Enterprising India

The Winning Dozen

1Q2013

Power of Compounding

Prabodh Agrawal
prabodh@iiflcap.com
(91 22) 4646 4697

Avi Mehta
avi.mehta@iiflcap.com
(91 22) 4646 4650

Bijal Shah
bijal@iiflcap.com
(91 22) 4646 4645

Dr Bino Pathiparampil
bino@iiflcap.com
(91 22) 4646 4648

J Radhakrishnan
radhakrishnan@iiflcap.com
(91 22) 4646 4653

Joseph George
joseph.george@iiflcap.com
(91 22) 4646 4667

Sampath Kumar
sampath.kumar@iiflcap.com
(91 22) 4646 4665

Sandeep Muthangi
sandeep.muthangi@iiflcap.com
(91 22) 4646 4686

Contents

The Winning Dozen 1
Criteria for stock selection 2
The Buffet way 17

Companies

HDFC Bank 23
Sun Pharmaceuticals 41
Bajaj Auto 57
Kotak Mahindra Bank 73
HCL Technologies 93
Asian Paints 109
Zee Entertainment 125
Marico Industries 141
M&M Finance 157
Exide Industries 177
Pidlite Industries 195
Havells India 211

The Winning Dozen

The dozen companies presented in this report are long-term winners, in our view, due to the structural nature of their earnings growth, their strong position within fast-growing industries, and their proven managements. Their track record has been exceptional: average stock price Cagr was 30% over the past three years, 20% over the past five years and 39% over the past 10 years as against Cagr of 5%, 0% and 20% respectively for the Sensex/Nifty. We expect this stellar performance to continue because the enabling conditions have not changed and their bases are still small.

The key criteria we have zeroed in on for selecting our 'Winning Dozen' are: 1) these companies are largely domestic plays on rising affluence, consumption, and investment themes, with the exception of IT and pharmaceutical companies; 2) they have scalable businesses; 3) their competitive position in the industry is strong; 4) their balance sheets are strong and return ratios are healthy; 5) they have a good management track record and there is visibility on its continuity; and 6) their valuations are justifiable i.e., they are not priced-for-perfection, based on PEGx criteria.

Personal income and consumption trends have shown a distinct acceleration in recent years. This is likely to continue even as working-age population and rate of urbanisation in India continue to increase. Penetration levels in sectors such as financial services, automobiles, FMCG, media and home ownership are low and are improving as income levels rise, powering the robust growth for companies in these sectors. The 'sweet spot' for many sectors can continue for the next two decades.

The most important differentiator between winners and others is perhaps their managements' vision and execution capability. Good track record and visibility on continuance of a performing management are highly reassuring, in our view. It is also important that the management's interest is aligned to that of the minority shareholders. We believe the stocks we have selected offer compounding potential over long periods. For example, at 20% Cagr, investment will grow more than 6x in 10 years; to put this in perspective, Warren Buffet, arguably the world's smartest investor, has delivered 6%, 13% and 17% Cagr over the past 10, 20 and 25 years respectively.

The Power of Compounding

Years/ Cagr	12%	15%	20%	25%	30%
3	1.4	1.5	1.7	2.0	2.2
5	1.8	2.0	2.5	3.1	3.7
10	3.1	4.0	6.2	9.3	13.8
20	9.6	16.4	38.3	86.7	190.0

Source: Company, IIFL Research

Figure 1: The 'Winning Dozen'

Company name	Bloomberg code	CMP (Rs)	Mkt Cap (US$ m)	EPS Cagr (FY12-15ii)	ROE (%) (FY13ii)	Net debt/equity (%) (FY13ii)	P/E (x) (FY14ii)	P/E (x) (FY15ii)	P/B (x) (FY14ii)
HDFC Bank	HDFCB IN	689	29,918	26.5	20.7	NA	19.2	15.5	3.8
Sun Pharma	SUNP IN	719	13,650	11.7	21.2	(36.0)	24.2	20.6	3.9
Bajaj Auto	BJAUT IN	2,081	11,059	9.6	44.9	(83.1)	16.3	14.6	6.3
Kotak Mahindra Bank	KMB IN	665	9,081	25.7	15.5	NA	17.7	13.5	2.8
HCL Tech	HCLT IN	631	8,044	19.1	29.4	(13.3)	12.2	10.8	2.9
Asian Paints	APNT IN	4,281	7,540	21.2	38.0	(14.3)	28.9	23.4	9.9
Zee Ent	Z IN	207	3,640	15.7	18.8	(34.0)	24.1	21.7	4.5
Marico	MRCO IN	221	2,612	23.1	25.4	44.2	27.6	22.8	5.9
M&M Finance	MMFS IN	1,090	2,276	26.2	23.6	NA	10.8	8.7	2.2
Exide	EXID IN	141	2,201	26.6	18.2	(23.6)	14.7	12.8	2.9
Pidilite	PIDI IN	213	2,000	24.0	27.3	(13.4)	21.2	17.4	5.6
Havells India	HAVL IN	606	1,389	20.1	37.1	41.2	14.2	11.8	4.6

Source: Company, IIFL Research

Criteria for stock selection

The dozen stock ideas in this report have been selected based on the following key criteria:

1. Largely domestic plays on rising affluence, consumption and investment themes (the exceptions are IT and pharmaceutical companies that leverage on India's advantages of low-cost intellectual capital)
2. Scalable businesses, i.e. a large addressable market or low penetration levels, ensuring many years of robust growth ahead
3. Competitive position in the industry with distribution reach and pricing power
4. Strong balance sheets and healthy return ratios
5. Management track record and visibility on its continuance
6. Justifiable valuations, i.e., not priced for perfection
7. Key concerns to watch out for: a) regulatory risks; b) track record of corporate governance, c) possibility of disruptive competition, if any.

1. Largely a domestic play on rising affluence, consumption and investment

There has been a distinct acceleration in growth in personal income levels in the past 6-7 years more than ever before. The five-year rolling Cagr in real GDP per capita has risen 6% or more since FY07.

Figure 2: Real GDP per capita (five-year rolling Cagr)

(5yr Cagr, %)
Real GDP per capita
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
(1.0)
FY56 FY58 FY60 FY62 FY64 FY66 FY68 FY70 FY72 FY74 FY76 FY78 FY80 FY82 FY84 FY86 FY88 FY90 FY92 FY94 FY96 FY98 FY00 FY02 FY04 FY06 FY08 FY10 FY12

Source: Company, IIFL Research

Income levels will continue to rise due to increasing share of working-age population and higher urbanisation

We believe that income levels will sustain this pace, primarily due to two factors: 1) rising share of working-age population, and 2) higher urbanisation.

India adds nearly 15m people to its workforce every year. The share of working-age people in the total population has risen from 61.1% to 64.5% in the past decade and is forecast to rise to 66.6% by 2020.

Figure 3: Working-age population and its share of total population

Source: Company, IIFL Research

India's share of urban population at 31% is far lower than that of China (49%), Indonesia (50%), Russia (74%) and Brazil (84%)

Secondly, the trend of higher urbanisation drives income and consumption levels. India's share of urban population at 31% in 2010 was far lower than other emerging markets such as China (49%), Indonesia (50%), Russia (74%), and Brazil (84%). Most of these markets witnessed rapid urbanisation in the past 2-3 decades, which coincided with the rapid growth in their economies.

Figure 4: India —share of urban population

Source: United Nations World Urbanization Prospects, IIFL Research

Note - For computing urban population, urban areas for India have been defined as,

i) Minimum population of 5,000;
ii) At least 75% male working population engaged in non-agricultural pursuits; and
iii) Density of population of at least 400 per sq. km. (1,000 per sq. mile).

Going forward, the rate of urbanisation in India can only accelerate and outpace other large emerging markets, after lagging for the past three decades.

Figure 5: Change in urbanisation in past three decades in major emerging economies

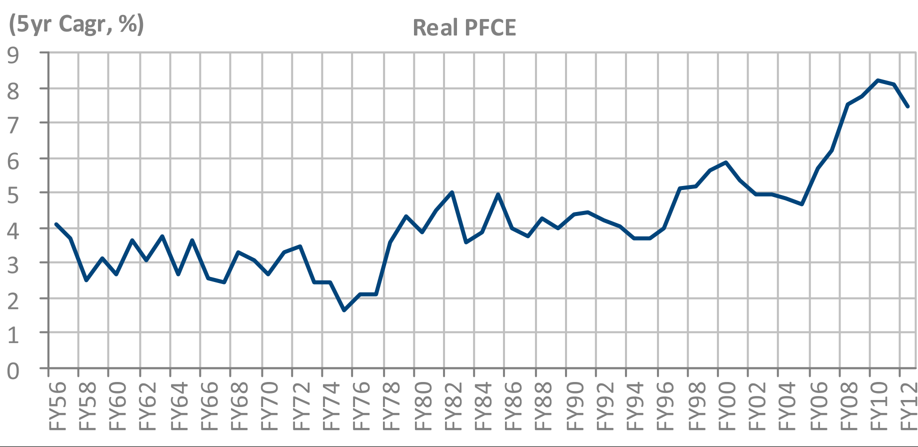
Urban population (% of total population)
1980 2010
100 80 60 40 20 0
Brazil 65 84
Russia 70 74
Indonesia 22 50
China 19 49
India 23 31

Source: United Nations World Urbanization Prospects, IIFL Research
Note - Urban population for each country has been defined as per the respective country's national statistical census.

Real private final consumption expenditure has risen by more than 7% Cagr in the past five years

Income levels are rising, and so is the propensity to spend. Five-year rolling Cagr in real private final consumption expenditure (PFCE) has risen by more than 7% in the past five years.

Figure 6: Real private final consumption expenditure

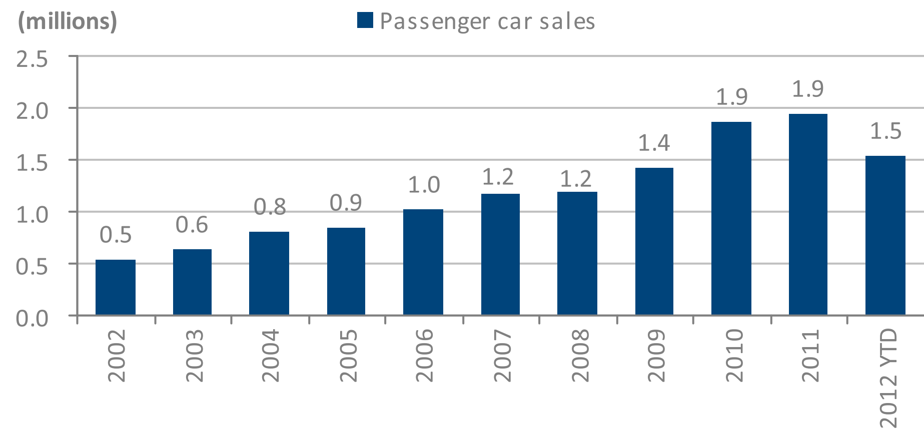


Source: Company, IIFL Research

We expect volume Cagr of 12-13% for 2Ws and 14-15% for cars over the next three years

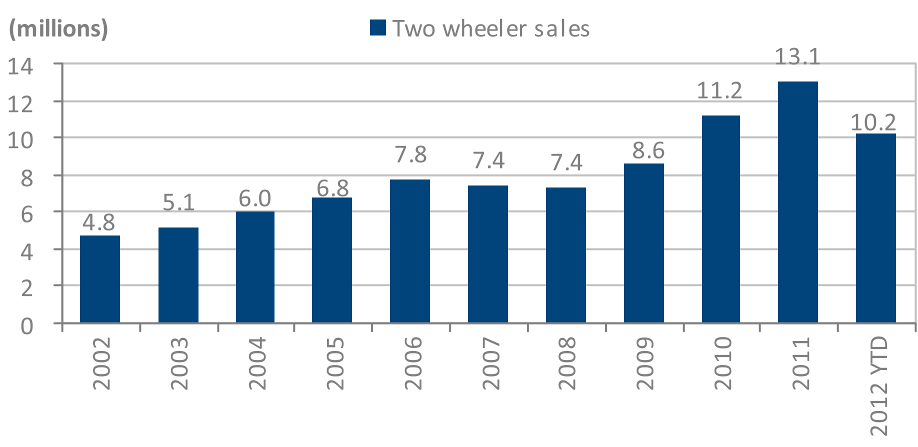
Auto sales are a good indicator of the increasing spending power of Indians. Between 2008 and 2011, passenger car sales increased more than 50% and two-wheeler (2W) sales increased nearly 80%. Notwithstanding the cyclical downturn seen over the past 12-18 months, we expect the growth momentum to resume and expect volume Cagr of 12-13% for 2W companies and 14-15% for car companies over the next three years.

Figure 7: Passenger car sales



Source: Company, IIFL Research

Figure 8: 2W sales



Source: Company, IIFL Research

2. Scalable business i.e. large addressable market or low penetration levels

Telephony penetration jumped from 4.4% (54m subscribers) in 2002 to 60.4% (731m) in 2012

One tends to dismiss the exceptionally low penetration levels for many goods and services in India due to poor affordability. Nevertheless, penetration is gradually improving on rising income levels, providing steady growth for companies catering to these sectors. Telephony penetration leapfrogged from 4.4% (54m subscribers) in 2002 to 60.4% (731m) in 2012. It was unthinkable a decade ago that telephony penetration would reach the current levels.

Figure 9: Low penetration levels

Sector	Penetration level in India	Global/EM average
Banking services	• 58.7% of Indian households have access to banking services	
	• 21 households per 1000 have loan accounts with banks	• 747 households per 1000 have bank loan accounts in Brazil
	• 10.6 bank branches and 8.8 ATMs per 100,000 adult Indians	• 46 bank branches and 120 ATMs per 100,000 adult Brazilians
Life insurance	• Life insurance premium was 1.3% of GDP and AUMs of life insurance cos were 18.3% of GDP in FY12	• Penetration in India is low compared to other developing and mature economies
Mutual funds	• Mutual fund AUMs 7.5% of GDP in end FY12	
Pharmaceuticals	• Healthcare spend at 5% of GDP in India	• Healthcare spend in EM is average 5-6% and in developed markets 12-13% of GDP
Automobiles		
2Ws	• 70 per '000 persons	• Per '000 persons 6-7 in S.Africa/Mexico, 20-21 in UK/USA, 41-48 in France/Germany, 131-250 in Vietnam/Indonesia/Malaysia/Thailand
Cars	• 13 per '000 persons	• Per '000 persons 15-19 in Kenya/Sri Lanka, 31-43 in Nigeria/Indo, 108-181 in S.Africa/Brazil/Mexico, 206-298 in Russia/Korea/Malaysia, 319-596 US/Europe
Tractors	• 24 per 1000 hectares	• 30+ per 1000 hectares in developing and developed mkts
Information Technology	• Indian IT services exports account for less than 10% of global IT services spending	
FMCG		
Paint	• Per capita paint consumption of 1.5-2.0 litres annually	• Global average per capita paint consumption is 6.5L
Soap	• 96% penetration; but premiumisation is the key growth driver, hence per capita consumption is important - Per capita soap consumption is 460gm/year	• Per capita soap consumption is 1100gm/year in Brazil
Detergents	• 92% penetration, Per capita detergents consumption is 2.7kg/year	• Global average per capita detergents consumption is 7.8kg
Shampoo	• 56% penetration, Per capita shampoo consumption is $0.3	• Per capita shampoo consumption is $1 in China and $2.7 in Malaysia
Skin care	• <20% penetration, Per capita consumption of skin care products is $0.3	• Per capita consumption of skin care products is $3.2 in China, $7.4 in Malaysia
Biscuits	• 76% penetration, Per capita biscuits consumption is 2.1kg	• Per capita biscuits consumption is over 10kg in US, UK, West European
Packaged food	• 16% penetration of fruit beverages, Per capita consumption of packaged foods is 39 lbs	• Per capita consumption of packaged food is 116 lbs in China, 787 lbs in US
Mortgage	• Penetration of mortgages declined from about 6% of GDP in FY09 to 4.6% in FY12	• 17% in Thailand, 20% in China, 34% in Malaysia, 36% in Korea
Media	• 61% of households have television	• 83% of households in Asia Pac and 95% in China have television
	• 88% of TV households have pay TV (cable & DTH); the high percentage is due to lack of sufficient free-to-air channels in India; however, over 80% of these viewers are undeclared to broadcasters and DTH players	• 29% of TV households in Japan, 44% in China and 49% in Asia Pac have pay TV - lower than India
	• Newspaper readership is 344m in India, while newspaper circulation is estimated at 76m	
	• Per capita ad spend is US$5	• Per capita ad spend is $17 in China, $26 in Asia Pac, $70 in Brazil and $555 in the US
	• Ad spend is 0.34% of GDP	• Ad spend as % of GDP is 0.31 in China, 0.55 in Brazil and 0.84 in Asia Pac

Source: Company, IIFL Research

An essential service such as banking is still not available to more than 40% of India's population

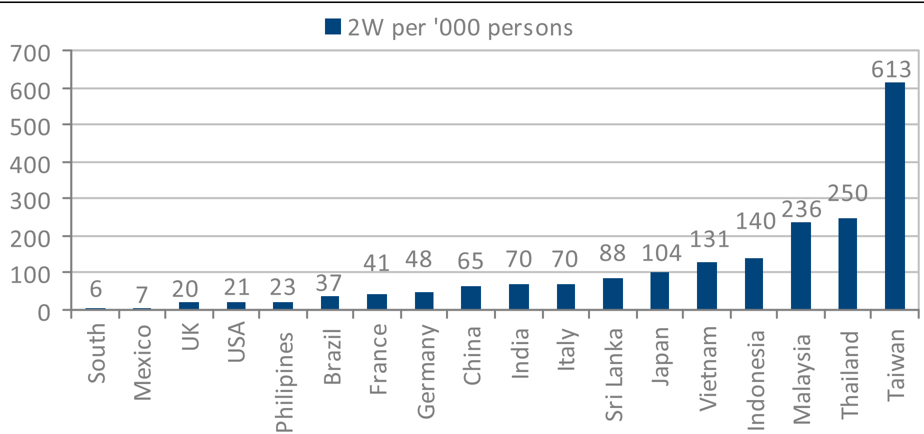
An essential service such as banking is still not available to more than 40% of India's population. This is primarily due to lack of viable and cost-effective technology to reach the large rural population, in our view. India has a much larger share of rural population compared with other large developing countries such as Brazil, Russia, China, and Indonesia.

But it is realistic to expect that such technology would be developed and that banking penetration in India would be much higher in one or two decades from now. Besides the unavailability of banking services due to lack of reach, India also has low penetration in areas such as mortgages, other retail loan products, life insurance, and mutual funds. Private banks and finance companies are better placed than government banks to leverage their technology platform, wide product bouquet, customer service orientation and entrepreneurial spirit to continue growing strongly. We believe that assets and profit of private banks, as a group, can grow at 25-30% Cagr for the next two decades.

We believe that assets and profit of private banks, as a group, can grow at 25-30% Cagr for the next two decades

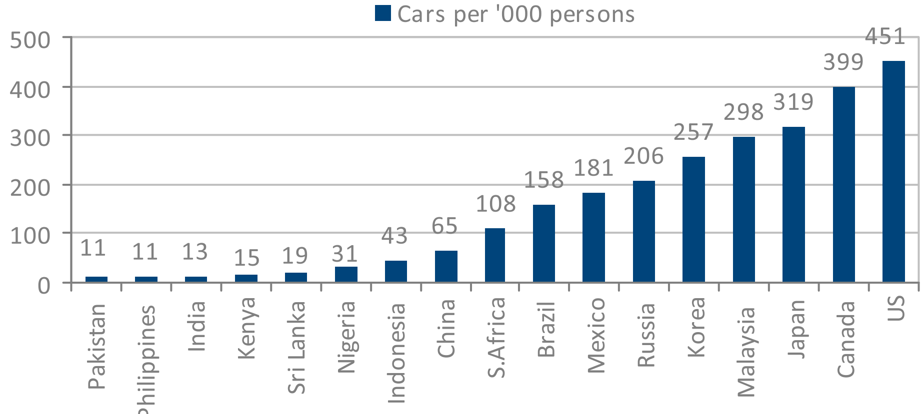
Penetration of 2Ws and four -wheelers (4Ws) is low compared with other developing countries such as Vietnam, Indonesia, Nigeria, South Africa, and Brazil. Besides rising affordability, there are two other important drivers of growth in automobile demand: poor state of public transport infrastructure and use of vehicle as a means of livelihood and not leisure travel. In smaller towns, 2Ws are an essential means for people in the low-to-middle-income bracket to reach their place of work: e.g. drivers, household helps, plumbers, electricians, and shopkeepers.

Figure 10: 2W penetration



Source: Company, IIFL Research

Figure 11: 4W penetration



Source: Company, IIFL Research

All 12 companies in our selection have dominant positions in their segments

3. Competitive position in the industry

It is important that companies are well established in their industry or sub-segment and have strong pricing power to protect themselves from any sharp changes in input costs, demand slowdown, rise in competition intensity, or regulatory changes. All 12 companies in our selection have dominant position in their segments: HDFC Bank (various retail loan categories), Sun Pharma (various therapeutic categories), Bajaj Auto (motorcycles and three-wheelers), Kotak Mahindra Bank (various retail loan categories), HCL Tech (IT services), Asian Paints (decorative paints), Zee Entertainment (cable TV broadcasting), Exide (automotive batteries), Marico (FMCG sub-segment of coconut hair oil), Pidilite (construction chemicals), M&M Finance (various retail loan categories) and Havells (electrical equipment).

Figure 12: Competitive position in the industry

Company	Industry	Market share	History of presence in the industry (No of years)	Market share of top 5 players	Share of unorganised players	Possibility of disruptive entry by a new foreign/domestic player
HDFC Bank	Banking	3.9%	20	44%	0	Low
	4W loans	27.8%				
	Credit cards	34.3%				
	Small biz loans	7.2%				
Sun Pharma	Pharma	4.70%	25	25%	60%	Low
	Neuropsychiatry	20.9%		50%		
	Gastrology	6.5%		25%		
	Cardiology	7.8%		29%		
	Diabetology	8.3%		48%		
	Ophthalmology	12.7%		30%		
Bajaj Auto	Auto	25% in motorcycles	50+ years in 2W industry	95%	0	Low
Kotak Mahindra Bank	Banking	0.8%	7	44%	0	Low
	4W loans	7.2%				
HCL Tech	IT	5th largest offshore IT services co	20	45%	Less than 0.1%	Low
Asian Paints	Consumer	50%+	67	65%	35%	Low
Zee Entertainment	Media	19%	20	>80%	Negligible	Medium
Exide Ind	Auto ancillary	72% in 4W OEM 71% in 2W OEM	50+	98%	0%	Low
		30% in 4W replacement 23% in 2W replacement	50+	55% in 4W replacement 50% in 2W replacement	45% in 4W replacement 50% in 2W replacement	Low
Marico	FMCG - coconut hair oil	57% share of organised mkt	24	60%	40%	Low

Company	Industry	Market share	History of presence in the industry (No of years)	Market share of top 5 players	Share of unorganised players	Possibility of disruptive entry by a new foreign/domestic player
Pidilite	Construction Chemicals	30-70% in various categories	50	50-90%	10-50%	Low
M&M Finance	Finance	NA	21	NA	NA	Low
Havells India	Electric Equipment	28% in Domestic MCBs; 6-15% in other electrical equipments	30	50-80%	20-50%	Medium

Source: IIFL Research

4. Strong balance-sheet and healthy return ratios

A strong balance sheet and consistent track record of healthy return ratios minimise the risk of nasty surprises. These reflect the financial prudence and avoidance of unnecessary risk taking by companies. The past few years have been replete with examples of even respectable companies burning their fingers by over-leveraging or taking out-sized bets in the foreign exchange market.

All our selected companies have low net debt-to-equity ratio, strong free cash flows and healthy return ratios (ROE, ROCE and ROA)

All our selected companies have low net debt-to-equity ratio, strong free cash flows and healthy return ratios (ROE, ROCE and ROA). Seven out of the nine non-finance companies have net cash; Marico and Havells have low level of debt due to recent acquisitions and these companies are also expected to turn net cash by FY15. They generate healthy free cash flows and are all dividend paying companies.

Figure 13: Balance-sheet strength and profitability ratios

Company / FY13ii	Net debt/equity (%)	Free cash flow /shareholders' funds (%)	ROE (%)	ROCE / ROA* (%)
HDFC Bank*	NA	NA	20.7	1.8
Sun Pharma	(36.0)	9.9	21.2	29.7
Bajaj Auto	(83.1)	34.3	44.9	62.0
Kotak Mahindra Bank*	NA	NA	15.5	2.1
HCL Tech	(13.3)	16.6	29.4	31.0
Asian Paints	(14.3)	11.3	38.0	48.0
Zee Entertainment	(34.0)	12.5	18.8	26.7
Exide Ind	(23.6)	8.0	18.2	25.5
Marico**	44.2	(34.4)	25.4	23.3
Pidilite	(13.4)	19.4	27.3	31.1
M&M Finance*	NA	NA	23.6	4.0
Havells India	41.2	43.5	37.1	27.6

*ROA for banks and NBFC

**free cash flow/shareholders' funds is estimated at 16% before acquisition related outflow

Source: IIFL Research, Company

Perhaps the most important differentiator between winners and others is the quality of management

5. Management track record and visibility on its continuance

Perhaps the most important differentiator between winners and others is the quality of management. Managements need to have both vision and execution capability. A management's track record is important and good indicator of future performance, provided there is continuity in the management and other enabling factors remain broadly unchanged e.g. industry and regulatory conditions.

Professional managers may change, but as long as the promoter group or company ethos remains the same and sound systems are well ingrained, investors can be assured of continuity in the management's vision and execution. PSUs are eliminated on this criterion and due to high chances of interference by the government.

Figure 14: Management track record and visibility on its continuance

Company	Promoter stake (%)	CEO/Group	Visibility on continuance of current mgmt for next five yrs	Revenue Cagr (FY07-12)	Net profit Cagr (FY07-12)	EPS Cagr (FY07-12)	Average ROE (FY07-12)
HDFC Bank	23.0	Aditya Puri /HDFC	High	28.6	35.3	25.2	17.2
Sun Pharma	63.7	Dilip Sanghvi	High	30.3	25.2	25.2	26.0
Bajaj Auto	50.0	Rajiv Bajaj	High	15.5	19.9	19.9	60.4
Kotak Mahindra Bank	45.2	Uday Kotak	High	20.2	27.8	24.6	16.5
HCL Tech	62.2	Vineet Nayar/ Shiv Nadar	High	28.4	14.0	13.1	21.6
Asian Paints	53.0	K B S Anand/Choksi, Dani, Vakil families	High	21.3	28.4	28.4	44.8
Zee Entertainment		Puneet Goenka	High	14.9	19.9	17.5	15.4
Exide Ind	46.0	T.V. Ramanathan/ Rajan Raheja Group	CEO may retire within 5yrs	22.3	24.3	22.2	25.4
Marico	60.0	Harsh Mariwala	High	20.8	26.4	26.1	43.6
Pidilite	70.6	M B Parekh	High	20.2	23.8	7.6	29.0
M&M Finance	57.2	Ramesh Iyer / M&M Group	High	27.5	36.7	31.5	20.2
Havells India	61.6	Anil Gupta	High	33.5	29.4	9.3	31.5
Sensex Index*				22.9	14.5	10.9	17.2
Nifty Index*				22.4	15.9	12.6	17.1

*same constituents

Source: Company, IIFL Research

Figure 15: Earnings track record

% YoY growth	FY06	FY07	FY08	FY09	FY10	FY11	FY12	1HFY13
HDFC Bank	29.5	28.5	25.5	17.6	22.1	31.0	30.4	30.3
Sun Pharma	44.7	46.5	76.9	22.2	(21.5)	28.6	41.0	54.6
Bajaj Auto	39.9	11.0	NA	(8.7)	131.3	44.5	20.0	(2.8)
Kotak Mahindra Bank	99.7	49.0	74.3	(34.4)	98.9	13.3	16.3	11.4
HCL Tech	28.7	75.2	(21.6)	22.5	(1.9)	29.7	51.9	71.7
Asian Paints	23.8	25.3	48.4	(5.6)	NA	NA	17.7	10.8
Zee Entertainment	(35.0)	6.5	62.5	(4.9)	65.0	(17.9)	7.3	19.1
Exide Ind	30.3	54.1	60.0	16.8	78.3	7.3	(24.0)	27.0
Marico	23.9	13.8	56.5	25.9	22.2	5.8	25.4	22.6
Pidilite	16.6	28.0	38.5	(28.7)	34.8	4.1	4.3	19.4
M&M Finance	10.1	12.4	25.2	14.0	62.4	33.7	27.0	39.6
Havells India	(10.6)	(19.3)	46.3	(77.0)	74.2	120.8	20.4	(19.1)

Source: Company, IIFL Research

Figure 16: Stock price performance

Company	Stock price Cagr (%)				
	1-year	2-year	3-year	5-year	10-year
HDFC Bank	59.8	25.0	26.0	15.6	33.7
Sun Pharma	38.8	26.9	36.1	26.9	40.2
Bajaj Auto	29.9	21.5	36.0	NA	NA
Kotak Mahindra Bank	36.3	19.4	18.7	1.1	45.5
HCL Tech	56.2	21.8	24.7	18.5	24.7
Asian Paints	55.4	26.3	37.2	35.3	37.0
Zee Entertainment	72.1	19.8	18.5	7.5	21.2
Marico	54.8	34.1	29.8	26.1	41.5
Exide Inds	20.1	(6.6)	8.6	15.0	44.6
M&M Finance	72.7	25.0	54.7	32.0	NA
Pidilite	48.6	20.2	32.2	18.7	36.1
Havells India	43.8	26.4	42.5	13.1	56.1
Average	**49.0**	**21.6**	**30.4**	**19.1**	**38.1**
BSE Sensex	21.6	(1.2)	4.2	(0.7)	19.2
Nifty Fifty	23.4	(0.5)	4.8	(0.6)	18.4

Source: Company, IIFL Research

6. Valuations should be justifiable i.e. not priced-for-perfection

"Everything has a price" may sound clichéd, but it is the fundamental basis for any investment decision

After all the selection criteria have been met, it is of paramount importance that the valuations of stocks should be reasonable and justifiable. "Everything has a price" may sound clichéd, but it is the fundamental basis for any investment decision.

Since all our selected stocks have a stellar track record, it is unrealistic to expect their valuations to be cheap, but they certainly should be not over the top. We would be willing to give premium to the stock, as long as the premium is justifiable, given the expected trajectory of future growth.

While we look at various valuation parameters like PEx (price/earnings), PBx (price/book), EV/Ebitda (enterprise value/earnings before interest, depreciation and tax) and DCF (discounted cash flows), we find PEGx or PEx/earnings growth as a useful valuation tool to compare stocks across sectors. Furthermore, looking at PEx in itself is not meaningful, unless it is seen together with expected earnings growth.

We calculated PEGx on FY15ii PEx divided by EPS Cagr for FY12-15ii. To some investors, FY15 PEx may appear too distant, but that is the forward multiple at which the stock would be trading in roughly a year's time. If this multiple appears reasonable, then probably there is an upside to the stock.

We believe PEGx of up to 1x is reasonable and offers value. Eight out of our 12 selected stocks fall in this category: HDFC Bank, Kotak Bank, HCL Tech, Exide, Marico, Pidilite, M&M Finance, and Havells India. The other four stocks may appear expensive at this point, but given the expected compounding in their earnings, valuations would appear reasonable in a not-too-distant future, if the stock price does not move up from the current level.

An important point to note is that, generally, earnings of these companies surprise on the upside, as analysts' moderate their expectations, even though the past track record and company outlook suggest otherwise. A case in point is HDFC Bank, which has delivered 30% net profit and more than 25% EPS Cagr for the past 40 consecutive quarters. This is likely to sustain in future. However, consensus forecasts are between 20% and 25% of growth ahead. As such, valuations may be more reasonable than they appear.

Figure 17: Valuation matrix of the 'Winning Dozen'

Company	Bberg	CMP (Rs)	Mkt Cap (US$ m)	EPS Cagr (FY12-15ii)	ROE (%) (FY13ii)	Net debt/ equity (%) (FY13ii)	P/E (x) (FY14ii)	P/E (x) (FY15ii)	P/B (x) (FY14ii)	PEG (x)*
HDFC Bank	HDFCB IN	689	29,918	26.5	20.7	NA	19.2	15.5	3.8	0.6
Sun Pharma	SUNP IN	719	13,650	11.7	21.2	(36.0)	24.2	20.6	3.9	1.8
Bajaj Auto	BJAUT IN	2,081	11,059	9.6	44.9	(83.1)	16.3	14.6	6.3	1.5
Kotak Bank	KMB IN	665	9,081	25.7	15.5	NA	17.7	13.5	2.8	0.5
HCL Tech	HCLT IN	631	8,044	19.1	29.4	(13.3)	12.2	10.8	2.9	0.6
Asian Paints	APNT IN	4,281	7,540	21.2	38.0	(14.3)	28.9	23.4	9.9	1.1
Zee Ent	Z IN	207	3,640	15.7	18.8	(34.0)	24.1	21.7	4.5	1.4
Marico	MRCO IN	221	2,612	23.1	25.4	44.2	27.6	22.8	5.9	1.0
M&M Finance	MMFS IN	1,090	2,276	26.2	23.6	NA	10.8	8.7	2.2	0.3
Exide	EXID IN	141	2,201	26.6	18.2	(23.6)	14.7	12.8	2.9	0.5
Pidilite	PIDI IN	213	2,000	24.0	27.3	(13.4)	21.2	17.4	5.6	0.7
Havells India	HAVL IN	606	1,389	20.1	37.1	41.2	14.2	11.8	4.6	0.6

Source: Company, IIFL Research *PEGx calculated by diving FY15ii PEx by EPS Cagr for FY12-15ii

Our selected stocks have a low beta, underscoring their relative steady growth and lower earnings volatility vis-à-vis the broader market

Low-beta stocks ideal for compounding returns over long periods

Our selected stocks have a low beta, underscoring their relative steady growth and lower earnings volatility vis-à-vis the broader market. To a certain extent, this is a reflection of our sector selection, since we have left out high-beta sectors such as capital goods, cement, infrastructure, metals, real estate, and utilities. However, there are high-beta stocks in our selected sectors as well and our short-listed stocks have among the lowest beta in their respective sectors. For example, HDFC Bank and Kotak Mahindra Bank have the lowest beta among private banks and M&M Finance has one of the lowest betas among NBFCs. Marico and Asian Paints have the lowest beta among FMCG and consumer discretionary companies respectively.

Figure 18: Low Beta of the 'Winning Dozen'

Company Name	Beta	Company Name	Beta
Bajaj Auto	**0.93**	ITC	0.75
Exide	**0.83**	**Marico**	**0.49**
Hero Motocorp	0.75	United Spirits	1.17
Mahindra & Mahindra	1.09	**HCL Tech**	**0.95**
Tata Motors	1.46	Infosys	0.94
Axis Bank	1.24	TCS	0.88
HDFC	1.04	Dish TV	1.02
HDFC Bank	**1.01**	Sun TV	0.71
ICICI Bank	1.28	**Zee**	**0.85**
IDFC	1.37	**Asian Paints**	**0.56**
Kotak Mahindra Bank	**1.06**	**Havells India**	**0.91**
LIC Housing	1.26	**Pidilite**	**0.71**
M & M Fin	**0.98**	Dr Reddys	0.63
Emami	0.66	Ranbaxy	0.75
Hind. Unilever	0.62	**Sun Pharma**	**0.72**

Source: Company, IIFL Research

7. Corporate Governance track record

From the point of view of minority shareholders corporate governance is an important criterion. It indicates that the interest of the management is aligned to that of the minority shareholders i.e., there is no conflict of interest. The corporate governance track record of a company should be as clean as possible.

When management's interest is aligned to that of minority shareholders, the latter can be assured that the management's entire focus and objective would be to enrich the value of the company

When management's interest is aligned to that of minority shareholders, the latter can be assured that the management's entire focus and objective would be to enrich the value of the company. A few MNC pharma and FMCG companies are examples of the opposite situation where the interests of the two sides are not fully aligned. The companies are still listed because of mandatory listing requirement a few decades ago; today, while these companies find it too onerous to buy out minority shareholders and de-list, they continue to increase their India franchise through wholly-owned subsidiaries. Other promoter groups with several businesses or listed companies can also have a wavering focus or conflict with minority shareholders of particular companies in the group.

Figure 19: CG track record

Company	Any CG issues in the past 10 years	Any group company, listed or unlisted, where promoters have higher stake or which causes conflict of interest
HDFC Bank	None	None
Sun Pharma	None	None
Bajaj Auto	Surprise revelation in 2007 that Allianz, Bajaj's partner in insurance ventures, had a 'call option' to buy up to 74% stake at a price determined as per a pre-agreed formula	None
Kotak Mahindra Bank	None	None
HCL Tech	None	Promoters hold 51% stake in another listed entity, HCL Infosystems. However, business models of HCL Tech and HCL Infosystems are entirely different with little overlap. The promoter group owns 62% stake in HCL Tech
Asian Paints	None	Promoters have stakes in suppliers of containers and chemicals to AP, but no major conflict
Zee Entertainment	1) Several restructurings of group businesses 2) Advances given to related parties prior to FY10	Dish TV and Zee News (both listed) are group companies in media space but there is no conflict of interest
Exide Ind	Investment in ING Vysya Life Insurance, an unrelated business	None
Marico	None	Promoter's son has a venture in premium handmade soap manufacturing (Soap Opera N More)
Pidilite	None	None
M&M Finance	None	None
Havells India	Payment of royalty to promoters for use of the Havells brand	None

Source: Company, IIFL Research

Regulatory changes or excessive regulation can at times mar the prospects of promising industries

8. Regulatory risks

Regulatory changes or excessive regulation can at times mar the prospects of promising industries. Oil marketing companies, mining, airlines, and telecom are examples of sectors that have been hurt by regulatory interferences or adverse policy administration. India has huge and growing demand in each of these areas and companies in these sectors would otherwise have had fared much better.

In a sector like banking, it may seem that there are too many possible regulatory risks. But most importantly, the leading banks have the pricing power to pass on cost increases due to any regulatory changes to their customers. In the past, banks have had to deal with tighter regulatory norms in several areas including ATM usage charges, credit card fees, cheque collection fees, distribution commission on insurance and mutual fund products. But their profitability has not reduced as they have other revenue sources to compensate for loss in these areas.

NBFCs have been adversely impacted by many changes in recent years. However, the stronger ones have adjusted to these changes and continue to grow strongly.

In sectors such as automobiles, IT and FMCG, regulatory risk is low. In pharmaceuticals there is some regulatory overhang since the sector is important in a social context. However, the leading domestic pharma companies have pricing power to retain their

profitability from products outside of regulatory control and from a diversified geographical base. The media sector is unique in benefiting from regulatory intervention.

Sectors such as construction, capital goods, infrastructure, telecom, power, and oil & gas are vulnerable to heavy regulatory interventions.

Figure 20: Key regulatory risks

Sector	Possible regulatory risks
Banking	• Tightening of Priority Sector Landing (PSL) norms • Tightening of single entity and group exposure norms • Tightening of classification and provisioning norms on NPLs and restructured loans • Tightening of Capital Adequacy Ratio (CAR) norms • Cap on misc fees charged to customers e.g. on distribution, ATM usage, credit card etc
NBFC	• Tightening of bank borrowing norms • Tightening of securitization norms • Tightening of CAR norms • Tightening of norms for loans qualifying for PSL
Pharmaceuticals	• Drug price control order in domestic market • Tightening of US FDA approval norms • Tightening of marketing norms for branded generics in overseas markets
Automobiles	• Tightening of emission norms • Cut in export incentives
Information Technology	• Tightening of visa norms • Tightening of outsourcing norms
FMCG	• None
Media	• Telecom Regulatory Authority of India (TRAI) imposing restrictions on advertisement e.g. ceiling on advertisements per clock hour
Construction	• Long list of required regulatory clearances • Frequent changes in Floor Space Index (FSI) norms • Creation of long awaited industry regulator would be positive

Source: Company, IIFL Research

BERKSHIRE HATHAWAY INC.

2011
ANNUAL REPORT

The Buffet way

Over the past 50 years, Warren Buffett has emerged arguably as the greatest investor in the US history. $10,000 invested in shares of Berkshire Hathaway in 1968 are worth $50m today. The same amount, if invested in the S&P500, would be worth only $529,000. This almost 100x outperformance, sustained over such a long period, has been a result of Buffett's investment approach and investing discipline.

Buffett is a follower of the 'value investing' school of stock picking. Value investors seek to identify great businesses trading at discount to their intrinsic values. This is easier said than done. In the sections below, we outline Buffett's tenets of value investing he has rigorously followed all his life.

Buffett looks at each investment opportunity as a whole. He is not really buying stock for capital gains. He is buying a business. He focuses on how well the company can make money as a business and not on how fast the market recognises this ability. Until any of his investments violate one or more tenets of his investment philosophy, he does not look to sell the business for capital gains. In other words, he evaluates the business in terms of its ability to generate positive cash flows into perpetuity.

A few questions below summarise the key tenets of Buffet's investing philosophy that have made him so successful:
1. Does he understand the business?
2. Is there an enduring competitive advantage that the business enjoys?
3. Is the management high on ability and honesty?
4. Do the financials stack up?
5. Is the business available at an attractive price?

1) Does he understand the business? Buffett prefers simple businesses that can be visualised 10 years into the future. He is disciplined in his approach and never goes outside his 'circle of competence'. So much so that even though he acknowledged Bill Gates as the best businessman he has ever run into, he chose not to invest in Microsoft because he did not know how the business was going to look 10 years hence. Neither did he know how Microsoft's competitors would look 10 years hence. He did not invest in any dotcoms. In fact, he never invested in an IT company ever. He did not feel bad about it though since he believed "one only needs a few good ideas in one's lifetime to be rich".

2) Does the company have an enduring competitive advantage? Although Buffett preferred simple businesses, he did not like a business that was easy for competitors. He would start by asking himself the following:
- How long does the management have to think before it decides to raise prices? If the answer is 'briefly' then it is a great business.
- Is the product such that if the customer finds it is out of stock somewhere, he/she would go across the street to the next shop to get it? If the answer is 'yes' then it is a great business.

Any business that passes the above screening possesses some enduring competitive advantage, or in Buffett's own words 'an

economic moat'. It could be lower cost, differentiated image (Disney), strong brand (Coca Cola, Hershey), higher reliability (American Express), better quality (patents), or preferred location etc, that allows the business to charge a premium to competitors. This helps the company to continue to increase its profit margins. Buffett spent considerable time in ascertaining how wide the moat around the business is.

Buffett bought into Coca Cola because he realised Cola has no taste memory. You can drink one every hour, yet the one you drink in the night tastes as good as the one you drank early in the morning. You cannot do that with non-cola drinks; you would get sick of them after a while.

When one says Disney, it conjures up something special in your mind. The same is not true of Universal Studios or 20th Century Fox. Kids love Disney's content. This helps Disney sell more and make a little bit more money on each sale compared with competition.

Buffett generally avoided commodity businesses. He saw limited pricing power in an undifferentiated product. Prospective buyers for Cadillac will not go to a showroom and ask for one made with steel from US Steel. Hathaway's textile business made over half of the men's suit linings in the US. It was a great product. Yet, it could not get another half a cent a yard because no customer asked for a suit with a Hathaway lining.

3) Is the management high on ability and honesty? Here, an example should suffice. Buffett bought a carpet making company from an 89-year old woman. She started the company in 1937 with $500 and never put in another dime. Her competitors took her to court on fair trade laws. When she got before the judge, she said she paid $3 a yard on the cloth. Her competitor paid $3 too. While they sold it for $6.99, she sold it for $3.99. She told the judge that she would fix her price going forward depending on how much the judge allowed her to rob her customers. The judge came in to her store and bought carpet worth $1,400. At age 97, she could tell how many square yards a room is and how much it will come to at $5.99 to the yard. Today, the company is the largest home furnishing business in the US by a factor of 2 to 1.

4) Do the financials stack up? The key questions that Buffett seeks answers to are:

- Are the return ratios improving? Enduring competitive advantage and credible management should result in improvement in profit margins over time. Buffett prefers to look at the long-term ROE trend to ascertain whether the equity holders' returns have been improving.
- What is the degree of operating leverage? Buffett prefers businesses that are less capital intensive and generate higher returns without requiring commensurate equity infusions. He says, "If you have a choice between going to work for a wonderful business that is not capital intensive, and one that is capital intensive, I suggest that you look at the one that is not capital intensive. I took 25 years to figure it out."
- What is the degree of financial leverage? Buffett prefers companies that do not have high debt. The analogy he gives is that buying a company with enormous debt is like driving a car down a slope and placing a dagger on the steering wheel pointed at one's heart. She will become a better driver, but if she hits a

big enough pothole, she is dead. He let the LBO (leveraged buyout) frenzy in the US pass him by because of his aversion of high leverage.

5) Is the business available at a discount to the intrinsic value? Buffett refers to this as the investor's *margin of safety*. He discounts free cash flows to equity at the cost of equity to arrive at the intrinsic value. If market capitalisation of the business is at an adequate discount to the intrinsic value, it is worth buying into the business.

Buffett's practical and down-to-earth tenets are a lesson in value investing, much like his personality: he still lives in the house he bought three decades ago, drives an old Lincoln town car and works in the Berkshire Hathaway headquarters, which is all of 3,500sq ft!

Figure 21: Berkshire Hathaway's portfolio

Stock	BBG ticker	Price	Shares held	Market Value ($m)	% of Portfolio
The Coca-Cola Company	ko us	37.93	400,000,000	15,172	20.66
Wells Fargo & Company	wfc us	33.20	422,549,545	14,029	19.10
IBM	ibm us	193.49	67,517,896	13,064	17.79
American Express	axp us	56.51	151,610,700	8,568	11.67
Proctor & Gamble	pg us	69.59	52,793,078	3,674	5.00
Walmart Stores Inc.	wmt us	70.20	46,708,142	3,279	4.46
U.S. Bancorp	usb us	32.58	61,264,601	1,996	2.72
DirectTV	dtv us	49.49	29,555,600	1,463	1.99
ConocoPhillips	cop us	56.67	24,123,911	1,367	1.86
Phillips 66	psx us	49.82	27,163,918	1,353	1.84
Moody's Corporation	mco us	47.32	28,415,250	1,345	1.83
DaVita Healthcare Partners	dva us	111.43	11,881,003	1,324	1.80
Mondelez International	mdlz us	25.62	30,464,350	780	1.06
The Washington Post	wpo us	352.50	1,727,765	609	0.83
Liberty Media Corp (Capital)	lmca us	109.04	5,500,000	600	0.82
M&T Bank Corporation	mtb us	99.67	5,382,040	536	0.73
The Bank of New York Mellon	bk us	24.43	19,633,915	480	0.65
USG Corporation	usg us	26.83	17,072,192	458	0.62
Costco Wholesale	cost us	97.62	4,333,363	423	0.58
Viacom, Inc.	viab us	50.48	7,607,200	384	0.52
General Motors Company	gm us	25.21	15,000,000	378	0.51
Deere & Company	de us	83.97	3,978,767	334	0.45
National-Oilwell Varco	nov us	72.60	4,186,800	304	0.41
General Dynamics	gd us	65.41	3,877,122	254	0.35
Visa Inc	v us	148.12	1,555,459	230	0.31
Precision Castparts	pcp us	179.34	1,248,901	224	0.30
Torchmark Corporation	tmk us	51.84	4,235,818	220	0.30
Mastercard Inc.	ma us	481.24	405,000	195	0.27
Sanfoi SA	sny us	44.87	4,063,675	182	0.25
Westpac Banking	wbc us	60.76	1,599,064	97	0.13
Johnson & Johnson	jnj us	69.56	492,028	34	0.05
Gannett Co., Inc.	gci us	17.83	1,740,231	31	0.04
Media General, Inc.	meg us	4.08	4,646,220	19	0.03
General Electric Company	ge us	21.04	588,900	12	0.02
Verisk Analytics, Inc..	vrsk us	48.09	156,434	8	0.01
GlaxoSmithKline plc	gsk us	43.17	150,500	6	0.01
United Parcel Service Inc.	ups us	71.98	59,400	4	0.01
Lee Enterprises	lee us	1.25	1,130,720	1	0.00
				73,438	**100.00**

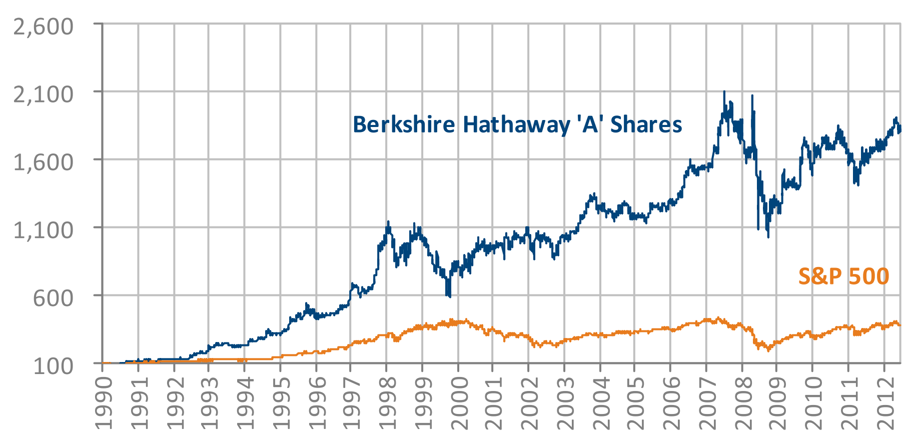
Source: Company, IIFL Research

Figure 22: Buffet's track record

Berkshire Hathaway	Share price ($)	CAGR
Current	131,444	
5 yr	148,300	(2.4%)
10 yr	70,400	6.4%
15 yr	46,700	7.1%
20 yr	11,250	13.1%
25 yr	2,775	16.7%

Source: Company, IIFL Research

Figure 23: Berkshire Hathaway versus S&P500



Performance indexed to 1993 = 100
Source: Company, IIFL Research

Companies

This page is left blank intentionally

CMP	Rs689
Target 12m	Rs860 (25%)
Market cap (US$ m)	29,230
Bloomberg	HDFCB IN
Sector	Banks

Dec 14 2012

52Wk High/Low (Rs)	706/400
Shares o/s (m)	2366
Daily volume (US$ m)	31
Dividend yield FY13ii (%)	0.0
Free float (%)	77.0

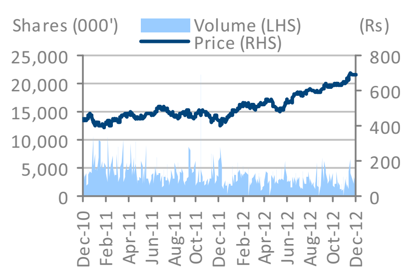
Shareholding pattern (%)

Promoters	23.0
FII	32.2
DII	10.1
Others	34.8

Price performance (%)

	1M	3M	1Y
HDFC Bank	6.4	12.4	58.6
Absolute (US$)	6.6	11.6	57.0
Rel. to Sensex	3.0	7.8	36.9
CAGR (%)		3 yrs	5 yrs
EPS		27.8	25.2

Stock movement



Sampath Kumar
sampath.kumar@iiflcap.com
+91 22 4646 4665

Abhishek Murarka
abhishek.murarka@iiflcap.com
91 22 4646 4661

www.iiflcap.com

HDFC Bank — BUY

The perfect blend

HDFC Bank's ability to maintain consistent asset and earnings growth by switching between multiple levers in adverse business cycles, consistent well-rounded performance and renowned management pedigree make it a long-term winner among Indian banks. We expect the bank to continue reporting robust earnings growth in the foreseeable future led by strong loan growth, high NIMs, high share of non-interest income and contained credit costs.

Poised to sustain growth and gain market share: HDFCB's next leg of growth will be driven by retail loans as it leverages its growing penetration, wide product delivery, and bundled approach to customer engagement. Loans against gold and personal loans are likely to achieve significant scale over the next few years while well-laid origination strategies in other retail segments will continue. Corporate loans are likely to pick up as the business cycle turns.

Robust growth and profitability justify premium valuation: HDFCB is expected to sustain 1.8% RoA and 20% RoE as well as 27% earnings Cagr over FY12-15ii. NIMs of 4.3-4.4% and contained credit costs will likely be key drivers of its best-in-class profitability profile. A reasonably high run-rate of branch expansion will limit efficiency gains and keep cost/income and cost/assets in the 47% and 2.8% range respectively. While we expect marginal deterioration in credit costs, at 80bps for FY13-15ii, they are still likely to be the best among peers.

Well-proven management execution skills: The present leadership has been with the bank since inception and has ingrained a strong credit culture and process-orientation into the bank. It has maintained an enviable track record for corporate governance over two decades. We are extremely confident of the management's ability to execute strong organic growth and achieve larger scale.

Well-established risk mitigation process: Strong growth does not beget undue risk at HDFCB, given its seasoned loan book, conservative lending policy and stringent due diligence process. The bank's two-decade long experience also gives it an empirical understanding of customer behavior. The bank also avoids concentration risk by maintaining extremely diversified retail and corporate portfolios.

Financial summary (Rs bn)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Pre prov. operating inc. (Rs bn)	77	90	115	143	181
Pre-exceptional PAT (Rs bn)	39	52	67	84	105
Reported PAT (Rs bn)	39	52	67	84	105
Pre-exceptional EPS (Rs)	16.9	22.0	28.7	35.9	44.6
Growth (%)	31.0	30.4	30.6	24.7	24.3
IIFL vs consensus (%)			2.4	1.5	(0.1)
PER (x)	40.8	31.3	24.0	19.2	15.5
Book value (Rs)	109	128	150	179	215
PB (x)	**6.3**	**5.4**	**4.6**	**3.8**	**3.2**
CAR (%)	16.2	16.5	15.2	13.9	12.9
ROA (%)	1.6	1.7	1.8	1.8	1.8
ROE (%)	**16.7**	**18.7**	**20.7**	**21.8**	**22.6**

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

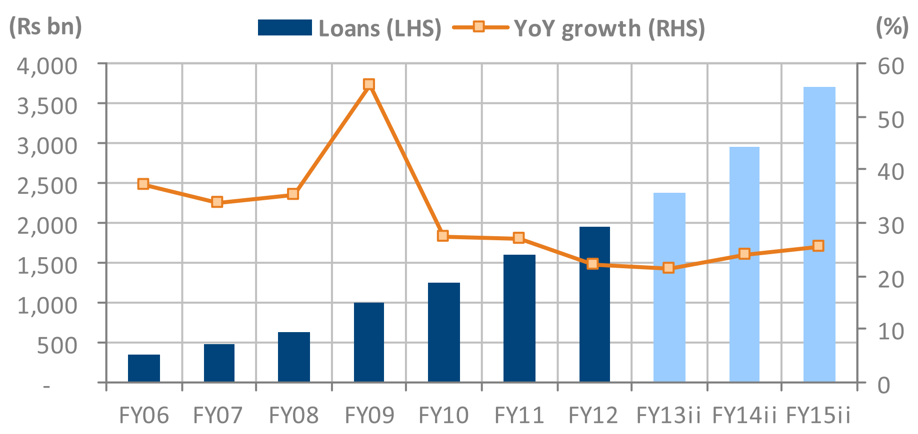
Poised to sustain growth and gain market share

HDFCB's loan growth to benefit from a diversified loan book, increasing penetration and strong customer engagement

HDFC Bank is well positioned to exploit loan growth opportunities despite increasing competition and worries of a slowdown in the economy. Its diversified retail and corporate loan books, increasing penetration, product diversity and customer engagement give it the necessary platform to drive loan growth initiatives. The strongly entrenched credit culture and risk assessment methodology in the bank keeps asset quality deterioration at a minimum.

An equal mix of retail and corporate loans gives HDFCB the flexibility to switch between either to drive loan growth, depending on the stage of business cycle. Hence, while it will exploit the higher growth rate in retail loan market currently, a change in the economic cycle might see the resurgence of growth in the corporate loan book.

Figure 1.1: Loan growth trend



Source: Company, IIFL Research

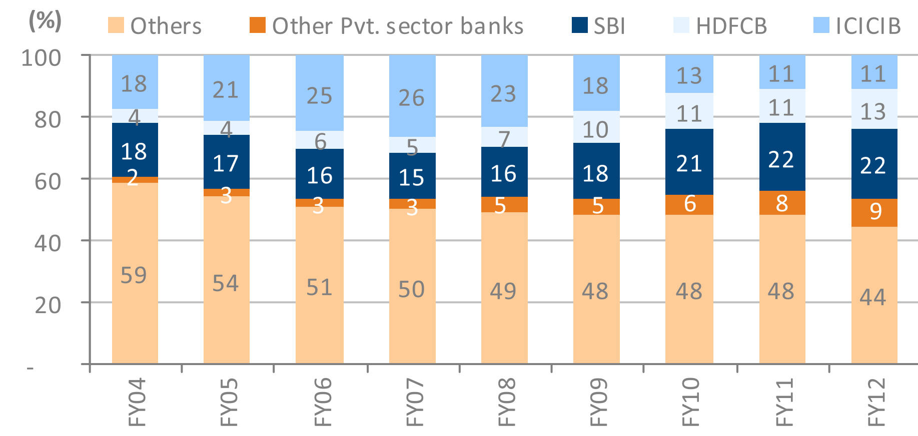
Retail to continue as the primary growth driver, sustaining execution the key

HDFCB's leadership position in the retail loan market provides key competitive advantage

HDFCB is among the top five banks in the retail loans market, having successfully improved its position over economic cycles (see figure 1.2 below). Retail loans have increased at 32% Cagr over FY07-12. Our outlook on HDFCB's ability to maintain and improve this market leadership position is underpinned by i) its strong presence across retail sub-segments, ii) increasing penetration and leveraging technology and iii) ability to limit asset quality headwinds through strong customer analytics and higher in-house sourcing. Together, these provide HDFCB its competitive edge in a crowded market.

HDFC Bank has well-defined strategy and process for each retail sub-segment (figure 1.4). Various business heads have had a long history of working with HDFC Bank. The bank has built a framework where the conservative credit culture and low attrition level in key areas minimises the impact of any change in senior management. Hence, the focus is firmly on execution to grow its franchise.

Figure 1.2: Retail loan market share trend – HDFCB, other new generation private sector banks such as Axis, KMB and IndusInd have garnered significant market share while state-owned banks other than SBI have conceded market share

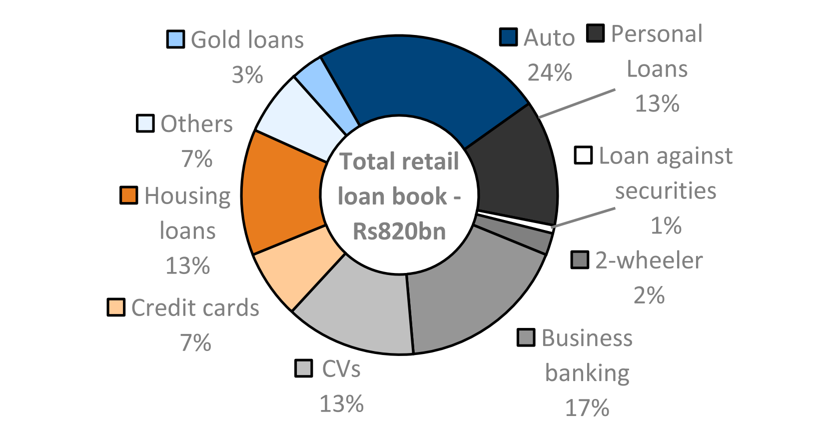


Source: Company, IIFL Research

Deepening penetration and higher cross-sell to drive growth in newer retail sub-categories

Within retail, product categories like loan against gold and personal loans are likely to grow faster. Loans against gold grew at 86% YoY in 1HFY12. The bank plans to double the branches where this product is available in FY13, which could further drive growth over the next 2-3 years. Increasing cross sell of personal loan products to existing customers is incrementally a focus area of the bank.

Figure 1.3: Retail loan mix as on 1HFY13



Source: Company, IIFL Research

Well-defined strategy for each sub-category makes execution much easier

Figure 1.4: Retail strategy in various sub-segments

Category	Strategy
Auto – Cars, 2-wheelers and 3-wheelers	• Focus on in-house originations which are ~70% of incremental sourcing • Quicker turnaround time by implementing an MIS-based approval process, quick re-imbursement to dealers • Identifying and expanding in new geographies
Commercial Vehicle	• Increased funding to LCV/Ultra-LCV to beat the slowdown in HCVs. Incrementally funding at only 45-50% LTV for HCVs (versus ~70% earlier) • Sourcing ~90% of the originations in-house to maintain better asset quality • Focus on deepening relationships and generating walk-ins
Construction Equipment	• Bundled loans to 4-5 products and avoids financing customized equipment, which have lower repeat business • Maintains an average tenor of 3 years and an average LTV of 80-85% for large customers and 75% for small customers
Personal loans, LAS*, Home loans, Credit Cards	• Focused on salaried category that has steadier cash flows • Sub-segmenting the categories for better price and product discrimination • Focusing on internal customers to distribute personal loans and credit cards • ~65% of unsecured loans sourced through internal channels

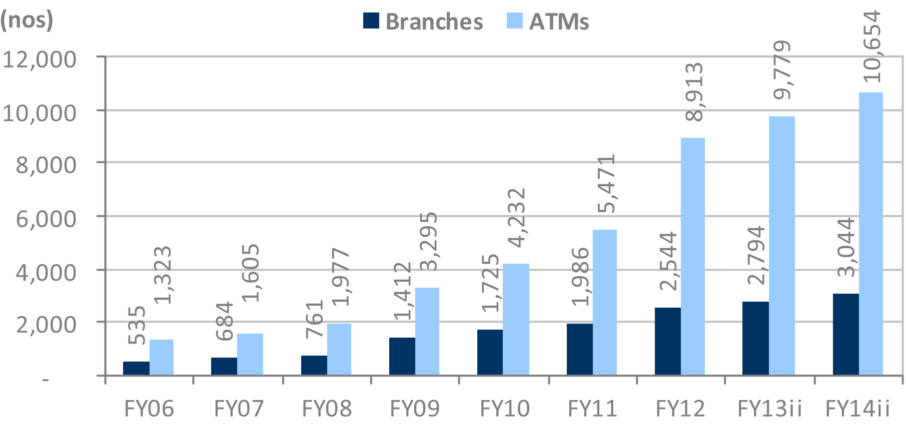
Source: Company, IIFL Research; Note: LAS=Loan against security

Leveraging delivery channels the key to sustain high retail growth

Leveraging delivery channels, product diversification at core of penetration strategy

To continue its current pace of growth, the bank has to keep expanding into new geographies (management claims they add ~25-30 new locations per month). The core of the penetration strategy revolves around encouraging greater utilisation of non-branch delivery channels, increasing coverage of products across branches and focus on niche categories such as loan against gold and personal loans. These are likely to keep growth momentum high and generate market share gains for the bank.

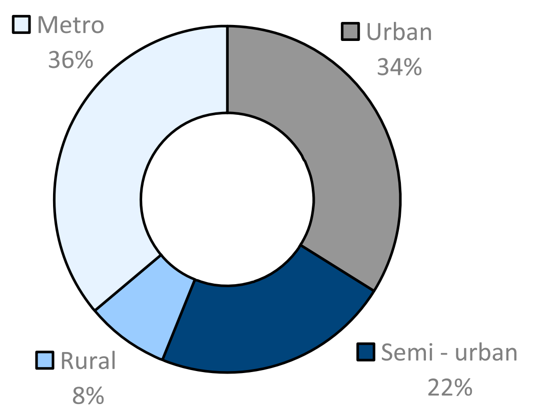
Figure 1.5: Branches and ATMs



Source: Company, IIFL Research

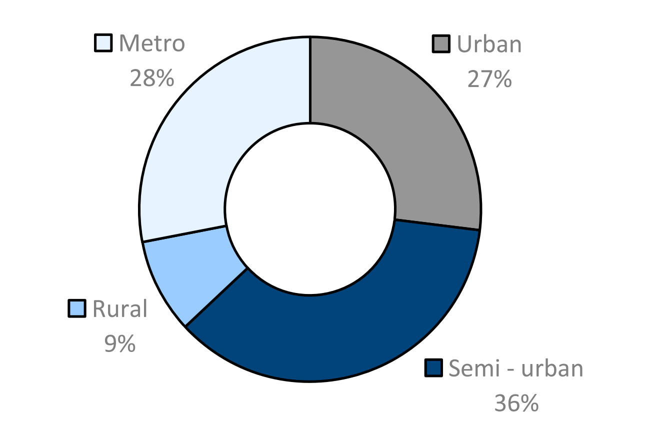
HDFCB is steadily penetrating semi-urban and rural centres where retail loan growth has been strong. Strong consumption growth drivers of the rural economy and diversifying sources of rural income present a potentially high growth opportunity.

Figure 1.6: FY09 – Distribution of branches



Source: Company, IIFL Research

Figure 1.7: FY12 – Distribution of branches



Source: Company, IIFL Research

Along with growth in its branch network, HDFCB has also focused on developing alternate delivery channels to lower its costs and increase reach. Currently, branches account for only 18% of total customer transactions while internet and ATMs account for 38% and 30% of overall transactions. The bank has made substantial investments in technology to make these channels secure. We believe HDFCB is yet to experience the larger impact of penetration through alternate delivery models.

Non-branch delivery channels are gaining in importance as customer utilisation of these is increasing rapidly

Figure 1.8: Retail customer initiated transactions

	2001	2012
Phone banking	14	12
Branches	43	18
Internet	2	38
Mobile	1	2
ATM	40	30

Source: Company, IIFL Research

Typically, various retail products are offered selectively across branches and geographies, tailored to their preferences. As the bank extends its penetration into newer geographies and as branches in older clusters season, more asset products are likely to be offered across branches. This will increase the product penetration as well, spurring overall retail growth.

Corporate loan book well diversified

Risk mitigation of the corporate loan book is effected by product and customer diversity, stringent approvals and deep customer engagement

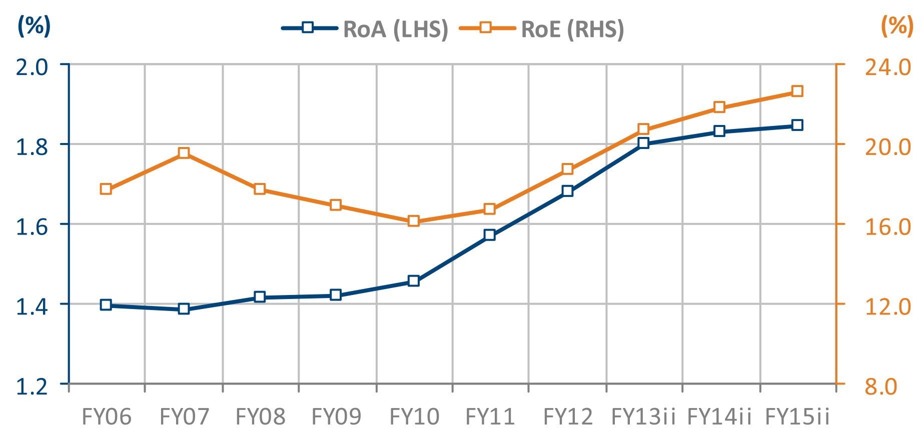
HDFCB continues to maintain a well-diversified corporate loan book with low single sector exposure and a fair mix between working capital and term loans. Separate origination and credit appraisal verticals, and a stringent process of approval through an escalation hierarchy ensures that there is no deviation in the credit quality of this portfolio. Much of the corporate loans are bundled with transaction banking services, which are state-of-the-art and provide flawless execution to customers. This helps improve customer relationships and limits migration of key customer accounts to competitors.

Robust growth and profitability justify premium valuation

Best-in-class profitability will sustain, with RoA of 1.7-1.8% and RoE of 20% through FY12-15ii

Profitability will remain robust with RoA at 1.7-1.8% and RoE at 20%, driven by 27% Cagr in earnings over FY12-15ii. Strong internal accrual will also keep capitalisation levels healthy over FY12-15ii. We do not envisage any capital requirement in the near term. HDFCB enjoys a valuation premium for its market leadership, marquee brand and solid profitability profile. It has maintained an enviable corporate governance track record. Processes relating to credit assessment, monitoring, risk, etc. are well laid out and middle-management changes have little impact on the functioning of the bank. While these characteristics remain firmly entrenched in the bank, its valuation premium versus peers is likely to continue.

Figure 1.9: Profitability ratios expected to get better



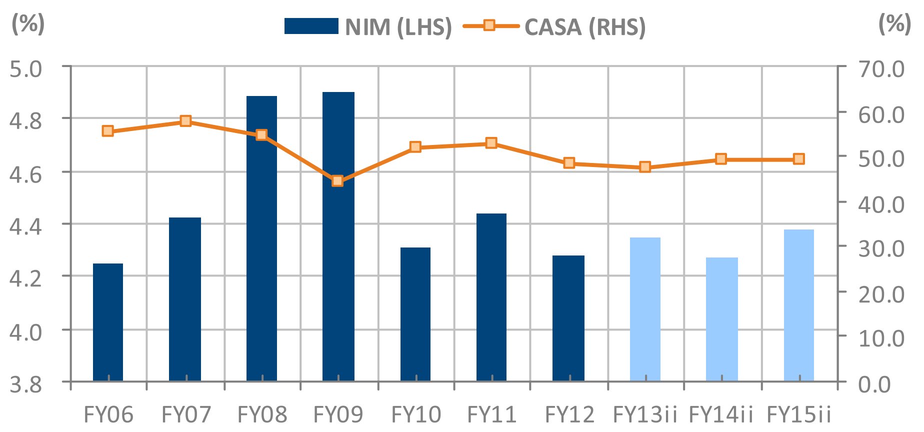
Source: Company, IIFL Research

Robust ALM, strong CASA ratio and diversified fee income will help sustain healthy earnings growth

Key earnings drivers to sustain their current course

Robust asset liability management is at the core of the 4.2-4.4% NIMs that HDFCB consistently generates. This is supported by stable growth strategies in both retail and non-retail loans and unwavering focus on maintaining a +45% CASA ratio. The asset strategy emphasizes maintaining an extremely diversified portfolio, which reduces volatility in interest yields.

Figure 1.10: High core CASA provides stability to NIMs

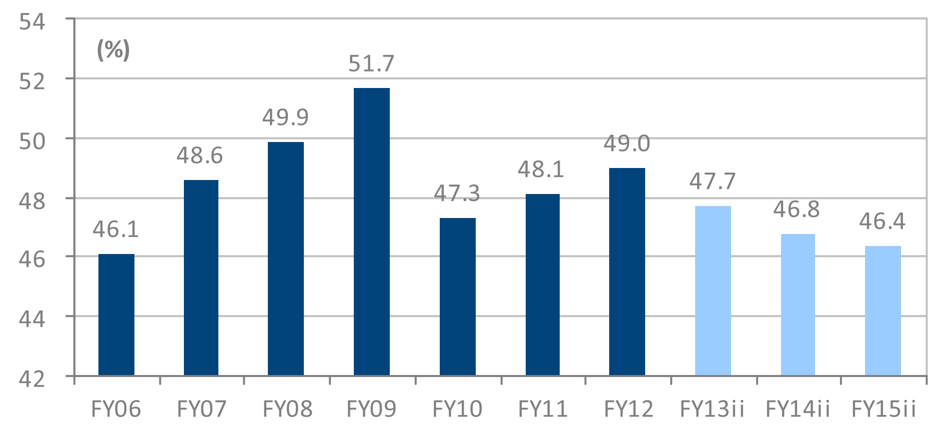


Source: Company, IIFL Research

Non-interest income has averaged at 30% of total operating income over FY07-12 and will likely sustain at this level going forward as well. Apart from balance sheet linked fees, income from cash management, trade finance, depository charges and banking charges make up for a large part of fee income. Given that HDFCB operates primarily in the retail segment, its cost ratios are higher than its peers. We do not expect any moderation in the same given continued focus on branch expansion and investments into technology. We estimate average cost/income of 47% and cost/assets of 2.8% through FY12-15ii.

Focus on branch expansion and investments in technology will lead to higher cost ratios

Figure 1.11: Cost/income trend



Source: Company, IIFL Research

HDFCB has a GNPA ratio of 0.9% and restructured assets ratio of 0.4% as of H1FY13. The ratio of total impaired loans is the lowest in the industry given its strong risk management, customer analytics and recovery processes. Though HDFCB's asset quality will continue to remain best in class, there will likely be some impact of the weakening economic cycle and reduced regulatory forbearance. Hence, our credit cost estimates of 80bps of loans have an upward bias.

Margins, fees and contained credit costs to keep earnings progression healthy

Figure 1.12: Key earnings drivers

(%)	FY10	FY11	FY12	FY13ii	FY14ii	FY15ii
Loan growth	27.3	27.1	22.2	21.2	24.2	25.5
Net interest margin	4.3	4.4	4.3	4.3	4.3	4.4
Net int income growth	13.0	25.7	16.6	23.1	21.2	27.1
Core fee income growth	12.6	31.3	22.7	21.5	22.7	23.9
Non-int inc as % of total	31.2	29.1	29.9	31.2	31.8	30.9
Operating costs growth	4.2	24.1	20.1	22.1	19.9	24.4
Cost/income ratio	47.3	48.1	49.0	47.7	46.8	46.4
Gross NPAs as % of loans	1.4	1.1	1.0	1.1	1.2	1.3
Total prov as % of loans	1.9	1.3	0.8	0.8	0.8	0.8
Tax rate	31.3	32.5	31.2	31.5	31.5	31.5

Source: Company, IIFL Research

Figure 1.13: RoA Decomposition

Y/e 31 Mar	FY10	FY11	FY12	FY13ii	FY14ii	FY15ii
Interest income	8.0	8.0	8.9	9.1	9.0	9.1
Interest expense	3.8	3.8	4.9	5.1	5.0	5.0
Net interest income	4.1	4.2	4.0	4.0	4.0	4.1
Non-interest income	1.9	1.7	1.7	1.8	1.9	1.8
Total operating income	6.0	6.0	5.7	5.9	5.9	5.9
Employee cost	1.1	1.1	1.1	1.1	1.1	1.1
Other operating expenses	1.7	1.7	1.7	1.7	1.6	1.6
Total operating expenses	2.8	2.9	2.8	2.8	2.7	2.8
Pre provision operating profit	3.2	3.1	2.9	3.1	3.1	3.2
Provisions for loan losses	1.0	0.3	0.2	0.3	0.4	0.4
Other provisions	0.1	0.5	0.3	0.2	0.0	0.1
Profit before tax	2.1	2.3	2.4	2.6	2.7	2.7
Taxes	0.7	0.8	0.8	0.8	0.8	0.8
Minorities and other	0.0	0.0	0.0	0.0	0.0	0.0
Net profit	1.5	1.6	1.7	1.8	1.8	1.8
Leverage	11.1	10.7	11.1	11.5	11.9	12.3
RoE	16.1	16.7	18.7	20.7	21.8	22.6

Source: Company, IIFL Research

Management's execution skills well-proven

Top management has been with the bank since inception, and has helped build the current franchise

The bank is professionally managed and strategies are Board determined. The present executive team comprising Mr. Aditya Puri (Managing Director) and Mr. Paresh Sukthankar (Executive Director) have been with the bank since inception and have executed the overall growth and expansion strategies of the bank over nearly two-decades.

Under present leadership, the bank has documented guidelines for corporate governance, internal audit, fair practices code for lending as well as various processes to be followed for credit appraisal, under-writing and monitoring. These are continuously evaluated and improved. The management has also bred the culture of following the banks' internal processes diligently. As a result, some recent management changes have had no effect on functioning of the retail division.

Figure 1.14: Management

Name	Designation	Remarks / management description
C M Vasudev	Chairman	Has been a Director of the bank since October 2006. A retired officer from the Indian Administrative Service (IAS), he has held key positions such as Finance Secretary, Government of India and Executive Director, World Bank.
Aditya Puri	Managing Director	Has been a professional banker for more than 25 years; before joining HDFC Bank in 1994, he was country head of Citibank's operations in Malaysia.
Paresh Sukthankar	Executive Director	Has been with the bank since inception (1994) and currently handles the retail and corporate credit verticals and treasury activities. He is also responsible for the Finance and Human Resources functions at the bank.
Harish Engineer	Executive Director	Has been associated with the bank since 1994 in various capacities and is currently Head, Corporate Banking. He has a 39year experience in finance and banking, with the first 26 years spent at Bank of America.
Sashi Jagdishan	Chief Financial Officer	He has been with the bank since 1996 and currently heads the finance function. He is a Chartered Accountant of the ICAI.
Kaizad Bharucha	Country Head (Wholesale Credit & Market Risk, Retail Credit Risk policy)	He has been a career banker with over two decades of banking experience and is Head of Credit and Market Risk. He was previously with SBI Commercial and International Bank Ltd. as Group Head of Credits.

Risk mitigation process well-established

HDFCB has ingrained conservative lending policies and rigorous due diligence into its DNA

HDFCB's stressed assets/loans ratio at 1.3% remains the best in the system as the bank strictly adheres to its well-defined risk-assessment processes for various loan categories. The bank's lending policies are conservative and due diligence is rigorous.

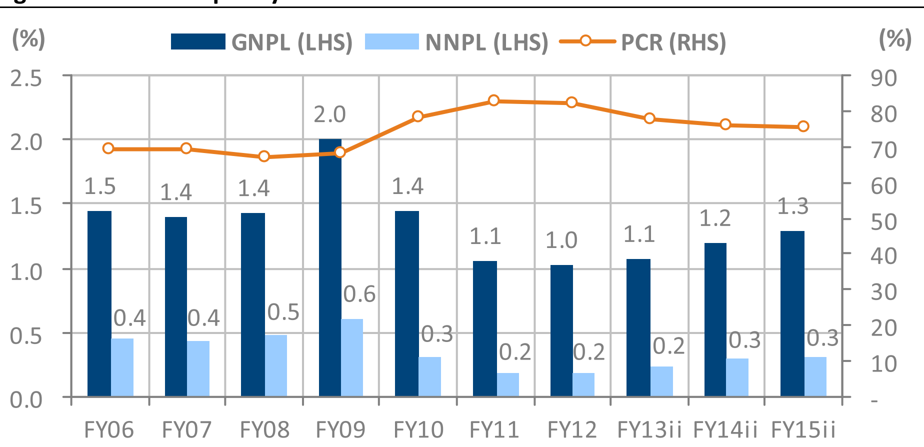
The quality of retail loans is kept in check by insisting for strong collateral, relying more on in-house originations, regularly rating and monitoring DSAs/dealerships and supplementing CIBIL scores through the bank's internal customer analytics. In case of credit cards or personal loans, the bank focuses on its internal liability customers to aggressively cross-sell these while maintaining a more conservative approach to external customers.

HDFCB benefits from being a large transaction banker for most large and mid-sized corporates and a large number of SMEs and as such it can observe cash flows of these entities. This serves as an early warning signal, providing a competitive advantage peculiar to only a few banks in the system. The bank strictly follows its defined escalation hierarchy and credit selection methodology to keep asset quality problems in check.

As a result, robust asset growth does not engender undue asset quality risk. We expect HDFCB to continue to maintain a superior asset quality profile versus the system.

Risk mitigation processes are rigorously followed, keeping the stressed assets creation best-in-the-system

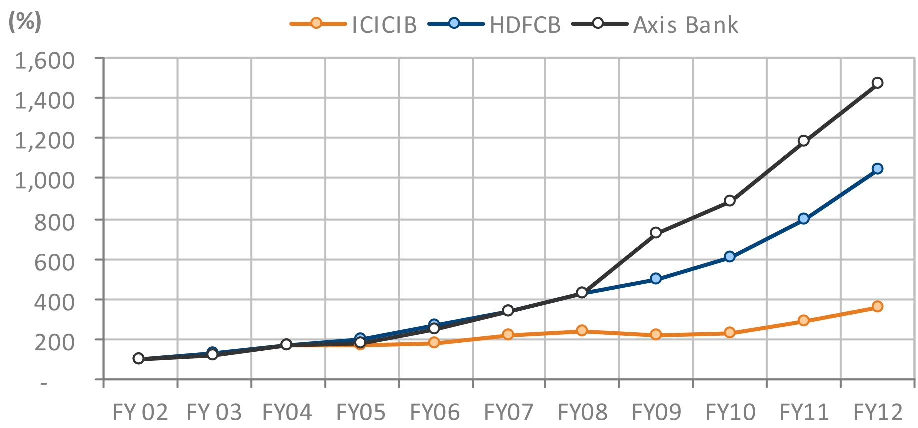
Figure 1.15: Asset quality trend



Source: Company, IIFL Research

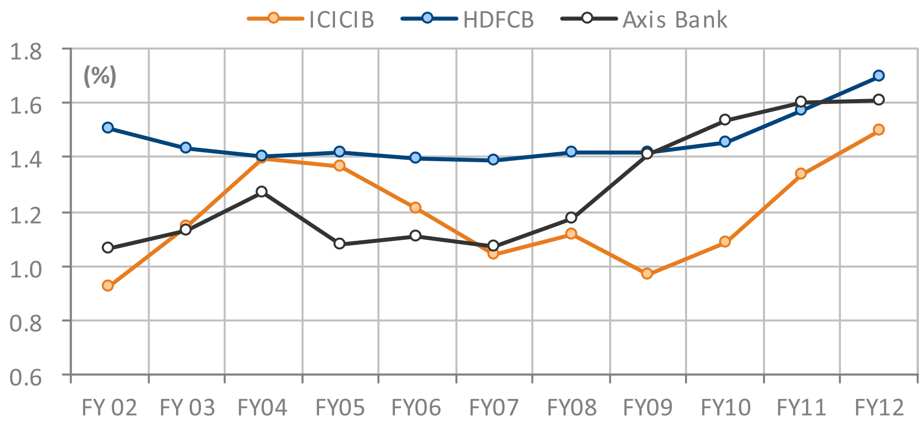
Among the large banks, HDFCB has delivered significantly stronger earnings compounding

Figure 1.16: EPS (indexed to 100 in FY02) – EPS growth compounding has been significantly higher for HDFCB compared to ICICIB over FY02-12



Source: Company, IIFL Research

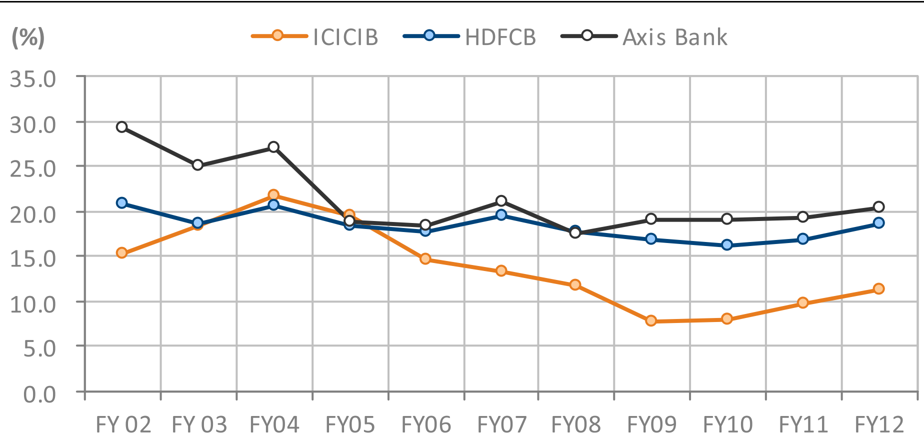
Figure 1.17: RoA trend for HDFCB versus ICICIBC – HDFCB's RoA has remained best in class



Source: Company, IIFL Research

RoE have been rock solid, supported by higher internal accrual and steady leverage

Figure 1.18: RoE trend for HDFCB versus ICICIBC – HDFCB's RoEs have maintained a steady course



Source: Company, IIFL Research

HDFCB scores high in delivering 'profitable growth' versus peers

Balance sheet metrics leave nothing to be desired in terms of asset quality, capitalisation and CASA ratio

Figure 1.19: Comparison with peers

	HDFCB	ICICIBC	AXSB	KMB	YES	SBI
5-year CAGR (FY07-12)						
EPS	25.0	10.2	34.4	24.5	52.4	16.4
Loans	33.0	5.3	35.7	27.8	43.3	20.8
Deposits	29.0	2.1	30.2	30.4	43.0	19.1
NPL	25.0	18.1	34.0	62.1	51.3*	31.7
Profitability (average over FY07-12)						
NIM	4.5	2.3	3.1	5.6	2.6	2.9
Non-interest income/op. revenue	30.3	48.2	42.2	61.9	43.6	33.6
Cost/income	49.0	45.1	44.3	71.3	42.9	48.2
Loan loss provisions/average assets	1.8	1.3	1.1	1.1	0.5	1.0
ROA	1.5	1.2	1.5	2.4	1.5	0.9
ROE	17.6	10.3	19.1	16.9	19.7	15.4
Key Parameters (FY12)						
Gross NPL	1.0	3.6	1.1	1.1	0.2	4.5
Net NPL	0.2	0.8	0.3	0.5	-	1.8
Restructured/total loans	0.4	1.7	1.8	0.1	0.5	3.7
Tier I CAR	11.6	12.7	9.4	16.5	9.9	9.8
Total CAR	16.5	18.5	13.7	17.9	17.9	13.9
CASA ratio	48.4	43.5	41.5	32.2	15.0	44.8
Loan-Deposit Ratio	79.0	99.3	77.1	138.0	77.3	93.1

Source: Company, IIFL Research

*Note: 4-year NPL Cagr for YES Bank as NPLs were NIL in FY07

Assumptions

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Core fee income growth (%)	31.3	22.7	21.5	22.7	23.9
CASA (%)	52.7	48.4	47.5	49.0	49.0
New NPL accrual rate (%)	1.1	1.1	1.4	1.8	1.5

Source: Company data, IIFL Research

Financial summary

Strong conviction on the compounding capability of earnings

Income statement summary (Rs bn)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net interest income	105	123	151	183	233
Fee Income	45	55	67	83	102
Portfolio gains	(1)	(2)	1	3	2
Others	(1)	(1)	0	0	0
Non-interest income	43	52	69	85	104
Total operating income	149	175	220	269	337
Total operating expenses	72	86	105	126	156
Pre provision operating profit	**77**	**90**	**115**	**143**	**181**
Provisions for loan losses	8	8	13	20	28
Other provisions	11	6	4	0	0
Profit before tax	58	75	98	123	153
Taxes	19	23	31	39	48
Net profit	**39**	**52**	**67**	**84**	**105**

Liability franchise to continue as the backbone of a well-managed balance sheet

Balance sheet summary (Rs bn)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net loans & advances	1,600	1,954	2,369	2,942	3,693
Placements to other banks	46	59	65	72	79
Cash & equivalents	251	150	188	233	280
Other interest-earning assets	709	975	1,209	1,505	1,844
Total interest-earning assets	**2,606**	**3,138**	**3,831**	**4,752**	**5,896**
Fixed assets	22	23	28	34	41
Other assets	146	217	250	287	330
Total assets	**2,774**	**3,379**	**4,109**	**5,073**	**6,267**
Customer deposits	2,086	2,467	3,034	3,808	4,760
Other interest-bearing liabilities	144	238	272	306	356
Total interest-bearing liabilities	2,230	2,706	3,307	4,114	5,116
Non-interest-bearing liabilities	290	374	449	539	647
Total liabilities	**2,520**	**3,080**	**3,756**	**4,653**	**5,763**
Total Shareholder's equity	**254**	**299**	**353**	**420**	**504**
Total liabilities & equity	**2,774**	**3,379**	**4,109**	**5,073**	**6,267**

Source: Company data, IIFL Research

Return ratios will sustain at robust levels, sustaining earnings progression

Ratio analysis - I

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Balance Sheet Structure Ratios (%)					
Loans / Deposits	76.7	79.2	78.1	77.3	77.6
Loan Growth	27.1	22.2	21.2	24.2	25.5
Growth in Deposits	24.6	18.3	23.0	25.5	25.0
Growth in Total Assets (%)	24.7	21.8	21.6	23.5	23.5
Profitability Ratios					
Net Interest Margin	4.4	4.3	4.3	4.3	4.4
ROA	1.6	1.7	1.8	1.8	1.8
ROE	16.7	18.7	20.7	21.8	22.6
Non-Int Income as % of Total Income	29.1	29.9	31.2	31.8	30.9
Net Profit Growth	33.2	31.6	30.6	24.7	24.3
FDEPS Growth	31.0	30.4	30.6	24.7	24.3
Efficiency Ratios (%)					
Cost to Income Ratio	48.1	49.0	47.7	46.8	46.4
Salaries as % of Non-Interest costs	39.6	39.6	40.2	40.2	40.4

Likely to face minimal asset quality issues owing to strong credit assessment culture

Ratio analysis - II

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	1.1	1.0	1.1	1.2	1.3
NPL coverage ratio	82.5	82.4	77.9	75.9	75.5
Total prov charges as % avg loans	1.3	0.8	0.8	0.8	0.8
Net NPLs as % of net loans	0.2	0.2	0.2	0.3	0.3
Capital Adequacy Ratios (%)					
Total CAR	16.2	16.5	15.2	13.9	12.9
Tier I capital ratio	12.2	11.6	11.1	10.7	10.3

Source: Company data, IIFL Research

Interview

Aditya Puri - CEO, HDFC Bank

Aditya Puri
CEO, HDFC Bank

1. **What are the key long-term growth drivers of the company?**
   We have products which address the banking needs of multiple customer segments cutting across the GDP of the country. While growth rates across these segments and products may vary, there is no single segment that we are focusing on to give us most of our growth.

2. **What is a sustainable rate of growth in volumes, revenue and earnings over the next 4-5 years?**
   We do not have absolute targets of growth for volumes or revenue. We believe our growth would be a function of the growth in the GDP and banking system. For the past several years we have targeted to grow slightly faster than the banking system - something that we would want to continue to do.

3. **What are the changing market dynamics or trends, if any, which call for your attention?**
   The trickle down effect of economic growth and wealth creation into semi-urban and rural India, the changing demographics and the evolving regulatory environment - all have been impacting market dynamics for various banking products across geographic and customer segments. Higher alternative channel usage (e.g. net banking on mobile) and intensifying competitions are also influencing customer expectations on speed of response and service levels.

4. **What factors, in your view, contributed to your exceptional performance in the past over a decade?**
   Simply put - a clear target market, strategy and execution. Further, early identification of ideas, piloting them and then scaling up are important.

5. **Anything you wish for, to deliver similar performance in the next decade?**
   We believe demand for most banking and financial services in the country exceeds supply. Therefore, our performance will largely be a function of execution of our business model.

6. **What part of the business takes up your maximum time and attention?**
   Vision, change management and execution.

7. **How would you prioritize the different stakeholders in your company —shareholders, employees, customers and government?**
   No priority - all are important stakeholders whose expectations have to be met in a balanced manner.

8. **Do you have a role model – an individual or a company?**
   No

9. **What are your biggest weaknesses, if any, and challenges do you face?**
We believe we could do better in several areas and we keep working towards these. The challenge is to keep improving and to ensure execution of our strategy across a substantially larger and growing footprint across India, without compromising on service quality or risk.

10. **What is your vision for the company?**
To be a preferred provider to our customers and be among the market leaders in all businesses the bank participates in while balancing growth, margins, and risk.

Technical analysis of HDFC Bank

The HDFCB stock has risen more than four fold from the troughs of March 2009; however, the momentum on the long-term charts remains upbeat. Prices have a strong potential of delivering higher absolute returns and outperformance vis-à-vis the Nifty in the near term.

Multi-year breakout facilitates renewed buying interest: A breakout above the 'rising resistance line' on the weekly chart has accelerated the positive momentum, with significant shift in the long-term support levels from Rs568 to Rs605.

Retracement projection: The first range breakout for HDFCB was seen in April 2010 above Rs357. This was followed with the upside range extending to Rs518. A 161.8% retracement from the intermediate price swing projects a target of Rs950

Affirming relative strength: RSI has been in the overbought terrain above 70 on the weekly charts, which demonstrates strength. Since no major divergence is visible, this move corroborates a typical bull market trading zone of 65-75.

Advantage of comparative strength: A major turnaround in the ratio happened during June 2010 and thereafter outperformance of HDFCB vis-à-vis the Nifty has been on the rise. The upmove tends to complete almost 100% of the earlier price swings after the 'Flag' consolidation. Thus, the projection of this ratio is 0.132, which is 18% higher from the current level of 0.112.

HDFC Bank – 10 year share price performance chart

This page is left blank intentionally

CMP	Rs719
Target 12m	Rs870 (21%)
Market cap (US$ m)	13,622
Enterprise value (US$ m)	13,834
Bloomberg	SUNP IN
Sector	Pharmaceuticals

Dec 14 2012

52Wk High/Low (Rs)	737/488
Shares o/s (m)	1034
Daily volume (US$ m)	12
Dividend yield FY13ii (%)	0.5
Free float (%)	36.3

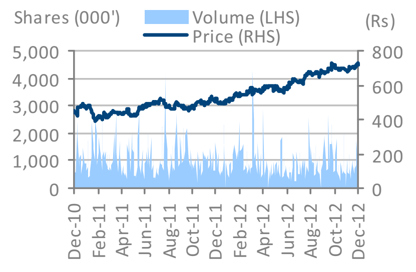
Shareholding pattern (%)

Promoter	63.7
FII	20.4
DII	5.2
Others	10.7

Price performance (%)

	1M	3M	1Y
Sun Pharma	4.4	6.0	37.9
Absolute (US$)	5.1	5.3	36.3
Rel. to Sensex	0.9	1.4	16.3
CAGR (%)		3 yrs	5 yrs
EPS		12.5	25.2

Stock movement



Dr Bino Pathiparampil
bino@iiflcap.com
91 22 4646 4648

Avnish Burman
avnish.burman@iiflcap.com
91 22 4646 4673

www.iiflcap.com

Sun Pharmaceuticals BUY

The Undisputed leader

Sun Pharmaceuticals (Sun) stands out for its quality of management, clear strategy, balance sheet strength, and experience in successfully executing an acquisition strategy. The decision to stick to select specialties in India and focus on the US as the key international market has been vindicated. Continued high-teen growth in India, multi-faceted performance in the US, a rapidly growing RoW business, and a strong war chest for acquisitions, will keep Sun on a strong growth path. Sun has consistently beaten growth expectations in the past. Though FY14 growth appears challenging, given the high base of FY13, we believe the stock will hold up and deliver superior value in the medium-to-long term.

Domestic franchise standing tall: Sun is the third-largest player in the Indian Pharma market. Key specialties include neuropsychiatry, gastroenterology, cardiology, and diabetology, in which Sun Pharma brands rank foremost in physician recall. Sales have grown at ~20% Cagr for the past 10 years and it is the only company with Ebitda margin in the mid-to-high thirties, in the domestic market.

US business to sustain the shine: Sun's US revenue has grown more than 6x to US$724m in the past five years and is likely to cross US$1b in FY13. Sun's standalone US business still has a small base (US$250m in FY12). However, with >120 ANDA filings pending approval, growth would pick up to 40%+ annually. USFDA has cleared the Caraco facility in Michigan and although the ramp-up may not be quick, it supports the growth outlook. There will be gradual increase in competition, but we still expect Taro to maintain the large upside from recent product price increases partly.

Well positioned for future: The Sun management stands out for its selection of right strategies, best-in-class execution and calculated risk taking. It has delivered the strongest growth and generated the largest free cash flow and earnings and superior margins and return ratios. A cash-rich balance sheet and experience of integrating large acquisitions buttress its inorganic growth potential. We believe the rich valuation will sustain due to strong domestic brand franchise, a healthy balance sheet, and frequent upside surprises to estimates.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	57,214	80,195	105,490	113,149	127,153
Ebitda margins (%)	34.8	40.7	43.1	38.0	37.0
Pre-exceptional PAT (Rs m)	18,360	25,884	31,022	30,812	36,060
Reported PAT (Rs m)	18,161	25,873	25,186	30,812	36,060
Pre-exceptional EPS (Rs)	17.7	25.0	30.0	29.8	34.8
Growth (%)	28.6	41.0	19.9	(0.7)	17.0
IIFL vs consensus (%)			0.6	(7.7)	(8.2)
PER (x)	**40.5**	**28.8**	**24.0**	**24.2**	**20.6**
ROE (%)	20.2	21.9	21.2	17.6	17.3
Net debt/equity (x)	(0.4)	(0.3)	(0.4)	(0.4)	(0.5)
EV/Ebitda (x)	37.8	23.1	16.7	17.8	16.4
Price/book (x)	7.2	5.6	4.7	3.9	3.3

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Domestic franchise standing tall

Indian Pharma market to sustain growth for multiple years

Sun enjoys one of the best brand franchises in the domestic market. A large but high-performance portfolio that is near-exclusively present in the high-growth areas of the market. It also enjoys one of the highest margins among peers, due to the high pricing power of its franchise and tight control on operating costs.

Indian pharma market – a secular growth story

The Indian domestic pharma market has been growing at 13-15% Cagr over the past several years. Several factors indicate the sustainability of similar growth over the next 1-2 decades. These include:

1. High overall economic growth
2. Better income levels in rural/semi-urban areas
3. Increasing health awareness
4. Steady increase in prevalence of lifestyle diseases
5. Low penetration of modern medical care

Figure 2.1: Healthcare spend expected to increase as the economy matures

Country	Healthcare as a % of GDP - CY11
US	15%
France	11%
Germany	11%
Russia	5%
China	5%
India	5%

Source: WHO, IIFL Research

Brand building gives opportunity for high, sustained profitability

A branded market helps players create value through strong brand building and ensures sustained and high profitability. We do not see a material change in the industry's structure over the next decade or two and believe that the recent headwinds in the form of price control and de-branding of generic medicines will not be severe.

Specialty segments are growth drivers

Acute general therapeutics account for more than 60% of the US$12b Indian pharma market. However, chronic/specialty therapeutics are growing significantly faster and increasingly gaining dominance. We believe this trend is likely to continue because:

- The pace of urbanisation and lifestyle change is leading to increasing prevalence of chronic diseases.
- Increase in affordability that generally comes with urbanisation, is expanding the purchasing power of the consumers.
- Awareness on chronic diseases such as diabetes and cardiovascular diseases is steadily improving, leading to increased early detection and active management.

Besides the fact that they are growing faster, the chronic/specialty segments offer higher margins and lower fluctuations in growth rate because:

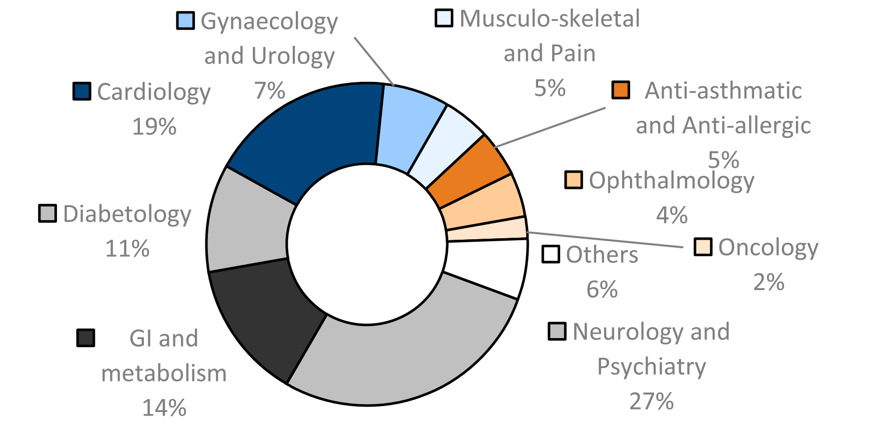
- Patients with lifestyle diseases are generally better informed and will try their best not to default on medication.
- Affordability is high in the segment and temporary economic woes do not generally result in patients abstaining from medication.
- The medications are typically long term. This gives an opportunity to create lasting brand value that cannot easily be replicated by a cheaper option.

Sun – early mover in key specialties

Sun - Leadership in key specialties

Sun is the third-largest branded generic player in India by prescription share. It has a sales force of about 2,700 medical representatives catering to around 130,000 specialist doctors. Its product portfolio is near-exclusively in select specialties, where strong brands ensure long-term sustained growth and profitability. Key specialties include neuropsychiatry, gastroenterology, cardiology, and diabetology.

Figure 2.2: Sun is strong in neuro-psychiatry and gastrointestinal medicine



Source: Company, IIFL Research

Sun has one of the strongest brand franchises

Undisputable strength in brand franchise

Sun's brands rank foremost in physician recall in six key high-growth specialties: psychiatrists, neurologists, cardiologists, ophthalmologists, orthopedic surgeons, and gastroenterologists. More than half of the company's brands feature among the top three brands in their class. We expect Sun to maintain the strong franchise and enjoy better growth experienced in its key segments of operation. Given the long-term nature of the diseases and their medications, existing brand value presents a big entry barrier to competition.

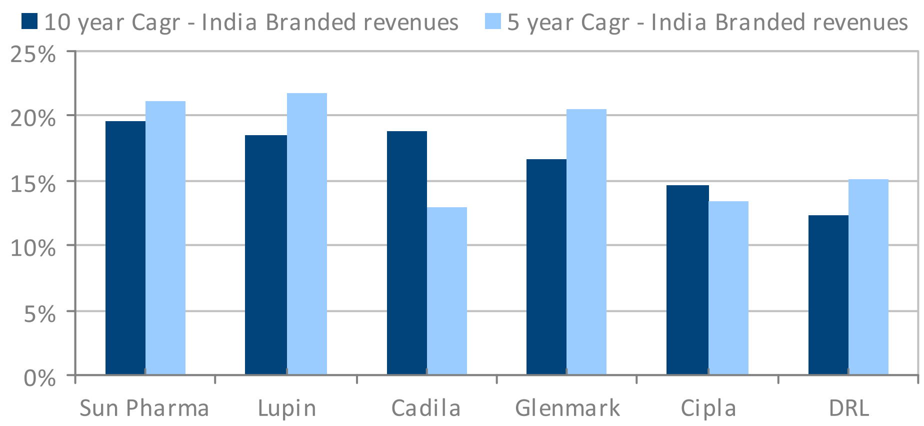
Franchise strength shows in performance

Strength of Sun's domestic franchise is clearly visible from the superior growth it has delivered over the long term. It has grown at ~20% Cagr for the past 10 years and it continues to clock similar growth rates. This is significantly faster than the overall market growth and is comparable only with growth of Lupin and Glenmark (both on smaller bases). Sun's margins stand out from peers even more than its growth: it is the only company that records Ebitda margin in the mid-to-high thirties in the domestic market. Margins of most peers are in the low-to-mid twenties. Even Glaxo Pharma,

which used to make Ebitda margin in the mid-thirties, has seen significant erosion in profitability in recent times.

Sun has had an unbeatable run in the domestic market

Figure 2.3: Sun has been a growth leader in the domestic market



Source: Companies, IIFL Research

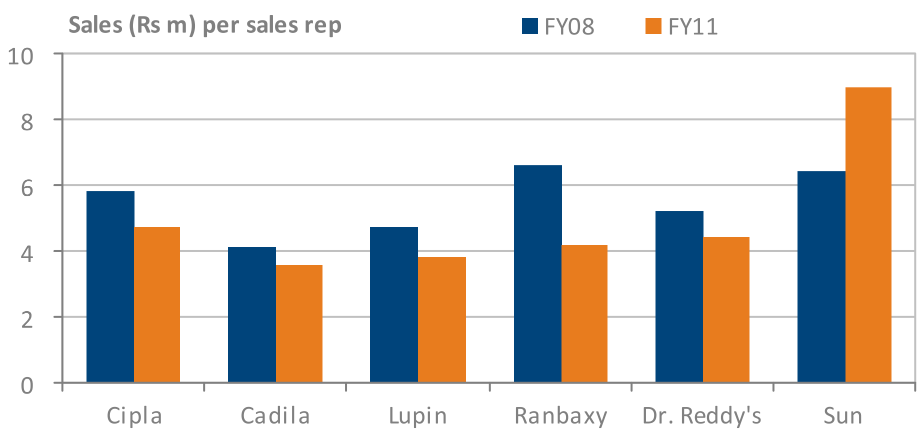
Sun has the highest sales per employee amongst its peers

Execution matches product strategy

Sun's superior growth and margins are also due to near-perfect execution of its strategy. Sun has the most efficient and lean operation and the highest sales per employee. Industry sources highlight the high level of satisfaction among Sun employees, leading to low attrition levels.

Sun has the highest sales per medical representative in the industry of ~Rs9m per representative. This is more than double that of most peers. Even as peers went in for rapid field force expansion, which diluted their productivity statistics, Sun stayed focused on its key geographies and relationships with specialist consultants and physicians.

Figure 2.4: Sun has the best productivity per employee



Source: Companies, IIFL Research

Figure 2.5: Sun remained focused on productivity while others expanded sales force

Source: Companies, IIFL Research

Strong execution skills, adaptability to changing market needs, specialty-focused portfolio will ensure future growth

Expect superior performance to continue

We believe that Sun will continue to deliver superior performance like in the past. The advantage of a pure specialties portfolio, execution skills honed over the years, and novel strategies that address changing market needs, will sustain this. New strategies include bringing high-technology low-competition products to the market and selling patented drugs through in-licensing or partnerships. SPARC, Sun's sister concern, (Sun Pharma Advanced Research Company), does high-end research in developing novel products and delivery forms of existing drugs that offer major therapeutic advantages to existing products in the market. The management is active in scouting opportunities for value-adding partnerships. The recent deal with Merck to sell sitagliptin (Januvia) and sitagliptin + metformin (Janumet) in India is a good example. We project Sun's domestic business to sustain 18-20% revenue growth in the medium term without dilution in profitability.

US business to sustain the shine

Strong focus on US market amongst international presence

Sun has consistently surprised on the upside with its US business, be it growth of its own portfolio, monetization of one-off opportunities or the acquisition, and subsequent price increases in Taro. Overall, Sun's US business has grown more than 6x in the past five years to US$724m in FY12. We expect this to cross US$1b in FY13 and sustain the strong momentum, despite some reversals in price increases by Taro.

New product approvals to drive parent portfolio

Sun's standalone US business still has a small base (US$250m in FY12) and could witness the high growth rate (40%+ annually) that is typical of such small businesses in that market. There are more than 120 ANDA filings pending approval in the portfolio and these products will be key growth drivers in the near-to-medium term. There is limited visibility on the products, but given the brief history of the business and Sun's strategy, a significant number of them could be limited-competition products with high sales and profit potential.

Low base and strong pipeline spell well for the future

Figure 2.6: Sun has one of the strongest pipelines amongst peers

ANDA awaiting approval

Sun Pharma, Lupin, Ranbaxy, Cadila, DRL, Glenmark

Source: Companies, IIFL Research

Extra boost from Caraco

Until FY09, the Caraco subsidiary contributed a majority of Sun's consolidated US business. It registered peak revenue of US$128m in FY08 from its own products (excluding parent's products that it used to distribute). However, in early FY10, it faced manufacturing quality issues, leading to a USFDA order to shut down the facility for deviations from current Good Manufacturing Practices (CGMP). After prolonged intermediation, the FDA inspected the facility in early 2012 and cleared it for a limited number of products.

Currently, Caraco is allowed to resume production for just two products (Carvedilol USP and Paramomycin USP). Other products pending approval from this site will go through the rigorous process defined in the consent decree before obtaining an approval. While the ramp-up may not be quick, it would boost growth outlook for Sun's US business.

Taro - recent price increases show portfolio strength

Sun took operational control of Taro in 3QFY11, after a long legal battle that lasted almost three years. It had signed a merger agreement with Taro way back in May'07, but soon it turned contentious and Taro unilaterally terminated the agreement. Sun

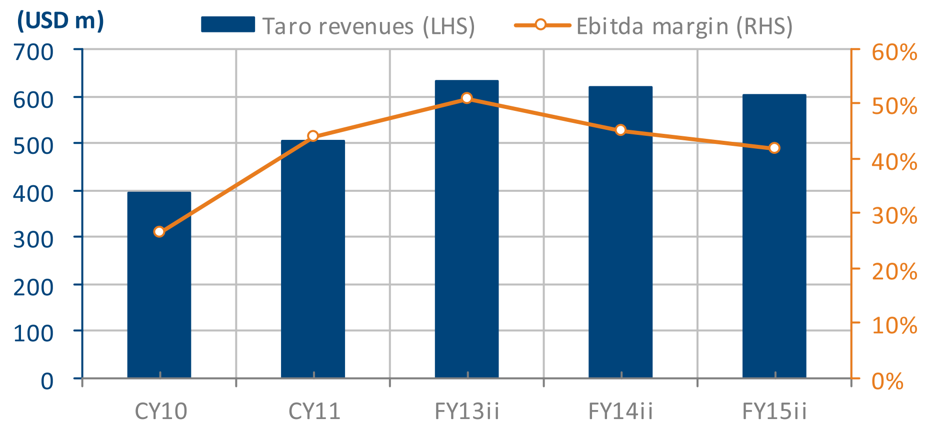
was able to enforce the agreement in the US and Israeli courts and currently owns ~66% stake of Taro.

More than 80% of Taro's top line comes from the US market. Dermatology products account for two-thirds of that. While the R&D pipeline of Taro is lean due to lack of long-term strategic planning by the former management, its existing product portfolio is exceptionally strong. This is evident from the large price increases that Sun could make in Taro's dermatology products starting 2QFY12. From a quarterly run rate of ~US$90-100m in revenue and US$18-20m in Ebit, Taro has jumped to a run rate of US$145-160m in revenue and US$65-80m in Ebit, under Sun's management.

Despite possible price reversals, Taro will continue to be extremely profitable franchise

We expect Taro to maintain the large upsides from product price increases in the near-medium term. There will be a gradual increase in competition and consequent part reversals in the price increases. However, despite that, we expect the significantly stronger-than-historical margins to sustain.

Figure 2.7: Taro makes industry-leading margins on a high base



Source: Company, IIFL Research

US market has been the key growth driver for Indian companies in the past

US market– large penetration opportunity still intact

The US market has been the single-largest growth driver for Indian players over the past decade. Rapid growth in the US was helped by:

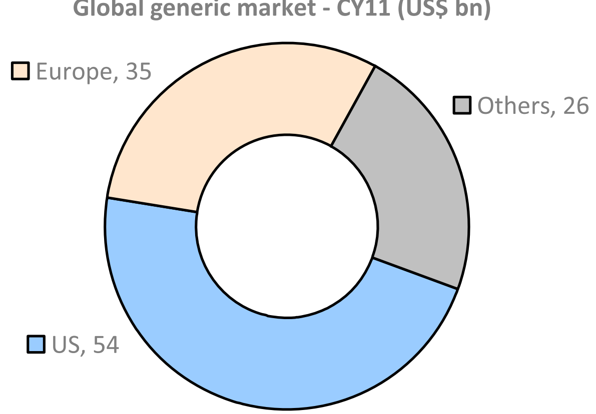
- The large size of the market
- Homogenous nature with established logistics network
- Straightforward, single-agency regulatory structure
- System of pharmacy-level substitution of brands with generics
- Cost advantages of Indian players
- Low base helping rapid market share gains
- Regulatory expertise that Indian companies were quick to acquire
- Leveraging of strong product development capabilities acquired in the home market
- Large patent expiries that kept the market in a flux
- The market-exclusivity scheme that provided opportunities to make large profit and accelerate market penetration
- Increasing generic penetration — at ~75%, the generic penetration in the US market is the highest in the regulated world.

Some of these, especially the benefit of a small base and the wave of large patent expirations may be diluted soon. However, the other factors remain intact. In fact, even after the decade-long strong growth, individual Indian players will have less than 2-3% share in

the market. Thus, the penetration-led growth will sustain for several more years, although at lower rates than in the past (growth rates could moderate to mid-high teens from the 35%+ rates witnessed in last 5-7 years). We expect Sun to remain a key beneficiary of this industry-level phenomenon.

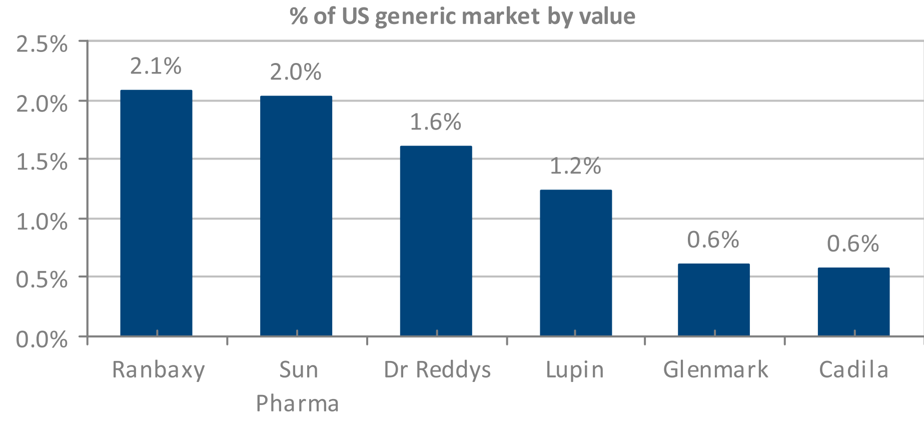
The sheer size of the market makes it the most attractive geography even today

Figure 2.8: The US still remains the largest generic market



Source: Company, IIFL Research

Figure 2.9: Indian players still have 1-2% market share in the US generic market



Source: Company, IIFL Research

Sun's FY14 growth may taper down but fundamentals remain strong

High FY13 base may impact FY14 growth

Sun's FY14 revenue and earnings growth (especially from the US business) may be muted, given the high base of FY13. Two factors that were responsible for growth in FY13 and will likely taper off going into FY14 are:

1) Limited competition and pricing power for Taro products – Taro has been able to hold on to the large price increases that it took in FY12, when competition had to exit the market due to manufacturing/logistics issues. Competition is likely to re-enter the market sooner than later and affect pricing. We believe that the impact will be gradual and hence, we have built in only a partial reversal of the upsides.
2) Sun was given an interim approval by the USFDA for supply of Lipodox in the US market after Johnson and Johnson (the original supplier) faced problems with one of its contract manufacturers. We estimate Sun to have made ~US$80-100m from this product alone in FY13. With Johnson and Johnson clearing the issues with its contract partner and entering the market, this upside will not continue into FY14.

Well positioned for future

Sun has all the ingredients for a bright future

Sun stands out among its peers on almost all parameters, be it quality of management, an in-place long-term strategy, a strong balance sheet to execute inorganic growth, and experience in successfully integrating large acquisitions. These strengths will steer the company forward, providing a sustained growth momentum.

Best management capabilities

Sun's management capabilities show up in the selection of right strategies, best-in-class execution, and calculated risk taking. These unique abilities have helped the company to grow from a small player in select therapeutic areas in the domestic market and outpace peers, to emerge as the largest Indian pharma company in market capitalisation.

The decision to stick to chronic therapeutics and select specialties in India and not go after mass market volume products, turned out to be one of the best choices in the market. Sun's focus segments have been consistently outgrowing the market, helping it keep its own growth rate substantially above the market growth rate. It has also delivered unmatched perfection in execution: its brands are one of the best-known and well-established ones in the market and command premium pricing. It also extracts the best margins in the industry through premium prices, optimized costs, and streamlined sales and marketing structures.

Strong execution capabilities on ground complement smart moves by top management

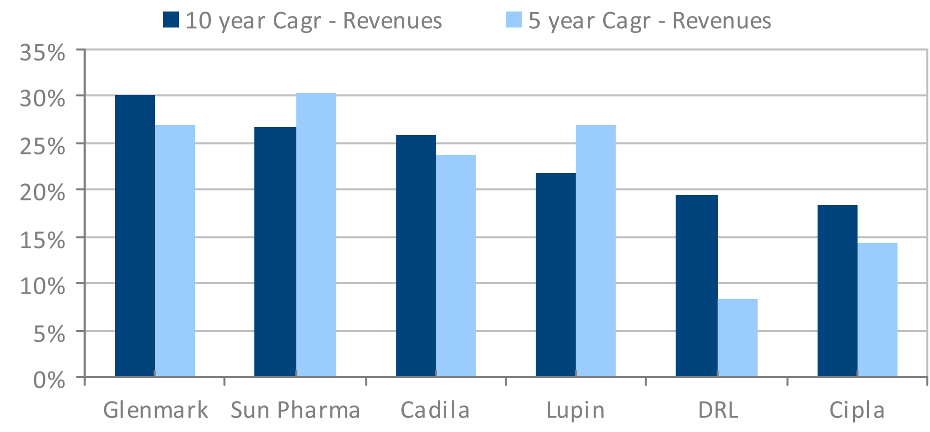
Sun's strategic decision to focus on the US as the key international market also paid off. Instead of providing divided attention to a number of businesses scattered across geographies and segments, Sun's focused strategy has helped it to emerge as one of the largest Indian players in the US. The management focuses all its efforts on the inorganic and organic growth of the US business. Even in the US market, a right product strategy and tight cost control have ensured that Sun maintains high profitability, not very different from its domestic business.

Sun's management has generally been conservative and has taken only calculated risks so that any impact of a negative outcome could be absorbed without serious damage to the company.

Historic performance – an indicator of future

Sun has delivered one of the best revenue and Ebitda growths among all Indian pharma companies over the past 10 years. The fact that it has delivered this growth while generating the largest amount of free cash flow among peers makes it even more commendable. Sun's capital efficiency ratios are among the best in the industry. We believe that these are all indicators of the company's execution capabilities and potential and will ensure continued performance in future.

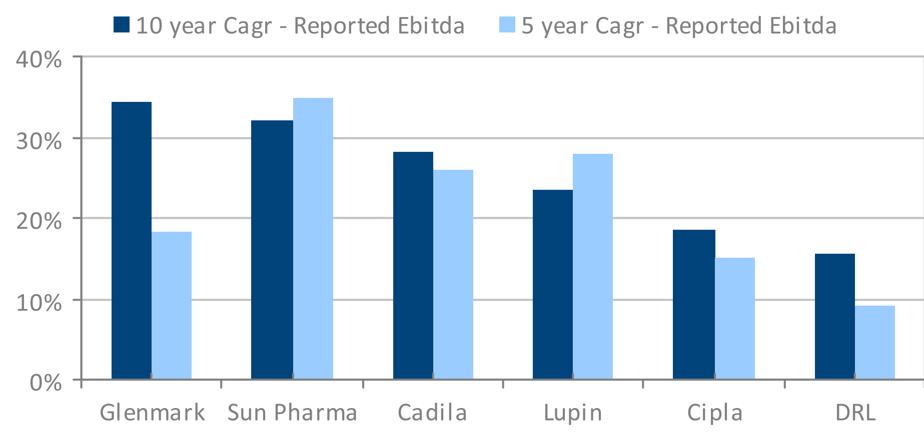
Figure 2.10: Sun's top-line growth is among the best



Source: Companies, IIFL Research

Sun has delivered consistently strong topline and bottom-line growth

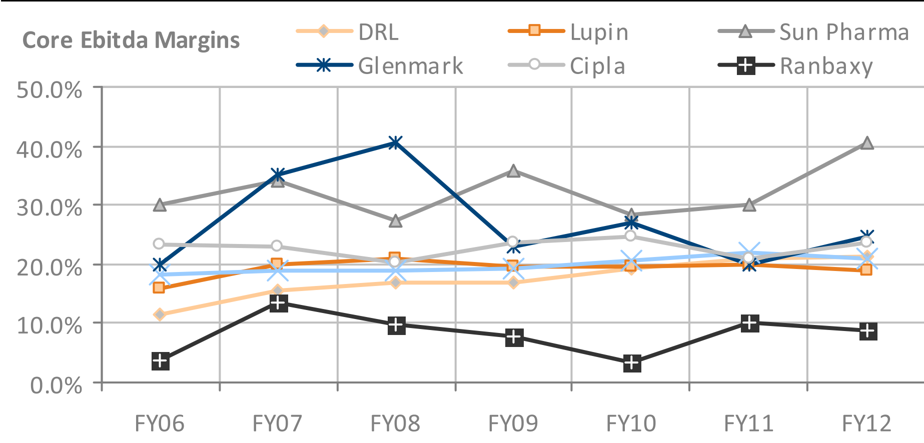
Figure 2.11: Sun has delivered one of the best Ebitda growth numbers



Source: Companies, IIFL Research

Sun has the best profitability amongst its domestic peers

Figure 2.12: Sun's profitability has remained the best in the industry



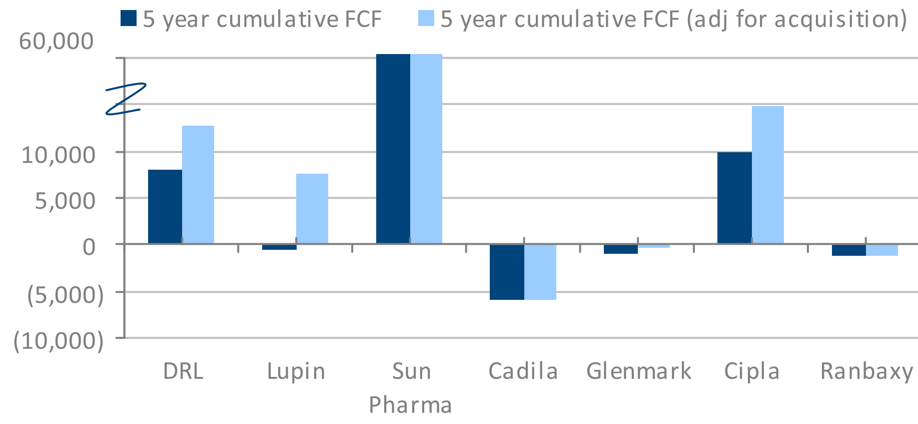
Source: Companies, IIFL Research

Figure 2.13: Sun's ROIC is unmatched in the industry

Source: Companies, IIFL Research

Strong balance sheet adds to the attractiveness

Figure 2.14: Sun is the top free-cash generating business in the industry



Source: Companies, IIFL Research

Cash-rich balance sheet; poised for M&A exploits

Sun has an exceptionally strong balance sheet with more than US$1bn cash on books. Its strong business ensures continuous cash flow that adds further to the reserves. Combine this with the management's stated intent of inorganic growth through value-accretive transactions, and Sun looks poised for major strides in the global market. The company has recently passed an enabling resolution that will further help mobilize funds up to US$2bn if need be. Sun also recently took on board, Israel Makov, the former CEO of Teva, as Chairman. His experience in building Teva as the largest-generic pharma company in the world will help Sun in its inorganic pursuits in the international markets.

Sun has been astute in its overseas acquisitions

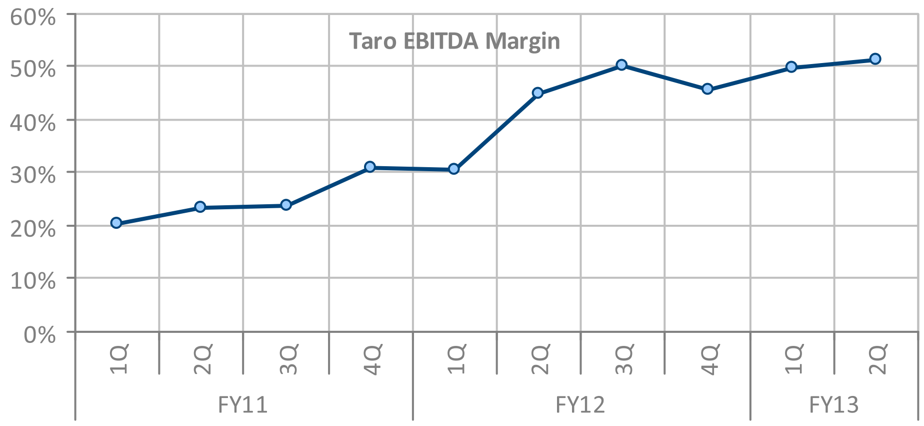
Experience in acquisitions to aid inorganic growth

Sun has so far had one of the best track records of acquisitions among Indian pharma companies. It has made two large acquisitions (compared with its size at the time of acquisition), which it successfully turned around and grew stronger. Caraco Labs in the US was acquired over 1997-2004 in a phased manner for US$50m in aggregate. The company grew several times larger registered strong growth before it was impacted by the US FDA action on manufacturing quality issues in 2009. Good synergies played out well with Caraco contributing to Sun's learning of the US pharmaceutical regulations and understanding of the market. It also spearheaded Sun's distribution in the US. The more recent acquisition of 66% stake in Taro Pharma in the US over 2007-10 has turned out to be a

big turnaround story as well. Within two quarters of gaining full operational control, Sun's management was able to identify the strength of Taro's portfolio and make select price increases in the US market, which helped Taro almost double its operating margins.

Price hikes at Taro has given a substantial boost to the overall profitability

Figure 2.15: Taro could make price increases, significantly expanding its profitability



Source: Company, IIFL Research

Valuations rich but justifiable

Sun shares trade at 27.5x FY13ii and 24.6 FY14x core earnings, at 20-40% premium to peers. We believe that the rich valuations are justified by the strong domestic brand franchise, healthy balance sheet, and frequent upside surprises to estimates. At our price target of Rs768, the stock would trade at 27.5x FY14ii core earnings plus cash and value of one-off exclusivities, adjusted for potential one-off Protonix liability.

Key Risks

Domestic pricing policy:

While the Supreme Court is still to rule on the newly proposed pharma pricing policy, we believe that in the current form of the policy as suggested by the government, Sun is one of the least impacted companies in the domestic market due to low exposure to the National List of Essential Medicines and increasing contribution from the US business to overall profitability.

Taro's supernormal profitability:

Taro's price increases in the US around a year ago have helped it post high growth in 2HFY12/1HFY13. Sustaining these hikes would be difficult as new players enter the market. With a high base of FY13 and a thin pipeline, Taro's revenue will likely be flat in FY14, putting pressure on overall growth for Sun.

Protonix liability

Sun is involved in a court case with Wyeth (acquired by Pfizer) regarding the at-risk launch of Protonix back in 2008. While Wyeth is seeking damages of about US$960m from Sun, in its own assessment, Sun recently made a provision of Rs5.8b for this. The pending litigation remains a key overhang on the stock.

Premium Valuation

Sun has historically maintained premium valuations compared with its large-cap peers in the pharma space. The rich valuations have been justified, given consistent and strong growth, industry beating

margins, healthy balance sheet, and strong cash flows. However, the valuations will re-rate if growth fails to keep up with the high expectations.

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Domestic growth (%)	30.5	22.2	2.5	18.0	18.0
US business growth (%)	105.3	54.0	58.4	(4.4)	7.5
ROW business growth (%)	29.6	72.6	30.9	16.5	16.7
EBITDA margin (%)	34.8	40.7	43.1	38.0	37.0
Tax rate (%)	6.3	11.4	17.6	17.5	17.5

Source: Company data, IIFL Research

Financial summary

Consistent performance in growth and margins

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**57,214**	**80,195**	**105,490**	**113,149**	**127,153**
Ebitda	19,900	32,676	45,497	42,997	47,106
Depreciation and amortisation	(2,041)	(2,912)	(3,402)	(3,600)	(3,830)
Ebit	17,859	29,765	42,095	39,397	43,276
Non-operating income	2,984	4,082	3,140	4,530	6,690
Financial expense	(285)	(282)	(821)	(222)	(229)
PBT	20,558	33,565	44,414	43,705	49,737
Exceptionals	(200)	(11)	(5,836)	0	0
Reported PBT	20,358	33,554	38,578	43,705	49,737
Tax expense	(1,284)	(3,826)	(7,834)	(7,648)	(8,704)
PAT	19,074	29,727	30,744	36,056	41,033
Minorities, Associates etc.	(913)	(3,855)	(5,559)	(5,245)	(4,974)
Attributable PAT	**18,161**	**25,873**	**25,186**	**30,812**	**36,060**

Decline in FY14 due to high base created by Taro and Lipodox upside

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	17.7	25.0	30.0	29.8	34.8
DPS	3.5	4.3	3.5	4.0	5.0
BVPS	99.8	128.7	153.5	184.2	219.1
Growth ratios (%)					
Revenues	39.5	40.2	31.5	7.3	12.4
Ebitda	38.2	64.2	39.2	(5.5)	9.6
EPS	28.6	41.0	19.9	(0.7)	17.0
Profitability ratios (%)					
Ebitda margin	34.8	40.7	43.1	38.0	37.0
Ebit margin	31.2	37.1	39.9	34.8	34.0
Tax rate	6.3	11.4	20.3	17.5	17.5
Net profit margin	33.3	37.1	29.1	31.9	32.3
Return ratios (%)					
ROE	20.2	21.9	21.2	17.6	17.3
ROCE	21.9	27.2	29.7	24.2	23.2
Solvency ratios (x)					
Net debt-equity	(0.4)	(0.3)	(0.4)	(0.4)	(0.5)
Net debt to Ebitda	(1.8)	(1.4)	(1.3)	(2.0)	(2.4)
Interest coverage	NM	NM	NM	NM	NM

Source: Company data, IIFL Research

Sufficient cash in hand for major acquisitions

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	40,884	49,911	60,404	89,202	115,516
Inventories	14,895	20,870	27,427	29,419	33,060
Receivables	11,049	19,261	23,208	24,893	27,974
Other current assets	9,103	11,366	16,154	17,686	20,486
Creditors	9,403	13,776	15,509	18,150	20,723
Other current liabilities	5,153	9,154	9,280	10,093	10,884
Net current assets	**61,374**	**78,478**	**102,404**	**132,956**	**165,428**
Fixed assets	24,689	29,582	31,179	33,080	35,250
Intangibles	10,599	13,378	13,378	13,378	13,378
Investments	3,460	5,890	5,890	5,890	5,890
Other long-term assets	9,053	12,347	12,347	12,347	12,347
Total net assets	**109,175**	**139,674**	**165,198**	**197,651**	**232,292**
Borrowings	4,325	3,283	3,178	3,814	2,269
Other long-term liabilities	1,545	3,113	3,113	3,113	3,113
Shareholders equity	**103,305**	**133,278**	**158,907**	**190,723**	**226,910**
Total liabilities	**109,175**	**139,674**	**165,198**	**197,651**	**232,292**

Robust free cash flow will aid growth through acquisitions

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	17,859	29,765	42,095	39,397	43,276
Tax paid	(693)	(2,268)	(7,834)	(7,648)	(8,704)
Depreciation and amortization	2,041	2,912	3,402	3,600	3,830
Net working capital change	4,877	(10,033)	(13,433)	(1,754)	(6,159)
Other operating items	(1,252)	3,106	(5,836)	0	0
Operating cash flow before interest	22,831	23,482	18,394	33,595	32,243
Financial expense	(577)	(286)	(821)	(222)	(229)
Non-operating income	2,133	1,877	3,140	4,530	6,690
Operating cash flow after interest	**24,387**	**25,073**	**20,713**	**37,902**	**38,705**
Capital expenditure	**(4,170)**	**(7,021)**	**(5,000)**	**(5,500)**	**(6,000)**
Long-term investments	(7,286)	(3,866)	0	0	0
Others	(69)	(14)	0	0	0
Free cash flow	**12,862**	**14,171**	**15,713**	**32,402**	**32,705**
Equity raising	0	0	0	0	0
Borrowings	(3,787)	(1,049)	(105)	636	(1,545)
Dividend	(3,314)	(4,096)	(5,115)	(4,240)	(4,846)
Net chg in cash and equivalents	5,761	9,027	10,493	28,798	26,313

Source: Company data, IIFL Research

Technical analysis of Sun Pharmaceuticals

Sun's share price has been on a secular uptrend since 2009 and has moved continuously higher with an increasing top and bottom formation. The price has rallied within the band of 'expanding diagonal', which suggests that the prices remain in the comfort zone for long-term accumulation.

40 WMA acting as a strong support: In the history of Sun, there have been numerous occasions when prices have turned around before testing the long-term average of 40 WMA. With the slope of long-term average marginally shifting higher, any correction in prices would be short lived.

Retracement projection: The prices have not seen major retracement after the medium-term breakout above Rs585. The 161.8% Fibonacci projection since Nov 2011 is acting as a major base, which provides a long-term target at Rs926.

RSI retreating to the multi-year support: With weekly RSI retreating towards the bull market support zone of 55 and coinciding with a rising support trend line, it has provided a good entry point for long-term investors.

Advantage of comparative strength: The weekly ratio chart of Sun with the Nifty as well as BSE Healthcare Index portrays a high degree of outperformance, especially after June 2010. However, the buying momentum could aggravate further after the ratio of Sun to the BSE Healthcare surpasses the resistance zone of 0.10.

161.8%
Price target Rs926
0.0%
38.2%
40 WMA
100.0%
Ratio with BSE Healthcare
Ratio with S&P CNX 500

Sun Pharmaceuticals – 10 year share price performance chart

CMP	Rs2081
Target 12m	Rs2200 (6%)
Market cap (US$ m)	11,020
Enterprise value (US$ m)	10,064
Bloomberg	BJAUT IN
Sector	Autos

Dec 14 2012

52Wk High/Low (Rs)	2106/1407
Shares o/s (m)	289
Daily volume (US$ m)	13
Dividend yield FY13ii (%)	2.4
Free float (%)	50.0

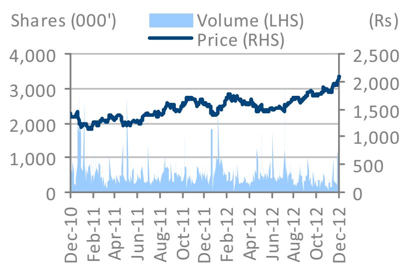
Shareholding pattern (%)

Promoter	50.0
FII	15.1
DII	10.0
Others	24.0

Price performance (%)

	1M	3M	1Y
Bajaj Auto	13.0	19.3	26.2
Absolute (US$)	13.4	18.5	27.6
Rel. to Sensex	9.5	14.7	4.6
CAGR (%)		3 yrs	5 yrs
EPS		58.9	19.9

Stock movement



Joseph George
joseph.george@iiflcap.com
91 22 4646 4667

www.iiflcap.com

Bajaj Auto — ADD

Fast rider

Bajaj Auto (Bajaj) will see robust earnings growth, driven by increasing two-wheeler (2W) penetration in the domestic market, a fast-growing export franchise, and margin expansion due to higher export realisations. We expect the domestic motorcycle volumes to grow at 12% Cagr over the medium term. Further, we expect Bajaj to benefit from upgradation by 2W users. In exports, growth in nascent markets and market share gains therein would drive volumes. We forecast Bajaj's earnings to grow at 16% Cagr over FY13-15.

Steady domestic growth: At 7%, penetration of two-wheelers (2W) in India is significantly below most Asian peers. We expect increasing penetration, especially in rural India, to drive 12% volume growth over the medium term. Being the second-largest motorcycle manufacturer in India with a stronger presence in motorcycles with higher cc, we expect Bajaj to capture the upgradation cycle.

Fast-growing export franchise: We expect Bajaj's export volume to grow at 16% Cagr over FY13-15 and account for 36% of revenue by FY15, from 33% in FY13. We see strong growth potential for Bajaj in Africa, led by a combination of high market growth and market share gains from unbranded Chinese motorcycles. In Asia, a recovery in Sri Lanka would help Bajaj generate high growth from FY14 onward.

Expect 16% EPS Cagr over FY13-15: We expect Bajaj to generate 16% EPS Cagr over FY13-15, led by sturdy volume growth and margin expansion. Bajaj has displayed strong pricing power in maintaining its industry-leading Ebitda margin in a narrow band. INR depreciation can potentially help Bajaj's Ebitda margin to increase by up to 200bps in FY14. High margins, low fixed-cost structure, high return ratios, strong FCFF generation, and a healthy 2.4% dividend yield make Bajaj one of the best long-term investment ideas in the Indian auto space.

Financial summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	163,982	195,290	204,734	241,631	275,700
Ebitda margins (%)	19.3	19.0	18.6	19.7	18.9
Pre-exceptional PAT (Rs m)	26,152	31,381	30,602	36,979	41,264
Reported PAT (Rs m)	33,397	30,041	30,602	36,979	41,264
Pre-exceptional EPS (Rs)	90.4	108.4	105.8	127.8	142.6
Growth (%)	44.5	20.0	(2.5)	20.8	11.6
IIFL vs. consensus (%)			(4.1)	(1.5)	2.5
PER (x)	**23.0**	**19.2**	**19.7**	**16.3**	**14.6**
ROE (%)	66.7	57.3	44.9	43.1	38.8
Net debt/equity (x)	(0.8)	(0.9)	(0.8)	(0.9)	(0.9)
EV/Ebitda (x)	17.7	14.8	14.1	10.9	9.5
Price/book (x)	12.3	10.0	7.9	6.3	5.2

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Company Snapshot

Bajaj is the second largest motorcycle manufacturer in India

Bajaj is the fourth-largest motorcycle manufacturer in the world. It is the second-largest motorcycle manufacturer in India and a leader in the three-wheeler (3W) industry with total sales (2W+3W) of 4.3mn units in FY12. The company has 25% market share in the domestic motorcycle segment and 40% share in the domestic 3W segment. The "Pulsar" model dominates the premium motorcycle segment whereas the "Discover" model has gained significant traction in the executive segment. Bajaj has also developed a four-wheeler passenger carrier positioned as a replacement for three-wheelers. Bajaj holds 47% stake in KTM, the Austrian sports bike maker. It has three plants with total capacity of 5.1mn units, two in Maharashtra at Waluj and Chakan and one in Uttaranchal at Pantnagar.

Bajaj exports motorcycles and 3Ws to Africa, the Middle East, Asia, and Latin America. In FY12, exports contributed 36% to Bajaj's volumes and 34% to revenue.

Background

The Bajaj Group is one of the biggest business houses in India. The Group was founded in 1926 by Jamnalal Bajaj. His son Kamalnayan Bajaj managed the business until the current chairman Rahul Bajaj took charge in 1965. The Rahul Bajaj group's footprint spreads across automobiles (2Ws and 3Ws), insurance, and consumer finance.

Figure 3.1: Exports contributed 36% to FY12 volumes

Source: Company, IIFL Research

Management

Name	Designation	Remarks / management description
Rahul Bajaj	Chairman	Honours Graduate in Economics and Law and a Business Graduate from Harvard Business School.
Rajiv Bajaj	Managing Director	Masters in Manufacturing Systems from University of Warwick. He has been responsible for the successful transition of the company from scooters to motorcycles and the launch of *Pulsar*.
Kevin D'sa	Vice President (Finance)	Fellow member of Institute of Chartered Accountants of India. Mr. D'sa has been with Bajaj for the past 30 years.

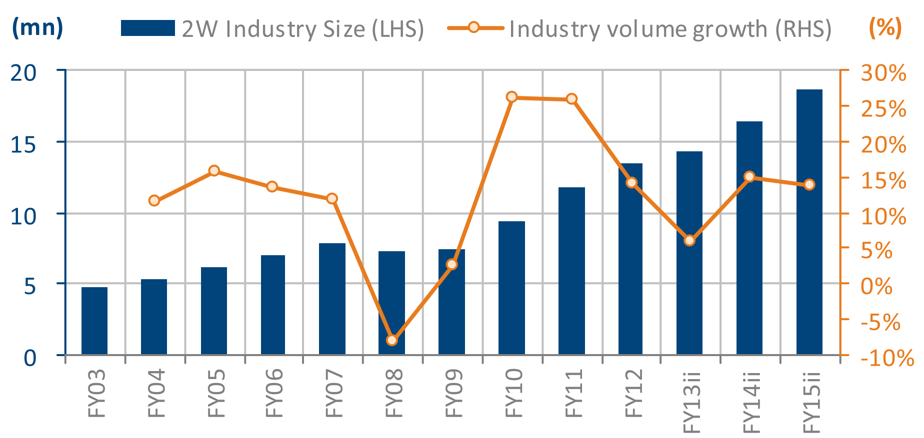
Domestic motorcycle – steady growth story

2W Industry is most resilient to macro woes

Two-wheelers: Least cyclical auto segment

Among all the auto segments in India, the 2W industry has been least cyclical and most resilient to unfavourable macro-economic factors such as rising interest rates and fuel prices. 2W industry has de-grown only once (FY08) in the past ten years. Rising fuel prices and weak consumer sentiment affected 2W demand in 1HFY13. We expect the industry to recover in 2H and grow at 14% Cagr over FY13-15.

Figure 3.2: 2W industry growth to bounce back in FY14 and FY15



Source: SIAM, IIFL Research

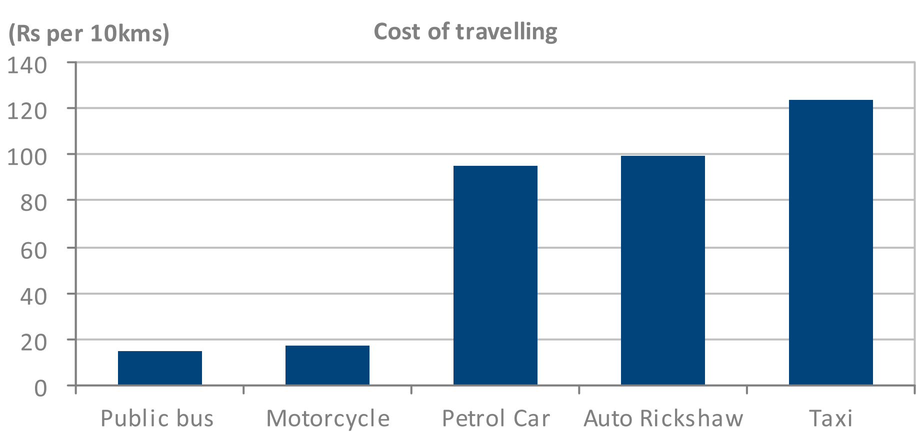
2Ws have a significant advantage over other modes of transport

2W demand driven by basic need for commuting

Demand for 2Ws in India is driven by the basic need of commuting, as evident from the fact that a vast majority of 2Ws sold in India are either scooters or 100-cc motorcycles.

Lack of efficient public transport systems, low cost of ownership/use, and convenience of last-point-connectivity give 2Ws a significant advantage over other modes of transport.

Figure 3.3: 2Ws provide a cheap and convenient mode of transport



Source: Company, IIFL Research

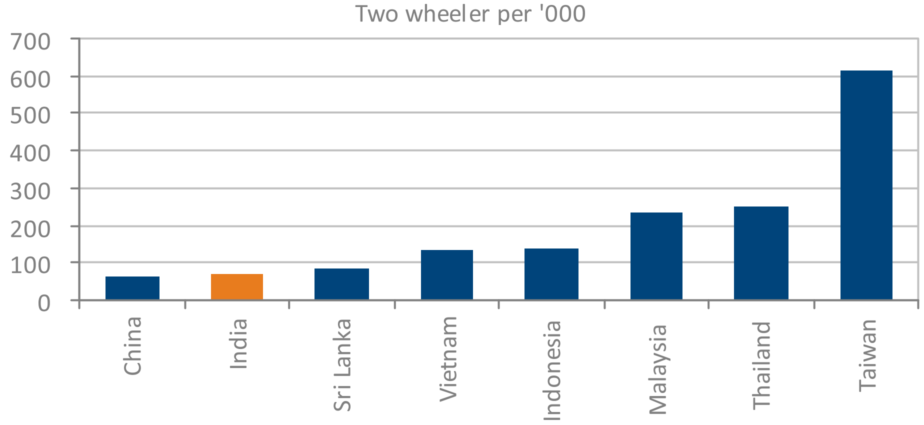
India is under-penetrated compared with Asian peers

At 7%, penetration of 2Ws in India is significantly below most of its Asian peers. Low penetration of personal transport vehicles combined with lack of a good public transport system in many parts

of the country presents a significant opportunity for 2W penetration, supported by increase in income levels.

2W penetration in India is significantly low

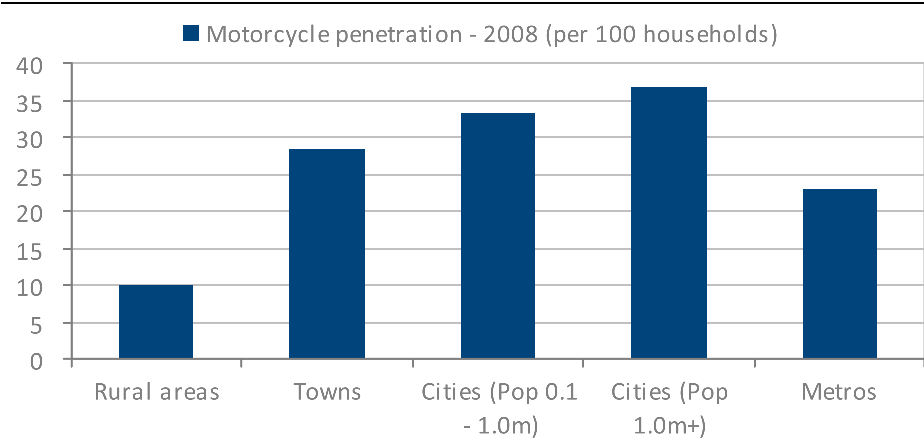
Figure 3.4: 2W penetration still low compared with other developing countries



Source: Company, IIFL Research

Within the country, we expect to see higher growth in rural markets where penetration of 2Ws and cars continues to be significantly below the country average.

Figure 3.5: Rural penetration is much lower than urban



Source: Company, IIFL Research

Demand shifting to scooters and higher cc motorcycles

Within the domestic motorcycle segment, scooters and mopeds have been growing faster than motorcycles. The share of mopeds has remained at around 5-6% whereas that of scooters has increased from 12% in FY07 to 19% in FY12 and 21% now. Within motorcycles, we see a shift in favor of the >125cc segment.

Figure 3.6: Scooters and >125cc motorcycles have been gaining share

Source: SIAM, IIFL Research

Bajaj will benefit significantly from consumer up trading

Bajaj will benefit from shift to higher cc motorcycles

Bajaj exited the scooters segment in 2009 and as per the management, it has no plans to re-enter the segment. However, Bajaj will benefit from customer shift from the <125cc motorcycles to the >125cc motorcycles since it has a higher market share in that segment.

Figure 3.7: Bajaj has higher market share in >125cc motorcycles

Source: SIAM, IIFL Research

We expect Bajaj's domestic 2W volumes to grow at 12% Cagr over FY13-15, slightly lower than the 14% growth we build in for the industry, primarily due to lack of presence in the fast-growing scooters segment.

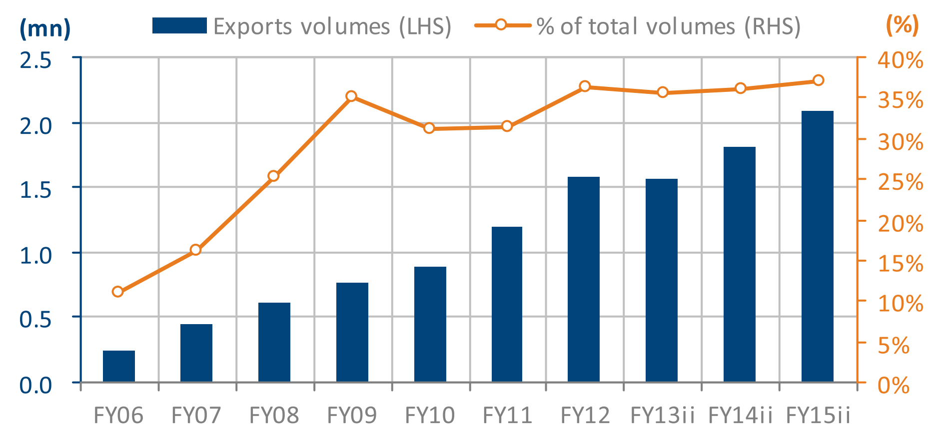
Exports to grow faster

Exports will provide required push to volume growth

Although growth in domestic volumes is likely to remain steady, growth in export markets will provide the much required push to volume growth. Bajaj's export volumes registered 29% Cagr over the past five years. We expect export volumes to deliver 16% Cagr over FY13-15, driven by recovery in Sri Lanka and Egypt and continued strength in Africa and LatAm.

We expect export growth to be driven by Africa and South Asia. In Africa, we expect Bajaj to grow faster than the industry as branded players gain market share from unbranded motorcycles. Current market split between unbranded and branded motorcycles in Africa is 70:30 in favour of unbranded motorcycles. In South Asia, where Indian manufacturers already have a lion's share, we expect growth to be in line with the industry.

Figure 3.8: We expect export volumes to grow at 16% Cagr over FY13-15



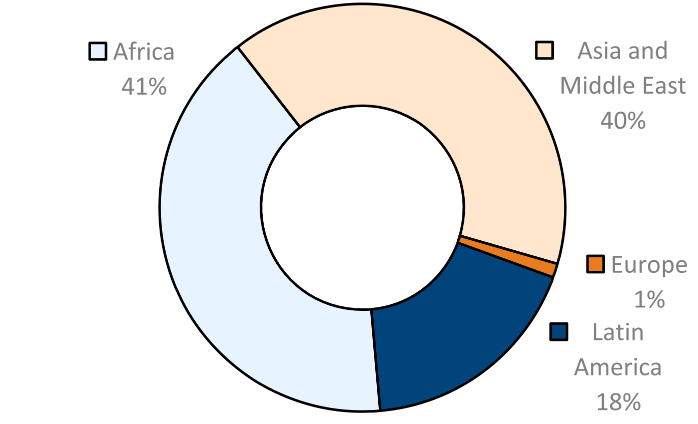
Source: SIAM, IIFL Research

Africa and South Asian countries are the key export markets for Bajaj

Africa and Asia contribute 80% in exports

Africa accounts for 41% of Bajaj's exports. Asia (mainly Sri Lanka and Bangladesh) and the Middle East together account for 40% of exports and Latin America accounts for the rest.

Figure 3.9: Geographical break-up of FY12 exports – Africa and Asia remain the key



Source: Company, IIFL Research

Figure 3.10: Key motorcycle export markets for Bajaj

Country	Industry volumes CY2011	5 Cagr	Comments
Nigeria	1mn		Bajaj enjoys significant premium over unbranded Chinese players; high growth opportunity for Bajaj
Sri Lanka	0.25mn	10.1%	Largely dominated by Indian players; export volumes to grow at respective industry rates
Bangladesh	0.1mn	16.1%	
Indonesia	8mn	12.7%	Dominated by Honda and Yamaha; Should provide significant growth opportunity to Bajaj
Brazil	2mn	10.0%	Dominated by Honda and Yamaha; Bajaj is planning to launch Duke with the help of KTM

Source: IIFL Research, AISI, ABRACICLO, BRTA, Department of Motor Traffic Sri Lanka

Bajaj has significant scope of gaining market share from unbranded players in African markets

1. Africa (Nigeria):

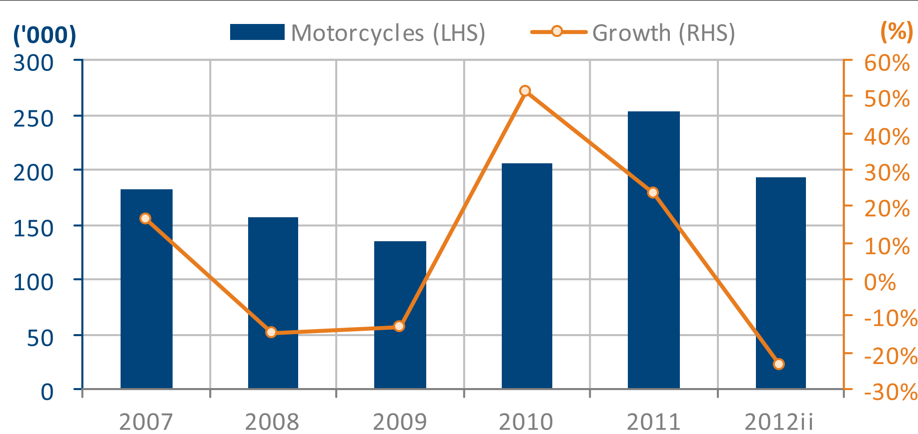
Out of total exports to the African continent, 60% exports are to Nigeria alone. Nigeria has emerged a key market in the African continent with annual sales of around 1mn units. Motorcycles are generally used as taxis in Nigeria owing to poor public transport infrastructure. Bajaj is a well-established player in the Nigerian market through its *Boxer* brand, which commands a premium over unbranded Chinese motorcycles. Within Nigeria, about 60% volumes are sold in the capital city of Lagos. Growth into other cities of Nigeria, expansion into nascent markets such as Kenya, Tanzania, Uganda, Sudan, and Congo, and market share gain from Chinese motorcycles, would ensure high growth for Bajaj in Africa. Market share of branded motorcycles in Africa is only around 30%, leaving a significant scope for market share gains from unbranded motorcycles.

Growth in Bangladesh and Sri Lanka will largely mirror industry growth

2. South Asian countries (Bangladesh and Sri Lanka):

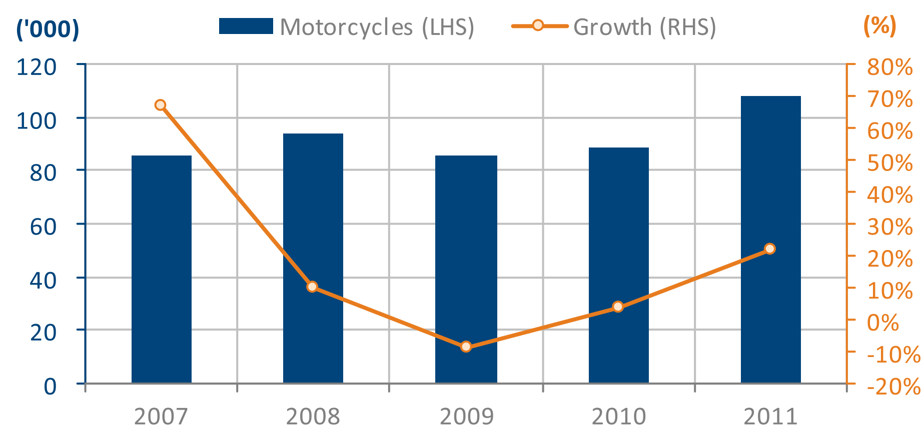
Bajaj is established well in Sri Lanka and Bangladesh with market share of 50% and 30% respectively. The Sri Lanka motorcycle market registered a significant decline in CY12 due to a steep increase in import duties by the Sri Lankan government. Bajaj has now sacrificed some of its margins in Sri Lanka by offering discounts. Bajaj's 2W exports to Sri Lanka dropped from an average of 10-11k/month in CY11 to 5-6k/month. However, with discounts offered by Bajaj and given a dearth of alternatives to motorcycles for basic commuting, we expect volumes to improve going forward. Since the Indian motorcycle makers already have 80%+ market share, we believe Bajaj's growth in these markets would be in line with market growth.

Figure 3.11: Sri Lanka motorcycle industry



Source: Company, IIFL Research

Figure 3.12: Bangladesh motorcycle industry



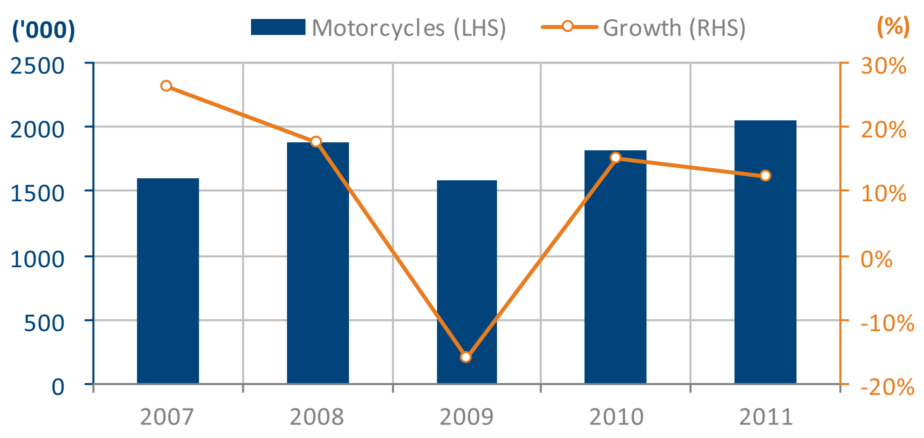
Source: BRTA, IIFL Research

Bajaj is planning to enter the Brazilian market with the KTM Duke

3. Latin America (Colombia, Central America, Brazil):

Bajaj also plans to enter the Brazilian market. With annual sales of 2m units in 2011, Brazil is the largest motorcycle market in Latin America. In Brazil, motorcycle sales grew at 10% Cagr over the past five years. Honda dominates the Brazilian market with 80% market share followed by Yamaha with 10%. Bajaj is planning to enter the Brazilian market with the KTM Duke.

Figure 3.13: Brazilian motorcycle industry

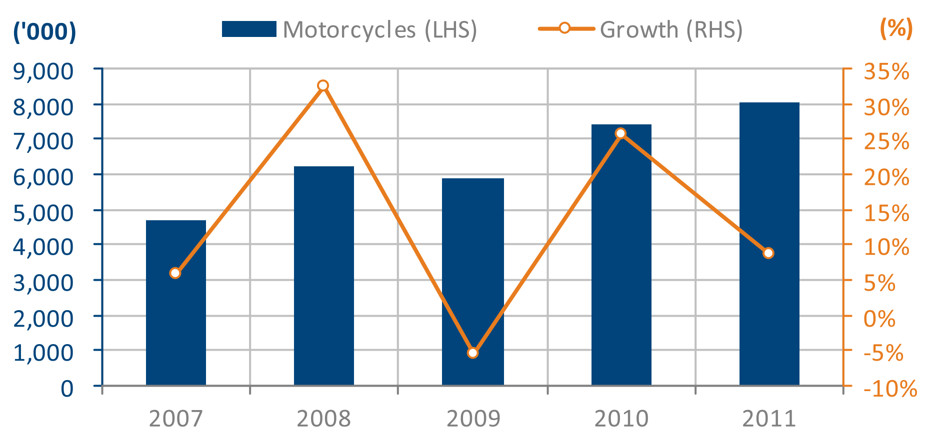


Source: ABRACICLO, IIFL Research

4. SE Asian (Indonesia):

Indonesia is the world's third-largest 2W market with annual sales of 8mn as of 2011. The 2W market is dominated by Honda and Yamaha, which together control >90% market share. The Indonesian motorcycle Industry registered Cagr of 12.7% over five years (9% in the past three years). Bajaj is present is this market through its subsidiary PT Bajaj Indonesia (PT BAI), which assembles and markets Pulsar in Indonesia. Bajaj sold 23,337 motorcycles in FY12.

Figure 3.14: Indonesian motorcycle industry



Source: AISI, IIFL Research

Tie up with Kawasaki will help Bajaj expand market reach

Bajaj Kawasaki tie-up to help expand market reach and penetration:

Bajaj and Kawasaki has been able to garner 45% market share in Philippines owing to its marketing tie-up with Kawasaki. Bajaj intends to replicate this success to other countries such as Indonesia and Brazil. Although the back-end operations will remain completely independent, the synergies will be exploited at the front-end operations. Bajaj's motorcycles will be sold through Kawasaki's distribution network as co-branded products. Although Bajaj has been able to penetrate the African and South ASEAN markets on its own, it has not been able to gain substantial market share in big market such as Indonesia. The partnership with Kawasaki will help Bajaj to penetrate these markets and expand its geographic reach through Kawasaki's widespread dealer network.

3Ws: Export-driven growth

3Ws account for only 12% of Bajaj's volumes but 22% of revenue (domestic: export ratio of 40:60). Given their high-margin nature, 3Ws contribute an estimated 28-30% to Bajaj's total Ebitda.

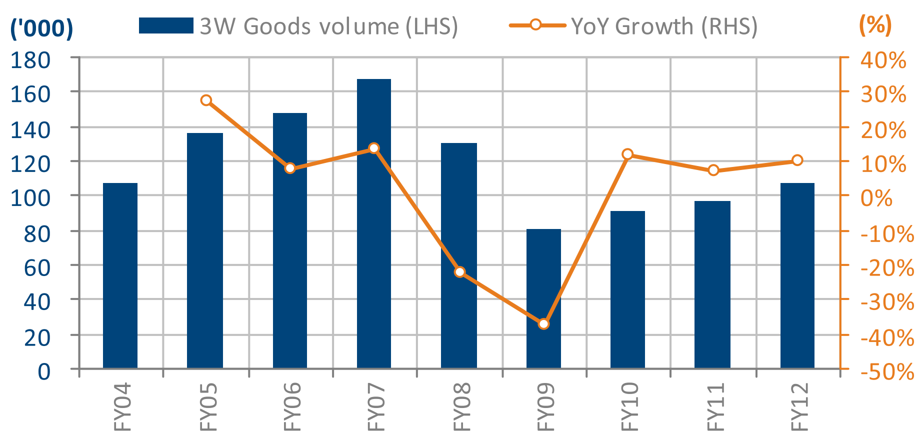
Bajaj derives about 96% of its 3W volumes in India from the passenger segment

Domestic 3W industry dominated by passenger segment
The passenger segment accounts for 80% of 3W industry volumes. Bajaj is the market leader here with 47-48% market share.

Bajaj derives about 96% of its 3W volumes in India from the passenger segment, of which almost half the volumes come from permit-controlled markets. Given unpredictability with regard to issue of new permits by city/state administrations, growth in this segment tends to be patchy.

Recently launched four-wheeler passenger carriers threaten passenger 3Ws
In the non-permit-controlled markets, we see a strong possibility of competitive threat from the small four-wheeler (4W) passenger carrier (*Tata Magic Iris*) recently launched by Tata Motors. Recall, the goods 3W segment was hit badly by the influx of small four-wheeler goods carriers such as *Tata Ace* and *Mahindra Maxximo*.

Figure 3.15: 3W goods volumes contracted significantly post launch of Tata Ace in FY06



Source: SIAM, IIFL Research

RE60 will help Bajaj capitalise on the potential shift from 3W to 4W passenger carriers

Bajaj entering the 4W passenger carrier segment
Bajaj has developed *RE60,* a new 4W passenger carrier. This product will help Bajaj capitalise on the potential shift from 3W to 4W passenger carriers. Bajaj plans to launch *RE60* in the Sri Lankan market before launching it in India. We are not building volumes from this segment into our revenue forecasts currently, given lack of clarity on timeline of the India launch.

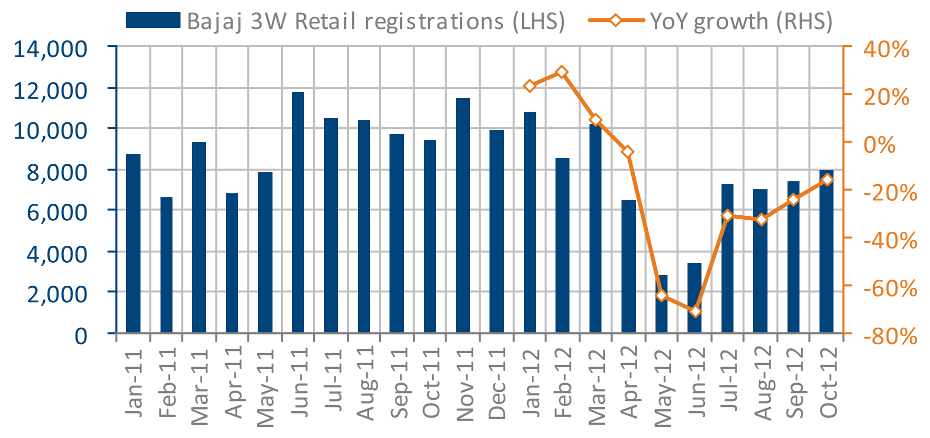
We are building a 5% volume Cagr for domestic 3Ws
Given the inherent lumpy growth in the passenger 3W segment (80% of 3W sales) and threat from 4W passenger carriers, we forecast 5% growth for Bajaj's domestic 3W volumes.

Exports to drive 3W growth

Bajaj's 3W exports grew at 17% Cagr over the past five years. Bajaj exports 3Ws mainly to South Asia (approx. 60%) and Africa (approx. 40%).

Bajaj's 3W exports to Sri Lanka came off significantly in FY13 after the Sri Lankan government increased import duty on 3Ws from 50-60% to 100% in April 2012. Bajaj has started offering high discounts in order to offset the impact of higher duties and prop up sales. As a result, volumes have recovered partially. Given the growing need for public/private transport and given that cars are not affordable (200-350% import duty) in Sri Lanka, we expect 3W volumes to recover fully in FY14.

Figure 3.16: Exports to Sri Lanka have recovered partially post price-cuts



Source: Company, IIFL Research

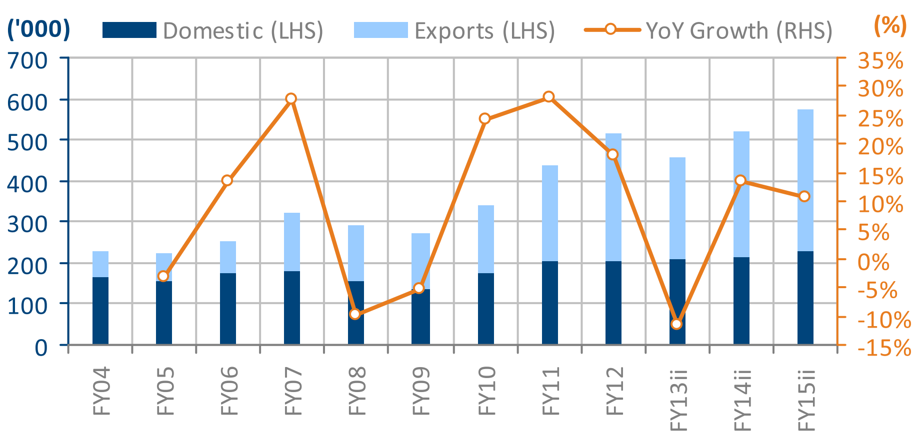
Bajaj's 3W exports also suffered in FY13 owing to political unrest in Egypt.

Recovery in Sri Lanka will help drive 3W export growth

Expect 18% growth over FY13-15 led by recovery in Sri Lanka and Egypt

We are building in 18% volume Cagr in 3W exports over FY13-15, driven by recovery in Sri Lanka and Egypt and continued growth in Africa.

Figure 3.17: Bajaj's 3W volumes to be driven by fast-growing exports



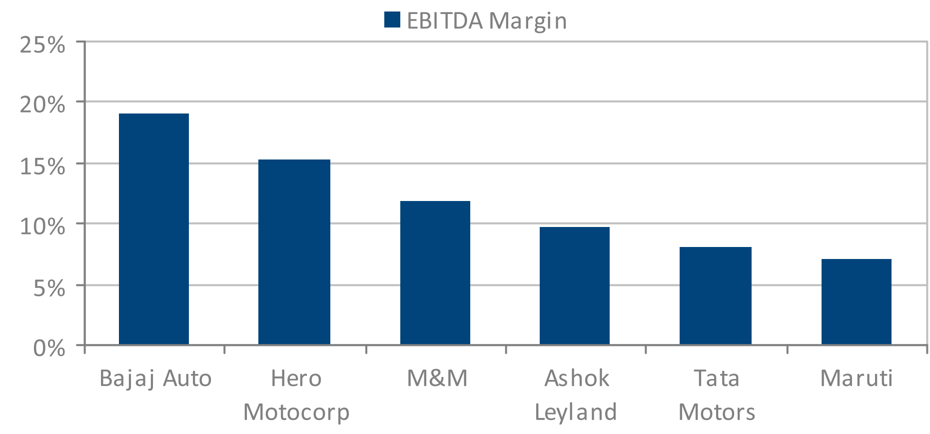
Source: SIAM, IIFL Research

Expect 16% EPS Cagr over FY13-15

Bajaj has the best margin profile among auto companies
Bajaj has the highest Ebitda margin among Indian Auto companies. High Ebitda margin and low fixed costs (fixed cost is 5-6% of revenues) reduce earnings volatility during periods of weak demand.

Bajaj has the highest Ebitda margin among Indian Auto companies

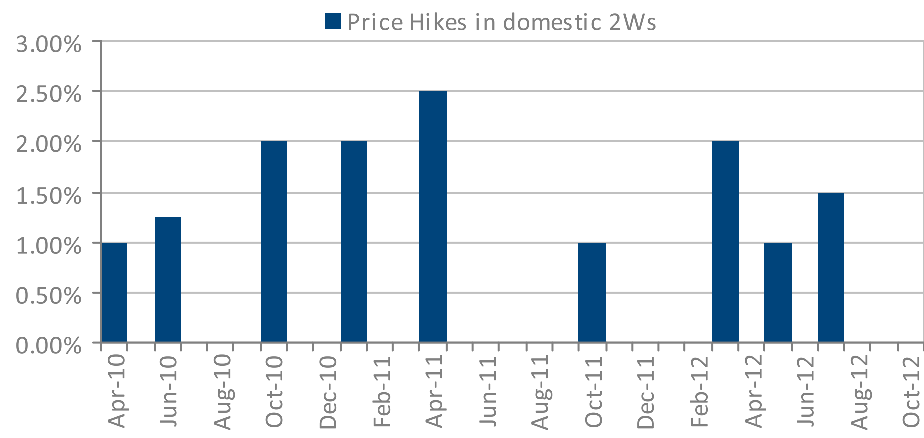
Figure 3.18: Bajaj has the best margin profile among auto companies



Source: Company, IIFL Research

Bajaj has displayed pricing power, helped by strong brands
Bajaj has been able to maintain its Ebitda margin in a narrow band of 18-20%. Helped by the strength of its brands, Bajaj has been able to pass through regular price increases in the motorcycle and 3W markets.

Figure 3.19: Bajaj has displayed strong pricing power



Source: Company, IIFL Research

Hedges in FY14 are far more favourable as compared to FY13

INR depreciation to act as a tailwind
Although Bajaj was not able to reap benefits of INR depreciation in FY13 due to its aggressive hedging policy, it is taking hedges for FY14 at highly favorable rates compared with FY13. While most of the hedges in FY13 were at USD-INR rate of 50, hedges for FY14 are range-forward contracts with low-end USD-INR rate of 53-55. Given that export revenue constitutes ~35% of Bajaj's total revenue, a USD-INR realisation of 53 would prop up Ebitda margin by 200bp, if the company chooses to retain the entire benefit and not pass on any of the benefit to its export consumers.

Figure 3.20: Benefits of INR depreciation will be seen from FY14

Source: Bloomberg, IIFL Research

High return rations, robust cash flow generation

The 2W industry in India boasts of high margins, negative working capital, and high ROI. In keeping with industry trends, Bajaj too generates high free cash flow. The company has maintained a healthy 40% payout ratio, implying 2.4% dividend yield.

Figure 3.21: High cash generation to ensure consistent dividend payout at 40%

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY13ii	FY14ii	FY15ii
Dom 2W	2,637,423	2,997,670	3,315,978
Volume growth (%)	2.8	13.7	10.6
Dom 3W	206,760	215,493	226,267
Volume growth (%)	1.9	4.2	5.0
Export 2W	1,315,548	1,513,945	1,741,037
Volume growth (%)	3.8	15.1	15.0
Export 3W	248,929	302,343	347,694
Volume growth (%)	-20.4	21.5	15.0
Total	4,408,660	5,029,450	5,630,977
Volume growth (%)	1.4	14.1	12.0
Revenue growth (%)	4.8	18.0	14.1
EBITDA margin (%)	18.6	19.7	18.9
EPS	105.8	127.8	142.6

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**163,982**	**195,290**	**204,734**	**241,631**	**275,700**
Ebitda	31,712	37,200	38,137	47,669	52,212
Depreciation and amortisation	(1,228)	(1,456)	(1,591)	(1,710)	(1,802)
Ebit	30,484	35,744	36,546	45,959	50,411
Non-operating income	5,765	6,080	6,758	6,868	8,538
Financial expense	(17)	(222)	(3)	0	0
PBT	36,232	41,602	43,302	52,827	58,949
Exceptionals	7,246	(1,340)	0	0	0
Reported PBT	43,478	40,262	43,302	52,827	58,949
Tax expense	(10,080)	(10,221)	(12,700)	(15,848)	(17,685)
PAT	33,397	30,041	30,602	36,979	41,264
Minorities, Associates etc.	0	0	0	0	0
Attributable PAT	**33,397**	**30,041**	**30,602**	**36,979**	**41,264**

Ratio analysis

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	90.4	108.4	105.8	127.8	142.6
DPS	40.0	45.0	50.0	60.0	60.0
BVPS	169.7	208.8	261.9	331.2	403.6
Growth ratios (%)					
Revenues	37.6	19.1	4.8	18.0	14.1
Ebitda	22.3	17.3	2.5	25.0	9.5
EPS	44.5	20.0	(2.5)	20.8	11.6
Profitability ratios (%)					
Ebitda margin	19.3	19.0	18.6	19.7	18.9
Ebit margin	18.6	18.3	17.9	19.0	18.3
Tax rate	23.2	25.4	29.3	30.0	30.0
Net profit margin	20.4	15.4	14.9	15.3	15.0
Return ratios (%)					
ROE	66.7	57.3	44.9	43.1	38.8
ROCE	76.0	72.9	62.0	60.3	54.6
Solvency ratios (x)					
Net debt-equity	(0.8)	(0.9)	(0.8)	(0.9)	(0.9)
Net debt to Ebitda	(1.3)	(1.4)	(1.7)	(1.8)	(2.0)
Interest coverage	NM	NM	NM	0.0	0.0

Source: Company data, IIFL Research

Ebitda margin to improve in FY14 led by favorable currency rates

Return ratios to remain high

Balance-sheet is cash positive

Balance sheet summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	42,946	53,488	64,210	84,830	107,394
Inventories	5,473	6,785	7,673	8,768	10,093
Receivables	3,628	4,232	4,776	5,523	6,293
Other current assets	14,061	19,183	19,759	22,385	25,094
Creditors	19,431	20,031	23,035	26,491	30,464
Other current liabilities	20,122	28,635	29,031	30,902	33,944
Net current assets	**26,554**	**35,023**	**44,351**	**64,112**	**84,465**
Fixed assets	15,483	14,914	18,873	19,163	19,761
Intangibles	43	320	320	320	320
Investments	10,571	11,889	13,969	13,969	13,969
Other long-term assets	0	0	0	0	0
Total net assets	**52,651**	**62,145**	**77,513**	**97,564**	**118,515**
Borrowings	3,252	1,250	1,250	1,250	1,250
Other long-term liabilities	297	484	484	484	484
Shareholders equity	**49,102**	**60,411**	**75,778**	**95,829**	**116,780**
Total liabilities	**52,651**	**62,145**	**77,513**	**97,564**	**118,515**

Cash-flow generation to remain strong

Cash flow summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	30,484	35,744	36,546	45,959	50,411
Tax paid	(9,773)	(11,483)	(12,700)	(15,848)	(17,685)
Depreciation and amortization	1,228	1,456	1,591	1,710	1,802
Net working capital change	(4,029)	989	1,394	859	2,211
Other operating items	90	92	0	0	0
Operating cash flow before interest	18,000	26,798	26,831	32,680	36,739
Financial expense	(17)	(222)	(3)	0	0
Non-operating income	5,765	6,080	6,758	6,868	8,538
Operating cash flow after interest	**23,748**	**32,656**	**33,587**	**39,548**	**45,277**
Capital expenditure	**(1,614)**	**(860)**	**(5,550)**	**(2,000)**	**(2,400)**
Long-term investments	(3,288)	(2,249)	(2,080)	0	0
Others	1,357	(1,885)	0	0	0
Free cash flow	**20,203**	**27,663**	**25,957**	**37,548**	**42,877**
Equity raising	0	0	0	0	0
Borrowings	(3,315)	(423)	0	0	0
Dividend	(6,737)	(13,420)	(15,235)	(16,928)	(20,313)
Net chg in cash and equivalents	10,151	13,820	10,722	20,620	22,564

Source: Company data, IIFL Research

Technical analysis of Bajaj Auto

The stock price of Bajaj has consolidated in a rectangular trading band with a 'round bottom' like pattern during the recent recovery, which indicates bullishness. This consolidation phase has to probably extend for a couple of more weeks and resume the rally towards Rs2650 thereafter.

Bullish consolidation in process: Prices have been consolidating in the band of Rs1400-1839 since October 2011. However, the stock prices have surpassed the previous high of Rs1839, which has negated the major 'double top' pattern, which further adds to the bullishness.

Retracement Projection: The stock has found support close to the 61.8% retracement levels and the 161.8% upside projection of the previous upmove indicates a target of Rs2457. Prices have the potential to retest the long-term average of 40WMA, which is placed at Rs1667 before unfolding of a sharp upmove.

Breakout in RSI: RSI has been taking strong support at the earlier breakout line, coinciding with the 55 level, which is acting as the bull market support zone. With no negative divergence visible, any correction is likely to be short lived.

Higher Comparative Strength: The weekly ratio of Bajaj to BSE Auto Index is a forming bullish triangle with breakout levels at 0.185. Above 0.185, the outperformance of Bajaj is likely to accelerate by 16%. Meanwhile, the ratio of Bajaj with Nifty index is still on a strong uptrend, confirming it as a Nifty outperformer.

Price target Rs2,650

Ratio with Nifty Index

Ratio with BSE Index

Bajaj Auto – 5 year share price performance chart

(Rs/share)

2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0

May-08
May-09
May-10
May-11
May-12

Company maintained a 16-17% volume growth; Ebitda margin improved from 19% in 1QFY12 to 20% in 2QFY12

Stock was pricing in the company guidance of 4.0mn vehicles in FY11. In 2HFY11, it became clear that volume guidance is likely to be missed

2W market-share recovered to 21% led by new launches (Discover); Ebitda margin improved from 13% in FY09 to 22% in FY10 led by operating leverage and favorable forex hedges on exports

Stock came off due to 1) mkt share loss in domestic 2Ws; 2) weak exports due to steep increase in import duty in Sri Lanka. From an over-sold state, the stock recovered sharply as domestic mkt share and exports started picking up gradually

Bajaj's 2W market-share dropped from 23% in FY08 to 13% in 4QFY09

CMP	Rs665
Target 12m	Rs860 (29%)
Market cap (US$ m)	9,004
Bloomberg	KMB IN
Sector	Banks

Dec 14 2012

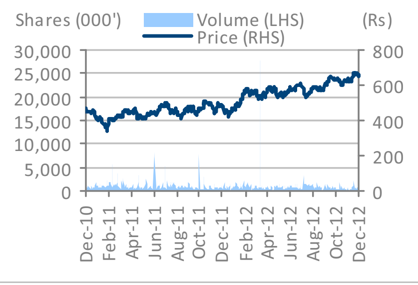
52Wk High/Low (Rs)	677/418
Shares o/s (m)	744
Daily volume (US$ m)	7
Dividend yield FY13ii (%)	0.0
Free float (%)	55.0

Shareholding pattern (%)	
Promoters	45.1
FII	29.8
DII	3.9
Others	21.2

Price performance (%)

	1M	3M	1Y
Kotak Mah Bank	7.6	9.1	36.2
Absolute (US$)	4.3	8.3	33.9
Rel. to Sensex	4.1	4.5	14.5
CAGR (%)		3 yrs	5 yrs
EPS		37.9	24.6

Stock movement



Sampath Kumar
sampath.kumar@iiflcap.com
+91 22 4646 4665

Abhishek Murarka
abhishek.murarka@iiflcap.com
91 22 4646 4661

www.iiflcap.com

Kotak Mahindra Bank BUY

Franchise benefits to continue

A rapidly growing commercial and consumer banking franchise and a well-established position in investment banking and stock broking make Kotak Mahindra Bank (KMB) a compelling pick among private sector banking stocks. Robust loan growth, stable NIM, strong asset quality outlook, and improving operating efficiency would power the 27% earnings Cagr through FY15ii, offsetting depressed earnings in the capital market business. Furthermore, a rebound in the economy and improvement in growth outlook for the capital market business would provide a fillip to earnings.

Focus on strengthening core franchises: A well-established niche in retail lending and significant in-roads into wholesale banking will likely drive 25% loan Cagr during FY12-15ii. KMB is improving its competitiveness by adopting an aggressive customer acquisition strategy in CASA deposits. The insurance business is focused on cost management and containing new business strain to generate substantial profit. KMB has established itself as a meaningful player in the insurance space. Headwinds continue in the investment banking and broking businesses owing to continued toughness in capital market conditions. However, being a sizeable player in these businesses, KMB will benefit from any improvement in outlook here.

Robust earnings growth outlook: Robust loan growth, stable NIM, and improvement in operating efficiency would drive 27% earnings Cagr over FY12-15ii. Asset quality outlook remains sanguine, given KMB's large exposure to retail lending, high-quality exposure within corporate lending, and no exposure to the troubled sectors such as infrastructure financing. Earnings growth and profitability would remain robust even after factoring in a downbeat outlook for the capital market businesses.

A play on growth and strong earnings upside: A small market share in commercial banking presents KMB significant potential to grow over the long term. Further, a strong financial position would enable it to register faster and healthier growth. KMB has the potential to leverage its balance sheet to boost ROE in the long term. The risk-reward is favourable given that an upside to earnings from improvement in the capital markets is significant and consensus expectations do not capture this fully.

Financial summary (Rs bn)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Pre prov. operating inc. (Rs bn)	24	28	34	46	60
Pre-exceptional PAT (Rs bn)	16	18	22	28	36
Reported PAT (Rs bn)	16	18	22	28	36
Pre-exceptional EPS (Rs)	21.3	24.7	29.3	37.6	49.1
Growth (%)	13.3	16.3	18.3	28.4	30.8
IIFL vs consensus (%)			4.6	9.9	14.3
PER (x)	31.3	26.9	22.7	17.7	13.5
Book value (Rs)	149	175	203	240	287
PB (x)	**4.5**	**3.8**	**3.3**	**2.8**	**2.3**
CAR (%)	19.5	17.9	17.0	16.1	15.4
ROA (%)	2.4	2.2	2.1	2.2	2.3
ROE (%)	**16.6**	**15.4**	**15.5**	**17.0**	**18.7**

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Focus on strengthening core franchises

Structural growth of the Group to be contingent on the bank, life insurance, asset reconstruction and asset management

KMB's business strategy has been built on four key pillars, viz., commercial bank, life insurance, capital markets, and asset reconstruction. While the commercial banking and life insurance businesses have achieved considerable scale over the past three years, the capital market related business has expectedly been tepid given tough capital market conditions. However, all these businesses remain long- term growth drivers and we believe the bank is well positioned to achieve further significant scale in each of these businesses.

Commercial banking to benefit from significant market opportunities

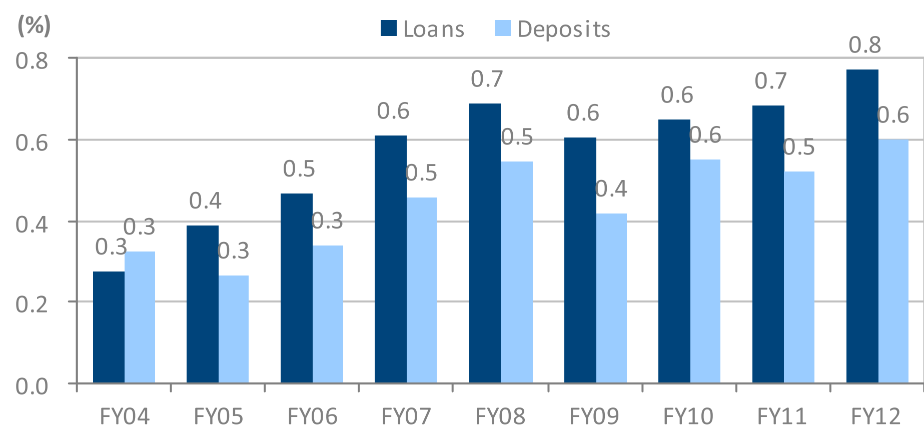
Given KMB's small market share of 0.8% in loans and 0.6% in deposits, we believe there is significant market opportunity for profitable growth over the longer term. KMB has also positioned itself well by developing the key qualities to build a robust franchise, including:

- Consistent market positioning through cycles
- Building competitiveness in its niche segments
- Maintaining a strong liability side to fund growth

The strategy of CASA acquisition through higher savings bank interest rates in the initial period will likely be followed by increasing cross-sell of loans and fee products to increase the stickiness of CASA customers.

Small market share provides huge potential to grow by acquiring market share, extending geographic presence

Figure 4.1: KMB remains a small bank, despite significant market share gains

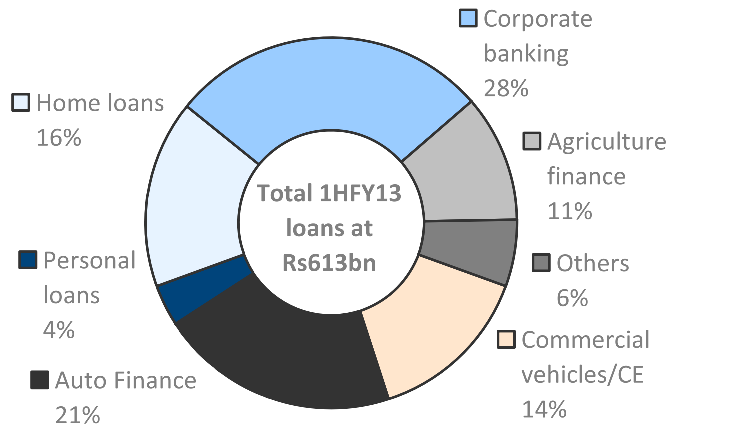


Source: Company, IIFL Research

Loan mix allows KMB to benefit from different business cycles
KMB's well-diversified loan book is split equally between retail and wholesale loans. In retail loans, car, tractor and commercial vehicle financing are its key niches. In wholesale banking, the bank's focus is on providing working capital, trade financing, and transaction banking. The loan mix allows KMB to benefit from either retail-led or corporate-led growth cycles, ensuring robust balance sheet growth on a sustained basis. We estimate loan growth of 25% Cagr over FY12-15ii.

KMB has a well-diversified and largely secured asset portfolio

Figure 4.2: Well-diversified loan book provides several growth levers and mitigates concentration risk



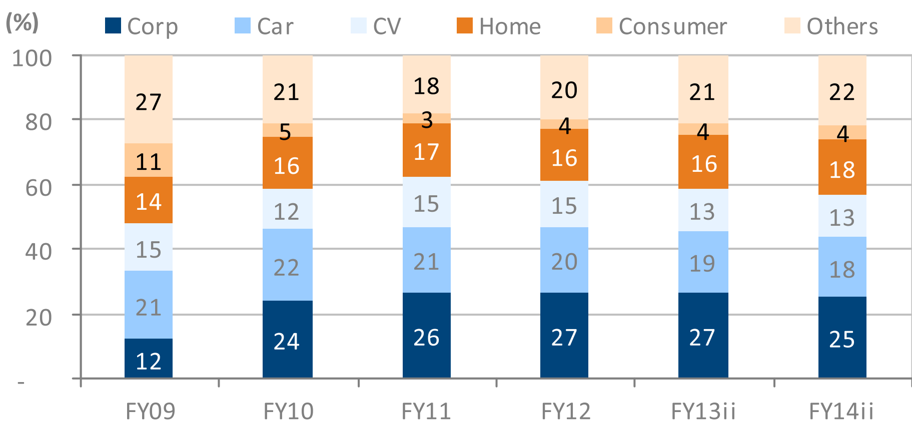
Source: Company, IIFL Research

Over FY08-12, the bank's growth was driven by its ability to gain retail market share from PSU banks and older private sector banks. KMB's long standing strength in financing cars, utility vehicles and CV/CE is due to its strong brand positioning, origination capabilities and higher cross-sell to existing customers. The bank has consistently exploited this competitive advantage to wrest market share from players that only rely on walk-ins and compete on lending rates. Despite the current slowdown in CV and auto, market share gains will likely keep flowing through.

More recently, the growth in wholesale banking segment has been more robust. However, KMB is solely focused on customer profitability. What it sacrifices in terms of yields for better-rated customers, it makes up by way of fee income from cross-sell and transaction banking. The focus is on keeping overall risk-adjusted returns healthy. Hence, KMB focuses on top end customers in the credit risk curve.

Secured products as corporate and home loans set to scale up

Figure 4.3: Loan mix has remained stable, although it has moved away from higher-risk personal loans towards corporate and home loans



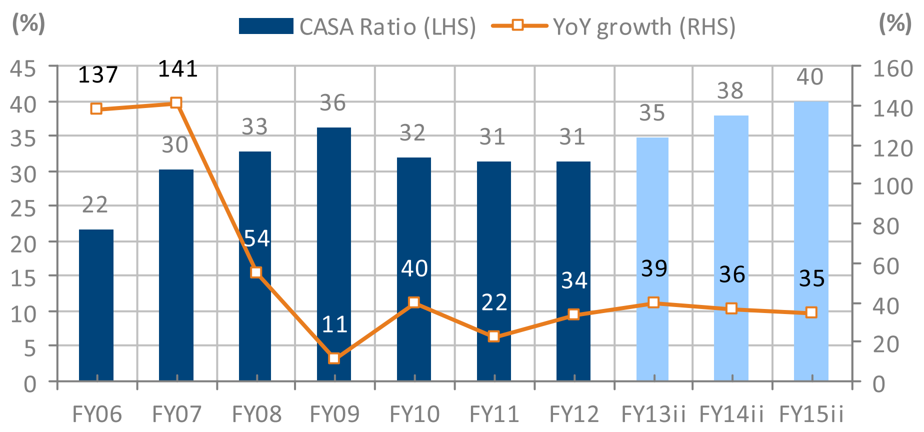
Source: Company, IIFL Research

CASA acquisition has been a primary focus since interest on savings bank deposits were de-regulated

CASA deposit acquisition driving liability strategy

The key driver of KMB's liability strategy has been the deregulation of savings bank interest rate. Right from the beginning, KMB offered 6% interest rate to its savings bank customers. While these funds may not be 'low cost' initially, the strategy followed by both KMB and YES is of customer acquisition and subsequently trying to increase the stickiness through active cross-selling loans, wealth and other fee based products.

Figure 4.4: High CASA growth to continue and drive improvement in CASA ratio

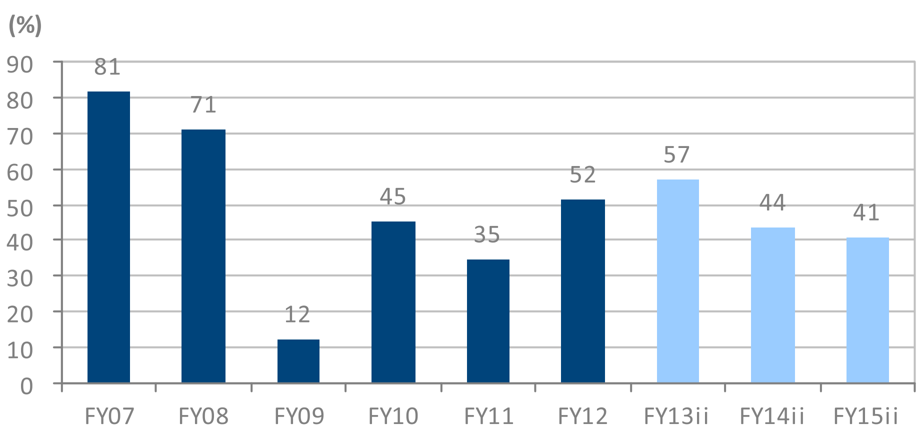


Source: Company, IIFL Research

Savings deposits, which had stagnated at 10-11% of total deposits since FY09 improved to 13% in 2QFY13 on the back of higher interest rate on savings bank account. The deregulation of savings bank interest rate has proved to be a strong catalyst to savings deposits accretion, primarily as large peers have abstained from using pricing to retain their customers.

Benefits of deregulation in savings bank rate to continue in the near future

Figure 4.5: Trend in growth in savings a/c balances: sharp pick up after deregulation in Oct 2011



Source: Company, IIFL Research

KMB's savings deposit/branches remain at half the level of more established private banks such as ICICI Bank, HDFC Bank, and Axis Bank.

Figure 4.6: SA per branch significantly behind larger private sector peers (1HFY13)

(Rs m/branch)

YES	IIB	KMB	ICICIBC	HDFC Bank	Axis Bank
97	120	152	291	302	323

Source: Company, IIFL Research

Awaiting a turnaround in capital market businesses

Operating environment for capital market related businesses remain tough; outlook uncertain

Revenue from investment banking grew rapidly in FY11, as demand for primary issue management and advisory remained robust. It appeared that recovery was underway following a muted performance during FY09 and FY10. However, downtrend in the equity capital markets drove down demand for services during FY12 and continued through 1HFY13. The outlook for capital markets remains uncertain for the rest of FY13ii and FY14ii.

KMB's equities business went through a turbulent FY11 and FY12 when it saw a 30% YoY decline in net profit for two consecutive years due to declining volumes and change in product mix. While volumes have come off their meagre FY12 levels, they are unlikely to reach the FY07-08 levels, keeping overall contribution from this business sluggish.

Life insurance – improving profitability

Life insurance is characterised by strong cost management and contained new business strain

KMB's life insurance business turned profitable in FY09, helped by better cost management and increase in surrender rate of policies by customers. The company implemented cost reduction measures in response to the global financial crisis of FY09, which allowed it to tide over the sluggish growth environment over FY11-12. Declining premium growth and amortisation costs over the lock-in period have also helped in generating operating surpluses.

The life insurance industry's growth outlook continues to face significant headwinds due to cap on pricing unit-linked products by the regulator. Premium income declined from October 2010 for all industry players, as they were significantly dependent on unit linked products. Growth in KMB's life insurance business has mirrored the industry trend.

Figure 4.7: Insurance premium growth trend remains sluggish

(%)
100 80 60 40 20 0 (20) (40)
Kotak Life
Private sector
FY06 FY07 FY08 FY09 FY10 FY11 FY12

Source: Company, IIFL Research

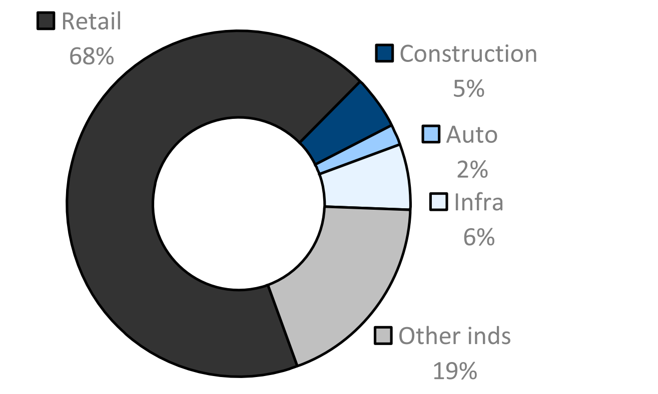
With surrender premium also diminishing as per IRDA ruling, key profit drivers for life insurance companies are likely to be aggressive cost management and very low new business strain. The outlook for new business premium growth over FY13-14ii remains subdued given continued sluggishness in the economic activity.

Sanguine outlook for asset quality

Large exposure to secured retail and sticking to higher rated corporate clients imparts reasonable steadiness to asset quality

KMB's asset quality is stable due to its exposure to retail and wholesale banking segments. Significant exposure to retail loans, high quality exposure in corporate lending and absence of exposure to project financing suggest that KMB is less likely to be adversely impacted by the cyclical downturn in economic activity. The industry-wise distribution mix too suggests low concentration risk in any particular segment, which should further aid the asset quality outlook for KMB.

Figure 4.8: Industry-wise exposure mix suggests low concentration risk as at end FY12



Source: Company, IIFL Research

An overwhelming proportion of retail lending is secured, namely, auto, home and CV financing (93% of retail loans as at end FY12). Unsecured lending constituted a small proportion (7% of retail loans as at end FY12).

Figure 4.9: Share of secured loans in retail loans

(%)

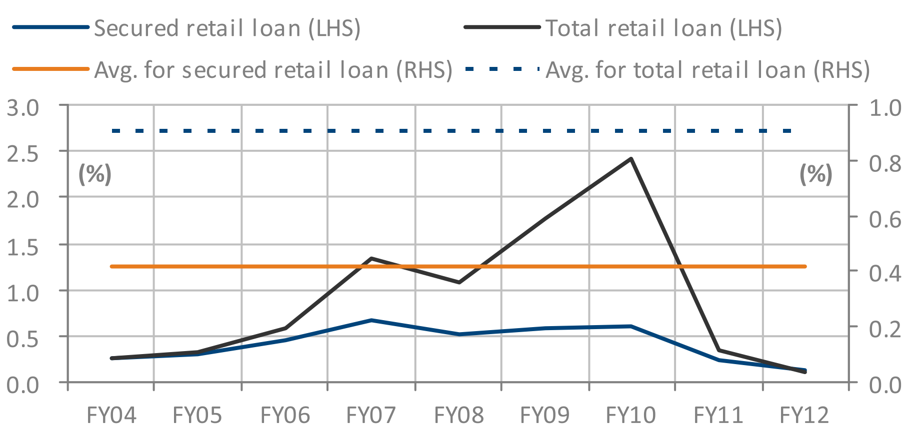
FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
93	92	90	85	80	78	82	92	94

Source: Company, IIFL Research

Large secured loan portfolio and conservative provisioning policy is very comforting in the current scenario

Historically, KMB had low level of loan loss provisions (LLP) on secured retail lending. Our estimates show that LLP in secured retail lending averaged 42bp over FY04-12 even as loans growth averaged 29% through this period. The low level of LLP underscores robust underwriting practices, strong collection process and aggressive charge off policy that ensures greater accountability among business and product groups (non-housing retail loans is fully provided once overdue for more than 180 days and home loans fully provided if overdue for more than a year).

Figure 4.10: Trend in LLP of secured and total retail loans



Source: Company, IIFL Research

Given KMB's long and well-established history in secured retail lending, and an unchanged credit underwriting practices, we expect its asset quality performance to remain superior in the near future. LLP in secured retail lending would increase from the low levels in FY12; however, it is unlikely to affect profitability adversely.

Corporate clients have reputable track records while priority sector obligations are met through careful credit selection

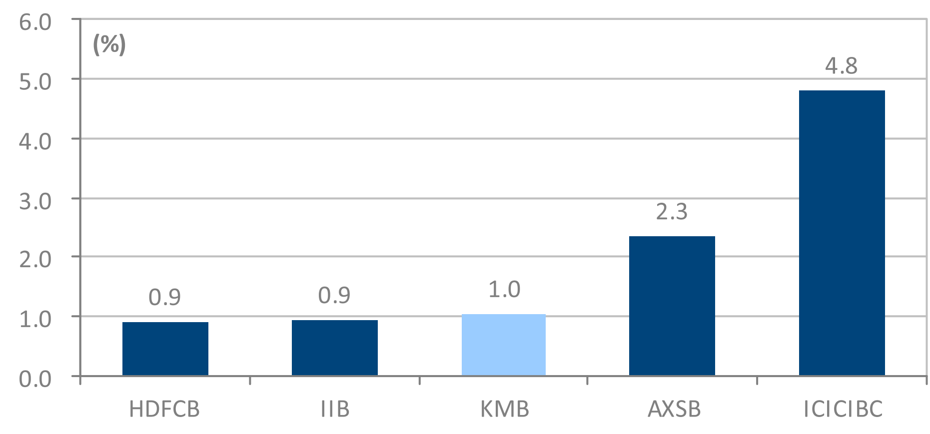
In wholesale lending, KMB lends to large and mid-corporate customers who enjoy strong credit worthiness. It provides finance only for working capital and not for long-term and project financing. By ensuring careful selection of customers and avoiding distressed sectors, asset quality in wholesale lending is likely to remain robust.

KMB has significant exposure to agriculture segment to comply with priority sector obligations. Here too through careful selection of product and customer segments, the group has delivered robust

asset quality performance. The key product segments include tractor financing, short-term financing and supply chain financing in cash crop segments. KMB has been able to choose its product and customer segments given its small market share in the loan markets. We believe the group retains substantial flexibility in choosing its product and customer segments due to its smaller size of the loan book in the near future too.

Despite meeting entire priority sector obligations, credit quality in this portfolio is best in class

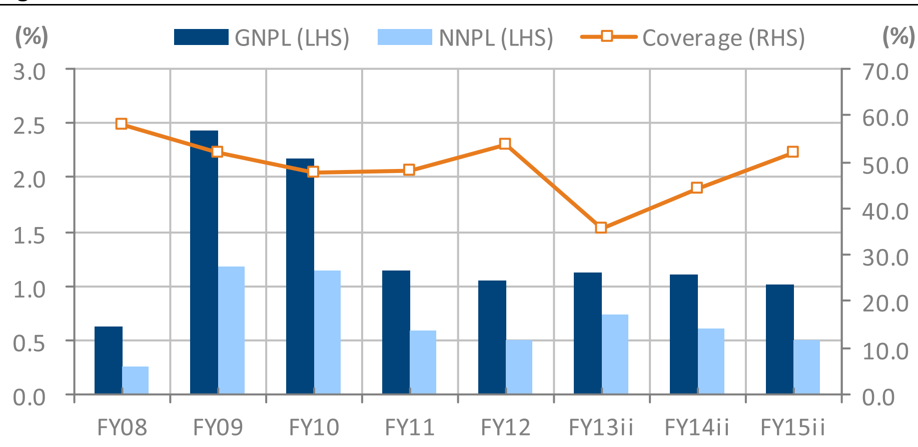
Figure 4.11: Agriculture sector NPAs in end FY12



Source: Company, IIFL Research

NPAs should largely remain in a healthy range, despite some near-term pressures due to a tough operating environment

Figure 4.12: GNPL and NNPL trend



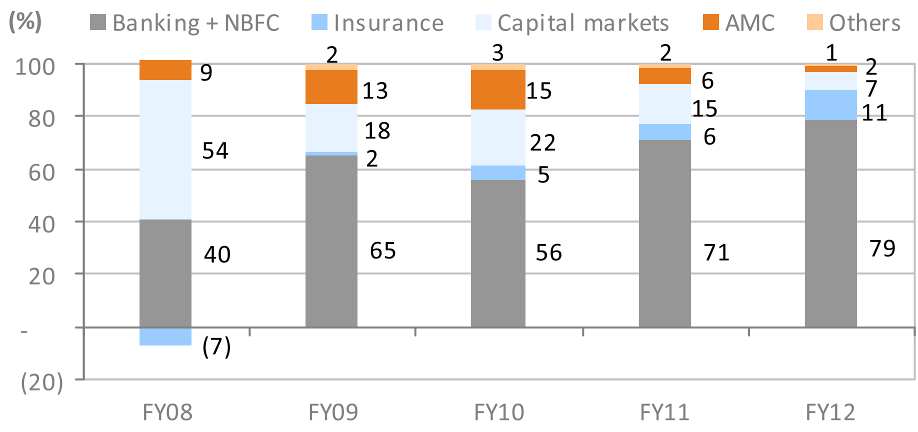
Source: Company, IIFL Research

Robust earnings outlook

Diversity of income stream to assist in maintaining robust growth trajectory

KMB's relies on commercial banking, life insurance, capital market related businesses and asset reconstruction to drive earnings. In the near term, however, earnings growth will more likely be generated by the commercial bank and the life insurance businesses as capital markets continue to face headwinds and income from asset reconstruction remains subdued. Earnings will likely be driven by robust loan growth, margins, and stable asset quality. Low new business strain and continued focus on containing costs will drive life insurance earnings. Together, this should drive a 26% Cagr in consolidated earnings over FY12-15ii.

Figure 4.13: Earnings mix – Banking and insurance to be key drivers



Source: Company, IIFL Research

Figure 4.14: Key earnings drivers

(%)	FY10	FY11	FY12	FY13ii	FY14ii	FY15ii
Loan growth	32.1	38.7	28.9	20.6	24.9	29.3
Net interest margin	6.4	5.7	5.0	4.7	4.8	4.8
Net int income growth	19.1	24.0	12.0	18.3	25.9	24.4
Core fee income growth	30.8	(4.6)	17.6	21.6	27.7	29.6
Non-int inc as % of total	65.8	58.2	53.6	53.4	52.1	51.4
Operating costs growth	48.6	2.3	(4.7)	15.0	15.8	17.8
Cost/income ratio	70.9	71.5	67.5	65.9	62.2	59.9
Gross NPAs as % of loans	2.2	1.1	1.1	1.1	1.1	1.0
Total provision charges as % of loans	2.1	0.3	0.2	0.4	0.6	0.6
Tax rate	30.2	30.2	30.3	30.5	33.0	33.0
Net profit growth	100.3	19.9	16.9	18.3	28.4	30.8

Source: Company, IIFL Research

Core banking franchise likely to be the strongest contributor to earnings growth

Standalone banking profit to remain high

Earnings in the banking business are expected to remain resilient given a sanguine loan growth outlook, steady NIMs and contained credit costs. NIMs should remain at 4.7-4.8% and will benefit in the longer run from a strictly run ALM and gradual increase in cross-sell to the new savings account customers.

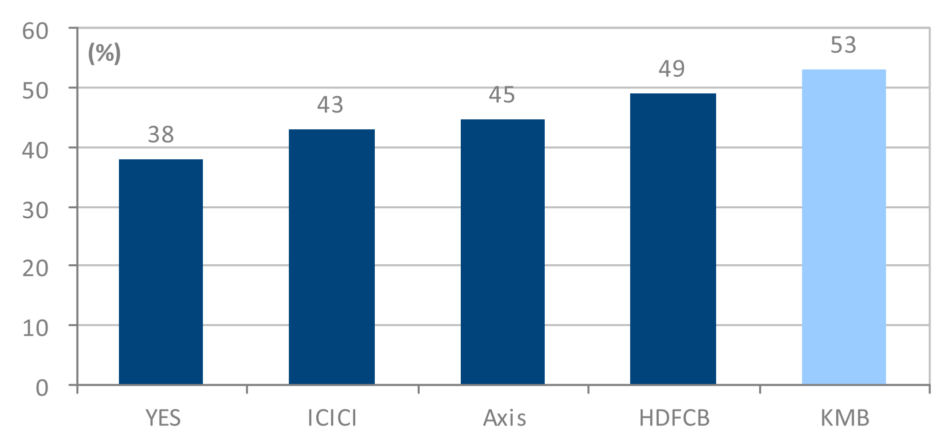
Cost-to-income ratio of 53% in FY12 was high versus peers. While there is ample scope to wean out efficiencies, strong branch growth and focus on retail loans will likely keep the ratio elevated over FY12-15ii with no substantial efficiency gains. However, in the longer

run, cost/income will definitely trend towards sector average as the growth momentum normalises.

We estimate that KMB's asset quality will remain better than peers, although there might be some uptick in gross impaired loans in keeping with industry trends. We estimate delinquency levels to increase to 1.1% over FY12-15ii versus 0.8% in FY10-12, which will lead to slight elevation in credit costs to 50bps over FY12-15ii.

High cost ratios imply enormous room to improve efficiencies

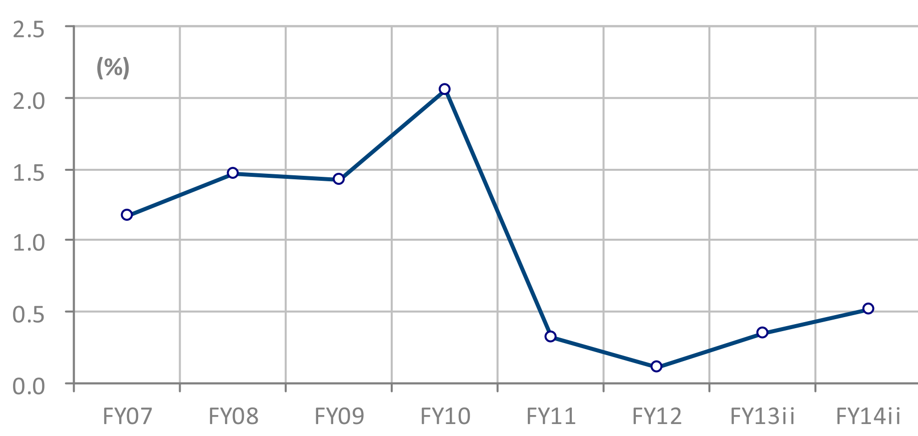
Figure 4.15: FY12 Cost-to-income ratio – scope for substantial efficiency improvements



Source: Company, IIFL Research

Credit costs unlikely to retrace to earlier high levels

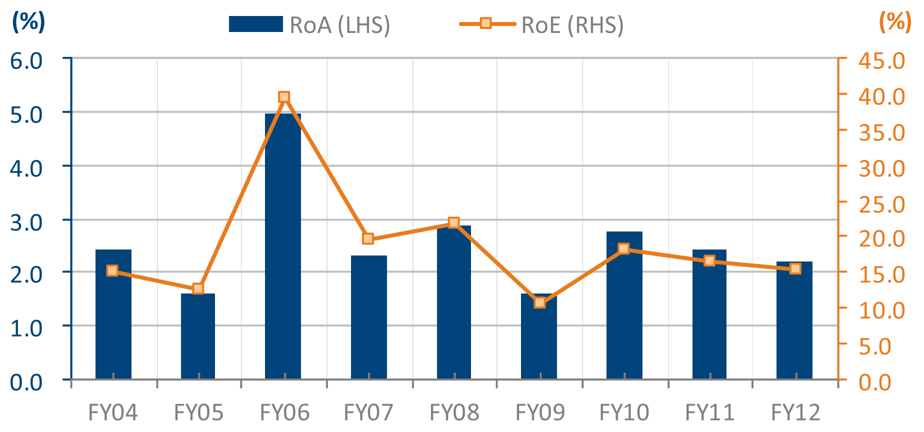
Figure 4.16: Credit costs to trend marginally higher but remain better than industry



Source: Company, IIFL Research

The core business is well capitalised with Tier 1 CAR of 14.9% and total CAR of 16.4%. RoA of the core business is likely to be at 1.6-1.7% through FY12-15ii; increasing growth and capital utilisation will lead to higher RoEs. We estimate that core RoEs will trend towards 15-16% by FY15ii.

Figure 4.17: RoA/RoE trend



Source: Company, IIFL Research

Healthy pace of profits and dividends from life insurance will be a key support to earnings

Insurance business would be a strong earnings driver

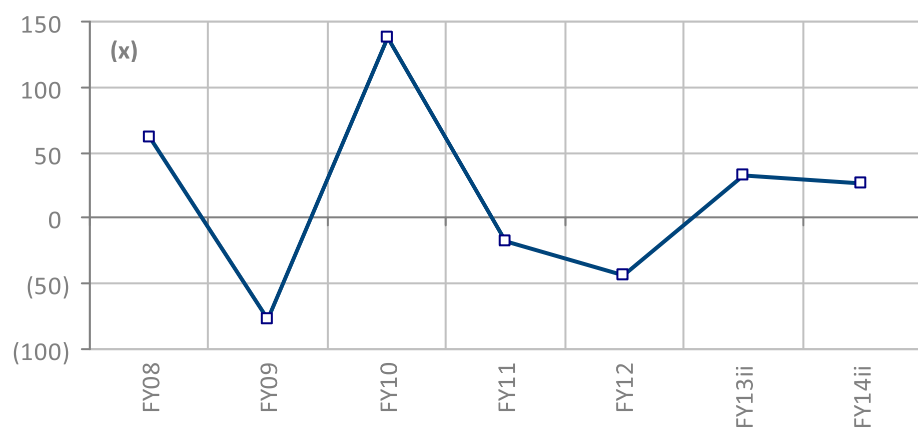
KMB's insurance business turned profitable from FY09 onwards and shown robust profit Cagr of 140% over FY09-12. Profit increased from Rs143m in FY09 to Rs2bn in FY12. Sustained focus on costs and reducing new business strain is likely to result in healthy growth in profit from the insurance business. Increasing persistency levels could also engineer faster than expected profit growth, providing a strong kicker to earnings.

Profit of capital market businesses likely to remain tepid

Contribution from the capital market businesses has been on a declining trend after peaking in FY06. It declined sharply during and in the aftermath of the global financial crisis. We expect these businesses' contribution to remain subdued over the medium term.

Outlook for capital market related businesses remains tepid

Figure 4.18: Growth in the capital market related businesses* will likely remain subdued



Source: Company, IIFL Research; *Note – Capital market related businesses are Kotak Securities and Kotak Mahindra Capital Company

Consolidated return ratios to remain best in class, RoE will improve as leverage increases

Figure 4.19: Consolidated RoA/RoE decomposition

RoA Tree	FY10	FY11	FY12	FY13ii	FY14ii	FY15ii
Interest income	9.7	9.5	10.2	10.3	10.3	10.3
Interest expense	3.7	4.1	5.5	5.7	5.7	5.7
Net interest income	5.9	5.4	4.7	4.5	4.6	4.6
Fee Income	2.8	2.1	1.7	1.7	1.8	1.9
Portfolio gains	0.9	0.7	0.1	0.0	0.0	0.0
Others	1.2	0.4	0.9	0.9	0.8	0.8
Non-interest income	4.9	3.2	2.7	2.6	2.6	2.7
Total operating income	10.8	8.7	7.4	7.1	7.3	7.3
Employee cost	2.6	2.4	1.9	1.8	1.7	1.7
Other operating expenses	3.1	2.6	2.2	2.0	1.9	1.8
Total operating expenses	5.8	5.0	4.1	3.8	3.6	3.5
Pre provision operating profit	5.1	3.7	3.3	3.3	3.7	3.8
Provisions for loan losses	1.1	0.2	0.1	0.2	0.3	0.3
Other provisions	(0.1)	0.1	0.1	0.1	0.1	0.1
Profit before tax	4.0	3.5	3.2	3.1	3.3	3.5
Taxes	1.2	1.1	1.0	0.9	1.1	1.1
Minorities and other	0.0	0.0	0.0	0.0	0.0	0.0
Net profit	2.7	2.4	2.2	2.1	2.2	2.3
Leverage	6.6	6.8	6.9	7.3	7.7	8.1
RoE	18.0	16.6	15.3	15.5	17.0	18.6

Source: Company, IIFL Research

A play on growth and strong earnings compounding

Stable leadership, customer loyalty in key niches and well-understood risk under-writing to help sustain the Group's longer-term objectives

Well placed to pursue long-term growth objectives
KMB has been providing financial services for over 2 decades through various entities including retail finance, capital market services and asset management. It has created a niche in retail finance and strong market position in capital market businesses over this period. The group created a unifying brand in 2003 when it received licence to set-up a bank. KMB has emerged as a diversified financial company over the past decade. The group's long-term vision is to emerge as one of the most trusted financial institutions. This would imply creating a strong market position in each of the businesses that the group has interest.

KMB is likely to enjoy continuity in its leadership in the near future. Uday Kotak, the promoter of the group, has been its key architect. He holds executive position in the group and at age 53, he has many more years ahead as leader of the group. Two key members, Jayaram and Dipak Gupta, serving as Joint Managing Directors of the group, assist him. Jayaram and Dipak bring varied experience across capital markets and commercial banking. Both have been associated with the group for over 2 decades and have participated in various milestones achieved by the group. Aged little over 50, both Jayaram and Dipak have many years of active professional careers ahead.

The group's key business principles revolve around creating strong customer loyalty through efficient service, creating a niche in key customer segments, and taking financial risks that are well understood by the management. The continuity in the leadership is likely to ensure that these guiding principles remain unchanged.

Valuation

KMB's high valuation multiple of 2.8x FY14ii BV is at its 5-year average level. The bank trades at premium valuations as it provides strong visibility on future earnings. Profitability of the insurance business has the potential to grow significantly with the possibility of a listing in the future. Strong corporate governance practices and premium branding also contribute to enhanced investor interest.

KMB is a play on both earnings consistency and multiple expansions. We remain extremely confident of KMB's earnings consistency and compounding in the near future. Over the past three years, the stock price has generated 18.5% Cagr while EPS has compounded at 38% Cagr. In our view, this justifies a further premium to current trading multiples. We believe that valuation premium to other private peers will possibly increase going forward.

KMB receives premium versus peers due to earnings trajectory, stable asset quality and pedigree management

Figure 4.20: P/BV chart for KMB

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Core fee income growth (%)	(4.6)	17.6	21.6	27.7	29.6
CASA (%)	31.3	31.4	34.9	38.0	40.0
Savings account per branch (Rs m)	133.7	157.3	226.4	268.1	320.9
CASA per branch (Rs m)	342.9	356.2	454.3	509.4	583.4
New NPA accrual rate (%)	0.8	0.8	1.1	1.1	1.1

Source: Company data, IIFL Research

Key risks

Reduction in promoter holding, higher new business strain in life insurance and asset quality overhang could be key risks to stock performance

The RBI requires KMB to pare promoter holding to 20% by FY18 from 45% currently. Given the already high capitalisation levels (tier-1 CAR of 14.9% as of 1HFY13), any forced dilution of promoter shareholding could put pressure on return ratios and stock price performance. However, capital consumption at KMB is expected to remain elevated as the bank continues to grow assets at a 24% Cagr over FY12-15ii. This will lead to rapid leverage and the impact of any dilution will be limited to an extent. Secondly, the bank has more than five years to bring down the shareholding, which gives it ample time to leverage the current unlevered capital and phase out capital mobilisation.

Resumption of growth in insurance business could add to new business strain and reduce the pace of growth in net profit. Given the sharply reduced costs in that business, we expect the company to negotiate this eventuality well, averting any meaningful impact on earnings.

Asset quality continues to remain a key risk to earnings from the banking business. The operating environment remains tough and asset quality in agriculture and corporate segments continues to remain under strain. An adverse development, despite the preventive steps and conservative lending, could lead to higher than anticipated asset quality headwinds. Every 10bps increase in credit costs in FY13ii would affect earnings by 1.7%.

Financial summary

Operating earnings will continue to benefit from strong growth, margins and fees

Income statement summary (Rs bn)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net interest income	35	39	46	59	73
Fee Income	14	16	19	25	32
Portfolio gains	4	1	0	0	0
Others	31	29	34	39	45
Non-interest income	49	45	53	64	77
Total operating income	84	85	100	122	150
Total operating expenses	60	57	66	76	90
Pre provision operating profit	**24**	**28**	**34**	**46**	**60**
Provisions for loan losses	1	1	2	4	5
Other provisions	0	0	0	0	0
Profit before tax	22	27	31	42	55
Taxes	7	8	10	14	18
Net profit	**16**	**18**	**22**	**28**	**36**

Loan growth trajectory to remain strong, driven primarily by retail

Balance sheet summary (Rs bn)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net loans & advances	412	531	641	801	1,036
Placements to other banks	9	15	19	22	27
Cash & equivalents	21	20	26	33	43
Other interest-earning assets	260	317	393	487	587
Total interest-earning assets	**703**	**884**	**1,078**	**1,343**	**1,692**
Fixed assets	6	6	7	8	10
Other assets	28	34	39	44	51
Total assets	**737**	**923**	**1,124**	**1,396**	**1,753**
Customer deposits	273	365	456	570	729
Other interest-bearing liabilities	221	292	353	442	552
Total interest-bearing liabilities	494	657	809	1,012	1,282
Non-interest-bearing liabilities	133	138	165	206	258
Total liabilities	**627**	**794**	**974**	**1,218**	**1,540**
Total Shareholder's equity	**110**	**129**	**150**	**177**	**213**
Total liabilities & equity	**737**	**923**	**1,124**	**1,396**	**1,753**

Source: Company data, IIFL Research

Robust profitability to sustain, driving strong earnings growth

Asset quality unlikely to throw negative surprises as the book remains primarily secured

Ratio analysis - I

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Balance Sheet Structure Ratios (%)					
Loans / Deposits	151.0	145.8	140.7	140.6	142.0
Loan Growth	38.7	28.9	20.6	24.9	29.3
Growth in Deposits	25.2	33.5	25.0	25.0	28.0
Growth in Total Assets (%)	33.7	25.3	21.7	24.1	25.6
Profitability Ratios					
Net Interest Margin	5.7	5.0	4.7	4.8	4.8
ROA	2.4	2.2	2.1	2.2	2.3
ROE	16.6	15.4	15.5	17.0	18.7
Non-Int Income as % of Total Income	58.2	53.6	53.4	52.1	51.4
Net Profit Growth	19.9	16.9	18.3	28.4	30.8
FDEPS Growth	13.3	16.3	18.3	28.4	30.8
Efficiency Ratios (%)					
Cost to Income Ratio	71.5	67.5	65.9	62.2	59.9
Salaries as % of Non-Interest costs	25.4	28.0	28.0	28.5	29.1

Ratio analysis - II

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	1.1	1.1	1.1	1.1	1.0
NPL coverage ratio	48.2	53.6	35.7	44.3	52.1
Total prov charges as % avg loans	0.3	0.2	0.4	0.6	0.6
Net NPLs as % of net loans	0.6	0.5	0.7	0.6	0.5
Capital Adequacy Ratios (%)					
Total CAR	19.5	17.9	17.0	16.1	15.4
Tier I capital ratio	18.1	16.5	15.9	15.2	14.6

Source: Company data, IIFL Research

Interview

Uday Kotak - Vice Chairman & CEO, Kotak Mahindra Bank

Uday Kotak
Vice Chairman & CEO,
Kotak Mahindra Bank

1. **What are the key long-term growth drivers of the company?**
   Strong market position in consumer lending, build up of stable and low cost liability base, significant growth opportunities in rural markets - penetrating deeper into India as well as Bharat and improvement in efficiency would be key long-term growth drivers of the company.

2. **What is a sustainable rate of growth in volumes, revenue and earnings over the next 4-5 years?**
   The financial services industry is a leveraged play on the economy and has the ability to grow by 1.5–2x of nominal GDP. If the economy grows by 14–15% in nominal terms, we should be able to grow at 20-30%. And simple arithmetic tells me that if you grow at 25%, you double your assets in three years; if you grow at 20%, you double the assets in four years. There are numerous opportunities for growth!

3. **What are the changing market dynamics or trends, if any, to which you need to pay attention?**
   Banks are highly leveraged Institutions. Prudence and steady and sustained build out of the franchise is important. All of this needs to be done with "humility" and without "glamour". It is also important to stay focused on the customer.

4. **What factors, in your view, contributed to your exceptional performance in the past over a decade?**
   Strong value focus across the organization, committed senior management team and strong employee engagement across all levels of organization has been responsible for our performance.

5. **Anything you wish for, to deliver similar performance in the next decade?**
   The level of banking penetration in India is presently low by global standards, and this is clearly a medium-term structural growth opportunity for banks in India. A facilitating factor in this context is favourable demographics. As long as these macro drivers remain, and we, as an institution, keep our focus on sound risk management and making our business simple, we should be in a position to perform well.

6. **What part of the business takes up your maximum time and attention?**
   My involvement varies from time to time and is based on functions. For anything concerned with risk management, I will be hands-on. In anything which has an ethical dimension, I would like to get involved.

7. **How would you prioritize the different stakeholders in your company – shareholders, employees, customers and government?**
   Customers first.

8. **Do you have a role model – an individual or a company?**
   No.

9. **What are your biggest weaknesses, if any, and challenges?**
   We have been conservative with our investments across various businesses….and this is part of our genes. This has led to missed growth opportunities few times in the past and could be viewed as weakness by others. However, preservation of capital is key to successful growth over the long term and we will retain this conservative approach. Managing people's expectation has been a challenge for us in the past.

10. **What is your vision for the company?**
    To be among the most trusted financial institutions in the world.

Technical analysis of Kotak Mahindra Bank

KMB's stock price has grown more than six fold from the troughs of March 2009. Momentum on the long-term charts has accelerated further after the breakout from a symmetrical triangle in Oct 2011. Prices still have a strong potential of delivering higher absolute returns and outperformance vis-à-vis the Nifty in the near term.

Multi-year triangle breakout reiterates bullishness: Breakout from three years of consolidation from the symmetrical triangle above Rs500 has impacted the stock positively. The amplitude of the triangle, when replicated from the breakout levels, projects a target of Rs990.

Retracement projection: The major price retracement in the stock took place in Feb 2011 when prices retraced more than 38.2%. Since then, prices have move steadily, taking the support of 40 WMA. The 161.8% Fibonacci projection of the previous upmove indicates a target of Rs1050.

Rebound in relative strength: RSI has managed to rebound after the whipsaw with the rising support line. A move above 55 has reinforced the positive momentum in the counter.

Breakout in comparative strength: Although the stock price has not been able to breach its 2008 peak of Rs717 so far, KMB's ratio vs. the Nifty has recently surpassed the 2008 high. This breakout in ratio adds to the comparative strength of the counter and reinforces the scope for further outperformance.

Target Rs990
Symmetical Triangle Breakout
0.0%
38.2%
100.0%
40 WMA
Ratio with Nifty

Kotak Mahindra Bank – 10 year share price performance chart

This page is left blank intentionally

CMP	**Rs631**
Target 12m	**Rs716 (13%)**
Market cap (US$ m)	**7,661**
Enterprise value (US$ m)	**7,963**
Bloomberg	**HCLT IN**
Sector	**Technology**

Dec 14 2012

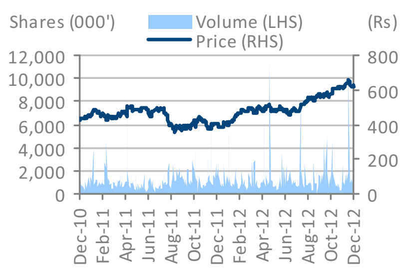
52Wk High/Low (Rs)	661/380
Shares o/s (m)	694
Daily volume (US$ m)	16
Dividend yield FY13ii (%)	2.4
Free float (%)	37.8

Shareholding pattern (%)	
Promoter	62.2
FII	20.3
DII	9.3
Others	8.2

Price performance (%)

	1M	**3M**	**1Y**
HCL Tech	2.5	8.2	53.3
Absolute (US$)	1.7	8.6	53.4
Rel. to Sensex	(1.0)	3.6	31.6
CAGR (%)		3 yrs	5 yrs
EPS		24.6	13.1

Stock movement



Sandeep Muthangi
sandeep.muthangi@iiflcap.com
91 22 4646 4686

www.iiflcap.com

HCL Technologies BUY

From an underdog to a leader

HCL Technologies (HCL Tech) has transformed significantly over the past five years. We believe that following the 2009 slowdown, the change in demand environment favours vendors such as HCL Tech that have higher flexibility in pricing and deal structuring. Over the past three years, the company has aggressively pursued and won many marquee accounts, which engender good mining opportunities. It also diversified its portfolio of services and bridged a critical gap in offering ERP implementation services. Focus on profitability, a weakness hitherto, has improved following the recent reorganisation. Nevertheless, HCL Tech's valuations continue to be at a significant discount to larger peers (10-40% discount on FY14ii PER). We estimate 20% EPS Cagr over FY12-15ii and expect a re-rating.

Marquee client wins: Being a late entrant, HCL Tech had relatively fewer mining opportunities compared with larger peers. This changed after the 2009 slowdown as clients looked out for vendors such as HCL Tech with flexible pricing models and willingness to structure complex/riskier deals to reduce their costs further. HCL Tech capitalised on the opportunity and won many marquee clients over the past three years, which offers good mining opportunities.

One of the most diversified service offerings: HCL Tech is arguably one of the best offshore vendors in the fast-growing infrastructure services segment. With the acquisition in FY09 of Axon, a SAP services firm, HCL has bridged a critical gap in its service portfolio and emerged a vendor with one of the most diversified services offerings. We believe HCL Tech has improved its competitiveness in a scenario where Indian vendors increasingly compete with bigger MNC vendors for large full-services deals.

Valuations at a significant discount: HCL Tech's focus on profitability has improved and it is investing in training campuses that provide structural benefits. We expect HCL Tech to register industry-leading EPS Cagr of 20% over the next three years. Even then, valuations are at 10-40% (13x FY13ii PER) discount to larger peers.

Financial summary (Rs m)

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	158,556	210,312	249,571	275,691	305,263
Ebitda margins (%)	16.6	18.8	20.6	20.0	20.0
Pre-exceptional PAT (Rs m)	15,887	24,210	33,687	36,294	40,898
Reported PAT (Rs m)	15,887	24,210	33,687	36,294	40,898
Pre-exceptional EPS (Rs)	22.8	34.6	48.1	51.8	58.4
Growth (%)	29.7	51.9	39.1	7.7	12.7
IIFL vs consensus (%)			3.6	1.9	3.3
PER (x)	**27.7**	**18.3**	**13.1**	**12.2**	**10.8**
ROE (%)	21.0	26.0	29.4	26.3	24.9
Net debt/equity (x)	0.0	(0.1)	(0.1)	(0.2)	(0.2)
EV/Ebitda (x)	16.1	10.8	8.1	7.4	6.5
Price/book (x)	5.3	4.3	3.5	2.9	2.5

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

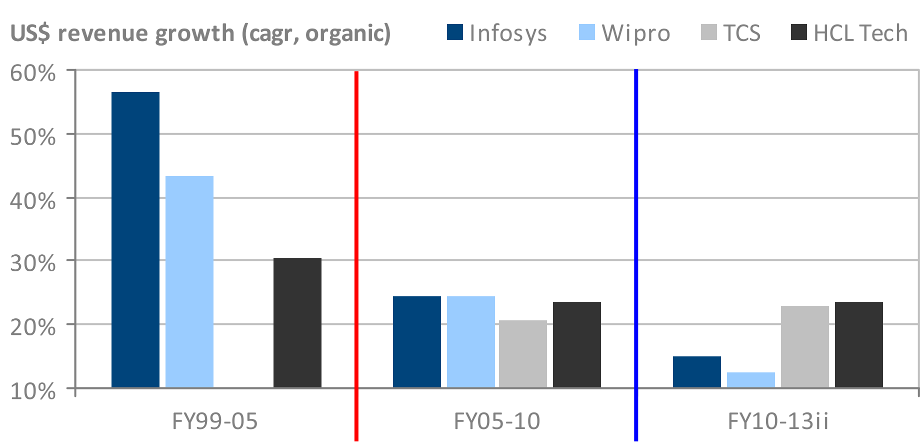
A brief history of HCL Tech's rise:

HCL Tech did not capitalise on the initial/explosive phase of IT offshoring during the 1990s. Vendors such as Infosys, TCS, and Wipro had their initial marquee client wins during this period, when firms such as GE and Amex were exploring the offshore delivery model. In addition to being good reference clients, these were significant mining opportunities for Indian IT vendors in subsequent years. We believe access to the best practices of such clients was instrumental in rapidly improving the process maturity of the offshore-based delivery models. We also believe these were necessary for Indian IT vendors to have benefited from the significant demand for custom development services during the 'dot com' boom.

HCL Tech was a late entrant in offshore IT services

HCL Tech started offering IT services as early as in 1991 when HCL's R&D unit was hived off into a separate entity. However, the focus to capitalise on the offshore delivery model increased and improved after 2004. We believe many issues including BOT (Build-Operate-Transfer) deals, poor diversification, and lack of marquee clients had impacted its growth in IT services in the initial years.

Figure 5.1: HCL Tech's growth lagged larger peers significantly during the initial phases of offshoring. But, it registered industry-leading growth over the past three years

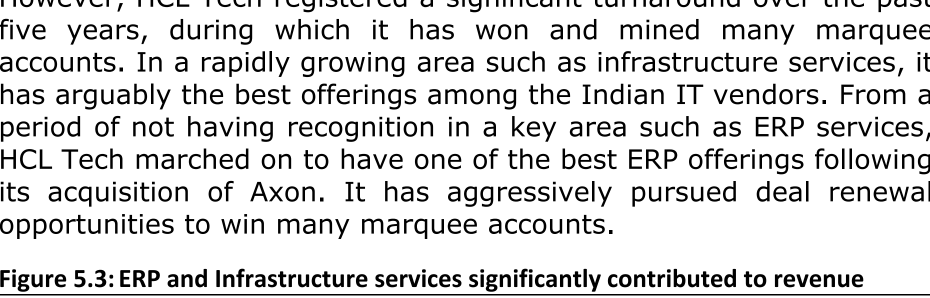


Source: Company, IIFL Research

Although HCL Tech's focus on IT services improved after FY05, its revenue growth continued to lag the larger peers

After 2004, although HCL Tech registered healthy revenue growth, its performance continued to lag the leading Indian IT vendors. We believe lack of marquee accounts to mine was one of the key reasons for the company's underperformance. In addition, HCL Tech also lacked the diverse range of services its peers offered. Notably, it lacked a presence in key service lines such as ERP implementation services. To put it in perspective, the ERP service line, which comprised only 15% of Infosys' revenue in FY04, contributed to a third of its incremental revenue over the next five years.

Figure 5.2: ERP services outperformed overall company growth



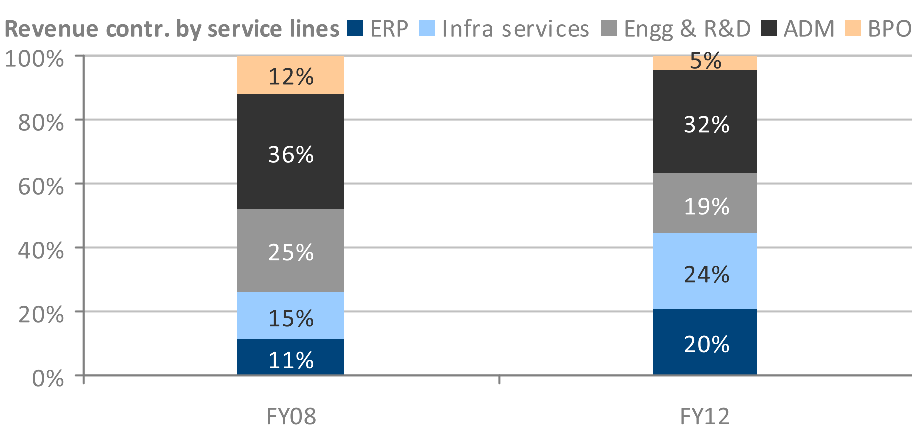
Source: Company, IIFL Research, * - TCS revenue Cagr (FY05-08)

HCL Tech's history shows that it had a higher flexibility in its approach to pricing and structuring deals. Its pricing was also at a material discount to other large vendors during the period of its underperformance. However, prevalence of traditional IT services deals, deep relationships with incumbent vendors, and little need for clients to look beyond the already significant cost savings from offshoring, made it difficult for vendors such as HCL Tech to gain market share.

HCL has registered a significant turnaround over the past five years. It has won many marquee clients and is mining them well

However, HCL Tech registered a significant turnaround over the past five years, during which it has won and mined many marquee accounts. In a rapidly growing area such as infrastructure services, it has arguably the best offerings among the Indian IT vendors. From a period of not having recognition in a key area such as ERP services, HCL Tech marched on to have one of the best ERP offerings following its acquisition of Axon. It has aggressively pursued deal renewal opportunities to win many marquee accounts.

Figure 5.3: ERP and Infrastructure services significantly contributed to revenue

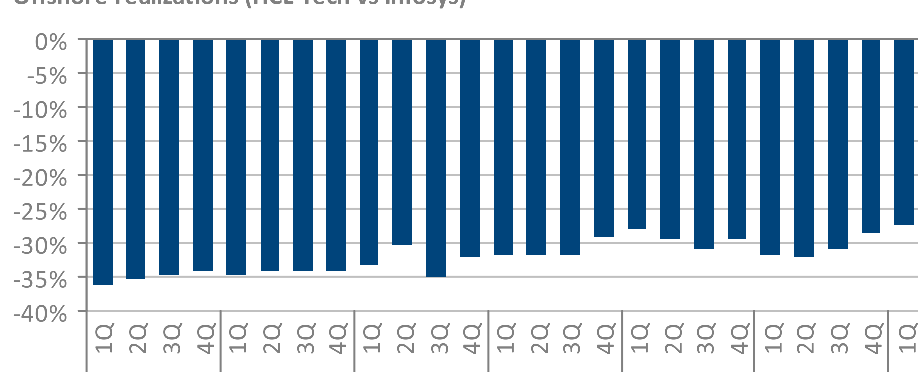


Source: Company, IIFL Research

Better suited to the current demand environment:

Historically, HCL Tech has priced aggressively to win deals. For instance, its offshore realisations are still 27% lower than that of Infosys. Since HCL Tech was a late entrant and given high margins in offshore IT services, we believe this strategy was necessary to gain scale. In addition, HCL Tech has been more flexible in entering into deals with relatively more complex revenue models (revenue sharing, asset-based pricing etc.)

Figure 5.4: HCL Tech's offshore pricing is still at a ~27.5% discount to that of Infosys



Source: Company, IIFL Research

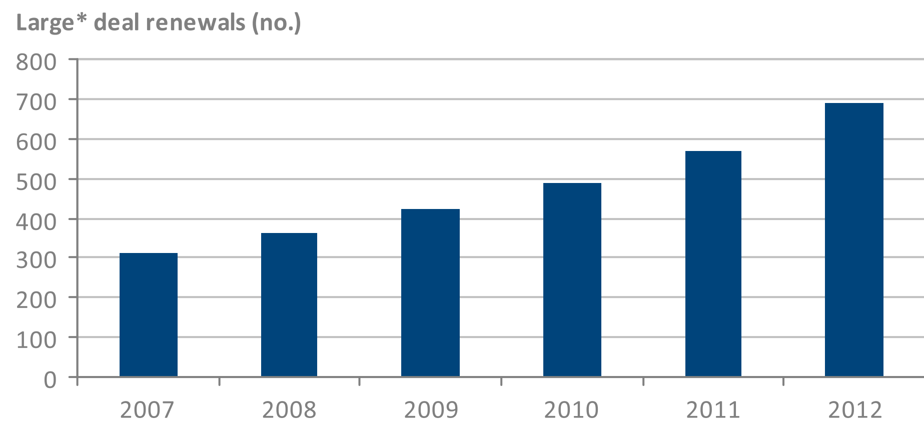
Being a late entrant, HCL Tech priced itself aggressively

However, we believe HCL Tech was not able to leverage such inherent advantages to improve its competitive positioning prior to the 2009 slowdown. We believe the reasons are numerous. One, not all IT contracts go through the Request for Proposal (RFP) stage as they are awarded based on existing relationships. Two, cost savings were already significant for firms that embraced offshoring in the early stages. Hence, we believe certainty in delivery was a more important criterion for them rather than a 5-10% further savings in costs. Three, clients feared that low pricing of companies such as HCL Tech may not directly translate into lower costs since the cost of transition to a new vendor would negate the benefit of low pricing.

Vendors like HCL Tech were inherently better suited to the post-2009 demand environment

This started to change after the 2009 slowdown. Offshore models based on Time and Material (T&M) pricing models had to shift to 'riskier' pricing models to offer further cost benefits. Structuring of contracts became more complex and needed higher flexibility. Diversity in service lines was increasingly important, as Indian vendors competed with incumbent foreign vendors for large deals. We believe the evolutionary drift in offshoring met the critical juncture of the 2009 slowdown. This led to a significant change in the demand conditions for Indian IT vendors. We believe only a vendor such as HCL Tech was inherently better suited to benefit from the new demand environment.

Figure 5.5: HCL Tech has capitalised on increasing the number of deals coming for renewal

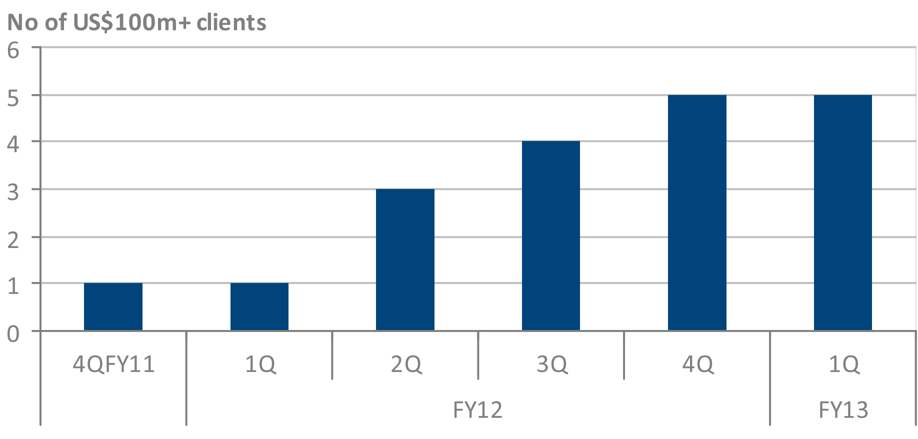


Source: Company, IIFL Research; *-TCV of US$25m+ (worldwide)

Aggressively pursuing new marquee clients during deal renewals led to many large deal wins

Anecdotal evidence and management's commentary indicate that HCL Tech focused on winning against incumbent vendors during deal renewals. The deal wins were especially noticeable in the infrastructure services space, which were a beachhead for capturing many larger marquee clients. In addition, the increasing diversity in its service lines enabled it to cross-sell more of its services and has been a key reason for its robust client mining.

Figure 5.6: Strong client mining led to increase in the number of US$100m+ accounts

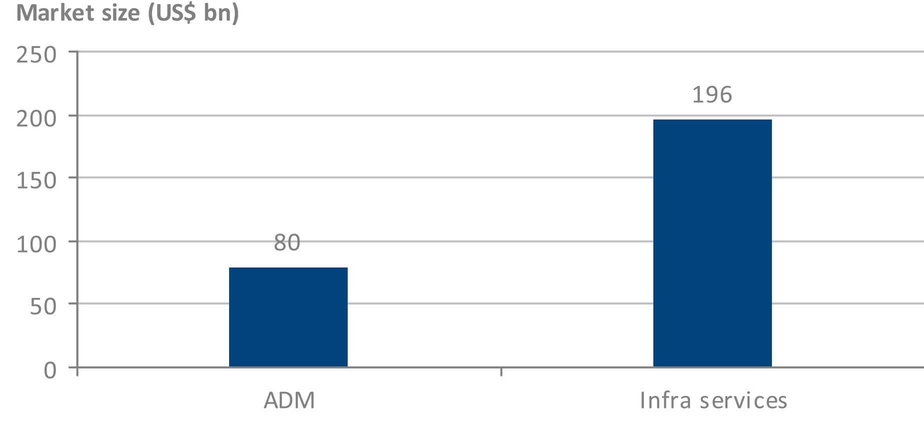


Source: Company, IIFL Research

Addressable market for Infra services is ~2.5x the size of traditional ADM

Strength in the fast-growing offshore infrastructure services: A strong infrastructure services offering has helped HCL Tech win many large deals. The addressable market for infrastructure services is larger than that for the traditional application development and management (ADM) space. In 2011, worldwide spend on IT infrastructure services was ~2.5x that of custom development services.

Figure 5.7: In 2011, market for infrastructure services was ~2.5x that of ADM



Source: Company, IIFL Research

However, penetration of Indian IT vendors in infrastructure services was limited due to several factors. Structuring of infrastructure deals is relatively complex involving large asset and employee transfers. In addition, profitability is typically lower than the ~30% Ebitda margins larger IT vendors earn on traditional IT services deals.

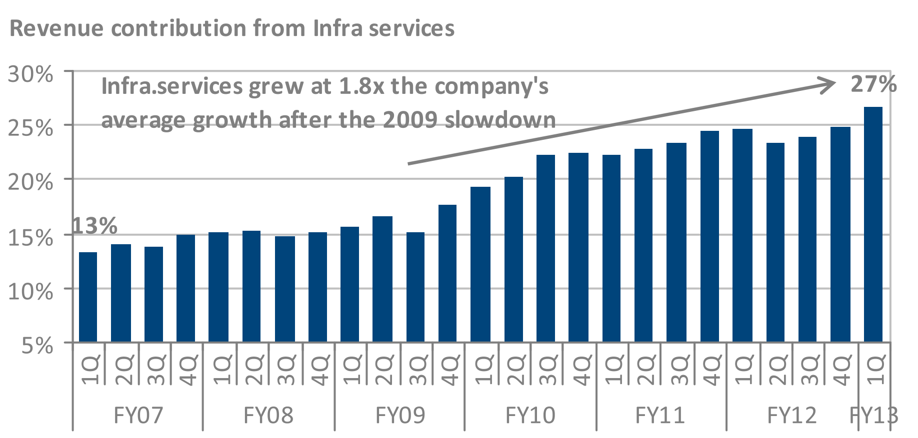
HCL Tech's expertise in Infra services put it in a good position to tap the emerging opportunities in this space

HCL Tech's expertise in infrastructure services puts it in a good position to tap emerging opportunities in this space. It had gained expertise in offering infrastructure services as its HCL Comnet unit did various IT infrastructure projects for the domestic market. With the growing popularity of Remote infrastructure Management services, HCL Tech aggressively targeted the renewal market. In almost all of these contracts, the incumbent vendors were MNCs with relatively weaker offshoring models. We believe HCL Tech was able to offer significant cost savings. Anecdotal evidence indicates cost savings of about 40% in some of the deals.

The contribution from infrastructure services increased from 15% to 27% of its overall revenues over the past three years

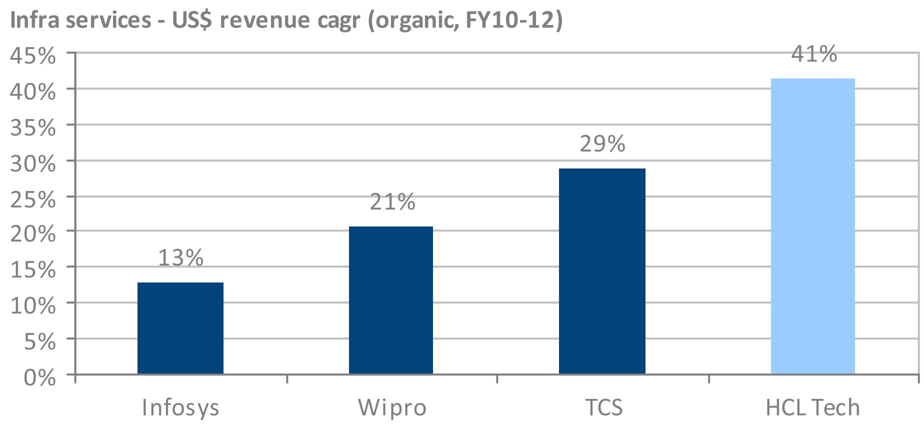
With growing popularity of virtualisation and cloud-based technologies, savings achieved by outsourcing infrastructure services continue to increase. As spending on infrastructure is often the largest component of IT spends of F500 firms, we believe HCL Tech will continue to benefit from the robust growth in this service line.

Figure 5.8: Infrastructure services contributed significantly to HCL Tech's revenue growth



Source: Company, IIFL Research

Figure 5.9: HCL Tech's infrastructure services growth has been the fastest among peers

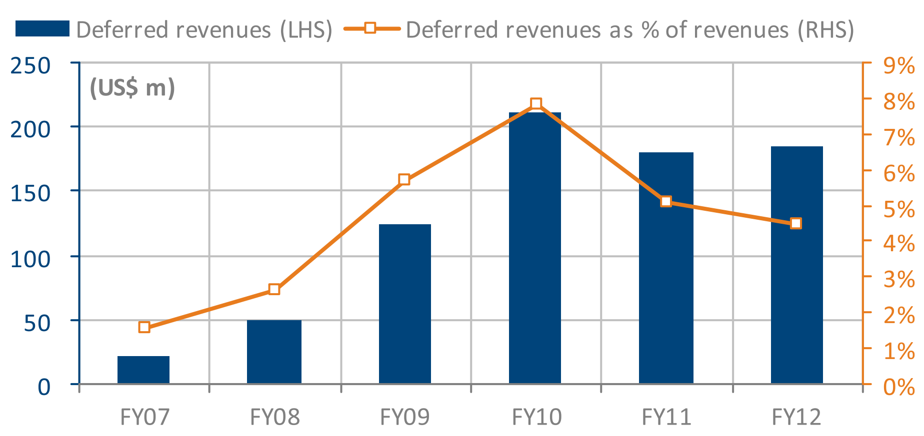


Source: Company, IIFL Research

HCL Tech's profitability and cash flow suffered due to initial transition costs and delays in infrastructure deals...

HCL Tech's profitability from this service line has also been improving. Due to transitions and the possibility of delays, large infrastructure deals have an impact on profitability and cash flow in the initial stages. Consequently, the relatively high contribution from new infrastructure deals 2-3 years ago impacted HCL Tech's profitability and balance sheet. The impact can be seen from the increase in certain balance sheet items.

Figure 5.10: Due to increasing scale, deferred revenue has stabilised over a period and is decreasing gradually as deals ramp up

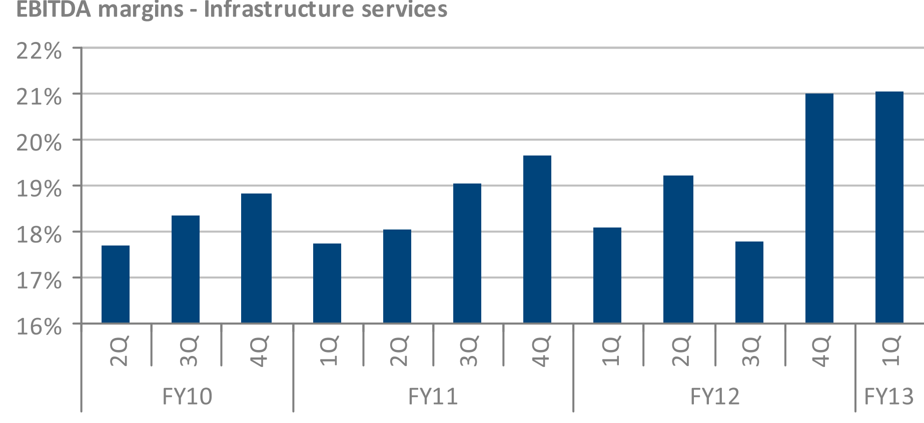


Source: Company, IIFL Research

....but due to increasing scale, these anomalies have reduced and profitability on infra deals has been increasing

With increase in scale, these 'anomalies' have reduced and profitability is also increasing. Although HCL Tech remains aggressive in bidding for renewals, we believe the management has a higher focus on improving operating efficiencies now. These can continue to result in a modest margin expansion in the near term.

Figure 5.11: With increasing scale, margins of infrastructure services are also improving

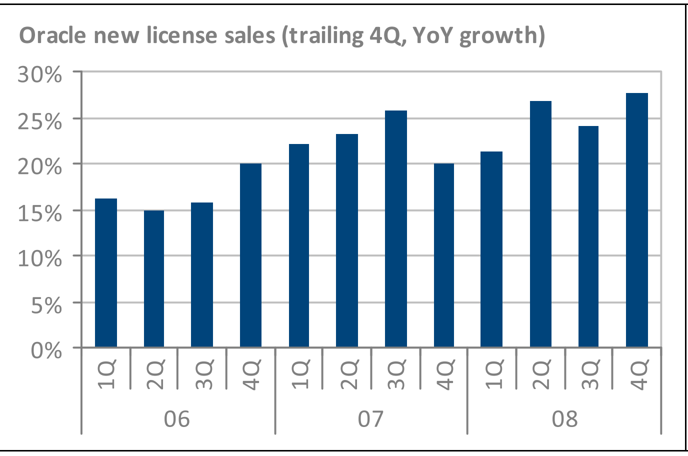


Source: Company, IIFL Research

Large Indian IT vendors have benefitted during the boom period of 2006-08 from the high ERP spends

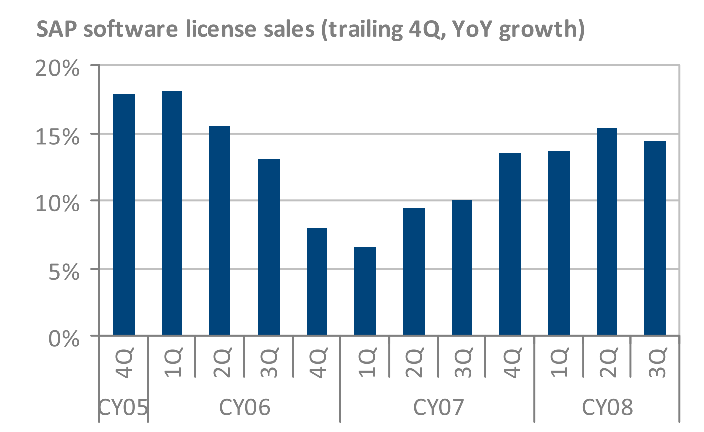
From an underdog to a key player in ERP services:
HCL Tech's larger peers had invested and benefited from the high ERP spending in the years preceding 2008. Infosys was an early entrant and this service line contributed to almost a third of its incremental revenue during FY04-09. Notably, it also focused on developing consulting capabilities. Wipro, while being a late entrant, was also able to register a robust growth in ERP-related services.

Figure 5.12: Oracle license sales growth has been robust before the downturn



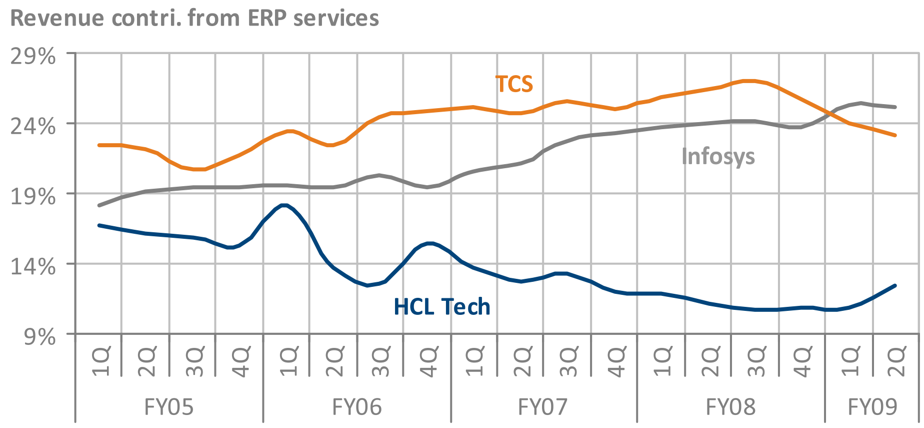
Source: Company, IIFL Research

Figure 5.13: SAP has also registered strong growth during the boom period



Source: Company, IIFL Research

Figure 5.14: HCL Tech's contribution from ERP services lagged peers prior to acquiring Axon

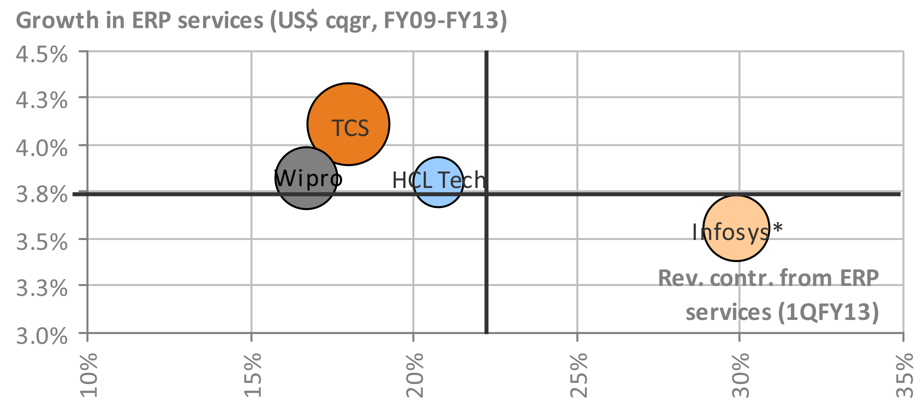


Source: Company, IIFL Research

HCL Tech filled a critical gap in offering ERP services by acquiring the SAP services firm, Axon

HCL Tech enhanced its presence in ERP implementation services by acquiring UK-based SAP solutions specialist Axon for US$710m in FY09. This increased contribution from ERP implementation services from 13% to 25%. Incidentally, this was at a time when a strong ERP implementation services player such as Satyam was involved in a scandal. Our channel checks indicate that HCL Tech had also invested and strengthened its portfolio of Oracle implementation services during this period.

Figure 5.15: HCL Tech's contribution from ERP services is relatively high now

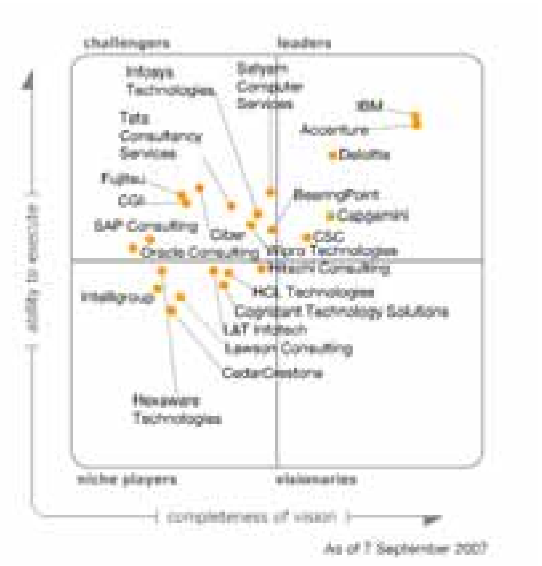


Source: Company, IIFL Research

The acquisition of Axon transformed HCL Tech from an also-ran to a leading provider of SAP based ERP services

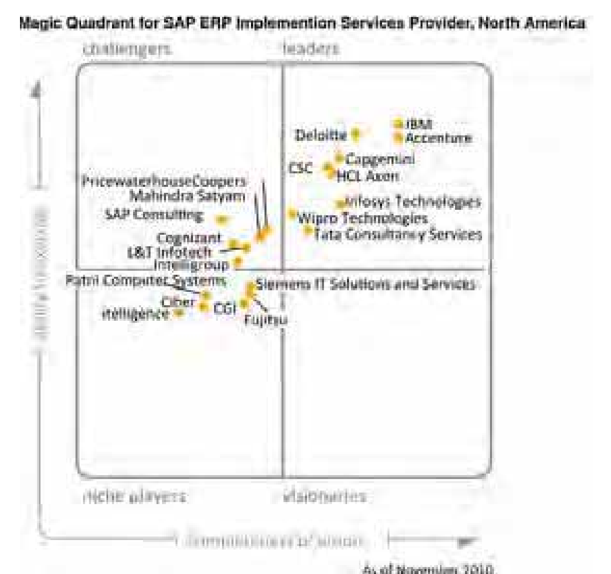
We believe that the Axon acquisition bridged one of the critical gaps in HCL Tech's portfolio and was instrumental in many subsequent large deal wins. Given the discretionary nature of ERP implementation services and slowdown in the current demand environment, growth here has been modest. In the near term, despite a robust environment for ERP-related services such as Business Intelligence (BI) or analytics, we expect growth rates to remain modest. Furthermore, we believe HCL Tech is among the best placed to benefit from any improvement due to its recognised presence across the ERP value chain (from consulting to implementation to infrastructure/BPO services).

Figure 5.16: Prior to the Axon acquisition, HCL Tech had one of the weakest ERP services offerings



Source: Company, IIFL Research, Gartner

Figure 5.17: HCL Tech has the best offering in SAP -elated ERP services after its acquisition of Axon



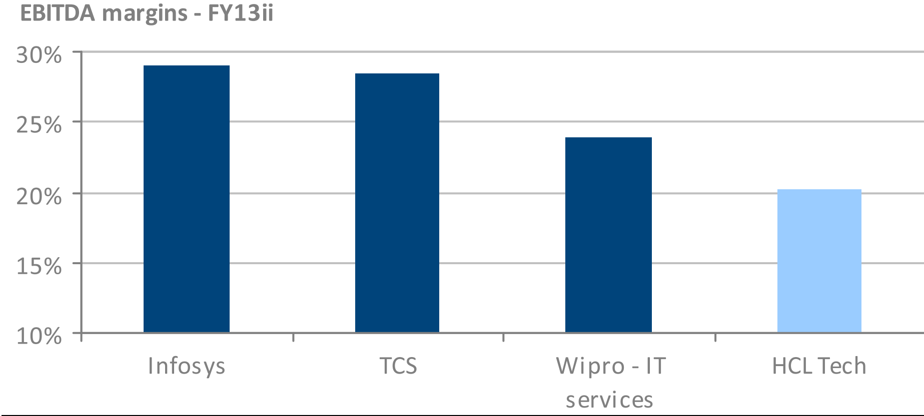
Source: Company, IIFL Research

A case for sustained re-rating:

HCL Tech's EBITDA margins are the lowest among large vendors

We believe improvement in profitability can be a key positive surprise. HCL Tech's operating margins (Ebitda) are the lowest among larger vendors. As highlighted already, HCL Tech has been a late entrant to IT services and it priced aggressively. In addition, in its employee pyramid, HCL Tech has a higher number of employees in the high-experience bucket (vs. peers).

Figure 5.18: HCL Tech margins are lowest among peers



Source: Company, IIFL Research

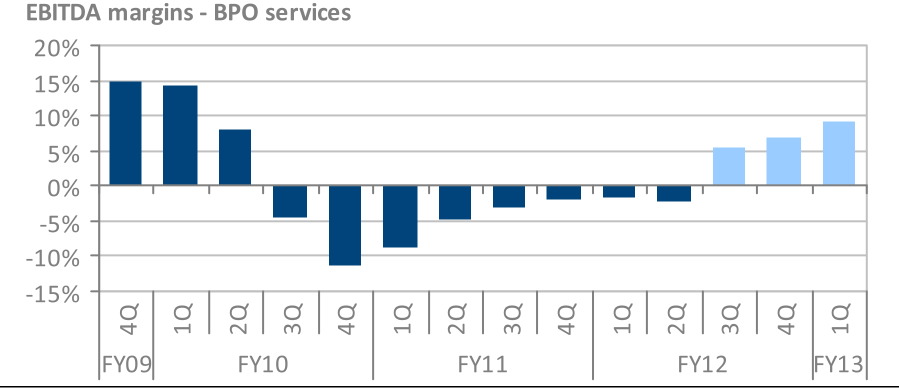
In the past, there were occasions when one could make a case for improvement in HCL Tech's margins. However, we believe the arguments then would never have been as strong as they are now. Although this indicates higher focus on profitability during various occasions earlier, we believe the company did not make the necessary investments for a structural improvement in profitability. In addition, the buoyant environment for deal renewals and their higher contribution (earlier) were continued headwinds to margins. Furthermore, HCL Tech's BPO unit had to undergo a painful (loss making) transition away from voice BPO services to financial services.

Focus on profitability has improved. Investments in areas like training centres are structural margin tailwinds

Now, investment in improving delivery matches the management's commentary on higher focus on profitability. For the first time, the company has a COO (a role created in the recent reorganisation), whose key responsibility is to improve delivery. Like its larger peers, HCL Tech is investing in training campuses for the first time to increase the intake of freshers and right-size its employee pyramid. The BPO unit too has registered a significant turnaround and has achieved breakeven three quarters ago (after eight quarters of Ebitda losses).

BPO has witnessed a significant turnaround. Profitability is improving

Figure 5.19: BPO unit has achieved breakeven three quarters ago

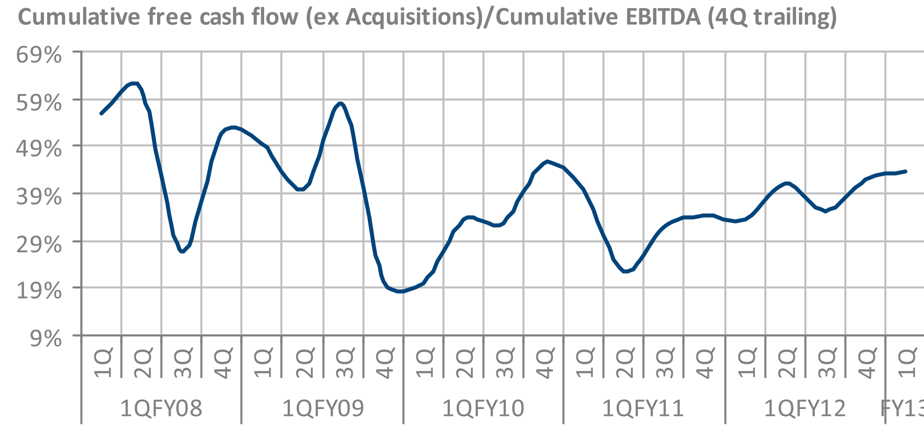


Source: Company, IIFL Research

HCL Tech's cash flows have been a subject of high scrutiny in the initial stages of its transformation

Worries over its cash balances were baseless:
In the initial stages of HCL Tech's transformation, its cash flows were highly scrutinised. Due to the transitions involved, we believe its cash flows were relatively inconsistent. In addition, some of its balance sheet items such as deferred revenue were perceived to be unique issues as these were not high for other vendors. Consequently, we believe its business was perceived to be riskier compared with other vendors. This has also reflected in its valuations remaining at a significant discount to peers.

Figure 5.20: HCL Tech's cash flows have been volatile in its initial stages

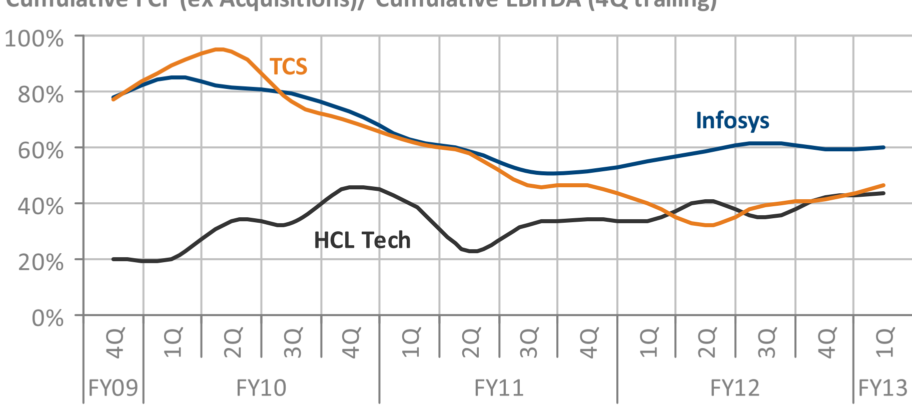


Source: Company, IIFL Research

HCL Tech's cash generation is on par with the best in the industry now

Our analysis of its cash flows over the past five years shows a significant improvement. Its trailing 4Q cash generation (FCF ex. Acquisition) has been similar to that of TCS over the past two years. Moreover, during this period, its receivable days improved significantly. HCL Tech's receivable days are the lowest among Indian IT vendors now.

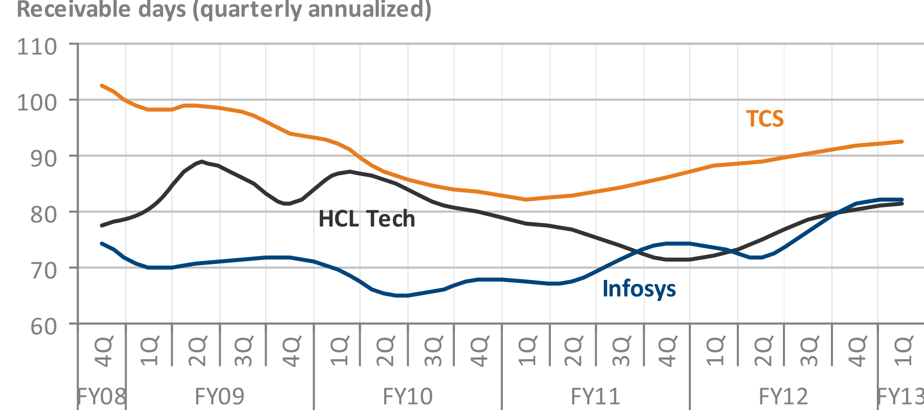
Figure 5.21: HCL Tech's cash flows have gradually improved and are in line with TCS



Source: Company, IIFL Research

HCL Tech's receivable days are amongst the lowest in the industry

Figure 5.22: DSOs improved significantly whereas they worsened for other vendors during the same period



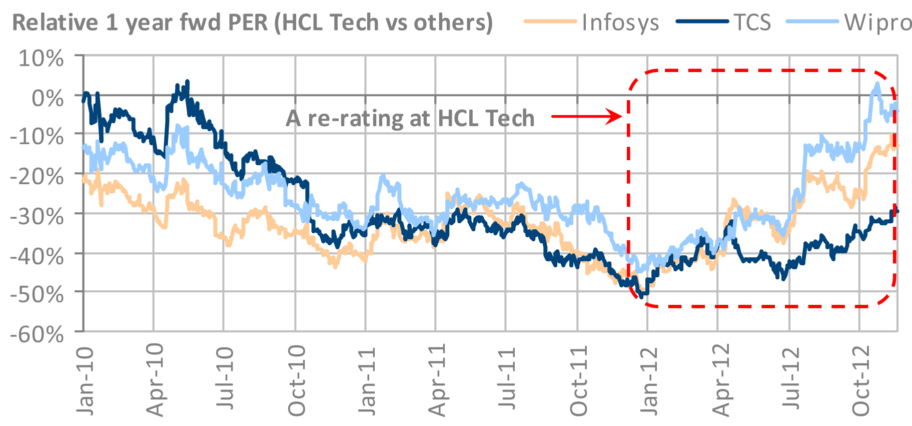
Source: Company, IIFL Research

A case for sustained re-rating:

Despite having one of the best revenue growth rates in the industry and increasing consistency in margin performance, HCL Tech's stock trades at a significant discount (10-40%) to its larger peers. While PER valuations have re-rated modestly (vs. larger peers) over the past year, given the valuation discount, we believe the case for re-rating of the stock continues to be strong. HCL Tech is our multi - year multi bagger in the IT services space.

We believe the high valuation discount to be unsustainable

Figure 5.23: The stock has modestly re-rated in recent times



Source: Company, IIFL Research

Assumptions

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Exchange rate	44.7	50.7	54.4	54.3	54.3
Income tax rate (%)	22.2	24.5	23.9	24.0	24.0
Ebidta margins (%)	16.6	18.8	20.6	20.0	20.0
Revenue growth (US$)	31.1	17.1	10.6	10.7	10.7

Source: Company data, IIFL Research

Financial summary

Robust Ebitda growth

Higher other income due to lower forex losses

Tax rates to remain largely stable

Income statement summary (Rs m)

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**158,556**	**210,312**	**249,571**	**275,691**	**305,263**
Ebitda	26,296	39,547	51,444	55,138	61,160
Depreciation and amortisation	(4,919)	(5,641)	(6,419)	(7,352)	(9,002)
Ebit	21,377	33,906	45,024	47,786	52,158
Non-operating income	910	(142)	769	1,418	2,894
Financial expense	(1,590)	(1,374)	(1,293)	(1,200)	(990)
PBT	20,697	32,390	44,500	48,004	54,062
Exceptionals	0	0	0	0	0
Reported PBT	20,697	32,390	44,500	48,004	54,062
Tax expense	(4,808)	(8,180)	(10,816)	(11,713)	(13,167)
PAT	15,889	24,210	33,684	36,291	40,895
Minorities, Associates etc.	(2)	0	3	3	3
Attributable PAT	**15,887**	**24,210**	**33,687**	**36,294**	**40,898**

A sluggish demand environment is leading to moderation in revenue growth. However, it will continue to be among the best among larger IT vendors

Ebitda margins have expanded over the past two years. We see minimal headwinds ahead

ROE has improved over the past two years. A moderation in ROE over FY14/15 is primarily due to higher cash balances

Ratio analysis

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	22.8	34.6	48.1	51.8	58.4
DPS	7.5	12.0	15.0	16.1	18.1
BVPS	118.8	146.9	179.7	214.8	254.3
Growth ratios (%)					
Revenues	26.2	32.6	18.7	10.5	10.7
Ebitda	5.7	50.4	30.1	7.2	10.9
EPS	29.7	51.9	39.1	7.7	12.7
Profitability ratios (%)					
Ebitda margin	16.6	18.8	20.6	20.0	20.0
Ebit margin	13.5	16.1	18.0	17.3	17.1
Tax rate	23.2	25.3	24.3	24.4	24.4
Net profit margin	10.0	11.5	13.5	13.2	13.4
Return ratios (%)					
ROE	21.0	26.0	29.4	26.3	24.9
ROCE	20.7	27.1	31.2	29.3	28.7
Solvency ratios (x)					
Net debt-equity	0.0	(0.1)	(0.1)	(0.2)	(0.2)
Net debt to Ebitda	(0.1)	(0.2)	(0.3)	(0.5)	(0.6)
Interest coverage	13.4	24.7	34.8	39.8	NM

Source: Company data, IIFL Research

Receivables days have improved significantly over the past two years

High intangibles is due to acquisitions

Balance sheet summary (Rs m)

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	24,961	27,996	35,378	41,426	51,262
Inventories	1,664	2,261	2,683	2,964	3,282
Receivables	34,065	53,439	54,594	63,235	70,579
Other current assets	10,871	12,937	15,352	16,958	18,777
Creditors	10,429	16,952	17,702	19,715	21,828
Other current liabilities	23,336	32,442	36,024	37,906	40,424
Net current assets	**37,796**	**47,240**	**54,280**	**66,963**	**81,648**
Fixed assets	21,190	22,341	31,411	39,488	48,398
Intangibles	41,892	49,419	48,959	48,530	48,118
Investments	0	0	0	0	0
Other long-term assets	10,625	18,448	21,892	24,183	26,777
Total net assets	**111,503**	**137,447**	**156,542**	**179,165**	**204,941**
Borrowings	21,626	21,141	18,641	15,641	12,641
Other long-term liabilities	6,909	13,349	12,014	13,008	14,147
Shareholders equity	**82,968**	**102,958**	**125,887**	**150,516**	**178,153**
Total liabilities	**111,503**	**137,447**	**156,542**	**179,165**	**204,941**

Cash flow generation remains strong

Dividend payout has also improved

Cash flow summary (Rs m)

Y/e 30 Jun, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	21,377	33,906	45,024	47,786	52,158
Tax paid	(4,808)	(8,180)	(10,816)	(11,713)	(13,167)
Depreciation and amortization	4,919	5,641	6,419	7,352	9,002
Net working capital change	(3,817)	(9,571)	(6,758)	(7,361)	(5,906)
Other operating items	0	0	0	0	0
Operating cash flow before interest	17,671	21,796	33,870	36,064	42,088
Financial expense	(1,590)	(1,374)	(1,293)	(1,200)	(990)
Non-operating income	1,011	204	772	1,421	2,897
Operating cash flow after interest	**17,092**	**20,626**	**33,349**	**36,285**	**43,995**
Capital expenditure	**(6,212)**	**(7,806)**	**(12,500)**	**(15,000)**	**(17,500)**
Long-term investments	(559)	(1,006)	0	0	0
Others	8	(19)	3	3	3
Free cash flow	**10,330**	**11,795**	**20,852**	**21,288**	**26,498**
Equity raising	896	391	391	391	391
Borrowings	(5,969)	(485)	(2,500)	(3,000)	(3,000)
Dividend	(5,218)	(8,665)	(11,361)	(12,631)	(14,053)
Net chg in cash and equivalents	38	3,035	7,382	6,048	9,836

Source: Company data, IIFL Research

Technical analysis of HCL Technologies

The stock price of HCL Tech has been forming higher highs and lows despite weakness in other large-cap IT stocks and is showing signs of a strong bull market. With a new base-building formation taking place above Rs580, the rally has scope to extend beyond Rs880.

Breakout above the rising resistance line: Major turnaround in the stock has been confirmed after the 'double bottom' breakout in March 2010 and same levels was retested in Aug 2011. Sustaining above the rising resistance line for more than five weeks has led to conversion of earlier resistance of Rs580 into strong support.

Retracement Projection: A 261.8% price extension from the base of 'double bottom' projects a target of Rs890. Prices have already crossed the resistance of 161.8% extension with 40 WMA turning into strong support.

Affirming Relative Strength: RSI has broken above the multi-year falling resistance line and has sustained above the 65 mark quiet comfortably. Such move indicates that the pace of upside momentum could accelerate further.

Bullish pattern in the Comparative Strength: Formation of an inverted head and shoulder pattern on weekly ratio of HCL Tech to Nifty projects levels of 0.135, which means a further increase in outperformance by 22%.

HCL Technologies – 10 year share price performance chart

(Rs/share)

700
600
500
400
300
200
100
0

Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Jan-09
Jan-10
Jan-11
Jan-12

Acquisition of software business from HCL Infosystems and BPO unit of HCL

Amalgamation of various Indian and overseas subsidiaries

Vineet Nayar is appointed the CEO

Acquisition of Axon, a SAP consultancy company. Filled a critical gap in offering ERP related services through this acquisition

Bid aggressively during deal renewals and won many marquee clients

This page is blank intentionally

CMP	**Rs4281**
Target 12m	**Rs5200 (21%)**
Market cap (US$ m)	**7,509**
Enterprise value (US$ m)	**7,417**
Bloomberg	**APNT IN**
Sector	**Paints**

Dec 14 2012

52Wk High/Low (Rs)	4414/2550
Shares o/s (m)	96
Daily volume (US$ m)	6
Dividend yield FY13ii (%)	1.1
Free float (%)	47.2

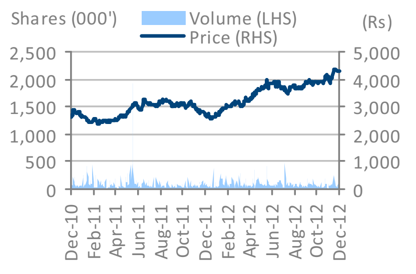
Shareholding pattern (%)

Promoter	52.8
FII	18.1
DII	8.8
Others	20.3

Price performance (%)

	1M	3M	1Y
Asian Paints	4.8	9.7	53.8
Absolute (US$)	6.6	9.2	52.7
Rel. to Sensex	1.4	5.1	32.2
CAGR (%)		3 yrs	5 yrs
EPS		35.6	28.4

Stock movement



Avi Mehta
avi.mehta@iiflcap.com
91 22 4646 4650

www.iiflcap.com

Asian Paints — BUY

Citius, Altius, Fortius

Asian Paints is the leader in the fast-growing Indian paints industry with more than 50% share of the organised market. We expect the company to maintain its industry-leading growth rates, given its strong distribution network (twice that of the second-largest player) and its ability to adapt to changing trends. We expect a strong 20% Cagr in domestic paints revenue to drive 21% Cagr in consolidated earnings over FY12-15ii. This should help maintain ROE at 38%. We expect Asian Paints' premium valuations to sustain, given its strong earnings growth.

Industry-leading growth in the fast-growing paints segment: We expect volumes in the organised paints industry to continue growing at 1.4-1.8x GDP, a trend seen over the past seven years, given increasing housing demand, reducing repainting frequency, and an underlying premiumisation trend towards emulsions and branded paints. Asian Paints is well placed to benefit given its unmatched distribution network, brand strength and focus on continued engagement with all stakeholders. Therefore, we expect the company to continue gaining market share (up 900bps over FY05-12 to c53%) and increase domestic revenue at 20% Cagr over FY12-15ii.

21% earnings Cagr led by healthy growth in domestic paints: Strong growth in domestic paint revenue should drive 20% Cagr in consolidated revenue. We expect Asian Paints' domestic Ebitda margins to sustain at 17%, the best among global peers, given high entry barriers. Consolidated Ebitda margins should improve 30bps over FY12-15ii on expansion in the international and industrial margins (currently at 0.5x domestic Ebitda margins) and in turn drive 21% earnings Cagr over FY12-15ii.

Strong return profile to sustain: Despite aggressive capacity addition plans across the industry (30-150% over the next three years), we expect Asian Paints' return ratios to remain healthy (ROIC to sustain above 45%), given the high share of outsourced production (16-33%). Further, we believe the premium valuations would sustain, given the strong earnings growth.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	77,223	96,323	114,212	138,210	167,720
Ebitda margins (%)	17.2	15.7	15.8	15.9	16.0
Pre-exceptional PAT (Rs m)	8,385	9,868	11,632	14,227	17,561
Reported PAT (Rs m)	8,432	9,888	11,632	14,227	17,561
Pre-exceptional EPS (Rs)	87.4	102.9	121.3	148.3	183.1
Growth (%)	1.2	17.7	17.9	22.3	23.4
IIFL vs consensus (%)			0.3	1.3	1.5
PER (x)	**49.0**	**41.6**	**35.3**	**28.9**	**23.4**
ROE (%)	43.0	40.0	38.0	37.8	38.0
Net debt/equity (x)	(0.4)	(0.2)	(0.1)	(0.2)	(0.3)
EV/Ebitda (x)	30.4	26.9	22.6	18.3	14.8
Price/book (x)	18.8	14.9	12.2	9.9	8.0

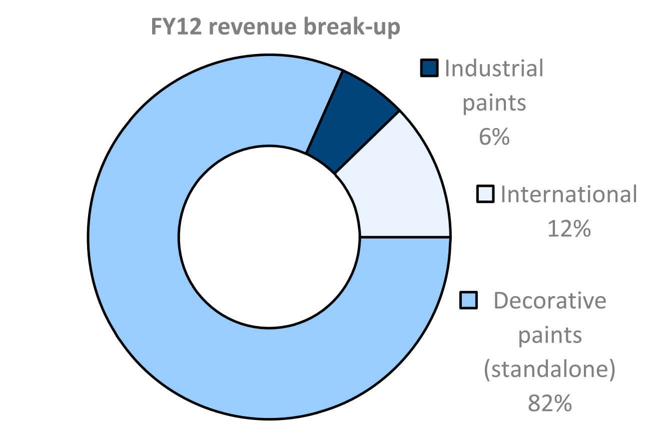
Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

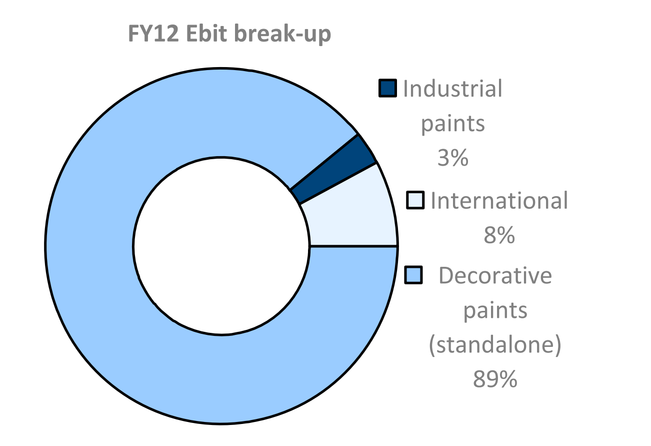
Company snapshot

Business description

- Asian Paints, the largest paint manufacturer in India, operates in the decorative and the industrial coatings segments (through its JV with PPG Industries) and has been the market leader in Indian paints industry since 1968.
- In the decorative paints segment, the company's products comprise the entire range of interior paints (distempers, emulsions), exterior paints, and enamels/finishes.
- Asian Paints is the second-largest automotive coatings supplier in India and caters to the auto OEM and refurbishment markets. Besides automobile coatings, the industrial division also caters to powder coatings and other industrial coatings segments.
- The company has 24 manufacturing plants located across the world of which nine are based in India. It has a strong distribution network in India with more than 27,000 dealers across the country, of which 21,000 have already installed tinting machines.

Figure 6.1: Break-up of revenue and Ebit in FY12





Source: Company, IIFL Research

Figure 6.2: Board of directors

Name	Designation	Comment
Ashwin Choksi	Chairman	Co-promoter; Brother Mahendra Choksi is also on board
Ashwin Dani	Vice Chairman	Co-promoter; Wife Ina Dani is also on board
Abhay Vakil	Director	Co-promoter; Brother Amar Vakil is also on board
KBS Anand	MD & CEO	33 years with Asian Paints; MBA from IIM Calcutta
S Sivaram	Independent dir	Doctorate from Purdue University in Chemical Engg
S Ramadorai	Independent dir	Vice Chairman of TCS
R A Shah	Independent dir	Senior partner at Crawford Bayley a law firm
Dipankar Basu	Independent dir	Ex-chairman of SBI
Mahendra Shah	Independent dir	Ex-MD of Indian Card Clothing, Suessan Asia
Deepak Satwalekar	Independent dir	Ex-MD of HDFC; Involved in policy work for Govt
Tarjani Vakil	Independent dir	Ex-chairperson and MD, EXIM Bank

Source: Company, IIFL Research

Industry-leading growth in the fast-growing paints segment

Growing housing demand, faster repainting cycles, and shift towards premium paint products such as branded paints and emulsions to aid growth momentum

Paint industry: multiple levers support growth momentum

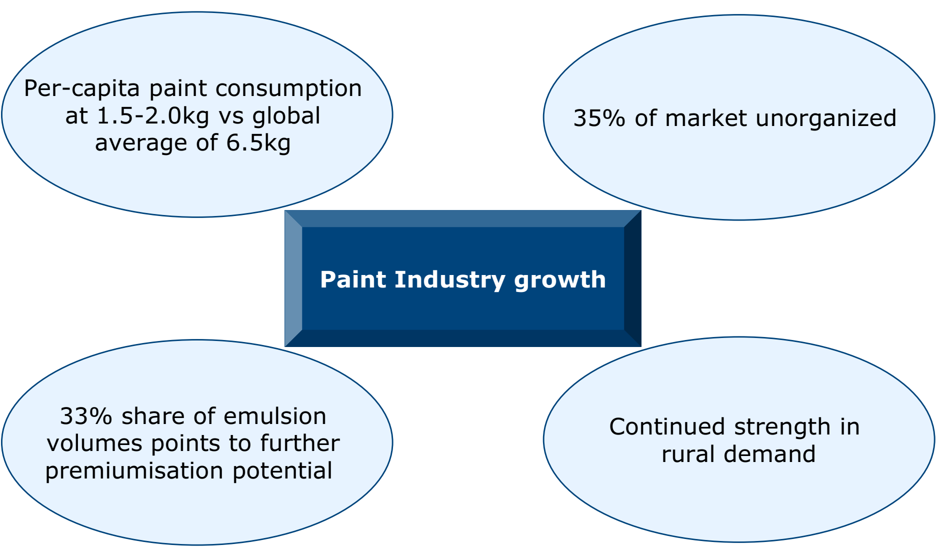
The Rs290bn annual organised paints industry is dominated by decorative paints, which constitute c77% of the market. We expect healthy growth in this segment over the medium term, given the multiple structural drivers, including growth in the housing market led by increasing urbanisation and conversion of *kuccha* (mud, asbestos etc.) houses to concrete structures (c35% of houses in the country are *kuccha*). We believe this would help sustain volume growth at 1.4-1.8x of GDP in the paint industry, a trend seen over the past seven years.

Further, growing disposable incomes have aided faster repainting cycles. Consumers are also increasingly looking to upgrade from economy paint products such as distempers to premium products such as emulsions. This is because a sharp increase in labour costs has resulted in the share of paints in the overall contract value declining from 50-60% to 30-40% over the last few years. Given that emulsions currently account for only 33% of the paint volumes, there is significant room for premiumisation to continue. This is also reflected in the fact that per capita consumption of paints in India is less than a third of the global average.

Furthermore, the unorganised market has a large 35% share in the Indian paint industry. This share should decline as consumers move up the value chain from unbranded to branded paints. Since FY01, the share of unorganised sector has declined from 45% to 35% currently.

Paint volume growth likely to sustain at 1.4-1.8x GDP

Figure 6.3: Multiple levers to sustain growth momentum



Source: IIFL Research

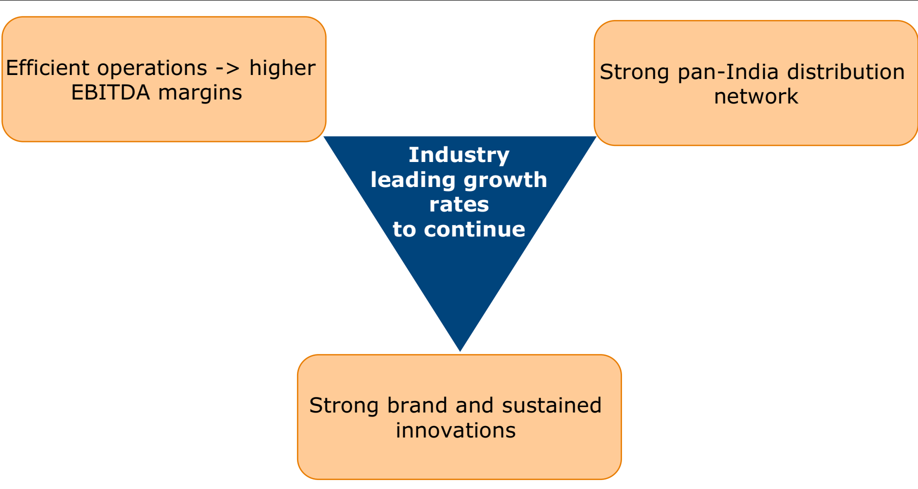
Asian Paints well placed to benefit from this growth

We believe Asian Paints is well placed to maintain its industry-leading growth rates, given its strong market leadership (more than 50% market share among organised paint manufacturers), which allows it to enjoy scale benefits. We believe the company should be able to continue to expand its market share on the back of its

unmatched distribution network (double that of the second-largest player). In a product like paints, it is difficult for new players to gain market share through a differentiated product offering.

Further, Asian Paints' ability to adapt to changing consumer trends reflects in its branding and service innovations. The company has now started focusing on enhancing the consumer paint purchase decision in these areas. This has ensured that Asian Paints is able to maintain a strong brand image in the paint industry.

Figure 6.4: Key strengths to sustain growth momentum



Source: IIFL Research

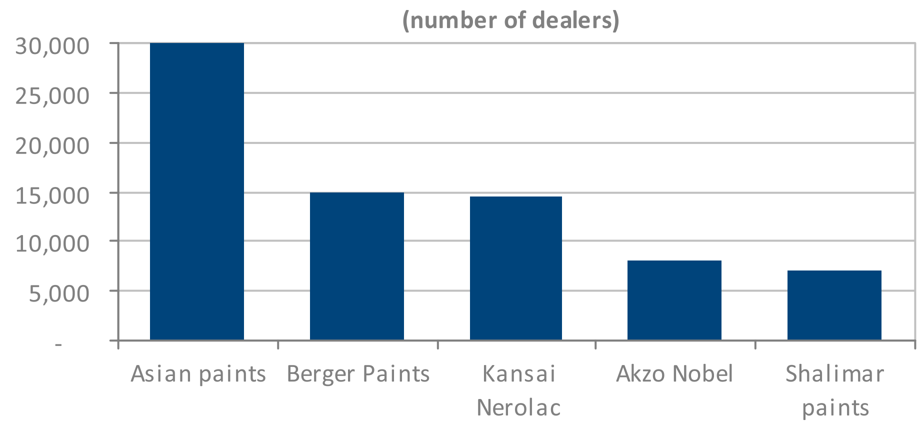
Strong distribution network creates entry barrier for new entrants while sustaining competitive advantage vs. peers

Unmatched distribution network

Unlike FMCG companies, the paints industry directly distributes paints to dealers, given a lower number of retailers. Further, with paint being a bulk commodity, retailers are dissuaded from stocking multiple brands. The emergence of tinting machines for emulsions has accentuated this dislike of stocking multiple brands. Each tinting machine takes significant space and hence it deters dealers from keeping more than 2-3 machines. Therefore, having a large dealer network is difficult and becomes a significant competitive advantage for a paint manufacturer.

Asian Paints has been consistently expanding its distribution network and currently has c30,000 dealers, close to twice the next largest player. The company has been aggressively adding new dealers and cementing relationship with existing dealers by adding more tinting machines, to strengthen its lead further. The company intends to add 1,000-1,500 new dealers annually to its network.

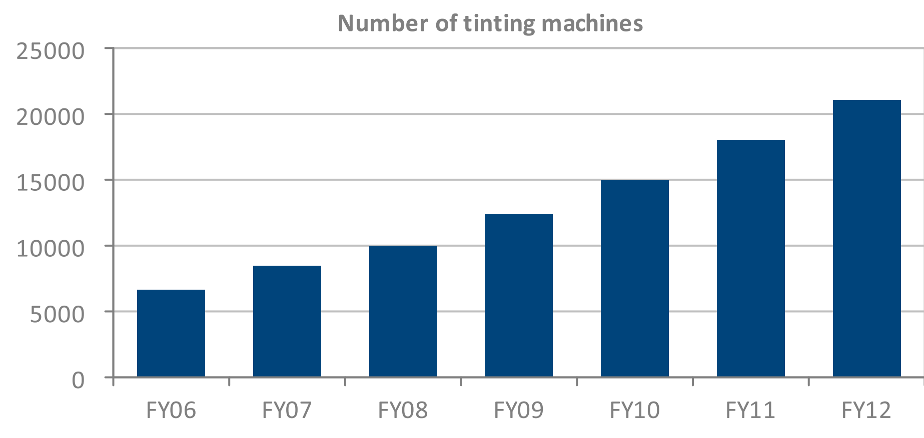
Figure 6.5: Strong distribution network: has access to almost twice the number of dealers than that of the second-largest decorative paints player



Source: Industry, IIFL Research

Dealers averse to keeping more than two tinting machines as these machines require investment by the dealer, and occupy significant space

Figure 6.6: Creating stronger barriers by adding more tinting machines



Source: Company, IIFL Research

Declining share of paint cost in overall housing painting cost has aided the premiumisation trend

Focus on initiatives to sustain consumer connect and recall

The share of paints in the overall house painting cost has declined from 50-60% to 30-40% over the past few years due to a sharp rise in labour costs. Coupled with an increase in the level of disposable income, this has resulted in customers increasingly looking to up-trade to premium variants such as emulsions. Furthermore, customers are getting increasingly more involved in the painting process, as the average age of first-time home buyer falls.

Asian Paints has been focused on adapting its branding and product portfolio to these trends. In order to ensure continued brand strength in this changing environment, Asian Paints has modified its branding from "focusing on generating a strong recall among customers" to "assisting customers in the paint purchase decision". This has been in the form of several innovations such as professional painting services, signature stores, and painting guides, to engage with the customers when they are choosing the colour shades. Further, the company continues to engage with other influencers such as painters and architects. We believe this focus on initiatives to ensure continued consumer connect and recall should help sustain its brand leadership in the paints market.

Scale benefits ensure that the company has the highest share of customer mindshare despite incurring lower ad-spends as a % of revenue.

Continued focus on involvement with all stakeholders

Figure 6.7: Innovations seek to make the brand relevant in the current scenario of increased consumer involvement in the paint buying decision

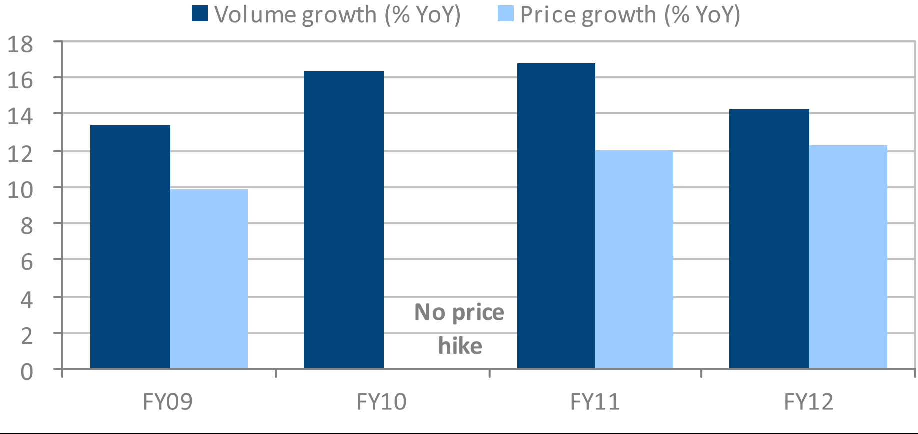
Key initiatives	Description
Professional painting services	Provides professional painting service to customers
Special effects/ Textured paints/ Glow themes	Different textures/ effects to enhance the décor of the room.
Signature store	Experiential store to de-mystify the painting category and provide information on painting colors/ techniques
Samplers	Allows customer to sample paint shades on their walls
Painting guides	Guides through selection of colours, products and assists in planning for the entire painting process
Colour consultancy @ home	Provides consultancy to assist in colour combinations, designer wall finishes for a nominal fee

Source: Company, IIFL Research

The strength of the brand is reflected in the fact that despite strong price increases to pass on input price increases, volume growth remains healthy.

Brand strength reflected in strong volume growth despite sharp price increases

Figure 6.8: Strong volume growth despite sharp 10-12% price increase over the past few years



Source: Company, IIFL Research

Asian Paints domestic revenue has grown at 20%+ levels for the past six years. Expect this trend to sustain

Growth drivers intact for long-term sustainable growth

We believe Asian Paints is well placed to enjoy industry-leading growth rates given: 1) scale benefits from its leadership position (c53% market share vs. 17-18% market share for the second-largest player); 2) unmatched pan-India distribution network, which helps sustain market leadership; and 3) strong brand positioning and continued focus on initiatives to sustain brand strength.

As a result, we expect Asian Paints to report c20% Cagr in domestic decorative paint revenue over FY12-15ii.

Figure 6.9: Expect domestic standalone revenue to grow at 20% Cagr over FY12-15ii

Standalone revenues (Rs bn)

	FY09	FY10	FY11	FY12	FY13ii	FY14ii	FY15ii
Standalone revenues (Rs bn)	43	51	63	80	93	113	136

Source: Company, IIFL Research

Competitive intensity lower given high entry barriers and existing players dissuading from aggressive price competition

Domestic paint margins to remain strong given strong competitive advantage; increasing input costs a key risk

Asian Paints has historically passed on a majority of input price reduction to support growth in the paint industry. That said domestic Ebit margins have remained strong at 15%+ levels for most of FY96-12 period. Given the high barriers to entry (difficulty in developing distribution network, no major product differentiation etc), entry of a new player is difficult and unlikely to materially hurt market shares for the organised players. Additionally, competitive intensity is muted with all players staying away from aggressive price competition to gain market share.

While the premiumisation trend should aid Ebit margin expansion in the domestic business, we would like to highlight that margins for some of the emulsion variants are lower than distempers. Moreover, management highlighted that competitive intensity could weigh on emulsion margins going forward. As a result, we do not expect significant margin expansion from premiumisation. We expect Ebit margins to expand 20bps over FY12-15ii from 15.7% in FY12 to 15.9% in FY15.

Among the top three players in most of the international geographies

Expect revival in Egypt to drive international growth

Asian Paints' international business contributed 12% to FY12 consolidated revenue and c8% to consolidated Ebit. The company currently operates in the Caribbean, Middle East, Asian, and South Pacific regions and is among the top-three players in most of these geographies. We expect strong market position in these regions along with pick-up in the economic conditions to aid 27% Cagr in international Ebit over FY12-15ii. Note that international Ebit grew c18% YoY in 1HFY13.

One-off events weighing on international segment earnings

While the Middle East and South Pacific have seen strong growth in revenue in 1HFY13, revenue growth in Egypt (25% of international revenues) remains weak, given the current political situation. We expect the Egypt market to start recovering over FY13-15 and accordingly build in marginal improvement in revenue growth.

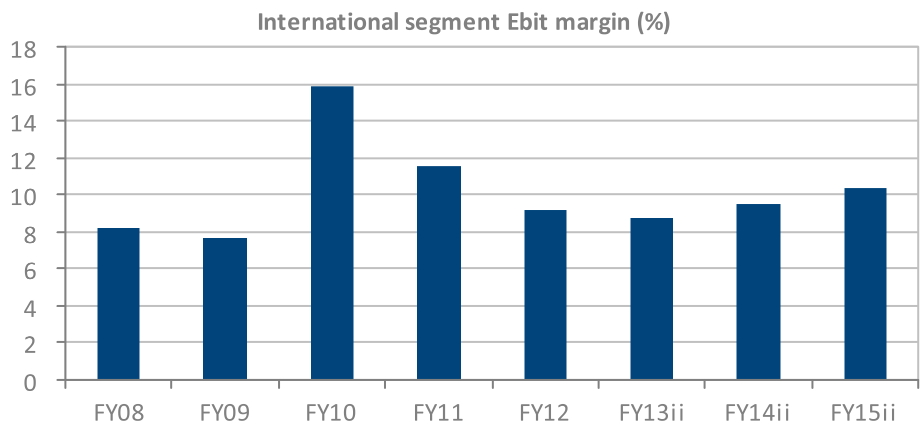
Growth in Egypt (25% of international revenues) impacted by one-off political events

Ebit margins for the international segment are almost half those in the domestic segment since the ability to pass on input price increases is lower in the international markets. The management

remains confident of Ebit margin expansion in the international segment going forward but expects margins to remain lower than the domestic levels.

We conservatively build in 120bps expansion in Ebit margins over FY12-15ii, assuming margins would remain below their FY11 levels.

Figure 6.10: International Ebit margins: we expect 120bps expansion



Source: Company, IIFL Research

Industrial to remain muted over the near term

Asian Paints' industrial business caters to the automotive and the other industrial coatings market in India. This segment contributes 6% to consolidated revenue and 3% to consolidated Ebit. The automotive division (c50% of industrial revenue) operates through a joint venture with PPG Industries (the largest automotive coatings supplier in the world) and caters to Original Equipment Manufacturers (OEMs) as well as the auto-refinish markets. We expect industrial segment Ebit to grow at 27% Cagr over FY12-15ii, on pick-up in industrial capex. However, the near-term growth is likely to remain muted.

Slowdown in domestic capex cycle to weigh on near-term industrial segment growth

With passenger, two-wheeler, and the commercial vehicle demand under stress, we expect growth in the automotive segment to decline from 17% in FY12 to 11% in FY13. Further, the powder coatings segment is likely to record muted growth in the near term, given the slowdown in the domestic capex cycle. However, healthy demand in the auto-refinish and the general industrial segments should support growth in the industrial segment.

Figure 6.11: Auto OEM demand remains weak, given demand weakness

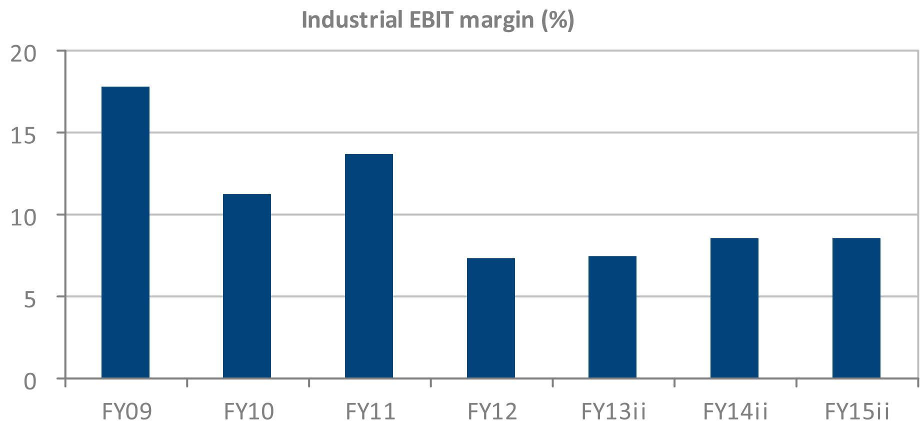
Four wheelers
Two wheelers
Commercial vehicles
Volume growth (% YoY)
50
40
30
20
10
0
(10)
(20)
(30)
FY08
FY09
FY10
FY11
FY12
YTDFY13

Source: Company, IIFL Research

We expect demand in the auto segment to pick up in FY14/15, which should drive 20%+ growth in auto-paint revenue in FY14 and FY15. However, margins are likely to remain muted, given the inability to pass input price increases to end-users. We build in a 100bps expansion in Ebit margins over FY13-15 from operating leverage gains.

Operating leverage gains to drive 100bps expansion in Industrial Ebit margins over FY12-15ii

Figure 6.12: Industrial Ebit margins likely to expand 100bps over FY12-15ii



Source: IIFL Research; Industrial segment margins prior to FY12 do not factor in Asian Paints' industrial coatings business

Expect 21% EPS Cagr on continued strength in the domestic paints business

We believe that strong 20% Cagr in domestic paint revenue should support c20% Cagr in consolidated revenue. This, along with improving profitability in the international and industrial segments should result in marginal 30bps expansion in Ebit margin (as well as Ebitda margins) over FY12-15ii. This should drive 21% Cagr in earnings over FY12-15ii.

Expect 21% EPS Cagr on continued strength in the domestic paints business

Figure 6.13: Expect 21% earnings Cagr over FY12-15ii

(Rs bn)	FY11	FY12	FY13ii	FY14ii	FY15ii	% Cagr
Revenue	77	96	114	138	168	20.3
% YoY	*15.6*	*24.7*	*18.5*	*21.0*	*21.4*	
Ebidta	13	15	18	22	27	21.0
% margin	*17.2*	*15.7*	*15.7*	*15.9*	*16.0*	
% YoY	*8.2*	*13.6*	*19.1*	*22.3*	*21.8*	
Ebit	12	14	17	20	25	21.0
% margin	*15.7*	*14.4*	*14.5*	*14.6*	*14.7*	
% YoY	*6.2*	*14.2*	*18.9*	*21.8*	*22.3*	
Adj PAT	8	10	12	14	18	21.2
% margin	*10.9*	*10.2*	*10.1*	*10.3*	*10.5*	
Adj EPS	87.4	102.9	120.7	148.4	183.2	
% YoY	1.2	17.7	17.3	22.9	23.5	
Reported PAT	8	10	12	14	18	21.1
% YoY	*0.9*	*17.3*	*17.1*	*22.9*	*23.5*	

Source: Company, IIFL Research

Strong and consistent return profile; balance sheet health to sustain growth momentum

The strong leadership position enjoyed by Asian Paints in the domestic market, along with its competitive strengths, has allowed the company to maintain healthy earnings growth and low working capital and in turn strong and consistent return ratios.

Working capital intensity the lowest among domestic peers...
Despite having one of the largest dealer networks, Asian Paints has been successful in creating an efficient supply chain network, which has ensured that it enjoys among the lowest inventory levels. Efficient collection processes ensure that Asian Paints has low debtor days. As a result, it enjoys one of the best working capital efficiencies.

Asian Paints has one of the best working capital efficiencies on the back of low inventory levels

Figure 6.14: Asian Paints has one of the best working capital efficiencies

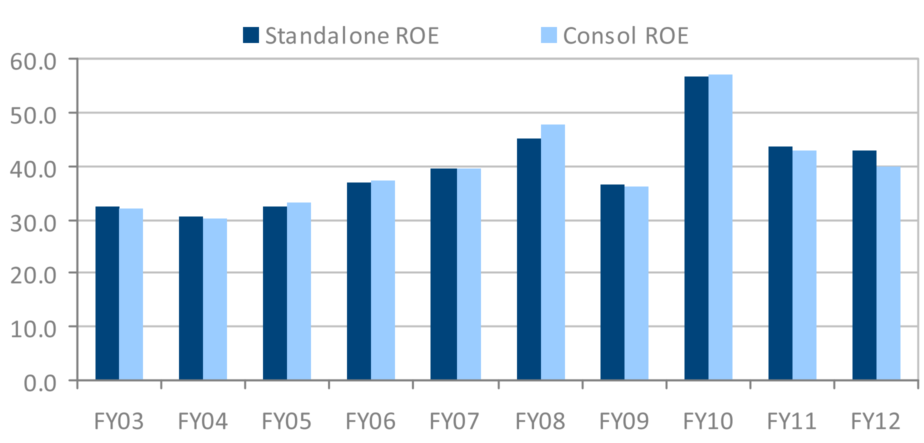
Standalone net working capital (days of revenues)	FY09	FY10	FY11	FY12
Asian Paints	28	11	18	23
Berger paints	70	61	61	63
Kansai Nerolac	35	36	39	50
Akzo Nobel	(7)	(21)	(2)	NM*
Shalimar Paints	64	54	60	63

Source: Companies, IIFL Research; *Akzo Nobel India for FY12 includes chemicals business and hence is not comparable

...resulting in strong and sustainable return ratios
Efficient working capital management has allowed Asian Paints to earn higher return ratios vs. peers. This is reflected in strong standalone return on equity over the past 15 years with ROE increasing from 25% in FY98 to 43% in FY12. This has helped compensate for lower return ratios in the international business and ensures that the company has delivered over 35% ROE at the consolidated level over the plats seven years.

Has delivered over 35% ROE at the consolidated level over the last seven years

Figure 6.15: Consol ROE above 35% levels for the past seven years



Source: Company, IIFL Research

Figure 6.16: Earns sector-leading ROE

Consol return on equity (%)	FY09	FY10	FY11	FY12
Asian Paints	36.2	56.9	43.0	40.0
Akzo Nobel	16.1	16.2	16.1	NM*
Berger Paints	22.0	24.4	23.3	24.3
Kansai Nerolac	15.8	23.2	22.2	21.8
Shalimar Paints	9.6	23.7	23.5	24.6

Source: Companies, IIFL Research; *Akzo Nobel India for FY12 includes the chemicals business and hence is not comparable

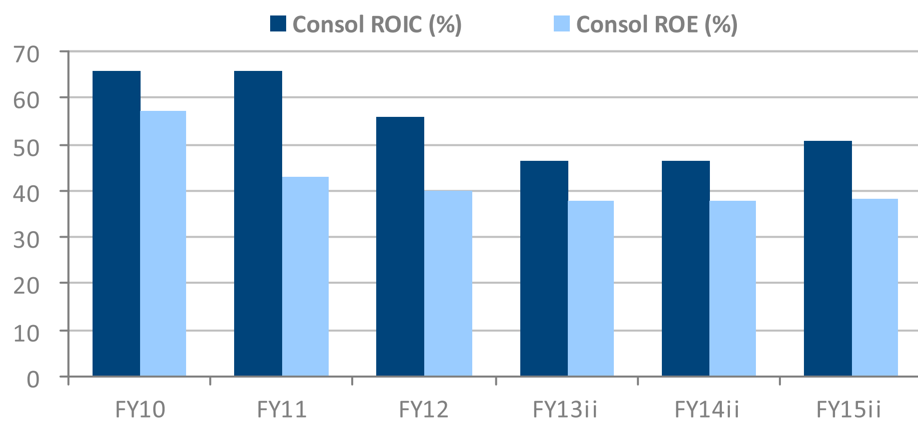
To remain net cash company despite aggressive capex plans
Given the strong volume growth seen in the paints industry over the past couple of years, Asian Paints has embarked on adding a 300,000kl greenfield paint manufacturing plant in Khandala (which can be scaled up to 400,000kl). Additionally, the company would add 4-6 regional distribution centres/depots every year to strengthen its distribution infrastructure and maintain its competitive advantage. Further, we believe that the company would need to start scouting for land parcels in FY15 to set up a new greenfield capacity to meet the growing demand, as it typically takes 3-4 years to set up a greenfield unit.

To remain net cash company despite aggressive capex plans

Despite such aggressive capex plans, we expect Asian Paints to remain a net cash company. Net cash levels would decline by Rs1.6bn to Rs4.7bn in FY13ii. However, with capex plans moderating going forward, net cash levels should increase to Rs15bn in FY15ii.

Return ratios to remain strong
Given Asian Paints' competitive strengths, we expect it to maintain its strong return profile. We expect ROIC to remain healthy at 45%+ level.

Figure 6.17: ROE to remain healthy at 38% level



Source: Company, IIFL Research

Significant capacity addition plans may not hurt margins materially

Across the decorative paint industry, strong demand growth has resulted in utilisation levels increasing to 70-90%. Accordingly, almost all the players are looking to increase capacity by 30-150% over the next three years. There are concerns that if demand growth falls short of expanded capacity, players may reduce prices to maintain utilisation levels.

Figure 6.18: Strong capacity addition across players in the paint industry

Company	Current Capacity	% capacity addition proposed	Comments
Asian Paints	644,000 KL	62%	Addition of 300,000 KL capacity by end FY13. Capacity can be scaled up to 400,000KL
Akzo Nobel	80,000 KL	150%	20,000 KL by end FY13, addition of another 100,000 KL by FY14-15
Berger Paints	370,000 KL	43%	160,000 KL by FY14
Kansai Nerolac	c183,000 KL	18%	c33,000 KL by end FY13
Shalimar Paints	47,500 KL	32%	15,000 KL by 4QFY13

Source: Industry, IIFL Research

Significant capacity addition plans unlikely to materially hurt margins given high level of outsourced production

However, we believe that the likelihood of such an event is lower, given the high share of outsourced production (c32% for Asian Paints). Note that the high share of outsourced production allows companies to sustain utilisation levels for new capacity by reducing their dependence on third-party manufacturers.

In order to understand how the industry typically copes with the period of high capacity addition and weak demand, we analyse the performance of paint companies over FY98-02. In FY99, paint companies added 37-94% capacity. However, such capacity addition coincided with a period of weakness in demand (FY99).

In response to this situation, companies reduced their share of outsourced production and allowed capacity utilisation levels to fall. As demand picked up in FY00, internal capacity was initially utilised at the expense of third-party capacity. It is only in FY01 that the share of outsourced production picked up.

Prior-period example suggests that market flooding is unlikely

Figure 6.19: Outsourced production and capacity utilisation levels initially fell and subsequently picked up

Company	% capacity addition in FY99	Capacity Utilisation				% outsourced production			
		FY98	FY99	FY00	FY01	FY98	FY99	FY00	FY01
Asian Paints	36.8	81%	69%	89%	90%	19%	17%	15%	19%
Berger Paints	61.6	58%	51%	63%	72%	35%	29%	27%	24%
Kansai Nerolac	94.2	45%	29%	40%	44%	27%	21%	10%	9%

Source: Industry, IIFL Research

Strong earnings growth to sustain valuation premium

Asian Paints has seen strong 28% earnings Cagr over FY06-12 on the back of 21% Cagr in revenue and a 270bps expansion in Ebitda margins. This is against 8% earnings Cagr for Kansai Nerolac and 13% for Berger Paints over the same period.

Over the past few years, Asian Paints has seen a re-rating in its multiples, led by strong 20%+ revenue growth for most of FY06-12. Further, the recent entry of the stock into the broader indices has helped re-rate valuation multiples.

Strong earnings growth to sustain valuation premium

We expect Asian Paints to report healthy 21% earnings Cagr over FY12-15ii, on the back of: 1) continued market share gains from unorganised players; 2) increasing premiumisation towards the emulsion category from lower-value variants; and 3) improving profitability in the international and industrial businesses.

Pick-up in industrial demand remains an upside risk

Stronger growth in domestic discretionary spends and in turn paint demand, remain an upside risk to our estimates. Furthermore, industrial paint segment may surprise positively, should industrial demand pick up from the current level. As a result, we expect Asian Paints' one-year forward multiple to remain strong.

Figure 6.20: Valuation comparison

Company	CMP	Mkt cap	ROE		EBIDTA margin		P/E		EPS Growth	
	(LCL)	(US$ bn)	FY12/ CY11	FY13/ CY12	FY12/ CY11	FY13/ CY12	FY13/ CY12	FY14/ CY13	FY13/ CY12	FY14/ CY13
Asian Paints	3968	6.9	40.0	38.0	15.7	15.8	32.7	26.8	17.9	22.3
Domestic Peers										
Berger Paints	140	0.9	24.3	23.6	10.5	10.5	23.0	19.3	16.7	19.3
Akzo Nobel	921	0.8	15.9	15.1	8.7	8.4	19.6	16.6	11.4	18.1
Kansai Nerolac	967	0.9	21.8	20.1	12.5	12.9	22.5	19.0	7.5	18.4
Intl peers										
Nippon Paints	662	2.1	9.34	11.1	10.7	13.0	11.0	10.0	28.9	9.8
PPG Industries	122	18.7	31.8	30.6	14.4	15.9	15.3	15.9	15.8	(3.9)
Sherwin Williams	157	16.2	31.8	39.1	11.0	12.6	24.2	20.0	34.4	21.2
Valspar*	61	5.5	25.2	27.6	NA	15.5	16.0	14.3	15.7	11.8
Consumer peers										
ITC	282	40.1	35.5	37.2	34.2	35.2	30.2	25.1	18.3	20.7
HUL	525	20.4	83.4	81.4	13.4	13.8	33.9	29.1	28.9	16.6
Nestle	4620	8.2	91.3	71.6	20.7	21.5	42.2	34.6	9.8	21.8

Source: Company, IIFL Research; *Year ending Oct

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Sales growth					
Domestic decorative paints	25.8	25.7	16.8	21.1	21.1
Industrial paints	23.7	65.4	25.3	20.0	20.0
International business	(18.8)	15.7	25.1	19.0	22.0
Paint EBIT margin	16.8	15.7	15.8	15.9	16.0
Tax rate	30.4	29.9	30.0	30.0	30.0

Source: Company data, IIFL Research

Financial summary

Revenue growth to be led by the domestic decorative paints segment

Expect Ebitda margins to sustain at 16% levels

ROE to sustain at 38% levels

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**77,223**	**96,323**	**114,212**	**138,210**	**167,720**
Ebitda	13,281	15,088	18,026	21,995	26,780
Depreciation and amortisation	(1,131)	(1,211)	(1,474)	(1,885)	(2,180)
Ebit	12,150	13,877	16,553	20,110	24,601
Non-operating income	680	1,074	1,182	1,418	1,701
Financial expense	(232)	(410)	(526)	(494)	(364)
PBT	12,597	14,542	17,208	21,034	25,939
Exceptionals	48	20	0	0	0
Reported PBT	12,645	14,561	17,208	21,034	25,939
Tax expense	(3,832)	(4,355)	(5,162)	(6,310)	(7,782)
PAT	8,814	10,207	12,046	14,724	18,157
Minorities, Associates etc.	(381)	(319)	(414)	(497)	(596)
Attributable PAT	**8,432**	**9,888**	**11,632**	**14,227**	**17,561**

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	87.4	102.9	121.3	148.3	183.1
DPS	32.0	40.0	48.0	58.0	71.0
BVPS	228.0	286.5	351.6	432.1	532.1
Growth ratios (%)					
Revenues	15.6	24.7	18.6	21.0	21.4
Ebitda	8.2	13.6	19.5	22.0	21.8
EPS	1.2	17.7	17.9	22.3	23.4
Profitability ratios (%)					
Ebitda margin	17.2	15.7	15.8	15.9	16.0
Ebit margin	15.7	14.4	14.5	14.6	14.7
Tax rate	30.3	29.9	30.0	30.0	30.0
Net profit margin	11.4	10.6	10.5	10.7	10.8
Return ratios (%)					
ROE	43.0	40.0	38.0	37.8	38.0
ROCE	54.6	50.5	48.0	49.3	51.2
Solvency ratios (x)					
Net debt-equity	(0.4)	(0.2)	(0.1)	(0.2)	(0.3)
Net debt to Ebitda	(0.6)	(0.4)	(0.3)	(0.4)	(0.6)
Interest coverage	NM	33.9	31.5	40.7	NM

Source: Company data, IIFL Research

To remain net cash company despite aggressive capacity addition

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	10,511	9,676	9,616	12,271	17,593
Inventories	13,054	15,989	18,958	22,942	27,840
Receivables	5,741	7,828	9,281	11,231	13,630
Other current assets	2,937	5,910	6,258	7,573	9,190
Creditors	12,083	16,490	18,775	22,719	27,570
Other current liabilities	7,575	9,013	9,720	10,576	11,688
Net current assets	**12,586**	**13,901**	**15,619**	**20,722**	**28,994**
Fixed assets	13,160	18,761	24,787	25,402	26,722
Intangibles	372	415	415	415	415
Investments	0	0	0	0	0
Other long-term assets	0	0	0	0	0
Total net assets	**26,118**	**33,077**	**40,821**	**46,539**	**56,132**
Borrowings	2,293	3,297	4,797	2,797	2,797
Other long-term liabilities	1,951	2,295	2,295	2,295	2,295
Shareholders equity	**21,874**	**27,485**	**33,730**	**41,447**	**51,040**
Total liabilities	**26,118**	**33,077**	**40,821**	**46,539**	**56,132**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	12,150	13,877	16,553	20,110	24,601
Tax paid	(3,919)	(4,296)	(5,162)	(6,310)	(7,782)
Depreciation and amortization	1,131	1,211	1,474	1,885	2,180
Net working capital change	(1,765)	(2,795)	(1,779)	(2,448)	(2,950)
Other operating items	28	266	(414)	(497)	(596)
Operating cash flow before interest	7,625	8,264	10,671	12,740	15,452
Financial expense	(232)	(404)	(526)	(494)	(364)
Non-operating income	0	0	0	0	0
Operating cash flow after interest	**7,393**	**7,860**	**10,145**	**12,247**	**15,089**
Capital expenditure	**(1,503)**	**(6,669)**	**(7,500)**	**(2,500)**	**(3,500)**
Long-term investments	(382)	(637)	0	0	0
Others	817	1,472	1,182	1,418	1,701
Free cash flow	**6,324**	**2,026**	**3,827**	**11,164**	**13,290**
Equity raising	0	0	0	0	0
Borrowings	56	970	1,500	(2,000)	0
Dividend	(3,168)	(3,831)	(5,387)	(6,509)	(7,968)
Net chg in cash and equivalents	3,212	(835)	(60)	2,655	5,322

Source: Company data, IIFL Research

Technical analysis of Asian Paints

The share price of Asian Paints has seen a secular increase, oscillating from the 2009 lows of Rs775 to more than Rs4000. Currently, the stock price has been facing critical resistance at Rs4200 above which there is a scope for significant price appreciation.

Negation of double top pattern above Rs4200: Prices have retreated after testing the channel resistance of Rs4200 but have a strong trend line support at Rs3850. A move past Rs4200 should act as a major trigger for the sharp price upswing.

Retracement projection: A decline during July 2012 was stalled nearly at 38.2% retracement support and prices have rallied effectively to test the June 2012 high of Rs4170. A 100% price extension from support of Rs3447 should provide a target of Rs5100, which also coincides with the rising channel getting replicated.

RSI cause of worry: The weekly RSI has been showing negative divergence, but has sustained above the 55 mark and 40 WMA. For the bull case scenario to emerge, prices need to rally higher and RSI should maintain above 55 level for a few more weeks.

Advantage of comparative strength: The weekly ratio chart of Asian Paints with Nifty has managed to bounce back, taking the support of previous peak of 0.68. The ratio hints that outperformance with the Nifty is likely to continue as long as the ratio sustains above 0.65.

Asian Paints – 10 year share price performance chart

(Rs/share)

4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0

Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

Acquistion of Berger International, SCIB chemicals in Egypt in 2002 and Taubmans Fiji in 2003

Exits certain international markets (Myanmar, The Phillipines and Australia) in CY06/07

Revenue growth rates sustained at 20%+ levels

Gross margins expand as company retains part of gains from commodity cost reduction

Credit crisis hurts revenue growth - down to 12% in 3QFY09

Ebitda margins contract given demand weakness in India, political instability in key international markets

Exists loss-making international markets (China, Malaysia, Hong Kong and Thailand) in CY09/10

Included in Nifty (15-Mar)

CMP	Rs207
Target 12m	Rs238 (15%)
Market cap (US$ m)	3,698
Enterprise value (US$ m)	3,433
Bloomberg	Z IN
Sector	Media

Dec 14 2012

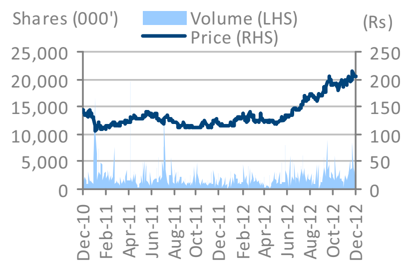
52Wk High/Low (Rs)	217/106
Shares o/s (m)	959
Daily volume (US$ m)	10
Dividend yield FY13ii (%)	1.0
Free float (%)	56.6

Shareholding pattern (%)	
Promoter	43.4
FII	36.1
DII	12.6
Others	7.9

Price performance (%)

	1M	3M	1Y
Zee Ent.	8.7	21.5	70.4
Absolute (US$)	4.5	20.7	69.1
Rel. to Sensex	5.2	16.9	48.7
CAGR (%)		3 yrs	5 yrs
EPS		13.2	17.5

Stock movement



Bijal Shah
bijal@iiflcap.com
91 22 4646 4645

Jaykumar Doshi
jaykumar.doshi@iiflcap.com
91 22 4646 4668

www.iiflcap.com

Zee Entertainment BUY

A to Z of entertainment

Zee Entertainment (Zee), India's leading television network, is the best play on booming consumption and structural improvement in India's pay television market. Zee's diversified bouquet of channels and improving network market share would translate into above-industry ad-revenue growth. Furthermore, digitisation and its distribution joint venture with Star network would help secure a rightful share of subscription revenue. Meanwhile, Zee is investing in new channels and markets, which we believe would buttress long-term growth. The company could largely pay back the expected, strong free cash flow to investors as dividend. BUY.

Investing in new growth drivers: Zee has a well-diversified revenue stream. Its high subscription revenue (~45% in FY12) shields its earnings during periods of slowdown in ad spend. Its large bouquet of channels provides resilience to absorb weakness in individual channels. Zee is investing afresh in existing channels and in newer genres, which would improve network's market share in the medium term.

Pay revenue – a huge opportunity that reduces risk of increasing competition: Following effective implementation of mandatory digitisation (expected by Dec-14) Zee's domestic subscription revenue would increase ~150% even without price increases. This would not entail any specific cost increase giving Zee the flexibility to invest in strengthening its network market share. Furthermore, digitisation reduces the risk of entry of new players who typically depend on advertising revenue, since they would find it difficult to compete with incumbents with sizable pay revenue.

High earnings visibility, increased payout: Contrary to market expectations, we believe Zee's margins would remain stable as narrowing of sports losses and strong growth in subscription revenue would offset increased losses from new launches. Zee's cash generation has significantly improved over the past few years and the company has also increased its payout (dividend + buyback at 68% of PAT in FY12 vs. 27% in FY08). At 24x FY14ii P/E, valuations are reasonable considering high earnings visibility and potential upside from digitisation. We see upside risks to our estimate of 16% EPS Cagr for FY12-15ii from recovery in GDP growth and effective implementation of digitisation.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	29,436	30,405	35,597	39,676	44,263
Ebitda margins (%)	25.7	24.3	24.5	26.4	26.7
Pre-exceptional PAT (Rs m)	5,600	5,891	6,884	8,178	9,089
Reported PAT (Rs m)	6,370	5,891	6,884	8,178	9,089
Pre-exceptional EPS (Rs)	5.7	6.1	7.2	8.6	9.5
Growth (%)	(17.9)	7.3	17.4	18.8	11.1
IIFL vs consensus (%)			0.8	(1.7)	(12.1)
PER (x)	**36.1**	**33.6**	**28.7**	**24.1**	**21.7**
ROE (%)	16.2	18.1	18.8	19.8	19.6
Net debt/equity (x)	(0.3)	(0.3)	(0.3)	(0.4)	(0.4)
EV/Ebitda (x)	**25.6**	**25.4**	**21.1**	**17.2**	**15.0**
Price/book (x)	6.5	5.8	5.1	4.5	4.0

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

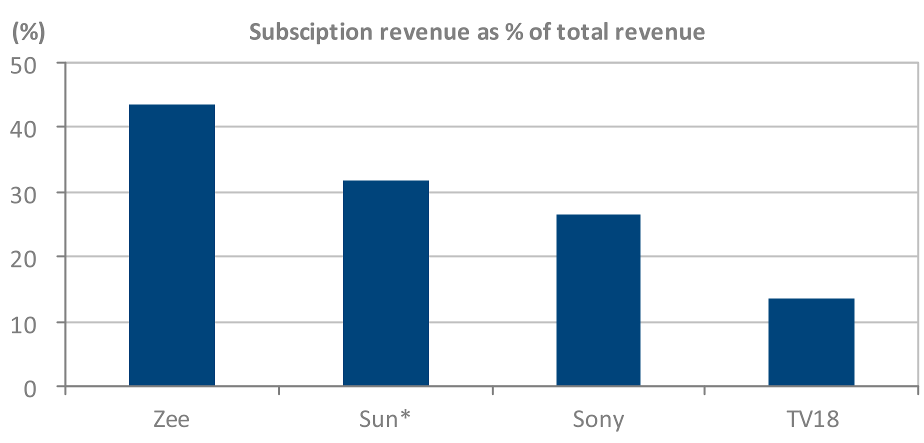
Core business on a strong footing

Subscription revenue, which is sticky in nature, contributes 44% to Zee's total revenue

Diversified revenue base – a huge advantage

Zee's key strength is its ability to monetise its content better compared with competitors. In FY12, domestic subscription revenue accounted for 30% and international pay revenue constituted 13% of total revenue. The subscription revenue stream is stickier compared with advertising revenue. This significantly reduces the impact of weakness in ad spend or a temporary weakness in the performance of a channel. A high base of subscription revenue gives Zee the flexibility to invest in existing as well as new channels. This is a big advantage vis-a-vis other young and less diversified networks that depend largely on ad revenue.

Figure 7.1: Zee's subscription revenue as % of total revenue is significantly higher than peers



Source: Company, IIFL Research *Sun's slot sale model for telecast of content bumps up the proportion of subscription revenue

A formidable and diversified bouquet of channels de-risks Zee's business model

Zee - more than just a flagship channel

A large and diversified bouquet of channels, coupled with a diversified audience base, significantly de-risks Zee's business model. Contrary to the perception that Zee is equivalent to the flagship channel *Zee TV,* Zee's viewership base is spread across genres. A comparison with competing networks shows that Zee and Star have the most formidable bouquet of channels in India. Thus, Zee's profitability is not linked to the performance of a single channel, which de-risks earnings.

Figure 7.2: A well diversified content offering

Channel	Mkt- Share*	Ranking	Remarks
Zee TV	18.7	2	Close competition between top 4 channels
Zee Cinema	22.4	3	Close competition between top 3 channels
Zee Bangla	25.4	2	Strong market position,
Zee Marathi	21.6	2	Strong market position, leadership alternating between Zee and Star
Zee Tamil	3.4	4	Distant #4; Zee is now increasing investments in this market
Zee Kannada	11.9	3	Market leader Udaya TV (Sun Group) has 27%
Zee Telugu	14.1	3	Joint #3 with ETV
Sports #	36.4	2	Some good cricket and other properties
Zee Cafe	13.5	3	Distant #3; AXN has ~50% share.
Zee Studio	4.3	5	Distant #5; Star Movies has 34% share

Source: TAM data, IIFL Research * Market share of a) 2QFY13 for Zee Cinema, b) 3QFY12-2QFY13 for sports and c) 1HFY13 for all other genres
Sony MAX which telecasts movies and cricket (IPL) is not included for market share calculation of sports genre

Figure 7.3: Zee and Star have the most formidable bouquet of channels

Key genres	Zee Entertainment	Star Network	Sony	Network18	Sun Network
Hindi					
- GEC	Zee TV	Star Plus	Sony Ent. Sony SAB	Colors	
- Movies	Z Cinema, Z Classic, Z Action, Z Premier	Star Gold Movies Ok	Sony MAX		
Regional					
- Tamil	Zee Tamil	Star Vijay			Sun TV + 6 channels
- Kannada	Zee Kannada	Asianet Suvarna		ETV Kannada	Udaya + 5 channels
- Telugu	Zee Telugu			ETV	Gemini + 6 channels
- Bangla	Zee Bangla Zee Bangla movie	Star Jalsha		ETV Bangla	
- Marathi	Zee Marathi Zee Talkies (movie)	Star Pravah		ETV Marathi	
- Malayalam		Asianet channels			Surya + 2 channels
- Bhojpuri					
Sports	Ten Cricket, Ten Sports Ten Action, Ten Golf	Star Cricket Star Sports, ESPN	SONY MAX SONY SIX		
English					
- GEC	Zee Cafe	Star World	AXN	Comedy Central	
- Movies	Zee Studio	Star Movies, Movies Now	Sony PIX		
Others (Hindi/English)					
- Kids	ZeeQ			The Disney channel Nick, Hungama	
- Youth Entertainment		Life OK			
- Lifestyle	Zee Trendz				
- Music	Zing, ETC	V Channel	Sony MIX	MTV, Vh1	
- Infotainment		National Geographic Fox History		History channel	

Source: Company, IIFL Research

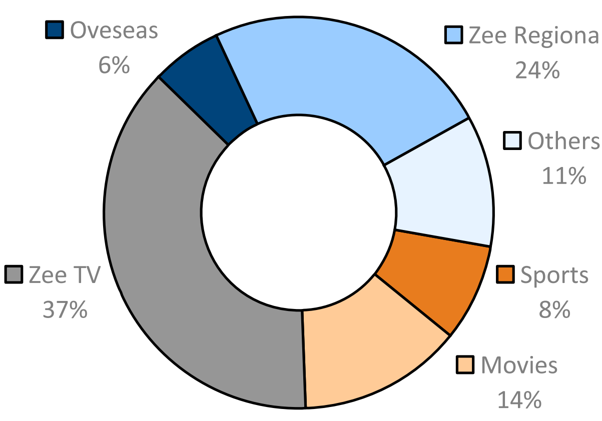
Legend	
Strong Player	(blue)
Weak Player	(light blue)
No presence (or negligible)	(orange)

Well diversified ad revenue cushions earnings from weakness in performance of an individual channel

Diversified advertising revenue base

Zee TV, the flagship channel, accounts for ~38% of Zee's advertising revenue and ~20% of total revenue. The remaining advertising revenue comes from regional movies, sports, music and other channels; none of these channels contributes more than 15% to the company's advertising revenue. Zee also earns advertising revenue from overseas markets and the bouquet of local channels *(Zee Aflam and Zee Alwan)* offered to the Indian Diaspora in overseas markets. This well diversified advertising revenue base cushions the company's earnings from weakness in the performance of an individual channel.

Figure 7.4: Zee's advertising revenue is well spread across channels

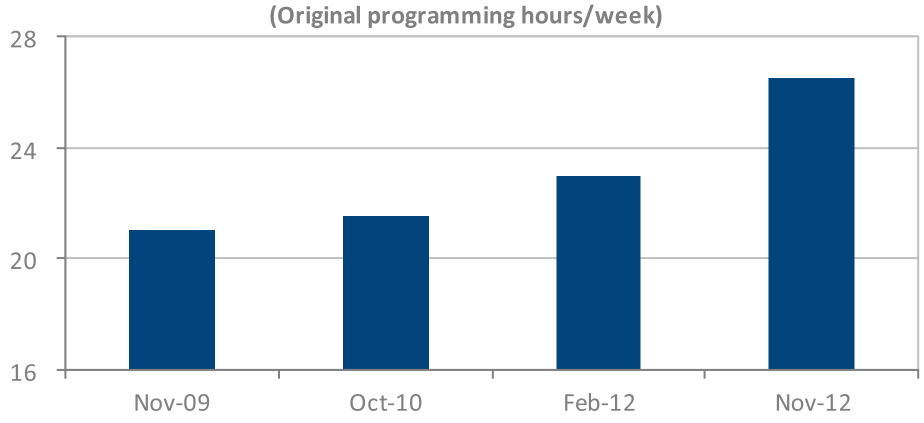


Source: IIFL Research

Reinvesting in existing bouquets

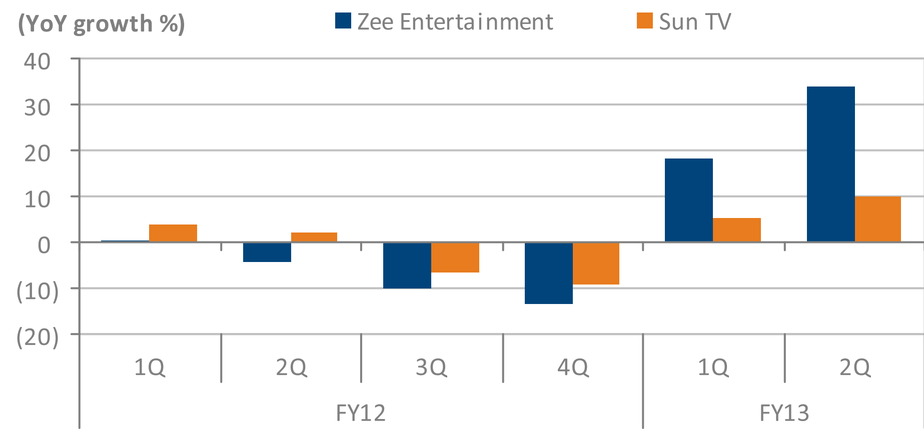
Hitherto, Zee had chosen profitability over viewership share while making programming decisions. Its underinvestment in content was a source of worry because it could have led to loss of market share and helped competition to strengthen its foothold. In a welcome change of strategy, the management indicated that it would increase investment across genres. Zee Entertainment's spend on movie acquisition increased 52% YoY to Rs3.3bn in FY12. Besides the higher investment in the acquisition of movies rights, the change in strategy is also evident in increased original programming hours (OPH) on its flagship channels. The results are already visible with Zee's advertising revenue growth outpacing industry growth.

Figure 7.5: OPH* of the flagship channel increased ~25%; the management expects OPH to increase to 30-35 in the medium term



Source: Company, IIFL Research * Original programming hours

Figure 7.6: Zee's advertising revenue growth has significantly improved relative to competition as its investments in content have started paying-off



Source: Company, IIFL Research

New channels launches and investments in existing channels would further strengthen Zee's strong bouquet

New channels lay the foundation for long-term growth

In keeping with its tradition, Zee is creating newer genres and making renewed push in genres where the opportunity is now easier to exploit. We believe these initiatives would further strengthen its already strong channel bouquet, increasing the network's market share. A stronger bouquet of channel would enable the company to exploit the subscription revenue stream in digital broadcasting-distribution space better. Additionally, in the medium term, as these channels garner viewership share, it would enable Zee to beat industry's advertising revenue growth.

Figure 7.7: Zee's recent channel launches in Indian market

Channel	Comment
Zee Bangla Movie	India's first 24 hours Bengali movie channel
ZeeQ	Children's channel for education and entertainment; this marks Zee's entry in fast growing kids entertainment segment

Source: Company, IIFL Research

Inspired by the success of its movie channel in Middle East, Zee recently launched a GEC in the region

Overseas markets present new growth opportunity

Zee is embarking on increasing its viewer base from 670m to 1bn in the medium term, which would partly come from overseas markets. Expansion in the overseas markets, especially the Middle East and Africa, is the corner stone to Zee's long-term growth strategy. Zee already had presence in the Middle East market through its movie channel *Zee Aflam*. It recently strengthened its presence in the market with the launch of *Zee Alwan*, a general entertainment channel. The advertising market in the Middle East is estimated at US$2bn and thus represents a big opportunity. The prospects for overseas ventures look promising, given that *Zee Aflam* has been able to build a loyal viewer base and achieve Ebitda breakeven within three years. Zee's overseas investments could boost medium–to-long-term earnings growth prospects.

Outlook for sports business improving

Zee's strategy for the sports business came under investor scrutiny as sports losses spiralled over the past two years. The following two key changes should improve profitability of the sports business in the years ahead. *Firstly*, profitability of the key sporting event depends on the ability to exploit the subscription revenue stream. Impending

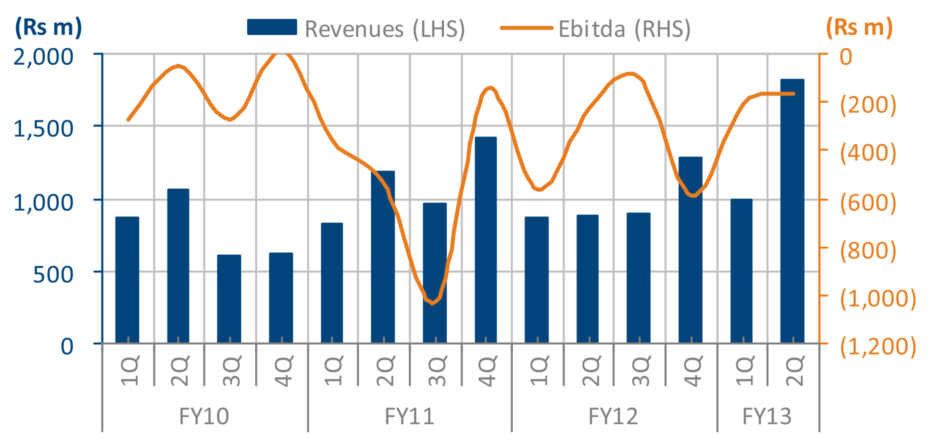
digitisation would significantly improve monetisation of the sports properties. *Secondly*, a nominal increase in cost of rights for key cricketing properties on renewal is a positive. For example, Zee renewed rights for cricket in South Africa at US$22.5m/year for 2012-19 compared with the US$18.5m/year for 2008-11.

Sports losses are likely to come down from Rs1.5bn in FY12 to less than Rs1bn in FY13

Incipient signs of improvement in profitability are visible

Zee's high sports losses are typically associated with higher cricketing days involving India. In 2QFY13 despite telecast of India Sri Lanka series, sports losses reduced and were below the quarterly run-rate, led by significant improvement in advertisers' interest. In addition, note that higher FY12 losses were partly associated with one-time events - launch of *Ten Golf* and a sports channel in high definition.

Figure 7.8: Revenue and Ebitda trends of Zee's sports business



Source: Company, IIFL Research

Subscription story keeps getting better

Subscription revenue – multiple drivers

Hitherto, a combination of low ARPUs, monopoly of local cable operators (LCOs) on the last mile and focus on advertising revenue deprived Indian broadcasters of their legitimate share of subscription revenue. We see this situation changing in coming years. Increasing proliferation of DTH services and impending digitisation would ensure equitable distribution of subscription revenue in the years ahead. In this environment, Zee is best placed to monetise its content, given its strong bouquet of channels and a distribution joint venture with Star, another strong broadcasting network in the country.

Digitisation would ensure equitable distribution of subscription revenue

Digitisation to drive cable subscription revenues

Complete transparency in the broadcasting distribution space would increase Zee's subscription revenue threefold, even without a price increase. At present, broadcasters barely receive their due share from the cable operators. This is evident from the fact that DTH, with less than half of the cable subscriber base, contributes ~10% higher subscription revenue than cable.

Figure 7.9: Despite a lower subscriber base, DTH contributes more to Zee's subscription revenue compared with cable

(Rs m) Revenues (LHS) Net sub base (RHS) (mn)

1,500 1,350 1,200 1,050 900

100 75 50 25 0

Cable DTH

Source: Company, IIFL Research. (2QFY13ii)

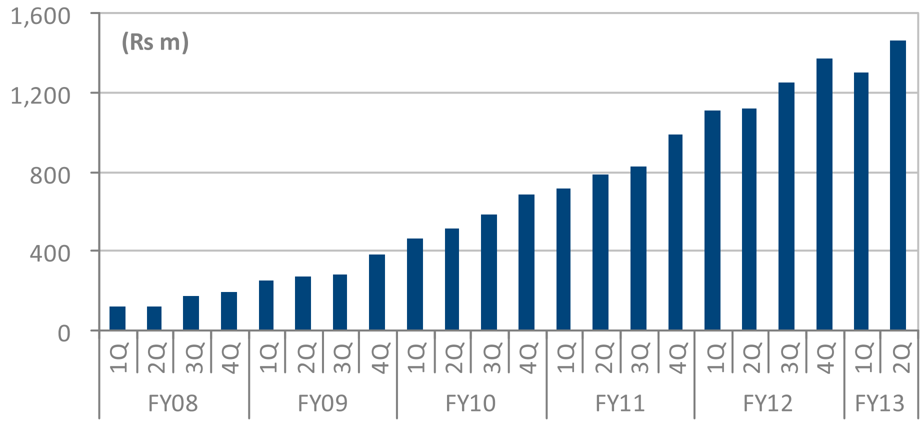
As per our calculations, Zee's ARPU from its cable subscriber base is a third of that from its DTH subscriber base. We believe digitisation is the first and an important step in bridging this gap. It is easier to increase cable tariffs and gain higher revenue share from LCOs in the digitised broadcasting distribution space. On phased implementation of mandatory digitisation, we expect gradual improvement in cable ARPU for Zee. Experience from DTH suggests that digitisation of broadcasting delivery leads to a sharp improvement in subscription revenue of broadcasters.

Figure 7.10: Digitisation timelines

Phase	Area	Timeline	Subscribers (mn)
Phase 1	Delhi, Mumbai, Chennai, Kolkata	31st Oct 2012	8
Phase 2	Cities with population > 1m	31st Mar 2013	23
Phase 3	All urban areas (Municipal areas)	30th Sep 2014	36
Phase 4	Rest of India	31st Dec 2014	38

Source: Company, IIFL Research

Figure 7.11: Rapid growth in Zee's subscription revenue from DTH; Pay revenue from cable would follow this trend on digitisation



Source: Company, IIFL Research

Figure 7.12: Zee's cable ARPU has a huge upside potential

FY12	DTH	Cable
Pay subscriber base (net) mn	22	66
Contribution to subscription revenues (Rsm)	4,801	4,417
ARPU (Rs/month)	18	6
Zee's cable ARPU as % of DTH		30.7

Source: Company, IIFL Research

Figure 7.13: Zee's subscription revenue could triple on complete digitisation, even without any price increase

	FY12		On complete digitisation	
	Sub. base	Revenues	Sub. base	Revenues
Analogue cable	62	4,417	0	0
Digital cable	4	NA	72	15,487
DTH	22	4,801	37	8,179
Total revenue		9,218		23,666
ARPU				
Analogue cable		6		NA
Digital cable		NA		18
DTH		18		18

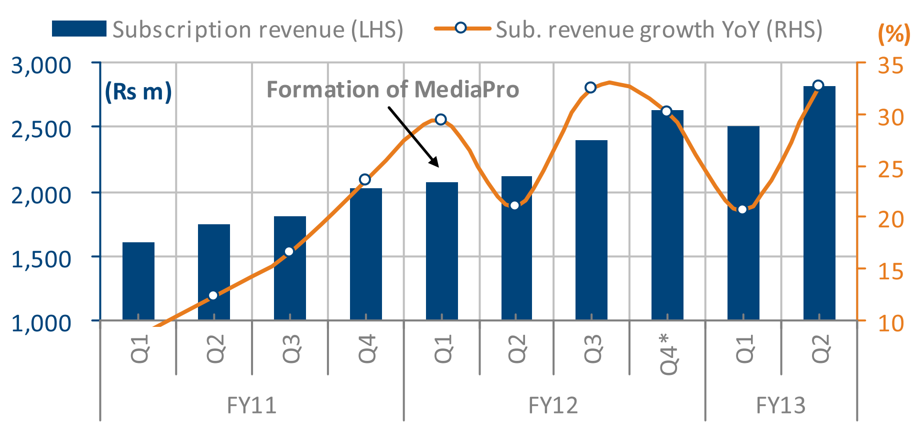
Source: Company, IIFL Research

Strong bargaining power of MediaPro has helped Zee better monetise its content

MediaPro has formidable prospects

In July 2011, India's two largest broadcasters Zee and Star Network merged their distribution arms to form *MediaPro.* As per the agreement, *MediaPro,* a single entity, is now distributing all channels, excluding the sports channels. Its bouquet consists of 67 channels, including some of the most popular channels in the country. This bouquet enjoys market share upward of 50% in several micro markets, e.g. Maharashtra and West Bengal. *MediaPro* would enable Zee to improve monetisation of its content even in case there are delays in implementation of the remaining three phases of digitisation. Since formation of the joint venture, Zee's domestic subscription revenue increased 35%, largely because of higher revenue from cable operators.

Figure 7.14: Zee's subscription revenue increased ~35% within five quarters of formation of *MediaPro*



Source: Company, IIFL Research * We have equally distributed Rs506m (included in 4QFY12 subscription revenue) pertaining to July11-March12 period across 2Q-4QFY12.

Potential upside from digitisation is not yet built in ours as well as consensus estimates

Upside risks to our subscription revenue forecast

At present, we are not building in any upside in subscription revenues because of implementation of digitisation. During the first phase, digitisation received a strong push from Information and Broadcasting Ministry (I&B) of the Government of India (GoI). This makes us more positive on implementation of the remaining three phases. Timely implementation of digitisation may drive strong subscription revenue growth in the medium term and presents meaningful upside risks to our FY15ii estimates.

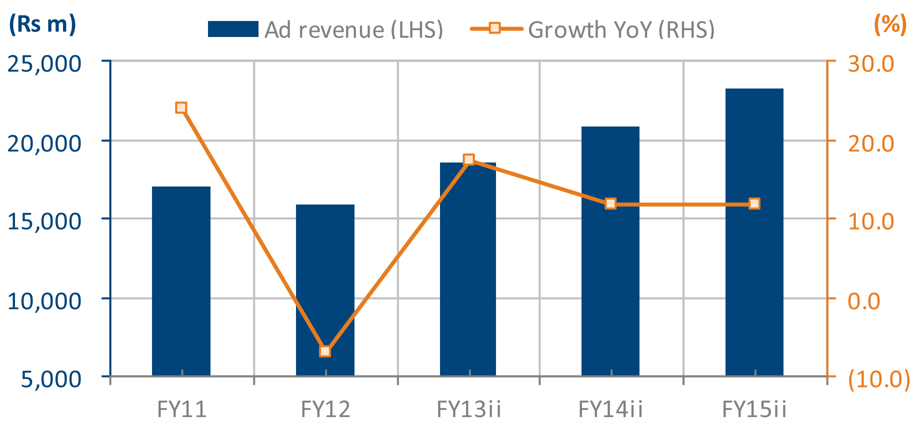
Strong earnings growth; Pay out on the rise

Ad spend in FMCG, the key advertising category, remains strong

Advertising revenue growth to remain robust

The recent deceleration in GDP growth has made investors nervous about the likely impact on ad-spend growth. We expect ad-spend growth to remain at 10% (~14.2% over FY05-12ii) because structural drivers such as low ad-spend-to-GDP ratio, strong consumption growth, increasing reach of television, and increasing brand penetration and premiumisation are in place. Also note that growth in the key advertising category, FMCG (accounting for ~55% of ad-revenue), remains strong. We expect Zee's ad-revenue to record 13% Cagr over FY12-15ii, higher than the industry, given its increasing network market share.

Figure 7.15: Ad-revenue growth set to accelerate after drop in FY12



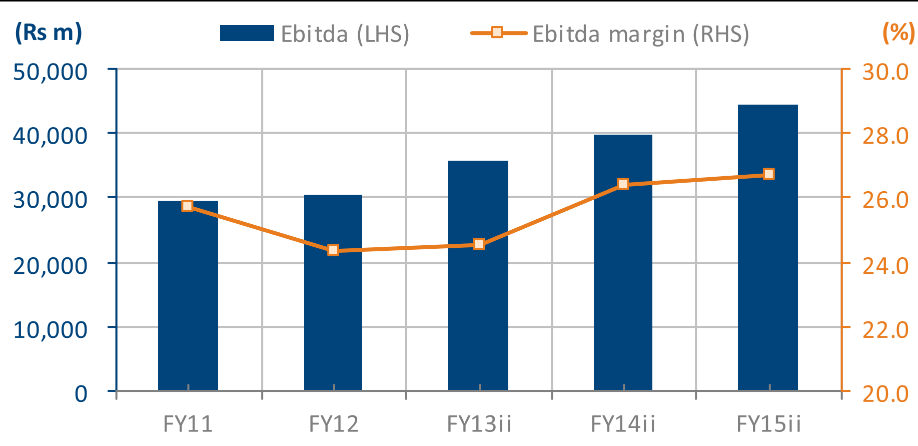
Source: Company, IIFL Research

Lower sports losses and higher subscription revenue would cushion margins

Margins not at risk despite investments

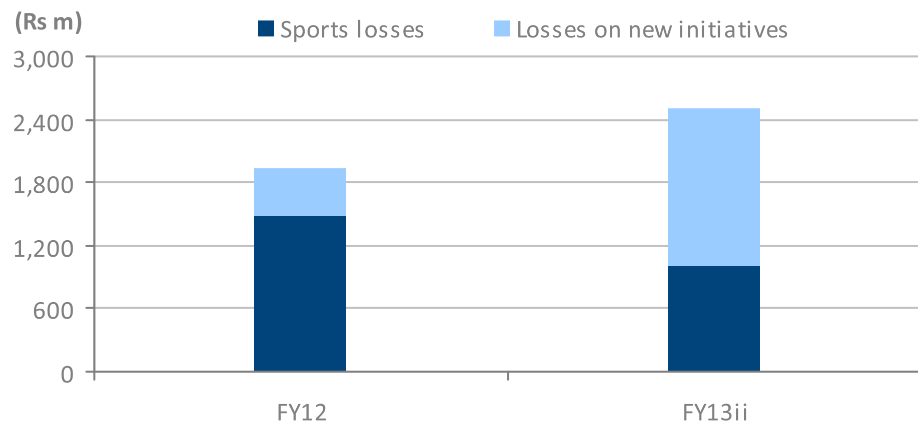
Zee has been increasing its investments in the existing bouquet and launching new channels as well. Investors are concerned that the resultant increase in expenses would lead to erosion of Ebitda margins. Despite an expected increase in expenses, we forecast an improvement in margins over the next two years. We see three margins levers. *Firstly*, sports losses would come down drastically in the quarters ahead. Additionally, digitisation would lead to better monetisation of sports content. Subscription revenue does not have any cost attached to it. Expected strong growth in this revenue stream increases Zee's flexibility to invest without hurting margins. *Lastly,* in the medium term as new initiatives build revenue streams their losses would reduce.

Figure 7.16: Zee's Ebitda margins set to improve



Source: Company, IIFL Research

Figure 7.17: Lower sports losses to offset increase in losses on new initiatives partly



Source: Company, IIFL Research

Higher subscription revenue and better monetisation of sports content on digitisation pose upside risks to our estimates

Expect earnings to grow at 16% Cagr over FY12-15ii

We expect strong revenue growth and improving Ebitda margins would drive 16% Cagr in earnings over FY12-15ii. There are several upside risks to our estimates, namely: 1) lower sports losses as monetisation of sports content improves in the digital environment; and 2) higher subscription revenue in FY15 if there is no delay in implementing phase II of digitisation.

Conversion of gross cash flow to operating cash flow has increased from <50% until FY09 to >75% in recent years

Cash conversion remains strong

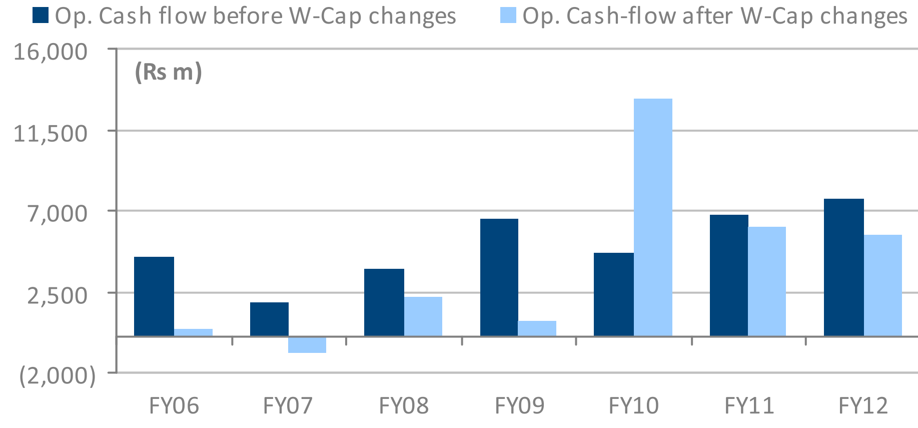
Despite strong profitability, Zee's operating cash flow until FY10 remained subdued owing to funds lent to group companies. In FY10, Zee recovered all the loans and stopped the practice of extending loans to group companies. This led to significant improvement in its cash generation. Conversion of gross cash flow to operating cash flow increased from less than 50% until FY09 to more than 75% in recent years. The decline in conversion of operating cash flow into free cash from 90% in FY11 to 75% in FY12 is primarily because of higher spend on movie rights.

Figure 7.18: Related-party lending has come down since FY10

Loans and adv. given
Loans and adv. (repayment recd.)
(Rs m)
18,000
15,000
12,000
9,000
6,000
3,000
0
FY06 FY07 FY08 FY09 FY10 FY11 FY12

Source: Company, IIFL Research.

Figure 7.19: Cash conversion remains healthy, although it is marginally hurt by higher working capital in FY12



Source: Company, IIFL Research. Cash profit from operations = NOPAT + depreciation

Zee's payout has gone up from 26% of PAT in FY08 to 68% in FY12

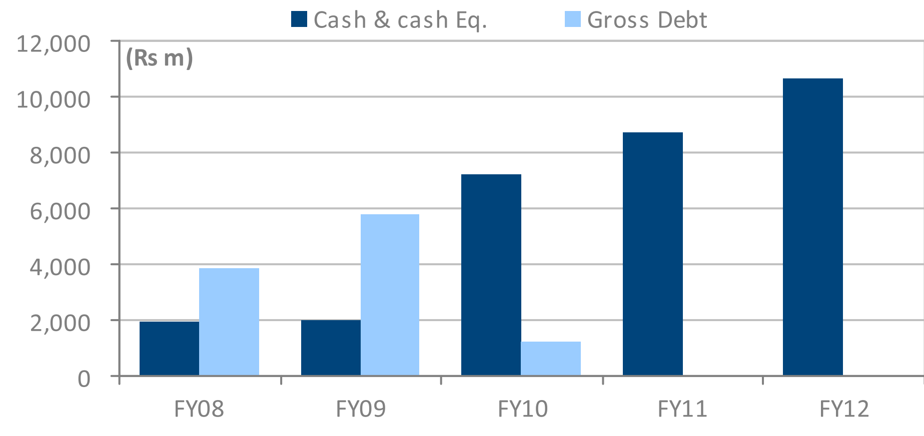
Payout to shareholders on rise

Zee has been consistently increasing its payout over the past five years. The company's payout (dividends + buyback) has gone up from 26% of PAT in FY08 to 68% of PAT in FY12. During the same period, the company has also turned from a net-debt (~Rs2bn net debt in FY08) to a net-cash company (Rs10.6bn net cash in FY12). This improvement is largely due to improved cash conversion led by better working capital management. The management believes that its growth plans and any inorganic growth can be easily funded from existing cash reserves and debt. Thus, we believe, the company will largely use free cash flow to pay shareholders.

Figure 7.20: Payout to shareholders on the rise

Source: Company, IIFL Research

Figure 7.21: Overall cash position has improved

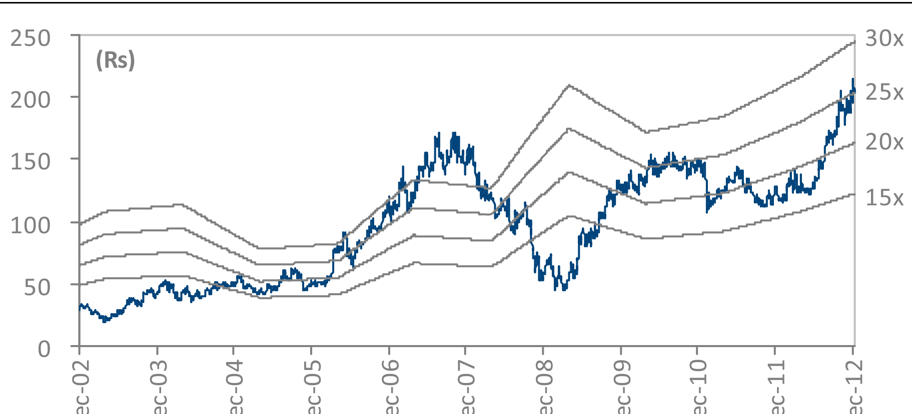


Source: Company, IIFL Research

Strong earnings growth and upside from digitisation to drive performance

Zee's cash generation has significantly improved over the past few years and the company has also increased its payout (dividend + buyback at 68% in FY12 vs 27% in FY08). A large proportion of subscription revenue and dependence on bouquet of channels lend high visibility to Zee's earnings. At 24x FY14ii P/E, valuations are reasonable considering high earnings visibility and potential upside from digitisation. We see upside risks to our estimate of 16% EPS Cagr for FY12-15ii from recovery in GDP growth and effective implementation of digitisation.

Figure 7.22: Zee is trading at 25x 1-year forward P/E multiple



Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ad-revenue growth (%)	59.4	(6.9)	17.4	11.9	11.8
Subscription revenue growth (%)	14.1	17.6	17.3	11.1	11.5
Sports losses (Rs m)	(1,974.0)	(1,480.0)	(1,000.0)	(1,000.0)	(1,000.0)

Source: Company data, IIFL Research

Financial summary

Earnings suppressed by sports losses and investments in new

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**29,436**	**30,405**	**35,597**	**39,676**	**44,263**
Ebitda	7,566	7,395	8,728	10,481	11,813
Depreciation and amortisation	(288)	(323)	(380)	(436)	(491)
Ebit	7,277	7,072	8,348	10,045	11,321
Non-operating income	851	1,384	1,460	1,600	1,615
Financial expense	(104)	(50)	(30)	(30)	(30)
PBT	8,025	8,406	9,778	11,615	12,906
Exceptionals	770	0	0	0	0
Reported PBT	8,795	8,406	9,778	11,615	12,906
Tax expense	(2,544)	(2,500)	(2,885)	(3,426)	(3,807)
PAT	6,251	5,906	6,894	8,188	9,099
Minorities, Associates etc.	118	(15)	(10)	(10)	(10)
Attributable PAT	**6,370**	**5,891**	**6,884**	**8,178**	**9,089**

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	5.7	6.1	7.2	8.6	9.5
DPS	2.0	1.5	2.0	3.0	3.5
BVPS	31.7	35.8	40.9	45.9	51.4
Growth ratios (%)					
Revenues	33.8	3.3	17.1	11.5	11.6
Ebitda	23.3	(2.3)	18.0	20.1	12.7
EPS	(17.9)	7.3	17.4	18.8	11.1
Profitability ratios (%)					
Ebitda margin	25.7	24.3	24.5	26.4	26.7
Ebit margin	24.7	23.3	23.5	25.3	25.6
Tax rate	28.9	29.7	29.5	29.5	29.5
Net profit margin	21.2	19.4	19.4	20.6	20.6
Return ratios (%)					
ROE	16.2	18.1	18.8	19.8	19.6
ROCE	23.1	25.9	26.7	28.1	27.8
Solvency ratios (x)					
Net debt-equity	(0.3)	(0.3)	(0.3)	(0.4)	(0.4)
Net debt to Ebitda	(1.2)	(1.4)	(1.5)	(1.6)	(1.7)
Interest coverage	NM	NM	NM	NM	NM

Source: Company data, IIFL Research

Healthy net cash position is sufficient to fund growth

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	8,722	10,607	13,265	16,471	20,058
Inventories	5,396	7,339	8,504	9,428	10,514
Receivables	8,955	8,690	10,174	11,340	12,651
Other current assets	4,818	6,105	6,105	6,105	6,105
Creditors	5,315	6,886	8,041	8,737	9,711
Other current liabilities	2,486	1,933	2,033	2,133	2,233
Net current assets	**20,090**	**23,922**	**27,974**	**32,474**	**37,384**
Fixed assets	8,582	9,432	10,042	10,396	10,694
Intangibles	0	0	0	0	0
Investments	2,099	675	675	675	675
Other long-term assets	192	337	337	337	337
Total net assets	**30,963**	**34,366**	**39,028**	**43,881**	**49,090**
Borrowings	17	12	12	12	12
Other long-term liabilities	0	46	46	46	46
Shareholders equity	**30,946**	**34,308**	**38,970**	**43,823**	**49,032**
Total liabilities	**30,963**	**34,366**	**39,028**	**43,881**	**49,090**

Steady free cash flow; Significant improvement in payout in FY12

Cash flow summary (Rs m)

z	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	7,277	7,072	8,348	10,045	11,321
Tax paid	(2,657)	(2,500)	(2,885)	(3,426)	(3,807)
Depreciation and amortization	288	323	380	436	491
Net working capital change	(683)	(1,947)	(1,394)	(1,293)	(1,323)
Other operating items	1,501	1,151	0	0	0
Operating cash flow before interest	5,727	4,099	4,449	5,761	6,682
Financial expense	(104)	(50)	(30)	(30)	(30)
Non-operating income	851	1,384	1,460	1,600	1,615
Operating cash flow after interest	**6,475**	**5,433**	**5,879**	**7,331**	**8,267**
Capital expenditure	**(389)**	**(1,260)**	**(1,000)**	**(800)**	**(800)**
Long-term investments	(217)	1,424	0	0	0
Others	(949)	274	0	0	0
Free cash flow	**4,919**	**5,872**	**4,879**	**6,531**	**7,467**
Equity raising	70	(2,311)	(5)	0	(1)
Borrowings	(1,178)	(5)	0	0	0
Dividend	(2,274)	(1,671)	(2,217)	(3,325)	(3,879)
Net chg in cash and equivalents	1,537	1,885	2,657	3,207	3,587

Source: Company data, IIFL Research

Technical analysis of Zee Ent.

Zee's stock price, after going through a long consolidation phase, has managed to confirm the horizontal line breakout after stock cemented its position above Rs180 for more than four weeks. A confirmation of a horizontal line breakout after an 'ascending triangle' pattern should act as catalyst for significant price appreciation.

Unfolding of a bullish ascending triangle: The major trigger for the stock came in after it surged above the resistance line of ascending triangle above Rs150 after which there was no looking back. The positive momentum accentuated further after prices surged above the 2008 peak, projecting a target of Rs300 and above.

Retracement projection: The all-time peak for Zee happened during 2000. The prices are now breaking out from the consolidation phase and are likely to retrace at least 61.8% of the earlier down move, which also coincides with the Rs300 levels.

Affirming RSI adds to optimism: Weekly RSI has entered in super bull market trading zone after the weekly close above 65 levels. It is now expected to hover in the trading band of 60-80 in the near term. Breakout is also visible in the momentum oscillator.

Mixed trend on the comparative strength: The weekly ratio chart of Zee with S&P CNX 500 has been facing a hurdle at around 0.045, despite a symmetrical breakout earlier. Once the immediate hurdle is cleared, outperformance is expected to increase 28%.

Zee Entertainment – 10 year share price performance chart

(Rs/share)

250
200
150
100
50
0

Shareholders approve Rs7bn buyback programme

Formation of MediaPro (Zee-Star distribution JV)

Demerger of cable business into WWIL and News & Regional broadcasting business into Zee News

Zee acquires regional entertainment business from Zee News

Zee aquires 50% stake in Ten sports

Indian govt grants first DTH license to Essel group

Demerger of DTH business into Dish TV

Market share of flagship channel recovers from lows of 2HFY12

Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

CMP	**Rs221**
Target 12m	**Rs270 (22%)**
Market cap (US$ m)	**2,601**
Enterprise value (US$ m)	**2,597**
Bloomberg	**MRCO IN**
Sector	**FMCG**

Dec 14 2012

52Wk High/Low (Rs)	250/134
Shares o/s (m)	645
Daily volume (US$ m)	2
Dividend yield FY13ii (%)	0.4
Free float (%)	40.2

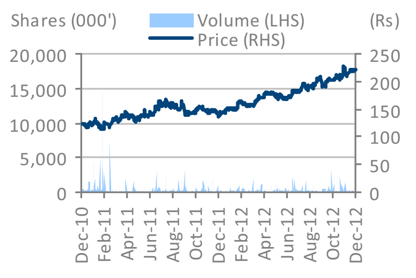
Shareholding pattern (%)

Promoter	59.8
FII	26.4
DII	6.7
Others	7.1

Price performance (%)

	1M	3M	1Y
Marico	(3.7)	11.6	54.1
Absolute (US$)	(2.3)	11.1	52.1
Rel. to Sensex	(7.2)	6.9	32.4
CAGR (%)		3 yrs	5 yrs
EPS		17.5	26.1

Stock movement



Avi Mehta
avi.mehta@iiflcap.com
91 22 4646 4650

www.iiflcap.com

Marico Industries BUY

Well oiled

Marico operates in the hair care segment with leadership position in its key markets of Asia, the Middle East, and Africa. It has gained market share in India in the hair oil and healthy edible oil segments underpinned by its brand strength and strong distribution network. We expect this trend to continue. Further, strong growth in its international operations, where it is cross-pollinating products/entering new geographies, and lower losses in its Kaya skin clinics should drive 23% EPS Cagr over FY12-15ii. Marico's strategy of investing gross margin gains in developing brands in new, fast-growing categories provides comfort that earnings will remain resilient over the long term. The stock trades at a reasonable 28x FY14ii earnings.

Market share gains in hair oil and edible oils to continue: Marico's market share in the hair oil and healthy edible oil segments has gone up 420-760bps over the past nine quarters. We expect this trend to continue given the unorganised nature of the market, Marico's portfolio of market-leading brands, its focus on volume growth, and support from an extensive distribution network. This should drive 17% Cagr in domestic consumer product earnings over FY12-15ii.

Investing gross margin gains in development of brands in new categories: Marico does not cut prices for large coconut hair oil packs despite fall in copra prices, a strategy it has followed over the past 11 years. It has invested most of these gross margins gains in developing brands (such as body lotions, oats, and Paras brands) in new fast-growing categories. Marico's demonstrated success in developing brands in allied (haircode hair dye in Bangladesh, value added hair oils in India etc) and new categories (market share gains in skin lotion category) supports our belief that this strategy would enhance long-term earnings growth.

Strong cash flow generation to drive debt reduction: Improving political environment in some of the countries where it is present, penetration gains in new markets, and reducing losses at Kaya should drive 23% earnings Cagr over FY12-15ii. Free cash flow of Rs10bn arising from this over FY14-15 should help repay debt taken for the Paras acquisition and turn Marico into a net cash company.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	31,350	40,083	48,027	55,412	63,986
Ebitda margins (%)	13.3	12.1	13.2	13.6	13.7
Pre-exceptional PAT (Rs m)	2,541	3,189	3,963	5,149	6,233
Reported PAT (Rs m)	2,864	3,171	3,963	5,149	6,233
Pre-exceptional EPS (Rs)	4.1	5.2	6.2	8.0	9.7
Growth (%)	5.8	25.4	18.6	29.9	21.1
IIFL vs consensus (%)			(6.1)	(0.4)	(1.4)
PER (x)	**53.3**	**42.6**	**35.9**	**27.6**	**22.8**
ROE (%)	32.4	31.0	25.4	23.5	23.2
Net debt/equity (x)	0.6	0.5	0.4	0.2	0.0
EV/Ebitda (x)	33.7	29.3	23.8	19.5	16.2
Price/book (x)	14.8	11.9	7.2	5.9	4.8

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Company snapshot

Business description

Marico operates in personal care and packaged foods categories in India with a significant presence in hair oils and edible oils segment. Its key domestic brands include: Parachute, Nihar, Hair and Care (hair oil segment), Saffola (premium edible oils, breakfast cereals), Zatak (deodorants), Livon (hair serum). The company has a strong international presence spread across Bangladesh, Middle East and North Africa (MENA), South East Asia, and South African regions. Marico has a presence in the skin-care solutions segment through 102 Kaya Skin Clinics located in India, the Middle East and four DermaRx stores located in Singapore and Malaysia

Figure 8.1: Portfolio of market-leading brands in fast growing categories

Segment	FY12 share*	Key brands	Comments
Domestic consumer products			
Coconut hair oil	24%	Parachute, Nihar	• Market leader with 57% market share • Volume growth of 11% in FY12
Value added hair oils	14%	Nihar, Hair and care	• 25% market share in value added hair oils • Volume growth of 24% in FY12
Premium edible oil	15%	Saffola	• Market leader with 58% market share • Volume growth of 11% in FY12
Personal care		Parachute body lotion, Set wet, Zatak and Livon	• Largest player in hair gels with 38% share • Third largest player in deodorant market with 6% market share
Packaged Foods		Saffola	• Second largest player in oats category • Presence in muesli, packaged rice segments
Others		Revive, Manjal, Medicker	• Fabric conditioning, soaps and lice treatment shampoo
Skin care services			•
Kaya skin care services	7%	Kaya, Derma RX	• Presence in India, Singapore, Malaysia and Middle East
International business	24%		• Presence in Bangladesh, MENA, South East Asia and South Africa

Source: Company, IIFL Research; * share of FY12 revenues

Figure 8.2: Acquisition-led growth strategy in the international segment

Region	FY12 share*	Key products	Remarks
Bangladesh	39%	Hair oil and hair dye (Parachute, Haircode)	• Parachute: Leader in coconut hair oil with 80% market share • Leader in hair dye under Haircode brand
MENA	27%	Hair care (Fiancée, Haircode, Parachute)	• Leader in Egypt hair care market with 57% market share
South East Asia	19%	Male grooming, women skin care range (X-men, Lovite, Code 10)	• Leadership in male shampoo market in Vietnam • No 2 in Vietnam male deodorant market
South Africa	11%	Hair care (Caivil just for kids, Black Chic)	• Leadership in kids hair care market in South Africa

Source: Company, IIFL Research; * Share of FY12 international revenues

Figure 8.3: Key management

Name	Designation	Comment
Harish Mariwala	Chairman and MD	Founded Marico in 1990.Transformed a traditional commodity-driven business into a leading consumer products and services company
Saugata Gupta	CEO - Consumer products business	B.Tech from IIT, Kharagpur and MBA from IIM-Bangalore. Has been with Marico since January,2004
Vijay Subramaniam	CEO - International business group	B.E from Madras University and MBA from JBIMS. Has been with Marico since March 2006
Ajay Pahwa	CEO - Kaya ltd	Graduate from Delhi university and MBA from IMD Lausanne (Switzerland). Has been with Marico since November,2009
Milind Sarwate	Group CFO	B.com from Mumbai university and CA, ICWA and CS .Has been with Marico since February, 1998

Source: Company, IIFL Research

Market leadership in hair oil/ edible oil segments to drive earnings

Marico has strong brands in the hair oil and premium edible oil markets in India, which are market leaders in their categories. Despite this, the company continues to gain market share in these segments (420 bps share gain in coconut hair oil and 760bps gain in edible hair oil segments over the past nine quarters). In the coconut hair oil segment, it has maintained focus on volume growth and sustained gross margins in a band. In addition, the strong functional positioning of the Saffola brand as a healthy oil alternative should continue to drive market share gains in the edible oil segment.

We expect 17% Cagr in domestic consumer product revenue over FY12-15ii, driven by continued market share gains in hair oil (55% of domestic revenue) and edible oils (22% of domestic revenue) led by strong product positioning and extensive distribution network.

Industry-leading growth to continue in the hair oil category given market leadership

The Indian hair oil category is the largest segment in the hair care market and is likely to see continued growth as Indians continue to prefer hair oils for their hair care needs. Coconut hair oil (48% share) dominates the Rs67bn hair oil category. Value added hair oils comprising Amla-based oils, light hair oils, cooling oils, and others constitute the rest.

Growth rates in the value added hair oils segment has been stronger than in coconut hair oils, reflected in the fact that the share of value added hair oils has increased 200bps YoY to 52%.

Figure 8.4: Hair oil market dominated by coconut category

Hair care market (Rs128bn)
→ Hair oil market (Rs67bn)
→ Coconut oil (Rs32bn) (48% share) | Amla based oil (Rs10bn) (15% share) | Light hair oil (Rs10bn) (15% share) | Cooling oils (Rs8bn) (12% share) | Others (Rs7bn) (10% share)

Source: Industry, Company, IIFL Research

Marico dominates the coconut hair oil segment with its flagship brands Parachute and Nihar, which account for 57% market share as of 1HFY13. Even in the value added hair oil segment, the company is a strong player with c25% market share.

Rural penetration and focus on volumes to drive growth in coconut hair oil

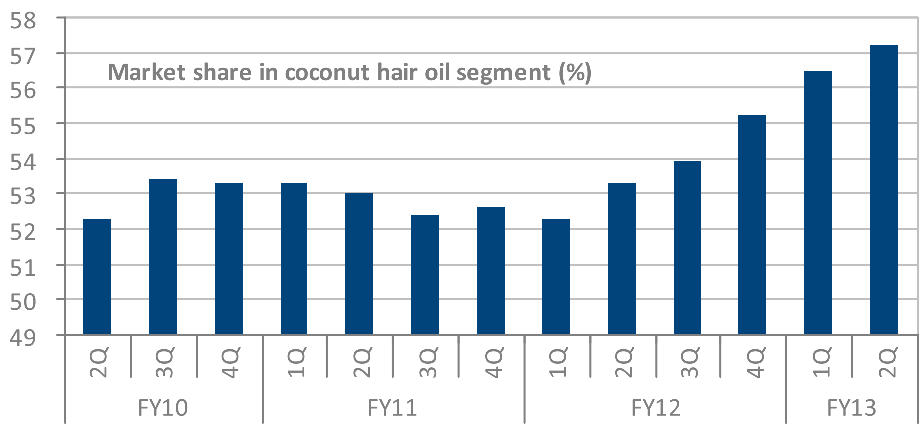
Rural penetration and focus on volumes to drive healthy 11% Cagr in coconut oil revenue

We expect strong growth in the coconut oil segment as Marico's leading brands Parachute and Nihar continue to gain market share from other branded and unbranded players. This would be supported by: 1) consumers upgrading to branded coconut hair oils from the unbranded/ loose format; 2) increasing penetration in rural markets

where Marico's market share is half that in urban areas; and 3) brand strength of the Parachute and Nihar.

Has gained market share for the last 12 quarters

Figure 8.5: Gained 490bps market share over the past 12 quarters in coconut hair oil

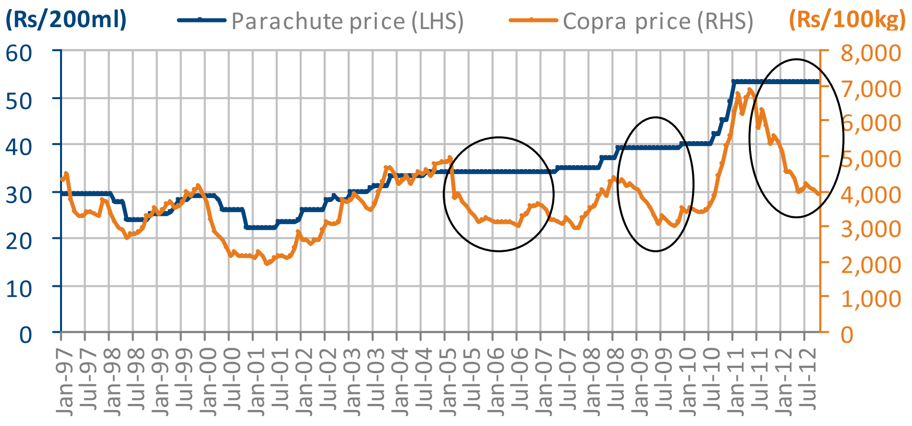


Source: Company, IIFL Research

Parachute's and Nihar's strong brand equity reflects in the fact that Marico has not cut prices of Parachute since 2002 (except for short-term promotions), despite going through two complete copra cycles.

Strong brand equity has allowed it to avoid price cuts over last three copra cycles

Figure 8.6: No price cuts taken over the past three copra cycles

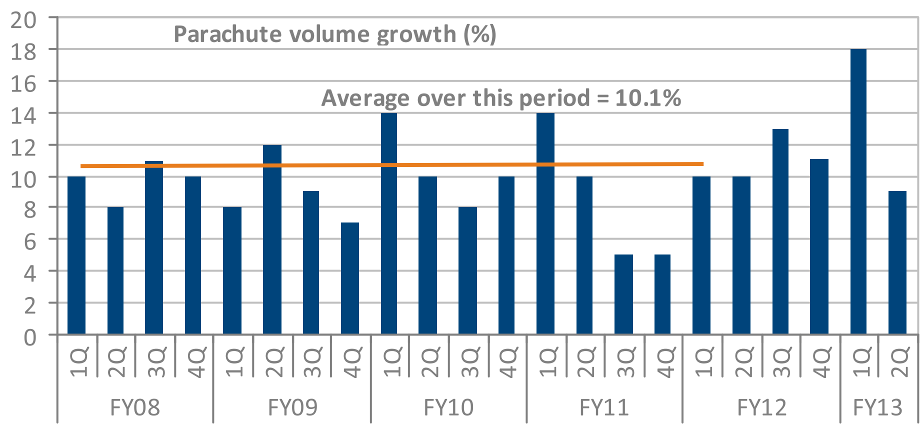


Source: Company, IIFL Research

We believe that distribution expansion in rural areas gives the management confidence that it can deliver higher-than-average growth in the medium term in case of the Parachute brand.

Coconut hair oil has grown at average 10% over 22 quarters

Figure 8.7: Coconut oil volumes growing at an average 10% over the past 22 quarters



Source: Company, IIFL Research

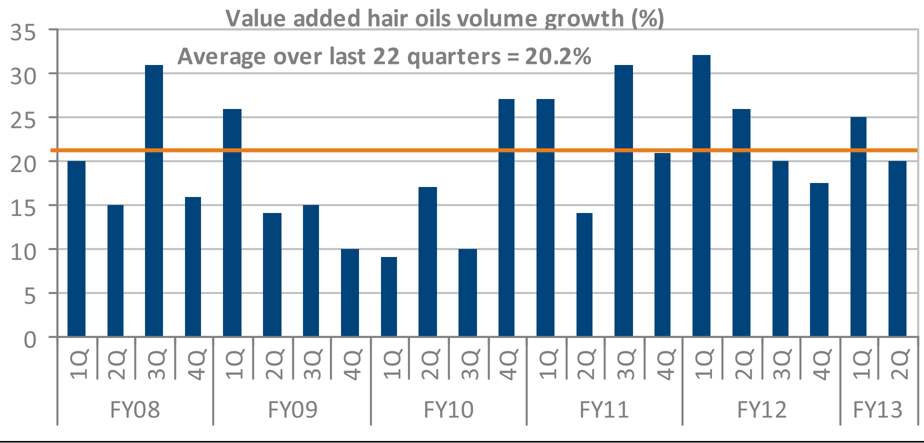
<u>Scale benefits from coconut oil leadership to support growth in value added hair oils</u>

Marico is a strong player in the value added hair oils segment with 25% market share. It occupies a strong number two and three position in the amla and light hair oil categories respectively, but has not been able to gain significant market share from competitors in the cooling oil segment.

Market leadership in coconut hair oil to aid growth in fast growing value added hair oils segment

Its strong position in the key coconut hair oil segment (c50% of the market) and its investments in enhancing rural distribution should drive 15-17% volume growth in the value added hair oil segment over the next 2-3 years as it continues to gain market share from competitors in this segment. Note that over the past 10 quarters, the company has increased its market share by 370bps to 25% through an aggressive pricing strategy.

Figure 8.8: Growth in value added hair oils has been higher



Source: Company, IIFL Research

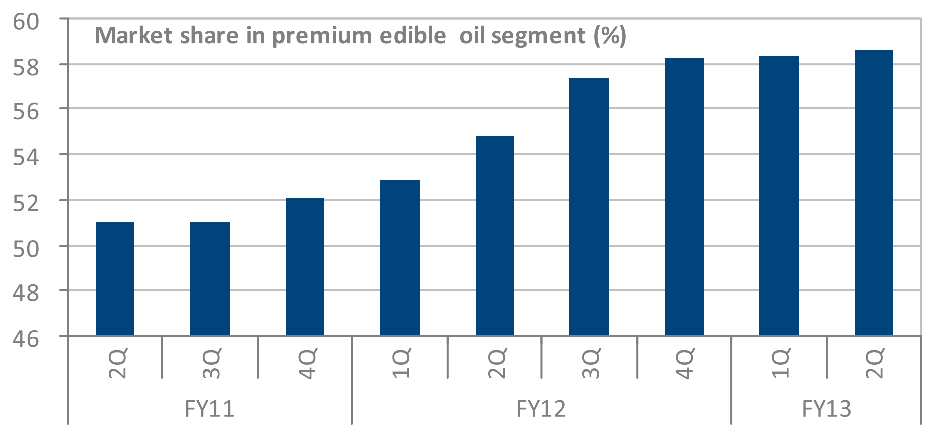
Continued market share gains in the under-penetrated healthy edible oil category

The Rs750bn edible oil market in India is highly unorganised with unorganised players accounting for c75% market share. Even in the organised market, premium packaged edible oils account for 5% share, reflecting the huge opportunity landscape.

Strong functional brand positioning around health in the under-penetrated edible oil segment

Saffola is the leader in the premium refined oil segment, accounting for 59% market share. Saffola has benefited from growing health awareness and rising disposable incomes of Indians. The brand enjoys a functional positioning on the health platform and has seen continued market share gains over the past nine quarters.

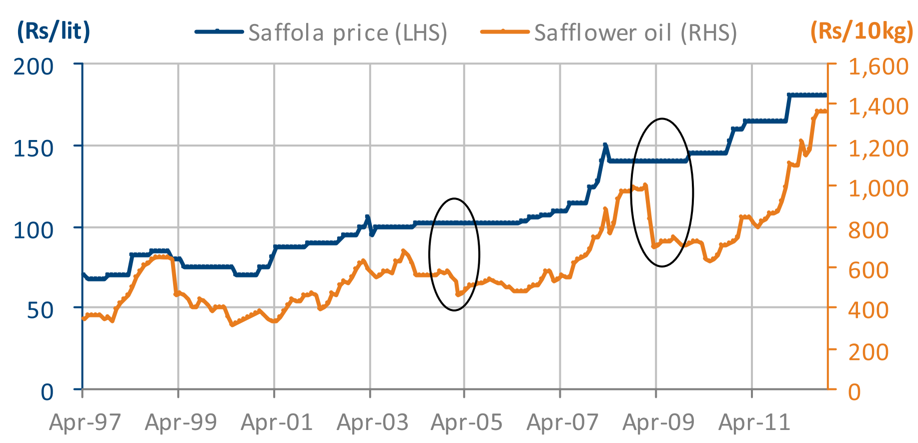
Figure 8.9: Gained 760bps market share since 1QFY11



Source: Company, IIFL Research

Maintained price levels despite input price reductions

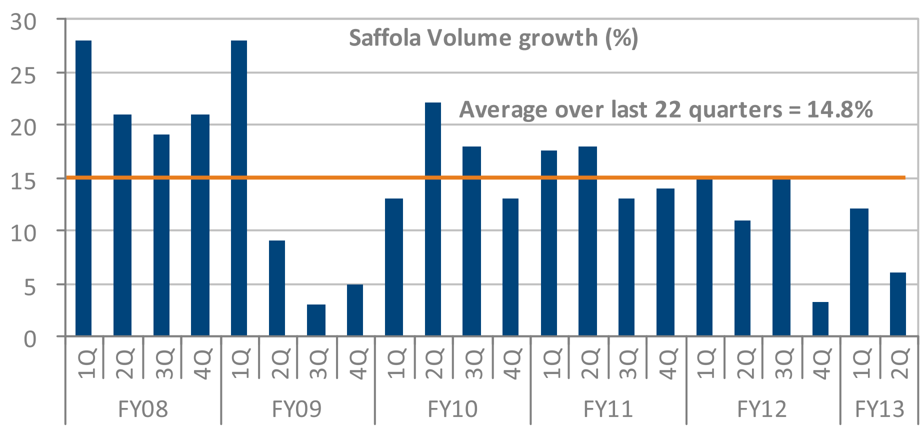
Figure 8.10: Has not cut prices despite input price reductions



Source: Company, IIFL Research

Volume growth likely to bounce back to historical levels on steady state basis

Figure 8.11: Volume growth likely to bounce back to historical levels on steady-state basis

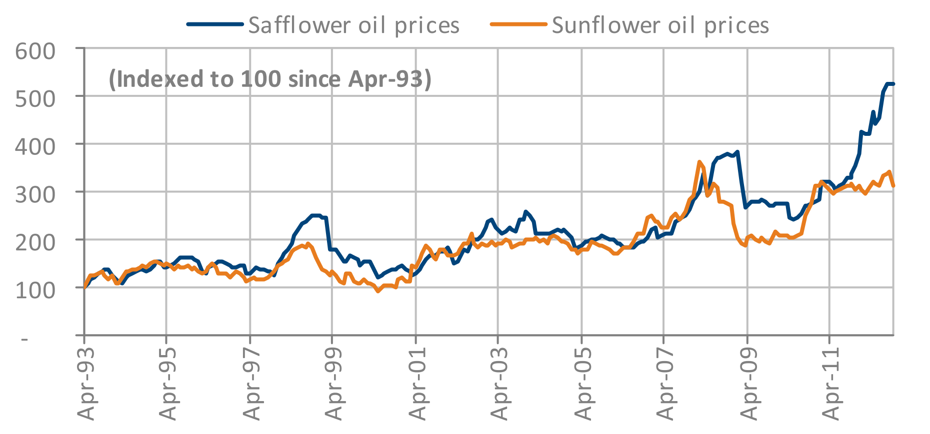


Source: Company, IIFL Research

The company should see market share gains going forward as its key rival, Sundrop, also focuses on margin over volume and hence steps back from pricing competition. However, volume growth has remained under pressure in the near term due to weak CSD sales and decline in rate of conversion of consumers to premium edible oils from regular refined edible oils. The rate at which consumers upgrade to Saffola has been impacted by expansion in the premium of Saffola vis-à-vis other refined edible oils (as inflation in safflower oil is significantly higher than inflation in sunflower oil).

Premium between sunflower and safflower oils likely to correct

Figure 8.12: Increasing premium between sunflower and safflower oils likely to correct going forward



Source: Company, IIFL Research

Near-term revenue growth and margins would remain under pressure as the company looks to take pricing action to spur volumes. Nevertheless, increasing health awareness and a strong functional brand positioning give us confidence that medium-term growth rate in edible oils segment would remain strong.

Leadership position in most international geographies

Marico has followed an acquisition-led strategy for growth in the international segment, acquiring businesses in the hair care segment in fast growing emerging markets. The geographies in which it operates are: Bangladesh (39% of revenue), MENA (27% of revenue), South East Asia (19% of revenue) and South Africa (11% of revenue). Marico is the market leader in Bangladesh and Egypt and has a strong presence in the other geographies.

Acquisition led growth strategy in international business

Figure 8.13: Acquisition-led strategy for international expansion

Year	Brands	Category	Comment	Amt (Rs m)
2006	Hair Code and Fiancée	Hair Care	Leadership position in hair creams and gels market in Egypt	NA
2007	Caivil, Black Chic and Hercules	Ethnic hair care and complementary medicines	Presence across premium to value for money hair care products in South Africa	520
2010	Code 10	Hair gels and creams	Among top 3 in Malaysian hair creams and gels market	200-250
2010	Derma Rx	Skin care solutions	Strong portfolio of skin care products for various skin problems Clinics in Singapore and Malaysia	NA
2011	X-men, Lovite and Thlian Pat	Personal care and food segment	Leadership position in male shampoo market in Vietnam	NA

Source: Company, IIFL Research

Marico's leadership position across geographies + ability to introduce and develop brand extensions successfully to result in strong's international growth

The company has seen weakness in growth in 1HFY13 due to subdued growth in Bangladesh and political uncertainty in Egypt. However, we remain confident of 17% revenue Cagr in the international segment over FY12-15ii, given Marico's leadership position across these geographies and its ability to introduce and develop brand extensions in these markets successfully.

New product introductions to aid growth in Bangladesh market (39% of international revenue)

Marico is the market leader in Bangladesh in coconut hair oils (80%+ market share). The company has successfully developed its "Haircode" brand in Bangladesh in the powdered hair dye segment, reaching No 1 position within three years of launch (in Sept-08). Even in the recently launched value added hair oils, the company had garnered 19% market share within two years of launch. We believe that the company should see healthy revenue growth going forward, on the back of strong growth in new categories (value added hair oils and powdered hair dye).

Expansion into new geographies to aid growth in MENA region (27% of international revenue)

Growth in the MENA region has been impacted by one-off events such as political uncertainty in some regions, disruption due to change in pack size in hair creams and restructuring of its distribution channels. Growth should bounce back over the medium term and benefit from geographical expansion into new countries.

Geographical expansion and market share gains to aid South East Asian growth (19 % of international revenue)

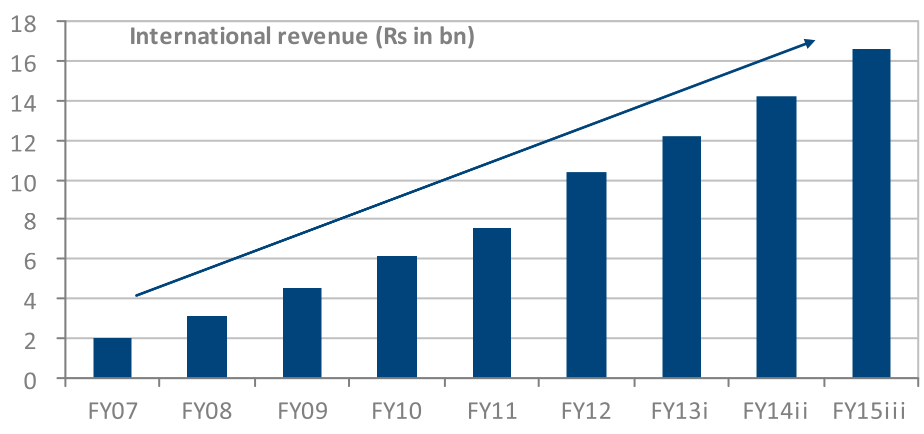
The company enjoys leadership in Vietnam's men's shampoo segment and has been gaining market share since acquisition of the business in Feb-11 (up 1200bps to 47% since acquisition). Also, in the male deodorant market in Vietnam, it is a formidable number 2. Furthermore, Marico has received good response to the "Code 10" brand extensions launched in the Malaysian market. We believe that continued market share gains (given strong brand strength) and geographical expansion into Myanmar, Nepal and Bhutan should aid growth in this geography.

Market share gains in existing categories and expansion into sub-Sahara region to drive South Africa growth (11% of international revenues)

Inflationary situation in South Africa has resulted in downtrading in South Africa's ethnic hair care segment. Despite this, Marico has sustained its leadership position in the kid's hair care market while benefiting from strong brands in the value-for-money hair care

segment. The opportunity landscape remains high, given proximity to the large sub-Sahara market.

Figure 8.14: International segment to see 17% Cagr in on pick-up in the Bangladesh and MENA regions



Source: Company, IIFL Research

Investing into development of brands in new fast-growing categories

We believe that company's strategy to invest gross margin gains in developing brands of new products (such as body lotions, oats) and Paras brands (reflected in 2QFY13 results) should aid development of long-term levers of revenue growth and enhance the company's growth potential.

We are increasingly confident that Marico would be able to generate market leaders from these new brands, given its successful history of developing new brands in other geographies. For example, Haircode hair dye has become the market leader in Bangladesh with 29% market share within three years of launch (in 2009).

In addition, its Marico's ability to attain a healthy 6% market share in the highly competitive skin lotion segment (with established FMCG players such as HUL, P&G, Emami) within a year of launch reflects its ability to penetrate new and competitive categories.

New categories have the potential to turn into major contributors to revenue growth

Leveraging on the healthy brand positioning for Saffola, Marico has entered the healthy packaged foods space under Saffola brand extensions. These include oats, muesli, flour additives for cholesterol management and low glycemic index rice. The packaged foods segment is worth Rs825bn and growing at 15-20% annually for the past few years and offers a large opportunity landscape for growth, given increasing awareness among Indian consumers. The company is confident that these new categories would account for c25% of Saffola's revenue (4% of consolidated revenue) over the next 2-3 years.

Has become second largest oats players within three years of launch

The fact that Marico has become the second-largest player (12% market share) in the competitive Rs2-3bn oats segment within three years of launch (launched in July 2010) is a testimony to its ability to develop brands in new categories. We are confident that the

company would see similar healthy growth in its muesli foray, given the strength of the Saffola brand.

Gained 6% market share in highly competitive body lotions segment within a year

Another category that may become a huge game changer for the company is skin lotions in which Marico's Parachute brand extension has become the third-largest player (6% market share) within a year of launch. This is despite competition from established companies such as HUL, P&G, and Emami. The Rs5.5bn skin lotions market is relatively under-penetrated (20% penetration), and has been seeing strong 25%+ growth for the past few years. Furthermore, strong brand positioning in skin lotions would offer a toehold in the Rs50bn skin care segment where Marico would be able to cross-pollinate products from other geographies.

New categories have the potential to turn into major contributors to revenue growth

Figure 8.15: New categories have potential to turn into major revenue contributors

Brand	Category	Comment
Saffola oats, Saffola muesli, Saffola Arise	Oats, Muesli and packaged rice	• Presence in the healthy packaged foods segments (Rs825bn) which has grown at 15-20% annually • Second largest player in Oats segment with 12% market share within 3 years of launch • Expect these brands to account for 25% of Saffola's revenues over next 2-3 years
Parachute Advansed skin lotion	Skin lotions	• Presence in Rs5.5bn skin lotion category which has been growing at 25%+ for last few years • Third largest player with 6% market share within a year of launch despite stiff competition • Offers toehold into Rs50bn skin care market
Set wet hair gel	Hair gel	• Emerging market as youth preferring gels for hair styling. Enjoys market leadership with c24% share
Livon hair serum	Hair serum	• Niche category in the hair care market expected to grow at 20%+ level. Market leader with 68% share
Zatak deodorant	Deodorants	• Highly competitive cRs9bn market growing at 40% levels. Third largest player with 6% market share

Source: Company, IIFL Research

Acquisition of Paras brands provides a platform to exploit new, fast-growing categories

Marico acquired a portfolio of market leading personal care brands from Reckitt Benckiser (which Reckitt had earlier acquired from Paras) in the hair care and deodorant categories. The acquisition of these brands, chief among them Set Wet (hair gels), Zatak (deodorants), Livon (hair serums) provides Marico a platform to exploit growth in these categories (each category is growing at 20-40% over the past few years) and access to new distribution channels to develop brands in allied categories.

Strong portfolio of youth-centric brands to exploit new fast growing categories

Figure 8.16: Paras brands provide a platform to exploit growth in the hair care and deodorants categories

Brand	Category	Comment
Set wet	Hair gels	• Market leader in India hair gel segment with c24% share
Livon	Hair serum	• Market leader in India hair serum segment with 68% market share
Zatak	Deodorant	• Third largest player in the Indian deodorant market with 6% market share

Source: Company, IIFL Research

Management remains confident of 25-30% growth in the Paras portfolio over next 2-3 years as it leverages its distribution network and scale benefits to market these brands. We remain bullish on growth in hair gels and hair serums markets (given the brand's leadership positioning in these markets). Nevertheless, we believe gaining market share in a highly competitive and relatively less brand conscious deodorants market will not be smooth. Having said that, Marico's performance in the highly competitive skin lotions segment showcases its ability to gain market share in a highly competitive market.

23% Cagr in consolidated earnings on strong growth in key hair oil and edible oil segments

While new initiatives (Saffola foods, Parachute skin lotions, Paras brands) should see healthy 20-35% growth over FY12-15ii, revenue growth would continue to be driven by performance in the hair oils and edible oils categories over the next 2-3 years. We expect domestic consumer product revenue to grow at 17% Cagr over FY12-15ii on the back of continued market share gains in the coconut hair oil and value added hair oils category.

Increasing share of product sales (23-25% of revenue in 1HFY13 vs. 13% in FY10), improving footfalls at Kaya stores, and a focus on cost rationalisation, should aid the current trend of reducing losses. However, we believe that breakeven would take a year more.

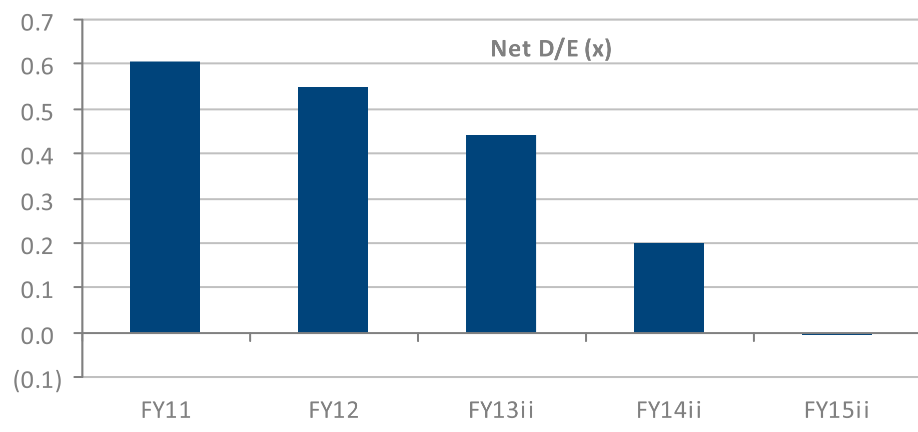
This coupled with improvement in the political environment in some of the countries in which Marico is present and penetration gains in new markets/ products should drive 17% Cagr in consolidated revenue over FY12-15ii.

We believe that Marico is unlikely to cut prices of large packs in coconut oils, except for short-term promotions, an approach it followed over the past 10 years over two copra cycles. In addition, international Ebitda margins should start touching the 13-14% level from the current 11-12%, as demand conditions improve and operational improvement initiatives bear fruit. However, promotions to sustain volumes and investments into new brands are likely to cap consolidated Ebitda margins at 13-14% level. Ebitda growth, however, would remain strong at 22% Cagr over FY12-15ii on the back of healthy revenue growth.

To turn into a net cash company in FY15

To fund the Rs7.4bn acquisition of Paras brands from Reckitt, the company had taken cRs3bn debt and made a Rs5bn QIP (Qualified Institutional Placement) issue. The resultant higher interest costs weighed on profits. However, with estimated free cash flow of Rs10bn generated from operations over the next two years, we expect the company to turn from a net debt (D/E=0.4x) company in FY13 to a net cash company in FY15.

Figure 8.17: To turn a net cash company in FY15



Source: Company, IIFL Research

The reduction in interest costs along with a 22% Cagr in Ebitda should help drive 23% EPS Cagr over FY12-15ii

Figure 8.18: EPS to grow at 23% Cagr over FY12-FY15ii

	FY11	FY12	FY13ii	FY14ii	FY15ii	Cagr FY12-FY15ii
Revenue	31,350	40,083	48,027	55,412	63,986	17%
% YoY	17.8	27.9	19.8	15.4	15.5	
Ebitda	4,181	4,844	6,332	7,526	8,752	22%
% margin	13.3	12.1	13.2	13.6	13.7	
% YoY	11.4	15.9	30.7	18.9	16.3	
Interest	410	424	576	331	191	(23%)
% YoY	59.6	3.4	35.8	(42.6)	(42.3)	
Adjusted PAT	2541	3189	3963	5149	6233	25%
% margin	8.1	8.0	8.3	9.3	9.7	
Adj EPS	4.7	5.2	6.2	8.0	9.7	23%
% YoY	5.8	25.4	18.6	29.9	21.1	
Reported PAT	2,864	3,171	3,963	5,149	6,233	25%
% YoY	23.6	10.7	25.0	29.9	21.1	

Source: Company, IIFL Research

Key concerns

- **Imposition of excise duty on coconut hair oil packs:** Marico has contested claims made by the Indian excise department that coconut hair oil sold in less than 200ml packs should attract excise duty. Marico believes that since the product is classified as edible coconut oil, excise duty is not applicable. The matter is currently sub-judice in the Supreme Court. As of 1HFY13, potential liability from an unfavorable verdict amounts to Rs3.3bn (c60% of FY13 PBT). Note that on six prior occasions, the Appellate Tribunal benches upheld Marico’s stand. Further, we believe a 2% price increase across the portfolio (which is not difficult) can offset the impact of the imposition of excise duty.
- **Slowdown in consumer demand**
- **Higher losses at Kaya skin clinics**

Financial summary

Volume led revenue growth

To turn into net cash company by FY15

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**31,350**	**40,083**	**48,027**	**55,412**	**63,986**
Ebitda	4,181	4,844	6,332	7,526	8,752
Depreciation and amortisation	(708)	(725)	(900)	(932)	(964)
Ebit	3,473	4,119	5,432	6,594	7,788
Non-operating income	212	326	363	422	490
Financial expense	(410)	(424)	(576)	(331)	(191)
PBT	3,275	4,021	5,220	6,686	8,088
Exceptionals	323	(18)	0	0	0
Reported PBT	3,598	4,003	5,220	6,686	8,088
Tax expense	(684)	(783)	(1,201)	(1,471)	(1,779)
PAT	2,914	3,221	4,020	5,215	6,309
Minorities, Associates etc.	(50)	(50)	(57)	(65)	(75)
Attributable PAT	**2,864**	**3,171**	**3,963**	**5,149**	**6,233**

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	4.1	5.2	6.2	8.0	9.7
DPS	0.8	0.8	0.9	1.0	1.0
BVPS	14.9	18.6	30.6	37.4	45.9
Growth ratios (%)					
Revenues	17.8	27.9	19.8	15.4	15.5
Ebitda	11.4	15.9	30.7	18.9	16.3
EPS	5.8	25.4	18.6	29.9	21.1
Profitability ratios (%)					
Ebitda margin	13.3	12.1	13.2	13.6	13.7
Ebit margin	11.1	10.3	11.3	11.9	12.2
Tax rate	19.0	19.5	23.0	22.0	22.0
Net profit margin	9.3	8.0	8.4	9.4	9.9
Return ratios (%)					
ROE	32.4	31.0	25.4	23.5	23.2
ROCE	26.1	24.3	23.3	22.8	25.7
Solvency ratios (x)					
Net debt-equity	0.6	0.5	0.4	0.2	0.0
Net debt to Ebitda	1.3	1.3	1.4	0.6	0.0
Interest coverage	8.5	9.7	9.4	19.9	40.8

Source: Company data, IIFL Research

Increase due to acquisition of Paras brands

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	2,206	1,588	1,638	2,082	3,477
Inventories	6,011	7,202	8,421	9,716	11,219
Receivables	1,779	1,816	2,176	2,510	2,898
Other current assets	1,607	2,177	2,572	2,940	3,367
Creditors	2,694	3,584	3,723	4,295	4,960
Other current liabilities	2,523	3,059	3,257	3,694	4,196
Net current assets	**6,387**	**6,140**	**7,827**	**9,258**	**11,806**
Fixed assets	4,578	5,018	6,719	6,187	5,623
Intangibles	3,976	3,955	3,955	3,955	3,955
Investments	889	2,957	10,357	10,357	10,357
Other long-term assets	1,285	1,458	1,458	1,458	1,458
Total net assets	**17,115**	**19,527**	**30,315**	**31,214**	**33,197**
Borrowings	7,742	7,848	10,348	6,848	3,348
Other long-term liabilities	219	249	249	249	249
Shareholders equity	**9,155**	**11,430**	**19,717**	**24,117**	**29,600**
Total liabilities	**17,115**	**19,527**	**30,314**	**31,214**	**33,197**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	3,473	4,119	5,432	6,594	7,788
Tax paid	(684)	(783)	(1,201)	(1,471)	(1,779)
Depreciation and amortization	708	725	900	932	964
Net working capital change	(411)	(240)	(1,638)	(987)	(1,152)
Other operating items	0	0	0	0	0
Operating cash flow before interest	3,086	3,822	3,494	5,068	5,821
Financial expense	(410)	(424)	(576)	(331)	(191)
Non-operating income	212	326	363	422	490
Operating cash flow after interest	**2,888**	**3,723**	**3,282**	**5,159**	**6,120**
Capital expenditure	**(1,289)**	**(1,166)**	**(2,600)**	**(400)**	**(400)**
Long-term investments	(3,908)	(2,349)	(7,400)	0	0
Others	273	(67)	(57)	(65)	(75)
Free cash flow	**(2,036)**	**142**	**(6,775)**	**4,694**	**5,645**
Equity raising	5	0	29	0	0
Borrowings	3,376	137	2,500	(3,500)	(3,500)
Dividend	(254)	(896)	4,296	(750)	(750)
Net chg in cash and equivalents	1,091	(618)	50	444	1,395

Source: Company data, IIFL Research

Technical analysis of Marico Industries

The stock price of Marico has been on an uptrend since 2009. However the pace of acceleration in the rally has increased after a confirmed breakout above Rs171 in March 2012. The rally has also surpassed the resistance of 'rising channel' and prices are likely to head towards Rs280.

Rising channel breakout: Marico was flirting with resistance of rising channel for almost six weeks now. However, renewed buying interest has forced prices to move above the channel above Rs206. Henceforth, earlier resistance of the channel would provide steady cushion near Rs200.

Retracement projection: In Feb 2011, prices found a strong support close to the 38.2% retracement level at Rs111. The 161.8% price extension from support of Rs111 provides a target of Rs280, which also coincides with replication of the channel on the higher side.

Steady uptrend in relative strength: RSI on weekly chart continues to be strong and has been hovering in the bull market trading zone of 55-75. Even the troughs have steadily inched higher, indicating an accumulation phase.

Positive comparative strength: The weekly ratio of Marico vs. S&P CNX 500 has resumed its upward journey after a correction in September 2012. History suggests that the outperformance has enhanced after testing the long-term support line. Hence the ratio is likely to accelerate after surpassing the level of 0.05.

Marico Industries – 10 year share price performance chart

(Rs/share)

250
200
150
100
50
0

Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

Expansion in gross margins led by weak commodity prices

Acquisition of second largest brand in hair oil segment - Nihar from HUL (28-Jan-06)

Revenue growth returned to double digit as volume growth sustained despite removal of price promotions

Credit crisis weighed on valuations

600bps expansion in Gross margins as company retains part of gains from commodity price reduction

Disinvestment of low -margin Sweekar brand to Cargill

Acquisition of Paras Brands from Reckitt Benkiser

Profit warning issued: Unprecented rise in copra prices (80% YoY)

CMP	Rs1090
Target 12m	Rs1420 (30%)
Market cap (US$ m)	2,046
Bloomberg	MMFS IN
Sector	Banks

Dec 14 2012

52Wk High/Low (Rs)	1151/568
Shares o/s (m)	114
Daily volume (US$ m)	3
Dividend yield FY13ii (%)	0.0
Free float (%)	47.7

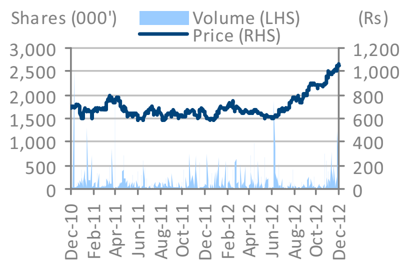
Shareholding pattern (%)

Mahindra group	57.3
FII	35.5
DII	6.8
Others	5.4

Price performance (%)

	1M	3M	1Y
M & M Fin. Serv.	14.7	37.3	69.1
Absolute (US$)	9.5	36.3	69.6
Rel. to Sensex	11.2	32.6	47.4
CAGR (%)		3 yrs	5 yrs
EPS		40.2	31.5

Stock movement



Sampath Kumar
sampath.kumar@iiflcap.com
+91 22 4646 4665

Abhishek Murarka
abhishek.murarka@iiflcap.com
91 22 4646 4661

www.iiflcap.com

M&M Finance — BUY

Strong rural play

MMFS is a key beneficiary of buoyancy in the rural economy and structural under-penetration of financial services in that segment. It has a well-entrenched business model, with strong parentage, expansive distribution network, and robust business processes and risk management capabilities. We forecast a healthy outlook for earnings and high ROE on the back of a competitive edge that MMFS derives through its investments in building a rural franchise; this would support its premium valuations.

Robust growth in AUM to sustain momentum: MMFS has delivered strong 30% Cagr in AUM growth over the past 12 years (FY01-12) driven by widening distribution, strong parentage, and well-established loan origination and recovery skills. The high growth momentum is likely to sustain over the long term, driven by significant opportunity to deepen its presence and tap into new growth avenues. We expect robust AUM Cagr of 26% over FY12-15ii aided by buoyancy in rural economy.

Well-entrenched business model drives strong financials: We forecast 26% earnings Cagr over FY12-15ii, aided by strong loan growth, healthy NIM, stable asset quality and higher operating leverage. Loan growth outlook is robust, driven by geographic and product diversification. The strong cash flow position of rural households is likely to support the benign outlook for MMFS' asset quality. We forecast ROA and ROE to sustain at 3.8-3.9% and 23% respectively through FY15ii. Capital raised by the company in November 2012 is likely to sustain growth until FY15ii and hence there is no risk of dilution to EPS through this period.

Robust growth, profitability justifies premium valuation: Strong earnings growth and superior profitability ratios, relative to peers, underpin the investment appeal for MMFS during FY09-12. We believe these factors would remain largely unchanged going forward as well. Strong parentage and continuity in leadership of the company would further boost confidence on sustainability of its business strategy and sound execution. MMFS' premium valuations are justified and sustainable due to its strong growth and robust profitability outlook.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Pre prov. operating inc. (Rs m)	9,059	11,212	15,850	20,462	25,548
Pre-exceptional PAT (Rs m)	4,929	6,435	8,992	11,376	14,144
Reported PAT (Rs m)	4,929	6,435	8,992	11,376	14,144
Pre-exceptional EPS (Rs)	49.3	62.6	83.6	101.2	125.8
Growth (%)	33.7	27.0	33.6	21.0	24.3
IIFL vs consensus (%)			10.1	11.4	6.5
PER (x)	22.1	17.4	13.0	10.8	8.7
Book value (Rs)	254	294	426	488	590
PB (x)	**4.3**	**3.7**	**2.6**	**2.2**	**1.8**
CAR (%)	19.5	18.0	19.8	18.1	17.2
ROA (%)	4.3	3.9	4.0	3.9	3.8
ROE (%)	**23.0**	**23.1**	**23.6**	**22.6**	**23.3**

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Robust growth in AUM to sustain momentum

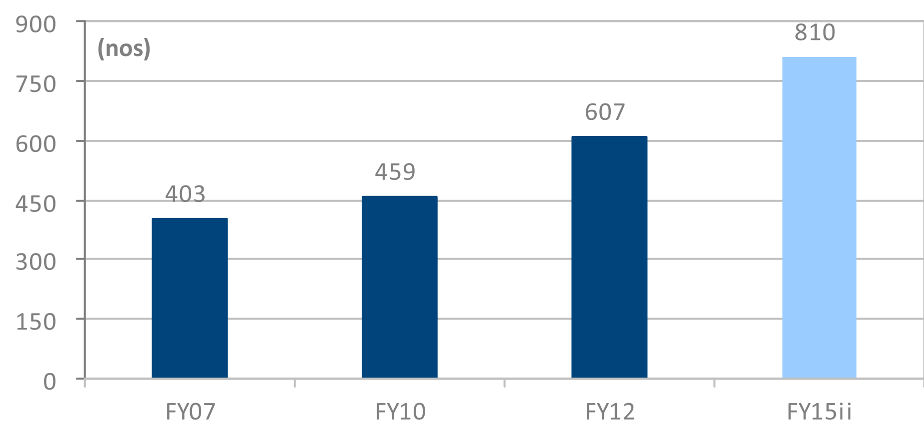
MMFS is likely to sustain its robust AUM growth on improving penetration and growth in non-M&M vehicles

MMFS recorded robust AUM (assets under management) Cagr of 25% over FY07-12, helped by significant expansion in its distribution reach and strong sales volume growth by its parent, Mahindra & Mahindra (M&M). We expect AUM to sustain robust 26% Cagr over FY12-15 though the drivers are likely to differ from the past. Higher contribution from financing of non M&M manufactured products and used vehicle financing are likely to be key growth drivers in the future, apart from organic expansion of branch network. We do not expect strong volume growth for M&M products given the high base created over FY07-12. However, robust volume performance by M&M can provide upside to our expectation for MMFS AUM growth.

Significant opportunity to deepen penetration

MMFS recorded a moderate increase in branch network between FY08 and FY10 due to sharp increase in NPL and moderate growth in new loan origination as a result of the global financial crisis in FY09. Branch network expansion gathered momentum from FY11 onwards. We expect MMFS to sustain this momentum through FY15ii and forecast 33% increase in its branch network over FY12-15ii.

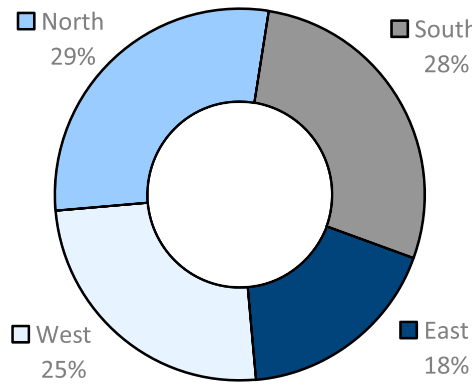
Figure 9.1: Trend in branch network



Source: Company, IIFL Research

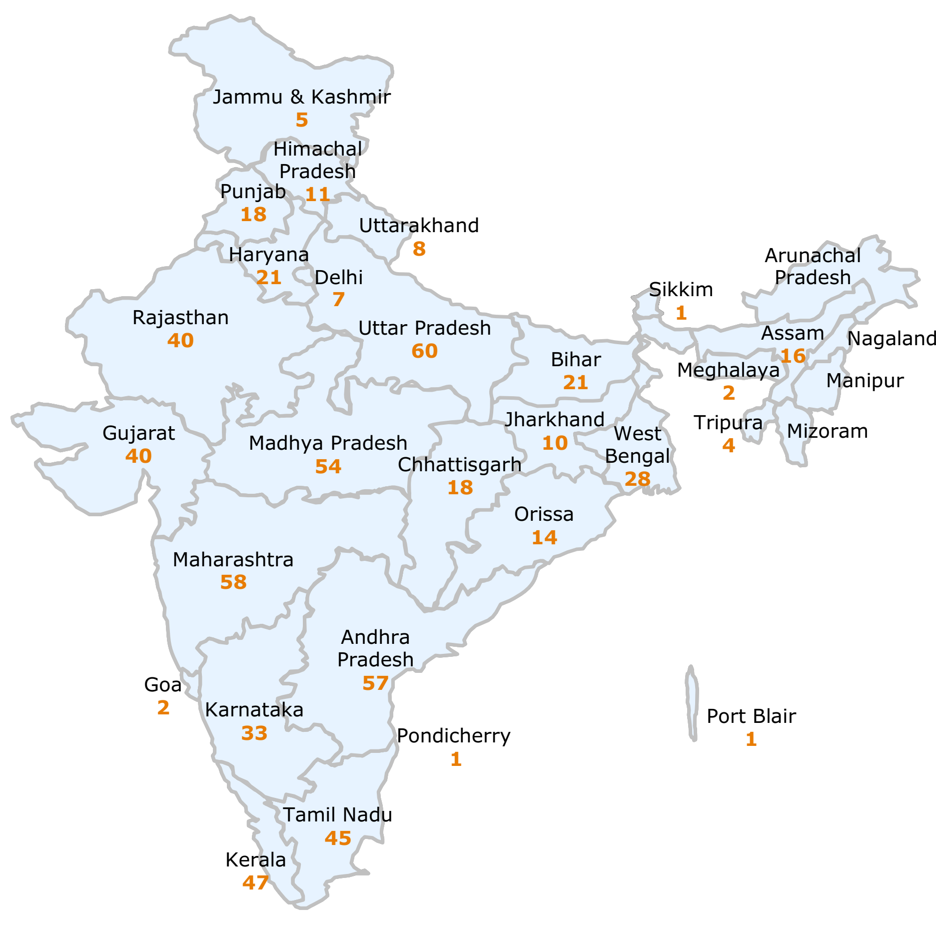
Diversified geographic reach a key determinant of sustained growth

Figure 9.2: Well-diversified geographic reach



Source: Company, IIFL Research

Figure 9.3: Spread of MMFS's branches



Source: Company

MMFS is focused on building a strong pan-India franchise to generate higher AUM growth with lesser concentration risk

MMFS presently operates from over 600 locations and has a further 2,703 distribution outlets through dealer network of OEMs with whom the company enjoys a close business association. The company's parent, M&M alone has 1,874 distribution outlets. By FY15, MMFS will likely have expanded its branch network to 810 locations. Opportunity to expand distribution network and deepen the presence remains significant over the long term for MMFS, in our view.

Widening horizons through product diversification

In the past, utility vehicles (UV) and tractors were primary drivers of MMFS' AUM growth as these were the parent companies' vehicles financed by MMFS. MMFS began financing non-M&M products in earnest in 2003. These primarily included cars and used vehicle financing. MMFS refrained from financing products that were competing with the parent's in utility vehicle (UV) and tractor segments. The share of MMFS' non-M&M AUMs has increased rapidly from 38% in FY07 to 47% in FY12. This portfolio grew at 34% Cagr over FY07-12 as MMFS made robust in-roads across various OEMs and their dealers. In the passenger cars segment, MMFS finances a meaningful share of cars manufactured by Toyota, Hyundai, Ford and Tata Motors. It is the no. 2 financier for cars manufactured by Maruti India.

Steep change in growth trajectory in various non-M&M asset classes to continue in future

Figure 9.4: Cagr of AUM for various asset classes financed by MMFS

%	FY06-09	FY09-12
Auto/UV (M&M)	18	25
Tractors (M&M)	35	26
Car	20	47
CV	63	62
Total	23	35

Source: Company, IIFL Research

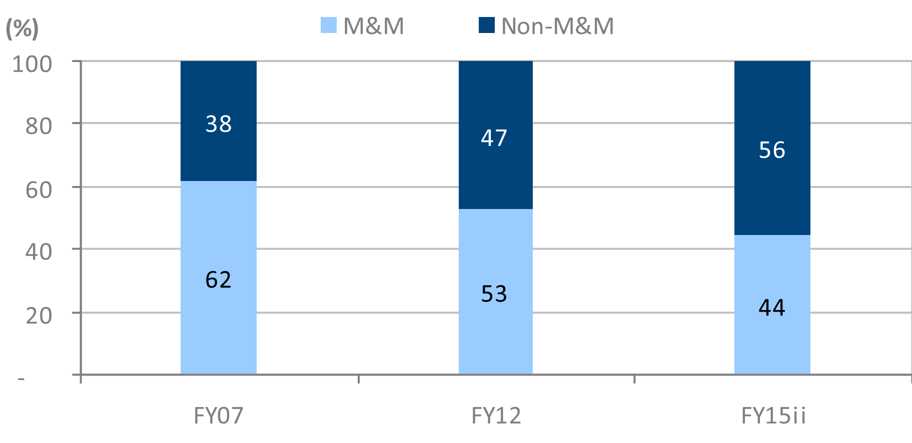
In recent years, however, the company has begun financing UVs and tractors that compete with parent's products. Market share of its parent, M&M, is 53% in UVs and 39% in tractors as at end-FY12, suggesting significant financing opportunity for MMFS in these segments. We estimate the addressable market in these two segments alone at Rs110bn as at end-FY12.

The constraint, however, is distribution. MMFS enjoys preferred financier status with OEMs (original equipment manufacturers) such as M&M and Maruti, which gives the company access to the OEMs' dealer network and hence access to customers at the point of sale. Such preferential access to customers would not be available for competitor's products of M&M. To overcome this constraint, MMFS has begun directly tapping its large captive client base (1.2mn outstanding loan contracts as at end-FY12). Such referrals are likely to generate significant financing opportunities for non-M&M products through FY15.

High base of M&M products financed and slowing sales of the parent are likely to result in muted growth in this segment

We forecast MMFS's loan disbursement for UV and tractors to record 22% Cagr over FY12-15ii. Loan disbursement for non-M&M products is likely to record 65% Cagr over the same period. Despite such rapid growth, MMFS's share in non-M&M products would be 12% as at end-FY15 offering significant growth opportunity in the foreseeable future.

Figure 9.5: Trend in AUM mix between M&M and non M&M manufactured products



Source: Company, IIFL Research

Larger product set for refinancing, increasing rural affluence and vehicle exchange platforms provide impetus to the refinancing opportunity

Untapped opportunity in refinancing market

Refinancing of used vehicles was limited to facilitate disposal of repossessed vehicles from customers by MMFS. However, increasing affluence in the rural economy and OEMs setting up a vehicle exchange platform to boost new vehicle sales in the rural markets are likely to increase the market opportunity for refinancing used vehicles. MMFS provided refinancing only in UVs and cars earlier. The

company has expanded used vehicle financing to tractors and commercial vehicles.

Disbursement for used vehicle financing has grown rapidly over FY10-12 (65% Cagr) and constituted 7% of AUM as at end-FY12. Financing opportunity for MMFS is large. Assets financed by MMFS between FY07 and FY11 would become available for refinancing over FY13-FY17ii. We estimate financing market opportunity of Rs210bn over this period. We forecast 40% Cagr in loan disbursement for MMFS over FY12-15ii. Despite rapid growth in this portfolio, it is likely to constitute 11% of AUM by end-FY15.

MMFS employs tighter underwriting norms when providing used vehicle financing. LTV (loan-to-value) ratio is maintained on average at 60-65% of the estimated value of asset (typically same or below the insured value of the vehicle). The duration of loan too is shorter for used vehicles compared to new vehicles (1.5-2 years for used vehicles as opposed to 3-7 years for new vehicles). As mentioned before, used vehicle loan portfolio would constitute small proportion of MMFS's overall portfolio. Taken together, we believe asset quality of MMFS is unlikely to be affected significantly from rapid growth in this portfolio even if we were to assume high credit losses on the same.

Well-entrenched operating model

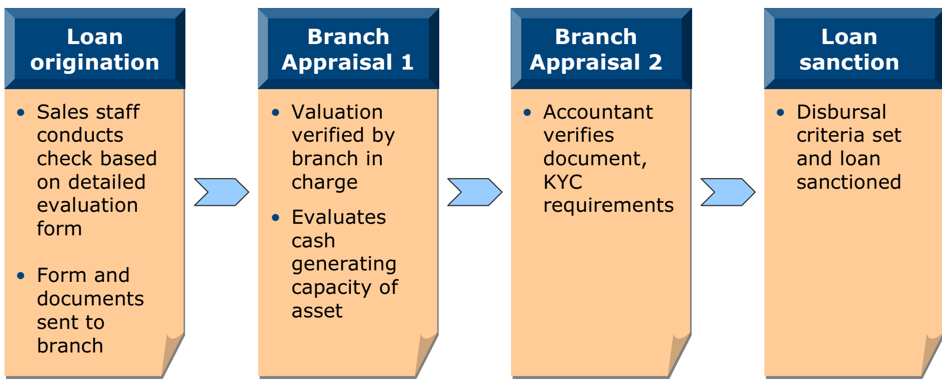
The operating model has been built on strong brand recognition, integrating technology with penetration and strong risk under-writing

MMFS has established itself as a strong asset finance company by successfully exploiting the well-recognised Mahindra brand in the tractors and utility vehicles market. It has also benefitted from this established brand identity in generating strong disbursements in other vehicles such as passenger cars, CV/CE and recently used cars. A wide distribution reach and well-established origination and collection methodologies give MMFS an edge over its competitors, especially in the rural and semi-urban markets where it operates. The parent's financial position also enabled the company to access funding from banking and capital markets at competitive rates. Currently, with ample scale and an established operational record, MMFS' reliance on its parent has declined over time.

Strong business processes at the core of the business model

MMFS has built up strong loan origination and credit assessment skills in rural and semi-urban markets. Most financiers find it difficult to appraise and collect in these geographies, and hence, this serves as a strong competitive edge vis-à-vis peers. Long origination history has now provided MMFS deep understanding of the credit behaviour of the unorganised sector, which helps the firm prospect and price risk effectively.

Figure 9.6: Loan origination and appraisal process



Source: Company, IIFL Research

Strong focus on ascertaining borrower's credit worthiness before loan disbursement

Ascertaining borrower cash flows central to lending process: Almost 80% of assets financed by MMFS are for commercial use, with most being employed for dual or multiple purposes. To evaluate the cash generating capacity of the assets, MMFS has a well-defined template for employees. These include detailed information gathering pertaining to:

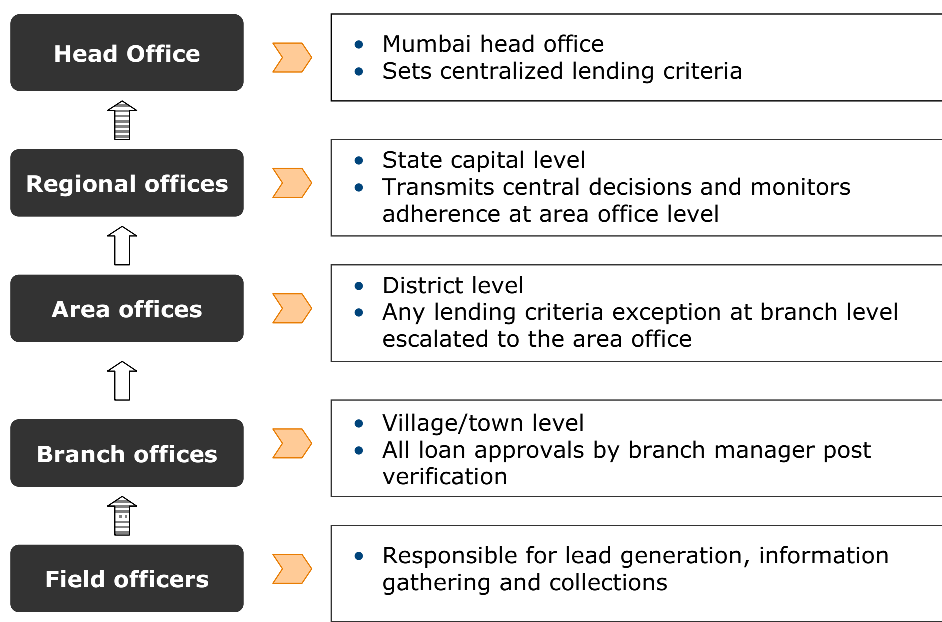
- Asset utilisation based on purpose of use (passenger/goods transport, agricultural usage)
- Capacity of asset, haulage distance, estimated hours of usage and rate per hour
- Expenses, including cost for fuel, driver, tyres and maintenance

In case of vehicles used for agricultural purposes, further details include:

- Landholding with details on type of irrigation facility available, agriculture inputs value, sowing and harvest months, estimated yield and expected realisation
- Similar details for past couple of years based on actual and verified with Mandi/buyer

A viability analysis is done based on total earnings in season as well as from other non-seasonal applications. Further details pertaining to social status, family land/livestock holding and guarantor is fed into a scoring model to aid in the final decision.

Figure 9.7: Well-defined organisational and escalation hierarchy



Source: Company, IIFL Research

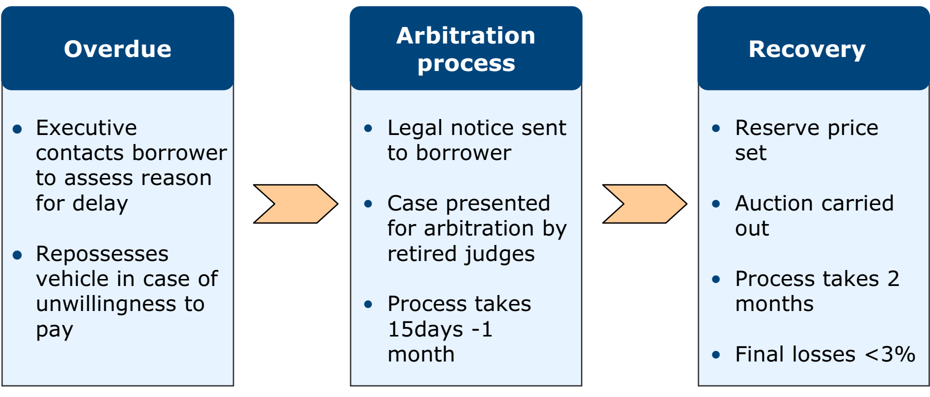
Control over employee behaviour and performance-linked compensation structure keeps collecting efficiency high

Strong collection and repossession skills

MMFS reduces credit risk through strong control over employee behaviour by using a suitable compensation structure. Employee compensation (25-30% variable) is tied to asset quality performance, with field officers being responsible for both customer acquisition and collections (at least for a period of six months from loan origination).

Following the period of high asset quality stress in FY09, MMFS has further strengthened risk management and collection efforts through: 1) introduction of monthly incentive programmes for employees linked to recovery performance; 2) increasing focus on in-house sourcing; and 3) beefing up of their legal and collections team. MMFS has a well-established recovery process on defaulted loans. On an average, MMFS repossesses 1,000 vehicles per month and through a process of legal arbitration, cases are settled within a month. Following this, the vehicle is auctioned off within two months. Management indicates that final losses have been limited to 1.5-2%.

Figure 9.8: Process for managing problem assets



Source: Company, IIFL Research

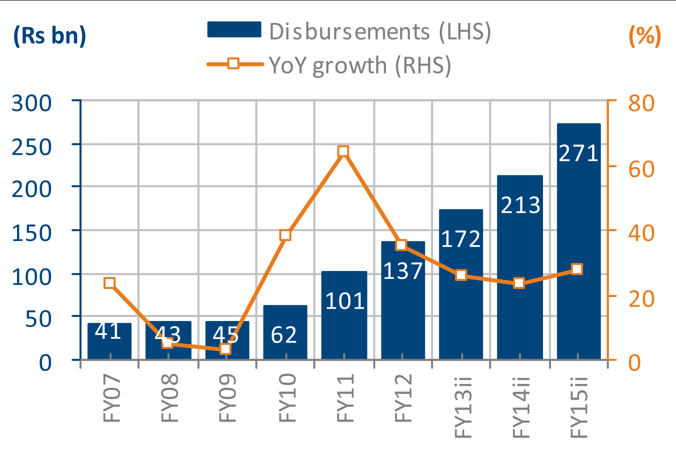
Strong financial performance likely to sustain

Strong loan growth, sustained margins and stable asset quality likely to be drivers of a robust earnings performance over the long term

Upbeat outlook for loan growth

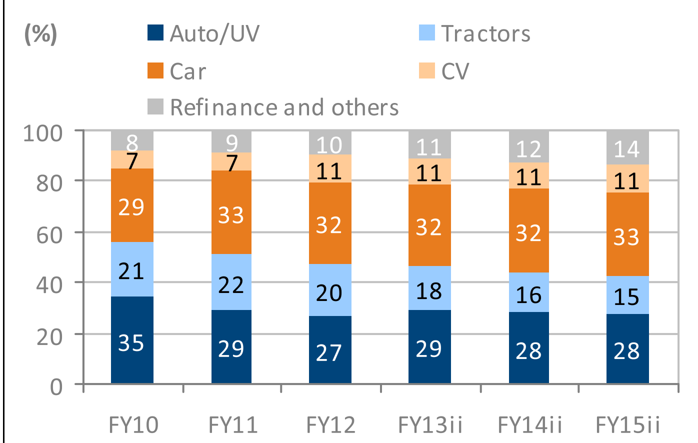
Deepening penetration of distribution network, diversification of product offering and higher growth potential in used vehicle financing would drive 26% Cagr in both loan disbursement and AUM over FY12-15ii. As mentioned before, MMFS's push into financing non M&M manufactured products and used vehicles would be significant drivers of growth over the next 3 years (33% Cagr in loan disbursement). The share of non M&M manufactured products is likely to increase to 56% of AUM by end-FY15 from 47% as at end-FY12 signifying increasing diversity of the company's loan portfolio.

Figure 9.9: Trend in loan disbursement and growth



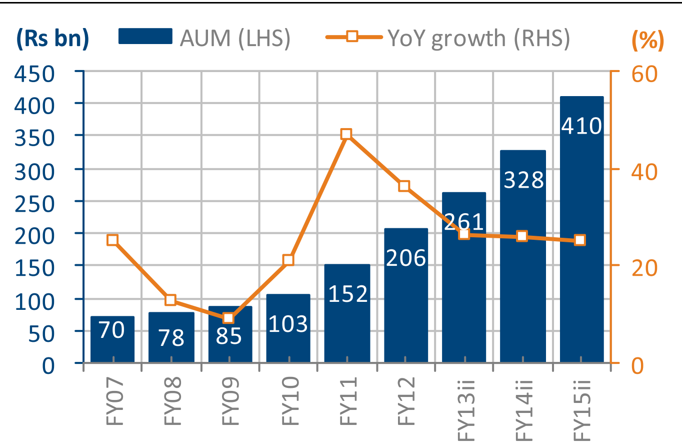
Source: Company, IIFL Research

Figure 9.10: Trend in loan disbursement mix



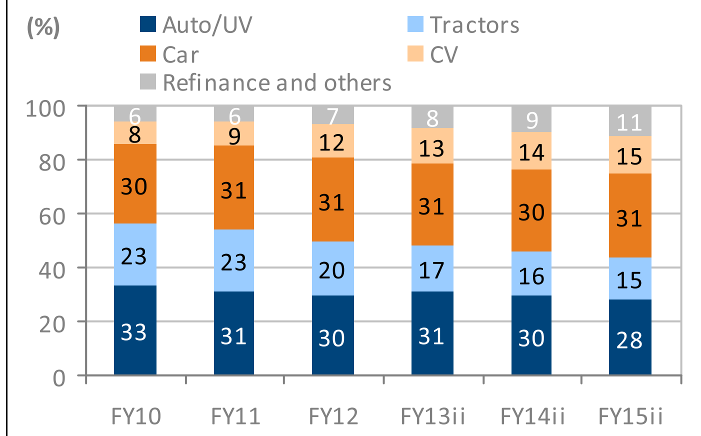
Source: Company, IIFL Research

Figure 9.11: Trend in AUM and growth



Source: Company, IIFL Research

Figure 9.12: Trend in AUM mix



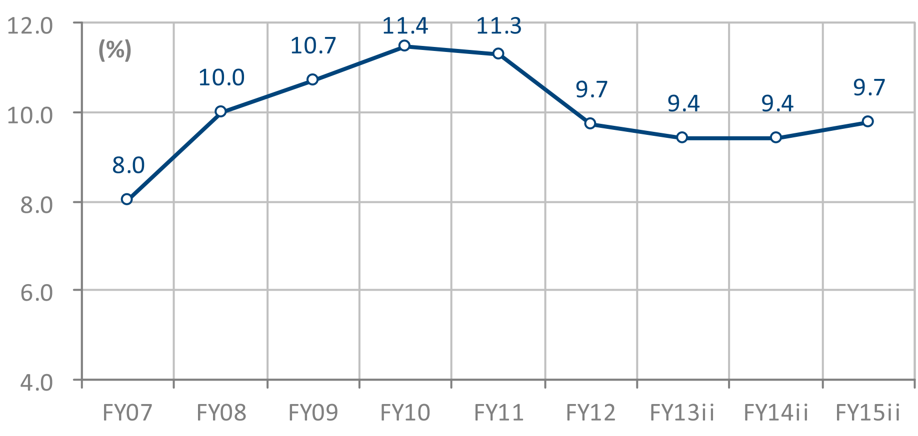
Source: Company, IIFL Research

Improvement in NIM, stable cost/income ratio to drive robust profit growth

NIM, which showed a declining trend since FY12, is likely to trough in FY13ii. The decline was attributable to incomplete pass through of higher funding cost by way of lending rates and change in mix of AUM that were lower yielding. We forecast NIM to improve by FY15 as the mix of AUM changes in favour of higher yielding assets. Potential decline in borrowing cost would likely aid in NIM expansion

further as lending rate decline tend to lag borrowing cost. The same, however, has not been factored into our forecast yet.

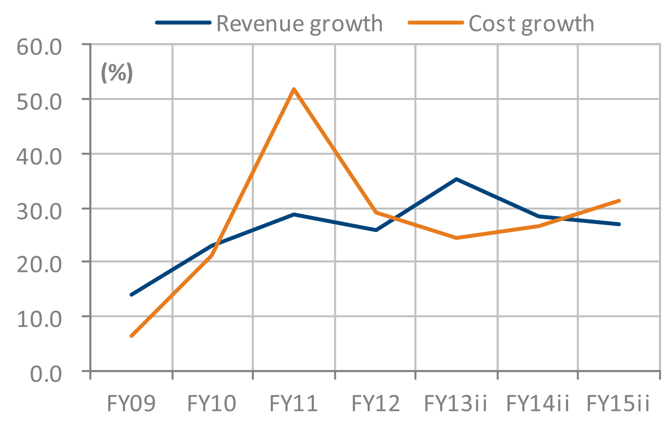
Figure 9.13: Trend in NIM



Source: Company, IIFL Research

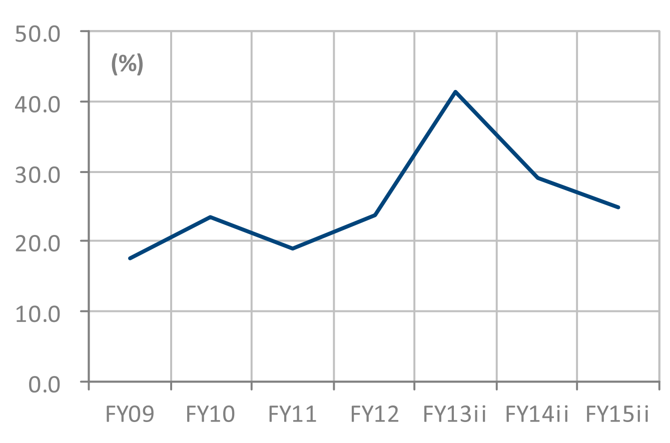
Due to network expansion and rapid growth in loan disbursement, operating expenses are expected to grow at a rapid clip (27% Cagr over FY12-15ii). However, faster growth in revenue and productivity enhancing measures such as direct marketing initiatives would likely keep cost/income ratio stable over FY12-15ii. We forecast 31% Cagr in pre-provision profits due to strong loan growth, improvement in NIM and stable cost/income ratio over FY12-15ii.

Figure 9.14: Trend in revenue and cost growth



Source: Company, IIFL Research

Figure 9.15: Trend in PPOP growth



Source: Company, IIFL Research

Favourable outlook for asset quality and credit cost

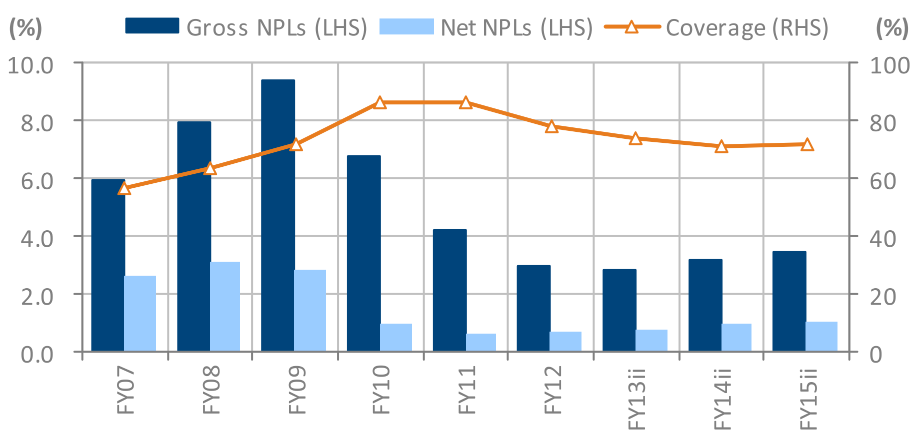
The robust rural economic environment and strong demand for loans point to a benign asset quality environment for MMFS. From the management's point of view, low LTV ratio, shorter duration of loans and decline in the cyclicality of loan recovery rates all point to strong repayment capacity of households leading to benign outlook on asset quality.

Low LTV, shorter repayment periods and declining cyclicality of loan recovery rates indicate strong repayment capacity of households

Over the last few years, MMFS has diversified across geographies, product lines, brands financed, and customer segments. This diversity has significantly reduced concentration in a particular segment. The management reiterated that it does not intend to pursue balance sheet growth by increasing LTV ratio (currently 60-65%, down from 85-90% in FY07) or by building longer-duration

assets (current average duration of loans is 28-29 months) as these would potentially dilute asset quality.

Figure 9.16: MMFS - Trend in NPL and coverage ratios

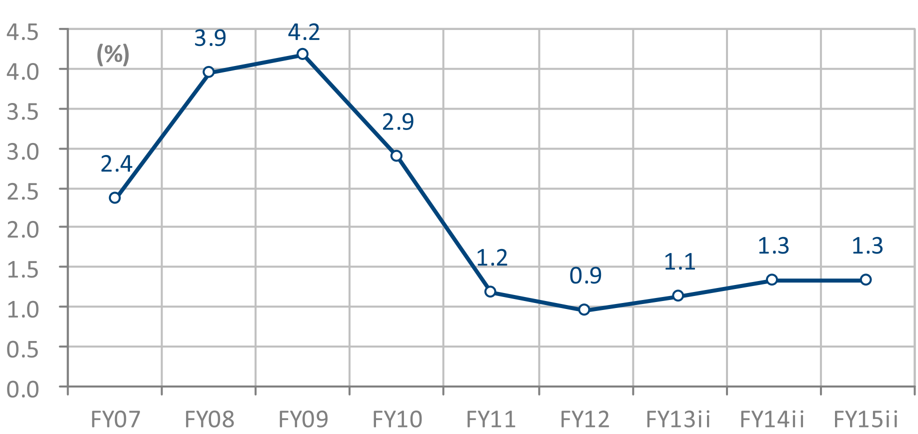


Source: Company, IIFL Research

Substantial recovery of overdue loans and diversification in geography, customer profile and products were key efforts to mitigate risk post FY09

NPL ratio as at end-FY12 was the lowest in the past 10 years. Substantial recovery of past overdue loans helped the company show its lowest NPL level in FY12. Without the benefit of large stock of NPL, recovery is likely to be slow and hence NPL ratios are unlikely to record significant improvement from here. As a result, loan loss provision (LLP) is likely to have reached its trough. We expect MMFS' LLP to increase over the medium term; however, a robust operating environment will likely help the company sustain lower LLP vis-à-vis its historical average.

Figure 9.17: Trend in LLP/avg. loans of MMFS



Source: Company, IIFL Research

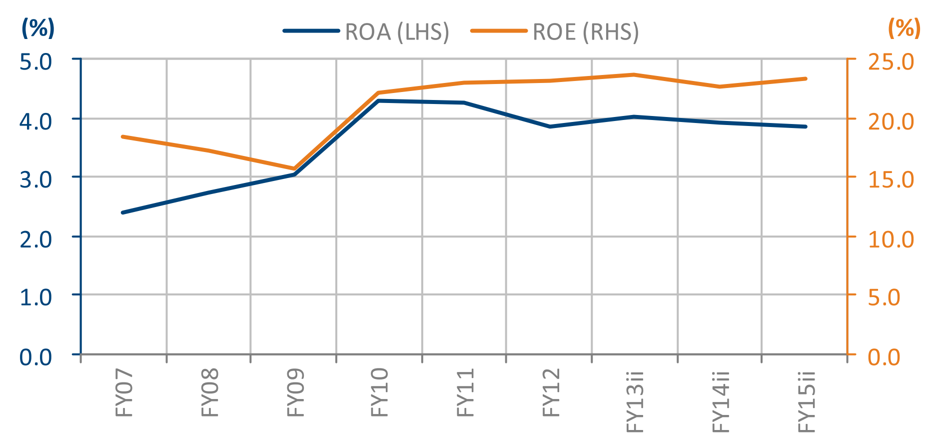
ROA likely to sustain above 3.5%

Robust NIM, favourable outlook for asset quality and higher branch productivity are likely to sustain high ROA through FY15ii. Robust NIM reflects strong competitive position of the company in the rural markets while low credit cost is due to favourable growth conditions that these markets have been witnessing. Preferential access to customers through strong OEM relationships, close-to-customer model requiring significant investment in resources for sourcing and servicing borrowers and robust credit management processes would ensure MMFS retaining significant competitive advantage over the long term. This coupled with favourable operating environment would sustain robust ROA, in our view. MMFS has been able to

access equity capital markets periodically to finance the rapid growth in assets. Robust profitability would enable the company to access equity capital markets to fund its asset growth and achieve regulatory capital requirements of the RBI in the future as well.

Profitability profile likely to sustain at current elevated levels

Figure 9.18: Trend in ROA and ROE of MMFS



Source: Company, IIFL Research

Figure 9.19: History of equity capital raising by MMFS

Date	Description	Capital raised (Rs mn)	Dilution to equity
5-Jan-06	Preferential allotment of shares to Chrys Capital	632	4%
9-Mar-06	Initial public offering	2,000	13%
28-Feb-08	Private placement of shares to TPG Axon and Standard Chartered Pvt Equity	4,251	13%
22-Feb-11	Allotment of shares to QIBs	4,324	6%
16-Nov-12	Allotment of shares to QIBs	8,668	9%

Source: Company, IIFL Research

Strong parentage and continuity of leadership further boosts outlook

Strong parentage ensured high brand recall, cost effective fund raising and easier acceptance among fractured customer segments

We believe MMFS derives significant advantage from its parent M&M. This includes branding and access to markets through dealership centres of M&M. MMFS has also benefited from the parent's strong financial position. This helped the company during early stages to secure high credit rating vis-à-vis its size, track record and financial position. The parent's financial position also enabled the company to access funding from banking and capital market sources at competitive rates. With an established performance record, MMFS is now less reliant on the parent's financial position to raise resources.

The incumbent CEO, Mr.Ramesh Iyer, has been the key architect behind the success of MMFS over the past decade. Mr.Iyer has been with the company since its inception in 1993 and assumed the role of CEO in 2001. Under his leadership, AUM of the company grew from Rs11bn in FY01 to Rs206bn in FY12 (30% Cagr) and net profit grew 33% Cagr over FY04-12. Aged 54, Mr.Iyer is likely to continue at the helm of the company for at least 5 years, with prospects of further extension by 5 years beyond 59. Continuity in leadership would likely ensure stability in time-tested business strategy and hence the growth outlook.

Robust growth, strong profitability justifies premium valuation

Valuation premium emanates from strong parentage, proven management record and robust profitability track record

MMFS is a key beneficiary of buoyancy in the rural economy and structural under-penetration of financial services. MMFS has a well-entrenched business model, thanks to large infrastructure, strong parentage, robust business processes and risk management capabilities. We believe the robust outlook for earnings, high ROE and competitive edge that MMFS derives through its investments in building the rural lending franchise would support premium valuation for the stock.

MMFS has delivered strong price performance since FY09 on the back of improved profitability and superior earnings growth relative to peers. ROA and ROE improved strongly during FY10-12 compared with the past. This was aided by: 1) historical high level of NIM on the back of low funding costs and strong pricing power, 2) low level of credit costs driven by sharp improvement in asset quality, 3) partly offset by higher operating expenses on the back of infrastructure expansion.

MMFS remains a strong play on rural consumption growth. Loan growth outlook is robust, driven by geographic and product diversification. The strong cash flow position of rural households is likely to support the benign outlook for asset quality. Robust loan growth, stable asset quality, and higher operating leverage are likely to drive 26% earnings Cagr over FY12-15ii.

Figure 9.20: Peer group comparison on Cagr in assets, revenue and net profit

FY12-15ii % Cagr	MMFS	BAF	SHTF	SCUF
AUM	26	31	18	31
Loan	29	31	25	31
NII	31	31	16	34
Net profit	30	28	19	31

Source: Company, IIFL Research

Figure 9.21: Peer group comparison on profitability, asset quality and capitalization

	MMFS		BAF		SHTF		SCUF	
	FY13ii	FY14ii	FY13ii	FY14ii	FY13ii	FY14ii	FY13ii	FY14ii
Profitability								
NIM	9.4	9.4	12.2	11.9	8.0	8.0	10.3	10.1
Cost/income ratio	33.8	33.3	46.3	46.1	22.5	22.1	39.1	38.3
Provisions/AUM	1.1	1.4	1.4	1.6	1.8	1.7	2.1	1.9
Asset quality								
GNPL ratio	2.8	3.2	1.4	1.6	2.7	2.8	1.8	2.0
PCR	74.1	70.7	79.9	73.0	94.0	95.2	80.3	81.6
Capitalisation								
Assets/equity	5.5	5.9	6.8	7.3	5.8	5.7	8.4	7.4
Tier I CAR	17.6	16.4	14.3	13.4	18.1	18.3	11.9	13.3

Source: Company, IIFL Research

Figure 9.22: Peer group comparison on return ratios

	RoA			RoE			EPS Cagr
	FY13ii	FY14ii	FY15ii	FY13ii	FY14ii	FY15ii	FY12-15ii
MMFS	4.0	3.9	3.8	23.6	22.6	23.3	26.2
BAF	3.7	3.5	3.3	24.6	24.5	24.7	26.8
SHTF	3.5	3.7	3.8	20.6	21.2	22.0	19.3
SCUF	3.0	3.1	3.0	23.4	24.3	22.6	24.7

Source: Company, IIFL Research

Figure 9.23: P/BX trend of MMFS

Source: Company, IIFL Research

Key risk is from government's profligacy, deceleration in rural economic activity

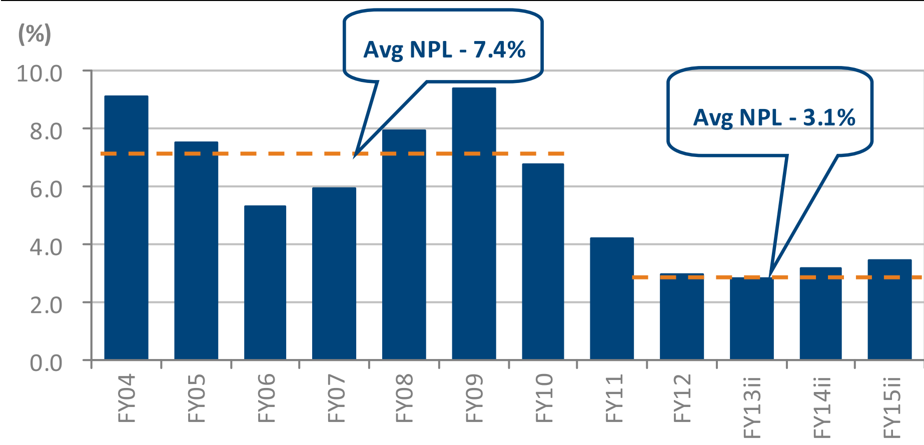
Any dole or waiver by the Government or slowing rural economy will engender risks for MMFS' balance sheet

Key risks to the business are a cyclical downturn in rural markets, any adverse change in parent's financial position and moral hazard arising from government largesse, such as the farm loan debt waiver scheme implemented in 2008.

MMFS's exposure to the rural economy renders its business vulnerable to a downturn in the rural economy. This could adversely affect revenue growth and credit costs, thus providing downside risks to our expectations. Geographical diversification mitigates this risk partially, in our view, as a downturn in the rural economy is seldom witnessed across all geographies.

Despite increasing proportion of lending to non-M&M vehicles, MMFS's business and credit rating remain closely tied to the parent's financial position. MMFS has benefited from the improving market share and financials, and credit fundamentals of M&M. Any adverse change in trend would have a negative impact.

Figure 9.24: NPL resolution strategies deeply entrenched following the asset quality disruption in FY08-09



Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Disbursement growth (%)	64.1	35.3	26.2	23.4	27.7
New NPL accrual rate (%)	1.4	1.5	2.0	2.5	2.5
Securitization income % of net interest income (%)	11.1	0.0	0.0	0.0	0.0

Source: Company data, IIFL Research

Financial summary

Robust growth momentum and margins to drive earnings

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net interest income	13,627	16,829	23,193	29,788	37,880
Fee Income	0	0	0	0	0
Portfolio gains	0	0	0	0	0
Others	455	875	746	911	1,115
Non-interest income	455	875	746	911	1,115
Total operating income	14,082	17,704	23,939	30,698	38,995
Total operating expenses	5,024	6,492	8,088	10,236	13,447
Pre provision operating profit	**9,059**	**11,212**	**15,850**	**20,462**	**25,548**
Provisions for loan losses	1,581	1,600	2,627	3,975	5,049
Other provisions	0	0	0	0	0
Profit before tax	7,478	9,613	13,223	16,487	20,499
Taxes	2,540	3,168	4,231	5,111	6,355
Net profit	**4,929**	**6,435**	**8,992**	**11,376**	**14,144**

Strong niches in geography, products and customer segments to drive overall loans

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net loans & advances	126,692	183,878	240,785	312,264	394,092
Placements to other banks	0	0	0	0	0
Cash & equivalents	3,236	2,717	3,442	3,851	4,766
Other interest-earning assets	6,452	4,552	5,016	5,529	6,094
Total interest-earning assets	**136,380**	**191,147**	**249,243**	**321,644**	**404,951**
Fixed assets	840	1,028	1,234	1,480	1,776
Other assets	2,176	2,033	2,440	2,928	3,513
Total assets	**139,396**	**194,208**	**252,916**	**326,052**	**410,241**
Customer deposits	0	0	0	0	0
Other interest-bearing liabilities	108,047	155,507	197,967	260,585	331,868
Total interest-bearing liabilities	108,047	155,507	197,967	260,585	331,868
Non-interest-bearing liabilities	5,899	8,391	9,084	10,594	11,986
Total liabilities	**113,946**	**163,897**	**207,051**	**271,179**	**343,854**
Total Shareholder's equity	**25,450**	**30,311**	**45,865**	**54,873**	**66,386**
Total liabilities & equity	**139,396**	**194,208**	**252,916**	**326,052**	**410,241**

Source: Company data, IIFL Research

Return ratios to compare well versus peers

Diversification in geography and customer segments will minimise the impact of any deterioration in the credit quality

Ratio analysis - I

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Balance Sheet Structure Ratios (%)					
Loans / Deposits	0.0	0.0	0.0	0.0	0.0
Loan Growth	49.3	45.1	30.9	29.7	26.2
Growth in Deposits	0.0	0.0	0.0	0.0	0.0
Growth in Total Assets (%)	51.6	39.3	30.2	28.9	25.8
Profitability Ratios					
Net Interest Margin	11.3	9.7	9.4	9.4	9.7
ROA	4.3	3.9	4.0	3.9	3.8
ROE	23.0	23.1	23.6	22.6	23.3
Non-Int Income as % of Total Income	3.2	4.9	3.1	3.0	2.9
Net Profit Growth	37.9	30.5	39.7	26.5	24.3
FDEPS Growth	33.7	27.0	33.6	21.0	24.3
Efficiency Ratios (%)					
Cost to Income Ratio	35.7	36.7	33.8	33.3	34.5
Salaries as % of Non-Interest costs	44.6	42.1	42.6	43.0	43.5

Ratio analysis - II

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	4.2	2.9	2.8	3.2	3.4
NPL coverage ratio	86.4	78.0	74.1	70.7	71.4
Total prov charges as % avg loans	1.2	0.9	1.1	1.3	1.3
Net NPLs as % of net loans	0.6	0.7	0.8	1.0	1.0
Capital Adequacy Ratios (%)					
Total CAR	19.5	18.0	19.8	18.1	17.2
Tier I capital ratio	17.0	15.1	17.6	16.4	15.8

Source: Company data, IIFL Research

Interview

Ramesh Iyer - CEO, M&M Finance

Ramesh Iyer
CEO, M&M Finance

1. **What are the key long-term growth drivers of the company?**
   Growth for the company will come from product expansion, increase in geographic penetration and increase in the value of underlying vehicles sold.

2. **What is a sustainable rate of growth in volumes, revenue and earnings over the next 4-5 years?**
   Historically, we have been growing at~25-30% Cagr. Given the opportunity provided by the geographies in which we operate, i.e. the rural and semi urban markets, we do not foresee a challenge in maintaining this level of growth.

3. **What are the changing market dynamics or trends, if any, to which you need to pay attention?**
   We want to be vigilant about emerging competition from the banking sector. Given our deep penetration, large customer base and strong relationship with manufactures and dealers, we expect to be ahead of competition.

4. **What factors, in your view, contributed to your exceptional performance over the past decade?**
   Well planned asset-side and liability-side risk management, recruitment of employees locally, and building capabilities through training are key factors that contributed to our success.

5. **Anything you wish for, to deliver similar performance in the next decade?**
   Improvement in rural infrastructure and availability of a talent pool in the local markets for deepening geographical penetration are the key factors that we wish for, to deliver superior performance in the next decade.

6. **What part of the business takes up your maximum time and attention?**
   Human resources management and improvement of process/technology to deliver better customer services and reduce operating cost occupies significant mind share of the management.

7. **How would you prioritize the different stakeholders in your company – shareholders, employees, customers and government?**
   We do not differentiate between our stakeholders; all of them are an important part of our growth journey.

8. **Do you have a role model – an individual or a company?**
   "M&M Group" is a role model for us. The way it has diversified into various products and geographies by having a customer-centric approach is really commendable. A professional management, strong corporate governance and well established risk management practices are key attributes to emulate.

9. What are your biggest weaknesses, if any, and challenges?

I run the business hands on, in order to maintain such a large balance sheet. Developing a strong management bandwidth has been an area of major focus. Continuously motivating employees and retaining them will continue to be my prime area of attention and interest.

10. What is your vision for the company?

Our vision is to be a leading financial services provider in semi-urban and rural India and we plan to achieve this through our mission of transforming rural lives and driving a positive change in the communities, which we believe is "True Financial Inclusion".

Technical analysis of M&M Finance

The MMFS stock has been trading close to its all-time highs. The positive momentum continues despite the oscillators entering the extreme overbought positions. A breakout above the 'flag pole' and RSI moving close to the 80 level indicate the upside projection at Rs1700.

Flag pole breakout: The high of flag pole made during Nov 2010 was surpassed in October 2012 above Rs913.4 and prices have formed a strong base above the same. This move confirms the horizontal line breakout replicating the trading range of Rs161.50-913.5 on the upside.

Retracement projection: Prices have found multiple supports close to the 38.2% retracement level at Rs652, which formed a solid base for the bullish flag. The 161.8% price extension from the base of Rs652 provides long-term target of Rs1850.

Spike in relative strength: The weekly RSI has crossed above the overbought zone of 75 but there are no signs of negative divergence. The momentum tends to remain extremely positive when such a move is visible and the prices usually accelerate further.

Breakout in comparative strength: A sustainable breakout on the weekly ratio of MMFS to S&P CNX 500 chart hints at a 33% increase in outperformance in the near term.

100
70
40
10

2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
161.8% price extension
Range Breakout
Price target Rs1700
Bullish flag breakout
0.0%
38.2%
40 WMA
100.0%
Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

0.33
0.28
0.23
0.18
0.13
0.08
0.03
Ratio with S&P CNX 500
Mar-06 Mar-07 Mar-08 Mar-09 Mar-10 Mar-11 Mar-12

M&M Finance – 7 year share price performance chart

This page is left blank intentionally

CMP	Rs141
Target 12m	Rs185 (31%)
Market cap (US$ m)	2,193
Enterprise value (US$ m)	2,064
Bloomberg	EXID IN
Sector	Autos

Dec 14 2012

52Wk High/Low (Rs)	166/99
Shares o/s (m)	850
Daily volume (US$ m)	5
Dividend yield FY13ii (%)	1.3
Free float (%)	54.0

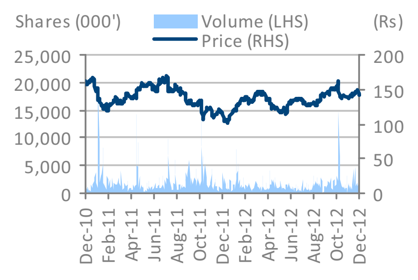
Shareholding pattern (%)

Promoter	46.0
FII	17.6
DII	13.8
Others	22.6

Price performance (%)

	1M	3M	1Y
Exide	0.9	(2.5)	18.7
Absolute (US$)	2.7	(2.5)	18.0
Rel. to Sensex	(2.6)	(7.1)	(2.9)
CAGR (%)		3 yrs	5 yrs
EPS		13.3	22.2

Stock movement



Exide Industries — BUY

Buy Exide or stop driving

After two years of weakness, Exide has entered a phase of upturn starting FY13, driven by strong replacement demand for four wheeler (4W) batteries. Replacement demand for two wheeler (2W) batteries, although small currently, is in a phase of multi-year, high growth due to adoption of electric-start vehicles. Persistent power deficit in the country will support demand for power back-up solutions (inverters and UPS). We forecast Exide's earnings to double over FY12-FY15.

Leader in a high-growth industry: The battery business in India has seen 20% revenue Cagr over the past five years. With 4W and 2W volumes expected to grow at 12-15% Cagr over the medium term and with vehicle population mirroring this growth, replacement demand for auto batteries will sustain its growth trajectory. The duopoly character of the industry is unlikely to change in the medium term. Thus, OEM relationships and distribution network of the incumbent leaders (60k touch points between Exide and Amara Raja) would be difficult to replicate.

Volume growth led by auto replacement demand: We expect replacement demand for auto batteries (57% of Exide's Ebitda) to register ~20% volume Cagr over FY12-15, tracking strong vehicle sales in FY10 and FY11 with a lag of 2-3 years. Replacement demand for 2W batteries should benefit due to the shift from kick-start to electric-start 2Ws and register 30% Cagr over FY12-15. We also expect industrial batteries to register strong growth starting FY13, as inverter demand bounces back due to persistent power deficit in the country.

Improved revenue mix to drive margin expansion: We expect the replacement-OEM mix of auto batteries (4W and 2W) to improve in FY13 and FY14 (to about 1:1) compared with FY12 (0.77:1). We expect this to support improvement in Ebitda margin from 13.4% in FY12 to 14.5% in FY14. We forecast Exide's earnings to double over FY12-15.

Financial summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	45,473	51,070	65,137	81,219	95,129
Ebitda margins (%)	19.3	13.4	13.8	14.5	13.8
Pre-exceptional PAT (Rs m)	6,060	4,612	5,974	8,158	9,349
Reported PAT (Rs m)	6,664	4,612	5,974	8,158	9,349
Pre-exceptional EPS (Rs)	7.1	5.4	7.0	9.6	11.0
Growth (%)	7.3	(24.0)	29.5	36.6	14.6
IIFL vs consensus (%)			(2.1)	11.5	0.4
PER (x)	**19.8**	**26.0**	**20.1**	**14.7**	**12.8**
ROE (%)	24.4	15.9	18.2	21.4	20.9
Net debt/equity (x)	(0.2)	(0.2)	(0.2)	(0.3)	(0.4)
EV/Ebitda (x)	13.0	16.5	12.4	9.1	7.8
Price/book (x)	4.4	3.9	3.4	2.9	2.5

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Joseph George
joseph.george@iiflcap.com
91 22 4646 4667

www.iiflcap.com

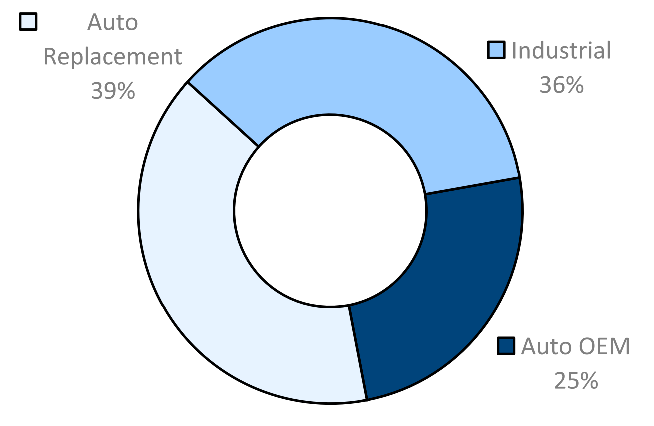
Company Snapshot

Exide is the largest manufacturer of storage batteries in India

Exide is the largest manufacturer of storage batteries in India. The company manufactures batteries in a wide range from 2.5 Ah to more than 20,000 Ah capacities that covers a range of applications. The company has six factories, two each in Maharashtra and Tamil Nadu and one each in West Bengal and Haryana. The company's predecessor carried on operations as an import house from 1916 under the name Chloride Electrical Storage Company. Thereafter, the company started manufacturing storage batteries and it has emerged one of the largest manufacturers of batteries in the Indian sub-continent.

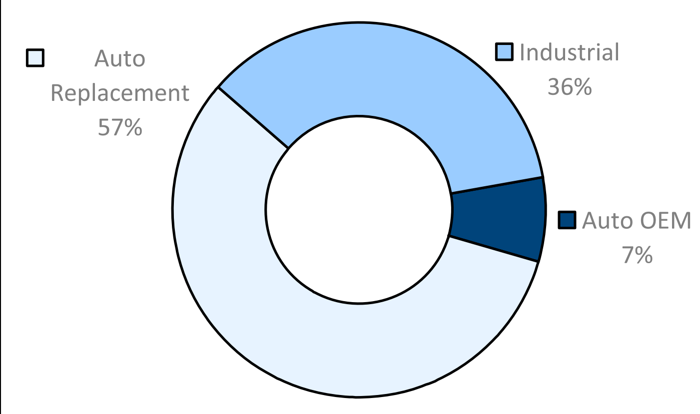
- **Automotive batteries**: In the domestic market, the company sells its products under the EXIDE, SF, SONIC and Standard Furukawa Brands. EXIDE and SF are its flagship brands. The company supplies batteries to almost all the car and two-wheeler manufacturers in the country. Exide has a distribution network comprising more than 40,000 touch points. The company also exports batteries to the Middle East, Japan, and CIS countries.
- **Industrial batteries**: The company designs and manufactures its industrial batteries in a wide range from 2.5 Ah to 20,000 Ah in the conventional flooded and Valve Regulated Lead Acid (VRLA) design. Industrial batteries find applications mostly in the infrastructure sector including railways, telecom, power plants, solar cells, and other segments such as UPS, inverters, and traction batteries.
- **Submarine batteries:** Exide also manufactures high-end submarine batteries. The company manufactures two to three submarine batteries a year to meet the country's defence requirements.

Figure 10.1 : FY12 revenue break-up



Source: Company, IIFL Research

Figure 10.2 : FY12 Ebitda break-up



Source: Company, IIFL Research

Management

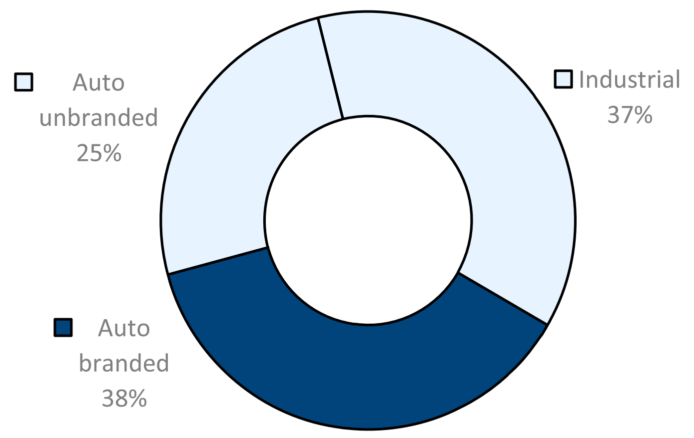
Name	Designation	Remarks / management description
Rajesh G. Kapadia	Chairman and Independent Director	Mr. Kapadia is a practicing Chartered Accountant and Senior Partner at G M Kapadia & Company, Chartered Accountants. Mr. Kapadia served as the President of the Indian Merchants Chamber for 2005-2006 and is an expert on accountancy / taxation.
T. V. Ramanathan	Managing Director & CEO	Mr. Ramanathan is a Chartered Accountant and Company Secretary. His 40+ years' experience includes 15 years overseas, of which nearly five years were with the World Bank.

Batteries – A high growth industry

Batteries have been a high-growth industry: Combined revenue of Exide and Amara Raja (the second-largest player in India) has grown at 20% Cagr over the past five years. We expect growth to remain strong over FY13-15 on the back of robust growth in the replacement market. Price increases will add to revenue growth over the next two years. Exide recently increased prices by 5% across its entire portfolio.

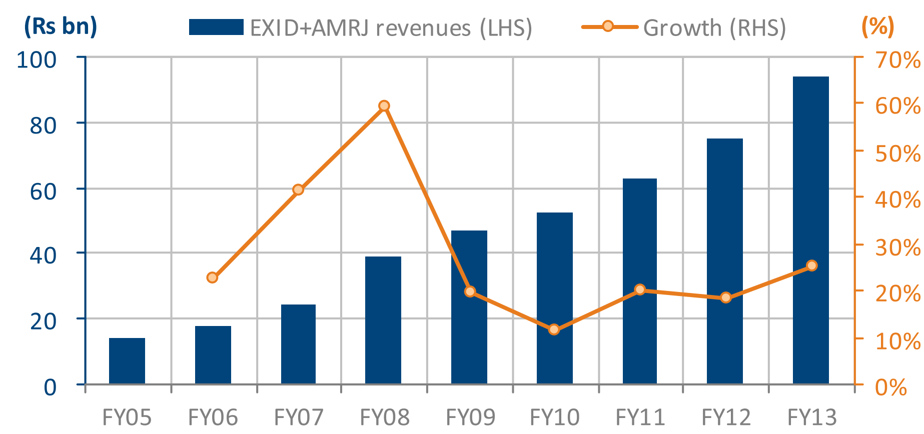
Combined revenue of Exide and Amara Raja has grown at 20% Cagr over the past five years

Figure 10.3 : Indian Battery industry snapshot – FY12



Source: Company, IIFL Research

Figure 10.4: Revenue of Exide and Amara Raja grew at 20% Cagr over five years



Source: Company, IIFL Research

Figure 10.5: Exide and Amara Raja account for a bulk of the organised market share

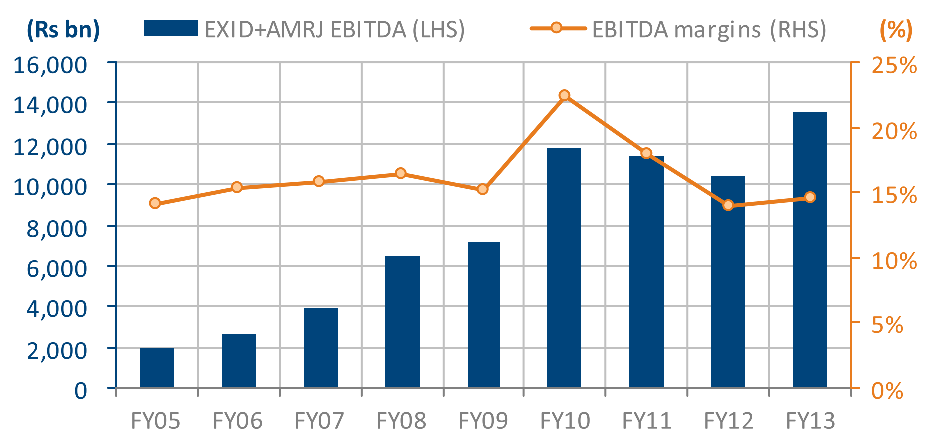
FY12 Market share	Amara Raja	Exide
Auto OEM	26%	72%
2W OEM	0%	71%
Auto Replacement (4W – organized)	34%	54%
Auto Replacement (2W – organized)	24%	46%
Industrial segment (Telecom)	42%	<10%
Industrial segment (UPS)	32%	35%

Source: Company, IIFL Research

Industry-level margins were steady in the past before the recent volatility: Industry-level Ebitda margin has been steady at around 15% over the past 6-7 years. FY10 saw a spike in Ebitda

margin to 20%+ levels following the crash in lead prices. However, since then, Ebitda margin reverted to the 14-15% levels in FY12. The 15% Ebitda margin was maintained even in FY08, when lead price had spiked to a peak of USD4,000 per ton, indicating strong pricing power.

Figure 10.6: Ebitda margins have been steady for industry

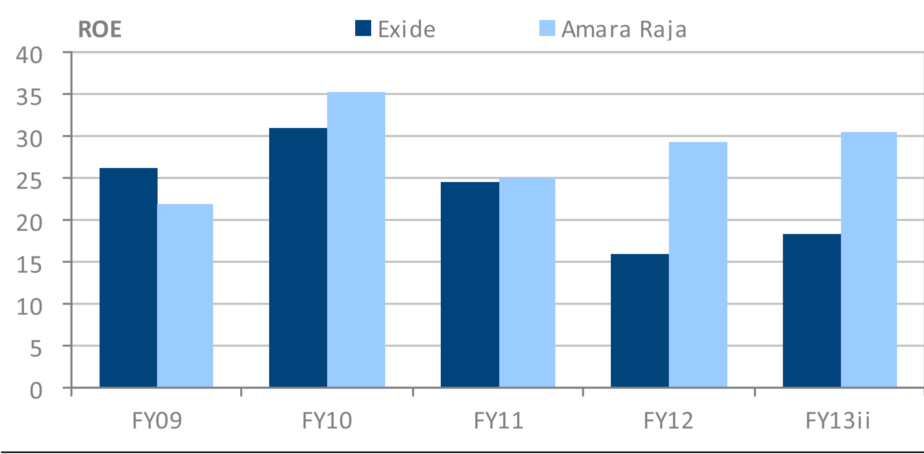


Source: Company, IIFL Research

High return ratios and strong FCFF generation

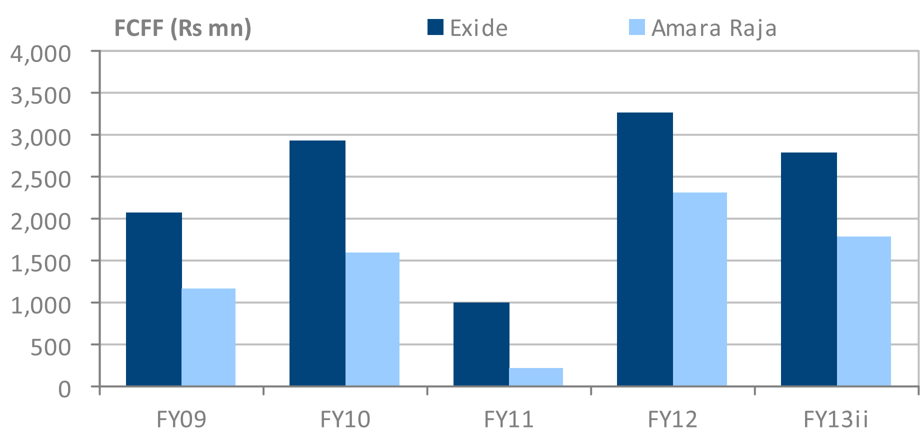
Battery Industry enjoys high return ratios and strong FCFF generation

Figure 10.7: Return ratios are high for the Industry



Source: Company, IIFL Research

Figure 10.8: Strong FCFF generation for the industry



Source: Company, IIFL Research

Growth drivers – a snapshot

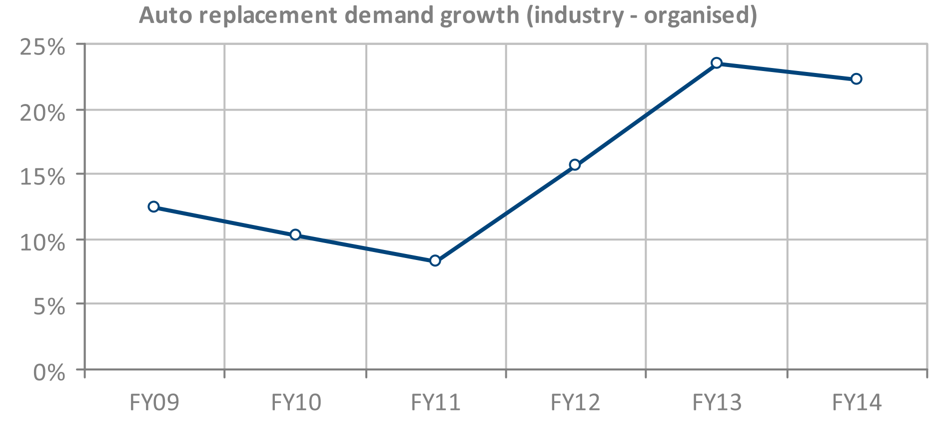
	Auto OEM	Auto replacement	Industrial batteries
FY12 Revenue contribution	25%	39%	36%
FY12 EBITDA contribution	7%	57%	36%
Exide's market share	72% in 4W OEM 71% share in 2W	30% in 4W 23% in 2W	UPS/Inverter segment: 35%
Expected volume growth	FY13: 2% FY14: 14%	FY13: 26% FY14: 19%	FY13: 17% FY14: 12%
Growth drivers	OEM growth is likely to be subdued in FY13 across segments due to high fuel costs and a general slowdown. In FY14, we expect a recovery driven by pent-up demand.	Replacement demand for 4W batteries has entered an upturn in FY13, being the 3rd anniversary of the strong vehicle sales in FY10, FY11. Replacement demand for 2W batteries will benefit from demand shift from kick-start to electric-start 2Ws	Worsened power situation should help drive demand for power back-up applications such as inverters and UPS UPS will also see strong replacement demand led by strong OEM growth in previous years

Auto replacement demand in an upturn

Replacement demand for 4W batteries has entered a cyclical upturn

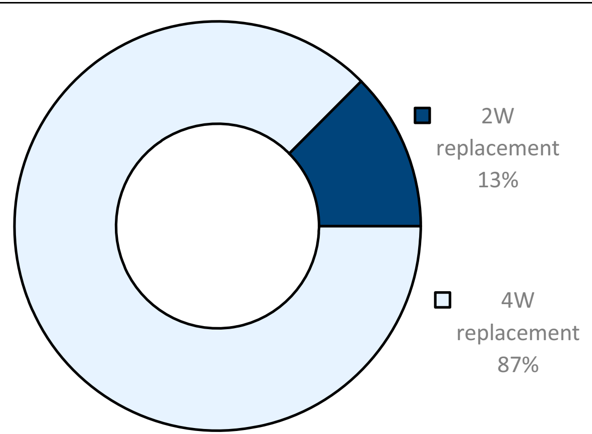
We expect replacement demand for auto batteries (57% of Exide's Ebitda) to register ~20% volume Cagr over FY12-15. Replacement demand for 4W batteries has entered a cyclical upturn, which should last at least 2-3 years. Replacement demand for 2W batteries should benefit because of the demand shift from kick-start to self-start 2Ws.

Figure 10.9: Expect auto replacement volume to grow at ~20% Cagr over FY12-15



Source: Company, IIFL Research

Figure 10.10: Break-up of Exide's auto replacement revenue (FY12)



Source: Company, IIFL Research

Strong growth in car/CV sales in FY10/FY11 will drive replacement demand growth starting FY13.

4W Batteries – Replacement demand in a cyclical upturn

After two muted years, replacement demand for 4W batteries has entered an upturn in FY13. Replacement demand for batteries tracks vehicle sales with a lag of 2-3 years. We expect strong growth in car/CV sales in FY10/FY11 to drive 17-18% replacement demand growth starting FY13. We expect the strong growth in replacement demand to continue for at least 2-3 years. Car sales grew 26% and 29% in FY10 and FY11 after a flat FY09. Although CV sales declined 22% in FY09, they recovered sharply in FY10 to 38% and FY11 to 27%.

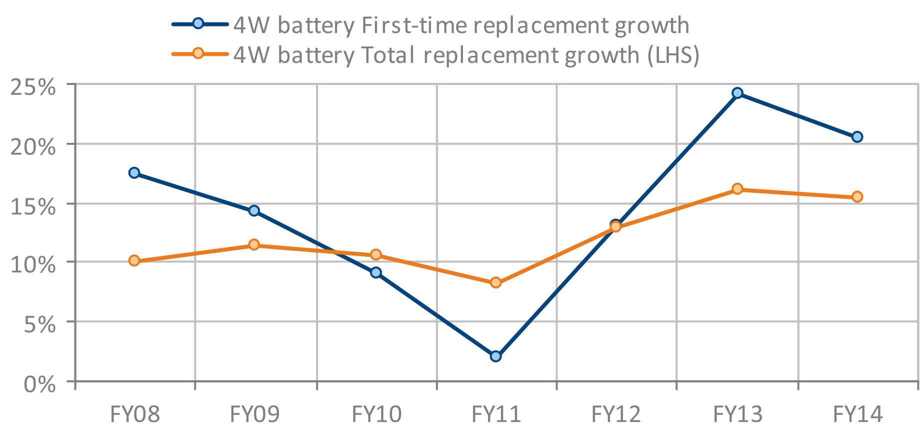
Figure 10.11: Growth in vehicle sales was strong in FY10 and FY11

Source: Company, IIFL Research

We expect replacement demand for 4W batteries to grow 15-16% in FY13 and FY14

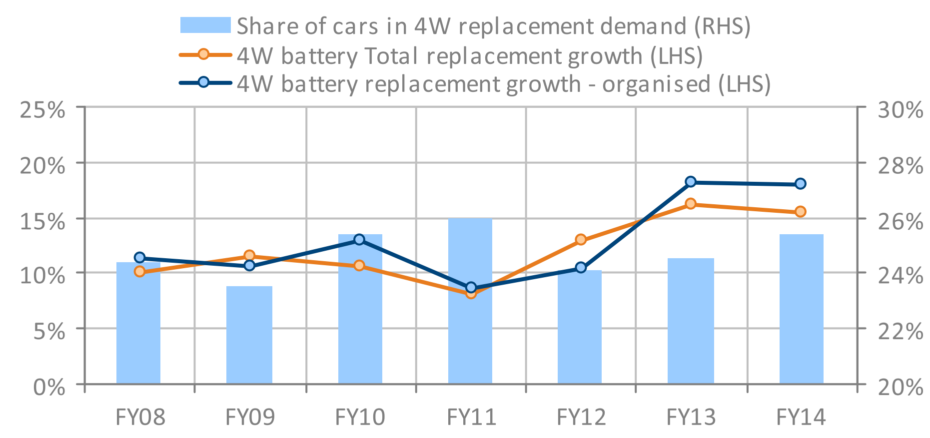
Car batteries typically have a replacement cycle of 2.5-3 years and CV batteries need replacement every 1.5-2.0 years. As a result, weak vehicle sales in FY09 impacted replacement demand in FY11 (CVs) and FY12 (cars). Coming into FY13, first-time replacement demand for batteries tracking the strong vehicle sales of FY10 has started driving demand for 4W batteries. We expect replacement demand for 4W batteries to grow 15-16% in FY13 and FY14. Replacement demand for car batteries is likely to grow faster than CVs over FY13-FY14, a follow-through of car sales in FY10-FY11. Since organised battery players have a higher market share in cars (80-90%) than CVs (30-35%), they are likely to grow faster than the market over FY13-14.

Figure 10.12: Expect replacement demand for 4W batteries to grow 15-16% during FY13, FY14 on the back of high vehicle sales of FY10 and FY11



Source: Company, IIFL Research

Figure 10.13: An increasing share of car batteries in replacement demand would drive faster growth of 17-18% for organised players



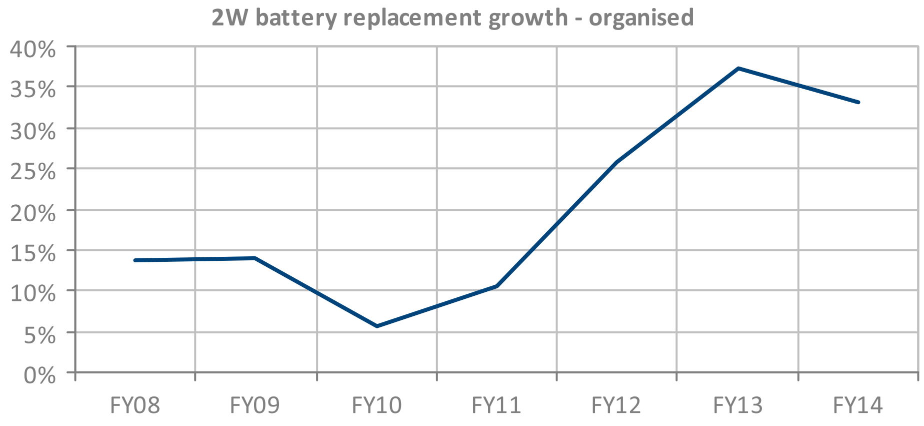
Source: Company, IIFL Research

Shift from kick-start to electric-start motorcycles will drive replacement growth for 2W batteries

2W Batteries – Replacement demand in a high-growth phase

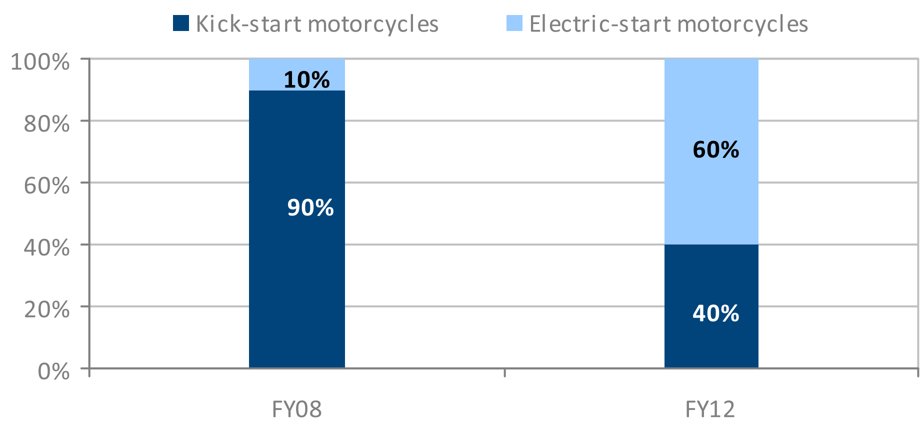
The influx of electric-start motorcycles over the past 3-4 years is driving the strong replacement growth for 2W batteries. We expect an average 30% growth over FY12-15.

Figure 10.14: Expect exponential growth in replacement demand for 2W batteries



Source: Company, IIFL Research

Figure 10.15: Adoption of electric-start motorcycles has increased substantially over the past 3-4 years



Source: Company, IIFL Research

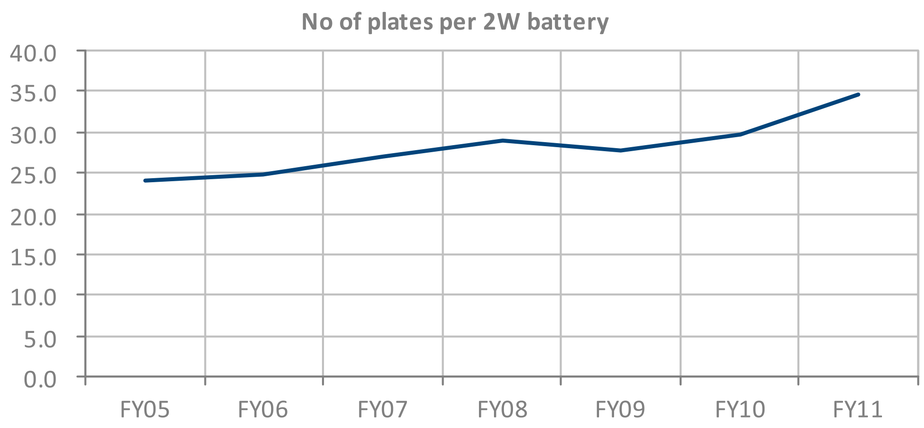
A kick-start motorcycle does not need a battery for ignition of the engine. Therefore, a large proportion of kick-start motorcycle-owners do not bother to replace batteries once the pre-fitted battery has exhausted. An electric-start motorcycle, on the other hand, needs a battery for engine ignition and hence, does not give the motorcycle-owner a choice of not replacing the battery, once it is exhausted.

According to industry sources, electrics-start 2Ws currently account for almost 60% of all 2W sales in India, up from 10% in FY08. These vehicles entered the replacement demand cycle starting FY12 and should drive strong growth in demand over FY12-15.

Need for electric-start 2Ws will drive increase in ASP of 2W battery

2W battery for electric-start is 50% more expensive than kick-start
Electric-start 2Ws require 4.0-5.0AmpHr batteries, compared with 2.5AmpHr batteries required for kick-start 2Ws. Batteries in the electric start 2Ws are used for ignition as well as lighting, whereas in the kick-start 2Ws, they are used only for lighting. This growing need will drive a significant increase in ASP of 2W battery. We have already seen significant increase in plates for 2W battery over the past 3-4 years.

Figure 10.16: Adoption of electric-start 2Ws has led to a sharp rise in the number of plates per 2W battery



Source: Company, IIFL Research

Exide's industrial batteries segment to bounce back in FY13
Exide's industrial segment slowed down in FY12 due to weakness in the inverter market (weak summer in 2011) as well as decline in the telecom batteries segment. With continued power deficit, demand for inverters has picked up significantly in FY13.

Figure 10.17: Exide's Industrial segment to recover in FY13 after a weak FY12

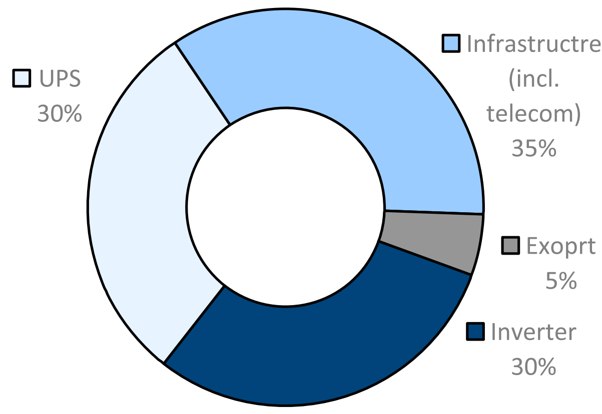
Industrial segment volume growth - Exide

25%
20%
15%
10%
5%
0%

2007 2008 2009 2010 2011 2012 2013 2014

Source: Company, IIFL Research

Figure 10.18: Exide's Industrial segment FY12 revenue break-up



Source: Company, IIFL Research

Industrial batteries to register strong growth starting FY13, as inverter demand bounces back due to persistent power deficit in the country

Power back-up (inverter, UPS) demand has picked up in FY13

Demand for inverters suffered in FY12 due to an abnormally moderate summer in 2011 and increase in competition. However, the power situation has worsened YoY over the past nine months and is helping drive improved inverter sales in FY13.

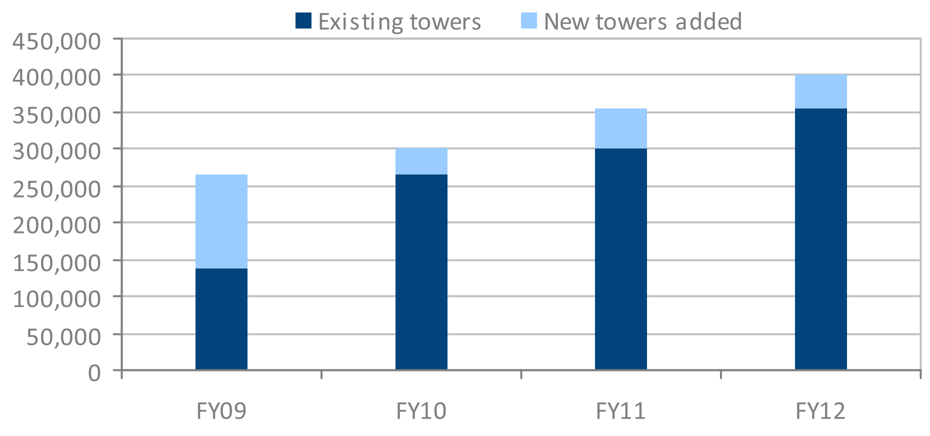
Previously, Exide supplied batteries to inverter OEMs as well as the replacement market. In FY12, Exide launched its own brand of inverters. Exide acquired the manufacturing facility of Kevin Power in 3QFY12. The facility had capacity of 40k units p.a., which is being ramped up to 200k p.a. The capacity can eventually ramp up to 500k. We believe that self-branded inverters will help Exide capture a higher volume market share and revenue share of the inverter market.

Demand for power back-up solutions in commercial establishments drives demand for UPS. OEM demand for UPS batteries may weaken in the near term, given the current economic slowdown. However, we expect replacement demand for UPS batteries to remain strong, led by strong OEM growth in the previous years (OEM demand for UPS inverters grew 38% in FY12).

Telecom battery demand unlikely to pick up

There has been a significant slowdown in the pace of telecom tower additions. While replacement demand may help drive single-digit growth, Exide's minimal participation in this segment (following losses in FY11) means that it will continue to be on the fringe.

Figure 10.19: Telecom towers: Pace of additions has slowed down substantially



Source: Company, IIFL Research

Exide is expanding its distribution network

Exide has distribution network of more than 40,000 touch points. In the auto battery segment, distribution comprises 16,000 authorised distributors/dealers and 14,000 Humsafar partners (garages, service centres, and petrol pumps etc.). For industrial batteries, Exide has a distribution network of 1,200 authorised dealers (Oct 2010). Exide currently operates from 204 locations in India through depot-cum-service stations. The company plans to expand to more than 250 locations by end-CY2013.

Margins set to improve in FY13

Better replacement-OEM mix will drive margin expansion

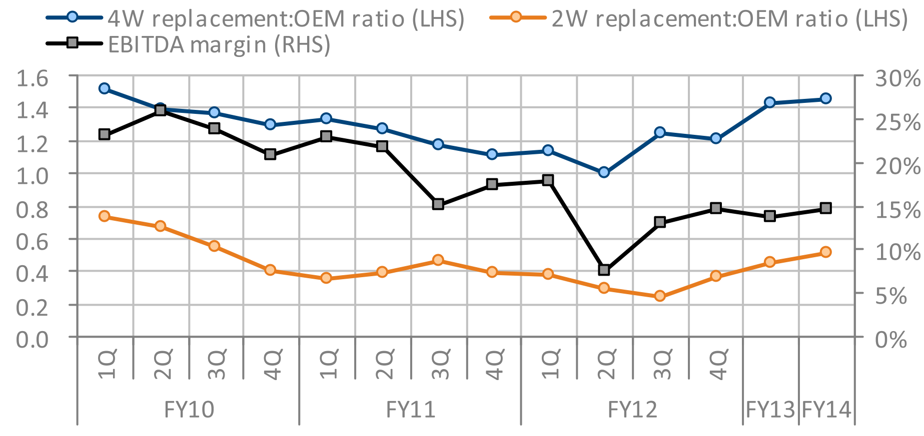
We expect Exide's Ebitda margin to improve from 13.4% in FY12 to 13.8% in FY13, and 14.5% in FY14. Better pricing power, better replacement-OEM mix and increased use of recycled lead will drive this.

Revenue mix to improve considerably due to better auto replacement and inverter sales

Among Exide's various segments, the Auto replacement segment generates the highest margins (19% in FY12). Margins are the lowest for the Auto OEM segment (4%). The Industrial segment generated 13.7% Ebitda margin in FY12. Within the industrial segment, the inverter segment is the most profitable. Given weak replacement demand in FY12, the volume mix for replacement: OEM in 4W batteries deteriorated considerably in FY12 (1.14 vs. 1.22 in FY11 and 1.38 in FY10). Similarly, the replacement OEM volume mix in 2W batteries deteriorated from 0.58 in FY10 to 0.36 in FY12. Sales of the high-margin inverter segment were also weak in FY12.

Over FY13 and FY14, we expect the replacement: OEM mix to improve considerably for both 4W and 2W batteries (1.28 and 0.49). We also expect the high-margin inverter sales to bounce back.

Figure 10.20: Expect Ebitda margin to pick up as replacement demand outpaces OEM demand in FY13 and FY14



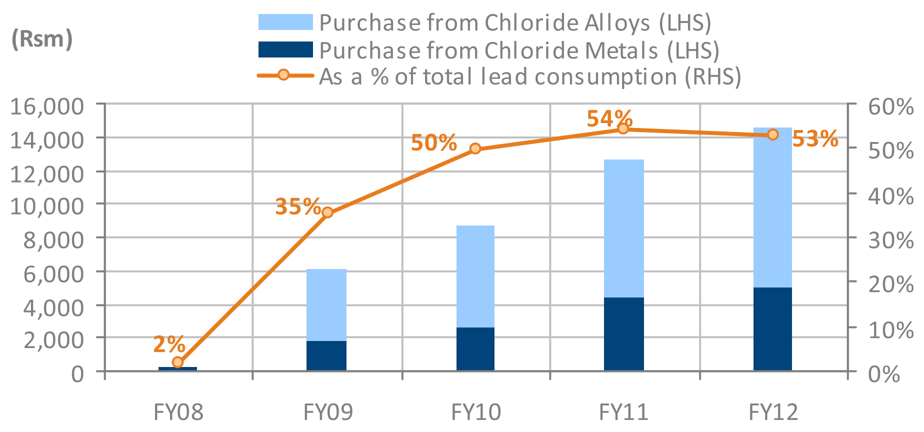
Source: Company, IIFL Research

Increased sourcing from smelters will provide significant cost advantage

Increasing reliance on recycled lead

To reduce the impact of volatility in international lead prices, Exide acquired two lead smelters: Chloride Metals Limited (Formerly Tandon Metals Limited) in FY08 and Chloride Alloys India Limited (formerly Leadage Alloys India Limited) in FY09. Exide ramped up capacities of its captive smelters and currently sources 53% of its lead requirement from these units. On an average, the smelters provide 10-12% price advantage to the company compared with imported lead. The company will expand the capacities of the smelters further in coming years, which would provide a significant cost advantage. Exide targets to increase the use of recycled lead from 53% now to 70% over the next 2-3 years.

Figure 10.21: Exide has increased lead sourcing from its two smelter subsidiaries



Source: Company, IIFL Research

Insurance business unlikely to require more cash

Exide acquired 50% stake in ING Vysya Life Insurance in FY06 to tap growing opportunities in India's insurance industry. The company is yet to turn profitable, given the high gestation period that is typical for insurance businesses. However, losses have narrowed significantly. Exide has invested about Rs7.4bn in the insurance business until date. We note that Exide did not make any fresh investments in ING Vysya Life Insurance in FY12.

Figure 10.22: Losses in ING Vysya have started to come off and so have Exide's investments

(Rs mn)
Investment by Exide in ING Vysya
Annual Loss ING Vysya
3,000
2,500
2,000
1,500
1,000
500
0
FY06 FY07 FY08 FY09 FY10 FY11 FY12

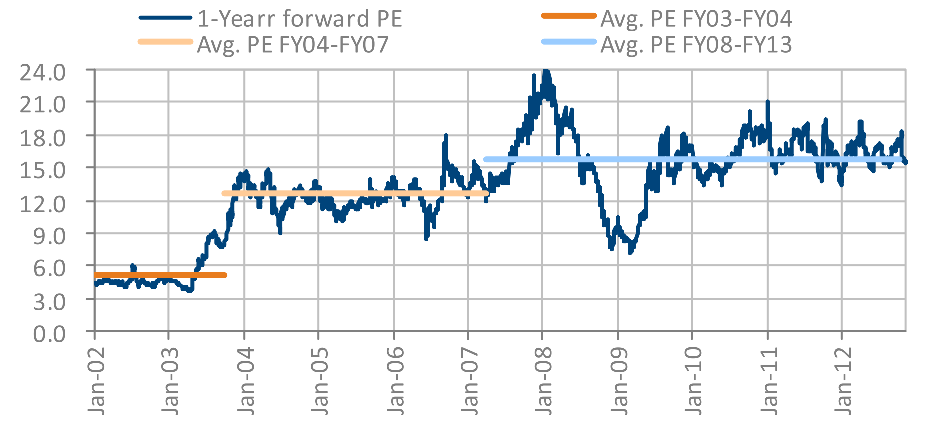
Source: Company, IIFL Research

Valuation – SoTP-based TP of Rs185/share

We value Exide based on 16x FY15 EPS and ascribe Rs9 to Exide's 50% stake in ING Vysya Life Insurance.

Exide has traded at 13-21x one-year forward P/E multiple over the past three years, with a mean of 16x. Adjusting for the value of 50% stake in ING Vysya Life Insurance, the three-year mean P/E would be closer to 15x. Given that the company is heading in an upturn, we value the core business at 16x P/E, at a slight premium compared with the adjusted historical mean P/E of 15x.

Figure 10.23: Exide has re-rated from 5x to 16x over the past 8-10 years



Source: Company, IIFL Research

We value Exide's 50% stake in ING Vysya Life Insurance at Rs9/share. Our value is based on 2x New Business Premium (NBP). This translates into 1x the investment made by Exide in ING Vysya Life Insurance until date.

Assumptions

Y/e 31 Mar, Consolidated	FY13ii	FY14ii	FY15ii
Volume growth			
Auto OEM (%)	1.8	13.5	13.5
Auto Replacement (%)	25.7	19.1	12.2
Total Auto segment (%)	12.2	16.3	12.9
Industrial segment (%)	16.7	12.0	13.0
Total volume growth (%)	13.9	14.7	12.9
Revenue growth (%)	27.5	24.7	17.1
EBITDA margin (%)	13.8	14.5	13.8

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**45,473**	**51,070**	**65,137**	**81,219**	**95,129**
Ebitda	8,786	6,839	8,976	11,817	13,152
Depreciation and amortisation	(835)	(1,007)	(1,157)	(1,297)	(1,419)
Ebit	7,951	5,832	7,819	10,520	11,733
Non-operating income	841	673	750	969	1,093
Financial expense	(60)	(53)	(24)	166	530
PBT	8,732	6,452	8,546	11,655	13,356
Exceptionals	603	0	0	0	0
Reported PBT	9,336	6,452	8,546	11,655	13,356
Tax expense	(2,672)	(1,840)	(2,572)	(3,496)	(4,007)
PAT	6,664	4,612	5,974	8,158	9,349
Minorities, Associates etc.	0	0	0	0	0
Attributable PAT	**6,664**	**4,612**	**5,974**	**8,158**	**9,349**

Ratio analysis

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	7.1	5.4	7.0	9.6	11.0
DPS	1.5	1.5	1.8	2.3	2.6
BVPS	32.3	36.0	41.1	48.5	56.6
Growth ratios (%)					
Revenues	19.9	12.3	27.5	24.7	17.1
Ebitda	(1.2)	(22.2)	31.3	31.6	11.3
EPS	7.3	(24.0)	29.5	36.6	14.6
Profitability ratios (%)					
Ebitda margin	19.3	13.4	13.8	14.5	13.8
Ebit margin	17.5	11.4	12.0	13.0	12.3
Tax rate	28.6	28.5	30.1	30.0	30.0
Net profit margin	14.7	9.0	9.2	10.0	9.8
Return ratios (%)					
ROE	24.4	15.9	18.2	21.4	20.9
ROCE	33.9	21.9	25.5	29.5	28.2
Solvency ratios (x)					
Net debt-equity	(0.2)	(0.2)	(0.2)	(0.3)	(0.4)
Net debt to Ebitda	(0.6)	(1.0)	(0.9)	(1.0)	(1.3)
Interest coverage	NM	NM	NM	(63.3)	(22.1)

Source: Company data, IIFL Research

Revenue growth led by high growth in replacement segment and price hikes

EBITDA margin to improve in FY14 as replacement-OEM mix improves

Balance-sheet is cash positive

Balance sheet summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	5,179	7,057	8,256	12,365	17,237
Inventories	8,589	9,681	12,307	14,958	17,592
Receivables	3,662	4,023	5,098	6,214	7,281
Other current assets	1,058	1,185	1,489	1,814	2,126
Creditors	5,276	5,765	7,353	9,168	10,739
Other current liabilities	2,673	3,780	4,850	5,671	6,702
Net current assets	**10,540**	**12,401**	**14,947**	**20,513**	**26,795**
Fixed assets	8,827	9,926	11,269	11,972	12,552
Intangibles	6	6	6	6	6
Investments	8,748	9,066	9,566	9,566	9,566
Other long-term assets	0	0	0	0	0
Total net assets	**28,121**	**31,398**	**35,787**	**42,056**	**48,919**
Borrowings	22	0	0	0	0
Other long-term liabilities	675	825	825	825	825
Shareholders equity	**27,425**	**30,573**	**34,962**	**41,231**	**48,094**
Total liabilities	**28,121**	**31,398**	**35,787**	**42,056**	**48,919**

Cash-flow generation to remain strong

Cash flow summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	7,951	5,832	7,819	10,520	11,733
Tax paid	(2,816)	(1,842)	(2,572)	(3,496)	(4,007)
Depreciation and amortization	835	1,007	1,157	1,297	1,419
Net working capital change	(2,026)	67	(1,348)	(1,456)	(1,411)
Other operating items	(1,416)	(581)	(727)	(1,135)	(1,623)
Operating cash flow before interest	2,528	4,482	4,329	5,729	6,111
Financial expense	(60)	(53)	(24)	166	530
Non-operating income	1,445	673	750	969	1,093
Operating cash flow after interest	**3,912**	**5,102**	**5,056**	**6,864**	**7,735**
Capital expenditure	**(2,160)**	**(1,991)**	**(2,500)**	**(2,000)**	**(2,000)**
Long-term investments	(1,421)	(492)	(500)	0	0
Others	680	652	727	1,135	1,623
Free cash flow	**1,011**	**3,271**	**2,783**	**5,999**	**7,358**
Equity raising	(2)	0	0	0	0
Borrowings	(672)	(22)	0	0	0
Dividend	(1,282)	(1,371)	(1,585)	(1,890)	(2,486)
Net chg in cash and equivalents	(945)	1,878	1,198	4,109	4,872

Source: Company data, IIFL Research

Technical analysis of Exide Industries

The stock price of Exide has found strong support at the base of the triangle pattern, which coincides with 40 WMA. If prices manage to sustain at these levels for a couple of weeks, a trend reversal could be on the cards. In the near term, positive momentum is likely to return on a move past Rs150.

Complexity of Pattern: Although prices hav e failed to sustain after the earlier triangle breakout, the long-term pattern is still only half done. If the stock manages to post recovery beyond Rs150, there is a good possibility of unfolding of a larger inverted head and shoulder pattern projecting a target of Rs240.

Retracement projection: Currently, prices are trading above the 50% retracement support of the upmove that began from December 2011 and also coincides with 40 WMA. A possibility of reversal remains high at these levels, provided prices do not move below Rs123.

RSI in neutral zone: Weekly RSI has been showing negative divergence with a move below 55 punctuating the positive momentum. The rising support line for RSI stands at 45 level, which provide a base for a strong rally.

Lacking comparative strength: The weekly ratio of Exide with S&P CNX 500 is trading at support of a bullish triangle after a failed breakout attempt. However, the long-term trend line still remains intact above 0.028 and a move past 0.034 should augment outperformance by 24%.

Exide Industries – 10 year share price performance chart

This page is blank intentionally

CMP	Rs213
Target 12m	Rs267 (26%)
Market cap (US$ m)	1,967
Enterprise value (US$ m)	1,932
Bloomberg	PIDI IN
Sector	Mid-caps

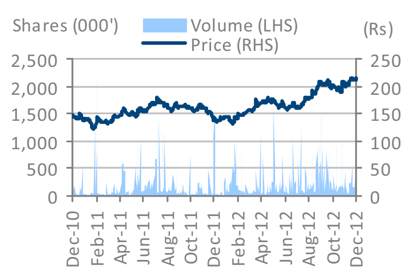
Dec 14 2012

52Wk High/Low (Rs)	225/134
Shares o/s (m)	513
Daily volume (US$ m)	1
Dividend yield FY13ii (%)	1.1
Free float (%)	29.4

Shareholding pattern (%)	
Promoter	70.6
FII	13.1
DII	5.0
Others	11.3

Price performance (%)	1M	3M	1Y
Pidilite	1.7	3.3	46.9
Absolute (US$)	4.1	2.5	45.9
Rel. to Sensex	(1.7)	(1.4)	25.3
CAGR (%)		3 yrs	5 yrs
EPS		23.8	42.2

Stock movement



J Radhakrishnan
radhakrishnan@iiflcap.com
91 22 4646 4653

Ankit Jain
ankit.jain@iiflcap.com
91 22 4646 4652

www.iiflcap.com

Pidilite Industries — BUY

Brand power at play

Pidilite Industries, a consumer and specialty chemicals company with strong presence in adhesives and sealants, is expected to record 23% Cagr in earnings over FY12-FY15, driven by strong demand for its consumer and bazaar products (81% of total revenue). Pidilite's products have a strong brand recall built over decades, which provides it pricing power. Its flagship brand Fevicol is a generic name for adhesives in India. Nearly 70% of its sales come from retail channels, where demand growth and margins are stable due to lack of credible competition. We believe that for a company that has strong brands comparable to those of FMCG companies, valuations are reasonable at 21.2x PER on FY14ii.

Consumer and bazaar products to drive growth: Pidilite's consumer and bazaar products are growing strongly (23% revenue growth in FY12), driven by the construction and paint chemicals divisions. We expect continued strong demand growth for these quasi-discretionary, maintenance-related products. We expect strong growth for adhesives and sealants, driven by revival in demand in the housing segment.

Pricing power led by strong brands: Pidilite's well-entrenched brands give it strong pricing power. The company generally increases prices for major products once a year to cover cost increases. Our channel checks indicate that Pidilite has more than 50% market share in most of its product categories whereas its competitors' share is normally less than 1/5th that of Pidilite's. We expect margins to be stable with a positive bias going forward.

Valuation reasonable: Pidilite's consolidated earnings recorded 24% Cagr in the past five years and we expect a 23% Cagr in earnings for FY12-FY15. The stock trades at 21.2x PER on our FY14 estimate. We feel this is reasonable, given the likely robust growth in earnings, driven by strong brand power. Pidilite has put its elastomer project in Dahej on hold. We believe that uncertainty relating to the project is largely in the price; our earnings estimate does not include any upside from the Dahej project; however if the management continues with the project, we would need to revise our capex estimate upward. We recommend a **BUY** on Pidilite with a target of Rs267.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	26,572	31,266	36,558	43,360	51,464
Ebitda margins (%)	17.6	15.5	15.9	16.9	17.3
Pre-exceptional PAT (Rs m)	3,101	3,244	3,977	5,080	6,189
Reported PAT (Rs m)	3,101	3,244	3,977	5,080	6,189
Pre-exceptional EPS (Rs)	6.1	6.4	7.8	10.0	12.2
Growth (%)	4.1	4.3	22.6	27.7	21.8
IIFL vs consensus (%)			0.5	5.5	4.4
PER (x)	**34.7**	**33.3**	**27.1**	**21.2**	**17.4**
ROE (%)	31.7	26.9	27.3	29.0	29.3
Net debt/equity (x)	0.0	0.0	(0.1)	(0.2)	(0.3)
EV/Ebitda (x)	22.7	21.8	17.8	13.9	11.1
Price/book (x)	9.9	8.1	6.8	5.6	4.7

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

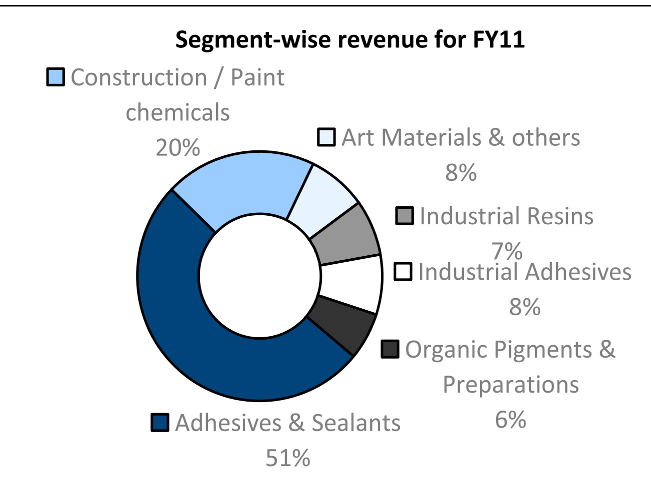
Company snapshot

Promoted by the Parekh family in 1959, Pidilite is one of the most innovative companies in the consumer space in India. The company's product range includes adhesives and sealants, construction and paint chemicals, automotive chemicals, art materials, industrial adhesives, industrial and textile resins, and organic pigments and preparations. Most of these products have been developed in-house, and two-thirds of the company's sales come from segments that it has pioneered in India.

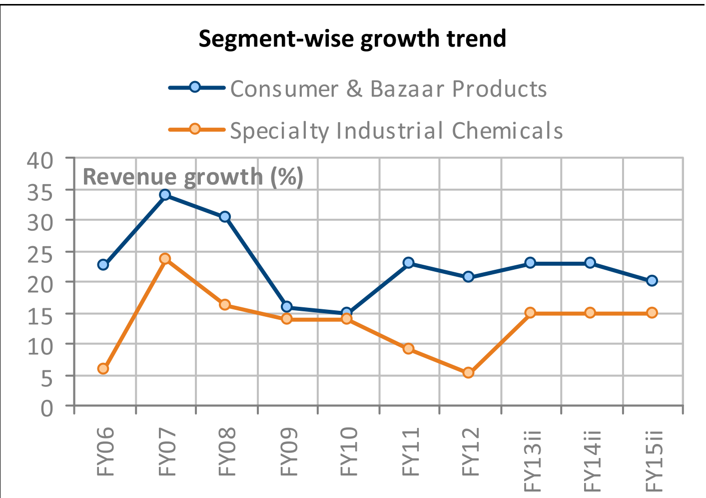
Consumer products segment contributes 79% of the total revenues for Pidilite Industries

The company has 14 overseas subsidiaries (four direct and 10 step-down), including those with significant sales and manufacturing operations in the US, Brazil, Thailand, and Dubai. These comprise about 10% of consolidated net sales. The company has two main areas of operation — consumer products and specialty industry chemicals. As of FY12, consumer products formed 79% of Pidilite's sales, comprising adhesives, construction and plant chemicals, and art materials. Pidilite's competitive advantage constitutes its ability to innovate constantly around unmet consumer needs in specific niches and create sustainable brands in the 'commodity' categories.

Segment-wise revenue for FY11



Segment-wise growth trend



Management

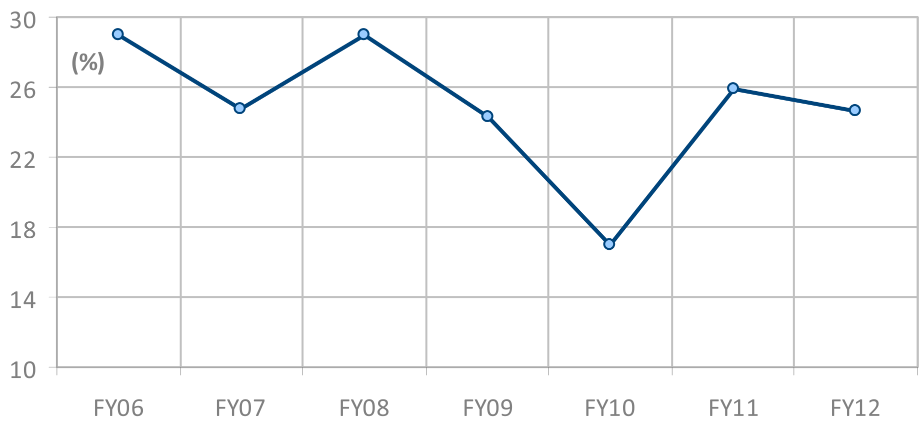
Name	Designation	Remarks / management description
B K Parekh	Chairman	Promoter serving as non-executive Chairman since 1972. Has a degree in law and senior management experience of more than 60 years.
M B Parekh	MD and Executive Director	Chemical engineer with B Chem Engg (Bom), MS Chem Engg. (USA). Has about 38 years of experience.

Consumer and bazaar products to drive growth

Construction chemicals is the fastest growing segment for Pidilite with Dr. Fixit and Roff being the chief brands

Construction chemicals are key growth drivers: Construction chemicals, which are quasi-discretionary maintenance products, constitute the fastest-growing segment for Pidilite. Generally, these chemicals are not do-it-yourself products and hence, the company needs to provide end-to-end integrated services. This is especially true for the more lucrative retail portion of the market (which forms 70% of Pidilite's category sales). Retail needs little credit (unlike construction companies) and is generally less price-competitive. This segment is growing at 25% Cagr for the past five years. The umbrella brand is Dr. Fixit, which commands strong brand recall. These products are used in waterproofing, crack filling etc. Dr. Fixit LW+ was launched two years ago. LW+'s potential is Rs15bn and the current market size is Rs1.5bn (Pidilite's share is ~40% in this segment).

Figure 11.1: Growth trend for the construction chemicals segment



Source: Company, IIFL Research

The key to competition in this category will be acquiring new technologies that address the Indian consumers' needs (water-proofing, damp-proofing, etc) and offer an integrated value proposition. Pidilite's strong distribution and nationwide delivery capability, along with its brand visibility and technology acquisition, will provide it an edge in this category. Our ground-level dealer checks indicate that in the water-proofing segment, Dr. Fixit and Roff are clear leaders. Some competition exists in this segment. However, dealers tell us that more than 40% of their sales come from the Dr. Fixit and Roff brands.

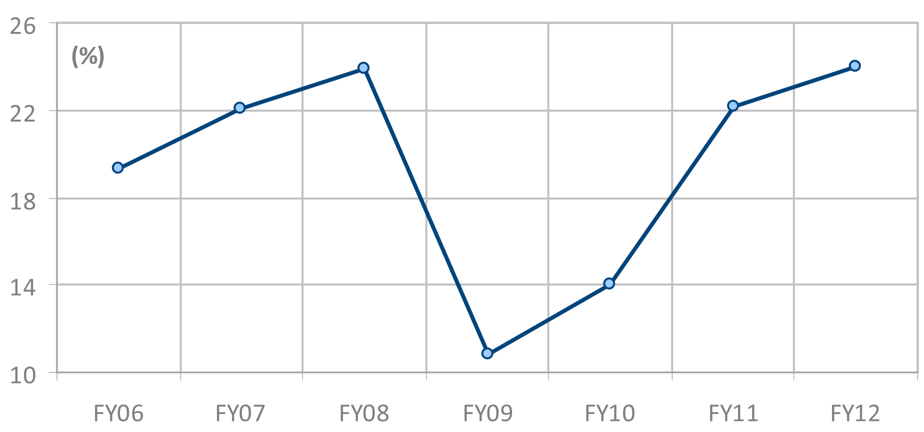
Higher volume growth has led to strong performance in the Adhesives segment

Adhesives and sealant's division growth surprises positively in FY12: After recording 10% volume Cagr for the five-year period ended FY11, the adhesives and sealants division recorded 24% revenue growth in FY12. We believe that a large part of this growth has come from higher volume growth. Technology is not a differentiator for this segment. However, strong brand building over the decades and an expansive distribution network have resulted in sustained growth. Pidilite sells adhesives under the Fevicol brand, which has become a generic name for adhesives in India.

The dealers we spoke to across cities told us that Fevicol continues to be a leader in the adhesive segment by a wide margin. Most dealers do not even store the competitor's products in the adhesives

segment. Jivanjor is at a distant second position in this segment. Dendrite and Sika are present in just a few regions.

Figure 11.2: Growth trend for adhesives and sealants segment

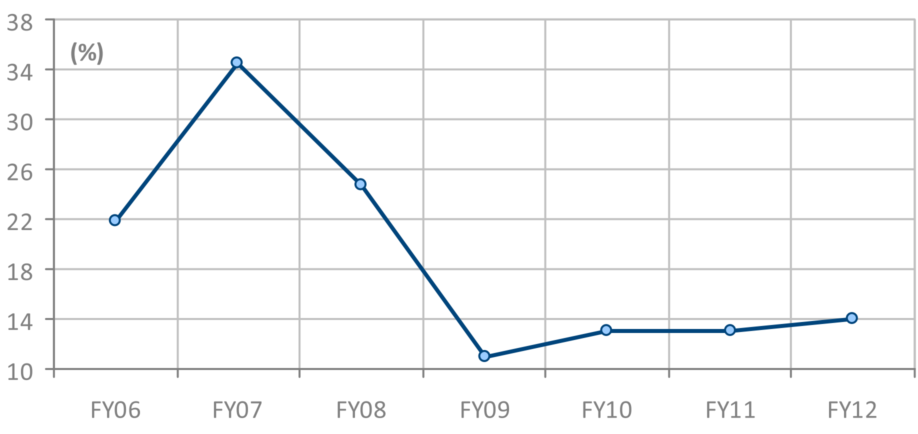


Source: Company, IIFL Research

We expect sluggish growth in the Art products segment due to lower discretionary spending

Art products — growth improving, but intense competition: Art products contribute to 8% of Pidilite's revenue. In art products, *Pidilite* is not the market leader. *Camlin*, *Faber-Castell* etc., are prominent competitors. In this category, imports, which are technologically superior as well, continue to dominate. Growth has been improving for Pidilite in this segment with an increase in number of *Hobby Idea* shops. We expect this segment to register sluggish growth owing to discretionary spending taking a hit, given the general weakness in the economy.

Figure 11.3:Growth trend for the art products segment



Source: Company, IIFL Research

Pidilite has acquired products that have become major brands over time like M-Seal and Roff

New product launches have boosted growth: Pidilite has developed differentiated products and built brands that have become strong standalone products over a period. Pidilite focuses on unidentified niche sub-segments of its competitors and develops brands here. It has also acquired products that can create sub-segments and some of them have become major brands over time (M-Seal, Roff). Pidilite re-launched Fevicol Marine, a waterproof adhesive, in FY11 and Fevicol Speedx, a fast-setting adhesive, in FY12. These products have received good acceptance and were the key drivers of growth in the adhesives segment in the past one year.

Strong acquisition track record

Acquisitions have strengthened product bouquet: Pidilite has acquired multiple brands and companies in the past two decades. The Dr. Fixit and Roff brands have turned out to be meaningful revenue contributors. Other notable acquisitions are M-Seal, Steelgrip and Ranipal. Pidilite's acquisition strategy has worked well and the only exception is the Dahej elastomer project. Pidilite makes small bolt-in acquisitions that find synergies with its bouquet of products or new technologies and give it a competitive edge. We expect Pidilite to continue with its acquisition strategy and small capex going forward.

Figure 11.4: List of acquisitions

Name	Year	Details
Metaplast (brand)	FY11	A polyester putty brand
Woodlok (brand)	FY10	Retail wood working brand of Henkel
Pulvitec do Brasil Industria e Commercio de Colas e Adesivos Limitada	FY08	Engaged in the business of adhesives, sealants and construction chemicals, this company and its manufacturing plant are located in Sao Paulo, Brazil. The business has annual sales of approximately Rs750m. This acquisition will help Pidilite enter high-potential Latin American market of adhesives and sealants. The cost of acquisition was around Rs531m.
Hardwood & Waud Mfg Company	FY08	The acquired assets include brands like Holdtite, Rustolene and Leakguard, which have healthy market shares in their respective segments. Total sales of the business are Rs150m. Acquisition cost was Rs118m.
Sargent Art	FY07	Sargent Art has been manufacturing and selling quality art materials in the educational market in USA for over 50 years. The product range includes tempera colours, acrylic colours, water colours and crayons.
Cyclo LLC	FY07	Cyclo has been selling automotive chemicals in USA and international market for over 50 years. The product range includes maintenance chemicals, performance chemicals and appearance chemicals for automotive segment.
Pagel Concrete Technologies	FY07	Indian company with technical and financial collaboration of Pagel Spezial-benton GMBH, and internationally renowned brand for industrial grouts and repair mortars. Pidilite acquired 75% equity stake in this company at a cost of Rs6.4m and loan contribution of Rs3.5m.
Bamco Ltd, Thailand	FY06	Bamco is a manufacturer of specialty bitumen-based waterproofing products and had, until then, marketed its products in Thailand, Indonesia, Malaysia and Singapore. Turnover of Rs86m on acquisition.
Jupiter Chemicals LLC	FY06	Pidilite Middle East Ltd, the company's wholly-owned offshore subsidiary in the Jebel Ali Free Zone in Dubai, acquired a 49% stake in Jupiter Chemicals LLC. Jupiter Chemicals manufactured reflective coatings, tile adhesives and plasters, and is expected to help grow the company's business in the high-potential Middle East market.
Tristar Colman/ Fine art brands business and some assets	FY06	Fine Art is a market leader in brushes for drawing and painting, while Tristar Colman is a well-known brand of canvas and student art colours. The acquisition strengthens the company's art materials portfolio and will help increase sales in the school and artist segments.
Roff (brand)	FY05	Roff has been a strong construction chemicals brand in India for over 18 years. This acquisition (for Rs137.7m) gives Pidilite access to both Roffe's product range and distribution network, as well as to a large number of trained and loyal applicators.
Chemson Asia Pte Ltd	FY05	A manufacturer of waterproofing products and exterior paints, in January 2005. Chemson had a manufacturing base in Singapore, from where it marketed products across the island state, Indonesia, Thailand and Malaysia. Consideration of S$437,500.
Bullbond and Vitapon (brands)	FY03	Brands of adhesives / resins from Parekh Marketing Ltd
Kalvyl, Tracol and Parvyl (brands)	FY03	Adhesives / resins brands from Kalva Chemicals Ltd in FY03 and land, buildings, plant and machinery etc in FY04 at cost of Rs50.7m; the cost is over and above the amount paid for brands in FY03
Steelgrip (brand)	FY02	Electrical insulation tape brand and business of Bhor Industries

Source: Pidilite, IIFL Research

Industrial chemicals is a niche commodity play

Visibility for the industrial chemicals segment remains low: Due to sluggish economic growth, growth in the industrial segment has turned volatile with a negative bias. Pidilite is present in industrial adhesives and resins, and organic pigments. The industrial chemical segment' contributes 19% to revenue and 18% to profit. In our view, outlook for this segment is weak due to sluggishness in the economy.

Figure 11.5: Mapping of products and brands

Category	Key products	End use/ segment	Key brands
Adhesives and sealants	White glue, Paper glue, Glue sticks, instant adhesive, epoxy putty, epoxy adhesive, maintenance spray, PVC insulation tape.	Home, school and office	Fevicol, Fevikwik, M-Seal
	Polyvinyl acetate white glue for joining wood, plywood, particle board, etc, contact adhesive for laminate and veneer pasting.	Woodworking	
	Contact adhesive for upholstery and flooring, white glue for wallpaper and parquet flooring.	Upholstery and flooring	
	Polyurethane-based adhesives, rubber-based adhesive.	Footwear	
	Silicone sealants, epoxy putty, epoxy adhesive, cyanoacrylate adhesives, PVC insulation tape, maintenance spray.	Automotive aftermarket, plumbing	
Construction and paint chemicals	Integral waterproofing compound, waterproofing coatings, waterproofing membranes.	Waterproofing	Dr Fixit, Roff, Cyclo
	Crack fillers, micro concrete, rust remover, repair mortars, epoxy bonding	Repair materials	
	Adhesives, additive, tile grouts.	Tile fixing solutions	
	Exterior coatings, protective coatings, heat reduction coatings, hygienic coatings.	Coating	
	Water reducing and retarding, plasticisers and accelerators.	Admixtures	
	Floor hardener, self leveling compound, epoxies.	Flooring	
	Polysulphides, silicones, acrylic and polyurethane sealants.	Sealants	
	High strength, non-shrink free-flow grouts.	Grouts	
	Lime binders, stainers/colourants, distempers, emulsion paints.	Interior coatings and wall	
	Wood preservatives, fillers, stains and finishes.	Wood finishes	
Art materials	Tempera colours, crayons, oil pastels, chalks, markers, pencils, poster paints, water colours, moulding clay, glitter paints.	Education	Sargent Art, Hobby Ideas
	Fabric colours, dimensional colours, glass colours, ceramic colours, silk colours, decoupage glue, moulding putty, brushes, hobby kits.	Hobby	
	Acrylic colours, oil colours, water colours, brushes, canvas.	Art students and artistes	
Industrial resins	Styrene acrylic, pure acrylic, VAM co-polymer emulsions, thickeners and dispersing agents.	Water-based decorative paints	
	Thermoplastic acrylic resins, acrylic polyols, polyester polyols, hardeners, flow and leveling agents	Industrial paints	
	Acrylic co-polymer emulsions.	Non woven fabric, flocked fabric, carpet, coated abrasives	
	Styrene-butadiene rubber and acrylic co-polymer emulsions.	Paper coating and construction chemicals	
	Acrylic syntans and binders, polyurethane binders, waxes, fillers and non ionic pigments.	Leather	

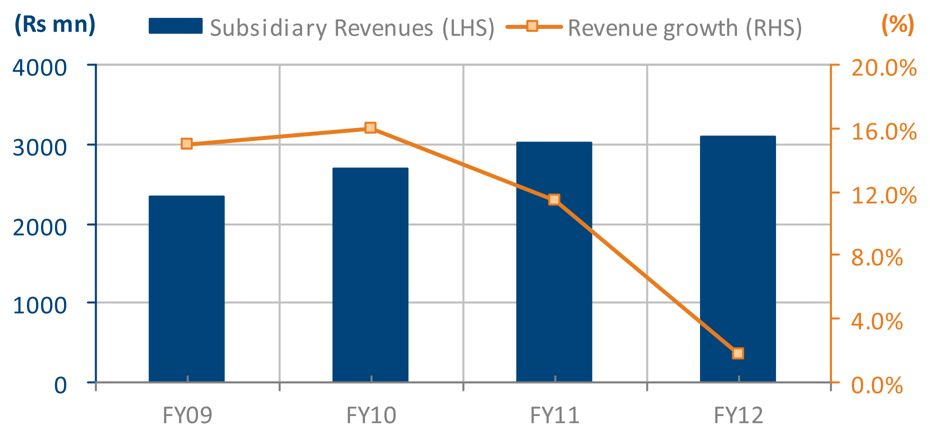
Category	Key products	End use/ segment	Key brands
Industrial adhesives	Water based adhesives, hot melt adhesives, solvent based and solvent free adhesives, pressure sensitive adhesives, etc.	Packing and converting, cigarette, book binding, stock labels	
	Epoxy adhesives, sprayable rubber based adhesives, brushable, rubber-based adhesives, cyanoacrylates, maintenance products, PVC insulation tape, acrylic adhesives.	Engineering and maintenance	
	Polyurethane based adhesives, rubber based adhesives, primers, hardeners, water-based adhesives, hot-melt adhesives and specialty products.	Footwear	
Organic pigments	Azo/Violet and quinacridone pigments.	Paint, plastic, ink and textiles	
	Pigment dispersions (preparations).	Paint and textiles	
	Colour concentrates.	Paints	

Source: Company

International business is still not very significant for Pidilite contributing 10% of total revenues and only 2% of Ebitda

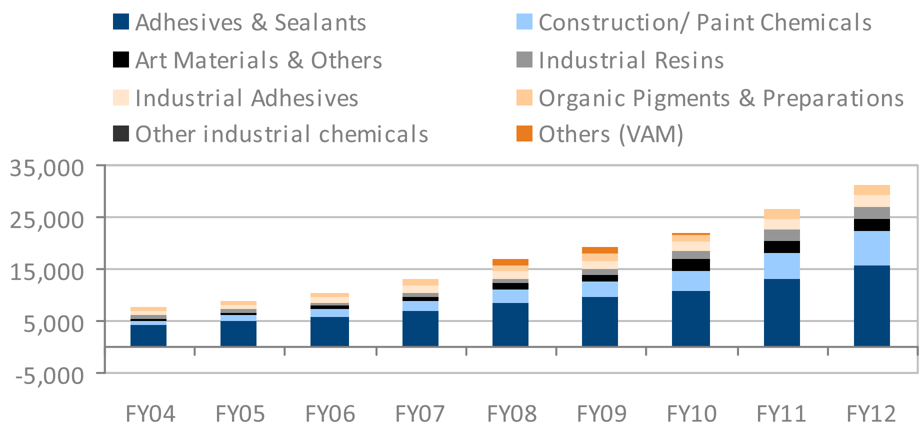
Stable revenues in overseas subsidiaries barring Brazil: Revenue from overseas subsidiaries constitutes 10% of overall revenue. Profitability is strong for subsidiaries barring the Brazil subsidiary. Brazil continues to be a drag and negates the positive contribution of other overseas subsidiaries. The subsidiaries contribute just 2% of overall Ebitda.

Figure 11.6: Overseas subsidiaries revenue and growth trend



Source: Company, IIFL Research

Figure 11.7: Category-wise revenue break-up over the years



Source: Company

Pricing power led by strong brands

More than 70% of Pidilite's revenue comes from the retail segment

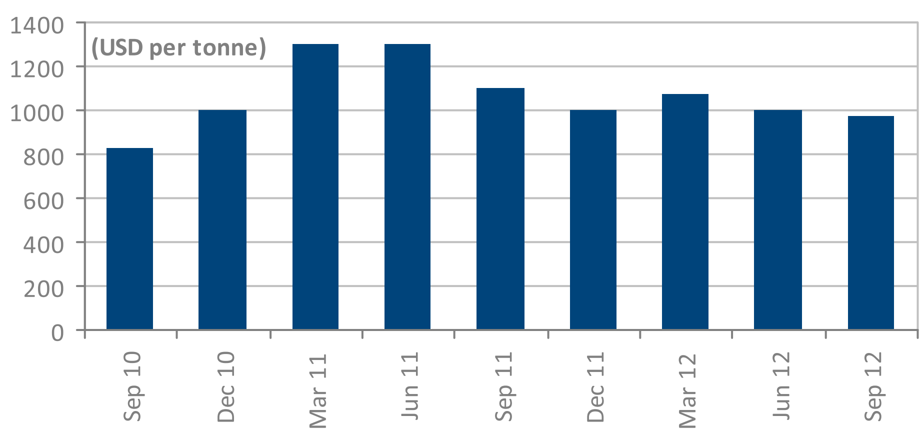
Large retail segment sales: Pidilite has lower exposure to project sales in the construction chemicals segment and its adhesives and sealants sales are concentrated more in the retail segment. We believe that more than 70% of its sales arise from the retail segment. Ticket size for Pidilite's products starts from Rs5 (9 US cents) and competition is practically absent in some of its product segments.

Robust brands built over years lend pricing power: Strong brand power of Pidilite has helped it pass on cost increases successfully over the years. Most of its raw materials are based on crude oil and volatility in crude oil prices impacts raw material costs. Currency movement also impacts cost of raw materials. Pidilite does not usually increase prices immediately if costs increase sharply for a temporary period since this may impact volume growth.

VAM prices have been on a declining trend

Vinyl Acetate Monomer (VAM) is a key raw material used in adhesives. Its price rose sharply in FY11, reaching US$1400 per tonne in May 2011, due to a rise in crude oil prices and supply tightness. VAM price has been on a declining trend and is in the range of US$950-1000 per tonne now. However, Pidilite could not benefit from the decline in raw material prices in FY12 due to the high cost of inventory and a sharp depreciation in INR. Pidilite has increased prices by ~8-10% in FY12 and ~5-6% in 1HFY13, largely to pass on cost increases. We believe that margins have largely bottomed out in FY12.

Figure 11.8:VAM price trend



Source: Company, IIFL Research

Brand power through innovative advertising and workshops: Pidilite has created brand awareness through innovative advertising for its products over the past few decades and by educating intermediary users (carpenters, plumbers, and civil contractors). Pidilite has allocated budgets for innovative advertising and it makes the efforts to train freelance contract workers as applicators to promote ease of application of its products.

Figure 11.9: Ad-spend trend for Pidilite

(Rs m) Amount in (LHS) As a of sales (RHS) (%)

1,200 1,000 800 600 400 200 -

5.0 4.0 3.0 2.0 1.0 0.0

FY06 FY07 FY08 FY09 FY10 FY11 FY12

Source: Company, IIFL Research

Competition has limited reach: Pidilite's advertising expenditure was Rs1074m or 3.4% of sales in FY12. Our channel checks indicate that the closest rival for Pidilite's adhesive brand Fevicol for wood applications is Jivanjor with a ~15% market share. Competition for other products in the organised sector is negligible and from the unorganised sector the reach is limited.

Figure 11.10: Pidilite's brands vs. competition

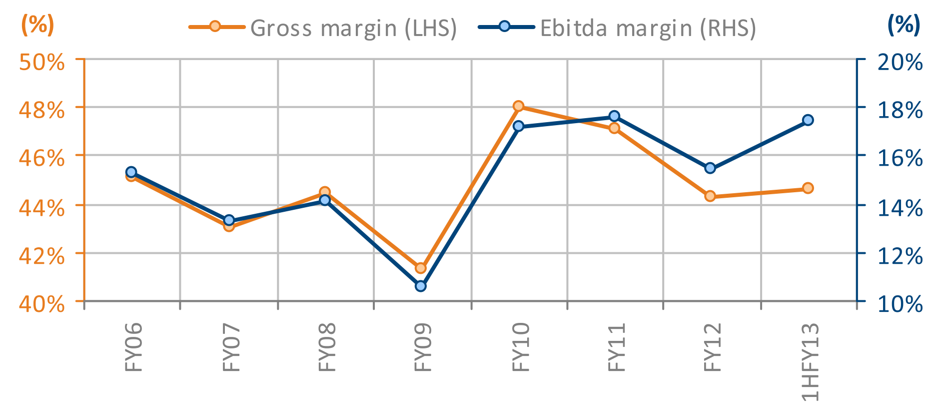
Brand	Segment	Estimated market share	Competing products
Fevicol	Adhesives	60%	Jivanjor, Dendrite, Sika
Fevikwik	Adhesives	90%	Negligible competition from Dendrite Phatak
Fevistik	Adhesives	50%	Kores Glue, Den Stick, Camlin
Dr. Fixit	Water proofing	40%	Unorganised segment
Roff	Tiling solutions	40%	Unorganised segment
M-Seal	Sealants	90%	Negligible competition from Araseal

Source: Industry, IIFL Research

Margins are likely to be robust in the medium-to-long term on account of Pidilite's strong brand power

We expect stable margins in the medium-to-long term: Pidilite normally increases prices once a year for most of its products, based on cost increases in the preceding year. Hence, sudden spikes in raw materials may result in short-term fluctuations in margins. Pidilite does not usually make steep increases in prices that may adversely impact demand growth. However, margins are likely to be smooth in medium-to-long term as Pidilite is likely to pass on the increase in costs, thanks to its strong brand power.

Figure 11.11: Gross and Ebitda margin trend



Source: Company, IIFL Research

Valuation reasonable

Earnings Cagr for FY07-FY12 at 24%; we expect 23% in FY12-FY15: Pidilite has recorded 24% earnings Cagr over FY07-FY12, underpinned by strong demand growth for construction chemicals and launch of new products in various sub-segments. We expect Pidilite to step up launches of new products. Coupled with this, we believe up-trading is also a likely growth driver, given the increasing brand recall of Pidilite's products.

Uncertainty on the Dahej elastomer project acquired in June 2007 largely priced in the stock

Dahej elastomer project put on hold: Uncertainty is high with regard to Pidilite's Dahej elastomer project. The management has put the project under review. Pidilite spent ~Rs3.7bn on this project until FY12 but has stopped investing in further capex for the past one year. According to the management, it is open to all options for the project. We believe that uncertainty of the project is largely reflected in the price of the stock. However, any decision to discontinue the project may have a short-term negative impact on the stock.

Valuations reasonable from a long-term perspective: The Pidilite stock is trading at 21.2x PER on our FY14 earnings estimate. The stock has traded at an average one-year forward PE of 19.7x for the past five years. We believe that current valuations are reasonable from a long-term perspective.

Figure 11.12: Pidilite vs. consumer peers

Company	CMP (Rs)	PER (FY14ii/CY13ii)	PER (FY15ii/CY14ii)	Earnings CAGR (%) (FY12 - FY15ii)	Dividend yield (FY13ii)	ROE (FY14ii)	P/BV (FY14ii/CY13ii)
Hindustan Unilever	517	29.9	26.4	14.8	2.5	85.3	22.5
ITC	296	26.1	22.1	18.5	1.9	37.5	9.5
Nestle	4783	35.8	30.6	20.9	1.2	67.9	21.6
Colgate	1387	30.3	26.2	17.2	2.1	108.5	30.9
Dabur	130	24.7	20.9	18.8	1.2	37.4	8.5
Marico	221	27.5	22.5	23.9	0.4	24.4	6.0
Emami	595	24.4	20.3	19.7	1.2	37.6	8.0
GSK Consumer	3750	30.8	26.0	19.5	1.2	33.9	9.4
Britannia	499	21.2	16.2	22.5	1.9	47.3	8.7
Average	NA	27.9	23.5	19.5	1.5	53.3	13.9
Pidilite	213	21.2	17.5	23.7	1.1	29.0	5.6

Source: Bloomberg. IIFL Research. Price as at close of business on 14 December 2012.

Trading at the mid-point of its P/E band

Figure 11.13:1-yr-fwd PE chart

Source: IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenue growth (%)	21.2	17.7	16.9	18.6	18.7
Gross margin (%)	47.1	44.3	44.7	45.2	45.2
Personnal Expenses/Sales (%)	10.8	10.4	10.3	10.3	10.3
Advertising expenses / Sales (%)	3.7	3.4	3.7	3.7	3.7
Ebitda margin (%)	17.6	15.5	15.9	16.9	17.3
Tax rate (%)	23.5	25.4	26.0	27.0	28.0

Source: Company data, IIFL Research

Financial summary

Revenue and Ebitda to grow driven by strong growth in construction chemicals division

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**26,572**	**31,266**	**36,558**	**43,360**	**51,464**
Ebitda	4,687	4,836	5,830	7,326	8,925
Depreciation and amortisation	(594)	(637)	(637)	(718)	(799)
Ebit	4,093	4,199	5,193	6,608	8,126
Non-operating income	300	435	500	600	720
Financial expense	(363)	(307)	(271)	(200)	(200)
PBT	4,030	4,327	5,422	7,008	8,645
Exceptionals	0	0	0	0	0
Reported PBT	4,030	4,327	5,422	7,008	8,645
Tax expense	(946)	(1,100)	(1,410)	(1,892)	(2,421)
PAT	3,084	3,226	4,012	5,116	6,225
Minorities, Associates etc.	17	17	(35)	(36)	(36)
Attributable PAT	**3,101**	**3,244**	**3,977**	**5,080**	**6,189**

Return ratios to improve with likely improvement in margins

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	6.1	6.4	7.8	10.0	12.2
DPS	1.8	1.9	2.4	3.0	3.7
BVPS	21.4	26.1	31.2	37.7	45.6
Growth ratios (%)					
Revenues	21.2	17.7	16.9	18.6	18.7
Ebitda	24.3	3.2	20.6	25.7	21.8
EPS	4.1	4.3	22.6	27.7	21.8
Profitability ratios (%)					
Ebitda margin	17.6	15.5	15.9	16.9	17.3
Ebit margin	15.4	13.4	14.2	15.2	15.8
Tax rate	23.5	25.4	26.0	27.0	28.0
Net profit margin	11.6	10.3	11.0	11.8	12.1
Return ratios (%)					
ROE	31.7	26.9	27.3	29.0	29.3
ROCE	31.0	29.4	31.1	33.8	35.4
Solvency ratios (x)					
Net debt-equity	0.0	0.0	(0.1)	(0.2)	(0.3)
Net debt to Ebitda	0.1	(0.1)	(0.4)	(0.6)	(0.8)
Interest coverage	11.3	13.7	19.2	33.0	40.6

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash and cash equivalents	2,742	3,715	5,398	7,520	10,175
Inventories	4,092	4,541	5,280	6,192	7,310
Receivables	3,460	3,952	4,621	5,480	6,505
Other current assets	862	1,108	1,108	1,108	1,108
Creditors	1,737	2,058	2,392	2,805	3,312
Other current liabilities	4,219	4,627	5,380	6,308	7,447
Net current assets	**5,200**	**6,631**	**8,635**	**11,186**	**14,337**
Fixed assets	9,270	10,383	10,995	11,777	12,678
Intangibles	0	0	0	0	0
Investments	0	0	0	0	0
Other long-term assets	0	0	0	0	0
Total net assets	**14,471**	**17,014**	**19,630**	**22,963**	**27,015**
Borrowings	3,201	3,279	3,279	3,279	3,279
Other long-term liabilities	422	473	508	544	580
Shareholders equity	**10,847**	**13,261**	**15,843**	**19,139**	**23,156**
Total liabilities	**14,471**	**17,014**	**19,630**	**22,963**	**27,015**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	4,093	4,199	5,193	6,608	8,126
Tax paid	(852)	(931)	(1,410)	(1,892)	(2,421)
Depreciation and amortization	594	637	637	718	799
Net working capital change	(150)	(458)	(320)	(429)	(497)
Other operating items	0	0	0	0	0
Operating cash flow before interest	3,684	3,447	4,100	5,005	6,007
Financial expense	(363)	(307)	(271)	(200)	(200)
Non-operating income	300	435	500	600	720
Operating cash flow after interest	**3,621**	**3,575**	**4,329**	**5,405**	**6,527**
Capital expenditure	**(1,275)**	**(1,564)**	**(1,250)**	**(1,500)**	**(1,700)**
Long-term investments	0	0	0	0	0
Others	(725)	1,617	0	0	0
Free cash flow	**1,621**	**3,629**	**3,079**	**3,905**	**4,827**
Equity raising	0	0	0	0	0
Borrowings	(1,120)	(1,626)	0	0	0
Dividend	(885)	(1,030)	(1,396)	(1,783)	(2,172)
Net chg in cash and equivalents	(384)	972	1,683	2,122	2,655

Source: Company data, IIFL Research

Strong free cash flow due to low capex; likely to decrease if Dahej project is revived

Interview

M B Parekh - MD, Pidilite Industries

M B Parekh
MD, Pidilite Industries

1. **What are the key long-term growth drivers of the company?**
   The key long-term growth drivers for the company are: a) achieving and maintaining a dominant position for our products and brands in different niche segments, and b) continuous innovation with respect to products and marketing initiatives.

2. **What is a sustainable rate of growth in volumes, revenue, and earnings over the next 4-5 years?**
   Our track record in the past 5-10 years is a good indication of likely growth in the next 4-5 years.

3. **What factors, in your view, contributed to your exceptional performance in the past over a decade?**
   A few factors that helped the company's performance, have been: a) Pioneering work in niche segments to gain significant market share; b) Effective brand building and communication; and c) Extensive grass-root contact and building close relations with end-users and influencers.

4. **Anything you wish for, to deliver similar performance in the next decade?**
   a) Consistent healthy growth of Indian economy.
   b) Strengthening of our management capabilities.

5. **What part of the business takes up your maximum time and attention?**
   a) Transformation of the company by strengthening management capabilities and revamping systems and processes.
   b) Defining the strategic direction for each of our businesses.

6. **How would you prioritise the different stakeholders in your company – shareholders, employees, customers, and government?**
   All stake holders have their special needs and requirements and it would not be fair to prioritise among them.

7. **Do you have a role model – an individual or a company?**
   Although we do not have any role model, we constantly learn from best practices of successful companies in India as well as abroad.

8. **What are your biggest challenges?**
   a) To impart entrepreneurial energy into all businesses and functions of the company.
   b) Take the company to the next level where we can continue to achieve high and sustainable growth without straining our resources.

9. **What is your vision for the company?**
   To see the company getting stronger in its chosen segments and deliver consistently strong results to all its stakeholders.

Technical analysis of Pidilite Industries

The stock price of Pidilite has been inching up with higher peaks and troughs and has negated the long-term bearish pattern on a close above Rs195 in Aug 2012. This was also coincided with the horizontal line breakout above Rs187.

Negation of 'rising wedge' a bullish catalyst:
Although the 'rising wedge' pattern is bearish but in case follow-up buying forces the prices to surpass the rising resistance line, the amplitude is replicated on the higher side, which projects a target of Rs285 in the current case.

Retracement projection: Correction during Feb 2012 had failed to retrace even 38.2%, which indicates inherent strength in the counter. Applying 161.8% price extension from the trough of Rs133.5 projects a price target of Rs374

Affirming relative strength: RSI has managed to bounce back in the bull market zone of 55-75 following negation of the bearish pattern. This move also helped to negate the bearish divergence, which prevailed over 12 months.

Neutral comparative strength: The ratio of Pidilite to S&P CNX 500 has been going through a phase of consolidation as support of 'rising wedge pattern' has not pierced below 0.04. The outperformance should resume on a move past 0.048.

161.8% price extension
Price target Rs285
Nigation of 'Rising Wedge' pattern
0.0%
38.2%
10 WMA
100.0%
Ratio with S&P CNX 500

Pidilite Industries – 10 year share price performance chart

(Rs/share)

250
200
150
100
50
0

Acquires Pulvitec of Brazil, a company engaged in adhesives, sealants and construction materials for US$13m

Acquires Polychloropene plant of French company Polymeri Europa elastomers for US$25m

Stock price declined on expectation of sale of its industrial products division

Acquires US based Sargent Art and Cyclo brands

Stock split with reduction in face value from Rs10 to Re1

Strong 2QFY08 results

Sharp run-up in key raw material prices result in decline in margins

Key raw material prices decline boosting visibility of margin expansion

Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

This page is left blank intentionally

CMP	Rs606
Target 12m	Rs744 (23%)
Market cap (US$ m)	1,383
Enterprise value (US$ m)	1,558
Bloomberg	HAVL IN
Sector	Mid-caps

Dec 14 2012

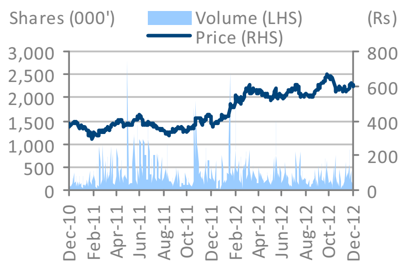
52Wk High/Low (Rs)	708/365
Shares o/s (m)	125
Daily volume (US$ m)	3
Dividend yield FY13ii (%)	1.3
Free float (%)	38.4

Shareholding pattern (%)	
Promoter	61.6
FII	20.0
DII	1.1
Others	17.3

Price performance (%)

	1M	3M	1Y
Havells India	2.8	3.7	41.3
Absolute (US$)	4.4	3.0	40.4
Rel. to Sensex	(0.6)	(0.9)	19.7
CAGR (%)		3 yrs	5 yrs
EPS		66.7	25.5

Stock movement



J Radhakrishnan
radhakrishnan@iiflcap.com
91 22 4646 4653

Ankit Jain
ankit.jain@iiflcap.com
91 22 4646 4652

www.iiflcap.com

Havells India — BUY

Geared for growth

Havells, a leading consumer electrical company with strong brands, is likely to record 20% earnings Cagr over FY12-FY15, driven by: 1) new launches in small home appliances and switchgears; 2) robust growth in domestic demand; and 3) consumer preferences shifting towards branded products. Havells derives nearly 70% of its sales from individual consumers. Steady growth in the housing segment is the key revenue driver. The overseas operations, which now account for 45% of sales and 31% of Ebit, are expected to show improved profitability as restructuring efforts begin to pay off. The Havells stock trades at an attractive PER of 14.2x our FY14 estimates.

Key segments growing strongly: Havells' strategy of growing through new product launches, expansion into new geographies, and widening of distribution channels, has resulted in strong 18-19% revenue Cagr and 26-31% earnings Cagr in the past 3-5 years. We expect revenue and earnings growth to remain robust, supported by increasing presence in small domestic appliances through a bouquet of products in FY12 and due to the launch of more products in the switchgear segment.

Sylvania's performance to improve: Sylvania's profitability turned around sharply in FY11 and FY12 (Havells acquired Sylvania in April 2007 and turned it around in FY11) as restructuring efforts paid off. However, profitability dipped in 1HFY13 due to a sharp fall in key raw material prices (rare earth phosphors) that had resulted in de-stocking by dealers. We believe this is only a short-term blip since raw material prices are now stabilising and may not fall further because a few producers are already facing losses.

Valuations are attractive: We expect Havells' margins to improve in FY14, led by improvement in Sylvania's operations. We expect margins to expand further in the medium term, underpinned by Havells' strong pricing power in all segments of its Indian operations barring the cable and wires segment. At 14.2x FY14 earnings estimates, the stock is valued attractively.

Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	56,356	65,579	75,394	85,591	96,107
Ebitda margins (%)	10.1	11.0	10.1	10.7	11.2
Pre-exceptional PAT (Rs m)	3,072	3,699	4,092	5,342	6,401
Reported PAT (Rs m)	3,031	3,699	4,092	5,342	6,401
Pre-exceptional EPS (Rs)	24.6	29.6	32.8	42.8	51.3
Growth (%)	120.8	20.4	10.6	30.5	19.8
IIFL vs consensus (%)			(1.7)	4.2	2.2
PER (x)	**24.6**	**20.5**	**18.5**	**14.2**	**11.8**
ROE (%)	58.3	46.0	37.1	36.9	34.0
Net debt/equity (x)	1.6	1.0	0.4	0.1	(0.2)
EV/Ebitda (x)	15.1	11.9	10.7	8.4	6.7
Price/book (x)	11.6	7.9	6.0	4.6	3.6

Source: Company, IIFL Research. Price as at close of business on 14 December 2012.

Background

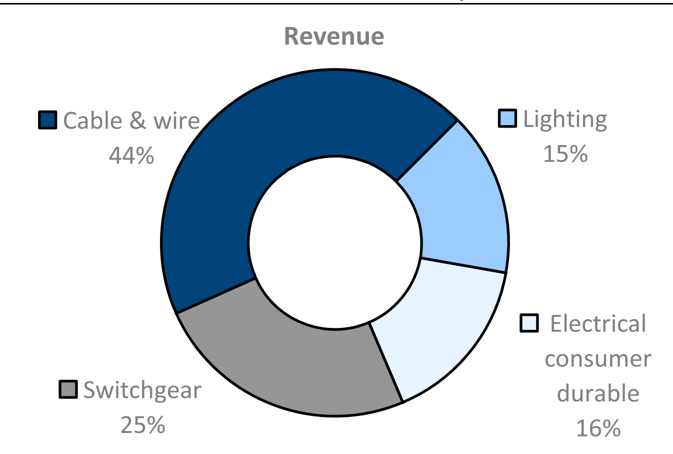
Havells owns several key brands and offers a wide range of products and services across various categories in electrical equipment

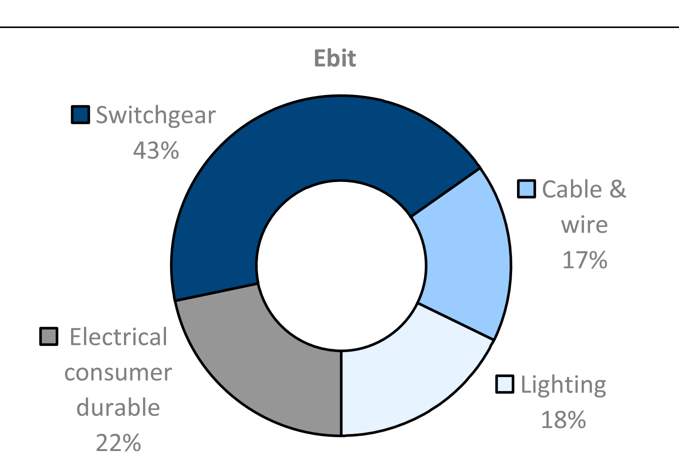
Havells India, incorporated in 1983, manufactures a wide range of low-voltage electrical equipment. The company offers a wide range of products and services — industrial and home protection switchgears, cables and wires, motors, fans, power capacitors, CFL lamps. luminaires for home and industrial applications, modular switches, and energy meters such as static and electromechanical meters.

The company acquired Sylvania, the global lighting fixtures company, in April 2007 for €227mn funded through debt of €200mn. Of this, €120mn was with recourse to Havells and it entailed a residual pension liability of €27mn.

Havells owns some prestigious global brands that include Crabtree, Concord, and Luminance. It has 91 branches and representative offices with more than 8,000 staff in 50 countries. The company has 11 manufacturing plants in India, located at Haridwar, Baddi, Samepur Badli, Noida, Sahibabad, Faridabad, Alwar, and Neemrana. Sylvania has eight manufacturing plants across Europe, Latin America, and Africa.

FY12 standalone revenue and Ebit break-up





Source: Company, IIFL Research

Management

Name	Designation	Remarks / management description
Qimat Rai Gupta	CMD	Chairman and group founder; has strong experience in trading of electrical goods.
Anil Rai Gupta	Joint MD	Graduate in Economics from Sriram College of Commerce, Delhi University. MBA (Marketing and Finance) from Wake University, North Carolina.

Key segments growing strongly

Havells focused on growth: In the past decade, Havells focused on increasing dealer network, expanding into new geographies, entering new segments, and building brand strength. This engendered revenue Cagr of 19% for the domestic operations and 31% for the consolidated entity in the past five years. Havells continues to see robust demand across segments and expects new product launches in the consumer division and switchgear division to boost growth. We expect 18% revenue Cagr in the next three years for the domestic operations since we expect rising income and increased disposable income in India to support the sustained up-

trading by consumers to branded products. Havells would be able to leverage the growing demand in the Indian brown goods space supported by its strategy of focusing on brands, increasing geographic presence, and widening the dealer network.

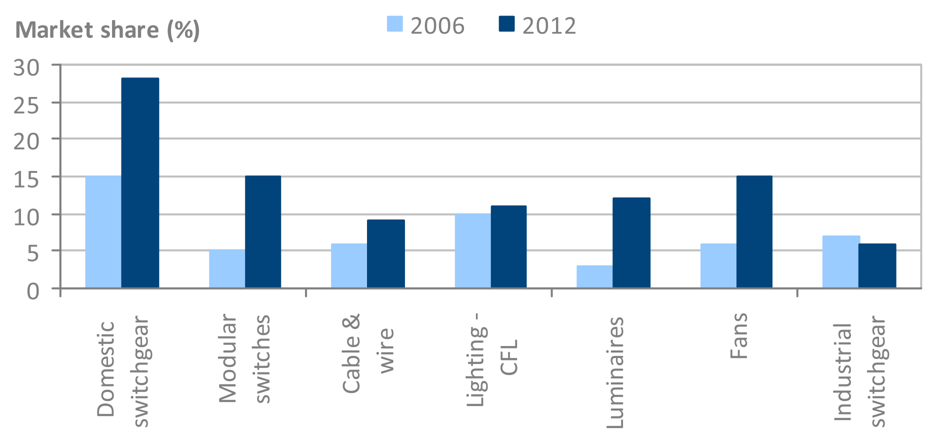
Market leader in domestic switchgears and amongst the top three producers in modular switches, cables and wires, CFL lighting and fans

A wide consumer electrical and lighting product portfolio: Havells has diversified from a switchgear company to a consumer electrical company in the past two decades. It now has a wide product portfolio and a presence across the household, commercial and industrial electrical segments, unlike peers. Havells derives ~70% of its sales from individual consumers. Increase in household spending for lighting and consumer durables will be a key revenue growth driver. Havells is a market leader in domestic switchgears and is among the top three producers in modular switches, cables and wires, CFL lighting, and fans. Barring industrial switchgear, Havells has increased market share in the past five years in all segments in which it operates, which is a testimony to its competitive capabilities and brand recall.

Figure 12.1: Havells' consumer electrical and lighting product portfolio

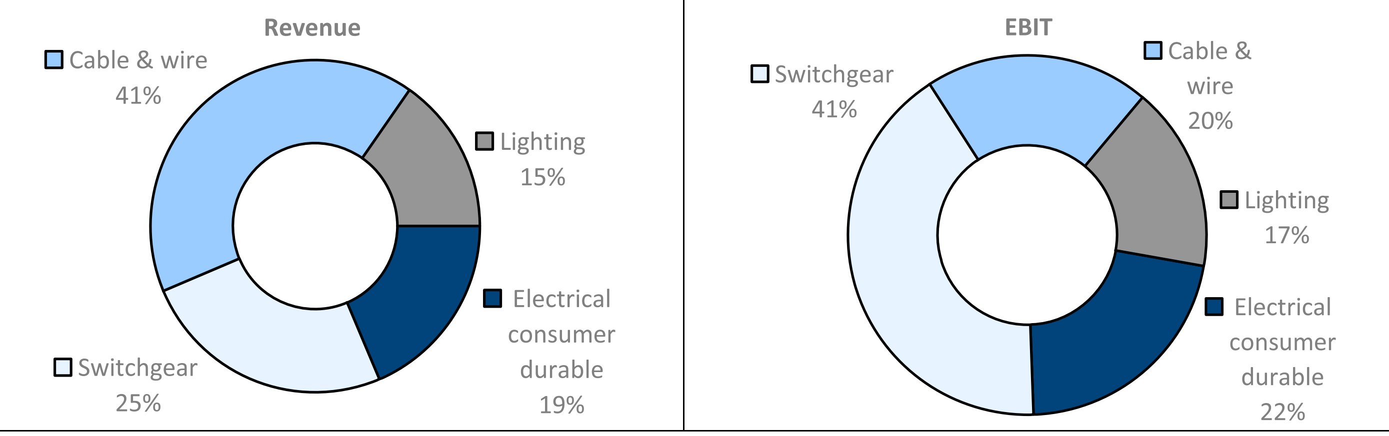
Source: Company, IIFL Research

Figure 12.2: Market share across product segments



Source: Company, IIFL Research

Figure 12.3: Segmental performance of Havells in 1HFY13



Source: Company, IIFL Research

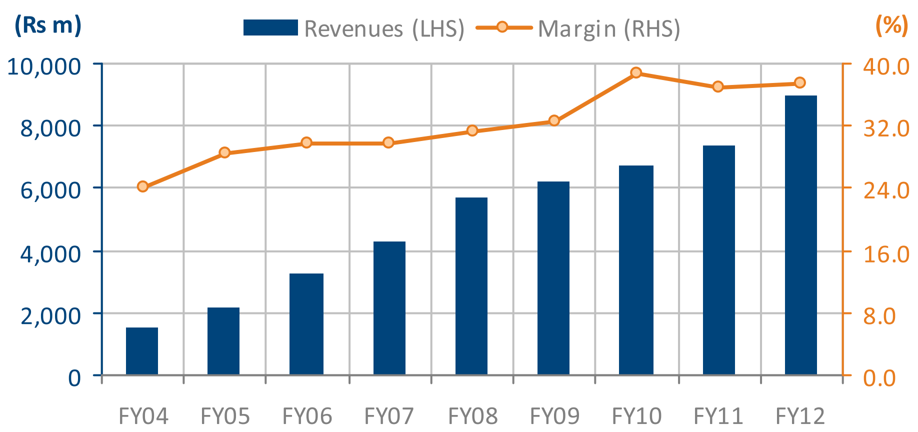
Switchgears – low volumes, high margins: The domestic switchgear market is dominated by Havells and multinationals. Competitors in this segment primarily comprise MNC players that have largely remained disciplined, resulting in strong margins. Havells is the largest player in this segment in India with 25% market share. Key competitors in this segment are Legrand (MDS and Indo Asian) and Schneider. Havells' range of products includes miniature circuit breakers (MCBs), mini MCBs, residual current circuit breakers (RCCBs), residual current breakers with overload protection (RCBOs), switches, sockets, regulators, moulded case circuit breakers (MCCBs), rewirable switches, off-load changeovers, on-load changeovers, and switch disconnector fuses (SDFs).

Largest player in the Switchgears segment in India with 25% market share

Havells has exclusive rights to market the Crabtree brand in India and it sells modular plate switches under this brand. Havells has positioned the brand in the premium segment. The brand is the second largest in modular switches with market share of 15%. Key competitors are Matsushita/Anchor Roma and Legrand. In the industrial switchgear segment, Havells has 6% market share, which ranks it fifth in the market. Key competitors in the industrial switchgear segment are L&T, Schneider, Siemens, and ABB.

Switchgears contributed 25% to 1HFY13 revenue and 41% to overall revenue. The housing segment powers the growth driver for the switchgear segment. Revenue growth improved in FY13 compared with FY12, boosted by new launches. We expect growth to improve further, led by a likely revival in the housing segment with mortgage rates trending downward.

Figure 12.4: Switchgears segment revenue and margin trend



Source: Company, IIFL Research

Higher competition with little value addition results in low margins in the cable and wire segment

Cable and Wire – high volumes, low margin: Although cables and wires is the largest business segment for Havells, margins here are among the lowest. This is largely because competition in the segment is high and there is little value addition. Havells is the second-largest player in this segment with 9% market share. Key competitors are Polycab, Finolex, and KEI. The company manufactures a complete range of low and high-voltage PVC and XLPE cables, domestic fire retardant and fire retardant smokeless (FR/FRLS) wires, and co-axial TV and telephone cables.

The cable and wire division recorded 15% revenue Cagr in the past five years. However, growth was largely due to increase in copper prices. In 1HFY13, revenue growth slowed down to 13% YoY owing to sluggishness in underground cables because of the economic slowdown. Most of the growth, we believe, would be due to cost inflation because of INR depreciation. This segment accounts for 44% of standalone revenue and 17% of profit. The segment is not a focus area for Havells. We build in 12% growth for the division for FY14.

Figure 12.5: Cable and wire segment revenue and margin trend

(Rs m) Revenues (LHS) Margin (RHS) (%)

Source: Company, IIFL Research

Third largest player in both the CFL segment and fans segment with 11% and 15% market share respectively.

Fans and lighting - fastest growing segments: The fans and lighting segment (reclassified as lighting and fixtures and electrical consumer durables since FY08) recorded 18% revenue Cagr in the past four years. Havells is present only in the CFL segment, the fastest-growing segment in lighting in the past few years. Havells is the third-largest player in India in the CFL segment with 11% market share. Key competitors in this segment are Philips, Surya, and Osram. In luminaires, the company's market share increased from 3% in FY06 to 12% in FY12. Havells is the fourth-largest player in this segment. Key competitors in luminaires are Phillips, Bajaj Electricals, Crompton, and Wipro.

In the fans segment, Havells has positioned itself at the high end of the segment, which has boosted overall growth and profitability. Havells is the third-largest player in the fan segment in India with 15% market share. Key competitors are Crompton, Usha, Orient, and Bajaj Electricals. We estimate the luminaires and fans segments to register 20-30% revenue Cagr over the next two years.

Small electrical appliances the new growth driver: Havells entered the small electrical appliances segment in September 2010 by launching the electrical water heater. It launched a range of

products in August 2011 that includes irons, mixers, toasters, blenders, juicers, and electrical cookers. These products are likely to fetch revenue of Rs1.5bn in FY13 and Rs2.2bn in FY14. Havells expects revenue to reach Rs5.0bn over the next 4-5 years from these products.

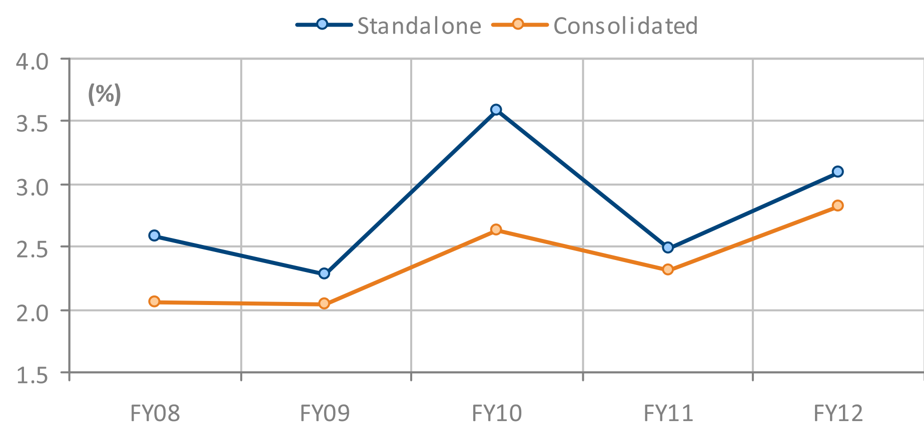
Figure 12.6: Electrical small appliances portfolio

Source: Company, IIFL Research

Reasonable advertising spends for brand development

Focus on brand building to continue: Havells' products have a high brand recall supported by spending on advertising and promotion (A&P). The company's A&P budget is comparable to other leading consumer companies. A&P expenses reduced in FY11 to 2.5% of net sales compared with 3.6% in FY10 but increased to 3.1% again in FY12. The management expects A&P expenditure at 2-3% of net sales.

Figure 12.7: Ad-spend-to-sales ratio



Source: Company, IIFL Research

Figure 12.8: Havells vs. competition in domestic markets

Segment	Market share (%)	Leadership position	Pricing power	Competing brands
Switchgears	~28	1st in Domestic MCB and 5th in Industrial switchgears	High	Legrand (MDS, Indo Asian), Schneider in MCBs and L&T, Schneider, Seimens, ABB in industrial segment
Switches	~15	2nd	Medium	Panasonic (Anchor), Legrand
Fans	~15	3rd	Medium	Crompton, Usha, Orient
Lighting & Luminaires	~11-12	2nd in Lighting and 4th in Luminaires	Medium	Phillips, Osram, Bajaj, Crompton, Wipro
Cables and wires	~9	2nd	Low	Polycab, Finolex, KEI

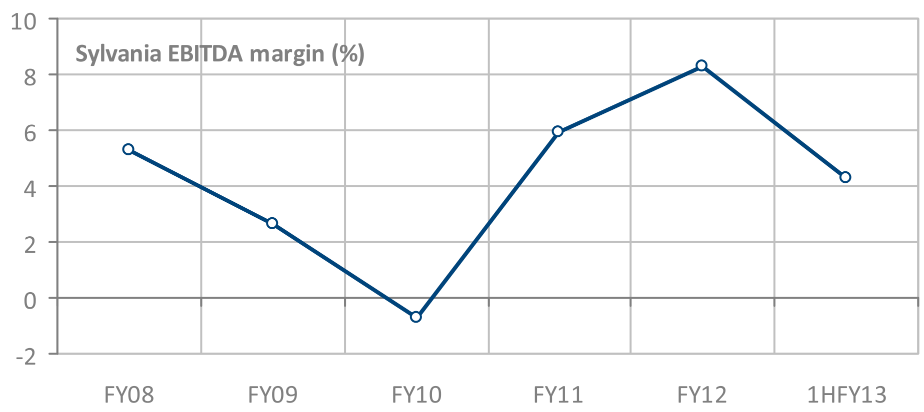
Source: Company, IIFL Research

Sylvania performance to improve

Ebitda margins have improved significantly in the past two years thanks to the restructuring efforts

Restructuring boosted performance in FY11 & FY12: The global recession in 2008 and 2009 resulted in sharp erosion in Sylvania's profitability. However, the company undertook restructuring from FY10 that included: 1) increasing outsourcing from India and China; 2) shutting down high-cost plants in Europe; 3) increasing sales in high-margin countries; and 4) reducing head count. The restructuring seems to be paying off, with Ebitda margins improving substantially in the past two years. We expect further margin improvement on higher sales from high-margin countries.

Figure 12.9: Ebitda margin trend for Sylvania (in constant currency)



Source: Company, IIFL Research

Revenue growth likely to be muted: Although margins have firmed up due to restructuring efforts in FY11 and FY12, the slowdown in Europe continues to hurt volume growth. Volumes in LatAm markets are growing at a healthy 10% annually. However, growth in Europe is muted at 0-4% due to a sluggish economy. We expect revenue growth at 4-5% annually for Sylvania, primarily led by growth in the LatAm markets and entry into new geographies in Asia.

Stabilisation of raw material prices is likely to improve performance going forward

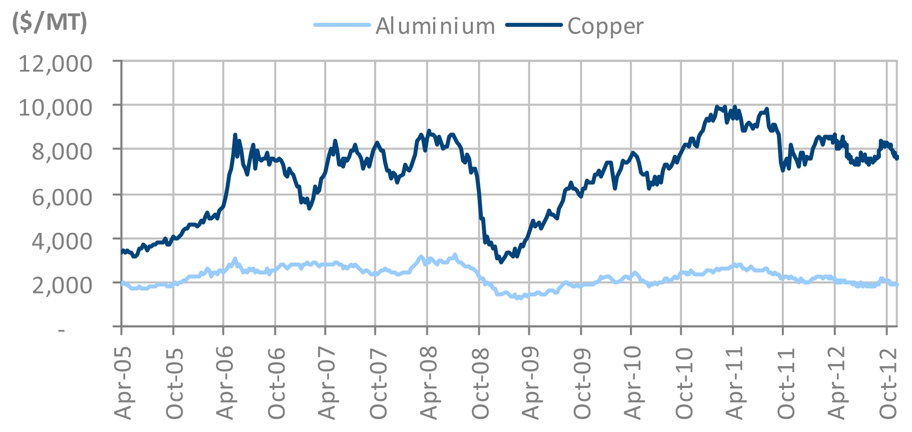
Short-term blip in performance; to improve going forward: Sylvania's profitability turned around sharply in FY11 and FY12 (Havells acquired Sylvania in April 2007 and turned it around in FY11) as the restructuring efforts paid off. However, profitability dipped in 1HFY13 due to a sharp fall in the prices of a key raw material resulting in de-stocking by dealers. The price of this raw material has now largely stabilised and a further sharp fall is not expected, in our view, since a few producers are already facing losses.

Recourse debt entirely paid: Havells acquired Sylvania for EV consideration of €227m, funded through debt of €200mn. Of this, €120mn was with recourse to Havells. In early FY12, the recourse debt was at €10m and Havells entirely paid it by end-FY12. We expect overall debt-to-equity to continue to reduce, as seen in the last one year (net debt/equity reduced to 1.0x in March 2012 from 2.3x in March 2010).

Valuations are attractive

Margins to look up for the standalone and consolidated entities: Prices of copper and aluminum, the key raw materials, have largely stabilised, after declining from the peak seen in 1HFY12. Havells increased its product prices in FY11 and FY12 to pass on increase in raw material costs. We expect Havells to pass on the cost increases in the domestic markets and expect improvement in operating leverage for Sylvania to boost margins in FY14. We estimate 70–110bps improvement in operating margins over the next two years for the consolidated entity.

Figure 12.10: Prices of key raw materials have stabilised in the past few months



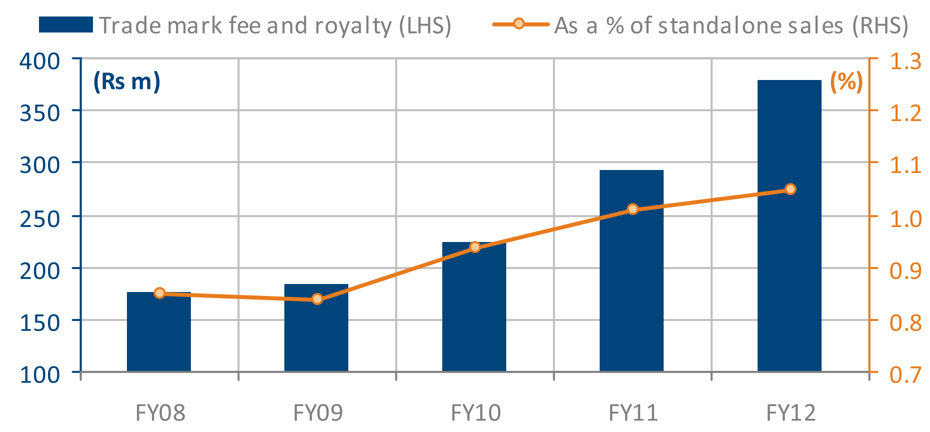
Source: Bloomberg, IIFL Research

Strong cash flows would result in a likely increase in net worth bringing the net debt-to-equity further down to 0.4x by March 2013

Balance sheet to become stronger: Havells leveraged its balance sheet strength to acquire Sylvania, which resulted in net debt-to-equity ratio increasing from 0.1x in FY07 to a peak of 2.3x in FY10. Havells started focusing on balance sheet strength and it brought down net debt-to-equity ratio to 1.0x in March 2012. We expect the ratio to reduce further to 0.4x by March 2013, with a likely increase in net worth owing to strong cash flows.

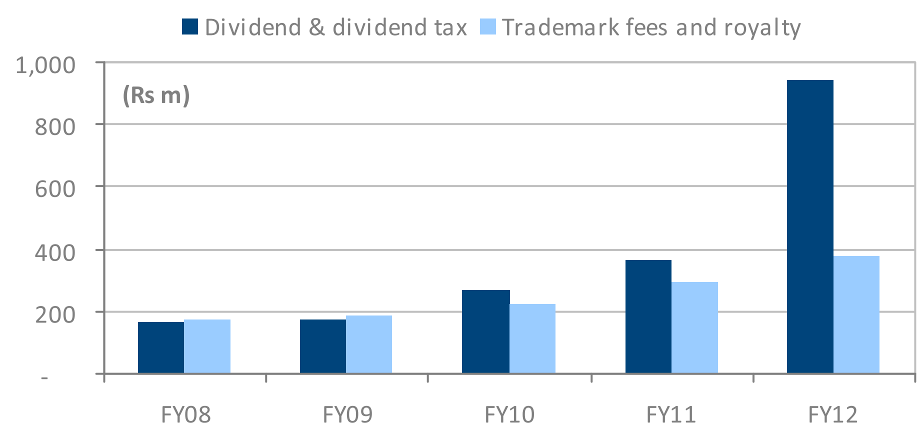
Large royalty payout to promoters for brand usage is a concern: Havells pays ~1% of its revenue as trade mark fees to its promoters for use of brand names. This fee has increased from ~0.8% of sales four years ago. In our view, the payment of royalty for use of brand is not in the interest of minority shareholders. Any further increase in the percentage of royalty would hurt the company’s profitability. Our channel checks indicate that the management is contemplating to put a cap on the absolute amount of royalty to be paid to the promoters for use of the trade mark; such an eventuality would mitigate concerns relating to the issue. Further, donation to associates increased from Rs6.5mn in FY11 to Rs60mn in FY12. Profitability would also suffer if donations increase sharply.

Figure 12.11: Trade mark fee and royalty expenses paid to promoters



Source: Company, IIFL Research

Figure 12.12: Dividend and trademark fee and royalty payment trend



Source: Company, IIFL Research

Margins are expected to improve due to likely increase in sales from better-margin regions for Sylvania and strong pricing power in the domestic segment

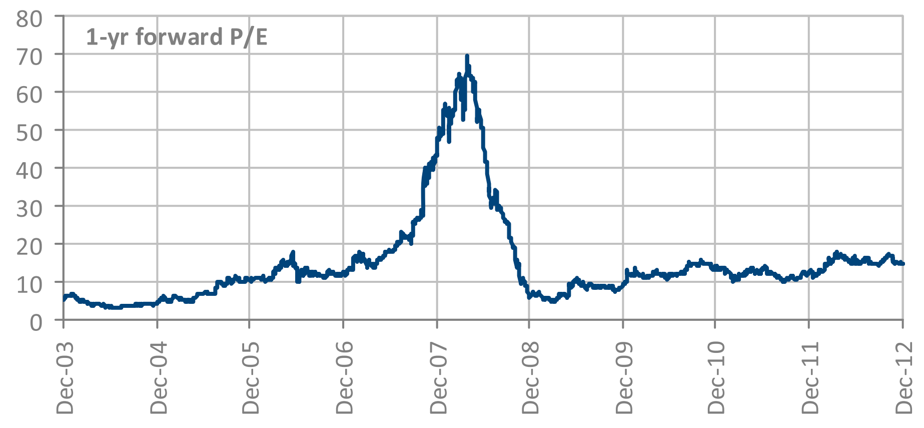
Valuations attractive, recommend BUY: We expect Havells' margins to improve in the near term due to reduction in prices of key raw materials. In the medium term, we expect margins to increase due to a likely increase in sales from better-margin regions for Sylvania and because of Havells' strong pricing power in all the domestic segments barring cables and wire. At 14.2x FY14 earnings estimates, the stock is attractive.

Figure 12.13: Havells vs. peers

Company	CMP (Rs)	PER (FY14ii/CY13ii)	PER (FY15ii/CY14ii)	Earnings CAGR (%) (FY12 - FY15ii)	Dividend yield (FY13ii)	ROE (FY14ii)	P/BV (FY14ii/CY13ii)
Crompton Greaves	112	12.6	9.8	24.9	1.2	14.1	1.7
TTK Prestige	3627	24.4	18.5	25.2	0.5	36.1	7.7
Bajaj Electricals	208	11.7	9.3	23.7	1.4	20.2	2.3
V Guard	530	16.9	NA	NA	0.7	29.6	4.6
Finolex Cables	60	5.6	NA	NA	1.3	15.0	0.9
Havells	606	14.2	11.8	19.9	1.3	36.9	4.6

Source: Bloomberg. IIFL Research. Price as at close of business on 14 December 2012.

Figure 12.14: Havells one-year forward P/E chart



Source: Bloomberg, IIFL Research

Figure 12.15: Sylvania geographical estimates

Geographical break up (€ mn)	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenue	449	468	469	500	522
Europe	281	281	272	280	280
Americas and Asia	164	183	192	215	236
Others	4	5	5	5	5
Geographical growth rates (%)	**FY11A**	**FY12A**	**FY13ii**	**FY14ii**	**FY15ii**
Revenue (%)	8.9	4.1	0.2	6.7	4.3
Europe growth (%)	(10.0)	0.0	(3.0)	3.0	0.0
Americas and Asia	35.6	11.0	5.0	12.0	10.0
Others	(18.5)	5.0	5.0	5.0	5.0

Source: Company data, IIFL Research

Expect improvement in geographical mix at Sylvania to result in better margins

Figure 12.16: Sylvania P&L projection

Y/e 31 Mar (€mn)	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net sales	449	468	469	500	522
Op EBIDTA	26	37	26	35	40
Other Income	7	1	1	1	1
Depreciation	8	9	9	9	9
Interest	11	11	10	10	11
PBT (pre- exceptional)	13	19	9	18	22
Exceptional items	1	0	0	0	1
PBT (post- exceptional)	13	19	9	18	21
Tax	6	6	3	5	6
PAT	7	13	6	13	13

Source: Company data, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Standalone revenue growth (%)	21.5	25.5	17.8	17.6	17.9
Cables & Wires growth (%)	25.2	29.3	17.0	15.0	15.0
Consumer durables growth (%)	40.4	21.9	25.0	30.0	30.0
Lighting & Fixtures growth (%)	27.3	24.7	22.0	20.0	20.0
Switchgear growth (%)	9.1	22.0	12.0	12.0	12.0
Standalone gross margin (%)	37.2	37.7	37.8	37.8	38.0
Standalone EBITDA margin (%)	12.2	12.6	13.5	13.3	13.4
Sylvania constant currency growth (%)	8.9	4.1	0.2	6.7	4.3
EUR-INR	60.8	63.5	70.0	71.0	71.0
Sylvania EBITDA margin (%)	5.8	7.9	5.6	7.1	7.7

Source: Company data, IIFL Research

Financial summary

Ebitda growth likely to improve in FY14 with likely improvement in Sylvania profitability

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	**56,356**	**65,579**	**75,394**	**85,591**	**96,107**
Ebitda	5,718	7,182	7,580	9,181	10,749
Depreciation and amortisation	(804)	(949)	(1,226)	(1,346)	(1,479)
Ebit	4,914	6,234	6,353	7,835	9,270
Non-operating income	8	17	130	141	142
Financial expense	(820)	(1,281)	(1,144)	(960)	(1,032)
PBT	4,102	4,969	5,339	7,016	8,380
Exceptionals	(36)	(212)	0	0	0
Reported PBT	4,066	4,757	5,339	7,016	8,380
Tax expense	(1,031)	(1,058)	(1,247)	(1,674)	(1,979)
PAT	3,035	3,699	4,092	5,342	6,401
Minorities, Associates etc.	(4)	0	0	0	0
Attributable PAT	**3,031**	**3,699**	**4,092**	**5,342**	**6,401**

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	24.6	29.6	32.8	42.8	51.3
DPS	2.5	6.5	7.8	9.7	11.3
BVPS	52.4	76.6	100.3	131.8	169.9
Growth ratios (%)					
Revenues	8.7	16.4	15.0	13.5	12.3
Ebitda	72.2	25.6	5.5	21.1	17.1
EPS	120.8	20.4	10.6	30.5	19.8
Profitability ratios (%)					
Ebitda margin	10.1	11.0	10.1	10.7	11.2
Ebit margin	8.7	9.5	8.4	9.2	9.6
Tax rate	25.4	22.2	23.4	23.9	23.6
Net profit margin	5.4	5.6	5.4	6.2	6.7
Return ratios (%)					
ROE	58.3	46.0	37.1	36.9	34.0
ROCE	28.4	30.1	27.6	29.5	29.8
Solvency ratios (x)					
Net debt-equity	1.6	1.0	0.4	0.1	(0.2)
Net debt to Ebitda	1.9	1.3	0.7	0.1	(0.3)
Interest coverage	6.0	4.9	5.6	8.2	9.0

With reduction in debt taken for Sylvania acquisition and improvement in profitability net debt to equity is likely to decline

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	1,779	2,336	6,638	10,269	14,841
Inventories	10,860	13,678	13,426	15,242	17,115
Receivables	7,721	8,905	10,328	11,725	13,165
Other current assets	1,325	1,799	1,978	2,176	2,394
Creditors	14,924	17,705	19,987	22,520	25,157
Other current liabilities	1,195	2,076	2,180	2,289	2,404
Net current assets	**5,566**	**6,936**	**10,204**	**14,603**	**19,955**
Fixed assets	10,204	10,946	10,720	10,374	9,894
Intangibles	3,354	3,625	3,625	3,625	3,625
Investments	0	0	0	0	0
Other long-term assets	393	465	502	502	502
Total net assets	**19,516**	**21,972**	**25,051**	**29,104**	**33,976**
Borrowings	12,415	11,859	11,859	11,859	11,859
Other long-term liabilities	564	557	682	802	922
Shareholders equity	**6,537**	**9,556**	**12,509**	**16,443**	**21,194**
Total liabilities	**19,516**	**21,972**	**25,051**	**29,104**	**33,976**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	4,914	6,234	6,353	7,835	9,270
Tax paid	(850)	(1,097)	(1,127)	(1,554)	(1,859)
Depreciation and amortization	804	949	1,226	1,346	1,479
Net working capital change	(2,587)	(813)	1,034	(768)	(779)
Other operating items	277	(460)	0	0	0
Operating cash flow before interest	2,558	4,812	7,486	6,859	8,111
Financial expense	(819)	(1,281)	(1,144)	(960)	(1,032)
Non-operating income	8	17	130	141	142
Operating cash flow after interest	**1,747**	**3,548**	**6,472**	**6,040**	**7,221**
Capital expenditure	**(1,584)**	**(1,511)**	**(1,000)**	**(1,000)**	**(999)**
Long-term investments	0	0	0	0	0
Others	(242)	(192)	(32)	0	0
Free cash flow	**(80)**	**1,845**	**5,441**	**5,040**	**6,222**
Equity raising	0	0	0	0	0
Borrowings	585	(924)	0	0	0
Dividend	(207)	(363)	(1,139)	(1,409)	(1,650)
Net chg in cash and equivalents	298	558	4,302	3,631	4,572

Source: Company data, IIFL Research

Free cash flow to improve with improvement in earnings and low capex

Interview

Anil Rai Gupta - Joint MD, Havells India

1. **What are the key long-term growth drivers of the company?**
   Our strategy to become a consumer centric company became a major growth driver even in times of economic slowdown. With a paradigm shift in consumer demand towards branded products, Havells sees a high and promising future on a long-term basis.

2. **What is the sustainable rate of growth in volumes, revenue, and earnings over the next 4-5 years?**
   We expect 15-20% growth in the branded electrical consumer product segment over the next few years. In addition, improvement in the housing sector and availability of power can provide a higher growth opportunity.

3. **What new opportunities or trends may provide additional growth drivers in the medium term?**
   Havells entered into new product category of Small Domestic Appliances in 2011. This segment has a large growing market in India, led by changing lifestyles and comfort.

4. **According to you, what are the factors that contributed to your exceptional performance over the past decade?**
   Havells' strong focus on relationship with dealers and a unique business model of selling multi products through the same channel helped us grow better than our peers. Nurturing the four pillars of growth — brand, distribution network, product categories, and manufacturing on a regular basis with exceptional investments in each of them created a sustainable growth opportunity for Havells over a decade.

5. **Anything you wish for, to deliver similar performance in the next decade?**
   Improvement in infrastructure and quest for better quality of living will further propel consumer demand. Reduced global volatility will provide a fillip to growth momentum for Havells, going forward.

6. **What part of the business takes up your maximum time and attention?**
   Havells aims to achieve sustainable long-term growth and hence we prepare ourselves to face the challenges of a large organisation and of increasing stakeholder value. This needs inculcation of high standards of transparency, ethics and governance and creation of a business culture around that.

7. **How would you prioritise the different stakeholders in your company – shareholders, employees, customers and government?**
   Havells works on a simple philosophy of sharing profit. We believe that all stakeholders should earn and be part of the wealth creation process over a longer period. Each one of us owns Havells and therefore we are committed to the growth of this organization. We are responsible for enhancing stakeholder value on a sustainable basis and individually benefit from that.

8. Do you have a role model – an individual or a company?
I believe that doing right thing with honesty and transparency makes one successful. To achieve higher levels one needs to think high. There are many such examples like Apple, Microsoft and mid-level Indian companies like Asian Paints, Hero Motors, which have created long-term sustainable businesses.

9. What are your biggest challenges?
We had acquired a large business in Europe, which is currently facing global macro-economic challenges. Bringing operational efficiencies, improving the business dynamics and profitability here are some key challenges for us in the near future.

10. What is your vision for the company?
I believe Havells has gained a lot of strength in the past few years and seeing the opportunity in India, it could grow multifold from here. Havells is led by example, to be recognized globally.

Technical analysis of Havells India

Havells' stock price has been declining in the past few weeks. Strong support is likely to emerge at the lower levels on the back of a rising support line. The breakout from the 'cup and handle' formation during Feb 2012 is still valid and has been projecting target of Rs840.

'Cup and handle breakout: Prices have retreated to the support of a rising trend line; however, a break below Rs565, which also coincides with 40WMA, would lead to further correction towards Rs530. The breakout line of 'cup and handle', if tested, would provide a good entry point in future.

Retracement projection: The rally from the lows of 2009 was stalled near 38.2% retracement support of Rs290 in Feb 2011. The 161.8% price extension from the low of Rs290 projects a price target well above the 'cup and handle' projection at Rs925 in the long term.

Faltering RSI: The weekly RSI has recently moved below the 50 level, which has dampened the positive momentum. This can also be substantiated by the negative divergence and time correction may extend further.

Fading comparative strength: The weekly ratio of Havells to S&P CNX 500 has reversed after forming a 'double top' but has still not violated the rising trend line at 0.11. Hence, the ratio may resume its outperformance after testing the long-term support line.

161.8% Price Extension
Price Target Rs840
Cup and Handle Breakout
0.0%
38.2%
40 WMA
100.0%
Ratio with S&P CNX 500

Havells India – 10 year share price performance chart

(Rs/share)

800
700
600
500
400
300
200
100
0

Jan-02 Jan-03 Jan-04 Jan-05 Jan-06 Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12

Sub-division of shares from face value of Rs 10/- each to Rs 5/-each

Acquired 10 acres land in the state of Uttranchal for future expansion and to avail Tax Incentives and other benefits

Acquired brand rights of Crabtree from the parent company, Crabtree UK for the Indian market

Acquired Sylvania for a total consideration of Euros 227m; financed entirely through debt.

Completed 100% acquisition of Standard Electrical Limited for Rs1.2bn

Issued bonus shares in the ratio of 1:1 as approved by the shareholders in the AGM on Sept 29,2010

Strong Q4FY11 nos beating consensus estimates by 17%

Entered into an agreement with Osram for settlement of the Sylvania brand and received one time fee of US$38m

Published in 2012, © India Infoline Ltd 2012

This research report was prepared by India Infoline Limited's Institutional Equities Research Desk ('IIFL'), a company authorized to engage in securities activities in India. IIFL is not a registered broker-dealer in the United States and, therefore, is not subject to U.S. rules regarding the preparation of research reports and the independence of research analysts. This research report is provided for distribution to "major U.S. institutional investors" in reliance on the exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). Any U.S. recipient of this research report wishing to effect any transaction to buy or sell securities or related financial instruments based on the information provided in this research report should do so only through IIFL Inc, a registered broker dealer in the United States.

IIFL Inc accepts responsibility for the contents of this research report, subject to the terms set out below, to the extent that it is delivered to a U.S. person other than a major U.S. institutional investor. The analyst whose name appears in this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority ("FINRA") and may not be an associated person of IIFL Inc and, therefore, may not be subject to applicable restrictions under FINRA Rules on communications with a subject company, public appearances and trading securities held by a research analyst account.

IIFL has other business units with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets. This report is for the personal information of the authorized recipient and is not for public distribution. This should not be reproduced or redistributed to any other person or in any form. This report is for the general information of the investors, and should not be construed as an offer or solicitation of an offer to buy/sell any securities. MICA(P) 017/10/2012

We have exercised due diligence in checking the correctness and authenticity of the information contained herein, so far as it relates to current and historical information, but do not guarantee its accuracy or completeness. The opinions expressed are our current opinions as of the date appearing in the material and may be subject to change from time to time without notice. IIFL or any persons connected with it do not accept any liability arising from the use of this document. The recipients of this material should rely on their own judgment and take their own professional advice before acting on this information.

IIFL or any of its connected persons including its directors or subsidiaries or associates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained, views and opinions expressed in this publication.

IIFL and/or its affiliate companies may deal in the securities mentioned herein as a broker or for any other transaction as a Market Maker, Investment Advisor, etc. to the issuer company or its connected persons. IIFL generally prohibits its analysts from having financial interest in the securities of any of the companies that the analysts cover. In addition, the company prohibits its employees from conducting Futures & Options transactions or holding any shares for a period of less than 30 days.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgment of its original date of publication by IIFL and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments.

Analyst Certification: (a) that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and companies; and (b) that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report.

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

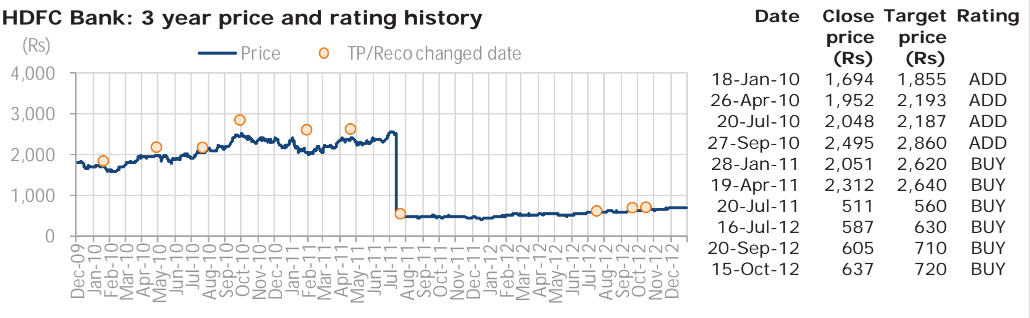
Add - Stock expected to give a return of 0-10% over the hurdle rate, i.e. a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, i.e. return of less than 10%.

Distribution of Ratings: Out of 166 stocks rated in the IIFL coverage universe, 90 have BUY ratings, 12 have SELL ratings, 31 have ADD ratings, and 33 have REDUCE ratings.

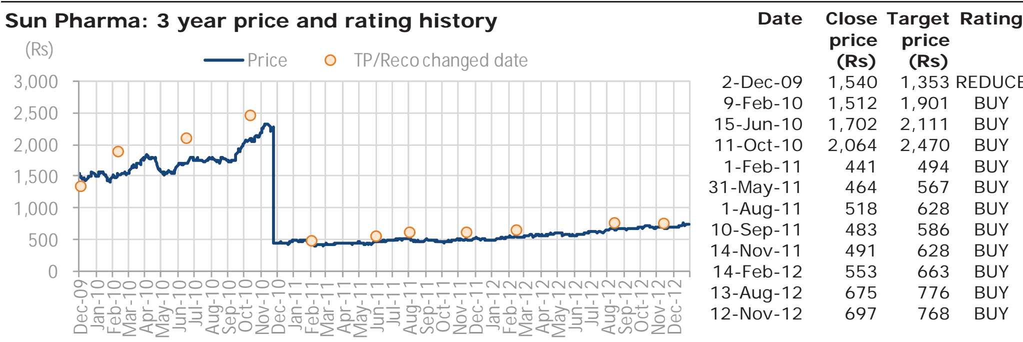
Price Target: Unless otherwise stated in the text of this report, target prices in this report are based on either a discounted cash flow valuation or comparison of valuation ratios with companies seen by the analyst as comparable or a combination of the two methods. The result of this fundamental valuation is adjusted to reflect the analyst's views on the likely course of investor sentiment. Whichever valuation method is used there is a significant risk that the target price will not be achieved within the expected timeframe. Risk factors include unforeseen changes in competitive pressures or in the level of demand for the company's products. Such demand variations may result from changes in technology, in the overall level of economic activity or, in some cases, in fashion. Valuations may also be affected by changes in taxation, in exchange rates and, in certain industries, in regulations. Investment in overseas markets and instruments such as ADRs can result in increased risk from factors such as exchange rates, exchange controls, taxation, and political and social conditions. This discussion of valuation methods and risk factors is not comprehensive – further information is available upon request.

HDFC Bank: 3 year price and rating history



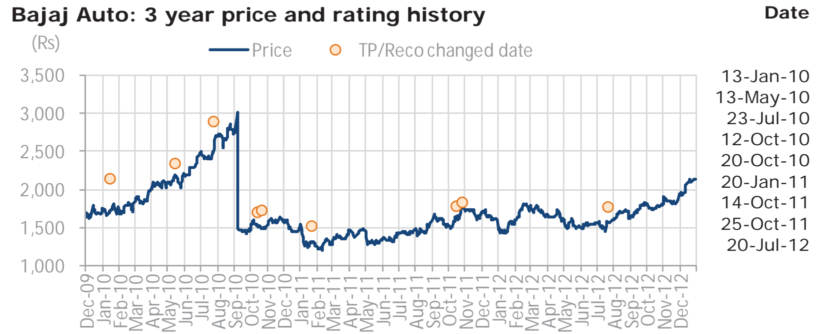
Date	Close price (Rs)	Target price (Rs)	Rating
18-Jan-10	1,694	1,855	ADD
26-Apr-10	1,952	2,193	ADD
20-Jul-10	2,048	2,187	ADD
27-Sep-10	2,495	2,860	ADD
28-Jan-11	2,051	2,620	BUY
19-Apr-11	2,312	2,640	BUY
20-Jul-11	511	560	BUY
16-Jul-12	587	630	BUY
20-Sep-12	605	710	BUY
15-Oct-12	637	720	BUY

Sun Pharma: 3 year price and rating history



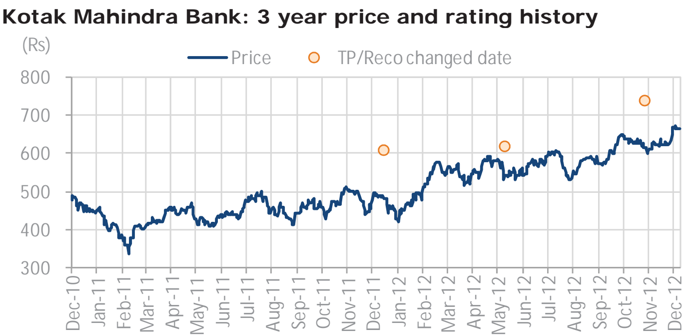
Date	Close price (Rs)	Target price (Rs)	Rating
2-Dec-09	1,540	1,353	REDUCE
9-Feb-10	1,512	1,901	BUY
15-Jun-10	1,702	2,111	BUY
11-Oct-10	2,064	2,470	BUY
1-Feb-11	441	494	BUY
31-May-11	464	567	BUY
1-Aug-11	518	628	BUY
10-Sep-11	483	586	BUY
14-Nov-11	491	628	BUY
14-Feb-12	553	663	BUY
13-Aug-12	675	776	BUY
12-Nov-12	697	768	BUY

Bajaj Auto: 3 year price and rating history



Date	Close price (Rs)	Target price (Rs)	Rating
13-Jan-10	1,704	2,150	BUY
13-May-10	2,146	2,350	BUY
23-Jul-10	2,491	2,900	BUY
12-Oct-10	1,552	1,710	BUY
20-Oct-10	1,514	1,735	BUY
20-Jan-11	1,322	1,530	ADD
14-Oct-11	1,586	1,790	ADD
25-Oct-11	1,694	1,840	ADD
20-Jul-12	1,548	1,780	ADD

Kotak Mahindra Bank: 3 year price and rating history



Date	Close price (Rs)	Target price (Rs)	Rating
14-Dec-11	486	610	BUY
9-May-12	556	620	BUY
26-Oct-12	626	740	BUY

HCL Tech: 3 year price and rating history

(Rs)
Price — TP/Reco changed date

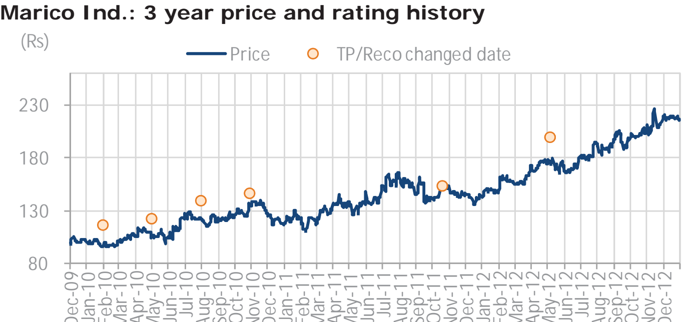
Date	Close price (Rs)	Target price (Rs)	Rating
17-Dec-09	344	400	ADD
22-Apr-10	374	440	ADD
14-May-10	399	475	BUY
15-Jun-10	370	481	BUY
30-Jul-10	378	475	BUY
21-Oct-10	426	515	BUY
20-Jan-11	508	590	BUY
21-Apr-11	523	621	BUY
29-Sep-11	407	508	BUY
19-Apr-12	494	562	BUY
26-Jul-12	514	606	BUY
18-Oct-12	581	668	BUY
22-Nov-12	618	716	BUY

Zee Entertainment: 3 year price and rating history

(Rs)
Price — TP/Reco changed date

Date	Close price (Rs)	Target price (Rs)	Rating
9-Dec-09	263	297	BUY
21-Apr-10	295	330	BUY
1-Nov-10	276	300	BUY
18-Jan-11	114	142	BUY
20-Apr-11	135	151	BUY
22-Jul-11	132	150	BUY
18-Oct-11	113	139	BUY
2-Mar-12	124	144	BUY
26-Jun-12	138	155	BUY
24-Jul-12	153	165	BUY
27-Aug-12	167	193	BUY
23-Oct-12	189	197	BUY
3-Dec-12	195	214	BUY

Marico Ind.: 3 year price and rating history



Date	Close price (Rs)	Target price (Rs)	Rating
29-Jan-10	99	117	BUY
29-Apr-10	112	123	BUY
29-Jul-10	125	140	BUY
27-Oct-10	133	147	BUY
18-Oct-11	151	154	ADD
4-May-12	179	200	ADD

Exide Ind.: 3 year price and rating history

Date	Close price (Rs)	Target price (Rs)	Rating
12-Jan-10	121	130	BUY
25-Jun-10	130	150	BUY
23-Aug-10	148	170	BUY
19-Jan-11	138	140	ADD
5-Jul-12	137	163	BUY
5-Nov-12	143	163	BUY

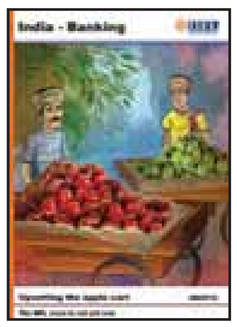
Pidilite Ind.: 3 year price and rating history

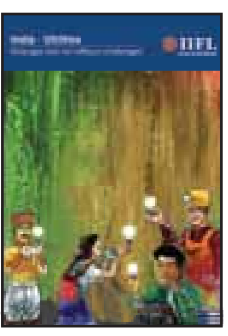
Date	Close price (Rs)	Target price (Rs)	Rating
15-Feb-10	188	250	BUY
16-Apr-10	114	125	BUY
28-Jun-10	119	150	BUY
21-Oct-10	150	170	BUY
28-Sep-11	165	180	ADD
11-Nov-11	168	174	ADD
7-Feb-12	145	189	BUY
28-May-12	170	191	BUY
26-Jul-12	165	199	BUY
27-Nov-12	203	246	BUY

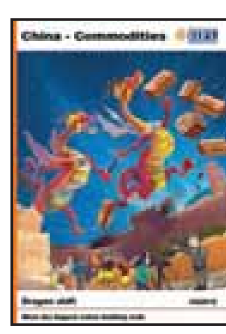
Havells: 3 year price and rating history

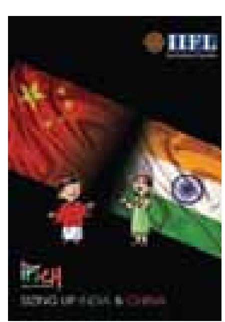
Date	Close price (Rs)	Target price (Rs)	Rating
19-Aug-10	793	950	BUY
2-Nov-10	412	475	BUY
25-Jan-12	430	538	BUY
31-Jan-12	444	536	BUY
31-May-12	547	600	BUY
18-Dec-12	616	744	BUY

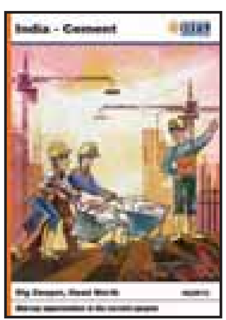
www.iiflcap.com

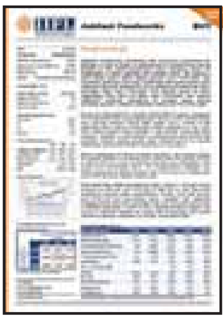


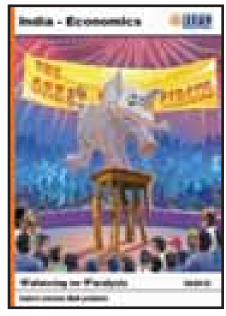


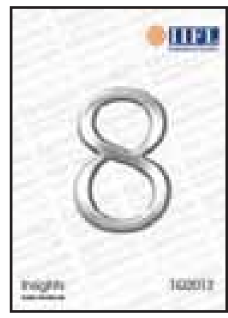


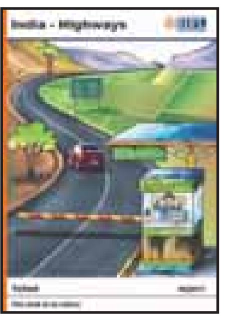


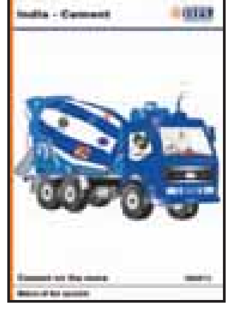


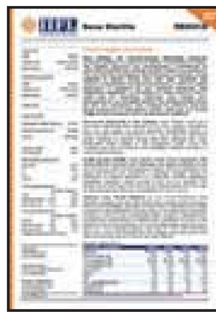


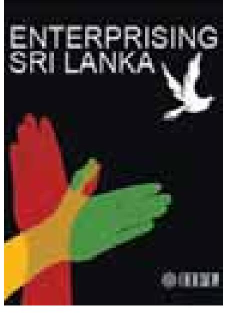


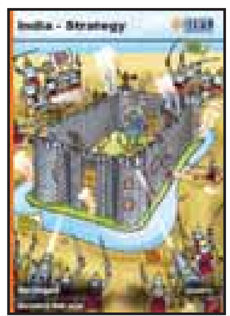


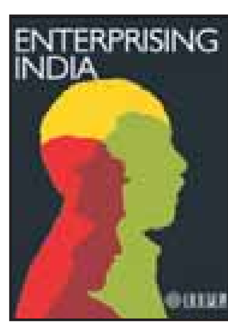












IIFL - India
India Infoline Ltd
9th Floor, IIFL Centre,
Kamala City, Senapati Bapat Marg, Lower Parel (W),
Mumbai - 400013
Tel +91-22-4646-4600
Fax +91-22-4646-4700

IIFL - Singapore
IIFL Securities Pte Ltd,
6 Shenton Way,
#18-08B,
DBS Tower Two,
Singapore - 068809
Tel +65-6511 6160
Fax +65-6224 0650

IIFL - UK
IIFL Wealth (UK) Limited
2nd Floor,
107 Cheapside,
London - EC2V 6DN,
United Kingdom
Tel +44 (0) 207-796-8637

IIFL - USA
IIFL Inc.
1114 Avenue of the Americas
34th Floor,
New York,
NY 10036
Tel +1-212-221-6800
Fax +1-212-221-6818

IIFL - Sri Lanka
IIFL Securities Ceylon (Pvt) Ltd
27th Floor, East Tower,
World Trade Centre,
Echelon Square,
Colombo - 1
Tel +94-112-333-000
Fax +94-112-333-383