. The recent correction in the stock presents a good entry point in the stock. We retain BUY on the stock with a target price of Rs400.

Figure 140: Regional peer comparison

	Market Cap (US$ m)	P/E		RoE		P/B	
		CY10/FY11	CY11/ FY12	CY10/FY11	CY11/ FY12	CY10/FY11	CY11/ FY12
Gujarat Gas	1,146	20.1	17.1	28%	27%	5.6	4.6
Petronas Gas	7,500	15.5	15.5	17%	17%	2.7	2.6
Xinao Gas	3,290	23.7	19.0	18%	19%	4.2	3.6
Tokyo Gas	11,676	13.5	13.8	8%	8%	1.1	1.1
Towngas China Co Ltd	1,233	22.7	18.8	5%	6%	1.2	1.1
Shenzhen Gas Corp	2,228	45.8	35.0	10%	12%	4.7	4.2
Northwest Natural Gas	1,253	17.3	16.6	10%	10%	1.8	1.7
South Jersey Indus	73,757	20.2	17.6	14%	14%	2.9	2.5
Average		22.3	19.2			3.0	2.7
Indraprastha Gas	943	16.9	14.8	30%	29%	5.0	4.2

Source: Bloomberg, IIFL Research; Price as of 11 March 2011

Key risk: adverse regulatory intervention

Unfavourable decision by the Supreme Court on Ghaziabad expansion is a potential risk to earnings

Expansion in Ghaziabad hinges on Supreme Court decision: Our earnings forecasts assume that IGL will continue to expand its operations outside Delhi, thereby supporting volume growth. However, in case the Supreme Court rules against the High Court order, and upholds PNGRB's power to call for bids in Ghaziabad, Noida and Greater Noida, IGL's earnings growth would moderate to ~12% as compared to 18% as estimated through FY11-13ii.

Significant increase in crude prices would adversely affect IGL's gross margins

Any runaway increase in gas prices may lead to volatility in quarterly margins: We reckon IGL has sufficient pricing power to pass on increases in input costs and maintain its gross margins and return ratios. We would like to highlight that since IGL is sourcing incremental gas at market rates (R-LNG), where prices are mostly linked to crude oil. Any runaway escalation in R-LNG prices, however, would have to be passed on in a calibrated manner. This may lead to volatility in quarterly margins, although we maintain that margins would remain unaffected on a yearly basis. However, should IGL fail to pass on any sharp increases in gas prices even with a lag, a 5% fall in CNG gross spreads coupled with a 20% fall in car conversion rate in Delhi (vis-à-vis our assumption) would translate to an 18% drop in FY12ii earnings.

Figure 141: FY12 earnings sensitivity to CNG spread and car conversion rate in Delhi

		CNG Spread (Rs/Kg)				
		9.25	9.75	10.25	10.75	11.25
Car conversion in Delhi	4,000	16.7	18.5	20.2	22.0	23.7
	4,500	16.8	18.6	20.4	22.2	23.9
	5,000	17.0	18.8	20.5	22.3	24.1
	5,500	17.1	18.9	20.7	22.5	24.3
	6,000	17.3	19.1	20.9	22.7	24.5

Source: IIFL Research

Financial summary

Other geographies have started to contribute to sales from FY11ii onwards

We expect profit to double over FY09-13ii

IGL to spend Rs4bn-5bn pa through FY11-13ii to grow in new centres

ROE maintained at 24-25%

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**8,528**	**10,781**	**18,461**	**25,515**	**32,587**
EBITDA	3,043	3,867	4,983	6,067	7,438
EBIT	2,369	3,092	3,879	4,580	5,619
Interest income	243	182	61	33	31
Interest expense	23	30	162	320	403
Profit before tax	**2,589**	**3,244**	**3,778**	**4,293**	**5,247**
Taxes	864	1,090	1,247	1,417	1,732
Net profit	**1,725**	**2,155**	**2,531**	**2,876**	**3,516**

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Profit before tax	2,589	3,244	3,778	4,293	5,247
Depr. & amortization	674	775	1,104	1,487	1,819
Tax paid	893	1,060	1,247	1,417	1,732
Working capital Δ	-175	272	-675	-390	-679
Other operating items	30	-30	0	0	0
Operating cashflow	2,224	3,201	2,960	3,973	4,655
Capital expenditure	-1,720	-3,904	-5,160	-4,289	-3,906
Free cash flow	**504**	**-703**	**-2,200**	**-315**	**749**
Investments	47	872	0	0	0
Debt financing/disposal	197	287	2,500	1,000	850
Dividends paid	-655	-797	-936	-1,064	-1,300
Other items	-30	92	0	0	0
Net change in cash	63	-249	-636	-379	299

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & equivalents	1,462	1,212	576	197	496
Sundry debtors	319	335	1,047	1,608	2,567
Inventories - trade	237	278	523	723	924
Other current assets	574	747	1,486	2,054	2,623
Fixed assets	5,211	8,340	12,396	15,198	17,285
Other term assets	1,042	170	170	170	170
Total assets	**8,845**	**11,083**	**16,199**	**19,950**	**24,065**
Sundry creditors	857	1,262	2,123	2,934	3,748
Other current liabs	679	776	936	1,064	1,300
Long-term debt/CBs	265	552	3,052	4,052	4,902
Net worth	**7,043**	**8,493**	**10,088**	**11,900**	**14,115**
Total liabs & equity	**8,845**	**11,083**	**16,199**	**19,950**	**24,065**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue growth (%)	20.8	26.4	71.2	38.2	27.7
Op Ebitda growth (%)	-0.5	27.1	28.9	21.7	22.6
Op Ebit growth (%)	-2.6	30.5	25.4	18.1	22.7
Op Ebitda margin (%)	35.7	35.9	27.0	23.8	22.8
Op Ebit margin (%)	27.8	28.7	21.0	17.9	17.2
Net profit margin (%)	20.2	20.0	13.7	11.3	10.8
Tax rate (%)	33.4	33.6	33.0	33.0	33.0
Net debt/equity (%)	-17.0	-7.8	24.5	32.4	31.2
Return on equity (%)	24.5	25.4	25.1	24.2	24.9
Return on assets (%)	19.5	19.4	15.6	14.4	14.6

Source: Company data, IIFL Research

Pidilite Industries BUY

Niche innovator

CMP	**Rs136**
Target 12m	**Rs170 (25%)**
Market cap (US$ m)	**1,525**
Bloomberg	**PIDI IN**
Sector	**Mid-caps**

14 March 2011

52Wk High/Low (Rs)	160/105
Shares o/s (m)	506
Daily volume (US$ m)	0.7
Dividend yield FY11ii (%)	1.6
Free float (%)	29.4

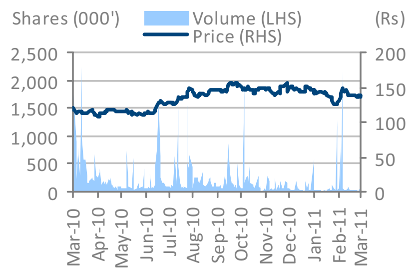
Shareholding pattern (%)

Parekh family	70.6
FIIs	10.3
DIIs	8.0
Others	11.2

Price performance (%)

	1M	3M	1Y
Pidilite Industries	4.1	-8.2	15.8
Rel. to Sensex	1.6	-1.3	10.0

Stock movement



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Pidilite Industries is a niche consumer and specialty chemicals player in India. It has pioneered multiple brands of national top-of-the-mind recall like Fevicol and M-Seal. Construction chemicals (primarily retail consumption) is the company's new growth driver, as legacy strengths remain in place for now mature categories like adhesives and sealants. This should drive ~16% revenue CAGR leading to 20.3% EPS CAGR over FY10-13ii. The stock is valued at 17.9x FY12ii P/E and offers 12-month upside of 25%. We recommend BUY.

Consumer products remain key driver: Of the three businesses that are part of the consumer and bazaars pie (78% of revenues), the construction chemicals business, with brands such as Dr Fixit and Roff (~20% of revenues), has registered over 25% revenue CAGR in the past five years. We expect this momentum to sustain. The core adhesive business is a mature staple (50% of revenues), which has a dominant market share (we expect 10-12% steady-state growth).

Profitability supported by pricing power: Pidilite enjoys a strong market position as the de facto price setter in 65-70% of the revenue pie. Our sensitivity analysis reveals that even if estimates of raw-material price inflation surprise on the upside by 12%, Pidilite can be earnings neutral by increasing product prices by 7%. We see no demand destruction for price increases up to the low teens.

Strong product development and capital discipline: Pidilite undertakes product development for long periods of time until they become significant contributors. The value of this discretion and patience is borne out in its brand creation track record. Barring FY09, the company has delivered 20%+ RoE for the last ten years, and dividend payouts have typically been one-third of profits.

Elastomer project an uncertainty, but valuations reasonable: The chief investment risk is Pidilite's elastomer project in Dahej—Rs2.6bn has been invested, with no visibility yet on commissioning, and a Rs1.5bn further investment requirement (as per company guidance). A comparison with our consumer coverage universe reveals that even after having high capital productivity, dividend yield (1.6%) and steady-state earnings growth of 18-20%, Pidilite trades at a significant discount to peers.

Financial summary (Rs m)

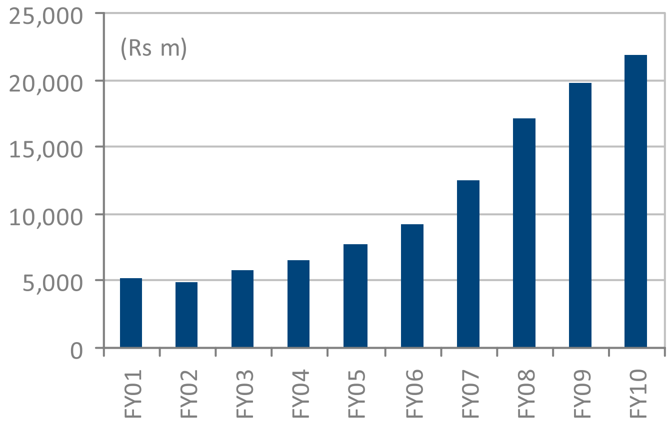
Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	19,863	21,916	25,969	30,049	34,787
EBITDA Margins (%)	10.6	17.2	18.8	19.6	20.3
Pre-Exceptional PAT (Rs m)	1,101	2,702	3,260	3,974	4,801
Reported PAT (Rs m)	1,105	2,979	3,260	3,974	4,801
EPS (Rs)	**2.2**	**5.3**	**6.3**	**7.6**	**9.2**
Growth (%)	-28.4	145.4	17.3	21.9	20.8
IIFL vs consensus (%)			1.9	6.8	5.7
PER (x)	**62.7**	**25.5**	**21.8**	**17.9**	**14.8**
ROE (%)	16.7	34.5	31.3	29.8	30.1
Debt/Equity (x)	0.9	0.5	0.3	0.3	0.2
EV/EBITDA (x)	**34.8**	**19.4**	**14.8**	**12.2**	**9.9**
Price/Book (x)	9.9	7.9	5.9	4.9	4.1

Source: Company, IIFL Research. Price as at close of business on 11 March 2011.

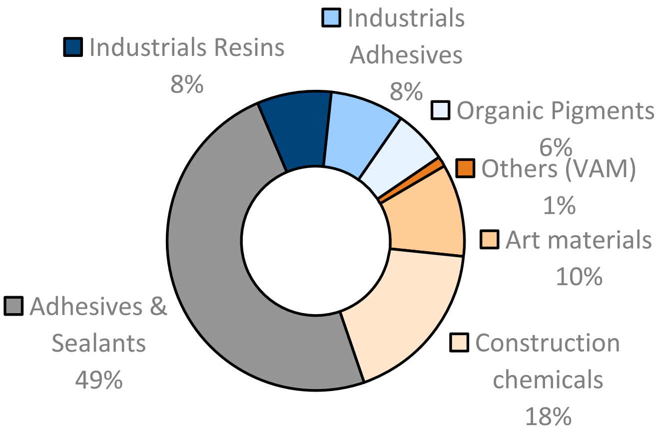
Company snapshot

Promoted by the Parekh family in 1959, Pidilite is one of the most innovative companies in the consumer space in India. The company's product range includes adhesives and sealants, construction and paint chemicals, automotive chemicals, art materials, industrial adhesives, industrial and textile resins, and organic pigments & preparations. Most of these products have been developed in-house, and two-thirds of the company's sales come from segments it has pioneered in India. The company has 13 overseas subsidiaries (four direct and nine step-down), including those with significant sales and manufacturing operations in the USA, Brazil, Thailand and Dubai. These comprise about 12% of consolidated net sales. The company has two main areas of operation—consumer products and speciality industry chemicals. As per FY10 data, consumer products form 78.3% of Pidilite's sales consisting of adhesives, construction and plant chemicals and art materials. Pidilite's competitive advantage lies in its ability to constantly innovate around unmet consumer needs in specific niches and create sustainable brands in so-called 'commodity' categories.

Revenues growing steadily



Revenue breakup - standalone - 2010



Management

Name	Designation	Remarks / management description
B K Parekh	Chairman	Promoter serving as Non-Executive Chairman since 1972. Has a degree in law and senior management experience of over 60 years.
M B Parekh	MD & Executive Director	Chemical engineer with B Chem Engg (Bom), MS Chem Engg. (USA). Has about 38 years of experience.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue growth (%)	16.3	10.3	18.5	15.7	15.8
Gross margin (%)	41.3	48.0	47.5	47.0	46.5
Personnel Expenses/Sales (%)	11.1	11.5	11.0	11.0	11.0
Advertising expenses/ Sales (%)	2.9	3.3	3.5	3.5	3.5
EBITDA margin (%)	10.6	17.2	18.8	19.6	20.3
Tax rate (%)	13.1	13.1	23.0	25.0	26.0
NWC (days of sales)	60	38	50	50	50
Payout ratio (%)	40.2	28.1	35.0	35.0	35.0
Revenue growth (%)	16.3	10.3	18.5	15.7	15.8

Source: Company data, IIFL Research

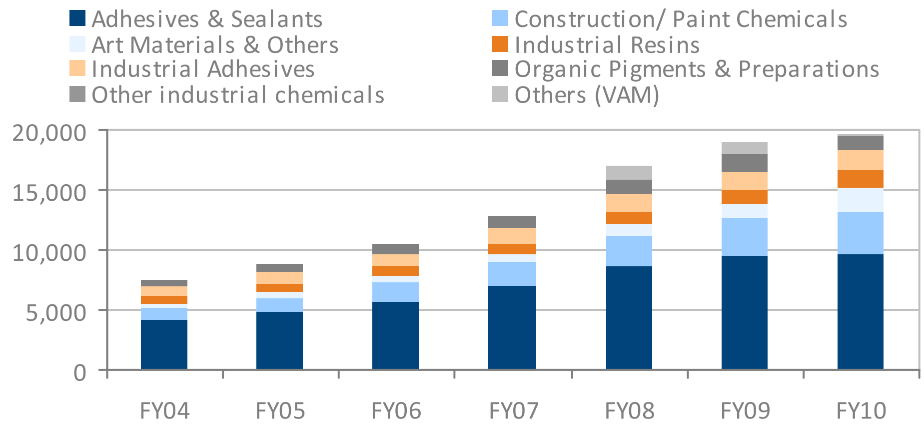
Consumer products remain key driver

Consumers business forms a lion's share of the revenue pie

Dual play on consumption and construction

Consumer products form 78.3% of Pidilite's sales. Growth in the consumer segment has been driven by specialty chemicals used in construction, under the *Dr Fixit* and *Roff* brands, whose sales have grown over 20% in FY10. We expect category revenue CAGR of 25%, going forward. As these products are primarily sold to retail consumers, demand is driven by both construction activity and consumers' propensity for quasi-discretionary maintenance expenditure. The core adhesive business is a staple, and art-related products are discretionary.

Figure 142: Revenue categories over years



Source: Company, IIFL Research. Note: Numbers till FY09 are gross revenues, while FY10 numbers are net revenues and hence FY10 growth appears lower than actual.

Adhesives dominant in all regional micro markets

Pidilite has a strong competitive position across categories

Adhesives - mature market dominated by Pidilite; greater than 50% market share for Fevicol in all regions: In consumer products, adhesives are a category where the dominance of the *Fevicol* brand is challenged only by a few regional brands like Dendrite. Fevicol has greater than 50% market share (including unorganised players) in all regional micro-markets. Technology is not a differentiator, and Chinese imports are not much of a threat. In sealants, M-Seal is a brand of national recognition. Fevicol contributes about 25% of topline or ~Rs5bn annually. We expect volume growth to be ~5% in this category with regular price increases (barring increases taken because of commodity inflation) of 5-6%.

Figure 143: Adhesives & sealants product basket

Source: Company

Figure 144: Fevicol, Fevikwik & M-Seal

Source: Company

Figure 145: Adhesives and sealants segment product map

Category	Key products	End use/ segment
Adhesives & sealants (Key brands – Fevicol, Fevikwik, M-Seal)	White glue, paper glue, glue sticks, instant adhesive, epoxy putty, epoxy adhesive, maintenance spray, PVC insulation tape.	Home, school and office
	Polyvinyl acetate white glue for joining wood, plywood, particle board, etc; contact adhesive for laminate and veneer pasting.	Woodworking
	Contact adhesive for upholstery and flooring, white glue for wallpaper and parquet flooring.	Upholstery and flooring
	Polyurethane-based adhesives, rubber-based adhesive.	Footwear
	Silicone sealants, epoxy putty, epoxy adhesive, cyanoacrylate adhesives, PVC insulation tape, maintenance spray.	Automotive aftermarket, plumbing

Source: Company, IIFL Research

Opportunity size large in construction chemicals

Construction specialty chemicals - emerging market with strong growth potential; the key growth driver: The biggest growth driver in the consumer segment, construction and plant specialty chemicals (often under the aegis of the *Dr Fixit* brand) has competition on both technology as well as ease of implementation. We expect ~25% revenue CAGR in this business in the next few years. These chemicals are generally not do-it-yourself products and end-to-end integrated services need to be provided. This is especially true for the more lucrative retail portion of the market (which forms 70% of Pidilite's category sales). Retail needs little credit (unlike construction companies) and is generally less price-competitive.

Pidilite trains applicators to promote its products

The key to competition in this category is to acquire new technologies that address the needs of the Indian consumers (water-proofing, damp-proofing, etc) and offer an integrated value proposition to consumers where an applicator can also be easily sourced. Focus on distribution and nationwide delivery capability is as important as brand visibility and technology acquisition. Pidilite spends considerable money and time to train freelance contract workers as applicators to promote ease of application of its products.

Similar to other niche consumer categories that Pidilite has pioneered, there is very little organised competition to *Dr Fixit* that has any consumer recall.

Figure 146: Construction and specialty chemicals segment product map

Category	Key products	End use/ segment
Construction and paint chemicals (Key brands – Dr Fixit, Roff, Cyclo)	Integral waterproofing compound, water proofing coatings, waterproofing membranes.	Waterproofing
	Crack fillers, micro concrete, rust remover, repair mortars, epoxy bonding	Repair materials
	Adhesives, additive, tile grouts.	Tile fixing solutions
	Exterior coatings, protective coatings, heat reduction coatings, hygienic coatings.	Coating
	Water reducing and retarding, plasticizers and accelerator.	Admixtures
	Floor hardener, self levelling compound, epoxies.	Flooring
	Polysulphides, silicones, acrylic and polyurethane sealants.	Sealants
	High strength, non-shrink free flow grouts.	Grouts
	Lime binders, stainers/colourants, distempers, emulsion paints.	Interior coatings and wall
	Wood preservatives, fillers, stains and finishes.	Wood finishes

Source: Company, IIFL Research

Dr Fixit is heavily advertised now

Figure 147: Dr Fixit products (construction chemicals)

Source: Company

Competitive position in art products is weak

Art products - strong growth, but intense competition: In art products, Pidilite is not the market leader; *Camlin*, *Faber- Castell*, etc, are prominent competitors. In this category, many imported products are sometimes technologically superior. We expect 12-14% revenue growth on a steady-state basis. Pidilite is a price-taker in this category.

Figure 148: Product map – Pidilite

Category	Key products	End use/ segment
Art materials (Key brands – Sargent Art, Hobby Ideas)	Tempera colours, crayons, oil pastels, chalks, markers, pencils, poster paints, water colours, moulding clay, glitter paints, sculpting material, brushes.	Education
	Fabric colours, dimensional colours, glass colours, ceramic colours, silk colours, decoupage glue, moulding putty, brushes, hobby kits, hobby books.	Hobby
	Acrylic colours, oil colours, water colours, brushes, canvas.	Art students and artists

Source: Company, IIFL Research

Figure 149: Art & stationery products

Source: Company

Specialty industry chemicals is a niche commodity play

Specialty industry chemicals, a commodity business but not intensely crowded market: Industrial specialty products form about 21.7% of the company's consolidated sales. The sub-segments are industrial resins, industrial adhesives and organic pigments & preparations. In specialty chemicals, prices are linked to the international market, and are influenced by commodity price cycles. Pidilite is among the few players who make these specialty products. Hence, pricing is usually a two-way dialogue between the buyer and seller and the dynamics of the business is different from a product where there are multiple manufacturers.

Consumer segment should drive ~16% topline growth

16% CAGR in revenues expected

We are building in 17.5% CAGR in the consumers and bazaar products business over the next three years on a consolidated basis. About 5pps of this CAGR, we reckon, would be on account of price inflation. In the industrial chemicals business, we expect a growth rate of about 11-12% to sustain. On a consolidated basis, this implies ~16% topline growth.

Figure 150: Revenue model

	FY10	FY11ii	FY12ii	FY13ii
Revenues (in Rs m)				
Consumer & Bazaar Products	17,435	20,573	24,071	28,163
Specialty Industrial Chemicals	4,653	5,211	5,784	6,421
Others (VAM)	176	185	194	204
Total	22,264	25,969	30,049	34,787

	FY10	FY11ii	FY12ii	FY13ii
Revenues (% of total)				
Consumer & Bazaar Products	78.3	79.2	80.1	81.0
Specialty Industrial Chemicals	20.9	20.1	19.2	18.5
Others (VAM)	0.8	0.7	0.6	0.6
Total	100.0	100.0	100.0	100.0

	FY10	FY11ii	FY12ii	FY13ii
Revenue growth (% YoY)				
Consumer & Bazaar Products	8.2	18.0	17.0	17.0
Specialty Industrial Chemicals	11.4	12.0	11.0	11.0
Others (VAM)	-82.9	5.0	5.0	5.0
Total	4.4	16.6	15.7	15.8

Source: Company, IIFL Research

Strong acquisition track record

Acquisitions have been well-chosen and granular

The company has made multiple acquisitions across geographies over the last few years. The acquisitions have been driven by brands, technology, operations and technology gaps. The key driver of this acquisition strategy has been to avoid big-ticket spends. The company has successfully integrated disparate technologies into its mainstream product line.

Figure 151: Acquisitions

Name	Year	Details
Pulvitec do Brasil Industria e Commercio de Colas e Adesivos Limitada	FY08	Engaged in the business of adhesives, sealants and construction chemicals; this company and its manufacturing plant are located in Sau Paulo, Brazil and the business has annual sales of ~Rs750m. This acquisition will help Pidilite enter high potential Latin American market of adhesives and sealants. The cost of acquisition was around Rs531m.
Hardwood & Waud Mfg Company	FY08	The acquired assets include brands like Holdtite, Rustolene and Leakgaurd, which have a healthy market share in their respective segments. The total sales of the business are Rs150m. Acquisition cost was Rs118m.
Sargent Art	FY07	Sargent Art has been manufacturing and selling quality art materials in the educational market in USA for over 50 years. The product range includes tempera colours, acrylic colours, water colours, crayons.
Cyclo LLC	FY07	Cyclo has been selling automotive chemicals in USA and international market for over 50 years. The product range includes maintenance chemicals, performance chemicals and appearance chemicals for the automotive segment.
Pagel Concrete Technologies	FY07	Indian company with technical and financial collaboration of Pagel Spezial-benton GMBH, and internationally renowned brand for industrial grouts and repair mortars. Pidilite acquired 75% equity stake in this company at a cost of Rs6.4m and loan contribution of Rs3.5m.
Bamco Ltd, Thailand	FY06	Bamco is a manufacturer of speciality bitumen-based waterproofing products and had, until then, marketed its products in Thailand, Indonesia, Malaysia and Singapore. Turnover of Rs86m on acquisition.
Jupiter Chemicals LLC	FY06	Pidilite Middle East Ltd, the company's wholly-owned offshore subsidiary in the Jebel Ali Free Zone in Dubai, acquired a 49% stake in Jupiter Chemicals LLC. Jupiter Chemicals manufactured reflective coatings, tile adhesives and plasters, and is supposed to help grow the company's business in the high potential Middle East market.
Tristar Colman/ Fine art brands, business and some assets	FY06	Fine Art is a market leader in brushes for drawing and painting while Tristar Colman is a well-known brand of canvas and student art colours. The acquisition strengthens the company’s art materials portfolio and will help increase sales in the school and artist segments.
Roff (brand)	FY05	Roff has been a strong construction chemicals brand in India for over 18 years. This acquisition (for Rs137.7m) gives it access to both Roff's product range and distribution network, as well as to a large number of trained and loyal applicators.
Chemson Asia Pte Ltd	FY05	A manufacturer of waterproofing products and exterior paints, in January 2005. Chemson had a manufacturing base in Singapore, from where it marketed products across the island state, Indonesia, Thailand and Malaysia. Consideration of SGD437,500.

Source: Company, IIFL Research

Significant overseas presence

Present in multiple geographies

The company has 13 overseas subsidiaries (four direct and nine step-down subsidiaries), including those with significant sales and manufacturing operations in the USA, Brazil, Thailand and Dubai. These account for about 12% of consolidated net sales.

Profitability supported by pricing power

Strong pricing power across categories

To understand the unique pricing strength that the company enjoys, it is important to look at the competitive environment in each of its categories. On a national level, Pidilite is a price-setter in roughly 65-70% of its revenue pie, with competition being limited to local players in regional micro-markets.

Figure 152: Pricing power map

Category	% of sales	Brands/sub categories	Competitive landscape	Pricing power
Adhesives and sealants	~50%	Fevicol (~25% of revenues)	Dominant to the extent of being synonymous with white glue. There is regional competition like Dendrite, but the company takes ritual 5% price increases annually even when raw-material prices are stable.	High
		M- Seal	There is competition from similar products, but it is the only brand with widespread consumer recognition.	High
		Other adhesive derivative products like Fevikwik	Widespread distribution and innovative advertising has made these products widely accepted in households. As there are no top-of-the-mind replacements with the consumer, positioning remains pretty unique.	High
Construction and specialty chemicals	~20%	Construction chemicals (Dr Fixit)	With 70% of business being retail consumers, the recent awareness campaigns again make it the only offering in its space with consumer mindshare.	High
		Auto chemicals	The Pidilite brands like Cyclo are not as unique to the consumer as previous categories.	Medium
Art products	~8%		Extremely competitive market. Pidilite is not at all dominant.	Low
Specialty industrial chemicals	~22%		Commodity industrial products but very few local manufacturers. The customers and the manufacturer work closely and large margin hikes or squeezes do not happen.	Low to Medium

Source: Company, IIFL Research

Evidence of pricing power in the current quarter

Pidilite has significant pricing power in most categories that should aid margin defence without demand destruction

Pidilite reported EBITDA margin expansion of 46bps YoY in the face of significant inflation in crude-linked raw-material costs in 3QFY11. This was a direct outcome of the pricing power of Pidilite's niche brands.

Company has taken price increases in 3QFY11

Gross margins were adversely affected by increasing raw-material costs and excise duty hikes. The company says that prices of the key raw material Vinyl Acetate Monomer (VAM) have hardened ~6% QoQ and 20% YoY. The company has taken 6-8% price increases in industrial chemicals and 3-4% in consumer and bazaar products. The margin defence has also come from partial deferment in advertising spends.

Figure 153: 3QFY11 (consolidated)

Rs m	3QFY10	2QFY11	3QFY11	% YoY	% QoQ
Net Sales	5,274	6,662	6,643	26.0	-0.3
COGS	2,711	3,497	3,570	31.7	2.1
Total cost	4,354	5,402	5,453	25.3	0.9
Gross Profit	2,563	3,165	3,073	19.9	-2.9
Gross Margin (%)	48.6%	47.5%	46.3%	-234 bps	-125 bps
Op Ebitda	920	1,260	1,190	29.3	-5.6
Ebitda Margin	17.4%	18.9%	17.9%	46 bps	-101 bps
Depreciation	173	149	148	-14.7	-0.8
Op Ebit	747	1,111	1,042	39.5	-6.2
Other income	70	44	55	-21.2	24.0
Interest expense	78	98	64	-17.7	-34.6
PBT	738	1,057	1,033	39.9	-2.3
Tax rate	16%	23%	23%	686 bps	-58 bps
APAT before minority interest	622	812	799	28.4	-1.6
Minority interest	-1				
APAT after minority interest	623	812	799	28.3	-1.6
Extraordinary Items	-21	19	-7		
Reported PAT	644	792	806	25.2	1.7

Source: Company, IIFL Research

Raw-material prices expected to inflate

VAM is a key raw material

The key raw material for Pidilite is vinyl acetate monomer, or VAM. Although this product is only 15% of total raw-material costs, the prices of most other inputs are also closely correlated to VAM prices. VAM is manufactured from ethylene, which is one of the products of crude cracking. However, VAM prices have generally traded in a band (except for 3QFY09, which we will focus on separately later) as seen in the 7-year annual data.

Figure 154: Pidilite VAM use

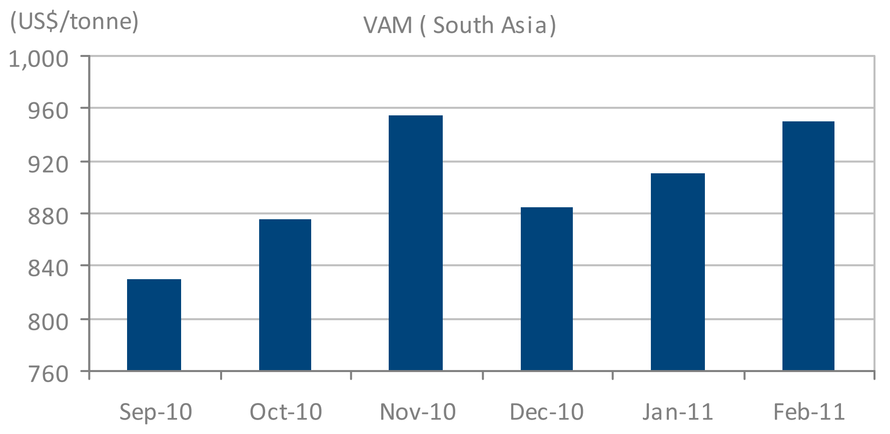
	FY04	FY05	FY06	FY07	FY08	FY09	FY10
VAM Qty (tonnes)	13,652	14,740	15,752	17,652	12,768	10,354	21,321
VAM consumption (Rs m)	570	760	817	946	758	723	991
VAM unit cost (Rs/tonne)	41,734	51,584	51,877	53,588	59,341	69,846	46,476

Source: Company, IIFL Research

VAM prices have hardened, with further hardening possible

VAM prices have hardened over the last quarter. If a bullish outlook on crude were to sustain, VAM prices could go up further. However, in the current quarter so far the prices seem to have stabilised. Feedstock (ethylene) prices have hardened and manufacturers may look at price increases going forward.

Figure 155: VAM prices

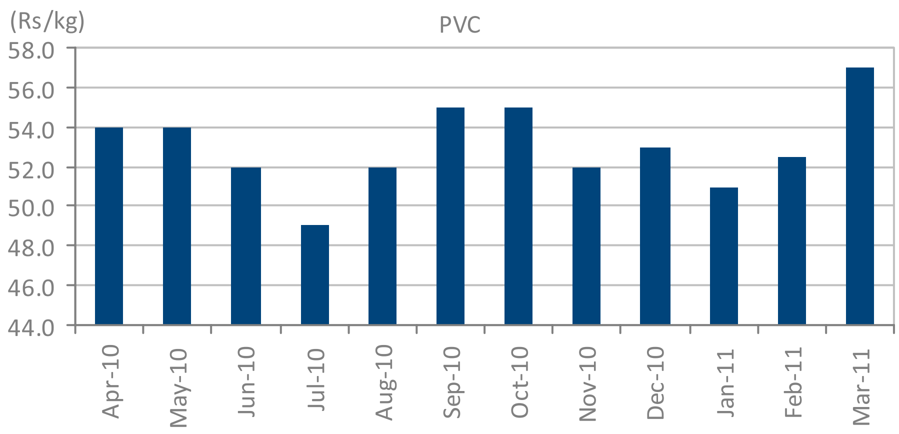


Source: Company, IIFL Research

Plastic packing material is expected to get more expensive if crude prices continue to harden

Packing materials are about 20% of the raw-material book and include plastics like HDPE and PVC. These products are petrochemicals, but their India prices have been stable, in spite of rising crude prices. However, there is generally a lag in the reaction of these prices in response to crude prices. We believe the prices of these commodities will rise going forward, which will be a challenge for Pidilite.

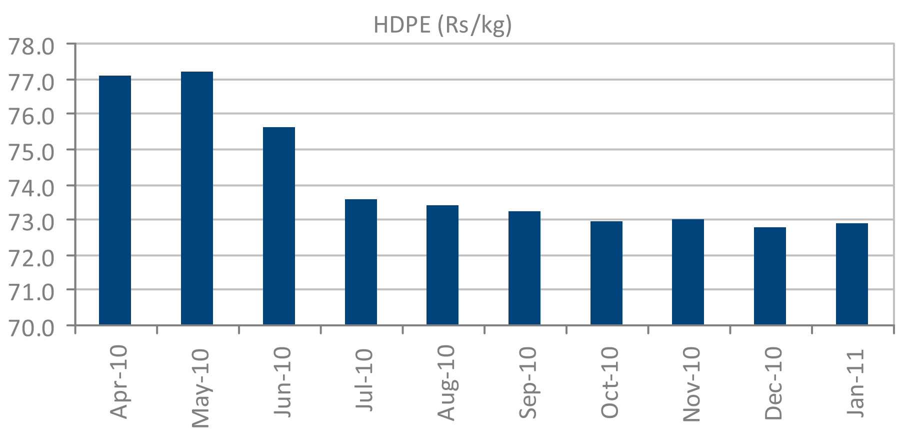
Figure 156: PVC prices



Source: Company, IIFL Research

PVC and HDPE prices could inflate further

Figure 157: HDPE prices



Source: Company, IIFL Research

Price increases and cost rationalisation work in tandem for margin defence

Multiple levers for margin defence

In view of these inflationary possibilities, margins may remain subdued in 4QFY11, but as the price increases and the rationalisation of ad spends comes in force, FY12 profits should not deviate much under normal raw-material inflation. A look at the sensitivity analysis of FY12 EPS (Rs7.6 is our estimate) to annual inflation in raw-material costs (in excess of budgeted) and price increases on the product side (in excess of regular hikes) reveals the possible impact.

Figure 158: FY12 EPS sensitivity

		Raw material price inflation					
		2%	4%	6%	8%	10%	12%
Product price increases	1%	7.5	7.1	6.6	6.2	5.7	5.3
	3%	8.3	7.8	7.4	6.9	6.5	6.0
	5%	9.0	8.6	8.1	7.7	7.2	6.7
	7%	9.8	9.3	8.9	8.4	7.9	7.5
	9%	10.5	10.0	9.6	9.1	8.7	8.2
	11%	11.2	10.8	10.3	9.9	9.4	9.0

Source: Company, IIFL Research

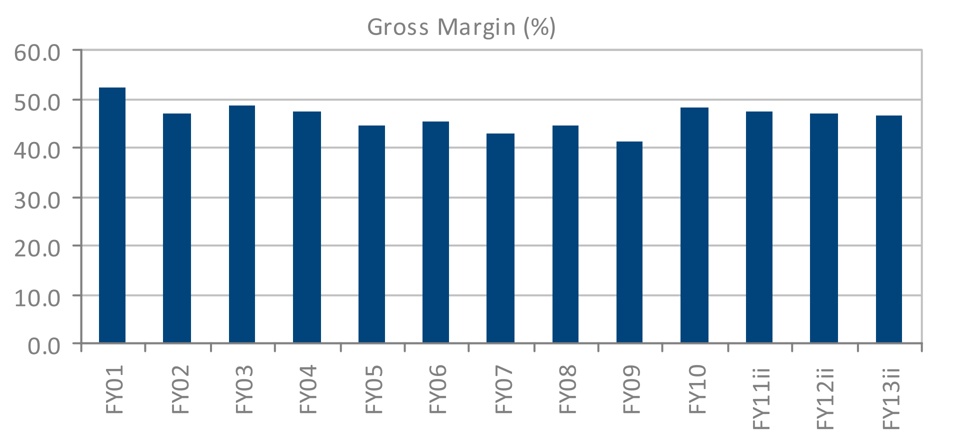
The key takeaway of this analysis is that raw-material inflation up to low teens is manageable because in such an inflationary environment, a ~10% product price increase annually, is not out of the ordinary. Note that for a 12% raw-material price inflation, a 7% price increase is required to be EPS neutral.

7% price increase tackles 12% raw-material inflation

We do not expect a repeat of FY09

The quarter ended December 2008 was a unique one for almost all consumer companies with commodity inputs. Almost all were hit by a sudden spike in raw-material costs. In anticipation of further price increases, most companies loaded up on RM inventory. This was followed by the credit crisis, and sales volumes were much lower than expectations—with the result that companies were stuck with high-cost RM inventory even as realisations dropped.

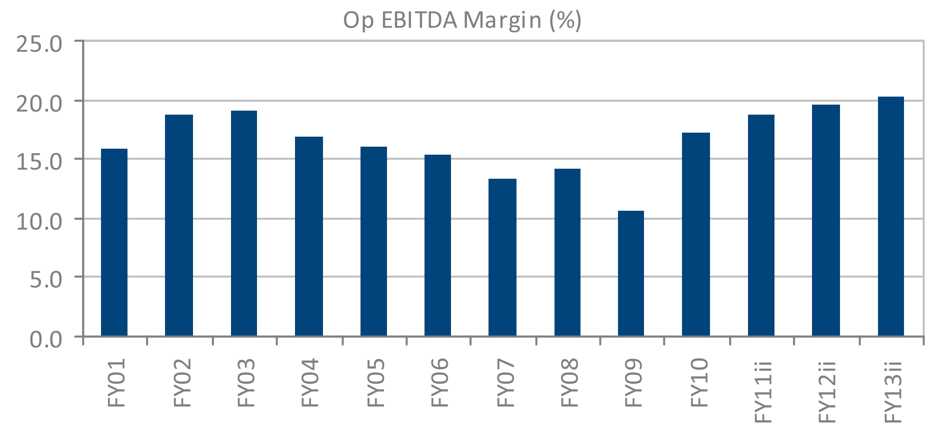
Figure 159: Gross margins – FY09 a blip



Source: Company, IIFL Research

Margins to improve on better operating efficiencies

Figure 160: EBITDA margins set to improve



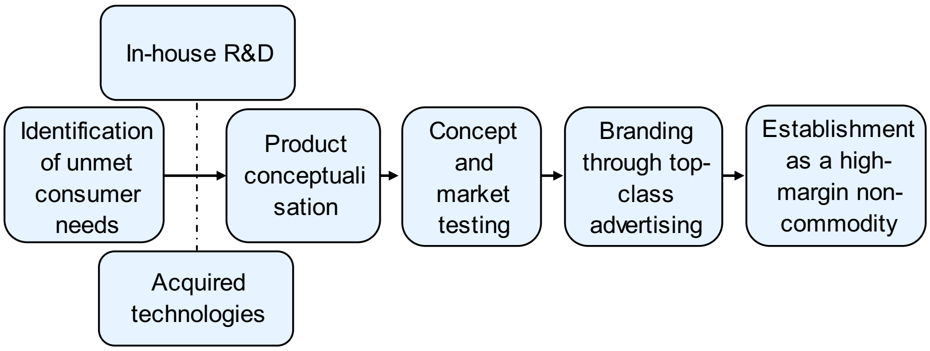
Source: Company, IIFL Research

Strong product development and capital discipline

Proven strength in product development and brand-building
Pidilite has pioneered brands that enjoy top-of-the-mind recall across the country, in categories where competition struggles to create any differentiation. The company's superior margins are a direct result of the pricing power derived from such instant recognition and customer loyalty. Furthermore, Pidilite has not stopped at the highly-successful *Fevicol* brand, but has built a portfolio of new brands and brand extensions across categories.

Focus on product innovation

Figure 161: Pidilite innovation model

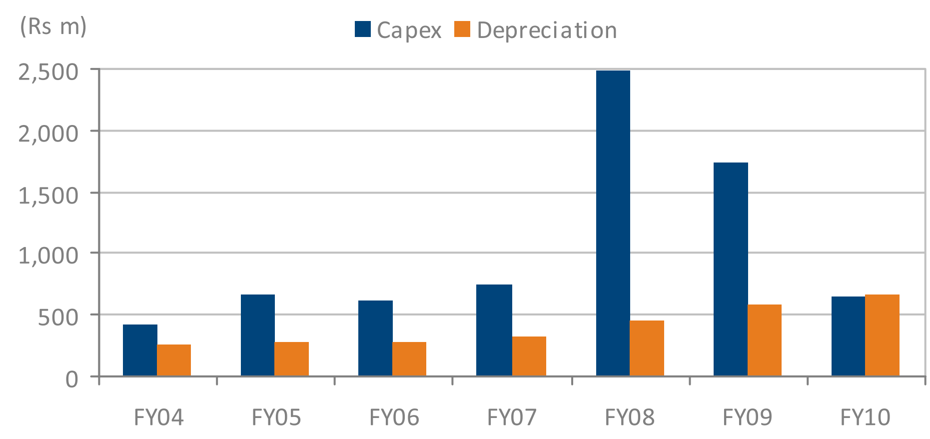


Source: IIFL Research

Capital expenditure: strong track record, but for one recent uncertainty
The company's capital expenditure so far has included three main applications: maintenance capex and new unit openings, acquisitions, and the ongoing Elastomer project in Dahej. The company has always maintained a steady capex-to-depreciation ratio (in spite of acquisitions) till the spike in FY08 and FY09, due to the elastomer project capex.

Strong capex discipline in most years

Figure 162: Capex vs depreciation



Source: Company, IIFL Research

Figure 163: Capex schedule

(Rs m)	FY08	FY09	FY10	FY11ii	FY12ii	FY13ii
Total Capex	2,484	1,734	643	1,900	2,000	1,600
Elastomer capex	1,053	1,120	400	1,000	1,000	500
VAM demerger asset acquisition	390					
Acquisitions	118					
Other fixed assets	900	614	243	900	1,000	1,100

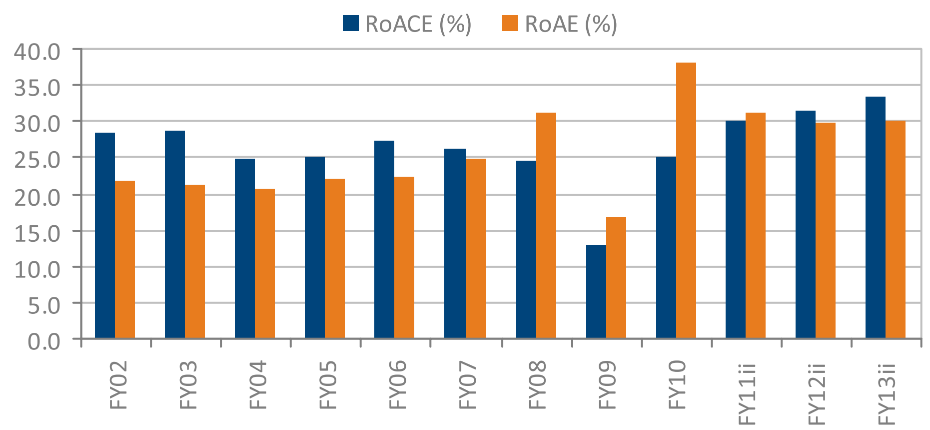
Source: Company, IIFL Research

Strong capital discipline, but for one exception

The company is disciplined in capital budgeting decisions and maintaining high capital productivity. The elastomer project's long-gestation period and big-ticket capital expenditure are a departure from the norm, but the project could indeed be economical if the commissioning and product margins pan out as expected. Nevertheless, this project is the biggest risk for Pidilite.

Efficient capital budgeting

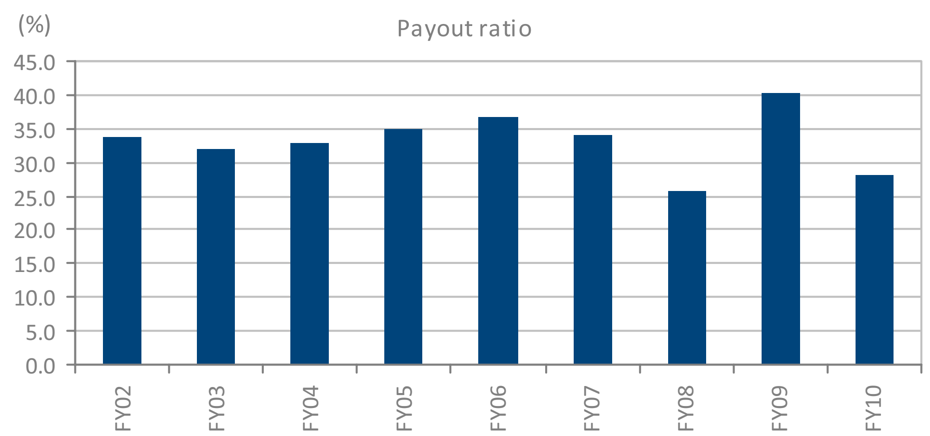
Figure 164: FY09 - the only blip



Source: Company, IIFL Research

Healthy dividend payouts

Figure 165: Payouts have always been healthy



Source: Company, IIFL Research

Elastomer project an uncertainty, but valuations reasonable

Elastomer project: uncertainty in big-ticket capex

Acquisition in June 2007

In June 2007, the company acquired plant and machinery, patents, trademark and technology of a synthetic elastomer (polycholoroprene rubber) facility. Polycholoroprene rubber is a speciality synthetic rubber featuring superior mechanical strength, load-bearing capacity, adhesion to metal, and superior resistance to weather, oil and chemicals vis-à-vis other synthetic rubbers. Hence, polycholoroprene rubber is the preferred synthetic rubber for many applications in automotive, industrial components, building products and adhesives. The plant was located in Champaigner, France, and was owned by Polymeri Europa Elastomers, France.

The plant was earlier expected to commence commercial production in March 2010, and its production capacity was estimated at 25,000tpa. This was to be increased to 35,000tpa through de-bottlenecking. The total capital investment in the plant, excluding de-bottlenecking, was estimated at Rs5.3bn. The company was also considering putting up a caustic soda + chlorine plant at an additional investment of Rs0.9bn at the same location, as both caustic soda and chlorine are important inputs for the manufacture of polycholoroprene.

Revised capex guidance of Rs1.5bn

However, in view of the slowdown in global industrial demand (especially global auto-linked demand), the company was going slow on the project. The company had earlier indicated that once it chooses to commence work in full swing, time to commissioning should be around 18 months.

Figure 166: Elastomer project outline

	Initial plan	Current guidance	Our assumption
Incremental capex	Rs2.5bn	Rs1.5bn	Rs2.5bn
Commissioning	Mar-10	Mar-12	Not by FY13
Capacity	25,000TPA (35,000TPA post de-bottlenecking)	19,000TPA	19,000TPA
Revenue generation	~US$150m at full utilization	US$60m at full utilization	No revenues assumed by us till FY13

Source: Company, IIFL Research

Elastomer project – uncertainties remain

The project was earlier indicated to entail a further capex of Rs2.5bn (Rs2.6bn has already been spent). Elastomer prices have ranged from US$3,000-6,000 per tonne in the recent past and are currently at the lower end of the range. At 19,000tpa guided capacity, this represents a ~US$60m revenue opportunity. The company is planning to commission the Elastomer capacity by FY12 with an incremental capex of Rs1.5bn (less by Rs1bn) plus working-capital deployments. **We are not building in any revenue from the Elastomer project in our projections, but we are assuming incremental capex of Rs2.5bn versus the revised lower guidance of Rs1.5bn from the company.**

Efficient asset utilisation

During the global financial crisis, the company's net working-capital intensity and asset turnover ratios remained range-bound, a testimony to the robustness of the operating model.

Figure 167: Asset utilisation ratios

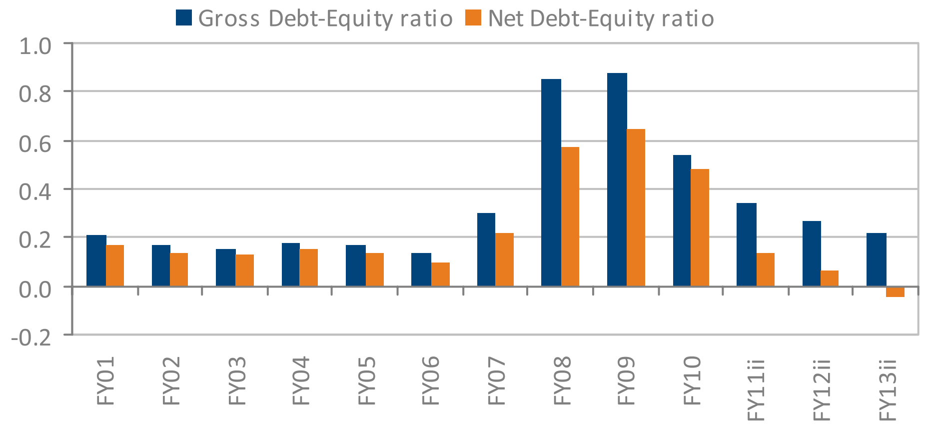
Asset Efficiency	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Inventory (Days of Sales)	46	59	55	58	62	62	65	64	51	50
Debtor (Days of Sales)	40	52	52	54	52	45	46	57	53	49
NWC (Days of Sales)-Net of cash	61	71	76	87	76	64	64	74	60	38
Fixed Asset Turnover (Sales/ Fixed Assets)	3.4	2.7	2.8	3.0	3.0	3.0	3.2	2.6	2.4	2.6
Sales to Capital Employed	2.0	1.6	1.7	1.6	1.7	1.8	1.9	1.4	1.5	1.6

Source: Company data, IIFL Research

Leverage set to decrease

Balance-sheet improving

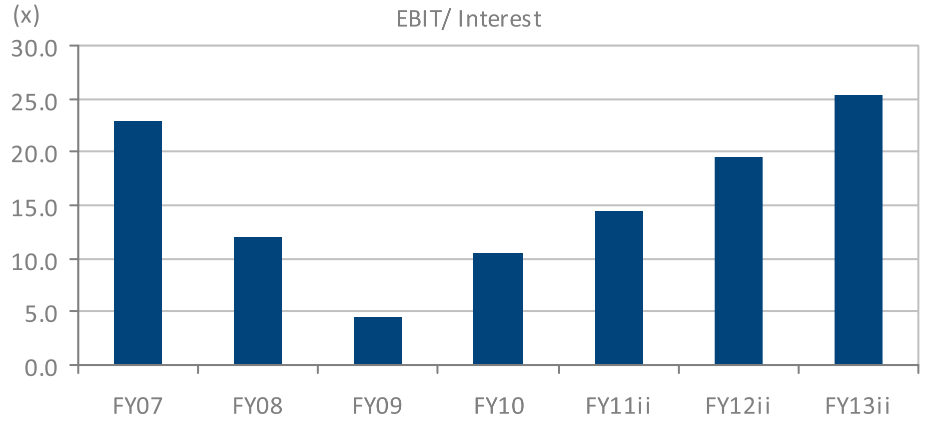
Figure 168: Debt-equity to fall



Source: Company, IIFL Research

Indebtedness to fall

Figure 169: Interest coverage to increase



Source: Company, IIFL Research

FCCB conversion assumed

2.83% dilution on FCCB conversion

Figure 170: FCCB details

Item	
Original value of Bonds issued (in US$m)	40.0
Less: Bonds bought back (in US$m)	2.8
Outstanding value of Bond (in US$m)	37.2
Rate of Exchange (Re/US$)	39.37
Value of Shares to be issued (in Rs m)	1,465
Conversion price after reset (Rs)	102.42
Potential Additional Shares on account of conversion	14,300,288
Number of Equity Shares	506,134,612
Total number of diluted equity shares	520,434,900
Extent of dilution (%)	2.83

Source: Company, IIFL Research

Valuations are reasonable

Valuations competitive given peer set

A comparison with our consumer coverage universe reveals that even after having high capital productivity, dividend yield and steady-state earnings growth of 18-20%, Pidilite trades at a discount to peers. While some discount is justified, given that 22% of Pidilite's revenues come from the commodity chemicals business - current valuations are reasonably attractive, in our view.

Figure 171: Consumer valuation matrix

Company Name	PER (FY11 / CY10)	PER (FY12/CY11)	Earnings CAGR (FY10-12ii)	Dividend Yield (FY10)	ROE (FY11)
Hindustan Unilever	28.2	24.1	9.3%	2.9%	72.3
ITC	26.8	21.8	21.5%	1.6%	30.3
Nestle	44.8	36.8	20.8%	1.5%	96.0
Colgate	28.7	25.2	3.9%	2.4%	94.1
Dabur	29.7	24.0	18.4%	1.7%	46.0
Godrej Consumer	24.5	18.6	32.1%	1.8%	29.0
Marico	29.1	23.3	19.2%	0.6%	31.1
Emami	23.3	18.3	31.7%	0.9%	30.6
GSK Consumer	29.0	24.2	24.2%	1.0%	26.5
Britannia	29.5	23.9	8.3%	1.6%	29.7
Average	**28.2**	**24.1**	**18.9%**	**1.6%**	**45.1**
Pidilite	**21.8**	**17.9**	**19.6%**	**1.6%**	**31.3**

Source: Company, IIFL Research

This is also evidenced by the 1-year forward PE, which is near the middle of its historical trading band.

Figure 172: 1-year forward P/E

Source: Company, IIFL Research

Trading at the mid-point of its P/E band

Key risks

Elastomer project is the biggest investment risk, in our view

Elastomer project: With Rs2.6bn invested, no visibility yet on commissioning and further investment requirement of Rs1.5bn, this project is the biggest risk in the investment case.

Ongoing business risks: The industrial pigments business is cyclical in nature and could pass through periods of unprofitability if inventories/capacities run high. In adhesives, margins are likely to erode over time, as it is now a mature market. In art products, external competition is strong, and Pidilite will need to fight to gain market share. In construction chemicals, managing service/solutions as it scales up fast will be the biggest challenge.

Raw-material price risks: The company is backward integrated in its key raw-material VAM and now has a hedging mechanism in place for the net RM import forex exposure. But in case of sharp swings, similar to that in FY09, impact on profitability cannot be ruled out.

Appendix

M B Parekh

Enterprising India 2: Excerpts from IIFL's interview with M B Parekh, MD, Pidilite Industries

A generation of Indians has been charmed by TV and print advertisements of the white-glue brand *Fevicol*. M B Parekh is at the helm of affairs of the consumer specialty-chemicals company Pidilite, which owns and markets *Fevicol*. From an industrial-pigments player to a consumer company with multiple top-of-the-mind brands, it's been a long and fulfilling journey.

The genial Mr Parekh completed his graduation in chemical engineering from UDCT Mumbai, and went on to study for an MS in the same subject from the US. He then worked for two years in Medlabs near Chicago before coming back and joining his father B K Parekh's business.

Since then, he has driven Pidilite's business on one key guideline: me-too products are a bad idea for any sustainable business in the crowded consumer-product segment. Starting at a time when his competition in pigment dispersion products were MNCs and white glue was not used in India, Pidilite has chosen to pave its own path.

Not that this serial innovation has been sustained without its share of pain. A number of product ideas either languished on the drawing board, or failed to sell in volumes. But this has not swayed Mr Parekh from his commitment to nurturing nascent product ideas.

Mr Parekh is today spearheading a management transformation in Pidilite. He is now busy grooming new managers and leaders to hand over the baton.

You started as a company making white glues, industrial chemicals and consumer specialty chemicals. Was this part of your early vision?
We work in an iterative manner while holding true to our unique way of doing things and our core values. Most of our segments have a unifying theme, or focus on the kaarigar (artisan) community, which included carpenters, masons, electricians, plumbers, etc. We have always tried to add value to this set of key influencers in the purchase decision. From the early days of Fevicol adhesives (more than 30 years ago) we mailed them furniture design books. Today it is a standard material that carpenters rely on all over the country.

You are currently one of the largest consumer specialty-chemicals players in India. Where do you see this business five years from now?
As the economy develops, we keep focussing on allied areas with high growth potential which can bear fruit after a few years of effort. For example, we started the construction chemicals business almost 15 years ago, and for a few years we were not sure if this will take off. This business made no money for the first ten years, but we continued to put in focussed effort. We did the hard yards of educating customers about our 150 products. We now think the future in this business is bright, as threshold volume levels have been surpassed and growth rates are very robust. Five years down

the line, this business could form a fairly big component of Pidilite's overall revenues, and emerge as a key growth driver.

There is another very strong product range—the industrial maintenance business. Just as we have products like M-Seal and Fevikwik in consumer maintenance, there are a range of products possible for industrial maintenance too. These products have enormous potential, given the thousands of small companies across the country. Industrial maintenance is more a sundry retail sort of business that is not in the B2B mould at all. This business runs through distributors who are located in industrial areas and sell to a large number of small units. It falls under the umbrella of MRO (maintenance repair overall), covering both industrial and automotive. We acquired a company called Cyclo in the US—an old brand but a very small company—with no significant presence in the US, but selling to 40-50 countries from there, with annual revenues of US$12m–14m. This business, targeting the automotive aftermarket segment, can now also come under the MRO umbrella.

Thirdly, we have launched the Hobby Ideas retail store chain—a pilot project to assess the segment's potential, including that in overseas markets.

In short, a number of business that are now small, could grow substantially 5–10 years down the line, and keep our growth momentum going.

What are your thoughts on inorganic growth options? How do you assess the suitability of potential takeover targets?
We are not keen on acquisition for the sake of numbers. Unlike some companies who use acquisitions as one of the means to meet their revenue or volume targets, we have no compelling need to go for big acquisitions for the sake of numbers. If there is a good opportunity to make meaningful progress in some segment or geography, we would be open to it, but not for the sake of delivering inflated numbers.

Among the many initiatives that you have undertaken, what would you call your biggest mistake?
There have been many mistakes, but more importantly, they were learning opportunities. We are generally shy of spelling out projections like five-year targets. That makes it much easier for us to accept mistakes, which are inevitable when you try new things. When we make an endeavour, we are fully aware that we need to be able to accept failure and modify or pull back. When I said we work iteratively, I meant that many such small efforts are ongoing; we avoid big leaps of faith.

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	**19,863**	**21,916**	**25,969**	**30,049**	**34,787**
EBITDA	2,104	3,770	4,881	5,893	7,065
EBIT	1,516	3,104	4,150	5,061	6,154
Interest expense	-361	-329	-319	-290	-270
Others items	119	335	436	566	651
Profit before tax	**1,275**	**3,111**	**4,266**	**5,338**	**6,535**
Tax expense	-167	-408	-981	-1,335	-1,699
Extraordinary items	4	276	0	0	0
Net Profit	**1,105**	**2,979**	**3,260**	**3,974**	**4,801**

Healthy profit growth

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	1,516	3,104	4,150	5,061	6,154
Depreciation & Amortization	588	666	732	832	912
Tax paid	-167	-408	-981	-1,335	-1,699
Working capital change	186	977	-1,249	-559	-649
Other operating items	-7	-1	-25	-30	-35
Operating Cash-flow	2,117	4,338	2,626	3,970	4,682
Capital expenditure	-2,251	-724	-1,900	-2,000	-1,600
Free cash flow	**-135**	**3,614**	**726**	**1,970**	**3,082**
Equity raised	76	-446	1,303	-206	-251
Investments	-221	-2,424	1,478	0	0
Debt financing/disposal	825	-1,402	-530	-249	-133
Dividends paid	-443	-759	-1,141	-1,391	-1,680
Other items	18	-17	100	100	100
Net change in Cash & cash equivalents	-122	-1,428	2,051	500	1,500

Strong operating cash flows

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	1,601	449	2,500	3,000	4,500
Sundry debtors	2,876	2,959	3,557	4,116	4,765
Trade Inventories	2,798	2,979	3,913	4,528	5,242
Other current assets	1,011	1,046	1,350	1,600	1,900
Fixed assets	8,331	8,390	9,558	10,726	11,414
Other assets	254	2,678	1,200	1,200	1,200
Total assets	**16,871**	**18,499**	**22,078**	**25,170**	**29,022**
Sundry creditors	3,401	4,675	5,263	6,128	7,142
Long-term debt/Convertibles	6,089	4,686	4,156	3,907	3,774
Other long-term liabilities	434	417	517	617	717
Minorities/other Equity	7	2	27	57	92
Networth	6,941	8,719	12,116	14,462	17,297
Total liabilities & equity	**16,871**	**18,499**	**22,078**	**25,170**	**29,022**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	16.3	10.3	18.5	15.7	15.8
Core EBITDA growth (%)	-12.8	79.1	29.5	20.7	19.9
Core EBIT growth (%)	-22.4	104.7	33.7	22.0	21.6
Core EBITDA margin (%)	10.6	17.2	18.8	19.6	20.3
Core EBIT margin (%)	7.6	14.2	16.0	16.8	17.7
Net profit margin (%)	5.5	12.3	12.6	13.2	13.8
Dividend payout ratio (%)	40.2	28.1	35.0	35.0	35.0
Tax rate (%)	13.1	13.1	23.0	25.0	26.0
Net Debt/Equity (%)	64.7	48.6	13.7	6.3	-4.2
Return on Equity (%)	16.7	34.5	31.3	29.8	30.1
Return on Assets (%)	6.9	15.3	16.1	16.8	17.7

Source: Company data, IIFL Research

Strong traction in revenues

Healthy capital return ratios

NOTES

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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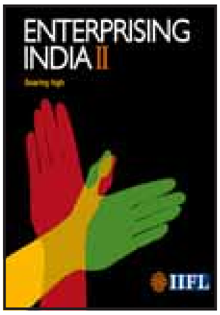

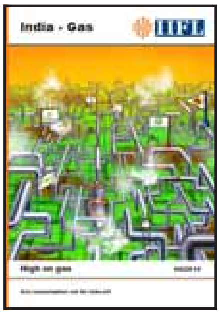

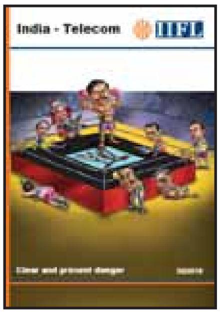

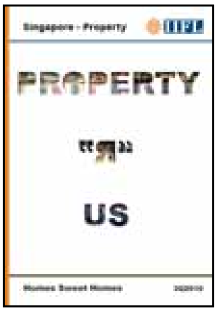

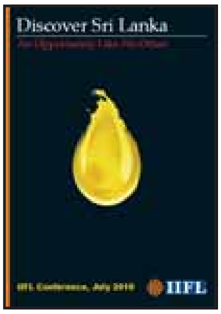

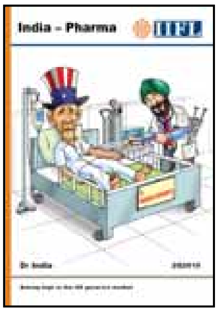

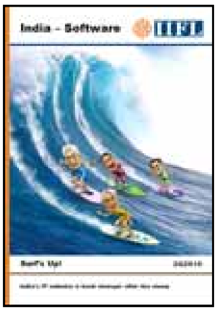

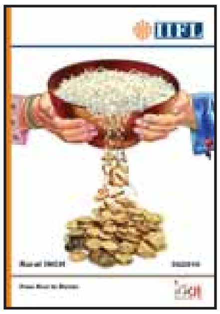

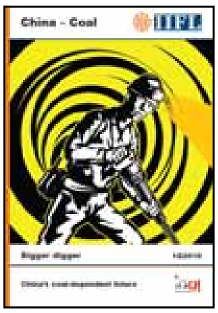

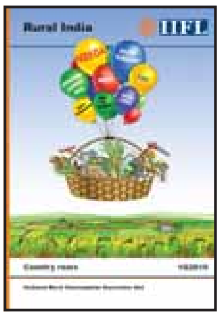

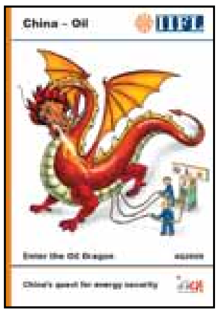

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