

SEPTEMBER 30, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **1,396**

Target price (Rs): **1,600**

BSE-30: **16,853**

**Sitting pretty.** Asian Paints (APNT) continues to be our top pick in midcap FMCG as we see (1) good volume growth sustaining, (2) potential for positive margin surprise in FY2010E versus Street estimates and (3) likely pickup in residential sales volumes in FY2010-11E. Our EPS estimates are the highest on the Street and 10% higher than consensus. Reiterate ADD.

#### Company data and valuation summary

Asian Paints

##### Stock data

52-week range (Rs) (high,low) 1,448-681

Market Cap. (Rs bn) 133.9

##### Shareholding pattern (%)

Promoters 50.0

FIs 14.1

MFs 3.4

##### Price performance (%)

Absolute 1M 3M 12M

Rel. to BSE-30 (0.3) 17.5 17.6

(5.8) 3.0 (8.6)

##### Forecasts/Valuations

	2009	2010E	2011E
EPS (Rs)	38.6	60.0	69.8
EPS growth (%)	(1.7)	55.5	16.3
P/E (X)	36.2	23.3	20.0
Sales (Rs bn)	42.7	50.9	59.5
Net profits (Rs bn)	3.7	5.8	6.7
EBITDA (Rs bn)	6.2	9.5	11.0
EV/EBITDA (X)	21.6	14.0	12.0
ROE (%)	36.6	46.8	43.8
Div. Yield (%)	1.3	1.9	2.2

#### QUICK NUMBERS

- Sustaining good volume growth
- Emulsions outperforming enamels and distempers
- Upside risk to our EBITDA margin assumption of 17.5% for FY2010E exist
- Our EPS estimates are highest on the Street; 10% higher than consensus

#### Sustaining good volume growth

In our view, factors aiding the good volume growth in decoratives (likely >12% in 1QFY10, similar trends seen in 2QFY10E) for APNT are (1) continuing good demand conditions in Tier II and III towns, (2) shorter repainting cycle driven by likely improvement in penetration and (3) likely return of demand in key metros. Media reports suggest APNT's sales growth in Tier II, III towns are outperforming top metros—confirming the view highlighted earlier (*report titled "Bright prospects" dated July 27, 2009*). The company is likely deriving ~65% of revenues from these markets.

#### Mix improvement and input cost correction pose upside risks to our (relatively high) estimates

We believe that upside risk to our aggressive EBITDA margin assumption of 17.5% for FY2010E exist as there is opportunity for APNT to retain significant portion of input cost correction in FY2010E as the competition is rational and price differentiation is not a critical decision making factor for the consumer (in higher end products, particularly emulsions). We highlight that our EPS estimates are highest on the Street, Rs60 and Rs69.8 (standalone) for FY2010E and FY2011E, respectively (Street estimates are Rs56.7 and Rs66.7 (consolidated)).

While APNT prefers volume growth over pricing led growth, we believe that, (1) relatively stronger position in emulsions, (2) underlying mix improvement and (3) benefits of input cost correction have helped EBITDA margins expansion of 650 bps to 21% in 1QFY10. We note that 1QFY10 margin performance is probably an outlier as (1) the company has effected a ~2.5% weighted average price correction in July 2009 and (2) 1QFY10 likely had the highest benefits of input cost correction (particularly MTO).

#### Favorable structural growth drivers

Growth drivers over the medium term, in our view, are, (1) growth in number of tinting machines = growth in emulsions, (2) upside in residential demand, (3) strong performance in South India and (4) improvement in mix.

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- ▶ **Growth in tinting machines implies a corresponding growth in emulsions.** APNT has a reach of ~26,000 distributors, we believe that further upsides from mix improvement is likely over the next 3-4 years as the company's plans to continue adding 1,000 TMs every year. At present, APNT has about 13,000 tinting machines (TM) installed, and it was adding about 1,000 TMs annually over the last 4-5 years. We believe that the addition of TM has a direct correlation to emulsions growth which APNT had over the last few years.
- ▶ **Upswing in residential demand.** APNT derives about 10 % of paints volume from new construction and the rest from repainting activity. Likely upswing in residential demand in FY2010E after the slump in FY2009 augurs well for APNT. KIE's real estate analysts, Puneet Jain and Sandeep Reddy, expect a strong pick up in residential sales volumes in FY2010E and FY2011E.

#### Recovery in residential volumes/revenues expected in FY2010E

Sales (Rs mn), residential sales (mn sq. ft) for FY2006-11E, March fiscal year-ends

	FY2006	FY2007	FY2008	FY2009E	FY2010E	FY2011E
<b>Housing revenues (Rs mn)</b>						
DLF	3,818	9,732	29,866	31,242	40,016	54,160
Unitech	5,110	12,970	18,562	11,999	21,615	27,205
Sobha	3,942	7,577	7,532	5,173	7,701	9,915
Puravankara	2,781	4,138	5,338	4,851	5,159	7,292
<b>Total</b>	<b>15,652</b>	<b>34,418</b>	<b>61,298</b>	<b>53,265</b>	<b>74,491</b>	<b>98,572</b>
<b>Housing volumes (mn sq. ft)</b>						
DLF		8.2	13.5	8.4	13.4	15.9
Unitech		6.5	7.3	3.2	11.4	15.0
Sobha			1.6	0.4	2.3	3.8
Puravankara			2.3	1.3	1.9	2.4
IBREL		0.0	0.0	1.4	2.8	4.9
<b>Total</b>		<b>14.6</b>	<b>24.6</b>	<b>14.8</b>	<b>31.7</b>	<b>42.0</b>

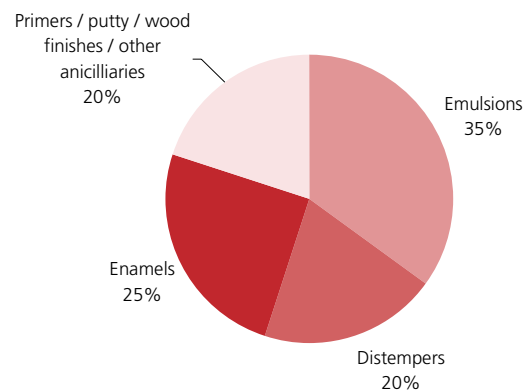
Source: Kotak Institutional Equities estimates

- ▶ **Strong performance in South.** South India is a major market for APNT (about 40% of sales, in our view) and we expect the company to improve its market position in the region due to (1) likely higher adspends and brand building activities in the region, (2) opportunity to drive mix improvement due to higher contribution of exterior paints, (3) relatively lower proportion of unorganized competition and (4) near normal monsoons in South India.
- ▶ **Mix improvement.** APNT's value sales mix is skewed towards emulsions which are at the top end of the value chain and exterior emulsions are outperforming industry growth. We expect this trend to continue.

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**Asian Paints' decorative business is dominated by emulsions**

Asian Paints estimated sales mix, %




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 Source: Industry sources, Kotak Institutional Equities
 

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However, we note that the uncertainties arising out of drought conditions in many parts of the country and its impact on the overall economy could play a vital role in paint demand in near term.

**Retain ADD; buy for a potential 15% upside**

We maintain our EPS estimates of Rs60 and Rs69.8 for FY2010E and FY2011E, respectively. We retain our target price of Rs1,600 and recommend buying the stock for a potential 15% upside. At our target price, the stock would trade at 21X FY2011E EPS. Our target price includes Rs80/share for international operations at a reasonable 6X FY2011E EBITDA. Over the past five years, the minimum, maximum and average P/E commanded by Asian Paints stock was 13X, 36X, 24X, respectively, and the average over the past 10 years was 20.9X.

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**One-year forward PE of Asian Paints (x)**

	Average	Maximum	Minimum
1-year	21.8	28.1	13.1
3-years	25.7	35.8	13.1
5-years	23.9	35.8	13.1
10-years	20.9	35.8	13.1

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 Source: Kotak Institutional Equities
 

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### Relative underperformance provide buying opportunity

Relative P/E of APNT versus Sensex (X)



Source: Kotak Institutional Equities

We note that there are upside risks to our multiple as (1) the ability to outperform expectations on margins is higher in FY2010E, (2) better-than-expected growth in urban areas provides mix improvement and hence higher margins and (3) likely continuation of rational competition.

Key risks to our ADD rating are (1) lower-than-expected volume growth and (2) upward revision in the Cenvat rate impacting margins.

Asian Paints: Profit model, balance sheet, cash model 2006-2011E, March fiscal year-ends (Rs mn)

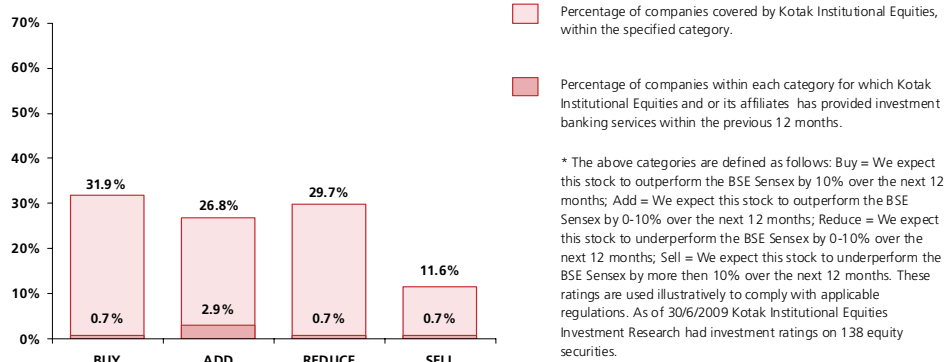
	2006	2007	2008	2009	2010E	2011E
<b>Profit model (Rs mn)</b>						
<b>Net sales</b>	<b>23,112</b>	<b>28,196</b>	<b>34,191</b>	<b>42,701</b>	<b>50,940</b>	<b>59,476</b>
<b>EBITDA</b>	<b>3,439</b>	<b>4,200</b>	<b>5,564</b>	<b>5,613</b>	<b>8,948</b>	<b>10,437</b>
Other income	439	405	602	601	551	636
Interest	(38)	(69)	(83)	(104)	(63)	(78)
Depreciation	(455)	(454)	(438)	(572)	(772)	(893)
Pretax profits	3,384	4,082	5,645	5,538	8,664	10,102
Tax	(1,171)	(1,400)	(1,880)	(1,836)	(2,906)	(3,408)
<b>Net profits</b>	<b>2,213</b>	<b>2,682</b>	<b>3,766</b>	<b>3,702</b>	<b>5,758</b>	<b>6,694</b>
<b>Earnings per share (Rs)</b>	<b>23.1</b>	<b>28.0</b>	<b>39.3</b>	<b>38.6</b>	<b>60.0</b>	<b>69.8</b>
<b>Dividend per share (Rs)</b>	<b>12.5</b>	<b>13.0</b>	<b>15.0</b>	<b>17.5</b>	<b>27.0</b>	<b>31.0</b>
<b>Balance sheet (Rs mn)</b>						
Total equity	6,223	7,441	9,285	10,945	13,673	16,888
Total borrowings	911	1,257	947	745	745	745
Current liabilities	5,408	6,482	9,516	9,577	11,301	13,175
Deferred tax liability	285	221	315	479	491	522
<b>Total liabilities and equity</b>	<b>12,827</b>	<b>15,401</b>	<b>20,063</b>	<b>21,747</b>	<b>26,210</b>	<b>31,330</b>
Cash	284	425	414	1,283	1,765	2,702
Current assets	6,550	8,167	10,029	10,999	12,752	14,828
Total fixed assets	3,247	3,465	5,392	7,118	9,346	11,452
Investments	2,746	3,344	4,229	2,348	2,348	2,348
<b>Total assets</b>	<b>12,827</b>	<b>15,401</b>	<b>20,063</b>	<b>21,747</b>	<b>26,210</b>	<b>31,330</b>
<b>Free cash flow (Rs mn)</b>						
Operating cash flow, excl. working capital	2,150	2,802	4,240	4,082	6,206	7,161
Working capital	(522)	282	27	(965)	(706)	(492)
Capital expenditure	(507)	(673)	(2,365)	(2,297)	(3,000)	(3,000)
Investments etc	(1,048)	(2,171)	(1,914)	49	(2,017)	(2,732)
<b>Free cash flow</b>	<b>73</b>	<b>241</b>	<b>(12)</b>	<b>869</b>	<b>482</b>	<b>937</b>
<b>Key assumptions (%)</b>						
Revenue growth	19.8	22.0	21.3	24.9	19.3	16.8
EBITDA margin	14.9	14.9	16.3	13.1	17.6	17.5
EPS growth	24.3	21.2	40.4	(1.7)	55.5	16.3

Source: Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2009

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**BUY.** We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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