



FMCG

Shift from Asian Paints to GSK Consumer Healthcare

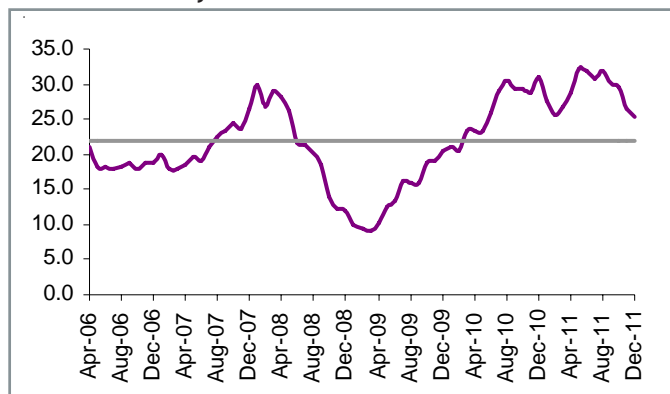
Key points

- ♦ **Asian Paints—slowdown in discretionary spend to hit sales volumes:** Empirical evidence shows that the prevailing inflationary and gloomy macro-economic environment can result in a sharp slowdown in the demand for the consumer discretionary spend-led sectors like paints. A slower growth in the key user segments of real estate and automotives can dent the volume offtake in the paint sector. In FY2009, when the gross domestic product (GDP) growth rate had declined to 6.7% year on year (YoY) from 9.2% YoY in FY2008, Asian Paints' sales volume growth had declined to 13.4% from a strong 17.5% YoY in FY2008. Moreover, the company's financial performance could also get dented by a slowdown in the international business, volatility in input cost and foreign exchange (forex) fluctuations.
- ♦ **GSK Consumer—demand for daily consumption items to stay relatively resilient:** The sales of daily consumption items such as packaged foods, biscuits, beverages, soaps and toothpaste may not suffer in the current environment. The packaged foods companies like GlaxoSmithKline Consumer Healthcare (GSK) are likely to witness a steady volume growth in the range of 10-12% in the coming quarter. This can be attributed to the increased demand for health and wellness products, improvement in rural penetration and stable product portfolio that caters to the needs of different consumer sections in India. Moreover, GSK's better pricing power would enable it to protect its margin.
- ♦ **Prefer GSK to Asian Paints:** In the current environment, there is a high risk of a downgrade of the consensus earnings estimate for Asian Paints driven by both a lower than expected volume offtake and higher margin pressure. Currently, the street is factoring in an earnings compounded annual growth rate (CAGR) of 15% for Asian Paints over a two-year period of FY2011-13. On the other hand, we are quite

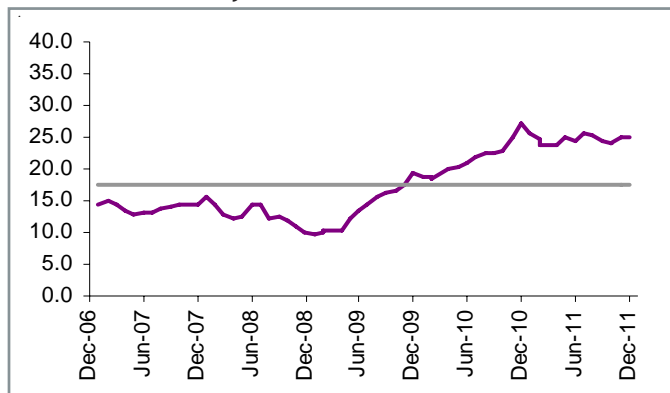
comfortable with the compounded annual growth of high teens in the earnings of GSK due to its better pricing power and demand environment. Thus, it would be better to switch from Asian Paints to GSK for better returns over the next 6-12 months.

Why do we prefer GSK to Asian Paints?

Asian Paints' one-year forward PE



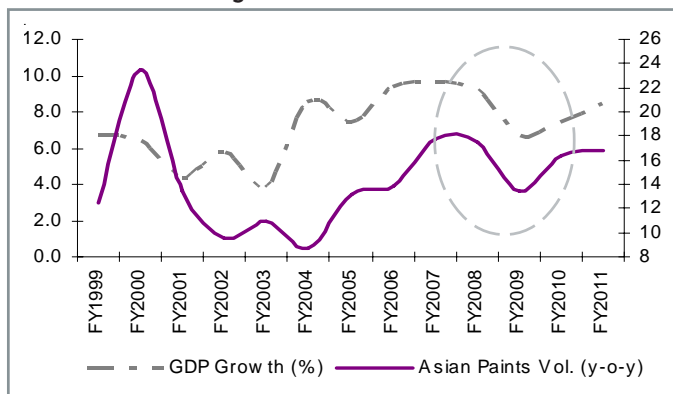
GSK Consumer's one-year forward PE



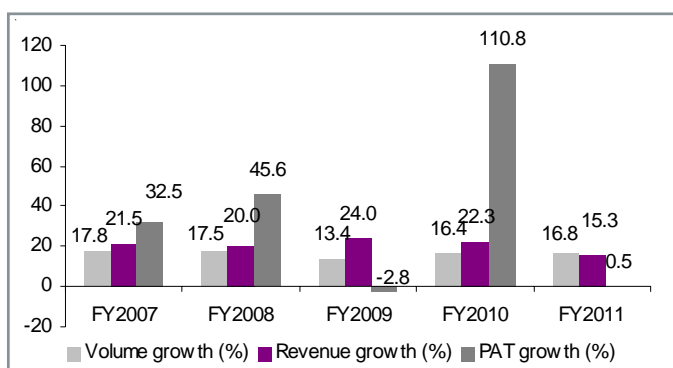
- ♦ **Prevailing inflationary environment may affect the paint offtake:** The prevailing inflationary environment has dampened the consumer sentiments in the domestic market which has resulted in the lowering of discretionary spends. Paints are considered as a discretionary category among consumer goods. The high food inflation along with the gloomy macro-

economic environment may slow down the offtake of paints in the coming quarters. Even in FY2009, when the GDP growth rate had fallen to 6.7% from 9.2% in FY2008, Asian Paints' volume growth had declined to 13.4% YoY. We might see the sales volume growth of some of the major decorative paint players like Asian Paints slowing down in the coming quarters.

Asian Paints' volume growth decelerated in FY2009

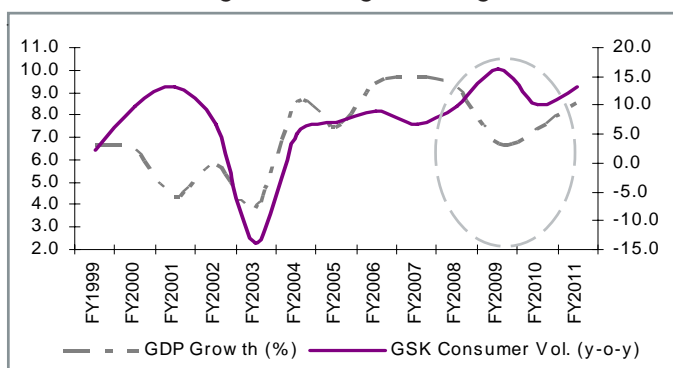


Trend in revenue growth and bottom line growth of Asian Paints

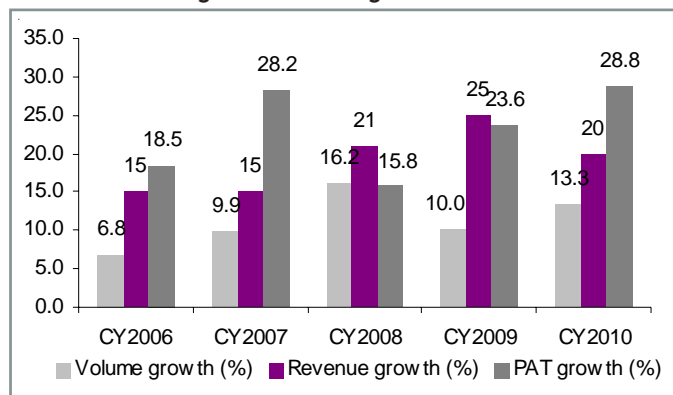


On the other hand, we expect GSK's volume growth to remain steady in the range of 10-12% in the coming quarters on account of the changing aspirations of the domestic consumers and an increase in demand for health and wellness products.

GSK's sales volume grew in strong double digits in FY2009



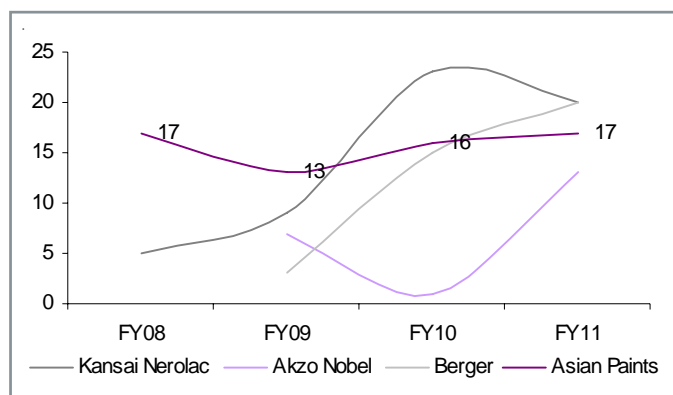
Trend in revenue growth and PAT growth of GSK



♦ Expansion in competitive landscape to hamper growth

Asian Paints is the leader in the paint industry with a stable volume market share of 52%. Though the company has delivered a double-digit volume growth, but the competition has been strong in the last two years keeping Asian Paints on its toes. However, competition is intensifying as peers are gearing up to increase their market share and the volume offtake is expected to dwindle through increasing reach and product innovation. Berger Paints and Kansai Nerolac are engaged in product innovation and have come out with newer products while Akzo Nobel is targeting to increase its dealership network by 50% from the current network of about 6,000 dealers in the next few years with focus on entering non-metros. The newer players like Jotun, Sherwin Williams and Nippon are also pushing to increase their dealership network. Competition has led to high advertising spends to increase the visibility of products. In the increasing competitive landscape, Asian Paints could see its market share and margins coming under pressure as to combat the intense competition advertisement spends are increased and prices are lowered.

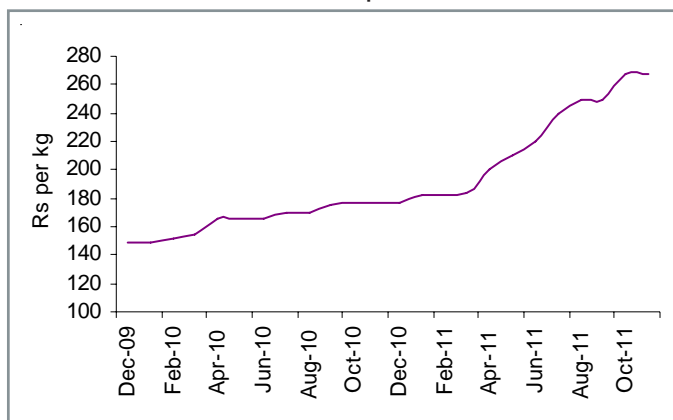
Trend in volume growth of key paint companies



GSK is better placed to withstand the competitive pressure in the domestic market. Judicious new launches and brand extensions for different age groups, keeping in mind the needs and preferences of consumers, and an increased distribution reach have helped GSK to stay ahead of the competition (especially new entrants like Hindustan Unilever Ltd [HUL] and Dabur India) and maintain its pricing power over the years.

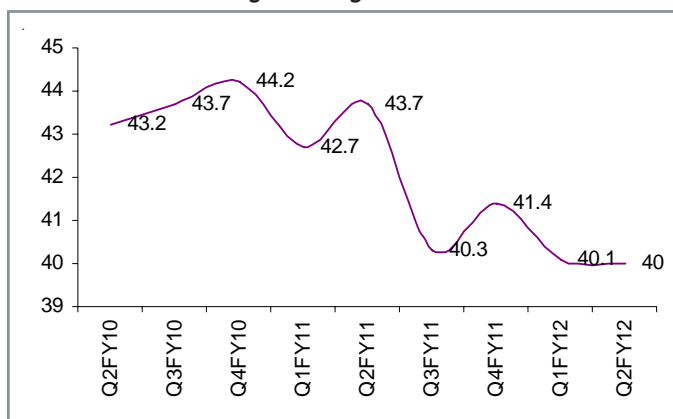
- ♦ **Asian Paints' margins to remain under pressure:** The rising input cost and limited pricing power (due to intensified competition) will continue to put pressure on the company's profitability in the coming quarters. Asian Paints' cost index was up by 17% in H1FY2012. The gross margin declined by 310 basis points YoY in the same period. The prices of the key inputs such as titanium dioxide have maintained their upward movement. Also, the rapid depreciation of the rupee against the dollar (dollar imports account for 25% of the company's raw material cost) would further increase the raw material cost in the coming quarters. Hence, we expect Asian Paints' margins to remain under pressure in the coming quarters.

Trend in titanium dioxide DuPont prices



Source: Bloomberg

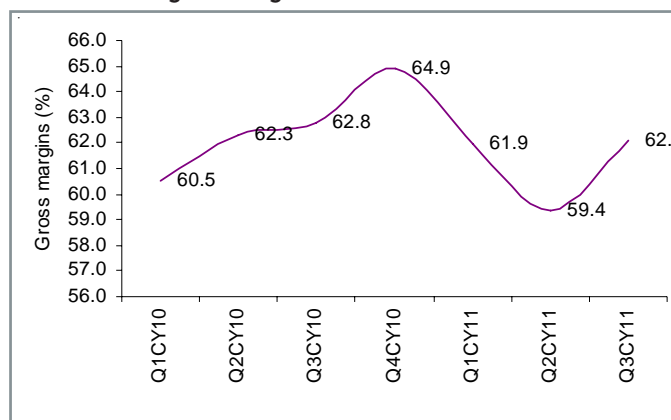
Trend in Asian Paints' gross margins



Source: Bloomberg

On the other hand, GSK with a better pricing power (due to its leadership position) has been able to mitigate the rise in the raw material cost.

Trend in GSK's gross margins



Uncertainty in Asian Paints' international operations, another dampener:

The international operations contribute about 13% of the revenues of the company. Though the contribution is low, the expectation was that the business would grow faster than the company average, thereby safeguarding the top line growth. However, the growth in the international revenues has been sluggish at 9% in H1FY2012 mainly due to the uncertain political environment in the Middle East, which contributes about 52% of the international revenues, and the weak demand environment in the Caribbean region, which contributes about 16-17% of the international revenues. Further, the earnings before interest and tax (EBIT) margin of the international business have been under pressure, it was down 270 basis points to 9.7% in H1FY2012 due to cost pressures and lower volume offtake. This had affected the overall margin of the business. The management expects the cost pressures to continue and with the uncertain macro-economic environment the volume offtake in the international markets could also experience pressure.

Trend in international business' revenues and profitability

Regions (revenues)	FY07	FY08	FY09	FY10	FY11
Caribbean	152.0	150.0	163.0	161.2	156.8
YoY%		-1.3	8.7	-1.1	-2.7
Middle East	261.0	319.0	465.0	536.1	515.9
YoY%		22.2	45.8	15.3	-3.8
Asia	146.0	172.0	221.0	200.8	240.3
YoY%		17.8	28.5	-9.1	19.7
South Pacific	73.0	62.0	62.0	71.9	75.0
YoY%		-15.1	0.0	16.0	4.3

Rs (cr)

Regions (EBIT)	FY07	FY08	FY09	FY10	FY11
Caribbean	4.0	7.0	6.0	10.6	11.9
YoY%		75.0	-14.3	76.7	12.3
Middle East	27.0	42.0	56.0	107.6	68.1
YoY%		55.6	33.3	92.1	-36.7
Asia	-12.0	2.0	3.0	21.7	23.8
YoY%		-116.7	50.0	623.3	9.7
South Pacific	5.0	5.0	5.0	11.1	12.9
YoY%		0.0	0.0	122.0	16.2

Outlook and view

GSK's ability to maintain its leadership in the paints market, better pricing power compared with the other consumer goods peers in the current inflationary environment and strong cash generation ability make it a value pick in the fast moving consumer goods (FMCG) space. Hence we expect GSK to post a better financial performance in the coming quarters compared with the other FMCG companies. At the current market price (CMP) GSK's stock is trading at 23.7x its CY2012E EPS of Rs101.3 and 20.0x its CY2013E EPS of Rs120.1.

Though Asian Paints' near-term growth outlook is exposed to the gloomy macro-economic environment, the long-term growth prospects of the company are much better. At the CMP Asian Paints' stock is trading at 25.8x its FY2012E (Bloomberg consensus) EPS of Rs102.3 and 21.1x its FY2013E (Bloomberg consensus) EPS of Rs125.4.

GSK's valuation table

Key Financials	CY09	CY10	CY11E	CY12E	CY13E
Revenues (Rs cr)	1921.5	2306.1	2723.1	3275.7	3910.4
Operating margins (%)	16.2	16.3	16.3	16.5	16.6
PAT (Rs cr)	232.8	299.8	360.9	426.0	504.9
% Growth	23.6	28.8	20.4	18.0	18.5
EPS (Rs)	55.4	71.3	85.8	101.3	120.1
P/E (x)	43.4	33.7	28.0	23.7	20.0
EV/EBIDTA (x)	23.2	18.5	15.3	12.6	10.3
RoNW (%)	27.9	32.2	33.8	33.1	33.6
RoCE (%)	43.0	48.7	51.2	50.1	50.8

Source: Bloomberg

Asian Paints valuation table

Particulars	FY2010	FY2011	FY2012E	FY2013E
Net sales (Rs cr)	6680.1	7706.2	9382.0	11037.7
Operating profit (Rs cr)	1149.9	1207.8	1469.2	1802.9
Adjusted PAT (Rs cr)	835.6	843.2	984.3	1216.4
OPM(%)	17.2	15.7	15.7	16.3
EPS (Rs)	87.1	87.9	102.3	125.4
P/E (x)	30.3	30.1	25.8	21.1
RoE (%)	57.4	43.3	39.1	38.4

Source: Bloomberg

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