Pidilite Industries PIDI.NS PIDI IN

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EQUITY RESEARCH

Upgrade to Buy

Growth driven by consumer and bazaar, margin expansion from falling raw material prices

February 9, 2012

Rating Up from Reduce	**Buy**
Target price Increased from 142	INR 174
Closing price February 7, 2012	INR 143
Potential upside	+21.7%

Action/valuation: Upgrade to Buy with ~22% potential upside

We upgrade PIDI to Buy from Reduce, as we gain confidence in its solid top-line growth (22% in 3Q, projected at ~19% in FY13-FY14) in the consumer and bazaar segment, driven by new product launches. The company is also benefiting from falling raw material prices and a strengthening INR. We have raised concern about its elastomer project in the past, and we believe this has underpinned the stock's significant underperformance (~17%) versus the CNX midcap index since the end of November. As we await more clarity around this project by March 2012, we think that valuation is now compelling. Our revised FY13-FY14 EPS estimates (up ~12.7%) support our revised target price of INR174 (up 23%), which is still based on the three-year average P/E of 17.5x

Catalyst: Margin expansion driven by falling raw material prices

VAM prices are down ~20% since the peak in Q1FY12 in USD terms, but have been largely offset by a depreciating INR in Q3. However, we believe that declining VAM prices (~23% in CY12) and an appreciating INR vs USD (~8% in CY12) should lead to margin expansion in the near term.

Probability of shelving/ divestment of the elastomer project is high

While the outcome of the elastomer project's consultant review has been delayed to Mar' 12, given that the project continues to be on hold, and considering media reports suggesting a potential divestment, we see the probability of management not going ahead with this project as higher now. We highlighted the risks of this project in our report "Risks outweigh rewards concerns around the elastomer project" published on 29 Nov'11.

31 Mar	FY11		FY12F		FY13F		FY14F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	26,721	31,289	31,533	36,576	37,051	42,960	43,650
Reported net profit (mn)	3,100	3,318	3,187	3,785	4,265	4,481	5,048
Normalised net profit (mn)	3,106	3,318	3,187	3,785	4,265	4,481	5,048
Normalised EPS	6.14	6.54	6.28	7.46	8.40	8.83	9.94
Norm. EPS growth (%)	9.6	6.5	2.3	14.1	33.8	18.4	18.4
Norm. P/E (x)	24.0	N/A	23.4	N/A	17.1	N/A	14.4
EV/EBITDA (x)	15.5	15.2	14.7	13.0	10.8	10.9	8.9
Price/book (x)	6.7	N/A	5.6	N/A	4.5	N/A	3.7
Dividend yield (%)	0.5	N/A	0.6	N/A	0.7	N/A	2.1
ROE (%)	33.4	28.8	27.8	27.1	30.3	26.5	29.1
Net debt/equity (%)	21.4	8.1	10.2	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. For the near term, we now factor in tailwinds from falling raw material prices and a strengthening INR which will positively impact margins.

Nomura vs consensus

Our FY13 EBITDA margin estimate is ~50 bps above consensus, as we believe the Street is yet to factor in falling VAM prices.

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

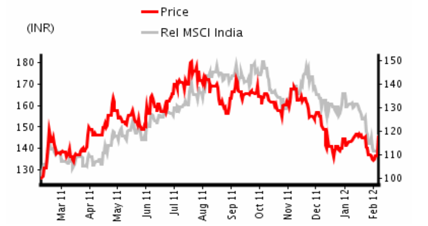
Key data on Pidilite Industries

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**22,133**	**26,721**	**31,533**	**37,051**	**43,650**
Cost of goods sold	-8,981	-11,152	-14,296	-15,603	-18,402
Gross profit	**13,152**	**15,570**	**17,237**	**21,447**	**25,248**
SG&A	-9,758	-11,368	-12,852	-15,524	-18,207
Employee share expense					
Operating profit	**3,394**	**4,202**	**4,385**	**5,923**	**7,041**
EBITDA	**4,059**	**4,797**	**5,020**	**6,598**	**7,756**
Depreciation	-666	-595	-635	-675	-715
Amortisation					
EBIT	3,394	4,202	4,385	5,923	7,041
Net interest expense	-329	-314	-282	-197	-47
Associates & JCEs	27	22	23	23	24
Other income	118	150	150	120	120
Earnings before tax	**3,211**	**4,060**	**4,276**	**5,869**	**7,138**
Income tax	-422	-954	-1,089	-1,605	-2,090
Net profit after tax	**2,789**	**3,106**	**3,187**	**4,265**	**5,048**
Minority interests	-1	0	0	0	0
Other items	44	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	**2,832**	**3,106**	**3,187**	**4,265**	**5,048**
Extraordinary items	-63	-5	0	0	0
Reported NPAT	**2,770**	**3,100**	**3,187**	**4,265**	**5,048**
Dividends	-885	-1,029	-956	-1,279	-1,514
Transfer to reserves	**1,884**	**2,071**	**2,231**	**2,985**	**3,534**
Valuation and ratio analysis					
FD normalised P/E (x)	26.3	24.0	23.4	17.1	14.4
FD normalised P/E at price target (x)	33.1	30.2	29.4	21.4	18.1
Reported P/E (x)	26.2	23.4	22.8	17.1	14.4
Dividend yield (%)	0.4	0.5	0.6	0.7	2.1
Price/cashflow (x)	18.6	23.2	24.0	16.3	18.0
Price/book (x)	8.3	6.7	5.6	4.5	3.7
EV/EBITDA (x)	18.8	15.5	14.7	10.8	8.9
EV/EBIT (x)	22.4	17.7	16.8	12.0	9.8
Gross margin (%)	59.4	58.3	54.7	57.9	57.8
EBITDA margin (%)	18.3	18.0	15.9	17.8	17.8
EBIT margin (%)	15.3	15.7	13.9	16.0	16.1
Net margin (%)	12.5	11.6	10.1	11.5	11.6
Effective tax rate (%)	13.1	23.5	25.5	27.3	29.3
Dividend payout (%)	32.0	33.2	30.0	30.0	30.0
Capex to sales (%)	3.9	4.9	2.8	1.6	1.4
Capex to depreciation (x)	1.3	2.2	1.4	0.9	0.8
ROE (%)	37.2	33.4	27.8	30.3	29.1
ROA (pretax %)	20.5	22.6	21.7	27.7	30.7
Growth (%)					
Revenue	10.0	20.7	18.0	17.5	17.8
EBITDA	69.9	18.2	4.7	31.4	17.6
EBIT	88.5	23.8	4.4	35.1	18.9
Normalised EPS	119.0	9.6	2.3	33.8	18.4
Normalised FDEPS	119.3	9.6	2.6	37.2	18.4
Per share					
Reported EPS (INR)	5.47	6.13	6.28	8.40	9.94
Norm EPS (INR)	5.60	6.14	6.28	8.40	9.94
Fully diluted norm EPS (INR)	5.44	5.97	6.12	8.40	9.94
Book value per share (INR)	17.23	21.43	25.76	31.64	38.61
DPS (INR)	0.57	0.71	0.88	1.02	2.98

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	0.2	-14.6	13.8
Absolute (USD)	7.3	-14.7	5.2
Relative to index	-12.9	-15.4	16.0
Market cap (USDmn)	1,474.5		
Estimated free float (%)	29.4		
52-week range (INR)	183.4/122.8		
3-mth avg daily turnover (USDmn)	0.51		
Major shareholders (%)			
Promoters	70.6		

Source: Thomson Reuters, Nomura research

Notes

Forecast margin expansion in FY13F

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	4,059	4,797	5,020	6,598	7,756
Change in working capital	977	-435	-983	-666	-1,742
Other operating cashflow	-1,024	-1,144	-933	-1,478	-1,963
Cashflow from operations	**4,012**	**3,218**	**3,104**	**4,454**	**4,051**
Capital expenditure	-865	-1,301	-897	-600	-600
Free cashflow	**3,147**	**1,917**	**2,207**	**3,854**	**3,451**
Reduction in investments	-2,380	1,108	0	0	0
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	11	14	0	0	0
Addition in other LT liabilities					
Adjustments	36	40	17	17	17
Cashflow after investing acts	**814**	**3,079**	**2,224**	**3,871**	**3,468**
Cash dividends	-519	-885	-956	-1,279	-1,514
Equity issue	0	0	0	0	0
Debt issue	-1,033	-1,321	-19	-2,665	-300
Convertible debt issue	-87	0	0	0	0
Others	-329	-283	-281	-197	-47
Cashflow from financial acts	**-1,966**	**-2,488**	**-1,256**	**-4,141**	**-1,861**
Net cashflow	**-1,152**	**590**	**969**	**-270**	**1,606**
Beginning cash	1,601	449	1,039	2,008	1,738
Ending cash	449	1,039	2,008	1,738	3,344
Ending net debt	4,238	2,317	1,329	-1,066	-2,972

Source: Company data, Nomura estimates

Notes

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	449	1,039	2,008	1,738	3,344
Marketable securities	2,624	1,635	1,635	1,635	1,635
Accounts receivable	2,959	3,460	4,135	4,799	5,737
Inventories	2,979	4,092	4,973	4,921	6,747
Other current assets	1,046	966	966	966	966
Total current assets	**10,056**	**11,191**	**13,716**	**14,058**	**18,428**
LT investments	54	70	70	70	70
Fixed assets	8,390	9,138	9,400	9,325	9,209
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	0	0	0	0	0
Total assets	**18,499**	**20,399**	**23,186**	**23,453**	**27,708**
Short-term debt	666	505	496	496	496
Accounts payable	1,709	2,153	2,726	2,673	3,694
Other current liabilities	2,966	3,621	3,621	3,621	3,621
Total current liabilities	**5,342**	**6,279**	**6,842**	**6,789**	**7,811**
Long-term debt	2,341	1,188	1,176	176	-124
Convertible debt	1,679	1,663	1,665	0	0
Other LT liabilities	417	421	421	421	421
Total liabilities	**9,778**	**9,550**	**10,104**	**7,386**	**8,108**
Minority interest	2	2	2	2	2
Preferred stock	506	506	508	508	508
Common stock	8,213	10,341	12,572	15,557	19,090
Retained earnings					
Proposed dividends	0	0	0	0	
Other equity and reserves	0	0	0	0	
Total shareholders' equity	**8,719**	**10,847**	**13,079**	**16,065**	**19,598**
Total equity & liabilities	**18,499**	**20,400**	**23,186**	**23,453**	**27,708**
Liquidity (x)					
Current ratio	1.88	1.78	2.00	2.07	2.36
Interest cover	10.3	13.4	15.5	30.1	149.9
Leverage					
Net debt/EBITDA (x)	1.04	0.48	0.26	net cash	net cash
Net debt/equity (%)	48.6	21.4	10.2	net cash	net cash
Activity (days)					
Days receivable	48.1	43.8	44.1	44.0	44.1
Days inventory	117.4	115.7	116.0	115.7	115.7
Days payable	61.2	63.2	62.5	63.1	63.1
Cash cycle	104.3	96.3	97.6	96.6	96.6

Source: Company data, Nomura estimates

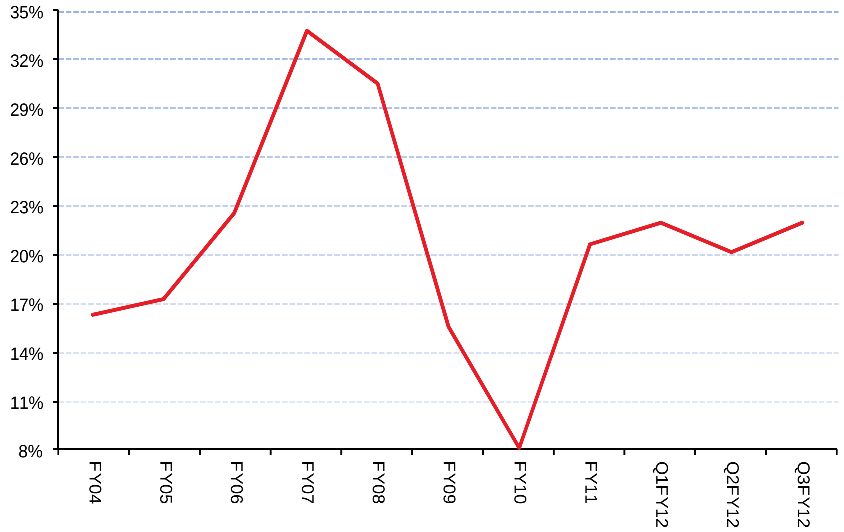
Notes

Forecast a net cash position in FY13F-FY14F

Introduction of new products continues to drive growth in the consumer & bazaar segment (~80% of group top-line)

Pidilite reported a solid ~22% top-line growth in Q3FY12 in this segment, which is ahead of our and street expectations. We attribute this to the group's strength in creating innovative products that cater to a niche segment, a strength that we had highlighted in our initiation report. According to management, new products introduced in this segment have continued to do well, and are an important factor in driving top-line growth. Most of the new products are being introduced in the construction-chemicals category, which is the fastest-growing sub-segment in the consumer and bazaar business. Our discussion with management suggests that products such as "Dr. Fixit Pidiproof LW+" & "Roff Stoneguard WB" introduced in FY11 under construction chemicals are now delivering the results in terms of a meaningful contribution to growth in the top-line. In the adhesive segment, products such as "Fevicol Marine" (also introduced in FY11) were also responsible for driving growth in 3Q FY12. In our opinion, the performance of this sector in 3Q FY12 is a testimony to the group's ability to grow at a decent clip even in a relatively muted macro backdrop, driven by a diversified portfolio and incremental sales from new products because of the company's better understanding of the end market compared to peers and a strong R&D.

Fig. 1: Consumer & bazaar segment – strong top-line growth driven by new products likely to continue



Source: Company data, Nomura research

The company's ability to introduce new products and increased awareness of its new products will continue to drive growth in the consumer and bazaar segment, in our view. Based on its strong growth in Q3 and our interaction with management, we raise our top-line growth forecast from 18.2%, 18% and 18.4% to 20.9%, 18.7% and 18.8% for FY12F, FY13F and FY14F, respectively.

Fig. 2: Fevicol Marine – one of the successful products launched in FY11

Source: Company data, Nomura research

Fig. 3: Dr. Fixit Pidiproof LW+ - one of the successful products launched in FY11

Source: Company data, Nomura research

Fig. 4: New products launched in FY11– to drive growth over FY12-14

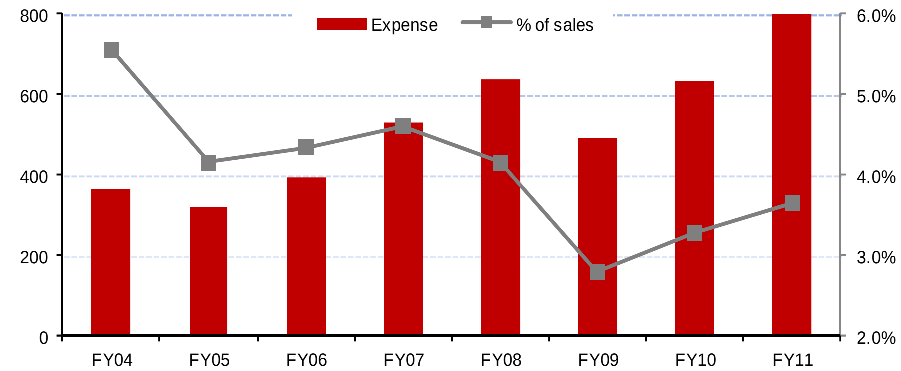
New Products	Application
Dr. Fixit Pidiproof LW+	Waterproofing compound for concrete and plaster which makes the concrete cohesive and prevents segregation
Roff Stoneguard WB	Water based penetrating sealer for porous & non porous stones. It protects stone or tile from water as well as stains
Fevicol Marine	Waterproof adhesive with a new look and an integrated campaign
DDL XT Booster	An innovative formula to give exterior durability to distemper paint and Wudfin Ezeestain, a water based wood stainer
Fevicol AC Duct King	Adhesive for AC Duct insulation for all residential and industrial projects

Source: Company data, Nomura research

Apart from new products, the company is also focusing on creating awareness about its products through innovative advertisement, loyalty programmes with Fevicol users (mainly carpenters) and campaigns. We believe these awareness programmes will help it to increase product penetration and drive growth.

Fig. 5: Advertisement expense/sales – increased spending to create awareness & launch of new products

INR mn

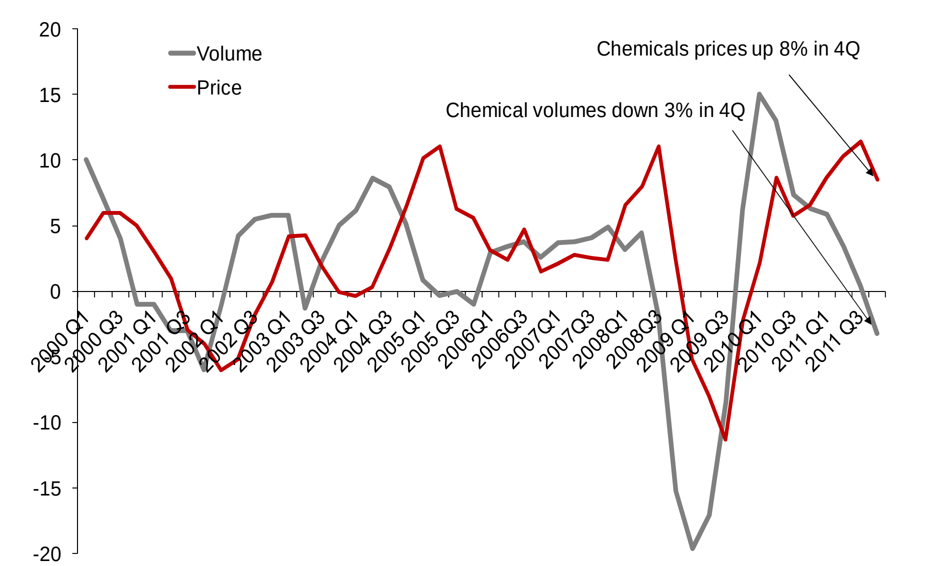


Source: Company data, Nomura research

Industrial products (~20% group top-line): De-stocking of inventory – a temporary phenomena, will likely drive growth in FY13F

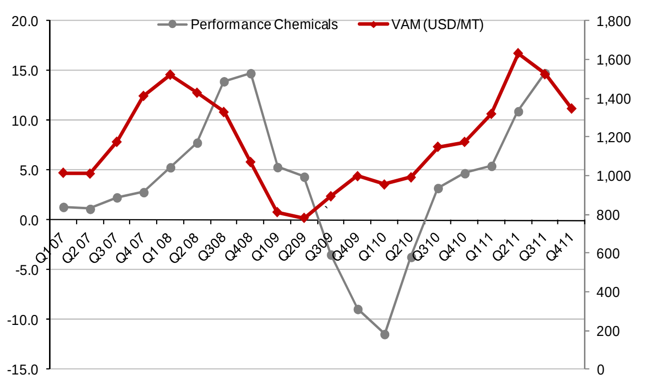
Sales in the industrial-product segment declined by ~2% in Q3FY12 and according to management, exports (~20% of the industrial-product business) to international markets (mainly to the US and Europe) declined by ~ 14% during the same period, implying a modest ~ 1% growth in the domestic Industrial-product business. Management attributed this to the de-stocking phenomena, which we believe will reverse once vinyl acetate monomer (VAM) prices stabilize. Amidst an uncertain environment (volatility in VAM prices increased until 1Q FY12 before reversing), many clients have cancelled or postponed their orders. While Pidilite had implemented price increases in order to pass on the increase in VAM prices until 3Q FY12, with the VAM prices trending down some of its clients have been destocking as they wait for these prices to stabilize at low levels.

Fig. 6: Global chemicals volume and price trends
y-o-y growth (%)



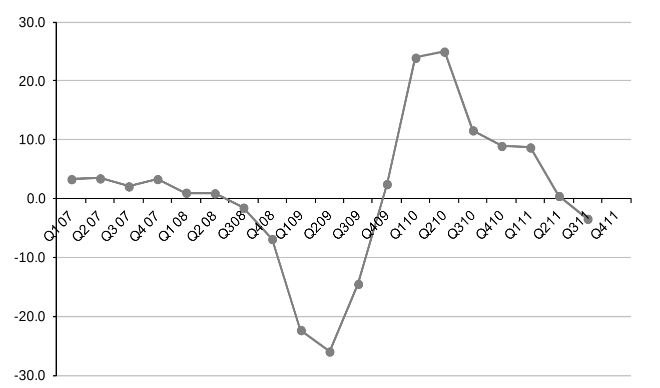
Source: Company data, Nomura European Chemical

Fig. 7: Performance Chemicals in Europe – increasing price with increasing VAM price



Source: Company data, Nomura European Chemical report

Fig. 8: Performance Chemicals in Europe – falling volume on account of increasing price

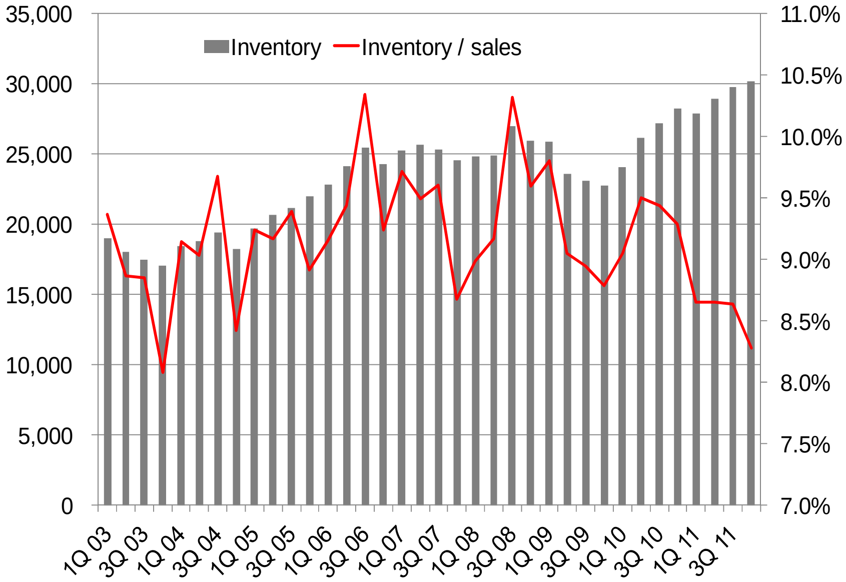


Sour e: Company data, Nomura European Chemical report

According to our European chemicals team, de-stocking is expected to continue until Q1FY13, post which we expect Pidilite's sales volumes in the industrial-product segment to jump on account of new stocking. As shown below, although inventory value has increased due to price increases, inventory/sales is decreasing, indicating de-stocking by chemical companies in Europe. For details, kindly refer to Nomura report "*Chemicals vol. declines in line with forecasts*" dated 30 Jan 2012 and "*Industrial chemicals offer best value*" dated 20 Jan 2012.

Fig. 9: **Inventory levels for a sample of European chemicals customers**

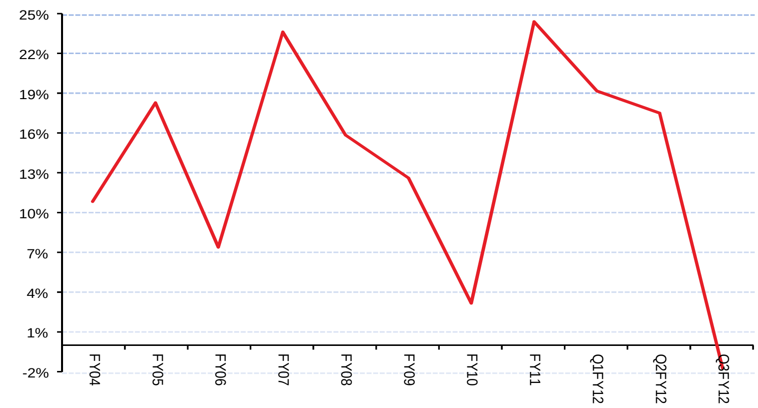
Inventories in EUR m(LHS) and Inventory/sales ratio in % (RHS)



Source: Bloomberg, Nomura research, Nomura European Chemical report

In India, because of declining VAM prices, clients are demanding lower prices. However the management team of Pidilite has indicated that it is willing to sacrifice orders in the short term and will continue to focus on margins. We believe as VAM prices stabilise, the company's domestic sales in this business will regain its growth trajectory in FY13F.

Fig. 10: Industrial Product – volume growth has been impacted on account of de-stocking & delay in purchase by clients



Volume growth has been impacted in this business on de-stocking of products and delay in product purchases from Pidilite. Customers expect product prices to drop on falling raw material prices. We expect volume growth to jump once VAM prices become stable.

Source: Company data, Nomura estimates

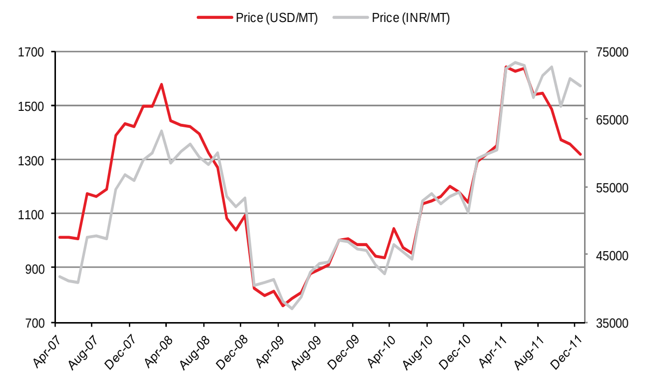
As we factor in the impact of a relatively weak Q3 driven by de-stocking, declining orders in the domestic and export markets, and weak performance in Q3, we scale back our FY12F sales growth forecast from 15.4% to 9.8%. Although we expect a relatively muted Q1FY13F (both in terms of volumes and pricing), we expect that to be offset by significant volume growth (driven by an anticipated restocking) in Q2-Q4FY13F. We maintain our sales growth of ~13.8% and 14.5% for FY13F and FY14F, respectively.

Margins to expand on account of falling VAM prices and appreciation INR vs USD

VAM is the most important raw material for the company. Although VAM constitutes only ~15%-20% of raw material prices, it gives an important indication of the raw material price trend as majority of them is crude derivatives similar to VAM. As shown below, VAM prices had continued to increase and peaked only in Q1FY12 at USD1,640/MT. Since the company imports VAM and other crude-linked raw materials in USD terms, a depreciating India rupee against the US dollar largely negated the benefits from a falling VAM price (in USD terms). Therefore, even as VAM prices declined by ~20% in USD terms from the peak, the decline was ~ 5% in INR terms.VAM prices declined to ~ USD1,300/MT in Dec'11 and according to management, current VAM prices are around ~ USD1,000/MT. As shown below, a falling VAM price trend along with an appreciating INR (versus the USD) will suggest a significant drop in VAM prices in INR terms.

Fig. 11: VAM Prices in USD and INR

Price in USD/MT (LHS) and in INR/MT(RHS)



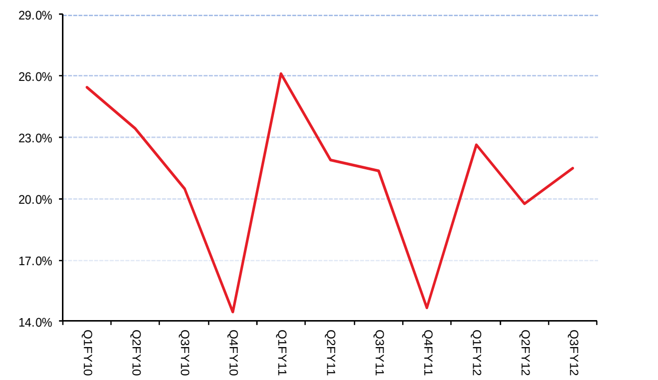
Source: Bloomberg, Nomura research

Fig. 12: Strengthening INR versus the USD will be positive

Source: Bloomberg, Nomura research

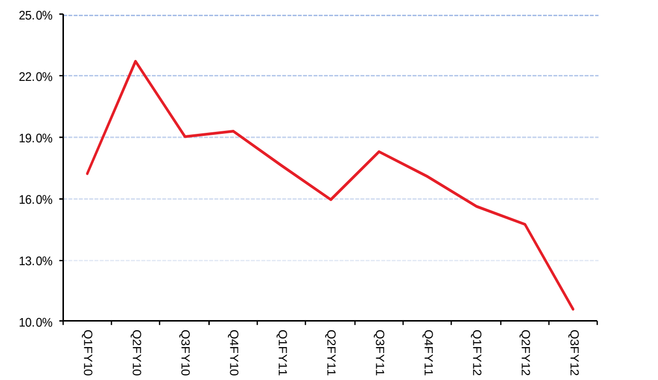
In order to offset the raw material headwinds such as rising VAM prices (in INR terms), the company has been hiking prices especially for products in the consumer and bazaar segment. However, margins in the industrial-product business (a B to B business) have been declining as the impact of rising raw material prices manifests itself after a lag of three to six months. We now believe that the margins in the industrial-product business have bottomed out. We expect a margin expansion in both the business segments given the fall in VAM prices (in INR terms as well).

Fig. 13: Improvement in consumer & bazaar EBIT margin - backed by price hike



Source: Company data, Nomura research

Fig. 14: Industrial Product EBIT margin at its bottom – to improve with fall in AM price



Sources : Company data, Nomura research

While we have moderated our gross margin assumption (by 70bps) for FY12F as we factor in the outcome in 3Q and the presence of the high-price VAM inventory, we now increase our gross margin assumptions by ~160bps for FY13F-14F.

Fig. 15: Sensitivity of Gross Margins to VAM price movement in INR

Sensitivity of gross margins to VAM price fluctuation								
VAM price movement (in % terms)	10%	5%	-5%	-10%	-15%	-20%	-25%	-30%
Gross Margin expansion (compression) in basis points	-69	-35	35	69	104	139	173	208

Source: Nomura estimates based on applying the sensitivity to 2011 gross margins after varying VAM prices but assuming that all factors remain constant

Probability of shelving/ divestment of the elastomer project high, in our view

While the outcome of the elastomer project's consultant review has been delayed to March 2012, given that the project continues to be on hold, and considering media reports(*http://www.yourmoneysite.com/+Pidilite+to+sell+its+elastomer+plant&ct=clnk*) suggesting a potential divestment, we believe that the probability of the management team not going ahead with this project is now higher. We had highlighted the risks with this project in our report published on 29 Nov'11 "Risks outweigh rewards concerns around the elastomer project". We believe that even if the outcome is to shelve the project, it will remove an overhang on the stock's multiple and potentially re-rate the stock more in line with some of the consumer names such as Asian (which we value at 25x 1-year forward P/E multiple).

Our detailed analysis of the elastomer project (INR5bn-plus investment, of which INR3.5bn or a quarter of the group total capital employed, has already been invested) indicates that it will be difficult for the project's ROCE to exceed the group's cost of capital even in the next three years. This is likely, in our view, especially considering that the end market primarily exports to the auto-component industry globally, where the outlook has moderated significantly and the global demand has been decreasing in the past few years. The project has already been delayed once from March 2010 to FY13 because of the economic crisis. The company plans to commission the first phase of the 20,000tpa(final capacity 35,000tpa) unit by the 1HFY13, but we believe that there is a possibility of a further delay given the macro backdrop. Even assuming that the plant starts operations, we believe that it will largely be reliant on exports and the company will at best be a marginal player (with ~4.5% capacity share in the global market) in a product where global supply is significantly higher than consumption. According to management, the company has sought external advice in the form of an international consultant to re-assess the prospects of this project, the outcome of which is likely to be disclosed after the end of FY12.

Fig. 16: Assessing the Economics of the Elastomer (Polycholoroprene) project

Metric	FY13 E	FY14 E	FY15 E	Comments
Capacity (in Tonnes/year)	20000	20000	20000	
Utilization Rates	50%	70%	85%	Progressive improvement in utilitzation rates
Implied Sale Volume (in Tonnes/year)	10000	14000	17000	
Price (in USD/tonne)	**5100**	**4590**	**4131**	Assumed a scenario of a 10% decline in global polychloprene prices, which given the macro backdrop and global demand supply situation, we think it is possible. Indeed, we foresee a significant risk in prices, given that this product is being substituted, the global supply of polychloroprene (of c452 thousand metric tonnes) is significantly more than the global consumption (estimate it to be approximately c310 thousand metric tonnes)
Sales in INRm	2504.1	3160	3453	Assuming USD/INR of 49.17
EBITDA margin	20%	22%	23%	Management has guided for a 30% margin, but we are conservative as the projects plans to export c80% of its production. With global supply significantly exceeding global demand, this means margins will likely remain subdued even as capacity utilization ramps up
EBITDA INRm	500.82	695	794	
Depreciation	-500	-500	-500	Assuming a straight line depreciation of the 500 crore investment in 10 years
EBIT in INR m	0.82	195	294	
Capital Employed INRm	5000	4500	4000	
ROCE post tax	0%	4%	7%	Assuming a 0% tax rate given that the project enjoys a tax break for 10 years
WACC	13%	13%	13%	

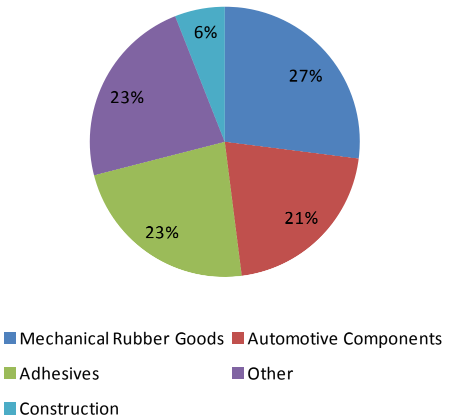
Source: Nomura estimates

Polycholoroprene demand — moderated due to increasing substitution from competing polymers

As per management, Pidilite's plant in Dahej, Gujarat, is expected to manufacture a specific variety of elastomer called Polycholoroprene (CR), but the demand for this has been moderating globally. Polycholoroprene rubber or chloroprene rubber (CR) is noted primarily for its high resilience and very strong resistance to ozone, flame and weathering. It also possesses high strength and offers good resistance to abrasion, oxidants, oil and aging. Among its drawbacks are fair dielectric properties, mediocre resistance to low temperatures and a high price relative to competing elastomers.

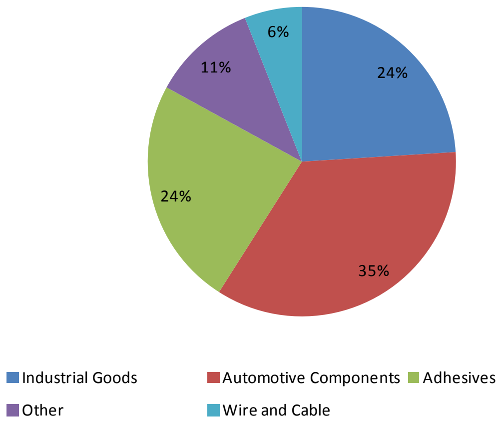
CR is primarily used in industrial and automotive rubber goods such as hoses and belts, waterborne adhesives and dipped goods, such as gloves as well as in footwear. Apart from the traditional rubber applications, an extensive range of special lattices and adhesive raw materials based on chloroprene rubber can also be produced. This is a premium application with higher margins than the other CR businesses.

Fig. 17: End market for Polycholoroprene in the US



Source: Chemical Economics Handbook June 2009, Review of Polycholoroprene

Fig. 18: End market for Polycholoroprene in Europe



Source: Chemical Economics Handbook June 2009, Review of Polychloroprene

Global demand for CR has been muted in recent years. This is due to its relatively high price and increasing substitution from competing elastomers. This trend has been most notable in the automotive sector, which represents more than a quarter of the global consumption. As engine temperatures increases, the need for thermoplastic or elastomers with higher heat resistance increases. Even in adhesive, which is the second-biggest segment, there has been a general trend toward growth of water-based formulations at the expense of solvent-based products

Fig. 19: Key substitutes for Polycholoroprene

Name	Heat Resistance versus CR	Price versus CR	Comment on why polycholoprene is being substituted
Ethylene propylene diene Monomer rubber	Higher	Low er	Consumption in the automotive sector is expected to decline as the average temperature in car engines increases and pushes past the threshold w here polychloroprene loses its elastomeric properties. In adhesives there has been a general trend tow ard grow th of w ater-based formulations at the expense of solvent-based products. In 2008, solvent-based adhesives represented 14% of the European market. Polychloroprene consumption in adhesives is expected to mirror this dow nw ard trend, as greater amounts of w ater-based adhesives are consumed.
Acrylonitrile-butadiene rubber	Higher	Low er	
Hydrogenated nitrile-butadiene rubber	Higher	Low er	

Source: Chemical Economics Handbook June 2009, Review of Polycholoroprene

Over the past few years, consumption of CR has increased in China but has declined in North America, Western Europe and Japan.

Competitive landscape for the Polycholoroprene business
Only a handful of producers currently produce chloroprene. Lanxess is the only significant producer in Europe and one of the biggest players globally that has been investing in new capacity. This is in contrast to what many others are doing. Dupont (DD US, not covered), the largest producer, decided to shut down one of its plants in 2007. Declining demand and issues with raw material supply specifically chlorine also caused Polimeri Europa to close its plant in France which was acquired by Pidilite.

Fig. 20: Competitive assessment of the Polycholoroprene under the Porter's 5 forces

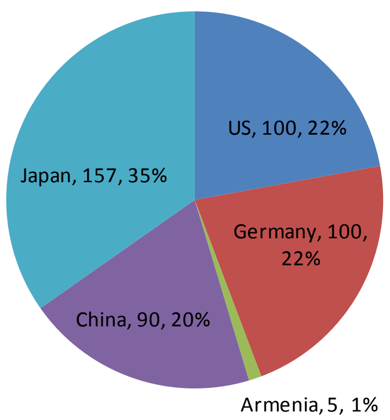
Force	Elements	Level of threat
Buyer Power	Sales to a wide variety of customers in different end markets	Moderate
Supplier Power	Supply using long-term contract with one or two suppliers. Dependence on supplier is high	High
Competition	Not much capacity is expected	Moderate
Substitutes	**Chloroprene is being substituted by other cheaper rubbers in many applications.**	**Very High**
Potential Entrants	Technology not a barrier. Raw material sourcing and time to build a new plant are the key barriers	Moderate

Source: Nomura research

A snap shot of the global demand supply, increasing Chinese presence
The key producers of Polycholoroprene globally have been the US (Dupont), Germany (Lanxess), Japan (Denki Kagaku Kogyo, Tosoh Corporation and Showa), which are also net exporters of the products. China, which was reliant on imports till 2008, has added significant capacity in recent years and now controls ~20% of the global capacity.

Two major **manufactures** in China are Changshou Chemical General and Shanxi Synthetic Rubber Group.

Fig. 21: **Geographic Distribution of Polycholoroprene Capacity (total of 452,000 metric tonnes)**



Source: Chemical Economics Handbook January 2011 from the Elastomer Overview

Change in estimates & valuation

As discussed above, the consumer and bazaar segment continues its strong top-line growth driven by new products. The company reported strong consolidated sales growth of ~16% in Q2, which was better than our expectation. We also factor in a potential re-stocking effect in Q2-Q4 FY13. Adjusting for these, we increase our sales growth forecasts over FY12F-14F. We also increase our margin assumptions as we factor in raw material tailwinds from falling VAM prices along with a depreciating INR that is expected to positively impact the EBITDA margin.

Fig. 22: Change in estimates – margin to expand, growth to moderate in industrial product

INR mn

	Old			New			% Change		
	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F
Revenue	31,039	36,326	42,710	31,283	36,801	43,400	0.8%	1.3%	1.6%
- growth	*17.4%*	*17.0%*	*17.6%*	*18.3%*	*17.6%*	*17.9%*	*0.9%*	*0.6%*	*0.4%*
EBITDA	5,196	5,941	6,960	5,020	6,598	7,756	-3.4%	11.1%	11.4%
- margin	*16.6%*	*16.2%*	*16.2%*	*15.9%*	*17.8%*	*17.8%*	*-0.7%*	*1.6%*	*1.6%*
Profit	3,318	3,785	4,481	3,187	4,265	5,048	-4.0%	12.7%	12.7%
EPS (INR)	6.54	7.46	8.83	6.28	8.40	9.94	-4.0%	12.7%	12.7%

Source: Nomura estimates

Fig. 23: Change in estimates - segmental growth rate

	Old			New			Change		
	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F
Consumer & Bazaar	18.2%	18.0%	18.4%	20.9%	18.7%	18.8%	2.7%	0.7%	0.4%
Industrial Product	15.4%	13.8%	14.5%	9.8%	13.8%	14.5%	-5.6%	0.0%	0.0%

Source: Nomura estimates

We continue to value the stock at 17.5x one-year forward P/E multiple (broadly in line with its 3-year average) on FY14F adj EPS of INR9.94 to arrive at our revised target price of INR174. Despite the company's strong brand and market positioning, we will wait for the resolution of the outcome of the elastomer project before assuming a multiple more in line with other consumer names in India.

Investment risk

Fluctuation economic activities or construction industry

Since a major part of Pidilite's revenue is derived from the construction sector, any deviation in the level of construction activities would have an impact our earnings estimates.

Outcome of the Elastomer project investment

According to management, Pidilite has spent INR3,500mn on an elastomer plant in Dahej, Gujarat, and is expected to spend another INR2,000mn. Commencement of this project, which was previously expected in FY13 (after it was delayed earlier due to the economic crisis in March 2010), has been put on hold as it is being reviewed by an external consultant. The outcome of this consultant review is now delayed to the end of March (possibly alongside the full-year FY12 results). This outcome will have a material impact on the stock price, in our view.

Raw material price volatility

Vinyl Acetate Monomer (VAM) is Pidilite's main raw material, and its price is governed mainly by its own demand, supply dynamics; however, it is also dependent on the price of the crude oil. High volatility in raw material prices can impact margins if the company is unable to pass on the price increase to its end customers.

Currency fluctuation

Pidilite currently imports nearly all of its VAM requirement and exports to more than 80 countries, but its net exposure is only INR1bn, according to management. It also has an outstanding FCCB debt of USD33.3mn (as of 2Q FY 2012). Any adverse movement in the USD-INR exchange rate would be unfavorable if thecompany has to pay back debts.

Appendix A-1

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Mentioned companies

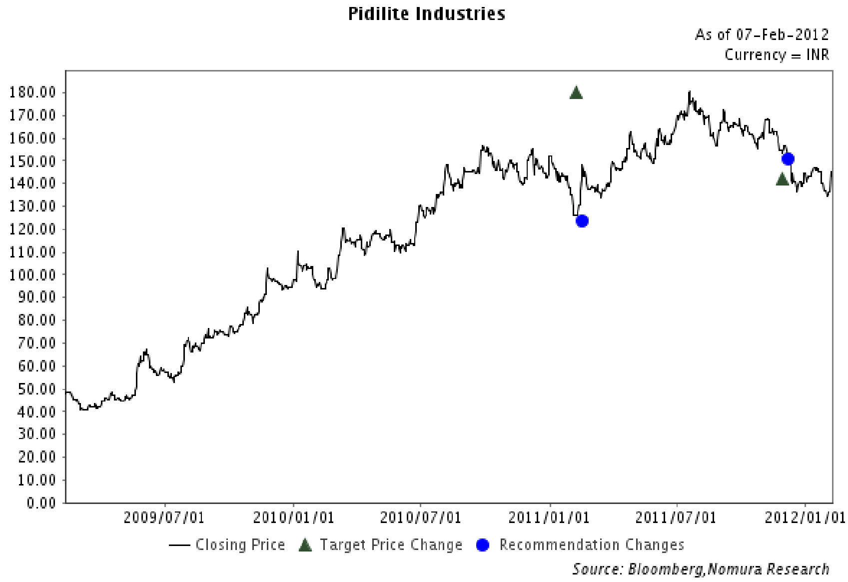
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Pidilite Industries	PIDI IN	INR 143	07-Feb-2012	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Pidilite Industries	Reduce	08-Feb-2012

Pidilite Industries (PIDI IN) **INR 143 (07-Feb-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
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 target P/E multiple of 17.5x (FY14F adj EPS of INR9.94) is in line with the three-year average; our target price is INR174.

Risks that may impede the achievement of the target price **Slowdown in economic activities or construction industry - since a major part of Pidilite's revenue is derived from the construction sector, any slowdown in construction activities would have an impact on our earnings estimates. Elastomer Plant in Dahej, Gujarat - according to management, Pidilite has spent INR3,100mn on an elastomer plant in Dahj, Gujarat, and is expected to spend another INR2,000-2,250mn. Commencement of operations, expected in March 2010, has been delayed by the economic crisis; it is now expected to start in FY13. Given the significant investment, any failure could lead to considerable write-offs. High volatility in raw material Vinyl Acetate Monomer (VAM) is Pidilite's main raw material, and its price is linked to crude oil. High volatility in raw material prices can squeeze margins, or the company might be stuck with high-priced inventory, resulting in write-offs. This is what happened in FY09. Currency fluctuation - Pidilite currently imports nearly all of its VAM requirement and exports to more than 80 countries, but its net exposure is only Rs1bn, according to management. It also has an outstanding FCCB debt of USD37.2mn. Any adverse movement in the US dollar-Indian rupee exchange rate would be unfavourable if the company has to pay back debt. Overseas subsidiaries - some of Pidilite's subsidiaries (Egypt, Dubai) are still making losses, although there have been reductions in these losses. With the economic recovery in the West likely to take longer, Pidilite's overseas subsidiaries might continue to report losses. Economic**

downturn - Pidilite's growth is based on consumption and construction activity. Any downturn in the economy would lead to a cut in these activities, thereby affecting the company's earnings.

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

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