26 November 2019

Update | Sector: Consumer

Colgate

BSE SENSEX 40,821 | S&P CNX 12,038

CMP: INR1,488 TP: INR1,815 (+22%) Buy

COLGATE-PALMOLIVE

Poised for strong earnings growth over medium term

Inexpensive valuations bolster upside potential

We recently met Colgate's (CLGT) management to understand its strategy to drive growth amidst changing market dynamics. Key highlights:

- **CLGT's market share has been stable over the past few quarters.**
- **Volume growth and market share expansion have taken precedence as part of its new strategy, even if it is at the cost of near-term profitability.**
- **Direct reach has increased by 30% over the past year.**
- **Good Rabi crop may not necessarily translate into a significant boost for FMCG sector volumes. It may take rural growth at par with urban growth. Anything additional will be a bonus.**
- **Premiumization is back in focus. No material downtrading is happening either.**
- **No material capex required until Dec'22.**
- **In our note post the corporate tax cut, we had included Colgate (CLGT) among our top picks. In another note on CLGT earlier this month, we had examined past instances among Indian MNCs where management change heralded a significant change in the strategy for the better. We remain bullish on CLGT from the medium-term perspective, given its reasonable valuations (39.7x FY21E EPS – a huge discount to MNC peer multiples of 50x-56x), likely escalation in earnings momentum and sharp potential improvement in the already impressive RoCE. Targeting 45x Sep'21E, we maintain our target price of INR1,815 with a Buy rating.**

Stable market share over past few quarters

- It was important for CLGT to arrest the hemorrhage in the toothpaste market share before resuming the growth path. In that regard, the company has done well over the past few quarters to maintain a stable market share of 51%-52% (although still below the peak of ~58%), led by:
  - **Launch of a host of herbal products** like Cibaca Ved Shakti and Swarna Ved Shakti, as well as the recently launched Charcoal toothpaste. This apart, it has a strong pipeline of products awaiting launch in both the herbal and non-herbal categories.
  - **Slowdown in growth of herbal** from ~30% YoY to mid-teens now. CLGT's market share in herbal is around one third and therefore sharp growth in the salience of the category (now 25-30% of toothpaste market sales) impacted its overall market share.
  - **Direct distribution reach** which reportedly expanded by 30% over the past year. At a time when wholesale trade (both rural and urban) is facing pressure, this move would have helped arrest the hemorrhage and is likely to aid growth in market share. While management did not share the number, we believe that CLGT's direct reach now equals or exceeds 2m outlets, making it the third company apart from HUVR (~3m outlets) and more recently Britannia (~2.1m outlets) to attain that figure.

Stock Info

Bloomberg	CLGT IN
Equity Shares (m)	272
M.Cap.(INRb)/(USDb)	404.8 / 5.7
52-Week Range (INR)	1641 / 1096
1, 6, 12 Rel. Per (%)	-7/26/9
12M Avg Val (INR M)	654
Free float (%)	49.0

Financials Snapshot (INR b)

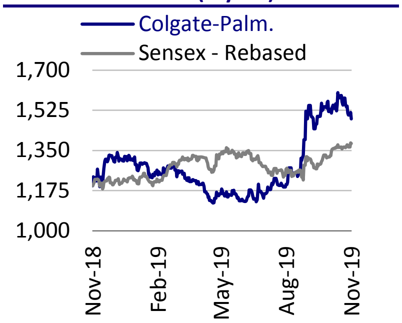
Y/E March	2019	2020E	2021E
Sales	44.6	47.3	53.8
EBITDA	12.4	12.4	15.2
Adj. PAT	7.5	8.2	10.2
Adj. EPS (INR)	27.4	30.1	37.5
EPS Gr. (%)	8.8	9.9	24.5
BV/Sh.(INR)	53.2	50.8	46.5
RoE (%)	50.1	57.9	77.1
RoCE (%)	47.9	54.2	71.6
P/E (x)	54.3	49.4	39.7
P/BV (x)	28.0	29.3	32.0

Shareholding pattern (%)

As On	Sep-19	Jun-19	Sep-18
Promoter	51.0	51.0	51.0
DII	11.6	10.5	13.3
FII	15.5	15.1	13.3
Others	22.0	23.4	22.4

FII Includes depository receipts

Stock Performance (1-year)



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- **Adspends and promotion spends increased steeply by 20% in 2QFY20 after** the arrival of the new MD in Aug'19 (+250bp YoY as a percentage of sales in 2QFY20). The company re-launched Colgate Dental Cream, Colgate Max Fresh with Cooling Crystals, and there has been a lot of communication on the mother brand of late. 'Saver packs' are now a year-round phenomenon rather than occasional earlier. Even INR10 toothpastes come with a brush now.
- **Revival in both premium and mass end (Colgate Cibaca)** augurs well for CLGT, in our view. The premium segment of the market was hurt amidst sharp growth in the salience of the natural segment, but this has changed over the past few months. From 8% of the oral care segment, the premium segment had slipped to 3-4% but is moving back to mid-to-high single-digits (at ~6% now). Similarly, growth at Colgate Cibaca – the company's value product – is recovering. Market share for CLGT is higher in these two segments compared to naturals.

Clearly articulated strategy on volume growth, market share expansion

- After achieving some stability in market share, the new MD, Mr. Ram Raghavan's aim is to expand it further – even if it is at the cost of near-term profitability.
- While we believe that oral care category volume growth on a steady state basis will be in single digits, CLGT has the potential to claw back some of the market share that it had lost over the past four years as a result of this renewed focus and also the aforementioned factors.
- Revival in premiumization bodes well for realization growth, which was hurt over the past 3-4 years partly on account of the surprising decline in the salience of the premium segment amidst the onslaught of herbal. Absence of significant downtrading even in the slowdown also augurs well for realization growth.

Volume growth recovery to be gradual

- Demand has neither revived nor slipped in recent months compared to 3-4 months ago.
- According to management, the expected good Rabi sowing (on account of above-normal monsoon) may not materially alter the demand scenario in rural India for the FMCG sector. At the most, it expects rural growth – which had slipped below urban growth over the past two quarters – to come at par but not surpass urban growth, at least in the next few quarters. This is in contrast to the scenario three quarters ago when rural growth was well above urban (1.3x urban growth) and driving overall growth for the sector.
- Oral care usually recovers with a lag after sector recovery. Management expects mid-single-digit volume growth for the full year. We assume 5.5% volume growth for FY20.

Corporate tax cut benefits yet to be passed on

- Management has not yet passed on the benefit of corporate tax cuts either in the form of price reductions or adspends. In our view, CLGT is waiting for some revival in demand before going the whole hog on adspend/promotion.

- Notably, CLGT was expected to pay taxes at a rate of ~33-34% for FY20 and FY21 before the announcement of the corporate tax cut by the government. Thus, corporate tax cuts will add INR850-1,150m to its profits.
- As mentioned in our note released after the announcement of the corporate tax cut, we need to assess the second-order effects of this measure. This includes the impact on (1) relative basis (v/s peers) in categories where the company operates and (2) absolute profit and absolute savings v/s peers. In our view, CLGT is well placed on both these fronts, given that Dabur and Patanjali will not see any material gains from the corporate tax cuts. CLGT can spend a significant part of INR850-1,150m incremental PAT by way of promotions/price-offs in an attempt to gain market share. Two points are important here: **(a) Gain further share or lead to further bleeding of peers**: None of its competitors would have such windfall gains, and if they choose to match CLGT's efforts on promotions and price-offs, they would end up bleeding further. **(b) Utilize/institutionalize multi-year benefit over peers:** Importantly, the corporate tax cuts offer multi-year benefits to CLGT, providing it with incremental benefit every year until competitors scale up well.

No material capex until end-2022

- CLGT cited it does not require significant incremental capex until Dec'22. This means that capex will be low until end-FY23.
- As mentioned in our recent note (where we looked at the similarities between CLGT and other MNCs), CLGT had created significant capacity over FY14-17 before the onslaught of herbal players, which delayed capacity utilization pick-up. Even if volumes for Colgate were to recover to high-single-digits (assuming some market share recovery) from low-to-mid single-digits, PAT growth will be much higher than EBITDA/revenue growth – as was witnessed in Nestle's case recently when it finally got the strategy right and was able to reap the benefits of massive capacity expansion earlier.

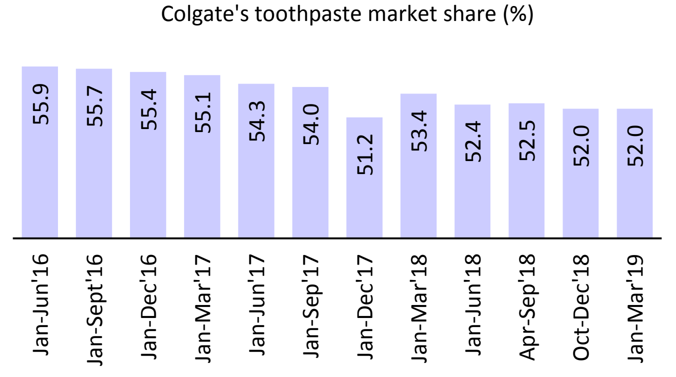
Comments on competition

- Management believes that Patanjali has not been gaining share recently.
- Dabur has started doing well in south and west India (traditionally weak geographies for that company) with Dabur Red.
- Lever Ayush has not made any material dent in oral care even in south India.

Non-oral care growth

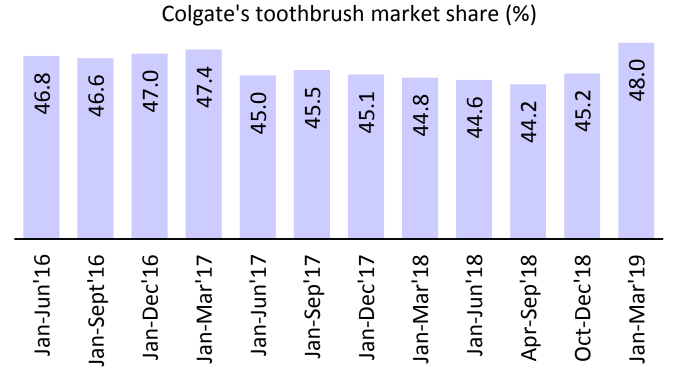
- While the focus now is on reviving growth in oral care, management is clear that non-oral care will play an important part in driving incremental sales growth over the medium-to-long term. CLGT already has over six million outlets (direct reach of two million, in our view) and once it sets the house back in order in terms of oral care, the company will be aggressive given its ability to piggyback on the existing distribution reach. In our view, CLGT will strategize well to not get into the mass market soaps/detergents businesses.
- Non-oral care is only ~2-3% of sales in India compared to half of global sales for the parent. According to management, while oral care will continue to be by far the largest chunk of sales in India, non-oral care could be a double-digit sales contributor over the next 10 years.

Exhibit 1: While management has not shared latest figures toothpaste market share has been stable of late…



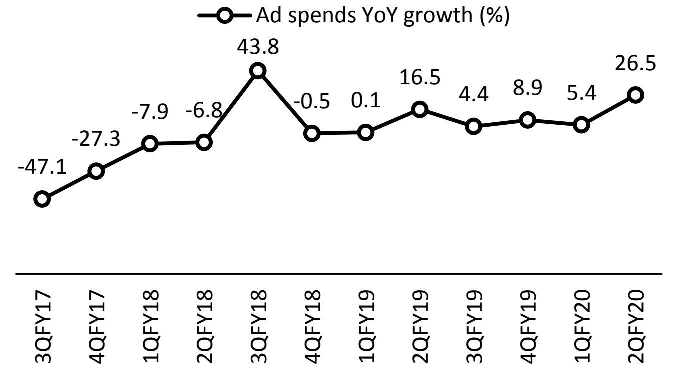
Source: Company, MOSL

Exhibit 2: ….and market share has expanded in toothbrushes



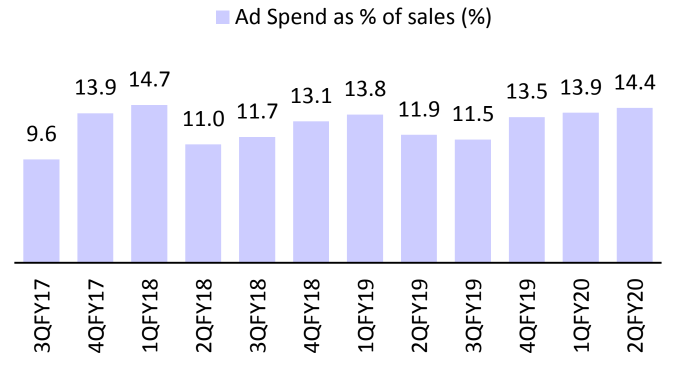
Source: Company, MOSL

Exhibit 3: Ad spends rose sharply YoY in 2QFY19



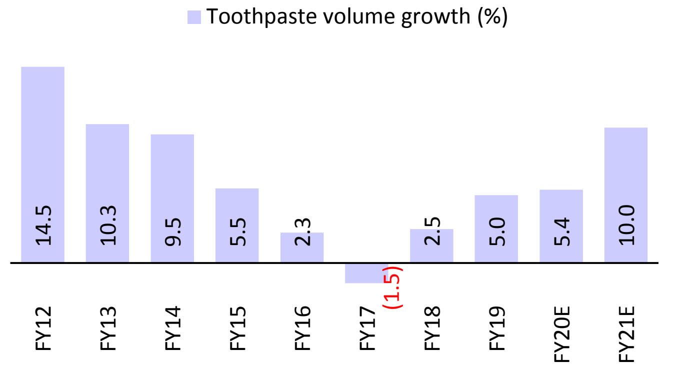
Source: Company, MOSL

Exhibit 4: Ad spends as % of sales have been increasing over the past three quarters



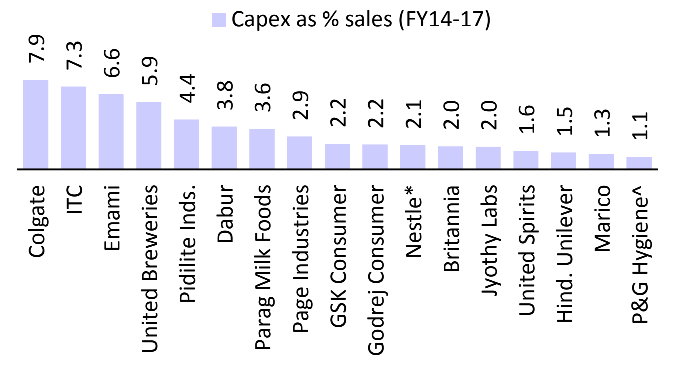
Source: Company, MOSL

Exhibit 5: CLGT's toothpaste volume growth expected to be in mid-single-digits in FY20



Source: Company, MOSL

Exhibit 6: Over FY14-17, CLGT incurred significantly higher capex as % of sales than other consumer companies…



Source: Company, MOSL

Exhibit 7: …thus, capex until FY23 is expected to be low

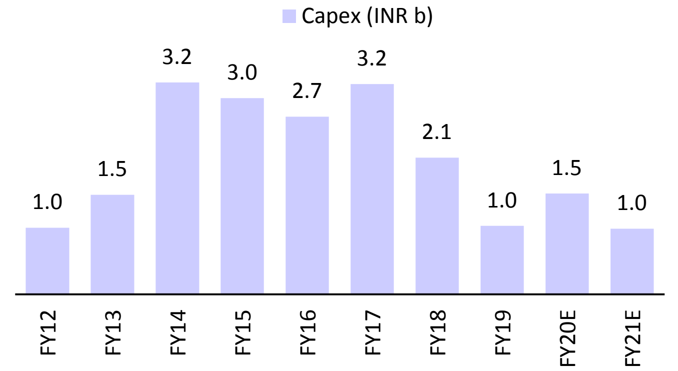


Exhibit 8: Higher capex over FY14-17 and weak earnings led to higher depreciation as % of EBITDA

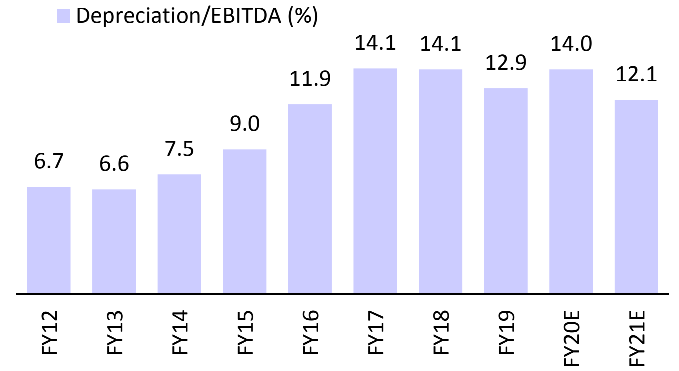


Exhibit 9: Expect muted sales growth in FY20 before potentially strong recovery in FY21

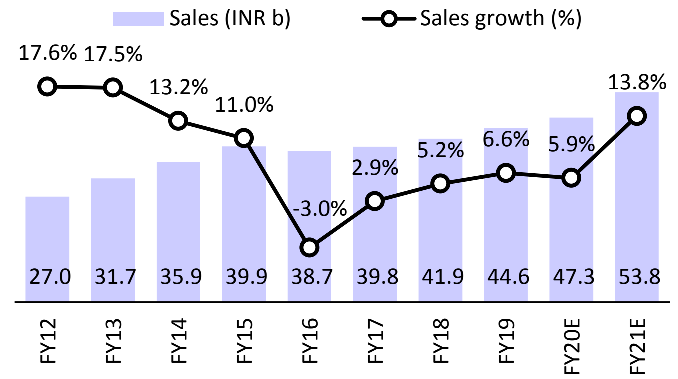


Exhibit 10: Expect flat EBITDA in FY20 because of higher adspends before growth in FY21

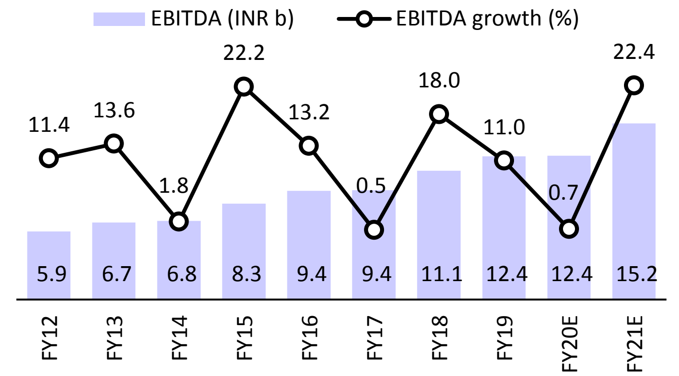


Exhibit 11: Expect EBITDA margin to expand 60bp over FY19-21

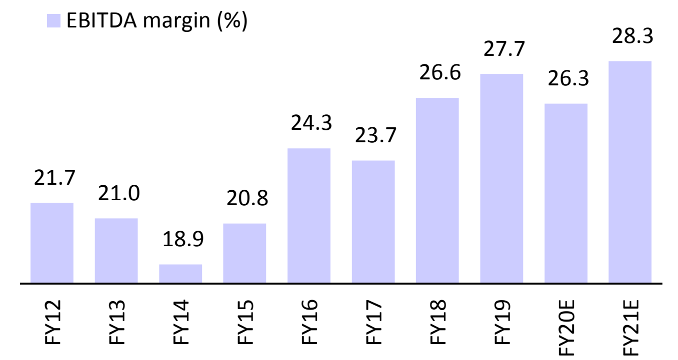


Exhibit 12: Expect PAT growth to be higher than EBITDA growth in FY20 and FY21

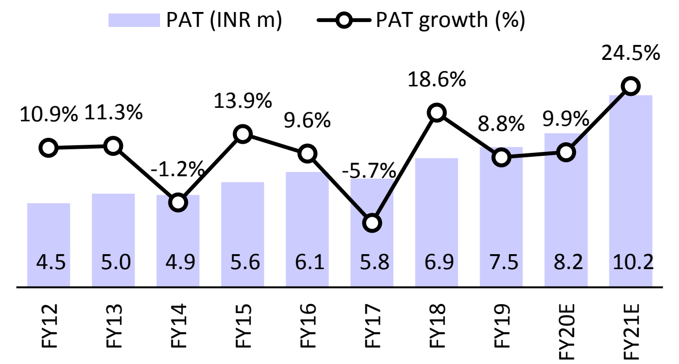
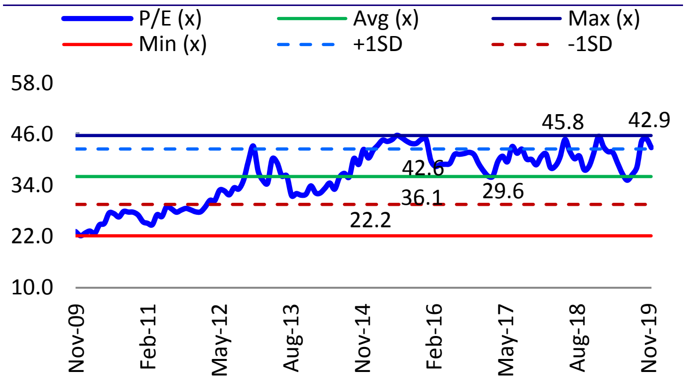
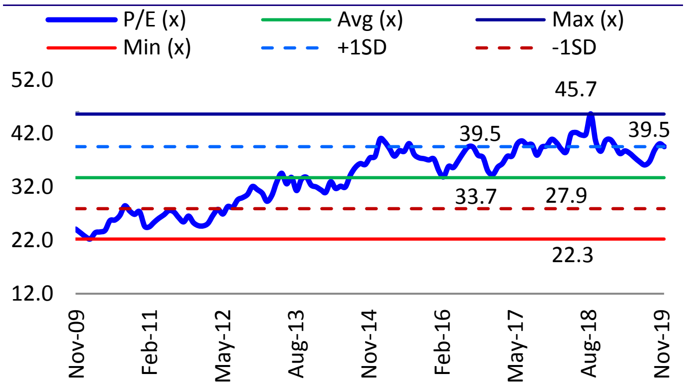


Exhibit 13: Colgate Palmolive P/E (x)



Source: Company, MOSL

Exhibit 14: Consumer sector P/E (x)



Source: Company, MOSL

Financials and Valuations

Income Statement							(INR M)
Y/E March	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Net Sales	**39,887**	**38,682**	**39,818**	**41,880**	**44,624**	**47,265**	**53,804**
Change (%)	11.0	-3.0	2.9	5.2	6.6	5.9	13.8
COGS	14,677	14,763	14,763	14,887	15,586	16,495	18,584
Gross Profit	**25,210**	**23,919**	**25,055**	**26,992**	**29,039**	**30,770**	**35,220**
Gross Margin (%)	63.2	61.8	62.9	64.5	65.1	65.1	65.5
Operating expenses	16,920	14,534	15,619	15,855	16,678	18,328	19,997
EBITDA	**8,290**	**9,385**	**9,435**	**11,137**	**12,361**	**12,442**	**15,223**
Change (%)	22.2	13.2	0.5	18.0	11.0	0.7	22.4
Margin (%)	20.8	24.3	23.7	26.6	27.7	26.3	28.3
Depreciation	750	1,114	1,332	1,565	1,592	1,748	1,849
Int. and Fin. Charges	0	0	0	0	25	80	80
Financial Other Income	264	395	411	375	377	328	332
Profit before Taxes	**7,804**	**8,666**	**8,514**	**9,947**	**11,120**	**10,942**	**13,626**
Change (%)	17.6	11.1	-1.8	16.8	11.8	-1.6	24.5
Margin (%)	19.6	22.4	21.4	23.8	24.9	23.2	25.3
Tax	2,009	2,541	2,740	3,022	3,717	2,754	3,429
Tax Rate (%)	28.4	29.3	32.2	31.1	33.0	25.2	25.2
Adjusted PAT	**5,590**	**6,125**	**5,774**	**6,850**	**7,451**	**8,188**	**10,196**
Change (%)	13.9	9.6	-5.7	18.6	8.8	9.9	24.5
Margin (%)	14.0	15.8	14.5	16.4	16.7	17.3	19.0
Non-rec. (Exp)/Income	0	-313	0	-117	305	0	0
Reported PAT	**5,590**	**5,812**	**5,774**	**6,734**	**7,756**	**8,188**	**10,196**

Balance Sheet							(INR M)
Y/E March	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Share Capital	272	272	272	272	272	272	272
Reserves	7,431	10,038	12,466	14,974	14,196	13,550	12,368
Net Worth	**7,703**	**10,310**	**12,738**	**15,246**	**14,468**	**13,822**	**12,640**
Loans	0	0	0	0	777	777	777
Deferred Liability	26	97	275	355	309	309	309
Capital Employed	**7,729**	**10,407**	**13,013**	**15,601**	**15,553**	**14,908**	**13,725**
Gross Block	12,829	14,866	17,188	19,077	21,077	22,618	23,618
Less: Accum. Depn.	-5,013	-4,785	-6,107	-7,617	-9,169	-10,916	-12,766
Net Fixed Assets	**7,816**	**10,081**	**11,081**	**11,459**	**11,909**	**11,702**	**10,852**
Capital WIP	1,412	784	1,666	1,586	1,987	1,987	1,987
Investments	371	312	312	312	312	312	312
Current	371	0	0	0	0	0	0
Non-current	0	312	312	312	312	312	312
Curr. Assets, L&A	**7,420**	**8,852**	**10,048**	**12,282**	**12,058**	**13,078**	**13,020**
Inventory	2,522	2,915	2,926	2,267	2,486	2,636	2,971
Account Receivables	696	1,015	1,299	2,010	2,098	2,315	2,343
Cash & Bank	2,545	2,887	2,943	4,562	3,994	4,534	3,994
Others	1,657	2,035	2,880	3,443	3,481	3,593	3,713
Curr. Liab. and Prov.	**9,290**	**9,622**	**10,094**	**10,037**	**10,712**	**12,170**	**12,446**
Account Payables	5,144	5,519	5,975	6,203	6,132	7,534	7,703
Other Liabilities	2,874	3,438	3,356	3,040	3,757	3,772	3,836
Provisions	1,272	664	763	794	823	864	907
Net Current Assets	**-1,870**	**-770**	**-46**	**2,245**	**1,346**	**908**	**575**
Application of Funds	**7,729**	**10,407**	**13,013**	**15,601**	**15,553**	**14,908**	**13,725**

E: MOFSL Estimates

Financials and Valuations

Ratios							
Y/E March	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Basic (INR)							
EPS	**20.6**	**22.5**	**21.2**	**25.2**	**27.4**	**30.1**	**37.5**
Cash EPS	23.3	26.6	26.1	30.9	33.2	36.5	44.3
BV/Share	28.3	37.9	46.8	56.1	53.2	50.8	46.5
DPS	12.5	11.0	11.0	24.0	23.0	26.2	33.7
Payout %	60.6	48.8	51.7	95.3	84.0	87.0	90.0
Valuation (x)							
P/E	72.4	66.1	70.1	59.1	54.3	49.4	39.7
Cash P/E	63.8	55.9	57.0	48.1	44.8	40.7	33.6
EV/Sales	10.1	10.4	10.1	9.5	9.0	8.5	7.5
EV/EBITDA	48.5	42.8	42.6	35.9	32.5	32.2	26.4
P/BV	52.5	39.3	31.8	26.6	28.0	29.3	32.0
Dividend Yield (%)	0.8	0.7	0.7	1.6	1.5	1.8	2.3
Return Ratios (%)							
RoE	81.6	68.0	50.1	49.0	50.1	57.9	77.1
RoCE	82.5	67.5	49.3	47.9	47.9	54.2	71.6
RoIC	236.5	119.0	75.7	76.5	78.4	92.3	129.1
Working Capital Ratios							
Debtor (Days)	6	9	11	17	17	18	16
Asset Turnover (x)	6.7	4.2	3.6	3.1	3.4	3.7	4.7
Leverage Ratio							
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.1	0.1	0.1

Cash Flow Statement							(INR M)
Y/E March	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
OP/(loss) before Tax	7,804	8,666	8,514	9,947	11,121	10,942	13,626
Depreciation	750	1,114	1,332	1,565	1,592	1,748	1,849
Int./Div. Received	97	-264	34	81	85	-328	-332
Interest Paid	-264	-261	-297	-290	-317	80	80
Direct Taxes Paid	-2,055	-2,524	-3,014	-3,474	-4,144	-2,754	-3,429
(Incr)/Decr in WC	49	156	311	-889	1,494	979	-207
CF from Operations	**6,382**	**6,887**	**6,880**	**6,940**	**9,830**	**10,667**	**11,587**
(Incr)/Decr in FA	-2,994	-2,713	-3,212	-2,087	-1,042	-1,541	-1,000
Free Cash Flow	**3,388**	**4,175**	**3,668**	**4,853**	**8,788**	**9,126**	**10,587**
Others	135	12	-205	564	-1,209	1,732	1,735
CF from Invest.	**-2,859**	**-2,631**	**-3,418**	**-1,523**	**-2,251**	**191**	**735**
Dividend Paid	-3,388	-2,987	-2,717	-2,986	-6,462	-8,833	-11,379
Others	-460	-928	-689	-812	-1,564	-1,484	-1,484
CF from Fin. Activity	**-3,848**	**-3,915**	**-3,406**	**-3,798**	**-8,147**	**-10,317**	**-12,863**
Incr/Decr of Cash	**-325**	**342**	**56**	**1,619**	**-568**	**541**	**-541**
Add: Opening Balance	2,870	2,545	2,887	2,943	4,562	3,994	4,534
Closing Balance	**2,545**	**2,887**	**2,943**	**4,562**	**3,994**	**4,534**	**3,993**

E: MOFSL Estimates

N O T E S

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

*In case the recommendation given by the Research Analyst is inconsistent with the investment rating legend for a continuous period of 30 days, the Research Analyst shall within following 30 days take appropriate measures to make the recommendation consistent with the investment rating legend.

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