Foods & Beverages | INDIA

CONSUMER RELATED

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NOMURA FINANCIAL ADVISORY AND SECURITIES (INDIA) PRIVATE LIMITED

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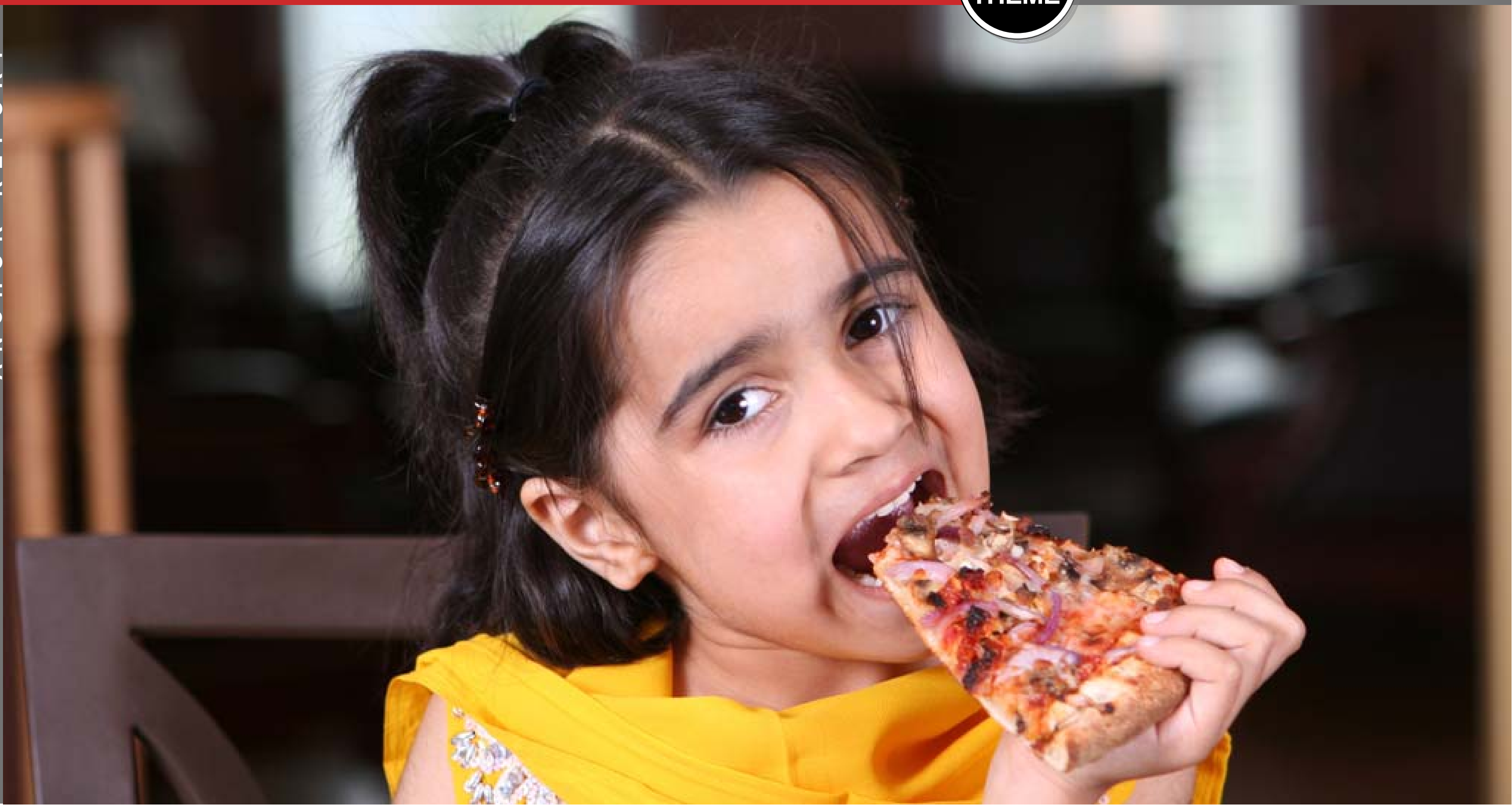
NEW THEME

ANCHOR REPORT



Young and hungry

While India's middle-class consumption story remains a strong long-term theme, we think the high-profile hygiene and personal care (HPC) subsector is already beyond the penetration phase, and further growth will have to be squeezed out from increasingly stiff competition. Traditional large HPC categories, such as soaps and detergents, have reached 90% or more penetration in both urban and rural markets. On the other hand, the organised food space continues to be underpenetrated at less than 25%, even in urban areas, and this is where we see the next big investment story as rising incomes seek out consumption upgrades and create demand for packaged foods, health foods and non-traditional cuisine. As economic growth spreads into the rural heartland, we think this trend will intensify. Our top picks on this theme are Jubilant Foodworks (exclusive franchisee for Dominos Pizza in India) and GSK Consumer (market leader in health drinks). We have two-year earnings CAGR forecasts of 36% on average for food companies, putting them significantly ahead of the HPC average of 14%. While current valuations for the food sector are at a 15% premium, we believe they should be higher given the longer-term opportunity.

① **We prefer food over hygiene and personal care**

② **Growth drivers in place**

③ **Modern retail to play a critical role**

④ **Incumbents to have a strong advantage**

⑤ **Jubilant Foodworks and GSK Consumer our preferred picks**

Nomura Anchor Reports examine the key themes and value drivers that underpin our sector views and stock recommendations for the next 6 to 12 months.

Stocks for action

Within the Indian consumer sector, we prefer the food space vs personal care. Our top BUYs are Jubilant Foodworks and GSK Consumer, while we are NEUTRAL on Nestle as we see shares as fairly valued. Hindustan Unilever remains our top REDUCE idea. In this report, we also include an update on QSR's (Malaysia) India story.

Stock	Rating	Price (Rs)	Price target
Jubilant Foodworks (JUBI IN)	BUY*	499	620
GSK Consumer Healthcare (SKB IN)	BUY*	2,101	2,505
Nestle (NEST IN)	NEUTRAL↑	3,391	3,525
ITC (ITC IN)	BUY	157	200
Hindustan Unilever (HUVR IN)	REDUCE	276	222

↑ Upgrading from Reduce to NEUTRAL.* Initiating coverage;
Note: 16 February 2011 local prices

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Action

We believe the food segment within the consumer sector will lead the next phase of growth, while hygiene & personal care (HPC) growth will be more muted due to greater penetration levels in urban and rural markets. Changing lifestyles, increased urbanisation, growing incomes and increasing need for convenience imply that packaged food will be a key growth driver for FMCG. We initiate coverage of SKB IN and JUBI IN with BUY calls and upgrade Nestlé to NEUTRAL.

Catalysts

Superior earnings growth and better profitability will likely lead the food sector to grow faster than HPC and this will be reflected in P/Es, in our view.

Anchor themes

We believe over the medium term, the food sector will grow faster than HPC in India from lower penetration and increased consumption. We are more upbeat on the long-term growth story of the food sector than that of HPC.

Stocks for action

Within the Indian consumer sector, we prefer the food space vs personal care. Our top BUYs are Jubilant Foodworks and GSK Consumer, while we are NEUTRAL on Nestle as we see shares as fairly valued. Hindustan Unilever remains our top REDUCE idea. In this report, we also include an update on QSR's (Malaysia) India story.

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Note: Pricing as of 16 February, 2011; local currency

Young and hungry

① We prefer food over HPC

Within India's consumer sector, we believe food offers more long-term growth visibility than HPCs, and will likely lead sector growth over the next decade. Rising commodity costs, intensifying competition, high price elasticity of demand and deep penetration imply that growth in HPC over the long term may continue to lag that in the food sector.

② Growth drivers in place

We believe that the Indian food sector is likely to register steady sales growth in the high teens over the next decade on rising penetration, increasing urbanisation and lifestyle changes. Over the medium term, the food sector will likely also benefit from a shift towards branded and organised packaged foods.

③ Modern retail to play a critical role

We believe that over the next decade, the evolution of modern retail will play a critical role in the growth rate of the food sector. A wider availability of products, focus on increasing consumption and supply chain efficiencies suggest faster growth prospects. Private labels will play a critical part in expansion of emerging categories, in our view.

④ Incumbent to have a strong advantage

Given brand loyalty and rigid consumer preferences, we believe the incumbent advantage is strong in the food sector. Companies with strong mother brands have greater pricing power, which will likely help in combating commodity price inflation and maintaining profitability.

⑤ Jubilant and GSK consumer our preferred picks in food

We believe that given strong incumbent advantage, GSK Consumer and Jubilant Foodworks will be the key beneficiaries and initiate on both stocks with BUYs. We upgrade Nestle to NEUTRAL (from Reduce) as valuations remain high.

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Drilling down

Industry snapshot

Fast moving consumer good (FMCG) sector growth to be led by food…

Exhibit 1. FMCG industry: food sector leads growth

Segment	Size CY06 (Rs bn)	Size CY10E (Rs bn)	CAGR (%)
Food	299.1	596.4	18.8
HPC	292.3	488.9	13.7
Others	139.3	213.2	11.2
Total FMCG	730.7	1,298.5	15.5

Source: AC Nielsen Data, Nomura Research

Exhibit 2. Increased share of food in FMCG

Segment	Share CY06 (%)	Share CY10E (%)
Food	40.9	45.9
HPC	40.0	37.7
Others	19.1	16.4
Total FMCG	100.0	100.0

Source: AC Nielsen Data, Nomura Research

… however, large categories in food still under-penetrated

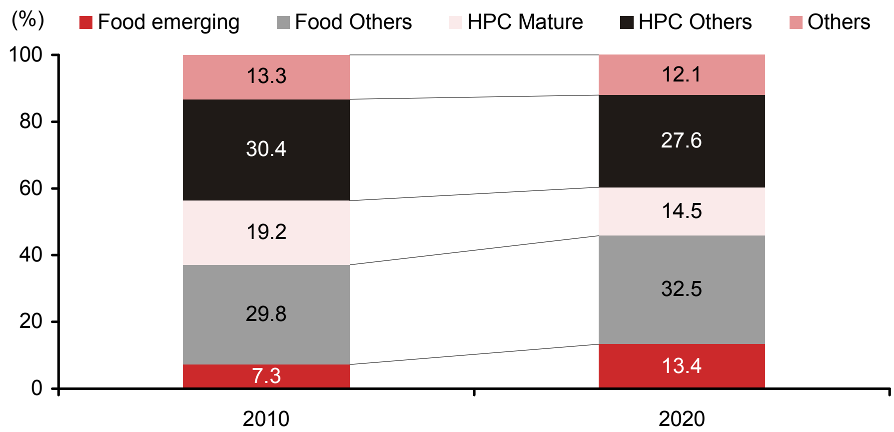
Exhibit 3. Low penetration even in urban markets

Category	Size (Rs bn)	Urban penetration (%)
Ice-cream	20	25
Milk powder	8	7
Chocolates	27	28
Ketchup	5	15
Coffee	9	23

Source: Godrej Consumer, Nomura Research

FMCG sector growth will be led by the emerging food sector

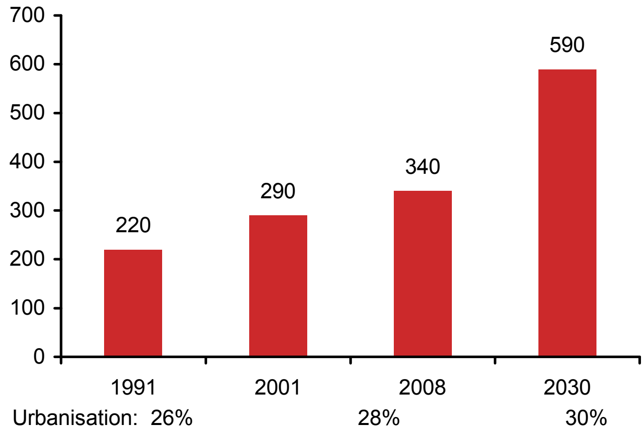
Exhibit 4. FMCG sector growth



Source: AC Nielsen Data, Nomura Estimates

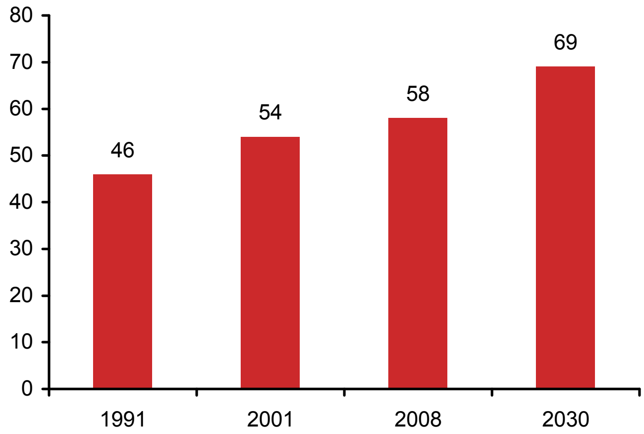
Urbanisation trends to pick up significantly, in our view

Exhibit 5. Urbanisation to pick up significantly



Source: McKinsey Global Institute

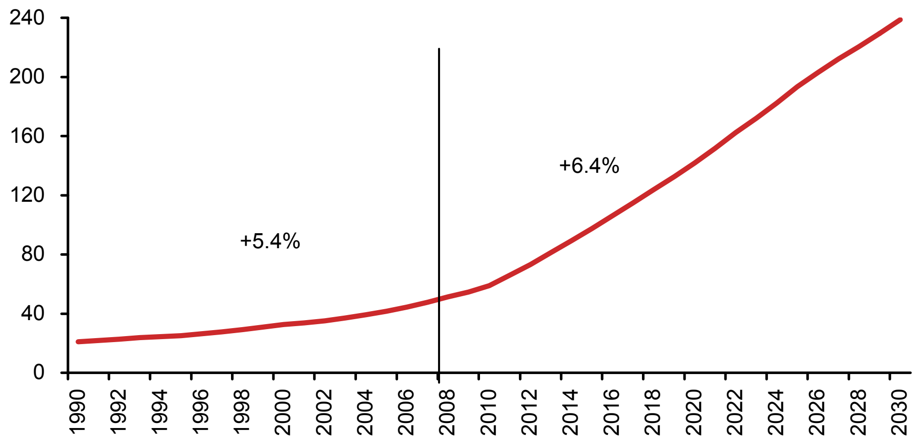
Exhibit 6. Share of cites contribution GDP to rise



Source: McKinsey Global Institute

Rise in urban disposable incomes will likely aid growth

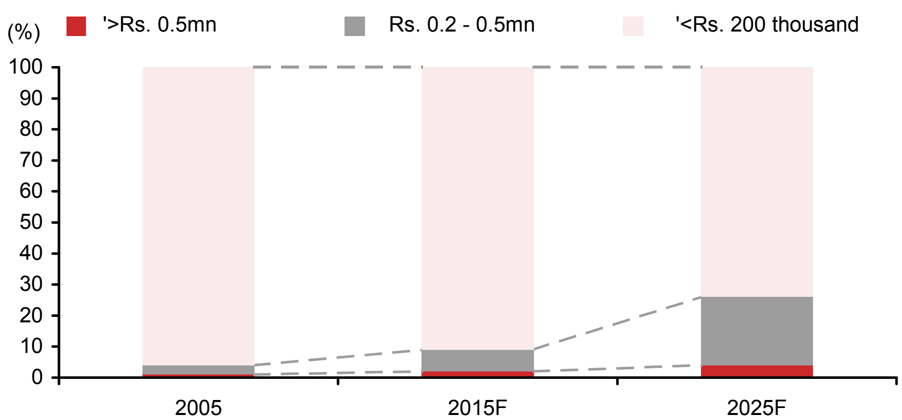
Exhibit 7. Urban India: Per capita disposable income



Source: McKinsey Global Institute

Rural household incomes to rise significantly, in our view

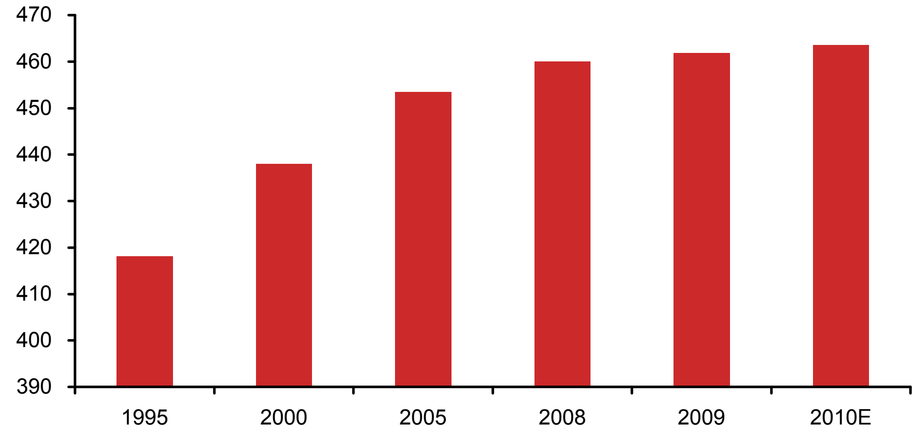
Exhibit 8. Rural household income distribution



Source: CII Rural Report, McKinsey Global Institute

Consumption class in India steadily expanding

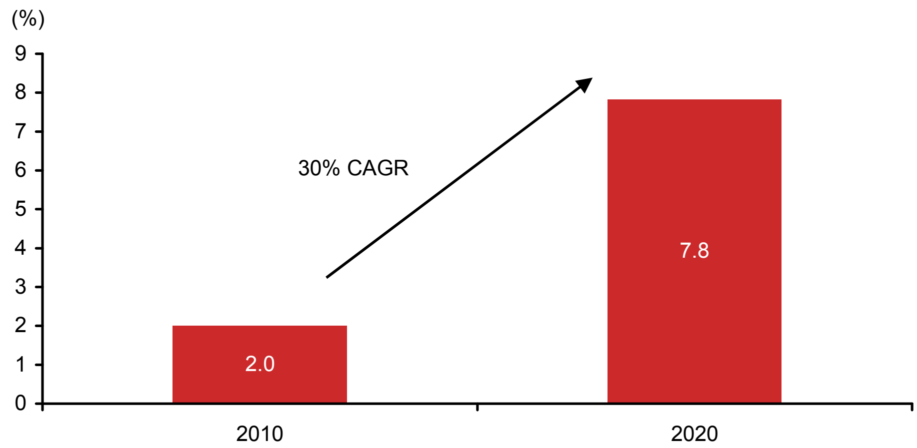
Exhibit 9. India: Rising consumption class



Source: US Census Bureau

Modern retail will likely be one of the key drivers for FMCG growth

Exhibit 10. Modern retail penetration in F&B



Source: Nomura Research

Exhibit 11. Valuation snapshot

Company	Ticker	Rating	Price (Rs)	P/E (x) FY11F	P/E (x) FY12F	FY12E PEG (x)
Food & Beverages						
Nestlé *	NEST IN	NEUTRAL	3,391	39.6	31.4	1.4
Jubilant Foodworks	JUBI IN	BUY	499	46.6	34.3	0.5
GSK Consumer *	SKB IN	BUY	2,101	29.5	24.4	0.8
United Spirits	UNSP IN	BUY	1,184	27.8	19.4	0.3
				35.5	**27.5**	
HPC						
Hindustan Unilever	HUVR IN	REDUCE	276	28.3	24.6	3.0
Godrej Consumer	GCPL IN	NEUTRAL	364	24.6	19.1	0.5
Dabur	DABUR IN	BUY	97	27.7	21.8	1.0
Marico	MRCO IN	REDUCE	125	27.0	22.9	1.3
Colgate Palmolive	CLGT IN	REDUCE	828	25.1	22.8	3.3
				27.4	**23.3**	
Tobacco						
ITC	ITC IN	BUY	157	24.5	21.0	1.3
Retail						
Pantaloon Retail	PF IN	BUY	278	16.6	12.1	0.3
Titan Industries	TTAN IN	REDUCE	3,257	43.1	34.3	1.1
				35.4	**27.9**	
Paints						
Asian Paints	APNT IN	BUY	2,550	27.0	23.0	1.2

* Calendar year based valuations

Source: Bloomberg, Nomura Research

Summary

Executive summary

India consumer: strong growth momentum…

FMCG sector growth led by the food sector

The FMCG industry in India has witnessed steady sales growth of a 12% CAGR over the past decade, according to AC Nielsen. Growth momentum picked up from a CAGR of 6% in FY01-05 and accelerated to 16% over FY06-FY10F. We attribute this to: 1) acceleration in India's GDP growth and favourable macro-economic conditions; 2) a sharp increase in rural incomes; and 3) a rising consumption culture.

… Primarily aided by the food segment

We believe that one of the most important facilitators for accelerating sector growth has been a significant pick-up in the processed and packaged food sector in India, in which sales have far outpaced HPC sales. Our analysis shows that the processed and packaged food sector (~46% of the industry) witnessed 19% sales growth in CY06-10, compared with 14% growth in the HPC segment and 16% growth in the overall FMCG industry. Mature HPC categories (top four categories: soap, shampoo, detergent and toothpaste) witnessed a sales CAGR of 13% during the same period.

Food space underpenetrated

Segments within the food sector still underpenetrated

While the Indian FMCG sector has witnessed rapid sales growth in the past few years, penetration rates across many categories are still low. While traditional large HPC categories, such as soap and detergent, have reached ~90% or more penetration in both urban and rural markets, the organised food space continues to be underpenetrated at less than 25%, even in the urban markets (source: AC Nielsen).

Within the food category, even in bigger categories such as edible oil, there exists a vast untapped market. The share of organised food retail players in the edible oil market is low, which implies opportunities for branded players. As consumers in urban and rural areas continue to trade up to the branded segment, growth in the organised food space will likely remain strong, in our view.

Food to lead sector growth

The Indian FMCG industry will witness a sales CAGR of 10-12% over the next decade, according to Booz & Co estimates. However, we believe the mix will incrementally shift towards food from HPC. The share of emerging food categories could double in the overall FMCG space over the next decade, in our view, aided by: 1) strong growth within the existing emerging food categories, and; 2) the emergence of newer categories within this space such as mass market infant nutrition, healthy dairy, healthy evening snacks and pet food.

Long-term growth drivers

We believe the food sector will witness structural sales growth in the high teens over the next few years. Potential growth drivers are increased penetration and a shift towards the branded and organised sector, in our view.

Untapped rural opportunity

Rural opportunity another attractive leg for growth

We think the rural opportunity for the food segment is largely untapped. While we acknowledge that this is on a much smaller base, rural India presents a great long-term opportunity, in our view. Over the next few decades, rural incomes are likely to rise steadily on: 1) government-supported programmes such as the National Rural Employment Guarantee Scheme (NREG); 2) rising minimum support prices, and; 3) improving information technology. Rising incomes would improve consumer demand in rural markets over the longer term, in our view.

Even urban markets are still underpenetrated

We believe that there is still a large untapped market in urban India that will play an important part in overall food market expansion. Even in some of the large and long standing food categories such as ice-cream and chocolate, urban penetration is less than 30% (see the Exhibit below). This is an indication of the opportunity in the urban food space in India.

Exhibit 12. Low penetration even in urban markets

Category	Size (Rs bn)	Urban penetration (%)
Ice-cream	20	25
Milk powder	8	7
Chocolate	27	28
Ketchup	5	15
Coffee	9	23

Source: Godrej Consumer, Nomura Research

In our opinion, growth in urban markets is likely to be aided by: 1) steady rise in real disposable consumer incomes; 2) pick-up in the pace of urbanisation, and; 3) accelerating "premiumisation".

Key challenges

In our opinion, some of the potential challenges are: 1) a steady rise in food price inflation, which has averaged 11% over the past three years. This is perhaps a double-edged sword, which hurts food companies' profitability and consumer demand; 2) food availability, which may also be an issue over the longer term, especially given that total food grain production only increased a marginal 3.2% CAGR over the past seven years, according to the Department of Agriculture; and 3) a low success rate in new food product launches.

Trends

Some of the key trends we foresee for the near to medium term:

- **Dining-in versus eating out:** As the pace of urbanisation picks up leading to infrastructure bottlenecks, we believe that the concept of dining-in is likely to catch up. We believe that speed and convenience of a "take away "or "ordering-in" will be sufficient to make a large part of the population shift towards dining-in. This trend has started with most chain eateries (eg, McDonald's and Subway) and standalone restaurants entertaining home delivery. This is one of the reasons for our Bullish view on Jubilant FoodWorks.
- **Steep innovation cycle:** We see increased focus on innovation, especially by food companies in packaging (smaller and more affordable packs), product (mass marketing of premium categories), pricing, and category (emergence of many new categories).
- **Regulatory environment to get tougher:** We believe that incrementally, the regulatory environment for food companies will get tougher with the implementation of the food safety and standard rule in 2011. We believe this will likely facilitate movement from the unorganised to the organised food sector.

We are Bullish on India's food space

We prefer companies in the food space vs. HPC

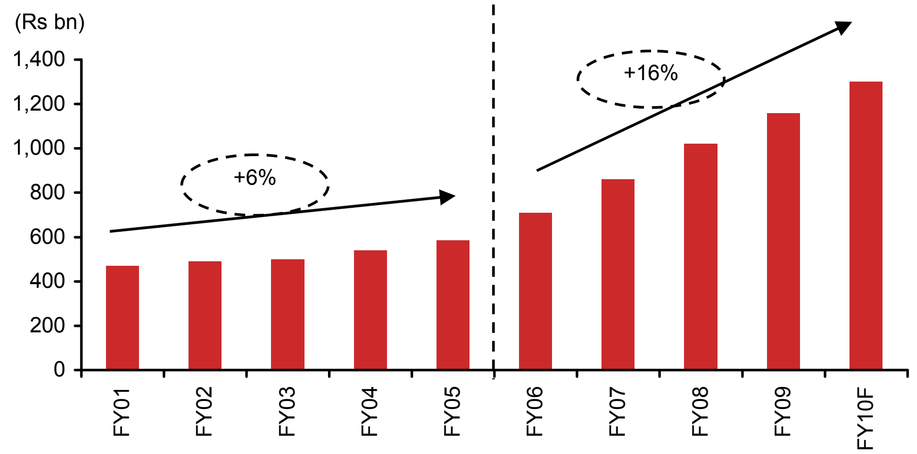
We prefer to have exposure to the food space versus HPC in India. We believe food offers more attractive longer-term growth opportunities with a number of categories still very underpenetrated. Our top picks in the sector: Nestlé (a market leader in chocolate and dairy), GSK Consumer (a market leader in malted beverage) and Jubilant Foodworks (an exclusive franchisee for Dominos Pizza in India with a 65% share of the pizza home delivery market, according to the company.

India consumer: growth momentum picking up …

The FMCG industry, accounting for ~2.2% of the country's GDP and an estimated size of US$29bn, according to AC Nielsen, has witnessed a steady sales growth of 12% CAGR over the past decade.

FMCG sector growth has picked up over the past five years

Exhibit 13. Indian FMCG industry: accelerating growth



Source: AC Nielsen data, Nomura Research

Growth has picked up from a CAGR of 6% in FY01-05 to 16% over FY06-FY10F. We attribute this to: 1) acceleration in India's GDP growth and favourable macro-economic conditions; 2) a sharp increase in rural incomes; and 3) rising consumption culture.

… primarily aided by the food segment

However, a significant pick-up in growth of the processed and packaged food sector has also boosted that of the FMCG sector. Our analysis shows that the processed and packaged food sector (~46% of the FMCG market) witnessed 19% sales growth in CY06-10, compared with 14% sales growth in the HPC segment and 16% sales growth in the overall FMCG industry.

Exhibit 14. FMCG industry: food sector leads growth

Segment	Size CY06 (Rs bn)	Size CY10E (Rs bn)	CAGR (%)
Food	299.1	596.4	18.8
HPC	292.3	488.9	13.7
Others	139.3	213.2	11.2
Total FMCG	730.7	1,298.5	15.5

Source: AC Nielsen Data, Nomura Research

Exhibit 15. Increased share of food in FMCG

Segment	Share CY06 (%)	Share CY10E (%)
Food	40.9	45.9
HPC	40.0	37.7
Others	19.1	16.4
Total FMCG	100.0	100.0

Source: AC Nielsen Data, Nomura Research

HPC has been the big laggard

One of the other noticeable trends has been a significantly slower growth rate in the overall HPC segment, which has been lagging growth in the overall consumer sector. Within the HPC space, emerging categories have witnessed robust growth (category size almost doubled in four years), registering a 21% sales CAGR over CY06-10F.

However, the mature HPC categories (comprising the top four categories in terms of size, ie, soaps, shampoos, detergents & toothpastes) witnessed a sales CAGR of 13% during the same period, below the sector average of 16% (source: AC Nielsen).

Exhibit 16. Category size

Category	CY06 (Rs mn)	CY10E (Rs mn)	CAGR (2006-10) (%)
Food: Milk products			
Milk powder	4,458	8,505	17.5
Milk food	7,132	13,825	18.0
Food: Emerging			
Breakfast cereals	1,125	3,214	30.0
Salty snacks	20,840	50,498	24.8
Chocolate	14,554	28,316	18.1
Noodles	8,255	18,001	21.5
Baby Food	4,017	7,361	16.4
Coffee	6,334	9,646	11.1
Food: Packaged Staples			
Iodised salt	12,528	24,906	18.7
Packaged wheat flour	8,671	20,933	24.7
Packaged rice	1,176	3,380	30.2
Packaged tea	39,571	68,373	14.4
Food: Others			
Beverages	15,205	28,278	16.8
Ketchups	2,379	4,775	19.0
Edible Oil	48,277	93,565	18.0
Biscuits	68,980	126,019	16.3
HPC: Mature categories			
Detergent cake	26,248	43,696	13.6
Washing Powder	43,540	77,426	15.5
Shampoos	18,805	30,011	12.4
Toothpaste	24,320	37,500	11.4
Toilet soaps	60,074	88,589	10.2
Hair Oil	16,961	30,739	16.0
HPC: Emerging categories			
Hair Conditioners	423	1,332	33.2
Liquid Toilet soap	450	1,372	32.1
Pre-post wash	521	1,219	23.7
Skin cream	25,352	54,138	20.9
Baby oil	1,827	3,471	17.4
Perfume & Deodorants	4,483	11,817	27.4
Floor cleaner	686	1,401	19.5
Toilet cleaner	1,242	2,256	16.1
HPC: Others			
Hair dyes	7,367	13,781	16.9
Coconut oil	14,403	21,832	11.0
Utensil cleaner	6,468	11,962	16.6

Source: AC Nielsen, Nomura Research

Consistency of growth food vs. HPC

Another noticeable trend is that the consistency of growth has been much better in the food space vs that of the HPC segment. For instance, sales of the breakfast cereals market has grown by >25% pa over the past four years, Even a long-existing and more mature category such as chocolates grew an average of 15% during the same period. This compares with HPC categories such as detergent cakes, where sales growth has been inconsistent over the past three years, growing by 9-25% pa, while toothpaste growth has fallen over the last few years (FY08–FY10F) from 12% to 7%. We attribute this to:

- **Food segment is nascent:** We believe that the primary reason for consistently higher growth is that the processed and packaged food segment is still nascent. As incomes have grown in the past few years and as health consciousness has increased for the urban consumer, this sector has witnessed acceleration in sales growth. We expect this trend to continue in the next few years.

On the contrary, large HPC categories are highly penetrated, especially in urban markets. Detergents, soaps and toothpastes all have ~90% or more penetration in the urban markets (source: AC Nielsen). This has led to structurally slower growth in these categories. Also, these categories have greater price elasticity, thus leading to lower brand loyalty. This impacts growth over longer periods of time.

- **Higher competition**: The HPC segment is highly competitive with a slew of local, national and multinational players competing for a share of the pie. This means that unlike the food category, which is still in a growth phase, HPC is far more susceptible to price wars, in our view. This would also take a toll on the value growth category.

State of play

Where we stand today

Penetration levels still low in many food segments across urban and rural India

While the Indian FMCG sector has witnessed rapid sales growth over the past few years, penetration levels across many categories continue to be low. This makes us believe that growth in the sector is likely to continue at a steady pace over the next decade as more non-users convert to users.

While traditional large HPC categories such as soaps and detergents have reached ~90% or more penetration in both urban and rural markets, the food segment, especially emerging categories such as coffee, ketchup and milk powder continue to be significantly underpenetrated. Despite robust sales growth in the past few years, penetration for these categories, even in urban areas, continues to be less than 25%. Even in the relatively bigger food categories, which we define as categories that have existed for a long time such as biscuits, soft drinks and chocolate, penetration levels in urban areas are a long way from being saturated.

Our assessment is high levels of penetration is the reason for the slowdown in these mature HPC categories. Also, this would mean that incremental growth in these categories can come only from consumers trading up to the branded segment and volume growth could further slow down over the next few years.

Within the HPC space there are categories still at a nascent stage, such as deodorants, post wash hair care products, hand sanitizers and surface cleaners, which are likely to continue to grow strongly over the medium term. The issue here is size. According to AC Nielsen, these emerging HPC categories together account for just 5% of the FMCG market and may not add substantially to a company's revenue for many years to come.

Within the food segment, even in bigger categories such as edible oil, which appears near saturation on the surface, we believe there is still a vast untapped market. The share of organised players in the edible oil market is still under 70% with Marico having only a 3.4% share, according to the company, which implies attractive opportunities for branded players such as Marico in the medium term. Marico sees ~10% pa sustainable volume growth in the category. As consumers in urban and rural areas continue to trade up to the branded segment, sales growth in the branded category should remain strong over the next few years.

Exhibit 17. FMCG penetration levels

Category	Urban	Rural
Food mature		
Edible Oil	98	95
Tea	92	82
Biscuits	88	65
Food emerging		
Soft Drinks	37	12
Ice-cream	25	9
Milk powder	7	3
Chocolates	28	7
Ketchup	15	NM
Mints	15	2
Coffee	23	8
HPC mature		
Washing powder	95	92
Toilet Soaps	96	89
Detergents Bar	94	86
Toothpaste	89	45
Shampoo	62	46
Balms	58	38
Utensils Cleaners	59	17
Talcum Powder	48	25
HPC emerging		
Skin cream	30	19
Deodorants	6	NM
Baby oils	8	2

Source: Godrej Consumer, Nomura Research

Industry dynamics

Industry dynamics: food and HPC

Following several meetings with players in the food and HPC space, we believe there are some structural differences in the operating environment between food and HPC. We highlight a few of these differences below:

Industry dynamics very different in food and HPC

- **Easier to experiment with HPC items compared with food:** Consumer habits, especially when it comes to food, are difficult to change. However, the willingness to try out a new product is far higher when it comes to HPC products, according to Marico. Deodorants, post wash hair care products and surface cleaners are classic examples of successes.

  When it comes to food, consumers are extremely reluctant to experiment. On the ground feedback suggests that it usually takes a long time to successfully make people change their food habits. This is also demonstrated by the fact that some of the now successful categories have been in existence for more than a decade. For instance, instant noodles were first introduced to India in the 1980s and breakfast cereals in the 1990s.

- **Brand loyalty is low in HPC space:** In our opinion, brand loyalty in the HPC space is extremely low even in some mature HPC categories, such as soaps and toothpastes. The best empirical evidence of this is the widely fluctuating market share among the three-four top players in soaps and shampoo and success of new entrants such as ITC.

- **Profitability same but shape of P&L different:** Our discussion with various consumer companies gave us an indication of food and HPC businesses' P&L. Food business players generally operate on a much lower gross margin, yet this in turn is compensated by lower advertising spending. HPC products typically have high gross margins, but because of high A&P spending, net margins are almost at par with food products. Some of the evidence of lower advertising spends by food companies:

  - According to TAM data, amongst the top 10 FMCG categories to be advertised across all three mediums (radio, print and television), food (ex aerated drinks) accounted for just 19% of total spending in 2010.
  - Amongst the top 10 FMCG advertisers, spending by pure food companies such as Cadbury and Nestlé accounted for just 12% of total spending in 2010.
  - Amongst the top three FMCG advertisers, HUL, ITC and Reckitt Benckiser, the share of food advertising was 7%, 39% and 0%, respectively, in 2010.

- **Supply chain:** Food and HPC have vastly different supply chain needs. Some of the typical examples of supply chain issues that F&B companies face are:

  - Supply chain can be complicated in perishable items such as dairy products, for which cold storage facilities and temperature controlled vans are necessary.
  - Another issue is that manufacturing facilities of some products, such as chips and salty snacks, need to be closer to the market. This is largely because of the high freight cost involved. Hence, these companies typically need several small manufacturing facilities and they need to be closer to the target market to ensure profitability.
  - Another issue faced is that food items tend to have a significantly shorter shelf life. This means much quicker delivery systems, regular replenishment of products on the shelf, and vastly different distribution and storage requirements. In the F&B segment, shelf life can vary from seven days to three months on average, while in the HPC space the shelf life can be up to three years, say if the product is hair oil.

This is a key reason why some of the companies may prefer to continue to grow in one category only. For instance, Dabur has said it will continue to focus on its HPC portfolio over the medium term and real juices will be the only active F&B category it will continue to be in.

- **Taste is an important determinant:** Our interaction across FMCG companies and modern retail participants threw up one common theme. Product taste in the F&B space is an important determinant for success. Even health products are made to satisfy a consumer's taste bud with "health" benefits offered as an add-on. To give an example, Marico's Saffola Zest, launched as a "healthy snack", failed to appeal to consumers' taste buds and was subsequently withdrawn. We also see this holding true with the continued success of Lays from PepsiCo and Bingo from ITC over the "healthier" Parle's baked chips. Thus, the taste platform is winning over the health platform, certainly in the salted snacks segment, in our opinion.

  Companies have already learnt from such examples and are looking to pitch taste with wellness across new product offerings. Marico is looking to push its new Saffola Oats as a product that can be used to make traditional Indian breakfasts, such as *upma* or *idli*. We believe more companies will look to follow this and ensure their products appeal to the taste buds while not ignoring the health aspect.

Learning from the HPC industry

While food has outpaced HPC over the last few years in terms of sales, what's interesting is that some of these mature HPC categories such as soaps have been able to register high single-digit to low double-digit growth in the past decade. This, while lower than the sector average, has to be viewed in the context of extremely high competition and relatively high penetration levels. This is where we believe that the food industry can learn some important lessons from the HPC players.

In the shampoo segment (penetration increased from 40% in 2002 to 62% in 2010, according to Hindustan Unilever, growth was led by companies investing in breakthrough innovation (radical changes in packaging and introduction of small pack sizes) and consumer awareness. In order to tap the rural and in some way urban, companies introduced sachet packaging (pioneered by Cavinkare). This was an India-specific pack size innovation, which led to a big improvement in penetration levels.

The success of these HPC categories was driven by:

- **Innovation:** Almost all or most growth in these large HPC categories are due to significant investments in research & development (R&D). HPC players have always made an effort to reinvent, from lowering pack sizes to introducing mass market formulations for premium products, to drive penetration.
- **Aggressive promotion:** Companies realised the importance of driving usage among consumers and have thus spent significant amounts of money on consumer awareness. The rural markets were opened up, which added to the growth opportunity. Some of the specific example of such consumer awareness programmes are "project Shakti" by HUL and the "Oral health month" by Colgate-Palmolive.
- **Conversion of non-users to users:** Significant amounts have also been invested to grow the consumer base by converting non-users to users. Some of the specific examples of this have been oral care and hair care products. Traditionally, the rural population used soaps to wash hair; CavinKare with Chic changed that. Likewise, Colgate managed to drive more people to start using toothpaste instead of traditional "neem sticks" and toothpowders.

- **Distribution:** This has also been one of the key contributors in the success of HPC products. Companies such as HUL have made an effort to drive availability of these products across the length and breadth of the country. Over the last few years, companies such as HUL, GSK Consumer and GCPL have made significant investments, increasing the direct reach to the urban and rural markets to keep the growth trajectory intact.

What we find interesting is that many of these factors are now playing out in the food space and we believe this may well be the growth engine of the next decade.

Competition in food and HPC

Competitive intensity stronger in the HPC space, while food is still a growing market

We have also looked at how competition has panned out in the food and HPC segments over the past few years. Here we find that competition has been more intense in HPC than in food, which we attribute to:

- **HPC categories near saturation:** One of the key reasons for the higher competitive intensity in the HPC segment is that the top six categories have all reached near saturation. This means companies cannot rely on growing penetration (especially in the urban markets) and expanding the category to grow their businesses. In such situations, incremental growth only comes from share gains, in our view.

  This is exactly what appears to be panning out in the Indian HPC space. The HPC pie is large but not growing as fast and competition seems intense among foreign (likes of Unilever and P&G), national (Marico, Dabur and Godrej) and regional players (brands such as Gadhi, Ajanta and Anchor). We continue to see bouts of significantly heightened competition across HPC categories over the next few years as global players continue to fight over market share in India. This could impede growth on a periodical basis.

- **Food, however, is still a growing market:** Market share at this time is less relevant in the food space. This is largely because in many of the categories, penetration levels are still very low. Industry players including modern retail participants are of the opinion that over the next few years, everyone will be happy to see the market grow.

  Several companies have launched products in the oats category, including Marico and Kellogg's, over the past few months, but pricing across the board has been more or less standard. We believe the market share game in food categories is still a long way off, allowing competition to be more muted than in the HPC space.

- **Higher margins to play:** As discussed, gross margins in the HPC space are much better than in food. This gives a HPC company a lever to invest significantly in advertising and promotions (A&P) with a view to gain market share. This is something already played out in the detergents segment in 2004 and in 2009, when HUL and P&G indulged in a price war with a view to gain market share, which subsequently led to significant margin cuts.

What are the near-term implications?

Mature HPC categories, such as soaps and detergents, have seen competition intensify. This has led to a rise in A&P spending and subsequent margin erosion. These are categories where penetration levels are high and consumers are more open to moving between brands. Competition has been largely price-led in these categories.

While competition in the food space has also been increasing, it has not been at the same level as in the HPC space. Categories such as salty snacks, chocolates and dairy have all seen a number of new entrants, but most of the increased competition has been in advertising and promotion-led events. Price-led strategy has not been as relevant in the food space, meaning that the increase in category size is largely due to advertising investment by all the players. Margins have also held much better as a result since companies are in a better position to pass through rising input costs to consumers.

This has also been borne out by performance of HPC companies over the last few quarters. GCPL's domestic business, which is largely soaps, home care and hair colours, has grown sales by an average 4.6% over the last four quarters, including two quarters of contraction. Marico, which mainly involves in edible and hair oils, has seen an average 11.3% sales growth while Colgate registered an average 13.4% growth. Contrast this with food companies such as GSK Consumer, which has seen an average sales growth of 20% over the last four quarters, while Nestlé has seen sales increase by 22.5%. A similar trend is also replicated on a longer-term time frame.

Looking at HPC, we see near-term issues revolving around volume growth as well as margin pressures.

- In categories such as soaps, detergents, shampoo and oral care, we believe sales growth will continue to slow due to high penetration and price elasticity.
- High food inflation will likely lead to consumers cutting back spending on HPC items. This is likely to further hurt growth of HPC companies.
- We believe that HPC categories will largely rely on aggressive pricing. This could have a further negative impact on volumes in the near term.

In the food categories we see the following near-term implications

- In categories such as instant noodles, biscuits, noodles, chocolates dairy products, volume growth continues to be strong and companies have some pricing power, suggesting that value growth is likely to be much ahead of that in the HPC space.
- In terms of margins, having better pricing power and consumers being more acceptable of pricing in food products mean food companies will be better placed to manage cost pressures.

Expect food to lead sector growth

Expect food to lead growth in the FMCG sector in the next decade

The FMCG sector has seen two phases of growth over the past decade. In the first half of the decade until 2005, the sector saw a slow CAGR of 6% before growth picked up significantly in the second half of the decade (CAGR of 16%). Many of the categories have grown ahead of the industry.

According to the Confederation of Indian Industry (CII), the consensus appears to be that the sector can easily clock in a CAGR of 10-12% over the next decade. However, if some of the bottlenecks such as FDI in multibrand retailing and the rollout of GST are removed, growth in the industry could see a much higher trajectory of closer to 17%, according to Booz & Co estimates. Hence, whichever scenario pans out, we believe the industry's outlook remains buoyant.

However, within this potentially more attractive next phase of industry growth, we believe leading segments will be different. We believe the mix within the industry will shift towards food from HPC. Amongst the existing ones, more attractive segments are likely to be breakfast cereals, juices, packaged foods, dairy products, deodorants and hand sanitizer.

We have looked at the total FMCG market and classified it into four broad categories, ie, food emerging, food others, HPC mature and HPC others. We have estimated growth for each of these categories to see how the shape of the industry will be in 2020.

In 2010, emerging food categories such as breakfast cereals, baby food and salted snacks were ~7.3% of total FMCG industry. We expect this to be the fastest-growing segment over the next decade, significantly outpacing growth in the industry. This means a decade later, emerging food categories could be ~13-14% of total industry.

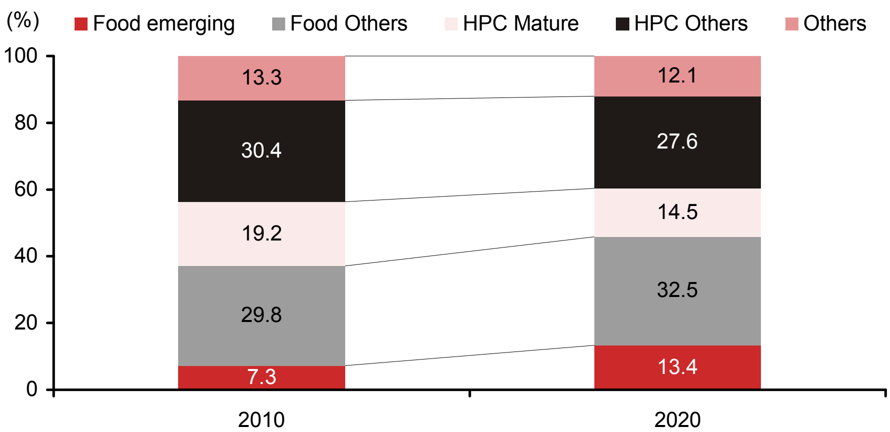
We believe this will be aided by two things: 1) strong pace of growth within the existing categories in emerging food, and; 2) emergence of newer categories within this space such as mass market infant nutrition, healthy dairy, healthy evening snacks, pet food etc. India remains a young country (median age of population is 24 years, according to US census data) and there is a large market waiting to be provided with products in these categories.

We believe even if the overall pace of the industry growth remains at 12% (which is the average of the last 10 years), the emerging food segment will grow much faster. If the industry growth is to exceed the average of the last 10 year, we believe the driver for this growth will come from other emerging food categories.

While we believe food remains a more attractive space within the FMCG space compared to HPC, there are some HPC categories such as deodorants which we believe will also see robust, significantly higher than industry growth. However, we believe there are relatively fewer segments in the HPC emerging category (with significantly higher competition) and hence there is a more likelihood of emerging food categories delivering the next phase of growth vs the emerging HPC categories.

Mature HPC categories is our least referred space (soaps, detergents, shampoo), as we believe they will likely lag behind in terms of growth and their profitability could also come under pressure as competition continues to remain strong. For instance, the detergents segment witnessed a collapse in profitability since the turn of the decade and has not gone back to those levels since. Shampoo is another segment where industry profitability has started to come down over the last few quarters, led by strong competition. Dabur, one of the bigger players in the shampoo segment, sees a structural downward shift in segment profitability over the longer term.

Exhibit 18. FMCG sector growth



Source: AC Nielsen Data, Nomura Estimates

We prefer companies who are early leaders in the food space, such as Nestlé (leader in chocolates and dairy products) and GSK Consumer (leader in the malted beverage space). There are various macro- and micro-economic factors that will help support growth of these categories and we believe most of the factors are now in place.

Food industry all set for structural growth

Long-term growth drivers in place

Organised food market still in infancy

Organised food segment still in infancy with penetration levels low

We believe that the food sector is likely to witness structural growth in high teens over the next few years. We expect growth drivers of:

- **Increasing penetration:** Penetration levels, across all categories, are still extremely low. While this is indeed true for emerging categories, penetration levels are fairly low even for some of the larger and long standing food categories. For instance, chocolate as a category is worth Rs27bn but the penetration level in urban areas is 28% and below 10% in rural areas, according to Godrej Consumer. We continue to see food consumption rising over the next few years.
- **Shift from unorganised to organised:** Although we agree that per capita consumption is now relatively high in some of the food categories such as dairy products, staples, edible oils etc., we believe this will continue to grow over the medium term as demand for food continues to grow and consumers move from the unorganised to the organised segment. We have already seen this happen in the urban areas, where packaged milk and other dairy products witnessed a marked shift from the unorganised to the organised segment. We expect Nestlé and Marico to be the biggest gainers from this shift.

Huge rural opportunity still to be tapped

Over the last few years, despite strong growth witnessed in the rural markets, Indian FMCG companies continue to concentrate in these areas, especially in the food segment. HPC companies have realised the potential of the rural markets in the last couple of years and have steadily worked on improving rural penetration. This has caused rural growth in many HPC categories to come in higher than urban growth.

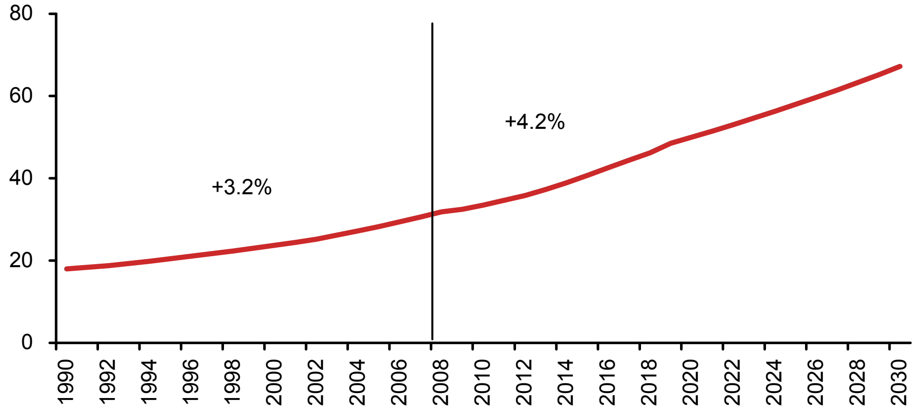
However, as far as the food segment is concerned, the opportunity is still largely untapped. While we acknowledge that this is on a much smaller base, rural India presents a great long-term opportunity.

Rural income: Steady rise ahead

Rural incomes will give consumers more spending power

Over the last 18 years, per capita rural disposable incomes have steadily increased at a CAGR of 3.2% to ~Rs32,000, according to McKinsey Global. However, what's interesting is that over the next few years, the pace of growth is likely to accelerate. According to estimates by McKinsey, rural disposable incomes are likely to increase at a CAGR of 4.2% over FY08-FY30. One of the biggest beneficiaries of this steady rise in rural incomes is likely to be the consumer sector and the food sector in particular, in our view.

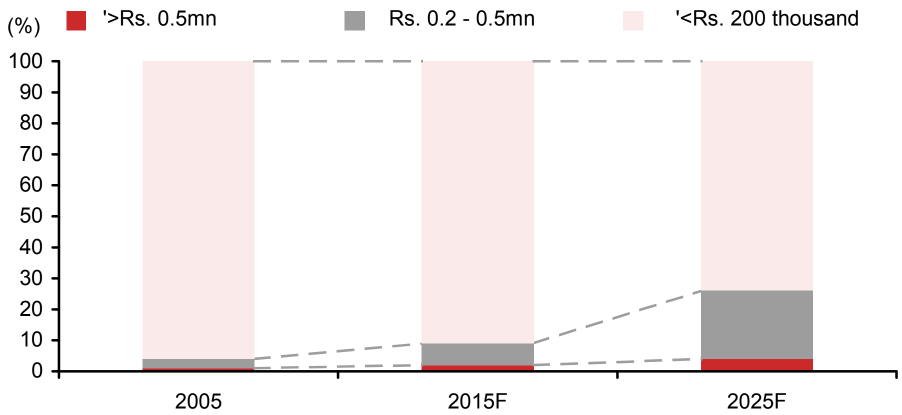
Exhibit 19. Rural India: Per capita disposable income



Source: McKinsey Global Institute, Nomura Research

While rural incomes are going to increase at a steady pace, the biggest beneficiary will be the rural middle class. According to McKinsey Global, the share of rural household with incomes between Rs0.2mn and Rs0.5mn is likely to rise to 22% in 2025 from 3% in 2005.

Exhibit 20. Rural household income distribution



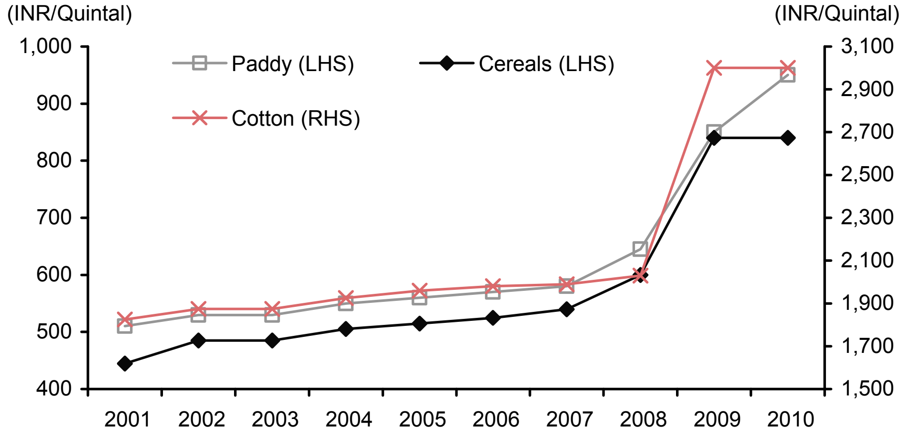
Source: CII Rural Report, McKinsey Global Institute

This increase in disposable incomes will continue to be supportive for FMCG companies, with penetration levels across several categories still very low in rural India. For example, soft drinks: 12%, Ice-cream: 9%, Milk powder: 3%. We believe the opportunity to grow penetration in these categories is one of the most attractive propositions for the FMCG industry.

The increase in rural incomes can be attributed to a few factors.

- **Growth in minimum support prices:** Over the last few years, there has been a marked increase in minimum support prices for agricultural crops from the Indian government. This has helped improve disposable incomes in rural areas as farmers benefitted from better prices for their produce.

Exhibit 21. Minimum support prices



Source: Department of Agriculture

- **NREGA and other Government schemes:** Government support for rural employment from schemes, such as the NREG, have significantly improved the income levels in rural areas. Wage increments under this scheme is now linked to inflation. This will help rural consumers have more disposable incomes. Construction activity under the government schemes has also helped, by directly providing employment and indirectly providing an end market for many ancillary industries in rural India. We have also seen this on our visits to various parts of rural India in the past few months.
- **Improving information technology:** Over the past decade, farmers have better access to information on their produce prices, enabling them to eliminate various middle men and resulting in more income.

Challenges in rural areas

However, there are challenges to be overcome in rural areas

While we see rural India as a great opportunity for FMCG companies over the next decade, there are certain challenges that need to be overcome. We believe companies with a keen focus on rural India have already started to look at these challenges. Some of the issues that we have identified are:

- **Consumer awareness:** One of the bigger challenges for companies in driving penetration of products in the rural areas is to ensure consumer awareness with regard to the existence of products and their utility. This is the first step in consumer engagement and it is the key driving factor to convince a consumer to try out the product, in our opinion. The advent of satellite television and subsequent penetration of TV in the rural areas has given companies a great platform to drive their message into rural India. Once the consumer is made aware of the product and its utility, the first battle is won.
- **Logistics:** Another key issue is the setting up of supply chain and distribution system in rural areas. Many small towns and villages in India lack adequate infrastructure, a major bottleneck in setting up supply chain networks, in our view. Even after years of driving rural penetration, most companies are only able to directly cover about half of rural India. Logistics and supply chain will also depend on the kinds of product that a company wants to take to its consumer. For instance, it is easier to bring HPC products to consumers in rural areas, where the inherent shelf life is longer, while it is more difficult to take products such as milk, chocolate, and ice-cream, which have a shorter shelf life and need investments in cold storage facilities. However, the soft drinks example clearly shows how the investment in setting up the supply chain can be a rewarding experience.

- **Affordability:** Once a consumer is made aware of the product and there is a supply chain in place to make sure the product reaches the consumer in the rural areas, typically the costs could have risen to high levels. The challenge for companies is to manage costs, as affordability of any product is an essential ingredient in driving the success of a product in rural areas. With per capita incomes much lower than in the urban areas, the percentage of population able to afford the product at the same price as in urban India is limited. However, with the concept of MRP (maximum retail price) in effect in India, companies will not be able to price differently in different areas. Companies that realised this have, over the past one decade, chosen to drive affordability by adopting smaller SKUs with lower price points. This is a strategy that has worked in products such as shampoo, for which the introduction of the sachet has led to a marked improvement in rural penetration. Going forward, we believe this is one of the key challenges for the industry in their efforts to drive rural penetration in many categories.

Some relative success stories

Companies which have been successful in driving penetration of their products in rural areas have overcome the above-mentioned challenges. The onset of satellite television has made the job of attracting consumers' interest in rural areas much easier. Companies have used this to their advantage and drive local area-specific strategies to help further improve the relevance of the product at the regional level.

Exhibit 22. Rural penetration (%)

Category	2001	2009
Toothpaste	32	45
Skin Cream	20	33
Dish Wash	12	16
Shampoo	16	46

Source: Booz & Company, Nomura Research

We believe one of the biggest successes in rural areas has been the shampoo sachets. Rural penetration in the shampoo category was very low in the early 2000s. However as companies made a push into rural areas, this was a key innovation they identified which helped significantly drive rural penetration of the product. Advertising made consumers more aware of the product and companies invested in distribution to push the product to smaller towns and villages. In addition, with the product priced reasonably, it saw a big success across rural India.

Likewise, the biscuit category, with a combination of advertising and affordable pricing, saw its market size grow many times over the last one decade.

Recent successes are Maggi's *chotu* (priced at Rs5 each) and Cadbury's dairy milk shots (priced at Rs2 each). Both products had an aspirational value attached to them, but because of the price points, they were offered in urban India and the affordability factor failed to work for rural consumers. However, both companies realised this and after having made pricing more relevant with smaller SKUs, recently drove significant penetration in the rural areas.

Even urban markets are still fairly underpenetrated

As mentioned earlier, under-penetrated rural markets are an attractive opportunity for the food sector in India and we expect this market to account for a large part of incremental growth over the next few years. However, as far as the food sector is concerned, we believe that there is still a large untapped market even in urban India, which we believe will play a very important part in overall food market expansion.

In some of the large and long standing food categories such as ice-creams and chocolates, the urban penetration level continues to be lower than 30%. This is a good indication of the huge opportunity in the urban food space in India, in our view.

Exhibit 23. Low penetration in urban markets (FY10)

Category	Size (Rs bn)	Urban penetration (%)
Ice-cream	20	25
Milk powder	8	7
Chocolates	27	28
Ketchup	5	15
Coffee	9	23

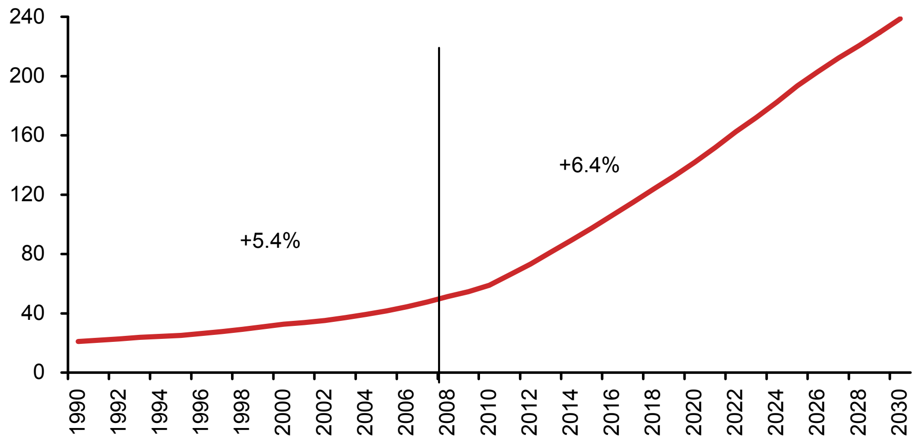
Source: Godrej Consumer, Nomura Research

Urban disposable income to accelerate

Disposable incomes in urban India will show a strong rise over the next two decades

Over the last 18 years, per capita urban disposable incomes have steadily increased at a CAGR of 5.4%, significantly ahead of the rural incomes. According to estimates by McKinsey, over the next few years, growth of urban disposable incomes is likely to accelerate, at CAGR of 6.4% over FY08-FY30. With steady rising incomes and the culture of consumerism increasing, we believe that there is significant opportunity in the food sector.

Exhibit 24. Urban India: Per capita disposable income



Source: McKinsey Global Institute

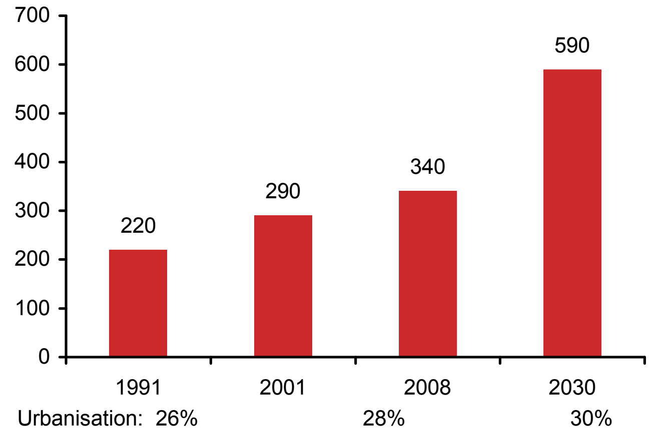
Pace of urbanisation to pick up significantly

Urbanisation trends will help growth in the food sector

Over the last one decade, we have seen increasing trends of urbanisation and we expect this to remain in the next decade. The fastest-growing states will continue to exhibit the highest urbanisation rate, in our view. By 2008, an estimated 340mn people would have already lived in urban India, representing ~30% of the total population. However, McKinsey estimates suggest that over the next 20 years, 70% of all the incremental jobs created in India are likely to be in urban India and these jobs are likely to be twice as productive as the equivalent jobs in rural India. Thus, the population in India's cities will increase to 590mn or 40% of India's population will live in cities in 2030, on McKinsey estimates.

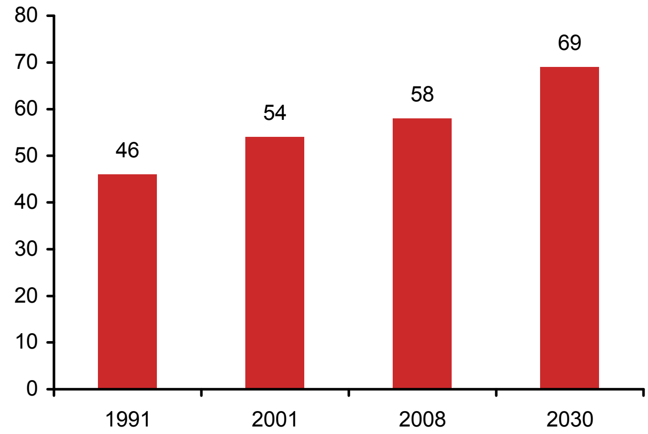
This pace of urbanisation, both in terms of speed and scale, has been unprecedented and has not been witnessed anywhere in the world except in China. More importantly, the urbanisation will be fairly well spread out, impacting almost all the states. The five largest states (Tamil Nadu, Gujarat, Maharashtra, Karnataka and Punjab) are likely to have urbanisation rates in excess of 50% by 2030, according to McKinsey.

Exhibit 25. Urbanisation to pick up significantly



Source: McKinsey Global Institute

Exhibit 26. Share of cites in GDP to rise



Source: McKinsey Global Institute

Likely to lead to accelerating premiumisation

Premiumisation trends will accelerate over the medium term

One of the consequences of increased urbanisation is accelerating "premiumisation". If urban disposable incomes increase nearly four fold in the next 20 years, then consumer preference is undoubtedly going to shift towards premium products, in our view.

This rapid premiumisation has been prevalent in India's urban markets over the last few years. One of the best empirical evidence of this is that almost all the companies under our coverage continue to report improved product mix, signalling up trading by consumer. Along with rising incomes and affordability, this is also a function of rising consumer aspiration. The upper middle class wants to emulate the rich and trade up towards higher-priced products.

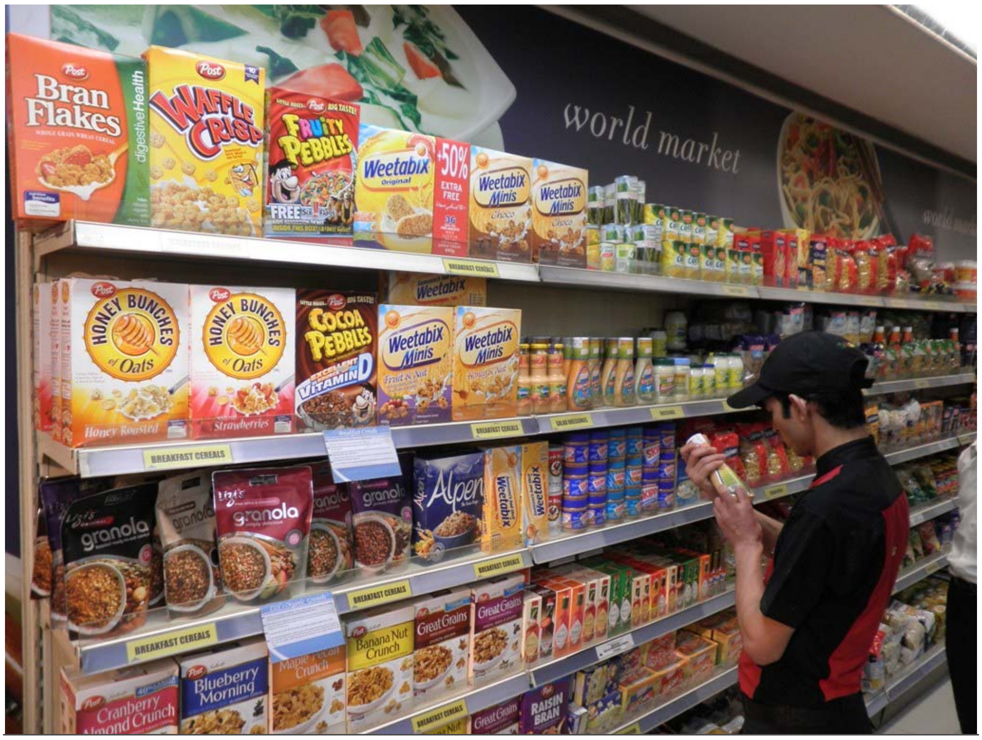
Improved purchasing power of Indian consumers is supported by greater participation of women in the workforce and increased number of younger workers, who are more willing to spend on lifestyle products. These factors will gradually combine to give a considerable push to premiumisation in the future, in our view, making it more pronounced compared to the last one decade. Continued favourable age distribution is also likely to be a driver for premiumisation in the future.

There are several examples of consumers trading up to more premium products, as well as FMCG companies launching various products to capture the premium market:

- Dove, a premium brand from HUL, increased its market share from 0.1% in 2005 to ~ 5% in 2010 in the hair care products category.
- L'Oreal has witnessed rapid growth in India with an ~8% market share in cosmetics, climbing up to the third position in this category. Similarly for hair colour, L'Oreal now occupies a 20% share of the market.
- P&G's Olay (premium anti-ageing skin-care brand) has now captured a 20% market share within one year of its launch.

Some evidence of this is also visible within the modern retail outlets in the top six cities. Within the F&B space, the share of luxury and imported products is significantly higher. The gourmet food bazaar (see pictures below) is the best example of this.

Exhibit 27. Imported goods shelf at a store in Delhi



Source: Nomura Research

Companies will be faced with the twin challenge of having to separate strategies for the urban and rural consumes over the next couple of decades. We believe the real winners will be companies that are able to tap these opportunities separately. Some of the categories which we believe will drive consumption in urban India over the next decade are Cereals, Fruit Juices, etc.

Urban consumer driving consumption in food

Urban consumer driving consumption in food

Processed and packaged food continues to be largely an urban category with most products having little or no penetration in rural markets. However, the demand from urban consumers has seen a sharp increase over the past few years, aided primarily by growing consumer incomes, increasing urbanisation and preference for convenience. This is likely to continue over the next few years, as consumers increasingly are looking for options which could make their meals more exciting as well as convenient.

This phenomenon will have particular relevance for categories such as breakfast cereals, for which the demand is likely to sustain over the long term, as producers of breakfast cereals have already responded to consumers' increased concerns over health and the growing trend for convenience by investing heavily. Our interactions with FMCG companies as well as modern retail participants suggest that the primary concern for companies at this stage is to build a presence in the category. Breakfast cereals in India, worth Rs5bn, is a small market in the context of the overall FMCG market, of which Oats is now worth Rs1.5bn, according to Marico.

Exhibit 28. Low penetration even in urban markets (FY10)

Category	Size (Rs bn)	Urban penetration (%)
Soft Drinks	70	37
Ice-cream	20	25
Milk powder	8	7
Chocolates	27	28
Ketchup	5	15
Coffee	9	23

Source: Godrej Consumer, Nomura Research

Newer and emerging categories to grow fastest

We believe growth in the food segment will also be driven from emerging categories such as juices, milk powder, baby foods, etc. With consumer preference moving towards convenience and with a large percentage of the wallet still being spent on food, these product categories are primed to take off, especially in urban areas.

Some of the best examples of this are breakfast cereals and packaged juices. Both categories are relatively new to the Indian market, but are growing at a fast clip. We expect breakfast cereals to deliver a medium-term growth rate of 20-25% and juices to continue to grow strongly over the next few years.

To put this into perspective, the breakfast cereals market is worth Rs5bn and juices is worth Rs15bn, according to AC Nielsen. Also note that in both these categories, consumers are moving from home-made/ unbranded products to packaged products. With demographics supportive for such a move, we see a big shift from unbranded products to packaged drinks. In the juices segment, Coca Cola India suggests that only 90mn cases out of the 660mn cases of juices market volume are packaged. This clearly leaves plenty of room for growth over the medium term. The first phase of this move has already started to happen, with packaged drinks moving from under 10% of the total juice market to 16-17% today (source: Coca Cola India).

We believe that modern retail is going to play a big role in the growth rates of these categories, given the high share of wallet and products being largely urban centric. We believe more of these emerging categories will be in the food space and that is where we find the most attractive opportunity across FMCG in India.

A case study: A food v/s HPC giant

A tale of two giants: HUL vs Nestlé India

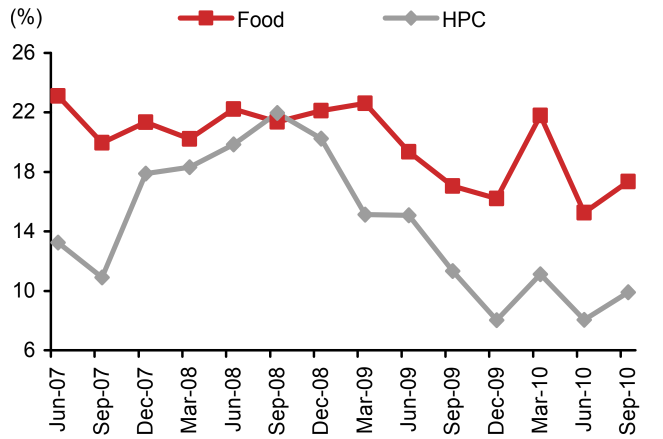
Nestle has better performance vs. HUVR over the last four years

The growth trajectory of these two sectors (ie, food and HPC) in the last few years has certainly had a deep impact on the fortunes of the companies in the respective sectors. Intuitively speaking, food sector companies such as Jubilant foodworks and Nestlé have done far better (in terms of growth, profitability and extending their leadership position) than leading HPC companies such as HUL, Colgate-Palmolive, Godrej Consumer etc, in our opinion.

This is also corroborated by industry data of the last four years. Food companies under our coverage have registered an average revenue growth of 20% in the last 18 quarters, a clear outperformance of 6% compared to the HPC companies.

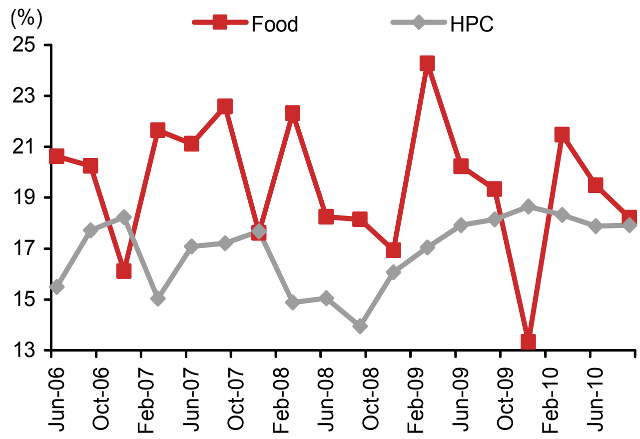
In terms of profitability, the average operating margin of food companies stood at 19.6%, almost 270bps higher than the average profit margin of HPC companies.

Exhibit 29. Revenue growth



Source: Company data, Nomura Research

Exhibit 30. Operating margins



Source: Company data, Nomura Research

In this section, we have also tried to back test our thesis by analyzing the operational details of HUL (an HPC giant) and Nestlé (a leading processed food player).

Nestlé India: A leading processed and packaged food player in India with strong presence in growing segments such as instant noodles, dairy products and beverages amongst others.

Hindustan Unilever: HUL is by far the biggest play in the HPC segment in India with a strong leadership position in segments such as soaps, body wash, fabric care, hair care and skin care. While HUL does have a meaningful presence in the food segment, recent efforts have met with less than expected success, resulting in the share of food diminishing in the overall revenues.

Growth and profitability: Nestlé wins hands down

The impact of being in two different segments is clearly visible on Nestlé India's growth profiles over the few years. Nestlé India's revenues have registered a CAGR of 22% (more than doubling in the process) in the past four years, while HUL registered a modest CAGR of 9%. As a result, HUL's revenue, used to be 4.4x that of Nestlé, is now just 2.8x of Nestlé's.

The impact of profitability has been even starker. Nestlé registered a 27% CAGR (margin improvement of 40bps in the past four years) in profits, while HUL registered a CAGR of 5% (margin decline of 120bps in the past four years) during the same period. As a result, HUL's PAT, which used to be 6x that of Nestlé, stands at just 2.8x that of Nestlé's.

Exhibit 31. HULvs Nestlé operational data

(Rsbn)	CY06	CY10	CAGR (%)
Revenues			
HUL	124,110	173,466	8.7
Nestlé	28,161	61,857	21.7
HUL/Nestlé (x)	4.4	2.8	
EBITDA margin (%)			
HUL	13.2	12.0	(120 bps)
Nestlé	19.7	20.1	40 bps
PAT			
HUL	18,905	23,180	5.2
Nestlé	3,151	8,241	27.2
HUL/Nestlé (x)	6.0	2.8	

Source: Company data, Nomura Research

Competition: a consistent issue with HUL

India's consumer sector is one of the fastest-growing markets globally, thus attracting a lot of new players. While there has been a significant rise in overall competitive intensity in the last few years, the degree and the resultant impact vary among sub-segments. We believe that the surge in competitive intensity has hurt HPC companies far more than food players.

Within the HPC space, HUL has been under three pronged attacks from international competitors (companies such as Reckitt Benckiser, Proctor & Gamble amongst others), large national players (companies like ITC in key segments such as soaps, skin and hair) and regional brands (brands such as Ajanta, Anchor, Ghadi). Large HPC categories such as body wash, hair care and skin care together represent almost one-third of the consumer market and in a growing phase, everyone wants a piece of the pie. The problem gets compounded for large players, such as HUL, since they have strong leadership and every time competition increases they feel the maximum impact.

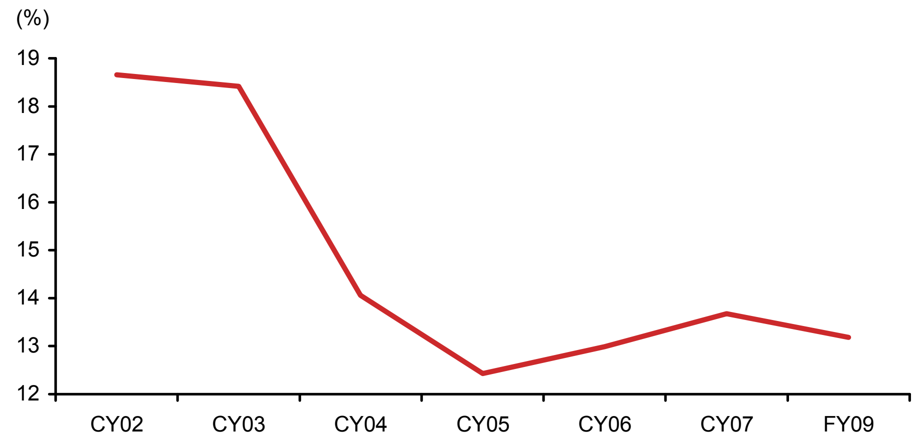
There is no denying that competition has also increased in the food space; however, the key difference is that the category is growing at a very rapid pace and thus the competition does not hurt to the same degree.

Price wars: permanent damage to profitability

One of the consistent themes in the HPC space has been that on a periodic basis, competitive intensity flairs up, leading to a price war between key players. HUL has engaged in two extremely damaging price wars in the past few years. The first was in 2002-04 when it engaged with P&G in the fabric care and hair care segment and with Colgate in the oral care segment, which resulted in price cuts of around 30-50%, which permanently damage the industry's profitability. The second price war was more recent (in CY09-10) and primarily limited only to the laundry category.

The impact on a company's profitability is fairly evident. On our estimates, from a sustained 18-19% EBITDA margins they have now come down to the 13-14% range.

Exhibit 32. HUL: profitability to a structural decline



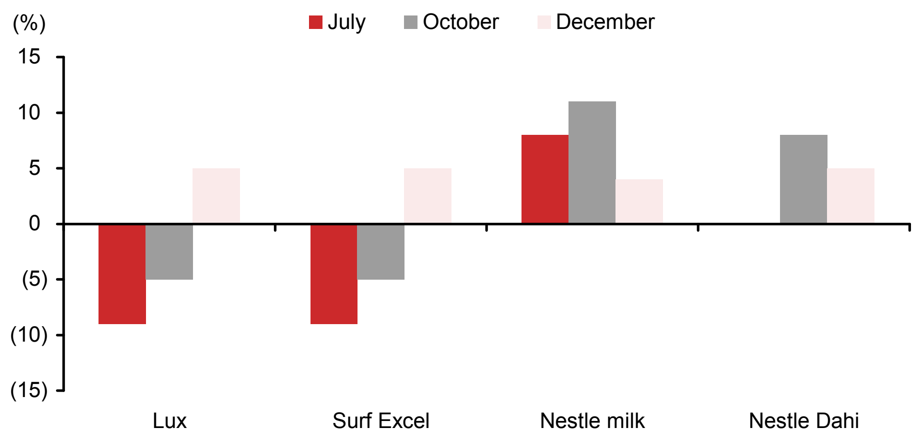
Source: Company data

HUVR's profitability under pressure over the last few years

Traditional HPC companies have failed to strike a balance between profitability and growth, in our opinion. In a quest to defend its leadership position, HUL has always been willing to sacrifice profitability. The company has time and again mentioned that this strategy is unlikely to be changed in the near future.

In the food space, while competition has increased with the entry of players such as Danone and ITC, it has not been price-led. Most of these categories are still growing and fairly under penetrated. The competition has been limited to some promotions but not really on pricing. On the contrary, companies in the dairy products business have consistently hiked prices in the past few months to offset input cost pressures.

Exhibit 33. Pricing in detergents and Food 1H FY11



Source: Company data, Nomura Research

Opportunity attractive… but stiff challenges ahead!

Challenges in the food space

While the opportunity in the food space is very attractive over the next decade, there are also some important challenges that the segment needs to overcome to grow faster than the overall consumer sector. We have identified some of the key challenges, which may be an impediment to sector growth.

Food segment has its own challenges

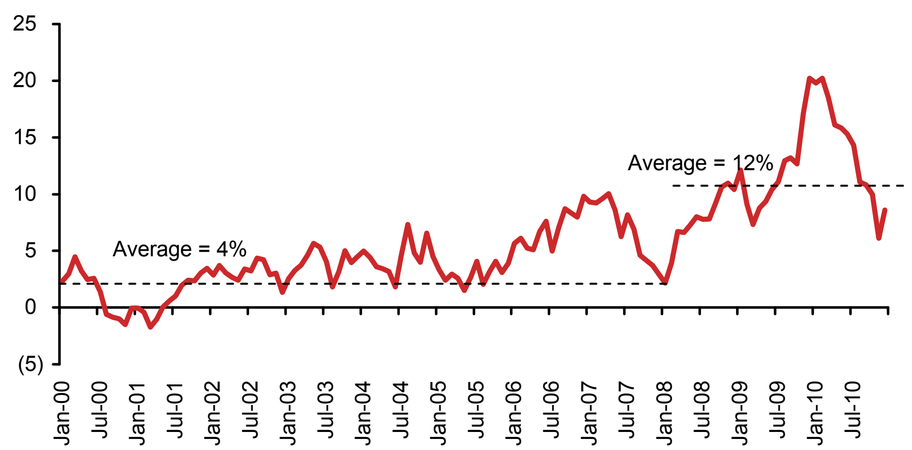
Food inflation a cause for concern

One of the key challenges that lies ahead for companies in the Indian consumer sector is sustained high food inflation. Over the near to medium term, this may hit the companies in two possible ways: 1) margin pressure as commodities such as milk, wheat, sugar etc witness an unprecedented price rise, and; 2) consumer demand may be hit as wallets come under a squeeze. Historically, there has been a strong correlation of high inflation and consumers trading down. This is especially true for high involvement (of consumer mind share) food products such as cooking oil which faced a significant demand slump in 2009 in the premium segment due to unprecedented price hikes.

Over the past few years, food inflation in India has trended up steadily. While part of this is due to rising global food prices, there are also some India-specific factors such as inadequate monsoon in 2009 and supply chain issues, such as loss due to pilferage, lack of proper storage and distribution, among others.

Our analysis suggests that food inflation is now becoming structural in nature. For instance, average food inflation was 4% between CY00 and CY08; since then, it has shot up to 11%.

Exhibit 34. Food inflation: Structural in nature



Source: Nomura Economics

Our on-the-ground feedback also suggests that prices of principal commodities (in the Maharashtra markets) have witnessed a significant rise (see the Exhibit below).

Exhibit 35. India: Soaring food prices

Food Item	November '09	November '09	Increase (% y-y)
Onions	24	50	108
Green Peas	110	160	45
Mutton	240	270	13
Chicken	92	110	20
Eggs	40	44	10
Rice (Basmati)	75	135	80

Source: Times of India, Nomura Research

Our interactions seem to suggest that the industry is aware of this issue and that there is a growing acceptance that food inflation could be structural in nature.

This, in essence, means affordability of food will continue to go down among some consumer classes, which is not a good sign for the near to medium term and is definitely a challenge for the industry, in our view.

When we look at household spending on food as a percentage of total income, we see India as among the highest in the world. This is clearly a result of high food inflation and GDP per capita growth not being able to catch up with food inflation. In developed economies, the share of food as a percentage of total household income can be as low as 20% (see the Exhibit below).

Exhibit 36. GDP per capita and household spending on food (FY10)

Country	GDP per capita (US$)	Household spending on food (%)
Asia		
Bangladesh	497	54
Vietnam	1,051	51
India	**1,017**	**50**
China	3,267	40
Sri Lanka	2,013	40
Thailand	4,043	39
Malaysia	8,209	37
Europe		
Switzerland	64,327	24
UK	43,541	23
Italy	38,492	22
France	44,508	22
Germany	44,446	19
North America		
Canada	45,070	18
United States	46,350	14
Asia Pacific		
Australia	47,370	20
New Zealand	30,439	19

Source: World Bank, FAO, USDA, CEIC and Nomura Global Economics estimates

Going into the next few years, we believe that a key challenge for the food companies will be to keep their product affordable, especially for the mass markets, to enable conversion from non-users to users and from unorganised to organised.

However, food companies have greater pricing power

We believe one of the key differentiations between the food and HPC segments is pricing power of a company. In the food space, companies such as Nestlé and GSK consumer have on average hiked prices by 8-10% over the past three years, but volume growth has continued to remain strong. Jubilant Foodworks said it would hike prices by 5% on average each year, which has been accepted by its consumers.

Contrast this with HPC names such as HUVR, whose pricing actions have a strong inverse relationship with volumes as witnessed in FY10, when the company took large price increases across its portfolio and saw volumes being hit significant. As the company reduced prices at the start of FY11, volume growth has come back strongly, but profitability has dropped significantly.

We believe food companies have greater pricing power largely on account of two reasons:

- The organised food industry in India still largely caters to the urban population, of which incomes are growing and consumers are more willing to pay a higher price for a product.
- Consumers cannot cut back their spending on food as they tend to do for HPC products in a period of high food inflation. Consumers, being used to higher prices

for basic food commodities, are also willing to pay higher prices for packaged foods than cut consumption.

Food availability may also be an issue

Another key challenge that the sector is likely to face is availability of food. Going by the total production data, food supply in India has been largely steady over the last few years, significantly below its consumption growth. This, incidentally, has also been one of the key reasons for steady food inflation.

Just to give some examples, total food grains production has witnessed a marginal 3.2% CAGR over the past seven years, with principle commodities such as rice and wheat also growing at the same pace. Sugarcane production, on the other hand, has actually declined marginally.

Exhibit 37. Food gain production in India (mn tonne, unless otherwise stated)

Crop	2003	2004	2005	2006	2007	2008	2009	2010
Rice	71.8	88.5	83.1	91.8	93.4	96.7	99.2	89.1
Wheat	65.8	72.2	68.6	69.4	75.8	78.6	80.7	80.7
Coarse Cereals	26.1	37.6	33.5	34.1	33.9	40.8	40.0	33.8
Pulses	11.1	14.9	13.1	13.4	14.2	14.8	14.6	14.6
Food grains	174.8	213.2	198.4	208.6	217.3	230.8	234.5	218.2
Oilseeds	14.8	25.2	24.4	28.0	24.3	29.8	27.7	24.9
Sugarcane	287.4	233.9	237.1	281.2	355.5	348.2	285.0	277.8
Cotton #	8.6	13.7	16.4	18.5	22.6	25.9	22.3	23.9
Jute & Mesta@	11.3	11.2	10.3	10.8	11.3	11.2	10.4	11.3

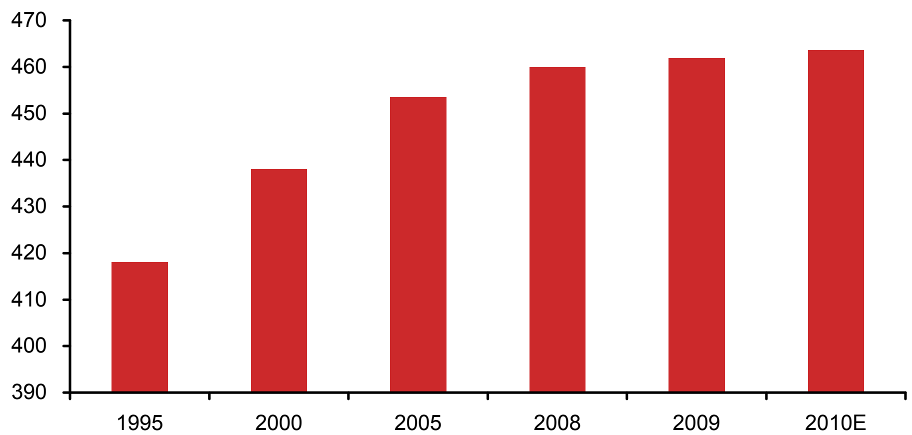
Note: # Million Bales of 170 kg each, '@ Million Bales of 180 kg each

Source: Directorate of Economics and Statistics, Department of Agriculture and Cooperation

Our belief is that consumption has increased at a much more rapid pace. While there is no data to back our claim, we believe that population growth hovering at 1-1.5% would mean that consumption growth is far more rapid.

Also, in the last fifteen years, 46mn new people have entered the consumption class (age 5-20), according to the US Census Bureau. We believe this is another indication of consumption rising at a fairly rapid pace.

Exhibit 38. India: Rising consumption class



Source: US Census Bureau

Another indication of consumption increasing at a rapid pace is that according to a report by NGOs "US AID" and "CARE INDIA", there has been an 8% decline in malnutrition cases in nine poorest states across India in the past seven years. A large part of the credit has been given to the government's 'Aanganwadi' scheme.

Also worth noting that India is a market where there is a significant amount of loss due to pilferage and wastages as infrastructure (setting up of storage facilities) remains inadequate and faulty. While there are no reliable estimates for how much of the production is lost due to pilferage, storage and transportation, the Food Corporation of India said that 18.3mn tonnes of wheat, 39.5mn tonnes of rice, 22,000 tonnes of paddy and 110 tonnes of maize were damaged between 1997 and 2007 due to supply chain issues. We would highlight non-availability of adequate storage facilities and loss due to pilferage, etc. as one of the key constraints for availability of food in the country.

Thus, with production not being able to keep pace with consumption, food supply and prices are likely to be an issue in the near to medium term in India.

Global consumption of food is expected to go up over the next decade, with growth in developing countries far outpacing the growth in developed countries. If production does not keep up with the increased demand, we could see food prices continue to rise in the next decade.

Exhibit 39. Global and regional per capita food consumption (kcal per capita per day)

Region	1964-1966	1974-1976	1984-1986	1997-1999	2015	2030
World	2,358	2,435	2,655	2,803	2,940	3,050
Developing countries	2,054	2,152	2,450	2,681	2,850	2,980
Near East and North Africa	2,290	2,591	2,953	3,006	3,090	3,170
Sub-Saharan Africa	2,058	2,079	2,057	2,195	2,360	2,540
Latin America and the Caribbean	2,393	2,546	2,689	2,824	2,980	3,140
East Asia	1,957	2,105	2,559	2,921	3,060	3,190
South Asia	2,017	1,986	2,205	2,403	2,700	2,900
Industrialised countries	2,947	3,065	3,206	3,380	3,440	3,500
Transition countries	3,222	3,385	3,379	2,906	3,060	3,180

Source: FAO.org

Low success rate in new food product launches

Success rate in new food product launches is lower than in HPC

We believe that one of the key challenges that lie ahead for companies is the relatively low rate of success in new food product launches. Compared to the HPC space, the success rate in new food product launches has traditionally been significantly lower. This is one issue we believe that companies are likely to continue to face in the near to medium term.

There are several issues in food which means that success rate is less than in HPC products. Some of the key issues are:

- **Food habits are difficult to change:** Empirical evidence suggests that consumers are far more willing to experiment when it comes to HPC items such as soaps, shampoos, etc. However, when it comes to making sustainable changes in their food habits, people are usually fairly hesitant. This is one of the key reasons that most successful launches in the food space have taken a relatively longer time to achieve critical mass.
- **Health and vitality important, but not at the cost of taste:** Another important thing, we believe, is to combine taste with health. This has been one area where most of the food players have struggled. Feedbacks from several companies suggest that while consumers are increasingly becoming health conscious, they still are not ready to sacrifice taste. This makes inroads, especially into new products/categories, difficult.
- **One country-one solution approach does not work: "**Indianising" / "regionalising" is of paramount importance when it comes to the food sector. India is a country where its population has many different tastes and preferences. Thus, a product needs to adapted/tweaked/changed to suit many different palates. This is one issue particularly faced by MNC players and often has regional players scoring over them.

There have been plenty of examples of food products that have not worked in India. HUL's first foray into the instant noodles segment was a failure. Marico's Saffola Zest only had moderate success before the product was being withdrawn. Nestlé's Milo, which is a very popular product worldwide, had failed to do well in India and was withdrawn. Nestlé's other products probiotic Yogurt etc. have met with moderate success.

Exhibit 40. Some of the not-so-successful food product launches

Product	Company	Category	Launch	Current status
Homemade	Dabur	Cooking aids	1995	Moderate success
Yakult	Danone	Probiotic drinks	Sep-09	Moderate success
Smoodles	HUVR	Instant Noodles	Jun-90	Re-launched
Modern Biscuits	HUVR	Biscuits	May-03	Withdrawn
Annapurna Aata	HUVR	Packaged Staples	Jun-98	Lower than anticipated success
Knorr Soupy Snax	HUVR	Snack	May-04	Withdrawn
4 O'Clock Tiffins	HUVR	Snack	May-03	Withdrawn
Aashirwad RTE	ITC	Packaged Food	Jul-03	Moderate success
Kitchens of India	ITC	Ready to Eat	Aug-01	Moderate success
Sunfeast Pasta	ITC	Ready to Eat	Mar-05	Moderate success
Saffola Zest	Marico	Salty snack	Jan-09	Withdrawn
Saffola Rice weight mgmt	Marico	Packaged Rice	Mar-09	Withdrawn
Saffola Cholesterol mgmt mix	Marico	Additive	Mar-09	Prototype
MTR	MTR	Ready to Eat	Year 2000	Lower than anticipated success
Nestlé Milo	Nestlé	Milk drink	Jun-05	Withdrawn
Nestlé probiotic products	Nestlé	Dairy products	Jan-09	Moderate success
Nestlé Cerevita	Nestlé	Baby Food	Dec-07	Withdrawn
Nesvita Pro Heart Milk	Nestlé	Packaged Milk	Jul-07	Moderate success
Kit Kat Lite	Nestlé	Chocolates	Early 2007	Withdrawn
Maggi Rice Mania	Nestlé	Instant Noodles	Early 2009	Withdrawn
Milkmaid Squeezy	Nestlé	Spread/Topping	May-03	Withdrawn

Source: Company data, Nomura Research

There have also been some great successes in the food space. Some of the brands which have been successful in new food product launches have been able to create a new category, with the result that some of these brands still have a large percentage market share, such as Maggi, Real Juices, Quaker Oats, etc. We list out some of the success stories below.

Exhibit 41. Successful launches in Food/Beverages

Product	Company	Category	Launch	Current status
Maggi	Nestlé	Instant Noodles	1983	Market Leader with an 80% share
Nestlé Milk	Nestlé	Packaged Milk	2001	Strong growth in Urban India
Real Fruit Juice	Dabur	Packaged Juice	1996	Strong 52% market share
Saffola Oil	Marico	Edible Oil	1988	Huge success
Knorr Soups	HUVR	Packaged Soups	2002	70% share of soups in India
Amul flavoured Milk	Amul	Flavoured milk	2001	70% share in India
Kellogg's Cornflakes	Kellogg's	Breakfast cereals	1994	65-70% share in India
Veggie Burger	McDonalds	Fast Food	1996	Market Leader
Sunfeast Biscuits	ITC	Biscuits	2004	Strong presence in the category
Lays	PepsiCo	Chips	1995	Market leader in packaged potato chips
Quaker Oats	PepsiCo	Oats	2006	Market Leader in the Oats category
Gatorade	PepsiCo	Sports Drink	2004	Market Leader in the Sports drink category

Source: Company data, Nomura Research

Some of the common features that have made all the earlier-mentioned products successful are:

- Most/all the successful product launches have taken a significant amount of time to achieve critical mass.

- Quite a few of the recent launches have been in the "healthy food" space. This underlines the increasing emphasis by consumer, especially in urban India, on health and wellness.
- Most/all the products are still largely present in urban India. Food is still a fairly small and nascent category in rural India.

Going forward, we believe the comparative low rate of success in new food product launches will likely be a big hurdle for consumer companies in the food segment. These companies will need to be prepared to face failures and will need substantial funding to invest in brands over a long period to achieve success.

Heterogeneity of the market is a big challenge

India is a heterogeneous market with consumer tastes and preferences changing every few miles. This makes it difficult to come up with a single product to satisfy the needs of consumers throughout India. Saffola Arise from Marico, launched at the start of the year, only has had moderate success in the North and East India, where consumer preference has always been for long grain rice. Where consumer preference has been for short grain rice like in South India, the product has done well.

This is a point which was also echoed by Pantaloon, and is also something it sees as a key challenge even in organised retail. Tastes and preferences across the country are very different and this means strategy across stores, sometimes even in the same city has to be different. For instance, there are stores in Bangalore which sell a traditional Maharashtrian savoury called '*bhakarwadi*', catering to a large percentage of Marathi-speaking population in Bangalore for their weekly grocery shopping. There is also a special variety of Bengali rice sold stores in Delhi, which is very popular with the Bengali-speaking population in Delhi. Even within the same city, stores which are a few kilometres apart have a different target audience. For example, a store in Mumbai would have specials around the Diwali holiday in November while another store would have specials near the Eid festival, although both festivals are only days apart.

Exhibit 42. Short grain-south Indian rice in a Delhi store

Source: Nomura Research

Exhibit 43. Revdi (sweet sesame snack) for north-India clientele in Mumbai

Source: Nomura Research

Indian consumer still evolving

Another key hurdle that Indian food companies are likely to face is the process of evolution by Indian consumers. While awareness levels of Indian consumers have gone up, a large part of consumption habits are still dictated by traditional beliefs and habits, in our opinion.

In our interactions with industry participants, we have learnt this phenomenon is particularly visible when the Indian consumer's buying behaviour of staple items is observed. Across retail stores, including large modern retail stores in metros, many consumers still prefer to touch and feel the staples before making their buying decision. To this day, a vast majority of staple sales across retail chains occurs on a loose basis compared to pre-packed staples. This is especially surprising given that there is marginal/ no difference in prices and hygiene is an important element involved.

This is a losing proposition for both retailers (increased man power costs, increased space consumption) and consumers (hygiene compromised in loose staple sales), yet 80% of the staple sales for large retailers happen on a loose basis.

This is just one example of the challenges faced by Indian food companies. Indian food companies would need to posses a deep understanding of their customers' traditions and beliefs and be agile enough to respond quickly to the evolving consumer needs.

Exhibit 44. Sale of loose staples in a modern retail outlet…

Source: Nomura Research

Exhibit 45. …no difference in quality or price though

Source: Nomura Research

Looking ahead… the next decade

Future trends

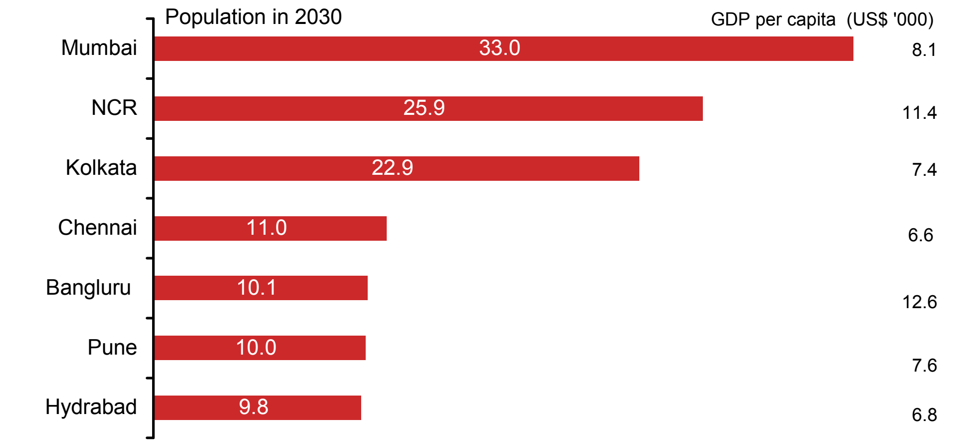
Dining in vs eating out

Trends going forward will include dining in vs eating out

Another key trend that we see catching up significantly in the next decade is the concept of dining in, especially in urban India. As mentioned earlier, the pace of urbanisation is likely to pick up significantly in the next few years. This would mean that urban India is likely to see a significant increase in its population, with the top seven cities having more than 10mn inhabitants. According to McKinsey estimates, India is likely to have 68 cities with a population of more than 1mn by 2030 compared to 42 cities today.

This population explosion is likely to lead to severe issues such as adequacy of public transport and road infrastructure.

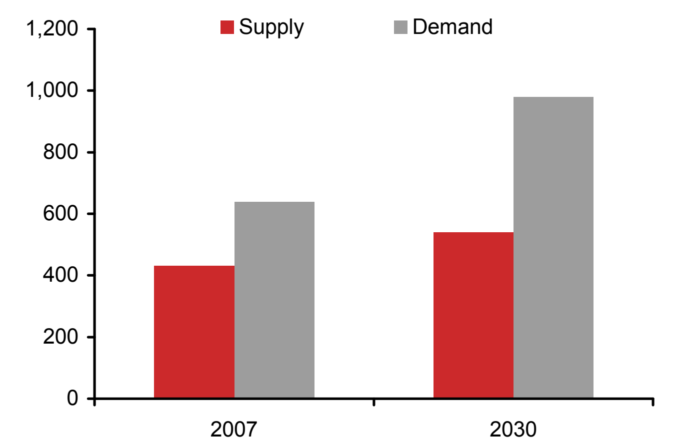
Exhibit 46. Urban population to expand significantly



Source: McKinsey

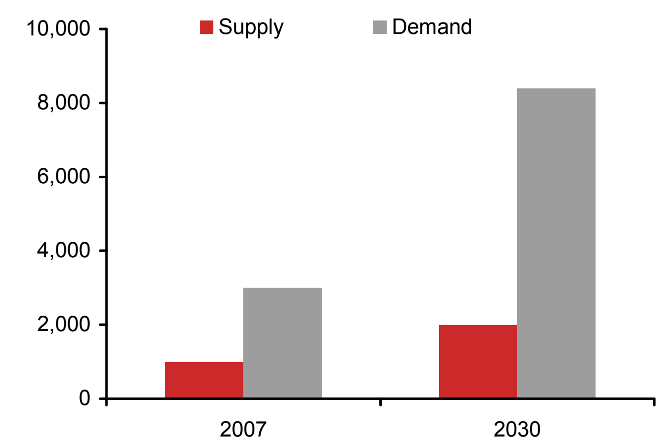
Likely to lead to infrastructure issues …

Exhibit 47. Private transport



Source: McKinsey

Exhibit 48. Rail-based mass transit



Source: McKinsey

This infrastructure bottleneck, combined with urban lifestyle, is likely to lead to a significant part of the eating out population migrating to “dining In”. We believe that speed and convenience (no long drives, no parking hassles and no waiting in long queues for a table) of a “take away “or “ordering in” are sufficient to make a large part of the population shift towards dining in over a period of time.

This trend has already started in a significant manner with most of the chain eateries (McDonalds, Subway, etc) and standalone restaurants now providing home delivery services.

In the longer term, while eating out should command a significant share of sales growth, we believe that a large part of the incremental growth is likely to be driven by Quick Service Restaurants (QSR). This is one of the key reasons for our Bullish view on Jubilant FoodWorks.

Competition continues to rise

One of the challenges that will continue to affect Indian food companies will be a steady rise in competition, in our view. This has been a steady phenomenon in the last few years but the pace of new food product launches seemed to pick up significantly in 2010. Some of the examples of product launched/plans in 2010 are as below:

- **ITC** recently entered the noodles space with its brand "Sunfeast Yippee!". This marks the third entry in the noodle space in recent times after **HUL** (Knorr Soupy Noodle) and **GKS Consumer** (Foodles). We believe this will make things incrementally tougher for Nestlé.
- **GSK consumer healthcare** also recently entered the biscuits & cookies segment, apart from health bars, in a bid to diversify its product profile.
- The global food giant, **Kentucky Fried Chicken (KFC)** also has robust plans to grow its business in Maharashtra. Currently, the company has three stores operating in Mumbai and one in Pune. It plans to move this to ~30 stores by FY12.
- Recently, global breakfast player **Kellogg** entered the oats segment in India. This space is already significantly crowded with companies such as Bagrry, Marico and Pepsi.
- **Costa Coffee** plans to expand its footprint in the country significantly. According to the company, it plans to open one store every 15 days to take the total store count to 75 by the end of the year.
- Global giant **Danone** recently entered the Indian markets with a range of dairy products. This again increases competition for companies such as Nestlé.
- Chocolate maker **Ferrero Rocher** has announced plans to expand its presence in the Indian confectionary segment.

Hence, we believe that incumbent advantage is significant in this segment. While in the near term this is unlikely to hurt Indian food companies, as the food space in India is still growing, we believe that in the longer term, Indian food companies need be careful of this issue.

Innovation is key to success

Innovation pipeline will be the key to success

Another key trend we see going forward is increased focus on innovation, especially by food companies. Some of the key innovation trends we expect to form are:

- **Packaging innovation:** We believe this has taken shape significantly in the past few years, but we see scope to increase significantly in the coming decade. If food penetration has to increase in rural India, then affordability is key. One of the easiest ways of making a product more affordable is to reduce the pack size.

  We believe the trend of packaged and processed food in affordable smaller packs, ie, PPP (popularly priced packs) is going to pick up significantly in the coming years. The Chotu Maggie (priced at Rs5 each) is a good example of this innovation.
- **Product innovation:** Product innovation is likely to be key to success in India's urban markets. Urban consumers are now increasingly getting more and more health conscious. Thus, all new introductions in the urban food space will necessarily need to address the question of health and vitality without compromising on the taste front, in our opinion.

- **Pricing innovation:** As mentioned earlier, affordability is key to success for many product categories. Unfortunately, not all products can be marketed in smaller packs. For instance, infant nutrition is not one that can be sold just on a trial basis, as either the consumer is going use it regularly or not. Thus, the key challenge for the companies is to innovate and bring in mass-market versions to ensure higher affordability.
- **Category innovation:** We believe that there is a lot of latent potential in the Indian food market and there is an existing demand for several products which are either not freely available in the market currently or the categories are just too small. Food companies will need to focus their energies on such products going into the next few years, in our view. Some of these categories are mass market infant nutrition, healthy dairy, healthy evening snacks and pet food.
- **Multi category positioning:** Another important innovation that we see companies focussing on is multi category positioning. This in essence means introducing new products in a manner which makes them relevant in more than one category, For instance, Unibic India is in the process of launching Chyawanprash cookie. This distinct positioning gives them the opportunity to tap consumers both in the cookie market and the Chyawanprash segment. Unibic India is a small player in the biscuits segment in India and we believe one way of establishing itself is innovation of products currently not launched by other players.

  Another example of a different kind of multi category positioning is Kellogg's. The company has become a market leader in the breakfast cereals market in India, but lacked a presence in the evening snack category. Packaging innovation with the Rs10 per pack placed alongside the salty snack packs has put the company's existing product into another category.

  These innovations will further add to the overall category growth as newer consumers come into the category. We believe this will not be a threat to the existing categories such as Chyawanprash, which will likely continue to grow.

Regulatory environment to get tougher

We believe that incrementally the regulatory environment for Indian food companies is likely to get tougher, even though implementation in the near term may be an issue. A couple of recent examples are outlined below:

Food safety and standard rules, 2011

The Ministry of Health and Family Welfare recently issued a draft for food safety and standard rules, which will become the Food Safety and Standards Act (FSS1) and will come into force over the next few months. FSSA is an all-encompassing act that seeks to regulate every aspect of the food industry right from manufacturing, storage, warehousing and transportation to packaging and labelling.

This will ensure that the overall focus on food safety and regulations behind the packaging and sale of food products will increase across the country. While intuitively, this appear to be negative as costs related to complying with these regulations will increase, we believe the incremental costs for organised players will not be significantly higher as most players are already following many of these guidelines voluntarily. However, this would be highly positive as the so far unregulated unorganised food industry would also come under the purview of the act. This would enable a smooth and slow transition of consumers from the organised to the unorganised sector.

Some of the key takeaways from the draft and the 2010 regulations are:

- Stricter regulations concerning packaging materials used for all kind of food products, especially for high risk products such as fish, meat, fresh fruits and vegetables, poultry and eggs, among others.
- More information on the labels to be shared with consumers detailing among other things ingredients used, declaration of food additives, addition of colour and added flavours.
- Edible oils packaging must be free of exaggerated claims such as 'Ultra-Refined', 'Anti-Cholesterol', 'Cholesterol Fighter', 'Soothing to Heart', 'Cholesterol Friendly', and 'Saturated Fat Free'.
- Although we have cited only a few examples above, what is clear is that the Ministry of Health is clearly focused on making sure that food products are safe for consumers. We see this as a catalyst for a crackdown on growth of the unorganised packaged food segment, which could mean a shift in demand to the organised segment.

We believe the focus on food safety and bring more regulations in the sector will be a longer-term positive, as this helps ensure products are safer for consumers and proper information is available. As consumer awareness increases over the next few years, these regulations will likely signal a shift in consumer choice from the unorganised to the organised segment and growth of packaged foods will likely continue to see a significant rise. We would point to the branded milk and packed curd as two products where the share of organised in the overall segment has increased significantly over the last few years. We see a further shift over the next few years, especially as consumers are becoming more aware of the health issues surrounding packaged foods. Some of the other categories which will see benefit from this are chocolates, packaged meat, staples etc.

Food safety pledge to also come into force soon

In 2009, seven companies in the food and beverages space, namely Hindustan Unilever, Coca-Cola, PepsiCo, Nestlé, Kellogg's, Mars and General Mills decided to sign the India Pledge on the lines of the pledge signed in the European Union. The pledge gave guidelines to restrict and regulate propagating unhealthy foods. The pledge was to demonstrate their commitment to social responsibility in marketing food and beverage products to children, provide a framework to promote healthier dietary choices and more active lifestyles to children.

The deadline to get this pledge signed was 31 December, 2010. Although the deadline has been missed, we expect this to be out soon as companies remain committed to the idea.

India will be the 12th country to have food and beverage companies coming together to sign the pledge. Countries where similar pledges have been signed include the US, Canada, Australia, Thailand, South Africa and Brazil.

The pledge is coming to India after it has already been in place in several other countries. In Europe, companies including Nestlé, Danone and Unilever have signed the pledge. This has entailed a higher cost as companies have to spend additional money to ensure that the information on labels etc is not misleading. We see the increased regulations in the food space having a cost, but being more beneficial for longer-term growth of the organised food sector.

Private labels would accelerate food sector growth rather than disrupt it

Role of modern retail

Evolution of modern retail key to driving FMCG sales

Modern retail will play a key role in the development of the FMCG sector

Modern retail, which has only really developed in India over the last few years, is still in a fairly nascent stage. However, what has been impressive has been the rapid pace of growth, especially in the urban markets where some estimates suggests that modern retail penetration is nearing ~25%. We believe this will continue to grow over the next few years as consumers move their preference away from traditional retail formats.

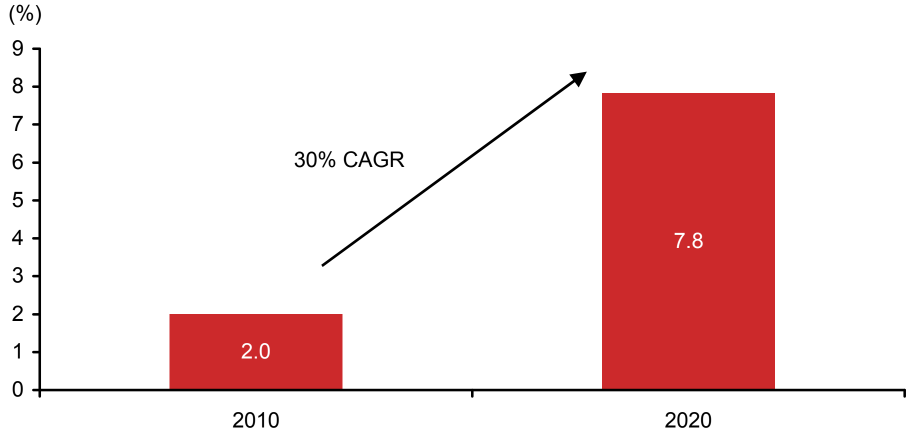
We believe modern retail will play an important role in FMCG growth over the next decade. Modern retail has a ~7% share of the overall FMCG sector in India, according to Booz and Co. As penetration of modern retail continues to grow over the next decade, we see the share of modern retail growing to 20% by 2020F. Note that the share of modern retail in urban India is already close to 25%. This will also keep increasing as consumers move their preference to modern retail over the next decade or so. In other words, this means modern retail will have a significant influence on the pace of growth for the Indian FMCG industry over the next decade.

F&B segment to lead the way

The food sector accounted for ~37% of India's total FMCG market in 2010, according to AC Nielsen. We believe over the next decade, this is likely to grow to ~46% as food categories outgrow the HPC ones. We believe modern retail will play an important role in this growth.

Currently, the share of modern retail in the F&B space is very low at 2%, but has grown an average 55% pa over the last few years, according to AC Nielsen. While we believe this level of growth is unlikely to be sustainable, a 30% CAGR over the next decade is possible as we believe F&B will continue to account for largest part of a consumer's expense. This is also supported by retail companies' strategy of increasing their exposure to the food space. We estimate that over the next 10 years, of the total incremental growth in the food category, 10% or so will be supported only by modern retail. We estimate that penetration of modern retail in the F&B space is likely to touch 8% over the next 10 years.

Exhibit 49. Modern retail penetration in F&B



Source: Nomura estimates

Recent interaction with stakeholders in the FMCG industry suggests that Indian FMCG companies are also aware of this phenomenon and are very inclined to do business via modern retail outlets. FMCG companies are keen to ensure their products are available through modern retail channels, which enable them to target the urban population with more disposable income. They are looking to give 'sweeter' deals to modern trades over general trades in urban areas, as the target audience can be reached better via the modern retail format. This is especially true for products such as processed foods, where the target audience is shopping at modern retail outlets than at traditional retail outlets.

Consumer wallet still dominated by Food & Beverage

Consumer wallet dominated by F&B in India

Despite the growing importance of other categories such as clothing, footwear, accessories, jewellery, etc, the share of food and beverages continues to dominate the share of a consumer wallet. According to Images India Retail, the retail F&B share is still ~60%, which means it remains the most important part of the overall retail trade. While this part of the trade has been dominated by traditional retail over the years, recent growth of modern retail has meant that the share of modern retail has improved. However, there is still a long way to go before modern retail accounts for a sizeable proportion of overall retail trade, especially in the F&B space.

Exhibit 50. Share of consumer wallet

Category	Share of wallet (%)	Penetration (%)	Growth (%)
Clothing, Textiles & Fashion Accessories	9.9	22.7	39.3
Jewellery	5.2	3.3	36.9
Watches	0.3	48.9	19.4
Footwear	1.2	48.4	49.0
Health, Beauty Care Services	0.3	14.3	65.0
Pharmaceuticals	3.7	3.2	40.0
Consumer Durables, Home Appliances / equipments	4.3	12.3	42.0
Mobile Handsets, accessories and services	2.0	9.9	55.2
Furnishings, Utensils, Furniture-home & Office	3.4	11.0	35.1
Food & Grocery	59.5	1.1	55.2
Out-of-home Food (Catering Services)	5.4	8.0	44.7
Books, Music & Gifts	1.2	13.4	31.0
Entertainment	3.4	5.3	53.8

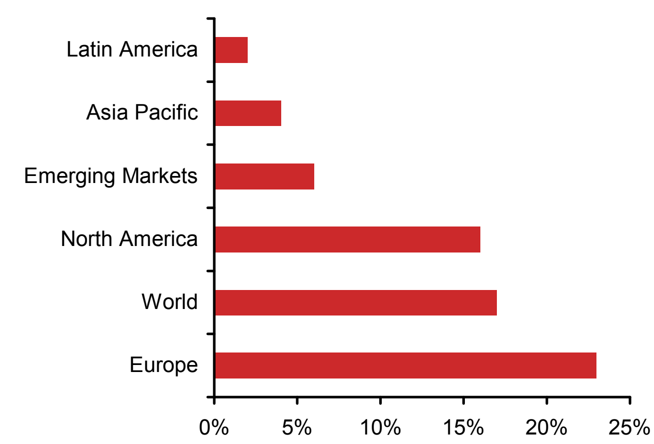
Source: Images India Retail 2009

Private labels – a modern retail phenomenon

As modern retail started to grow in India, private labels started to make an entry into the FMCG market. The steady rise of private labels has been a consistent phenomenon across the globe now. Globally, private label market penetration as a percentage of retailers' overall sales is significant: the global average is ~17, Europe: 23% and US: 16%. Emerging markets, however, are still behind in terms of private label penetration, at ~6%. In India, the overall share of private labels within organised retail is ~5%, which makes it one of the lowest in the world (Images India Retail 2009).

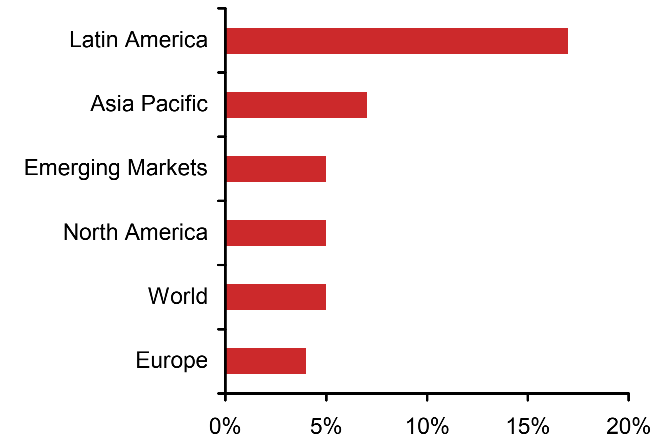
However, therein lies an opportunity for Indian retailers, with retailers increasingly realising that private labels can be a significant success if the product offering presents value to the consumer. This is especially true for a country like India where consumers' perception of 'value' is extremely important.

Exhibit 51. Private label penetration



Source: Images India Retail 2009

Exhibit 52. Private label sales growth



Source: Images India Retail 2009

Private labels are shelf led brands

Private labels are a phenomenon of modern retail and are, hence shelf led brands, for which the advertising happens in terms of shelf placement as against manufacturer brands which are adverting led, on TV, print, etc. This is a key differentiator in terms of costs, where private labels seem to have a distinct advantage over manufacturer brands. Manufacturer advertising may lead the consumer to the category or the product but at the point of sale, consumer may prefer to go with private label brands over manufacturers' brands.

Exhibit 53. Product differentiation is minimal

Source: Nomura Research

F&B category dominates

Within the private label space, most retailers have a large percentage share of the category in F&B. We estimate F&B has on average a 30-35% share of private labels across retailers. This is the segment which we believe the retailers have also recognised is the best opportunity in FMCG and have been growing aggressively over the last few years. Categories such as pasta, instant noodles, other processed foods, packaged staples are the segments where retailers are concentrating their efforts in.

Private label success has led to category expansion

Private labels have started in India at a much earlier phase in the development of modern retail. However, in developed countries, private labels only came into being once the category penetration was nearly saturated. The role of private label in those countries was to provide consumers with a lower price point for a comparable product.

In India, the penetration levels across categories are still low and the role of modern retail is largely to drive the category penetration. Private labels have been instrumental in leading category growth in several FMCG segments. By category growth, we mean an inclusive growth consisting of both increased penetration and per capita consumption.

The recent success of categories such as breakfast cereals (corn flakes, oats, muesli, etc) has been helped by the entry of private labels, which helped push products to many more new consumers than before.

Private labels brands cheaper but not inferior in quality

There is a perception among consumers that private labels are cheaper compared to established brands because the quality of goods is much lower. However, in our interaction with Pantaloon Retail India, the company pointed out that its private label brand premium harvest, which is the umbrella brand for packaged staples, is cheaper than established brands only because its costs are lower and there are no significant quality differentiations.

Exhibit 54. Premium Harvest staples in Big Bazaar

Source: Nomura Research

Private labels enhance bargaining power for modern retail …

As the costs of having private label brands in the store are much lower, there is more leverage for retailers stocking private label brands in terms of profitability. Retailers' shelf space is sought after by FMCG companies, and the presence of private labels gives retailers the bargaining power to negotiate better terms with manufacturers. Some of this benefit may be passed on to the consumer, which will also help in driving category sales, in our view.

Exhibit 55. Breakfast cereals category growing strongly

Source: Nomura Research

… but not a threat to established brands

Although private labels are growing strongly, the share of organised retail under 10% means they are not a threat to established brands. Moreover, the primary role of private labels is to drive category growth and because the market for many categories is growing, private brands, in our view, are not a threat to established brands.

Modern retail to help convert non-users to users

Converting non-users to users will be a big opportunity

One of the opportunities across FMCG is to convert non users to come into the categories, even at the lowest part of the value chain. This has the potential to significantly shift the growth trajectory across categories upwards, as there is still a large majority of consumers in India who are non users of many of the products across the FMCG industry. This is especially true for the food category, where the penetration level in many categories is still very low compared to HPC's, in which some of the categories are close to being optimally penetrated. Modern retail has taken the lead in this regard across the FMCG categories by luring more and more consumers into the category by way of different promotions and strategies.

In several categories such as oats and instant noodles, modern retailers have launched their private label brands which are expected to grow significantly. This has aided the growth rates of the categories.

India remains a huge unbranded market and therein lies an opportunity for retailers. Future FMCG group is looking at opportunities across categories, which include cosmetics, for which the value of brands is seen as key to success. However, in that sense, we see India as a distinctive market which provides an opportunity to migrate non users into the category. This is where modern retail has a big advantage over established brands in luring consumers.

Modern Retail's role in developing the supply chain

The importance of supply chain in the development of modern retail cannot be stressed more. Having an efficient supply chain system will not only ensure that product availability is enhanced, but also helps in putting controls in place on costs.

One of the key concerns for the FMCG industry has been the low fill rates that are prevalent in the country. The fill rate is defined at the percentage of time that the product which the consumer is willing to buy is actually available in the store. According to Images India Retail 2009, the industry average fill rate is close to 65-70%, which means about 30% of the time, the consumer is not able to find the product that he/she is looking for. This is direct cost to the retailer and the manufacturer, as non availability of the product leads to loss of revenues.

Modern retail has invested heavily behind developing an efficient supply chain. One of the benefits of having an efficient supply chain is that many of the inefficiencies in the form of additional costs get taken out of the system. This would result in cost to the consumer coming down, which also leads to improved consumer off take and an increase in per capita consumption.

This is especially relevant given the recent sharp rise in food prices, a result of inefficiencies in the supply chain. Many of this relates to traditional retail including wholesalers, local retailers, etc. The recent presentation from Bharti Wal-Mart cash and carry business suggests that with direct procurement, proper storage and distribution, prices can be kept under control.

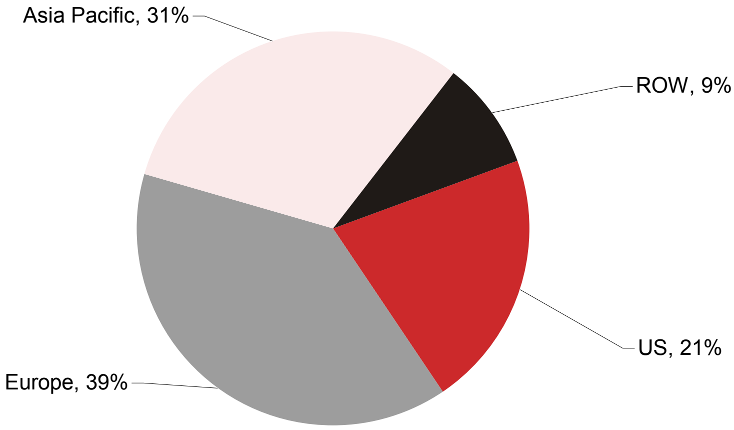
Food in the global context

Global food industry

Global food opportunity is evolving

Global food opportunity is constantly evolving as a result of changing lifestyles and preference for more convenience and variety. Global processed food opportunity is valued at €2.5tn, of which the US, Europe and Japan combined account for 60%, according to a FICCI report. In that context, the share of the rest of the world (ROW) is quite small, but the opportunity size is much larger.

Exhibit 56. Global processed food industry



Source: FICCI

However consumer preferences across regions different

Consumers are increasingly demanding more customised products across the world. However, since consumer development and processed food market development is at a different stage across the world, the categories which are most attractive across the region are also different. According to a recent survey by AC Nielsen, the global trend in food choice across regions throws up some interesting results.

What the results indicate is that within the processed food segment, consumer preferences are different across regions. In mature markets such as the US and Europe, consumers are looking at products such as drinkable yogurt, fruit bars, etc, while in emerging markets consumers are looking at categories such as juice drinks, noodles/pasta and cheese.

Exhibit 57. Regional trend in food preference

Europe	North America	Asia Pacific	Emerging markets
Dairy Drinks	Frozen Meal	Frozen Meal	Juice Drinks
Fish and Seafood	RTE Salads	Frozen Fruit	Noodles/Pasta
Sweet Pastries	Frozen Meat	Drinkable Yogurt	Meat Products
Drinkable Yogurt	Fruit Bars	Vegetables	Cheese

Source: AC Nielsen, FICCI

Food inflation to be a global concern

We expect the global food demand-supply condition to undergo a significant change, leading to a surge in global food inflation. To quote from our economists Rob Subbaraman's report (*The coming surge in food prices*, 8 September, 2010):

The surge in commodity prices in 2003-08 was the largest, longest and most broad-based of any commodity boom since 1900. The prices of energy and metals surged the most, but it was the agricultural market that saw the most fundamental change. It *may not take much of a disruption in food supply to trigger another surge in prices given that the dynamics have become a whole lot more uncertain as a result of new and some increasingly powerful influences acting on both sides of the food supply-demand equation.*

We expect another multi-year food price rise, partly because of burgeoning demand from the world's rapidly developing – and most populated – economies, where diets are changing towards a higher calorie intake. We believe that most models significantly underestimate future food demand as they fail to take into account the wide income inequality in developing economies.

India to follow global trends

We would also point out that preferences for processed foods also reflect the stage of development in the country's demand for processed food. For instance, in developed markets the preferences are for more premium products such as niche dairy drinks, drinkable yogurt, etc., while in emerging countries, which are just seeing growth in the processed food segment, categories such as juice and noodles are the most popular ones. We believe India will follow the global trend and over the next decade some of the categories which will grow the fastest are breakfast cereals, baby food, juices etc., all of which have reached saturation in developed markets.

The China example

We have briefly looked at the history of growth in the packaged food category in China to see how growth may pan out in India.

In 2008, the packaged food industry in China was US$111bn, with a CAGR of 11.5% over 2003-08, attributable to a few key factors:

- **Strong GDP growth:** Strong real GDP growth rates in China (a 10.8% CAGR over 2003-08) have led to rapid growth of the Chinese middle class (source: McKinsey). The middle class in China is commonly defined as comprising households with an annual income of between US$7,500 and US$70,000. This led to a sharp increase in spending on processed foods, although the total share of F&B in total household income reduced as increase in income was also beneficial for other consumer-related categories.
- **Urbanisation plays a big role:** China's population has also become increasingly urbanized over the last two decades. In 1990, 27.4% of China's population were living in urban areas and by 2005, this increased to 40.4% (source: McKinsey). This trend is projected by McKinsey to continue, and, by 2015, it is expected that about half (49.2%) of China's population will be living in an urban centre. As a consequence, we believe there will be an increase in the demand for packaged foods as seen over the last one decade.
- **Modern Retail drives growth:** Growth in the last few years has been driven by changes in the retail landscape. The rising role of modern retail formats such as supermarkets, convenience stores and hypermarkets also has a big impact on the type of food consumers are buying. Buying patterns have shifted from staples to processed foods.

We believe India is also on the cusp of a consistent period of strong growth over the next decade. If India follows in the footsteps of China, we believe India in the next decade is going to see a strong development of the processed food category. GDP growth is expected to be strong, urbanisation trends are evident and modern retail is growing strongly in India, all factors which have helped modern retail in China to grow over the past few years.

Valuations food versus HPC

Valuations reflects higher growth

Valuations reflect the higher growth trajectory

In the consumer space, we prefer food companies over the HPC names as food companies offer more attractive longer-term opportunities. This also partly gets reflected in valuations as food companies trade at a 15% P/E premium to the HPC names in India. However, we highlight:

- In the near to medium term, HPC names are likely to face intense margin pressure and thus earnings are at risk with downward bias. Thus the multiples (which have corrected partly in the past few months) may be higher than they appear now. Hence, the actual premium of food names is significantly lower.
- We believe that food companies offer an attractive long-term opportunity which is unlikely to be held back due to issues like competition, commodity cycles and lack of pricing power.

Hence, we believe that food names should trade at an even greater premium. Jubilant Foodworks and GSK Consumer are our picks in the sector.

Exhibit 58. Valuation snapshot

				P/E (x)		FY12E
Company	**Ticker**	**Rating**	**Price (Rs)**	**FY11F**	**FY12F**	**PEG (x)**
Food & Beverages						
Nestlé *	NEST IN	NEUTRAL	3,391	39.6	31.4	1.4
Jubilant Foodworks	JUBI IN	BUY	499	46.6	34.3	0.5
GSK Consumer *	SKB IN	BUY	2,101	29.5	24.4	0.8
United Spirits	UNSP IN	BUY	1,184	27.8	19.4	0.3
				35.5	**27.5**	
HPC						
Hindustan Unilever	HUVR IN	REDUCE	276	28.3	24.6	3.0
Godrej Consumer	GCPL IN	NEUTRAL	364	24.6	19.1	0.5
Dabur	DABUR IN	BUY	97	27.7	21.8	1.0
Marico	MRCO IN	REDUCE	125	27.0	22.9	1.3
Colgate Palmolive	CLGT IN	REDUCE	828	25.1	22.8	3.3
				27.4	**23.3**	
Tobacco						
ITC	ITC IN	BUY	157	24.5	21.0	1.3
Retail						
Pantaloon Retail	PF IN	BUY	278	16.6	12.1	0.3
Titan Industries	TTAN IN	REDUCE	3,257	43.1	34.3	1.1
				35.4	**27.9**	
Paints						
Asian Paints	APNT IN	BUY	2,550	27.0	23.0	1.2

* Calendar year based valuations

Source: Bloomberg, Nomura Research

Feedback from company meeting

Feedback from company visits

Marico on the foods business

Exhibit 59. Marico food portfolio

Source: Company data

The company has been looking to aggressively grow its food business over the past few years. Saffola Arise, which has a lower glycemic index than regular rice, has been launched on the health and wellness platform and has a marked differentiation compared with other varieties of rice. It uses short grain rice, which is more popular in the south and west and less so in the north and east, where traditionally people prefer long grain rice, according to the company. Also more people in the north prefer to have basmati rice, which compared with other varieties has a higher glycemic index and a much better aroma and flavour (an important factor for consumers in the north, in our view). The company is now looking to get a long grain variety of rice, with a lower glycemic index to improve its performance in north India. The packaged rice market is currently worth Rs4.5bn and has grown at ~25% pa over the past two years. However, this market size is based only on consumer pack sizes of 1, 2 and 5kgs. There are much bigger pack sizes available and have not been considered in estimating the size of the market (source: company data).

Saffola Oats

The latest launch in the food segment is Saffola Oats, which has had an encouraging start. The company attributes this to:

- **Nascent stage of market:** Growth in the breakfast cereals market is at a nascent stage in India. This means in the initial years, it will see strong growth with newer players entering to establish brands in the category. The total breakfast cereals market is worth close to Rs5bn, of which the oats market is worth ~Rs1.35bn (source: company data).
- **Easier to change food habits at breakfast:** While changing consumer eating habits is tough, consumers are more willing to try out new breakfast foods. Oats is an urban-centric market. The target audience is an urban household willing to try new breakfast foods that offer more convenience and compared to traditional breakfast options, oats score better in this aspect.

Reasons for entry into foods segment

- **Strong Saffola brand:** The company always has the advantage of having strong brand equity through its edible oil brand Saffola. The brand's focus on health and wellness and 'good for heart' is something which Marico could leverage for its foray into a new category. In that sense, food is one of the best segments to enter as it ties in well with what the company already has.

Processed food segment one of the most attractive: Marico believes the processed food segment will be one of the most attractive segments across Indian FMCG over the next few years. This is also borne out by the fact that it has been one of the top three fastest growing segments over the past few years, according to AC Nielsen. This segment presents a huge opportunity as market growth is expected to remain strong in the medium term, meaning the opportunity size is going to get bigger over time.

- **Margins comparable:** In terms of margin profile, the foods business operates on a much lower gross margin compared with segments such as HPC. However, A&P spending in the segment is also much lower, meaning the EBITDA margins are almost comparable (source: company data). The point on A&P spending being much lower is established by the fact that more than 70% of the A&P is spent on HPC products by FMCG companies. This also means the ROCE matrix is attractive from a longer-term perspective.
- **Higher success rate:** Another important factor is that the success rate of new product launches is much higher in the food category compared with HPC, suggesting lower spending needed to move consumers towards the new product.

Key challenges in the food segment

- **Taste – most important determinant:** Marico's experience with Saffola Zest indicates that taste is the most important determinant of success and product acceptability. With Saffola Zest, the company tried to put health and wellness benefits higher than the taste benefits, which led to moderate success for the product. This is a key lesson for the company, and something it will incorporate into future product launches, according to the company.
- **Regional biases important:** One of the key challenges in the food segment is that regional biases play a very important role in the success of the product. With tastes and preferences changing every few hundred kilometres in India, the probability of one homogeneous product being able to succeed across the country is less likely than in most other countries in the world. This is a challenge, which is almost unique to the Indian market.
- **Supply chain issues:** In the food category, supply chain issues are more complex as it depends on the kind of product a company is looking to launch, For instance, a health and wellness product such as Saffola Zest only needs to be available in modern retail outlets and bigger traditional retail outlets. However, a snack item launched at lower price points such as Lays, by PepsiCo, needs wider availability across Kirana stores, small retail outlets and across the country. Hence the distribution channel required will be much wider and deeper compared with a niche product such as Saffola Zest. This is an example of how two products within the same category of 'snacking' requires different investment strategies in supply chain and distribution.
- **Shelf life shorter compared with HPC:** Another important consideration for products in the food space is that the shelf life is much shorter compared with HPC products. This means that distribution and storage requirements are vastly different. Products in the food segment have a shelf life from about seven days to three months, while in the HPC space the range is much broader, from about three months to three years.

Pantaloon on the food business

Key reasons for entry into food business

- **Initial strategy was not food led:** Pantaloon's initial strategy was not led by the food category as the thought was that consumers would not be willing to pay more for the convenience offered. Hence, Pantaloon started off as a fashion and general merchandise retailer. This anomaly of consumers not wanting to pay for convenience at a convenience store meant the food strategy came much later compared with the fashion and general merchandise.

- **Change in consumer behaviour pattern:** Once the consumers came on board for the fashion and general merchandise, there was a realisation that modern retail offering food and fresh would be something the company was willing to experiment with. Consumers were also willing to pay for this additional service, if the value delivered was more than the cost incurred.
- **Modern trade key to FMCG companies:** Although modern trade accounts for only 6-7% of total sales for FMCG companies per Images India Retail 2009, the importance cannot be over emphasised. This is especially true for premium products and products, which are more relevant for consumers in the urban areas. Modern retail's share in urban areas is close to 25%, which is a significant share and is growing fast, as retailers continue to expand (source: CII FMCG forum).
- **FMCG companies inclined to modern trade:** FMCG companies are keen to ensure their products are available through the modern retail channels (source: CII FMCG Forum). They are looking to give 'sweeter' deals to the modern retail channels vs the traditional retail channels in urban areas, as the target audience can be reached better via modern retail. This is especially true for products such as processed foods, where the target audience is shopping at modern retail outlets vs traditional retail outlets.

Challenges in fresh business

- **Increasing the range:** One of the most important challenges in the food category is to provide the consumers with a large number of options or varieties in categories. For instance, providing consumers with six varieties of potato or tomato, and getting to upgrade them to pay more for a particular variety of basic food item. While this may seem simple, the value that can be derived from this strategy is one of the most attractive across the food sector in India, according to Pantaloon.
- **Supply chain important:** Pantaloon has stressed the importance of having a good supply chain, and has invested significantly in this. Future Logistics, the group company, has played a role in executing its back-end systems across the formats. However, the market is of the opinion that the supply chain is key to driving retail sales, which seems to be overplayed. The 'low hanging fruit' is in driving consumers to pay more for the basic varieties of fresh and groceries, according to Pantaloon.
- **Loose staples:** Stores across the Indian retail space still sell staples loose, where the consumer can come in, feel the variety of staples and get them packed before buying. This behaviour has more to do with the thought that touching and feeling staples would enable one to differentiate the quality of various staples, although according to Pantaloon, only a minority of the consumers can tell the difference. While this may seem not much of a concern for retailers, the cost of selling loose staples packed in the store is ~2.5% higher than the same variety of staples packed at the warehouse, according to Pantaloon. This is because the packaging happens at store rentals rather than at warehouse rentals, so the consumer is waiting for the packaging to be done and the dedicated resource will only spend time packing the material intermittently vs doing the job full time at a warehouse, which means his productivity is much lower in the store. However, this is a challenge that retailers will continue to face until consumer behaviour changes.
- **Time spent may not be a concern:** The common opinion that consumers who come to the modern retail outlets are pressed for time may not be the case. A consumer may need to drive 20-30 minutes to go to a mall and, hence may expect the modern retail stores to provide more options compared to the traditional retails formats. By keeping the consumer engaged, it provides an opportunity to drive per footfall sales or ticket sizes.
- **Foods in private label space:** In developed markets, where the concept of brand is much more entrenched among consumers, private labels are seen as the poor

man's brand. This is true in all categories, but it is especially true for food, where the value of a trusted brand is much more than in the HPC space, according to Pantaloon. However, in India, this is not the case. Private labels in the food space have been actively looking for innovations and in some case, have also led the innovation strategy in the category. The launch of ketchup in 1kg pouches comes from Future Group's private label brand, and other branded manufacturers soon followed the move. This innovation made a big change in the value of the category by taking about Rs30 off the value chain in terms of costs related to packaging, transport etc, and allowed new consumers to come into the category at a lower point of entry. This trend could continue as retailers are now very close to the consumer at the point of sales and may have a better insight into what are being demanded compared with manufacturers.

- **Private labels are shelf-led brands:** Private labels are a phenomenon of modern retail and, hence are shelf-led brands, where advertising is in terms of shelf placement compared with manufacturer brands that are advertising-led, on TV, print, etc. This is a key differentiator in terms of costs, where private labels seem to have a distinct advantage compared to manufacturer brands. Manufacturer advertising may lead the consumer to the category or the product but at the point of sale, the consumer may prefer to go with private label brands.

- **Non-users are the biggest opportunity:** One of the biggest opportunities across FMCG is to convert non-users to come into the categories, even at the lowest part of the value chain. This has the potential to significantly shift the growth trajectory across categories upwards, as there is still a large majority of consumers in India who are non-users of many products across the FMCG industry. According to Pantaloon, this is especially true for food; the penetration levels in many food categories are still very low compared with HPC (some of HPC categories are close to being optimally penetrated). At this stage of consumer evolution, the company sees this as an opportunity for all the players in the category, and market shares etc will become more relevant once these categories are optimally penetrated.

- **Private labels opportunity in other categories:** India remains a huge unbranded market and therein lies the opportunity for retailers to capitalise. The part of the market that is brand conscious is also always looking for value, and is willing to look at other brands if the value proposition is good. Future Group is looking at opportunities across categories, which include cosmetics, where the value of brands is seen as key to success, according to Pantaloon. However, in that sense India is a unique market where there is an opportunity to migrate non-users (a large percentage of population are non-users) into the category.

- **Consumer buying patterns difficult to gauge:** One of the most difficult things to gauge in modern retail is changing consumer behaviour. For example, a family of four would want to buy packs of 10 Pears soaps, 6kgs of Surf, 10kgs of potatoes, three large packs of toilet cleaners, etc. However in India, such buying patterns are influenced by many other factors, such as buying in bulk with a view to giving a portion to family members, elderly neighbours etc, which are difficult to explain purely from a consumption perspective.

- **Modern retail exists to facilitate consumption:** The role of modern retail is to facilitate consumption and not be concerned too much by consumer buying behaviour. At this stage of modern retail evolution, the real opportunity lies behind increasing consumption and not be overly concerned explanations behind these buying patterns.

- **Processed foods a big opportunity:** Processed food will be a very attractive opportunity over the coming years, per Pantaloon, helped by a variety of factors including increasing urbanisation, rising consumer incomes, and preference for convenience foods among a growing percentage of the population. However, growth in this category is going to be secondary to the potential growth in trading consumers up (ie, getting consumers to buy more premium stuff within the same category) in basic categories such as staples and fresh (eg, moving people to buy organic vegetables). This is largely because the share of modern retail in the overall retail market is still under 10% and grocery and staples still account for about 60% of the consumer basket spending, according to Pantaloon.

- **Breakfast cereals maybe first category to grow big:** Following feedbacks from a number of players in the category, one of the categories which may be the first to see a breakthrough is breakfast cereals, as consumers are more willing to try new breakfast items. Indeed, many leading consumer companies in India have launched breakfast cereals in the past few years, with a view to gaining a first-mover advantage. Private labels are also active in this segment, and retailers have launched variants similar to branded players across the portfolio which may help move new consumers into the category. However, the opportunity size still remains very attractive. Nestlé has yet to enter the category, and the company recently said it would leverage its parent company's portfolio to launch products in India in the near term. Local companies such as Marico have also launched products into this category and competition in this category is expected to be tough in the coming years, according to Pantaloon, although growth in the category itself is likely to be very attractive. Most players currently are only concerned about growing the category, focusing on share only when the category has expanded, according to Pantaloon.
- **Innovation:** There has been a lot of focus on innovation in the last few years. While innovation is going to be the key driver, according to Pantaloon, execution is not an easy task in a heterogeneous market like India. Consumer taste and preferences change every few miles in India and, hence one product serves all strategy (one product to meet the needs of all consumers) does not work in India. This is true across all the categories and this will be the key challenge in India. In this context, modern retail, being closer to the consumer in terms of point of sale, may have an advantage over manufacturers. For instance Future Group sells *Chitle Bandhu Bhakarwadi* (local snack) in one of its stores in Bangalore and *Govindbhog* rice in a Big Bazaar store in Delhi. This has driven sales at the store from a particular community, as people come to the store for the product and buy other goods from the store at the same time.
- **Innovation needs an Indian touch:** Innovation in food needs an "Indian touch" to be successful, which could be in any form to connect better with the consumer. This is one area that could offer bigger opportunity for retailers than for FMCG manufacturers. Future Group, through its Big Bazaar stores, has been offering idly and dosa batter, which is very popular with consumers from north India, according to Pantaloon. Retailers also have better opportunities than FMCG manufactures to target consumers for specific events such as festivals. For instance in 3Q CY10, a couple of stores in Bangalore located closed to each other offered specific products tailored to consumers celebrating Eid and Diwali. A differentiated product offering such as this is more difficult for FMCG companies to manage.
- **MNC houses looking to standardise:** FMCG companies tend to look to standardize a product offering across a country, but this strategy does not work well in India, where consumer choices are heterogeneous. Standardisation, attractive from a company perspective as it improves ROI, will be difficult to yield good results in India. While Maggi Noodles, Pepsi and Coca-Cola have been successful, many others face a daunting task of winning consumers using a standardised product. For example, Horlicks (more popular in south India even years after its launch) and Saffola Arise (more popular in the south than in the north). There is also evidence of companies having succeeded in their product strategy when they have looked to customize as against standardize their product offering. HUL and Tata Tea have different varieties of tea sold in different parts of the country under the same brand name, and have recorded big success.

KFC on the India opportunity

Exhibit 60. KFC India customised menu

Source: Company

We had a meeting with Mr Hezal Ahmed, the CEO of QSR brands in Maharashtra (12 December, 2010). The two private companies under which these restaurants are managed are Mumbai Chicken Private Limited and Pune Chicken Restaurants Private Limited. QSR brands now have the right of first refusal to grow the KFC brands franchise in Maharashtra. Feedback from the meeting:

- **Robust plans to grow KFC restaurants business:** The company has robust plans to grow the KFC business in Maharashtra. Currently, the company has three stores operating in Mumbai and one in Pune and it plans to move this to ~30 stores by FY12. This will mean significantly improving penetration of the KFC restaurants in the state, which should help drive higher footfalls and sales over the next few years.
- **Low penetration:** According to the company, the KFC restaurants per 100 people has shown significant under penetration even in metro areas such as Mumbai when compared with markets such a Malaysia, Singapore etc. Malaysia's population is close to 27mn and the number of KFC restaurants in the country is close to 550. In India, even if we consider only 10% of the entire population as a target audience, there would be close to 100mn people and there are 89 KFC restaurants in India. In Maharashtra, the numbers are equally underpenetrated.
- **Competition:** Management believes competition is mainly from McDonalds in India, as both restaurants have many similarities. Dominos, Pizza Hut and Subway, while all being part of the overall category of QSR, are different in terms of product and model of delivery. The company, which considers its product offering unique, is confident of driving the market for fried chicken in the longer term.
- **Pricing:** The company is cautious about following the path of price cuts to attract customers. It expects to maintain pricing at a premium to McDonald's and expects its average consumer invoice to be higher than that of McDonald's, given the premium pricing and the menu which is skewed more towards premium products.
- **Adaptation of menu:** The company recognizes the need to change recipes, even its flagship product (KFC fried chicken) so that it suits the tastes of the local consumers. It has already taken steps to change the taste of its products, like making the fried chicken spicier than it is in other countries. It also has a full vegetarian menu with items such as vegetarian zinger burger and pulao.
- **Realty costs locked in:** The company acknowledges that there has been a rise in realty costs, but said the leases are all long-term leases with escalation clauses already built in. As such, it is able to plan for the longer term, keeping in mind the cost dynamics as far as lease expenses are concerned.
- **Personnel expenses:** The company has been hiring across the various levels as it builds out the stores. Availability of trained personnel is in short supply in the retail sector in India. However, the company is now investing in training and investing in career growth and development of the employees, which it hopes will encourage

more loyalty towards employers with employees taking a longer term view of their prospects.

- **Consumer sentiment:** The company pointed to a key difference between pizza restaurants and its restaurants. The basic ingredients in a pizza is vegetarian, with the optionality of non-vegetarian toppings making it more acceptable as against the fried chicken that KFC sells. In a country where consumers are more skewed towards vegetarian food, it is easier to market the idea of a pizza than fried chicken. This is the reason why pizza as a category has taken off since the entry of international brands in the late 1990s, while success of the KFC restaurants has been relatively subdued.
- **Delivery option:** Pizza also has the delivery option attached to it, which adds convenience to a product which is already more accepted among the consumers. Also home delivery within 30 minutes of a pizza ensures very small difference in the product between home delivery and eating out. This is clearly not the case for a product like fried chicken, which has to be served hot in the restaurant.
- **Plans to get other brand owned by Yum!:** Yum! Brands owns six restaurant brands including KFC, Pizza Hut, Taco Bell, Long John Silvers and Pizza Hut Delivery. While the opportunity to get other brands such as Taco Bell into India remains, the company is only looking to grow the KFC brand in Maharashtra (only place it has a licence to grow from Yum Brands! International). It mentioned that the focus would only be on growing the KFC franchise, with other options to be looked at a later time, once it has established a strong base of KFC restaurants in Maharashtra.
- **Sourcing of poultry:** The company sources poultry from Venky's, which is listed in India. The company has locked in longer-term supply contracts, which ensure a stable supply at prices which are reasonable for both the buyer and seller. The relationship with KFC restaurants will also mean strong growth opportunities for Venky's considering the growth path KFC restaurants are on per company.
- **Store levels economics:** The company imports about 90% of the in-store equipment requirements from outside India. Considering the import duty the cost of setting up a store is high, which in turn means the breakeven period is longer than in some other countries. Investment cost per store is close to US$300-400k. However, this is helped by revenue per store being higher than the average in Malaysia. The average store revenues are in the range of RM440,000, which is almost double the Malaysian average and is also more than the average in Singapore per company.

ITC on the food category

Exhibit 61. ITC foods product portfolio

Source: Company

- **Competition in the food category to increase:** Foods remains one of the best opportunities across consumer space over the next few years, according to ITC. However, this will also mean the competition is going to be tough, with many new entrants coming into the category.
- **Input costs a concern:** Input cost prices for food will continue to remain volatile, but the longer-term trend is certainly moving higher. Current thinking in the industry is how to handle the volatility, but longer term the concern is how the handle the structural input cost inflation. Nestlé, a market leader in many of the food segments, recently echoed the same thing (according to the company 3Q FY10 presentation) and some companies realize the importance of the longer-term structural increase in food prices. This is on account of dwindling food supplies worldwide with increasing urbanization.
- **Modern trade key to success:** Growth of modern trade will be one of the key factors for success of the FMCG industry over the next few years. This is especially true for the urban areas, where penetration of modern trade is much faster. Modern trade will have to be seen as part of the 'delivery process' which starts with conceptualizing a product to actual delivery to the consumer. Modern trade profitability is low, but going forward as it becomes more important to the delivery process, profitability will also grow.

- **Cycles getting smaller:** Trends in the FMCG sector will probably move much faster than many other sectors. This will mean product cycles getting much shorter and companies having to constantly evolve their products to suit changing consumer needs and preferences.

- **Change in consumer demand:** As India's income has increased over the past two-three decades, the needs of the consumer in relation to FMCG products have also undergone a change. In the 1970s the Indian consumer was largely looking for basic food, and this meant the focus was only on staples grocery. In the 1980s and 1990s with incomes moving up, the consumer started to look at other options which offered him/her convenience along with value for money. This was the period for products such as instant noodles, which have today become a large segment on their own. Since 2000, the focus has further shifted to ready to eat products and the trend towards premiumisation. This is likely to continue over the medium term, as growing urbanisation means the consumer has less time to devote to cooking. The challenge is to create new categories and develop new options at an affordable price to help the consumer make the choice to move up.

Future value retail on food business

- **Private brands as category champions:** One of the key things to consider while evaluating private label brands is that their primary aim is to grow the market for the product. Most people consider private label brands as something where the retailers have to disrupt established brands and help in having better negotiating power. While that is important, retailers are looking to grow the category which will help drive sales both of branded and private labels in their stores. A large supermarket in an area can help push up sales by 15% and in some categories by even 35% per company.

- **India is a huge unbranded opportunity:** India remains a huge unbranded opportunity across the FMCG space and this is a gap that private label can help fill over the longer term and help move consumers from unbranded to local branded private labels. Consumers can then at some point move to branded products certainly in some categories. Modern retail thus has strong power to be the game changer over the longer term.

- **Private labels can be fast and nimble:** Since private label brands do not invest in R&D, they can be much faster and nimble in understanding consumer needs and preferences. With many categories only just starting to emerge in India, this will be a key differentiating factor for retailers over the next few years per company.

Bharti Wal-Mart on cash and carry business

- **Bharti Wal-Mart cash and carry business in India:** The company has five stores, one each in Amritsar, Zirakpur, Jalandar, Kota and Bhopal (a new store just launched). The average store size is 3.5-5.0 acres, which gives customers ample parking space and makes it easier for them to transport goods back to their warehouses. The company plans to have about 15 stores in operation by 2011 in India. The stores offer a wide variety of products, which are relevant to the consumers in the local area at transparent and low prices on a consistent basis. Most importantly, at these stores, the fill rates are close to 90-95%, which is one of the main differences between the growth trajectories that a retail outlet could see.

- **Regulation a concern:** Modern retail still makes up only less than 10% of the overall retail business in India. One of the main reasons is that regulation does not allow 100% FDI in multi-brand retail at this time. Regulation, however, allows 100% FDI in cash and carry business, which has some basic criteria:

  – Goods must be sold to businesses with a valid licence; and

  – Invoices must be settled on the spot.

- **Modern retail share to remain below EMG average:** The company estimates the share of modern retail, even assuming a 27% sales CAGR over the next six years, will be less than 20%. This is because it expects the overall market size to continue to grow, and although modern retail is likely to grow faster, it will likely take much longer for the modern retail share to inch up towards even other EMG market levels.
- **Mom-and-pop stores dominate:** There are about 12mn mom-and-pop stores of which about 7mn are *kirana* (smaller version of mom-and-pop store) stores. Although this number of 12mn is likely to trend down, it is likely to remain a major part of overall retail trade, as we highlight in our initiation report on India retail.
- **Competition is from local wholesalers:** Cash and carry business faces competition from local wholesalers who have been in existence for a long period of time and have established relationships with businesses in the area. However, with modern retail formats providing a host of services and products which these traditional wholesalers are not able to offer, this number might dwindle if cash and carry business takes root in the economy. However, cash and carry business at this stage is very small and is unlikely to be a threat to wholesalers in the near term.
- **Customer profile:** In terms of customer profile for the cash and carry business, about 60-65% is made up of resellers of smaller wholesalers. This ensures a continuous customer base as these smaller wholesalers then sell to local retailers and kirana stores. Some 15-20% of the consumers are from the HoReCa category, which is defined as hotels, restaurants and cafe, while another 15-20% is offices and institutions, according to the company.

Jubilant Foodworks on what's made it successful

Exhibit 62. Dominos Pizza menu in India

Source: Company

- **Why target the food segment**: According to the company, the initial idea came about from promoters who travelled to the US and saw the Dominos model work in the US. There were no such models operating in India at the time (mid 1990s) and this was the opportunity that the promoters saw fit to bring to India. There were three factors which were considered key determinants for the success of the model.
  - **Less time:** Increased urbanisation after the opening up of the Indian economy post 1991 meant people would have less time for meals. This was a gap which could be bridged by the home delivery model, where you did not need to go out for a meal, but it would be delivered fresh at home to the consumer.
  - **Convenience:** The home delivery system offered a convenient way for the consumer to get a new product in the convenience of their homes. This was a big differentiating factor in the initial success of the products.
  - **Vegetarian base:** The pizza had a vegetarian base (flour, cheese and vegetables). This is key in a market where about 70% of the people are vegetarian per the company. The option for non-veggie toppings ensured that both target audiences were happy, but the product had a vegetarian base.
  - **No competition:** Although there were some regional stores (Nirula's) selling an Indian version of pizza, the products had no real competition in the country at the time. This allowed the company to establish its products in the minds of the

consumer before any real competition came in the form of Pizza Hut and other regional stores.

- **Early learning was key:** At the start of 2001, the company had about 35 stores in the country. It then went on an expansion spree and by the end of the year the company had scaled up to 100 stores. This rapid pace of growth came with its problems, as not enough research which went into studying the customer profile in the areas per the company. This led to the company not being able to handle the pace of the growth during the following year.

  The company took great learning from this phase which allowed it to plan its store expansion much better over the next few years. This was key to the sustained growth which the company has since achieved.

- **Profitability first:** Since the time of consolidation in 2001, the company has maintained a strict criterion of putting profitability first. Store expansion was undertaken with a singular focus on profitability. The company has since put in place a payback period criterion for opening new stores. This payback period is three years, and any store across all the regions is evaluated using this benchmark. Store managers across the regions are asked to adhere to this benchmark and any deviation from this plan is evaluated.

- **Supply chain:** The company invested in the supply chain early in its growth stage. This ensured that the systems were in place to help store managers evaluate performance real time. It has four commissaries in the four regions in India, which supply materials and other ingredients to the stores in the region.

- **Growth still ahead:** There have been some suggestions per the company that the optimal number of stores in the country is close to 750, based on demographics, urbanisation trends, size of the population and size of the country, which Dominos International uses to evaluate store potential in any country. For example, in the UK, 750 seems to be the optimal number and has remained at that level for the past few years per the company. In the US, the optimal number is close to 5,500 per the company. However, this evaluation was done a couple of years back and this suggests there is now greater potential in India, as per the company. The company believes there is at least another 10-12 years of growth ahead in India before the product hits saturation levels.

- **Market share game still far away:** The company believes the market for QSR restaurants will continue to grow in India for the next 10-12 years. The inflexion point for eating out and dining in has just started and will continue to be on the growth path for many years per the company. Once the rapid growth phase moves to a stable growth trajectory, incremental success will likely depend on market share gains. However just like the breakfast cereals market in India, that phase still seems to be many years away and in the meantime, participants will focus on growing the market and not on gaining share per the company.

- **Human resources:** The company has placed emphasis on human resources and invested in training and development to ensure employees are motivated. It places emphasis on providing deserving employees opportunities to grow within the company. An example of this is the head of western region who first joined the company as a delivery man. The company prides itself on providing such growth opportunities for its employees.

- **Sourcing entirely domestic:** The company sources all the required raw materials locally. This has been a conscious decision compared with the early phase and has helped to bring down costs. It also only manufactures dough at its commissaries and everything else is outsourced to external trade partners. It believes in expertise and the value it can bring, and hence does not feel the need to source those materials internally. Also the scale of the company gives good bargaining power with suppliers.

- Factors for choosing a store:
  - **The key factors:** The company has a clear idea of how it chooses a new store. The most important determinants are the number of households. For example: schools, offices, etc, in the area, income profile of the people in the area, eating habits based on the social demographics in the area. These factors determine the potential in any area and whether it will be profitable to setup stores in the area. While the company will not have exact income details of the people in the area, it looks at demographics and spending patterns of a typical population in the area to determine the viability of stores.
  - **Rentals:** Rentals is one of the most important factors for choosing store locations, but is used by the company as a plug factor after determining all the above factors. While the company admits to seeing a sharp rise in rentals over the past few years, store size is much smaller compared to dine-in restaurants, which means the rentals are not very high in absolute terms. The company also negotiates long-term leases, which helps in having more bargaining power. Going forward, the company expects lease rentals to move up, but in a manageable manner. It largely has the stores on a fixed rental basis and only 10% or less of the total stores have a revenue-sharing component built in. This creates huge operating leverage as sales increase per the company, which the company is confident will flow through to the bottom line over the next couple of years.
- **Issues for failure of stores:** The company believes there are two major issues with a store not performing up to expectations. First is lack of frequency of orders. This means that consumers are not ordering it as frequently as expected. This may be due to several possible issues such as not being satisfied with the products, product being too expensive, not enough variety for their liking, etc. Store managers are asked to evaluate these on an ongoing basis and to take remedial measures. Some of the remedial measures are to build in more promotions, and to have a more customized approach to the area. Second is lack of penetration. This happens when not enough consumers are ordering in from the stores. This second issue now arises less than the first one, which suggests product acceptance is much higher across the country and is positive for the longer term.
- **Indianisation very important:** As has been the feedback from various participants in the food industry from manufacturers to retailers, "Indianisation" of the menu is very important for it to succeed. The company learned this at the very beginning of its growth phase, which allowed it to establish firm brand equity in the minds of consumers. Consumers want the best of both worlds of having an international product with the customisation to support their tastes and preferences. This proved to be a winning proposition as the acceptance of the product, often the most important challenge in food, was won very quickly. It helped that the product is largely vegetarian and in a country where most of the population is vegetarian, this was a unique and easy to accept. More than 50% of the product menu is vegetarian-only and no beef is sold in any of the stores. There are also stores which are purely vegetarian, to support the sentiments of the local population. One of such store is in Ahmadabad.
- **SG&A leverage:** The company believes as the same store sales growth continues to be robust, the operating leverage from SG&A will be very strong and most of it will flow through to the bottom line. This is especially true as the ratio of new stores compared with overall stores reduces, which means a larger percentage of the total are the older more profitable stores. On average the company makes 18% EBITDA margins and 8-9% SG&A expenses, meaning margins of 26-27%. It believes there is a 5-6% margin movement both way across the store portfolio, which means there are some stores which are above that average and some which are below. It aims

over the next few years to ensure that more of the stores are above this range, which will ensure that the overall margin profile at the company level improves.

- **Pricing:** The company has been looking to take pricing up by 5% each year across its portfolio. This has worked as consumers are aware of the rising food prices and are willing to pay more if the product continues to offer value to them. Per the company, it will continue to use this as a long-term target, but will have a mix of promotions and varied price increases across its portfolio to manage input costs.
- **MSA till 2024:** The company's current master franchise agreement runs until 2024 after which it has the right of first refusal for another 10 years. The company is confident that essentially the agreement will run to perpetuity as the only issue could be of execution. To back its claim, the company has been consistently ranked as the top-three Dominos franchisee worldwide, per the company, including the top franchisee in 2006, 2007 and 2009. Dominos Worldwide does random checks across countries and this is based on results from those surveys as well as other operating parametres. This augurs well for the company to maintain its long-term relationship with Dominos Inc.

Jubilant Foodworks JUBI IN

CONSUMER RELATED/FOOD & BEVERAGE | INDIA

Initiation

BUY

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Action

With an estimated 61% earnings CAGR over FY10-FY13F, a dominant 65% share of the pizza delivery market and an opportunity to bring other international fast food brands into India, Jubilant Foodworks (JFL) is, in our view, one of the most attractive opportunities related to the consumer food & beverage theme in India. We initiate coverage with a BUY and a PT of Rs620, which implies 24% upside.

Catalysts

We believe operating leverage in the model will mean margins will continue to improve over the next few years.

Anchor themes

JFL is the market leader in the fast-growing Indian pizza market and has a 65% share in the home delivery segment. With robust sales and profit growth, helped by strong operating leverage, the company should deliver strong FCF CAGR over the next few years, in our view, which makes for an attractive long-term story.

Closing price on 16 Feb	Rs498.8
Price target	**Rs620**
Upside/downside	24.3%
Difference from consensus	**24.0%**
FY12F net profit (Rsmn)	925
Difference from consensus	**0.8%**

Source: Nomura

Nomura vs consensus

While we are largely in line with consensus on earnings for FY12F, our FY13F forecast is 9% higher. We believe consensus is overly cautious on margin performance in FY13F.

Delivering pizzas and profits

① Rapid growth

Jubilant Foodworks (JFL) is the fastest-growing consumer company in our coverage universe, and we expect it to deliver a 61% earnings CAGR over FY10-FY13F led by strong same-store sales growth and rapid expansion. On our estimates, this should translate into FCF growth of 98% over the period.

② Strong brand equity and incumbent advantage

JFL has a dominant 65% share of the pizza home-delivery market and 50% share of the overall pizza market in India. With 364 stores in India, it is twice the size of its nearest competitor. We believe it will continue to lead the pizza market, given the strong emotional connect that the Dominos brand enjoys among consumers.

③ Operating leverage to help margin improvement

We believe that the Dominos model carries a significant amount of operating leverage. Margins should improve 110-130bps over the next few years, based on our estimates, as SG&A, A&P and rental expense growth lags sales growth.

④ Expansion into smaller cities and other fast food brands

We believe consensus is overly worried about the lack of growth drivers over the medium to long term. We believe that the top six metros are still fairly underpenetrated and should drive growth comfortably for the next six years, beyond which the smaller cities should lead growth. The opportunity to bring in another international fast food brand could provide an additional boost to JFL.

⑤ Initiate with a BUY rating and PT of Rs620

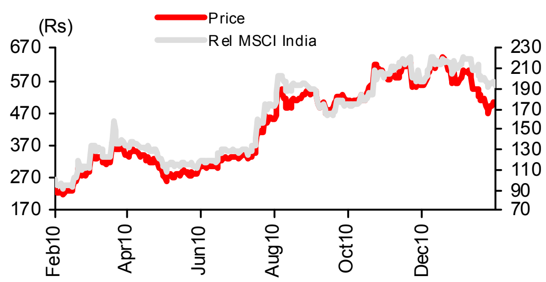
We initiate coverage at BUY and a PT of Rs620, which implies 24% upside. With valuations attractive at 22.7x FY13F, which translates into a PEG of 0.5x (consumer sector average of 1.2x), we believe the current share price offers an attractive entry point.

Key financials & valuations

31 Mar (Rsmn)	FY10	FY11F	FY12F	FY13F
Revenue	4,239	6,346	8,873	11,942
Reported net profit	330	682	925	1,400
Normalised net profit	334	682	925	1,400
Normalised EPS (Rs)	5.25	10.71	14.54	22.01
Norm. EPS growth (%)	320.3	104.1	35.7	51.4
Norm. P/E (x)	95.0	46.6	34.3	22.7
EV/EBITDA (x)	47.7	26.5	17.6	11.9
Price/book (x)	27.0	14.1	11.1	8.8
Dividend yield (%)	0.0	0.0	1.0	2.0
ROE (%)	46.6	39.8	36.3	43.3
Net debt/equity (%)	1.3	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (Rs)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(11.3)	(14.8)	10.2
Absolute (US$)	(11.6)	(15.2)	13.2
Relative to Index	(7.6)	(5.2)	11.3
Market cap (US$mn)			697
Estimated free float (%)			38.0
52-week range (Rs)			643/219.9
3-mth avg daily turnover (US$mn)			8.70
Stock borrowability			Hard
Major shareholders (%)			
Promoters			61.3
HDFC			11.0

Source: Company, Nomura estimates

Drilling down

Executive summary

JFL is the market leader with a 65% share in an under-penetrated pizza market

- JFL is the market leader in the fast-growing Indian pizza market, and according to the company, its share in the home-delivery segment is 65%. With robust sales and profit growth, helped by strong operating leverage, JFL should deliver strong FCF CAGR (we estimate 98%) over the next few years, which makes the long-term story very attractive, in our view, although short-term valuations appear marginally stretched.
- Continual addition of stores, expansion into tier II and tier III cities and increasing penetration in metros will likely aid robust sales growth. Operating leverage in the model means margins are set to expand meaningfully over the next few years and this should drive improvement in profitability and a strong FCF CAGR, in our view.
- JFL is likely to benefit from strong growth of the quick service restaurant format in India over the next few years, in our view, helped by its market dominance in the pizza format.

We initiate coverage with a Buy rating and price target of Rs620, 24% potential upside

- Although the near-term valuation may appear rich, we believe the opportunity size must be taken into account when valuing JFL. Our DCF-based valuation of Rs650 captures the longer-term growth potential. Even on a P/E basis, we have assigned the company a multiple of 28x one-year forward earnings to account for our expectation of strong growth. Our P/E-based PT of Rs620 implies upside of 24%.
- We believe one risk to our view could come from a lower-than-expected store count addition over the next few years, which in turn, would mean operating leverage may not be as meaningful as we expect. However, with the quick service format likely to gain popularity rapidly over the next decade as incomes across the Indian middle-class population rise, we believe JFL will be able to deliver strong growth over the medium term.

Dominant position in a fast-growing market

JFL has exclusive franchise rights to the globally successful Dominos Pizza brand in India, Sri Lanka, Nepal and Bangladesh. It has, over the past decade, established a strong presence in the country across tier I and tier II cities and is continuing to lead penetration in both existing and newer cities. JFL has a dominant position in the market with more than 65% share and should continue to benefit from strong market growth over the next decade, in our view.

Store additions, strong operating leverage should aid 61% EPS CAGR over FY10-FY13F

Expect company to deliver 61% EPS CAGR over FY10-FY13F

We believe the company will continue to benefit from growth in the Indian pizza market and will deliver strong 41% sales CAGR over FY10-FY13F, in line with the latest five-year average of 42%. The strong operating leverage of JFL's current model could help increase profitability by more than 250bps over the next two years, which combined with the robust sales growth, would mean a 61% EPS CAGR over FY10-FY13F on our estimates.

Strong balance sheet can fund store additions and dividends in the next two years

JFL has no debt on its balance sheet and can fund capex requirements for new stores by way of internal accruals. Store expansion and greater penetration could result in greater profitability, we believe, which might lead the company to return cash to shareholders either by way of dividends or a share buyback, which would be a positive.

Opportunity to bring other international fast food brands to India

Opportunity to bring other international fast food restaurants into India

Despite the entry of many international quick service restaurant brands into India over the past decade, there are many large international brands that still do not have an India presence. JFL could look to bring one of these brands into India in the same way it brought Dominos Pizza. With its experience of developing a quick service restaurant brand in India, we believe this could be a key development over the next year and would be a catalyst for the stock.

Quick service restaurant format: attractive opportunity in India

We believe quick service restaurants are an attractive opportunity in India over the next decade or so, because penetration remains very low vs that in other countries. Pizza is one the top two categories within this space, and Dominos is the market leader in this segment with more than twice the number of stores vs the second-largest player (Pizza Hut).

Valuation

We have valued the company using multiple methodologies. Our DCF-based valuation of Rs650 gives potential upside of 30%. However, we use a P/E approach to arrive at our Rs620 price target, in line with the valuation methodology we use for other consumer companies under our coverage. We assign a target multiple of 28x FY13F EPS of Rs22.

The stock trades at a P/E multiple of 34.3x our FY12F EPS of Rs14.5. Current valuations might appear rich relative to the sector (at 23.5x). But we believe a story like JFL should be looked at in light of the significant growth opportunity over the medium term.

Our average valuation for the consumer companies we cover is 23.5x one-year forward earnings, with average earnings growth of 20%, which translates into a PEG of 1.2x. Over FY10-FY15F, we expect JFL to deliver an earnings CAGR of 45%, so a P/E multiple of 28x translates into a PEG multiple of 0.5x, which we consider reasonable as compared to the sector. Our P/E multiple-based PT of Rs620 implies 24% upside.

Risks to our investment view

Risk to our numbers and estimates could come from the following:

- Termination of its master franchise agreement with Dominos Inc would be the biggest risk, as JFL's only line of business at present is the exclusive franchise of the Dominos Pizza brand in India, Nepal, Sri Lanka and Bangladesh.
- Sharp rise in input costs could cap improvement in profitability if JFL does not pass on the rise in prices to consumers.
- Lease rentals are an important part of overall costs and a sharp increase in lease rentals both for new and old stores could pressure profitability.
- The company's longer-term success depends on the acceptability of its product in tier II and tier III cities. Slower-than-expected progress in these regions could lead to a slowdown in longer-term earnings growth.

Financial analysis

Strong sales, improving margins and FCF

Expect company to deliver strong sales growth and margins improvement

- With macro conditions remaining supportive, demographics offering long-term attractions and a largely under-penetrated market, we expect JFL to deliver strong earnings growth over the next couple of years helped by:
  - Robust same-store sales growth (in the mid-teens).
  - Aggressive expansion in key markets. We expect the company to add 65-70 stores per annum in the medium term.
  - Steady increase in ticket size, as well as frequency of orders per household.
- We expect margins to improve steadily if:
  - the company maintains its strong focus on cost savings by streamlining the back-end; we believe savings in freight, procurement and logistics would flow through to the bottom line.
  - operating leverage keeps flowing into the bottom line. Even mid-teen same-store sales growth would enable the company to improve profitability significantly, based on our estimates.
- JFL turned FCF positive in FY10, and we expect continuing strong generation of FCF as operating leverage should help improve profitability. We also expect the company could start paying dividends as early as FY12F.

Exhibit 63. Jubilant Foodworks — Key assumptions

	FY11F	FY12F	FY13F
Total store count	376	446	516
Revenues (Rs mn)	6,346	8,873	11,942
Revenue growth (%)	*49.7*	*39.8*	*34.6*
EBITDA margins (%)	*18.3*	*19.5*	*20.8*
EPS (Rs)	10.7	14.5	22.0
Net-cash (Rs mn)	856	1,349	2,058

Source: Nomura estimates

Robust revenue growth

We expect JFL to deliver a robust 41% revenue CAGR over FY10-FY13F helped by a strong contribution from existing stores, as well as store additions. We expect average revenue per store to grow by 24%+ over FY12F and FY13Fand for the company to open 70 new stores each year.

Exhibit 64. Jubilant Foodworks — Robust revenue growth

	FY09	FY10	FY11F	FY12F	FY13F
Store addition (nos)	61	65	70	70	70
Year-end store count (nos)	241	306	376	446	516
Same-store sales growth (%)	6	22	20	16	15
Average revenue/store (Rs mn)	14.9	17.4	20.9	24.2	27.8
Revenues (Rs mn)	2,806	4,239	6,346	8,873	11,942
Revenue growth (%)	32.9	51.1	49.7	39.8	34.6

Source: Company data, Nomura estimates

Margins now at an all-time high…

From FY05 to FY09, JFL's operating margins remained in a narrow band of 11-13%, as the company continued to invest in expansion and had yet to achieve critical mass. However, 2010 marked a breakthrough for the company as far as profitability was concerned, with margins expanding suddenly by 350bps to an all-time high of 15.7%

as the benefits of operating leverage kicked in. 9M FY11 also witnessed a further margin expansion of 250bps y-y to an average of 18%.

We believe this has been possible on account of the following: a rapid pick-up in same-store sales growth and operating leverage kicking in as costs such as rent, logistics, salaries did not grow at the same pace as sales.

Operating margin has seen a marked improvement and we expect this trend to continue

This should also facilitate quicker break-even for new stores, in our view, as the brand-building efforts over the past few years have enhanced brand recall and customers are increasingly more receptive to the cuisine and the menu, based on findings by the company.

Exhibit 65. Jubilant Foodworks — Operating leverage kicks in

As a % of sales	FY09	FY10	Increase/(decrease) (bp)
EBITDA margin	12.2	15.7	352
Employee Cost	19.8	19.0	(82)
Manufacturing Cost	20.3	19.3	(107)
Advertising and Promotion	4.7	4.0	(69)
Rent	9.5	9.3	(28)

Source: Company data, Nomura research

…should continue to drive profitability higher in coming years

We believe the operating leverage of JFL's model will continue to drive profitability higher over the next few years. As the company continues to deliver strong sales growth, we expect margins to continue to show an improvement over the next few years.

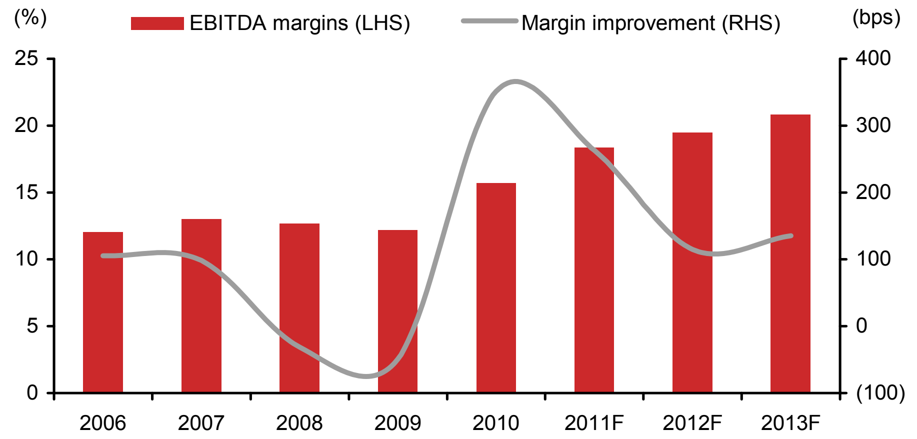
As JFL continues to follow its strategy of saturating existing markets and increasing penetration across the top six cities, the benefits of streamlined logistics should mean newer stores will turn profitable more quickly, in our view. Also, the company should save significant money on advertising, thus enhancing profitability. With penetration in top six cities still less than 50%, we believe the room to grow is significant over the next five years.

Furthermore, the company follows a unique business model which ensures that new stores turn profitable in the third year: 1) its delivery model ensures that the size of each outlet is relatively small compared to other dine-in pizza outlets in India, yielding cost savings on décor; 2) the company also saves on rents on account of the smaller size of outlets; and 3) given the high brand recall among consumers, little or no extra effort is required in driving sales at a new outlet. We believe this helps ensure that rapid expansion does not excessively weigh on the company's profitability.

As a result, peak margins for the company are still some years away, in our view, and over the next few years, we see profitability continuing to rise. Additionally, our bottom-up single-store model suggests margins should start seeing a sharp rise from year 3 of the store opening, which implies that the majority of stores opened before FY09 should deliver strong margin performance over the next couple of years. This should also help improve margins at the company level, we expect.

Our discussions with the company suggest some stores are already operating at 23-24% margins, while others are at 15-16%. We believe over the next couple of years, the stores operating at the upper end of this band will rise as a percentage of overall stores, which would help improve margins at the company level. We have not built in the entire benefit of these levers into our model at this stage and are looking for a ~110bp improvement in margins in FY12F and 135bp improvement in FY13F.

Exhibit 66. Jubilant Foodworks — Improving margin profile



Source: Company data, Nomura estimates

Strong FCF generation starting FY10

Expect strong FCF generation over the next couple of years

JFL turned FCF positive in FY10, and with operating leverage flowing through to the bottom line over the next few years, we expect FCF generation to continue to gather strong momentum. The company generated FCF of Rs164mn in FY10, but this number should increase significantly to Rs1,346mn in FY13F, on our estimates. With cashflow from operations remaining ahead of guided capex requirements over the next few years, we believe FCF generation will be significant.

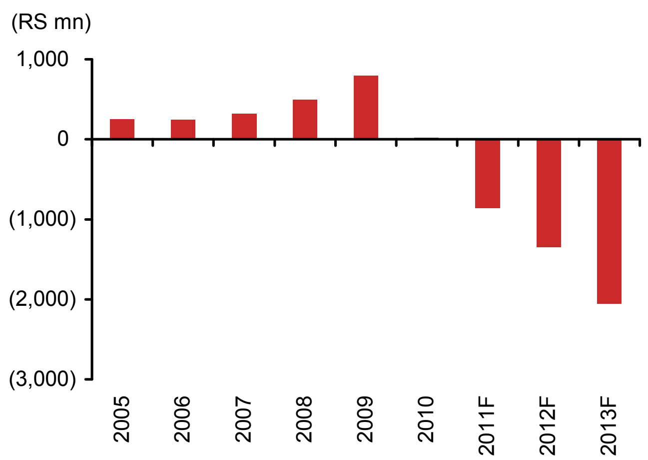
Debt repaid post IPO

JFL had debt of Rs824mn at the end of FY09. For the first few years of its operations, JFL used debt capital and some internal accruals to fund new store expansion. However, post its IPO in February 2010, the company has repaid this debt. The absence of an interest burden adds to the attractiveness of the business in the longer term, in our opinion.

Strong balance sheet supports dividend payout

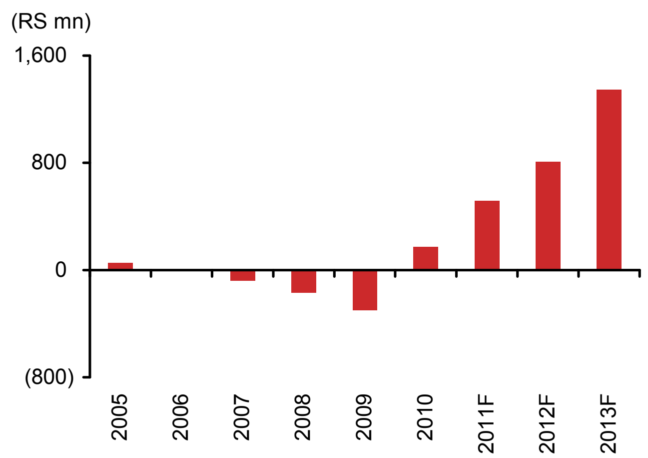
As revenue momentum remains robust, margins and FCF improve, JFL's balance sheet will continue to look stronger over the next few years, in our view. Strong FCF generation means cash on books will rise significantly over the next few years. We model for cash levels to increase from Rs70mn in FY10 to Rs1.3bn in FY12F. To date, the company has never paid a dividend, but we believe with FCF generation high and capex requirements adequately covered by internal accruals, it could start paying dividends by FY12F.

Exhibit 67. Jubilant Foodworks — net debt



Source: Company data, Nomura estimates

Exhibit 68. Jubilant Foodworks — free cash flow



Source: Company data, Nomura estimates

Valuation

Valuation appears high — not unusual

Valuation higher than sector average, but growth opportunity much bigger

The stock trades at a P/E multiple of 22.7x our FY13F EPS of Rs22. While valuations appear rich at first glance, we believe a story like JFL should be viewed in terms of the opportunity it offers over the medium term. On this basis, we think the valuation is justifiable. Our valuation methodology for JFL reflects this thought process. We have used multiple valuation methodologies for the stock.

We used a three-stage DCF-based valuation model with the following key assumptions.

- Near-term CAGR of 61% (FY10-13F), medium-term CAGR of 20% (FY14-19F) and longer-term CAGR of 13% (FY20-25F).
- Cost of equity at 13%
- Terminal value at 6%

Our DCF-based valuation is Rs650, with potential upside of 30% from current levels.

We believe our medium-term growth rate assumption is justified as over the past few years, the company has delivered strong growth. With the market still largely under-penetrated even in urban areas, we think the company looks poised to deliver average 20% growth. We expect growth to slow progressively to a more stable 13% over the longer term.

We also looked at what the current market price is factoring in for the medium- to longer-term growth trajectory for the company based on the same DCF model. In our view, the current market price only factors in a ~14% growth rate over the medium term. We believe the market is underestimating the long-term store growth potential and the improvement in margins at the current price, and hence, valuation on consensus numbers may appear high. We believe margins will improve further on account of operating leverage and continued strong revenues. However, consensus does not appear to share our view; consensus FY13F earnings estimates are 9% lower than ours.

We have also valued the stock using a P/E methodology. For JFL, we have used a P/E multiple of 28x one-year forward earnings. Our P/E multiple-based price target is Rs620, with potential upside of 24% from the current levels.

The assigned multiple is at a 15% premium to that assigned to the consumer sector average and 8% premium to the multiple assigned to other food companies in our coverage. We believe that the premium multiple is justified as:

- We believe JFL offers an impressive growth trajectory in the near term and more attractive opportunity in the longer term than its peers, given the following:
  - For all the hygiene and personal care (HPC) companies in our coverage, profitability will likely remain under pressure on account of rising competition, increasing commodity costs and high penetration. Thus, we believe HPC companies should trade at a justifiable discount. However, JFL does not face steep competition, its input cost pressure is lower due to better sourcing and bargaining power with suppliers, and it has greater pricing power given strong brand and acceptance of the product.
  - JFL has traded at an average multiple of 35.3x in its one-year trading history. Our target multiple of 28x is a 20% discount to its own trading history and a 15% premium to the average of the consumer companies in our coverage, for the reasons stated above.
  - Our average valuation for the consumer companies we cover is 23.5x one-year forward earnings, with average earnings growth of 20%, which translates into a PEG of 1.2x. Over FY10-15F, we expect JFL to deliver an earnings CAGR of 45%, so a P/E multiple of 28x translates to a PEG multiple of 0.5x.

Exhibit 69. Sector valuation

Company	Ticker	Rating	Price (Rs)	FY12F PEG (x)
Asian Paints	APNT IN	BUY	2,550	1.2
Colgate Palmolive	CLGT IN	REDUCE	828	3.3
Dabur	DABUR IN	BUY	97	1.0
Godrej Consumer	GCPL IN	NEUTRAL	364	0.5
Hindustan Unilever	HUVR IN	REDUCE	276	3.0
ITC	ITC IN	BUY	157	1.3
Marico	MRCO IN	REDUCE	125	1.3
United Spirits	UNSP IN	BUY	1,184	0.3
Titan Industries	TTAN IN	REDUCE	3,257	1.1
Nestle *	NEST IN	NEUTRAL	3,391	1.4
Pantaloon Retail	PF IN	BUY	278	0.3
Jubilant Foodworks	JUBI IN	BUY	499	0.5
GSK Consumer *	SKB IN	BUY	2,101	0.9
Average				**1.2**

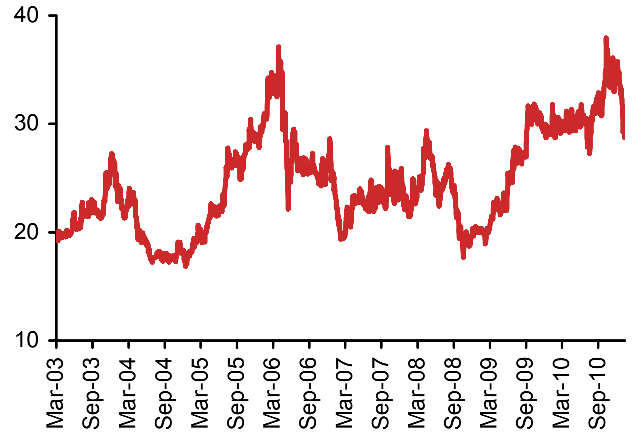
Pricing as of Feb 16
Note: * Nestle and GSK Consumer are CY year-based valuations

Source: Bloomberg, Nomura research

Food multiples are higher than HPC due to better long-term growth prospects

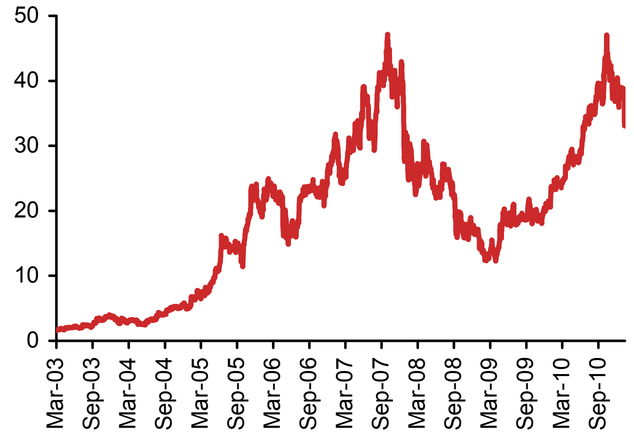
We also point out that the P/E multiple at which food companies have traded is higher than that of the HPC space. One of the reasons is the faster growth trajectory for the food names vs. companies in the HPC space. For high-growth companies such as Nestle and Titan, the market is willing to pay a higher multiple than for HPC names. Thus, valuations for these high-growth companies may look expensive when compared to the sector, but the possibility of earnings surprise on the upside and higher-than-industry average growth helps to ensure that the trading band itself is higher than that for other consumer names.

Exhibit 70. Nestle India — one-year forward P/E



Source: Bloomberg, Nomura research

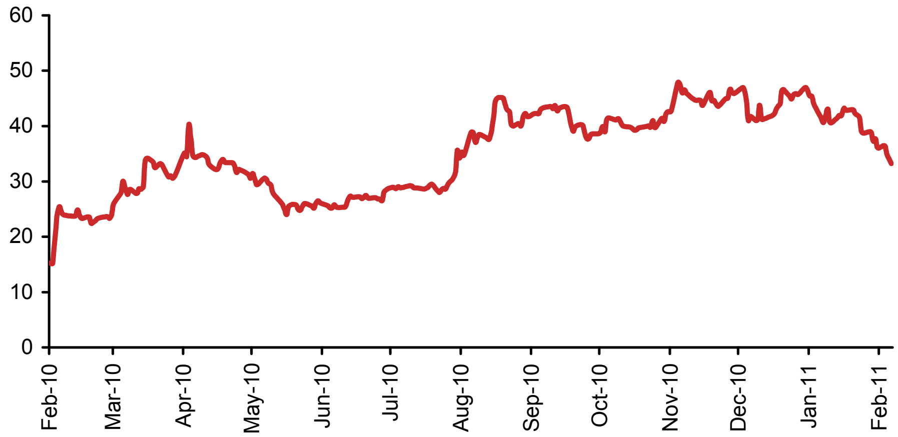
Exhibit 71. Titan — one-year forward P/E



Source: Bloomberg, Nomura research

Hence, our one-year forward price target on the stock is Rs620, with potential upside of 24% from current levels. We believe that JFL is one of the best possible plays on the food opportunity in India and should be the biggest beneficiary of rising urbanisation and incomes. We initiate coverage with a BUY rating.

Exhibit 72. Jubilant Foodworks — Historical one-year forward P/E



Source: Bloomberg, Nomura Research

Where could we go wrong?

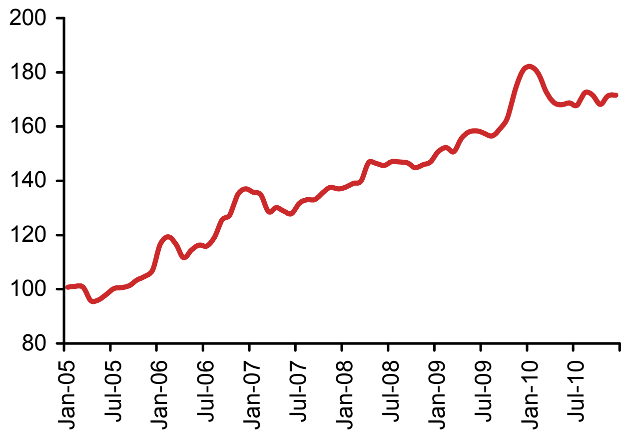
Risks to our view

While we believe JFL offers an attractive entry to the quick service restaurant industry in India, there are certain risks which could impede our estimates and price target. We see the following risks to our view.

Rising input costs could lead to lower margin progression and is a risk to our view

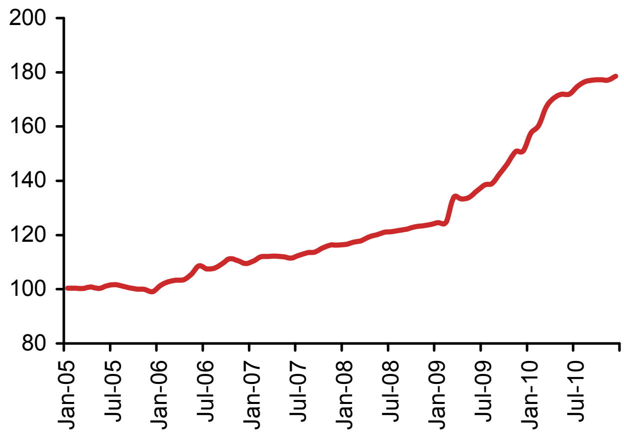
- **Rising input costs**: Raw materials such as cheese, dough, vegetables etc equalled about 21% of sales in FY10. There has been an increase in the cost of these inputs over the last two years, but the company has been able to mitigate the impact by having better negotiating power with suppliers, as well as by effecting price increases. However, ongoing increases in input prices (cheese, chicken, vegetables) could have a negative impact on margins if the company can no longer pass those increases on to consumers.

Exhibit 73. Wholesale wheat price index



Source: Business Beacon, Nomura research

Exhibit 74. Wholesale milk price index



Source: Business Beacon, Nomura research

- **Rising competition**: While pizza remains one of the most popular formats across the quick service restaurant industry in India, competition is rising, both from other pizza brands as well as other quick service restaurant formats. Brands such as US Pizza, Papa Johns, KFC, McDonald's and Subway are already present in India and are looking to increase their presence. There are also other global brands looking to enter/grow in India over the next few years, such as Taco Bell, Church's Chicken, and Round Table Pizza, among others, according to company managements. This could have a twofold negative impact on Dominos in India, in our view. With competition increasing, there could be price-led promotion strategy with a view toward gaining share, which could impact profitability. Also with increased choices to choose from certainly in the big cities, sales growth could see a slowdown.

Exhibit 75. Pizza restaurants in India

	2003	2010
Pizza brands		
Dominos	75	306
Pizza Hut	70	158
Smoking Joes	31	52
US Pizza	20	60
Pizza Corner	30	54
Garcia's Pizza	-	20
Papa Johns	-	21
Total	**226**	**671**

Source: Company websites

- **Termination of MFA agreement**: The company does not have any other business line apart from being the franchisee of Dominos Pizza in India. Its current master franchise agreement (MFA) with Dominos Inc is in effect until December 2024 with an option to renew it for another 10 years. The risk of termination of this agreement would be if JFL does not comply with preset conditions. However, there is no history of Dominos Inc. cancelling franchise agreements across the world.
- **Faster-than-expected rise in leasing costs**: Success of the company depends on driving new stores into existing cities, as well as expansion into newer towns and cities. However, we see two possible risks to this expansion plan. First, availability of real estate could be an issue; and second, cost of leasing the properties could rise. A significant rise in leasing costs could have a negative impact on profitability in the medium term.
- **Slower-than-anticipated success in tier II and tier III towns**: One of the key long-term drivers for the success of the company is its planned expansion into tier II and tier III cities. Management anticipates that these markets will offer a strong success rate; however, if this does not pan out as expected, long-term attractiveness of the business could suffer. This is a risk to our longer-term assumptions.

Strong business model

Introduced pizza to India

Globally successful model and brand

Dominos getting a slice of the India market via Jubilant

Dominos is a globally recognised brand, and the franchisee model has proven to be consistently successful over the past 50 years in many countries including the UK and several in Europe and Asia Pacific. Dominos now has more than 8,500 stores worldwide across more than 60 countries involving more than 2,000 franchisees. The company encourages differentiation across countries, based on local factors both for store expansion and menu offerings. For example, in Ireland and the UK, Dominos has not given exclusive franchise rights to one franchisee; however in India, Jubilant Foodworks has this exclusivity. Menu offerings are also modified to suit local tastes and preferences (eg, vegetarian pizza in India, prawn toppings in Australia).

Exhibit 76. Dominos — Strong global footprint – top 10 markets

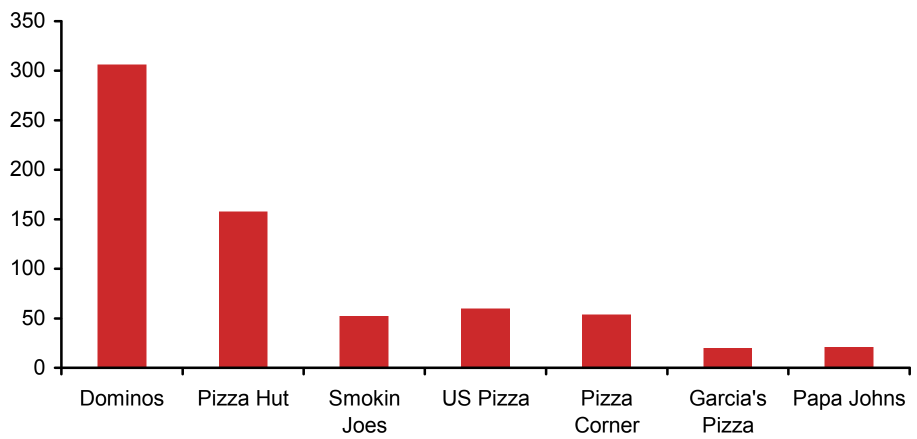
Country	End-2010 store	Delivery market position
Mexico	590	1
United Kingdom	586	1
Australia	419	1
India	337	2
South Korea	337	3
Canada	332	1
Japan	177	3
France	175	1
Turkey	151	1
Taiwan	132	2
Total	**3,236**	

Source: Dominos

Market leader in a growing market

Dominos Pizza has a dominant 50% share of the pizza market in India and an even higher 65% share of the home-delivery pizza market, according to JFL management. We expect the company to maintain its leadership position over the next few years as the global brand name and significant scale in India give it a strong competitive advantage vs other pizza brands in terms of availability and penetration. The second-biggest player (Pizza Hut) only has half the number of stores that Dominos has in India, which we believe will be a continuing advantage over the medium term.

Exhibit 77. Dominos — by far the largest player



Source: Dominos, Nomura research

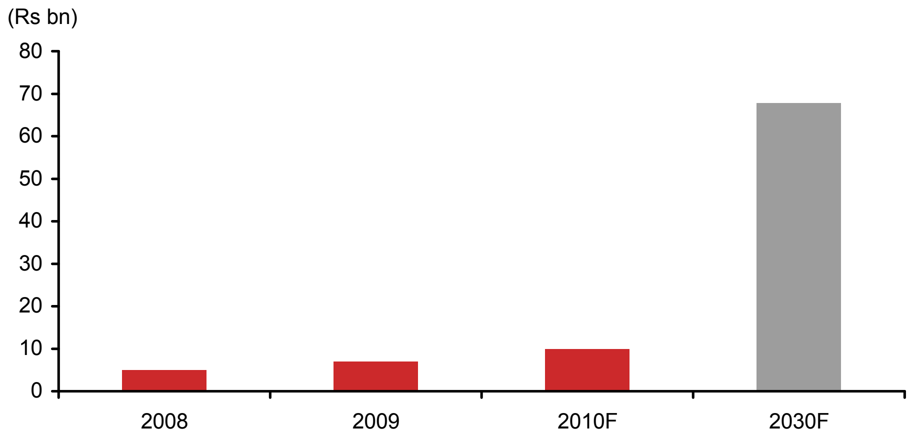
Pizza: an attractive long-term opportunity

We see this market being worth roughly Rs51bn in 2030F

The pizza market in India remains in a nascent stage, despite the sector's robust growth over the past few years. The current pizza market is worth Rs10bn, which has doubled from Rs5bn in 2008, according to the Federation of Indian Chambers of Commerce and Industry (FICCI). Using macro indicators based on data from McKinsey Global and Nomura's economics team about growing urbanisation trends, the increasing number of smaller household size and growing penetration levels, we estimate the market itself will be worth Rs51bn (~5x growth) by 2030F on a base-case scenario and Rs68bn (~7x growth) in an optimistic scenario.

Our assumption works with penetration levels of close to 40% from the current 20% and average households ordering four pizzas a year (same as current levels, according to JFL).

Exhibit 78. Pizza market in India set to grow 5x



Source: FICCI, Nomura estimates

Core market still highly under-penetrated

We believe the pizza market is still largely under-penetrated in India, even after accounting for the robust growth seen over the past decade. Our thesis is based on certain assumptions on demographics, market potential and existing store count. We find that even in metros such as Mumbai and Delhi, there is still a long way to go before we see store count reach full potential.

We have analysed company business by way of store count in the top 50 cities in India. For the purpose of this evaluation, we assumed that each store is able to serve 20,000 people to operate at an optimal level.

We find that even cities such as Mumbai and the NCR area are operating only at about 35-40% penetration. Even looking at the top six cities, if we work with a medium-term company target of opening 65 stores pa over the next few years, our model shows that there is enough potential for JFL to expand for the next six years. This, however, does not take into account the increase in population and urbanisation, which should only expand the available opportunity size.

It will be quite some time before the major cities themselves are exhausted, in our view

This essentially implies to us that the company need not even look very aggressively at going into smaller cities over the next few years as there is plenty of growth potential in the major cities itself.

Dominos Inc in a recent presentation put the optimal number of stores for India at 750, but our analysis suggests that with demand for the product growing at such a fast clip, the optimal number of stores could be nearer 1,100 stores.

Exhibit 79. Store-level penetration

Rank	City	Population 2010	Stores existing	Potential	Penetration (%)
1	Mumbai / Thane	16.4	55	164	33.5
2	NCR	17.3	68	173	39.2
3	Bangalore	5.4	39	54	71.7
4	Kolkata	5.1	14	51	27.2
5	Chennai	4.6	22	46	47.7
6	Hyderabad	4.1	18	41	44.2

Source: US census data, JFL, Nomura research

Smaller cities to lead phase-two growth

We think smaller cities will deliver the next phase of growth for the company

If we look beyond the top six cities, the under-penetration is starker, which means the potential for growth is much greater in those cities, in our view. For example, in cities such as Ahmedabad, Pune and Surat, the population base is more than 3mn people already. These cities are growing in population terms every year and not just by natural increase but backed by urbanisation, which means that the potential for store count to increase in these cities should be significant.

Exhibit 80. Smaller cities and towns very underpenetrated

City	Population 2010	Stores existing	Potential	Penetration (%)
Ahmedabad	4.0	6	40	15.2
Pune	5.0	19	50	37.7
Surat	3.3	3	33	9.0
Kanpur	3.2	3	32	9.3
Jaipur	3.2	3	32	9.3
Lucknow	2.8	4	28	14.5
Nagpur	2.4	3	24	12.3
Patna	1.9	-	19	0.0
Indore	1.9	2	19	10.8
Bhopal	1.8	2	18	11.2
Ludhiana	1.7	2	17	11.5
Agra	1.7	2	17	11.9
Nashik	1.6	2	16	12.6
Vadodara	1.5	4	15	26.0
Faridabad	1.5	4	15	26.3
Ghaziabad	1.5	5	15	33.2
Rajkot	1.5	1	15	6.9
Meerut	1.4	2	14	14.2
Amritsar	1.2	3	12	24.5
Varanasi	1.2	1	12	8.3
Aurangabad	1.2	1	12	8.3
Solapur	1.2	1	12	8.6
Allahabad	1.1	1	11	8.8
Jabalpur	1.1	1	11	9.2
Srinagar	1.1	-	11	0.0
Ranchi	1.1	1	11	9.3

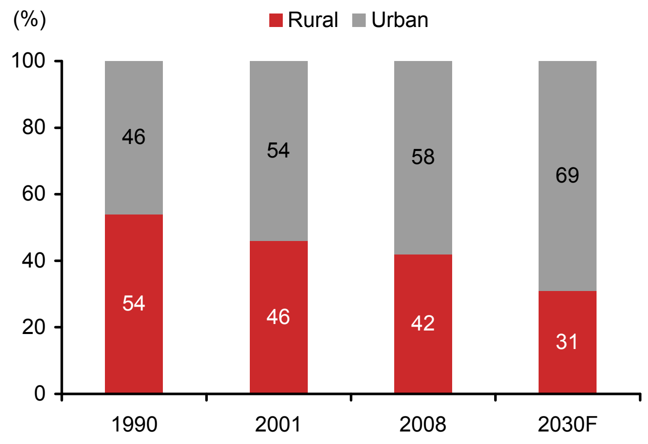
Source: US census data, JFL, Nomura research

Increasing urbanisation should provide long-term opportunity

McKinsey Global estimates that by 2030, based on urbanisation trends, nearly 70% of the Indian population will live in urban areas; this implies an attractive longer-term opportunity to grow the company's business in current tier II and tier III cities. For instance, according to McKinsey, the population of Kanpur is expected to increase from 3.2mn in 2010 to 4.2mn in 2030 (current penetration of 9.3%), and Surat will see its population increase from 3.3mn to 7.4mn (current penetration of 9%).

There are several other cities in India where population increase is expected to be significant and should offer solid longer-term opportunity for the company to increase the number of stores consistently over the next several years.

Exhibit 81. Urbanisation trends in India



Source: McKinsey Global Institute

Exhibit 82. Penetration still low

	2010F	2030F	Increase (x)	Penetration (%)
Ahmedabad	4.0	8.4	2.1	15.2
Surat	3.3	7.4	2.2	9.0
Jaipur	3.2	5.4	1.7	9.3
Nagpur	2.4	5.2	2.2	12.3
Vadodara	1.5	4.2	2.8	26.0
Kanpur	3.2	4.2	1.3	9.3

Source: McKinsey Global Institute

Quick service restaurant model in EMG market – exploring KFC growth in China

We also explored how one of the most successful fast food formats in China has evolved over the past couple of decades, becoming the market leader in a country where its products were unknown just a few years back. This is similar to Dominos in India – whose product was also unknown a few years back.

KFC business has been very successful in China

In 1987, Kentucky Fried Chicken (now called KFC) became the first fast-food chain to open a restaurant in China. Some 20 years later, it has more than 2,200 stores all over China with annual revenue of US$1mn each and 20% profit margins. KFC outperforms all competitors in China in number of outlets, revenue and market share, according to a company presentation. In 2010, the company had more than 3,000 stores vs McDonald's 100 outlets and Burger King's >30 outlets.

Tracing back history, by 2001, there were more than 500 KFC outlets all over China. By 2008, KFC had twice as many outlets in China as McDonald's, a reversal of the ratio in other parts of the world. The company continues to open 350 outlets per year even after the robust growth of the past two decades.

Yum! Brands, parent of KFC, cites many reasons for the huge success of the product, but the most important one which still holds in China was acceptance of the product by the people in the country. Fried chicken was simply more palatable in China than hamburgers, management believes.

Even after seeing the robust growth in KFC restaurants over the past two decades, the company believes that the potential for the number of stores to be opened in China remains robust. Currently, there are about 300mn people in China who are in the middle class by local standards, according to a recent YUM! presentation. By 2030, the company believes there will be at least 750mn people in the middle-class segment. If KFC continues to operate the same ratio of restaurants per million middle-class persons as it does now, management sees potential to open another 4,500 KFC restaurants. If the company increases the number of restaurants serving one million middle-class citizens, the potential for store count could even be 5x greater than current levels. That would still be much lower than the density of McDonald's restaurants in the US or Tim Horton's in Canada, based on according to YUM!.

Exhibit 83. Potential for KFC restaurants in China

Year	Middle class mn	KFC per mn middle class	KFC Restaurants
2010	300	10	3,000
2030	750	10	7,500
2030	750	15	11,250
2030	750	20	15,000

Source: Yum Brands international

While our bottom-up analysis suggests Dominos could open more than 1,000 stores in India (over the next 15 years), we believe this estimate could be conservative if we look at how successful quick service restaurants have been in China. While we do not think building in such robust longer-term potential into our model is justified, we highlight that long-term potential could take a different trajectory to what we currently forecast. We note some common success factors between JFL's India operations and KFC in China in terms of product innovation, robust supply chain and consumer acceptance of its products.

Dominos versus other pizza brands

While the pizza market in India has seen robust growth over the past decade or so, the Dominos brand has grown at a faster pace. We attribute this to:

- **Concentration on market depth and breadth**: Dominos entered the Indian pizza market in the mid-1990s, and until 2003, the company was growing broadly in line with the second-biggest competitor Pizza Hut. For example in 2003, Dominos had 75 stores in India, while Pizza Hut had 70 stores. Yet over the next seven years, Dominos grew its number of stores to 306; Pizza Hut now has only 158 stores. The company has been aggressively growing the depth of existing markets (8 Mumbai stores in 2003; 55 in 2010) and ventured into newer cities such as Bhopal, Bhubaneswar and Cochin. We think this ability to take the brand into newer markets and deepen penetration in existing markets is unmatched across the industry, which has made the company the market leader in India's pizza segment. This, we believe, is one of the most important factors in the success of the brand. Given the logistical challenges, proximity to the consumer is most important, in our view.
- **Brand strength**: The company has invested a significant amount of money in branding and consumer awareness over the past decade. We think this has ensured that consumers connected with the brand "emotionally" based on feedback from the company, which the company has leveraged to grow its business faster in existing cities and take the brand into other cities. In the past couple of years, it has invested Rs304mn in advertising and promotion (A&P). In our view, although operating leverage means the proportion of money spent on A&P should continue to trend down over the next few years (as already happened in FY10), we see the absolute amount spent remaining significant. We think this means that connections with consumers will continue to get stronger. The company's advertising campaign, "Khusion ki home delivery", has nurtured a strong emotional connect with the consumer, in our view, and this has helped the company attract consumers and made it easier to retain them whenever they plan to order a pizza.
- **Focus on home-delivery model**: JFL has consistently given the message that its focus is on the home-delivery segment. We think many of the stores across the country have some space for dine in, but the company's branding message has emphasised that it specialises in home delivery. This has had a few positives for the company in our view.
  - The message to the consumer has been clear and consistent in terms of branding and made the company the preferred option for pizza home delivery.

- The company has been able to grow the number of stores in a more robust manner versus competition as the space requirement for a largely home delivery-based model is much smaller versus the dine-in option.
- Profitability has been better as rentals for a smaller space are much lower versus a dine-in restaurant in a mall or a commercial area. This means the dine-in option is slower to develop and the company has been able to grow profitability faster due to operating leverage.

- **Innovation**: One of the key success factors for JFL in our view has been the focus on innovation and "Indianisation" of the menu. Half the menu has always been vegetarian, and management has pointed out that in a country like India where the majority of consumers are vegetarian, this was critical. We think that this is where Dominos and McDonald's have succeeded, in that from the first day of operation, there was an elaborate vegetarian menu which was not the case with KFC when it launched in India. JFL has over the years continued to focus on innovation to keep the menu "fresh and exciting", in our view.
- **Focus on front-end**: During the first phase of its development, JFL concentrated on developing the front-end of its business and tried to connect with the consumer. The back-end, including the supply chain and logistics, came a bit later once the front-end was established. This is a message which we have also received from Pantaloon Retail (India's biggest food retailer) regarding its food business in terms of back-end and supply chain, sourcing, and benefits of scale: while the back-end is important to drive efficiency, the primary focus on developing the back-end first is not generally a great way to go about developing the business according to Pantaloon management.
- **Availability with affordability**: While JFL's focus has been on making the product available to more consumers throughout the country, it also has tried to make the product affordable to a larger section of the population. The company's pricing strategy shows that despite being the market leader, comparable prices for the basic varieties of pizza and up to the higher-end range are less than those of most comparable brands. The company launched innovative products such as "Pizza Mania" which start at Rs39 per pizza, making it affordable to a large section of the population.

Exhibit 84. Dominos: affordability is important, as is availability

(Rs)	Margherita	Simple Veg
Papa Johns	104	154
Pizza Hut	85	115
US Pizza	75	100
Dominos	70	100
Smokin Joes	65	90
Garcia	60	90

Note: All prices for regular 7" pizza

Source: Dominos, Nomura research

Operating leverage in the model starting to emerge

We believe that the Dominos model in India carries a significant amount of operating leverage. In our view, the best way to understand this is to construct a store-level P&L and do a bottom-up analysis to see how the operating leverage works in the Dominos model in India.

Given available demographic data the way company looks at it, we assume the average number of households in a catchment area at 20,000, and each household orders four pizzas per year. We assume that the number of orders per year grows by ~10% each year over the first five years of a store's opening. We believe the average ticket size increases by 6-8% each year (4-5% pricing and 2-3% mix improvement).

We assume rental increases run slightly ahead of the long-term (15 years) inflation rate (assumption 6%) at 9%. However, as sales growth outstrips rental growth in our model, there is a significant amount of operating leverage which flows through to the bottom line. Similarly with SG&A and A&P expenses, the rise in these line items is well below the rise in sales, which means margins see a marked improvement in our model. The overall impact of these moves is that we find margins improve by close to 350-400bps over the first five years of operation after store opening.

To evaluate the effectiveness of our model, we back-tested it by calculating the payback period for each store. Company comments suggest a payback period of close to three years for most stores. Our model assumes a payback period of slightly more than three years, which means our assumptions maybe conservative, particularly in the first three years of operation.

We believe this model is replicated across the company, such that as the percentage of older stores rises, margins for the company rise. JFL has achieved a certain scale and new stores may number 65-70 per year over the next three years, in our view. This translates to a new-store contribution of 12-18% as a percentage of existing stores over the next three years. As such, we expect the company should benefit from operating leverage and margin expansion over the next few years.

Exhibit 85. Nomura estimated store-level P&L

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	100	119	142	171	207
Growth (%)		19	19	21	21
RM Cost	30	30	36	44	53
Manufacturing Costs	23	23	27	33	40
Total Employee Cost	34	31	34	38	46
Rent	29	18	13	11	12
SG&A and A&P	20	18	20	23	26
Operating Profit	(17)	(1)	11	23	30
Operating Margin (%)	(17.2)	(1.0)	8.0	13.2	14.3

Source: Nomura estimates

Dominos model elsewhere demonstrates strong operating leverage

We also looked at how the Dominos franchisee model has evolved in other markets. We see a marked similarity in many other markets in terms of the existence of operating leverage. For example, we looked at the UK market to see how the Dominos business has evolved there over the past decade or so. As the company expanded its footprint in the country, it reports that sales more than doubled in 2001-06 and profits increased by almost 5x. Margins improved from 3% in 2001 to 5.9% in 2006. Despite many years of operations and a robust store count in the country (600), operating leverage continued to increase according to management. In 2009, margins improved to 7.3%, and with store additions continuing to be a factor over the next decade, they could increase to 12% over the next decade. This is a 9% increase in margins over 20 years, which means that margins typically keep improving marginally as store count increases.

Exhibit 86. Dominos UK model

	2001	2006	2007	2008	2009	2020F
No. of Stores	237	451	501	553	608	1,200
Sales GBP m	98	240	296	351	407	1,217
PBT in GBP m	2.9	14.2	18.7	23.4	29.9	146
PBT/Sales (%)	3.0	5.9	6.3	6.7	7.3	12.0
Store Increase (01-06) (x)		1.9				2.0
Sales Increase (01-06) (x)		2.4				3.0
PBT Increase (01-06) (x)		4.9				4.9
Margins improvement (bp)		296	40	35	68	465

Source: YUM! Brands presentation

Robust supply chain in place

Over the past few years, the company has invested in a robust back-end supply chain system, to ensure stable product availability and control costs. The company tries to open stores near a city as it makes it easier to reach those stores with one trip from the commissary, minimising travel and freight costs. The supply of raw materials is regulated through four regional centres or commissaries in Noida, Mumbai, Bangalore and Kolkata. These commissaries primarily manufacture the dough and act as a warehouse for most of the other ingredients. Two of the company's commissaries also process pasta and three of them process Choco Lava Cake. The raw materials are sourced and supplied to the stores by the commissaries. The company has signed with multiple vendors for its input and raw material requirements, which reduces supply risks, in our view. The idea behind this is to ensure that each commissary is able to reach every store in the country within one day to supply raw materials. There are, however, a small number of stores which source requirements locally as it is not possible to reach these stores within one day.

Scale gives better bargaining power with suppliers; India a key growth driver

According to the company, Dominos Inc regularly evaluates the potential number of stores across all its markets. We have looked at how the company is faring in its top 10 markets and where it sees the potential for growth. In 2009, the company estimated that the ideal number of stores in India is about 700. However, seeing the robust pace of growth both in store count and in the business, it increased this number to 750 in its latest investor presentation. India is one of only two countries where the company has increased its potential store count target among the top 10 markets, the other one being the UK. The pace of growth of stores in India over the past year has moved India up from being the company's sixth-biggest market to its fourth largest as at end 2010. If the pace continues, India could become the third-biggest market for Dominos worldwide by the end of FY12F, in our view.

We believe the actual store potential in India is closer to 1,100 stores based on our bottom-up analysis, which would put it on par with the UK as the number one market in terms of store potential. Over the longer term, management believes the attractiveness of having 1,100 stores serve a population of more than a billion people is much more than having the same number of stores serve a population of 60mn (as in the UK). Over the next five years, we see India becoming the most important market for Dominos worldwide.

Exhibit 87. Dominos — Store count potential

Country	YE 2010 store	Delivery market position	Potential store count	Potential reached (%)	Change vs. FY09
Mexico	590	1	700	84	-
United Kingdom	586	1	1,100	53	200
Australia	419	1	550	76	-
India	337	1	750	45	50
South Korea	337	2	400	84	-
Canada	332	3	400	83	-
Japan	177	3	700	25	-
France	175	1	650	27	(50)
Turkey	151	1	400	38	-
Taiwan	132	2	150	88	-
Total	**3,236**		**5,800**	**56**	**200**

Source: Dominos Inc

Opportunity to bring other quick service restaurant brands to India

One of the biggest opportunities for JFL in the near to medium term is to bring other quick service restaurant brands into India. Recent press articles (*Economic Times*, 8 February 2011, "Jubilant in talks with Starbucks for India Foray") reported the JFL was in discussions with Starbucks Coffee to bring Starbucks outlets to India, although Starbucks has entered into a partnership with Tata Coffee for its foray into India. However, Tata Coffee in a press release suggested that this partnership may only be for sourcing of coffee beans; thus, a partnership to roll out retail stores with another company may still be possible. We believe there are other international chains that do not have a presence in India that JFL may look to bring into India. According to JFL management, they are in talks with two brands and may be bringing one of them into India over the next six months. We think any related announcement or newsflow could prove to be a strong medium-term catalyst for the stock. Management's success and experience with leading a new brand into India is established, in our view, and investors would likely look at such a development favourably.

Exhibit 88. International restaurants presence in India

Company	Brands	Presence in India
McDonald's Corp	McDonald's	Yes
Starbucks Corp	Starbucks	Yes
Yum! Brands	Pizza Hut	Yes
Yum! Brands	Taco Bell	Yes
Darden Restaurants	Red Lobster, Olive Garden, LongHorn Steakhouse, Bahama Breeze, Seasons 52	No
Chipotle Mexican Grill	Chipotle Mexican Grill	No
Burger King Holding	Burger King	Yes
Whitbread	Costa Coffee	Yes
Dominos Pizza Inc.	Dominos	Yes
Ruby Tuesday Inc.	Ruby Tuesday	Yes
Dunkin Brands	Dunkin Donuts	No
Dunkin Brands	Baskin-Robbins	Yes
Brinker	Chili's Grill & Bar	Yes
Brinker	Romano's Macaroni Grill, Maggiano's Little Italy	No
Dine Equity	International House of Pancakes, Applebee's Grill	No
Subway	Subway	Yes

Source: Company websites, Nomura research

Industry analysis

Indian food industry

The Indian food industry is estimated to be worth US$200bn in 2007 and is expected to grow to US$300bn by 2015F as per Technopak. This growth (CAGR of 5.2%) will be helped by consumers spending more in absolute terms on their food requirements, although as incomes rise, the percentage of income spent on food will decline we expect. We think there will also be a change in terms of consumer food basket as incomes continue to rise and look for preferences to shift from basic food grains, edible oil and sugar to include fruits and vegetables, meat, eggs, fish, beverages and processed foods.

Food service industry to benefit from this growth

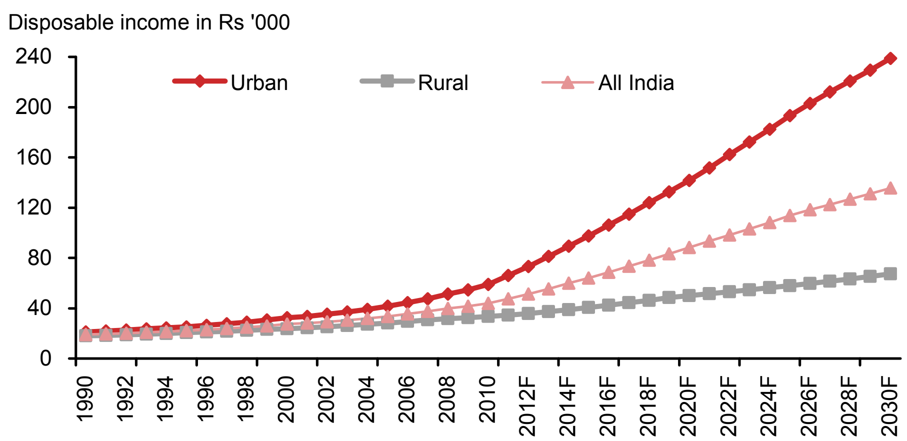
The food service industry is defined as sale of food and drinks which are ready for consumption either from premises from which they were bought, in designated eating areas or delivered to home. This industry is sizeable, but largely unorganised in India. The Food Franchising Report 2009, an industry report published by the Federation of Indian Chambers of Commerce and Industry (FICCI) estimates that the food services industry was US$12.4bn in 2008, of which only US$1.7bn was in the organised sector. Within the organised sector, some of the formats are fine dining, casual dining, quick service restaurants, food courts, cafés and kiosks. Within these formats quick service restaurants and cafés are the fastest-growing formats over the past few years, according to the report.

Key drivers of the food service industry

The food service industry in India is likely to grow strongly over the next few years and we note several structural triggers that should support this growth.

- **Rising income levels**: One of the key determinants for the success of quick service restaurants is improving affordability of the products on offer. With per capita incomes in India continuing to rise and expected to be buoyant over the next few years (based on a McKinsey Global Institute report), one of the key beneficiaries should be the quick service restaurant as disposable income continues to rise.

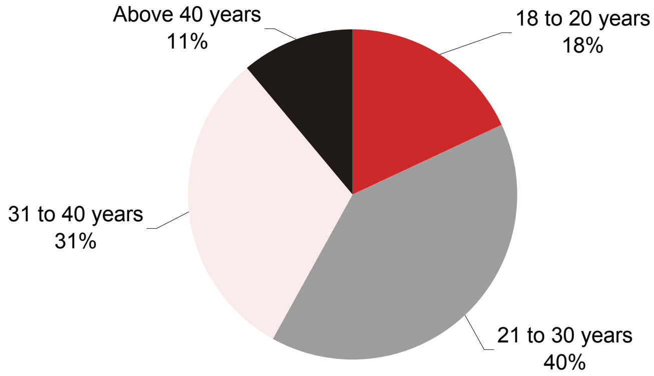
Exhibit 89. Urban incomes to rise faster than rural incomes



Source: Mckinsey Global Institute

- **Younger population**: India is a young country (median age of the population is 24 years, according to the US census bureau). This has a big influence on the growth of the quick service restaurant industry, and this factor should remain supportive in the medium term, in our view.

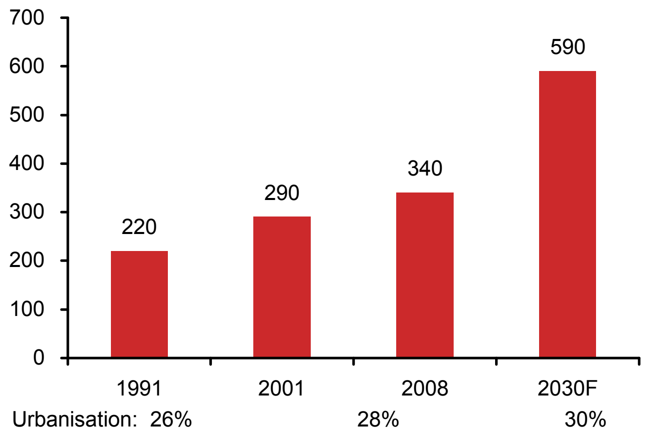
Exhibit 90. Younger population eats out more often



Source: McKinsey Glboal, Technopak Report 2009

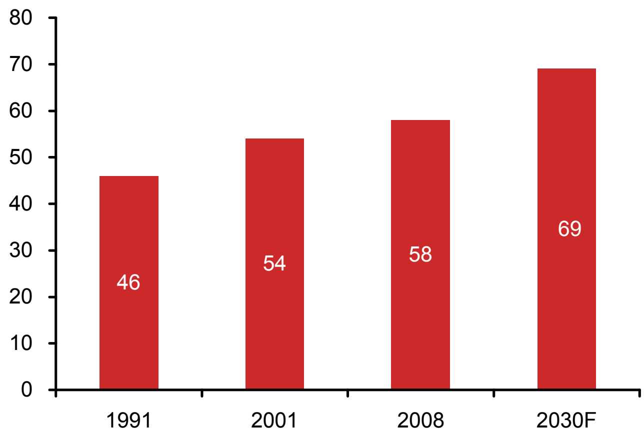
- **Rising urbanisation**: Based on data compiled by McKinsey Global Institute, over the past decade, we have seen increasing trends of urbanisation, and this will likely remain a trend over the next decade. Moreover, the fastest-growing states will continue to exhibit the highest urbanisation rate. By 2008, an estimated 340mn people lived in urban India, representing ~30% of the total population. However, McKinsey estimates suggest that over the next 20 years, 70% of all the incremental jobs created in India are likely to be in urban India and these jobs are likely to be twice as productive as equivalent jobs in rural India. Thus, the population of India's cities is expected to increase to 590mn or 40% of India's population will live in the cities in 2030. This should be supportive for the long-term growth of the quick service restaurant industry, in our view.

Exhibit 91. Urbanisation to pick up significantly



Source: McKinsey Global Institute

Exhibit 92. Share of cites in GDP to rise



Source: McKinsey Global Institute

- **Increase in nuclear families and rising number of women in the workforce**: As urbanisation trends take shape in India, families are becoming smaller. The McKinsey data also shows a trend of an increasing number of women in the workforce, which means there is less time to cook at home, which in turn should be a positive for growth of the quick service restaurant industry in India over the medium term, we believe.

Quick service restaurant industry: robust growth in recent years

As discussed, the quick service restaurant industry has seen robust growth over the past few years. This has been supported by several structural macroeconomic triggers, as well as the industry recognising the opportunity and investing in improving the availability and affordability of the product. This has been true across various quick service restaurant formats such as pizza (both delivery and dine in), cafés, burgers and fried chicken restaurants.

Exhibit 93. Quick service restaurant industry seeing robust growth

QSR restaurants	2003	2010	Growth (x)
Pizza brands			
Dominos	75	306	4.1
Pizza Hut	70	158	2.3
Smoking Joes	31	52	1.7
US Pizza	20	60	3.0
Pizza Corner	30	54	1.8
Garcia's Pizza	-	20	
Papa Johns	-	21	
Total	**226**	**671**	**3.0**
Non-Pizza brands			
Café Coffee Day	35	923	26.4
Barista	50	230	4.6
McDonalds	50	169	3.4
Subway	24	145	6.0
Nirula's	30	67	2.2
KFC	2	72	36.0
Costa Coffee	-	40	
Total	**191**	**1,646**	**8.6**

Source: Company data, Nomura research

However, within the quick service restaurant industry, the two most dominant segments in terms of growth have been pizza and cafés. Pizza stores have increased in number by 3x over the past seven years according to a FICCI food franchising report. Dominos has been the leader in the pizza segment and has grown its number of stores from 75 in 2003 to 306 in 2010 and is on course add another 70 stores by the end of March 2011, according to the company. This translates to 4x the number of stores and is ahead of industry growth. The second-biggest competitor is almost half the size of Dominos, which is a huge advantage in a market which is growing at an attractive pace.

The café segment has also been growing strongly, although the market is more consolidated with Café Coffee Day almost 5x as big as the second-largest competitor, with the big two having a dominant share of more than 90% in terms of number of stores, according to the company.

Opportunity size will continue to grow

We also believe the opportunity for out-of-home food is likely to grow significantly over the next few years as it benefits from favourable demographics, rising urbanisation and strong growth in incomes. Out-of-home food only constitutes 5% of disposable income according to Images India as of 2009. As incomes grow, share of food and grocery should continue to trend down and these savings will likely be spent by the consumer on discretionary items. One of the most popular segments in India, in our view, will remain food, and here we expect to see more consumers shift from the unorganised sector out-of-home food to the organised segment. We think this will be a key positive for JFL in the longer term.

Exhibit 94. India — Consumer wallet spend

	(%)
Food & Grocery	59.5
Out-of-home food	**5.4**
Leisure	1.2
Entertainment	3.4
Clothing & Fashion Accessories	9.9
Jewellery	5.2
Watches	0.3
Footwear	1.2
Health & Beauty Care	0.3
Pharmaceuticals	3.7
Consumer Durables	4.3
Mobiles & Accessories	2.0
Furnishings & Utensils	3.4

Source: Images India Retail 2009

Consumer acceptance will continue to drive long-term growth

As mentioned, one of the key success factors in the food segment is consumer acceptance of the product and the format. This is a significant positive for JFL as the product and the format are now well accepted by consumers, which means there is an inherent bias from the consumer towards spending on the product. It is important that in a country like India, the basic ingredient in a pizza is vegetarian. This is feedback we also received from one of the company's competitors in the QSR segment – KFC India. According to KFC, it has had to endure a much more challenging path to convince the consumer to try its products as the most important product is chicken. We believe McDonald's success in India was helped by the company's introducing a vegetarian option at the onset.

Appendix

Feedback from 3Q FY11 conference call — company data

- **Store expansion plans on track**: The company remains committed to increasing the store count by ~70 stores in FY12. In FY11, it has already opened 58 new stores over the first nine months with 28 stores added in 3Q. We believe there could be upside potential to the 70 new store count in FY11, but are not building it in to our numbers.
- **Price hikes as planned**: The company took price hikes of 2-2.5% at the end of the September quarter. This is in line with company policy of taking such quantum of price hikes every six months, which helps to ensure that consumers do not feel impacted by price hikes and the value proposition.
- **Employee cost**: In 3Q FY11, there was a significant increase in employee costs of +78% y-y on account of salary hikes in the range of 16-17% across the stores, as well as bringing shift managers under the variable compensation scheme linked to growth of EBITDA at the store level. This was also impacted by higher number of temporary employees who are hired specifically to handle the seasonal pick-up in business in 3Q each year on account of the holiday season.
- **New cities showing good traction**: During the quarter, the company entered eight new cities including Patna, Bhopal, Bhubaneswar and Zirakpur. The company's assessment is that initial feedback has been extremely positive with stores doing better than expectations. Management believes that in some of cities, one store will be good enough for a period of one year or so, while in other cities, it opened the second store soon after opening the first store. Consumer acceptance has been more rapid than the company's initial estimate, according to management, and this bodes well for longer-term growth in these cities.
- **Capex**: The company has planned capex of Rs550mn in FY11, which should grow by a bit in FY12 as it plans 70 new store additions. The company expects it will be able to generate funds internally for new store expansions.
- **Debt and cash position**: JFL has no debt on the balance sheet. We believe net cash will improve further as capex requirements will eventually be less than the company's cash generation over the next couple of years.
- **Talks with more international QSR brands**: The company is in talks with two major international QSR brands with a view to bringing the brand into India over the next four to six months, according to management. The company is still talking to both brands and will look at finalising only one of them over the near term.
- **Margin improvement**: The company believes that margins will continue to improve marginally over the next couple of years as operating leverage gels. We believe the company's own guidance is conservative and think margin improvement could reach ~100bps each year over the next couple of years.
- **International expansion**: The company plans to start its first store in Sri Lanka at the end of March or early April and will grow the number of stores in that country depending on consumer response. Management believes India is a more attractive opportunity than Sri Lanka and will continue to focus on India.

Background

Company background

Jubilant Foodworks, part of the Jubilant Bhartia group, holds the master franchise agreement (MFA) for the Dominos Pizza brand in India, Nepal, Bangladesh and Sri Lanka. The company, earlier known as Dominos Pizza India Ltd, was founded in 1995 and launched its first store in New Delhi in 1996. Today, the company has 364 stores under operation in 78 cities in India.

Jubilant Foodworks is the market leader in the organised pizza space in India with 50% share and has a 65% share in the pizza delivery segment. It competes with other pizza brands as well as other QSR restaurants and local restaurants in the areas where it operates. The company's stores mostly have a delivery and dine-in option. The stores are served by four commissaries located at Noida, Bengaluru, Mumbai and Kolkata.

JFL pays Dominos Inc a royalty of 3% of sales and has an agreement to pay this for the remainder of the period that the MFA is valid (ie, through 2024).

Management

Mr Shyam S Bhartia, aged 57, chairman and founder director

Mr Shyam S Bhartia holds a bachelor's degree in commerce from St Xavier's College, Calcutta University. He is also a fellow member of the ICWAI. Shyam Bhartia has over 22 years of experience in the pharmaceuticals and specialty chemicals, food, oil and gas, aerospace and IT sectors. He is a member of the executive committee of FICCI. He also has served as a member of the board of governors of the Indian Institute of Technology, Mumbai, and the Indian Institute of Management, Ahmedabad.

Mr Hari S Bhartia, aged 53, co-chairman and founder director

M Hari S Bhartia holds a bachelor's degree in chemical engineering from the Indian Institute of Technology, Delhi. Hari Bhartia has over 20 years of experience in the pharmaceuticals, food, oil and gas, aerospace and information technology sectors. His institutional work includes a role as chairman, board of governors, Indian Institute of Technology, Kanpur (1997-2003), in various capacities with Indian Institute of Technology, Delhi and vice president, Confederation of Indian Industry (CII) in 2009-10.

Mr Ajay Kaul, aged 46, chief executive officer and whole-time director

Mr Kaul holds a bachelor's degree in technology from the Indian Institute of Technology, Delhi, and a master's degree in business administration from XLRI, Jamshedpur. Mr Kaul has over 20 years of experience in industries such as financial services, airlines, express distribution and logistics and food retail. Previously, he worked in Indonesia as the country head of TNT Express Division. He has also worked with Modiluft and American Express TRS. He became CEO of Jubilant Foodworks on 7 February, 2005, and was appointed as an additional director on the board with effect from 14 March, 2005.

Ownership structure

Promoter and Promoter Group together hold 61.3% of the shares in the company.

Exhibit 95. Shareholding structure

Shareholder	% shares O/S
Promoter and Promoter Group	**61.3**
Indian	53.8
Foreign	7.5
Public	**38.7**
Institutions	30.7
Foreign Institutional Investors	21.1
Domestic Institutional Investors	9.6
Non-institutional	8.0
Other Corporate	3.0
Total	**100.0**

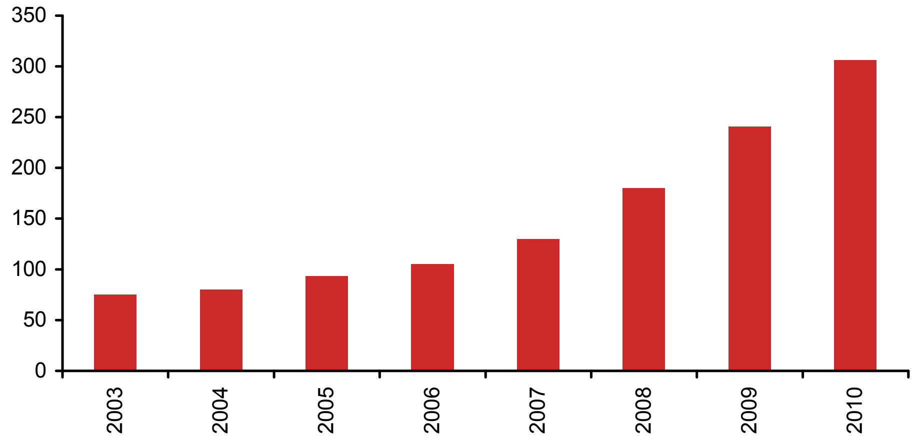
Source: BSE

Competitive profile

Dominos Pizza brand was launched in India in 1996 and has grown rapidly to become the market leader in both the overall pizza market, as well as the home-delivery segment. The company started its expansion process slowly and up until 2003, had about 75 stores in India. However, over the past few years, the company increased its pace of expansion significantly, and it now has twice as many stores as the second-largest competitor in the market. This focus on increasing penetration in existing cities has also helped to make Dominos is one of the most profitable names across the food service industry in India, in our view.

Competition in India's domestic pizza market is very strong, with new entrants such as Papa Johns and Garcia's Pizza starting up shop recently and international chain California Pizza Kitchen now also entering India. However, we believe the market itself will growth at ~9% CAGR over the next 20 years, driven by increasing urbanisation, penetration into smaller cities and towns and increasing incidence of orders in major cities. We expect the Dominos brand to be one of the key beneficiaries of this growth.

Exhibit 96. Jubilant Foodworks — Rapid expansion in number of stores



Source: Company data

Exhibit 97. Jubilant Foodworks — Robust store growth

QSR restaurants	2003	2010
Dominos	75	306
Pizza Hut	70	158
Smoking Joes	31	52
US Pizza	20	60
Pizza Corner	30	54
Garcia's Pizza	-	20
Papa Johns	-	21
Total	**226**	**671**

Source: Company data

Financial statements

Income statement (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Revenue	2,806	4,239	6,346	8,873	11,942
Cost of goods sold	(831)	(1,215)	(1,723)	(2,324)	(3,035)
Gross profit	**1,975**	**3,024**	**4,623**	**6,549**	**8,907**
SG&A	(1,246)	(1,797)	(2,548)	(3,446)	(4,498)
Employee share expense	(556)	(805)	(1,206)	(1,730)	(2,329)
Operating profit	**173**	**423**	**869**	**1,372**	**2,080**
EBITDA	**342**	**666**	**1,164**	**1,729**	**2,488**
Depreciation	(169)	(243)	(295)	(356)	(408)
Amortisation					
EBIT	**173**	**423**	**869**	**1,372**	**2,080**
Net interest expense	(89)	(91)	-	-	-
Associates & JCEs					
Other income	4	4	5	8	10
Earnings before tax	**87**	**335**	**874**	**1,380**	**2,090**
Income tax	(8)	(1)	(192)	(456)	(690)
Net profit after tax	**79**	**334**	**682**	**925**	**1,400**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**79**	**334**	**682**	**925**	**1,400**
Extraordinary items	(6)	(4)	-	-	-
Reported NPAT	**73**	**330**	**682**	**925**	**1,400**
Dividends	-	-	-	(318)	(636)
Transfer to reserves	**73**	**330**	**682**	**607**	**764**
Valuation and ratio analysis					
FD normalised P/E (x)	399.3	95.0	46.6	34.3	22.7
FD normalised P/E at price target (x)	496.4	118.1	57.9	42.6	28.2
Reported P/E (x)	434.5	96.2	46.6	34.3	22.7
Dividend yield (%)	-	-	-	1.0	2.0
Price/cashflow (x)	172.7	47.5	20.7	22.0	15.9
Price/book (x)	132.7	27.0	14.1	11.1	8.8
EV/EBITDA (x)	95.1	47.7	26.5	17.6	11.9
EV/EBIT (x)	188.3	75.1	35.5	22.1	14.3
Gross margin (%)	70.4	71.3	72.8	73.8	74.6
EBITDA margin (%)	12.2	15.7	18.3	19.5	20.8
EBIT margin (%)	6.2	10.0	13.7	15.5	17.4
Net margin (%)	2.6	7.8	10.7	10.4	11.7
Effective tax rate (%)	9.1	0.2	22.0	33.0	33.0
Dividend payout (%)	-	-	-	34.4	45.4
Capex to sales (%)	18.2	11.9	9.8	7.1	5.4
Capex to depreciation (x)	3.0	2.1	2.1	1.8	1.6
ROE (%)	36.5	46.6	39.8	36.3	43.3
ROA (pretax %)	14.0	25.2	41.2	52.9	66.8
Growth (%)					
Revenue	32.9	51.1	49.7	39.8	34.6
EBITDA	27.7	94.6	74.8	48.5	43.9
EBIT	17.7	144.7	105.7	58.0	51.6
Normalised EPS	(5.0)	320.3	104.1	35.7	51.4
Normalised FDEPS	(5.0)	320.3	104.1	35.7	51.4
Per share					
Reported EPS (Rs)	1.1	5.2	10.7	14.5	22.0
Norm EPS (Rs)	1.2	5.2	10.7	14.5	22.0
Fully diluted norm EPS (Rs)	1.2	5.2	10.7	14.5	22.0
Book value per share (Rs)	3.8	18.5	35.3	44.9	56.9
DPS (Rs)	-	-	-	5.0	10.0

Source: Nomura estimates

EBITDA margins should continue to benefit from operating leverage

Cashflow (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
EBITDA	342	666	1,164	1,729	2,488
Change in working capital	(38)	108	163	159	184
Other operating cashflow	(121)	(107)	205	(448)	(680)
Cashflow from operations	**184**	**667**	**1,532**	**1,440**	**1,993**
Capital expenditure	(512)	(503)	(622)	(629)	(647)
Free cashflow	**(328)**	**164**	**910**	**811**	**1,346**
Reduction in investments	-	-	-	-	-
Net acquisitions					
Reduction in other LT assets	-	-	-	-	-
Addition in other LT liabilities	29	10	(39)	-	-
Adjustments					
Cashflow after investing acts	**(300)**	**174**	**871**	**811**	**1,346**
Cash dividends	-	-	-	(318)	(636)
Equity issue	-	605	-	-	-
Debt issue	308	(739)	(86)	-	-
Convertible debt issue					
Others					
Cashflow from financial acts	**308**	**(134)**	**(86)**	**(318)**	**(636)**
Net cashflow	**8**	**40**	**785**	**493**	**710**
Beginning cash	22	30	70	856	1,349
Ending cash	30	70	856	1,349	2,058
Ending net debt	794	16	(856)	(1,349)	(2,058)

Source: Nomura estimates

Strong balance sheet supports store growth, as well as dividend payouts

Balance sheet (Rsmn)					
As at 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Cash & equivalents	30	70	856	1,349	2,058
Marketable securities					
Accounts receivable	12	29	36	50	73
Inventories	55	71	104	122	131
Other current assets	239	362	435	656	907
Total current assets	**336**	**533**	**1,431**	**2,176**	**3,169**
LT investments	-	-	-	-	-
Fixed assets	1,155	1,429	1,755	2,028	2,266
Goodwill					
Other intangible assets					
Other LT assets					
Total assets	**1,491**	**1,961**	**3,186**	**4,204**	**5,435**
Short-term debt	-	-	-	-	-
Accounts payable					
Other current liabilities	398	663	939	1,350	1,817
Total current liabilities	**398**	**663**	**939**	**1,350**	**1,817**
Long-term debt	824	86	-	-	-
Convertible debt					
Other LT liabilities	29	39	-	-	-
Total liabilities	**1,251**	**787**	**939**	**1,350**	**1,817**
Minority interest	-	-	-	-	-
Preferred stock					
Common stock	582	636	636	636	636
Retained earnings	(342)	538	1,611	2,218	2,982
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**239**	**1,174**	**2,247**	**2,854**	**3,618**
Total equity & liabilities	**1,490**	**1,962**	**3,186**	**4,204**	**5,435**
Liquidity (x)					
Current ratio	0.84	0.80	1.52	1.61	1.74
Interest cover	1.9	4.6	na	na	na
Leverage					
Net debt/EBITDA (x)	2.32	0.02	net cash	net cash	net cash
Net debt/equity (%)	332.1	1.3	net cash	net cash	net cash
Activity (days)					
Days receivable	1.6	1.8	1.9	1.8	1.9
Days inventory	20.7	18.9	18.5	17.8	15.2
Days payable	-	-	-	-	-
Cash cycle	22.2	20.7	20.4	19.6	17.0

Source: Nomura estimates

GSK Consumer Healthcare SKB IN

CONSUMER RELATED/FOOD & BEVERAGE | INDIA

NOMURA

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Initiation

BUY

Action

GSK Consumer is the dominant market leader, with a 70% share in the malted beverage drink market in India. With penetration levels still low for the product, we believe the long-term opportunity remains attractive. The company's focus on leveraging the Horlicks brand to build other categories will deliver diversification benefits over the next few years, in our view. We initiate with a BUY rating.

Catalysts

Increasing penetration levels for malted drinks, diversification into other food categories and option on large cash on balance sheet are potential catalysts.

Anchor themes

The processed food sector in India is one of the most attractive segments in the consumer space. The segment is currently largely focussed on urban India, where increasing income and changing demographics are helping to drive demand. Longer term, rural India presents a largely untapped market for processed foods.

Closing price on 16 Feb	Rs2,101
Price target	**Rs2,505**
Upside/downside	19.2%
Difference from consensus	4.4%
FY11F net profit (Rsmn)	3,616
Difference from consensus	-0.5%

Source: Nomura

Nomura vs consensus

Consensus is largely in line with our forecasts.

'Boost'ing the energy

① Market leader in a growing category

GSK Consumer is the market leader in the growing malted drinks market in India with a ~70% share. With industry revenue growth expected to be 18-19%, on our estimates, and GSK growing above that trend, we believe it is best placed to deliver strong earnings growth over the next two years.

② Strong earnings growth

We expect the company to deliver strong 21% earnings CAGR over CY10-12F which is significantly higher than the average for the Indian HPC companies we cover on the back of increasing penetration of its products and improving profitability.

③ Category penetration still low

Despite the Horlicks brand being in existence for over 30 years, category penetration for malted drinks as a category is still low at ~20%. We believe this is a big positive, as the category is a long way off from being saturated.

④ Diversification will be a long-term catalyst

The company is now looking to leverage its Horlicks brand to drive entry into other categories. We believe this will be a positive catalyst in the longer term, as it builds other growth drivers. GSK Consumer has already successfully launched Horlicks Foodles (instant noodles category) and Lucozade (sports drinks category) recently.

⑤ Initiate with a BUY and price target of Rs2,505

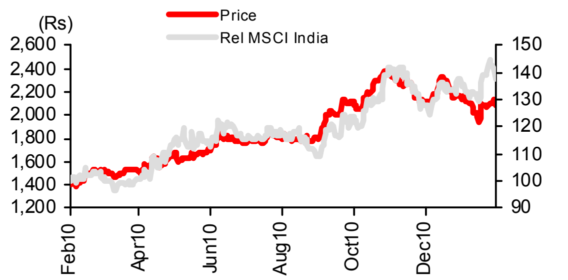
We initiate coverage with a BUY rating and a Rs2,505 price target, representing 19% upside from current levels. We believe GSK Consumer is a solid long-term play in the India consumer space.

Key financials & valuations

31 Dec (Rsmn)	FY09	FY10F	FY11F	FY12F
Revenue	19,215	23,061	28,504	34,428
Reported net profit	2,328	2,999	3,616	4,387
Normalised net profit	2,222	2,999	3,616	4,387
Normalised EPS (Rs)	52.8	71.3	86.0	104.3
Norm. EPS growth (%)	28.6	35.0	20.6	21.3
Norm. P/E (x)	39.8	29.5	24.4	20.1
EV/EBITDA (x)	22.0	18.2	14.4	11.6
Price/book (x)	9.8	8.9	8.3	7.8
Dividend yield (%)	1.0	2.4	3.3	4.2
ROE (%)	27.9	31.6	35.2	40.0
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (Rs)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(3.2)	(12.0)	15.7
Absolute (US$)	(3.5)	(12.4)	18.9
Relative to Index	0.5	(2.4)	17.0
Market cap (US$mn)			1,941
Estimated free float (%)			57.0
52-week range (Rs)			2,390/1,386
3-mth avg daily turnover (US$mn)			1.04
Stock borrowability			Hard
Major shareholders (%)			
Horlicks Ltd			43.2
LIC India			5.9

Source: Company, Nomura estimates

Dominant market leader in an underpenetrated segment

Executive summary

- Main product category underpenetrated.
- Processed foods/drinks is the one of the most attractive categories in FMCG.
- Long-term opportunity to drive penetration in rural areas.
- Valuation still inexpensive vs FMCG peers.
- Rising input costs and consumers switching into other categories are risks to our call.

Long-term value drivers for the company

- **Main product category underpenetrated**: Penetration levels remain fairly low at just about 20% in the malted beverage category, and management believes there is scope for increasing the category size over the longer term. Market penetration is more skewed to South and East India (45% penetration), while penetration in North and West India remains low (10%).

Malted beverage category is still underpenetrated, providing a long-term growth opportunity

- **Still largely urban focused**: In terms of mix, 70% of the company's sales come from urban markets, thus there is a large, unexplored rural market. The company has introduced lower-priced packs in the rural markets, which it hopes will persuade consumers to try out its products.

Largely focuses on urban markets with market share close to 70%

- **Rural markets could provide long-term upside**: GSK Consumer is aggressively looking to expand its presence in rural markets. It recently launched value Horlicks at Rs80 for a 500g pack (a discount of 50% to normal Horlicks). It has also activated various price points targeted at consumer aspirations, which it believes will fuel growth in rural markets.

Catalysts that we believe will move the stock

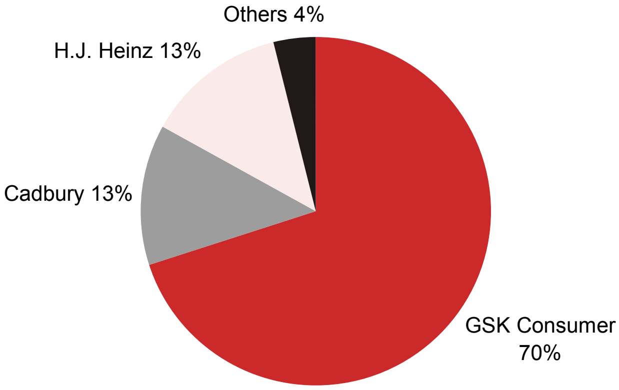
Driving higher penetration levels, success in other categories and a large dividend payout are catalysts which will drive stock price

- Success in driving penetration levels
- Innovation into other categories
- Potential large dividend payout

Malt-based drinks category dominated by GSK Consumer

The malt-based drinks category accounts for ~95% of company revenues. The total market for this category is around ~Rs23-25bn, according to GSK Consumer. The company's brands under this category include Horlicks, Boost, Viva and Moltova. These products are mixed with milk and consumed. Penetration levels remain fairly low at just about 20% in the country, and management believes there is scope for increasing the category size over the longer term. Along with GSK Consumer, other companies in the category are Cadbury, H.J. Heinz and some local players.

Exhibit 98. Malt-based drinks category value share



Source: Company data, Nomura research

Valuation methodology

We initiate coverage with a Buy rating and TP of Rs. 2,505 potential upside of 19%

We have used a sum-of-the-parts methodology to value GSK Consumer. Our valuation is based on a P/E multiple of 25x on the core business. The core business net income excludes interest income. We have valued the cash on the balance sheet at book value. Based on this valuation methodology, we arrive at our target price of Rs2,505. The detailed breakdown is as below.

- We value the core business at 25x CY12F earnings excluding the interest earned from investments. We estimate core EPS of Rs76.9 in CY11and Rs94.3 in CY12. This gives us core business per share value of Rs2,325.
- The company also had cash of Rs8.4bn as at December 2009, which we estimate will rise to Rs8.6bn in CY10F. This gives us per share value of Rs180.
- Our cumulative target price thus adds up to Rs2,505, which represents ~19% potential upside from current levels.

Target multiple in line with consumer average

Our target multiple for GSK Consumer is based on 25x CY12F core earnings. GSK Consumer has over the past seven years traded at 15.6x one-year forward P/E, but this does not take into account the P/E re-rating that the stock has seen over the past couple of years, which reflects the improved operational metrics of the company and its renewed focus on innovation.

Working capital metrics have seen a strong improvement, and we believe this is likely to continue for the medium term. This has led to a P/E re-rating towards the wider consumer average. One of the reasons the company historically traded at a discount to the wider consumer sector was its over-reliance on just one category for a large majority of its revenues and profits. Malted drinks (Horlicks, Boost, Moltova and Viva brands) contributed close to 96% of sales in CY06. We estimate this will come down closer to 91% by CY13F as other categories become meaningfully large.

On a PEG basis, the company still trades at a discount to peers. With the company expected to post 21% profit growth over the next couple of years, on our estimates, GSK Consumer offers one of the most attractive growth profiles among consumer companies in India. The P/E re-rating reflects this improved growth potential and we believe the stock will now trade higher than its consumer peers' long-term average of 24-25x one-year-forward earnings (on Nomura estimates).

Risks to our investment view

Consumer switching out of malt-based drinks

Rising input costs and a slower-than-expected increase in penetration levels for the category are risks to our view

One risk to our price target is that consumers move out of malt-based drinks category into other categories. However, we see little risk of that happening with the category still underpenetrated and brands across the market having strong brand equity. The recent exit of Nestle India's brand Milo from the category points to strong entry barriers, with new players finding it difficult to dislodge existing incumbents.

Rising input costs

The main input costs for the company are milk powder, liquid milk, malt and malt extract, and wheat. Milk prices have been stable over the past few months, and with government initiatives to encourage an increase in milk production, we believe increased supply will continue to keep a tab on milk prices. GSK Consumer has long-term contracts with suppliers and the ability to source large amounts, which gives it some bargaining power in terms of input costs.

Financial analysis

Revenue drivers in place

- Price/mix benefits to drive revenue growth ahead of volume growth, in our view.
- Diversification into newer categories could yield benefits over the longer term.
- Margin is likely to trend higher as the company benefits from operating leverage, cost savings and mix improvement.
- Balance sheet supportive for acquisitions or increased shareholder returns.

Volumes growth in line with industry, but price/mix better

Longer term volumes should grow inline with industry with price/mix slightly better

GSK Consumer operates in some fast-growing categories such as malt-based drinks and instant noodles. Volume growth in these categories is expected to be strong over the next couple of years, and we think this should help GSK deliver solid volume growth in the medium term (over the next 5-10 years).

In malt-based drinks, GSK is by far the largest player in the industry, with a market share of 70%, almost 3x the share of its nearest competitor, Cadbury India (unlisted). The company's efforts have been focused primarily around helping the category grow.

Even though the company commands a lion's share in the category and incremental market share gains may be difficult, we believe given the significant under-penetration of malt-based drinks in large parts of the country, average volume growth of ~11% should be readily achievable over the near to medium term.

In addition, we have also built a price increase/mix improvement of 4-5% into our model. We believe this should help the company deliver value growth of 18% over the next couple of years in the category.

In instant noodles, we estimate volume growth to be ahead of the industry at 25-30% with price/mix of ~6-7% over the next couple of years. This has been one new product which has met with success, and we view it as a likely future growth driver for GSK.

Overall, we expect company to deliver a revenue CAGR of 21% over FY10-12F. We are not building in upside from any other product launches over the next few years. For instance, Lucozade sports drink has already been launched, and we expect the brand to gain traction, but we have not incorporated it into our forecasts.

Exhibit 99. Sales breakdown

Sales breakdown	CY08	CY09	CY10	CY11F	CY12F
Malt-based food					
Volume growth (%)	16.2	10.0	11.0	11.0	11.0
Value growth (%)	21.8	17.9	18.8	22.1	19.9
As % of total sales	96.0	95.0	93.4	92.9	92.2
Biscuits					
Volume growth (%)	21.8	31.9	25.0	22.0	20.0
Value growth (%)	24.2	28.0	30.0	28.1	26.0
As % of total sales	3.5	3.8	4.1	4.3	4.5
Nutrition Bar					
Volume growth (%)			50	50	50
Value growth (%)			57.5	62.0	62.0
As % of total sales		0.1	0.1	0.1	0.1
Instant Noodles					
Volume growth (%)			2000	30	30
Value growth (%)			2105	38	39
As % of total sales		0.05	0.04	0.03	0.03

Source: Company data, Nomura research

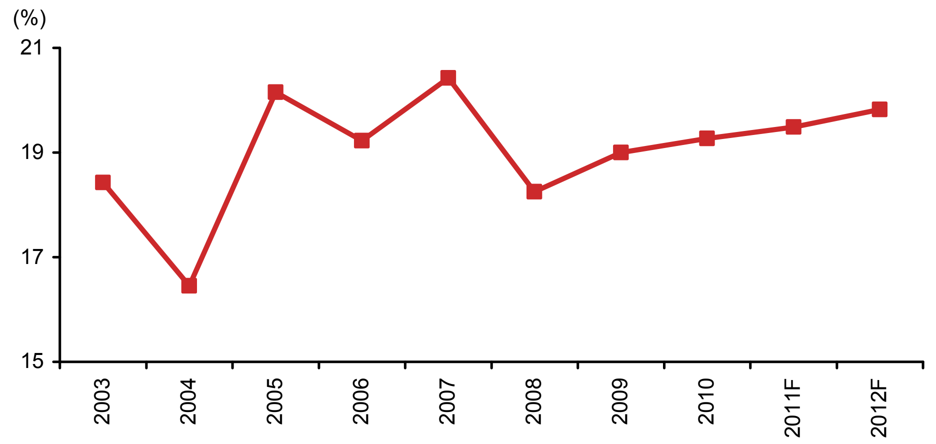
Margin performance expected to benefit from better price/mix

GSK Consumer reported EBITDA margins of 19.3% in CY10, which was up 30bps compared with CY09. Going into CY11F, we expect operating margins to improve, by 40bps to 19.7%. While we do acknowledge that rising milk and barley prices are likely to put pressure on margins, we believe aggressive pricing action (5% price hike in the past three months) should help alleviate some of the margin pressure.

Margin improvement trend to be sustained on account of price and mix benefits

We believe with the GSK Consumer's brand equity having become stronger over the past five years, the company can now make more price increases than in the past.

Exhibit 100. Margin uptrend likely to be sustained



Source: Company data, Nomura research

Balance sheet strong, provides optionality on cash

The company has historically had a strong balance sheet. However, since 2007, it has made various changes in its operating environment, particularly on working capital. For instance, debtor days, which were close to 21 in 2002 have now moved to 6. Working capital days have moved from 9 in 2008 to -30 in 2009.

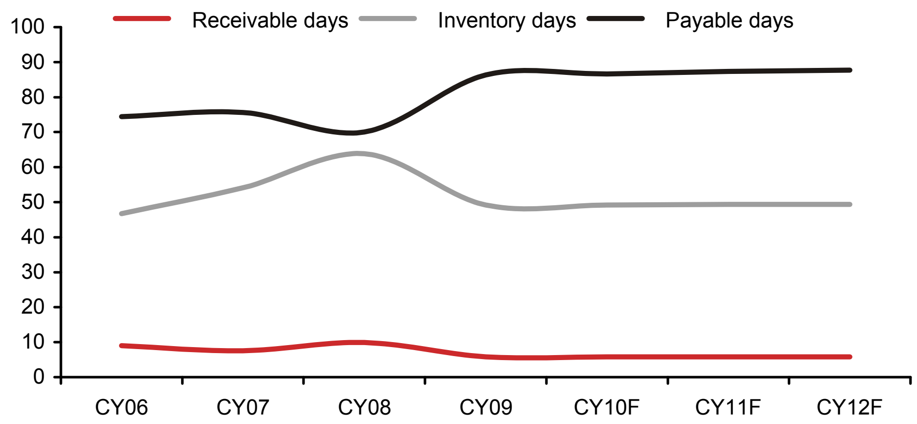
Company has a strong balance sheet which gives optionality on use of cash for larger dividend payout or acquisitions

These moves have resulted in significant improvement in the company's working capital requirements, which have meant that cash balance on the books rose from Rs937mn in CY07 to Rs8.2bn in CY10. Although we expect the increase from these levels to be more moderate in future, we still expect the company's cash balance to rise in the absence of a large dividend payout.

GSK Consumer management has stated that it does not plan on giving out a special dividend, but is continually looking at ways to deploy the cash. We believe, however, that some part of this will be given out as a special dividend, but the timeline on this is unclear to us.

The company has incurred a large amount of capex this year (Rs1.2bn) to set up a plant to increase its manufacturing capacity to meet increased demand over the next few years. We believe capex will revert to the long-term average of Rs250-300mn over the next few years. However, we believe that the company's plans to branch out into other categories as well as to leverage Horlicks brand further will require some additional investment.

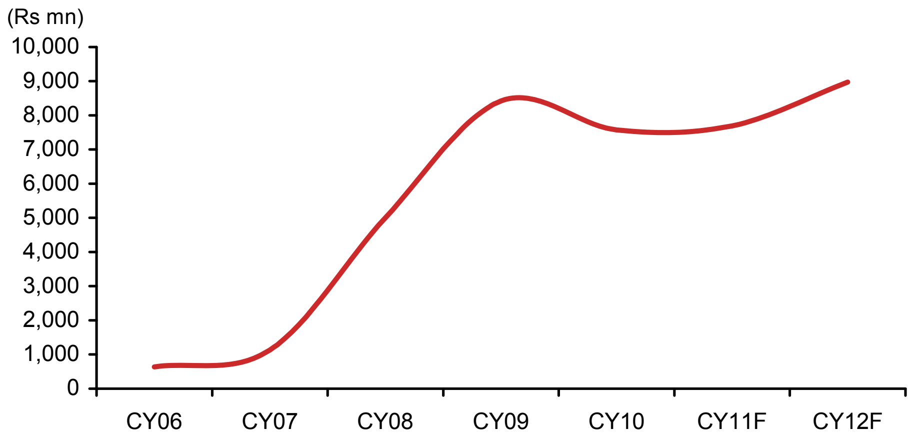
Exhibit 101. Improving working capital



Source: Company data, Nomura research

This focus on working capital has resulted in a significantly improved balance sheet, with cash on the books going up from Rs937mn in FY07 to Rs8.2bn in FY09. We estimate this will rise to Rs8.7bn in FY12F.

Exhibit 102. Cash on the balance sheet (year-end) in Rs mn



Source: Company data, Nomura research

Capex plans executed as planned

The company invested ~Rs1.2bn in CY10 on capex in order to set up a new factory to augment its production capabilities. We believe this will be a long-term positive, as the company should consequently have enough capacity to meet the steady growth in demand over the next few years.

Company to remain in the full tax bracket

GSK Consumer has been in the full tax bracket. We estimate tax rates will be ~33% over the next few years.

Strong 21% net profit CAGR expected over CY10-CY12F

We expect company to deliver 21% net income growth over the next two years. This will be led by strong revenue growth (we estimate an average of 22% over the next two years) and operating margin profile (we estimate an average of 19.8% over the next two years). The company also offers the added incentive of a potentially large cash dividend payout over and above the 30% growth in dividends we have modelled for the next couple of years.

Valuation

Valuation reasonable on PEG basis

- We use a sum-of-the-parts price target methodology, based on a 25x multiple for the core business and cash valued at book value.
- Increasing penetration of the products and a potential large dividend payout could be catalysts for the share price. Additionally, the success of newer products, particularly Noodles, could be an additional catalyst.
- Competition remains strong from Heinz and Cadbury, but GSK continues to hold its share.

Target price methodology

We have used a sum-of-the-parts valuation for GSK Consumer.

- We value the core business on a P/E multiple of 25x CY12F core earnings (excluding the non-operating other income). For CY12F, we estimate core net income of Rs3.9bn and value the core business at a 7% discount to the multiple assigned to Nestle. This gives us a core business per share value of Rs2,325.
- Company also has cash of Rs7.5bn as at December 2010. We value the cash at book value as at CY10. This gives us per share value of Rs180.
- Our cumulative target price thus adds up to Rs2,505, which represents ~19% upside potential from current levels.

Stock re-rating likely to continue

Our target multiple for GSK Consumer is based on a P/E multiple of 25x one-year-forward earnings. GSK Consumer has historically traded at average 15.5x one-year-forward P/E, but this does not take into account the P/E re-rating that the stock has seen over the past couple of years, which reflects the improved operational metrics of the company and renewed focus on innovation.

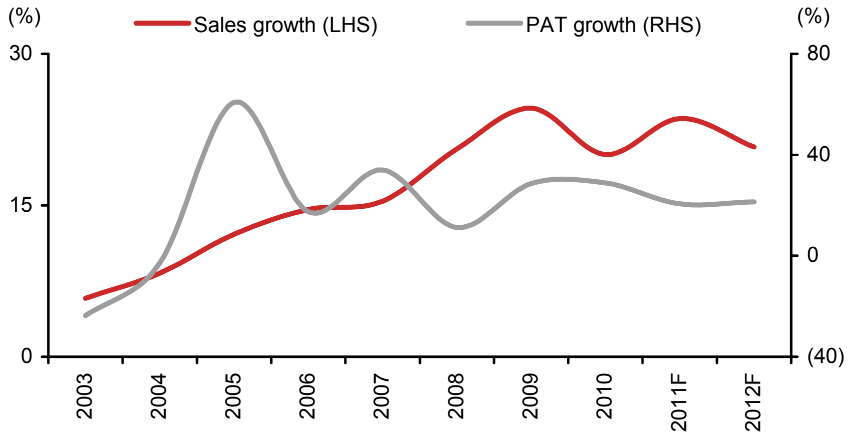
We believe that our assigned multiple is fair, largely on account of the following:

- **Accelerated growth trajectory likely to sustain**: GSK's growth has seen a strong upturn over the past few years, as the market for malted beverages has taken off, especially in urban markets. With GSK the market leader in the segment, a significant part of market development has been led by the company, and this has, in turn, also resulted in the company benefiting the most from the market's growth.

  For instance, average realization was less than 2% during the period from CY03 to CY06. Volume growth also averaged 7% during this period. This led to investors looking at this stock as more of a commodity play with high single-digit volume growth and low single-digit pricing gains.

  However, since CY07, volume growth has consistently averaged more than 10%, with realisations also moving up to ~6%. We believe this is on the back of greater acceptance of the company's products, and hence reduced elasticity of product volumes vs pricing.

Exhibit 103. Revenue and PAT growth trending up strongly



Source: Company, Nomura research

- **Increased focus on innovation and portfolio diversification**: GSK Consumer has over the past few years aggressively grown its biscuits and instant noodles businesses. This was done with the specific aim of 'de-risking' the business model from the malted beverage category. The company has not only been able to establish these businesses, but has also grown them aggressively and has become a serious competitor in these segments. For instance, in the noodles segment, GSK Consumer now has close to 3% share of the Indian market. Additionally, the company's focus on innovation means that new products should account for 25% of incremental sales over the next couple of years, according to the company. Recently the company has also said that it plans to leverage its Horlicks brand for its foray into other categories such as breakfast cereals and mid-day meals. In addition, the company recently launched the Lucozade sports drinks line, which should add to the attractiveness of the longer-term business model. This, we believe, is likely to keep the trading multiple closer to the consumer average.
- Working capital metrics have seen a strong improvement that are likely to continue in the medium term. This has been one of the reasons for the P/E multiple re-rating, in our view.

On a PEG basis, the company still trades at a discount to its peers. With the company expected, by our estimates, to post 21% profit growth over the next couple of years, GSK Consumer offers one of the best growth profiles among consumer companies in India. The P/E re-rating reflects this improved growth potential, and we believe stock will now trade marginally higher than the consumer peers' long-term average of 24-25x one-year-forward earnings.

Exhibit 104. FMCG PEG valuation

Company	Ticker	Rating	Price Rs.	FY12F P/E (x)	FY12F PEG (x)
Asian Paints	APNT IN	BUY	2,550	23.0	1.2
Colgate Palmolive	CLGT IN	REDUCE	828	22.8	3.3
Dabur	DABUR IN	BUY	97	21.8	1.0
Godrej Consumer	GCPL IN	NEUTRAL	364	19.1	0.5
Hindustan Unilever	HUVR IN	REDUCE	276	24.6	3.0
ITC	ITC IN	BUY	157	21.0	1.3
Marico	MRCO IN	REDUCE	125	22.9	1.3
United Spirits	UNSP IN	BUY	1,184	19.4	0.3
Titan Industries	TTAN IN	REDUCE	3,257	34.3	1.1
Nestle *	NEST IN	NEUTRAL	3,391	31.4	1.4
Pantaloon Retail	PF IN	BUY	278	12.1	0.3
Jubilant Foodworks	JUBI IN	BUY	499	34.3	0.5
GSK Consumer *	SKB IN	BUY	2,101	24.4	0.8
Average				**23.5**	**1.2**

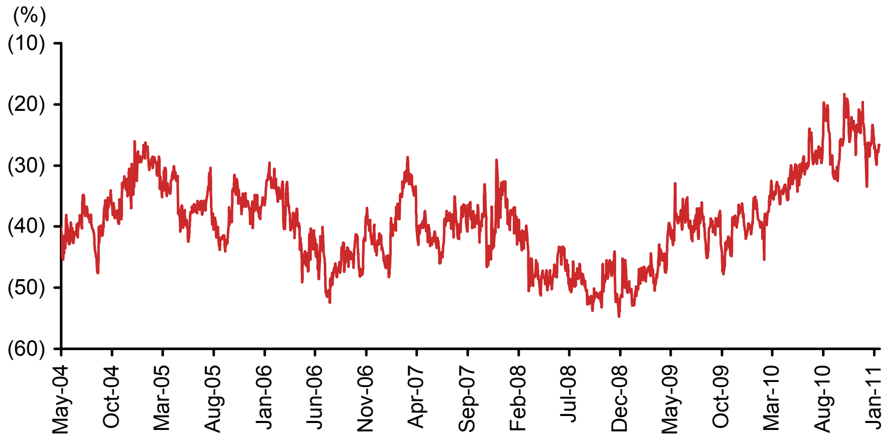
Pricing as of 16 Feb 2011
Source: Bloomberg, Nomura research

Trading at a fair discount to Nestle

If we look at the trading multiple at which GSK trades and compare it with that of Nestle, we see that GSK is trading at a significant 27% discount. While the stock has historically traded at a discount to Nestle, we believe there is a case for that discount vs. Nestle to narrow over the next few years.

This has already partly happened, with the discount to Nestle narrowing from 50% at the start of 2009 to 27% currently. However, we expect the discount to narrow gradually even more as the company executes on its stated objectives.

Exhibit 105. GSK Consumer discount to Nestle



Source: Bloomberg, Nomura research

Conclusion

We believe GSK Consumer is one of the most attractive stories across the FMCG space in India. Its market leadership position in the underpenetrated malted beverage space, forays into the fast-growing biscuits and instant noodles spaces and exposure to niche categories such as sports drinks make it one the most attractive stories to own across the FMCG space in India, in our view. We initiate coverage with a BUY rating and a price target of Rs2,505, representing potential upside of 19% from current levels.

Where could we go wrong?

Risks to our view

We believe GSK Consumer is well positioned to deliver strong earnings growth over the next two years. However, risks to our view and the achievement of our price target come from rising input costs and category penetration growing slower than our expectations.

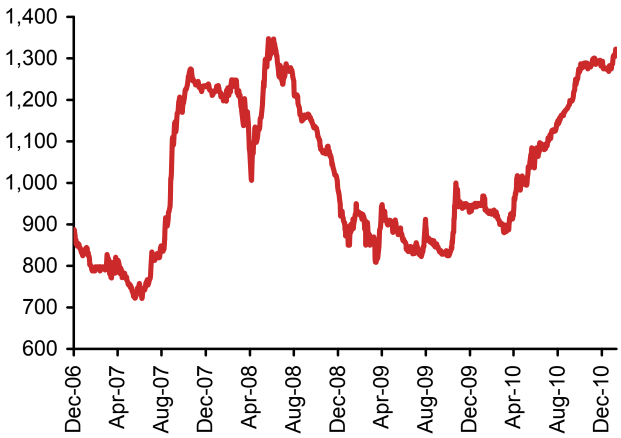
Rising input prices, lower than expected increase in penetration levels present risks to our estimates

Rising input prices

Going into the next few quarters, one of the challenges that the company faces is rising commodity costs. Prices for some of its principal inputs such as milk (accounting for ~40% of the input cost basket) and barley (accounting for ~35 of the input cost basket) have risen steadily over the past 12 months. While barley prices have risen by an average 24% in CY10, milk prices have firmed up 25% during the same period.

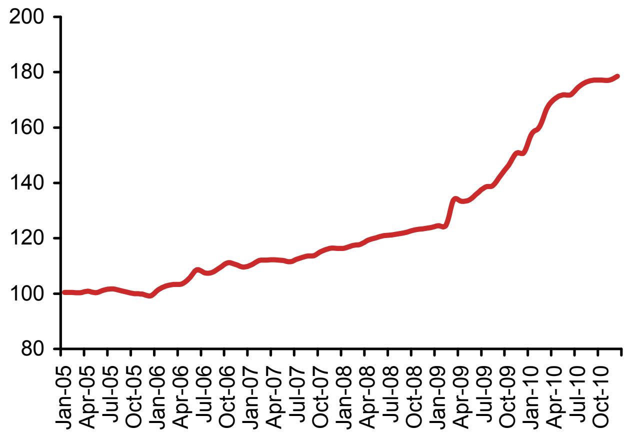
Our analysis shows that for every 1% increase in milk price, profit declines 0.3%, all else remaining constant. Furthermore, for every 1% increase in the price of barley, profits declines 0.4%, all else remaining constant.

Exhibit 106. Domestic barley price



Source: Bloomberg, Nomura research

Exhibit 107. Wholesale milk price index



Source: Business Beacon, Nomura research

High category penetration in key regions

Category penetration levels have steadily increased as more consumers are able to afford the company's products. This is particularly true for the southern and eastern parts of the country, which account for >80% of revenue. Remember, these regions are typically milk-deficient states, which is one of the main reasons for the popularity of malt-based drinks. The northern and western parts of India still have very low penetration and are traditionally the milk-rich belts.

However, penetration levels are still low even in urban India. We are building in a 15% revenue growth trajectory over the next couple of years based on our expectations of increasing penetration and strong volume growth, as demand continues to be strong.

Industry growth prospects strong; GSK Consumer is the dominant market leader

Malt-based drinks to remain the mainstay

Malt based drinks segment to account for majority of revenues

Malt-based drink additives are products which are added into hot or cold milk, to enhance the nutritional value as well as taste of milk.

One of the long-standing concerns on GSK has been that it's largely a single product company, with malt-based drinks accounting for more than 90% of its consolidated revenues. While the company has been addressing this concern by proactively diversifying into many new categories, we believe that going into the next few years, malt-based drinks (Horlicks, in particular) will continue to account for the lion's share of GSK Consumer's revenues. In fact, the company itself has set a target of bringing down its dependence on malt-based drinks to 80% over the next few years, which could be a stiff challenge in our view.

We have also looked at how company P&L may look in FY20F.

We expect malt-based foods to grow at a value CAGR of ~11%, biscuits to grow 20-21%, instant noodles to grow 23-25% from a relatively lower base and nutrition bars to growth at 25%.

Our calculations show that even after fairly robust growth in all the new categories, malt-based drinks would still account for ~85% of revenues.

Exhibit 108. Malt-based segment will continue to be big

(%)	CY05	CY10F	CY15F	CY20F
Malt-based food	94.9	93.4	90.2	84.7
Biscuits	4.2	4.1	5.4	8.6
Instant Noodles	0.0	1.4	2.7	4.1
Nutrition Bar	0.0	0.7	1.7	2.4

Source: Company data, Nomura research

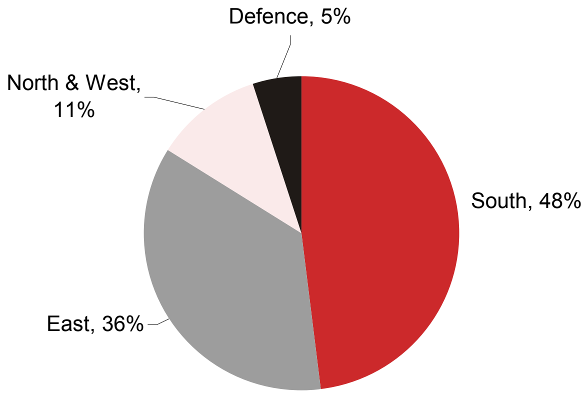
While the company continues to focus on reducing its dependence on malt-based drinks over the medium term, we believe this will be a gradual process. There are two reasons for this.

- First, given the size of the malt-based drinks segment for the company, for new categories to become meaningful in size would take a significant amount of time, even if the company grows faster than the segment (eg noodles, biscuits).
- Second, the market for malt-based drinks is itself underpenetrated, with North and West India still offering significant headroom for the company to grow. Even in South and East India, where penetration levels are higher, GSK Consumer continues to focus on increasing the consumption level. This means, in our view, the malt-based drinks segment itself should continue to grow over the medium term.

Penetration uneven across the country, significant opportunity

The company's sales mix for malt-based drinks is spread unevenly across the country, with South India the dominant region, contributing ~50% of total sales in CY10, according to the company. East India is also a sizeable contributor at 37% of sales.

Exhibit 109. Revenue breakdown, by region



Source: Company, Nomura Research

This intuitively suggests that penetration levels in North and West India are below the pan-India penetration level, and far below the penetration levels in South and East India. This is a fact that has been corroborated by the company, although they have not provided specific numbers.

We believe this difference in geographic penetration levels is largely on account of the following two reasons:

- Culturally, North and West India are milk strong regions where supply is not constrained. Thus, habitually people are milk drinkers and have never felt the need to use the aid of an additive.
- Also, South and East India have traditionally felt the need to use milk additives to enrich the nutrient content in milk which has been of poorer quality in these markets.

Thus, we believe there is a significant market in North and West India the company can tap over the next few years. The market potential also depends on availability of milk and milk products in the region, as well as consumption habits of the consumer in these regions.

We do acknowledge that driving penetration levels in these milk-strong markets could be difficult, as it entails changing consumer preferences. However, the company has mentioned in the past about the “2/10 and 4/12 matrix” which it feels will drive penetration and consumption over the next few years. Simplified, the strategy is:

2 out of 10 customers buy Horlicks and consume it in 4 out of 12 months.

This is the near- to medium-term target for the company and also its stage-I strategy of driving penetration and usage levels higher over the longer term.

Consolidated market – core brand Horlicks has no competition

GSK Consumer has a dominant 70% share in the malted beverage market, and competition is not very strong, with the closest competitor, Cadbury India, only having 20% share. Additionally Cadbury India has also been actively pursuing the ‘chocolate flavour’ market, where it competes with GSK’s Boost brand. However, the core Horlicks brand in its standard flavour has no real competition in the marketplace. This gives company the opportunity to drive its advantage home and increase share.

The results of GSK Consumer’s advantage was reflected when Nestlé’s brand Milo exited the market in 2009. The chocolate-based malt drink Milo had ~7% share when it decided to exit. This market share was split between Cadbury’s Bournvita and GSK Consumer’s Boost.

This meant that market share was consolidated, with the top two players gaining further ground over the rest.

Exhibit 110. Malted beverages value market share

(%)	2005	2006	2007	2008	2009
GSK Consumer	70.0	70.6	70.6	70.2	70.2
Cadbury India	16.1	16.0	15.9	15.9	20.8
Nestle India	5.9	6.4	6.4	6.9	1.0
Others	8.0	7.0	7.0	7.0	8.0
Total	**100**	**100**	**100**	**100**	**100**

Source: Company data, Nomura research

Smaller packs to drive growth

GSK Consumer has also undertaken other initiatives in order to make the malted beverage product more relevant in semi-urban and rural areas. It has launched its products in smaller SKUs, which makes it more affordable for consumers. With rising consumer incomes in the rural areas helped by increasing wages and other government initiatives, we believe the rural consumer is one of the most important segments for FMCG companies. Smaller SKUs helps to introduce these consumers to the product (acquire new consumers) and make it more affordable for the consumer to try the product (increase consumption). The success of smaller SKUs in other categories such as chocolates, shampoo and soaps in the past makes us confident that this will also lead to success in the malt-based drinks segment.

Recent diversification successful

The company has used Horlicks' strong brand equity with consumers to branch out into different categories under the same umbrella brand. Brand extensions such as Junior Horlicks (for kids), Women Horlicks (for mothers) and Horlicks lite in the malted beverage space have all been successful. The core Horlicks brand is now worth Rs13bn. However, if we add the value of the other Horlicks brand extensions which are in themselves worth more than Rs3bn, then we have a brand worth Rs16bn, on our estimates.

We believe this strategy of driving new consumers into the category by targeting specific sets of consumers has yielded very good results. While the company continues to benefit from the growth in the core Horlicks brand, this strategy will help it to also develop extensions that will be worth a significant amount over the next few years, in our view.

Exhibit 111. Horlicks brand extensions sizeable

Brand	Rs mn
Horlicks Core Brand	13,000
Women's Horlicks	250
Junior Horlicks	2,000
Horlicks Lite	400
Mother's Horlicks	400

Source: Company, Nomura Research

Conclusion: what growth are we building into our numbers?

For the malt-based food segment, we are building in 11% volume growth in the segment over the next couple of years. The company has delivered an average of 12% volume growth over the past three years, and our estimates assume a marginal slowdown over the next couple of years.

In terms of realization, company has achieved pricing of 6% over the past three years. GSK Consumers' products have high brand equity and lack any credible competition, and hence in an inflationary scenario, the company has found it reasonably easy to pass on additional costs to consumers. Volume growth has continued to be strong, which signifies low price elasticity of demand, unlike other consumer products. We are building in average pricing growth of 8% pa over the next couple of years. Our assumptions work out to average revenue growth 21% pa over the next couple of years.

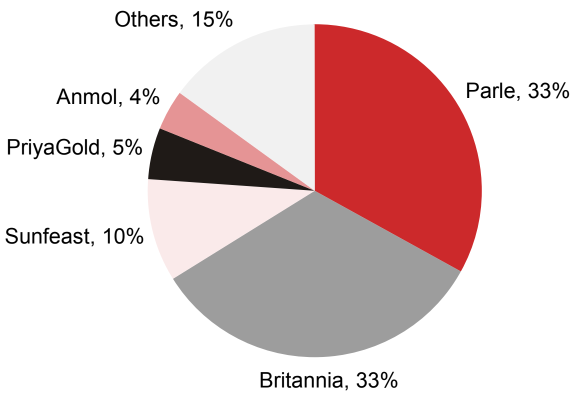
Biscuits a strong pillar of growth

Biscuits are the second-largest category for the company, contributing Rs771mn, or 3.8% to revenues in CY09. This category is also one of the fastest-growing segments, clearly growing well above the industry growth rate for biscuits over the last couple of years. We expect the category to continue to maintain a growth trajectory of 25%+ over the next couple of years, driven primarily by new product introductions. This strong growth over the next few years will mean contribution from biscuits category could reach ~5% by CY13F, by our estimates. We also expect profitability in the segment to improve as contributions from the cookies and creams categories increase over the next few years.

GSK's still a marginal player…

The total biscuits segment in Indian is worth Rs123bn (source: Biscuit Manufacturers Association of India) and GSK Consumer has less than 1% share in this market. Britannia and Parle each have cornered a third of the market, with ITC having a ~10% share. GSK Consumer's brand Horlicks operates in the glucose category, although the company plans to launch other categories of biscuits and reduce the share of glucose over time. Margins for glucose biscuits are significantly lower than for the other categories.

Exhibit 112. Biscuits market share



Source: Industry, Nomura research

…a lot of headroom to grow share

We believe GSK Consumer's brands are well positioned with consumers (particularly Horlicks) and it has the opportunity to grow revenues well above the industry growth rate. This will be helped by the following, in our view:

- First, company has over the past couple of years become fairly aggressive in launching new products and targeting newer segments. GSK has launched a number of new products in the category such as Horlicks Lite, Horlicks Cream and Horlicks Cookies over the past three years.

- Second, the market is dominated by two players, Britannia and Parle – both of which have a third of the market. With competition increasing from smaller players, we expect the industry picture to look more fragmented over the next five years, although the larger players should continue to grow. This is an attractive opportunity for Horlicks to capture some incremental share away from the leaders.
- Third, some of the players in the market with 4-5% share, such as Anmol and Priyagold, do not have a national presence or a brand big enough to rival Horlicks. The company's renewed focus on the category will mean that these brands could potentially lose share to Horlicks over the next few years.

Increased focus already yielding results

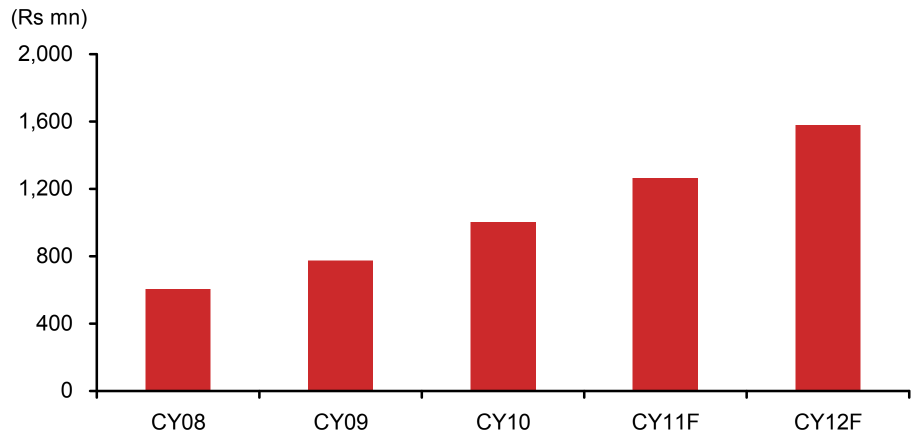
Since CY08, as the company increased its focus on the biscuits segment, growth momentum has picked up significantly, with the company growing its biscuits division in terms of value well ahead of the industry. GSK Consumer has realized the importance of growing its biscuits segment, which, in our view, provides two benefits

- Presence in an attractive category
- 'De-risking' of the business model away from the malted beverage segment.

The company's growth trajectory has moved significantly higher from the 13% (CY04-06) range to 25% (CY08-10F).

We expect this momentum to continue over the next few years, as company now has established brands in various segments of the market.

Exhibit 113. Biscuits segment momentum strong



Source: Company data, Nomura research

… and entry into cookies segment will be further positive

The company entered the cookies market in India in 2H10. This is the fastest-growing sub segment within the biscuits segment in India. The total market for premium cookies is estimated by the company at Rs7.5bn, or 7% of the overall biscuits market. Competitors are Unibic India, Britannia and Parle. Competition is getting stronger in this segment with the entry of other players such as ITC into the segment. However, despite the strong competition in the segment, it is also a very attractive opportunity, with an industry sales growth rate of 20%, ahead of the growth for the overall biscuits segment.

Medium-term growth ahead of industry

These initiatives from the company will mean a medium-term growth rate ahead of the industry in the biscuits segment, in our view. We estimate that over the medium term, the company can grow its biscuits segment by over 20% annually in volume terms, which is ahead of the industry. We believe this will translate into the company gaining a substantial incremental share of the growing biscuits market over the next few years.

Horlicks has two decades of experience in the industry

Horlicks biscuits were first launched in 1992. GSK Consumer has been in the biscuits business for a large part of the past two decades. The company has seen the industry move through various phases, and the Horlicks brand has survived those periods and still is one of the most recognisable brands in India.

Early part of the decade marked by industry slowdown…

The biscuits category saw robust growth for most of 1990s as the company's Horlicks brand connected with consumers across the country. However, from the turn of the millennium, until 2004, the biscuits segment saw a turbulent period. This was partly an industry-wide issue, as annual growth for the industry declined 3.5% in 2000-01, mainly due to a 100% hike in the Central Excise Duty (from 9% to 16%). Industry production numbers also took a hit, and with rainfall less than average in 2002-03, FMCG sector growth slowed to the low single digits. Biscuits as a category were also hit hard during this time, with the company's volumes down 15% y-y in CY02 and flat in CY03.

… and company-specific issues

In addition to industry wide issues in the early part of the decade, there were certain company-specific issues that also led to growth being modest. Some of those were:

Company's product mix was less robust

One reason for the relatively unsuccessful period in the early part of the decade was the company's product mix. The biscuits category only consisted of the Horlicks brand in Standard and Elaichi flavours. This meant that while the product offerings across the segment went up with competitors launching various products in other segments such as creams and cookies, GSK Consumer still only had the basic Horlicks biscuit brand with which to compete. This led to the company's biscuits business growing much slower than its competitors.

Concentration in less profitable segment

Horlicks brand was present in the glucose segment of the market, which was dominated by two of the other big players, Britannia and Parle. The typical product (100gm) was sold for Rs4, and with raw material prices on the rise and the need for investment behind A&P to grow the market and the brand, segment profitability took a hit.

Competitors realized that they needed to improve the product mix in the segment to improve profitability. This led to a slew of product launches in the creams, cookies and other more profitable segments across the industry. Since GSK Consumer did not adopt this strategy and enter these other segments, its profitability also took a hit, which meant less funds available to support the base Horlicks brand.

Increased competition

Biscuit industry competition also increased significantly, as existing players launched products across various sub segments and new players such as ITC entered the market. This led to an increase in A&P spending across the sector, putting profitability under pressure, particularly in the basic glucose segment.

Robust recovery

The industry took a few years to recover from this and it is only since 2004 that a robust recovery set in. From 2004 to 2006, the company saw robust growth in the biscuits segment, with volume growth averaging more than 13% pa. This was a phase of high growth for the industry, as well. However, it wasn't until CY08 that the biscuits segment really took off for the company.

What are we building in for CY11F and CY12F

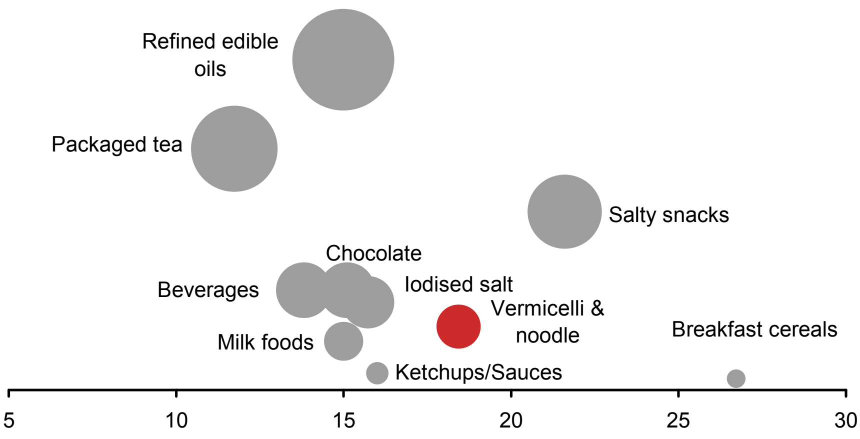
We believe the company will be able to grow above the market growth rate over the next few years, and are building in average volume growth of 20% and realisation of 5% each year. This does not take into consideration any upside from entry into the cookies segment, where profitability is higher and the market is growing faster than the overall biscuits category.

Instant noodles has had instant success

Instant noodles – another attractive category

Instant noodles are one of the most attractive and fastest-growing category in India's FMCG space over the past few years. The total noodles category is worth ~Rs17bn, of which instant noodles is ~70%, or Rs11.9bn (source: AC Nielsen). The instant noodles segment has been growing at an18% CAGR over the past five years. Even in terms of size of the segment, instant noodles are one of the largest segments across the food space in India.

Exhibit 114. Noodles: a fastest growing category in food space



Source: AC Nielsen data, Nomura research

Consumer acceptance is key in food segment

We believe consumer acceptance is the determinant of success in the food segment. The instant noodles category was launched in India in 1982-83 by Nestlé under the Maggi brand. Over the past three decades, the category has seen consumer acceptance grow across the country. From first being a product largely only relevant in urban India, it has now found acceptance even among rural consumers. Nestle first launched its original '2 minute Maggi noodles,' and since then there have been various innovations that have made the product more relevant to a larger audience both in the urban and consumer markets. This is a significant advantage to new entrants in the market, as consumers are well educated about the product and have an acceptance of it as well as the value proposition it presents.

Attractive market with a dominant market leader

The instant noodles market in India is dominated by Nestle's Maggi brand, which has more than 70% share. The market is growing at more than 18-20% and this makes it an attractive opportunity. However market continues to be dominated by Nestlé's Maggi brand and the opportunity for newer players to grow share is attractive.

This opportunity has attracted several new players into the market recently. ITC (Sunfeast brand), Hindustan Unilever (Knorr Soupy Noodles) and GSK Consumer (Foodles) have all entered the market in the past year or so. Adding to the mix are the private-label brands of major retailers such as Pantaloon, Aditya Birla Retail and Tata Star Bazaar, making the market quite crowded.

Exhibit 115. Instant noodles landscape in India

Company	Brand	% share	Year of launch
Nestle India	Maggi	70	1983
Nissin Foods	Top Ramen	11	1991
Hindustan Unilever	Knorr Soupy Noodles	4	2010
GSK Consumer	Horlicks Foodles	3	2010
Capital Foods	Smith & Jones	3	
ITC	Sunfeast	4	2010
Organised Retail	Private Labels	3	2008-2010

Source: Company data, Nomura research

Healthy variants launched across the board

The new competitors also realised that to make a meaningful dent in the market and challenge the market leader, they needed to come up with products which offered consumers a different proposition. This led to the new launches being positioned as a niche category within the instant noodles space. For instance, Hindustan Unilever launched its noodles which combines with soup (Soupy Noodles), GSK Consumer launched its noodles with minerals mixed in (Foodles), and Nestle itself launched variants of the Maggi brand such as 'atta noodles' made from wheat, and multigrain noodles made from a combination of various grains. The one common feature across most of the recent launches is that they have all been launched on the health platform. We believe this segment will grow much faster than the plain noodles segment in a few years' time.

Instant noodles has had instant success

GSK Consumer entered the instant noodles segment in India at the end of CY09. The company launched its product under the Horlicks umbrella brand and called it 'Foodles' – a healthy variety of noodles. This has met with instant success, with the company able to garner revenues of Rs280m in the first nine months of operations. This translates to ~3% market share within the first year of launch on a pan India basis. We believe this will continue to be a strong growth pillar for the company as instant noodles as a category continues to grow. The opportunity to grow market share is still largely ahead, and with Horlicks' strong brand equity, we believe GSK Consumer's instant noodles business will continue to grow at an above-market rate in the medium term.

What are we building in

For the instant noodles category, which is growing at 20% per year in sales terms over the past two years, according to the company, we expect the company to outgrow the market from a low base. We are building in 30% volume growth and for price/mix to grow by ~6-7% over CY11-13F. We believe this is realistic, as the company's successful launch in CY10 demonstrates consumer acceptance of the product.

New launches to improve growth

The company has over the past year been very active in launching new products, with a view to grow the business at a fast clip. We believe these new launches will enable GSK Consumer to supplement its fast growth in the malted beverage space over the medium term.

Horlicks Asha still in test marketing phase

The company launched Horlicks Asha – a low-priced variant of the base Horlicks brand — in CY2010. It is still in the test marketing phase in some rural areas in India, and if the results are satisfactory, the company plans to roll it our nationally over the next year. Asha is priced at Rs85 for a 500-gram pouch pack, at a significant 37% discount to a Horlicks pack of similar size. There is also a 200-gram pack that costs Rs50. The company has taken up this initiative to make the Horlicks brand more accessible to consumers in rural areas. We believe with rural incomes continuing to rise, and aspiration levels rising as well, smaller SKUs or lower-priced variants of successful brands can be very successful. We would cite the example of Dairy Milk shots, a smaller variant of Dairy Milk chocolate from Cadbury India, which has been a great success in the rural areas since its launch.

Launch of products in niche categories

The company has over the past year launched a number of products in niche categories such as health supplements, nutrition bars and sports drinks. These categories are very small currently in India, but are established and quickly growing categories in developed markets elsewhere.

We believe there is a growing market for these products in major cities in India, and company stands to benefit from having the first-mover advantage in these segments, in our view. Competitive intensity in these segments is relatively lower, and as these categories get bigger over the next few years, the company has an opportunity to establish a strong presence. Remember, margins for these products are also relatively higher, which should help the company improve profitability.

GSK Consumer launched the Nutribar cereal bar in February 2009 as a product that offers nutrition and convenience to the urban consumer. Although the category is small, it is growing strongly, and the company expects to take a significant market share over the next few years. Management has targeted sales of ~Rs1.0-1.5bn over the next five years in this category. Competition comes from General Mills (Nature Valley brand) and Naturell (Rite Bite brand).

Exhibit 116. Ambitious targets for new launches

Brand	Category	Launch date	Market size (Rs bn)	Target
Nutribar	Healthy snack	Feb-09	1.0	Sales of Rs1.5bn in 5 years
Actigrow	Health supplements	Jan-09	1.5	No Specific Target
Lucozade	Sports drink	Sep-10	1.5	No Specific Target
Chilled Doodh	Flavoured milk	Apr-10	0.5	Sales of Rs1bn in 5 years

Source: Company data, Nomura research

Appendix 1

Feedback from conference call

4Q10 result highlights

- Sales were +21% y-y and PAT was +58%, helped by double-digit growth in the core Horlicks and Boost brands. All the subcategories within the Horlicks brand recorded double-digit growth as well, with the Boost brand having one of its best years with sales +25% in Q4. The biscuits segment saw sales growth of 71%, helped by the launch of cookies and cream variants.
- Volumes growth momentum remained strong across segments, with blended volume growth of 15% and price/mix benefit of 7% in 4Q10.
- Exports remained flat due to a slowdown in Sri Lanka.
- Margins improved by 230bps y-y, but were down 400bps q-q. This is in line with historical Q4 trends.
- On input costs, milk and milk powder prices were +17% in Q4 with wheat prices +2-3% and malted barley prices flat. This led to overall input cost inflation of 7.5% in 4Q10.

FY10 result highlights

- **Strong momentum in FY10**: The company saw strong momentum across all segments in FY10, with a particularly strong start to its instant noodles business and significant improvement in the biscuits category. The core malted beverage category also saw above-average growth.
- **Noodles have been a success**: The company's foray into the instant noodles category with the Foodles brand was very successful, with company having a 3% share of the market across India. Results in East and South India, where the company launched the product initially, were better, with company gaining a 6% share in those markets.
- **Biscuits performance strong**: Biscuits segment performance was strong, with sales +30% for FY10, helped by the launch of the cookies and creams segment. The core Horlicks biscuits continue to perform well.
- **Exports weaker**: Exports growth was weaker, with some slowdown seen in markets such as Sri Lanka. For FY10, exports were +17% vs +20% in FY09.
- **Input costs inflation**: The company saw 7.5% blended input cost inflation for FY10. Milk and milk powder saw an average of 15-16% inflation and malted barley saw 2-3% deflation for FY10.
- **Price increases**: The company has been able to pass on price hikes of 10% to offset this, with the latest hike of 5% being taken during Q4 in the core Horlicks brand. GSK Consumer has also increased prices in the Horlicks brand extensions over the past month or so, and this should ease the pressure of cost inflation on margins, in our view.
- **Market share gains**: The company has been able to hold its market share in the core Horlicks brand at 53%. Boost has seen a 1.0-1.5% market share gain, and is now at 15%. The Viva and Maltova brands have 2-3% share of the market. Overall, market share improved by 1% due to improvement in Boost market share.

Outlook for FY11

- **Core segment momentum strong**: The company expects momentum to remain strong in the core malted beverage segment, with growth expected to improve as focus on North and West India increases. The company expects medium-term volume growth of 9-10% in the core malted beverage space, with 4-5% pricing growth. It has been operating at a much higher level over the past few years, and continuing momentum at this level would mean volume growth in the range of 12-13%.
- **Noodles to grow strongly**: Management expects the noodles segment to continue to grow at well above the market growth rate over the next couple of years and for share gains to be significant over the medium term. The company is targeting market share of 15% over the next three-year period, which would mean a significantly higher growth trajectory vs the overall market for instant noodles. Although FY10 performance has been strong so far in the segment, it has been short of the company's internal targets, but this is on account of supply-side constraints and not demand issues. The company expects this to be fixed soon.
- **Focus on biscuits**: GSK Consumer has continued to increase its focus on the biscuits segment in FY10 and will continue to focus on increasing its distribution reach over the next few years. The biscuits opportunity continues to be an exciting opportunity, valued at Rs123bn and growing at 20-25%, according to management. The company also seen margins improving over the medium term as its share of the cookies and creams segment increases. However, competition in the segment remains strong, which could mean near-term margins will remain stable as company invests behind A&P.
- **De-risking strategy**: Management plans to take its share of biscuits and noodles to ~15 of sales over the next three years. This will mean that biscuits and noodles grow much faster than the market and the company continues to maintain share in the core malted beverage segment. We believe these targets are aggressive, and our implied growth forecasts in the biscuits and noodles segments are much lower vs company expectations.
- **Input cost inflation**: Company sees 8.0-8.5% blended input cost inflation in FY11. It plans to offset this by cost-savings measures as well as some calibrated price hikes across categories.
- **Payout ratio could increase**: GSK Consumer management believes that the payout ratio could increase further in FY11, but this will depend on business performance and the M&A opportunities the company plans to pursue over the next year or so. Average payout ratio has been 35% over the past few years, which could rise in FY11.

Company background

History

"GSK's journey began with Horlicks. In the early years, Horlicks, manufactured by Horlicks Limited, Slough, England, was being imported, bottled and sold in India. The year 1955 saw a change in import policy, following which the import of Horlicks was stopped.

In 1956-57, a team from Horlicks Limited visited India to explore the possibilities of setting up a plant. With the support of the then Maharaja of Nabha, His Highness Pratap Singh, a plant was set up at Nabha, in Punjab. Thus was born on October 30, 1958, Hindustan Milkfood Manufacturers Pvt. Ltd., promoted by Horlicks Ltd.

In the year 1969, Beecham plc., acquired Horlicks Limited and became the majority shareholder in Hindustan Milkfood Manufacturers Limited. Ten years later in 1979, Beecham India (Pvt) Ltd. merged with Hindustan Milkfood Manufacturers Limited and the non-resident equity shareholding was reduced to 40%. The name of the company was also changed to HMM Limited, in 1991.

Beecham plc, UK and SmithKline, USA merged in 1989 to form SmithKline Beecham plc, with its registered office in the UK. HMM Limited thus became part of SmithKline Beecham Consumer Brands, one of the three sectors of SmithKline Beecham and its name was changed to SmithKline Beecham Consumer Brands Limited.

Yet another christening took place in March 1994 when the name of the Company was changed to SmithKline Beecham Consumer Healthcare Limited, reasserting the Company's promise of providing healthcare to consumers.

The plan to form GlaxoSmithKline was announced in London on January 17, 2000. It was on December 27 that the two global giants SmithKline Beecham and Glaxo Wellcome merged to form GSK. The company's new identity, GSKCH, has been created to reflect our shared values towards scientific research and improving people's lives. "

Source: Company website

Management

Mr Simon Scarff, Non Executive Chairman

"Simon Scarff started his career at Horlicks Limited, UK (now part of GlaxoSmithKline plc). He was first in India in 1963 at Nabha, in Punjab, responsible for the marketing and sales of the company's products. He then returned to the UK to work within the UK Marketing department. He returned to India as the Managing Director on the 1st of June, 1978 and led the company till October 2002. In January 1999, Mr Scarff was awarded the Officer of the Order of the British Empire (OBE).

In 1993, he was appointed as a Director of SmithKline Beecham Pharmaceuticals India Limited (now GlaxoSmithKline Pharmaceuticals India Limited), and he continues in this post. "

Mr Zubair Ahmed, Managing Director

"Mr Zubair Ahmed took over the responsibility for running the Consumer Healthcare business in the India Sub-continent region, as Managing Director, effective 1st January, 2007. Mr Ahmed brings to this role a wealth of thirty years of experience in the FMCG sector. Prior to joining this Company, Mr Ahmed was the Managing Director of Gillette India Limited where he was credited for turning the company's business onto a profitable growth path as well as spearheading Gillette's clear value leadership in its product categories in India.

Mr Ahmed was associated with Gillette for over 14 years where his leadership competencies in the areas of strategic planning, strategic relationship building and result orientation led him to work on prestigious assignments in the company's operations in Middle East and India."

Source: Company website

Manufacturing facilities in India

"The factory at Nabha was set up in 1960 to produce Horlicks for the first time in India. The Rajahmundry factory was set up in 1975 to meet the increasing demand of Horlicks.

The factory at Village Khewra, Sonepat District, on 140 acres of land, incorporates the highest and most stringent global manufacturing practices in the industry. Set up at a cost of Rs252 crores, the beauty of the factory is in its automated design that allows the final product to be produced hygienically and completely untouched by human hands. Fully operational, the plant will have the capacity to produce 26,100 tons of Horlicks per annum.

GSKCH has a strong marketing and distribution network in India comprising over 1800 wholesalers and direct coverage of over 4,00,000 retail outlets."

Competitive positioning

"The company is the market leader in the malted beverage space with its four brands, Horlicks, Boost, Viva and Maltova together accounting for more than 70% of the total market. Horlicks is by far the market leader in the segment, and its brand extensions such as Horlicks Mother and Horlicks Lite have also had reasonable success.

In the noodles space, the company has a market share of 6%. GSK Consumer's entry into the segment has been very strong, with a national rollout the products still some way off. The noodles product, called 'Foodles,' has been positioned on the healthy noodles platform and under the Horlicks umbrella brand. This has meant consumers have been more willing to try it, out as the brand recall for the Horlicks is very high. "

Source: Company website

Exhibit 117. Malt-based drinks value market share

Company	2005	2006	2007	2008	2009
GlaxoSmithKline Consumer (%)	70.0	70.6	70.6	70.2	70.2
Cadbury India (%)	16.1	16.0	15.9	15.9	20.8
Nestle India (%)	5.9	6.4	6.4	6.9	1.0
Others (%)	8.0	7.0	7.0	7.0	8.0
Total (%)	**100**	**100**	**100**	**100**	**100**

Source: Company data, Nomura research

Exhibit 118. Competitive positioning

Category	Share (%)	Position
Malt-based drinks	70	#1
Biscuits	1	n.m.
Instant noodles	6	#3
Nutrition bars	30	#1

Source: Nomura research

Financial statements

Income statement (Rsmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	15,418	19,215	23,061	28,504	34,428
Cost of goods sold	(7,694)	(9,213)	(11,567)	(14,337)	(17,260)
Gross profit	**7,723**	**10,002**	**11,494**	**14,166**	**17,168**
SG&A	(3,610)	(4,764)	(5,150)	(6,349)	(7,725)
Employee share expense	(1,720)	(2,007)	(2,297)	(2,761)	(3,235)
Operating profit	**2,394**	**3,231**	**4,047**	**5,057**	**6,208**
EBITDA	**2,813**	**3,651**	**4,444**	**5,619**	**6,875**
Depreciation	(419)	(420)	(397)	(562)	(667)
Amortisation	-	-	-	-	-
EBIT	**2,394**	**3,231**	**4,047**	**5,057**	**6,208**
Net interest expense	(53)	(43)	(26)	(40)	(40)
Associates & JCEs	-	-	-	-	-
Other income	362	245	498	381	419
Earnings before tax	**2,702**	**3,433**	**4,519**	**5,397**	**6,587**
Income tax	(974)	(1,211)	(1,520)	(1,781)	(2,200)
Net profit after tax	**1,728**	**2,222**	**2,999**	**3,616**	**4,387**
Minority interests	-	-	-	-	-
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	**1,728**	**2,222**	**2,999**	**3,616**	**4,387**
Extraordinary items	155	106	-	-	-
Reported NPAT	**1,883**	**2,328**	**2,999**	**3,616**	**4,387**
Dividends	(738)	(886)	(2,103)	(2,944)	(3,680)
Transfer to reserves	**1,145**	**1,442**	**896**	**672**	**707**

Valuation and ratio analysis					
FD normalised P/E (x)	51.1	39.8	29.5	24.4	20.1
FD normalised P/E at price target (x)	61.0	47.4	35.1	29.1	24.0
Reported P/E (x)	46.9	38.0	29.5	24.4	20.1
Dividend yield (%)	0.8	1.0	2.4	3.3	4.2
Price/cashflow (x)	45.0	15.8	27.0	18.5	15.5
Price/book (x)	11.6	9.8	8.9	8.3	7.8
EV/EBITDA (x)	29.7	22.0	18.2	14.4	11.6
EV/EBIT (x)	34.9	24.8	20.0	16.0	12.8
Gross margin (%)	50.1	52.1	49.8	49.7	49.9
EBITDA margin (%)	18.2	19.0	19.3	19.7	20.0
EBIT margin (%)	15.5	16.8	17.5	17.7	18.0
Net margin (%)	12.2	12.1	13.0	12.7	12.7
Effective tax rate (%)	36.0	35.3	33.6	33.0	33.4
Dividend payout (%)	39.2	38.0	70.1	81.4	83.9
Capex to sales (%)	0.9	2.1	9.0	5.3	1.1
Capex to depreciation (x)	0.3	1.0	5.2	2.7	0.6
ROE (%)	26.8	27.9	31.6	35.2	40.0
ROA (pretax %)	33.5	53.6	56.6	54.3	58.1
Growth (%)					
Revenue	20.6	24.6	20.0	23.6	20.8
EBITDA	7.7	29.8	21.7	26.4	22.4
EBIT	10.0	35.0	25.3	24.9	22.8
Normalised EPS	11.1	28.6	35.0	20.6	21.3
Normalised FDEPS	11.1	28.6	35.0	20.6	21.3
Per share					
Reported EPS (Rs)	44.8	55.4	71.3	86.0	104.3
Norm EPS (Rs)	41.1	52.8	71.3	86.0	104.3
Fully diluted norm EPS (Rs)	41.1	52.8	71.3	86.0	104.3
Book value per share (Rs)	180.9	215.2	236.5	252.5	269.3
DPS (Rs)	17.5	21.1	50.0	70.0	87.5

Source: Nomura estimates

Strong revenue growth over the next two years

Cashflow (Rsmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	2,813	3,651	4,444	5,619	6,875
Change in working capital	(523)	2,108	(116)	298	383
Other operating cashflow	(327)	(156)	(1,058)	(1,140)	(1,551)
Cashflow from operations	**1,964**	**5,603**	**3,271**	**4,777**	**5,708**
Capital expenditure	(144)	(409)	(2,072)	(1,500)	(375)
Free cashflow	**1,820**	**5,193**	**1,199**	**3,277**	**5,333**
Reduction in investments	2,978	-	-	-	-
Net acquisitions					
Reduction in other LT assets	-	-	-	-	-
Addition in other LT liabilities	-	-	-	-	-
Adjustments	(287)	(819)	166	(300)	(270)
Cashflow after investing acts	**4,511**	**4,374**	**1,365**	**2,977**	**5,063**
Cash dividends	(738)	(886)	(2,103)	(2,944)	(3,680)
Equity issue	-	(0)	-	-	-
Debt issue	-	-	-	-	-
Convertible debt issue					
Others					
Cashflow from financial acts	**(738)**	**(886)**	**(2,103)**	**(2,944)**	**(3,680)**
Net cashflow	**3,773**	**3,489**	**(738)**	**33**	**1,383**
Beginning cash	937	4,710	8,198	7,303	7,337
Ending cash	4,710	8,198	7,460	7,337	8,720
Ending net debt	(4,710)	(8,198)	(7,303)	(7,337)	(8,720)

Source: Nomura estimates

Balance sheet (Rsmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	4,710	8,198	7,303	7,337	8,720
Marketable securities	-	-	-	-	-
Accounts receivable	433	314	376	465	562
Inventories	2,772	2,660	3,193	3,946	4,766
Other current assets	620	667	779	937	1,108
Total current assets	**8,534**	**11,839**	**11,651**	**12,685**	**15,157**
LT investments	0	0	0	0	0
Fixed assets	2,261	2,323	3,998	4,935	4,643
Goodwill					
Other intangible assets					
Other LT assets					
Total assets	**10,795**	**14,162**	**15,649**	**17,620**	**19,800**
Short-term debt	-	-	-	-	-
Accounts payable	2,502	3,810	4,572	5,651	6,826
Other current liabilities	684	1,301	1,130	1,349	1,647
Total current liabilities	**3,186**	**5,111**	**5,702**	**7,000**	**8,472**
Long-term debt	-	-	-	-	-
Convertible debt					
Other LT liabilities					
Total liabilities	**3,186**	**5,111**	**5,702**	**7,000**	**8,472**
Minority interest	-	-	-	-	-
Preferred stock					
Common stock	421	421	421	421	421
Retained earnings	7,188	8,630	9,527	10,199	10,907
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**7,609**	**9,051**	**9,947**	**10,620**	**11,327**
Total equity & liabilities	**10,795**	**14,162**	**15,649**	**17,620**	**19,800**
Liquidity (x)					
Current ratio	2.68	2.32	2.04	1.81	1.79
Interest cover	44.8	75.6	155.7	126.4	155.2
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	8.4	7.1	5.5	5.4	5.5
Days inventory	112.3	107.6	92.4	90.9	92.4
Days payable	111.4	125.0	132.2	130.1	132.3
Cash cycle	9.3	(10.3)	(34.4)	(33.9)	(34.4)

Source: Nomura estimates

Cash on the balance sheet provides opportunity for a large dividend payout or potential acquisition opportunity

Nestle India NEST IN

CONSUMER RELATED/FOOD & BEVERAGE | INDIA

From Reduce

NEUTRAL

NOMURA

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Action

We are upgrading our rating on Nestlé India from Reduce to NEUTRAL as the recent correction in the share price (Nestle -11.7% vs FMCG index -10.8%), has meant stock is now nearer fair value levels, in our view. While valuations are still expensive at 26x CY12F, we believe Nestle is an attractive long-term story in the Indian food sector.

Catalysts

Input cost environment remains volatile, which is negative, while continued focus on innovations will likely support strong revenue growth and margin improvement.

Anchor themes

Food remains a strong opportunity in urban India; Nestlé India is one of the most attractive plays on this theme, with a strong market share in milk & milk products, confectionery and chocolates. Potential to leverage off the parent's portfolio should help it deliver above-average revenue/earnings growth in the medium term.

Closing price on 16 Feb	Rs3,391
Price target	**Rs3,525**
	(set on 10 Nov 10)
Upside/downside	4.0%
Difference from consensus	2.2%
FY11F net profit (Rsmn)	10,409
Difference from consensus	4.8%

Source: Nomura

Nomura vs consensus

We are largely in line with consensus.

Starting to look interesting

① Turning more positive, but limited upside

The recent correction in the share price (Nestle -11.7% vs FMCG index -10.8%), has meant the stock is now nearer fair value levels, in our view. While we believe the longer-term opportunity is attractive, current valuations at 26x CY12F mean we would wait for a better entry point.

② Long-term play on urban consumption

The company operates in the fast-growing, yet under-penetrated processed food opportunity in India, and hence, we believe the sustainability of earnings is significantly higher than at hygiene and personal care (HPC) names. We believe Nestle is an attractive play on the longer term growth of the processed foods space in urban India, however, due to valuations we are NEUTRAL.

③ Rising input costs a short-term concern

Rising input costs are a cause for concern in the short term, as milk and sugar prices have been rising. The company has taken some price hikes to offset the pressure on margins, but could see some short-term risk to earnings over the next couple of quarters.

④ Maintain estimates and target price; move to NEUTRAL

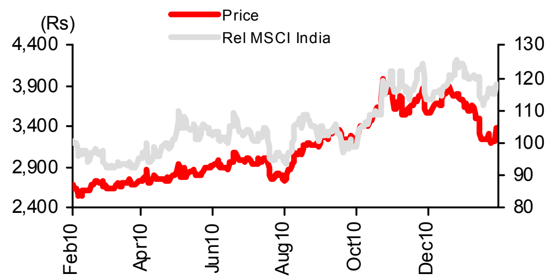
We are keeping our estimates and target price unchanged and are turning more positive tactically on the back of the recent correction. However, with the stock trading at 26x CY12F, we believe there is limited upside from current levels. We value the stock at 27x average CY12F earnings which is in line with the long-term average trading multiple for the stock.

Key financials & valuations

31 Dec (Rsmn)	FY09	FY10F	FY11F	FY12F
Revenue	51,294	61,857	72,309	85,937
Reported net profit	6,549	8,241	10,409	12,587
Normalised net profit	6,976	8,241	10,409	12,587
Normalised EPS (Rs)	72.4	85.5	108.0	130.5
Norm. EPS growth (%)	22.9	18.1	26.3	20.9
Norm. P/E (x)	46.9	39.7	31.4	26.0
EV/EBITDA (x)	30.8	26.1	20.8	17.4
Price/book (x)	56.2	42.4	32.4	25.2
Dividend yield (%)	1.7	1.9	2.5	3.0
ROE (%)	124.2	121.9	116.9	109.0
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		8,241	10,409	12,587
Change from previous (%)		-	-	-
Previous norm. EPS (Rs)		85.5	108.0	130.5

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(9.0)	(13.0)	22.7
Absolute (US$)	(9.3)	(13.4)	26.1
Relative to Index	(5.2)	(3.3)	24.2
Market cap (US$mn)			7,183
Estimated free float (%)			38.0
52-week range (Rs)			4,002/2,552
3-mth avg daily turnover (US$mn)			2.86
Stock borrowability			Hard
Major shareholders (%)			
Nestle			62.8
LIC of India			2.7

Source: Company, Nomura estimates

Drilling down

Leadership across various segments

Through innovation, the company has established itself as the market leader across various popular FMCG categories in India. Apart from the well-known positions in instant noodles, the company also has leadership positions in the dairy & coffee segments.

Exhibit 119. Established leadership across segments

Category	Brand	Nestle position
Light meals	Maggi	1
Meal embellishment	Maggi	1
Dairy	Nestle	2
Wafers & whites	Munch, Milky bar	1
Confectionery	Éclairs	1
Coffee	Nescafe	1
Baby food	Cerelac	1
Infant formula	Lactogen	1

Source: Company

Ability to handle competition puts Nestle on a strong wicket

While the company has been able to demonstrate its category-building skills over the years, what makes this more compelling, in our view, is Nestlé's ability to maintain this leadership over time. One of the best demonstrations of this is in the instant noodles category where it has consistently beaten the competition, despite many players entering the fray. Hindustan Unilever has been trying to establish itself in the category since the mid 1990s, but has not been able to build a sustainable presence. The current opportunity in the category is ~INR11.9bn as per AC Nielsen, and growing at 18-20% per annum. The medium-term opportunity continues to remain strong in the category with penetration levels still low in rural India.

The company has been actively looking to build on its leadership positions with innovations across the urban and rural markets. In the urban markets, the company has looked to position the brand as a healthy option along with convenience with the 'Maggi atta noodles'. To tap the potential growth in rural areas, the company has launched new smaller packs, which should help it target more households in the medium term.

Exhibit 120. Instant noodles market

Company	Brand	% share	Year of launch
Nestle India	Maggi	70	1984
Indo Nissin Foods	Top Ramen	11	1991
Hindustan Unilever	Soupy Noodles	N.A	2010
GSK Consumer	Horlicks Foodles	3	2010
Capital Foods	Chings Secret	3	1996
ITC	Sunfeast Yippee Noodles	N.A	2010
Organized Retail	Private Labels	2	2008-2010

Source: Company, Nomura research

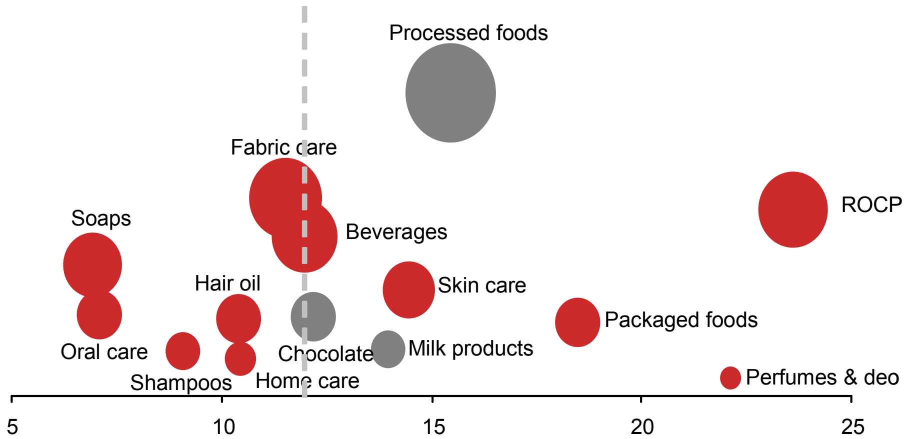
We would also highlight that the company has over the last two months implemented aggressive price hikes in the chocolate portfolio and milk products portfolio, in both the core milk category and the dairy category. This aggressive pricing strategy, despite increased competition, underlines the company's strong brand franchise and leadership, in our view.

Presence in a fast-emerging category to help sustain growth in the longer term

One of the biggest advantages that Nestle India's has over its competitors, in our view, is its very strong presence in the biggest, yet one of the fastest-growing segments of the consumer sector. Processed food is a US$4bn category (the biggest in terms of size) in India, and has been growing steadily at 12-15% p.a. over the past few years (amongst the fastest in the sector).

The key thing to keep in mind is that processed foods as a category are a strong play on urban consumption, and would be one of the key beneficiaries of rising income levels and increasing urbanization trends, in our view. Hence, we believe there is little doubt over the sustainability of the growth for the category from a long-term perspective. Nestle has a strong presence in the category and we expect the company to be one of the main beneficiaries of the upcoming strong growth.

Exhibit 121. Consumer sector size and growth



Note: Bubble size indicates size and axis indicates revenue growth CAGR over FY06-FY10,
Bubbles marked in grey are categories where Nestle has a strong presence
Source: AC Nielsen, Nomura Research

Strong in terms of innovation capabilities

The company has a strong track record of being able to bring innovation through to the market place. It first did this when it established the instant noodles market in India in the 1980s; since then, it has expanded into a number of categories where it has grown the market, along with maintaining its number one position. While milk products and nutrition continue to be a major contributor to the company, other categories have emerged in recent years, such as beverages, along with innovations in prepared dishes and cooking aids and chocolate and confectionery which have helped the company to consistently deliver strong earnings growth.

Parent has a big portfolio to bring into India

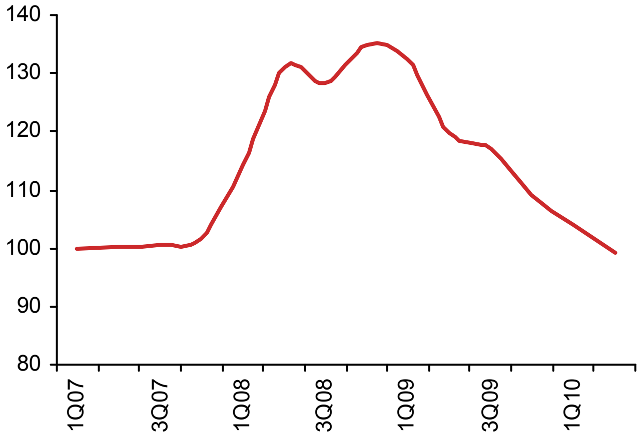
Nestlé India's parent company has a strong portfolio of products across the food and confectionery space which it could leverage. The company has recently said that it plans to enter the breakfast cereals category in India with brands such as Chocapic, Cookie Crisp and Cheerios. The company has already introduced its ice cream brands Mövenpick and Haagen-Dazs through the modern retail formats. The *Economic Times* reported on March 10, 2010 that the company may bring its popular weight management programme, Jenny Craig, to India. The opportunity to leverage the parent's large portfolio remains an attractive option, which gives Nestle India the opportunity to enter and grow categories in the medium term, in our view. We believe the company will look to expand its presence in India; introducing new products will help revenue growth in the medium term. In this regard, we believe the medium-term revenue growth opportunity is one of the most attractive across the FMCG sector.

Input costs continue to remain strong

Input costs remain a cause of concern

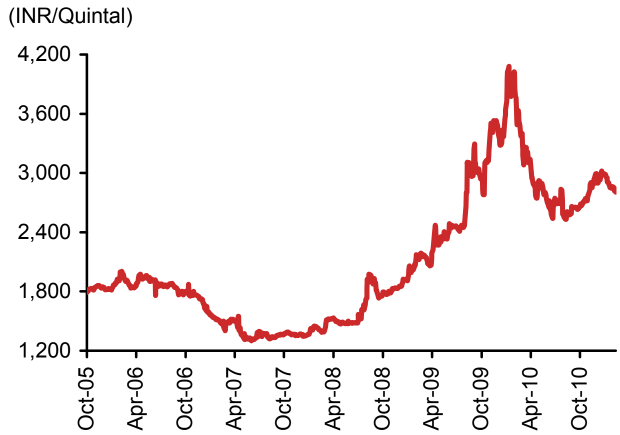
We believe with raw material prices will be the key challenge for the company. Some of the key input price trends are outlined in the charts below:

Exhibit 122. Green coffee price index



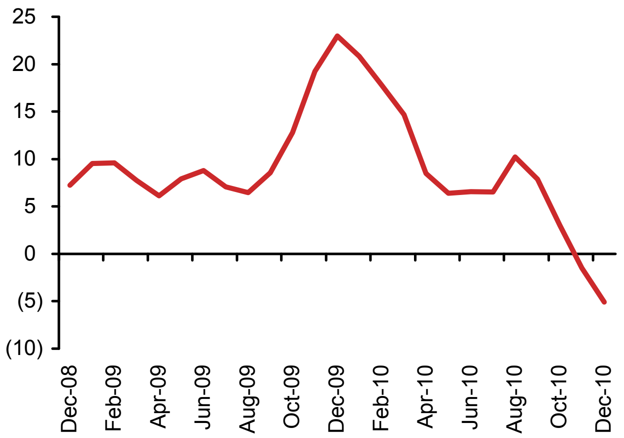
Source: Company data

Exhibit 123. Mumbai sugar prices



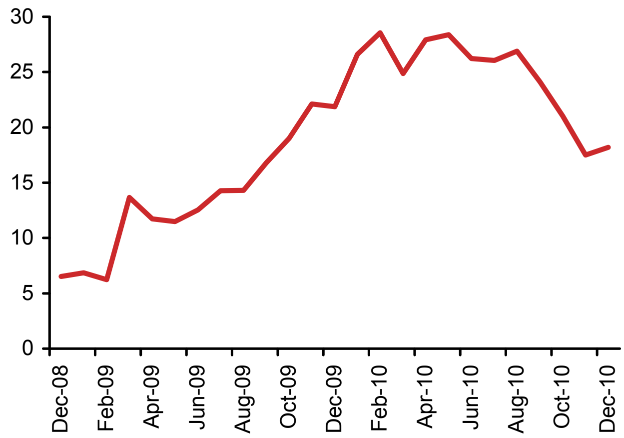
Source: Bloomberg

Exhibit 124. Wheat price index



Source: Bloomberg

Exhibit 125. Milk price increase



Source: Bloomberg

Valuations

Stock has underperformed so far this year

The stock has been an underperformer YTD, underperforming the consumer index and Sensex by 0.9% and 0.7%, respectively. This is partly due to high valuations as well as on concerns of rising input cost environment negatively impacting profitability.

Exhibit 126. Consumer stock performance

Stock	16-Feb-11	03-Jan-11	Return YTD (%)
Hindustan Unilever	276	313	(11.8)
Nestle India	3,386	3,836	(11.7)
Asian Paints	2,550	2,875	(11.3)
Sensex	18,301	20,561	(11.0)
FMCG Index	3,295	3,693	(10.8)
ITC	157	175	(10.4)
Godrej Consumer	364	387	(6.0)
Dabur	97	101	(3.6)
Colgate Palmolive	828	828	(0.0)
Marico	125	121	3.1

Source: Bloomberg, Nomura research

Premium valuations for higher & sustainable growth

Nestle India trades at 26x CY12F earnings. Although this is higher than the sector average of 23.5x, we believe this is justified for two reasons.

- Nestle also offers a strong 23% earnings CAGR over the next two years, according to our estimates, which is much higher than the sector average.
- Current valuation is in line with its own long-term average valuation.

Exhibit 127. Consumer sector valuations

Company	Ticker	Rating	Price (Rs)	P/E (x) FY11F	P/E (x) FY12F	FY12F PEG (x)
Asian Paints	APNT IN	BUY	2,550	27.0	23.0	1.2
Colgate Palmolive	CLGT IN	REDUCE	828	25.1	22.8	3.3
Dabur	DABUR IN	BUY	97	27.7	21.8	1.0
Godrej Consumer	GCPL IN	NEUTRAL	364	24.6	19.1	0.5
Hindustan Unilever	HUVR IN	REDUCE	276	28.3	24.6	3.0
ITC	ITC IN	BUY	157	24.5	21.0	1.3
Marico	MRCO IN	REDUCE	125	27.0	22.9	1.3
United Spirits	UNSP IN	BUY	1,184	27.8	19.4	0.3
Nestle *	NEST IN	NEUTRAL	3,386	39.6	31.4	1.4
Jubilant Foodworks	JUBI IN	BUY	499	46.6	34.4	0.5
GSK Consumer *	SKB IN	BUY	2,100	29.4	24.4	0.9
Average				**28.0**	**23.5**	**1.2**

Note: * = Nestle valuations are for CY10 & CY11F; Pricing as of 16 Feb 2011

Source: Bloomberg, Nomura Research

Earnings and target price unchanged

We have not changed our earnings estimates or target price. We believe Nestle will be able to deliver more than a 22% earnings CAGR over CY10-CY12F, despite some concerns around rising input cost prices. The company has strong pricing power which should help mitigate some of the margin pressures over the next few quarters.

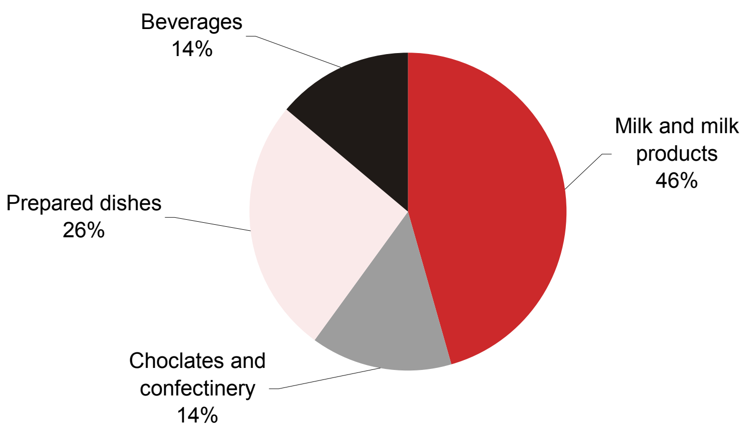
Long-term attraction remain

Over the longer term, we prefer the food space in India vs. HPC, and Nestle is one of the most attractive opportunities. However, we see stock as fairly valued at current levels offering only 4% upside to our target price of INR3,525.

Appendix 1

Business mix

Exhibit 128. Nestle CY09 sales category split



Source: Company, Nomura Research

Exhibit 129. Segments, brands and market position

Category	Brand	Nestle position
Light meals	Maggi	1
Meal embellishment	Maggi	1
Dairy	Nestle	2
Wafers & whites	Munch, Milkybar	1
Confectionery	Eclairs	1
Coffee	Nescafe	1
Baby food	Cerelac	1
Infant formula	Lactogen	1

Source: Company data

Financial statements

Income statement (Rsmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	43,242	51,294	61,857	72,309	85,937
Cost of goods sold	(23,487)	(26,982)	(33,154)	(37,826)	(45,101)
Gross profit	**19,755**	**24,312**	**28,702**	**34,483**	**40,837**
SG&A	(8,737)	(10,550)	(12,202)	(14,021)	(16,539)
Employee share expense	(3,146)	(4,324)	(5,233)	(6,286)	(7,497)
Operating profit	**7,873**	**9,438**	**11,267**	**14,177**	**16,800**
EBITDA	**8,796**	**10,550**	**12,450**	**15,490**	**18,259**
Depreciation	(924)	(1,113)	(1,183)	(1,313)	(1,459)
Amortisation					
EBIT	**7,873**	**9,438**	**11,267**	**14,177**	**16,800**
Net interest expense	(16)	(14)	(10)	(10)	(10)
Associates & JCEs					
Other income	207	172	349	494	691
Earnings before tax	**8,064**	**9,596**	**11,607**	**14,661**	**17,482**
Income tax	(2,387)	(2,620)	(3,366)	(4,252)	(4,895)
Net profit after tax	**5,676**	**6,976**	**8,241**	**10,409**	**12,587**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**5,676**	**6,976**	**8,241**	**10,409**	**12,587**
Extraordinary items	(335)	(426)	-	-	-
Reported NPAT	**5,341**	**6,549**	**8,241**	**10,409**	**12,587**
Dividends	(4,794)	(5,471)	(6,345)	(8,015)	(9,692)
Transfer to reserves	**547**	**1,079**	**1,895**	**2,394**	**2,895**
Valuation and ratio analysis					
FD normalised P/E (x)	57.6	46.9	39.7	31.4	26.0
FD normalised P/E at price target (x)	59.9	48.7	41.2	32.7	27.0
Reported P/E (x)	61.2	49.9	39.7	31.4	26.0
Dividend yield (%)	1.5	1.7	1.9	2.5	3.0
Price/cashflow (x)	39.4	36.8	37.9	26.3	20.7
Price/book (x)	69.1	56.2	42.4	32.4	25.2
EV/EBITDA (x)	36.9	30.8	26.1	20.8	17.4
EV/EBIT (x)	41.3	34.5	28.8	22.7	19.0
Gross margin (%)	45.7	47.4	46.4	47.7	47.5
EBITDA margin (%)	20.3	20.6	20.1	21.4	21.2
EBIT margin (%)	18.2	18.4	18.2	19.6	19.5
Net margin (%)	12.4	12.8	13.3	14.4	14.6
Effective tax rate (%)	29.6	27.3	29.0	29.0	28.0
Dividend payout (%)	89.8	83.5	77.0	77.0	77.0
Capex to sales (%)	6.0	4.0	2.8	2.5	2.8
Capex to depreciation (x)	2.8	1.9	1.5	1.4	1.7
ROE (%)	119.8	124.2	121.9	116.9	109.0
ROA (pretax %)	54.8	55.8	56.9	65.5	70.9
Growth (%)					
Revenue	23.4	18.6	20.6	16.9	18.8
EBITDA	24.3	19.9	18.0	24.4	17.9
EBIT	24.4	19.9	19.4	25.8	18.5
Normalised EPS	30.8	22.9	18.1	26.3	20.9
Normalised FDEPS	30.8	22.9	18.1	26.3	20.9
Per share					
Reported EPS (Rs)	55.4	67.9	85.5	108.0	130.5
Norm EPS (Rs)	58.9	72.4	85.5	108.0	130.5
Fully diluted norm EPS (Rs)	58.9	72.4	85.5	108.0	130.5
Book value per share (Rs)	49.1	60.3	79.9	104.8	134.8
DPS (Rs)	49.7	56.7	65.8	83.1	100.5

Source: Nomura estimates

Strong revenue growth over the next two years

Cashflow (Rsmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	8,796	10,550	12,450	15,490	18,259
Change in working capital	2,220	1,417	(806)	717	1,759
Other operating cashflow	(2,714)	(3,073)	(3,027)	(3,768)	(4,214)
Cashflow from operations	**8,303**	**8,894**	**8,617**	**12,439**	**15,804**
Capital expenditure	(2,605)	(2,064)	(1,736)	(1,801)	(2,424)
Free cashflow	**5,697**	**6,830**	**6,881**	**10,637**	**13,380**
Reduction in investments	595	(1,684)	-	-	-
Net acquisitions					
Reduction in other LT assets	-	-	-	-	-
Addition in other LT liabilities	82	(49)	-	-	-
Adjustments					
Cashflow after investing acts	**6,374**	**5,098**	**6,881**	**10,637**	**13,380**
Cash dividends	(4,794)	(5,471)	(6,345)	(8,015)	(9,692)
Equity issue	-	-	-	-	-
Debt issue	(21)	(8)	50	-	-
Convertible debt issue	-	-	-	-	-
Others					
Cashflow from financial acts	**(4,815)**	**(5,479)**	**(6,295)**	**(8,015)**	**(9,692)**
Net cashflow	**1,559**	**(381)**	**586**	**2,622**	**3,689**
Beginning cash	378	1,937	1,556	2,142	4,764
Ending cash	1,937	1,556	2,142	4,764	8,453
Ending net debt	(1,929)	(1,556)	(2,092)	(4,714)	(8,403)

Source: Nomura estimates

Balance sheet (Rsmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	1,937	1,556	2,142	4,764	8,453
Marketable securities					
Accounts receivable	456	642	832	992	1,173
Inventories	4,349	4,987	6,261	7,238	8,614
Other current assets	1,238	1,380	1,380	1,380	1,380
Total current assets	**7,980**	**8,566**	**10,615**	**14,375**	**19,621**
LT investments	349	2,033	2,033	2,033	2,033
Fixed assets	8,622	9,758	10,311	10,799	11,765
Goodwill					
Other intangible assets					
Other LT assets					
Total assets	**16,950**	**20,356**	**22,959**	**27,207**	**33,418**
Short-term debt					
Accounts payable	5,066	5,876	7,337	8,672	10,436
Other current liabilities	6,773	8,348	7,544	8,063	9,615
Total current liabilities	**11,840**	**14,224**	**14,881**	**16,735**	**20,051**
Long-term debt	8	-	50	50	50
Convertible debt					
Other LT liabilities	369	320	320	320	320
Total liabilities	**12,217**	**14,544**	**15,251**	**17,105**	**20,421**
Minority interest					
Preferred stock					
Common stock	964	964	964	964	964
Retained earnings	3,769	4,848	6,744	9,138	12,033
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**4,733**	**5,813**	**7,708**	**10,102**	**12,997**
Total equity & liabilities	**16,950**	**20,356**	**22,959**	**27,207**	**33,418**
Liquidity (x)					
Current ratio	0.67	0.60	0.71	0.86	0.98
Interest cover	479.2	674.8	1,126.7	1,417.7	1,680.0
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	4.2	3.9	4.3	4.6	4.6
Days inventory	65.1	63.1	61.9	65.1	64.3
Days payable	75.3	74.0	72.7	77.2	77.5
Cash cycle	(6.0)	(7.0)	(6.5)	(7.5)	(8.6)

Source: Nomura estimates

Strong balance sheet to support future growth

ITC ITC IN

CONSUMER RELATED/GENERAL CONSUMER | INDIA

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Maintained

BUY

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NOMURA FINANCIAL ADVISORY AND SECURITIES (INDIA) PRIVATE LIMITED

Action

While ITC is the market leader in the Indian tobacco space, its foray into FMCG, particularly foods, will be a key medium-term growth driver, in our view. The company has been able to build strong positions in completely new businesses such as soaps, packaged staples and snacks over the past few years. This adds another strong leg to the medium-term growth prospects for ITC.

Catalysts

Reducing losses in existing FMCG categories and success in new categories such as noodles and pasta will drive company profitability and earnings higher.

Anchor themes

As consumer awareness and income levels improve, we expect more people to shift to cigarettes from traditional forms of tobacco consumption. Additionally other businesses such as FMCG, Retail and Hotels will be longer-term growth drivers.

Closing price on 16 Feb	Rs156.9
Price target	**Rs200.0**
	(set on 29 Oct 10)
Upside/downside	27.5%
Difference from consensus	3.1%
FY12F net profit (Rsmn)	56,849
Difference from consensus	-1.9%

Source: Nomura

Nomura vs consensus

We are marginally ahead of consensus on price target and believe that success in the consumer business is a likely medium-term catalyst.

All set to take off

① ITC a major player in the food business

ITC is already a well-established brand in the food space in India with a presence across segments such as packaged staples, finger snacks, biscuits and packaged foods. ITC's food portfolio has (end-FY10) attained a size of US$600mn and accounts for 9% of the company's consolidated revenues.

② Packaged and processed food the next growth driver

The company has, over the past few years, invested significantly in expanding its food business portfolio and the related supply chain. This has helped create a strong backbone on which we expect the company to deliver strong earnings growth in the medium term.

③ Focus on growth and profitability

While the company's focus has been on expanding the FMCG business, it has also maintained that growth will not be at the expense of profitability. Losses in the FMCG business have declined steadily and the company expects to breakeven sometime in FY13F.

④ Risk-reward favourable, maintain BUY

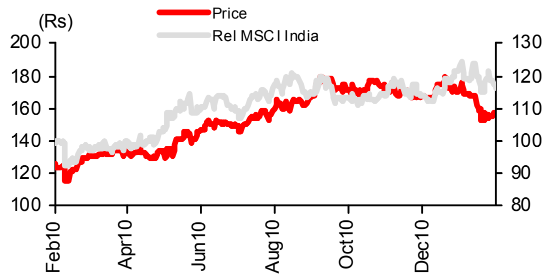
ITC is trading at 21.1x FY12F vs. a sector average of 23.5x. We are BUY on the stock because ITC offers strong earnings growth over the next two years and the recent correction offers a good entry point, in our view. In the short term the cigarette business will deliver strong earnings and cash flows, while longer term we expect the food business contribution to steadily increase. Profitability of the food business will also increase as the need for new investments in the business reduces.

Key financials & valuations

31 Mar (Rsmn)	FY10	FY11F	FY12F	FY13F
Revenue	192,918	213,353	243,108	273,479
Reported net profit	41,682	48,839	56,849	65,783
Normalised net profit	41,682	48,839	56,849	65,783
Normalised EPS (Rs)	5.46	6.40	7.44	8.61
Norm. EPS growth (%)	23.5	17.2	16.4	15.7
Norm. P/E (x)	28.7	24.5	21.1	18.2
EV/EBITDA (x)	17.9	15.6	13.3	11.4
Price/book (x)	7.7	6.8	6.2	6.0
Dividend yield (%)	3.7	2.5	3.3	5.1
ROE (%)	27.0	29.4	30.9	33.7
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		48,839	56,849	65,783
Change from previous (%)		-	-	-
Previous norm. EPS (Rs)		6.40	7.44	8.61

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(8.0)	(7.7)	(0.9)
Absolute (US$)	(8.3)	(8.1)	1.9
Relative to Index	(4.3)	2.0	(0.0)
Market cap (US$mn)			26,601
Estimated free float (%)			67.0
52-week range (Rs)			179.8/116.1
3-mth avg daily turnover (US$mn)			28.89
Stock borrowability			Hard
Major shareholders (%)			
LIC of India			13.6
UTI			11.8

Source: Company, Nomura estimates

Drilling down

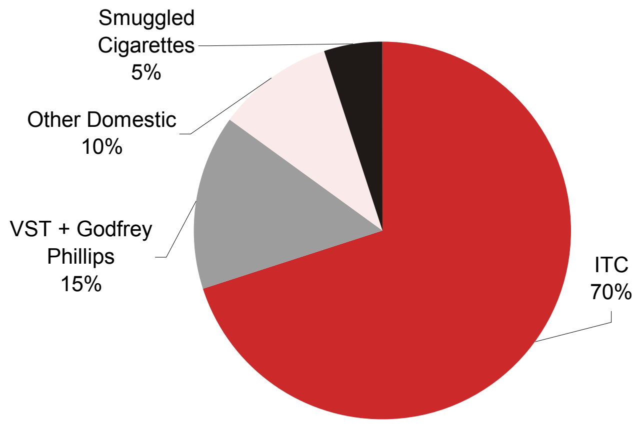
ITC a dominant player in the tobacco space

ITC's is one of India's oldest and by far the biggest player in the cigarette market. The company commands a strong 70% market share and is more than 5x the size of its nearest competitor (source: company data).

Along the lines of other global markets, the regulatory environment in India remains tough on all tobacco companies. The government targets tobacco consumption through taxation and non-tax regulations in a relentless manner. Over the next few years, we believe regulations will tighten further. This makes ITC's incumbent advantage even stronger, in our view.

We foresee ITC maintaining its stronghold in the domestic cigarette sector as it continues to build on the strength of its brands and its extensive distribution network.

Exhibit 130. Indian domestic cigarette sector

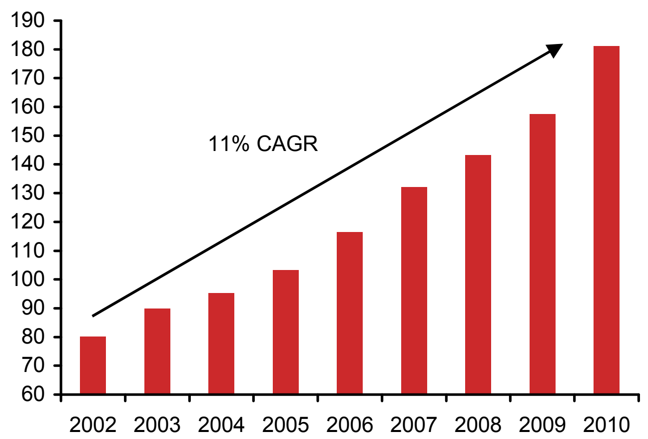


Source: Company data, Nomura research

Strong growth with improvement in margins

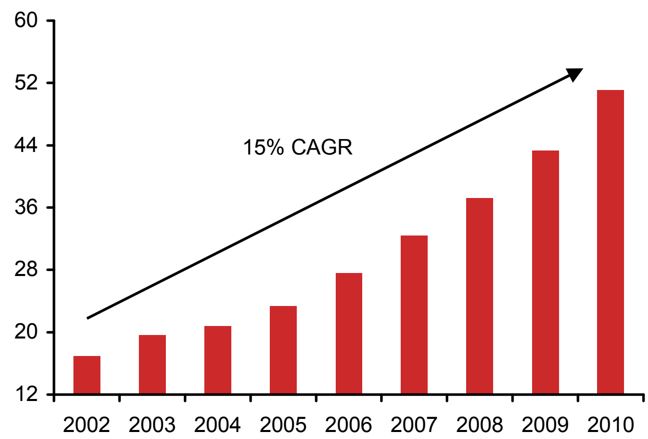
Over the past eight years, ITC's cigarette business has delivered 11% sales CAGR; importantly, this growth has been on improvement in margins. This has meant the division's profits have increased by a CAGR of 15% over the same time period.

Exhibit 131. Revenues from Cigarette business



Source: Company data, Nomura research

Exhibit 132. Profits from Cigarette business



Source: Company data, Nomura research

The cigarette business profitability has also seen a marked improvement. Operating margins have improved from 21.1% in 2002 to 28.2% in 2010. This has been helped by:

- **Strong pricing power**: ITC has been able to make significant price hikes over the past few years, which have partly helped offset the rise in excise duties and have also helped improve profitability.
- **Mix improvement**: Over the past few years, ITC's consumers have traded up to more expensive brands in its portfolio, which has improved its margin profile.

Strong cash generation; helps invest in diversification

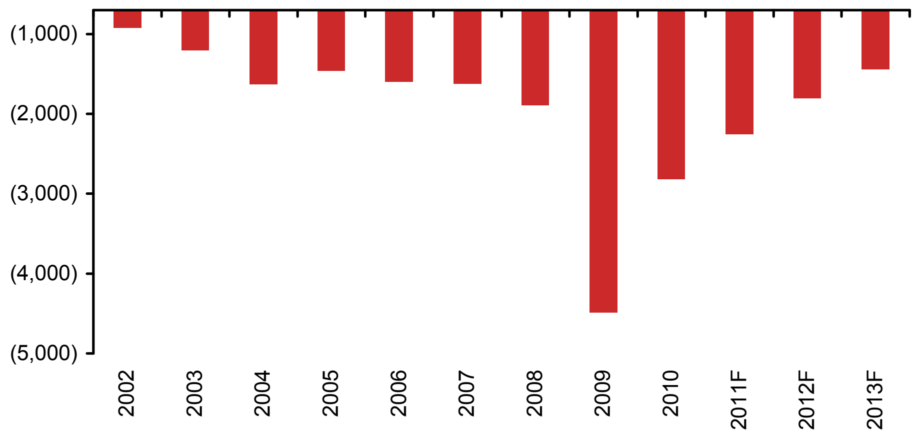
The cigarette business generates considerable cash, which has allowed the company to invest successfully in expanding other businesses. Our analysis shows that the cigarette business has generated US$5bn of operating cash flow for ITC in the past eight years. This strong cash generation has been one of the major strengths of the company, helping them to successfully diversify into newer businesses.

Non-cigarette business: focus on growth and profitability

ITC realises that longer term, growth in the cigarette business is going to be an issue, with growth slowing, and hence has consistently made an effort to diversify into newer business. It has built some strong brands in areas such as hotels, paper and agri-products. Its latest endeavour is to expand the non-cigarette FMCG business, ie, food, HPC (Hygiene and Personal Care) and retailing. This strong focus has resulted in revenues from the business registering a 67% CAGR in the past eight years (from 2002 to 2010) and today accounts for ~15% of the company's revenues.

While the profitability of the cigarette business gives ITC the financial leeway to invest in other businesses, we believe the company has also concentrated on further increasing the profitability of its non-cigarettes business. Losses in the non-cigarette FMCG business have been decreasing steadily over the past few years. The company reiterated with its 3Q FY11 results that losses will decrease by 20% each year over the next couple of years and breakeven could be some time in FY13F.

Exhibit 133. FMCG business losses reducing



Source: Company data, Nomura estimates

FMCG business across food and HPC

ITC is already a well-established brand in the food space in India with presence across segments such as packaged staples, finger snacks, biscuits and packaged foods. ITC's food portfolio has (at end-FY10) attained a size of US$600mn and accounts for 9% of the company's consolidated revenues.

Exhibit 134. ITC's food business portfolio

Brand name	Segment	Position/Share
Sunfeast	Biscuits	# 3 player with strong market position
	Noodles	Launched in 2010, share less than 2%
	Pasta	Launched in 2010; category still new
Aashirwad	Packaged Staples	#1 brand - share of organised is only 3% of total market
Bingo	Salted Snacks	#2 position
Kitchens of India	Packaged Food	Strong brand equity

Source: Company data, Nomura research

Over the past few years, ITC has made an effort to succeed in the food business and some of the enabling factors, in our view, have been:

- **Distribution build out**: This was one of ITC's biggest disadvantages when it first ventured into the food business. The firm's non-cigarette distribution network was non-existent. It has taken a sustained effort on the company's part to master this chain, a process which started off with its Aashirvad aata (packaged wheat flour) product offering.
- **Consumer activation**: One of the company's hallmarks has been its ability to build up a credible market share in completely new categories. This has been achieved chiefly because of sustained investment in consumer awareness and education. The best example of this is its Bingo range of potato chips, which garnered a strong No.2 position in the market in the first year of launch itself.
- **Sourcing advantage:** ITC has an extremely strong supply chain, which enables it to maintain tight control over the supply of inputs for the food business. The E-chaupal initiative has been pivotal in the success of the packaged staples business as well as other food businesses, enabling ITC to not only maintain control over quality but also cost of products.
- **Strong R&D capabilities:** One of the company's strengths has been a strong focus on innovation. When Bingo was first launched in India, ITC realised it would not be able to compete with PepsiCo on the plain salted variety of potato chips. Hence, it simultaneously launched several local flavours for each region, thus creating a niche for itself.

A brief look at ITC's foods businesses

- **Staples**: ITC's brand in the packaged atta (wheat flour) segment has been very successful over the past few years. Even after strong growth in the past few years, packaged atta is only ~3% of the total atta market. Hence, the opportunity to move consumers from loose to packaged atta is large. We see modern retail as a catalyst for this move over the next few years; this should add to revenue growth for this business in the medium term. ITC has now extended the Aashirwad brand to packaged salt and launched multi grain variants of the wheat flour. These brand extensions will help extend the offering to a wider consumer base, in our view.
- **Snacks**: ITC has been spending significantly to establish a strong presence in the branded snacks category (source: company). In this segment, ITC is competing with market-leader PepsiCo and has been able to establish a 12-13% market share, which it continues to expand. Profitability should improve as ITC gains scale by increasing market share. Although the market for salty snacks remains competitive, ITC has been able to establish a strong presence and we expect it to be one of the stronger players in the category over the medium term.
- **Biscuits**: ITC has a strong 10% market share in the biscuits segment and its brands have performed well over the past couple of years. It is now looking at mix improvement by reducing the share of glucose biscuits (source: company). Together with some benefits of scale, ITC expects to improve margins in the

segment over the next year or so. This is a very attractive market valued at Rs123bn (in 2010) and growing at 15% (source: Biscuit Manufacturers Association of India), and ITC's Sunfeast brand now has an established presence in the segment.

- **Pasta and Noodles**: Recently the company forayed into pastas and instant noodles under the Sunfeast brand. Both these categories are growing strongly and as with other segments in which the company has invested, we expect ITC to be a serious player in the segment in the medium term.

Success in HPC space a solid platform

We believe ITC's success in the HPC space, particularly in soaps and shampoo, indicates that they are in the business for the longer term and will continue to invest heavily in the short term with a view to becoming a significant player. Expanding soaps category market share from 0% to 5% within a year of launch gives enough evidence that the company has the right people working towards expanding the business, in our view, and we expect success to continue into other segments both in the HPC space (skin care) as well as food space (Noodles and Pasta).

Management feedback on the food business

- **Competition in the foods category to increase**: Foods remains one of the best opportunities across the consumer space over the next few years. However, this will also mean competition will be very tough, with many new entrants coming into the category.

- **Input costs a concern:** Input cost prices for food will remain volatile, but the longer term trend is certainly moving higher. At present, the industry might be considering ways of handling the volatility, but longer term the concern will be handling structural input cost inflation. Nestle, the market leader in many of the food segments, recently echoed the same view and some companies realise the importance of longer-term structural increase in food prices. This is on account of dwindling food supplies worldwide with increasing urbanisation.

- **Modern trade key to success:** Growth of modern trade will be a key factor for the success of the FMCG industry over the next few years. This is especially true for urban areas, where penetration of modern trade is much faster. Modern trade will have to be seen as part of the 'delivery process,' which starts with conceptualising a product to actual delivery to the consumer. Modern trade profitability is low at present, but going forward as it becomes more important to the delivery process, its profitability will also grow.

- **Cycles getting smaller:** Trends in the FMCG sector will probably move much faster than many other sectors going forward. This will mean product cycles shortening and companies having to constantly improvise so their products suit changing consumer needs and preferences.

- **Change in consumer demand**: As India's income has increased over the past 2-3 decades, the FMCG needs of the consumer have also changed. In the 1970s the Indian consumer was largely looking for basic food, and this meant the focus was only on staples. In the 1980s and 1990s with incomes moving up, the consumer started to look at options that offered convenience along with value for money. This was the period for products such as instant noodles, which have today become a large segment on their own. Since 2000, focus has shifted further to ready to eat products and the trend has been moving towards premiumisation. This is likely to continue over the medium term, as growing urbanisation means the consumer has less time to devote to cooking. The challenge going forward is to create new categories and develop new options at an affordable cost to help the consumer make the choice the move up.

Valuations

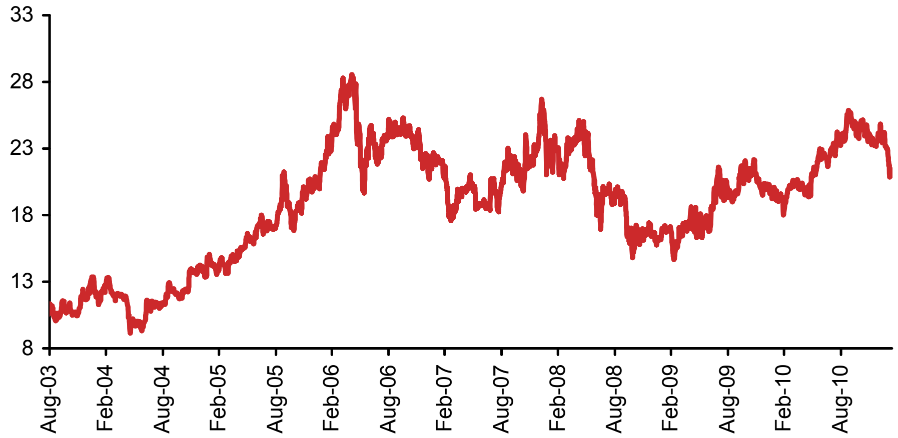
ITC is trading at 21.1x FY12F vs. a sector average of 23.5x. We are BUY on the stock because ITC offers strong earnings growth over the next two years and the recent correction offers a good entry point, in our view.

Valuation methodology

We value ITC using a Sum of the parts based valuation methodology. We value the core cigarettes business at INR149 per share based on a P/E multiple of 22x FY11F earnings. The other core businesses are valued at around INR44 per share. We have valued the net cash (after deducting corporate expenses) at book value.

Risks to our estimates and price target come from regulatory changes in the tobacco sector.

Exhibit 135. ITC one-year forward P/E



Source: Bloomberg, Nomura research

Financial statements

Strong profit growth

Income statement (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Revenue	166,893	192,918	213,353	243,108	273,479
Cost of goods sold	(62,633)	(72,713)	(78,324)	(87,670)	(96,557)
Gross profit	**104,260**	**120,206**	**135,029**	**155,437**	**176,922**
SG&A	(43,225)	(45,282)	(49,847)	(55,977)	(61,500)
Employee share expense	(13,228)	(14,640)	(16,623)	(19,016)	(21,723)
Operating profit	**47,808**	**60,283**	**68,560**	**80,444**	**93,700**
EBITDA	**53,616**	**66,722**	**75,771**	**88,312**	**102,092**
Depreciation	(5,809)	(6,439)	(7,211)	(7,868)	(8,392)
Amortisation	-	-	-	-	-
EBIT	**47,808**	**60,283**	**68,560**	**80,444**	**93,700**
Net interest expense	(290)	(735)	(105)	(105)	(105)
Associates & JCEs	-	-	-	-	-
Other income	2,446	2,909	4,007	4,007	4,007
Earnings before tax	**49,963**	**62,457**	**72,461**	**84,346**	**97,601**
Income tax	(16,254)	(20,349)	(23,622)	(27,497)	(31,818)
Net profit after tax	**33,709**	**42,108**	**48,839**	**56,849**	**65,783**
Minority interests	(348)	(426)	-	-	-
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	**33,361**	**41,682**	**48,839**	**56,849**	**65,783**
Extraordinary items	885	-	-	-	-
Reported NPAT	**34,246**	**41,682**	**48,839**	**56,849**	**65,783**
Dividends	(16,452)	(44,523)	(29,548)	(39,539)	(60,520)
Transfer to reserves	**17,794**	**(2,842)**	**19,291**	**17,311**	**5,263**
Valuation and ratio analysis					
FD normalised P/E (x)	35.5	28.7	24.5	21.1	18.2
FD normalised P/E at price target (x)	45.3	36.6	31.3	26.9	23.2
Reported P/E (x)	34.6	28.7	24.5	21.1	18.2
Dividend yield (%)	1.4	3.7	2.5	3.3	5.1
Price/cashflow (x)	29.4	14.9	26.1	19.3	17.3
Price/book (x)	7.8	7.7	6.8	6.2	6.0
EV/EBITDA (x)	22.3	17.9	15.6	13.3	11.4
EV/EBIT (x)	25.0	19.8	17.3	14.5	12.4
Gross margin (%)	62.5	62.3	63.3	63.9	64.7
EBITDA margin (%)	32.1	34.6	35.5	36.3	37.3
EBIT margin (%)	28.6	31.2	32.1	33.1	34.3
Net margin (%)	20.5	21.6	22.9	23.4	24.1
Effective tax rate (%)	32.5	32.6	32.6	32.6	32.6
Dividend payout (%)	48.0	106.8	60.5	69.6	92.0
Capex to sales (%)	10.9	6.3	4.6	4.1	1.8
Capex to depreciation (x)	3.1	1.9	1.4	1.3	0.6
ROE (%)	24.1	27.0	29.4	30.9	33.7
ROA (pretax %)	26.7	29.2	29.5	32.0	35.2
Growth (%)					
Revenue	12.9	15.6	10.6	13.9	12.5
EBITDA	13.7	24.4	13.6	16.6	15.6
EBIT	12.7	26.1	13.7	17.3	16.5
Normalised EPS	10.1	23.5	17.2	16.4	15.7
Normalised FDEPS	10.1	23.5	17.2	16.4	15.7
Per share					
Reported EPS (Rs)	4.54	5.46	6.40	7.44	8.61
Norm EPS (Rs)	4.42	5.46	6.40	7.44	8.61
Fully diluted norm EPS (Rs)	4.42	5.46	6.40	7.44	8.61
Book value per share (Rs)	20.22	20.46	22.98	25.25	25.94
DPS (Rs)	2.18	5.83	3.87	5.18	7.93

Source: Nomura estimates

Cashflow (Rsmn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
EBITDA	53,616	66,722	75,771	88,312	102,092
Change in working capital	(2,902)	29,261	(4,936)	(2,585)	(101)
Other operating cashflow	(10,426)	(15,462)	(24,957)	(23,605)	(32,917)
Cashflow from operations	**40,288**	**80,521**	**45,879**	**62,122**	**69,074**
Capital expenditure	(18,200)	(12,228)	(9,764)	(10,000)	(5,000)
Free cashflow	**22,088**	**68,293**	**36,115**	**52,122**	**64,074**
Reduction in investments	1,008	(24,934)	-	-	-
Net acquisitions					
Reduction in other LT assets	(866)	2,195	5,236	-	5,000
Addition in other LT liabilities	-	-	-	-	-
Adjustments					
Cashflow after investing acts	**22,230**	**45,555**	**41,350**	**52,122**	**69,074**
Cash dividends	(16,452)	(44,523)	(29,548)	(39,539)	(60,520)
Equity issue	12	88	-	-	-
Debt issue	(383)	(759)	-	10	-
Convertible debt issue	-	-	-	-	-
Others	-	-	-	-	-
Cashflow from financial acts	**(16,823)**	**(45,195)**	**(29,548)**	**(39,529)**	**(60,520)**
Net cashflow	**5,407**	**360**	**11,803**	**12,593**	**8,553**
Beginning cash	11,537	16,944	17,304	29,107	41,700
Ending cash	16,944	17,304	29,107	41,700	50,253
Ending net debt	(15,077)	(16,196)	(27,999)	(40,593)	(49,146)

Source: Nomura estimates

Balance sheet (Rsmn)					
As at 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Cash & equivalents	16,944	17,304	29,107	41,700	50,254
Marketable securities	19,905	44,239	44,239	44,239	44,239
Accounts receivable	21,669	22,553	24,942	31,970	35,964
Inventories	47,943	50,920	61,960	73,265	82,418
Other current assets	2,326	3,057	3,381	3,330	3,746
Total current assets	**108,787**	**138,074**	**163,629**	**194,505**	**216,622**
LT investments	5,166	5,766	5,766	5,766	5,766
Fixed assets	78,826	87,740	95,529	97,661	99,269
Goodwill	-	-	-	-	-
Other intangible assets	-	-	-	-	-
Other LT assets	12,431	10,236	5,000	5,000	-
Total assets	**205,210**	**241,815**	**269,924**	**302,932**	**321,656**
Short-term debt	1,678	1,098	1,098	1,098	1,098
Accounts payable	32,347	37,371	41,330	49,954	56,194
Other current liabilities	17,038	45,868	50,726	57,800	65,021
Total current liabilities	**51,063**	**84,337**	**93,154**	**108,852**	**122,314**
Long-term debt	189	10	10	10	10
Convertible debt	-	-	-	-	-
Other LT liabilities	-	-	-	-	-
Total liabilities	**51,252**	**84,347**	**93,164**	**108,862**	**122,323**
Minority interest	1,300	1,264	1,264	1,264	1,264
Preferred stock					
Common stock	7,549	7,636	7,636	7,636	7,636
Retained earnings	136,504	140,763	160,054	177,365	182,627
Proposed dividends					
Other equity and reserves	8,606	7,806	7,806	7,806	7,806
Total shareholders' equity	**152,659**	**156,205**	**175,496**	**192,807**	**198,069**
Total equity & liabilities	**205,210**	**241,815**	**269,924**	**302,932**	**321,656**
Liquidity (x)					
Current ratio	2.13	1.64	1.76	1.79	1.77
Interest cover	164.6	82.0	651.5	764.5	890.4
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	47.0	41.8	40.6	42.8	45.3
Days inventory	264.1	248.1	263.0	282.3	294.3
Days payable	180.8	175.0	183.4	190.5	200.6
Cash cycle	130.3	115.0	120.3	134.6	139.0

Source: Nomura estimates

Strong balance sheet

QSR Brands Berhad QSR MK

CONSUMER RELATED/FOOD AND BEVERAGE | MALAYSIA

From Buy → NEUTRAL

NOMURA
NOMURA SECURITIES MALAYSIA SDN BHD

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Action

QSR Brands' expansion remains on track in India, where we see relative under-penetration presenting scope for long-term upside by FY12F, supported by continued stability in its home market of Malaysia. But, near-term headwinds of rising raw materials costs look set to limit upside for the time being, with soy and corn prices approaching 2008 highs. Downgrading to NEUTRAL from Buy, after a strong 42% gain and 27% outperformance since July 2010 on slower margin expansion and, as a result, lowering earnings by ~7% in FY11F-12F.

Catalysts

1) Continued store openings in Malaysia and India; 2) sustained positive consumer sentiment; and 3) confidence in robust economic recoveries across the region.

Anchor themes

Fast-food operators such as QSR are likely to benefit from young populations and rising incomes across a diversified geographical base in ASEAN and India.

Closing price on 16 Feb	RM5.47
Price target	RM5.84
	(from RM6.12)
Upside/downside	6.8%
Difference from consensus	-8.6%
FY11F net profit (RMmn)	135.9
Difference from consensus	-0.6%

Source: Nomura

Nomura vs consensus

We pare earnings a clip below consensus on our muted outlook amid rising costs (and 1pp cut in margins) despite remaining positive on top-line growth and India potential.

On track, but with near-term cost pressures

① India expansion remains the next growth driver

The December acquisition of two KFC stores in Pune kick-started QSR's consolidation of its ownership of KFC stores in the state of Maharasthra. KFC stores remain relatively under-penetrated, and we believe QSR will continue to acquire Yum!-owned restaurants in 2011F whilst organically expanding deeper into the Mumbai metro area. Yum!'s focus on growing the China market should provide scope for QSR to penetrate further into India from its base in Maharasthra over the coming years, we believe.

② Rising raw material costs limit near-term upside

While we expect its bulk procurement strategy to remain intact and its pricing power to be relatively robust amid captive demand and high consumer confidence in its major home market of Malaysia (geographically contributing nearly 80% of the top line), QSR's near-term margin expansion and upside will likely be capped by rising cost pressures. This is in line with our Asian strategy team's view on rising soft commodity prices and declining stock to consumption ratios.

③ Earnings pared by 7-11%; downgrading to NEUTRAL

Mirroring the more conservative outlook on the cost side, we revise down our net margin assumptions by an average of 1pp, largely to reflect the 2008 scenario of raw material cost spikes, which implies an across-the-board lowering of earnings by 7-11% for FY10F-12F. Following a strong share price gain of 42% and outperformance of 27% since July 2010, we downgrade our call a notch to NEUTRAL ahead of the FY10F results release next week, in line with our more muted immediate-term outlook and as it continues 2011 execution. We remain positive on its long-term growth fundamentals.

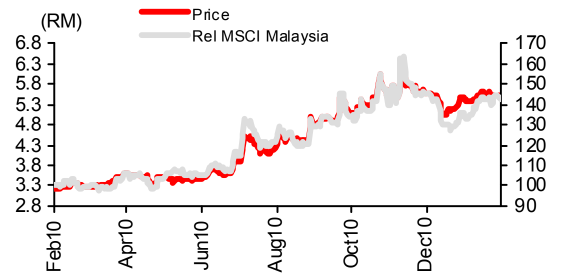
This report was first published on 17 February.

Key financials & valuations

31 Dec (RMmn)	FY09	FY10F	FY11F	FY12F
Revenue	2,760	3,001	3,245	3,577
Reported net profit	90.9	113.0	135.9	161.0
Normalised net profit	90.9	113.0	135.9	161.0
Normalised EPS (RM)	0.31	0.39	0.47	0.55
Norm. EPS growth (%)	6.6	24.3	20.2	18.5
Norm. P/E (x)	17.0	15.6	13.0	11.0
EV/EBITDA (x)	5.4	4.7	3.8	3.0
Price/book (x)	2.3	2.1	1.8	1.6
Dividend yield (%)	1.4	1.8	2.1	2.5
ROE (%)	13.8	15.5	16.6	17.3
Net debt/equity (%)	20.2	25.0	14.5	net cash
Earnings revisions				
Previous norm. net profit		126.9	147.4	174.0
Change from previous (%)		(11.0)	(7.8)	(7.4)
Previous norm. EPS (RM)		0.55	0.64	0.76

Source: Company, Nomura estimates

Share price relative to MSCI Malaysia



	1m	3m	6m
Absolute (RM)	(0.2)	2.2	30.2
Absolute (US$)	0.2	5.2	35.9
Relative to Index	4.4	2.2	20.2
Market cap (US$mn)			522
Estimated free float (%)			37.0
52-week range (RM)			6.26/3.20
3-mth avg daily turnover (US$mn)			1.18
Stock borrowability			Hard
Major shareholders (%)			
Kulim Malaysia Berhad			56.0

Source: Company, Nomura estimates

Still positive on long-term exponential growth from India

India expansion remains next growth driver

India expansion remains on track, with the Yum! Brands' results and continued re-franchising strategy ex-China supporting QSR's foray into India

As of January 2011, QSR operates eight stores in Maharashtra, comprising three in Pune, one in Aurangabad and four in Mumbai. The recent release of FY10 results at Yum! Brands Inc. reaffirms the positive direction of QSR's future involvement in India, in our view, given the former's plans to continue re-franchising its company-owned restaurants to focus on what it sees as high-growth, high-return businesses — namely China, with same-store sales growth of 8% y-y in 2010, which contributes more to operating profit than all other countries under the Yum! International division combined. This supports QSR's consolidation in India, as Yum!'s five restaurants in Mumbai will potentially be transferred over to QSR in the near term, as discussed in our 8 February, 2011 report (http://www.nomura.com/research/getpub.aspx?pid=417790).

India is one of the top-10 emerging markets for Yum! Restaurants International

India was one of the top 10 emerging markets for Yum! Restaurants International (ie, the overseas division), registering sales growth of 39% on 21% store expansion (the highest among emerging markets) in FY10.

Exhibit 136. Store openings in Mumbai and Pune from 2H10

	Location	Opening date / planned date
1.	Orchid City Centre Mall, Mumbai, Maharasthra	Opened
2.	Prozone mall, Aurangabad, Maharasthra	Opened
3.	S.V Road, Mumbai	2011
4.	KStar mall, Chembur, Mumbai	Opened
5.	Inorbit Mall, J.M Road Pune	Feb 2011
6.	Viva City Mall, Thane	2011
7.	G-Corp Retail Mall, Pune	2011
8.	Phoenix Highstreet Mall	2011
9.	Nashik, Maharasthra	2011

Source: Company data, KFC India website

But, immediate near term may see rising raw material prices

Rising raw material costs limit near-term upside

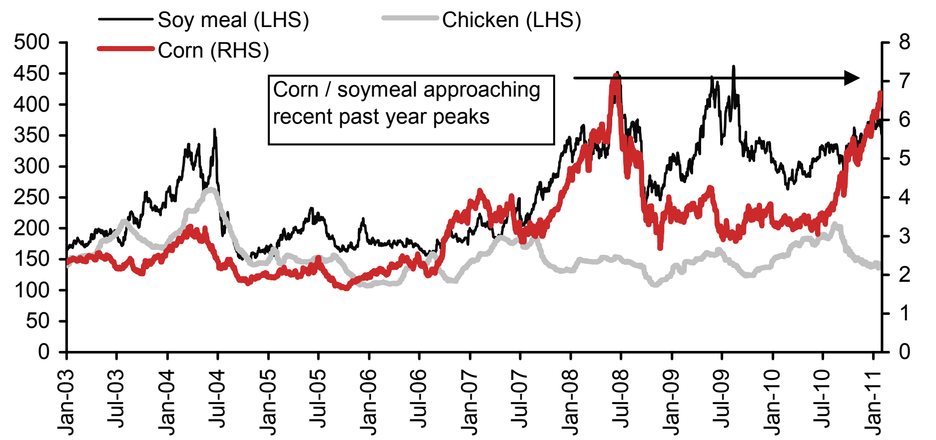
As discussed in our 21 July, 2010, report, *Lickin' good in India and ASEAN*, QSR negotiates bulk procurement contracts for most of its food inputs (eg, cheese) under Yum!'s global procurement strategy, while chicken feed inputs are obtained on a bulk purchase basis with other Malaysia buyers.

Bulk procurement strategy (implying relatively stronger purchasing power) to limit downside risk to margins, we believe…

Based on recent USDA reports highlighting falling stock-to-consumption ratios for most soft commodities (ie, corn and soy) and our bullish house view on soft commodity prices (as per Nomura Chief Asia Strategist Sean Darby, 19 January, 2011, *Asia's soft commodity crunch (XXIII)* (http://www.nomura.com/research/getpub.aspx?pid=413028), we expect lower margin upside momentum despite maintaining store growth assumptions of close to 10% for FY10-12F.

…but, less scope for margin expansion with feed inputs (soy, corn) closing in on 2008 peaks

Exhibit 137. Supply chain ownership, bulk procurement and fairly resilient pricing power to limit downside risk to margins; but imply limited margin expansion upside in the near term



Source: Bloomberg

For the past three years, average price hikes for KFC products have been in the range of 3-5% (generally slightly outpacing inflation), and a sharp weakening in pricing power or resistance to price hikes is unlikely, in our view, given wide acceptance of KFC products (reflected in its leading market share in Malaysia of 46% in 2009, according to a Euromonitor International report dated 13-Oct-2009) coupled with rising incomes and buoyant consumer sentiment in Malaysia.

Pricing power remains fair, given robust demand and consumer sentiment in Malaysia, which contributes nearly 80% of earnings

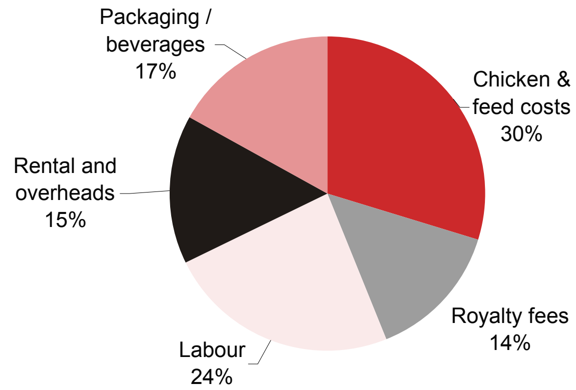
As such, our revised margin assumptions are largely based on a 2008-type scenario, where margin contraction was within a c. 1pp range.

Exhibit 138. QSR: revised margin assumptions

	FY10F	FY11F	FY12F
Old gross margins (%)	57.3	56.6	55.4
New gross margins (%)	57.3	56.2	54.0
Change	0	(0.4)	(1.4)
Old net margin (%)	4.2	4.6	4.9
New net margin (%)	3.8	4.2	4.5
Change	(0.4)	(0.4)	(0.4)

Source: Nomura estimates

Exhibit 139. Chicken and feed = c30% of total costs



Source: Nomura estimates based on FY09 numbers

With our downward margin revision, we pare our earnings forecasts for FY10-12F by 7-11% (ahead of the FY10F results announcement scheduled for 21 Feb), as we expect a rising cost outlook to potentially mute any margin expansion.

We impute the earnings impact of higher forward expenditure on expansions in the last quarter and rising costs potentially muting margin expansions, ahead of the FY10F results next week

Long-term positive, but near-term upside muted

NEUTRAL on muted near-term upside; although long-term fundamentals intact

We see the shares taking a breather while the company continues to deliver on its expansion progress, however long-term fundamentals remain intact and unchanged

After a c. 42% increase in its share price since July 2010 (outperforming the KLCI by 27%), we expect QSR's share price performance to take a breather as the company continues delivering on its expansion plans amid a muted cost outlook.

We remain positive on the expansion (and timeline), given the company's solid 37-year experience in the Malaysian market, as well as the positive growth over the longer-term from its foray into India. Our SOTP valuation methodology for QSR remains unchanged, valuing the rest of the business (ie, ex-India) at c. 12x earnings, average of its -1SD and mean level of 15x.

Exhibit 140. Revised valuation breakdown: no change to valuation methodology

PAT (RM '000)	**FY10F**	**FY11F**	**FY12F**
Integrated Poultry	11,857	12,387	11,861
Ancillary	463	2,178	1,633
Pizza Hut	26,579	29,979	34,058
KFC restaurants (elsewhere)	73,703	88,009	105,896
India	425	3,313	7,568
	113,027	135,867	161,015
			Multiple ascribed (x)
FV for rest of business			12
FV for India			22
Fair value breakdown			
Integrated Poultry	146,437	152,982	146,479
Ancillary	5,722	26,897	20,165
Pizza Hut	328,247	370,242	420,612
KFC restaurants (elsewhere)	910,227	1,086,917	1,307,817
India	9,529	74,215	169,517
	1,400,162	1,711,254	2,064,589
Fair value / Share breakdown			
Integrated Poultry	0.45	0.47	0.45
Ancillary	0.02	0.08	0.06
Pizza Hut	1.02	1.15	1.30
KFC restaurants (elsewhere)	2.82	3.36	4.05
India	0.03	0.23	0.52
FV / Share	**4.33**	**5.30**	**6.39**
PT derived from average of FY11F-FY12F FV/share			**5.84**

Source: Nomura estimates

We continue to derive our PT from the average of our FY11-12F FV/share, given that we expect the growth from India to become meaningful from FY12F onwards. Based on our revised estimates, our new PT is RM5.84 (was RM6.12).

Exhibit 141. On market numbers, Pizza Hut no longer free but not overvalued either

(RMmn, unless otherwise stated)	Mkt value (RMmn)	QSR stake (%)	Mkt value of QSR stake (RMmn)	Value per QSR share (RM)	QSR share price (RM)
KFC MK stake	2,776	50.64	1,406	4.84	5.47

Note: pricing as of 16 February, 2011

Source: Bloomberg

Exhibit 142. Comparative valuation

Company	Code		Mkt cap (US$mn)	Curr.	Price (Loc)	Rating	ROE (%) 2010F	ROE (%) 2011F	EPS gth (%) 2010F	EPS gth (%) 2011F	P/BV (x) 2010F	P/BV (x) 2011F	P/E (x) 2010F	P/E (x) 2011F
Malaysia F&B / Consumer space														
QSR Brands Bhd	QSR MK	Quick Service	524	RM	5.47	NEUTRAL	15.5	16.0	24.3	15.7	2.1	1.8	15.6	13.0
KFC Holdings Malaysia Bhd	KFC MK	Quick Service	912	RM	3.49	Not rated	16.9	16.8	13.0	12.5	2.9	2.5	18.2	16.2
Parkson Malaysia	PKS MK	Retail	1,995	RM	5.55	Not rated	17.0	17.1	14.5	18.1	3.0	2.6	18.9	16.0
Nestle Malaysia Berhad	NESZ MK	F&B	3,484	RM	45.36	Not rated	66.4	64.1	7.6	5.2	16.9	15.7	24.5	23.3
F&N Holdings Bhd	FNH MK	F&B	1,835	RM	15.60	Not rated	38.0	21.0	100.8	-34.8	3.3	3.1	11.1	17.0
AEON	AEON MK	Retail	707	RM	6.15	Not rated	14.3	15.1	19.6	10.2	2.0	1.8	13.7	12.4
International														
Fairwood Ltd	52 HK	Restaurants	176	HK$	10.9	Not rated	24.3	31.5	31.3	19.0	3.0	2.9	13.0	10.9
Little Sheep	968 HK	Restaurants	621	HK$	4.33	Not rated	17.4	21.7	20.6	25.4	4.2	3.8	23.9	19.1
Fraser & Neave	FNN SP	F&B	6,587	S$	6.06	BUY	10.7	9.3	62.7	3.9	1.4	1.3	14.5	13.9

Source: Bloomberg for not rated stocks, Nomura estimates for rated stocks; pricing as of 16 February, 2011

Risks to our price target

Downside risks to our PT include: 1) non-renewal of the franchise licence with Yum! after the 10+10 year contract period; 2) deteriorating domestic consumer confidence on worries of a double dip in QSR's key markets; and 3) fewer-than-expected store openings. Upside risks include: 1) store opening growth greater than our assumption of c10% pa overall.

Financial statements

Income statement (RMmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	533	2,760	3,001	3,245	3,577
Cost of goods sold	(163)	(1,166)	(1,281)	(1,423)	(1,644)
Gross profit	**370**	**1,594**	**1,720**	**1,822**	**1,933**
SG&A	(346)	(1,388)	(1,475)	(1,522)	(1,571)
Employee share expense	-	-	-	-	-
Operating profit	**24**	**206**	**245**	**300**	**363**
EBITDA	**50**	**320**	**381**	**453**	**533**
Depreciation	(24)	(104)	(136)	(153)	(170)
Amortisation	(2)	(10)	-	-	-
EBIT	**24**	**206**	**245**	**300**	**363**
Net interest expense	(9)	(12)	(13)	(13)	(16)
Associates & JCEs	57	-	-	-	-
Other income	26	36	37	37	37
Earnings before tax	**98**	**230**	**269**	**323**	**383**
Income tax	(14)	(72)	(81)	(97)	(115)
Net profit after tax	**84**	**158**	**188**	**226**	**268**
Minority interests	2	(67)	(75)	(91)	(107)
Other items					
Preferred dividends	-	-	-	-	-
Normalised NPAT	**85**	**91**	**113**	**136**	**161**
Extraordinary items					
Reported NPAT	**85**	**91**	**113**	**136**	**161**
Dividends	(19)	(23)	(28)	(34)	(40)
Transfer to reserves	**66**	**68**	**85**	**102**	**121**
Valuation and ratio analysis					
FD normalised P/E (x)	17.7	17.0	15.6	13.0	11.0
FD normalised P/E at price target (x)	18.9	18.1	16.7	13.9	11.7
Reported P/E (x)	18.6	17.5	14.1	11.7	9.9
Dividend yield (%)	1.2	1.4	1.8	2.1	2.5
Price/cashflow (x)	28.3	4.9	6.4	4.2	3.6
Price/book (x)	2.5	2.3	2.1	1.8	1.6
EV/EBITDA (x)	16.3	5.4	4.7	3.8	3.0
EV/EBIT (x)	21.5	8.4	7.3	5.7	4.4
Gross margin (%)	69.4	57.7	57.3	56.2	54.0
EBITDA margin (%)	9.4	11.6	12.7	14.0	14.9
EBIT margin (%)	4.4	7.5	8.2	9.3	10.1
Net margin (%)	16.0	3.3	3.8	4.2	4.5
Effective tax rate (%)	14.3	31.2	30.0	30.0	30.0
Dividend payout (%)	22.1	25.3	25.0	25.0	25.0
Capex to sales (%)	8.8	7.8	7.3	6.6	6.0
Capex to depreciation (x)	1.9	2.1	1.6	1.4	1.3
ROE (%)	15.4	13.8	15.5	16.6	17.3
ROA (pretax %)	9.9	14.7	12.1	13.5	15.2
Growth (%)					
Revenue	14.2	418.1	8.7	8.1	10.2
EBITDA	7.5	539.9	19.1	19.0	17.6
EBIT	(0.3)	770.3	18.9	22.5	20.9
Normalised EPS	27.3	6.6	24.3	20.2	18.5
Normalised FDEPS	13.1	4.3	8.6	20.2	18.5
Per share					
Reported EPS (RM)	0.29	0.31	0.39	0.47	0.55
Norm EPS (RM)	0.29	0.31	0.39	0.47	0.55
Fully diluted norm EPS (RM)	0.31	0.32	0.35	0.42	0.50
Book value per share (RM)	2.18	2.36	2.65	3.00	3.41
DPS (RM)	0.06	0.08	0.10	0.12	0.14

Source: Nomura estimates

Lowered margins by 1pp across the board, implying slower-than-expected margin expansion, however long-term fundamentals remain unchanged

Cashflow (RMmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	50	320	381	453	533
Change in working capital	2	32	(74)	2	6
Other operating cashflow	5	(28)	(57)	(75)	(95)
Cashflow from operations	**56**	**324**	**249**	**380**	**443**
Capital expenditure	(47)	(215)	(220)	(215)	(215)
Free cashflow	**9**	**109**	**29**	**165**	**228**
Reduction in investments	(84)	605	-	-	-
Net acquisitions	(1)	(6)	-	-	-
Reduction in other LT assets	4	(621)	(52)	(65)	(56)
Addition in other LT liabilities	1	38	-	-	-
Adjustments	53	66	(50)	(58)	14
Cashflow after investing acts	**(18)**	**191**	**(73)**	**42**	**186**
Cash dividends	(19)	(23)	(45)	(34)	(40)
Equity issue	102	0	-	-	-
Debt issue	(72)	(18)	88	81	58
Convertible debt issue	-	-	-	-	-
Others	(6)	(16)	-	-	-
Cashflow from financial acts	**5**	**(57)**	**43**	**47**	**18**
Net cashflow	**(14)**	**134**	**(30)**	**88**	**204**
Beginning cash	42	28	162	132	220
Ending cash	28	162	132	221	424
Ending net debt	150	139	192	126	(6)

Source: Nomura estimates

Relatively positive free cashflow position despite expansion plans

Balance sheet (RMmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	28	162	132	220	425
Marketable securities	-	-	-	-	-
Accounts receivable	30	166	194	210	232
Inventories	29	190	228	253	293
Other current assets	-	-	-	-	-
Total current assets	**87**	**519**	**555**	**684**	**949**
LT investments	605	-	-	-	-
Fixed assets	146	866	951	1,013	1,058
Goodwill	51	72	72	72	72
Other intangible assets	-	-	-	-	-
Other LT assets	14	636	688	753	809
Total assets	**903**	**2,093**	**2,266**	**2,522**	**2,889**
Short-term debt	6	37	61	35	59
Accounts payable	79	394	386	429	495
Other current liabilities	1	16	16	16	16
Total current liabilities	**86**	**447**	**463**	**480**	**570**
Long-term debt	173	265	264	311	359
Convertible debt	-	-	-	-	-
Other LT liabilities	10	48	48	48	48
Total liabilities	**269**	**759**	**775**	**839**	**977**
Minority interest	1	646	722	812	920
Preferred stock	-	-	-	-	-
Common stock	286	286	286	286	286
Retained earnings	307	379	469	576	703
Proposed dividends	(19)	(23)	(28)	(34)	(40)
Other equity and reserves	59	45	42	42	42
Total shareholders' equity	**633**	**687**	**769**	**871**	**992**
Total equity & liabilities	**903**	**2,093**	**2,266**	**2,522**	**2,889**
Liquidity (x)					
Current ratio	1.01	1.16	1.20	1.43	1.66
Interest cover	2.5	17.7	19.5	22.4	22.4
Leverage					
Net debt/EBITDA (x)	3.01	0.44	0.51	0.28	net cash
Net debt/equity (%)	23.7	20.2	25.0	14.5	net cash
Activity (days)					
Days receivable	20.8	12.9	21.9	22.8	22.6
Days inventory	47.8	34.2	59.6	61.8	60.8
Days payable	158.7	74.0	111.1	104.5	102.9
Cash cycle	(90.0)	(26.8)	(29.6)	(20.0)	(19.5)

Source: Nomura estimates

Hindustan Unilever HUVR IN

CONSUMER RELATED/GENERAL CONSUMER | INDIA

Maintained

REDUCE

NOMURA

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Action

Although recent volume growth momentum has been a positive surprise, continued margin pressure and tough comps over the next couple of quarters remain a concern for us. Despite the recent correction, valuations are rich at 24.6x FY12F. We would sell into strength at these levels. Maintain REDUCE with unchanged TP of Rs222.

Catalysts

We believe the company's focus on regaining lost market share will keep A&P spending high and pricing power low, which could hurt margins in FY12.

Anchor themes

HUVR has a dominant position across various categories in the FMCG space, but is now facing intense pressure from global and local players, which, we believe, will hold back earnings growth in FY12F.

Closing price on 16 Feb	Rs275.9
Price target	Rs222.0
	(set on 17 Jun 10)
Upside/downside	-19.5%
Difference from consensus	-11.2%
FY11F net profit (Rsmn)	21,298
Difference from consensus	-12.1%

Source: Nomura

Nomura vs consensus

We believe consensus expectation is overtly optimistic with regard to improvement in margins into FY12F. We believe margin pressures will get worse before it gets better.

Prefer food names in the sector

① Prefer food names within India consumer

As we have said in main section of this report, we believe the longer term attractions in food far outweigh the HPC space in India. The company's focus in the near term will continue to remain in the HPC space, which we believe will see a structural decline in profitability over the medium term. We prefer investment in food names such as Jubilant Foodworks and GSK Consumer (both BUY) and Nestlé India (NEUTRAL).

② Margin pressure to intensify

Q3FY11 was the fourth consecutive quarter of EBITDA & PAT decline. The company has really felt the heat of rising competition and increase in commodity prices. Despite recent price hikes, we believe the situation will continue to worsen. This remains the primary cause for concern for us.

③ Volume growth unlikely to sustain

Given the high base of Q4FY10 and H1FY11 and recent fill reductions, we believe that volume growth is unlikely to sustain. Amongst the business, performance of body wash and personal products remains a cause of concern as there could be a structural decline in profitability.

④ Valuations expensive, maintain REDUCE

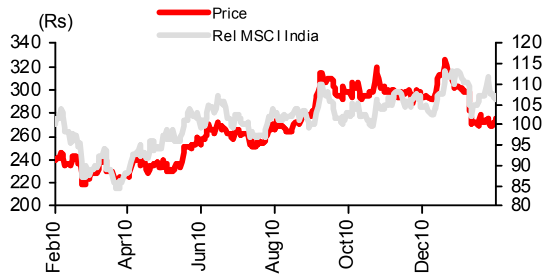
YTD, Hindustan Unilever has underperformed the Sensex and FMCG index by 0.8% and 1% respectively. The stock trades at 24.6x FY12F, which translates into a PEG of 3x (vs a sector average of 1.2x) and offers negative incremental risk-reward, we think. We continue to remain negative on the stock given that pressure on profitability is likely to intensify over the next couple of quarters. Maintain REDUCE.

Key financials & valuations

31 Mar (Rsmn)	FY09	FY10	FY11F	FY12F
Revenue	207,827	180,256	193,344	215,378
Reported net profit	24,754	21,566	21,298	24,478
Normalised net profit	24,899	20,971	21,298	24,478
Normalised EPS (Rs)	11.42	9.61	9.76	11.22
Norm. EPS growth (%)	43.1	(15.8)	1.6	14.9
Norm. P/E (x)	24.2	28.7	28.3	24.6
EV/EBITDA (x)	18.0	19.9	19.6	17.1
Price/book (x)	31.9	24.9	22.5	20.6
Dividend yield (%)	3.7	3.1	3.2	3.7
ROE (%)	155.8	100.2	83.5	87.4
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		20,971	21,298	24,478
Change from previous (%)		0.0	0.0	(0.0)
Previous norm. EPS (Rs)		9.61	9.76	11.22

Source: Company, Nomura estimates

Share price relative to MSCI India



	1m	3m	6m
Absolute (Rs)	(8.8)	(7.6)	2.2
Absolute (US$)	(9.1)	(8.0)	5.1
Relative to Index	(5.1)	2.1	3.1
Market cap (US$mn)			13,227
Estimated free float (%)			41.2
52-week range (Rs)			325.7/219.4
3-mth avg daily turnover (US$mn)			15.89
Stock borrowability			Hard
Major shareholders (%)			
LIC of India			6.9
New India Assurance			1.3

Source: Company, Nomura estimates

Business update

Amongst the worst performing stocks in the consumer space

Valuations expensive vs. peers despite recent correction

After an extremely strong run in the H2CY10, Hindustan Unilever has been one of the worst performing stocks in our consumer coverage YTDCY11. The stock has corrected in excess of 16% since early January, thereby underperforming the consumer index and Sensex by 1.3% and 2.6% respectively. We think some of the triggers for this outperformance have been:

- Rising commodity prices which are likely to put further pressure on the company's profitability.
- Competitive intensity continues to remain high and thus rising advertising spends would keep operating margins under pressure. Further, with the Cricket world cup just round the corner, we believe that the stakes are likely to rise further.
- The stock had run up in H2CY10 on the back of defensive buying interest and expectation of improvement in performance.

Exhibit 143. Consumer stock performance

Stock	16-Feb-11	3-Jan-11	Return YTD (%)
Hindustan Unilever	**276**	**313**	**(11.8)**
Nestle India	3,386	3,836	(11.7)
Asian Paints	2,550	2,875	(11.3)
Sensex	18,301	20,561	(11.0)
FMCG Index	3,295	3,693	(10.8)
ITC	157	175	(10.4)
Godrej Consumer	364	387	(6.0)
Dabur	97	101	(3.6)
Colgate Palmolive	828	828	(0.0)
Marico	125	121	3.1

Source: Bloomberg, Nomura Research

However, valuations still look expensive

However, despite the steep correction, valuation continues to remain expensive on a relative basis. At CMP, the stock trades at a P/E multiple of 24.6x FY12F earnings, which is a 5% premium to the sector average. We believe HUVR should trade at a reasonable discount to the sector average as it offers one of the lowest earnings growth profile. We believe current valuations are building in significant improvement in profitability into FY12F, which we see as unlikely. On a PEG basis HUVR trades at 3x vs. the sector average nearer 1.2x.

Exhibit 144. Consumer Sector valuations

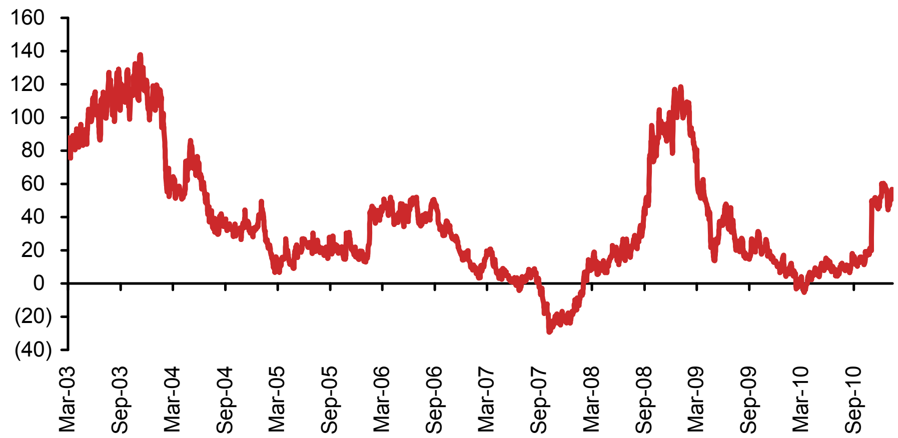
Company	Ticker	Rating	Price (Rs)	P/E (x) FY11F	P/E (x) FY12F	FY12F PEG (x)
Asian Paints	APNT IN	BUY	2,550	27.0	23.0	1.2
Colgate Palmolive	CLGT IN	REDUCE	828	25.1	22.8	3.3
Dabur	DABUR IN	BUY	97	27.7	21.8	1.0
Godrej Consumer	GCPL IN	NEUTRAL	364	24.6	19.1	0.5
Hindustan Unilever	HUVR IN	REDUCE	276	28.3	24.6	3.0
ITC	ITC IN	BUY	157	24.5	21.0	1.3
Marico	MRCO IN	REDUCE	125	27.0	22.9	1.3
United Spirits	UNSP IN	BUY	1,184	27.8	19.4	0.3
Titan Industries	TTAN IN	REDUCE	3,257	43.1	34.3	1.1
Nestle *	NEST IN	NEUTRAL	3,386	39.6	31.4	1.4
Pantaloon Retail	PF IN	BUY	278	16.6	12.1	0.3
Jubilant Foodworks	JUBI IN	BUY	499	46.6	34.4	0.5
GSK Consumer *	SKB IN	BUY	2,100	29.4	24.4	0.9
Average				**28.0**	**23.5**	**1.2**

Note: * = Nestle valuations are for CY10 & CY11E

Source: Bloomberg, Nomura Research

Even on a premium/discount to Sensex basis, the stock has seen the premium increase significantly over the last 4-5 months on the back of no significant improvement in operational performance. We believe that the current premium of 60% to Sensex will also shrink over the near to medium term as earnings keep disappointing.

Exhibit 145. Hindustan Unilever: Premium to Sensex



Source: Bloomberg, Nomura Research

Margins under pressure…

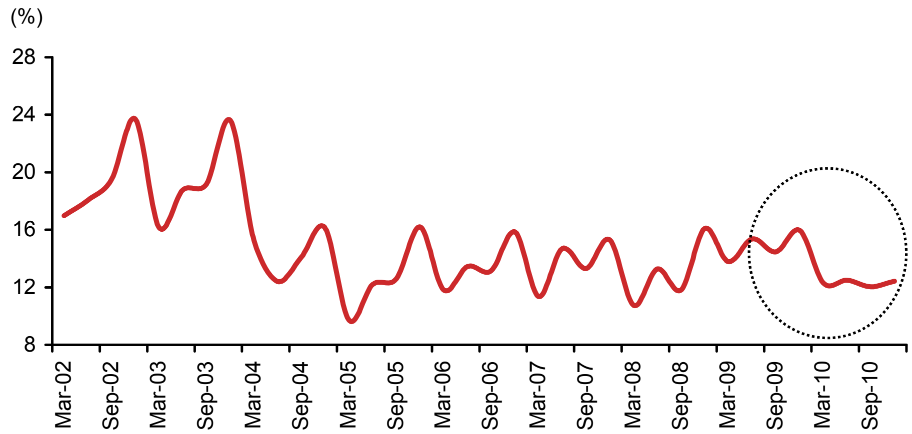
EBITDA margins have continued to remain under pressure

As we have said in the past, margin volatility has been on account of the company trying to balance volume growth vs. profitability, which they unfortunately have been unsuccessful in. They have either delivered on strong volume growth performance like the past few quarters, or have delivered on high margins at the expense of volume growth like in FY10.

Margins in Q3FY11 were down 360bps y-y to 12.4%, amongst the lowest level in the last nine quarters. Incidentally this is the fourth straight quarter of EBITDA decline for the company. This is a cause for serious concern, in our view.

The going from here is going to get even tougher as Q4FY11 & Q1FY12 face tough comps even in terms of volumes, and we would expect weakness in margins to worsen as commodity prices increase.

Exhibit 146. Operating profit margins trending down



Source: Company, Nomura Research

...led by a sharp fall in personal products

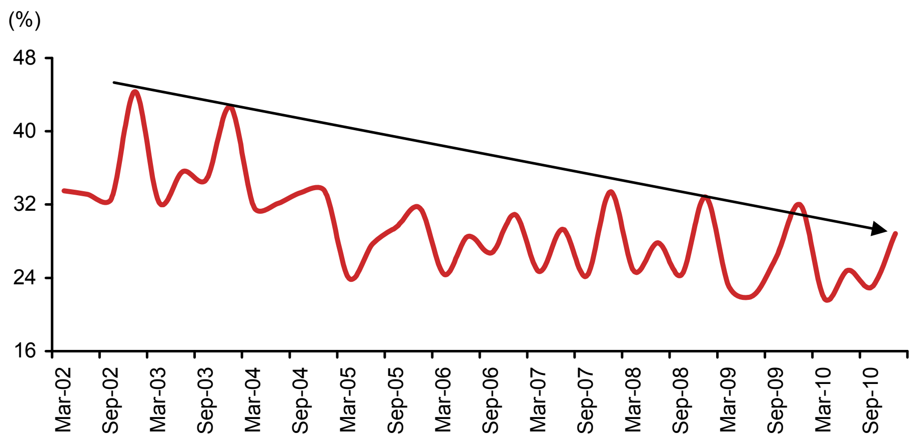
Personal products business, which contributes about 32% to total company sales & 65% of the profits, witnessed a margins decline of 310bps y-y. This we believe is the biggest cause of concern. The thing to note is that operating margins in personal products portfolio at 28.8% are now the lowest witnessed in Oct-Dec quarter in the last 8 years for HUL.

This is on the back of continuing promotions in the shampoo segment which have taken a toll on profitability. Also, things continue to be tough in the oral care segment where they have been consistently losing share and have recently upped the ante in terms of promotions.

Things we believe are going to worsen here, given the entry of ITC in the skin care segment (which is the highest margin business for HUL).

This used to be one of the highly profitable businesses within the HUVR portfolio a few years back, but has seen a steady long-term decline in margins as competition from both national and MNC players have eaten into the company's profitability. With competition expected to remain tough in the near to medium term, margins in this segment will continue to remain under pressure.

Exhibit 147. Personal products segment profitability



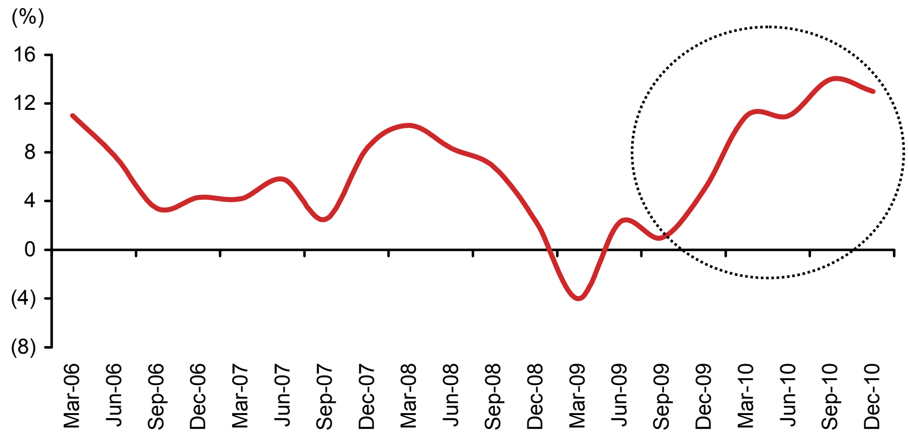
Source: Company, Nomura Research

Going to get tough now

One of the things which the Street seems to be excited about has been the robust volume growth. While we do acknowledge that it has been a surprise, we believe what has helped the company has been: a) weak comps from last year, b) increase fill levels due to the on going price wars, and c) inventory build up at the dealer level.

However, we believe the current growth momentum is likely to be tough to maintain given that the comps will now get progressively tougher (Q4FY10: 11% and Q1FY11:11%). This we believe is something to watch out for.

Exhibit 148. Volume growth

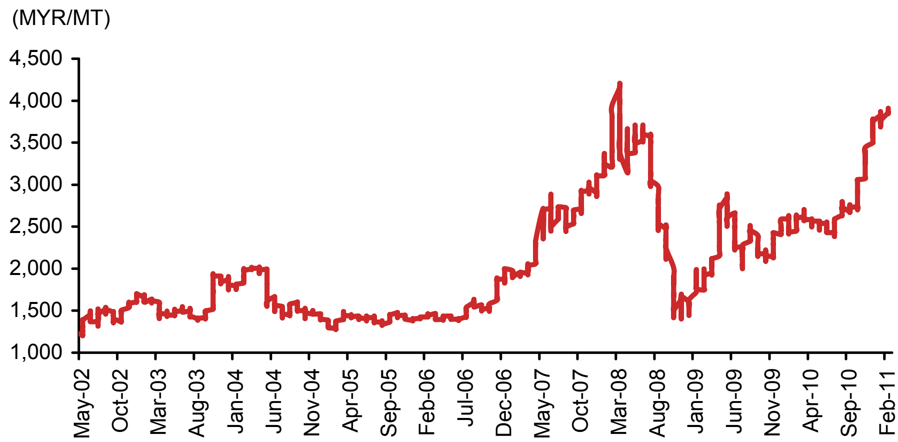


Source: Company, Nomura Research

Input prices continue to harden

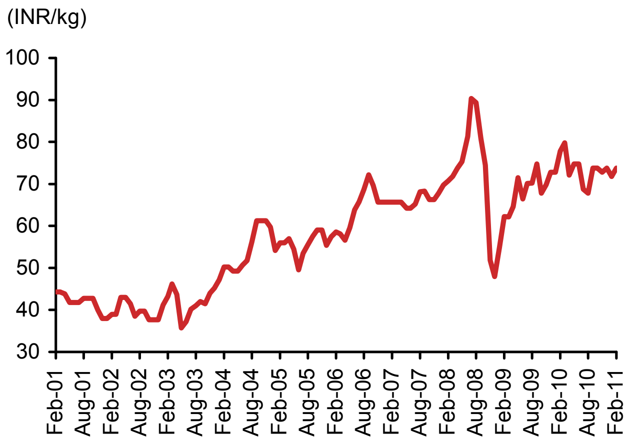
Input prices have continued to harden over the past few months. Although the company has made some price hikes, this is only to partly offset these rising input costs. The company did acknowledge that only a part of the rise in input costs has been passed on to consumers. This has led to margins continuing to remain under pressure and company will need more prices hikes in the coming quarters to offset this. However, this could mean a negative impact on volume growth.

Exhibit 149. Malaysian palm oil prices



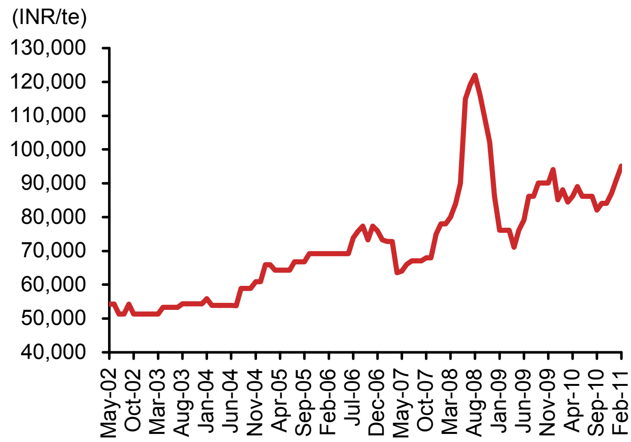
Source: Bloomberg, Nomura Research

Exhibit 150. Polymer prices



Source: Bloomberg, Nomura Research

Exhibit 151. LAB prices



Source: Bloomberg, Nomura Research

No changes to TP & earnings estimates

We have not made any changes to our target prices or earnings estimates. Our target price of Rs222 is based on 20x FY12F multiple of Rs11.2.

Conclusion

We continue to remain negative on the stock given that profitability increasingly keeps coming under pressure. Rising commodity costs and higher advertising spends are likely to bring margins under pressure. Moreover, what makes risk-reward unfavourable is valuations, which look rich at 24.6x FY12F. We believe the food sector is a much better play on the long term consumption story and would advise investors to switch to Jubilant foodworks and GSK Consumer. Maintain REDUCE.

Upside risks

Upside risks to our numbers could come from a sharp drop in input prices as well as from a marked slowdown in the competitive environment in the sector. However, we do not believe either of these scenarios will pan out in the near term.

Financial statements

Income statement (Rsmn)					
Year-end 31 Mar	**FY07**	**FY09**	**FY10**	**FY11F**	**FY12F**
Revenue	140,552	207,827	180,256	193,344	215,378
Cost of goods sold	(73,782)	(109,938)	(90,115)	(98,129)	(109,206)
Gross profit	**66,770**	**97,889**	**90,141**	**95,215**	**106,172**
SG&A	(37,183)	(55,389)	(53,152)	(56,920)	(62,760)
Employee share expense	(7,815)	(11,890)	(9,709)	(10,480)	(11,674)
Operating profit	**21,772**	**30,610**	**27,279**	**27,815**	**31,738**
EBITDA	**23,191**	**32,610**	**29,198**	**29,756**	**33,769**
Depreciation	(1,419)	(2,000)	(1,919)	(1,940)	(2,030)
Amortisation					
EBIT	**21,772**	**30,610**	**27,279**	**27,815**	**31,738**
Net interest expense	(265)	(264)	(75)	(11)	(11)
Associates & JCEs	-	-	-	-	-
Other income					
Earnings before tax	**21,507**	**30,346**	**27,204**	**27,804**	**31,727**
Income tax	(4,090)	(5,392)	(6,153)	(6,506)	(7,250)
Net profit after tax	**17,417**	**24,953**	**21,051**	**21,298**	**24,478**
Minority interests	(40)	(54)	(80)	-	-
Other items					
Preferred dividends					
Normalised NPAT	**17,377**	**24,899**	**20,971**	**21,298**	**24,478**
Extraordinary items	1,771	(145)	594	-	-
Reported NPAT	**19,148**	**24,754**	**21,566**	**21,298**	**24,478**
Dividends	(19,597)	(22,409)	(18,874)	(19,168)	(22,030)
Transfer to reserves	**(449)**	**2,345**	**2,691**	**2,130**	**2,448**
Valuation and ratio analysis					
FD normalised P/E (x)	34.6	24.2	28.7	28.3	24.6
FD normalised P/E at price target (x)	27.8	19.5	23.1	22.7	19.8
Reported P/E (x)	31.4	24.3	27.9	28.3	24.6
Dividend yield (%)	3.3	3.7	3.1	3.2	3.7
Price/cashflow (x)	37.4	21.1	15.2	34.0	19.4
Price/book (x)	46.4	31.9	24.9	22.5	20.6
EV/EBITDA (x)	25.9	18.0	19.9	19.6	17.1
EV/EBIT (x)	27.6	19.2	21.3	21.0	18.2
Gross margin (%)	47.5	47.1	50.0	49.2	49.3
EBITDA margin (%)	16.5	15.7	16.2	15.4	15.7
EBIT margin (%)	15.5	14.7	15.1	14.4	14.7
Net margin (%)	13.6	11.9	12.0	11.0	11.4
Effective tax rate (%)	19.0	17.8	22.6	23.4	22.9
Dividend payout (%)	102.3	90.5	87.5	90.0	90.0
Capex to sales (%)	0.7	2.5	2.8	(0.2)	1.0
Capex to depreciation (x)	0.7	2.6	2.7	(0.2)	1.1
ROE (%)	na	155.8	100.2	83.5	87.4
ROA (pretax %)	na	48.3	40.1	38.0	41.9
Growth (%)					
Revenue	11.8	47.9	(13.3)	7.3	11.4
EBITDA	15.7	40.6	(10.5)	1.9	13.5
EBIT	14.8	40.6	(10.9)	2.0	14.1
Normalised EPS	2.6	43.1	(15.8)	1.6	14.9
Normalised FDEPS	(9.1)	43.0	(15.8)	1.6	14.9
Per share					
Reported EPS (Rs)	8.79	11.36	9.88	9.76	11.22
Norm EPS (Rs)	7.98	11.42	9.61	9.76	11.22
Fully diluted norm EPS (Rs)	7.98	11.41	9.61	9.76	11.22
Book value per share (Rs)	5.94	8.64	11.10	12.28	13.40
DPS (Rs)	9.00	10.28	8.65	8.79	10.10

Source: Nomura estimates

EBITDA margins have continued to be under pressure

Cashflow (Rsmn)					
Year-end 31 Mar	**FY07**	**FY09**	**FY10**	**FY11F**	**FY12F**
EBITDA	23,191	32,610	29,198	29,756	33,769
Change in working capital	1,329	(766)	13,278	(5,999)	4,593
Other operating cashflow	(8,440)	(3,307)	(2,973)	(6,057)	(7,261)
Cashflow from operations	**16,080**	**28,537**	**39,503**	**17,699**	**31,101**
Capital expenditure	(1,025)	(5,209)	(5,102)	424	(2,205)
Free cashflow	**15,055**	**23,328**	**34,401**	**18,123**	**28,896**
Reduction in investments	9,231	11,415	(9,368)	-	-
Net acquisitions	-	-	-	-	-
Reduction in other LT assets		-	-	-	-
Addition in other LT liabilities		-	-	-	-
Adjustments					
Cashflow after investing acts	**24,287**	**34,743**	**25,033**	**18,123**	**28,896**
Cash dividends	(23,322)	(22,409)	(18,874)	(19,168)	(22,030)
Equity issue	(3,014)	394	(390)	-	-
Debt issue	97	3,320	(4,233)	-	-
Convertible debt issue	-	-	-	-	-
Others	(32)	(31)	(53)	-	-
Cashflow from financial acts	**(26,272)**	**(18,727)**	**(23,550)**	**(19,168)**	**(22,030)**
Net cashflow	**(1,985)**	**16,016**	**1,483**	**(1,045)**	**6,866**
Beginning cash	4,609	2,624	18,641	20,124	19,079
Ending cash	2,624	18,641	20,124	19,079	25,945
Ending net debt	(1,603)	(14,300)	(20,015)	(18,971)	(25,837)

Source: Nomura estimates

Balance sheet (Rsmn)					
As at 31 Mar	**FY07**	**FY09**	**FY10**	**FY11F**	**FY12F**
Cash & equivalents	2,624	18,641	20,124	19,079	25,945
Marketable securities					
Accounts receivable	4,649	5,606	6,917	7,026	8,046
Inventories	20,038	25,805	22,264	23,932	26,631
Other current assets	6,885	7,816	6,088	8,047	8,120
Total current assets	**34,196**	**57,868**	**55,393**	**58,085**	**68,741**
LT investments	14,292	2,876	12,244	12,244	12,244
Fixed assets	17,477	21,359	24,943	22,579	22,754
Goodwill					
Other intangible assets					
Other LT assets					
Total assets	**65,965**	**82,103**	**92,580**	**92,908**	**103,739**
Short-term debt					
Accounts payable	38,977	43,325	53,522	49,593	55,245
Other current liabilities	12,974	15,515	14,638	16,305	19,036
Total current liabilities	**51,950**	**58,839**	**68,160**	**65,898**	**74,281**
Long-term debt	1,021	4,341	108	108	108
Convertible debt					
Other LT liabilities					
Total liabilities	**52,972**	**63,181**	**68,269**	**66,006**	**74,390**
Minority interest	55	78	105	105	105
Preferred stock					
Common stock	2,177	2,180	2,182	2,182	2,182
Retained earnings					
Proposed dividends				-	-
Other equity and reserves	10,761	16,664	22,026	24,615	27,063
Total shareholders' equity	**12,938**	**18,844**	**24,207**	**26,797**	**29,245**
Total equity & liabilities	**65,965**	**82,103**	**92,580**	**92,908**	**103,739**
Liquidity (x)					
Current ratio	0.66	0.98	0.81	0.88	0.93
Interest cover	82.2	115.7	365.2	2,566.0	2,927.9
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	12.2	11.3	12.7	13.2	12.8
Days inventory	52.7	95.1	97.3	85.9	84.7
Days payable	118.8	170.7	196.1	191.8	175.7
Cash cycle	(53.8)	(64.4)	(86.1)	(92.7)	(78.1)

Source: Nomura estimates

Balance Sheet remains strong

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