# Pidilite Industries – BUY

| PIDI IN | Rs188 | Mid-caps | 15 February 2010 | Initiating coverage |
|---|---|---|---|---|

## Banking on innovation

**Pidilite has pioneered strong brands in categories earlier considered non-differentiable industrial commodities. Consumer products form 73% of sales (adhesives being the stable mainstay and specialty and construction chemicals being the growth engine). We estimate a CAGR of 15% in sales and 18.8% in EPS over FY10-12ii. The stock is trading at an attractive 13.8xFY11ii EPS. We initiate coverage with BUY and a target price of Rs250, based on 15x FY12ii EPS.**

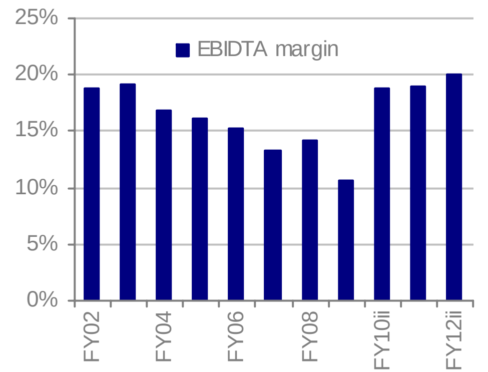
**Consumer products remain key driver:** The construction specialty chemicals business (Dr Fixit, Roff brands) has grown over 40% in FY09. These products are primarily aimed at retail customers, so demand is driven by both construction activity as well as consumer propensity for quasi-discretionary maintenance. The core adhesive business is a staple and art-related products are discretionary.

**Profitability has rebounded in FY10:** In FY09, Pidilite suffered from margin squeeze from high-cost RM inventory, forex losses on unhedged foreign RM buying, and sluggish demand. 3QFY10 results show a rebound, with sales growth of ~15% YoY and gross margin expansion of 1337bps YoY.

**Strong product development, capital budgeting discipline:** In categories where competition struggles to create any differentiation, Pidilte has pioneered brands of national top-of-the-mind recall. Save FY09, the company has delivered 20%+ RoE for the last 10 years, and payouts have typically been a third of profits. The chief investment risk is Pidilite's elastomer project in Dahej, with Rs2.6bn invested, no visibility yet on commissioning, and a Rs2.5bn further investment requirement.

**Strong financials, attractive valuations—BUY for 33% upside:** A comparison with our consumer universe reveals that even for high capital productivity, dividend yield and steady state earnings growth of 17-18%, Pidilite trades at a significant discount to peers. BUY.

**Margins bounce back in FY10**




Source: Company, IIFL Research

**Financial Summary**

| Y/e 31 Mar | FY08A | FY09A | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| Revenues (Rs m) | 17,082 | 19,863 | 22,842 | 26,268 | 30,209 |
| EBITDA Margins (%) | 14.1 | 10.6 | 18.7 | 18.9 | 20.0 |
| Pre-Exceptional PAT (Rs m) | 1,713 | 1,101 | 3,003 | 3,561 | 4,362 |
| Reported PAT (Rs m) | 1,726 | 1,105 | 2,978 | 3,561 | 4,362 |
| EPS (Rs) | 6.1 | 4.4 | 11.9 | 13.7 | 16.8 |
| Growth (%) | 37.9 | -28.4 | 172.8 | 15.3 | 22.5 |
| **PER (x)** | **31.0** | **43.3** | **15.9** | **13.8** | **11.2** |
| ROE (%) | 31.1 | 16.7 | 38.3 | 33.8 | 32.0 |
| **Price/Book (x)** | **8.6** | **6.9** | **5.5** | **4** | **3.3** |
| Debt/Equity (x) | 0.8 | 0.9 | 0.7 | 0.3 | 0.2 |
| **EV/EBITDA (x)** | **23.6** | **24.9** | **12.3** | **10.5** | **8.5** |

Price as at close of business on 11 February 2010

| ***12-mth TP*** | ***(Rs) 250 (33%)*** |
|---|---|
| **Market cap (US$ m)** | **1,025** |
| 52Wk High/Low (Rs) | 229/76 |
| Diluted o/s shares (m) | 253 |
| Daily volume (US$ m) | 1 |
| Dividend yield FY10ii (%) | 2.2 |
| Free float (%) | 29.4 |

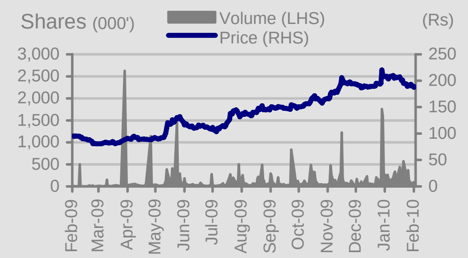
**Shareholding pattern (%)**

| | |
|---|---|
| Promoters | 70.6 |
| FIIs | 9.3 |
| DIIs | 8.6 |
| Others | 11.5 |

**Price performance (%)**

| | 1M | 3M | 1Y |
|---|---|---|---|
| Pidilite Industries | -9.7 | 12.6 | 94.0 |
| Rel. to Sensex | -1.9 | 16.8 | 26.0 |

**Stock movement**

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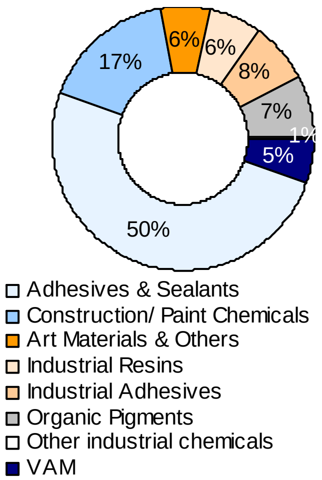
# Company snapshot

### Business description

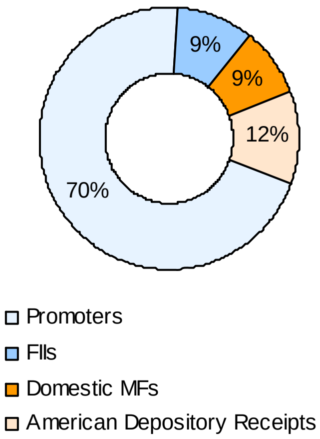
The company has two main areas of operation—consumer products and speciality industry chemicals. As per FY09 data, consumer products form 73% of Pidilite's sales—adhesives (50%), construction and plant chemicals (17%) and art materials (6%). In FY09, sales of these three sub-segments grew by 10.8%, 24.3% and 11%, respectively, leading to an overall increase of 13.6% in consumer-product sales. Consumer-product sales have grown at an average annual rate of 20% in the last five years.

Industrial specialty products form about 21% of the company's sales—industrial resins (8%), industrial adhesives (7%), and organic pigments & preparations (6%). Revenue from this business grew 13.8% in FY09. Industrial products' share of the company's revenue has been falling over the years.

**FY09 revenue break-up**




**Shareholding pattern**




**Management**

| Name | Designation | Remarks / management description |
|---|---|---|
| B K Parekh | Chairman | Promoter serving as Non-Executive Chairman of the board since 1972. He has a degree in law and senior management experience of over 60 years. |
| M B Parekh | MD & Executive Director | He is a qualified chemical engineer [B.Chem. Engg. (Bom), MS.Chem Engg. (U.S.A)] and has experience of about 38 years. |

### Background

Promoted by the Parekh family in 1959, Pidilite is one of the most innovative companies in the consumer space in India. The company's product range includes adhesives and sealants, construction and paint chemicals, automotive chemicals, art materials, industrial adhesives, industrial and textile resins, and organic pigments & preparations. Most of these products have been developed in-house, and two thirds of the company's sales come from segments it has pioneered in India. The company has 14 overseas subsidiaries (four direct and 10 step-down subsidiaries), including those with significant sales and manufacturing operations in the USA, Brazil, Thailand and Dubai. These comprise about 12% of consolidated net sales.

### Promoter group

The company was founded by B K Parekh, who remains as a Chairman and other members of the family are also involved in senior management positions.

### Competitive landscape

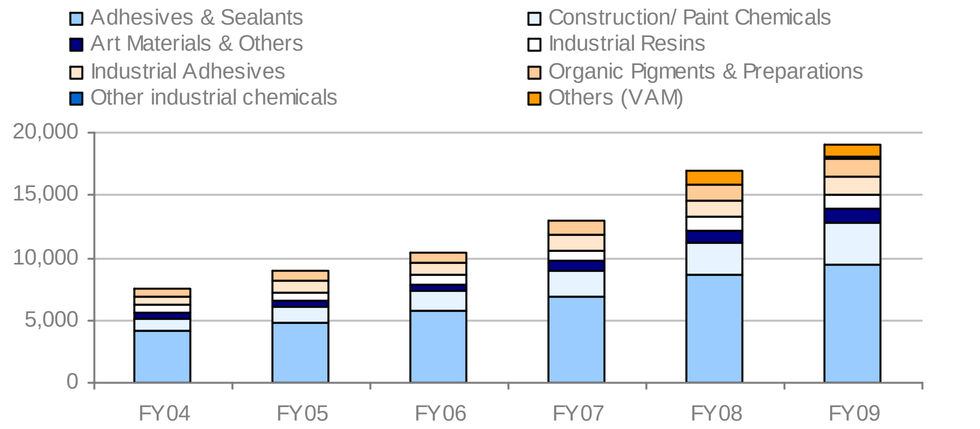
Pidilite's competitive moats consist of its ability to continuously innovate around unmet consumer needs in specific niches and create sustainable brands in so-called 'commodity' categories.

# Consumer products remain key driver

### Dual play on consumption and construction

As per FY09 data, consumer products form 73% of Pidilite's sales. Growth in the consumer segment has been driven by specialty chemicals used in construction, under the *Dr Fixit, Roff* brands, whose sales have grown over 40% in FY09 and continue to grow at over 30%. As these products are primarily sold to retail consumers, demand is driven by both construction activity and consumers' propensity for quasi-discretionary maintenance expenditure. The core adhesive business is a staple, and art-related products are discretionary.

**Figure 1: Revenue break-up into categories over the years**




Source: Company,

### Pidilite has a strong competitive position across categories

***Adhesives—mature market dominated by Pidilite:*** In consumer products, adhesives are a category where the dominance of the *Fevicol* brand is challenged only by a few regional brands. Technology is not a differentiator, and Chinese imports are not much of a threat.

***Construction specialty chemicals—emerging market with strong growth potential:*** The biggest growth driver in the consumer segment, construction and plant specialty chemicals (often under aegis of the *Dr Fixit* brand) has competition on the basis of both technology as well as implementation. These chemicals are generally not do-it-yourself products and the market is one where an end-to-end integrated service needs to be provided. This is especially true for the more lucrative retail end of the market (which forms 70% of Pidilite's category sales). The retail end needs little credit (unlike construction companies) and is generally less price-competitive. The key to competition in this category will be acquiring new technologies that address Indian consumers' needs (water-proofing, damp-proofing, etc) and offer an integrated value proposition to consumers. The game is as much about distribution and nationwide delivery capability as it is about brand visibility and technology acquisition.

***Art products—strong growth, but intense competition:*** In art products, *Pidilite* is not the market leader; *Camlin*, *Faber- Castell,* etc, are prominent competitors. In this category, there are a lot of imports that are sometimes even technologically superior.

In speciality chemicals, prices are linked to the international market, and are influenced by commodity price cycles.

***Specialty industry chemicals account for one fourth of the company's revenue:*** Industrial specialty products form about 21% of the company's sales and their sales grew 13.8% in FY09. The sub-segments are industrial resins (8%), industrial adhesives (7%), and organic pigments & preparations (6%).

## Product map

**Figure 2: Mapping of products and brands**

| Category | Key products | End use/ segment | Key brands |
|---|---|---|---|
| Adhesives & sealants | White glue, Paper glue, Glue sticks, instant adhesive, epoxy putty, epoxy adhesive, maintenance spray, PVC insulation tape. | Home, school and office | Fevicol, Fevikwik, M-Seal |
| | Polyvinyl acetate white glue for joining wood, plywood, particle board, etc, contact adhesive for laminate and veneer pasting. | Woodworking | |
| | Contact adhesive for upholstery and flooring, white glue for wallpaper and parquet flooring. | Upholstery and flooring | |
| | Polyurethane-based adhesives, rubber-based adhesive. | Footwear | |
| | Silicone sealants, epoxy putty, epoxy adhesive, cyanoacrylate adhesives, PVC insulation tape, maintenance spray. | Automotive aftermarket, plumbing | |
| Construction and paint chemicals | Intergral waterproofing compound, waterproofing coatings, waterproofing membranes. | Waterproofing | Dr Fixit, Roff, Cyclo |
| | Crack fillers, micro concrete, rust remover, repair mortars, epoxy bonding | Repair materials | |
| | Adhesives, additive, tile grouts. | Tile fixing solutions | |
| | Exterior coatings, protective coatings, heat reduction coatings, hygienic coatings. | Coating | |
| | Water reducing and retarding, plasticisers and accelerators. | Admixtures | |
| | Floor hardener, self levelling compound, epoxies. | Flooring | |
| | Polysulphides, silicones, acrylic and polyurethane sealants. | Sealants | |
| | High strength, non-shrink free-flow grouts. | Grouts | |
| | Lime binders, stainers/colourants, distempers, emulsion paints. | Interior coatings and wall | |
| | Wood preservatives, fillers, stains and finishes. | Wood finishes | |
| Art materials | Tempera colours, crayons, oil pastels, chalks, markers, pencils, poster paints, water colours, moulding clay, glitter paints. | Education | Sargent Art, Hobby Ideas |
| | Fabric colours, dimensional colours, glass colours, ceramic colours, silk colours, decoupage glue, moulding putty, brushes, hobby kits. | Hobby | |
| | Acrylic colours, oil colours, water colours, brushes, canvas. | Art students and artistes | |
| Industrial resins | Styrene acrylic, pure acrylic, VAM co-polymer emulsions, thickeners and dispersing agents. | Water-based decorative paints | |
| | Thermoplastic acrylic resins, acrylic polyols, polyester polyols, hardeners, flow and levelling agents | Industrial paints | |
| | Acrylic co-polymer emulsions. | Non woven fabric, flocked fabric, carpet, coated abrasives | |
| | Styrene-butadiene rubber and acrylic co-polymer emulsions. | Paper coating and construction chemicals | |
| | Acrylic syntans and binders, polyurethane binders, waxes, fillers and non ionic pigments. | Leather | |
| Industrial adhesives | Water based adhesives, hotmelt adhesives, solvent based and solvent free adhesives, pressure sensitive adhesives, etc. | Packing and converting, cigarette, book binding, stock labels | |
| | Epoxy adhesives, sprayable rubber based adhesives, brushable rubber based adhesives, cyanoacrylates, maintenance products, PVC insulation tape, acrylic adhesives. | Engineering and maintenance | |
| | Polyurethane based adhesives, rubber based adhesives, primers, hardeners, water based adhesives, hotmelt adhesives and speciality products. | Footwear | |
| Organic pigments | Azo/Violet and quinacridone pigments. | Paint, plastic, ink and textiles | |
| | Pigment dispersions (preparations). | Paint and textiles | |
| | Colour concentrates. | Paints | |

Source: Company

### Consumers segment should drive ~15% topline growth

We are building in 17% CAGR in the consumers and bazaar products business over the next three years on a consolidated basis. About 5pps of this CAGR, we reckon, would be on account of price inflation. In the industrial chemicals business, we expect about 11% growth rate to sustain. On a consolidated basis, this implies ~15% growth in Pidilite's top line.

**Figure 3: Revenue model assumptions**

| Revenues (Rs m) | FY08 | FY09 | FY10e | FY11e | FY12e |
|---|---|---|---|---|---|
| **Consumer & Bazaar Products** | 13,932 | 16,117 | 18,856 | 22,062 | 25,812 |
| **Specialty Industrial Chemicals** | 3,668 | 4,178 | 4,637 | 5,147 | 5,713 |
| **Others (VAM)** | 1,154 | 1,031 | 1,083 | 1,137 | 1,194 |
| **Total** | 18,753 | 21,326 | 24,576 | 28,346 | 32,720 |
| Revenues (% of total) | **FY08** | **FY09** | **FY10e** | **FY11e** | **FY12e** |
| **Consumer & Bazaar Products** | 74.3 | 75.6 | 76.7 | 77.8 | 78.9 |
| **Specialty Industrial Chemicals** | 19.6 | 19.6 | 18.9 | 18.2 | 17.5 |
| **Others (VAM)** | 6.2 | 4.8 | 4.4 | 4.0 | 3.6 |
| Revenue growth (% YoY) | **FY08** | **FY09** | **FY10e** | **FY11e** | **FY12e** |
| **Consumer & Bazaar Products** | 30.4 | 15.7 | 17.0 | 17.0 | 17.0 |
| **Specialty Industrial Chemicals** | 16.3 | 13.9 | 11.0 | 11.0 | 11.0 |
| **Others (VAM)** | | -10.6 | 5.0 | 5.0 | 5.0 |
| **Total** | 35.5 | 13.7 | 15.2 | 15.3 | 15.4 |

Source: IIFL Research, Company

### Present in multiple geographies

The company has 14 overseas subsidiaries (four direct and 10 step-down subsidiaries), including those with significant sales and manufacturing operations in the USA, Brazil, Thailand and Dubai. These account for about 12% of consolidated net sales.

**Figure 4: List of subsidiaries**

| Entity | Nature |
|---|---|
| Fevicol Company Ltd. | 100% Subsidiary |
| Bhimad Commercial Co Pvt Ltd. | 100% Subsidiary |
| Madhumala Traders Pvt Ltd. | 100% Subsidiary |
| Pagel Concrete Technologies Pvt Ltd. | 75% Subsidiary |
| Pidilite International Pte Ltd. | 100% Subsidiary |
| Pidilite Middle East Ltd. | 100% Subsidiary |
| Pulvitec do Brasil Industria e Comercio de Colas e Adesivos Ltd | 100% Subsidiary |
| Pidilite USA Inc | 100% Subsidiary |
| Jupiter Chemicals (LLC) | 100% Subsidiary of wholly owned subsidiary |
| Nebula Trading FZE | Wound up wef 11th January 2009 |
| P.T. Pidilite Indonesia | 100% Subsidiary of wholly owned subsidiaries |
| Pidilite Speciality Chemicals Bangladesh Pvt Ltd. | 100% Subsidiary of wholly owned subsidiaries |
| Pidilite Innovation Centre Pte Ltd. | 100% Subsidiary of wholly owned subsidiaries |
| Pidilite Industries Egypt - SAE | 100% Subsidiary of wholly owned subsidiaries |
| Chemson Asia Pte Ltd. | 100% Subsidiary of wholly owned subsidiary |
| Pidilite Bamco Ltd. | 75% Subsidiary of wholly owned subsidiary |
| Pidilite South East Asia Ltd. | 100% Subsidiary of wholly owned subsidiary |
| Bamco Supply Services Ltd. | 49% Subsidiary of wholly owned subsidiary |

Source: IIFL Research

## Acquisitions

The company has made multiple acquisitions across geographies over the last few years. The acquisitions have been driven by brands, technology, operations and technology gaps.

**Figure 5: List of acquisitions**

| Name | Year | Details |
|---|---|---|
| Pulvitec do Brasil Industria e Commercio de Colas e Adesivos Limitada | FY08 | Engaged in the business of adhesives, sealants and construction chemicals, this company and its manufacturing plant are located in Sau Paulo, Brazil. The business has annual sales of approximately Rs750m. This acquisition will help Pidilite enter high-potential Latin American market of adhesives and sealants. The cost of acquisition was around Rs531m. |
| Hardwood & Waud Mfg Company | FY08 | The acquired assets include brands like Holdtite, Rustolene and Leakguard, which have healthy market shares in their respective segments. Total sales of the business are Rs150m. Acquisition cost was Rs118m. |
| Sargent Art | FY07 | Sargent Art has been manufacturing and selling quality art materials in the educational market in USA for over 50 years. The product range includes tempera colours, acrylic colours, water colours and crayons. |
| Cyclo LLC | FY07 | Cyclo has been selling automotive chemicals in USA and international market for over 50 years. The product range includes maintenance chemicals, performance chemicals and appearance chemicals for automotive segment. |
| Pagel Concrete Technologies | FY07 | Indian company with technical and financial collaboration of Pagel Spezial-benton GMBH, and internationally renowned brand for industrial grouts and repair mortars. Pidilite acquired 75% equity stake in this company at a cost of Rs6.4m and loan contribution of Rs3.5m. |
| Bamco Ltd, Thailand | FY06 | Bamco is a manufacturer of speciality bitumen-based waterproofing products and had, until then, marketed its products in Thailand, Indonesia, Malaysia and Singapore. Turnover of Rs86m on acquisition. |
| Jupiter Chemicals LLC | FY06 | Pidilite Middle East Ltd, the company's wholly-owned offshore subsidiary in the Jebel Ali Free Zone in Dubai, acquired a 49% stake in Jupiter Chemicals LLC. Jupiter Chemicals manufactured reflective coatings, tile adhesives and plasters, and is expected to help grow the company's business in the high-potential Middle East market. |
| Tristar Colman/ Fine art brands, business and some assets | FY06 | Fine Art is a market leader in brushes for drawing and painting, while Tristar Colman is a well-known brand of canvas and student art colours. The acquisition strengthens the company’s art materials portfolio and will help increase sales in the school and artist segments. |
| Roff (brand) | FY05 | Roff has been a strong construction chemicals brand in India for over 18 years. This acquisition (for Rs137.7m) gives Pidilite access to both Roffe's product range and distribution network, as well as to a large number of trained and loyal applicators. |
| Chemson Asia Pte Ltd | FY05 | A manufacturer of waterproofing products and exterior paints, in January 2005. Chemson had a manufacturing base in Singapore, from where it marketed products across the island state, Indonesia, Thailand and Malaysia. Consideration of S$437,500. |

Source: Pidilite, IIFL Research

# Profitability has rebounded in FY10

**Pressure on profitability in FY09**

In 3QFY10, consumer and bazaar products segment grew 19.1% against consolidated revenue growth of 15.0%. Even without immediate disclosure, construction specialty chemicals business should have grown at >30%. Notably, gross margin in December 2008 was 35.2%, vs 48.6% recorded a year later.

**Figure 6: Quarterly results**

| | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | % YoY | % QoQ |
|---|---|---|---|---|---|---|---|---|---|
| **Net Sales** | **5,606** | **5,487** | 4,586 | **4,185** | **5,868** | **5,843** | 5,274 | **15.0** | **-9.7** |
| COGS | 3,118 | 3,148 | 2,971 | 2,427 | 3,035 | 3,051 | 2,711 | -8.7 | -11.2 |
| Employee expenses | 544 | 550 | 539 | 572 | 666 | 631 | 602 | 11.7 | -4.6 |
| Employee expenses / sales (%) | 9.7% | 10.0% | 11.7% | 13.7% | 11.3% | 10.8% | 11.4% | -34 bps | 61 bps |
| Other expenses | 1,156 | 1,299 | 835 | 601 | 990 | 949 | 1,041 | 24.6 | 9.7 |
| Other expenses / sales (%) | 20.6% | 23.7% | 18.2% | 14.4% | 16.9% | 16.2% | 19.7% | 152 bps | 350 bps |
| **Total cost** | **4,818** | **4,997** | 4,344 | **3,600** | **4,690** | **4,631** | 4,354 | **0.2** | **-6.0** |
| Gross Margin | 2,488 | 2,339 | 1,615 | 1,758 | 2,833 | 2,792 | 2,563 | 58.7 | -8.2 |
| Gross Margin (%) | 44.4% | 42.6% | 35.2% | 42.0% | 48.3% | 47.8% | 48.6% | 1337 bps | 81 bps |
| **Op Ebitda** | **788** | **490** | 241 | **585** | **1,178** | **1,212** | 920 | **281.6** | **-24.1** |
| Ebitda Margin | 14.1% | 8.9% | 5.3% | 14.0% | 20.1% | 20.7% | 17.4% | 1218 bps | -330 bps |
| Depreciation | 136 | 155 | 140 | 158 | 146 | 169 | 173 | 23.3 | 2.4 |
| **Op Ebit** | **653** | **335** | 101 | **428** | **1,032** | **1,043** | 747 | **641.8** | **-28.4** |
| Op Ebit Margin | 11.6% | 6.1% | 2.2% | 10.2% | 17.6% | 17.8% | 14.2% | 1196 bps | -369 bps |
| Other income | 6 | 5 | 1 | 107 | 30 | 16 | 70 | 6218.2 | 342.7 |
| Interest expense | 58 | 85 | 104 | 114 | 87 | 95 | 78 | -25.2 | -17.5 |
| **PBT** | **601** | **256** | -2 | **421** | **974** | **964** | 738 | **-29640.0** | **-23.4** |
| Tax | 97 | 33 | -44 | 64 | 173 | 154 | 81 | -281.7 | -47.7 |
| Deferred tax | 1 | -17 | 32 | 1 | -33 | -6 | 36 | 13.2 | -756.4 |
| Tax rate | 16% | 6% | N/A | 15% | 14% | 15% | 16% | | |
| **PAT before minority interest** | **502** | **240** | 10 | **356** | **834** | **816** | 622 | **6181.8** | **-23.8** |
| Minority interest | | | 2 | 5 | | | -1 | | |
| **PAT after minority interest** | **502** | **240** | 8 | **351** | **834** | **816** | 623 | **7586.4** | **-23.7** |
| Extraordinary Items | | | 211 | -215 | | | 23 | | |
| **Adjusted PAT** | **502** | **240** | -203 | **566** | **834** | **816** | 600 | | **-26.4** |

Source: IIFL Research, Company

Gross margin dropped 740bps QoQ from a low base

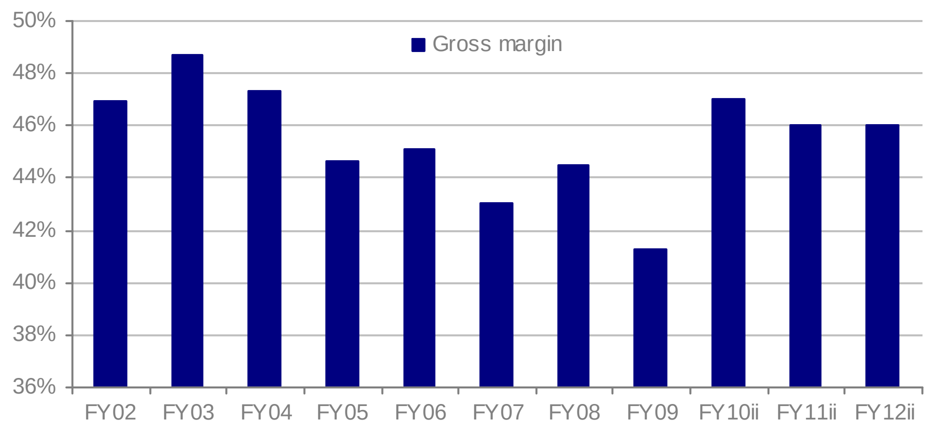
**RM costs played spoilsport in FY09…**

The quarter ended December 2008 was a unique one for almost all consumer companies with commodity inputs. Almost all were hit by a sudden spike in raw-material costs. (The key raw material for Pidilite is vinyl acetate monomer, or VAM). In anticipation of further price increases, most companies loaded up on RM inventory. This was followed by the credit crisis, and sales volumes were much lower than expectations—with the result that companies were stuck with high-cost RM inventory even as realisations dropped.

**…and currency exchange rates did not help**

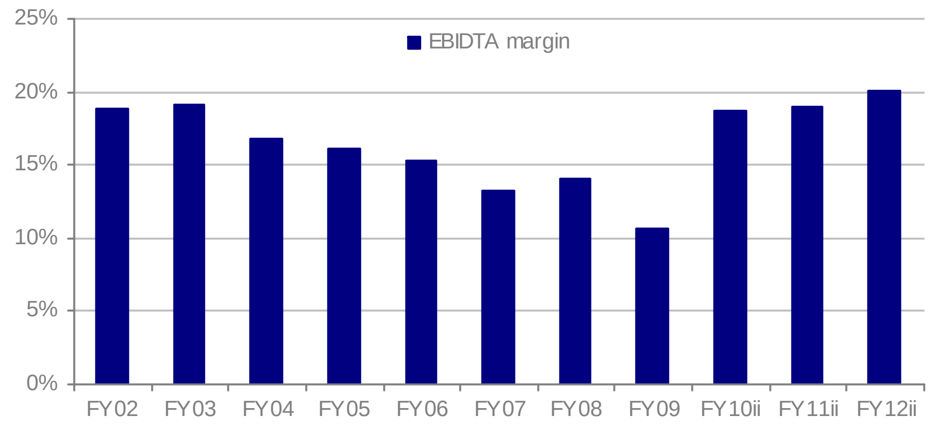
In 3QFY09, the company registered FCCB translation losses of ~Rs200m, as the rupee depreciated close to 15% QoQ. Much of this was reversed in the subsequent quarter; as per AS11, companies were allowed to amortise translation losses on FCCBs over the outstanding duration of the bond.

**Figure 7: Gross margins rebound from FY09 onwards**




Source: Company, IIFL Research

**Figure 8: EBIDTA margins improve in sync**

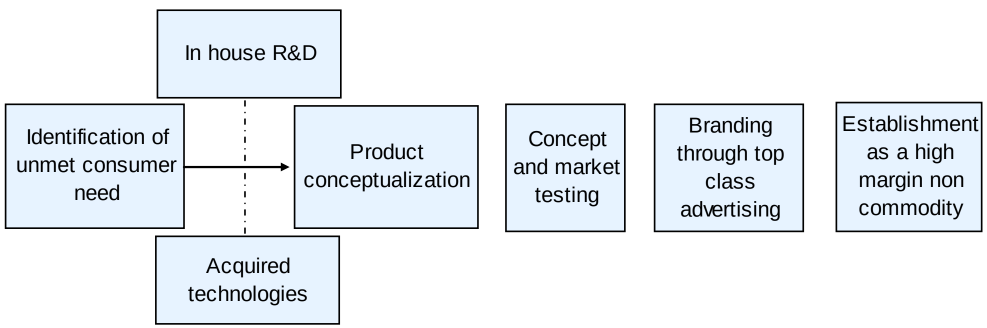



Source: Company, IIFL Research

## Strong in product development, capital budgeting

**Proven strength in product development and brand-building**
Pidilte has pioneered brands that enjoy top-of-the-mind recall across the country, in categories where competition struggles to create any differentiation. The company's superior margins are a direct result of the pricing power derived from such instant recognition and customer loyalty. Furthermore, Pidilite has not stopped at the highly-successful *Fevicol* brand, but has built a portfolio of new brands and brand extensions across categories.

**Figure 9: The Pidilite product innovation model**




Source: IIFL Research

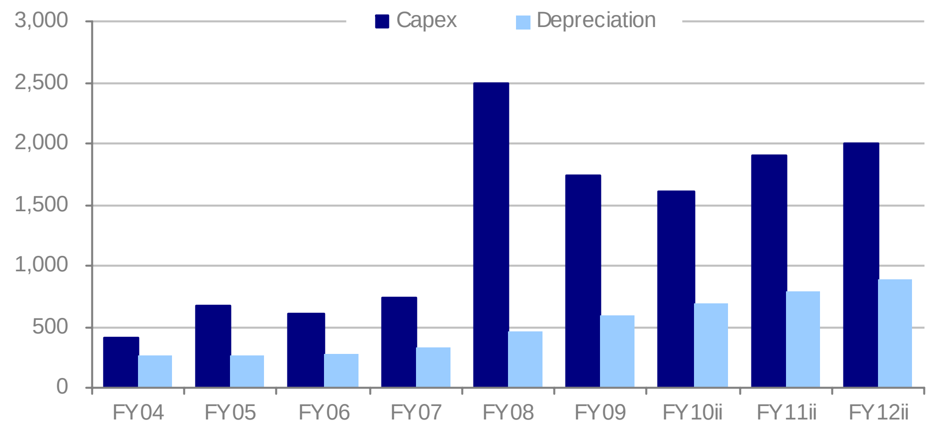
**Capital expenditure: strong track record, but for one recent uncertainty**
The company's capital expenditure so far has included three main applications: maintenance capex and new unit openings, acquisitions, and the ongoing Elastomer project in Dahej. The company has always maintained a steady capex-to-depreciation ratio (in spite of acquisitions) before the spike in FY08 and FY09 due to the elastomer project capex.

**Figure 10: Capex details**

| (Rs m) | FY08 | FY09 | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| **Total capex** | **2,484** | **1,734** | **1,600** | **1,900** | **2,000** |
| *Elastomer capex* | *1,053* | *1,120* | *800* | *1,000* | *1,000* |
| *VAM demerger asset acquisition* | *390* | | | | |
| *Acquisitions* | *118* | | | | |
| *Fixed-assets increase* | *900* | *614* | *800* | *900* | *1,000* |

Source: IIFL Research

**Figure 11: Capex and depreciation**



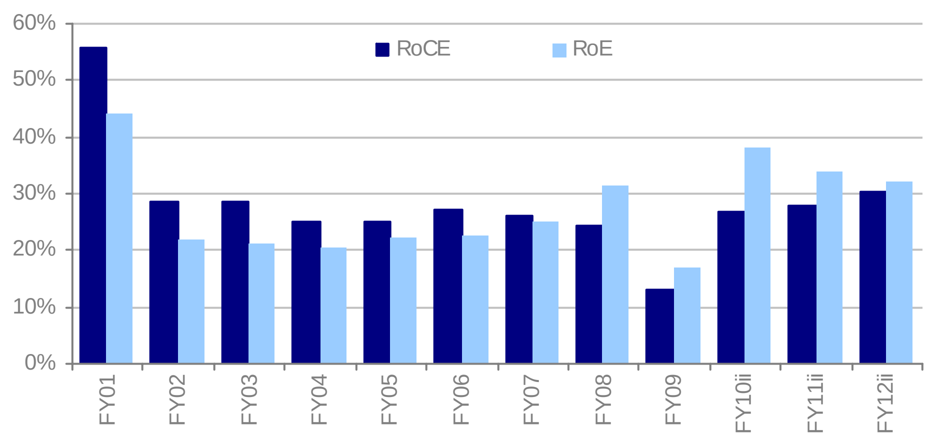

Source: IIFL Research

**Elastomer project: uncertainty in big-ticket capex**
In June 2007, the company acquired plant and machinery, patents, trademark and technology of a synthetic elastomer (polycholoroprene rubber). Polycholoroprene rubber is a speciality synthetic rubber featuring superior mechanical strength, load-bearing capacity, adhesion to metal, and superior resistance to weather, oil and chemicals vis-à-vis other synthetic rubbers. Hence, polycholoroprene rubber is the preferred synthetic rubber for many applications in automotive, industrial components, building products and adhesives. The plant was located in Champaigner, France, and was owned by Polymeri Europa Elastomers, France.

The plant was earlier expected to commence commercial production in March 2010, and its production capacity was estimated at 25,000tpa. This was to be increased to 35,000tpa through de-bottlenecking. As at end-FY09, total capital investment in the plant, excluding de-bottlenecking, was estimated at Rs5.3bn. The company was also considering putting up a caustic soda + chlorine plant at an additional investment of Rs0.9bn at the same location, as both caustic soda and chlorine are important inputs for the manufacture of polycholoroprene.

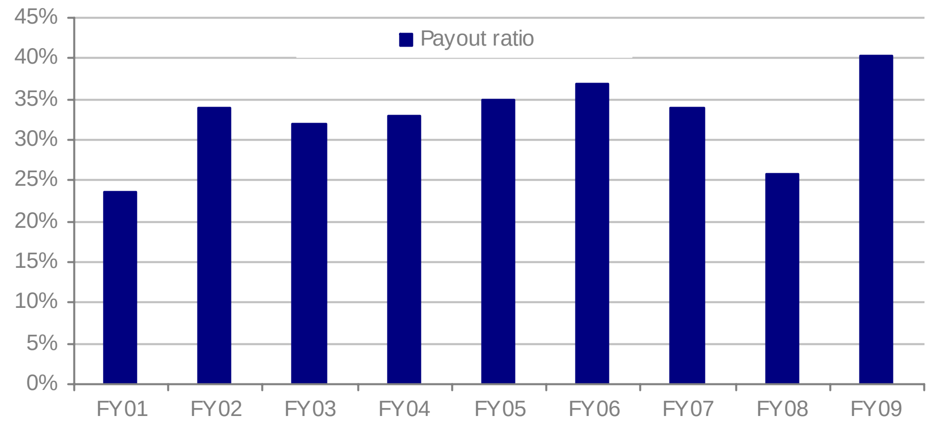
However, in view of the slowdown in global industrial demand (especially global auto-linked demand), the company is going slow on the project. The company indicated that once it chooses to commence work in full swing, time to commissioning should be around 18 months. According to current estimates, the company would build capacity of around 19,000tpa in phase 1. This would entail a further capex of Rs2.5bn (Rs2.6bn has already been spent). Elastomer prices have ranged from US$,3000-6,000 per tonne in the recent past and are currently at the lower end of the range. At 19,000tpa capacity, this represents a ~US$60m revenue opportunity. **We are not building in any revenue from the elastomer project in our projections.**

**Figure 12: FY09 was the only blip in long-term track record**




Source: Company, IIFL Research

**Figure 13: Dividend payouts have always been high**




Source: Company, IIFL Research

**Strong capital discipline—with this one exception**

The points above are a clear testimony to the discipline with which the company makes capital budgeting decisions, and its emphasis on maintaining high capital productivity. We recognise that the elastomer project's long gestation period and big-ticket capital expenditure are a departure from the norm, but feel that the project could indeed be economical if the commissioning and product margins pan out as expected. Nevertheless, this project is the biggest risk in the investment case for Pidilite.

# Strong financials, attractive valuation – BUY for 33 % upside

### Strong operating cash flows

In line with its character of being a consumer-driven business, the company produces strong operating cash flows.

**Figure 14: Strong cash-flow record**

| Rs m | FY05 | FY06 | FY07 | FY08 | FY09 | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|---|---|---|
| **Cash flow from operations** | | | | | | | | |
| Net profit before tax | 1,056 | 1,287 | 1,458 | 2,077 | 1,275 | 3,537 | 4,217 | 5,273 |
| Add: Depreciation | 270 | 278 | 328 | 459 | 588 | 685 | 780 | 880 |
| Add: Interest paid | 17 | 15 | 66 | 190 | 361 | 289 | 240 | 199 |
| Less: Dividend received | 3 | 6 | 3 | 16 | 9 | | | |
| Less: Interest received | 19 | 12 | 11 | 24 | 11 | | | |
| Less: profit on sale of assets | -2 | 11 | 45 | 5 | 1 | | | |
| Add: Foreign exchange loss on FCCB/ ECB | 0 | 0 | 0 | 0 | 150 | | | |
| Less : Taxes paid | 246 | 403 | 336 | 292 | 106 | 433 | 579 | 854 |
| Add: Other items | 0 | 7 | 9 | 20 | 255 | | | |
| Less: Increase in net working capital | 167 | 68 | 640 | 1,141 | -218 | 470 | 563 | 648 |
| **Operating cash flow** | **911** | **1,088** | **826** | **1,268** | **2,720** | 3,607 | 4,095 | 4,849 |
| | | | | | | | | |
| **Cash flow from investments** | | | | | | | | |
| Decrease/ (increase) in fixed assets | -687 | -754 | -1,079 | -2,858 | -2,011 | -1,600 | -1,900 | -2,000 |
| Less: Increase in investments | 0 | -33 | 1 | -21 | 220 | 913 | 0 | 0 |
| Add: Other items | 23 | 18 | 15 | 40 | 20 | | | |
| **Investment cash flow** | **-664** | **-703** | **-1,065** | **-2,797** | **-2,210** | -2,513 | -1,900 | -2,000 |
| | | | | | | | | |
| **Cash flow from financing** | | | | | | | | |
| Increase in borrowings | 65 | -64 | 886 | 3,494 | 275 | -195 | -1,495 | -412 |
| Less: interest paid | 17 | 15 | 66 | 190 | 361 | 289 | 240 | 199 |
| Less: dividend paid | 228 | 288 | 360 | 443 | 513 | 1,230 | 1,449 | 1,768 |
| Add: other items | 0 | 2 | 0 | 5 | -29 | 20 | 1,489 | 30 |
| **Financing cash flow** | **-180** | **-366** | **460** | **2,866** | **-627** | -1,694 | -1,695 | -2,349 |
| | | | | | | | | |
| **Total cash flow** | **67** | **20** | **220** | **1,337** | **-118** | -601 | 500 | 500 |

Source: Company, IIFL Research

## Efficient asset utilisation

Through the downturn the company's net working capital intensity and asset turnover ratios remained range-bound, a testament to the robustness of the operating model.

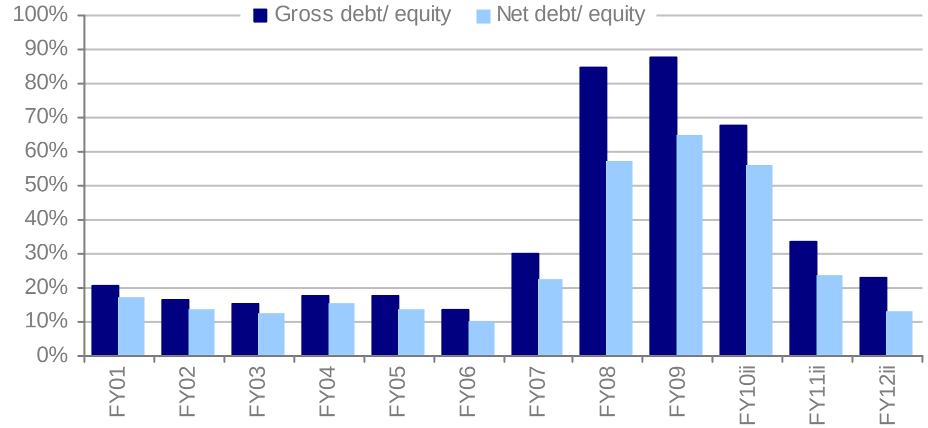
**Figure 15: Asset-turn ratios stable**

| | FY01 | FY02 | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 |
|---|---|---|---|---|---|---|---|---|---|
| Inventory (days of sales) | 46 | 59 | 55 | 58 | 62 | 62 | 65 | 64 | 51 |
| Debtor (days of sales) | 40 | 52 | 52 | 54 | 52 | 45 | 46 | 57 | 53 |
| Net op WC (days of sales) | 61 | 71 | 76 | 87 | 76 | 64 | 64 | 74 | 60 |
| Fixed-asset turnover (Sales/ Fixed assets) | 3.4 | 2.7 | 2.8 | 3.0 | 3.0 | 3.0 | 3.2 | 2.6 | 2.4 |
| Sales to capital employed | 2.0 | 1.6 | 1.7 | 1.6 | 1.7 | 1.8 | 1.9 | 1.4 | 1.5 |

Source: Company, IIFL Research

## Leverage coming down

**Figure 16: Debt-to-equity to fall, assuming FCCB conversion in FY11**




Source: Company, IIFL Research

## FCCB details

In December 2007, the company raised US$40m through zero-coupon FCCBs. The bonds have a yield-to-maturity of 6.75% per annum (calculated on a semi-annual basis), and are redeemable in 2012, that is after five years and 1 day from closing date. The bonds are convertible until 1 December 2012. Initially, the conversion price was set at Rs256.04, but has been reset at Rs204.83. The company repurchased two tranches of bonds of face value of US$1.1m in February 2009 and US$1.7m in April 2009, as these were available at attractive discounts. The bonds so purchased have been cancelled and extinguished. We assume the FCCBs will convert in FY11.

**Figure 17: FCCB details**

| Item | Value |
|---|---|
| Original value of Bonds issued (in US$m) | 40.0 |
| Less: Bonds bought back (US$m) | 2.8 |
| Outstanding value of Bond(US$m) | 37.2 |
| Rate of exchange (Rs/US$) | 39.37 |
| Value of shares to be issued (Rs m) | 1,465 |
| Conversion price after reset (Rs) | 204.83 |
| Potential additional shares on account of conversion | 7,150,144 |
| Number of equity shares | 253,067,306 |
| Total number of diluted equity shares | 260,217,450 |
| Extent of dilution (%) | 2.83 |

Source: Company, IIFL Research

After payment of US$0.99m for issue-related expenses, the company has utilised US$21.32m for investment in equity capital of its overseas subsidiaries, US$13.94m for capex, US$0.75m for buyback of FCCBs and finance cost of US$0.43m. The balance amount has been deposited in banks. On the entire amount deployed into overseas subsidiaries, the company is expensing YTM interest through the P&L. Interest is being capitalised only on the capex part.

## Valuations are attractive

A comparison with our consumer universe reveals that even for high capital productivity, dividend yield and steady state earnings growth of 17-18%, Pidilite trades at a significant discount to peers. It should be noted, however, that the 55% FY09-12ii EPS CAGR is an aberration caused by an extraordinarily lacklustre FY09.

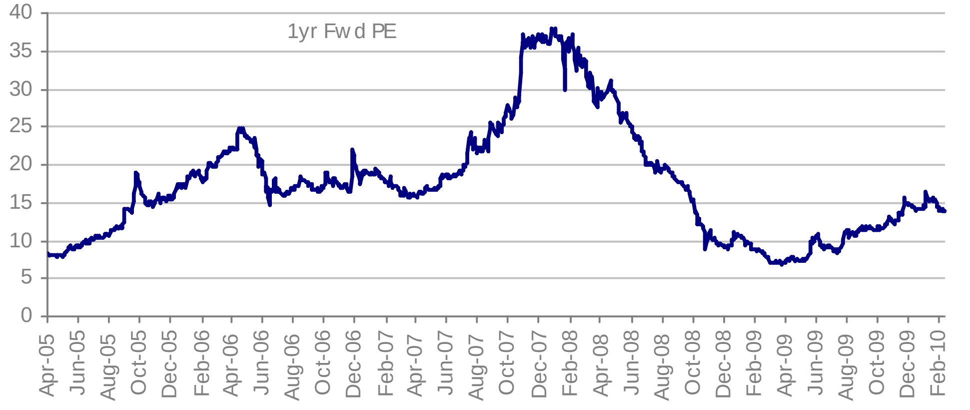
**Figure 18: Pidilite vs consumer peers**

| Company | CMP (Rs) | PER (FY10ii / CY09ii) | PER (FY11ii / CY10ii) | Earnings CAGR (FY09-12ii) | Dividend yield (FY10ii) | ROE (FY10ii) |
|---|---|---|---|---|---|---|
| Hindustan Unilever | 233 | 22.4 | 18.8 | 10.1% | 3.6% | 91.5 |
| ITC | 247 | 22.8 | 19.2 | 19.5% | 2.1% | 26.2 |
| Nestle | 2738 | 37.3 | 30.9 | 23.2% | 2.1% | 134.1 |
| Colgate | 703 | 26.1 | 24.2 | 16.6% | 2.5% | 138.9 |
| Dabur | 173 | 30.8 | 25.3 | 21.9% | 1.7% | 41.0 |
| Marico | 100 | 21.8 | 19.0 | 22.9% | 0.9% | 38.5 |
| Emami | 576 | 25.1 | 17.9 | 30.5% | 1.1% | 22.3 |
| GSK Consumer | 1437 | 23.7 | 19.7 | 21.6% | 1.4% | 25.8 |
| United Sprits | 1299 | 39.2 | 25.8 | NA | 0.9% | 12.5 |
| Britannia | 1630 | 18.5 | 15.4 | 15.6% | 3.0% | 49.9 |
| Average | | 26.8 | 21.6 | 20.6% | 1.9% | 58.1 |
| **Pidilite** | **188** | **13.7** | **11.4** | **55.9%** | **2.2%** | **38.0** |

Source: IIFL Research

This is also borne out by an examination of the forward multiple at which this company has traded. We note that the company has traded at a higher forward multiple in the last five years, except for brief periods in 2005 and 2009.

**Figure 19: 1-yr-fwd PE chart**




Source: IIFL Research

## 33% upside on a 12m basis, BUY

Our target price of Rs250 is based on 15xFY12ii EPS. This indicates an upside of 33% from CMP. We initiate coverage with BUY.

## Key risks

**Elastomer project:** With Rs2.6bn invested, no visibility yet on commissioning and further investment requirement of Rs2.5bn, this project is the biggest risk in the investment case.

**Ongoing business risks:** The industrial pigments business is cyclical in nature and could pass through periods of unprofitability if inventories/capacities run high. In adhesives, margins are likely to erode over a period of time, as it is now a mature market. In art products, external competition is strong, and Pidilite will need to fight a strong battle to gain market share. In construction chemicals, managing service/solutions as it scales up fast will be the biggest challenge.

**Raw material price risks** – The Company is backward integrated in its key raw material VAM and now has a hedging mechanism in place for the net RM import forex exposure. But in case of sharp swings like FY09, impact on profitability cannot be ruled out.

# Financial summary

### Income statement summary (Rs m)

| Y/e 31 Mar | FY08A | FY09A | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| Revenue | 17,082 | 19,863 | 22,842 | 26,268 | 30,209 |
| EBITDA | 2,412 | 2,104 | 4,281 | 4,974 | 6,050 |
| EBIT | 1,954 | 1,516 | 3,596 | 4,195 | 5,171 |
| Interest income | 0 | 0 | 0 | 0 | 0 |
| Interest expense | -190 | -361 | -289 | -214 | -145 |
| Exceptional items | 0 | 0 | 0 | 0 | 0 |
| Others items | 314 | 119 | 250 | 288 | 331 |
| Profit before tax | 2,077 | 1,275 | 3,557 | 4,269 | 5,357 |
| Tax expense | -363 | -167 | -533 | -683 | -964 |
| Extraordinary items | 13 | 4 | -25 | 0 | 0 |
| Net Profit | 1,726 | 1,105 | 2,978 | 3,561 | 4,362 |

### Cashflow summary (Rs m)

| Y/e 31 Mar | FY08A | FY09A | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| Profit before tax | 1,954 | 1,516 | 3,596 | 4,195 | 5,171 |
| Depreciation & Amortization | 459 | 588 | 685 | 780 | 880 |
| Tax paid | -363 | -167 | -533 | -683 | -964 |
| Working capital change | -1,277 | 186 | -470 | -563 | -648 |
| Other operating items | -2 | -7 | -20 | -25 | -30 |
| Operating Cash-flow | 771 | 2,117 | 3,257 | 3,703 | 4,408 |
| Capital expenditure | -3,258 | -2,251 | -1,600 | -1,900 | -2,000 |
| Free cash flow | -2,487 | -135 | 1,657 | 1,803 | 2,408 |
| Equity raised | 106 | 76 | -134 | 1,277 | -230 |
| Investments | 127 | -221 | -913 | 0 | 0 |
| Debt financing/disposal | 3,814 | 825 | -195 | -1,758 | -688 |
| Dividends paid | -443 | -443 | -1,051 | -1,246 | -1,527 |
| Other items | 81 | 18 | 100 | 100 | 100 |
| Net change in Cash & cash equivalents | 1,322 | -122 | -576 | 250 | 250 |

Source: Company data, IIFL Research

### Balance sheet summary (Rs m)

| Y/e 31 Mar | FY08A | FY09A | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| Cash & cash equivalents | 1,718 | 1,601 | 1,000 | 1,250 | 1,500 |
| Sundry debtors | 2,656 | 2,876 | 3,129 | 3,598 | 4,138 |
| Trade Inventories | 2,988 | 2,798 | 3,442 | 3,958 | 4,552 |
| Other current assets | 928 | 1,011 | 1,100 | 1,350 | 1,600 |
| Fixed assets | 6,668 | 8,331 | 9,247 | 10,367 | 11,487 |
| Intangible assets | 0 | 0 | 0 | 0 | 0 |
| Other assets | 32 | 254 | 1,167 | 1,167 | 1,167 |
| Total assets | 14,992 | 16,871 | 19,085 | 21,691 | 24,445 |
| Short-term debt | 0 | 0 | 0 | 0 | 0 |
| Sundry creditors | 3,102 | 3,401 | 3,916 | 4,589 | 5,324 |
| Other current liabilities | 0 | 0 | 0 | 0 | 0 |
| Long-term debt/Convertibles | 5,264 | 6,089 | 5,894 | 4,135 | 3,447 |
| Other long-term liabilities | 416 | 434 | 534 | 634 | 734 |
| Minorities/other Equity | 13 | 7 | 27 | 52 | 82 |
| Networth | 6,198 | 6,941 | 8,714 | 12,281 | 14,857 |
| Total liabilities & equity | 14,992 | 16,871 | 19,085 | 21,691 | 24,445 |

### Ratio Analysis

| Y/e 31 Mar | FY08A | FY09A | FY10ii | FY11ii | FY12ii |
|---|---|---|---|---|---|
| Sales growth (%) | 36.9 | 16.3 | 15.0 | 15.0 | 15.0 |
| Core EBITDA growth (%) | 45.2 | -12.8 | 103.4 | 16.2 | 21.6 |
| Core EBIT growth (%) | 46.5 | -22.4 | 137.2 | 16.6 | 23.3 |
| Core EBITDA margin (%) | 14.1 | 10.6 | 18.7 | 18.9 | 20.0 |
| Core EBIT margin (%) | 11.4 | 7.6 | 15.7 | 16.0 | 17.1 |
| Net profit margin (%) | 10.0 | 5.5 | 13.1 | 13.6 | 14.4 |
| Dividend payout ratio (%) | 25.9 | 40.2 | 35.0 | 35.0 | 35.0 |
| Tax rate (%) | 17.5 | 13.1 | 15.0 | 16.0 | 18.0 |
| Net Debt/Equity (%) | 57.2 | 64.7 | 56.2 | 23.5 | 13.1 |
| Return on Equity (%) | 31.1 | 16.7 | 38.3 | 33.8 | 32.0 |
| Return on Assets (%) | 14.4 | 6.9 | 16.7 | 17.5 | 18.9 |

Source: Company data, IIFL Research

**Key to our recommendation structure**

**BUY** - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
**SELL** - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

**Add** - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
**Reduce** - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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