# FMCG

## Thematic Report

## Time to switch from HUL to ITC

Key points

Hindustan Unilever Ltd (HUL) and ITC have outperformed the broader market with absolute returns of around 30% and 18% respectively in the last one year. In the present turbulent market the fast moving consumer goods (FMCG) sector is being perceived as a safe haven and both the stocks have had a good run-up in recent times.

However, HUL has now turned expensive on an absolute basis as well as relative to ITC. HUL trades at a 22% premium to its historic average multiple of 26x one-year forward earnings and at a 120% premium to Sensex valuations (among the highest in the last decade except for the troubled period of 2008-09). HUL also trades at a 38% premium over ITC which is much higher than the average of 24% premium it has traded at in the past six years.

In addition to the distortion in valuations, there are three key reasons for our preference for ITC over HUL.

1. HUL has higher sensitivity to input cost pressures due to its limited pricing power in the fiercely competitive categories of soaps and detergents. On the other hand, ITC's core business of cigarettes is relatively price insensitive.
2. The improved performance of businesses other than tobacco in case of ITC would result in better earning growth for ITC over the long run.
3. ITC has a better earnings visibility with an expected compounded annual growth rate (CAGR) in the bottom line of 21% over FY2011-13. In comparison, HUL's bottom line is expected to grow at a CAGR of 17% over the same period.

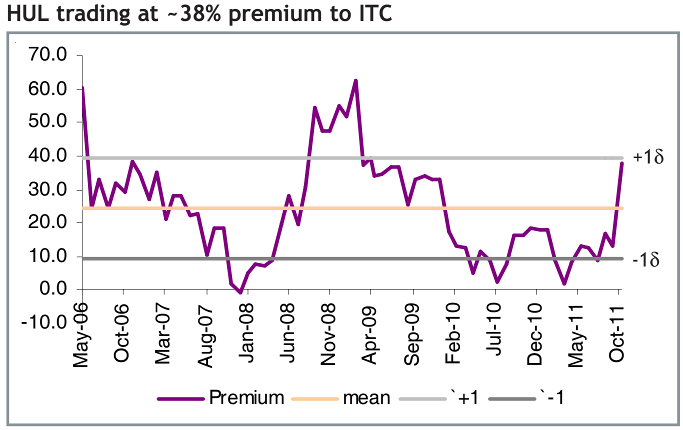
The risk to our thesis is a higher than expected hike in excise duty on cigarettes in the forthcoming budget and also softening of input cost pressure for HUL.

### HUL expensive on absolute as well as relative terms

While the Sensex corrected by 12% from the levels of 18200 in July 2011, HUL maintained its strong run and gained by 19% to reach around Rs395 from its price of Rs331.23 in July 2011. The stock is currently trading at 31.6x its FY2012-13E average earning per share (EPS) of Rs12.5, which is a 22% premium to the average price earning (P/E) of 26.0x. The same is also evident from the chart below that shows that HUL trades at a stark premium of 120% to the Sensex which is significantly high considering a mean premium of 45% since April 2006. Hence considering premium valuations and the current profitability concerns due to volatility in raw material prices, we don't see any upside in the stock price from the current levels.

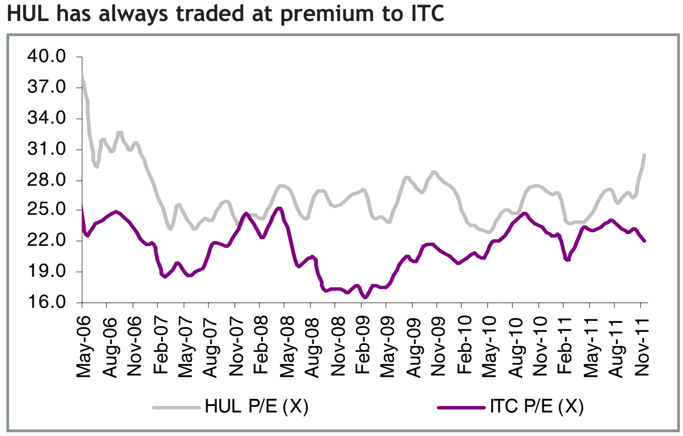
On the other hand ITC moved up by 2.0% from the levels of Rs202.5 in July 2011. The stock is currently trading at 23.7x its average FY2012-13E EPS of Rs8.7, which is at a 16.9% premium to its average P/E of 20.3x. HUL has always traded at a certain premium to ITC, but the gap has slightly widened in the recent times. HUL is currently trading at a premium of 38% to ITC, which is ahead of the mean premium of 24% since April 2006. With HUL likely to hover at the current levels in the prevailing market environment, we believe ITC should move up by around 15% to limit the gap between it and HUL.

**HUL trading at ~38% premium to ITC**



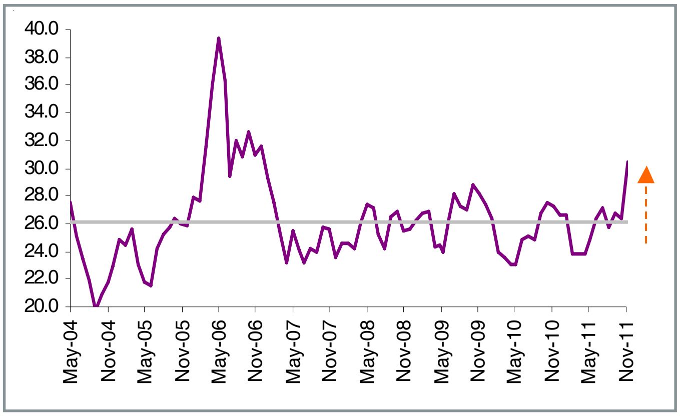

Source: Sharekhan Research

**HUL has always traded at premium to ITC**



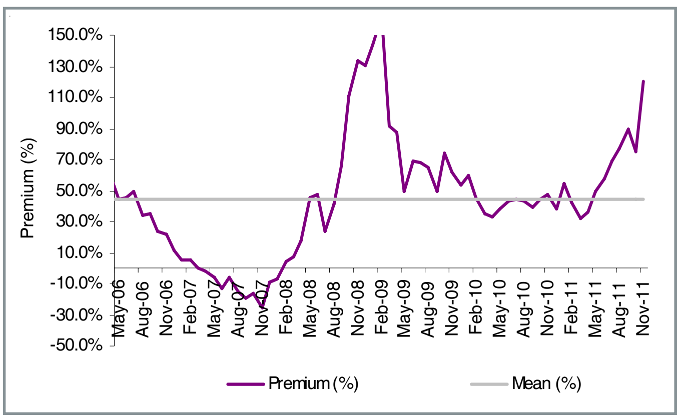

Source: Sharekhan Research

**HUL's one year forward P/E chart**



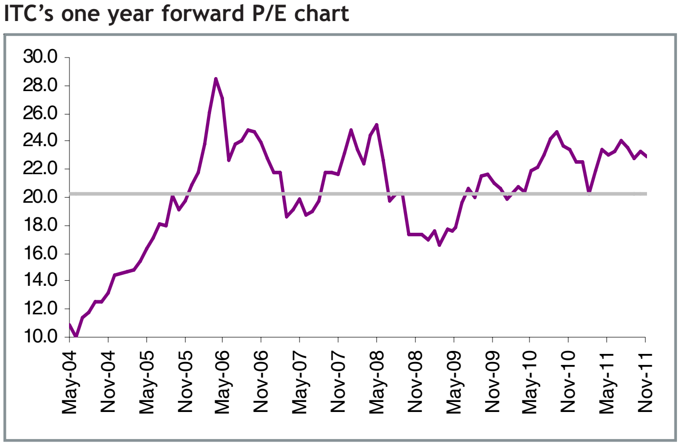
Source: Sharekhan Research

**HUL is trading at 120% premium to Sensex**




Source: Sharekhan Research

**ITC's one year forward P/E chart**

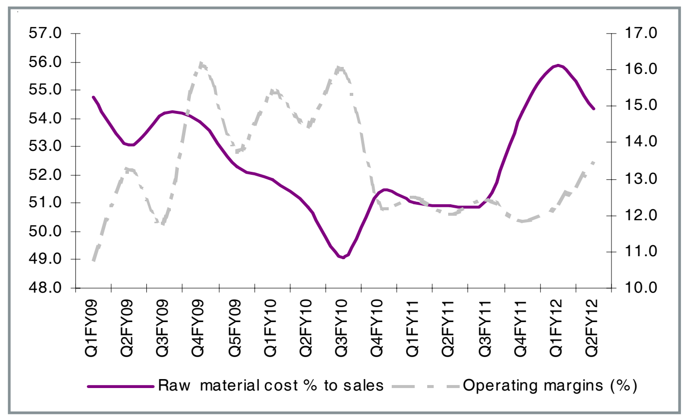


Source: Sharekhan Research

## Fundamental reasoning for preferring ITC over HUL

- **Margin sensitivity to input cost prices:** HUL's profitability sensitivity to raw material costs is much higher in the FMCG space due to its limited pricing power in the highly competitive and penetrated segment of soaps and detergents. This segment which contributes close to 50% to HUL's top line has been bearing the brunt of higher input prices (including palm oil and LAB) in the recent past. The company had taken price increases which were not good enough to cover the entire input cost pressure. It is difficult for HUL to take frequent price increases considering the intense competition in the segment. The profit before interest and tax (PBIT) margin of the segment has reduced from approximately 15% in FY2009 to 10% in FY2011. The raw material prices have remained volatile and with the recent depreciation in the rupee against the dollar, we expect an additional rise in the raw material cost in the coming quarters. Hence, gross margins are expected to remain under pressure in the near term.

**HUL's profitability susceptible to input cost pressure**

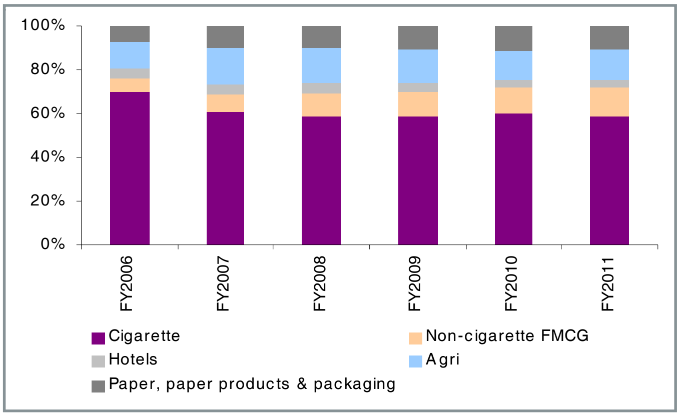



Source: Sharekhan Research

ITC's profitability is less vulnerable to input cost pressure in the FMCG space. This is largely due to its strong pricing power in the cigarette business, which contributes around 57% to the total revenues and around 80% to the overall PBIT. Cigarette sales volumes are price insensitive and hence despite the price increases the company is consistently achieving good volume growth in the cigarette business for the last two quarters. The PBIT margin of the business has remained strong at around 30% for the past few quarters.

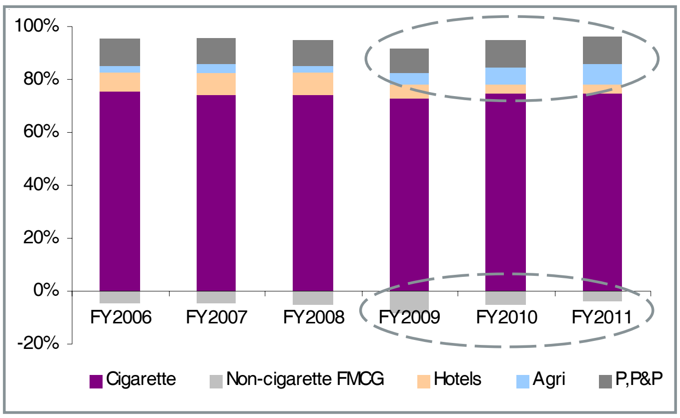
- **ITC's other businesses performing well:** Over the years ITC has diversified its revenue stream by entering into businesses such as non-cigarette FMCG, hotel, agri and paperboard, paper & packaging by infusing cash from its cash cow cigarette business. The company is focusing on enhancing the scale of these businesses and improving their profitability, which will add to the overall business' profitability.

**Other businesses' contribution to the top line**




Source: Sharekhan Research

**Other businesses' contribution to the profitability**




Source: Sharekhan Research

- **ITC has better earnings visibility:** With a sustained volume led growth in the cigarette business and strong growth in the other businesses coupled with improvement in the profitability, we expect ITC's earnings to grow at a CAGR of 21% over FY2011-13. However any harsh steps implemented by the government to curb the cigarette consumption or any slowdown in the growth of the other key businesses would act as a key risk to our earning estimates.

  On the other hand, we expect HUL's bottom line to grow at a CAGR of 17% over FY2011-13. However in the environment of volatile commodity prices, any significant upward movement in the raw material prices would be risk to our earnings estimates.

- **Fundamental view:** Considering the better pricing power, strong earnings visibility and a decent upside from the current levels, we prefer ITC over HUL in the near term. Having said that barring the near term raw material cost pressure, HUL's long term growth story is intact and any correction in its stock price (which is unlikely in the current market environment) should be looked as an opportunity to get into the stock.

**Valuation**

| Companies | CMP | EPS (Rs) | | | PE (x) | | | EV / EBIDTA (x) | | | Reco | Price |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (Rs) | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | FY11 | FY12E | FY13E | | target |
| HUL | 395 | 9.9 | 11.6 | 13.5 | 40.1 | 34.2 | 29.3 | 34.6 | 29.0 | 23.9 | Hold | ** |
| ITC | 207 | 6.4 | 7.9 | 9.4 | 31.6 | 25.8 | 21.6 | 20.7 | 16.8 | 14.0 | Buy | 227 |

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