

Havells India (HVEL.BO)

Buy: Good Business; Better Corporate Governance

- Company Update
- Target Price Change

- **Maintain Buy – Top India Industrial pick** — As (1) the India business can comfortably grow at 15-20% in medium term, (2) Havells' pan-India distribution network provides the company with an opportunity to grow its business not only through penetration of small towns/villages but also through new products and (3) Sylvania's margins have recovered, cash flows are stable and debt has reduced.
- **Increasing TP to Rs734 from Rs664** — as we (1) roll over India P/E of 18x and Sylvania EV/EBITDA of 6x to June 2014 from March 2014, (2) peg P/E multiple on EPS excluding brand royalty payment to promoters; as the amount of this payments for next four years is fixed and payments will terminate after 2016 and (3) reduce NPV (at CoE of 13%) of four years of brand royalty payments from valuations.
- **Listed entity will gain Rs400mn/year (~8% of FY13 EPS)** – After 2016, royalty payments from Havells to promoters will stop. Currently, Havells India pays promoters ~1% of sales of Havells brand subject to a cap of Rs400mn per year. This amount is equivalent to ~8% of FY13 EPS.
- **Forgoing consideration for Havells brand is a good (and clever) move** – As valuing the brand would have led to more questions and doubts. If Havells pays out entire saving of Rs400mn as dividend (which is quite likely given healthy cash flows) promoters stand to lose only ~Rs125/year – a small price to pay for enormous goodwill this action has generated.
- **Improving corporate governance is a major positive** — After having increased the dividend payout ratio to 27% (from 13%), the transfer of the brand to a listed entity is second strong signal of improving corporate governance. We view this development as a significant positive as it not only benefits financials but also underlines management's intent to share rewards with minority shareholders.
- **Risks** — Sharp slowdown in Europe is key risk.

Buy	1
Price (08 Jan 13)	Rs645.10
Target price	Rs734.00
	<i>from Rs664.00</i>
Expected share price return	13.8%
Expected dividend yield	1.4%
Expected total return	15.2%
Market Cap	Rs80,492M
	US\$1,458M

Price Performance (RIC: HVEL.BO, BB: HAVL IN)



Figure 1. Havells India – Statistical Abstract

Year to	PAT	EPS	Chg	Adj. P/E	RoE	Cons PAT	Cons EPS	Chg	Conso P/E	ROE	Yield
31-Mar	(RsM)	(Rs)	(%)	(x)	(%)	(RsM)	(Rs)	(%)	(x)	(%)	(%)
2009A	1,451	12.1	-3%	50.4	18.4%	384	3.2	-77.0%	201.9	6.0%	0.2%
2010A	2,287	18.3	52%	33.2	22.1%	701	5.6	75.7%	114.9	13.8%	0.3%
2011A	2,420	19.4	6%	31.4	19.5%	3,071	24.6	338.3%	26.2	58.3%	0.4%
2012A	3,134	25.1	30%	24.2	21.3%	3,703	29.7	20.6%	21.7	46.0%	1.0%
2013E	3,603	28.9	15%	21.1	20.8%	3,813	30.6	3.0%	21.1	35.0%	1.2%
2014E	4,369	35.0	21%	17.4	21.8%	4,858	38.9	27.4%	16.6	34.0%	1.4%
2015E	5,164	41.4	18%	14.7	22.1%	5,801	46.5	19.4%	13.9	32.5%	1.7%

Source: Citi Research estimates

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HVEL.BO: Fiscal year end 31-Mar						Price: Rs645.10; TP: Rs734.00; Market Cap: Rs80,492m; Recomm: Buy					
Profit & Loss (Rsm)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	28,817	36,156	42,609	50,404	59,579	PE (x)	33.3	26.4	22.3	18.4	15.6
Cost of sales	-25,411	-31,599	-37,239	-43,976	-51,981	PB (x)	6.0	5.0	4.3	3.7	3.2
Gross profit	3,406	4,557	5,370	6,428	7,598	EV/EBITDA (x)	22.1	16.3	13.7	11.3	9.3
Gross Margin (%)	11.8	12.6	12.6	12.8	12.8	FCF yield (%)	2.3	2.6	2.9	3.7	4.6
EBITDA (Adj)	3,406	4,557	5,370	6,428	7,598	Dividend yield (%)	0.4	1.0	1.2	1.4	1.7
EBITDA Margin (Adj) (%)	11.8	12.6	12.6	12.8	12.8	Payout ratio (%)	13	27	27	27	27
Depreciation	-293	-447	-524	-601	-664	ROE (%)	19.6	20.7	20.8	21.8	22.1
Amortisation	0	0	0	0	0	Cashflow (Rsm)	2011	2012	2013E	2014E	2015E
EBIT (Adj)	3,113	4,110	4,847	5,827	6,934	EBITDA	3,406	4,557	5,370	6,428	7,598
EBIT Margin (Adj) (%)	10.8	11.4	11.4	11.6	11.6	Working capital	437	-142	-864	-1,037	-1,216
Net interest	-191	-349	-386	-386	-386	Other	-415	-809	-994	-1,209	-1,525
Associates	0	0	0	0	0	Operating cashflow	3,427	3,606	3,513	4,182	4,857
Non-op/Except	177	72	72	72	72	Capex	-1,584	-1,483	-1,194	-1,233	-1,193
Pre-tax profit	3,099	3,833	4,533	5,513	6,620	Net acq/disposals	0	0	0	0	0
Tax	-679	-699	-929	-1,144	-1,456	Other	-1,699	-537	57	57	56
Extraord./Min.Int./Pref.div.	1	-80	0	0	0	Investing cashflow	-3,283	-2,020	-1,137	-1,176	-1,137
Reported net profit	2,421	3,054	3,603	4,369	5,164	Dividends paid	-363	-943	-1,112	-1,348	-1,594
Net Margin (%)	8.4	8.4	8.5	8.7	8.7	Financing cashflow	-335	-715	-1,419	-1,654	-1,894
Core NPAT	2,421	3,054	3,603	4,369	5,164	Net change in cash	-191	870	957	1,352	1,826
Per share data	2011	2012	2013E	2014E	2015E	Free cashflow to s/holders	1,843	2,123	2,318	2,949	3,665
Reported EPS (Rs)	19.40	24.48	28.88	35.01	41.38						
Core EPS (Rs)	19.40	24.48	28.88	35.01	41.38						
DPS (Rs)	2.50	6.50	7.67	9.30	10.99						
CFPS (Rs)	27.47	28.90	28.15	33.51	38.93						
FCFPS (Rs)	14.77	17.01	18.58	23.64	29.37						
BVPS (Rs)	107.45	128.89	148.86	173.07	201.68						
Wtd avg ord shares (m)	125	125	125	125	125						
Wtd avg diluted shares (m)	125	125	125	125	125						
Growth rates	2011	2012	2013E	2014E	2015E						
Sales revenue (%)	21.5	25.5	17.8	18.3	18.2						
EBIT (Adj) (%)	8.3	32.1	17.9	20.2	19.0						
Core NPAT (%)	6.1	26.2	18.0	21.2	18.2						
Core EPS (%)	6.1	26.2	18.0	21.2	18.2						
Balance Sheet (Rsm)	2011	2012	2013E	2014E	2015E						
Cash & cash equiv.	492	1,362	2,319	3,671	5,497						
Accounts receivables	1,121	1,597	1,882	2,226	2,632						
Inventory	4,699	6,489	7,647	9,046	10,692						
Net fixed & other tangibles	7,303	8,340	9,010	9,641	10,170						
Goodwill & intangibles	0	0	0	0	0						
Financial & other assets	8,088	8,682	8,723	8,765	8,810						
Total assets	21,702	26,470	29,580	33,350	37,801						
Accounts payable	3,319	3,472	4,091	4,840	5,721						
Short-term debt	0	0	0	0	0						
Long-term debt	1,336	1,286	1,286	1,286	1,286						
Provisions & other liab	3,639	5,629	5,629	5,629	5,629						
Total liabilities	8,294	10,386	11,006	11,754	12,635						
Shareholders' equity	13,408	16,083	18,575	21,595	25,165						
Minority interests	0	0	0	0	0						
Total equity	13,408	16,083	18,575	21,595	25,165						
Net debt	844	-76	-1,033	-2,385	-4,211						
Net debt to equity (%)	6.3	-0.5	-5.6	-11.0	-16.7						

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For definitions of the items in this table, please click [here](#).

Transfer of Havells Brand to Listed Entity

Increasing role of dividends and reducing importance of brand royalty payment for promoters

- Havells promoters have around a 62% stake in company. A few years ago the proportion of royalty in the payout was significant (~64% of payout). Additionally, the total payout amount to promoters was also very small. With accelerating earnings growth and an increase in the dividend payout ratio, the proportion of brand royalty in the total payout to promoters has declined to 35% as of FY12.
- Additionally, total payout to promoters has gone up >3x as it was ~Rs1.07bn in FY12 (including dividends).
- There is a significant chance that the dividend payout ratio will go up further over next 2-3 years and earnings growth of 15-20% will continue, thus the importance of brand royalty for promoters will further decline and the absolute dividend payout to promoters will keep increasing.

Figure 2. Havells – Payout to promoters

Rent paid to promoters (Rsmn)	FY08	FY09	FY10	FY11	FY12
QRG Enterprises	11.8	128.6	172.6	174.3	193.4
As % of sales	0.1%	0.6%	0.7%	0.6%	0.5%
As % of total payout	4.3%	31.7%	32.0%	26.4%	18.0%
Trademark fees and Royalty (Rsmn)	FY08	FY09	FY10	FY11	FY12
Trademark fees and Royalty (Rsmn)	175.6	184.9	223.9	292.8	379.2
As % of sales	0.9%	0.8%	0.9%	1.0%	1.0%
As % of total payout	63.5%	45.5%	41.6%	44.4%	35.4%
Dividend (to promoters) (Rsmn)	FY08	FY09	FY10	FY11	FY12
Dividend	89.1	92.6	142.3	192.0	499.3
As % of total payout	32.2%	22.8%	26.4%	29.1%	46.6%
Total Payout to Promoters	277	406	539	659	1,072

Source: Company, Citi Research

Forgoing the consideration is good move

- Havells India is generating substantial free cash flows and is in a position to pay the entire savings of Rs400mn. Adjusting for taxes etc, promoters will “lose” only ~Rs125mn per year (and not the entire Rs400mn per year).
- However, this decision has generated enormous amount of goodwill for management. It appears to us that Rs125mn/yr is a rather small price to pay for the goodwill.

Figure 3. Small Price to Pay for Enormous Goodwill

	Rsmn
Royalty Payment (Rsmn)	400
After tax payment to promoters (Tax @30%)	280
If Havells Pays Dividend	
Gain to Havells	400
Net of Income tax (@ 25%)	300
Dividend distribution tax (@16.5%)	48.6
Net Dividend	251
Promoters share	155
Net loss to promoters per year v/s royalty payment	125

Source: Citi Research

Valuing the brand would have led to more questions

- Valuing the brand would have been too messy and any valuation would have led to several more questions.
- One option was to increase stake in listed company. But then “how much to increase the stake” is a difficult question to answer.
- Second option was to capitalize royalty payments by a factor of say 10x and take that as the value of the brand. But then there would have been questions on why not capitalize by 5x or 15x?

Business Update

We met Havells India's promoters, senior management, and dealers and visited the company's switchgear manufacturing facility at Baddi, H.P. The following are the key takeaways.

- **India business to grow comfortably at 15-20%** - driven by growth in current product lines over medium term. The company is continuously introducing new products (e.g. mass-market switches under the brand name "Reo") and new product introductions can add to additional top-line growth over 15-20%.
- **Dealers are even more optimistic** - The dealers we spoke to are even more optimistic they will see more than 15-20% growth and expect 30-40% growth over the medium term in their respective dealerships. Production managers have an internal target of 30% growth - Havells' Baddi manufacturing facility, which we visited, manufactures switchgears for domestic and export markets and contributes ~8-10% of India sales. The production managers have been given internal targets of growing production by 30% next year.
- **Sylvania margins have recovered / debt has reduced** - Sylvania has taken price hikes in Europe and margins have already recovered to 6% (after a very weak 2Q). Demand in Europe is flat. Latin America continues to grow at 10-15% with 8-9% margins. The adjustment due to last year's currency fluctuations is complete and cost pressures have been passed on to consumers. Sylvania's net debt has reduced to €70mn against depressed EBITDA of €26mn. Annual interest expense is €7-8mn. The financial position of Sylvania is stable.
- **Capex requirement to reduce** - The capex requirement is set to reduce further as (1) a lot of capex to achieve growth has already been incurred, and (2) capacity can be increased relatively easily. For example, Reo, which is already doing sales of Rs50mn/month with margins of 20-25%, incurred capex of only Rs200mn for manufacturing capacity.
- **Possibility of further increase in dividend payout** - In FY12, Havells increased its dividend payout ratio to 26% from 10%. Mgmt. mentioned that it intends to either maintain the ratio or increase it further in future.
- **Our take on India growth** - The feedback on the demand environment from dealers and production managers is much more optimistic than management's formal guidance of 15-20% growth. Some of this could be due to the fact that (1) production managers have stretched targets, (2) the dealers we spoke to are large established dealers (average turnover of ~Rs1bn - Rs2bn per year) and hence may be more successful and optimistic than other dealers. However, even adjusting for these factors, management's formal guidance of 15-20% over the medium term looks quite achievable.
- **Appliances sales were good in festive season** – The festive season saw healthy traction in appliances sales (Appliances + Water Heater) with sales touching ~Rs300mn/month. Water heater and domestic appliance revenues will reach ~Rs2bn this year.
- **"Reo" mass-market switches are already seeing good traction** - Havells has launched mass-market switches branded as "Reo", targeted at small towns and villages. The product is already seeing good traction with monthly sales of ~Rs50mn. The product will help Havells to expand its distribution network to small towns. The market size of these mass-market switches is ~Rs15-20bn and Anchor is the current market leader. In FY14, Havells expects sales of ~Rs1bn.

- **Expansion in service network to 350 towns** – The company's after-sales service network has been expanded to 350 towns now.
- **Co. seems prepared for likely increase in LED demand in Europe** – In response to concerns on changing customer dynamics in Europe towards LED lighting, the company said that 8 – 10% of Sylvania's revenues currently come from LED products and is hence prepared to handle the demand increase.
- **Potential new product lines** – Based on customer feedback and dealer demand, the company plans to introduce new products that can be distributed through Havells' existing distribution channels (one example could be Invertors – though the company has no plans of introducing this right now).
- **Any future acquisition to be limited in scope and size** – Mgmt. mentioned that Sylvania has provided it with a huge distribution in Europe and clarified that Havells might acquire small companies that will enhance Havells' distribution network and aid brand expansion. However, acquisitions would be limited and will be small in size

Increasing Target price to Rs734 (from Rs664)

- As we (1) roll over India business multiple of 18x and Sylvania EV/EBITDA multiple of 6x to June 2014 from March 2014, (2) peg our P/E multiple on EPS excluding brand royalty payment to promoters; as the amount of this payments for next four years is fixed and payments will terminate after 2016, (3) Reduce NPV (at CoE of 13%) of brand royalty payments from valuations.

Figure 4. Havells India – Target Price

Parent	New	Old
Parent Adjusted EPS (June 14)	39	35
P/E Multiple	18	18
Parent Value	704	630
Sylvania		
EBITDA (June 14)	1,855	1,791
EV/EBITDA	6.0	6.0
EV	11,127	10,745
Sylvania Debt	7,339	7,339
Sylvania Cash	806	806
Net Debt	6,533	6,533
Equity Value	4,595	4,212
Sylvania Per share	37	34
Less : 4 years of Royalty payment to promoters (NPV@13% CoE)	937	
Per share value of royalty payment to promoters	7.5	
Total Value	734	664

Source: Citi Research

Havells India

Company description

Havells is an electrical and power distribution equipment manufacturer with a presence in industrial and domestic circuit protection switchgears, cables and wires, motors, fans, power capacitors, CFL lamps, luminaries for domestic/commercial and industrial applications, and modular switches. It owns several brands across these products, namely Crabtree, Sylvania, Concord, Luminance, Linolite, and SLI Lighting. Havells has 12 manufacturing plants in India located at Haridwar, Baddi, Noida, Sahibabad, Faridabad, Alwar, Neemrana, and 6 manufacturing plants located across Europe and Latin America.

Investment strategy

We rate Havells shares Buy, with a target price of Rs734. We believe that Havells' India business is a quality play on domestic construction and consumer demand. Company has managed to create entry barriers in a competitive business and has established large network of dealers (~4300) across India to sell its products. There is a significant opportunity to grab share from unorganized players in different product segments. Moreover recent results have demonstrated healthy demand in India. Business in Europe remains largely stable with focus on profitability.

Valuation

Our target price of Rs734 is based on a sum-of-the-parts approach. We value the India business at Rs704 and Sylvania at Rs37. The parent business is valued at 18x June 14 EPS, at a premium to its historical average of 14x to reflect buoyant demand and strong business traction in India. The 18x P/E is supported by a ~18% EPS CAGR over FY12-15E and ~22% average RoE. P/E is generally used to value branded consumer and capital goods companies, segments in which Havells operates. We value Sylvania on 6x June 14E EV/EBITDA. Despite recovery in operations and profitability, PAT is expected to remain depressed due to high depreciation and interest costs and thus we prefer to use EV/EBITDA. We conservatively use 6x, derived from a comps analysis, taking the European risks into consideration, and opportunities for expansion in South East Asia and Africa. At our TP of Rs734, Havells will trade at consolidated P/E of ~19x on FY14 EPS with FY12-15 EPS CAGR of 16%.

Risks

Downside risks to our target price include poorer performance from Sylvania, higher commodity prices, unsuccessful new-product launches, increase in competitive intensity and demand slowdown in India.

Appendix A-1

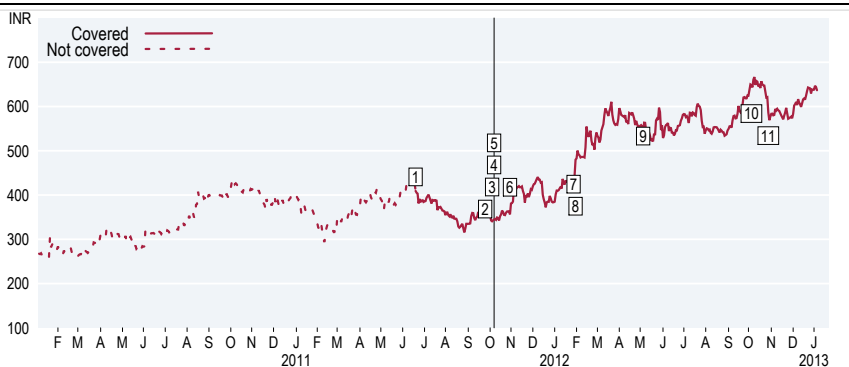
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Havells India (HVEL.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Atul Tiwari, CFA
Covered since June 20 2011



	Date	Rating	Target Price	Closing Price
1	20-Jun-11	*3L	*425.00	409.35
2	26-Sep-11	3L	*347.00	357.65
3	5-Oct-11	3L	*335.00	340.70
4	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
5	7-Oct-11	*3	335.00	344.85
6	31-Oct-11	*1	*425.00	356.35
7	27-Jan-12	1	*502.00	428.85
8	31-Jan-12	1	*554.00	480.00

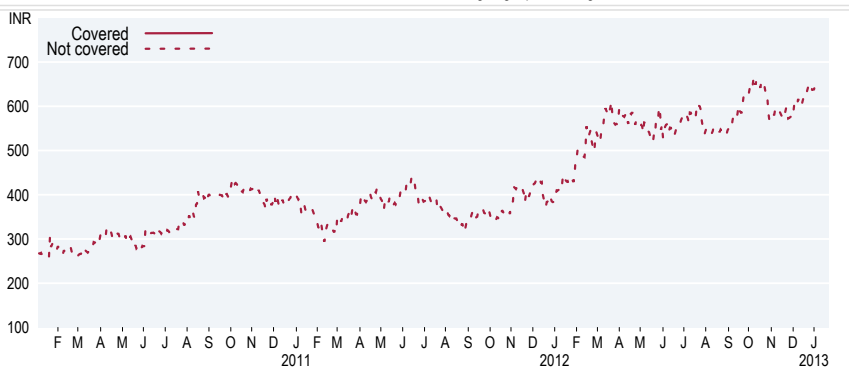
	Date	Rating	Target Price	Closing Price
9	4-May-12	1	*633.00	540.70
10	4-Oct-12	1	*739.00	648.25
11	29-Oct-12	1	*664.00	586.55

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Havells India (HVEL.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Atul Tiwari, CFA
Covered since June 20 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Dec 2012

Citi Research Global Fundamental Coverage	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	49%	38%	12%	7%	86%	7%
% of companies in each rating category that are investment banking clients	53%	49%	45%	60%	49%	55%

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