Deutsche Bank
Markets Research

Asia
India
Consumer

Industry
India Consumer

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Forecast Change

Manoj Menon
Research Analyst
(+91) 22 7180-4358
manoj.menon@db.com

Mihir P. Shah
Research Associate
(+91) 22 7180-4034
mihir.shah@db.com

Smooth 2H likely, but for the noise about "profiteering"

Top picks are HUL, Jubilant, Dabur, Bajaj Corp

Corporate commentaries are turning markedly bullish (rural demand recovery) post 2QFY18, with the recent GST reduction providing hope for a volume-led recovery and low 2HFY17 comps possibly helping to sustain expensive valuations in 2HFY18. The price-offs seen on the ground (passing on GST benefits) are positive for volume recovery as penetration-driven growth is the most important volume growth driver for consumer staples and the products have high price elasticity. Our sector view remains positive. Potential government action on anti-profiteering remains the significant overhang.

Our top picks are based on bottom-up stock selection:

- Executing better – Hindustan Unilever, Dabur, Titan, Marico
- Turnaround – Nestle, Jubilant, United Spirits
- Relatively cheap valuations – ITC, Bajaj Corp, GSK Consumer
- Hold-rated stocks – Asian Paints, Godrej, Britannia

While there are tailwinds for the sector …

- Return of modest price growth; however, price elasticity challenges likely to persist – Beneficiaries: Asian Paints, HUL, Marico and Nestle
- Return of rural real wage growth – Beneficiaries: HUL, Dabur, Emami
- After demonetization and GST, there is evidence of share gains for the market leaders in Discretionary and select Staples categories – Beneficiaries: Titan, Godrej, HUL, Marico
- GST has been less disruptive than consensus has feared
- GST rate reduction is positive, as penetration-driven growth is the most important volume growth driver and the products have high price elasticity – Beneficiaries: HUL, Nestle

… However, potential government action on anti-profiteering remains the significant overhang. See our reports for more – The curious case of "cost savings" driving profit growth – Part I (here) and Part II (here).

MSCI India consumer staples P/E shows downside potential …

The MSCI India consumer staples' P/E with respect to the MSCI India P/E chart shows that the sector-relative P/E is still high at +1 STDEV. This would seem to indicate potential for de-rating. Over the past 12 months, the Consumer index has delivered 36% absolute return (outperformed the Sensex by 6ppt).

… and we recommend investors use DBCMI

Consumer sector valuations are still expensive as per DB Consumer Momentum Indicator ("DBCMI", key to our sector top-down view – Figure 4). We believe the DBCMI is a good reflection of relative valuations (22-year back-tested lead indicator), as it considers relative earnings momentum. According to DBCMI, the sector could relatively correct 12% to be in line with relative earnings, in our view (or relative earnings need ~13% upgrade).

Key Changes

Company	Target Price	Rating
JUBI.BO	1,775.00 to 2,000.00(INR)	-
BACO.BO	475.00 to 525.00(INR)	-
EMAM.NS	1,200.00 to 1,300.00(INR)	-
NEST.BO	7,800.00 to 8,500.00(INR)	-

Source: Deutsche Bank

Top picks

Hindustan Unilever (HLL.BO),INR1,268.05	Buy
Jubilant Foodworks (JUBI.BO),INR1,808.00	Buy
Dabur (DABU.BO),INR347.00	Buy
Bajaj Corp (BACO.BO),INR470.65	Buy

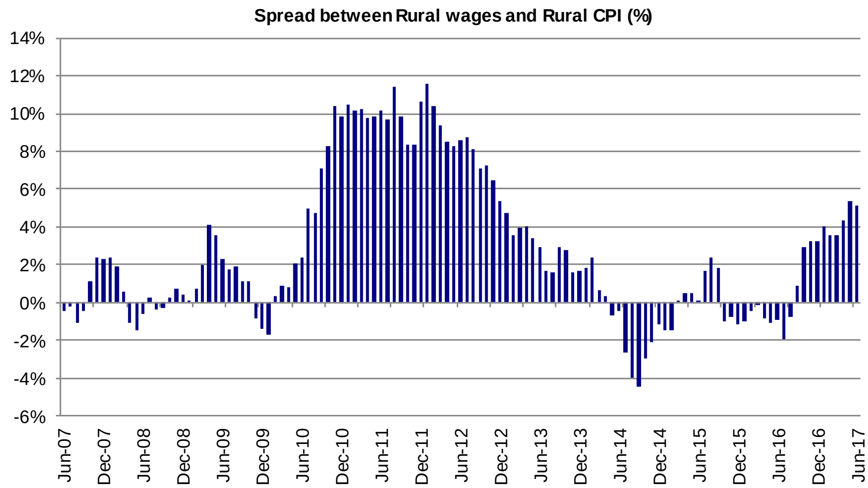
Source: Deutsche Bank

Valuation and risks:
We value consumer companies on Sep-19E P/E, DCF and SOTP. Adjusting for the 2Q results and the recent channel checks, we have tweaked earnings estimates and target prices of various stocks in this update (details in Figure 5; valuation and risks pp. 4-5).

Key upside/downside risks:
Slower/faster-than-expected recovery in urban/rural demand, potential government action on anti-profiteering.

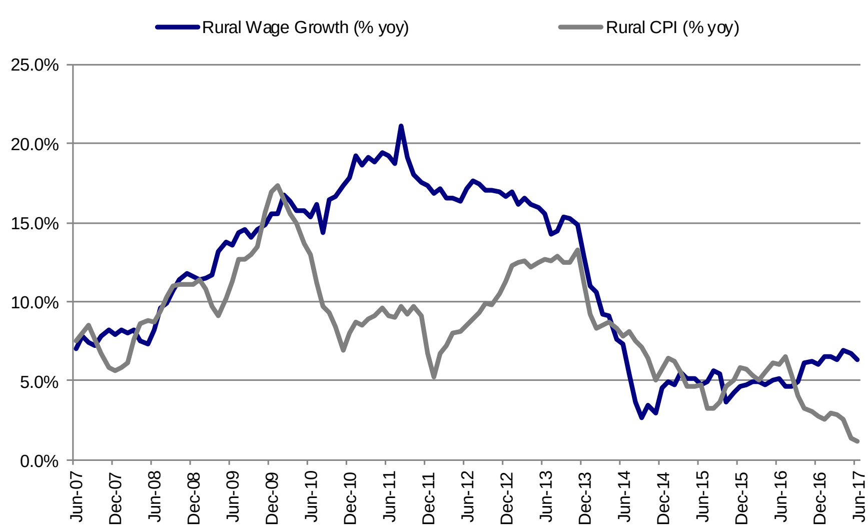
Return of rural real wage growth

Figure 1: Spread between rural wages and rural CPI



Source: RBI, Deutsche Bank

Figure 2: Rural wage growth and rural CPI

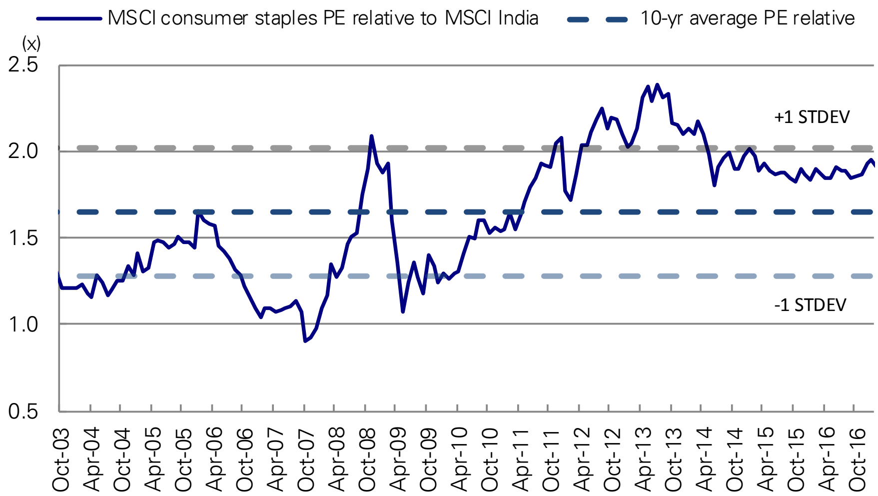


Source: RBI, Deutsche Bank

MSCI India Consumer Staples P/E shows downside potential …

The MSCI India Consumer Staples P/E with respect to the MSCI India P/E chart shows that the sector-relative P/E is still high at +1 STDEV. This would seem to indicate potential for de-rating. Over the past 12 months, the consumer index grew 36%, while Sensex grew 30%.

Figure 3: MSCI Consumer Staples P/E relative to MSCI India P/E

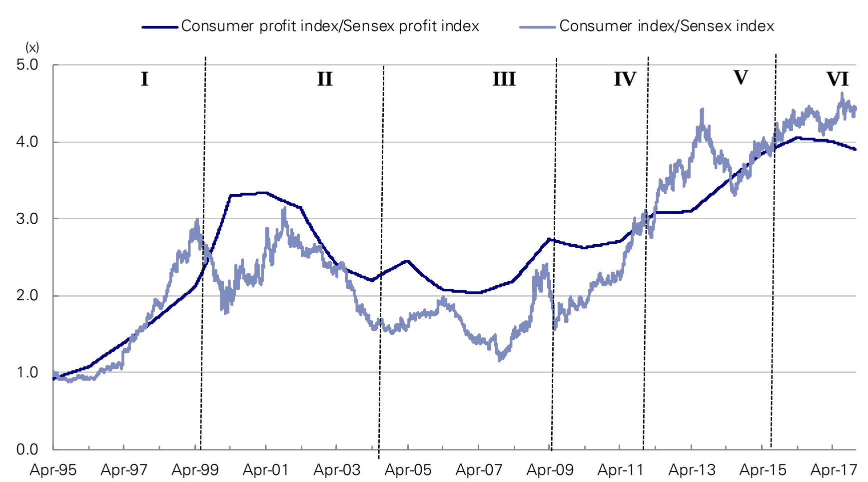


Source: Bloomberg Finance LP, Deutsche Bank

DB Consumer Momentum Indicator suggests relative price to earnings is still high

Consumer sector valuations are still expensive as per the DB Consumer Momentum Indicator ("DBCMI", key to our sector top-down view – Figure 4). We believe the DBCMI is a good reflection of relative valuations (20-year back-tested lead indicator), as it considers relative earnings momentum. According to DBCMI, the sector could relatively correct 12% to be in line with relative earnings (or relative earnings need a ~13% upgrade).

Figure 4: DB Consumer Momentum Indicator



Source: Bloomberg Finance LP, Deutsche Bank

The two line charts show a relative earnings index vs. a relative price index. For the earnings index, we have taken the cumulative profits of consumer companies and the Sensex as 100 (base) for March 1995 and plotted the ratio. Similarly, for the relative price index, we have taken the cumulative market cap for consumer companies (100 base for FY95) and the Sensex (100 base for FY95). The slope of the two line graphs indicates relative growth in earnings or market cap for the sector compared with the overall market.

We have analysed the graph in six distinct phases:

- Phase 1: Expectation of the neo 'Indian middle class' consumption story
- Phase 2: Reality check – consumption hit by low per capita income growth and consecutive droughts affecting rural consumption
- Phase 3: Bull run in banks and infrastructure – consumer sector underperforms
- Phase 4: HUL and ITC outperform during the credit crisis-induced market correction (2008) and the mean reversion (2009)
- Phase 5: Consumer earnings growth outperforms Sensex earnings growth; 'flight to safety and predictability' supports sector valuations
- Phase 6: Consumer sector maintains 'premium' even as bullishness returns to the Indian markets.

Figure 5: Changes in estimates and target prices

(INR)	EPS FY18E			EPS FY19E			Target Price			Rating	
	New	Old	% change	New	Old	% change	New	Old	% change	New	Old
Bajaj Corp	16.8	16.8	0	19.6	19.6	0	525	475	11	Buy	Buy
Colgate	23.6	26.0	(9)	27.2	29.6	(8)	1,100	1,100	0	Buy	Buy
Emami	27.7	32.3	(14)	32.9	38.0	(13)	1,300	1,200	8	Buy	Buy
Jubilant Foodworks	21.3	21.3	0	33.3	33.3	0	2,000	1,775	13	Buy	Buy
Nestle	125.4	119.3	5	152.5	150.0	2	8,500	7,800	9	Buy	Buy
United Spirits	37.2	43.0	(14)	49.3	54.2	(9)	3,275	3,275	0	Buy	Buy

Source: Deutsche Bank estimates

Valuation and risks

Bajaj Corp: We raise our DCF-based target price to INR525 (vs. INR475) due to rollover to Sept '19E. The key assumptions of our three-stage FCFF (free cash flow to firm) methodology are: risk-free rate of 7%, market risk premium of 7.1% (we apply a standard estimated risk-free rate and market risk premium to all Indian companies under coverage), and beta of 0.73 (Bloomberg Finance LP data), implying a cost of equity of 12.2% and terminal growth of 6%.

Risks: Low equity returns by the flagship promoter company are an overhang. Slower-than-expected urban recovery. A trend reversal from sticky to non-sticky hair oils. Any change in the usage of hair oil (consumer shifts to shampoo / conditioners / creams).

Colgate: We cut our FY18/19E earnings by 9%/8% to factor in the weak 2QFY18 results. We maintain our DCF-based target price at INR1,100 as we roll over to Sep '19E. The key assumptions of our three-stage FCFF (free cash flow to firm) methodology are risk-free rate of 7%, market risk premium of 7.1%, and beta of 0.45 (Bloomberg Finance LP), implying WACC of 10.2%. Terminal growth of 6%.

Risks: Increase in competitive intensity in the category in-turn impacting volume growth and earnings, delay in rural recovery, failure of new product launches.

Emami: We cut our FY18/19E earnings by 14%/13% to factor in the weak 2QFY18 results. We increase our DCF-based target price to INR1,300 (vs. INR1,200) as we roll over valuation to Sep '19E. The key assumptions of our three-stage FCFF (free cash flow to firm) methodology are: risk-free rate of 7%, market risk premium of 7.1% and beta of 0.44 (Bloomberg Finance LP), implying a cost of equity of 10.1% and a terminal growth rate of 6%.

Risk: Increase in competitive intensity from Ayurvedic / non-ayurvedic players in its core categories, leading to lower sales growth or market share losses.

Jubilant: We increase our DCF-based target price to INR2,000 (vs. INR1,775) as we roll over to Sep '19E. The key assumptions of our DCF analysis are a 13.8% WACC (risk-free rate of 6.7%, market risk premium of 7.1%, 1.0 beta) and a 4.0% terminal growth rate.

Risks: A slower-than-expected recovery in the demand environment and a step-up in competitive intensity by food aggregators and other QSR players.

Nestle: We increase our CY17/18/19E earnings by 5%/2%/2% as we factor in the good 2QFY18 results. We increase our target price to INR8,500 (vs. INR7,800) as we roll over to Sep '19E. We value Nestle at 49x (unchanged) Sep '19E earnings (5% premium to its five-year average one-year forward P/E).

Risks: Weaker-than-anticipated recovery in sales growth contrary to our assumption of urban recovery and successful new launches. If recovery does not materialize as planned, our earnings growth would have a downside risk. Any change in business priority for parent (margins over revenues) impacting the Indian subsidiary's plans.

United Spirits: We cut our FY18/19E earnings by 14%/9% as we adjust our model post the GST implementation, highway ban (and its subsequent reversal) and 2QFY18 results. We maintain our DCF-based target price at INR3,275. The key assumptions for our two-stage FCFE methodology are: RFR 7%, market risk premium 7.1% and beta of 0.9, implying WACC of 13.3%. Terminal growth assumption is 6%.

Risks: Regulatory risk with respect to increased taxation on liquor is a key downside risk. Prohibition for liquor consumption by more states after Bihar implementing it in 2016.

Current prices: Colgate-Palmolive India, INR1,055.3; Emami, INR1,266.5; Nestle India, INR7,501.5 and United Spirits, INR3,256.6.

Appendix 1

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Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

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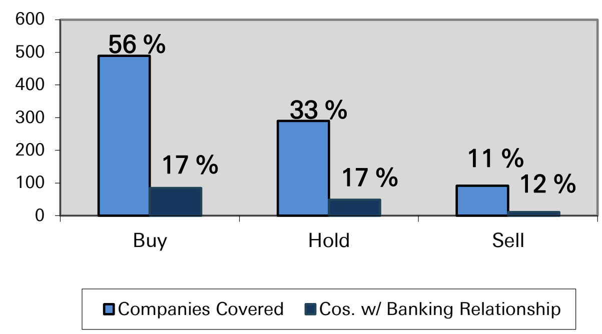

Asia-Pacific Universe

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Raj Hindocha
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Sydney, NSW 2000
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Tel: (61) 2 8258 1234

Deutsche Bank AG
Mainzer Landstrasse 11-17
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Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500