

FY 2013

Equity Research Report

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[COLGATE PALMOLIVE (INDIA)]

Colgate is a large global dental hygiene brand. Colgate is an equally strong brand in India and enjoys almost 50% market share in the dental fluoride (toothpaste) space. This research report looks at the company's performance and future potential to arrive at a valuation for the company using a value investment approach. It endeavors to provide an investment recommendation on the Colgate (India) stock to value investors.

Value Investment Philosophy and Analysis Framework

Value Investing is a discipline that assesses the performance of a business independent of market perceptions. This enables us to identify major mispricing of stocks and use this to our advantage. Popular investment theory believes in efficient markets free of any mispricing, a notion that 'the markets are always right'. We dispel such notions and specifically look for such mispricing as investment opportunities. The discipline of value investing believes that the markets have wild mood swings ranging from exuberance to pessimism, thus implying that 'the markets are always wrong' when it comes to pricing stocks.

The mispricing that we observe in the market often tends to last for very long periods. Hence, it is important for us to be very long term investors. If one does not have the patience to hold onto an investment for 3 to 5 years, this is not an appropriate investment approach for them.

Since we start with the notion that the market is inaccurate at pricing stocks, what consequently follows is that there is no single correct valuation for a company and that value is a perception of every individual investor. The problem for small investors under such an approach is that transactions can only be executed at the market price, whatever may be their perception of value. Thus there is always a risk that one's perceived value may never be realized in the market. In order to reduce this risk, we have a section on 'market perception' in our report, to keep us cognizant of how the market has historically valued a company and how different is it from our valuation.

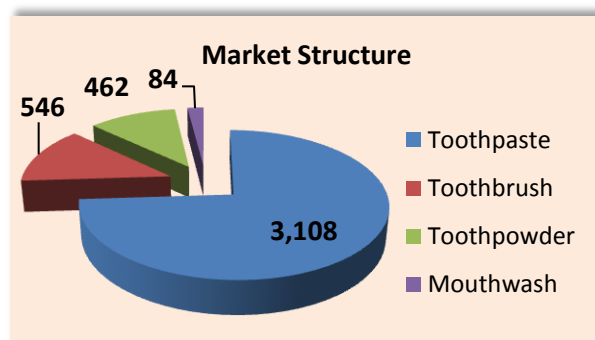
Another major concept in our valuation approach is conservatism. We are fully aware of the fact that there a multitude of assumptions that go into a valuation, many of which could be wrong. Hence, it is important to maintain a margin of safety in our recommendations. It is because of this that we come up with a very wide price range between the 'undervalued' and 'overvalued' state for a stock. This reduces our ability to do frequent trades in a stock but enables us to do a few transactions with very little risk and high return potential.

Market Structure Analysis

It is the economy and the market in which a business operates that determines how it will perform in future. Thus an analysis of these markets enables us to come up with good projections for the future performance.

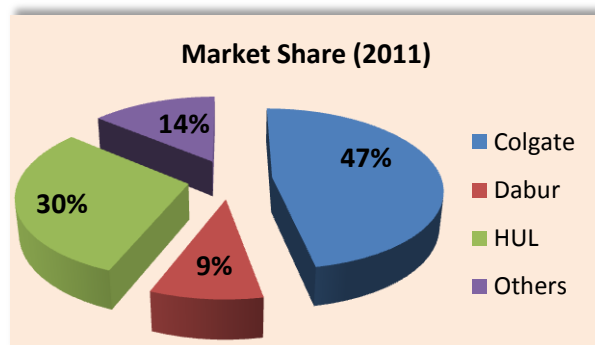
The Indian Dental Care market comprises of several products, the largest of which is Toothpaste. Details of Market size of various products are as follows:

Dental Care Market	By Value	Market size
Products	2011	2011
Toothpaste	74%	3,108
Toothbrush	13%	546
Toothpowder	11%	462
Mouthwash	2%	84
Total Size (Rs. Cr.)		4,200



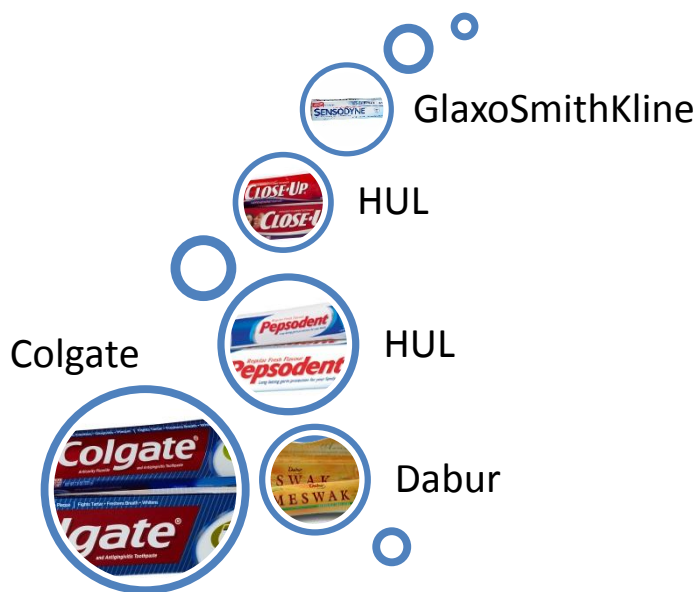
In this market, Colgate has almost half the market share, with HUL being the second. Details of Market Share are as below.

Market Share	2011
Colgate	47%
Dabur	9%
HUL	30%
Others	14%



The various players and their brands are as below:

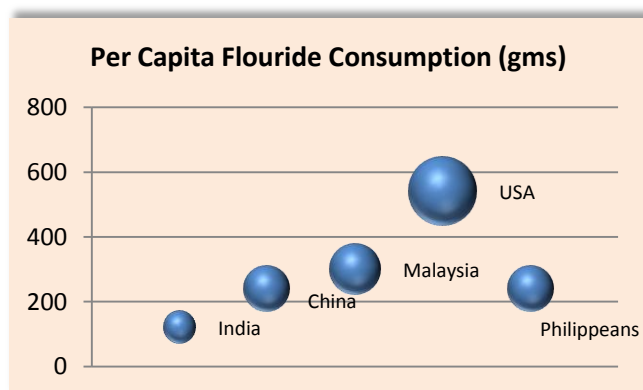
Company	Brands
Colgate-Palmolive	Colgate Cibaca
HUL	Pepsodent Close Up
Dabur	Promise Dabur Babool Meswak
GSK	Sensodyne
Vico	Vico
Perfetti	Happydent
Wrigley	Orbit
Johnson and Johnson	Listerine



Market Size and Potential

The per capita fluoride (toothpaste) consumption in India is much lower than other developed and many developing countries. Being a very basic need commodity, we believe that its consumption patterns can be projected based on increases in per capita income. The chart below shows details of these metrics.

Country	Per Capita Flouride Consumption (gms)	Per Capita Income (PPP)
	2012	2012
India	120	3650
USA	540	48112
China	240	8400
Malaysia	300	16051
Philippeans	240	4119



Market Size & Revenue Projections

Approach 1: Based on Economic Parameters. We have projected the following Market Size Growth.

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Projected Population	1,210	1,227	1,244	1,262	1,279	1,297	1,315	1,334	1,352	1,371	1,390	1,410	1,430	1,450
Projected GDP (PPP) Growth	4,711	5,041	5,394	5,771	6,175	6,607	7,070	7,565	8,094	8,661	9,267	9,916	10,610	11,353
Per Capita Income	3,893	4,108	4,335	4,575	4,827	5,094	5,375	5,672	5,985	6,316	6,665	7,033	7,421	7,831
Per Capita Flouride Consumption	120	126	133	141	148	156	165	173	183	193	203	214	226	240
Flouride Consumption (tonnes)	1,45,200	1,55,183	1,65,853	1,77,257	1,89,444	2,02,469	2,16,390	2,31,269	2,47,170	2,64,164	2,82,327	3,01,739	3,22,485	3,47,929
Growth (%)		6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	6.88%	7.89%
Projected Market Size	4,200	4,704	5,268	5,901	6,609	7,402	8,290	9,285	10,399	11,647	13,045	14,610	16,363	18,327

Assumptions:

Population growth of 1.4%

GDP Growth of 7%

Per Capita Flouride Consumption Growth of 5.4%

Value Growth due to Value Addition and Inflation = 5%

Market Size Growth of 12%

Approach 2: Based on Past Market Size Growth rates

The Past Sales in Volume and Value Terms for both HUL and Colgate are as below. We have used these as a secondary source to verify if the above projections make sense. In case of HUL, we've used the data of their Personal Products Division, of which Dental Products is a part, as separate data for their Dental Products brands is not available. Hence, it is not comparable to Colgate, but it serves our limited purpose of projecting the market growth rates accurately as the market for Dental Products would generally behave on similar lines as that of Personal Products.

Quantity Sales	2007	2008	2009	2010	2011
Colgate (toothpaste) – dozens	8,23,02,066	8,60,71,290	9,70,97,536	11,02,22,340	
<i>Growth</i>		4.58%	12.81%	13.52%	
Colgate (toothbrush) – dozens	1,53,73,342	1,41,66,463	1,62,76,173	2,02,90,312	
<i>Growth</i>		-7.85%	14.89%	24.66%	
HUL (Personal Products) – thousands		1,24,30,657	1,34,07,782	1,50,27,047	1,72,96,730
<i>Growth</i>			7.86%	12.08%	15.10%

Value Sales	2007	2008	2009	2010	2011	2012
Colgate (toothpaste) Rs. Lacs	1,16,624	1,30,884	1,51,926	1,74,657	2,04,299	2,41,382
<i>Growth</i>		12.23%	16.08%	14.96%	16.97%	18.15%
Colgate (toothbrush) Rs. Lacs	12,709	16,121	17,334	21,338	27,107	31,980
<i>Growth</i>		26.85%	7.53%	23.09%	27.04%	17.98%
HUL (Personal Products) Rs. Lacs		3,86,080	4,49,290	5,10,733	5,92,617	6,84,586
<i>Growth</i>			16.37%	13.68%	16.03%	15.52%

One of the risks with this assumption is that we are using sales growth numbers of companies as a substitute for the Market's growth rates. An increase in market share will lead to higher projection of growth rates and a drop in the market shares can lead to a lower projection of growth rates. In case of Colgate, we know that the company's Market share has been steady. However, we do not know the same about HUL's Personal Care division.

However, we can adjust for this by being conservative in our projections. In any case past growth rates can never be an accurate indicator of future growth.

Revenue Projections for Colgate

We are making 3 different Revenue projections for Colgate.

1. The first one is the most optimistic one, assuming a 15% market growth rate, based on past growth rates for 5 years, followed by 12% till 2025. Market Share is assumed to remain constant.
2. The second one is a more realistic one, assuming a 12% market growth rate till 2025, based on economic parameters. Market Share is assumed to remain constant.
3. The third one is the most conservative one, assuming a 12% market growth rate till 2025, but assuming a drop in Market share by 100 bps every year.

In all cases, Revenue from sources other than the core toothpaste business is projected to grow at 10%.

Optimistic:

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Projected Market Size	4,200	4,830	5,555	6,388	7,346	8,448	9,715	10,881	12,186	13,649	15,287	17,121	19,175	21,476
Projected Market Share	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Projected Revenue – Toothpaste	2,100	2,415	2,777	3,194	3,673	4,224	4,857	5,440	6,093	6,824	7,643	8,560	9,588	10,738
Other Revenue	643	707	778	856	941	1,036	1,139	1,253	1,378	1,516	1,668	1,835	2,018	2,220
Total Revenue	2,743	3,122	3,555	4,050	4,614	5,259	5,997	6,693	7,471	8,340	9,311	10,395	11,606	12,958

Realistic:

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Projected Market Size	4,200	4,704	5,268	5,901	6,609	7,402	8,290	9,285	10,399	11,647	13,045	14,610	16,363	18,327
Projected Market Share	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Projected Revenue – Toothpaste	2,100	2,352	2,634	2,950	3,304	3,701	4,145	4,642	5,200	5,823	6,522	7,305	8,182	9,163
Other Revenue	643	707	778	856	941	1,036	1,139	1,253	1,378	1,516	1,668	1,835	2,018	2,220
Total Revenue	2,743	3,059	3,412	3,806	4,246	4,736	5,284	5,895	6,578	7,340	8,190	9,140	10,200	11,383

Conservative:

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Projected Market Size	4,200	4,704	5,268	5,901	6,609	7,402	8,290	9,285	10,399	11,647	13,045	14,610	16,363	18,327
Projected Market Share	50%	50%	49%	48%	47%	46%	45%	44%	43%	42%	41%	40%	39%	38%
Projected Revenue – Toothpaste	2,100	2,352	2,582	2,832	3,106	3,405	3,731	4,085	4,472	4,892	5,348	5,844	6,382	6,964
Other Revenue	643	707	778	856	941	1,036	1,139	1,253	1,378	1,516	1,668	1,835	2,018	2,220
Total Revenue	2,743	3,059	3,360	3,688	4,048	4,440	4,870	5,338	5,850	6,408	7,016	7,679	8,400	9,184

Valuation

Discounted Cash Flow Approach

We have valued Colgate based on a DCF approach with the following assumptions for various variables.

Factors	Optimistic	Moderate	Conservative
PAT Margin	17%	16%	15%
Discount Rate (post tax)	8%	8%	8%
Terminal Growth Rate	3%	3%	3%
No. of Shares outstanding	13.5993	13.5993	13.5993

The Revenue Projections for the Optimistic, Moderate and Conservative growth scenarios are taken from the Market Projections above.

The Valuations are as follows:

	Optimistic	Moderate	Conservative
Value of Total Equity	25,680	21,445	16,913
Value per Share	1,888	1,577	1,244

Sensitivity:

We have applied some sensitivity to key variables and arrived at the following valuations under various scenarios.

Sensitivity to Interest Rate	7%	8%	9%
Optimistic	2,438.31	1,888.31	1,526.49
Moderate	2,031.98	1,576.95	1,277.51
Conservative	1,589.96	1,243.64	1,015.14

Sensitivity to Perpetual Growth / PE Multiple	4%/26	3%/20	2%/17
Optimistic	2,209.94	1,888.31	1,673.89
Moderate	1,842.87	1,576.95	1,399.67
Conservative	1,444.77	1,243.64	1,109.55

Asset Value Approach

We have done a simple Asset Value based approach to figure out the amount of intangibles that are built into the current valuation.

Asset	Rs. Cr.
Book Value	434.58
Intangibles	
Channel Asset	655.97
Brand Asset	5,530.40
Asset Value	6,620.95
AV per Share	486.86

In the above valuation, we have taken Channel Asset at 5 years value of 5% of Revenue and Brand Asset as 10 years of Advertisement and Sales Promotion Expenditure.

Reconciling AV and DCF

We realize that Colgate has a substantially higher value in terms of Earnings Power than it has in terms of Asset Value. This implies that the Intangibles in this business, especially the value of the Brand are substantially higher than we have estimated. We have reverse engineered the AV to figure out the number of years' Intangibles are captured in a valuation of Rs. 1500 per share.

Head	Rs. Cr.
Valuation Per Share	1,500.00
Value of Equity	20,398.95
Book Value of Company	434.58
Intangibles Value	19,964.37
Annual Channel and Brand Exp.	684.23
No. of years advantage	29

Our calculations imply that at a valuation of 1500, the company has a 29 year competitive advantage. This seems absurdly high. In order to see if this is normal or is an anomaly, we look at the Price to Book value ratios of FMCG companies in the Indian Market, as well as in the Developed Markets.

Price to Book Ratio in Indian Markets

Sr	Company Name	Last Price	% Chg	Book Value	PBV Ratio	Year
1	Godrej Consumer	843.65	0.45	74.16	11.38	Mar '12
2	Emami	659.55	-0.02	46.04	14.33	Mar '12
3	Godrej Ind	306.25	-1.15	36.46	8.40	Mar '12
4	Colgate	1,508.95	0.27	32.02	47.13	Mar '12
5	Marico	216.90	-1.70	17.43	12.44	Mar '12
6	HUL	572.40	0.01	16.24	35.24	Mar '12
7	Dabur India	160.45	6.54	7.48	21.46	Mar '12

Price to Book Ratios in Global Markets

Company	P/B Ratio	P/E Ratio
Unilever	6.11	21.45
Procter & Gamble	3.22	17.52
Colgate	31.77	24.75

Thus, we can see that Colgate does have a very strong brand, giving it a high P/B ratio in Indian as well as Global Markets. Hence, its intangible value seems to be very high.

Comparables based Valuation

We have also done a comparables based valuation, to see if our DCF based valuation is in line with the Market or not.

Company	P/E Ratio	Sales
Colgate	40.69	2,688
HUL	32.60	22,118
Marico	32.62	2,977
P&G	46.48	1,297
Dabur	47.33	3,759
Godrej Consumer	56.21	2,975
Gillette	80.25	1,232
Industry Average PE	38.65	37,046
Colgate EPS	32.83	
Valuation per Share	1,268.89	

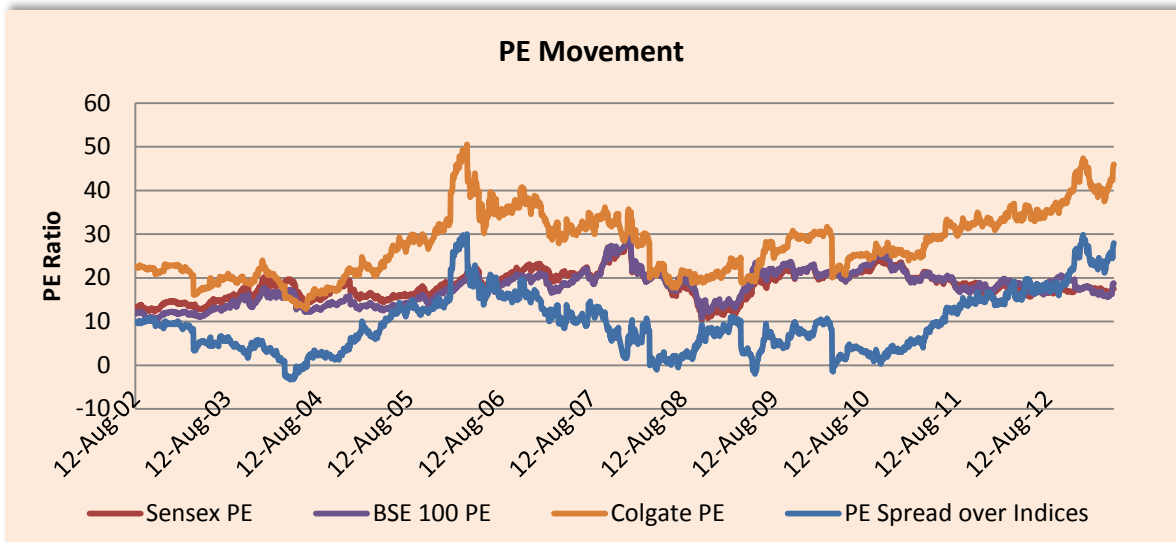
Reverse Engineering DCF

Colgate has historically traded in a wide PE range from 25 to 50. We have looked at various PE levels to see what its implications are for our valuation assumptions. Keeping the Post Tax Interest rate at 8% and Perpetual Growth Rate at 3%, the following PE ratios are implied by various growth rates and growth periods.

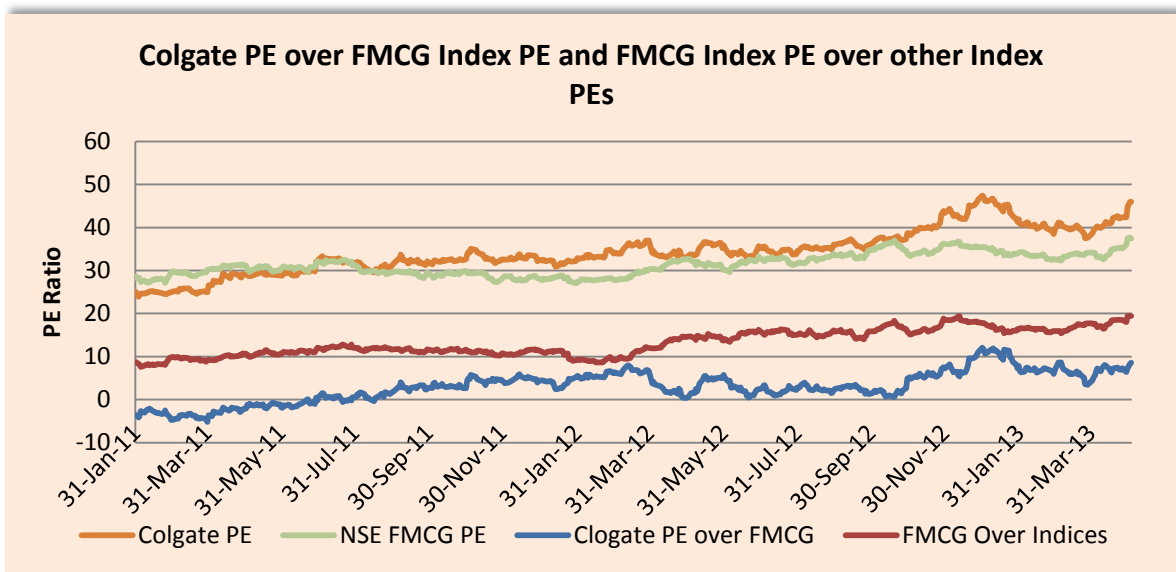
Projected PE Ratios	No. of years' high growth period								
	6	8	10	12	14	16	18	20	
Growth Rate over high growth period	10%	28	31	34	37	41	44	47	51
	12%	31	35	40	45	50	56	62	68
	14%	34	40	46	53	61	70	80	91
	16%	37	45	54	64	76	89	105	123
	18%	41	51	63	77	94	114	138	166
	20%	45	57	73	92	116	145	180	225

Market Perception

The Movement of PE ratios of Colgate and various Indices, as well as PE Spread over those Indices are as per chart below.



Comparison of Colgate PE with FMCG Index PE and FMCG Index PE with other Index PEs



Summary and Recommendation

Colgate (India) is a typical 'Stalwart' in our categorization of stocks. The company has a very strong brand and around 50% market share in India. The Indian operations are supported by a strong global brand. While it faces stiff competition from other players that could lead to gradual loss of market share, we can still expect growth in volumes on the strength of increasing fluoride consumption in India. Thus there is enough room for the market growth. Furthermore, due to its brand strength, we expect the company to be able to retain its profit margins in the foreseeable future.

We would expect a stock like Colgate to follow a predictable and sustainable growth path for a long time. These factors combine to give Colgate (and other FMCG majors) a high PE ratio. While it may be a good stock to hold, we do not see any extra-ordinary upside to the company's and its shareholders' fortunes. Hence, we do not view it as a value investment opportunity at its current prices.

Based on our analysis, we value the Colgate Palmolive (India) stock at Rs. 1577. Our valuation range is Rs. 1244 and Rs. 1888 for the stock.

Analyst Certification

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