Focus on double-digit volume growth

All-time high adhesives margins a near-term risk

- **Pidilite Industries (PIDI) is cautious on near-term performance, given GST implementation. While it might take a month or so to assess the impact of GST, PIDI perceives it as a positive reform for the Adhesives industry.**
- **Underlying demand remains healthy, and during our meeting, Mr Puri reiterated time and again PIDI's long-term target of delivering double-digit volume growth. He also reiterated that current margins are unsustainable, prioritizing volumes over margins.**
- **While he highlighted the attractive long-term opportunity in a variety of categories, PIDI does not intend to enter Paints unless it gets a disruptive proposition. The company has a strategy of deriving 2/3rd growth from "Growth" and "Pioneer" categories and the remaining 1/3rd from "Core" categories. It will continue to expand reach and make significant investments in R&D to build a strong foundation for multiple years of growth.**

Our view: Its track record of consistent delivery on volumes and profits drives our preference for PIDI. We prefer PIDI to Asian Paints (both NEUTRAL-rated stocks), as return ratios have converged – Asian Paints' RoCE has come off from mid-40s to late 20s in five years while its valuations have expanded. Even fixed asset turns are similar now. Asian Paints' growth moderation over the last 3-4 years also makes it relatively unattractive.

Prioritizing volumes over margins

PIDI is prioritizing volume growth over margins. During our meeting, Mr Puri emphasized the company's overarching focus on growth, with margins at risk at current high levels: "When we have 12 months of economy without any disruption, we should go to double-digit volume growth." In CY16, PIDI had expected record volume growth, and had planned accordingly, but demonetization played spoilsport. Mr Puri reminisced about the good old days when the Consumer sector grew at 2x (GDP + Inflation), and how growth fell to 1.5x (GDP + Inflation), and then to the current 1x (GDP + Inflation). Yet, PIDI is confident of double-digit volume growth in the medium term.

Pricing premium vis-à-vis unorganized players to narrow

PIDI has candidly stated that its current margins are unsustainable. The company currently enjoys 35% premium over unorganized players; in Adhesives, its margins are at all-time highs. PIDI sees this premium narrowing to 15-20%. Recent price increases by the company have been modest; in 1QFY18, the gap between volume growth and value growth was 1%. PIDI intends to pass on only ~75% of the cost inflation to customers and has lately been passing on the benefits of declines in raw material costs in the form of discounts.

VAM prices have shot up due to unusual shutdowns and maintenance problems at suppliers' end. Prices went up from USD750/MT (recent low when crude prices corrected) to USD950/MT, and are now stabilizing at USD900/MT. A large part of this price rise is due to supply disruptions rather than demand improvement.

Pidilite Industries

Mr Bharat Puri—
Managing Director

Mr Puri's association with Pidilite began as an Independent Director in 2008. He started his career with Asian Paints in 1982 and rose to the position of General Manager - Sales & Marketing. He then moved to Cadbury in 1998 as Director of Sales and Marketing for Cadbury India. In 2002, he was appointed Managing Director South Asia, after which he moved to Singapore in 2006 where he was responsible for Strategy, Marketing and Sales for the Asia Pacific region. In his last assignment, he was President - Global Chocolate, Gum and Candy Categories at Mondelez International, Zurich with worldwide responsibilities for the growth of these categories. Mr Puri has completed his MBA from the Indian Institute of Management, Ahmedabad.

GST – lot of flux; will take another month or so to figure out actual impact

In the run-up to GST, the wholesale channel was impacted the most in June. In July, sales are returning to normal, but are also boosted because of re-stocking post the de-stocking in June. PIDI will need another 30-45 days to see how sustainable the sales growth is and this will also be a function of tertiary consumer demand.

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PIDI was first off the block in educating the supply chain on GST. The company started billing on 2nd July, while most others are still finding their way and are sending consignments just now. It is too early to figure out the reset in the channel. Most traders are still confused on billing.

PIDI expects the proportion of official sales to go up post GST. For unorganized players, there will be a dramatic difference between sales post-GST and sales pre-GST. Unorganized players are concerned about the repercussions if the extent of their real sales is detected by the tax authorities. As far as the consumers are concerned, they were in any case paying taxes in the earlier regime. It is just that now CGST and SGST are shown separately on the bill.

In the Arts & Stationery segment, business is largely unaffected. However, in the Building Materials segment (Plywood, Hardware, and Paints & Allied Products), business is at a virtual stand-still. The unorganized segment is sizable, and there has been very little supply in the last 20-25 days. Players are adopting a wait-and-watch strategy.

Consistently evaluating new categories, markets for future growth

PIDI classifies its business in three buckets: Core, Growth and Pioneer categories. Fevicol and Fevikwik constitute the Core categories. Construction, Waterproofing, and Joinery segments constitute the Growth categories. In the Pioneer categories, PIDI currently has Tiling Adhesives. PIDI targets to grow its Core categories at 1-1.5x GDP, its Growth categories at 2-3x of GDP, and intends to ensure that today's Pioneer categories become tomorrow's Growth categories. It targets 2/3rd growth from Pioneer and Growth categories, and 1/3rd from Core categories.

There are a lot of Pioneer categories in India. PIDI needs to choose a few, and make it BIG. While the company is spoilt for choice, it will enter only those categories where it believes it has a 'right to win'. It has invested aggressively in R&D over the last four years – as a cost item, R&D has seen the highest jump. It has set up a research lab in USA through a tie-up with University of North Carolina. It will be looking at technologies and how to make them relevant for emerging markets.

PIDI keeps looking at markets similar to India. Some of these, including Turkey and Brazil are 7-8 years ahead of India in a few categories. This enables PIDI to decide category adjacencies for future.

The company has set up a separate entity, PLUB Pidilite to focus large institutional (including government) business.

Waterproofing – successfully transitioned from Pioneer to Growth category

PIDI is a pioneer in the waterproofing segment. Having created the market, it now sees expanding the market as its task. Eight out of 10 houses in India have waterproofing issues, and the opportunity is immense. Some competition is welcome, as it will help to expand the size of the market. The big competition is from MNCs. World over, new construction constitutes 70% of the waterproofing market and repairs constitute 30%. In India, repairs constitute the major part of the waterproofing market.

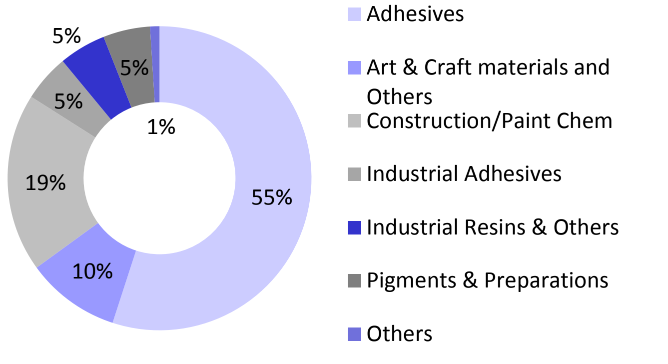
PIDI believes the key ingredients for success are a strong brand, better-informed service offering, and wide reach. Its *Dr Fixit* brand has become a dominant brand in the segment. PIDI has often emphasized its 'four feet on the street' – two extra feet to educate the consumer on how to use the product. One of PIDI's strengths is that its sales personnel focus not only on sales but also on servicing and creating demand. The company has resisted suggestions from consultants on consolidation of its sales force and thus expanding margins by a few basis points. For its waterproofing products, PIDI reaches 25,000 paints dealers, next only to APNT.

The retail segment constitutes ~70% of *Dr Fixit* sales. However, institutional business has been a large growth driver. PIDI believes RERA is positive; good builders will now look at waterproofing more seriously.

Competition / entry into paints / APNT's Loctite adhesive launch

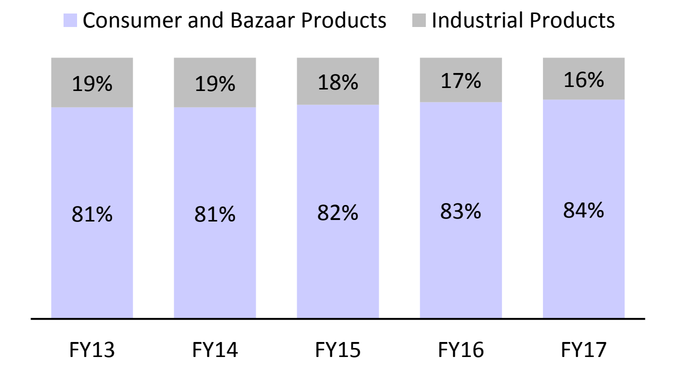
- PIDI will enter Paints only when it feels it can disrupt the category – does not want to be number-5 in Paints.
- APNT's entry in Adhesives (*Loctite* launch in 1HCY16) has not created much flutter (corroborated by our own dealer checks – we had released a note (link) after doing a survey of 46 dealers in Mumbai).

Exhibit 1: Segment composition as on FY17



Source: Company, MOSL

Exhibit 2: Consumer and Bazaar segment has been growing



Source: Company, MOSL

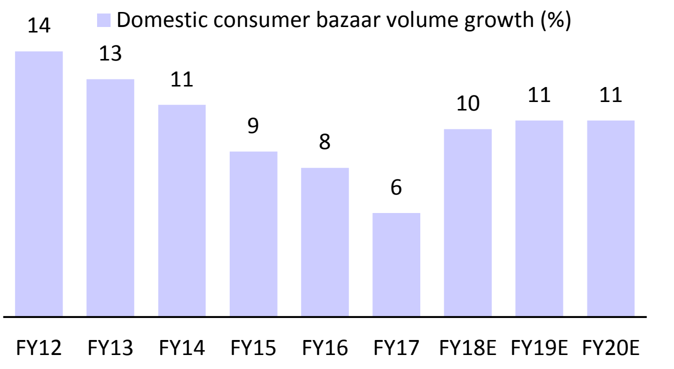
Exhibit 3: Consumer and Bazaar segment grew at 15% CAGR over FY12-17

Consumer and Bazaar	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Sales (INR m)	21,036	25,242	30,205	35,157	40,231	47,932	51,241
Sales Growth (%)		20.0	19.7	16.4	14.4	19.1	6.9
EBIT (INRm)	4,621	5,068	6,217	7,027	7,658	11,859	12,581
EBIT margin %	22.0	20.1	20.6	20.0	19.0	24.7	24.6

Exhibit 4: Industrial Products segment grew at 9% CAGR over FY12-17

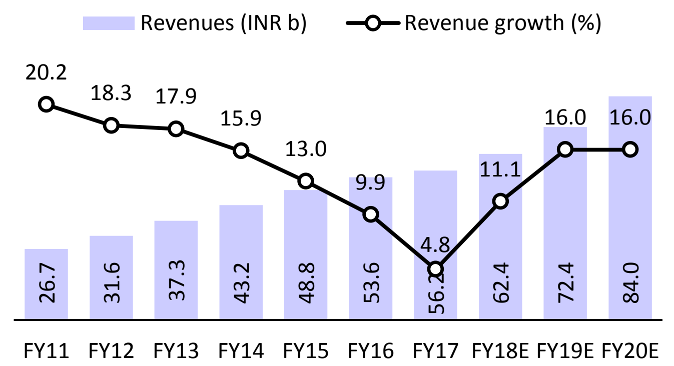
Industrial Products	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Sales (INR m)	5,809	6,363	7,082	8,157	8,692	9,400	9,590
Sales Growth (%)		*9.5*	*11.3*	*15.2*	*6.6*	*8.1*	*2.0*
EBIT (INRm)	1,001	822	807	803	967	1,542	1,646
EBIT margin %	*17.2*	*12.9*	*11.4*	*9.8*	*11.1*	*16.4*	*17.2*

Exhibit 5: Domestic consumer bazaar volumes expected to grow in double digits, going forward



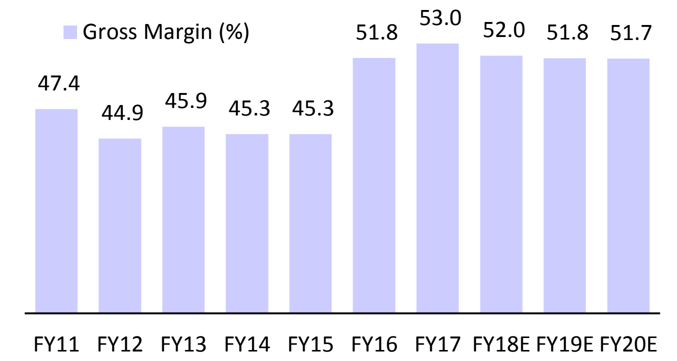
Source: Company, MOSL

Exhibit 6: Consolidated sales to grow at a CAGR of 14.3% over FY17-20



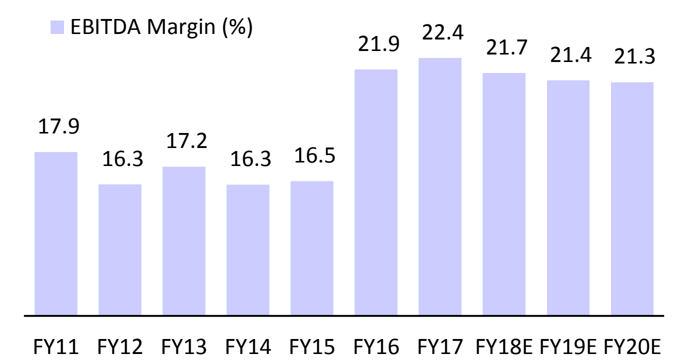
Source: Company, MOSL

Exhibit 7: Gross margin to contract 130bp from unsustainable levels of FY17



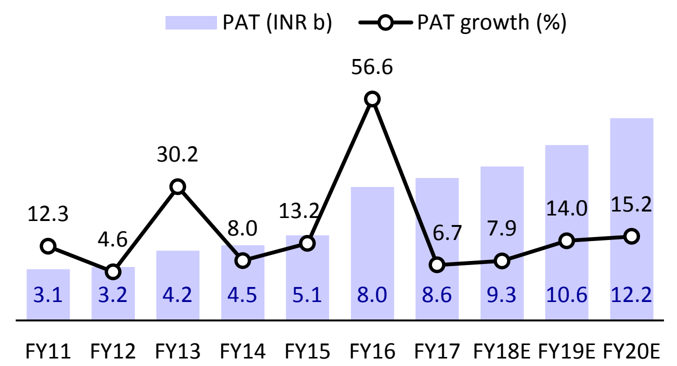
Source: Company, MOSL

Exhibit 8: EBITDA margin to contract 120bp over the same period



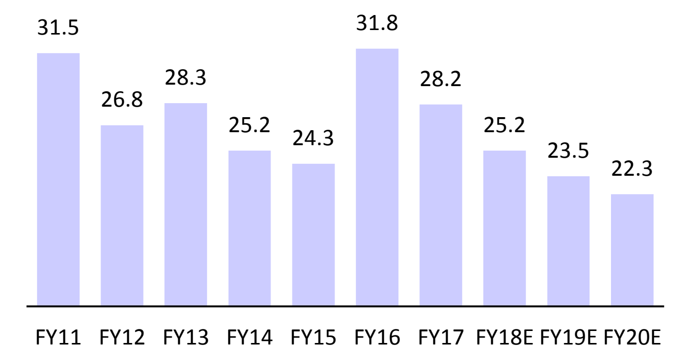
Source: Company, MOSL

Exhibit 9: Expect 12.3% CAGR in adjusted PAT over FY17-20



Source: Company, MOSL

Exhibit 10: Trend in RoE (%)



Source: Company, MOSL

Financials and Valuations

Income Statement						(INR Million)
Y/E March	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**	**FY20E**
Net Sales	**48,783**	**53,612**	**56,168**	**62,414**	**72,397**	**83,978**
Change (%)	13.0	9.9	4.8	11.1	16.0	16.0
Raw Materials	26,686	25,847	26,396	29,973	34,926	40,534
Gross Profit	**22,097**	**27,765**	**29,772**	**32,440**	**37,471**	**43,443**
Margin (%)	45.3	51.8	53.0	52.0	51.8	51.7
Operating Expenses	14,048	16,030	17,174	18,888	22,013	25,580
EBITDA	**8,049**	**11,735**	**12,598**	**13,552**	**15,458**	**17,864**
Change (%)	14.2	45.8	7.4	7.6	14.1	15.6
Margin (%)	16.5	21.9	22.4	21.7	21.4	21.3
Depreciation	1,178	1,005	1,151	1,264	1,416	1,633
Int. and Fin. Charges	156	133	139	127	127	127
Other Income	113	778	1,123	1,259	1,382	1,526
Profit before Taxes	**6,828**	**11,376**	**12,430**	**13,419**	**15,297**	**17,630**
Change (%)	10.3	66.6	9.3	8.0	14.0	15.2
Margin (%)	14.0	21.2	22.1	21.5	21.1	21.0
Tax	1,694	3,335	3,851	4,160	4,742	5,465
Tax Rate (%)	24.8	29.3	31.0	31.0	31.0	31.0
Adj PAT	**5,134**	**8,040**	**8,579**	**9,259**	**10,555**	**12,164**
Change (%)	13.2	56.6	6.7	7.9	14.0	15.2
Margin (%)	10.5	15.0	15.3	14.8	14.6	14.5

Balance Sheet						(INR Million)
Y/E March	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**	**FY20E**
Share Capital	513	513	513	513	513	513
Reserves	22,193	27,316	32,553	40,013	48,769	59,134
Net Worth	**22,706**	**27,829**	**33,066**	**40,526**	**49,281**	**59,646**
Loans	584	848	848	848	848	848
Deferred Liability	566	670	670	670	670	670
Minority Interest	51	427	427	427	427	427
Capital Employed	**23,907**	**29,774**	**35,011**	**42,471**	**51,226**	**61,591**
Gross Block	17,867	20,646	23,024	25,445	27,918	30,462
Less: Accum. Depn.	8,298	9,573	11,083	12,769	14,658	16,835
Net Fixed Assets	**9,570**	**11,073**	**11,941**	**12,676**	**13,260**	**13,627**
Capital WIP	4,618	4,001	4,001	4,001	4,001	4,001
Goodwill	215	239	239	239	239	239
Others	68	97	97	97	97	97
Investments	**3,599**	**6,490**	**7,990**	**9,490**	**10,990**	**12,490**
Curr. Assets, L&A	**15,077**	**17,149**	**22,090**	**27,328**	**35,551**	**45,830**
Inventory	6,410	6,290	7,605	8,536	9,904	11,490
Account Receivables	5,861	7,294	9,127	9,390	10,894	12,639
Cash and Bank Balance	860	1,319	2,495	6,254	11,271	17,827
Others	1,946	2,246	2,863	3,148	3,482	3,874
Curr. Liab. and Prov.	**9,240**	**9,276**	**11,347**	**11,361**	**12,911**	**14,693**
Account Payables	6,933	8,418	8,086	9,172	10,660	12,368
Provisions	2,308	858	3,261	2,189	2,251	2,325
Net Current Assets	**5,837**	**7,873**	**10,743**	**15,967**	**22,639**	**31,137**
Application of Funds	**23,907**	**29,774**	**35,011**	**42,470**	**51,226**	**61,591**

E: MOSL Estimates

Financials and Valuations

Ratios						
Y/E March	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**	**FY20E**
Basic (INR)						
EPS	**10.0**	**15.7**	**16.7**	**18.1**	**20.6**	**23.7**
Cash EPS	12.3	17.6	19.0	20.5	23.4	26.9
BV/Share	44.3	54.3	64.5	79.0	96.1	116.3
DPS	2.9	4.2	4.9	3.0	3.0	3.0
Payout %	28.7	28.5	29.2	16.6	14.6	12.6
Valuation (x)						
P/E		50.2	47.0	43.6	38.2	33.2
Cash P/E		44.6	41.4	38.3	33.7	29.2
EV/Sales		7.4	7.0	6.2	5.3	4.5
EV/EBITDA		33.8	31.2	28.7	24.7	20.9
P/BV		14.5	12.2	10.0	8.2	6.8
Dividend Yield (%)		0.5	0.6	0.4	0.4	0.4
Return Ratios (%)						
RoE	24.3	31.8	28.2	25.2	23.5	22.3
RoCE	23.6	30.3	26.8	24.1	22.7	21.7
RoIC	39.1	46.3	41.1	39.2	40.6	42.9
Working Capital Ratios						
Debtor (Days)	44	50	59	55	55	55
Creditor (Days)	62	73	68	69	68	68
Asset Turnover (x)	3.2	2.8	2.5	2.2	2.0	1.9
Leverage Ratio						
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement						(INR Million)
Y/E March	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**	**FY20E**
PBT before Extra Ord	6,828	11,376	12,430	13,419	15,297	17,630
Add: Depreciation	1,178	1,005	1,151	1,264	1,416	1,633
Interest Paid	156	133	139	127	127	127
Less: Taxes Paid	1,694	3,335	3,851	4,160	4,742	5,465
Interest income	113	778	1,123	1,259	1,382	1,526
(Incr)/Decr in WC	-718	-1,577	-1,694	-1,465	-1,655	-1,942
CF from Operations	**5,637**	**6,822**	**7,054**	**7,927**	**9,061**	**10,456**
Extra ordinary items	-107	-48	-4	0	0	0
CFO after extraordinary	**5,529**	**6,774**	**7,050**	**7,927**	**9,061**	**10,456**
Incr in FA	-3,723	-1,892	-2,019	-2,000	-2,000	-2,000
Free Cash Flow	**1,806**	**4,882**	**5,031**	**5,927**	**7,061**	**8,456**
Pur of Investments	-996	-2,891	-1,500	-1,500	-1,500	-1,500
CF from Invest.	**-4,719**	**-4,782**	**-3,519**	**-3,500**	**-3,500**	**-3,500**
Change in Networth	-3,647	-5,276	-6,239	-1,791	-1,791	-1,791
Incr in Debt	125	264	0	0	0	0
Dividend Paid	1,789	2,519	2,909	0	0	0
Interest Paid	-156	-133	-139	-127	-127	-127
Others	167	1,093	1,114	1,250	1,375	1,518
CF from Fin. Activity	**-1,722**	**-1,533**	**-2,355**	**-668**	**-543**	**-400**
Incr/Decr of Cash	**-912**	**459**	**1,176**	**3,759**	**5,017**	**6,556**
Add: Opening Balance	1,772	860	1,319	2,495	6,254	11,271
Closing Balance	**860**	**1,319**	**2,495**	**6,254**	**11,271**	**17,827**

E: MOSL Estimates

NOTES

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