India Consumer Sector

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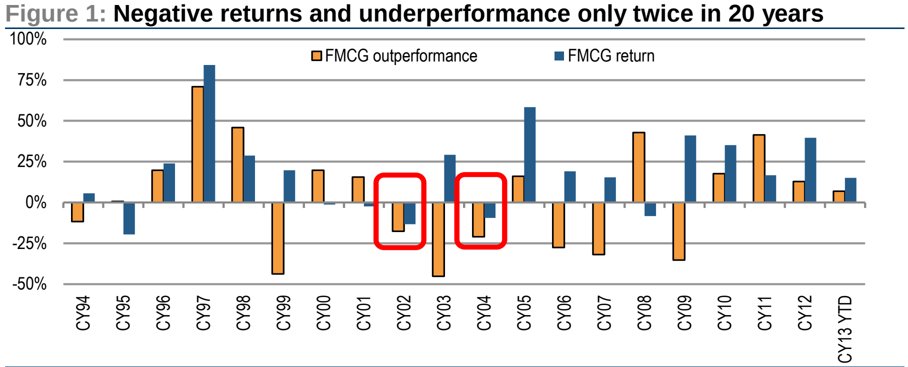
COMMENT

FMCG: Not just a defensive in India

Figure 1: **Negative returns and underperformance only twice in 20 years**

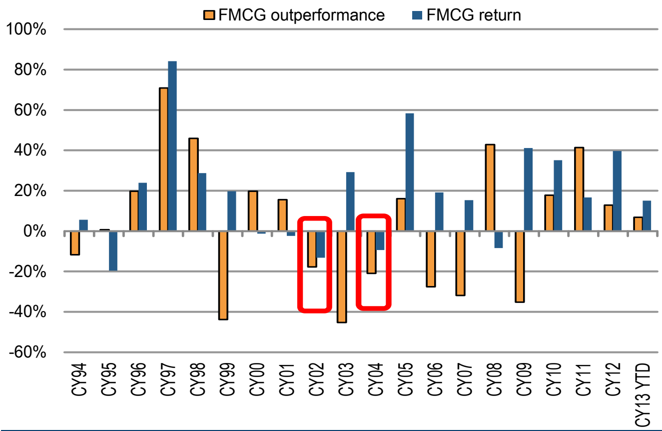


Source: Company data, Bloomberg

- **FMCG a growth sector in India—outperformed over most medium-term cycles.** FMCG outperformed during the consumption growth phase of 1996-2000, was in line during the 2000-04 rural slowdown and outperformed the 2008-13 period of strong rural growth. Contrary to the common perception, FMCG (ex-HUL) even outperformed the market in the first three years of the 2004-08 bull market. HUL faced internal issues in the mid-2000s due to its power brands strategy, which culminated in a detergent price war in CY04.
- **Only two years of combined negative returns and underperformance in 20 years.** The FMCG sector delivered a combination of negative returns and underperformance only twice in the past 20 years—CY02 and CY04; years of rural distress due to consecutive droughts and P&G's price war.
- **Strong defensive traits—negative returns only in years of extreme distress.** FMCG (ex-HUL) gave negative returns in only four of the past 20 years. These include two years of droughts in the early 2000s and the global financial crisis of 2008. There is only one year of a 15%+ negative return of the sector at an annual level (CY02). On a daily 12-month trailing basis, the FMCG sector delivered more than 15% negative returns on 7% instances, 6% of which were during the 2000-04 period.
- **Stock picking is the key; average gap between the best and worst performer has been ~64% annually.** The FMCG sector is very heterogeneous as stocks operate in different categories with many bottom-up factors. Thus stock picking is the key in the sector. Over the past 20 years, the average difference in annual stock performance of the best and worst performing stocks among the major stocks in the sector has been ~64%. We thus pick stocks bottom up with high growth visibility—ITC, Emami, Marico, GCPL are our top picks in the sector.

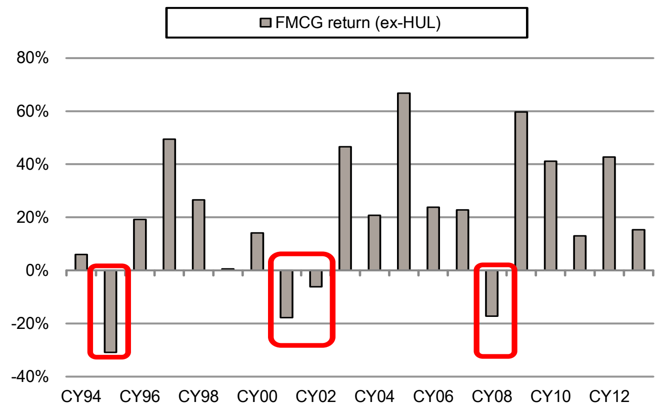
Focus charts

Figure 2: **Combination of negative returns and underperformance in only two out of 20 years**



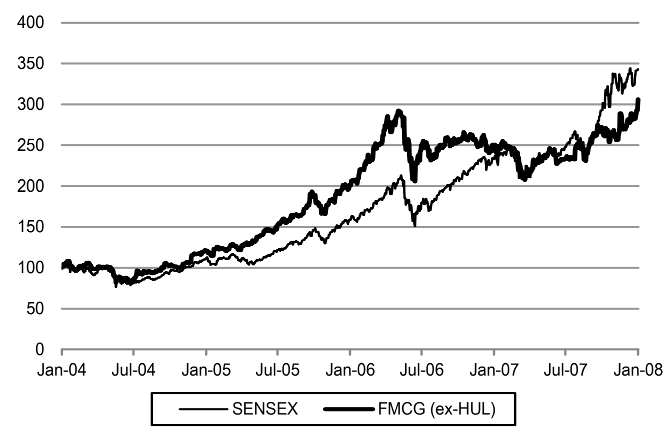
Source: Company data, Bloomberg

Figure 3: **Negative returns are in years of extreme distress like droughts or the global financial crisis**



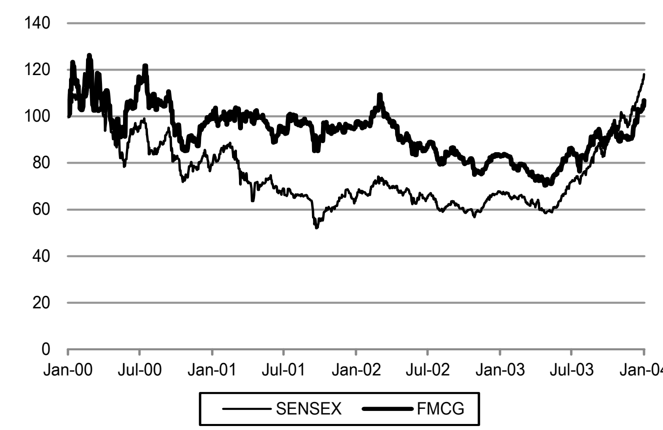
Source: Company data, Bloomberg

Figure 4: **FMCG even outperformed the first three years of the 2004-08 bull market of the investment cycle**



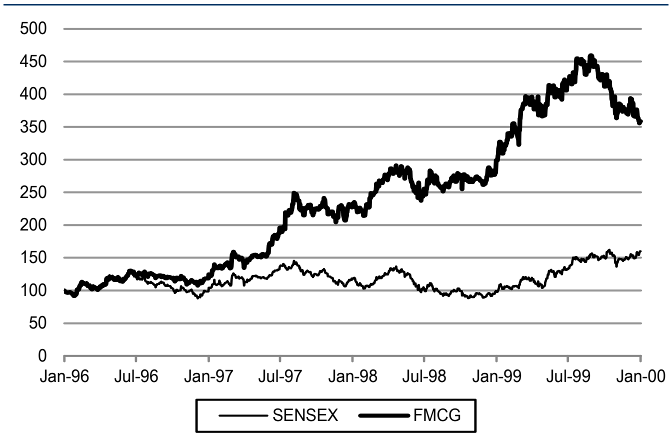
Source: Company data, Bloomberg

Figure 5: **FMCG was in line with market in the weak consumption growth phase of 2000-04**



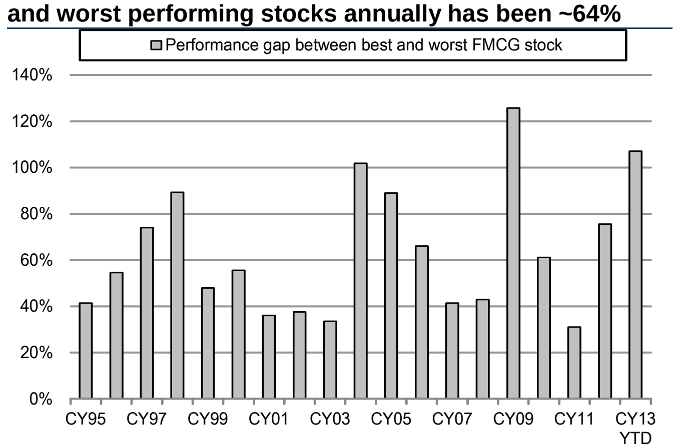
Source: Company data, Bloomberg

Figure 6: **FMCG massively outperformed during 1996-2000**



Source: Company data, Bloomberg

Figure 7: **Stock picking key—average gap between best and worst performing stocks annually has been ~64%**



Source: Company data, Bloomberg

FMCG: Not just a defensive in India

FMCG is not just a defensive sector in India but also a growth sector—as a result, stocks have done well even during bull markets led by investment cycle stocks. We look at four-year cycles from 1996 to analyse the FMCG performance. Excluding the second half of the 2004-08 bull market, FMCG either performed well above or in line with the market. Even during the underperformance of 2006-08, absolute returns were strong for the sector.

#1: 1996-2000: FMCG stocks significantly outperformed the market during the strong consumption growth cycle of 1996-2000 led by HUL.

#2: 2000-2004: There was a sharp slowdown in consumption due to rural distress from consecutive droughts in the 2000-04 period, but even during this period FMCG performed in line with the market. However, absolute returns from FMCG stocks were muted.

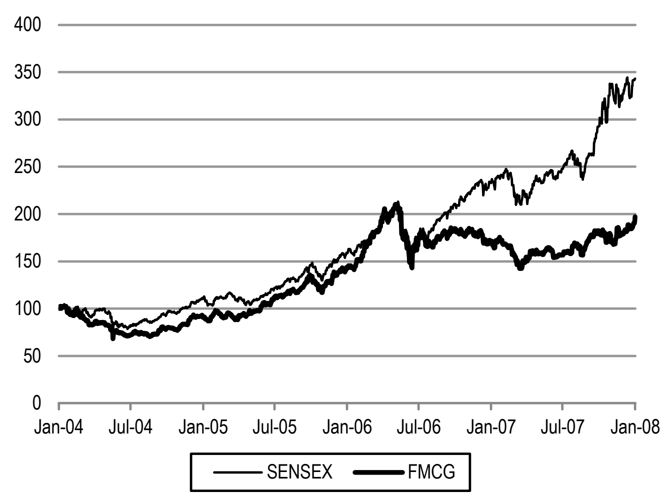
#3 2004-08: India saw a bull market led by the investment cycle stocks. However, even in this cycle FMCG performed in line for the first two years from 2004 to 2006, and delivered strong returns in the next two years, albeit underperforming the market. Excluding HUL, which had internal issues of strategy linked to its power brand strategy, FMCG outperformed the market for the first three years of the rally from 2004 to 2007. In the last year of the cycle, these stocks underperformed, but delivered strong absolute returns.

#4 2008-13: FMCG stocks significantly outperformed the market on the back of strong rural growth, premiumisation in urban India and strong strategic moves by companies like foreign acquisitions etc. Sectors linked to the investment cycle were under stress during the period which increased the outperformance.

FMCG outperformed even in the first two years of the 2004-08 bull market

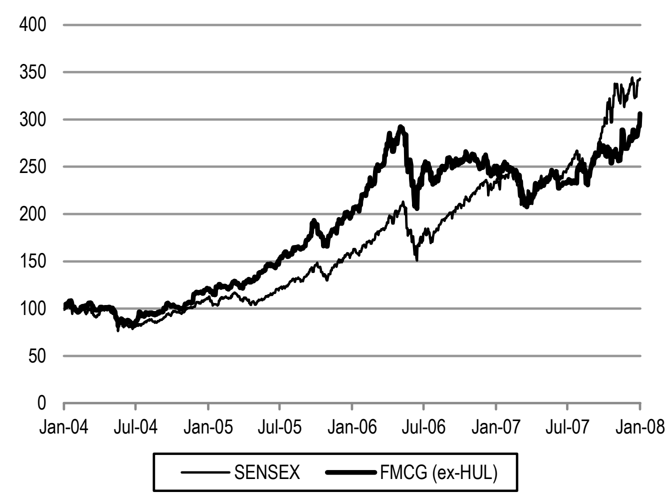
Contrary to perception, the FMCG sector did not underperform the first two years of the 2004-06 bull market in India which was led by stocks from the investment cycle. In fact, excluding HUL, FMCG outperformed the market for the first three years of the 2004-08 cycle, and only in 2007 the sector underperformed. Absolute returns remained strong even in the last two years of the cycle, when consumer underperformed the index.

Figure 8: **FMCG performed in line for the first two years of the 2004-08 bull market for the investment cycle**



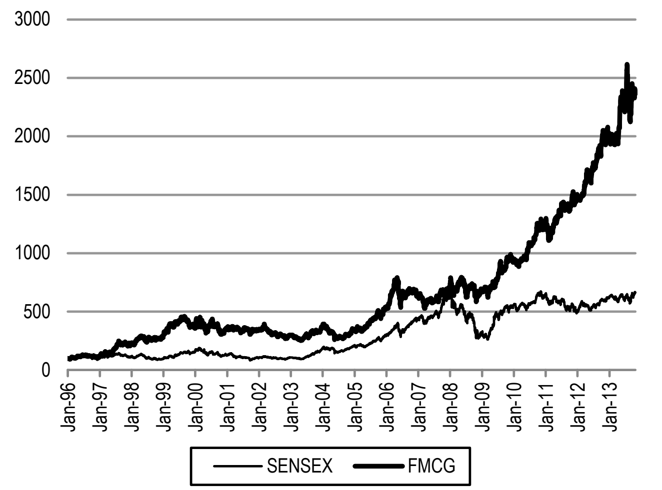
Source: Company data, Bloomberg

Figure 9: **Excluding HUL, which had internal issues, FMCG outperformed the first three years of the 2004-08 cycle**



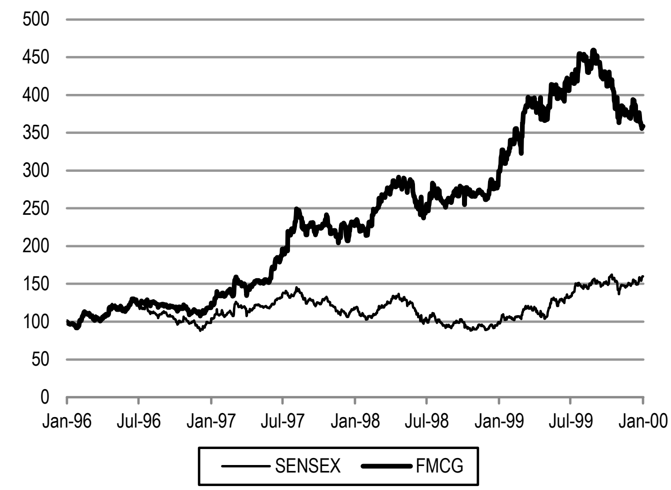
Source: Company data, Bloomberg

Figure 10: **FMCG has outperformed the market over many cycles since 1996**



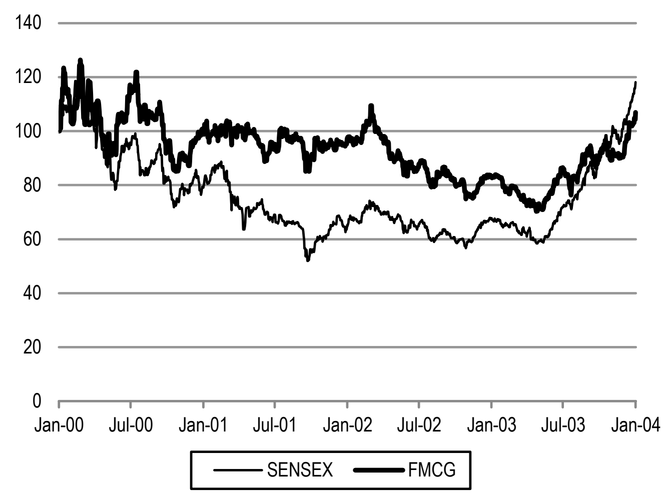
Source: Company data, Bloomberg

Figure 11: **Over 1996-2000, consumption growth was strong and FMCG outperformed massively**



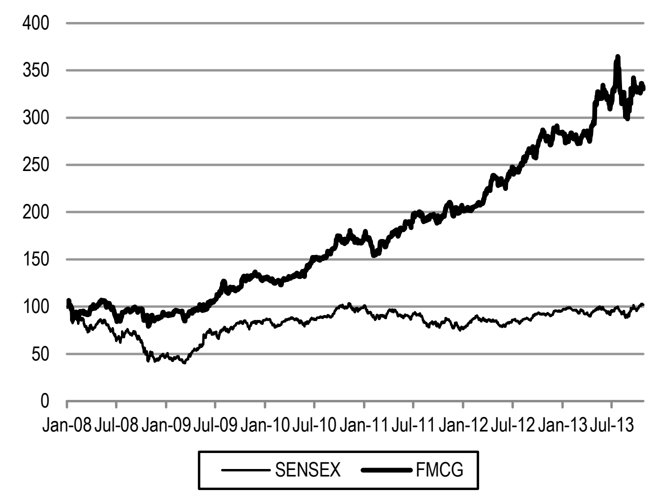
Source: Company data, Bloomberg

Figure 12: **Over 2000-04, consecutive droughts led to rural distress and weak growth and HUL got hurt from power brands, but the sector performed in line with the market**



Source: Company data, Bloomberg

Figure 13: **Over 2008-13, FMCG massively outperformed as rural growth picked up strongly and the investment cycle stocks were beaten down**

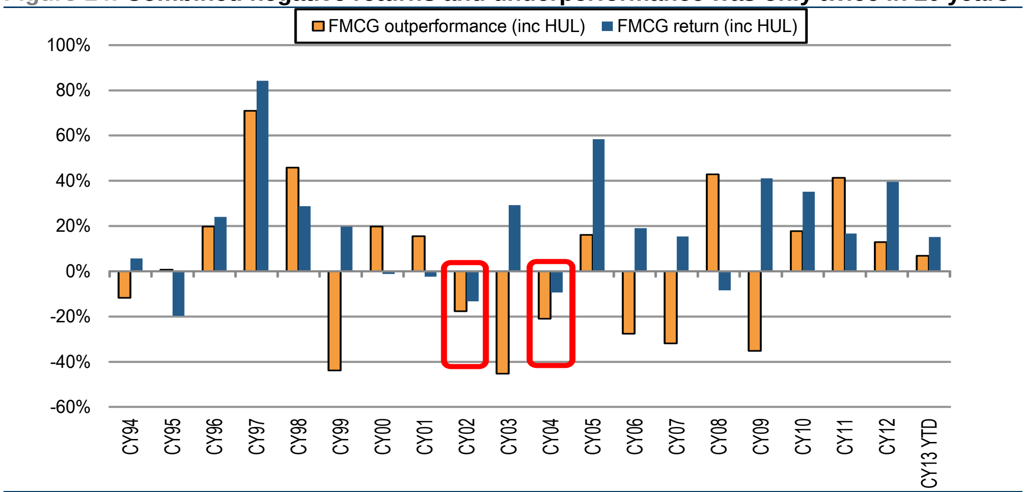


Source: Company data, Bloomberg

Combined negative returns and underperformance a rarity

Over the past 20 years from CY94 to CY13, there have been just two years of a combination of negative returns from FMCG and underperformance over the market. Excluding HUL, the number years comes down to just one. This instance is also during the 2000-04 period, which saw three years of drought and extreme distress in rural India which caused a sharp decline in FMCG growth rates.

Figure 14: **Combined negative returns and underperformance was only twice in 20 years**

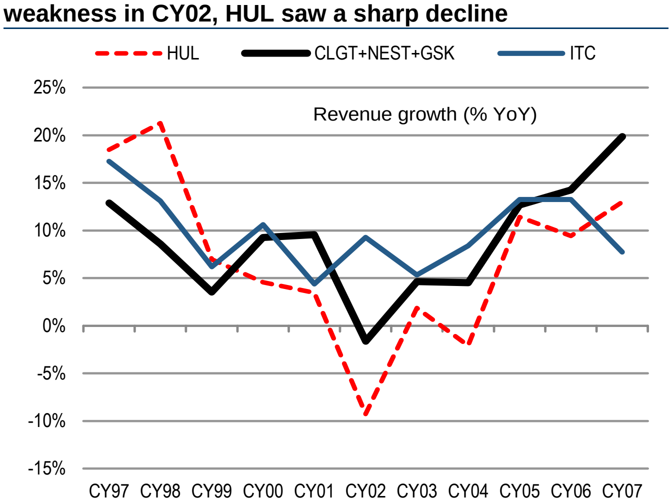


Source: Company data, Bloomberg

Growth a bigger factor compared to the market cycle

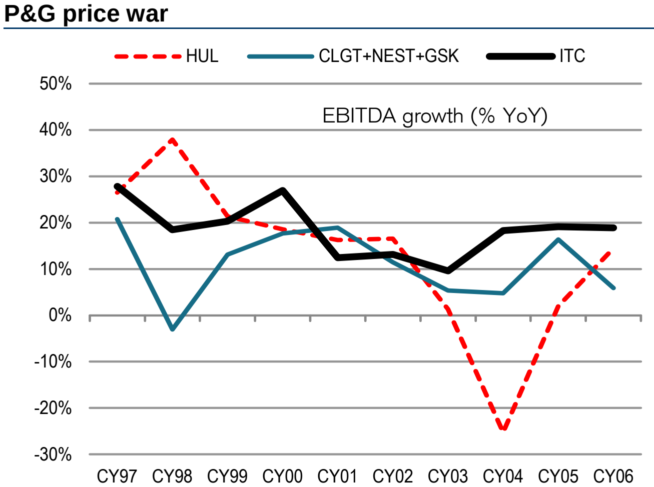
Looking at these trends, one can relate the stock performance to growth in revenues and EBITDA rather than the market cycle. The reason for the weak performance of stocks in the early 2000s is to do with (1) the rural slowdown due to consecutive droughts and (2) HUL's power brand strategy that has increased its market share but culminated into a detergent price war with P&G. The stock performance in that period directly reflects weak growth trends for sales as well as EBITDA.

Figure 15: **Most FMCG companies had revenue growth weakness in CY02, HUL saw a sharp decline**



Source: Company data

Figure 16: **EBITDA for HUL declined in CY04 due to the P&G price war**

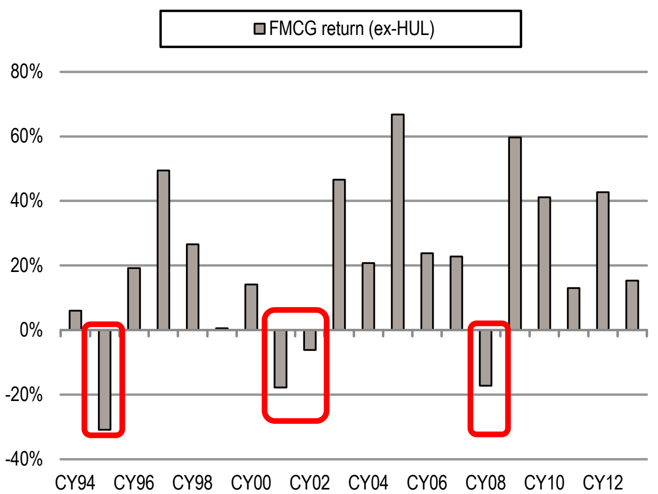


Source: Company data

Strong defensive traits: Negative returns only in extreme distress

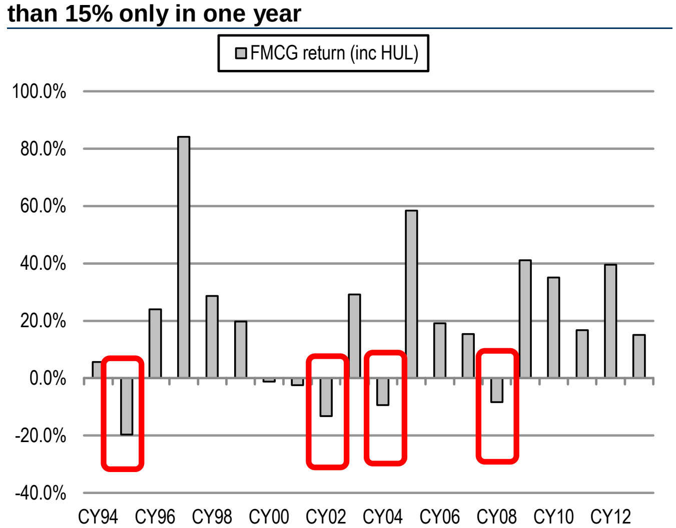
FMCG, excluding HUL, has seen just three years of negative returns over the past 20 years—all three were cases of extreme economic stress. These years were (1) CY08—global financial crisis and (2) CY00 and CY01—consecutive droughts and extreme income stress in rural India. We exclude HUL from the calculation as between CY00 and CY06 the company underwent a self-inflicted problems from the power brand strategy, which saw the company shrinking focus brands from 130 to 40 and giving up a huge market share to competition, and finally having to slash prices of detergents in the price war with P&G.

Figure 17: FMCG (ex-HUL) had three years of negative returns in 20 years



Source: Company data, Bloomberg

Figure 18: Including HUL, negative returns were more than 15% only in one year



Source: Company data, Bloomberg

The quantum of negative returns has also historically not been high. Looking at trailing 12-month returns, we see that only 7% instances in the past 20 years have had more than 15% negative returns. Over 6% of these instances are during the 2000-04 period, when consumption growth has sharply come off due to consecutive droughts and the subsequent distress on rural incomes and impact on rural consumption.

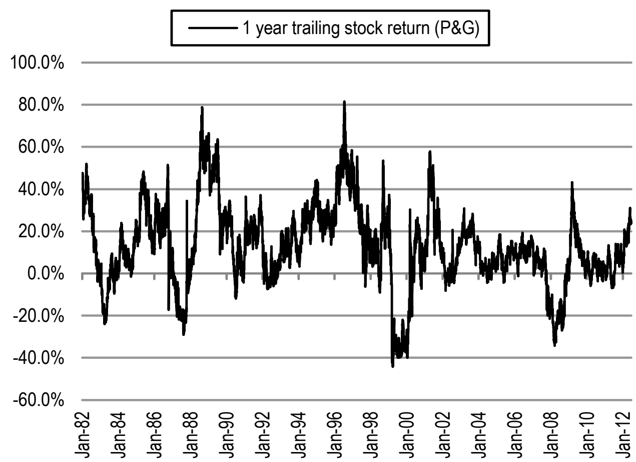
Figure 19: Few instances of over 15% negative returns on a trailing 12-month basis

Source: Company data, Bloomberg

Quality FMCG stocks have defensive traits across the world

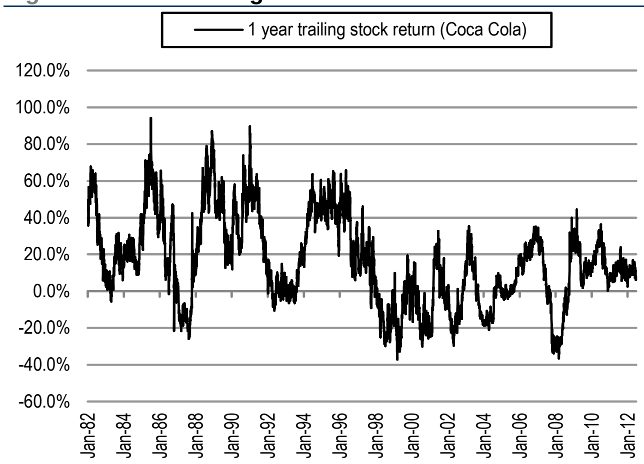
The defensive trait of quality FMCG stocks is common in developed markets. These companies do not deliver significant negative returns except in case of a strategic issue or if there is a sharp market correction. Over a 30-year period, P&G and Coca Cola have had just 9% and 11% days in which the trailing 12-month decline was more than 15%.

Figure 20: **Coca Cola trailing 12-month stock returns**



Source: Company data, Bloomberg

Figure 21: **P&G trailing 12-month stock returns**

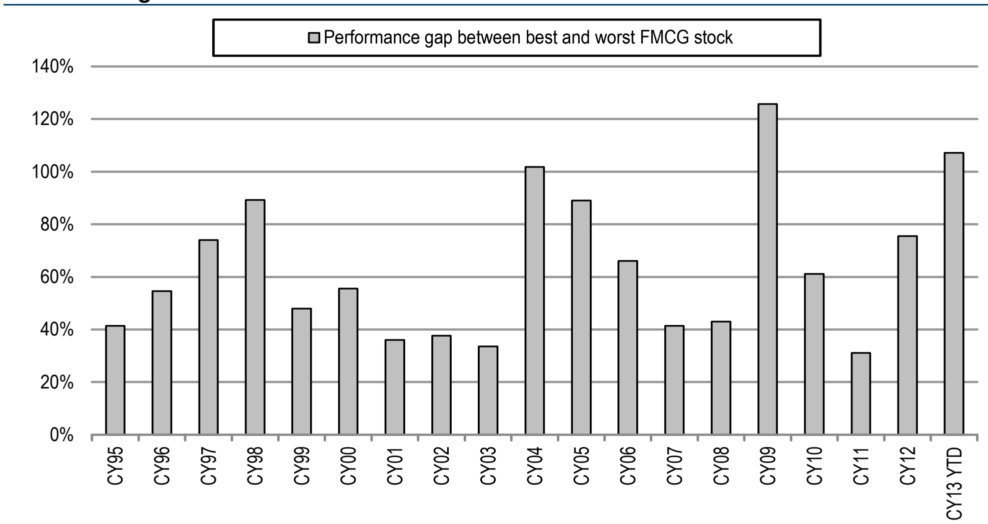


Source: Company data, Bloomberg

Stock picking the key in the consumer sector

The FMCG sector is very heterogeneous as companies operate in completely different categories, have different drivers and a large number of bottom-up factors. Most of the medium-cap stocks are bottom up stories. Thus stock picking is the key in the sector. Over the past 20 years, the average difference in annual stock performance of the best and worst performing stocks in the sector has been ~64%. This analysis does not include smaller market cap stocks like Emami in the recent times and Marico in the 1990s which may have had very high returns in some years as they got discovered. This analysis has Top 5 stocks from 1994 to 2003—ITC, HUL, Colgate, Nestle, GSK Consumer, and post 2004 also includes GCPL, Britannia, Marico and Dabur.

Figure 22: **The gap between the best and worst performer among stocks has been 64% on an average**



Source: Company data, Bloomberg

CAGRs of stock prices across the longer cycles (1) 1996-2000, (2) 2000-04, (3) 2004-08 and (4) 2008-13, have also been much differentiated.

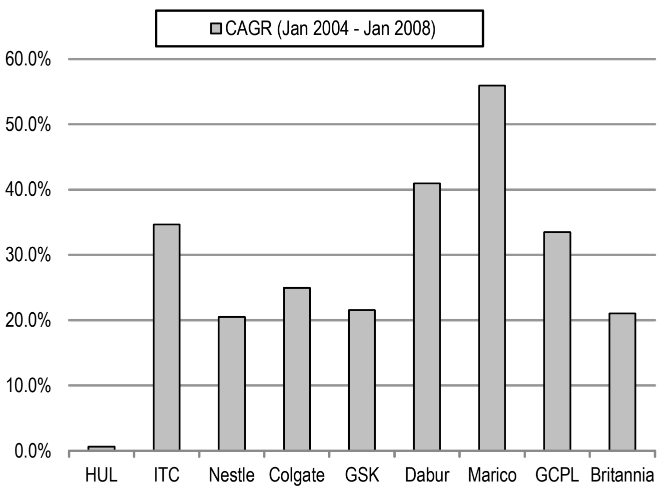
#1: 1996-2000: HUL led the sector with a 35% CAGR in the share price, while Colgate had a negative CAGR of 5%.

#2: 2000-04: Nestle and ITC delivered a 10%+ CAGR; HUL, Colgate and GSK delivered negative returns.

#3: 2004-08: Marico led with 55% CAGRs; Dabur, ITC and GCPL also delivered 30-40% CAGRs, and HUL was the laggard with ~0% CAGR.

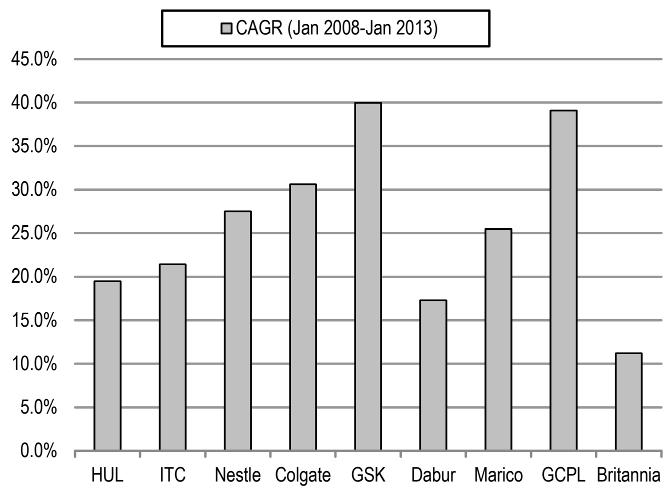
#4: 2008-13: GSK and GCPL led with ~40% CAGRs; Britannia lagged with a ~10% CAGR.

Figure 23: **Divergence in stock performance 2004-08**



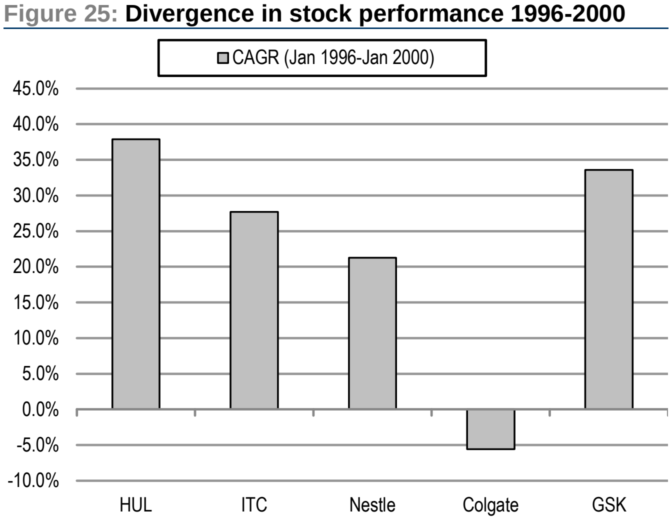
Source: Company data, Bloomberg

Figure 24: **Divergence in stock performance 2008-13**



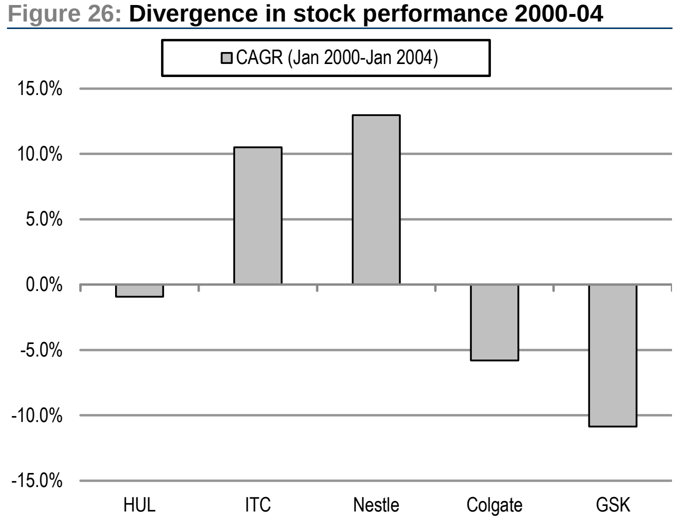
Source: Company data, Bloomberg

Figure 25: **Divergence in stock performance 1996-2000**



Source: Company data, Bloomberg

Figure 26: **Divergence in stock performance 2000-04**



Source: Company data, Bloomberg

We thus focus on stocks with high growth potential and visibility

We thus focus on picking stocks which will give strong absolute returns. Our top picks in the sector are ITC, Emami, Marico and Godrej Consumer. These stocks, in our view, have good growth headroom, visibility of earnings growth over the next few quarters and have sound management strategy which will benefit the companies over a two- to three-year horizon. We like ITC for its strong pricing power in cigarettes and the high potential given low penetration of cigarettes within the smoking population. Emami is a unique play on niche categories in healthcare and personal care, which face minimal competition from large players and have high pricing power. Marico is transitioning from largely a coconut oil company to a more diversified portfolio of value added oils, skin care, male grooming and foods. GCPL continues to show very high innovation success rate of new products in India and its international businesses. We also like GSK Consumer's medium-term strategy of going deeper into rural India through distribution and small packs.

Companies Mentioned *(Price as of 11-Nov-2013)*

Britannia Ind (BRIT.BO, Rs876.05)
Colgate-Palmolive India (COLG.BO, Rs1234.0)
Dabur India (DABU.BO, Rs161.1)
Emami Ltd (EMAM.BO, Rs467.85)
GlaxoSmithkline Consumer Healthcare (GLSM.BO, Rs4505.45)
Godrej Consumer Products Ltd (GOCP.BO, Rs854.6)
Hindustan Unilever Ltd (HLL.BO, Rs576.15)
ITC Ltd (ITC.BO, Rs317.0)
Marico Ltd (MRCO.BO, Rs206.9)
Nestle India (NEST.BO, Rs5608.8)

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