Hindustan Unilever HLL.NS HUVR IN

GENERAL CONSUMER

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Open offer a good price to exit

Open offer presents a good price for investors; earnings could be at risk; Reduce

June 27, 2013

Rating Remains	**Reduce**
Target price Increased from 418	INR 535
Closing price June 26, 2013	INR 588
Potential downside	-9%

Action: Investors should tender in the open offer

We maintain our Reduce rating on HUVR on the back of several headwinds, heading into FY14. Based on our on-the-ground feedback, volume growth is likely to remain subdued in the near term; hence, we are building in 6–7% volume growth in the near term against the long-term average of ~9% and peak of 14%. We do not see any material downside from these levels, but investor expectations build in an improvement, which we believe is unlikely in the near term. Urban consumer sentiment remains weak and should impact the company, we think. While commodity prices have softened, rising polymer prices, advertising spends and a depreciating INR would pose a risk to margins. Given the risk of subdued volume growth, risk to earnings, the open offer from Unilever comes at an opportune time for investors, in our view, and presents a good exit opportunity.

Catalyst: Continued subdued volume growth performance and a depreciating INR are negative catalysts

Valuation: HUVR trades at 31.9x FY15F vs. sector average of 26x

HUVR currently trades at 31.9x FY15F P/E (EPS: INR 18.44) vs. the sector average of 26x. The significant 23% valuation premium largely reflects the open offer rather than core business fundamentals, we think. We believe that given the strong headwinds, current multiples are undeserved. We would tender the shares in the open offer, as our base case valuation for the business is INR477.

Our new TP is INR535, which is the average of the open offer price of INR600 and our base case valuation. Reaffirm Reduce.

31 Mar	FY13	FY14F		FY15F		FY16F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	270,040	310,124	310,124	357,505	357,505		405,252
Reported net profit (mn)	38,394	34,727	36,173	38,586	39,853		45,355
Normalised net profit (mn)	32,337	34,727	36,173	38,586	39,853		45,355
FD normalised EPS	14.96	16.07	16.73	17.85	18.44		20.79
FD norm. EPS growth (%)	20.8	13.8	11.9	11.1	10.2		12.8
FD normalised P/E (x)	39.3	N/A	35.2	N/A	31.9	N/A	28.3
EV/EBITDA (x)	26.4	N/A	24.0	N/A	20.5	N/A	18.0
Price/book (x)	47.9	N/A	42.1	N/A	37.6	N/A	33.2
Dividend yield (%)	2.3	N/A	2.6	N/A	2.8	N/A	3.2
ROE (%)	125.1	87.6	127.5	89.1	123.9		124.5
Net debt/equity (%)	net cash	net cash	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

HUVR's profit growth of low double digits over the next few years will be below the estimated sector average pace and slower than other mid-cap consumer names. We see valuation multiples correcting over time.

Nomura vs consensus

We are largely in line with consensus over the next two years on earnings.

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

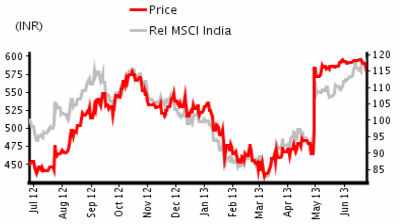
Key data on Hindustan Unilever

Income statement (INRmn)

Year-end 31 Mar	FY12	FY13	FY14F	FY15F	FY16F
Revenue	**234,363**	**270,040**	**310,124**	**357,505**	**405,252**
Cost of goods sold	-125,017	-140,871	-158,103	-180,856	-204,822
Gross profit	**109,347**	**129,169**	**152,022**	**176,650**	**200,430**
SG&A	-62,241	-70,182	-87,026	-101,176	-114,670
Employee share expense	-12,009	-14,127	-15,884	-18,311	-20,737
Operating profit	**35,096**	**44,860**	**49,112**	**57,163**	**65,023**
EBITDA	**37,432**	**47,374**	**52,073**	**60,484**	**68,704**
Depreciation	-2,335	-2,513	-2,961	-3,321	-3,681
Amortisation					
EBIT	35,096	44,860	49,112	57,163	65,023
Net interest expense	-17	-257	-230	-230	-230
Associates & JCEs	0	0			
Other income					
Earnings before tax	**35,080**	**44,603**	**48,882**	**56,933**	**64,793**
Income tax	-8,215	-12,267	-12,709	-17,080	-19,438
Net profit after tax	**26,865**	**32,337**	**36,173**	**39,853**	**45,355**
Minority interests	-95	0	0	0	
Other items					
Preferred dividends					
Normalised NPAT	**26,770**	**32,337**	**36,173**	**39,853**	**45,355**
Extraordinary items	1,137	6,057	0	0	0
Reported NPAT	**27,907**	**38,394**	**36,173**	**39,853**	**45,355**
Dividends	-18,839	-29,103	-32,555	-35,868	-40,819
Transfer to reserves	**9,068**	**9,291**	**3,617**	**3,985**	**4,535**
Valuation and ratio analysis					
Reported P/E (x)	45.6	33.1	35.2	31.9	28.3
Normalised P/E (x)	47.5	39.3	35.2	31.9	28.3
FD normalised P/E (x)	47.5	39.3	35.2	31.9	28.3
FD normalised P/E at price target (x)	45.8	37.9	33.9	30.8	27.3
Dividend yield (%)	1.5	2.3	2.6	2.8	3.2
Price/cashflow (x)	39.7	43.3	26.7	25.1	22.7
Price/book (x)	36.5	47.9	42.1	37.6	33.2
EV/EBITDA (x)	33.4	26.4	24.0	20.5	18.0
EV/EBIT (x)	35.7	27.9	25.4	21.7	19.0
Gross margin (%)	46.7	47.8	49.0	49.4	49.5
EBITDA margin (%)	16.0	17.5	16.8	16.9	17.0
EBIT margin (%)	15.0	16.6	15.8	16.0	16.0
Net margin (%)	11.9	14.2	11.7	11.1	11.2
Effective tax rate (%)	23.4	27.5	26.0	30.0	30.0
Dividend payout (%)	67.5	75.8	90.0	90.0	90.0
Capex to sales (%)	0.6	0.9	3.2	1.7	1.5
Capex to depreciation (x)	0.6	0.9	3.4	1.8	1.6
ROE (%)	92.6	125.1	127.5	123.9	124.5
ROA (pretax %)	39.9	46.7	47.0	49.9	50.8
Growth (%)					
Revenue	17.0	15.2	14.8	15.3	13.4
EBITDA	26.2	26.6	9.9	16.2	13.6
EBIT	28.2	27.8	9.5	16.4	13.7
Normalised EPS	28.8	20.8	11.9	10.2	12.8
Normalised FDEPS	29.0	20.8	11.9	10.2	12.8
Per share					
Reported EPS (INR)	12.91	17.76	16.73	18.44	20.79
Norm EPS (INR)	12.38	14.96	16.73	18.44	20.79
Fully diluted norm EPS (INR)	12.38	14.96	16.73	18.44	20.79
Book value per share (INR)	16.12	12.29	13.96	15.66	17.74
DPS (INR)	8.72	13.46	15.06	16.44	18.71

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	0.4	24.5	30.5
Absolute (USD)	-7.2	12.4	23.0
Relative to index	6.9	25.7	20.6
Market cap (USDmn)	21,077.7		
Estimated free float (%)	41.2		
52-week range (INR)	598.05/432.15		
3-mth avg daily turnover (USDmn)	27.39		
Major shareholders (%)			
LIC of India	6.9		
New India Assurance	1.3		

Source: Thomson Reuters, Nomura research

Notes

Cashflow (INRmn)

Year-end 31 Mar	FY12	FY13	FY14F	FY15F	FY16F	Notes
EBITDA	37,432	47,374	52,073	60,484	68,704	
Change in working capital	3,850	7,854	6,740	7,420	7,611	
Other operating cashflow	-9,244	-25,832	-11,113	-17,310	-19,668	
Cashflow from operations	**32,037**	**29,396**	**47,700**	**50,594**	**56,647**	
Capital expenditure	-1,447	-2,330	-10,000	-6,000	-6,034	
Free cashflow	**30,590**	**27,066**	**37,700**	**44,594**	**50,612**	
Reduction in investments	-11,337	698	0	0	-5,000	
Net acquisitions	0	0				
Reduction in other LT assets	0	0	0	0	0	
Addition in other LT liabilities	0	0	0	0	0	
Adjustments						
Cashflow after investing acts	**19,254**	**27,764**	**37,700**	**44,594**	**45,612**	
Cash dividends	-16,211	-29,103	-32,555	-35,868	-40,819	
Equity issue	-726	381	-387	0	0	
Debt issue	-108	0	247	0	0	
Convertible debt issue	0	0	0	0	0	
Others						
Cashflow from financial acts	**-17,046**	**-28,721**	**-32,695**	**-35,868**	**-40,819**	
Net cashflow	**2,207**	**-957**	**5,005**	**8,727**	**4,793**	
Beginning cash	17,756	19,964	19,006	24,011	32,737	
Ending cash	19,964	19,006	24,011	32,737	37,530	
Ending net debt	-19,964	-18,759	-23,763	-32,490	-37,283	

Source: Company data, Nomura estimates

Balance sheet (INRmn)

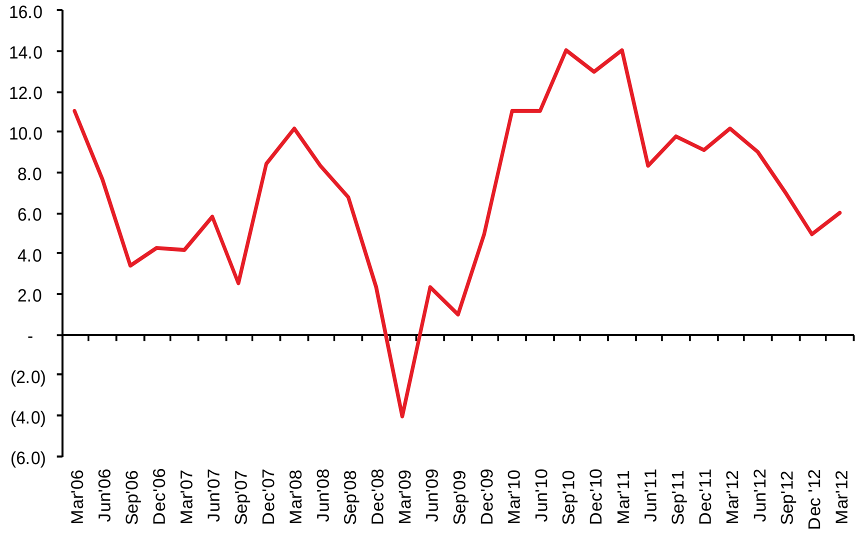
As at 31 Mar	FY12	FY13	FY14F	FY15F	FY16F	Notes
Cash & equivalents	19,964	19,006	24,011	32,737	37,530	
Marketable securities						
Accounts receivable	8,567	9,965	11,513	13,272	15,031	
Inventories	26,674	27,060	31,262	36,038	40,814	
Other current assets	8,641	13,739	11,755	13,759	15,464	
Total current assets	**63,846**	**69,770**	**78,541**	**95,807**	**108,839**	
LT investments	23,222	22,523	22,523	22,523	27,523	
Fixed assets	25,036	26,539	31,891	34,570	36,924	
Goodwill						
Other intangible assets						
Other LT assets						
Total assets	**112,104**	**118,832**	**132,956**	**152,900**	**173,287**	
Short-term debt						
Accounts payable	57,399	64,830	74,898	86,341	97,783	
Other current liabilities	19,680	26,985	27,423	31,939	36,349	
Total current liabilities	**77,079**	**91,815**	**102,321**	**118,280**	**134,131**	
Long-term debt	0	247	247	247	247	
Convertible debt						
Other LT liabilities						
Total liabilities	**77,079**	**92,062**	**102,568**	**118,528**	**134,378**	
Minority interest	183	209	209	209	209	
Preferred stock						
Common stock	2,162	2,162	2,162	2,162	2,162	
Retained earnings						
Proposed dividends						
Other equity and reserves	32,680	24,400	28,017	32,003	36,538	
Total shareholders' equity	**34,842**	**26,562**	**30,179**	**34,164**	**38,700**	
Total equity & liabilities	**112,104**	**118,832**	**132,956**	**152,900**	**173,287**	
Liquidity (x)						
Current ratio	0.83	0.76	0.77	0.81	0.81	
Interest cover	2,127.1	174.4	213.5	248.5	282.7	
Leverage						
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash	
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	
Activity (days)						
Days receivable	14.2	12.5	12.6	12.7	12.8	
Days inventory	81.1	69.6	67.3	67.9	68.7	
Days payable	169.9	158.3	161.3	162.7	164.5	
Cash cycle	-74.5	-76.2	-81.3	-82.1	-83.1	

Source: Company data, Nomura estimates

HUVR's volume growth is now stabilising

One of the biggest overhangs on the stock over the past few months has been a sustained decline in volume growth of the core business. Volume growth, which reached a peak of 14% in March '11, touched a 12-quarter low of 5% in December '12 before recovering marginally to 6% in the latest March '13 quarter.

Fig. 1: Quarterly volume growth performance



Source: Company data, Nomura research

According to the company, the significant slowdown in volume growth can be attributed to several key factors: a) challenging general economic conditions leading to a sharp slowdown in discretionary demand; b) a significant slowdown in CSD (the army's Canteen Service Department), which accounts for a good 7% of revenue; and c) a slowdown in modern trade (accounts for 10% of revenue).

Management commentary suggests volume growth is likely to be stable over the next few quarters at current levels, which is effectively also what we are building into our numbers.

While it is a positive that volume growth appears to be stabilising, it does not compare well with the company's historical growth record. Average volume growth over the past four years has been around 8.5%, with peak growth of 14%. In the light of this, volume growth remains sluggish and needs to pick up materially in the coming quarters, we think.

What are the challenges facing the company?

A closer look at the company's product portfolio reveals several issues that the company is facing. Below, we try and dwell a little deeper into those issues:

- **Oral care – Colgate has been holding strong**: One of the very few segments where HUVR neither holds nor has been able to attain a leadership position is oral care. Its biggest competitor, Colgate-Palmolive (CLGT IN, Neutral), which despite sitting on a sizeable 55% market share, has been able to successfully hold on to its share with 11–15% volume growth for three years now (Source: company data).

  To give credit to HUVR, it has been trying to regain some lost ground through aggressive promotions and new product launches in the premium segment like "Pepsodent Expert Protection". While this has yielded some initial success, we believe there is still a long way to go.

  Furthermore, we believe, HUVR's portfolio lacks completely in the entry-level segment to compete with brands such as "Colgate Cibaca" and "Dabur Red". This, we believe, has been holding back volume growth and would need to be addressed for regaining any ground.

- **Skin care – Fair & Lovely is facing issues**: Over the past couple of quarters, HUVR's growth in the personal care business has been held back because its bread & butter skin care brand "Fair & Lovely" has been facing issues.

  A few months ago, the company had re-launched the brand and also increased the prices of its sachet (accounts for a big chunk of volumes) from INR7 to INR8. However, the 14% price hike slowed down volumes for the brand which are yet to recover meaningfully.

  Furthermore, we note, skin care as a category has slowed down significantly over the past couple of quarters given the discretionary nature of the product. While its market share seems to have stabilised, volumes are yet to recover.

- **Detergents – mass market portfolio needs attention**: HUVR's premium segment has been faring well, with its brands such as "Rin and Surf" growing in double digits. However, one of its key brands "Wheel", positioned in the mass market, has been facing competition from local brands in the wake of falling material costs. While the company has been taking necessary marketing measures to revive growth of this category, we believe a full-scale recovery is sometime away.

- **Foods – packaged foods suffering from consumption slowdown**: In general, the packaged segment has been suffering from a slowdown, and HUVR has been no exception to the same. Growth has now slowed down to 7% from a peak of 51% in the September '11 quarter.

  While the overall macroeconomic environment can be blamed for the slowdown, HUVR's key innovation in its foods portfolio i.e., "Knoor Soupy Noodles" has been facing issues and had to be re-launched. We are yet to witness any significant pick-up in demand for same.

Outlook continues to be subdued

Over the near term, any significant pick-up in volume growth is unlikely, we believe, given that the consumer segment remains sluggish and specific brand challenges remain intact. We believe it would be sometime before the company can hope to get back to double-digit volume growth of the past. For FY14F, we are building in steady 6–7% value weighted volume growth in our earnings model.

Ground feedback too suggests demand remains weak

Our extensive interaction with several dealer/distributors/retailers and even supermarket chains, and consistent on-the-ground feedback suggests that consumer demand which had fallen significantly in January '13 remains at a weaker level. There has been no significant pick-up in demand m-m for the past several months now.

In fact, our interaction suggests that going into the next few months as well there is little visibility on a pick-up in demand. While rural demand continues to be strong, urban consumer sentiment is proving to be a dampener.

HUVR's volume growth trajectory has been lower than peers

Notably, our volume growth analysis of HUVR and its peers in the sector reveals that the company's volume growth trajectory has been far lower than that of other players with a similar portfolio.

While we do understand the logic of size, we believe that over the past few quarters, in a slowing environment, HUVR has been slower to react and has been more engaged in defending its leadership and extending it. We believe that with a superior distribution mix, brand portfolio and resources, it should at least be able to match the growth trajectory of the past.

Fig. 2: Volume growth performance in the HPC space

	Q1FY13	Q2FY13	Q3FY13	Q4FY13F
GSK MFD segment volume growth (%)	7.0%	7.0%	7.0%	8.0%
Hindustan Unilever volume growth (%)	9.0%	7.0%	5.0%	6.0%
Marico volume growth (%)	14.0%	14.0%	12.0%	8.0%
Dabur volume growth (%)	12.0%	10.5%	9.5%	12.0%
Emami Domestic Business volume growth (%)	17.0%	16.0%	16.0%	13.0%

Source: Company data, Nomura research

Margin expansion capped by rising A&P, INR depreciation

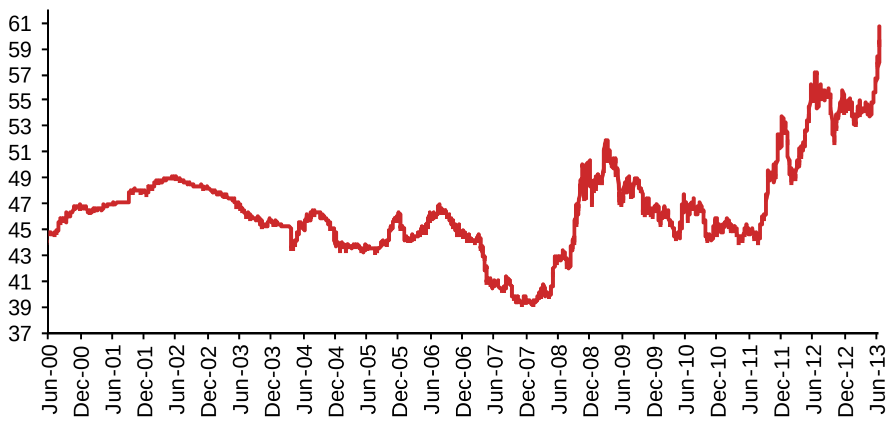
With a sharp decline in input prices over the past few months, there is a general belief among investors that gross margins and EBITDA margins in the HPC space are set to expand significantly over the coming quarters.

We believe that while margin expansion is likely to happen, it may not be as much as the Street is building in. Below, we present some of the factors that we believe will likely hold back margin expansion:

- **Continued depreciation of the INR against the USD**: The INR continues to be weak against the USD, and this we believe can have an impact on the company's gross margins given that ~45% of its input basket is either directly imported (commodities such as palm oil and benzene) or is import-parity linked. The INR has now depreciated ~4% since the start of the year and ~7% from the lows of Feb 2013.

  We believe the Street is not building this risk into its estimates. Our analysis shows that a 1% depreciation in the INR against the USD, HUVR's EBITDA margins can get impacted by ~20bps. However, the impact on the company's profitability can vary depending on: a) quarterly mix changes and b) the company's procurement prices which generally vary from spot prices.

Fig. 3: INR vs. USD



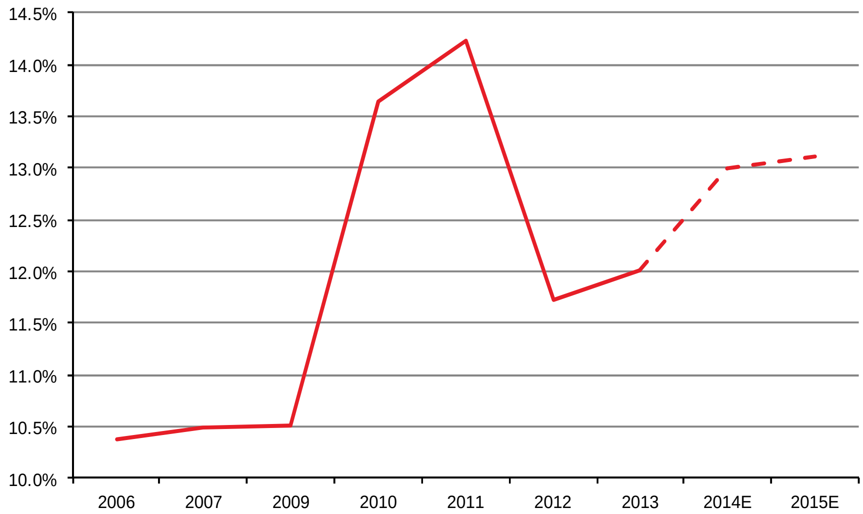
Source: Bloomberg, Nomura research

- **A&P spends to rise**: Over the past few years, with competitive intensity being relatively lower and the company being in the process of rebalancing its portfolio, A&P spend has fallen sharply thus enabling the company to expand margins even in a scenario of rising commodity prices.

  A case in point being FY12 when EBITDA margin expanded by 140bps y-y largely on the back of a 250bps y-y cut in A&P/sales. However, we believe, FY14F is likely to witness a reversal of this trend, with A&P spend rising 100bps y-y to 13%, thus capping margin expansion.

  We expect the rise in A&P spend is likely to be on the back of two drivers: a) rising competitive intensity in the consumer markets which has pushed up promotional spends significantly, and b) rising advertising rates following the TRAI (Telecom Regulatory Authority of India) directive to limit advertising slots to just 12mins/hour.

Fig. 4: A&P spends (% of sales) – all set to rise



Source: Company, Nomura estimates

In conclusion, the overall earnings outlook remains stable, with HUVR looking set to report ~12% earnings growth over the next couple of years, we estimate. However, we believe the growth would be largely led by margin expansion rather than accelerating volume growth. Furthermore, a depreciating INR poses a risk to our and Street estimates.

Open offer from Unilever to increase stake in HUVR is a positive

Unilever (UNVR, Buy) announced on 30 April 2013 an offer to acquire a 22.5% additional stake in Hindustan Unilever at INR600 per share. The promoter's (Unilever) stake as at end of the March quarter was 52.48%; therefore, on our reading, if the promoter is able to acquire the maximum number of shares, Unilever's stake in HUVR will go up to 75% (maximum allowable limit if it needs to be listed on the stock exchange). This is a 20% premium to the market price, one day prior to the announcement and 33x FY15F consensus earnings. The total cost of acquiring new shares will be USD 5.3bn, we estimate.

The open offer at INR600 per share signals two things to the market, in our view:

- Unilever has confidence in the fundamentals of the India business in the longer-term, which is why it is paying a significant premium to the sector average multiple to buy what is only an incremental stake in its subsidiary.
- It sets price expectations differently for investors who remain shareholders post the conclusion of the open offer.

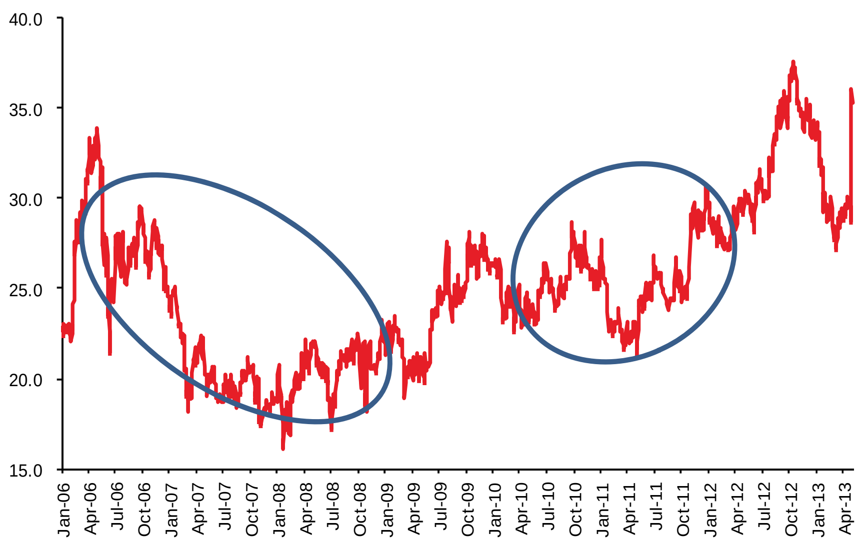
However, valuation reflects volume growth trends over the longer term

While earnings growth and profitability are important, consumer stock valuations do tend to be more closely connected to volume growth. In the past, valuation multiples of consumer companies have expanded even during low profitability periods, when they have been able to maintain their growth trajectory intact and market share steady.

We have looked at how the valuation for HUVR has moved over various cycles of high and low volume growth. Valuation multiples, here too, tend to expand during periods of more robust volume growth and tend to contract when volume growth is more subdued.

The chart below proves our hypothesis, between March '06 and December '08 HUVR's P/E multiple contracted sharply (from 30x-plus to a low of 20x) on the back of softening volume growth (trajectory had softened from 11% to 2% during the same time). Similarly, its P/E multiple expanded sharply in 2010–2011 when volume growth hit a high of 14%.

Fig. 5: HUVR – One-year forward P/E



Source: Company data, Nomura research

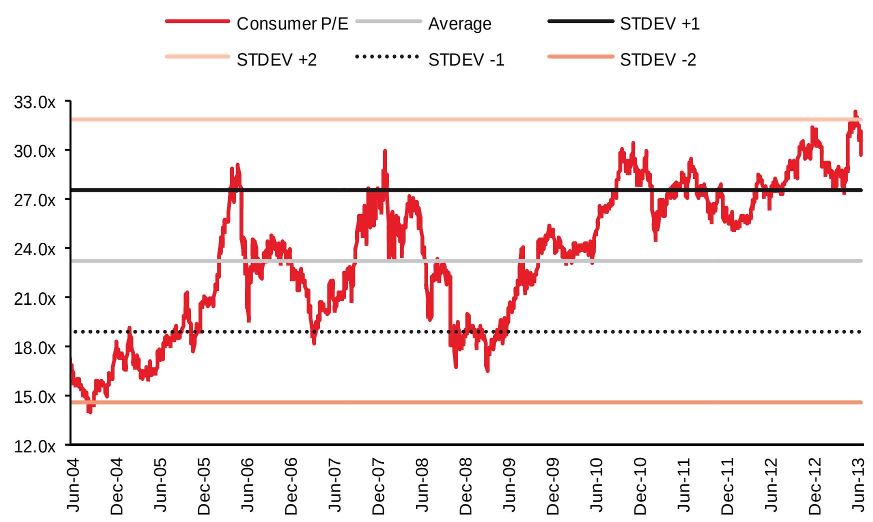
As mentioned above, currently, the company is in a phase where volume growth is stable, although at the lower end of the historical band of 5-7%. However, despite slack volumes, the stock is currently trading at 32.1x FY15F P/E (EPS: INR18.44), which we believe is a big departure from the past. At these volume growth levels, historically the stock has traded at a 23–25x P/E multiple range. In FY10–11 too, when HUVR reported 11–14% volume growth, the stock traded at 25–30x P/E multiple and did not breach the 30x multiple on a sustained basis for long periods.

We believe the current growth trajectory does not merit the multiples at which the stock is trading currently, and some of the key reasons for the disconnect are:

- **Open offer by the parent**: While the Q4FY13 results were largely in line with our expectations, the stock witnessed a sharp uptick given the offer by Unilever (parent) to buy back shares from investors. We have analysed the same in greater detail ahead in the report.
- **General consumer stock valuations are moving up**: Since April '13, the consumer sector index has risen by 13.6%, thereby outperforming the market by a significant 10.5% over the same period. This effectively implies that the consumer sector has been the best performer during this financial year, so far. The consumer sector has been closely followed by the Healthcare Index which has risen ~9% during the same period. This effectively implies that the defensive bias in the markets continues.

  In fact, the sector P/E multiple remains at an all-time high and is currently hovering slightly below the 2-standard-deviation mark. We believe that these rich valuations are undeserving and are unlikely to be sustained at these levels.

Fig. 6: Consumer sector P/E multiple



Source: Bloomberg, Nomura research

From a fundamental business perspective, we would be more bullish on companies like Emami (HMN IN, Buy, which though small, have a significantly higher growth trajectory than Hindustan Unilever (15.5% vs. 6% in FY13F) and the penetration levels for core products are significantly lower which essentially means much higher growth visibility going forward too. Purely from a fundamental business perspective, there is little justification for the core business valuation of HUVR.

Company valuation now becomes a two-part process

Given the open offer, which started on 21 June 2013 and will run up to 4 July 2013, the stock price is likely to remain in the vicinity of INR600, we estimate.

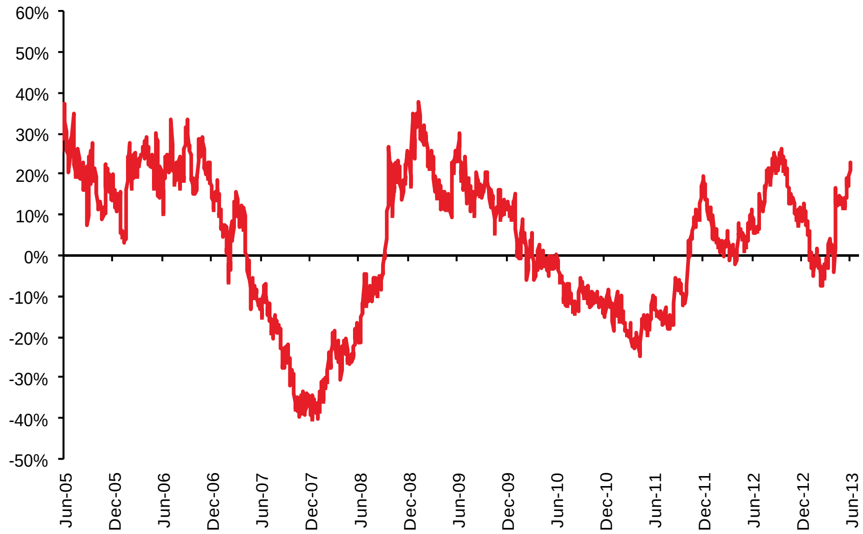
Unilever is looking to acquire a further 22.5% stake (it already owns 52.5%), so theoretically the acceptance ratio if everyone tenders is 47%. However, we do believe there will be some long-term shareholders who will want to continue to own HUVR as it remains the best proxy for the consumer sector in India. The open offer price will certainly remain one consideration for determining the fair price in the near-term.

Once the open offer is closed, the share price should reflect the long-term growth fundamentals of the business. We believe HUVR will deliver low-teens earnings growth and single-digit volume growth over the next couple of years. Given the long-term average valuation multiple of 25x, we believe the stock should settle down at close to those valuation levels once the open offer is through.

HUVR is trading close to life-time premium vs. the sector

We have also looked at the long-term historic trading range for HUVR vs. the sector. Over a longer time period, HUVR has traded at a 21% premium to the sector. The premium now is ~23%. It is also close to the peak premium the stock has traded vs. the sector for the past five years.

Fig. 7: HUVR premium vs. sector



Source: Bloomberg, Nomura research

Maintain Reduce

We maintain our Reduce rating on the stock, as we believe valuations over the medium-term are likely to hold at the upper-end of the long-term average for the company. If Unilever does get the 22.5% stake for which it has made an open offer, the free float would reduce considerably. This would imply that the stock will also have a significant liquidity premium attached to it in the longer term.

In case the open offer fails, investors are likely to expect a revised offer from Unilever and hence even in that case the stock price is likely to hold up, we think.

Our TP moves from INR418 to INR535. As discussed above, our revised TP is a combination of two factors. Firstly, the business valuation based on a P/E multiple of 25x (earlier 24x) which gives INR477. We believe that a multiple of 25x is justified given that:

A) It is in line with the long-term average trading multiple of the company,

B) It is in line with the multiple accorded to other consumer companies in our coverage. We have assigned a similar multiple despite lower volume growth to account for market position and brand strength of the company,

C) As mentioned above, volume growth and multiples have a strong linkage and given the current trajectory and outlook, we believe 25x is a fair multiple.

However, the open offer price is INR600, an average of these two gives us INR535 as our new TP.

An alternative way to look at our INR535 TP is that is equals to a little ~28x on rolling four quarters earnings. The 28x, incidentally, is also the multiple at which the stock has traded over the past three years.

Valuations continue to be at a premium

Valuations continue to remain rich across all companies in the sector. While INR deprecation threatens to eat into profitability and with growth remaining slow, sector valuations at 26x FY15 earnings continue to be rich.

Fig. 8: Consumer sector valuations

Company	Ticker	Rating	Price INR	EPS growth FY14E %	EPS growth FY15E %	FY14E P/E	FY15E P/E	FY15E PEG	Market Cap US$ mn
Nestle *	NEST IN	Neutral	4,910	22%	23%	32.2x	26.2x	1.2x	8,608
GSK Consumer *	SKB IN	Reduce	4,300	20%	21%	35.3x	29.2x	1.4x	3,292
Jubilant Foodworks	JUBI IN	Reduce	1,009	20%	27%	42.0x	33.0x	1.2x	1,197
United Spirits	UNSP IN	Buy	2,292	139%	49%	47.6x	31.9x	0.7x	5,451
F&B Average						**37.9x**	**28.9x**		
Colgate Palmolive	CLGT IN	Neutral	1,257	15%	15%	27.8x	24.1x	1.6x	3,107
Dabur	DABUR IN	Buy	152	20%	18%	28.6x	24.2x	1.3x	4,823
Godrej Consumer	GCPL IN	Buy	771	24%	24%	27.3x	22.0x	0.9x	4,773
Hindustan Unilever	HUVR IN	Reduce	588	12%	10%	35.1x	31.9x	3.1x	23,104
Marico	MRCO IN	Buy	190	39%	22%	24.4x	20.0x	0.9x	2,128
HPC Average						**31.6x**	**27.9x**		
ITC	ITC IN	Buy	320	19%	19%	27.9x	23.6x	1.3x	45,931
Asian Paints	APNT IN	Neutral	4,362	27%	19%	30.4x	25.5x	1.3x	7,606
Titan Industries	TTAN IN	Neutral	229	10%	19%	24.0x	20.1x	1.1x	3,691

Note: Prices as on June 26, 2013. * Indicates Calendar year based valuation
Source: Bloomberg, Nomura estimates.

Should investors tender the shares in the open offer?
We believe at INR600, Unilever is offering a very generous multiple of 33x FY15F EPS of INR18.18. This is a significant 32% premium to the long-term average of 25x. On a large cap name in the sector, 33x is an attractive valuation. Also, considering that on a standalone basis, we would value the stock closer to INR477. We would tender the shares in the open offer and consider it an attractive price for investors.

What are the changes to our numbers?
We have incorporated a couple of changes:

- We have now incorporated audited FY13 earnings into our model.
- We now expect a 40bps improvement in operating margins in FY14F, compared with our earlier expectation of a 20bps improvement. This change reflects the decline in input costs; consequently, we are now building in a more robust gross margin improvement story.
- However, A&P spends are likely to rise again in FY14F, given that advertising rates have moved up and competitive intensity too has picked up.
- Other income was at significantly higher levels in FY13. However, as we are building in a more normalised scenario in FY14F, other income declines sharply.

Owing to our more robust margin improvement expectations than before and incorporation of FY13 audited earnings, our earnings estimates move up by 3–4% for FY14F/FY15F.

Risk to our investment view:
While our fundamental business analysis shows that the company's core value currently stands at INR477, the share price in the near term may be driven more by technical factors.

What can hold the stock price?

In case the open offer fails, expectations of a revised offer from Unilever or hopes of a possible delisting in the medium term can potentially hold the stock up just as it had happened to GSK consumer.

What can take the stock down?

If the open offer is successful, the free float, implying that the index weight also goes down. That itself will trigger a minor sell off in the stock price.

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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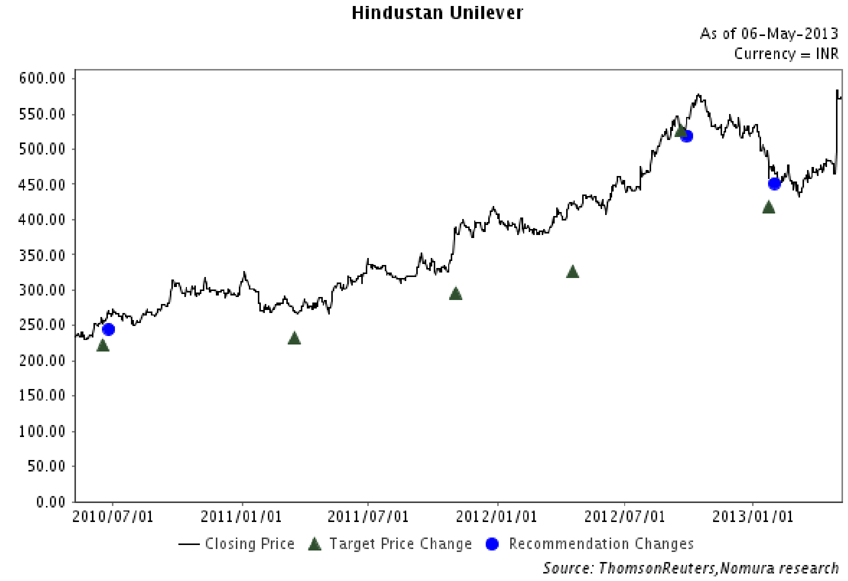
Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Hindustan Unilever	HUVR IN	INR 588	26-Jun-2013	Reduce	Not rated	

Hindustan Unilever (HUVR IN) **INR 588 (26-Jun-2013)** Reduce (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
23-Jan-13	Reduce		460.05
23-Jan-13		418.00	460.05
20-Sep-12	Neutral		527.50
20-Sep-12		527.00	527.50
18-Apr-12		327.00	422.85
02-Nov-11		296.00	390.05
17-Mar-11		232.00	270.70
17-Jun-10	Reduce		253.00
17-Jun-10		222.00	253.00

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

Valuation Methodology Our target price of INR535 values HUVR at an average of business valuation of INR 477 (25x one year forward EPS of INR 19.1) and open offer price of INR 600.

Risks that may impede the achievement of the target price A sharp decrease in input prices would improve gross margins significantly, which would be an upside risk to our numbers. Another risk is a sharp pick up in volume growth numbers driven by an increase in discretionary spend.

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

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