Marico Industries MRCO.NS MRCO IN

GENERAL CONSUMER

NOMURA
EQUITY RESEARCH

Back to being a well-oiled machine

Improving fundamentals into FY14; new businesses to aid LT growth. Upgrade to Buy

May 28, 2013

Rating Up from Neutral	**Buy**
Target price Increased from 220	INR 255
Closing price May 22, 2013	INR 219
Potential upside	+16.4%

Action: Performance to improve into FY14; upgrade to Buy

Over the past few quarters, Marico has underperformed the FMCG index, as performance of its key brands Parachute and Saffola has lagged the LT average. Its international business, too, has faced disruptions, but the company foresees a more stable environment for the division ahead. We believe Parachute will see a turnaround starting 1QFY14F on modest price cuts, while improvement in Saffola will be visible in FY14 but more measured. Focus will also likely turn to improving the profitability of its international business, which should help to consolidate margins over the next few years. New businesses (packaged foods + youth brands) are growing at 20%-plus pa and are the likely long-term growth pillars for Marico. However, we believe this turnaround is not built into current valuations. Hence, we are turning buyers ahead of the improvement.

Catalysts: Pick-up in volume growth and low input prices

We see two catalysts for the stock over the next couple of quarters. First, we expect a pick-up in volume growth over the next few quarters. Second continuing stability in input costs should help to improve domestic business margins. International business should also perform better going forward, post the subdued performance of 4QFY13F.

Valuation: Trading at 23x FY15F P/E – below sector average

Marico trades at 23x FY15F EPS of INR 9.5, vs mid-cap peers such as Dabur at 25x. We expect valuations to converge to the sector average over the next few quarters. We see Marico as a solid long-term story in India's FMCG space, with exposure to mature segments (eg, hair oil) and high-growth segments (eg, oats, muesli, deodorant, hair gel, etc).

31 Mar	FY13		FY14F		FY15F		FY16F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	45,962	56,138	54,715	64,994	63,477		73,698
Reported net profit (mn)	3,959	5,297	5,031	6,462	6,149		7,424
Normalised net profit (mn)	3,627	5,297	5,031	6,462	6,149		7,424
FD normalised EPS	5.62	8.21	7.80	10.02	9.54		11.51
FD norm. EPS growth (%)	13.7	20.7	38.7	22.0	22.2		20.7
FD normalised P/E (x)	38.9	N/A	28.1	N/A	23.0	N/A	19.0
EV/EBITDA (x)	23.4	N/A	18.9	N/A	15.7	N/A	13.1
Price/book (x)	7.1	N/A	5.8	N/A	4.8	N/A	3.9
Dividend yield (%)	0.4	N/A	0.4	N/A	0.6	N/A	0.8
ROE (%)	25.3	29.8	22.8	28.0	22.8		22.5
Net debt/equity (%)	26.4	8.3	9.4	net cash	0.1		net cash

Source: Company data, Nomura estimates

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

Anchor themes

Marico has a strong market position and established brands which should help to grow its domestic business. Exposure to fast-growth categories such as deodrants, hair gels, and oats will be a long-term growth driver.

Nomura vs consensus

Our EPS estimates are 5-6% ahead of consensus for FY14F and FY15F. We believe consensus has yet to capture the upside risk to margins over the next couple of years.

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

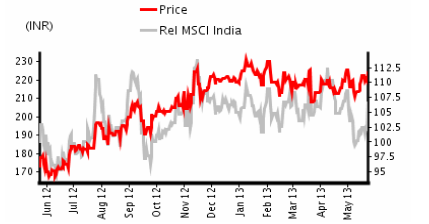
Key data on Marico Industries

Income statement (INRmn)

Year-end 31 Mar	FY12	FY13	FY14F	FY15F	FY16F
Revenue	**40,083**	**45,962**	**54,715**	**63,477**	**73,698**
Cost of goods sold	-20,987	-22,099	-26,403	-30,727	-35,797
Gross profit	**19,096**	**23,863**	**28,312**	**32,750**	**37,901**
SG&A	-11,904	-14,665	-17,250	-19,767	-22,745
Employee share expense	-3,073	-3,806	-4,436	-5,030	-5,695
Operating profit	**4,119**	**5,392**	**6,626**	**7,953**	**9,462**
EBITDA	**4,844**	**6,258**	**7,612**	**8,994**	**10,562**
Depreciation	-725	-866	-986	-1,041	-1,100
Amortisation					
EBIT	4,119	5,392	6,626	7,953	9,462
Net interest expense	-424	-580	-600	-600	-600
Associates & JCEs					
Other income	326	375	425	525	650
Earnings before tax	**4,021**	**5,187**	**6,451**	**7,878**	**9,512**
Income tax	-783	-1,462	-1,355	-1,654	-1,998
Net profit after tax	**3,238**	**3,725**	**5,096**	**6,224**	**7,514**
Minority interests	-50	-98	-65	-75	-90
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	**3,189**	**3,627**	**5,031**	**6,149**	**7,424**
Extraordinary items	-18	332	0	0	0
Reported NPAT	**3,171**	**3,959**	**5,031**	**6,149**	**7,424**
Dividends	-500	-515	-588	-882	-1,103
Transfer to reserves	**2,671**	**3,444**	**4,443**	**5,267**	**6,322**
Valuation and ratio analysis					
Reported P/E (x)	42.5	35.7	28.1	23.0	19.0
Normalised P/E (x)	42.2	38.9	28.1	23.0	19.0
FD normalised P/E (x)	44.3	38.9	28.1	23.0	19.0
FD normalised P/E at price target (x)	44.5	39.1	28.2	23.1	19.1
Dividend yield (%)	0.4	0.4	0.4	0.6	0.8
Price/cashflow (x)	50.4	14.3	30.2	22.6	19.0
Price/book (x)	11.8	7.1	5.8	4.8	3.9
EV/EBITDA (x)	30.5	23.4	18.9	15.7	13.1
EV/EBIT (x)	35.8	27.2	21.7	17.8	14.6
Gross margin (%)	47.6	51.9	51.7	51.6	51.4
EBITDA margin (%)	12.1	13.6	13.9	14.2	14.3
EBIT margin (%)	10.3	11.7	12.1	12.5	12.8
Net margin (%)	7.9	8.6	9.2	9.7	10.1
Effective tax rate (%)	19.5	28.2	21.0	21.0	21.0
Dividend payout (%)	15.8	13.0	11.7	14.3	14.9
Capex to sales (%)	2.9	21.9	2.0	1.7	1.7
Capex to depreciation (x)	1.6	11.6	1.1	1.1	1.2
ROE (%)	30.8	25.3	22.8	22.8	22.5
ROA (pretax %)	18.3	18.2	18.6	20.3	21.4
Growth (%)					
Revenue	28.1	14.7	19.0	16.0	16.1
EBITDA	15.9	29.2	21.6	18.2	17.4
EBIT	18.6	30.9	22.9	20.0	19.0
Normalised EPS	34.1	8.5	38.7	22.2	20.7
Normalised FDEPS	28.0	13.7	38.7	22.2	20.7
Per share					
Reported EPS (INR)	5.16	6.14	7.80	9.54	11.51
Norm EPS (INR)	5.19	5.62	7.80	9.54	11.51
Fully diluted norm EPS (INR)	4.95	5.62	7.80	9.54	11.51
Book value per share (INR)	18.59	30.73	37.74	46.07	56.09
DPS (INR)	0.81	0.80	0.91	1.37	1.71

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	2.3	-0.8	29.7
Absolute (USD)	-0.8	-3.1	29.1
Relative to index	-2.6	-4.4	4.2
Market cap (USDmn)	2,541.4		
Estimated free float (%)	36.0		
52-week range (INR)	238.5/165.35		
3-mth avg daily turnover (USDmn)	0.96		
Major shareholders (%)			
Arisaig Partners (Asia) Pte	5.8		
Oppenheimer Developing Markets Funds	5.0		

Source: Thomson Reuters, Nomura research

Notes

Cashflow (INRmn)

Year-end 31 Mar	FY12	FY13	FY14F	FY15F	FY16F	Notes
EBITDA	4,844	6,258	7,612	8,994	10,562	
Change in working capital	-748	59	-1,405	-1,053	-1,233	
Other operating cashflow	-1,293	3,580	-1,522	-1,696	-1,902	
Cashflow from operations	**2,803**	**9,897**	**4,684**	**6,245**	**7,428**	
Capital expenditure	-1,167	-10,072	-1,094	-1,095	-1,278	
Free cashflow	**1,635**	**-175**	**3,590**	**5,150**	**6,150**	
Reduction in investments	-2,067	1,440	0	-2,000	-2,000	
Net acquisitions	0	0				
Reduction in other LT assets	77	223	0	0	0	
Addition in other LT liabilities	0	58	-58	0	0	
Adjustments	0	0	0	0	0	
Cashflow after investing acts	**-354**	**1,546**	**3,532**	**3,150**	**4,150**	
Cash dividends	-500	-515	-588	-882	-1,103	
Equity issue	1	30	0	0	0	
Debt issue	-30	284	-1,500	-2,000	-2,000	
Convertible debt issue	0	0	0	0	0	
Others	0	0	0	0	0	
Cashflow from financial acts	**-530**	**-200**	**-2,088**	**-2,882**	**-3,103**	
Net cashflow	**-884**	**1,346**	**1,444**	**267**	**1,047**	
Beginning cash	2,205	1,321	2,667	4,112	4,379	
Ending cash	1,321	2,667	4,112	4,379	5,427	
Ending net debt	6,302	5,240	2,295	28	-3,020	

Source: Company data, Nomura estimates

Balance sheet (INRmn)

As at 31 Mar	FY12	FY13	FY14F	FY15F	FY16F	Notes
Cash & equivalents	1,321	2,667	4,112	4,379	5,427	
Marketable securities	0	0	0	0	0	
Accounts receivable	5,494	6,082	7,195	8,348	9,692	
Inventories	7,202	8,627	9,744	11,304	13,124	
Other current assets	0	0	0	0	0	
Total current assets	**14,017**	**17,376**	**21,051**	**24,031**	**28,243**	
LT investments	2,956	1,516	1,516	3,516	5,516	
Fixed assets	5,019	14,224	14,332	14,386	14,563	
Goodwill	3,955	3,955	3,955	3,955	3,955	
Other intangible assets	0	0	0	0	0	
Other LT assets	223	0	0	0	0	
Total assets	**26,170**	**37,072**	**40,855**	**45,889**	**52,278**	
Short-term debt	0	0	0	0	0	
Accounts payable	5,672	7,727	8,476	9,849	11,454	
Other current liabilities	1,197	1,214	1,290	1,576	1,902	
Total current liabilities	**6,869**	**8,941**	**9,766**	**11,425**	**13,357**	
Long-term debt	7,623	7,907	6,407	4,407	2,407	
Convertible debt	0	0	0	0	0	
Other LT liabilities	0	58	0	0	0	
Total liabilities	**14,491**	**16,906**	**16,173**	**15,832**	**15,764**	
Minority interest	249	351	351	351	351	
Preferred stock	0	0	0	0	0	
Common stock	615	645	645	645	645	
Retained earnings	10,815	19,170	23,686	29,061	35,518	
Proposed dividends	0	0	0	0	0	
Other equity and reserves	0	0	0	0	0	
Total shareholders' equity	**11,430**	**19,815**	**24,330**	**29,705**	**36,163**	
Total equity & liabilities	**26,170**	**37,072**	**40,855**	**45,889**	**52,278**	
Liquidity (x)						
Current ratio	2.04	1.94	2.16	2.10	2.11	
Interest cover	9.7	9.3	11.0	13.3	15.8	
Leverage						
Net debt/EBITDA (x)	1.30	0.84	0.30	0.00	net cash	
Net debt/equity (%)	55.1	26.4	9.4	0.1	net cash	
Activity (days)						
Days receivable	45.0	46.0	44.3	44.7	44.8	
Days inventory	115.2	130.7	127.0	125.0	124.9	
Days payable	89.0	110.7	112.0	108.8	108.9	
Cash cycle	71.2	66.0	59.3	60.9	60.8	

Source: Company data, Nomura estimates

Marico has underperformed mid-cap peers and FMCG index

Since the start of the year, Marico has significantly underperformed both the FMCG index as well as mid-cap peers such as Dabur, Emami and Godrej Consumer. YTD, the FMCG index has risen +13%, vs Marico 0%, Dabur +22% and GCPL +16%. We believe the underperformance clearly reflects the company's performance over the past couple of quarters, when it saw its volume growth momentum slow significantly.

Fig. 1: Stock underperformance, YTD

Stock	Ticker	22-May-13	1-Jan-13	YTD
GSK Consumer	SKB IN	4,957	3,834	29%
United Spirits	UNSP IN	2,484	1,953	27%
Emami	HMN IN	747	599	25%
Dabur	DABUR IN	157	129	22%
ITC	ITC IN	336	287	17%
Godrej Consumer	GCPL IN	838	724	16%
FMCG Index	**BSETMCG**	**6,703**	**5,946**	**13%**
Hindustan Unilever	HUVR IN	585	531	10%
Asian Paints	APNT IN	4,836	4,423	9%
Nestle India	NEST IN	5,240	4,952	6%
Sensex	SENSEX	20,062	19,581	2%
Marico	**MRCO IN**	**219**	**220**	**0%**
Titan Industries	TTAN IN	275	287	-4%
Colgate Palmolive	CLGT IN	1,412	1,560	-9%
Jubilant Foodworks	JUBI IN	1,100	1,313	-16%

Source: Bloomberg, Nomura research

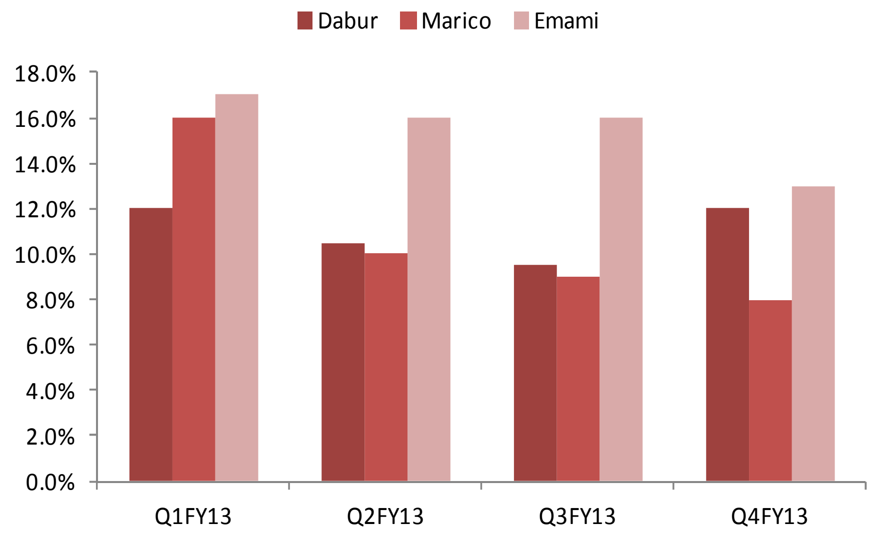
How does performance compare with other mid-cap peers?

If we look at the volume growth performance of mid-cap consumer companies such as Dabur, Marico and Emami, we observe a clear divergence in volume growth trends over the past couple of quarters. While volume growth for Dabur and Emami has clearly moved ahead in the double digits, Marico's growth has slipped into the high single digits. More importantly, Marico's performance over the past couple of quarters suggests a loss of growth momentum, but we argue that this is simply a question of timing on correction of the volume growth trend. Marico has taken price cuts to correct the situation, but as the timing of such price cuts was delayed to mid-4QFY13, the impact on volume growth recovery was not visible in that quarter.

After 3QFY13, we had expected volume growth to return to normalcy in 4Q; however, this has not materialised and some brands continue to grow below trend and the company's medium-term guidance. This has clearly been a dampener for stock performance, with mid-cap peers Dabur, GCPL and Emami outperforming Marico YTD. Even large-cap stocks, where growth has been stable, have outperformed Marico YTD.

However, while this has dampened near-term stock price performance, we believe it does not signal a change in growth trend for the company. Short-term price performance has clearly been influenced by softer growth in some brands, but brand dynamics remain unchanged, and hence a reversal will likely come through over the next few quarters, in our view.

Fig. 2: Domestic mid-cap companies – volume growth performance in FY13



Source: Company data, Nomura research

Key question is, has there been any long-term change in growth trajectory?

As the performance of some mid-cap consumer brands has lagged over the past few quarters, the question that needs to be asked is if there has been any long-term change in the growth trajectory of any of the key brands.

Based on the performance over the past few years, in this note, we assess whether any of the brands are showing signs of a change in the long-term growth trajectory. While we believe there will clearly be issues with the growth rate of Saffola over the next couple of quarters, we see no change to the long-term growth prospects.

Importantly, there are parts of Marico's portfolio such as value-added hair oils, oats, and youth brands which are all growing at a much faster pace than the company average. We believe these categories are future growth drivers and offer Marico long-term visibility on growth.

Marico's international business has faced some issues over the past year or so, but management is confident of turning it around in the near term and believes that FY14F will be a significant improvement over FY13.

We note that management at Marico is one of the best in the domestic consumer industry, with a proven track record of delivering growth and maintaining profitability. It has also demonstrated its ability to build new brands and categories from scratch and grow these profitably. While there have been some disappointments such as Saffola Zest and some HPC products, the overall record is positive.

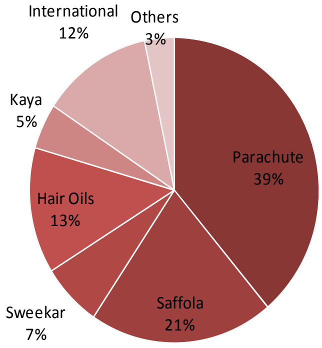
We assess Marico's portfolio in its entirety and look at the growth potential, risks and challenges for each part of the portfolio. A few of our key observations are:

- The portfolio is more balanced now vs five years ago. A more complete value-added hair oil portfolio, a bigger international business, oats, and youth brands have all been added to make the overall portfolio much more balanced.
- Its international business has become more geographically diverse, with significantly less reliance on Bangladesh.
- Long-term growth drivers are now in place, with a presence in categories such as oats, deodorants, hair gels, and hair serums.

More diverse and balanced portfolio vs five years back

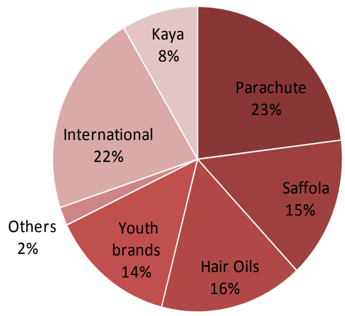
As we exit FY13, we take a look at Marico's portfolio of businesses. As expected, hair oils and edible oils account for a large part of the overall portfolio, but Marico also has a sizeable international business as well as fast-growth categories such as foods (oats + muesli) and youth brands (Set Wet, Zatak, etc).

Fig. 3: Revenue split (FY07)



Source: Company data, Nomura research

Fig. 4: Revenue split (FY13)



Source: Company data, Nomura research

Over the past seven years, management has taken significant efforts to diversify the portfolio away from its two large brands, Parachute and Saffola. On the whole, this has been a successful exercise, we observe, with Parachute and Saffola now accounting for less than 40% of Marico's overall revenue, down from FY07, when Parachute alone accounted for ~39% of revenue, Saffola 21% and Sweekar (a brand since sold) 7%.

The value-added hair oils segment which accounted for 13% of revenue in FY07 is now at 16%, and has been growing at a significant 20%-plus for the past many quarters.

The company has experimented with the packaged foods category (earlier foray into snacking with the Saffola Zest brand), and is now building its presence in the oats and muesli segment. This is a fast-growth segment and one where all players in the market have been growing at 20%-plus over the past two years, as per management. Marico is now the number two player in the market; it has introduced innovations such as 'masala oats' which now account for 60% of overall oats sales for the company.

In FY13, the company also acquired youth brands such as Set Wet and Zatak from Reckitt Benckiser India (unlisted). This portfolio now accounts for 14% of the company's revenues.

Marico's international business has been growing steadily and accounted for 22% of its portfolio as at end-FY13 (from only 12% in FY07).

Kaya, the skin services business, accounted for 8% of revenue in FY07, although this business continues to make losses. However, as per the scheme of separating this business which the company had disclosed in 4QFY13, Kaya will be demerged into a separate company.

As is clearly visible from the above, Marico has a much more balanced portfolio now than it did in FY07. Importantly, this portfolio has not only added more diversification but also comprises several fast-growth segments such as youth brands, oats, etc, which were not present earlier. We believe this implies more robust revenue growth over the next few years.

Analysing the portfolio – strengths, weakness and medium-term prospects

Parachute hair oil

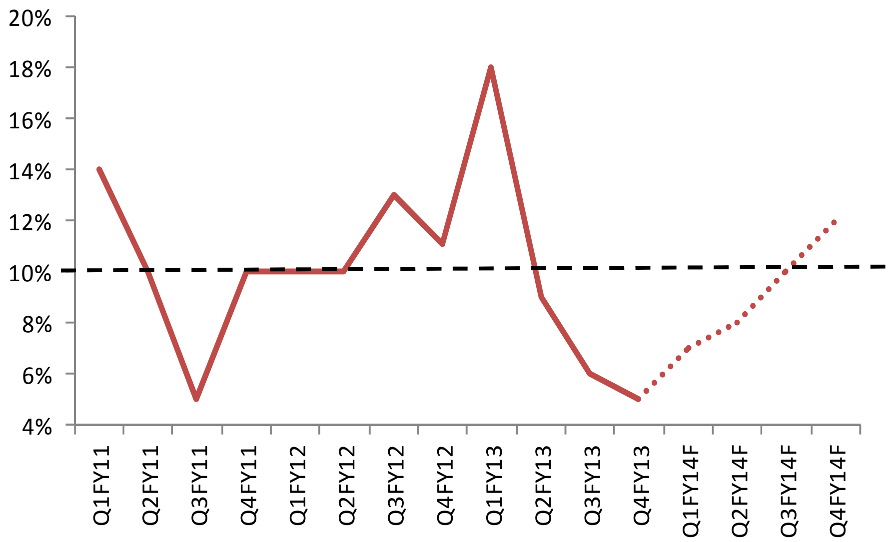
Hair oil, as a category, is growing in India, with the key being not penetration-led growth (category penetration is ~90%) but a shift from loose oil to packaged oil. Parachute is one of the largest brands of hair oil in the country and continues to see consumers shifting from unbranded or loose hair oil.

The key strength for Parachute is its brand value, we believe. Over the past couple of decades, Parachute has established itself as not only one of the key hair oil brands in India, but also as one of the most recognisable across categories in the country. The hair oil category has a high penetration rate of nearly 90%. Clearly, being the marquee brand in the segment, its market share is very high, certainly in the urban market. Parachute, along with Nihar, has a 58% share in the coconut oils segment. Rural market share is 35-40% for both the brands, and we believe, the company continues to have significant upside room to grow in those areas.

A key concern for us over the medium term is for how long will coconut hair oil, as a category, remain relevant in India. However, the company has recognised this risk and has already built an advanced value-added hair oils portfolio, which consumers could move to when they decide to move out of the Parachute hair oil segment. Value-added hair oils and hair gels (under the Parachute brand as well as other sub-brands) will offer consumers a choice within the Marico portfolio in the long-term.

Company guidance of 7-8% volume growth over the medium term appears to take into consideration this risk. We see this number as being achievable over the next three years, but longer-term risks could be to the downside, even if in terms of market share, there is significant upside room certainty in the rural areas. Even the history of the brand performance suggests that a recovery will be reasonably quick, with growth tracking above the 7-8% guidance for majority of the past three years. Thus, we are confident that growth will trend back to that level. In our view, the key to driving volume growth for this brand is to maintain the right level of premium vs other coconut oil options. The company has initiated price cuts already and the impact should be visible over the next couple of quarters, in our view.

Fig. 5: Volume growth trend – Parachute brand



Source: Company data, Nomura research

Saffola edible oil

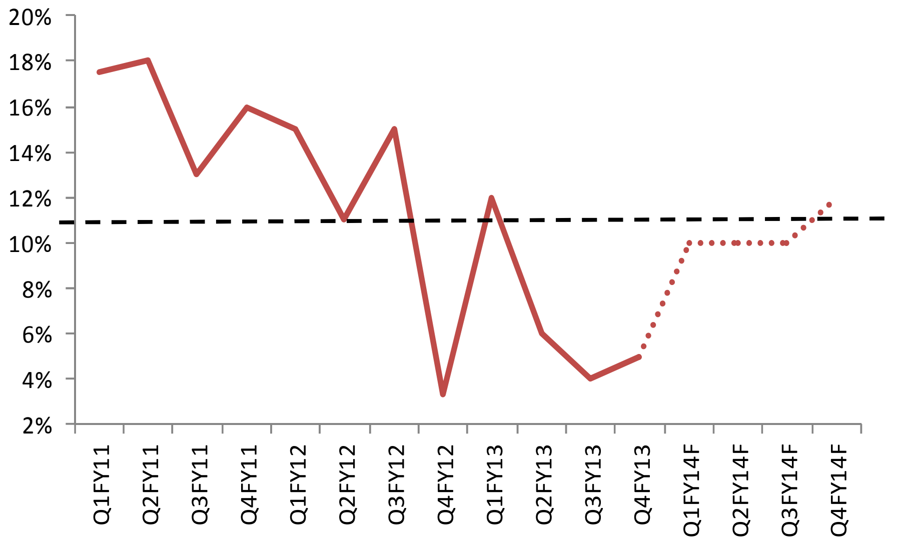
Packaged edible oils is an attractive category in India. Saffola has a 58% share in this space, with opportunity to upgrade consumers from other packaged edible oils being a source of long-term growth.

We believe a key strength of the Saffola brand is the platform of 'heart healthy' on which it has been built. The company has invested significantly in creating the heart healthy image of the brand, with a consistent message being delivered through various forms of advertising. Saffola is marketed as an edible oil which is healthy for the heart, which allows it to be sold at a premium vs other edible oils. As per management, consumers, over the years, have been willing to pay a premium to move from other edible oils to Saffola and continue to do so. However, over the past couple of quarters, this trend of acquisition of new consumers into the Saffola brand has seen a marginal slowdown according to management. However, a key to note is that consumers do not appear to be moving out of the Saffola brand into cheaper alternatives.

A key concern over the medium term will be how to get more consumers to move into the Saffola brand. Driving volume growth organically by existing consumers consuming more is difficult. Hence, the only way to drive volume growth is by migrating consumers from other edible oil brands into Saffola. Over the past few quarters, volume growth has tapered and is well below the long-term average. Competition is also a concern in this segment, as brands such as Fortune have started to advertise aggressively and are also competing to take additional share in the edible oils market. This, we believe, could also force Marico to spend more on A&P for this brand in particular, as well as make promotions more aggressive in the near term.

The company's medium-term guidance is for 12-14% volume growth for the brand. We believe this is still possible, as a large population still consumes various other forms of edible oils in India. However, the cost of growing at that pace may increase over time, as consumers now have more options than before. Our estimates build in lower-than-trend growth for FY14F, with some pick-up in FY15F and beyond.

Fig. 6: Volume growth trend – Saffola brand



Source: Company data, Nomura research

Value-added hair oils

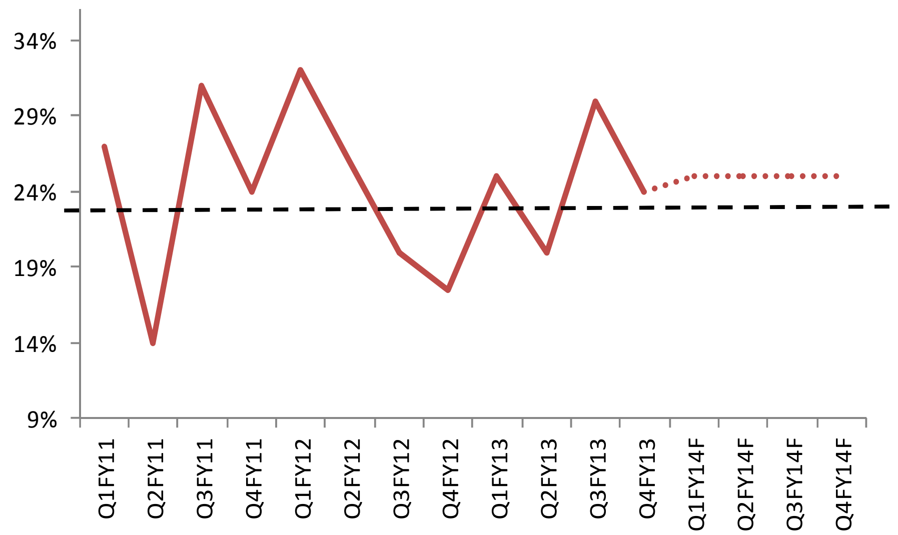
Value-added hair oils have been one of the fastest growing segments in the consumer sector over the past couple of years. Marico, Dabur and Emami all compete within various sub-segments within this category. Various forms of hair oils such as Amla, Badam, cooling oil, etc, are all grouped under this segment. Marico has an offering in most of the sub-segments, which we believe is a positive given that no other company has a portfolio spread comparable with Marico's in this category.

In this segment, Marico has gained share in the Amla hair oil category, while it is largely holding on to its share in other sub segments. In FY13, volume growth in this segment was 24%, which came on the back of strong growth in the previous year as well. Management sees this segment as continuing to be a growth engine, and expects high double-digit growth for the next couple of years.

A key concern in this segment is a slowdown in volume growth over the medium term. While current trends do not suggest that volume growth is likely to slow, the base and the pace of growth are high, hence there remains a risk of a slowdown in headline growth numbers.

Our expectations are similar to management guidance of high double-digit volume growth for the next couple of years. It is also likely that part of the growth could come from consumers moving out of plain coconut oil into value-added hair oil, eg, consumers moving out of plain Parachute oil into Parachute advanced cooling oil. Even history suggests that rarely has the growth trajectory slipped below 20% in the past three years. We expect this trend of 20% growth in value-added hair oils to continue over the next couple of years, and we believe this is a positive as profitability of this segment is higher than the plain coconut hair oil category.

Fig. 7: Volume growth trend – value-added hair oils segment



Source: Company data, Nomura Research

International business

Over the past few years, Marico has built a sizeable international business. In FY07, its international business was largely spread across Bangladesh and MENA (Middle East and North Africa). However, over the past five years, the company has acquired businesses in Vietnam, which implies that its international business portfolio is more geographically diversified now.

FY13 performance was disappointing, with overall revenues largely flat. The Middle East region was a clear laggard and this pulled down the growth rate for the overall business. Bangladesh also faced several issues, which impacted business during the year. Some of the key issues were:

– Parachute business in the Middle East was impacted by distribution restructuring.
– A packaging change was implemented in the hair creams segment in the MENA region, which impacted sales.
– Market closure in Bangladesh in 4QFY13 implies there were only 10 working days in March.
– Its market in Egypt was impacted on account of the closure of ports for a few days which impacted logistics in the region.

Owing to the above mentioned issues, operating margins were also impacted, with FY13 reported margins for the international business coming in at 8%.

However, management expects a significant pick-up in growth going into FY14F. Most of the aforementioned issues were one offs which should not occur again in FY14. The impact of a change in packaging etc is now fully absorbed, hence FY14 should be better.

This turnaround should impact margins positively as well and margins should trend back to double digits in FY14F, as per management. Longer term, management expects margins of the international business to be closer to the company average of 14%. This may take a few years, but management is confident of achieving this goal.

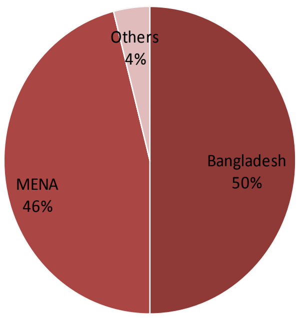
We have two key concerns for the international business:

Our first concern is volatility in quarterly performance. This has been somewhat addressed, with the expansion of its geographical presence across more regions. Performance in Bangladesh is still very important, but the other regions also contribute meaningfully now vs. five years ago (see Figs 8 and 9 below). We see this as a step in the right direction, although some quarterly variations will likely be an ongoing feature. Management has already taken the value-added hair oils segment into Bangladesh, which we think is positive from the perspective of revenue and profitability.

Our second concern is profitability of the international business. FY13 was a weak year for the international business, with EBITDA margin of around 8%. However, management expects to return to the average of the past few years of double-digit EBITDA margins in FY14F.

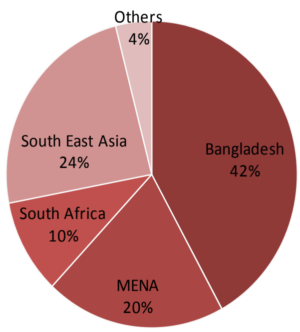
Recovering margins back to double-digit levels is realistic, we think, and we expect the company to deliver on that front. This, in part, can be attributed to the low base of FY13, which was impacted by specific one-off issues in the Middle East and Bangladesh. Management is clearly focused on driving profitability higher and, given its track record of delivering in the past, we would give them the benefit of the doubt.

Fig. 8: International business split (FY07)



Source: Company data, Nomura research

Fig. 9: International business split (FY13)



Source: Company data, Nomura research

Kaya

Kaya is the skin care solutions business that has grown into 105 clinics, with 83 in India, 18 in the Middle East and four Derma RX clinics in Singapore and Malaysia. In FY13, the Kaya business recorded revenue of INR3.36bn (+21% y-y), with same-store-sales growth of 12%.

However, the business continued to report a loss in FY13. Losses at the EBIT level in FY13 were INR185mn, vs a loss of INR308mn in FY12.

As per management's guidance, it has managed to increase the share of products within the business revenue mix from 7% to 11% as at end-FY13. This continues to be a long-term target and one which should give the business more stability in terms of revenue and consumer walk-ins, as per management.

Kaya, however, will be spun-off into a separate company in 2QFY14, once the court approves the demerger. The company announced this scheme at the end of FY12; hence, after the demerger of Kaya, Marico will only have its consumer business (India + international). Although the demerger scheme will take effect from 1 April 2013, the demerger is still a couple of quarters away (expected to be closed by October 2013, as per the company). The company expects the new entity Marico Kaya Enterprises Limited (MaKE) will be listed on the stock exchange in 3QFY14.

In terms of financials, since Kaya continues to post small losses, its demerger will be positive for shareholders of the consumer business. In terms of revenue, Kaya accounts for around 8% of consolidated revenue and this will likely be adjusted downward. However, the company is yet to provide full details on financials, and hence our current numbers still include the Kaya business.

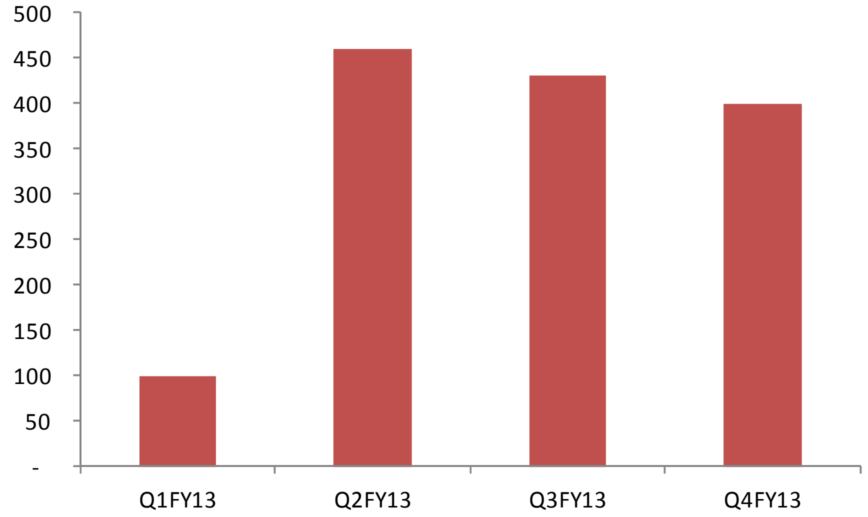
Youth brands

Marico acquired brands such as Set Wet, Zatak and Livon from Reckitt Benckiser in early-FY13. The acquisition aimed to add new pillars of growth for the long term and buy into established brands in an attractive growth category.

The acquisition ticked all the boxes, hence Marico made the acquisition. So far, in FY13, the company has achieved a turnover of INR1.39bn, although this takes into account that the brands have only been with Marico since the start of June 2012.

This is the first year, post the acquisition, and Marico has managed to grow the business by 18%. However, it targets 25-30% growth in the medium term, given the low penetration in these categories (deodorants, hair gels, hair serums) and we expect FY14F to be much more robust in terms of sales growth. As per management, operating margins of this business are in line with its expectations. However, despite the fact that A&P spends are likely to increase in FY14 to support the higher sales growth targets, management is confident that this will be a very profitable business in the medium term.

Fig. 10: Sales of youth brands (FY13)



Source: Company data, Nomura research

Packaged foods

Marico is present in the packaged foods category, with products such as Saffola Arise (packaged rice), Saffola Zest (snack), Saffola diabetes management aata mix, etc. There has been mixed success in this category over the past few years.

However, its more recent entry into the oats category has been a success, and the company now has a 15% share in the market for oats, which management estimates to be worth ~INR3bn, and is growing at around 30% annually. Marico is the number two player in the market, with the market leader being Quaker (unlisted).

In the muesli market, it has re-launched products under the Saffola brand; the total market size is ~INR1bn and Marico has a 9% share in the market. Growth rate in this segment is around 40% annually, albeit off a smaller base.

We believe this is a really attractive growth category from a long-term perspective and Marico's early entry into this segment provides it a good opportunity to establish itself as one of the top-three players in the long term. We believe management has adequate experience in building brands and this should stand it in good stead.

While we do not have any concerns as far as this category is concerned, we believe competition is likely to be strong over the next few years. Hindustan Unilever and Nestle also plan to enter the segment, which should further increase competitive intensity in this segment, we think. (*Source: Economic Times, HUL and Nestle to battle it out for share of the INRR200-crore oats market, January 4, 2013*.) However, with a growth rate of 30% for the oats market, we believe there is room for more players to enter the fray.

Changes to our estimates

We lower our estimates at the headline level. However, this is a result of FY13 numbers coming in lower than our expectations. As discussed above, this was a result of H2FY13 performance being lower than what we had estimated. Once we take FY13 reported numbers into account, there is actually an earnings upgrade, because FY13 sales/ EBITDA numbers were 5%/6% lower than our expectations, while our FY14F numbers are -3%/0% on comparable parameters.

The key change we are making to our numbers is on the margin front. Our earlier expectation was that margins are more likely to remain flat over the next couple of years, given that management has always talked about maintaining margins, while focusing on volume growth. While the overall message remains, we believe management is now also focused on improving group margins. As discussed above, we expect its international business to record a significant margin uplift in FY14F, which should help improve consolidated margins, we estimate.

We are now building in a 30bp margin improvement over each of the next couple of years, driven by: a) its international business; and b) domestic consumer business ex Parachute and Saffola. The value-added hair oils business is more profitable as a segment, and higher growth in that segment should translate into improved profitability, going forward.

Fig. 11: Changes to our estimates

(INR mn)			FY14F			FY15F
	Old	New	Chg (%)	Old	New	Chg (%)
Revenues	56,138	54,715	-3%	64,994	63,477	-2%
EBITDA	7,583	7,612	0%	8,774	8,994	3%
EBITDA margins (%)	13.5%	13.9%		13.5%	14.2%	
Net Income	5,297	5,031	-5%	6,462	6,149	-5%

Source: Nomura estimates

Upgrade to Buy; TP raised to INR255

We expect Marico to report improved volume growth momentum over the next few quarters. While we acknowledge that 1QFY14 may not reflect the extent of improvement that we are building in, we believe this story has several tailwinds behind it over the next few quarters.

The underperformance since the start of the year will correct over time, we expect, as reporting gets better. There are no changes to the long-term fundamentals of the business. Marico continues to have a strong brand portfolio, with consumers willing to pay a premium to move from other options in those segments. Its core brands Parachute and Saffola continue to be market leaders in their respective categories.

Over the past few years, the company has also added a portfolio of brands in categories where growth rates are significantly higher than the company average. We expect the new brand additions to be growth drivers in the medium term.

Our TP moves from INR220 to INR255, as we roll forward to FY15F and we lift our target multiple marginally higher from 24x to 25x to be in line with the multiple we assign to its mid-cap peers such as Godrej Consumer, Dabur and Emami.

Our earlier discount reflected the fact that the Kaya business continued to drag earnings. In addition, Marico had a much less balanced portfolio, with very high reliance on Parachute and Saffola. However, that has now been fixed, with organic growth of the oats and muesli portfolio and acquisition of youth brands which was completed over the past year. Considering these factors and given the similar profiles of other mid-cap peers, we believe the valuation multiples should be similar. Hence, we now value Marico at 25x one-year forward earnings as with other mid-cap peers.

The increase in the multiple for Marico is also marginal, and does not influence our TP upgrade in a big way. Of the 16% increase in our TP, only 4% is on account of the multiple increase. Earnings are a negative, as our FY15F numbers are down 5%, while majority of the increase in TP is on account of the roll-forward.

Cheap valuation vs sector and mid-cap peers

Marico trades at 23x FY15F EPS of INR9.5, a discount to the sector (29.2x) as well as its mid-cap peers such as Dabur (25x), GCPL (23.9x) and Emami (23.5x). Over the next couple of years, we expect Marico to deliver higher earnings growth vs. other mid-cap companies. Given the valuation discount, uptick in volume momentum (we expect in H1FY14), and tailwinds on margins, we expect Marico to significantly outperform its mid-cap peers over the next year. We turn buyers at the current level ahead of our forecasts for improvement in FY14. Marico underperformed in FY13 as profit growth (14%) was lower than peers such as GCPL (44%), Dabur (17%) and Emami (18%). However, we foresee the situation changing in FY14F and beyond, hence we expect the valuation gap to close vs mid-cap peers.

Risks: Sharp increase in input prices will be a material risk to earnings. Also higher than expected increase in A&P spends can mean downside risk to earnings

Fig. 12: Sector valuations

Company	Ticker	Rating	Price INR	EPS growth FY13E %	EPS growth FY14E %	EPS growth FY15E %	FY14E P/E	FY15E P/E	FY15E PEG	Market Cap US$ mn
Nestle *	NEST IN	Neutral	5,240	18%	22%	23%	34.3x	28.0x	1.2x	9,185
GSK Consumer *	SKB IN	Reduce	4,957	24%	20%	21%	40.6x	33.7x	1.6x	3,794
Jubilant Foodworks	JUBI IN	Reduce	1,100	19%	20%	27%	45.8x	35.9x	1.3x	1,305
United Spirits	UNSP IN	Buy	2,484	84%	139%	49%	51.6x	34.6x	0.7x	5,908
F&B Average							**41.3x**	**31.5x**		
Colgate Palmolive	CLGT IN	Neutral	1,412	20%	15%	15%	31.2x	27.1x	1.8x	3,492
Dabur	DABUR IN	Buy	157	17%	20%	18%	29.5x	25.0x	1.4x	4,983
Godrej Consumer	GCPL IN	Buy	838	44%	24%	24%	29.6x	23.9x	1.0x	5,183
Hindustan Unilever	HUVR IN	Reduce	585	14%	14%	11%	36.4x	32.8x	2.9x	23,000
Marico	MRCO IN	Buy	219	14%	39%	22%	28.1x	23.0x	1.0x	2,449
Emami	HMN IN	Buy	747	18%	25%	20%	28.2x	23.5x	1.2x	2,054
HPC Average							**33.4x**	**29.2x**		
ITC	ITC IN	Buy	336	24%	23%	18%	28.2x	23.9x	1.3x	48,208
Asian Paints	APNT IN	Neutral	4,836	20%	20%	20%	33.8x	28.2x	1.4x	8,433
Titan Industries	TTAN IN	Neutral	275	28%	10%	19%	28.9x	24.2x	1.3x	4,443

Source: Bloomberg, Nomura estimates. Note: Prices as on May 22, 2013. * indicates Calendar year pricing

Feedback from management meeting

- The past few quarters have been disappointing in terms of domestic business volume growth, we believe largely owing to slowing consumer demand and a wrong pricing strategy. This has been one of the key concerns that the market has had for the stock. According to the company, however, it has taken quite a few corrective steps and now expects volume growth to rebound as soon as in 1QFY14F, with the complete turnaround expected to happen in the next couple of quarters and a return to the long-term average growth by 3QFY14F. We believe this is quite a positive sign, as 4QFY14 was particularly concerning for Marico, given that amongst the major HPC companies it was the only one that did not witness any growth pick-up.
- As per the company's guidance, Parachute should see 7-8% volume growth on a full-year basis in FY14F (average 5% volume growth in 2HFY13). It has cut prices for the brand in recruiter packs of 100ml (INR2 off) and 250ml and that has already started yielding results, with April being better than the Jan-March average.
- The other flagship brand, Saffola, could see a slow recovery, and it may be a while before there is any significant volume pick-up for the brand. The issues faced are two: a) increased competition in the premium segment from brands like Fortune; and b) increased premium compared with other brands. The latter has been corrected and the major chunk of 2-3% price cuts has been in the 5-litre pack (which is also the highest selling pack-size for the product). The company expects to close the year with double-digit volume growth.
- Over the longer term, marketing strategy for the brand will need to be re-worked due to rising competition. While Saffola has always stood for "good for heart platform", management feela the need to be more specific in communicating the benefits. Also, consumers are generally cutting oil consumption, as per management; hence, growth can only be maintained by getting people to shift brands, something which marketing will need to reflect.
- The value-added hair oil segment continues to be a sweet spot for the company, where it is gaining share particularly in the Amla category. Management is confident of maintaining the 20% growth rate of this business. The key differentiator is that Marico is the only company to offer consumers a portfolio of brands/products to choose from in the category, unlike most competitors who are all single-product players.

- New products such as oats, muesli, youth brands all continue to grow at a fast pace and the outlook for FY14F remains strong. Marico has a ~15% share in the oats category, with revenue of INR450mn in FY13. It expects growth of 25-30% for the overall market, and hence at this point it is not about market share gains. Management expects its youth brands should grow at a sustainable pace of 25% over the next few years, and it plans to start exporting the products to Bangladesh as well.
- Marico's international business has been plagued by a slowdown in Bangladesh and the MENA region, and management expects the situation should start improving gradually over FY14F. Margins of this business are currently fairly low at 8% (FY13), which should start to gradually improve going into FY14F, as per management. The company is talking about increasing the margins of its international business over the next couple of years, with a medium-term target of matching them with overall company margins. If that happens as planned, management estimates Marico should see a steady 30-50bp consolidated margin improvement over the next few years,.
- The outlook for input costs such as copra and vegetable oils remains stable, but given the significant base for gross margins last year, management believes margins are unlikely to see that level of expansion in FY14F. In fact, management estimates EBITDA margins, too, will close flattish for FY14F.

Appendix A-1

Analyst Certification

We, Manish Jain and Anup Sudhendranath, 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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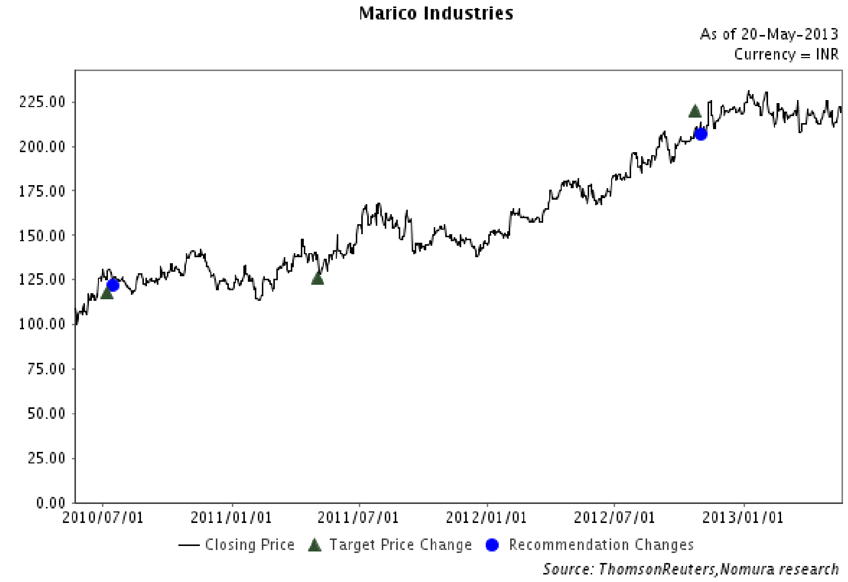
Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Marico Industries	MRCO IN	INR 219	20-May-2013	Buy	Not rated	

Marico Industries (MRCO IN) **INR 219 (20-May-2013)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
23-Oct-12	Neutral		210.00
23-Oct-12		220.00	210.00
04-May-11		126.00	137.90
06-Jul-10	Reduce		125.20
06-Jul-10		118.00	125.20

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

Valuation Methodology Our INR255 target price values Marico at 25x one year rolling forward EPS of INR 10.

Risks that may impede the achievement of the target price Downside risk to our numbers could come from a sharp rise in key raw material prices such as copra.

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STOCKS

A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of '**Suspended**', indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including, but not limited to, when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company. Benchmarks are as follows: **United States/Europe**: please see valuation methodologies for explanations of relevant benchmarks for stocks, which can be accessed at: http://go.nomuranow.com/research/globalresearchportal/pages/disclosures/disclosures.aspx; **Global Emerging Markets (ex-Asia):** MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology.

SECTORS

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

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A Target Price, if discussed, reflects in part the analyst's estimates for the company's earnings. The achievement of any target price may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings differ from estimates.

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