Pidilite Industries PIDI.NS PIDI IN

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In fair value zone after recent outperformance

Longer-term story intact but near-term headwinds on raw-material and elastomer persist

June 8, 2012

Rating Down from Buy	**Neutral**
Target price Reduced from 174	INR 169
Closing price June 7, 2012	INR 174
Potential downside	-2.9%

Action/Valuation: Cut to Neutral; don't see upside from current levels
We downgrade Pidilite to Neutral, as we believe the stock is now in a fair value zone after its recent outperformance although concerns over raw material prices and the elastomer project still persist. We continue to derive our target price based on a P/E multiple of 17.5x on FY14F adj EPS of INR9.66 (we have scaled back our FY14F estimate by ~3%).

Increasing VAM price and depreciating INR suggest margin pressure
We expect VAM prices to remain high, backed by strong demand for ethylene (a key raw material for VAM) and high crude oil prices (Nomura forecasts per barrel to average USD110 in FY13F and USD105 in FY14F vs ~USD98 in FY12. Since VAM is imported, depreciation of the rupee vs the US dollar would further add to raw material headwinds for Pidilite.

Slowing demand in domestic market & export to limit price increase
We expect moderating growth in consumer & bazaar (C&B) on slowing new construction and industrial products, reflected in weak IIP numbers, to constrain Pidilite's ability to pass on rising raw material costs. For FY13F, we build in margin declines in the C&B and industrial-product divisions.

Overseas subsidiaries performance remains a concern
Overseas subsidiaries (especially Brazil and the Middle East) continue to be a drag on group performance.

Catalyst: Outcome on the progress of the elastomer project, which is currently on hold, should remove an overhang on the stock's multiple

31 Mar	FY11		FY12F		FY13F		FY14F
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	26,721	31,533	31,266	37,051	36,598	43,650	43,030
Reported net profit (mn)	3,100	3,187	3,244	4,265	3,664	5,048	4,903
Normalised net profit (mn)	3,106	3,187	3,311	4,265	3,664	5,048	4,903
Normalised EPS	6.14	6.28	6.52	8.40	7.22	9.94	9.66
Norm. EPS growth (%)	9.6	2.3	6.3	33.8	10.7	18.4	33.8
Norm. P/E (x)	28.3	N/A	26.6	N/A	23.4	N/A	17.5
EV/EBITDA (x)	18.2	14.7	17.7	10.8	14.8	8.9	11.0
Price/book (x)	7.9	N/A	6.6	N/A	5.5	N/A	4.5
Dividend yield (%)	0.4	N/A	0.5	N/A	0.6	N/A	1.7
ROE (%)	33.4	27.8	28.4	30.3	26.6	29.1	29.3
Net debt/equity (%)	21.4	10.2	15.4	net cash	3.9	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

We remain optimistic on the long-term prospects of spending on construction chemicals and adhesives. But in the near term, we factor in headwinds in raw material prices and the impact of a depreciating INR which we believe will adversely impact margins.

Nomura vs consensus

Our FY13 EBITDA estimate is ~8% below consensus, as we believe the Street is not factoring in higher VAM prices and depreciating INR vs USD.

Research analysts

India Mid-Caps

Ankur Agarwal,CFA - NFASL
ankur.agarwal@nomura.com
+91 22 4037 4489

Lalit Kumar - NFASL
lalit.kumar@nomura.com
+91 22 4037 4511

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

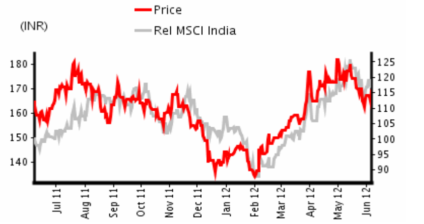
Key data on Pidilite Industries

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**22,133**	**26,721**	**31,266**	**36,598**	**43,030**
Cost of goods sold	-11,391	-14,047	-17,403	-20,719	-23,529
Gross profit	**10,742**	**12,674**	**13,863**	**15,880**	**19,501**
SG&A	-7,348	-8,473	-9,574	-10,784	-12,669
Employee share expense					
Operating profit	**3,394**	**4,202**	**4,289**	**5,095**	**6,832**
EBITDA	**4,059**	**4,797**	**4,926**	**5,773**	**7,549**
Depreciation	-666	-595	-637	-677	-717
Amortisation					
EBIT	3,394	4,202	4,289	5,095	6,832
Net interest expense	-329	-314	-307	-197	-47
Associates & JCEs	27	22	27	28	29
Other income	118	150	435	120	120
Earnings before tax	**3,211**	**4,060**	**4,444**	**5,046**	**6,934**
Income tax	-422	-954	-1,130	-1,382	-2,031
Net profit after tax	**2,789**	**3,106**	**3,314**	**3,664**	**4,903**
Minority interests	-1	0	0	0	0
Other items	44	0	-3	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	**2,832**	**3,106**	**3,311**	**3,664**	**4,903**
Extraordinary items	-63	-5	-67	0	0
Reported NPAT	**2,770**	**3,100**	**3,244**	**3,664**	**4,903**
Dividends	-885	-1,029	-1,119	-1,099	-1,471
Transfer to reserves	**1,884**	**2,071**	**2,125**	**2,565**	**3,432**
Valuation and ratio analysis					
FD normalised P/E (x)	31.1	28.3	26.6	23.4	17.5
FD normalised P/E at price target (x)	33.1	30.2	28.3	24.9	18.6
Reported P/E (x)	30.9	27.6	26.4	23.4	17.5
Dividend yield (%)	0.3	0.4	0.5	0.6	1.7
Price/cashflow (x)	21.9	27.3	33.6	26.2	19.0
Price/book (x)	9.8	7.9	6.6	5.5	4.5
EV/EBITDA (x)	22.0	18.2	17.7	14.8	11.0
EV/EBIT (x)	26.2	20.8	20.3	16.8	12.2
Gross margin (%)	48.5	47.4	44.3	43.4	45.3
EBITDA margin (%)	18.3	18.0	15.8	15.8	17.5
EBIT margin (%)	15.3	15.7	13.7	13.9	15.9
Net margin (%)	12.5	11.6	10.4	10.0	11.4
Effective tax rate (%)	13.1	23.5	25.4	27.4	29.3
Dividend payout (%)	32.0	33.2	34.5	30.0	30.0
Capex to sales (%)	3.9	4.9	2.9	1.6	1.4
Capex to depreciation (x)	1.3	2.2	1.4	0.9	0.8
ROE (%)	37.2	33.4	28.4	26.6	29.3
ROA (pretax %)	20.5	22.6	20.8	22.3	27.9
Growth (%)					
Revenue	10.0	20.7	17.0	17.1	17.6
EBITDA	69.9	18.2	2.7	17.2	30.8
EBIT	88.5	23.8	2.1	18.8	34.1
Normalised EPS	119.0	9.6	6.3	10.7	33.8
Normalised FDEPS	119.3	9.6	6.6	13.5	33.8
Per share					
Reported EPS (INR)	5.47	6.13	6.39	7.22	9.66
Norm EPS (INR)	5.60	6.14	6.52	7.22	9.66
Fully diluted norm EPS (INR)	5.44	5.97	6.36	7.22	9.66
Book value per share (INR)	17.23	21.43	25.56	30.61	37.37
DPS (INR)	0.57	0.71	0.88	1.02	2.90

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	-2.7	9.5	3.2
Absolute (USD)	-6.2	-0.6	-16.6
Relative to index	-0.2	14.7	14.7
Market cap (USDmn)	1,543.2		
Estimated free float (%)	29.4		
52-week range (INR)	187.45/133.65		
3-mth avg daily turnover (USDmn)	0.55		
Major shareholders (%)			
Promoters	70.6		

Source: Thomson Reuters, Nomura research

Notes

We forecast margin to be under pressure in FY13F

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	4,059	4,797	4,926	5,773	7,549
Change in working capital	977	-435	-1,551	-1,240	-1,137
Other operating cashflow	-1,024	-1,144	-755	-1,255	-1,902
Cashflow from operations	**4,012**	**3,218**	**2,620**	**3,278**	**4,510**
Capital expenditure	-865	-1,301	-897	-600	-600
Free cashflow	**3,147**	**1,917**	**1,723**	**2,678**	**3,910**
Reduction in investments	-2,380	1,108	0	0	0
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	11	14	0	0	0
Addition in other LT liabilities					
Adjustments	36	40	20	20	20
Cashflow after investing acts	**814**	**3,079**	**1,743**	**2,698**	**3,931**
Cash dividends	-519	-885	-1,119	-1,099	-1,471
Equity issue	0	0	0	0	0
Debt issue	-1,033	-1,321	-19	-2,665	-300
Convertible debt issue	-87	0	-2	0	0
Others	-329	-283	-307	-197	-47
Cashflow from financial acts	**-1,966**	**-2,488**	**-1,446**	**-3,961**	**-1,818**
Net cashflow	**-1,152**	**590**	**297**	**-1,263**	**2,113**
Beginning cash	1,601	449	1,039	1,336	73
Ending cash	449	1,039	1,336	73	2,186
Ending net debt	4,238	2,317	2,001	599	-1,814

Source: Company data, Nomura estimates

Notes

Assumed FCCB repayment in FY13F

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	449	1,039	1,336	73	2,186
Marketable securities	2,624	1,635	1,635	1,635	1,635
Accounts receivable	2,959	3,460	4,090	4,734	5,651
Inventories	2,979	4,092	6,063	7,073	7,845
Other current assets	1,046	966	966	966	966
Total current assets	**10,056**	**11,191**	**14,090**	**14,481**	**18,283**
LT investments	54	70	70	70	70
Fixed assets	8,390	9,138	9,398	9,321	9,203
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	0	0	0	0	0
Total assets	**18,499**	**20,399**	**23,558**	**23,872**	**27,556**
Short-term debt	666	505	496	496	496
Accounts payable	1,709	2,153	3,204	3,619	4,171
Other current liabilities	2,966	3,621	3,621	3,621	3,621
Total current liabilities	**5,342**	**6,279**	**7,320**	**7,735**	**8,287**
Long-term debt	2,341	1,188	1,176	176	-124
Convertible debt	1,679	1,663	1,665	0	0
Other LT liabilities	417	421	421	421	421
Total liabilities	**9,778**	**9,550**	**10,582**	**8,332**	**8,584**
Minority interest	2	2	2	2	2
Preferred stock	506	506	508	508	508
Common stock	8,213	10,341	12,466	15,031	18,463
Retained earnings					
Proposed dividends	0	0	0	0	
Other equity and reserves	0	0	0	0	
Total shareholders' equity	**8,719**	**10,847**	**12,974**	**15,538**	**18,970**
Total equity & liabilities	**18,499**	**20,400**	**23,558**	**23,872**	**27,557**
Liquidity (x)					
Current ratio	1.88	1.78	1.92	1.87	2.21
Interest cover	10.3	13.4	14.0	25.9	145.5
Leverage					
Net debt/EBITDA (x)	1.04	0.48	0.41	0.10	net cash
Net debt/equity (%)	48.6	21.4	15.4	3.9	net cash
Activity (days)					
Days receivable	48.1	43.8	44.2	44.0	44.0
Days inventory	92.6	91.9	106.8	115.7	115.7
Days payable	48.3	50.2	56.3	60.1	60.4
Cash cycle	92.4	85.5	94.6	99.6	99.3

Source: Company data, Nomura estimates

Notes

Debt free balance sheet in FY13F

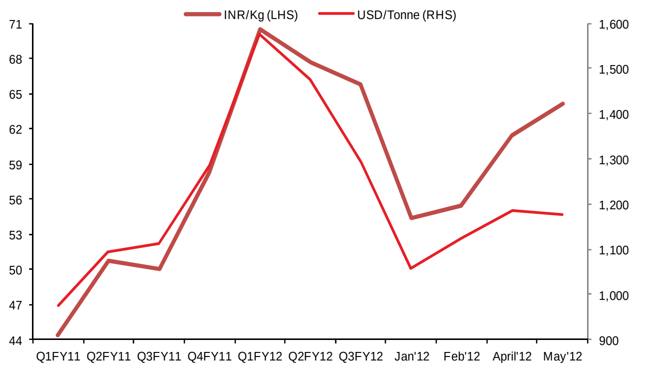
Raw material headwinds, as we expect higher VAM prices to continue

Vinyl acetate monomer (VAM) is a key raw material for Pidilite. As shown below, VAM prices dropped steadily in 2011 but started to increase from January 2012. Since Pidilite maintains raw material inventory for 30-40 days, we believe the increase in VAM prices in February-March 2012 will have an adverse impact on its margin in 1QFY12.

While management is suggesting a decline in VAM prices by USD50-100/tonne given that Ethylene prices (raw material for VAM) have declined in the past two months, our analysis indicates that ethylene prices will likely strengthen in FY13F-14F. Our analysis is based on demand trends for ethylene (shown below) and Nomura's view on crude prices to which ethylene prices are strongly correlated with.

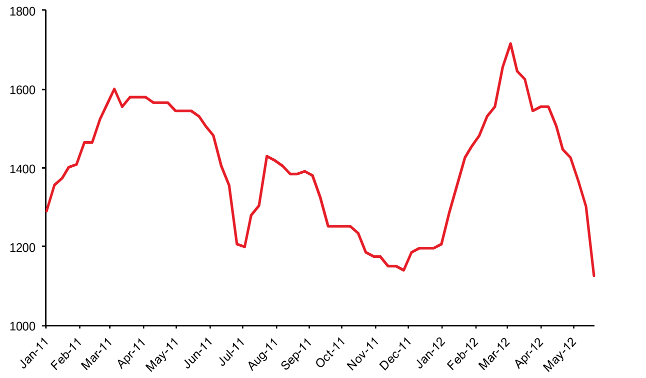
As per our interaction with Nomura's European chemicals team, the increase in ethylene prices during January-March 2012 was not completely passed on by VAM manufacturers, thereby impacting their margins. Ethylene prices have fallen over the past two months on uncertainty over crude oil prices, so buyers are waiting for ethylene prices to fall further. Hence, even though ethylene prices fell in April-May 2012, VAM prices have remained at high levels during this period, as shown below. As such, although we believe that ethylene prices may fall in the near term, we believe VAM prices will continue remain at current high levels.

Fig. 1: VAM price – increase from Feb'12 to have an impact on margins in 1QFY13



Source: ISIC, Nomura Research

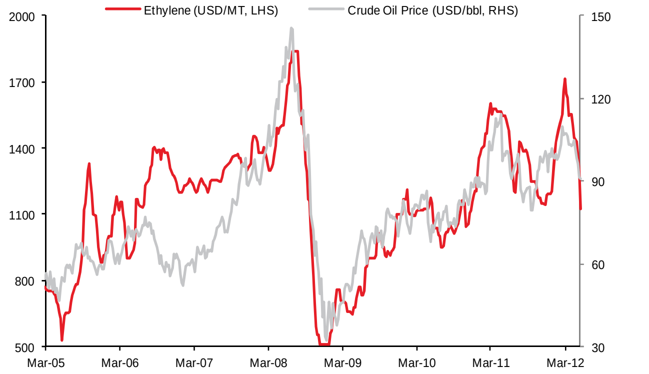
Fig. 2: Ethylene Prices – fallen over the past two months (USD/MT)



Source: Bloomberg, Nomura Research

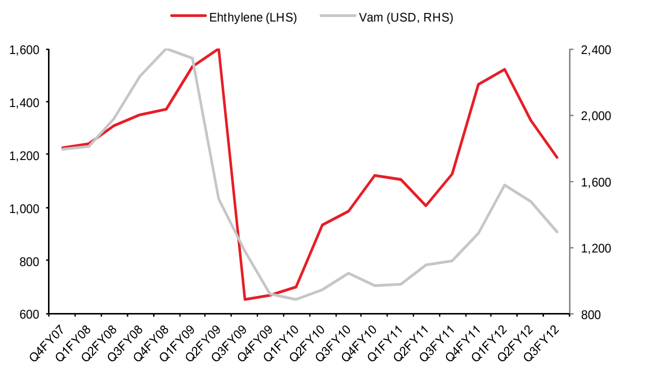
Ethylene is an important raw material for VAM strongly correlated with crude oil prices.

Fig. 3: Correlation between crude oil & ethylene prices



Source: Bloomberg, Nomura Research

Fig. 4: Ethylene - an important raw material for VAM (in USD/MT)



Source: Bloomberg, ICIS, Nomura Research

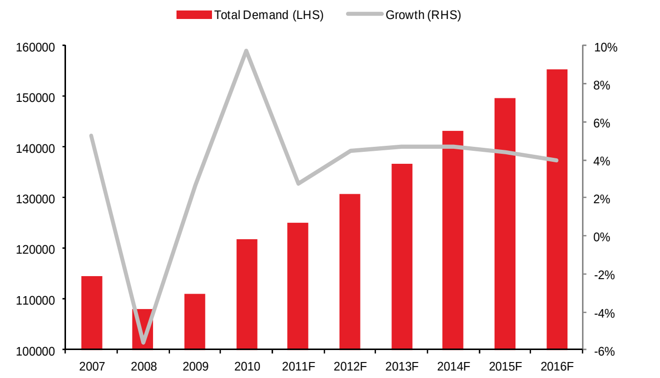
Crude oil prices averaged USD97.15 per barrel in FY12 and as per Nomura forecast, crude prices will average USD110 per barrel in FY13F and USD105 per barrel in FY14F.

We believe high crude oil prices will keep ethylene prices and thus VAM prices at elevated levels.

We expect global demand for ethylene (the most important raw material for VAM) to be strong and post a CAGR of ~4.6% over CY11-14F. Increased oil prices and increased demand for ethylene will likely lead to higher ethylene prices and thus, stronger VAM prices over FY13F-14F, in our view.

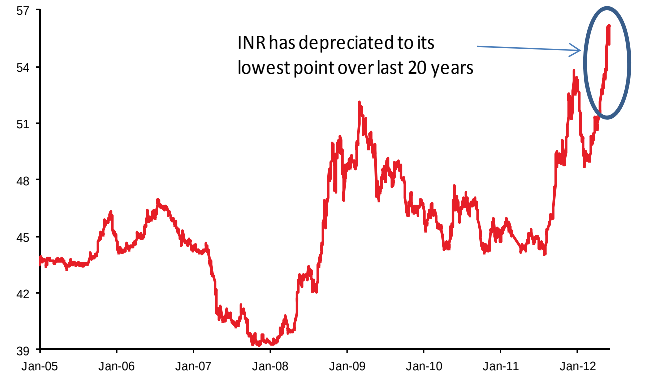
Fig. 5: Global ethylene demand – expected to be strong over CY11-14F

'000 MT



Source: IHS, Nomura Research

Fig. 6: USDINR– depreciating INR vs USD to make VAM more expensive and increase margin pressure



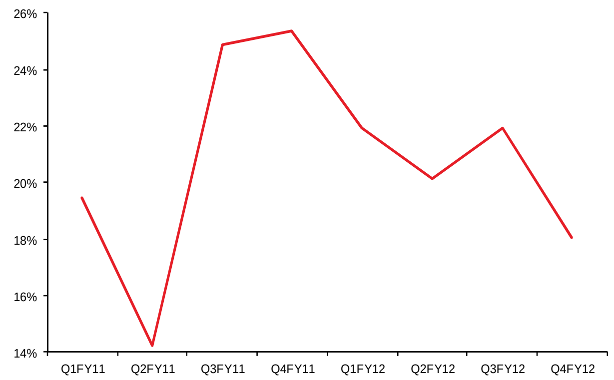
Source: Bloomberg, Nomura Research

Pidilite imports (USD denominated) its entire VAM requirement, which means that the impact of a depreciating rupee will further add to the raw material headwinds. The rupee is at a 20-year low versus the US dollar, as shown in the chart above.

Will the proposed price increase in 1QFY12 enough to offset margin pressure in the current demand backdrop?

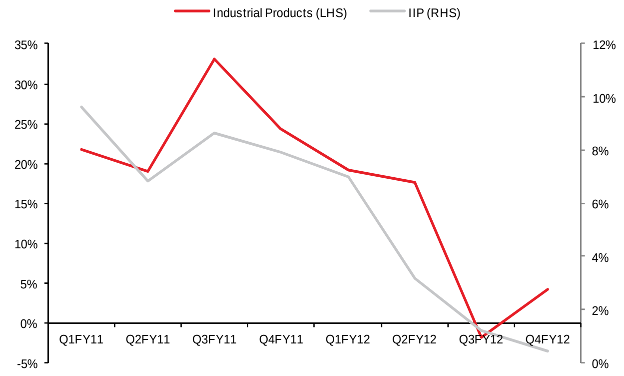
Pidilite, at its 1QFY12 conference call, indicated that it planned to hike prices in 1QFY12 in order to pass on the rise in raw material prices. With growth moderating, we believe taking enough price increases to offset the raw material headwinds may not be easy. While it is relatively easier to hike prices in the C&B segment as this is consumer-facing, it is more difficult to hike prices in the industrial-product business, which is a B2B business. As shown in the diagram below, revenue growth has moderated in C&B (which is linked to new construction, or discretionary expense such as furniture apart from the repair-and-maintenance segment) and in the industrial-product business. In an inflationary environment, slowing consumer discretionary spending, limited new residential construction in India, a slowing export market and falling IIP will, in our view, constrain Pidilite's ability to hike prices, especially in the industrial-product business.

Fig. 7: Consumer and Bazaar Business – sales growth slowing down



Source: Company data, Nomura Research

Fig. 8: Industrial Products business & Index of Industrial Production (IIP) – slowing down



Source: Company data, CEIC, Nomura estimates

Pidilite reported top-line growth of ~4.1% in 4QFY12 against -1.8% in 3QFY12, due to re-stocking in Q4 vs de-stocking in Q3. For FY13F, we have reduced our margin estimates by 150bps for the C&B division. For the industrial-product business, we reduce our margin estimates by 450 bps for FY13F and by 150 bps for FY14F.

No outcome yet on the elastomer project

Pidilite has so far (starting 2007) incurred a capex of~ INR3.55bn to build an elastomer project in Dahej to manufacture Polycholoroprene. The project has already been delayed once from March 2010 to FY13 because of the economic crisis and it continues to be "on hold" currently. This project is "under review" as the company has appointed a consultant to assess the prospects of the project. The final outcome, originally expected in 3QFY12 as mentioned at the 2QFY12 result conference call, was delayed again with no concrete outcome disclosed in 4QFY12. According to management, after the consultant submitted the report, the company board members wanted a further review of some aspects of the project.

We remain of the view that it is better for Pidilite to shelve the project than to continue pursuing it. Please see our detailed analysis published on 29th Nov 2011 in our report "***Risks outweigh rewards, concerns around the elastomer project***"

Performance of overseas subsidiaries continues to be below par

Pidilite has 14 overseas subsidiaries. Weak demand in the international markets, particularly in Brazil, has lead to muted performance of the overseas subsidiaries and export for the domestic business. The company is currently facing tough macro and aggressive competition in Brazil (South America). The fact that it is not a market leader in Brazil (Pidilite is a clear market leader in India in the adhesive business with products such as Fevicol having a 70% market share, according to management) further aggravates the situation in a market where competitors are focussed on gaining market share over profitability.

In 4QFY12, total overseas subsidiaries sales declined by ~3.3% while South America reported a loss of USD64mn at the EBITDA level, mainly due to weak performance in Brazil. As shown below, Pidilite continued to post a loss (albeit lower than FY12) in the Middle East at the operating level. The company took a provision of INR250mn (FY11) in its investment in Pidilite Middle East. This was on account of continued underperformance of Jupiter Chemicals (Dubai), a subsidiary of Pidilite Middle East. Pidilite took a further provision of INR29mn in FY12 for a similar reason.

Fig. 9: Performance of overseas subsidiaries (in USDmn)

	FY09	FY10	FY11	FY12
North America				
Sales	1,111	1,181	1,227	1,276
- growth		*6.3%*	*3.9%*	*4.0%*
EBITDA	(43)	26	57	62
- margin	*-3.9%*	*2.2%*	*4.6%*	*4.9%*
South America				
Sales	797	1,023	1,255	1,261
- growth		*28.4%*	*22.7%*	*0.5%*
EBITDA	(111)	98	33	(93)
- margin	*-13.9%*	*9.6%*	*2.6%*	*-7.4%*
Middle East and Africa				
Sales	207	236	199	296
- growth		*14.0%*	*-15.7%*	*48.7%*
EBITDA	(36)	(32)	(81)	(49)
- margin	*-17.4%*	*-13.6%*	*-40.7%*	*-16.6%*
South & South East Africa				
Sales	201	255	339	417
- growth		*26.9%*	*32.9%*	*23.0%*
EBITDA	(24)	16	31	45
- margin	*-11.9%*	*6.3%*	*9.1%*	*10.8%*
Total				
Sales	2,316	2,695	3,020	3,250
- growth		*16.4%*	*12.1%*	*7.6%*
EBITDA	(214)	108	40	(35)
- margin	*-9.2%*	*4.0%*	*1.3%*	*-1.1%*

Source: Company data, Nomura Research

4QFY12 performance – higher other income inflates the outcome at the net level

4QFY12 performance was marked by a slowdown in the domestic market (particularly the industrial product segment) and export market. Sales grew by ~14.3% and ~16.8% on consolidated and standalone basis, respectively. Weak performance of overseas subsidiaries (particularly Brazil) resulted in low consolidated sales growth as mentioned above.

Fig. 10: Q4FY12 consolidated performance – sales in line, higher profit on account of higher income

INRmn

	Q4FY11	Q3FY12	Q4FY12				
			Actual	Nomura	Difference	Consensus	Difference
Revenue	6,259	7,681	7,153	7,338	-3%	7,364	-3%
- growth	*23.0%*	*16.5%*	*14.3%*	*16.9%*		*17.7%*	
EBITDA	736	1,201	883	836	6%	947	-7%
- margin	*11.7%*	*15.6%*	*12.3%*	*11.3%*		*12.9%*	
Net Income	462	786	640	536	19%	564	13%
EPS	0.91	1.55	1.26	1.06	19%	1.10	15%
Adj EPS	0.89	1.59	1.28	1.03	24%	1	18%

Source: Company data, Bloomberg, Nomura research

Gross margin improved ~315bps q-q on a consolidated basis in 4QFY12 on falling VAM prices until January 2012 as shown above but was below the FY11 level, indicating margin pressure on high raw material prices. Q4 has, historically, been a weak quarter due to seasonality. EBITDA margins improved by ~60bps y-y, driven by an improvement in gross margin and the fact that advertising expense was lower than that a year earlier, when it rose due to the cricket world cup. Pidilite reported other income of INR152mn in 4QFY11 against INR85mn in 4QFY12 on account of higher investment income which resulted in PAT being better than our and Street expectations.

Fig. 11: 4QFY12 standalone performance

INRmn

	Q4FY11	Q4FY12	y-y growth
Revenue	5,547	6,476	16.8%
- growth	*24.0%*	*16.8%*	
EBITDA	771	958	24.3%
- margin	*13.8%*	*14.7%*	
Net Income	292	710	142.8%
Adj Income	446	740	66%
Basic EPS	0.58	1.40	

Source: Company data, Nomura Research

Pidilite also took a provision of INR250mn in 4QFY11 vs INR29mn in 4QFY12. This provision was on account of diminution in the company's investment in Pidilite Middle East Ltd (Jupiter Capital).

Fig. 12: Segmental Performance – margin pressure continues in the industrial products business

INRmn

	Q4FY11	Q3FY12	Q4FY12	Q4FY12F
Consumer & Bazaar Products				
Sales	4,816	6,349	5,686	5,762
- growth	*-25.3%*	*21.9%*	*18.1%*	*19.7%*
EBIT	707	1,363	898	891
- margin	*14.7%*	*21.5%*	*15.8%*	*15.5%*
Industrial Products				
Sales	1,590	1,400	1,655	1,672
- growth	*24.4%*	*-1.8%*	*4.1%*	*5.1%*
EBIT	272	148	205	211
- margin	*17.1%*	*10.6%*	*12.4%*	*12.6%*

Source: Company data, Nomura estimates

In 4QFY12, sales of overseas subsidiaries declined by ~3.3% in constant currency terms and ~4.2% in rupee terms.

Change in estimates and valuation

In a backdrop of slowing demand especially on the industrial side in India and the export market, we have scaled back our FY13F estimate from ~14% to ~9.2% for the industrial product business. We were already building in moderation in terms of revenue growth in the C&B segment, as we forecast top-line growth of ~18% in FY13F vs the average of ~20% in FY11-FY12. We have also scaled back our EBITDA margin assumption by 150bps (FY13F) in C&B , and by 450bps (FY13F) and 250bps (FY14F) in the industrial-product business, as we factor in the raw material headwinds amidst slowing demand which we believe will make it difficult to implement significant price increases.

Fig. 13: Change in estimates – reducing margin on account of increasing VAM prices

INRmn

	Old		New		% Change	
	FY13F	FY14F	FY13F	FY14F	FY13F	FY14F
Revenue	36,801	43,400	36,348	42,780	-1.2%	-1.4%
- growth	*17.6%*	*17.8%*	*16.9%*	*17.7%*	*-0.7%*	*-0.1%*
EBITDA	6,598	7,756	5,773	7,549	-12.5%	-2.7%
- margin	*17.8%*	*17.8%*	*15.8%*	*17.5%*	*-2.0%*	*-0.3%*
Profit	4,265	5,048	3,664	4,903	-14.1%	-2.9%
EPS (INR)	8.40	9.94	7.22	9.66	-14.1%	-2.8%

Source: Nomura estimates

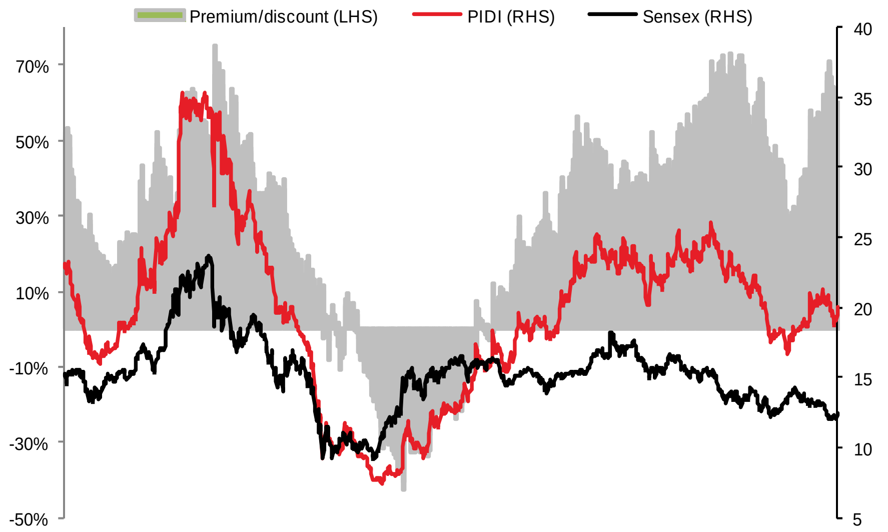
Fig. 14: Segmental growth & margin estimates – Industrial-product segment to be impacted most on week IIP and difficulty in taking price hikes

	Old		New		Change	
	FY13F	FY14F	FY13F	FY14F	FY13F	FY14F
Consumer & Bazaar						
- Sales growth	*18.7%*	*18.8%*	*18.4%*	*18.6%*	*-0.2%*	*-0.2%*
- EBIT Margin	*21.5%*	*21.5%*	*20.0%*	*21.5%*	*-1.5%*	*0.0%*
Industrial Product						
- Sales growth	*13.8%*	*14.5%*	*9.2%*	*14.0%*	*-4.7%*	*-0.5%*
- EBIT Margin	*16.5%*	*16.5%*	*12.0%*	*15.0%*	*-4.5%*	*-1.5%*

Source: Nomura estimates

We continue to value the stock at 17.5x one-year forward P/E multiple (broadly in line with its 3-year average) on FY14F adj. EPS of INR9.66 to arrive at our revised target price of INR169. We like the company's ability to build solid brands in niche segments and its solid positioning as a branded adhesive player. However, we will wait for the resolution of the outcome of the elastomer project before assuming a multiple that is more in line with other consumer names in India.

Fig. 15: One year forward P/E trading multiple – Pidilite is trading at a significant premium to the Sensex



Source: Bloomberg, Nomura estimates

Investment Risks

Key upside risks to our view can emanate from:

1. Possible divestment of the elastomer project at a reasonable price, which may re-rate the stock.
2. Significant decline in Vinyl Acetate Monomer (VAM) prices, which would be a deviation from our current assumption of continued strength in the VAM prices.
3. Reversal in the macro –economic backdrop in India which results in improvement in consumer sentiment.

Key downside risks to our view:

1. The company decides to invest further in the elastomer project, which in our view could lead to a de-rating of the stock.
2. Further deterioration in the consumer sentiment and new–residential activity in India, which could lead to lower-than-expected growth, especially in the C&B (Consumer and Bazaar) segment.
3. Significant increase in VAM prices, which is higher than our current assumption.

Appendix A-1

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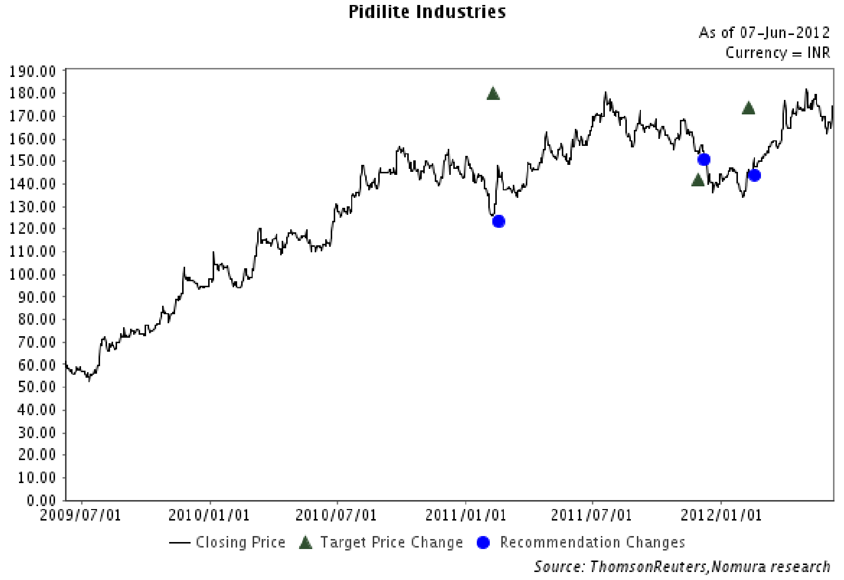
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Pidilite Industries	PIDI IN	INR 174	07-Jun-2012	Neutral	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Pidilite Industries	Buy	07-Jun-2012

Pidilite Industries (PIDI IN) **INR 174 (07-Jun-2012)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
09-Feb-12	Buy		146.45
09-Feb-12		174.00	146.45
29-Nov-11	Reduce		153.50
29-Nov-11		142.00	153.50
08-Feb-11	Buy		126.10
08-Feb-11		180.00	126.10

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

Valuation Methodology Our target P/E multiple of 17.5x (FY14F adj EPS of INR9.66) is in line with the three-year average; our target price is INR169.

Risks that may impede the achievement of the target price Slowdown in economic activities or construction industry - since a major part of Pidilite's revenue is derived from the construction sector, any slowdown in construction activities would have an impact on our earnings estimates. Elastomer Plant in Dahej, Gujarat - according to management, Pidilite has spent INR3,100mn on an elastomer plant in Dahj, Gujarat, and is expected to spend another INR2,000-2,250mn. Commencement of operations, expected in March 2010, has been delayed by the economic crisis; it is now expected to start in FY13. Given the significant investment, any failure could lead to considerable write-offs. High volatility in raw material Vinyl Acetate Monomer (VAM) is Pidilite's main raw material, and its price is linked to crude oil. High volatility in raw material prices can squeeze margins, or the company might be stuck with high-priced inventory, resulting in write-offs. This is what happened in FY09. Currency fluctuation - Pidilite currently imports nearly all of its VAM requirement and exports to more than 80 countries, but its net exposure is only Rs1bn, according to management. It also has an outstanding FCCB debt of USD37.2mn. Any adverse movement in the US dollar-Indian rupee exchange rate would be unfavourable if the company has to pay back debt. Overseas subsidiaries - some of Pidilite's subsidiaries (Egypt, Dubai) are still making losses, although there have been reductions in these losses. With the economic recovery in the West likely to take longer, Pidilite's overseas subsidiaries might continue to report losses. Economic downturn - Pidilite's growth is based on consumption and construction activity. Any downturn in the economy would lead to a cut in these activities, thereby affecting the company's earnings.

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