# Pidilite Industries PIDI.NS PIDI IN

CONSUMER RELATED

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Valuation appears full, see limited upside

# Moderating growth in the consumer business, weakness in the industrial business

November 8, 2012

| | |
|---|---|
| **Rating**<br>Remains | **Neutral** |
| **Target price**<br>Increased from 169 | INR 214 |
| **Closing price**<br>November 6, 2012 | INR 191 |
| **Potential upside** | +12% |

## Action: Maintain Neutral, valuation largely reflects resilient but moderating growth in the business

The share price of PIDI is up 35% YTD vs. the Sensex's return of 21%. The stock currently trades at 20.3x FY14F EPS which is broadly in line with its 5-year historical average even as growth is moderating in its consumer and bazaar (C&B) business (~80% of its topline) where y-y growth of 17.1% in 2Q was the weakest in the last 8 quarters and weakness is evident in the industrial products division which posted a mere 3.6% y-y growth along with significant margin compression. Management outlook and our analysis of industry data also does not indicate a substantial pick-up in the near term but indicates increasing competition from some organized players in its fast-growth C&B sub-segment of construction chemicals.

## Catalyst- Clarity on the outcome of the elastomer project

**Positive**: INR strengthening, easing VAM prices; **Negative**: Growth tapering off further in the C&B and the industrial business, uptick in VAM prices, continuation of uncertainty around the elastomer project

## Valuation: We raise our target price to INR214 (from 169)

We have raised our price target to INR214 as we now value the company at a P/E multiple of 21.3x (15% discount to our target multiple for Asian Paints) applied to the FY14F-FY15F EPS average and now explicitly deduct the INR7/share for capex incurred so far in the elastomer project (where ~29% of its total capital employed is invested), which in our view has a high likelihood of being written off.

| 31 Mar | FY12 | FY13F | | FY14F | | FY15F | |
|---|---|---|---|---|---|---|---|
| Currency (INR) | Actual | Old | New | Old | New | Old | New |
| **Revenue (mn)** | 31,266 | 36,598 | 36,041 | 43,030 | 41,713 | | 48,319 |
| **Reported net profit (mn)** | 3,244 | 3,664 | 3,769 | 4,903 | 4,797 | | 5,816 |
| **Normalised net profit (mn)** | 3,311 | 3,664 | 3,828 | 4,903 | 4,797 | | 5,816 |
| **FD normalised EPS** | 6.36 | 7.22 | 7.52 | 9.66 | 9.39 | | 11.39 |
| **FD norm. EPS growth (%)** | 6.6 | 13.5 | 18.2 | 33.8 | 24.9 | | 21.3 |
| **FD normalised P/E (x)** | 30.0 | N/A | 25.4 | N/A | 20.3 | N/A | 16.7 |
| **EV/EBITDA (x)** | 19.6 | N/A | 16.5 | N/A | 13.0 | N/A | 10.8 |
| **Price/book (x)** | 7.3 | N/A | 6.1 | N/A | 5.2 | N/A | 4.4 |
| **Dividend yield (%)** | 0.5 | N/A | 0.5 | N/A | 2.0 | N/A | 2.4 |
| **ROE (%)** | 26.9 | 26.6 | 25.7 | 29.3 | 27.5 | | 28.2 |
| **Net debt/equity (%)** | 3.6 | 3.9 | net cash | net cash | net cash | | net cash |

Source: Company data, Nomura estimates

**Key company data:** *See page 2 for company data and detailed price/index chart.*

### Anchor themes

We remain optimistic on the long-term prospects of spending on construction chemicals and adhesives. The company's ability to identify niche demand and accordingly innovate new products should drive long-term growth.

### Nomura vs consensus

Our FY13 EBITDA estimate is ~4% below consensus, as we believe the Street is not completely factoring in higher VAM prices and depreciating INR vs USD.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

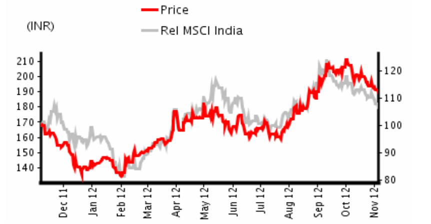
# Key data on Pidilite Industries

## Income statement (INRmn)

| Year-end 31 Mar | FY11 | FY12 | FY13F | FY14F | FY15F |
|---|---|---|---|---|---|
| **Revenue** | **26,721** | **31,266** | **36,041** | **41,713** | **48,319** |
| Cost of goods sold | -14,047 | -17,403 | -19,713 | -22,417 | -25,984 |
| **Gross profit** | **12,674** | **13,863** | **16,329** | **19,296** | **22,335** |
| SG&A | -8,473 | -9,574 | -11,266 | -12,868 | -14,681 |
| Employee share expense | | | | | |
| **Operating profit** | **4,202** | **4,289** | **5,063** | **6,428** | **7,653** |
| | | | | | |
| **EBITDA** | **4,797** | **4,926** | **5,767** | **7,199** | **8,491** |
| Depreciation | -595 | -637 | -704 | -771 | -837 |
| Amortisation | | | | | |
| EBIT | 4,202 | 4,289 | 5,063 | 6,428 | 7,653 |
| Net interest expense | -314 | -307 | -231 | -109 | -67 |
| Associates & JCEs | 22 | 27 | 28 | 29 | 29 |
| Other income | 150 | 435 | 411 | 436 | 605 |
| **Earnings before tax** | **4,060** | **4,444** | **5,271** | **6,784** | **8,220** |
| Income tax | -954 | -1,130 | -1,443 | -1,987 | -2,404 |
| **Net profit after tax** | **3,106** | **3,314** | **3,828** | **4,797** | **5,816** |
| Minority interests | 0 | 0 | 0 | 0 | 0 |
| Other items | 0 | -3 | 0 | 0 | 0 |
| Preferred dividends | 0 | 0 | 0 | 0 | 0 |
| **Normalised NPAT** | **3,106** | **3,311** | **3,828** | **4,797** | **5,816** |
| Extraordinary items | -5 | -67 | -59 | 0 | 0 |
| **Reported NPAT** | **3,100** | **3,244** | **3,769** | **4,797** | **5,816** |
| Dividends | -1,029 | -1,122 | -1,319 | -1,919 | -2,327 |
| **Transfer to reserves** | **2,071** | **2,122** | **2,450** | **2,878** | **3,490** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| Reported P/E (x) | 31.1 | 29.8 | 25.8 | 20.3 | 16.7 |
| Normalised P/E (x) | 31.1 | 29.2 | 25.4 | 20.3 | 16.7 |
| FD normalised P/E (x) | 32.0 | 30.0 | 25.4 | 20.3 | 16.7 |
| FD normalised P/E at price target (x) | 34.2 | 32.1 | 27.1 | 21.7 | 17.9 |
| Dividend yield (%) | 0.5 | 0.5 | 0.5 | 2.0 | 2.4 |
| Price/cashflow (x) | 33.2 | 19.5 | 25.9 | 21.4 | 18.2 |
| Price/book (x) | 8.9 | 7.3 | 6.1 | 5.2 | 4.4 |
| EV/EBITDA (x) | 20.5 | 19.6 | 16.5 | 13.0 | 10.8 |
| EV/EBIT (x) | 23.4 | 22.5 | 18.8 | 14.5 | 12.0 |
| Gross margin (%) | 47.4 | 44.3 | 45.3 | 46.3 | 46.2 |
| EBITDA margin (%) | 18.0 | 15.8 | 16.0 | 17.3 | 17.6 |
| EBIT margin (%) | 15.7 | 13.7 | 14.0 | 15.4 | 15.8 |
| Net margin (%) | 11.6 | 10.4 | 10.5 | 11.5 | 12.0 |
| Effective tax rate (%) | 23.5 | 25.4 | 27.4 | 29.3 | 29.2 |
| Dividend payout (%) | 33.2 | 34.6 | 35.0 | 40.0 | 40.0 |
| Capex to sales (%) | 4.8 | 5.0 | 2.8 | 2.4 | 2.1 |
| Capex to depreciation (x) | 2.1 | 2.5 | 1.4 | 1.3 | 1.2 |
| ROE (%) | 31.7 | 26.9 | 25.7 | 27.5 | 28.2 |
| ROA (pretax %) | 22.6 | 21.4 | 23.4 | 27.7 | 30.6 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 20.7 | 17.0 | 15.3 | 15.7 | 15.8 |
| EBITDA | 18.2 | 2.7 | 17.1 | 24.8 | 17.9 |
| EBIT | 23.8 | 2.1 | 18.0 | 27.0 | 19.1 |
| Normalised EPS | 9.6 | 6.3 | 15.3 | 24.9 | 21.3 |
| Normalised FDEPS | 9.6 | 6.6 | 18.2 | 24.9 | 21.3 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (INR) | 6.13 | 6.39 | 7.40 | 9.39 | 11.39 |
| Norm EPS (INR) | 6.14 | 6.52 | 7.52 | 9.39 | 11.39 |
| Fully diluted norm EPS (INR) | 5.97 | 6.36 | 7.52 | 9.39 | 11.39 |
| Book value per share (INR) | 21.43 | 26.12 | 31.45 | 36.99 | 43.83 |
| DPS (INR) | 0.88 | 1.02 | 1.02 | 3.76 | 4.56 |

Source: Company data, Nomura estimates

### Relative performance chart (one year)




Source: ThomsonReuters, Nomura research

| (%) | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (INR) | -8.2 | 6.3 | 13.6 |
| Absolute (USD) | -12.5 | 8.3 | 2.6 |
| Relative to index | -6.9 | -1.6 | 7.7 |
| Market cap (USDmn) | 1,772.8 | | |
| Estimated free float (%) | 29.4 | | |
| 52-week range (INR) | 223.9/133.65 | | |
| 3-mth avg daily turnover (USDmn) | 1.19 | | |
| Major shareholders (%) | | | |
| Promoters | 70.6 | | |

Source: Thomson Reuters, Nomura research

### Notes

Moderating growth in FY13F on account of slowing economic and industrial activity and exports

## Cashflow (INRmn)

| Year-end 31 Mar | FY11 | FY12 | FY13F | FY14F | FY15F |
|---|---|---|---|---|---|
| EBITDA | 4,797 | 4,926 | 5,767 | 7,199 | 8,491 |
| Change in working capital | -495 | -305 | -932 | -1,107 | -1,349 |
| Other operating cashflow | -1,309 | 460 | -1,083 | -1,543 | -1,790 |
| **Cashflow from operations** | **2,993** | **5,081** | **3,751** | **4,549** | **5,352** |
| Capital expenditure | -1,275 | -1,564 | -1,000 | -1,000 | -1,000 |
| **Free cashflow** | **1,718** | **3,517** | **2,751** | **3,549** | **4,352** |
| Reduction in investments | 1,108 | 885 | 0 | 0 | 0 |
| Net acquisitions | 0 | 0 | 0 | 0 | 0 |
| Reduction in other LT assets | 14 | 10 | 0 | 0 | 0 |
| Addition in other LT liabilities | | | | | |
| Adjustments | 37 | 110 | 20 | 20 | 20 |
| **Cashflow after investing acts** | **2,877** | **4,522** | **2,772** | **3,570** | **4,372** |
| Cash dividends | -885 | -1,030 | -1,319 | -1,919 | -2,327 |
| Equity issue | 0 | 0 | 0 | 0 | 0 |
| Debt issue | -1,120 | -1,626 | -1,950 | -700 | 0 |
| Convertible debt issue | 0 | 0 | 299 | 0 | 0 |
| Others | -283 | -172 | -231 | -109 | -67 |
| **Cashflow from financial acts** | **-2,288** | **-2,828** | **-3,201** | **-2,727** | **-2,394** |
| **Net cashflow** | **589** | **1,694** | **-429** | **842** | **1,979** |
| Beginning cash | 449 | 1,038 | 2,732 | 2,303 | 3,145 |
| Ending cash | 1,038 | 2,732 | 2,303 | 3,145 | 5,123 |
| Ending net debt | 2,322 | 481 | -1,040 | -2,582 | -4,560 |

Source: Company data, Nomura estimates

**Notes**

Company to pay ~INR1,950mn of FCCB in Dec-12. We expect dividend payout ratio to increase from 35% in FY12 to 40% in FY14F on account of increase cash flow from operating activities.

## Balance sheet (INRmn)

| As at 31 Mar | FY11 | FY12 | FY13F | FY14F | FY15F |
|---|---|---|---|---|---|
| Cash & equivalents | 1,038 | 2,732 | 2,303 | 3,145 | 5,123 |
| Marketable securities | 1,641 | 909 | 909 | 909 | 909 |
| Accounts receivable | 3,460 | 3,952 | 4,555 | 5,275 | 6,115 |
| Inventories | 4,092 | 4,541 | 5,144 | 5,850 | 6,781 |
| Other current assets | 1,048 | 1,366 | 1,366 | 1,366 | 1,366 |
| **Total current assets** | **11,280** | **13,500** | **14,277** | **16,545** | **20,294** |
| LT investments | 63 | 74 | 74 | 74 | 74 |
| Fixed assets | 8,024 | 9,129 | 9,580 | 9,965 | 10,283 |
| Goodwill | 625 | 601 | 534 | 467 | 400 |
| Other intangible assets | 427 | 385 | 296 | 208 | 120 |
| Other LT assets | 9 | 10 | 10 | 10 | 10 |
| **Total assets** | **20,427** | **23,699** | **24,771** | **27,269** | **31,181** |
| Short-term debt | 751 | 2,290 | 560 | 560 | 560 |
| Accounts payable | 1,737 | 2,058 | 2,331 | 2,651 | 3,072 |
| Other current liabilities | 4,060 | 4,694 | 4,694 | 4,694 | 4,694 |
| **Total current liabilities** | **6,548** | **9,041** | **7,584** | **7,904** | **8,326** |
| Long-term debt | 946 | -742 | 703 | 3 | 3 |
| Convertible debt | 1,663 | 1,665 | 0 | 0 | 0 |
| Other LT liabilities | 420 | 468 | 468 | 468 | 468 |
| **Total liabilities** | **9,578** | **10,432** | **8,755** | **8,375** | **8,797** |
| Minority interest | 2 | 5 | 5 | 5 | 5 |
| Preferred stock | 506 | 508 | 511 | 511 | 511 |
| Common stock | 10,341 | 12,754 | 15,500 | 18,378 | 21,868 |
| Retained earnings | | | | | |
| Proposed dividends | 0 | 0 | 0 | | |
| Other equity and reserves | 0 | 0 | 0 | 0 | 0 |
| **Total shareholders' equity** | **10,847** | **13,261** | **16,010** | **18,889** | **22,378** |
| **Total equity & liabilities** | **20,427** | **23,699** | **24,771** | **27,269** | **31,181** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.72 | 1.49 | 1.88 | 2.09 | 2.44 |
| Interest cover | 13.4 | 14.0 | 21.9 | 59.2 | 114.2 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 0.48 | 0.10 | net cash | net cash | net cash |
| Net debt/equity (%) | 21.4 | 3.6 | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 43.8 | 43.4 | 43.1 | 43.0 | 43.0 |
| Days inventory | 91.9 | 90.8 | 89.7 | 89.5 | 88.7 |
| Days payable | 44.8 | 39.9 | 40.6 | 40.6 | 40.2 |
| Cash cycle | 90.9 | 94.3 | 92.1 | 92.0 | 91.5 |

Source: Company data, Nomura estimates

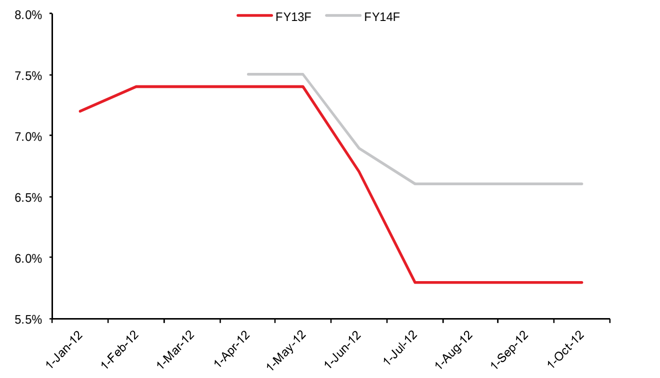
**Notes**

Net debt positive balance sheet

## Growth moderating in the consumer & bazaar business

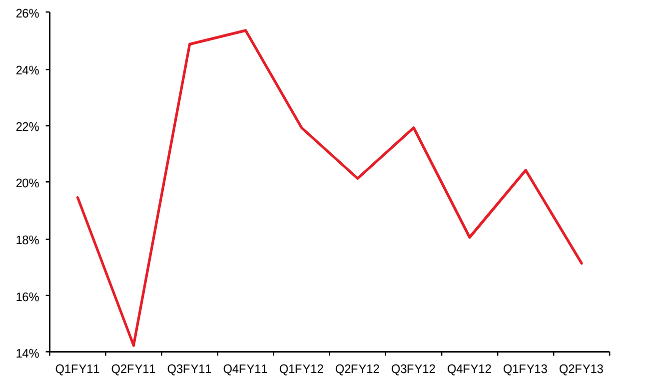
Growth in the consumer and bazaar segment, which contributes ~80% of consolidated sales, has moderated, as was evident from the 17.1% y-y growth in 2Q, which was the weakest in the last 8 quarters. In volume terms, growth has slowed down from ~14%-15% in FY12 to 11% in 2QFY13. Growth in the adhesive business (part of the consumer & bazaar segment and contributed ~25%-26% to consolidated sales) is very much linked to GDP growth. With GDP forecasts trending down as shown below, we have reduced our growth forecast in adhesive business to 11.8%/12.4% in FY13F/FY14F from 14.5%/14.3% earlier.

**Fig. 1: Nomura GDP forecast – trending downward**




Source: Nomura estimates

**Fig. 2: Consumer & bazaar segment growth – slowing down**




Source: Company, Nomura research

## Performance of overseas subsidiaries remains below par and a drag on profitability

Pidilite has 14 overseas subsidiaries. Weak demand in the international markets, particularly in Brazil, has led to a consistently muted performance of the overseas subsidiaries. The company is currently facing tough macro and aggressive competition in Brazil (South America). The fact that it is not a market leader in Brazil (a contrast to its position as a market leader in India in the adhesive business with products such as Fevicol having a 70% market share, according to management) further aggravates the situation in a market where competitors are focussed on gaining market share over profitability. In 2QFY13, although overseas subsidiaries reported sales growth of 5.7% in constant currency, EBITDA loss widened to INR14.6mn vs a loss of INR4.4mn in 2QFY12 mainly due to weak performance in South America, dragging overall profitability.

**Fig. 3: Performance of overseas subsidiaries**

INR mn

| | FY09 | FY10 | FY11 | FY12 | Q1FY13 |
|---|---|---|---|---|---|
| **North America** | | | | | |
| Sales | 1,111 | 1,181 | 1,227 | 1,276 | 439 |
| *- growth* | | *6.3%* | *3.9%* | *4.0%* | *27.4%* |
| EBITDA | (43) | 26 | 57 | 62 | 22 |
| *- margin* | *-3.9%* | *2.2%* | *4.6%* | *4.9%* | *5.1%* |
| **South America** | | | | | |
| Sales | 797 | 1,023 | 1,255 | 1,261 | 277 |
| *- growth* | | *28.4%* | *22.7%* | *0.5%* | *-13.6%* |
| EBITDA | (111) | 98 | 33 | (93) | (44) |
| *- margin* | *-13.9%* | *9.6%* | *2.6%* | *-7.4%* | *-15.9%* |
| **Middle East and Africa** | | | | | |
| Sales | 207 | 236 | 199 | 296 | 89 |
| *- growth* | | *14.0%* | *-15.7%* | *48.7%* | *1.6%* |
| EBITDA | (36) | (32) | (81) | (49) | 0 |
| *- margin* | *-17.4%* | *-13.6%* | *-40.7%* | *-16.6%* | *0.3%* |
| **South & South East Africa** | | | | | |
| Sales | 201 | 255 | 339 | 417 | 142 |
| *- growth* | | *26.9%* | *32.9%* | *23.0%* | *49.6%* |
| EBITDA | (24) | 16 | 31 | 45 | 29 |
| *- margin* | *-11.9%* | *6.3%* | *9.1%* | *10.8%* | *20.5%* |
| **Total** | | | | | |
| Sales | 2,316 | 2,695 | 3,020 | 3,250 | 946 |
| *- growth* | | *16.4%* | *12.1%* | *7.6%* | *11.7%* |
| EBITDA | (214) | 108 | 40 | (35) | 8 |
| *- margin* | *-9.2%* | *4.0%* | *1.3%* | *-1.1%* | *0.8%* |

Source: Company, Nomura Research

## Increasing competition in construction chemicals from organized players

Construction chemicals, which contributed ~19% to consolidated sales, has been the fastest growing segment, growing at a healthy clip of close to 25% (FY12 growth was 24.6% while management has been suggesting growth in the range of 25-30%). Our interaction with distributors of Pidilite in the past has reinforced the fact that, in the absence of any competition from the organized sector, for some specific distributors this product was actually growing in excess of 30%. However, this may change as organized players such as Asian Paints have recently made a foray in the construction chemical space.

Asian Paints has recently launched 3 products - Asian Paints Smartcare Damp proof, Asian Paints Smartcare Damp block and Asian Paints Smartcare crack seal - which clearly are a foray in a category where Pidilite so far has faced limited competition. We believe that while it is still at an early stage, Asian Paints with its solid distribution network may pose a significant threat to Pidilite. We are now building in topline growth for this segment at 24% for FY14 (versus 27% earlier) and 21% for FY14 (versus 27% earlier).

**Fig. 4: Pidilite & Asian Paints competing products in construction chemicals**

INR

| Product | Price | Company | Application |
|---|---|---|---|
| Damp Guard | 376/Kg | Pidilite | Exterior & Interior |
| Damp Proof | 246/Litre | Asian Paints | Exterior |
| Damp Block | 225/Kg | Asian Paints | Interior |

Source: Nomura research

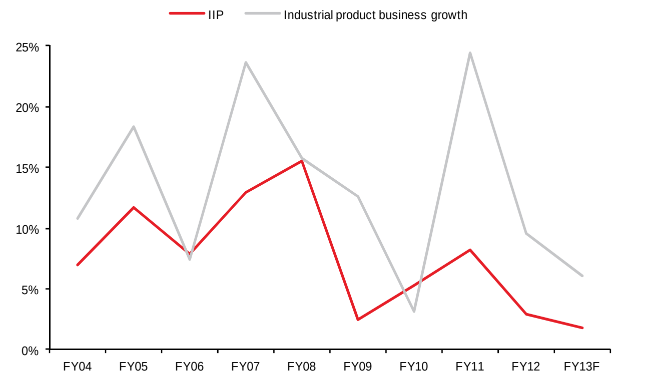
## Exports slowdown in backdrop of a tough macro conditions

Pidilite exports ~10% of its standalone sales (majority of which pertains to the industrial products division) to the international market which includes Europe and the US. As per 2QFY13 conference call, exports were weak in 2Q on account of weak economic condition in Europe and the US. There is no visibility on an improvement in these markets, so we expect the company's exports to remain weak.

## Weakness in key industries reflects in slow growth of the industrial products division

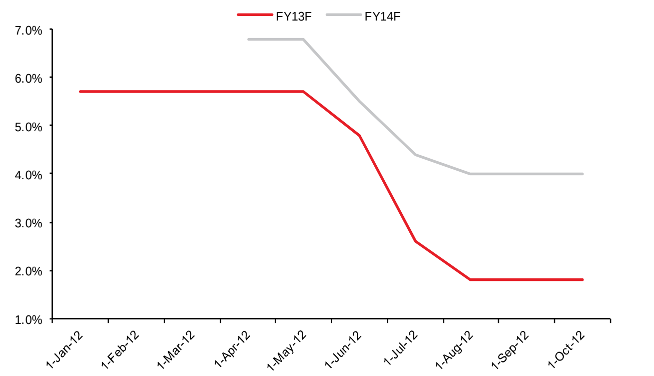
The company supplies industrial products to a number of industries such as packaging, leather, textile, footwear, paint, etc, which are slowing down either on account of slowing economic activity in India or slowdown in exports to Europe and the US by companies in these industries. The index for industrial production (IIP) forecast data (shown below) has been trending down which clearly indicates weakening industrial activity in the country. Recent IIP growth for the April-August 2012 period is ~0%. We have accordingly reduced growth forecast of industrial products segment to 6.2%/9.0% in FY13F/FY14F from 9.2%/14% earlier.

**Fig. 5: Correlation between IIP & growth in industrial product segment – Fall in IIP to 1.8% would imply fall in industrial products growth in FY13F**




Source: CEIC, company, Nomura research

**Fig. 6: Nomura forecast of IIP – trending downward**




Source: Nomura estimates

## 2Q performance clearly indicated moderate growth in the C&B business and weakness in the industrial segment

Pidilite's consolidated sales, at INR9,047mn, were ~3% below Nomura's estimate and consensus. Sales growth moderated to 14.7% y-y in 2QFY13 vs 17.7% in 1QFY13 and 18.2% in 2QFY13 versus our and street expectation of ~18%. Slowdown was visible in the consumer & bazaar segment as well as the industrial products business on account of slowdown in economic and industrial activity and exports to markets such as Europe and the US. In terms of volume, the consumer and bazaar segment achieved ~11% volume growth and ~8% realization growth in the domestic business vs 13-14% volume growth achieved in 1QFY13 and 2QFY12. Industrial products reported sales growth of ~3.6% y-y with flat volume in 2Q.

The company's price increases in Q1FY13 and Q2FY13 resulted in stable gross margin q-q and a 120bp increase y-y. VAM price increased in 1QFY13, but its impact on 2QFY12 was negated by the price hike effected by the company. Increase in advertisement expenditure which was pushed forward from 1QFY13 (where it was lower than last year) resulted in a fall in EBITDA margin to 15.9% in 2Q. EBITDA margin in 1HFY13 was almost flat compared to 1HFY12.

Consolidated PAT came in at INR957mn, which was ~13%/7% below our/street expectation. The company reported forex loss of INR81mn on export earnings kept in USD, adjusted for which net income was ~8% below our estimate. Interest expense was lower at INR41mn on account of conversion of a USD2.4mn FCCB, in line with our expectation.

Performance of overseas subsidiaries continued to disappoint. While sales grew by 7.3% in INR terms (5.7% in constant currency), consolidated overseas subsidiaries reported a loss of INR14.6mn vs a loss of INR4.4mn in 2QFY12 excluding exceptional items. While North America sales grew by 18.8% on account of ~23% growth in student art material, South America sales declined by ~3.2% y-y. Egypt and Bangladesh continued to perform well but sales continued to decline in Dubai.

**Fig. 7: 2Q consolidated performance**

INR mn

| INR mn | Q2FY12 | Q1FY13 | Q2FY13 | | | | |
|---|---|---|---|---|---|---|---|
| | | | Actual | Nomura | Difference | Consensus | Difference |
| Revenue | 7,878 | 10,026 | 9,047 | 9,333 | -3% | 9,283 | -3% |
| *- growth* | *18.2%* | *17.7%* | *14.8%* | *18.5%* | | *17.8%* | |
| EBITDA | 1,314 | 1,890 | 1,434 | 1,597 | -10% | 1,587 | -10% |
| *- margin* | *16.7%* | *18.9%* | *15.9%* | *17.1%* | | *17.1%* | |
| Net Income | 772 | 1,280 | 957 | 1,104 | -13% | 1,032 | -7% |
| Adj net Income | 811 | 1,280 | 1,017 | 1,104 | -8% | | |
| EPS | 1.52 | 2.52 | 1.88 | 2.17 | -13% | 2.01 | -6% |
| Adj EPS | 1.60 | 2.52 | 2.00 | 2.17 | -8% | | |

Source: Company, Bloomberg consensus, Nomura estimates

**Fig. 8: Standalone Performance – slowing growth in domestic business**

INR mn

| | Q2FY12 | Q1FY13 | Q2FY13 |
|---|---|---|---|
| Revenue | 7,103 | 9,077 | 8,159 |
| *- growth* | *20.3%* | *18.5%* | *15.6%* |
| EBITDA | 1,302 | 1,907 | 1,468 |
| *- margin* | *18.3%* | *21.0%* | *18.0%* |
| Net Income | 815 | 1,334 | 1,040 |
| Adj Income | 852 | 1,333 | 1,099 |
| Basic EPS | 1.61 | 2.63 | 2.05 |

Source: Company, Nomura research

**Fig. 9: Consolidated segmental performance**

INR mn

| | Q2FY12 | Q1FY13 | Q2FY13 |
|---|---|---|---|
| **Consumer & Bazaar Products** | | | |
| Sales | 6,389 | 8,359 | 7,483 |
| *- growth* | *20.1%* | *20.4%* | *17.1%* |
| EBIT | 1,262 | 1,964 | 1,446 |
| *- margin* | *19.8%* | *23.5%* | *19.3%* |
| **Industrial Products** | | | |
| Sales | 1,646 | 1,844 | 1,705 |
| *- growth* | *17.6%* | *11.0%* | *3.6%* |
| EBIT | 243 | 238 | 166 |
| *- margin* | *14.8%* | *12.9%* | *9.8%* |

Source: Company, Nomura research

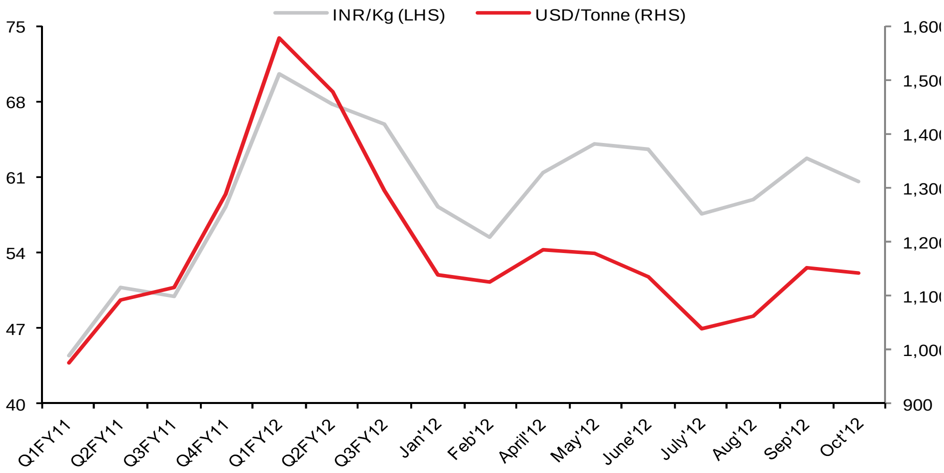
## VAM price – to remain stable

VAM is the main raw material for Pidilite and we expect its price to remain stable for the following reasons:

- Ethylene is an important raw material for VAM (Ethylene + Acetic Acid+ oxygen) which in turn is derived mainly from crude oil apart from natural Gas & Coal. Average crude oil price is USD109.4 per barrel in line with our house estimate of USD100 for FY13F. As per Nomura estimates, the average crude oil price should fall to USD105 in FY14F and USD100 in FY15F, which would imply a fall in VAM price.

- As per ICIS, VAM price outlook is bearish for 3QFY13 as consumers are expected to be conservative in building inventory due to year-end holiday season.
- The company imports VAM in USD and depreciation of INR vs USD will likely offset fall in price of VAM to some extent, As per Nomura estimates, USD/INR would be INR54 by FY13F and INR58 by end of FY14F.

**Fig. 10: VAM price - Stabilizing at low levels**




Source: ISIC, Nomura research

## FCCB maturity on 3 December 2012

The company has issued 400 FCCB of USD0.1mn each totalling USD 40mn. Outstanding FCCB as of 31 March 2012 were USD33.3mn. Bond holders have converted USD7.6mn till now in FY13 resulting in issuance of ~2.9mn shares. As shown below, at current USD/INR exchange rate, FCCB will be converted to shares at stock price of INR194. We still have a month left for FCCB maturity (3 December 2012) and we are not factoring the conversion explicitly in our model at this point.

**Fig. 11: FCCB – at current USDINR exchange rate, FCCB to be converted beyond INR194, higher than current share price**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Bond face value (USD m) | 0.1 | | | | | | |
| FV (2012) in (USD m) | 0.1394 | | | | | | |
| PV in (USD m) | 0.1387 | | | | | | |
| USD/INR Scenarios | 50 | 51 | 52 | 53 | **54.4** | 55 | 56 |
| Conversion price in INR/share | 101.4 | 101.4 | 101.4 | 101.4 | 101.4 | 101.4 | 101.4 |
| USD/ INR (at which FCCB was issued) | 39.4 | 39.4 | 39.4 | 39.4 | 39.4 | 39.4 | 39.4 |
| Number of shares on conversion per bond | 38,821 | 38,821 | 38,821 | 38,821 | 38,821 | 38,821 | 38,821 |
| Share value (INR mn) | 6.9 | 7.1 | 7.2 | 7.3 | 7.5 | 7.6 | 7.8 |
| Share value (USD mn) | 0.139 | 0.139 | 0.139 | 0.139 | 0.139 | 0.139 | 0.139 |
| Break even market price in INR/share depending on exchange rate at which the FCCB will be converted | 179 | 183 | 186 | 189 | **194** | 196 | 200 |

Source: Company, Nomura estimates

## Valuation – We raise our target price to INR214 (from INR169)

We have raised our price target to INR214 as we now value the company at a P/E multiple of 21.3x (15% discount to our target multiple for Asian Paints and in-line with its 10-year historical average, versus our earlier multiple of 17.5x) applied to the FY14F-

FY15F EPS average and now explicitly deduct the INR7/share for capex incurred so far in the elastomer project (where ~29% of its total capital employed is invested), which in our view has a high likelihood of being written off. Management has not been allocating any capex to this project in the last 3 quarters and is unlikely in our view to proceed with this project whose outcome is likely to be decided by end of FY13 (as per the management which has indicated that the consultant has submitted a report and the board will take a final decision in Q4) in our view. The company has incurred a capex of ~INR 3.65bn till now on setting up elastomer project in Dahej. As we have highlighted in our report “Downgrading to Reduce” dated 29 November 2011, we see concerns around demand & supply of Polycholoroprene elastomer and ROCE to be dilutive.

**Fig. 12: Target price increased to INR214**

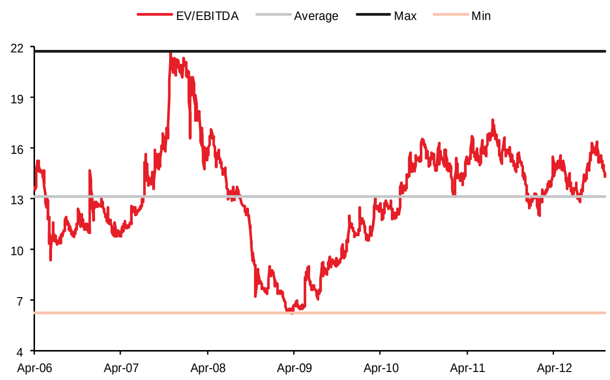
| | | Comment |
|---|---|---|
| P/E Multiple | 21.3 | Increased to 20x from 17.5x as we write off elastomer project |
| Average EPS (INR) | 10.39 | Average of FY14F and FY15F |
| Price Target (INR) | 221 | Before writing off elastomer project |
| | | |
| Capex (INR mn) | 3,659 | Capex in elastomer project till now |
| Number of shares | 511 | Assuming no furthur conversion of FCCB |
| Capex per share | 7 | Write off value per share |
| | | |
| Price Target (INR) | **214** | H1FY14 target post writing off elastomer project |

Source: Company, Nomura estimates

**Fig. 13: Pidilite – historical P/E trading multiple**

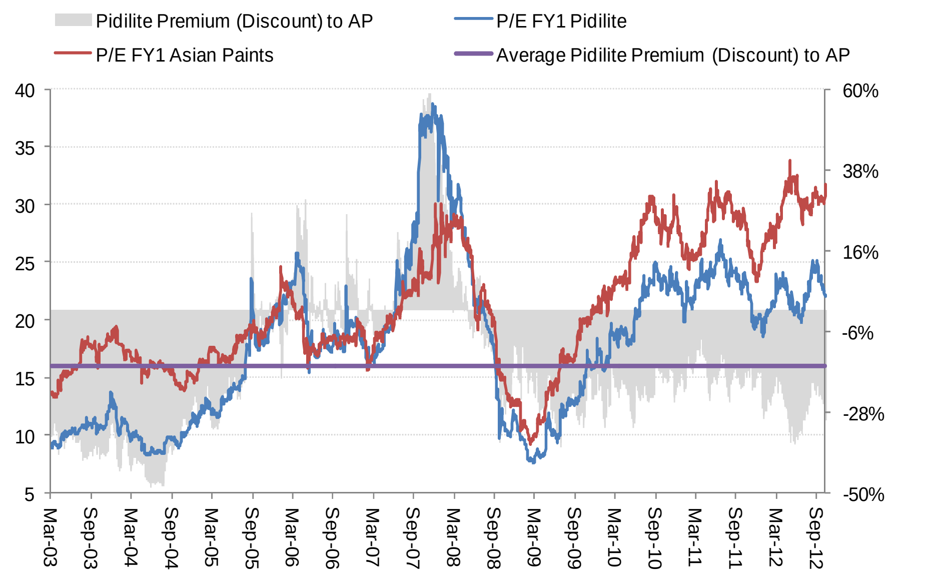

Source: Bloomberg, Nomura estimates

**Fig. 14: Pidilite – historical EV/EBITDA trading multiple**




Source: Bloomberg, Nomura estimates

**Fig. 15: P/E premium/discount – Pidilite has traded at ~ 15% discount to Asian Paints over last 10 years**




Source: Bloomberg, Nomura estimates

## Change in estimates

We have scaled back our revenue forecast for FY13F and FY14F on account of slowdown in adhesive business (as FY13F GDP forecast has been cut from7.4% as of March 2012 to 5.8% as of October 2012), slowdown in exports due to weak economic conditions in Europe and the US, slowdown in industrial activity (indicated by cut in IIP) and emerging completion from organized players in the construction chemicals business.

We have also moderated our margin assumption in the industrial products business as we believe that it will be difficult to effect price hikes in the backdrop of weakening domestic Industrial activity and exports. We have also increased our other income estimate in line with the trend in 1HFY13.

**Fig. 16: Change in estimates – capturing cut in GDP & IIP and weakening export**

INR mn

| | Old | | | | % Change | |
|---|---|---|---|---|---|---|
| | FY13F | FY14F | FY13F | FY14F | FY13F | FY14F |
| Revenue | 36,598 | 43,030 | 36,041 | 41,713 | -1.5% | -3.1% |
| *- growth* | *17.1%* | *17.6%* | *15.3%* | *15.7%* | *-1.8%* | *-1.9%* |
| EBITDA | 5,773 | 7,549 | 5,767 | 7,199 | -0.1% | -4.6% |
| *- margin* | *15.8%* | *17.5%* | *16.0%* | *17.3%* | *0.2%* | *-0.3%* |
| Profit | 3,664 | 4,903 | 3,769 | 4,797 | 2.9% | -2.2% |
| EPS (INR) | 7.22 | 9.66 | 7.40 | 9.39 | 2.5% | -2.8% |

Source: Nomura estimates

## Investment risks

**Key upside risks to our view can emanate from:**

- Possible divestment of the elastomer project at a reasonable price, an event that we ascribe a very low probability to.
- Significant decline in Vinyl Acetate Monomer (VAM) prices, which would be a deviation from our current assumption of continued strength in the VAM prices.
- Strengthening of the INR given that it imports most of its raw material.

- Reversal in the macroeconomic backdrop in India which results in improvement in consumer sentiment.

**Key downside risks to our view:**

- The company decides to proceed ahead and invest more in the elastomer project,
- Further deterioration in the consumer sentiment and new–residential activity in India, which could lead to lower-than-expected growth, especially in the C&B segment.
- Increase in VAM prices
- Ban on export of polyethylene by Iran - As per a news article in pudialy.com, the government of Iran has banned export of 50 products which includes petrochemical products including polymers. The list includes polyethylene, polypropylene, polyvinyl chloride and PET. This news came as the US and Europe stepped up sanctions against Iran in an attempt to curb its nuclear program. Ethylene is the raw material for polyethylene and ban on export of petrochemical products would lead to increase in demand for ethylene to manufacture polyethylene outside Iran, thereby leading to an increase in the price of ethylene. Increased price of ethylene can potentially lead to an increase in VAM price. We believe that this is temporary as Iran has manufacturing capacity of 3x domestic consumption which would imply excess supply in the domestic market, thereby hurting local manufacturers.

# Appendix A-1

## Analyst Certification

We, Ankur Agarwal and Lalit Kumar, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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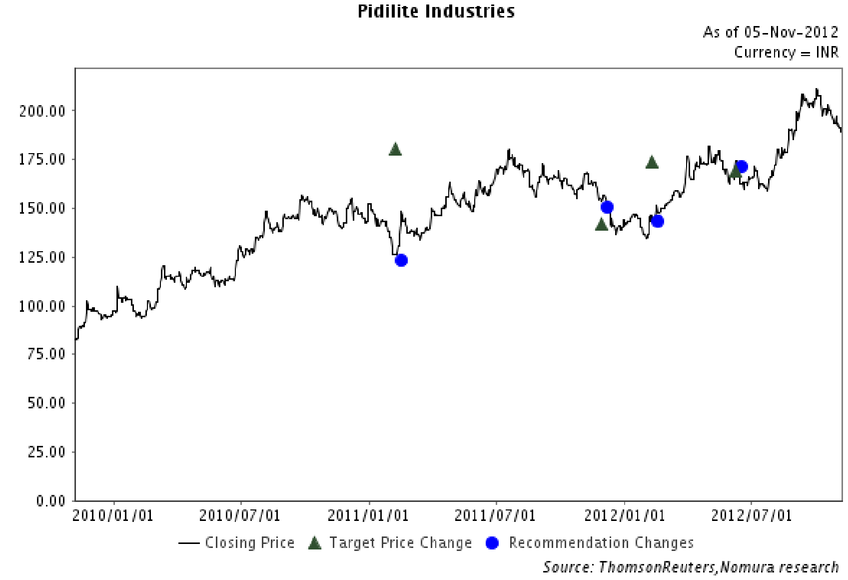
| Issuer name | Ticker | Price | Price date | Stock rating | Sector rating | Disclosures |
|---|---|---|---|---|---|---|
| Asian Paints | APNT IN | INR 4095 | 06-Nov-2012 | Neutral | Not rated | |
| Pidilite Industries | PIDI IN | INR 191 | 06-Nov-2012 | Neutral | Not rated | |

### Previous Rating

| Issuer name | Previous Rating | Date of change |
|---|---|---|
| Asian Paints | Buy | 02-Aug-2012 |
| Pidilite Industries | Buy | 08-Jun-2012 |

**Pidilite Industries (PIDI IN)** **INR 191 (06-Nov-2012)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)




| Date | Rating | Target price | Closing price |
|---|---|---|---|
| 08-Jun-12 | Neutral | | 174.40 |
| 08-Jun-12 | | 169.00 | 174.40 |
| 09-Feb-12 | Buy | | 146.45 |
| 09-Feb-12 | | 174.00 | 146.45 |
| 29-Nov-11 | Reduce | | 153.50 |
| 29-Nov-11 | | 142.00 | 153.50 |
| 08-Feb-11 | Buy | | 126.10 |
| 08-Feb-11 | | 180.00 | 126.10 |

For explanation of ratings refer to the stock rating keys located after chart(s)

**Valuation Methodology** Our price target of INR214 is based on a P/E multiple of 21.3x (15% discount to our target multiple for Asian Paints and in-line with its 10-year historical average) applied to the FY14F-FY15F EPS average and we now explicitly deduct the INR7/share for capex incurred so far in the elastomer project (where ~29% of its total capital employed is invested), which in our view has a high likelihood of being written off.

**Risks that may impede the achievement of the target price** Key upside risks to our view: (1) possible divestment of the elastomer project at a reasonable price, an event that we ascribe a very low probability to; (2) significant decline in VAM prices, which would be a deviation from our current assumption of continued strength in the VAM prices; (3) strengthening of the INR given that it imports most of its raw material; (4) reversal in the macroeconomic backdrop in India which results in improvement in consumer sentiment. Key downside risks to our view: (1) the company decides to proceed ahead and invest more in the elastomer project; (2) further deterioration in the consumer sentiment and new–residential activity in India, which could lead to lower-than-expected growth, especially in the C&B segment; (3) increase in VAM prices; and (4) ban on export of polyethylene by Iran.

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