J.P.Morgan

Asia Pacific Equity Research
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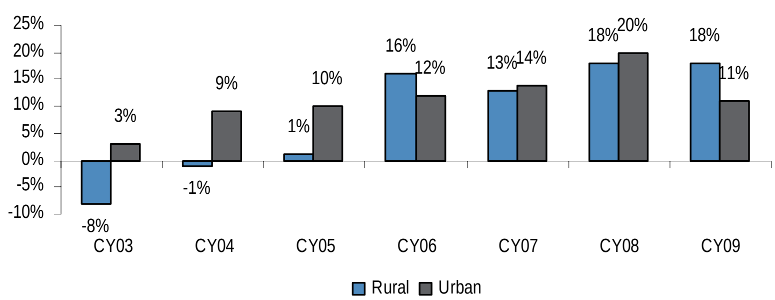
India Consumer Insights

Rural Consumption : The Tipping Point

Our recent visits to four key grain producing states of Punjab, Haryana, Uttar Pradesh and Tamil Nadu reaffirmed the robust growth trends seen in rural regions, particularly with benign monsoons this year. In this report we share our observations regarding changing consumer attitudes and its likely influence on spending patterns.

- **Information age is impacting rural consumption.** Rising awareness levels driven by increased media penetration and higher distribution reach by national companies is leading to a more demanding and discerning rural consumer. Quality and brand perception is becoming an important parameter for purchase decision; 'premiumisation' across segments is underway. Discretionary spends particularly on durables, housing, automobiles and private education are rising
- **Societal changes are spurring new consumption trends and issues. Nuclearisation of families** bodes well for demand for new homes, durables, automobiles etc. Also increasing emphasis on education will create opportunity/inputs for a growing service economy. **Saving levels are trending down** and bank credit is gaining wider acceptance particularly for increased discretionary purchases. **Higher land prices have further amplified the 'wealth' effect** visible in rural consumption. **Rising labor shortage** is raising cost of farming, though it is also pushing the pace of farm mechanization.
- **Opportunity for growth is large, but fight for share of wallet will become increasingly expensive.** Rising income levels in rural areas will definitely brighten revenue growth prospects for FMCG companies. However increasing fragmentation of consumer-spends, imply that competitive costs (marketing/distribution) for players will rise as fight for share intensifies as consumer pull becomes stronger than retailer push. Distribution advantage of market leaders (like HUL) is receding as other companies are gaining ground. Best rural consumption plays in our coverage universe are ITC (OW), United Spirits (OW), Nestle India (N) and Mahindra & Mahindra (OW).

Figure 2: India FMCG Growth - Rural and Urban



Source: Company reports.

India
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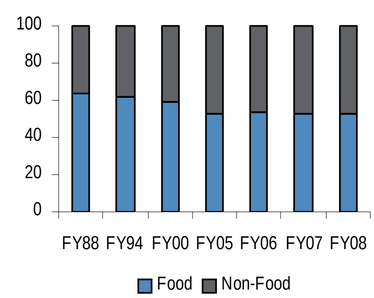
Figure 1: Share of Rural Consumption

%



Source: NSSO

See page 20 for analyst certification and important disclosures, including non-US analyst disclosures.

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Executive Summary

Rural India presents a large and resilient target consumption market for corporate India. There are significant mindset/lifestyle shifts taking place in rural India over the last 3-4 years driven by rising household incomes, growing awareness levels, increasing media penetration and farmer friendly government policies which are influencing buying decisions. We highlight below key trends we noticed during our recent visit to rural regions in four states of India.

Income Trends

Government's focus on the rural economy via its support and development schemes and substantial increases in minimum support prices of agri commodities have aided rural prosperity and improved farmer's financial health. Over past few years there has been a steady shift of rural workforce towards non-agricultural sector (services, own enterprises, etc) which has further supplemented rural household income. Land sales (to govt. in most cases) have resulted in higher capital flows for farmers too.

Social Trends

Rural India (particularly the youth) is gradually moving from 'savings' to 'consumption' mindset. Confidence levels have risen amongst farming community as perception of income earning capabilities has gone up. Higher land prices have further amplified the 'wealth effect' which is fueling discretionary spends and rising acceptance of cheap bank credit is also facilitating this trend.

Growing media penetration (rising TV and DTH penetration) in rural areas has been a key influencer on lifestyle and consumption patterns. Nuclear families are fast replacing joint families and this is leading to higher demand for homes, durables, two wheelers etc. Also increasing emphasis on education will create opportunity/inputs for a growing service economy.

A key challenge being faced is short supply of labor on account of rising affluence and government schemes like NRGEA. A positive offshoot, however, of this is growing demand for farm mechanization.

Consumption Trends

Consumer pull is now greater than retailer push. Rural consumer is now aware of more choices and is becoming more demanding and brand conscious, thanks to growing media penetration and increasing distribution reach of FMCG companies. In order to adhere to the purchasing preferences of various consumer segments, new packaging sizes and price points are being introduced. Premiumisation across categories is underway in rural areas. Distribution gap between HUL and other players is narrowing as other companies are gaining ground in a substantial manner.

Rural consumer spends are increasingly turning discretionary given higher household income, rising aspirational levels and increasing urbanization. This should benefit sales for consumer durables, autos and tractor companies.

Our preferred stocks to play the rural consumption story in FMCG space are ITC (OW), United spirits (OW) and Nestle India (N) which will benefit at the expense of local/unorganised brands. Asian Paints (NR) is beneficiary of rising housing demand (led by increasing nuclearisation of families) and uptrading to value-added products. Dish TV (NR) is a play on rising acceptance of DTH platform in rural areas. Mahindra & Mahindra* (OW) and Escorts (NR) are key beneficiaries of strong momentum in tractor purchases.

* - Mahindra & Mahindra is covered by Aditya Makharia at J.P. Morgan

Quotes from discussions with FMCG distributor/retailers – 1) While Re1 shampoo sachet dominates the sales mix, the Rs3 *Dove* shampoo sachet has started to sell well in past year or so (now about 10-15% of shampoo sachet for this distributor), 2) Sales of *Tide Naturals* have been weak (compared to regular *Tide*) as consumers are wary of quality at lower price, 3) I did not keep *Surf Excel* in the shop till 3 yrs back but now consumer's demand for this brand has led them to stock it.

A paints distributor noted that he has started keeping water-proof paints (priced 50% higher) which now account for close to 10% of its product sales in villages.

Takeaways from discussions with auto dealers - Number of two wheelers per household are rising with youth demanding separate vehicles (than those used by their fathers). Better roads have further facilitated the use of two wheelers.

A tractor dealer noted that rules for granting loans for tractor purchases have eased with limit for land holding to get a loan decreasing (e.g. Canara bank and SBI have landholding requirement of 6 acres while OBC and PNB have lowered this requirement to 2.5 acres in this village)

Cost of labor for farming has risen anywhere between 25-50%over past two years in the villages that we visited.

Our field trip to a sugar cane farm employing micro irrigation facilities revealed that yields have improved 25-30% due to micro irrigation.

While Rs1100 worth Samsung Guru mobile phone sells the most, premium Nokia N Series phone also found some shelf space in a rural telecom shop. Idea Cellular is popular in this village as it provides a recharge option for as low as Rs10 versus Vodafone/Airtel which offered recharge options starting Rs30.

A FMCG distributor in a small town in Haryana (deriving 60% sales from nearby villages and 40% from town) noted that about 1-2 new stores open every 2-3 months in nearby villages (over past 2 yrs or so).

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Table 1: India Consumer Valuations

Company	Price	MCAP		P/E			EV/EBITDA			P/Sales	
	Rs	US$mn	FY10	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
HUL	265	12,568	28.1	26.4	22.8	19.9	19.3	16.5	3.3	3.0	2.7
ITC	326	27,059	30.7	26.0	22.1	18.6	15.9	13.4	6.9	6.0	5.2
Colgate-Palmolive	825	2,439	28.0	25.5	21.8	22.4	19.7	17.1	5.7	5.0	4.4
Godrej Consumer	371	2,500	33.8	24.9	20.4	27.8	19.7	15.7	5.6	3.2	2.6
Dabur	209	3,936	35.9	30.1	24.5	29.3	24.6	20.6	5.4	4.6	4.0
Nestle India	3050	6,393	42.2	35.0	28.8	28.1	23.7	19.8	5.7	4.9	4.2
United Spirits	1432	3,804	33.0	34.0	24.9	18.2	16.8	13.8	2.8	2.6	2.3
Zee Entertainment	287	2,986	27.4	22.4	18.9	22.2	16.0	13.1	6.4	4.9	4.3
Dish TV*	51	1,158	NM	NM	NM	57.7	27.9	14.6	5.0	3.8	3.0
Jain Irrigation	1245	2,078	39.0	35.1	26.5	17.2	14.1	11.7	2.8	2.3	1.9
Mahindra & Mahindra	627	7,654	18.3	14.7	13.1	13.0	11.8	10.5	1.9	1.7	1.5

Source: Company reports and J.P. Morgan estimates. *- Consensus estimates for Dish TV, all prices as of 31 Aug.

Income trends

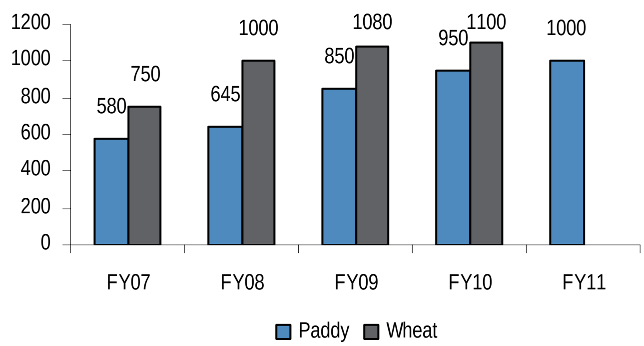
Government initiatives have spurred farm income

Government's focus on the rural economy via its support and development schemes (Bharat Nirman, NREGS, etc.) and substantial increases in minimum support prices of agri commodities have aided rural prosperity and improved farmer's financial health. Over past 3-4 years minimum support prices (MSP) for various crops have been raised considerably by the government (refer Fig 3 below). Most of the farmers we met expect MSPs to keep rising, though the quantum of increase would be moderate. With rising awareness levels farmers with large land holdings are also opting for crop diversification to enhance their overall farm income.

Higher emphasis on infrastructure development in rural regions by the government has also attracted the workforce – especially under National Rural Employment Guarantee Act (NREGA) which ensures hundred days of wage-employment in a year to a rural household whose adult members volunteer to do unskilled manual work.

Figure 3: Minimum Support Price (MSP) for Paddy and Wheat

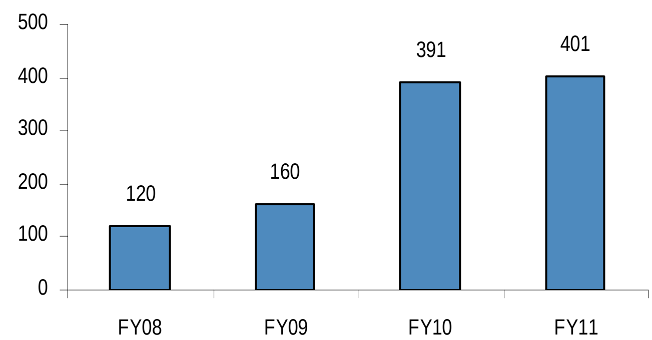
Rs/quintal



Source: GoI

Figure 4: Government allocation for NREGA

Rs bn



Source: GoI

Dependence on non-farm income sources is rising

Over past few years there has been a steady shift of rural workforce towards non-agricultural sector (services, own enterprises, etc) which has supplemented rural household income. With more awareness and increasing education levels, family members are now more keen to have their children move out to service jobs which provide higher income. There are also instances where educated farmers have moved out to nearby towns to take up jobs while handing back day-to-day operational supervision of farms to their employees, but still keeping a close eye on the farm management. With more mechanisation available on farmlands now, need for family members for farming has also reduced. In states like Punjab, NRI inflows have enhanced the income for several rural households.

Land acquisitions have aided capital flows

Farmers in some states have also benefited from land acquisitions by the state governments as well as from rising land values around the larger cities /towns. State governments have been acquiring farm land for road construction/industrial development, which has resulted in significant capital flows to these farmers.

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Social trends

Information age impacts rural India

Media penetration has been a key influencer on consumption patterns. TV penetration is quite high at 70-80% in nearly all the villages we visited. Increasingly DTH platforms are gaining acceptance in households which further facilitate penetration in cable dark areas. Besides TV medium, we also noticed more out-of-home advertising (billboards etc) and Point of Purchase advertising to increase brand awareness. Rising media exposure is accelerating the pace of urbanization in rural regions and influencing purchasing decisions across product segments.

For planned purchases like durables and jewelry, farmers are now looking for more choices and are now going to nearby towns (facilitated by better road infrastructure/connectivity) to purchase these products from big branded shops bypassing the local jeweler/electronic shop.

Key plays on rising media penetration include broadcasters like Zee TV (N) and Sun TV (NR) who benefit from growing regional advertisement spends and Dish TV (NR), country's leading DTH service provider with 35% share.

Figure 5: DTH is gaining traction at a fast pace in rural markets

Source: J.P. Morgan

Figure 6: Companies are stepping up marketing spends

Source: J.P. Morgan

Higher land prices have amplified the 'wealth effect'

It was interesting to note how higher land prices have been able to create a feeling of being wealthy for the farmer. This has actually translated into increased spending levels. More important to note is that earlier farmer was always very keen to add more land (to push up his farm income) and now with land prices going up, he is unable to buy additional land and hence prefers to spend his income on improving his living status. In many instances, we also found that farmer is also now able to rent farmland (as some farmers move to towns and are open to give their land on rent), and hence his capital investments are not necessarily high.

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Saving rates are trending down, bank loans are big facilitators now

Farmers (particularly the youth) are gradually moving from 'savings' mindset to 'consumption' mindset. Confidence levels have risen amongst farming community as perception of income earning capabilities has gone up.

With bank credit becoming available at easier rates (5-7% with *Kisan* Credit Card scheme being a key one), farmers are opting for these and are increasingly using this money for non-farm use (like buying durables, automobiles, housing, weddings etc). However some farmers did point out the procedural delays in getting bank loans and they find it more comfortable to take loans from local commission agents with whom farmers have relationships that are built over decades. The commission agents charge an interest rate of 12 - 18% from the farmers, depending on their individual profiles.

A tractor dealer noted that rules for granting loans for tractor purchases have eased with limit for land holding to get a loan decreasing (e.g. Canara bank and SBI have landholding requirement of 6 acres while OBC and PNB have lowered this requirement to 2.5 acres) in his village.

Table 2: SBI - Growing reach in rural regions

	Mar'08	Mar'09	June'09	Mar'10	Jun-10
Coverage of unbanked villages	12515	53000	58000	104000	107000
Rural & Semi Urban branches :					
No. of branches	6956	7697	7834	8390	8442
Average business per branch (Rs mn)	353.9	416.3	418.3	451.7	431.5

Source: Company reports.

The rise of nuclear family

Nuclearisation of families is fast catching up in rural areas and increasingly joint families are making way for smaller households. This change is having major influence on consumer behavior and is leading to higher demand for homes, durables, two wheelers etc.

One cement dealer noted that his monthly sales of 500 bags about 3-4 years back has now risen to around 2000 bags. Most of the demand is coming from new home construction

Our discussions with cement dealers indicated that their key source for demand is coming from new housing as nuclear families are fast replacing joint families and creating demand for new homes. Additionally renovation of homes has picked up pace with rising incomes and this is aiding demand for cement, sanitary ware, paints etc.

As nuclear families are replacing large families, there is also more focus on family planning aspect. With fewer children per household (and thanks to more awareness levels and affluence) parents are now more keen to provide best facilities to their children and good education is clearly on top of the focus list for them. They now want good education for their children and see it as a means to get good employment. Rich farmers staying closer to towns/cities are getting their children enrolled at city schools and have arranged for private taxis for commute.

In one of the villages we visited, three new private schools have been set up in past one year which are affiliated to boards like CBSE.

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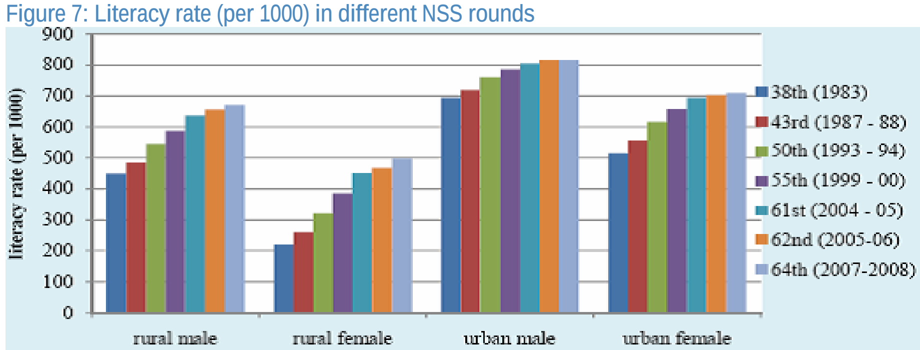
Figure 7: Literacy rate (per 1000) in different NSS rounds

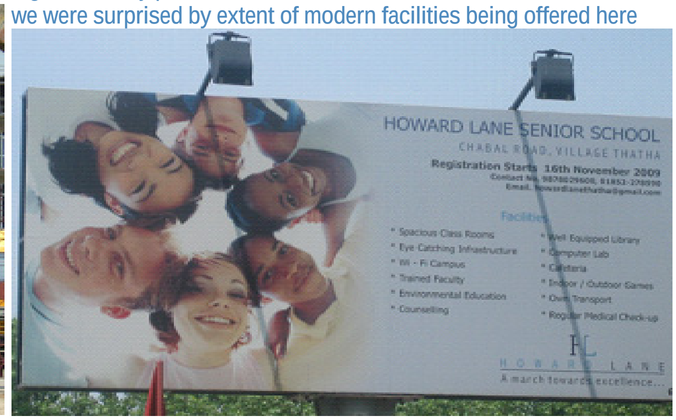


Source: GoI

Figure 8: A recently built school in a Punjab village

Source: J.P. Morgan

Figure 9: Many private schools have been established in rural areas, we were surprised by extent of modern facilities being offered here



Source: J.P. Morgan

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Short supply of labor is fueling demand for mechanisation

A common grievance which we came across during most of our meetings with the farmers was labor shortage. Labor costs have been rising at a consistent pace and government schemes like NREGA seem to have amplified this issue. The alternative employment option has reduced the availability of labor for farming, particularly during the harvesting season. Migration of laborers from relatively poorer states like Bihar and UP to Punjab and Haryana has reduced, further aggravating the problem of labor shortage.

Cost of labor for farming has risen anywhere between 25-50% over past two years in the villages that we visited.

Further with rising income levels and social status, increasingly younger generation is avoiding getting involved in farming. And this has led to meaningful shift towards mechanisation and modern farming options like micro irrigation in some regions. Also smaller farmers who are unable to make large investments in installing modern farm equipment are open to rent these facilities from larger farmers. Crop yields have benefited significantly from these investments.

Our field trip to a sugar cane farm employing micro irrigation facilities revealed that yields have improved 25-30% due to micro irrigation.

Tractor sales have been buoyant this year and key plays on high demand potential for tractors are Mahindra & Mahindra (OW) and Escorts (NR). Jain Irrigation* (UW) is a beneficiary of growing acceptance of micro irrigation in certain parts of the country.

Figure 10: Micro Irrigation is fast gaining acceptance for plantation/horticulture

Source: J.P. Morgan

Figure 11: Process of cleaning the paddy has been mechanized now

Source: J.P. Morgan

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Consumption trends

Consumer pull is greater than retailer push

Rural consumers are now kept well informed about the product offerings by various companies (thanks to availability of cable/DTH in most of the homes) and it's the customer who now dictates what he wants to purchase rather than the retailer pushing the product sales. Of course consumer is now surrounded by many choices (with most of the FMCG companies having spread their distribution reach) and this is resulting in increased fragmentation of FMCG spends in rural markets.

Takeaways from a rural retailer: There are now higher purchases for refined oil (shift away from desi ghee as health awareness increases). Some rural consumers are (surprisingly) now also moving towards branded atta (wheat flour).

While higher consumption of FMCG products in rural markets does act as a strong growth driver for consumer companies' sales, at the same time it will become increasingly expensive to get these customers on board as marketing spends rise to woo the well informed consumer. Clearly distribution advantage for market leader like HUL is receding as other companies are gaining ground.

We believe the best way to play the rural consumption story in FMCG is ITC (OW), UNSP (OW), and Nestle (N). These companies dominate their respective product segments with limited competitive risks and are benefiting from increasing penetration of their brands in rural markets (at expense of unorganized/local players).

We expect Hindustan Unilever (UW) which has highest rural reach amongst the FMCG companies to face higher competitive challenges as other players scale up their product portfolio and distribution reach in rural areas.

Low unit packs (LUP) are finding favor across more product segments and with more consumer companies. These small packs are playing an important role in switch towards national brands

Figure 12: National brands are fast gaining acceptance amidst local products

Source: J.P. Morgan

Its not all about value

While price remains an important parameter for any purchase decision, we find that rural consumers are cognizant of quality and brand image of the product. Premiumisation in categories like soaps, shampoos and laundry is setting in. Packaged foods (noodles, jam, ketch ups, branded atta etc) are finding acceptance at a fast pace in these markets.

A FMCG distributor in small town noted that over last two years his sales for 'Fair & Lovely' skin cream have been more in rural areas than in the urban town area. In shampoos while Re1 sachet dominates the sales mix, the Rs3 Dove shampoo sachet has started to sell well in past year or so (now about 10-15% of shampoo sachet sales for this distributor). And these premium products are finding demand via media advertisements and not necessarily by distributor push.

A cement dealer noted that he has to now keep different brands at his shop as farmers are now aware about cement brands and they even ask for a specific brand at their shops.

The consumer purchase basket at a mom and pop FMCG store has expanded significantly as more products are being made available at affordable price points. Also consumer uptrading to higher price products is underway. A shopkeeper noted that on an average if his customer was spending Rs500 worth of FMCG purchases about 3-4 years back, this amount has increased to Rs2000 now (of course inflation also has some role to play here).

The recently introduced men's fairness cream *'Fair & Lovely Max fairness'* has already reached villages in sachet form.

A retailer stated that sales of *Tide Naturals* have been weak (compared to regular *Tide*) as consumers are wary of quality at lower price. He mentioned that till three years back he did not keep *Surf Excel* in his shop but now consumer's demand for this brand has led them to stock it.

Figure 13: Share of premium products in personal products offerings is inching up. Notice the premium skin and hair care brands at a rural distributor's centre

Source: J.P. Morgan

Figure 14: In this retail shop for detergent cakes/powders, brands are gaining shelf space

Source: J.P. Morgan

Figure 15: Besides shampoos, sachet formats are helping food products to penetrate better

Source: J.P. Morgan

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Figure 16: While Rs1100 worth Samsung Guru pack is selling fast, higher priced Nokia N Series phone also found some shelf space in a telecom shop in a village in Punjab

Source: J.P. Morgan

Figure : While new phones are coming at affordable prices, market for used mobiles is also thriving well. From the same shop which carried new Samsung and Nokia N series

Source: J.P. Morgan

Rural consumer spends are increasingly turning discretionary

Farmers are now spending on building bigger and better homes, private school education for children, automobiles, consumer durables and premium personal products. Fast food joints are cropping up now in villages and consumption of carbonated drinks is also rising.

Table 3: Share of spends on non-food products is rising in rural India

%

% per capita consumption	(1993-94)	(1999-00)	(2004-05)	(2005-06)	(2006-07)	(2007-08)
Cereals	23.80	22.16	17.38	17.05	16.51	16.06
Gram	0.17	0.13	0.13	0.15	0.17	0.15
Cereal Substitutes	0.10	0.07	0.07	0.07	0.07	0.06
Pulses and their Products	3.74	3.81	2.97	3.21	3.26	3.07
Milk and Milk products	9.33	8.75	8.17	8.17	8.09	7.79
Edible Oil	4.37	3.74	4.44	4.08	3.92	4.31
Egg fish and Meat	3.29	3.32	3.21	3.90	3.50	3.41
Vegetables	5.94	6.17	5.88	6.07	6.19	6.28
Fruits and Nuts	1.71	1.72	1.80	1.88	1.79	1.76
Sugar	3.01	2.38	2.29	2.38	2.02	1.60
Salt & Spices	2.59	2.96	2.40	2.11	2.34	2.31
Beverages etc.	4.09	4.19	4.38	4.19	4.41	5.55
Food Total	62.15	59.41	53.11	53.27	52.28	52.35
Pan,Tobacco & Intoxicants	3.11	2.87	2.60	2.54	2.55	2.45
Fuel & light	7.24	7.52	9.81	9.69	9.50	9.72
Clothing	7.41	6.85	6.74	6.29	6.10	6.34
Footwear	0.98	1.10	1.01	1.00	0.94	0.95
Misc goods & services	16.81	19.63	22.97	23.69	24.86	24.60
Durable Goods	2.31	2.62	3.75	3.52	3.77	3.59
Non Food Total	37.85	40.59	46.89	46.73	47.72	47.65
Total Expenditure	100.00	100.00	100.00	100.00	100.00	100.00

Source: GoI

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Penetration levels remain low in most of discretionary product categories indicating significant headroom for growth which Corporate India is trying to leverage on.

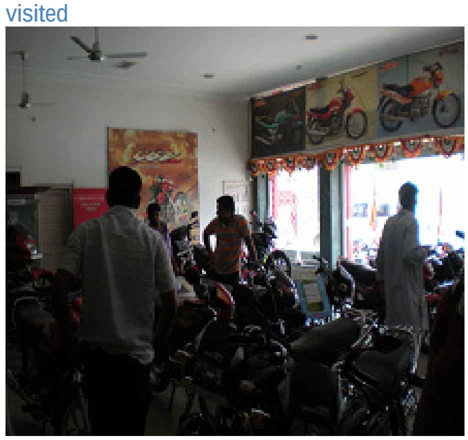
Table 4: Penetration levels in Rural India

	2000	2005	2008
Packaged Edible Oil	8.7	13.7	17.7
Packaged biscuits	39.1	54.2	64.0
Chocolates	2.0	2.7	3.1
Shampoo	13.3	31.9	44.2
Skin/face cream	16.1	17.8	20.2
Utensil Cleaners	10.4	14.6	15.6
Toothpaste/powder	61.3	65.7	71.5
Colour TV	3.7	11.1	18.1
Refrigerator	3.2	4.2	5.1
Motorcycle	3.0	5.3	7.4

Source: Marketing Whitebook

Number of two wheelers per household are rising with youth demanding separate vehicles (than those used by their fathers) and this has been an important factor for motorcycle sales rising at a faster pace. Better roads have further facilitated the use of two wheelers.

Figure 17: The automobile showrooms were buzzing with customers in most of the places we visited



Source: J.P. Morgan

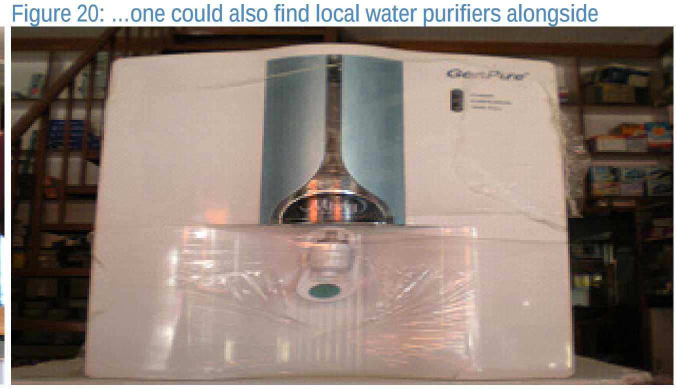
Figure 18: Over the past 2-3 years road infrastructure has improved considerably facilitating higher usage of 2-wheelers

Source: J.P. Morgan

Figure 19: While small size TVs & Refrigerators dominate shelf space..

Source: J.P. Morgan

Figure 20: ...one could also find local water purifiers alongside



Source: J.P. Morgan

A paints distributor noted that he has started keeping the water-proof paints (priced 50% higher than regular distempers) which now account for close to 10% of its product sales in villages. He also stated that sales growth for him has been very good in past 2-3 years (20%+), something which was not noticed in last 10-12 years. Most of the demand has come from housing segment.

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Distribution networks are growing

Number of retail shops in rural areas is increasing inline with growing demand for FMCG products. Companies like HUL are also deploying direct selling route via new initiatives like Shaktimaan to access the distant villages.

Increasing distribution reach (and more importantly direct reach) remains a key focus area for nearly all the FMCG companies. HUL has for example stated its intention to triple its rural reach this year. Similar is the story for other players who now intend to expand their revenue base beyond saturated urban markets.

A FMCG distributor in a small town in Haryana (deriving 60% sales from nearby villages and 40% from town) noted that about 1-2 new stores open every 2-3 months in nearby villages (over past 2 yrs or so).

Not only have product options changed, the retail structure is also witnessing some changes, albeit at slow pace.

The consumer offers provided in a *Haryali Kisaan Bazaar* in a UP village mirrors marketing offers seen in urban markets by organized retailers.

Figure 21: Consumer offers in a Haryali Kisaan Bazaar – Modern Retail outlets in villages

Source: J.P. Morgan

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ITC Limited

Overweight
Rs159.3

India
Consumer

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J.P.Morgan India Private Limited

Company description
ITC Limited (ITC) is the largest cigarette manufacturer in India with over 75% volume market share, and is the biggest FMCG player in the country in terms of market capitalization. It has diversified into other areas such as hotels, paperboards, agri-business, packaged foods, branded apparel, and other FMCG products.

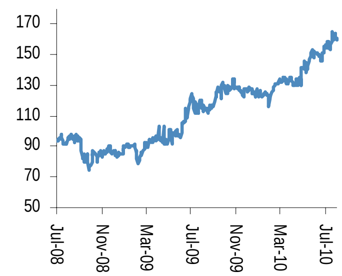
Volume growth – It's only a matter of time: Despite tough government stance towards the cigarette industry (in view of harsh tax hikes), the industry has displayed commendable resilience. We expect volumes to pick up in subsequent quarters and are confident that cigarette division will be able to register marginal positive volume growth in FY11. While government taxation policies will continue to influence cigarette consumption, longer term ITC's volume growth prospects remain intact. We expect fundamental drivers of rising income levels, higher aspirations and increased awareness levels to lead to gradual shift towards cigarettes (particularly in rural areas) from other forms (such as *bidis*)

A play on pricing power: While cigarette volume offtake is likely to remain subdued in the near term, ITC's medium-term investment case will depend on pricing power, which drives earnings much more than volumes.

Non-cigarette businesses continue to show significant improvement and we expect them to deliver EBIT growth of 32% over FY10-12 and their EBIT contribution to increase from 17% in FY10 to 21% in FY12. We expect increased focus on businesses such as hotels, paper and foods to drive long-term earnings and value for the company. Personal care business is ramping up well in mass and mid segment led by improved distribution.

Valuation and risks: Our Mar'11 sum-of-parts-based PT is Rs315. Our target EV/EBITDA multiple for cigarette division is 13x, in line with the benchmark to global tobacco multiples adjusted for growth. Our PT implies one-year forward P/E and EV/EBITDA multiples of 21x and 12.5x, respectively, which are in line with company's last five-year averages. Key risks – (1) Substantial decline in cigarette volumes and any legislative changes that impact cigarette demand, (2) Any business diversification that is substantially dilutive of earnings

Price performance
Rs.



Source: Bloomberg.

Performance

	1M	3M	12M
Absolute (%)	3%	18%	45%
Relative (%)	4%	12%	30%

Source: Bloomberg.

Company data

52-wk range (Rs)	109-166
Mkt cap. (Rs MM)	1224,360
Mkt cap. (US$ MM)	26,050
Avg. daily volume (MM)	8.6
Average daily value (US$ MM)	24.5
Shares O/S (MM)	7659
Index (BSE Sensex)	17,993
Exchange rate	47

Source: Bloomberg.

Reuters: ITC.BO, Bloomberg: ITC IN
Rs in millions, year-end March

	FY09	FY10	FY11E	FY12E
Net sales	156,119	181,532	210,122	243,203
Net profit	32,636	40,610	47,957	56,300
EPS (Rs)	4.3	5.3	6.3	7.4
DPS (Rs)	1.9	5.0	3.0	3.5
Net sales growth (%)	12%	16%	16%	16%
Net profit growth (%)	5%	24%	18%	17%
EPS growth (%)	5%	23%	18%	17%
ROE (%)	24%	29%	33%	32%
ROCE (%)	37%	43%	49%	52%
P/E (x)	36.8	30.0	25.4	21.6
EV/EBITDA (x)	23.0	18.1	15.2	12.8
Dividend yield	1.2%	3.1%	1.9%	2.2%

Source: Bloomberg, Company reports and J.P. Morgan estimates.

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ITC: Summary Financials

Rs mn, year end Mar

Profit and Loss statement

	FY09	FY10	FY11E	FY12E
Net sales	156,119	181,532	210,122	243,203
% change Y/Y	12%	16%	16%	16%
EBITDA	52,286	65,035	77,175	90,417
% change Y/Y	10%	24%	19%	17%
EBITDA Margin (%)	33%	36%	37%	37%
EBIT	46,792	58,948	70,696	82,926
% change Y/Y	8%	26%	20%	17%
EBIT Margin (%)	30%	32%	34%	34%
Interest expense	-183	-534	-534	-534
Other income/expense	1,649	1,739	362	403
Earnings before tax	48,257	60,153	70,525	82,795
% change Y/Y	6%	25%	17%	17%
Tax	(15,622)	(19,543)	(22,568)	(26,494)
as % of EBT	-32%	-32%	-32%	-32%
Net Income (Adjusted)	32,636	40,610	47,957	56,300
% change Y/Y	5%	24%	18%	17%
Shares Outstanding	3776	3825	3825	3825
EPS (Adjusted)	8.6	10.6	12.5	14.7
% change Y/Y	5%	23%	18%	17%

Cash flow statement

	FY09	FY10	FY11E	FY12E
EBIT	46,792	58,948	70,696	82,926
Depreciation & amortisation	-5,494	-6,087	-6,479	-7,491
Change in working capital	-3,264	2,912	-13,355	-4,560
Taxes	-14,402	-19,898	-22,568	-26,494
Interest	-183	-534	-534	-534
Others	8,968	10,965	13,320	15,385
Cash flow from operations	32,417	46,307	41,081	59,232
Capex	-16,997	-10,945	-13,081	-14,829
Free cash flow	15,420	35,362	28,000	44,403
Equity raised/ (repaid)	0	0	0	0
Debt raised/ (repaid)	-66	-82	0	0
Other	1,008	3,884	969	1,002
Dividends paid	-13,190	-13,965	-43,991	-26,394
Change in cash	3,172	25,199	-15,022	19,010
Beginning cash	26,592	29,765	54,963	39,941
Ending cash	29,765	54,963	39,941	58,951
DPS	3.7	10.0	6.0	7.0

Balance sheet

	FY09	FY10	FY11E	FY12E
Cash and cash equivalents	29,765	54,963	39,941	58,951
Accounts receivable	6,687	8,588	9,306	10,592
Inventories	45,997	45,491	61,756	70,291
Others	18,603	15,929	16,870	17,872
Current assets	101,052	124,971	127,873	157,707
Investments	8,923	13,569	13,569	13,569
Net fixed assets	84,860	91,514	98,115	105,453
Total assets	194,835	230,053	239,557	276,728
Liabilities				
Payables	29,237	34,441	38,069	43,330
Others	17,799	46,042	47,951	49,955
Total current liabilities	47,036	80,482	86,020	93,286
Total Loans	1,776	1,077	1,077	1,077
Other liabilities	8,672	7,850	7,850	7,850
Total liabilities	57,484	89,410	94,947	102,212
Shareholders' equity	137,351	140,644	144,610	174,516
BVPS	36.3	37.2	38.2	46.1

Ratio Analysis

%	FY09	FY10	FY11E	FY12E
EBITDA margin	33%	36%	37%	37%
EBIT margin	30%	32%	34%	34%
Net profit margin	21%	22%	23%	23%
SG&A/sales	19%	17%	15%	15%
Sales growth	12%	16%	16%	16%
Net profit growth	5%	24%	18%	17%
EPS growth	5%	23%	18%	17%
Interest coverage (x)	NM	NM	NM	NM
Net debt to total capital	Net Cash	Net Cash	Net Cash	Net Cash
Net debt to equity	Net Cash	Net Cash	Net Cash	Net Cash
Sales/assets	0.8	0.8	0.9	0.9
Assets/equity	3.4	2.6	2.5	2.7
ROE	24%	29%	33%	32%
ROCE	37%	43%	49%	52%

Source: Company reports and J.P. Morgan estimates.

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United Spirits

Overweight
Rs1395

India
Consumer

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Company description

United Spirits is a leading spirits company in India with over 55% market share. It strengthened its hold over the industry with the acquisition of Shaw Wallace's spirits business. Whisky accounts for over 60% of its sales volume. Other products include rum, brandy, vodka and wine. In 2007 it acquired bulk scotch manufacturer Whyte & Mackay based in Scotland.

Structural growth drivers in place. We are bullish on UNSP's long-term prospects as it is an attractive proxy to the steadily growing domestic spirits market with high entry barriers, with a dominant market share of 60%. Fundamental factors such as changing lifestyle, affordability, low per-capita consumption and progressive distribution structure reforms remain intact.

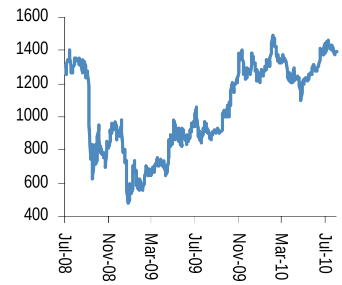
Domestic business still on a high. We see faster growth for domestic profits led by steady volume growth, price hikes, mix improvement and sharp gross margin expansion (driven by soft ENA cost environment). We estimate 30% EBITDA CAGR over FY10-12 for domestic business. ENA cost/case during 1HFY11 is likely to decline 5% y/y, with further drop anticipated as cane crushing season begins in 2HFY11. Price/mix growth of 5% seen in Q1FY11 is likely to sustain for full year and further support margin growth.

Branded shift to hurt W&M's near-term earnings. UNSP's decision to exit the bulk scotch business and focus on scaling up the branded scotch sales (with 3x higher margins vs. bulk) has led to lowering of FY11 EBITDA guidance to GBP33mn As per the changed strategy W&M's EBITDA will likely improve gradually and reach GBP60mn over five years.

Valuation and risks. We have sum-of-parts based TP of Rs1475. We use EV/EBITDA target multiple of 14x for the domestic business which is at 20% premium to global spirits companies and use 10x EV/EBITDA target multiple for Whyte & Mackay business which is at 10% discount to global spirits valuations. Key risks to our TP and rating are: 1) sharp hike in ENA prices if sugar cane crop next year comes in significantly lower, 2) significant slow down in domestic liquor consumption, and 3) high group leverage and promoter's pledged stake in UNSP.

Price performance

Rs.



Source: Bloomberg.

Performance

	1M	3M	12M
Absolute (%)	1%	14%	46%
Relative (%)	0%	8%	31%

Company data

52-wk range (Rs)	845-1514
Mkt cap. (Rs MM)	170,444
Mkt cap. (US$ MM)	3,626
Avg. daily volume (MM)	0.6
Average daily value (US$ MM)	15.9
Shares O/S (MM)	122.2
Index (BSE Sensex)	17,993
Exchange rate	47

Source: Bloomberg.

Reuters: UNSP.BO, Bloomberg: UNSP IN

Rs in millions, year-end March

	FY09	FY10E	FY11E	FY12E	FY13E
Revenue	54,681	63,283	67,081	77,535	89,747
Net profit	1,872	3,865	5,139	7,015	8,887
EPS (Rs)	21.0	31.6	42.1	57.4	72.7
DPS (Rs)	2.4	1.4	4.2	5.7	7.3
Net sales growth (%)	18%	16%	6%	16%	16%
Net profit growth (%)	14%	107%	33%	37%	27%
EPS growth (%)	12%	51%	33%	37%	27%
ROE (%)	8%	10%	10%	12%	14%
ROCE (%)	11%	12%	13%	14%	16%
P/E (x)	66.5	44.1	33.2	24.3	19.2
EV/EBITDA (X) adjusted	19.6	17.9	16.5	13.5	11.4
Dividend yield (%)	0.2%	0.1%	0.3%	0.4%	0.5%

Source: Company reports and J.P. Morgan estimates.

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United Spirits - Summary Financials

Rs mn, yr end Mar

Profit and Loss statement	FY09	FY10E	FY11E	FY12E	Cash flow statement	FY09	FY10E	FY11E	FY12E
Revenue	54,681	63,283	67,081	77,535	EBIT	9,966	12,117	13,280	16,071
% change Y/Y	18%	16%	6%	16%	Depreciation & amortisation	926	1,246	1,396	1,596
EBITDA	10,892	13,363	14,676	17,667	Change in working capital	-4,753	-4,100	-6,371	-2,838
% change Y/Y	1%	23%	10%	20%	Taxes	-2,314	-2,082	-2,648	-3,615
EBITDA Margin (%)	20%	21%	22%	23%	Interest	7,176	6,168	5,491	5,439
EBIT	9,966	12,117	13,280	16,071	Others	-8,646	-6,168	-5,491	-5,439
% change Y/Y	-1%	22%	10%	21%	Cash flow from operations	2,354	7,181	5,656	11,214
EBIT Margin (%)	18%	19%	20%	21%					
Interest expense (Net)	7,176	6,168	5,491	5,439	Capex	-952	-2,000	-3,000	-4,000
Earnings before tax	2,790	5,949	7,788	10,631	Free cash flow	1,402	5,181	2,656	7,214
% change Y/Y	-39%	113%	31%	37%	Equity raised/ (repaid)	50	25,109	0	0
Tax	916	2,082	2,648	3,615	Debt raised/ (repaid)	-2,294	-22,163	2,000	0
Associates/Minority interest	-3	-2	-2	-2	Other	37	-8,760	-5,491	-5,438
Net Income (Adjusted)	1,872	3,865	5,139	7,015	Dividends paid	-143	-177	-514	-702
% change Y/Y	14%	107%	33%	37%	Change in cash	-948	-809	-1,349	1,074
Shares Outstanding	89	122	122	122	Beginning cash	5,437	4,489	3,681	2,332
EPS (Adjusted)	21.0	31.6	42.1	57.4	Ending cash	4,489	3,681	2,332	3,406
% change Y/Y	12%	51%	33%	37%	DPS	2.4	1.4	4.2	5.7

Balance sheet	FY09	FY10E	FY11E	FY12E	Ratio Analysis %	FY09	FY10E	FY11E	FY12E
Cash and cash equivalents	4,490	3,681	2,332	3,406	EBITDA margin	20%	21%	22%	23%
Accounts receivable	8,880	10,403	13,784	14,870	EBIT margin	18%	19%	20%	21%
Inventories	17,458	20,805	22,054	25,066	Net profit margin	3%	6%	8%	9%
Others	9,544	10,499	13,176	14,494					
Current assets	40,372	45,387	51,346	57,836					
Goodwill	44,738	44,738	44,738	44,738	Sales growth	18%	16%	6%	16%
Investments	9,501	9,501	9,501	9,501	Net profit growth	14%	107%	33%	37%
Net fixed assets	16,558	17,312	18,916	21,320	EPS growth	12%	51%	33%	37%
Others	7,249	7,249	7,249	7,249					
Total assets	118,418	124,188	131,751	140,645					
					Interest coverage (x)	1.4	2.0	2.4	3.0
Liabilities					Net debt to total capital	0.7	0.6	0.5	0.5
Payables	13,879	15,604	16,541	19,118	Net debt to equity	2.9	1.6	0.9	0.9
Others	2,584	2,584	2,584	2,584	Sales/assets	0.5	0.6	0.6	0.7
Total current liabilities	16,463	18,188	19,125	21,703	Assets/equity	4.6	2.8	2.1	2.0
Total Loans	73,605	51,442	53,442	53,442	ROE	8%	10%	10%	12%
Other liabilities	4,494	4,004	4,005	4,007	ROCE	11%	12%	13%	14%
Total liabilities	94,562	73,634	76,573	79,152					
Shareholders' equity	23,856	50,554	55,179	61,492					
BVPS	267.4	413.8	451.6	503.3					

Source: Company reports and J.P. Morgan estimates.

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Hindustan Unilever Limited

Underweight
Rs264

India
Consumer

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Company description
Hindustan Unilever (HUL) is India's largest consumer products company. Unilever owns 51% of the company. It has presence across key FMCG categories, such as detergents, soaps, shampoos, oral care, skin care, beverages, and foods. HUL's extensive distribution network, coupled with its strong brand equity and high quality management, provide the company an edge over its competitors.

Multiple headwinds in near term. HUL's strategy in the near term will be to focus entirely on volume growth and achieve market share gains across product categories it operates in. The company has adopted various measures like improving competitiveness of mass laundry driven by sharp pricing actions, re-launching the entire soap portfolio and enhancing brand investments across the portfolio to achieve share gains. We believe HUL's attempts to revive volume growth will entail additional marketing and trade promotion investments which along with firm commodity prices and increased royalty payouts may limit margin expansion expectations in FY11.

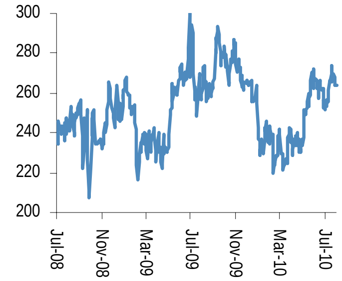
Distribution advantage for HUL is receding as other players are gaining ground particularly in rural markets, which has been a stronghold for the company. HUL remains focused on increasing its direct store reach, looking to triple the reach in rural areas in near term to grow share.

Stepping up the pace of innovation. HUL is now more focused on driving proactive innovation particularly in high-growth personal care and foods categories. Besides new variant launches/re-launches in existing categories, it intends to build scale in future growth categories such as hair and fabric conditioners, men's skin care, water and instant noodles. However most of these categories are not big enough to make any significant difference in near term, in our view.

Valuation and risks: Our Mar'11 target price is Rs235, based on 20x one year forward earnings. Our target multiple is at 15% discount to its average 3 year trading multiple which we believe is justified considering stiff competitive environment leading to poor earnings growth visibility in near term. Key risks to our PT are benign input cost environment, sharp recovery in volumes and lower competitive intensity than expected.

Price performance

Rs.



Source: Bloomberg.

Performance

	1M	3M	12M
Absolute (%)	4%	12%	4%
Relative (%)	4%	5%	-12%

Source: Bloomberg.

Company data

52-wk range (Rs)	218-296
Mkt cap. (Rs MM)	57,5150
Mkt cap. (US$ MM)	12,237
Avg. daily volume (MM)	2.8
Average daily value (US$ MM)	15.1
Shares O/S (MM)	2182
Index (BSE Sensex)	17,993
Exchange rate	47

Source: Bloomberg.

Reuters: HLL.BO, Bloomberg: HUVR IN

Rs in millions, year-end March

	FY09 (15mnth Mar'09)	FY2010	FY2011E	FY2012E
Net sales	202,393	175,238	191,040	212,315
Net profit	24,522	20,587	21,939	25,413
EPS (Rs)	11.3	9.4	10.0	11.6
DPS (Rs)	7.5	6.5	7.5	8.5
Net sales growth (%)	NM	NM	9%	11%
Net profit growth (%)	NM	NM	7%	16%
EPS growth (%)	NM	NM	7%	16%
ROE (%)	112.1	100.0	79.5	80.4
ROCE (%)	121.7	121.7	103.4	104.5
P/E (x)	29.3	28.0	26.3	22.7
EV/EBITDA (%)	21.5	18.8	18.2	15.6
Dividend yield (%)	2.8	2.5	2.8	3.2

Source: Company reports and J.P. Morgan estimates.

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Hindustan Unilever: Summary financials

Rs mn, yr end Mar

Profit and Loss statement	FY09 (15mnth)	FY10	FY11E	FY12E
Revenues	202,393	175,238	191,040	212,315
% change Y/Y	NM	NM	9%	11%
Gross Margin (%)	47%	49%	49%	49%
EBITDA	32,458	28,981	30,452	35,034
% change Y/Y	NM	NM	5%	15%
EBITDA Margin (%)	16%	17%	16%	17%
EBIT	30,505	27,141	28,542	33,034
% change Y/Y	NM	NM	5%	16%
EBIT Margin (%)	15%	15%	15%	16%
Net Interest	253	70	50	30
Earnings before tax	30,251	27,071	28,492	33,004
% change Y/Y	NM	NM	5%	16%
Tax	5,729	6,484	6,553	7,591
as % of EBT	19%	24%	23%	23%
Net Income (Adjusted)	24,522	20,587	21,939	25,413
% change Y/Y	NM	NM	7%	16%
Shares Outstanding	2178	2184	2184	2184
EPS (Adjusted)	11.3	9.4	10.0	11.6
% change Y/Y	NM	NM	7%	16%

Cash flow statement	FY09 (15mnth)	FY10	FY11E	FY12E
EBIT	30,505	27,141	28,542	33,034
Depreciation	1,284	1,449	1,910	2,000
Change in working capital	1,167	(13,035)	1,609	(3,503)
Taxes	(5,729)	(6,484)	(6,553)	(7,591)
Others				
Cash flow from operations	27,226	9,071	25,508	23,939
Capex	(4,991)	(5,021)	(1,500)	(1,500)
Disposal/ (purchase)	(23)	99	0	0
Net Interest	(253)	(70)	(50)	(30)
Free cash flow	21,959	4,079	23,958	22,409
Equity raised/ (repaid)	0	2	0	0
Debt raised/ (repaid)	0	0	0	0
Other	1,048	4,864	0	0
Dividends paid	(14,360)	(15,231)	(18,427)	(20,884)
Beginning cash	15,351	19,526	30,573	32,886
Ending cash	19,526	30,573	32,886	41,418
DPS	7.5	6.5	7.5	8.5

Balance sheet	FY09 (15mnth)	FY10	FY11E	FY12E
Cash and cash equivalents	20,011	30,573	32,886	41,418
Accounts receivable	10,127	8,660	9,441	10,492
Inventories	25,289	21,799	27,589	30,705
Others	5,369	6,784	6,281	6,980
Current assets	60,796	67,817	76,196	89,596
Investments	1,088	990	990	990
Net fixed assets	20,789	24,361	23,951	23,451
Total assets	82,673	93,167	101,137	114,036
Liabilities				
Payables	42,558	52,917	56,074	62,695
Others	15,280	14,416	15,715	17,466
Total current liabilities	57,838	67,332	71,790	80,160
Total Loans	4,219	-	-	-
Other liabilities	-	-	-	-
Total liabilities	62,057	67,332	71,790	80,160
Shareholders' equity	20,615	25,835	29,347	33,876
BVPS	9.5	11.8	13.4	15.5

Ratio Analysis %	FY09 (15mnth)	FY10	FY11E	FY12E
Operating Margin	15.0%	15.7%	15.0%	15.6%
EBITDA margin	16.0%	16.5%	15.9%	16.5%
EBIT margin	15.1%	15.5%	14.9%	15.6%
Net profit margin	12.1%	11.7%	11.5%	12.0%
SG&A/sales	15.3%	14.7%	14.7%	14.0%
Sales growth	NM	NM	9%	11%
Net profit growth	NM	NM	7%	16%
EPS growth	NM	NM	7%	16%
Interest coverage (x)	NM	NM	NM	NM
Net debt to total capital	NM	NM	NM	NM
Net debt to equity	NM	NM	NM	NM
Sales/assets	2.0	1.9	1.9	1.9
Assets/equity	4.0	3.6	3.4	3.4
ROE	112%	100%	80%	80%
ROCE	122%	122%	103%	104%

Source: Company reports and J.P. Morgan estimates.

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Companies Recommended in This Report (all prices in this report as of market close on 30 August 2010)
Colgate-Palmolive (India) Limited (COLG.BO/Rs795.20/Neutral), Hindustan Unilever Limited (HLL.BO/Rs263.65/Underweight), ITC Holdings (ITC/$58.01/Overweight), Jain Irrigation Systems Ltd (JAIR.BO/Rs1,246.80/Underweight), Mahindra & Mahindra (MAHM.BO/Rs609.35/Overweight), Nestlé India Limited (NEST.BO/Rs3,106.80/Neutral), United Spirits Limited (UNSP.BO/Rs1,395.60/Overweight)

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