FY 2013

Equity Research Report

Author: Spruhal Mody

[HINDUSTAN UNILEVER]

Hindustan Unilever is a large global FMCG company with multiple brands in its portfolio. Several of HUL's brands are market leaders in India. 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 HUL 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 whit 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 FMCG Market has a total market size of USD 13 Billion (INR 65,000 Crores) as at 2012. The top companies in this sector and their market share are as below.

Company	Market Size	Share
HUL	22,118	34.03%
Dabur	3,759	5.78%
Marico	2,977	4.58%
Godrej	2,975	4.58%
Colgate	2,688	4.14%
P&G	1,297	2.00%
ITC (Food and Personal Care)	4,370	6.72%
Others	24,816	38.18%
Total	**65,000**	
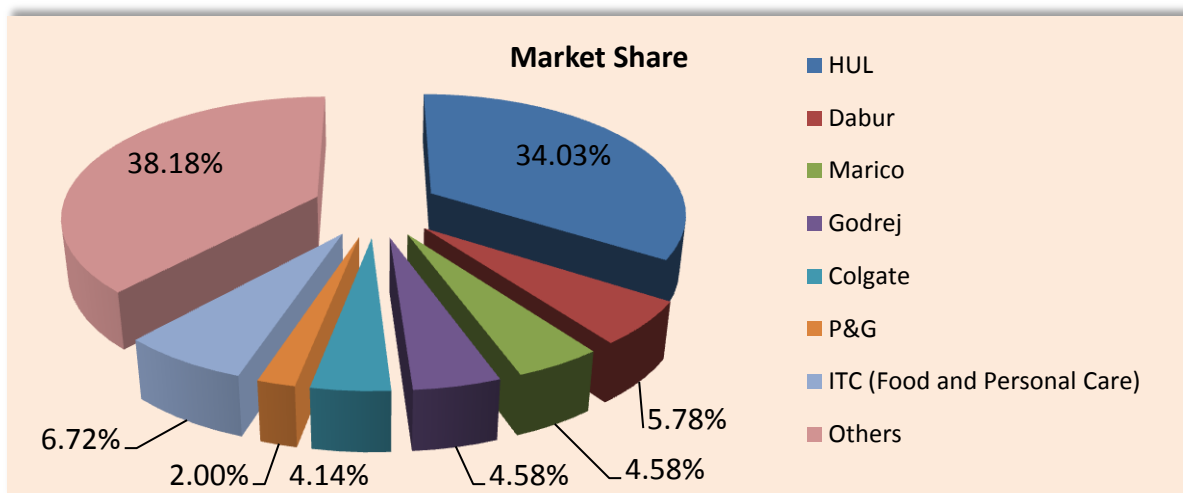
This sector comprises of several sub-categories. These are Soaps and Detergents, Personal Products, Beverages (Tea and Coffee) and Packaged Food. HUL's distribution of Revenue across these segments is as below.

| Business Segment	Revenue (Rs. Cr) 2012
Soaps and Detergents	10,636
Personal Care Products	6,846
Beverages (Tea and Coffee)	2,617
Packaged Food	1,359
Others	636
Total	**22,094**

HUL's Revenue Split by business segment
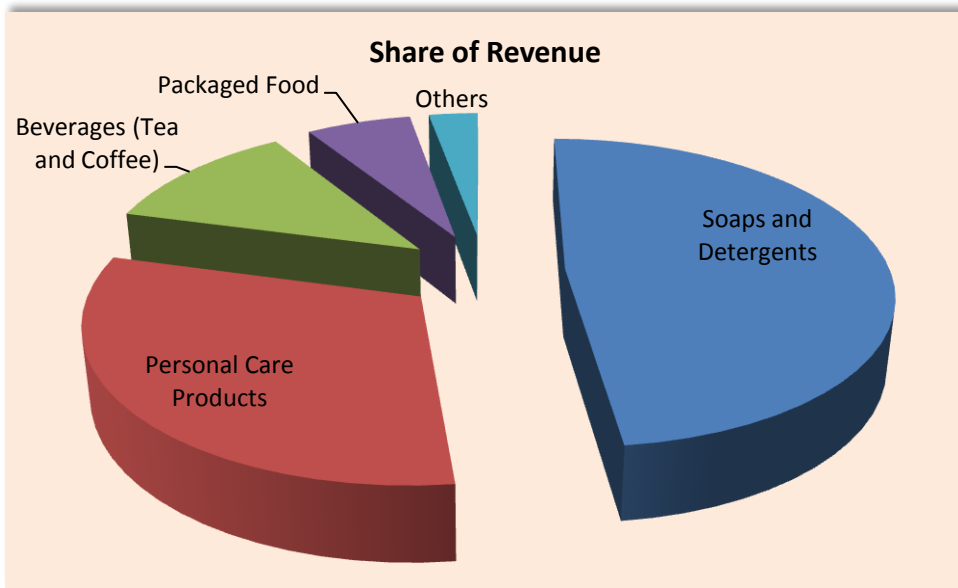
Within these segments, HUL has some of the topmost brands in each category

Market growth potential

The per capita consumption of most categories of FMCG products is very low in India as compared to the rest of the world. While we cannot project exact market size for every category and aggregate it, it is useful to look at these numbers to know that there is enough headway for growth.
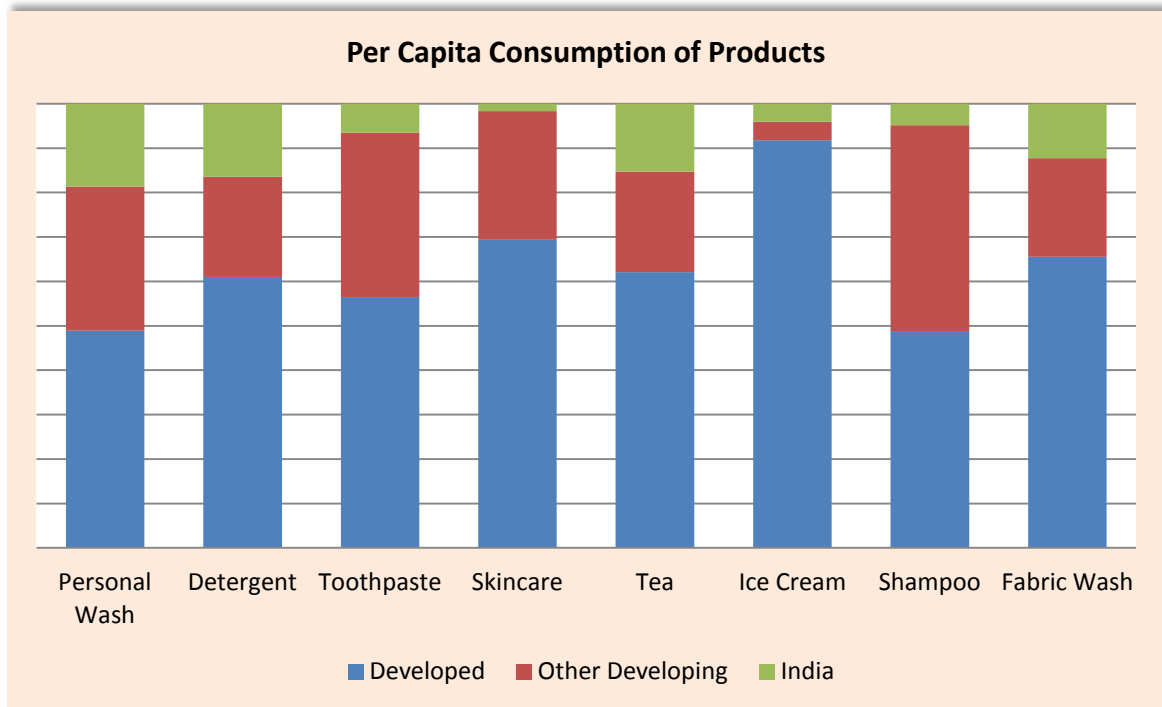
Market Size & Revenue Projections

HUL is such a large player in the market and there are multiple product markets that it caters to. We are not making any specific market size projections and are assuming HUL's market share to remain constant. We can make such assumptions as a drop in market share in one product can be covered up by a gain in the market share of other products. Hence, we are directly projecting HUL's revenue, based on its past growth rates and our expectation of future Industry Growth rates.

Revenue and Profit Projections

We are making 3 different Revenue projections for HUL – Optimistic, Moderate and Pessimistic. We have used various growth rates for different lines of business over the future years to arrive at these projections.

We have studied the profitability of various business segments and projected the future profitability of the company.

Revenue and Profit Projections:

Revenue	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Optimistic	22,094	25,457	29,336	33,810	38,972	44,929	51,759	59,641	65,822	72,656	80,213	88,539	97,749	1,07,939
Moderate	22,094	25,229	28,811	32,904	37,582	42,929	47,261	52,033	57,288	63,076	69,451	73,618	78,035	82,717
Pessimistic	22,094	24,786	27,807	31,198	35,004	39,276	42,827	46,699	50,922	55,527	60,549	64,182	68,033	72,115
Profits														
Optimistic	2,885	3,323	3,827	4,409	5,079	5,852	6,739	7,762	8,560	9,441	10,414	11,486	12,670	13,979
Moderate	2,509	2,865	3,271	3,735	4,265	4,871	5,362	5,902	6,498	7,153	7,875	8,348	8,849	9,380
Pessimistic	2,240	2,513	2,819	3,163	3,548	3,981	4,341	4,734	5,162	5,629	6,138	6,506	6,896	7,310

Projected Growth Rate and Margins:

Margins	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Optimistic	13%	13%	13%	13%	13%	13%	13%	13%	13%	13%	13%	13%	13%	13%
Moderate	11%	11%	11%	11%	11%	11%	11%	11%	11%	11%	11%	11%	11%	11%
Pessimistic	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Growth Rate														
Optimistic		15.22%	15.24%	15.25%	15.27%	15.28%	15.20%	15.23%	10.36%	10.38%	10.40%	10.38%	10.40%	10.43%
Moderate		14.19%	14.20%	14.21%	14.22%	14.23%	10.09%	10.10%	10.10%	10.10%	10.11%	6.00%	6.00%	6.00%
Pessimistic		12.18%	12.19%	12.19%	12.20%	12.20%	9.04%	9.04%	9.04%	9.04%	9.04%	6.00%	6.00%	6.00%

The above projections are based on our Revenue Growth and Margin assumptions for HUL's individual business segments. These are detailed below.

Projected Segment wise Revenue Growth Rates:

Optimistic Scenario	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Soaps and Detergents	15%	15%	15%	15%	15%	15%	15%	15%	10%	10%	10%	10%	10%	10%
Personal Care Products	15%	15%	15%	15%	15%	15%	15%	15%	10%	10%	10%	10%	10%	10%
Beverages (Tea and Coffee)	15%	15%	15%	15%	15%	15%	15%	15%	10%	10%	10%	10%	10%	10%
Packaged Food	20%	20%	20%	20%	20%	20%	20%	20%	15%	15%	15%	15%	15%	15%
Others	12%	12%	12%	12%	12%	12%	8%	8%	8%	8%	8%	6%	6%	6%

Moderate Scenario	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Soaps and Detergents	14%	14%	14%	14%	14%	14%	10%	10%	10%	10%	10%	6%	6%	6%
Personal Care Products	14%	14%	14%	14%	14%	14%	10%	10%	10%	10%	10%	6%	6%	6%
Beverages (Tea and Coffee)	14%	14%	14%	14%	14%	14%	10%	10%	10%	10%	10%	6%	6%	6%
Packaged Food	18%	18%	18%	18%	18%	18%	12%	12%	12%	12%	12%	6%	6%	6%
Others	12%	12%	12%	12%	12%	12%	8%	8%	8%	8%	8%	6%	6%	6%

Pessimistic Scenario	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Soaps and Detergents	12%	12%	12%	12%	12%	12%	9%	9%	9%	9%	9%	6%	6%	6%
Personal Care Products	12%	12%	12%	12%	12%	12%	9%	9%	9%	9%	9%	6%	6%	6%
Beverages (Tea and Coffee)	12%	12%	12%	12%	12%	12%	9%	9%	9%	9%	9%	6%	6%	6%
Packaged Food	15%	15%	15%	15%	15%	15%	10%	10%	10%	10%	10%	6%	6%	6%
Others	12%	12%	12%	12%	12%	12%	8%	8%	8%	8%	8%	6%	6%	6%

Segment wise profit margins projected:

Segment Profitability	Optimistic	Moderate	Pessimistic
Soaps and Detergents	12%	10%	9%
Personal Care Products	16%	14%	12%
Beverages (Tea and Coffee)	12%	11%	10%
Packaged Food	10%	10%	10%
Others	10%	10%	10%

Valuation

Discounted Cash Flow Approach

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

Factors	Optimistic	Moderate	Conservative
Discount Rate (post tax)	8%	8%	8%
Terminal Growth Rate	3%	3%	3%
No. of Shares outstanding	220	220	220

The Revenue and Profit 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 Equity (Rs. Crore)	1,71,079	1,20,278	94,802
Value of Share	777	546	430

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	1001	777	629
Moderate	698	546	446
Conservative	549	430	352

Sensitivity to Perpetual Growth / PE Multiple	4%/26	3%/20	2%/17
Optimistic	907	777	691
Moderate	633	546	488
Conservative	498	431	385

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.

Head	Rs. Cr.
Book Value	3,681
Intangibles	
Channel Asset	5,924
Brand Asset	26,969
Asset Value	**36,575**
AV per Share	166

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 HUL 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. 550 per share.

Head	Rs. Cr.
Valuation Per Share	550
Value of Equity	121,000
Book Value of Company	3681
Intangibles Value	117,319
Annual Channel and Brand Exp.	3,882
No. of years advantage	30

Our calculations imply that at a valuation of 550, the company has a 30 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 HUL does have a very strong brand, but its P/B ratio in the Global Market is much lower than in the Indian market. However, this can be justified by the fact that HUL is a clear market leader in India, with no competitor to match its size and brand value.

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
Gilette	80.25	1,232
Industry Average PE	**38.65**	**37,046**
HUL EPS	12.91	
Valuation per Share	499.00	

Reverse Engineering DCF

HUL has historically traded in a wide PE range from 15 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 HUL and various Indices, as well as PE Spread over those Indices are as per chart below.
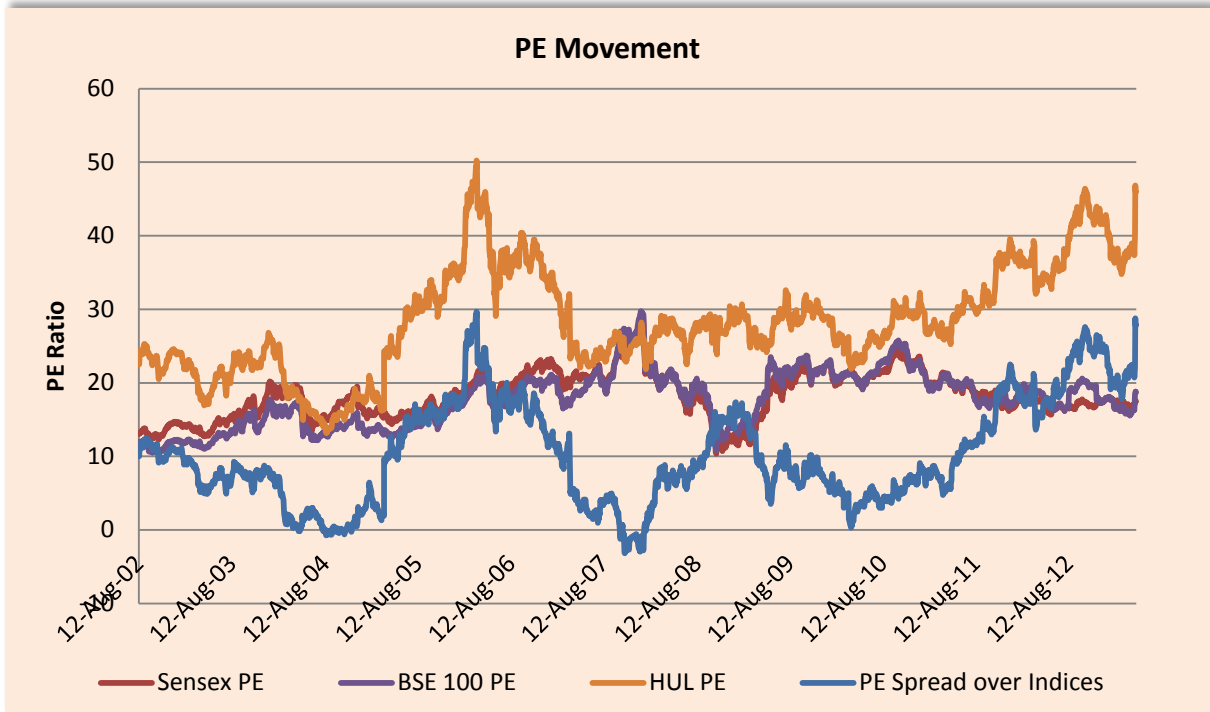
Comparison of HUL PE with FMCG Index PE and FMCG Index PE with other Index PEs
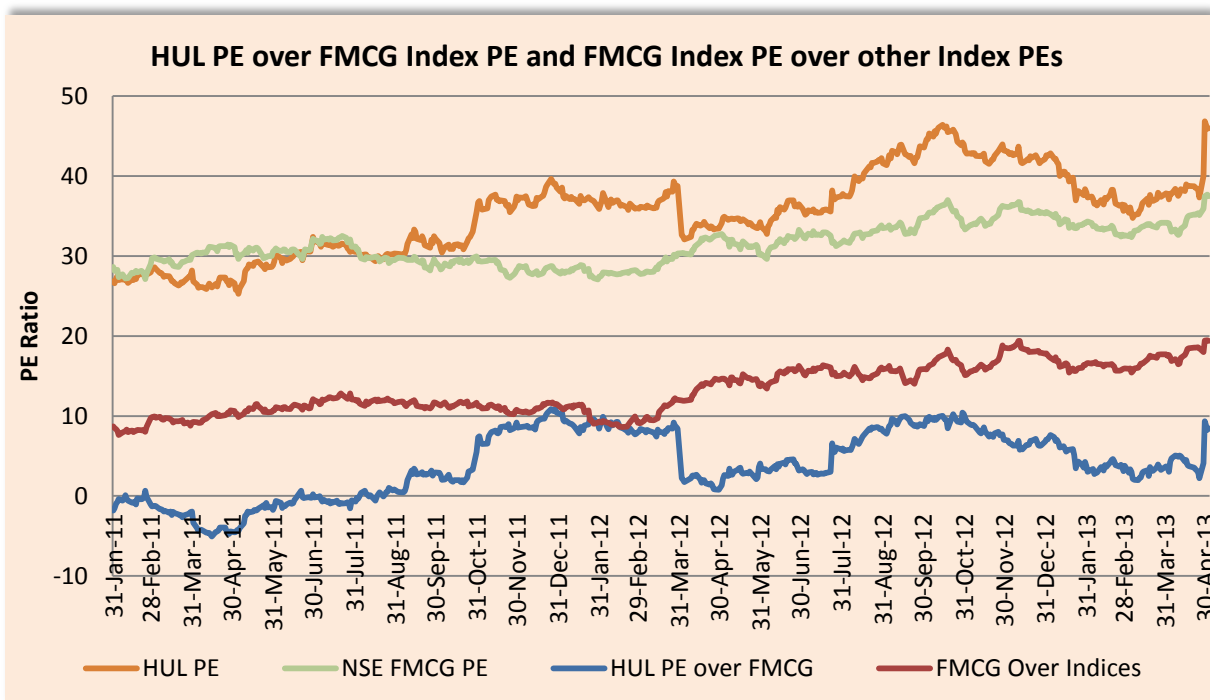
Summary and Recommendation

Hindustan Unilever is a typical 'Stalwart' in our categorization of stocks. The company has very strong brands with leadership positions in most of its markets. The Indian operations are supported by a strong global parent. The quality of the management is regarded as one of the best in India. This leads us to believe that the company will be able to maintain its leadership position in most of its markets for a long time in the future. Furthermore, there is enough room for market growth in the FMCG segment on the back of increased economic growth and prosperity in India.

We would expect a stock like HUL to follow a predictable and sustainable growth path for a long time. These factors combine to give HUL (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 consider a fair valuation of the company at Rs. 546 per share. Our valuation range for the stock is Rs. 430 and Rs. 777.

Analyst Certification

"I, Spruhal Mody certify that the opinions contained in this report are my independent opinions and are a result of my personal research. I do not derive any direct or indirect compensation from the publication of this report or any opinions contained therein. My personal investment positions are consistent with the views expressed in this report as of the date of its publication."

Analyst Contact:

spruhal_mody@yahoo.co.in
http://spruhalinvests.wordpress.com