June 27, 2022

Volumes expected to recover in H2FY23…

The FMCG sector has been going through challenging times due to very high commodity inflation in the last one year. The high inflation (~2x last year) in palm oil & crude based derivatives has compelled FMCG companies to take price hike to the tune of 10-15%. Moreover, smaller SKUs grammage reduction were also taken given such price points cannot be tinkered with. Despite such price hikes, FMCG companies have witnessed gross margin contraction to the tune of 200-500 bps in the last two quarters. The incessant price hikes have also led to demand contraction specifically in rural regions. Consumer have been switching to economy brands & smaller SKUs in detergent, soaps & edible oil categories. However, some categories like juices, carbonated drinks witnessed strong demand due to low base & extreme heat in summer season. The last quarter of FY22 saw revenue growth entirely contributed by prices & volume growth was flat to negative. We believe margin pressure would continue in Q1FY23 as well given commodity inflation was persistent until mid-June and volume growth would also be flattish. We expect volume growth to come back to the positive territory in H2FY23.

Some signs of cooling down inflation

In the last 15 days, some important commodity prices have declined sharply specifically after the US Fed rate hike of 75 bps. Global palm oil prices have dipped from US$1800/tonne to US$1300/tonnes, a decline of ~27%. The edible oil manufacturers in India have also started passing on some of these dips through price cuts in last few days. Similarly, crude prices are also showing some signs of dip in last one week. However, it still remains above US$100/barrel. However, we believe its impact on gross margins would only be reflected in H2FY23. With the rise in interest rates globally, commodities are likely to further cool off in the next three to six months. A reflection of that in gross margins would give FMCG companies manoeuvring power to spend more towards advertisement, support new launches and foray into newer categories. This would bring back volume growth in H2FY23.

Companies to lower weightage of palm, crude to outperform

FMCG stocks have underperformed the market in the last two years given huge liquidity in global markets favours cyclical sectors. However, with increasing volatility in global markets due to high inflation & rising interest rates, investors now would be parking money in defensive sectors like FMCG. Within the FMCG sector, companies with lower weightage of crude & palm oil in their raw material basket would outperform. Moreover, detergent, soaps, oral care and some highly penetrated categories are likely to witness muted growth whereas foods & beverages categories are likely to grow faster in the medium term. Some commodities like tea & copra saw dip in FY22 but crude based derivatives, edible oils (palm, sunflower & soybean), wheat witnessed sharp price increase after Russia-Ukraine war broke-out in February 2022. We believe companies with high proportion of imported commodities in their raw material basket would continue to remain impacted for some more time. We remain cautious on FMCG margins & volume growth in near term. However, we still like Dabur, Tata Consumer Products and Varun Beverages in our coverage universe given key raw materials like herbs, tea, sugar prices have been benign in the last one year and addressable market in foods, beverages, health & Ayurveda categories is fairly large, which would keep the growth rate high for these companies. Dabur, Tata Consumer Products and Varun Beverages remain our top picks in the FMCG sector.

Sector View: Neutral

Top Picks in FMCG Space

Company	CMP	Old Target	New Target	Upside (%)
Dabur	517	680	680	32
TCPL	729	910	910	25
Varun Beverages	777	867	900	16

Nifty FMCG index Underperforming broader markets in last two years

- Global liquidity post Covid-19 period resulted in sharp rise in key commodity prices for FMCG sector
- Inflation in imported & agri commodities got aggravated after Russia-Ukraine war broke-out in February, 2022
- However, rising global inflation is leading to sharp increase in interest rate by several central banks (US Fed increased interest rates by 75 bps recently)
- Higher interest rates is expected to cool down commodity prices, eventually ease off gross margins pressure from FMCG companies
- Volume growth is expected to recover in H2FY23 specifically benefiting due to perk up in rural growth due to high agri exports

Key risks to our call

- Persistent inflation in key commodities like crude based derivatives & other commodities could continue to pressurise gross margins
- Strong recovery in volumes in rural region due to high agri exports

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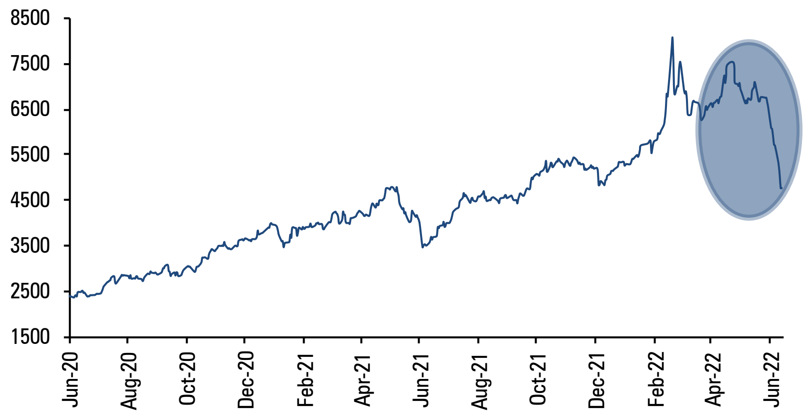
Sector Update

ICICI Securities – Retail Equity Research

Financial story in charts….

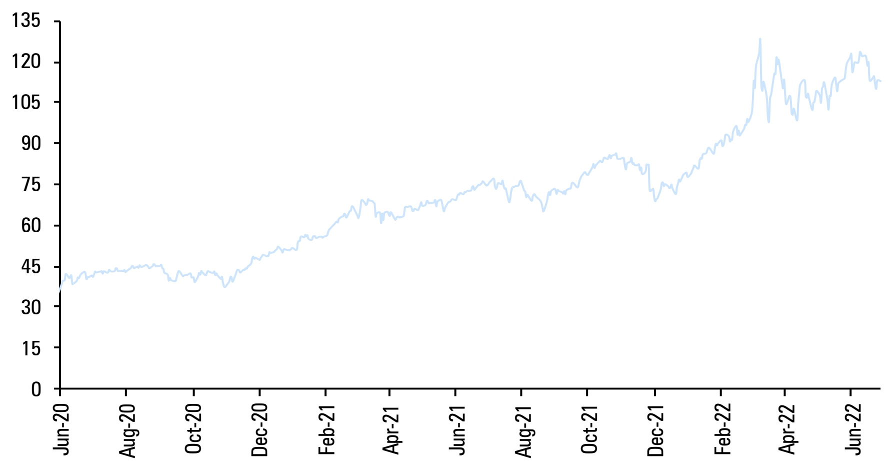
Exhibit 1: Palm oil prices dip sharply in last 15 days (Malaysian Ringgit / tonne)



Source: Company, ICICI Direct Research

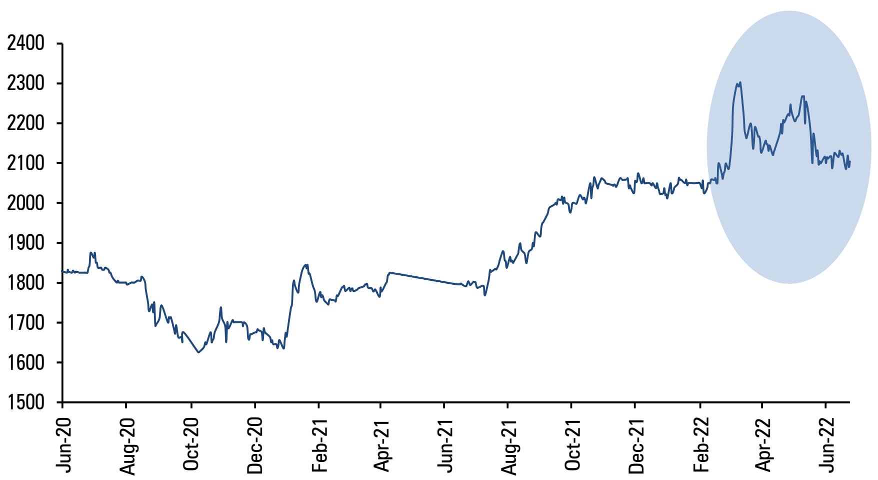
Palm oil prices have risen 3x between March 2020 and May 2022 on account of increase in global commodity prices. This was further aggravated after Russia-Ukraine war in February 2022. With the global liquidity tightening, palm oil prices have sharply fallen from the peak in last 15 days

Exhibit 2: Crude prices have come off from peak, still above US$100/barrel



Source: Bloomberg, Company, ICICI Direct Research* Conversation ratio form cotton to yarn=1.2kg

Exhibit 3: Wheat prices stabilise after export ban (₹ / quintal)



Source: Ministry of Commerce, Company, ICICI Direct Research

Top bets in FMCG Coverage Universe

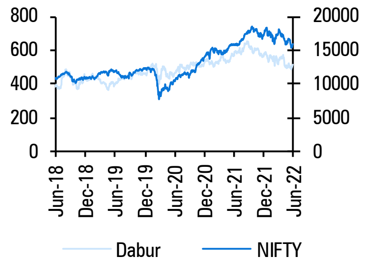
Dabur India (DABIND)

Dabur India (DIL) is one of the biggest FMCG companies with a presence in Ayurveda based products across categories. The company has a dominant market share in health supplement, OTC & Ethical products, hair oils & Juices. Moreover, it is continuously gaining market share in oral care category

- Dabur has been least impacted by high inflation in commodity prices given most of the raw materials are related to agri commodities. Moreover, high wheat, rice, sugar and other agri commodity exports would rather improve income levels of rural economy in the medium term
- The company is increasing the addressable market by diversifying in categories like fruit drinks, health foods (under Real brand), herbs & baby products under Dabur brand, edible oil & extending Chyawanprash, Honey into new variants
- Extensive rural distribution expansion, increasing direct distribution reach & ecommerce presence to support newer & under-penetrated category sales

The stock price has given a return of 75% in last five years. We believe Dabur is best placed to curb margin pressure given its low dependence on crude based raw material. Further, volume recovery would be fastest given high proportion of revenue contributed by rural regions and increasing agri commodity prices & exports would perk up rural income. We maintain our target price at ₹ 680 as well as **BUY** recommendation ascribing 52x FY24 earnings multiple

Price Chart



Particulars

Particular (₹ crore)	Amount
Market Capitalization	91,270.7
Total Debt (FY22)	1,030.1
Cash and Investments (FY22)	6,780.3
EV	85,520.5
52 week H/L (₹)	659 / 482
Equity capital	176.6
Face value (₹)	1.0

Exhibit 4: Financial summary for Dabur India

Key Financials	FY20	FY21	FY22	5 Year CAGR (FY17-22)	FY23E	FY24E	CAGR (FY22-24E)
Net Sales	8703.6	9561.7	10888.7	7.2	11997.4	13343.1	10.7
EBITDA	1792.4	2002.7	2253.8	8.4	2456.3	2785.8	11.2
EBITDA Margin %	20.6	20.9	20.7		20.5	20.9	
Net Profit	1447.9	1694.9	1742.3	6.4	2053.4	2304.8	15.0
EPS (₹)	8.2	9.6	9.9	6.3	11.6	13.0	15.0
P/E	63.0	53.9	52.4		44.5	39.6	
RoNW %	21.9	22.1	20.8		22.5	22.8	
RoCE (%)	26.1	24.5	24.9		25.5	26.4	

Source: Company, ICICI Direct Research

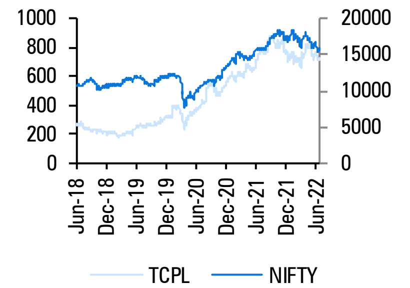
Tata Consumer Products (TATGLO)

Tata Consumer Products (TCPL) is one of the major FMCG companies present in tea, coffee & other beverages in India, UK, US, Canada & some other geographies. In India, it also has salt, pulses, spices & other foods products. Its subsidiary NourishCo is present in packaged water & other beverages. The company is in a JV with Starbucks, which has 268 stores in India.

- TCPL would continue to witness strong margins improvement with benign prevailing tea procurement prices. North India tea prices in May-June 2022 are slightly lower (0-5%) compared to last year
- Strong innovation & premiumisation strategy in salt, tea, Sampann & Soulful (acquired brand) in Indian market is expected to drive sales & margins. TCPL's JV with Starbucks is witnessing strong growth with significant improvement in operating margins

The stock has moved up 5x in the last five years. We continue to remain positive on TCPL’s strategy of driving premiumisation trend in foods business & foray in large opportunity size categories. Moreover, benign raw material trend for the company (specifically when companies are experiencing inflationary pressure in their respective RM basket) would be advantageous in commanding high valuation multiples. We maintain our target price at ₹ 910 as well as **BUY** recommendation, ascribing 52x FY24 earnings multiple.

Price Chart



Particulars

Particulars (₹ crore)	Amount
Market Capitalization	67,201.5
Total Debt (FY22)	1,454.6
Cash and Investments (FY22)	2,797.9
EV	65,858.2
52 week H/L (₹)	889 / 651
Equity capital	92.2
Face value (₹)	1.0

Exhibit 5: Financial summary for Tata Consumer Products

Key Financials	FY20	FY21	FY22	5 Year CAGR (FY17 - FY22)	FY23E	FY24E	CAGR (FY22-24E)
Net Sales	9637.4	11602.0	12425.4	12.9%	13633.9	14954.4	9.7%
EBITDA	1292.2	1543.8	1718.8	16.8%	2120.5	2406.9	18.3%
EBITDA Margin %	13.4	13.3	13.8		15.6	16.1	
Adjusted Net Profit	641.8	932.6	1015.2	17.4%	1379.7	1610.7	26.0%
EPS (₹)	5.0	10.1	11.0	8.9%	15.0	17.5	26.0%
P/E	146.1	72.2	66.2		48.7	41.7	
RoNW %	4.6	6.4	7.0		8.8	9.8	
RoCE (%)	6.9	8.0	8.4		10.3	11.3	

Source: Company, ICICI Direct Research

Top bets in FMCG Coverage Universe

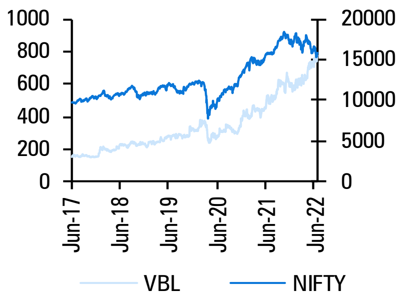
Varun Beverages (VARBEV)

Varun Beverage is one of the largest franchisees of PepsiCo in the world. The company produces & distributes carbonated drinks, juices & packaged drinking water in six countries including India. Some of the PepsiCo brands produced by VBL includes Pepsi, Diet Pepsi, Seven-Up, Mirinda, Mountain Dew, Nimbooz, String, Slice, Tropicana, Aquafina among others.

- With normalisation of mobility, strong summer season after acquisition of South & West territories is likely to drive robust volume growth.
- The company has launched several new brands in last two years i.e. String, 'Mountain Dew ICE', milk based beverages. New products are contributing ~10% to volumes and are likely to aid revenues, going forward.
- Given the capex requirement equal to depreciation, VBL would be able to completely de-leverage its balance sheet in the next three to four years with strong free cash flow. The reduction in interest cost to boost profitability

The stock has given 5x return in the last five years. Robust volume growth aided by extreme summer season, new product launches & reduction in interest expense would aid revenue as well as earnings growth. Moreover, prices of key raw material like sugar has been benign and the company has stored high level of inventory for PET chips (crude derivatives) for 2022 summer season to safeguard from volatility in raw material prices. We change our target price to ₹ 900/ share (earlier ₹ 867) and maintain **BUY** recommendation, valuing the business at 25x CY23 EV/EBITDA.

Price Chart



Particulars

Particulars (₹ crore)	Amount
Market Capitalization	50,469.9
Total Debt (CY21)	3,341.9
Cash & Investments (CY21)	336.0
EV	53,475.8
52 week H/L (₹)	778 / 474
Equity capital	288.7
Face value	10.0

Exhibit 6: Financial summary for Varun Beverages

	CY19	CY20	CY21	5 Year CAGR (CY16 - CY21)	CY22E	CY23E	CAGR (CY21-23E)
Net Sales	7129.6	6450.1	8823.2	18.0	10911.7	12172.5	17.5%
EBITDA	1447.7	1201.9	1654.6	15.8	2217.7	2481.9	22.5%
EBITDA Margin %	20.3	18.6	18.8		20.3	20.4	
Net Profit	472.2	362.1	746.1	73.1	1120.8	1312.6	32.6%
Diluted EPS (₹)	7.27	5.57	11.49	34.2	17.26	20.21	32.6%
P/E	106.9	139.4	67.6		45.0	38.4	
RoNW %	14.2	10.3	18.3		22.8	23.0	
RoCE (%)	15.5	10.9	17.1		25.6	29.7	

Source: Company, ICICI Direct Research

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Hold: -5% to 15%;

Reduce: -5% to -15%;

Sell: <-15%

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