INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

Colgate Palmolive (CLGT IN)

Patanjali threat inflated; Colgate to have the last laugh

INDIA | FMCG | Company Update

15 March 2016

While Colgate continues to be the market leader in both toothbrushes and toothpastes by a considerable margin, its dominance has once again been challenged – this time by Patanjali. Past contenders have included Anchor, Pepsodent, and Oral B. Patanjali's challenge comes at a time when the oral care category is seeing sluggishness in volume growth – Colgate's volumes were +2% in 9MFY16, slowest in the last five years. Its share price has corrected 15% in three months based on slow volumes and because the market expects a complete disruption of the oral care category by Patanjali's Dant Kanti. Here is what we believe – (1) while Dant Kanti will see growth based on its strong positioning and word-of-mouth publicity, its threat to Colgate is overstated, and (2) while Colgate may find it challenging to grow volumes in the short term, it will emerge victorious in the medium term – with higher market share and stronger brand equity. We continue to maintain Buy with a target price of Rs 1000 (unchanged). Our key arguments are as follows:

Ability to take price hikes even in a deflationary environment: While most FMCG players are struggling with falling realisations due to tumbling commodity prices, Colgate is among the few that are reporting strong price growth in the last few quarters – this has helped it to deliver high-single-digit adjusted value growth, despite sluggish volumes. We expect 11% CAGR in value for Colgate in FY16-18 – among the highest in the FMCG sector.

Margin expansion to continue: While Colgate has gained from low commodity costs, it has not been forced to pass on the benefits to consumers due to its strong brand positioning and its complete dominance in the oral care category – which led to a gross-margin expansion of 110bps yoy in 9MFY16 (despite excise cessation impact of ~500bps). We expect margin expansion to continue because of sustained low input costs and price hikes, steady premiumisation, and operating leverage.

The Patanjali threat is exaggerated: Our analysis of past instances (discussed later) of disruptions in the oral care category indicate that the threat from Patanjali is not unprecedented and that Patanjali's market share gains will be capped. This is because Patanjali, like Anchor, lacks a strong innovation culture and currently competes with Colgate based on a single major product Dant Kanti (just like Anchor did in 1997). Dant Kanti has gained huge success in a short span due to strong word-of-mouth publicity and positioning. However, once the 'new trials' growth starts reducing, and competitors introduce similar products in the herbal-ayurvedic space, Patanjali's market share gains will also be capped. In addition, Patanjali does not have a strong innovation culture – in contrast, introduction of innovations by Colgate and other competitors will put pressure on Patanjali's market share and lead to gains for Colgate.

Innovations to help sustain growth ahead: Over the years, Colgate has consistently introduced new variants and new products in the toothpaste category, in line with changing trends. This strong innovation culture will continue to enable Colgate to garner new trials, thereby increasing its market share. It currently has a product portfolio of 21 types of toothpastes. In addition, due to its global operations, it is far easier for Colgate to introduce innovations in the Indian markets, based on successful products in other geographies and the economies of scale in innovations.

Outlook and valuations: Colgate's earnings growth has reached the bottom of the cycle. In FY17, the impact of excise cessation will go away. Volume growth will revive as rural growth improves due to strong rural impetus in the union budget and expectations of normal monsoon. We expect Colgate to deliver earnings CAGR of 16% in FY16-18 and continue to value Colgate at Rs 1000 (33x FY18 earnings). Maintain Buy.

Buy (Maintain)

CMP RS 845

TARGET Rs 1000(+18%)

COMPANY DATA

O/S SHARES (MN) :	272
MARKET CAP (RSBN) :	230
MARKET CAP (USDBN) :	3
52 - WK HI/LO (RS) :	1099 / 791
LIQUIDITY 3M (USDMN) :	5.3
PAR VALUE (RS) :	1

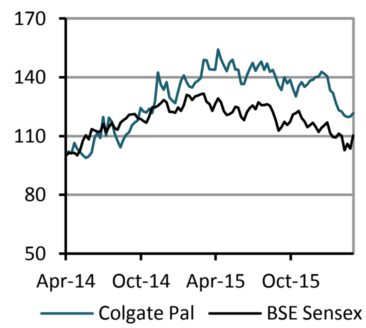
SHARE HOLDING PATTERN, %

	Dec 15	Sep 15	Jun 15
PROMOTERS :	51.0	51.0	51.0
FII / NRI :	20.5	20.5	24.1
FI / MF :	5.8	5.8	5.0
NON PRO :	1.5	1.5	0.9
PUBLIC & OTHERS :	23.9	23.9	22.3

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	0.9	-14.3	-18.3
REL TO BSE	-7.0	-12.9	-5.3

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	40,943	45,004	50,498
EBIDTA	9,477	11,306	12,967
Net Profit	6,225	7,152	8,309
EPS, Rs	22.9	26.3	30.5
PER, x	36.9	32.1	27.7
EV/EBIDTA, x	23.9	20.0	17.3
ROE, %	73.9	76.9	80.5

Source: PhillipCapital India Research Est.

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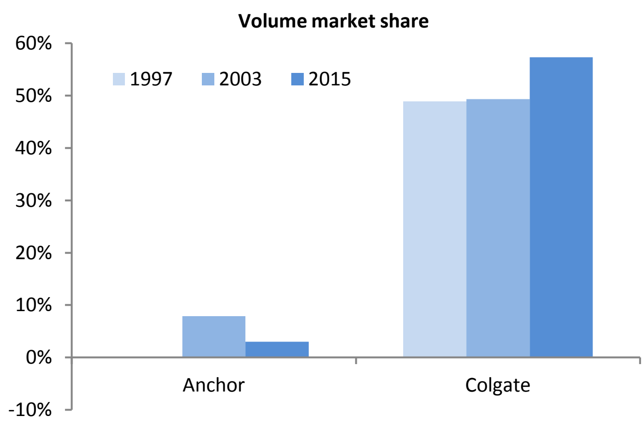
History shows Colgate always has the last laugh

Case study 1: The rise and fall of Anchor

The rise

In 1997, Anchor, a little-known brand then, disrupted the Indian oral care category at unprecedented levels. That year, it launched Anchor White Toothpaste claiming that it is 100% vegetarian toothpaste unlike most others. It was certainly a revolutionary product, as the company was the first to extract calcium phosphate (toothpaste ingredient) from rock rather than from bone ash. To top that, the product was available at a considerable discount to Colgate (~40%) and the company offered promotions like toothpaste + toothbrush combo pack. The product was an instant success. Colgate, which had 15% CAGR in FY93-98, saw its sales dip 2% in FY99. By 2003, within just six years of its launch, Anchor had grabbed a sizeable market share of almost 8%.



Source: AC Neilson, PhilliCapital India Research Estimates

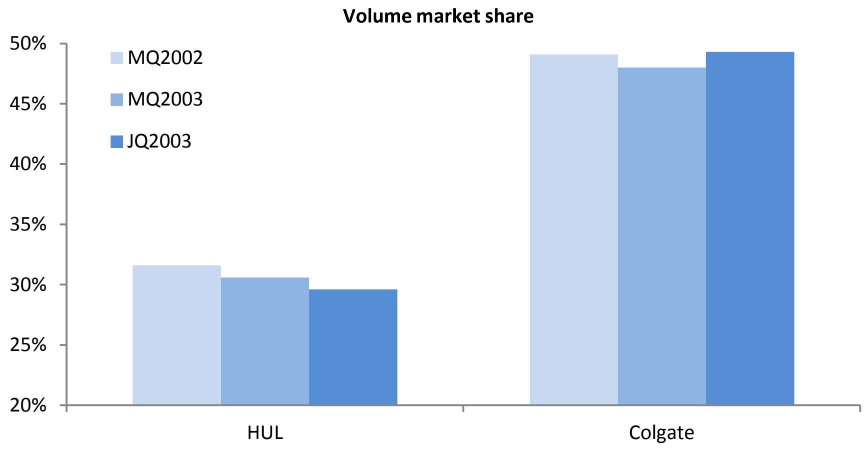
The fall

Just when it seemed that multinationals would lose against the local challenger brands, Colgate revitalized its existing 'discount segment' brand Cibaca and HUL revitalized Aim. Both Aim and Cibaca competed at Anchor's price points and the market share tide started reversing. Within a year, Colgate's Cibaca captured 50% of the 'discount segment', and its market share growth was back on track. In FY99-01, Colgate grew 9% yoy. However, HUL's brand Aim could not replicate Cibaca's success and was subsequently withdrawn from the markets.

While Colgate has maintained a healthy innovation pipeline for its product portfolio throughout the last 15 years, Anchor did not see any major innovations after the initial one (100% vegetarian toothpaste). As a result, its market share gains began reversing – currently, it has less than 3% share (as per our estimates) from highs in double digits a decade ago. In contrast, Colgate continued to gain market share – its current share is 57.3% vs. 48.9% in 1997.

Case study 2: The stagnation and stagnation of Pepsodent

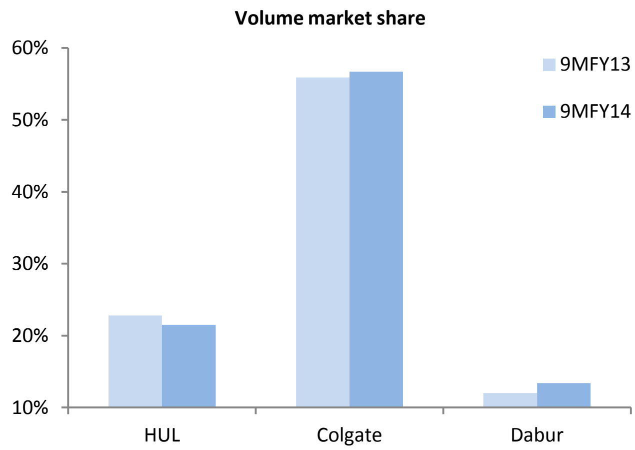
<u>Price wars of 2003 – HUL loses market share</u>



Source: ORG figures, PhilliCapital India Research Estimates

In 2003, to revitalise its oral care category, HUL reduced prices (by 15-20%) across key SKUs of both Pepsodent and Close Up. This came after a year of negative industry growth in 2002 and deterioration of HUL's market share by 100bps yoy due to aggressive pricing by smaller players such as Anchor, Babool, and others. Colgate immediately responded by cutting prices across key SKUs by a similar margin. What followed was more promotions and more freebies (soaps and toothbrushes free with toothpastes). The trend only reversed towards the end of 2003 with more rational pricing. However, once the war was over, the result (as per ORG figures) was very clear – while Colgate held on to its volume shares in a falling market, HUL saw its share eroded. In the March 2002 quarter, Colgate had a volume market share of 49.1% whereas HUL's was at 31.6%. Colgate saw its volume market share increase to 49.3% in the June 2003 quarter from 48% in the March 2003 quarter while HUL saw its market share eroded to 29.6% from 30.6%.

<u>Ad wars of 2013 – HUL loses market share again</u>



Source: AC Neilson, PhilliCapital India Research Estimates

In August 2013, as Oral B was developing its toothpaste category (launched Oral B toothpaste), HUL released ads that directly stated that Pepsodent's Germi check was better than Colgate's Strong Teeth. The ads proclaimed that Pepsodent's product had 130% germ attack power vs. that of Colgate's. HUL had been suffering from market share erosion in oral care and saw its share dip to 22% in 2013 from 26% in 2010. What followed was a spike in ad spends by Colgate, HUL, and P&G. While HUL attempted to gain market share during the start of the campaign, data by AC Nielson indicated that it was actually Dabur and Colgate that gained share at HUL's expense. HUL saw it volume market share drop by 130bps yoy to 21.5% in 9MFY14. In comparison, Colgate/Dabur had gained market shares by 80bps/140bps yoy to 56.7%/13.4% in the same period.

We believe that HUL's Pepsodent has seen sluggish growth because of two major reasons: (1) Colgate's strong dominance in the category, which provides it economies of scale in branding and marketing, and (2) lack of adequate differentiation in product portfolio between Pepsodent and market leader Colgate.

Case study 3: The fall and fall of Oral B

The muted launch

In July 2013, P&G's Oral B, the second-largest toothbrush brand in India after Colgate, entered the toothpaste category in India with three variants of toothpastes (Oral-B Pro-Health, Oral B Health 32, and Oral B All Rounder). P&G partnered with Indian actress Madhuri Dixit for Oral B's brand endorsement. Further, to promote the toothpaste, P&G unconventionally offered toothpaste free with the toothbrush. This increased the competitive intensity in the oral care space with Colgate and HUL jumping into the fray with bold advertisements against each other. In the end, Colgate and Dabur emerged victors with increased market share – HUL saw its market share eroded and P&G saw a muted launch with market share gains of only 0.2% in the first month of its launch.

The eventual fall

From July 2013 till now, P&G has managed to garner less than 1% of market share (as per our estimates) despite its significant marketing efforts. As per a media article in March 2016, P&G plans to exit the toothpaste category in India as it moves away from low-margin businesses and focuses on profitability.

We believe that P&G saw sluggish growth in the oral care category in India because of multiple reasons: (1) lack of adequate differentiation in product portfolio, (2) increase in competitive intensity, which made market share gains costlier, and (3) lack of innovation in the last two years.

Case study 4: Patanjali's astounding rise

In a very short span, Baba Ramdev's Patanjali Ayurveda (established in 2006) has become an important force in the FMCG industry. In FY15, Patanjali Ayurveda clocked sales of Rs 25bn (75% CAGR in FY12-15). While the company has garnered sizeable market share in various HPC and foods categories, one of its most talked about products (and a huge hit in the category) is its toothpaste 'Dant Kanti', whose consumers belong to all economic classes. As per the company, the herbal toothpaste does not contain chemicals or synthetic compounds. As per media sources, Dant Kanti has a market share of 4-5% and has eaten into Colgate's market share, which led to many analysts triming Colgate's volume growth expectations, and its stock falling.

<u>What next?</u>

We believe that while Patanjali will continue to expand in the oral care category, it is not a threat to Colgate's long-term sustainable growth. We also believe that its market share gains will soon hit a ceiling due to its business model (explained below) while Colgate's market share will continue to grow based on the inherent superiority of its business model.

- **Dant Kanti market share will hit a ceiling soon:** Patanjali has only three products in toothpastes – Dant Kanti, Dant Kanti Medicated, and Dant Kanti Junior. We believe this offers very limited choice to consumers and ignores flavour and fragrance preferences of a large proportion of users. Our survey across 50 consumers from various Indian cities showed that only 22% of consumers who tried Dant Kanti retained it while 78% switched to other toothpastes – for reasons including: (1) did not like taste, (2) did not like colour, (3) did not get a fresh feeling after brushing, (4) do not want to try (any more) products of Baba Ramdev, and (5) liked the taste of their old toothpaste more. We believe that Dant Kanti's rapid fame helped it to gain market share quickly due to word-of-mouth, but once its new-trials rate starts reducing, its market share gains will slow down. Eventually, this share will hit a ceiling.

- **Lack of strong innovation culture will lead to loss of market share for Patanjali:** While having successfully scaled its business in core categories, Patanjali has not introduced any significant innovation in the market. Most of its products are me-too replicas of the market leader in the particular categories. Nevertheless, the products have been successful in capturing market share due to Baba Ramdev's strong brand equity and the herbal-ayurvedic positioning. We believe that Patanjali's business model faces two threats: (1) introduction of herbal-ayurvedic variants by competitors who have a more efficient sales and marketing setup, and (2) introduction of innovations by competitors that will attract consumers willing to try new products. Due to Patanjali's lack of innovation culture, it will hit a market share ceiling soon, after which it will see a deterioration of market share. Companies with a strong innovation background (like Colgate) will be the biggest beneficiaries of this impending shift.

Case study 5: The absolute dominance of Colgate

While many consider the emergence of Patanjali's Dant Kanti to be an eventual game changer in the oral care industry, one that will completely disrupt it, we believe that the current situation is not unprecedented, but very much like earlier instances. We also believe that history will repeat itself and Colgate will again emerge the eventual winner in the oral care with a higher share, once the market stabilises. Our belief rests of the following reasons:

- **Strong innovation culture:** Over the years, Colgate has consistently introduced new variants and new products in the toothpaste category, in line with changing trends. It has also been a trendsetter in the category – such as addition of salt in toothpaste or charcoal in Colgate Total variant. This strong innovation culture will continue to help Colgate get new trials, thereby increasing its market share. It currently has a product portfolio of 21 types of toothpastes. Due to its global operations, it is far easier for Colgate to introduce innovations in the Indian markets based on successful products in other geographies and economies of scale in innovations.

- **Strong brand equity and complete dominance in the category:** Colgate is one of the few products in India where its brand has become synonymous with the product (another example is Xerox to photocopying). The strong brand equity and trust it has developed over decades because of consistent quality and newer offerings will help it to retain customers better than other brands. Additionally, Colgate's complete dominance in the oral care category provides it economies of scale in marketing and distribution.

Product Portfolio comparison – Colgate has the most extensive product portfolio among peers

Colgate	HUL	Oral B	Dabur	Anchor
Colgate Strong Teeth with Calci-lock Protection Toothpaste	Pepsodent 2 in 1 Germicheck	Oral B All-Rounder Healthy 32	Dabur Red	Anchor White Toothpaste
Colgate MaxFresh Spicy Fresh Toothpaste	Pepsodent Germi Check Whitening	Oral B All-Rounder Extra Fresh	Babool	Anchor Gel
Colgate MaxFresh Citrus Blast Toothpaste	Pepsodent GC Clove & Salt	Oral B Pro-Health All-Around Protection Mint	Babool Neem	
Colgate MaxFresh Peppermint Ice Toothpaste	Pepsodent Germi Check Magnets		Meswak	
Colgate Active Salt Toothpaste	Pepsodent Germi Check Expert Protection Complete			
Colgate Active Salt Neem Toothpaste	Pepsodent Germi Check Expert Protection Whitening			
Colgate Active Salt Healthy White Toothpaste	Pepsodent Centre Fresh Toothpaste			
Colgate Total Charcoal Deep Clean Toothpaste	Pepsodent Gum Care Toothpaste			
Colgate Total Advanced Whitening Toothpaste	Pepsodent Expert Protection Complete			
Colgate Total Advanced Health Toothpaste	Pepsodent Expert Protection Pro Sensitive Relief & Repairs			
Colgate Total Pro-Gum Health Toothpaste	Close Up Deep Action – Red Hot			
Colgate Sensitive Pro-Relief Toothpaste	Close Up Deep Action – Menthol Fresh			
Colgate Sensitive Pro-Relief Enamel Repair Toothpaste	Close Up Deep Action – Lemon Mint			
Colgate Visible White Toothpaste	Close Up Deep Action – Eucalyptus Mint			
Colgate Visible White Plus Shine Toothpaste	Close Up Fire-Freeze – Original			
Colgate Sensitive Original Toothpaste	Close Up Diamond Attraction – Power White			
Colgate Cibaca Toothpaste				
Colgate Maximum Cavity Protection plus Sugar Acid NeutralizerTM Toothpaste				
Colgate Herbal Natural Toothpaste				
Colgate Barbie Toothpaste				
Colgate Spider Man Toothpaste				

Source: Company

Colgate product portfolio

Source: Company

Financials

Income Statement

Y/E Mar, Rs mn	FY15E	FY16E	FY17E	FY18E
Net sales	**39548**	**40943**	**45004**	**50498**
Growth, %	11.6	3.5	9.9	12.2
Other income	272	293	315	327
Total income	39819	41236	45320	50826
Raw material expenses	-14677	-14735	-15424	-17286
Employee expenses	-2589	-2525	-2730	-2953
Other Operating expenses	-14331	-14499	-15859	-17619
EBITDA (Core)	**8222**	**9477**	**11306**	**12967**
Growth, %	23.8	15.3	19.3	14.7
Margin, %	20.8	23.1	25.1	25.7
Depreciation	-750	-1116	-1182	-1266
EBIT	**7472**	**8361**	**10124**	**11700**
Growth, %	21.8	11.9	21.1	15.6
Margin, %	18.9	20.4	22.5	23.2
Interest paid	0	0	0	0
Other Non-Operating Income	332	386	472	609
Pre-tax profit	**7803**	**8747**	**10596**	**12310**
Tax provided	-2214	-2522	-3444	-4001
Profit after tax	**5589**	**6225**	**7152**	**8309**
Net Profit	**5589**	**6225**	**7152**	**8309**
Growth, %	16.4	11.4	14.9	16.2
Net Profit (adjusted)	**5589**	**6225**	**7152**	**8309**
Unadj. shares (m)	272	272	272	272
Wtd avg shares (m)	272	272	272	272

Balance Sheet

Y/E Mar, Rs mn	FY15E	FY16E	FY17E	FY18E
Cash & bank	2,545	3,254	4,212	6,122
Debtors	696	926	1,109	1,351
Inventory	2,522	2,241	2,661	2,738
Loans & advances	1,657	1,931	2,089	2,294
Total current assets	7,420	8,353	10,071	12,505
Investments	371	371	371	371
Gross fixed assets	12,829	13,779	14,779	15,829
Less: Depreciation	-5,013	-6,129	-7,311	-8,578
Add: Capital WIP	1,412	1,412	1,412	1,412
Net fixed assets	9,227	9,061	8,879	8,663
Non-current assets	0	0	0	0
Total assets	**16,993**	**17,760**	**19,295**	**21,514**
Current liabilities	9,290	9,333	9,992	11,193
Total current liabilities	9,290	9,333	9,992	11,193
Total liabilities	9,290	9,333	9,992	11,193
Paid-up capital	136	272	272	272
Reserves & surplus	7,567	8,155	9,031	10,049
Shareholders' equity	7,703	8,427	9,303	10,321
Total equity & liabilities	**16,993**	**17,759**	**19,295**	**21,513**

Source: Company, PhillipCapital India Research Estimates

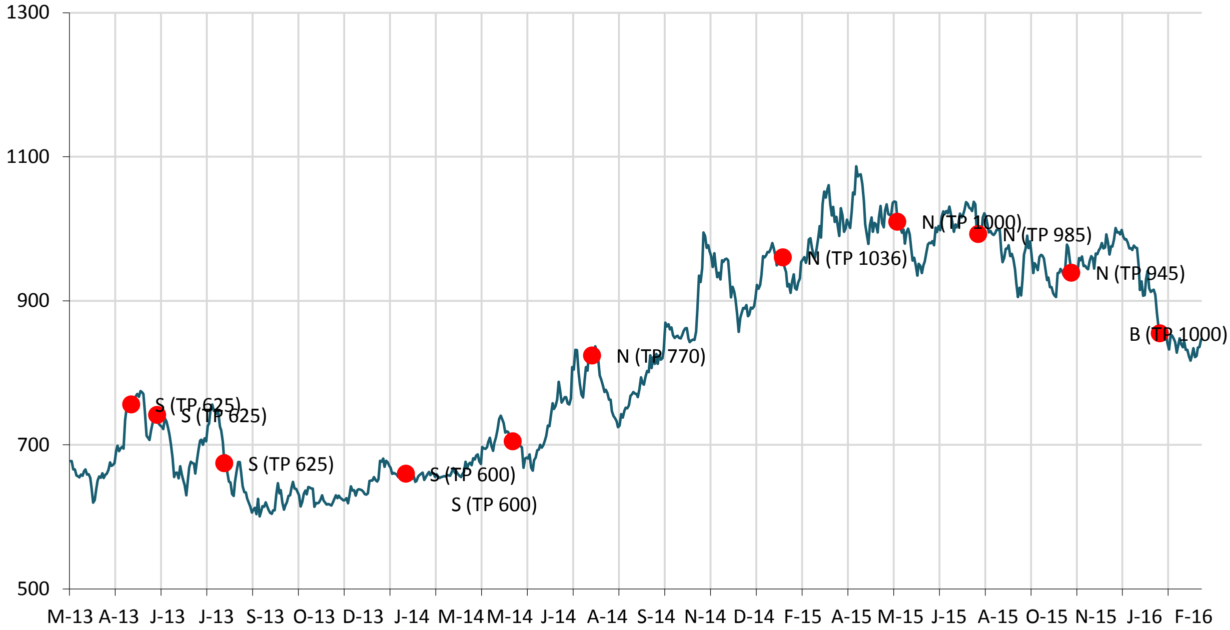
Cash Flow

Y/E Mar, Rs mn	FY15E	FY16E	FY17E	FY18E
Pre-tax profit	7,803	8,747	10,596	12,310
Depreciation	750	1,116	1,182	1,266
Chg in working capital	20	-181	-100	676
Total tax paid	-2,010	-2,522	-3,444	-4,001
Cash flow from operating activities	**6,564**	**7,161**	**8,234**	**10,251**
Capital expenditure	-3,004	-950	-1,000	-1,050
Chg in investments	0	0	0	0
Cash flow from investing activities	**-3,004**	**-950**	**-1,000**	**-1,050**
Free cash flow	3,560	6,211	7,234	9,201
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-3,884	-5,187	-6,276	-7,291
Cash flow from financing activities	**-3,884**	**-5,187**	**-6,276**	**-7,291**
Net chg in cash	-324	1,023	958	1,910

Valuation Ratios

	FY15E	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	20.6	22.9	26.3	30.5
Growth, %	16.4	11.4	14.9	16.2
Book NAV/share (INR)	28.3	31.0	34.2	37.9
FDEPS (INR)	20.6	22.9	26.3	30.5
CEPS (INR)	23.3	27.0	30.6	35.2
CFPS (INR)	22.9	24.9	28.5	35.5
DPS (INR)	12.0	16.3	19.7	22.9
Return ratios				
Return on assets (%)	35.1	35.8	38.6	40.7
Return on equity (%)	72.6	73.9	76.9	80.5
Return on capital employed (%)	81.6	77.2	80.7	84.7
Turnover ratios				
Asset turnover (x)	10.7	8.5	9.4	11.7
Sales/Total assets (x)	2.5	2.4	2.4	2.5
Sales/Net FA (x)	4.9	4.5	5.0	5.8
Working capital/Sales (x)	(0.1)	(0.1)	(0.1)	(0.1)
Fixed capital/Sales (x)	0.2	0.2	0.2	0.2
Working capital days	(40.7)	(37.7)	(33.5)	(34.8)
Liquidity ratios				
Current ratio (x)	0.8	0.9	1.0	1.1
Quick ratio (x)	0.5	0.7	0.7	0.9
Interest cover (x)				
Dividend cover (x)	1.7	1.4	1.3	1.3
Net debt/Equity (%)	(33.0)	(38.6)	(45.3)	(59.3)
Valuation				
PER (x)	41.1	36.9	32.1	27.7
Price/Book (x)	29.8	27.3	24.7	22.3
Yield (%)	1.4	1.9	2.3	2.7
EV/Net sales (x)	5.7	5.5	5.0	4.4
EV/EBITDA (x)	27.6	23.9	20.0	17.3
EV/EBIT (x)	30.4	27.1	22.3	19.1

Stock Price, Price Target and Rating History



Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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