Financial Analysis
&
Corporate Valuation
of
asianpaints

A report by:

Finance Group #5

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Asian Paints

Financial Analysis & Corporate Valuation

CMP – Rs. 701
Recommendation – Hold

Company profile

Set up in 1957, Asian Paints (India) is a paint manufacturer in the country. Its products include paints, enamels, varnishes, resins & powder coatings. The company manufactures a wide range of surface coatings catering to different end-uses. The company also manufactures vinyl pyridine latex which is used in the manufacture of rubber tyres. Asian Paints' plants are located at UP, Gujarat, Maharashtra and Andhra Pradesh.

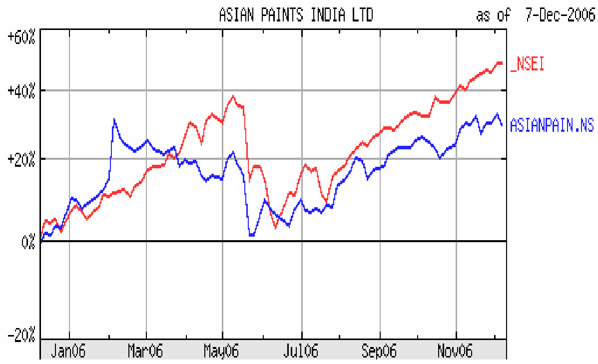
The company ranks among the top ten decorative paints company in the world with a supply chain and a distribution network of 16,000 dealers and 5,000 CTM's, making it also a leader in-terms of market reach.

Outlook

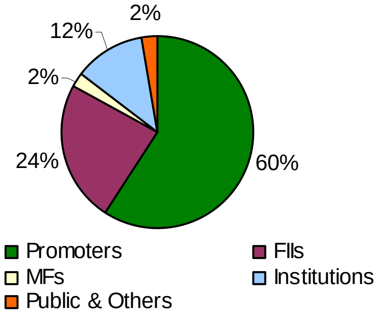
- Paint industry in India is expected to register around 14% volume growth backed by a favourable outlook in the user industries.
- The company expects revenue from international operations to grow by 15%. This seems achievable as Middle East and the Caribbean markets are expected to perform well. Steps have been taken by the company to reduce losses in South East Asia and South Asia regions and these regions are expected to attain a critical scale in near future which would help in increasing the market share and hence the margins.

Share Data

Market cap. (Rs. crores)	6735.02
52 week high /low	800 / 500
P/BV	10.86
P/Sales	2.40



Shareholding Pattern



Valuation Summary

Intrinsic Value based on	
FCFE	659
DDM	669
Average	664
Upside / Downside	- 5.61%

Snapshot of Shareholder Value Maximization Framework		
Framework	**Weight**	**Reasons**
Profitability	+	**High Monopolistic and Pricing Power**
Growth	+	**Aggressive management & marketing; potential for global expansion**
Risk	+	**Volatility is low due to it large size and wide reach**
Capital Market conditions	+	**Booming Indian Economy**
Net		**4+**

Financial Historicals of Asian Paints				
Year	**2003**	**2004**	**2005**	**2006**
	2,807.05	2,366.16	2,111.08	1,887.70
Net Income (Rs ten Million)	186.78	173.48	147.79	142.01
EPS (Rs.)	19.47	18.09	15.41	14.81
Return on capital (%)	29.70%	28.54%	26.58%	26.87%
Capital Employed	694.86	641.63	603.48	580.24
Return on total assets (%)	15.98%	14.65%	13.89%	14.90%
Operating Assets to Total Assets (%)	6.96%	5.18%	2.62%	9.60%
Market Value of Equity (Rs Ten Million)	6,723.98	3,759.58	2,891.98	3,165.35
Book Value of Equity (Rs Ten Million)	622.28	572.22	531.54	476.63
book value per share	64.88	59.66	55.42	49.69
No of shares	95,919,779.00	95,919,779.00	95,919,779.00	95,919,779.00
MVA (Rs Ten Million)	6,101.70	3,187.36	2,360.44	2,688.72
EVA (Rs Ten Million)	138.62	127.11	104.78	108.66
Cumulative EVA (Rs Ten Million)	479.17	340.55	213.44	108.66
Share price (Rs.)	701	391.95	301.5	330
P/E	36.00	21.67	19.57	22.29
Beta	0.46	0.31	0.37	0.20
P/BV	10.81	6.57	5.44	6.64
L.T. Debt to Equity (%)	23.33%	24.26%	27.07%	43.48%
Times Interest Covered	10.44	11.40	8.16	6.02
Current Ratio	1.21	1.17	1.13	1.39
Cost of Equity	10.53%	9.49%	9.95%	8.75%
Cost Of Debt	9.91%	8.64%	10.01%	10.40%
Estimated Cost of Capital	9.75%	8.73%	9.21%	8.14%

Current Performance

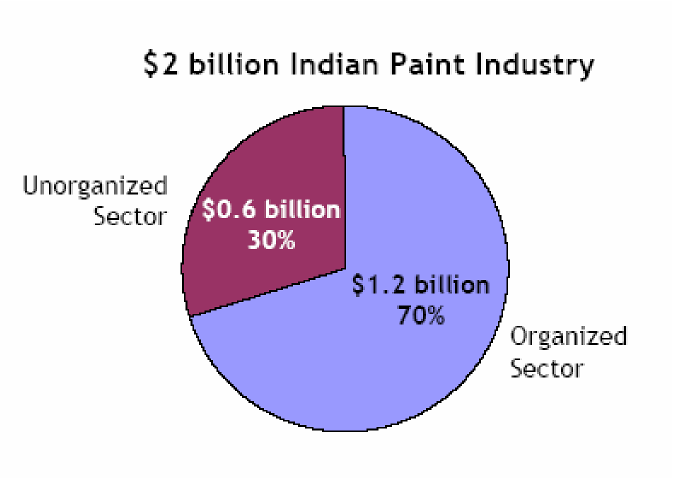
There has been a significant improvement in the working capital position, which has resulted in growth in operating cash flow by 111%. The net working capital days has improved from 71 days to 58 days and the company expects it to be sustainable. The reasons attributed to improved working capital are improvement in the inventory and debtor levels and efficiency improvement.

The company has estimated a capex of Rs.1000 million for the year FY07. For the six months ended 30 September 2006, Consolidated Sales & Operating Income has increased by 22.2% to Rs. 17753.8 mn from Rs. 14532.9 mn. PBDIT has increased by 25.4% to Rs. 2536.8 million from Rs. 2025.3 mn. Net profit after tax has increased by 40.3% to Rs. 1441 mn from Rs. 1027.1 mn.

Indian Paints Industry

India per capita paint consumption of 700 gms against 15-20 kgs for developed markets, India offers a huge demand potential with a market size of Rs. 7,000 crores. The demand for paints is relatively price-elastic but is linked to the industrial and economical growth. India’s paint market is dominated by decorative paints (70%). While house construction activity and re-painting form the demand drivers (30% and 70%, respectively) for the decorative category;

growth in automobiles, consumer durables & infrastructure development determine the demand for industrial category of paints.

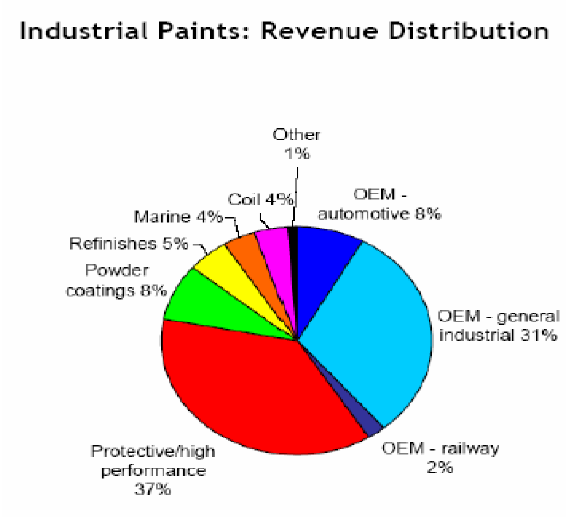


*Source: HDFC Securities Analyst Report

In India the organized sector controls 70 percent of the total market with the remaining 30 percent being in the hands of nearly 2000 small-scale units.

Nearly 20 per cent of all decorative paints sold in India are distempers and it is here that the unorganized sector has dominance. The demand for decorative paints is highly price-sensitive and also cyclical. Monsoon is a slack season while the peak business period is Diwali festival time, when most people repaint their houses.

The industrial paints segment, on the other hand, is a high volume-low margin business. In the decorative segment, it is the distribution network that counts while in the industrial segment the deciding factor are technological superiority and tie-up with automobile manufacturers for assured business.



The industry is raw-material intensive. There are around 300 raw materials, nearly half of them are imported petroleum products. Thus, any fluctuation in global oil prices directly affects the bottom-line of the players.

Industry Outlook

The Industry outlook for the paints industry in India has positive outlook and it is heading towards a boom, both sectors decorative and industrial are expected to show high growth rates. Some of the reasons that lead us to conclude this are:

- Expected Market Growth of about $200 - $400 million per year for the Paint Industry (in India) over next 5 years.

- Growth rate in the organized sector expected to be 15 – 17% per annum

- Boom in Housing sector to fill demand for over 30 million new homes. This Boom in Indian Housing Sector is a result of increasing urbanization, cheaper housing loans and a shift from semi-permanent to permanent housing structures have been driving growth in decorative paints segment, which constitutes 70% of the $2 billion paint industry in India

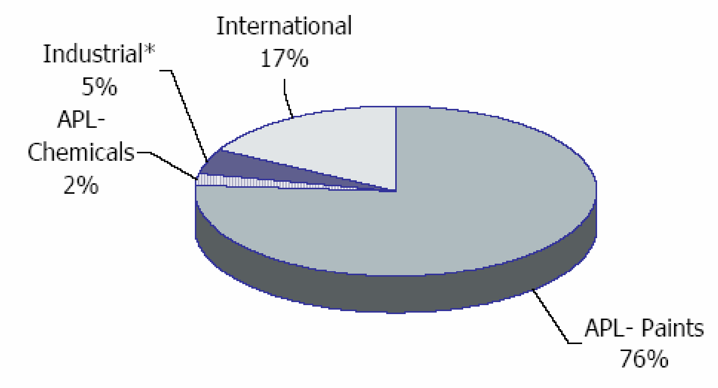
- Strong Industrial growth: An average growth of about 10% in the in automobile sector which provides 50% of the revenues in the industrial paints segment. Industrial paints account for 30% of the paint industry revenue in India

- Heavy Infrastructure Spending: New projects in roads, ports and industrial segments increases revenues from protective coatings for civil applications and road-marking paints to all parts of the building paints sector, whether interior, exterior, waterproofing or floor coatings.

Sales analysis

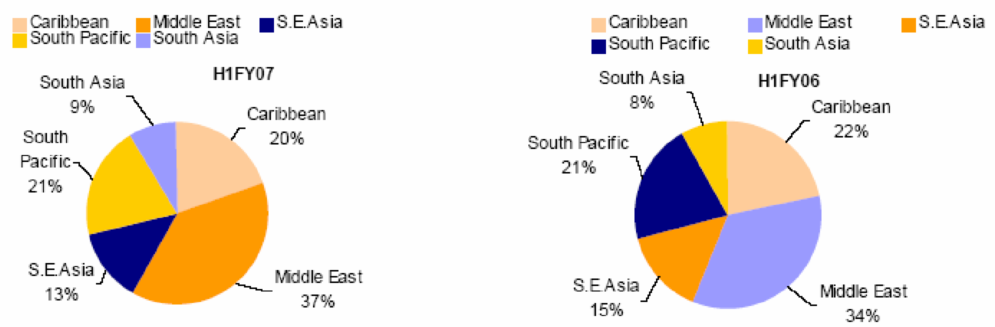
The Net Sales have grown by 26.8% yoy to Rs7.8bn from Rs6.1bn. To combat high raw material costs Asian Paints has hiked prices by nearly 3% across products in the first half which have been well absorbed by the market with no effect on demand. For the first half Net profit has increased by 28.5% yoy to Rs1,356mn from Rs1,055mn. The paints business contributes 93% to the total sales.

Sales Break-Up



International operations form almost 17% of the company's total sales, and they grew by w by 25%, with the Middle-East region being the key growth drivers registering sales growth in excess of 30%. However on the profitability front, international operations (especially in the South-Asian region) continued to be a drag.

The diagram below shows the distribution of international sales this year and last year. The biggest change was recorded by the Middle East and the Caribbean.



Competitors

Asian Paints is the market leader with a 46% market share. It has a turnover of Rs. 26 bn, more than twice the size of the closest competitor.

The leaders in the organised paint industry are Asian Paints (India) Ltd. (APIL), Nerolac Paints Ltd. (GNPL), Berger Paints, Jenson & Nicholson Ltd. (J&N) and ICI (India) Ltd. Nerolac dominates the industrial paints segment with 41 per cent market share. It has a lion's share of 70 per cent in the Original Equipment Manufacturer (OEM) passenger car segment, 40 per cent share of two wheeler OEM market and 20 per cent of commercial vehicle OEM market.

It supplies 70 per cent of the paint requirement of Maruti (India's largest passenger car manufacturer) besides supplying to other customers like Telco, Toyota, Hindustan Motors, Hero Honda, TVS-Suzuki, Mahindra & Mahindra, Ashok Leyland, Ford India, PAL Peugeot and Bajaj Auto. Nerolac also controls 20 per cent of the consumer durables segment with clients like Whirlpool and Godrej GE. The company is also venturing into new areas like painting of plastic, coil coatings and cans. Asian Paints second after Nerolac in the industrial segment with a 15 per cent market share. But with its joint venture Asian- PPG Industries, the company is aggressively targeting the automobile sector. It has now emerged as a 100 cent OEM supplier to Daewoo, Hyundai, Ford and General Motors and is all set to ride on the automobile boom. Berger and ICI are the other players in the sector with 10 per cent and 9 per cent shares respectively. Shalimar too, has an 8 per cent share.

	D/E	Market Cap
Asian Paints Ltd.	0.12	67,239,765,079
Berger Paints India Ltd.	0.19	20,639,712,102
I C I India Ltd.	0.00	6,058,461,299
Kansai Nerolac Paints Ltd.	0.27	2,986,693,380

	Levered Beta	Unlevered beta	R	R2
Asian Paints Ltd.	0.27	0.25	0.16	0.03
Berger Paints India Ltd.	0.36	0.32	0.16	0.05
I C I India Ltd.	0.51	0.51	0.37	0.14
Kansai Nerolac Paints Ltd.	0.33	0.28	0.22	0.05
Industry beta	**0.37**	**0.34**		
Weighted Industry beta	**0.30**	**0.28**		

The 5 year beta for Asian paints is below that of its peer, this could be mainly attributed to the size and pricing power which gives more stability to the revenue model and performance of the company. It's important to note that the R2 is quite low so the above value might be questionable (as to the degree that they represent the actual volatility). The unlevered beta for the industry is 0.26.

One Year beta values

Year	Beta	
	AP	ICI
2006	0.46	0.36
2005	0.35	0.36
2004	0.37	0.59
2003	0.20	0.44
6 year (weekly)	0.27	0.51

Operating Leverage	12.93%	13.92%	13.96%	15.28%
Financial Leverage	1.186775	1.209711	1.250095	1.273189

As is evident from the table above the company's beta has increased from 0.20 in 2003 to 0.46 in 2006. This indicates that the market views the company to be more risky; however since the debt rate has decreasing until year 2006 and operating leverage has also decreased from 15.28% in 2003 to 12.93 in 2006 it indicates that the business risk has increased.

The 5 year weekly beta is less than the one year beta, this is because stocks are less volatile when measured over a longer period of time. Long-term investors would be more interested in long-term volatility and short term traders would be more concerned with the short term volatilities. However both short and long term investors should monitor the short term betas because they indicate the current health of the company.

We believe the increase in business risk is attributable to the changes in the macro economic environment. The competition in the competition Paint Industry is becoming increasingly more and more fierce. Currently Asian paints has managed to increase its market share from 33% 2 years ago to 46% market share through an aggressive marketing campaign, but there are other forefront players in the Indian paint industry such as Nerolac Paints with 18% (mainly in the industrial sector), followed by Berger Paints with 14% share and ICI India and Jenson and Nicholson constitute 11% and 6 respectively. There are local other players as well like Bombay Paints, Shalimar Paints and soon overseas player will emerge. Once the Quantity restrictions are lifted from the markets global players will be competing head on head against the local paint companies the bottom lines of Indian manufacturers are bound to come under a great amount of pressure especially given that an imported emulsion paint cost Rs 35/- to Rs 40/-, whereas Indian manufacturers sell at about Rs 85/- to Rs 90/- per litre.

International retailers had until January 2006 been able to operate in India only through franchise arrangements with local partners. The Indian Government passed a regulation in January 2006 allowing entry of foreign single retail brands without the need for franchise arrangement.

Starting February 2006, foreign single retail brands are allowed to:

- Open their own stores in India, or
- Own up to 51% of local joint ventures

All the above macroeconomic factors will adding pressures in margins and prices thus this will definitely have a negative effect on sales, (the quantity restrictions are expected to be lifted by next year).

Market risk premium

Mkt. Risk Premium	
Jan 1, 1996	903
Nov 24, 2006	3950.85
Rm	14.36%
Rm - Rf	6.76%

The market risk premium was calculated based on the CAGR for the NIFTY index in the past 11 years.

Cost of capital & WACC

The above table show the cost of capital based and WACC based on the g5 year and 1 year betas.

	Weighted 5/1 year	1 Year
Risk Free rate		
T- bills	6.71%	6.71%
Gov bonds	7.43%	7.43%
Rm - Rf	6.75%	6.75%
D/E	0.23	0.23
Mar Tax	35%	35%
Beta		
Equity beta	0.34	0.46
Unlevered Beta	0.3	0.4
Ke	**9.73%**	**10.53%**
WACC		
Equity/V	0.94	0.94
Debt/Value	0.06	0.06
Kd	8.43%	8.43%
Kd*(1-t)	0.055	0.055
WACC	**9.47%**	**10.22%**

Analysts Opinions:

Analysts Reports				
Analyst/ Research Firm	**Batlivala & Karani**	**India Info Line**	**B&K research;**	**Average**
Sales	17.50%	22.90%	15.20%	**18.53%**
PAT	21.90%	26.70%	19.70%	**22.77%**
Operating Profit	18.50%	23.60%	19.60%	**20.57%**
Paint Industry	14.50%	15%	14%	**14.50%**
ROE	35.60%	36.40%	35.50%	**35.83%**

Cost Analysis

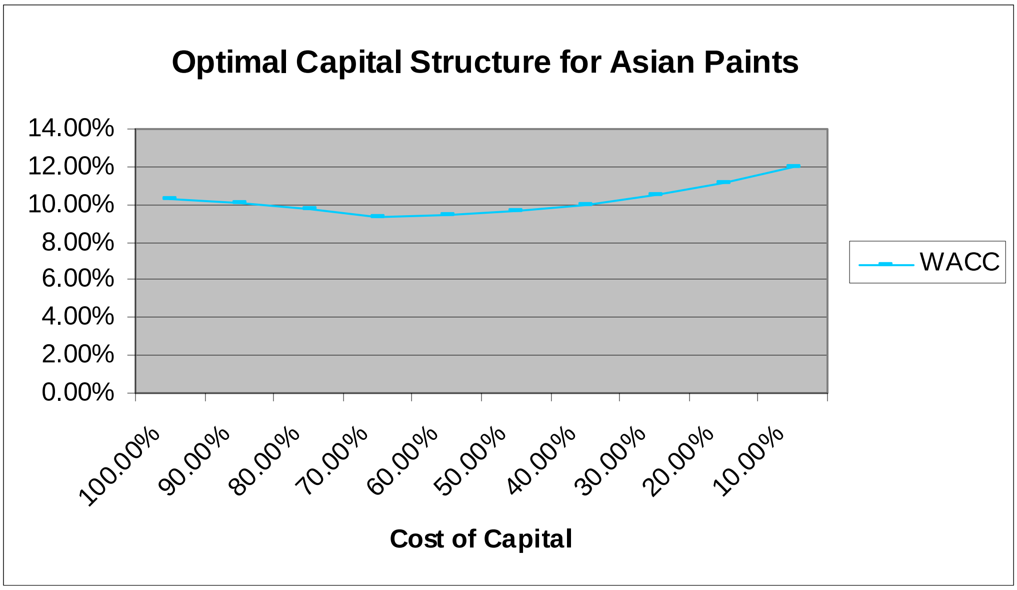
Most imported raw materials fall under the peak custom duty structure. The 5% reduction in peak custom duty announced in the budget has helped the company contain raw material cost to a certain extent.

The raw material prices have seen an increase due to rising crude oil prices. The management has said that inventories and working capital are well under control. Rising freight charges also pose a problem.

The major raw materials include titanium dioxide, phthalic anhydride and peutarithrithol, these constitute 50 per cent of the total cost. There are other raw materials such as castor, linseed and soybean oils, turpentine. The raw materials cost sums up to a whopping 70 per cent. The table below covers the major raw materials that are used by Asian Paints to manufacture paints.

Raw Materials in Rs. Cr			Mar-06
Product Name	**Unit**	**Quantity**	**Value**
Pigments	MT	144,122	339.87
Solvents	KL	54,685	170.89
Additives	MT	16,720	145.86
Orthoxylene	MT	25,604	95.8
Oils	MT	23,399	92.92
Resins	MT	13,508	77.34
Monomers	MT	9,272	77.32
Others	MT	14,313	47
Cost of goods sold	NA	NA	28.27
Paints-Purchased	MT	12,770	23.99
Methanol	MT	7,038	10.94
Acetaldehyde	MT	1,888	7.17
Miscellaneous	MT	NA	0
Solvents	MT	5,301	0
Total			**1,117.30**

Capital Structure



The optimal capital structure is that with a 33% debt to equity ratio, this D/E structure will maximize the firm value. The current capital structure is 23% debt to equity. Hence the company has the potential to further maximize the firm value by increasing its debt level to 33%

Assumptions:

		Phase 3 (Constant)	Phase 2 growth (2 years)				Phase 1 growth (Years)	
DDM Growth rates		7.50%	9.00%	11.00%	12%	14%	15%	15%
FCFE Growth rates		6%	6.5%	7%	8%	9%	9%	9%
Beta	0.34							
Rm-Rf	6.75%							
Ke	0.09725							

First Phase: The growth rates for the first 2 years was assumed to be around 15%. The actual growth in the first 2 quarters of this year was 22% and the last two quarter growth should be higher because it includes Diwalli season (which is s a major season). This exponential growth is mainly attributed to aggressive marketing activities that the company is taking; the company has been following a very aggressive market approach and has seen its market share rise from 33% to 46% this year.

According to HDGC Securities the paints market is growing in the range of 14-15%. Construction of 6 million houses envisaged over a period of next four years (starting from 2006) under the Bharat Nirman Programme signals a buoyant demand for decorative paints.

Further more the construction boom that is currently in India and the more that is expected to come is more likely to create more and more demand for paints. To capitalize on all these growth opportunities the company is engaging in expansionary plans through acquisitions and through high capx (1 billion Rupees this year).
Based on the above it seems more than reasonable to assume a 15% growth rate[1].

The **second Phase** is where the growth in EPS declines to reach the economy growth rates over a period of four years. Since the demand for paints are economy driven and India is a fast emerging economy that is expected to experience high growth rates for the next 20 years or so, however the forecast is set on a declining trend for four years because of potential competition in the local markets. Its important to note that this company has a very high reach and to be successful in the paints industry reach is very important and as such it will take time for competitions to catch up. Also the outlook for oil indicates that demand will exceed supply over the next 30 years and since petroleum products form a significant percentage of raw material costs it will be modest to expect margins to drop to some extent (even though Asian paints has a high pricing power)

The **third Stage** is where the company matures and the growth rates reach the economy growth rates (6-8%). The reason why we assumed the terminal growth to higher range (of the economy growth) is due to many factor some are company specific and other are related to the macroeconomic and global conditions:

- The aggressive nature of the Asian paints management has created an organizational culture that is aggressive and oriented towards excellence.

- The brand value and reach that Asian Paints enjoys will enable it to achieve higher stable growth rates than it peers.

- There is a shift in consumer preferences (Lotus Strategic Management Consultants) in the paints industry in India; consumers are more becoming more environment friendly and as such preferences are shifting towards better grade paints that are more environment friendly like the ones produced by Asian paints.

- Also the expansion and growth in international operations (was growing at 15% this year) that the company aims to achieve (they plan to acquire more companies outside India to form to be as an entry into new foreign markets) will also support the company to maintain high growth rates during this phase.

[1] Please note that the correlation between the Growth in EPS and the growth is sales is .67 as such the growth rate in sales should approximate 22.5%. This correlation should be retested periodically to determine its viability.

FCFE

The growth rates that were assumed for FCFE were calculated based on the historical relationship between the growth in sales and PAT. Also the CAPX expansion was smoothed over the first two years, in later years it was assumed as a percentage of sales. Changes in working capital were assumed as a percentage of the increase in sales. The major Capx expenditure was in the first two years (! Billion Rupees based on the management estimates).

The most appropriate models for valuation are the FCFE and DDM because the company is large and has a stable cash flow as well as a stable and clear dividend policy. Relative price multiples give skewed values because the size of its closest peer was almost half the size of the company, as such these multiples cannot be compared.

Risks

1. **High dependence on the local economy:** more than 80% of total sales is derived from the domestic market as well macro factors like GDP growth and inflation and in turn consumer sentiment plays a key role in determining the short term demand for paints. Any decrease in GDP growth or purchasing power will affect the demand for paints.

2. **Material costs:** Paint manufacture uses a wide variety of 300 raw materials, of which 50% are petroleum-based. Raw materials, which account for 70% of the total expenditure, are highly sensitive to any fluctuations in crude oil prices and thus susceptible to margin risk. However, the pricing power of the company and the industry as a whole (due to the nature of the product), with the ability to pass on any cost increase to end consumers should limit the impact.

3. **Exchange rates:** The global presence of the company (22 countries) in form of subsidiaries and overseas acquisitions and thus revenue earnings in different currencies makes it vulnerable to risk from exchange rate fluctuations. However this currency risk is not substantial because around 14.7% of sales are from foreign markets.

Data Sources

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2. http://www.nseindia.com
3. http://www.moneycontrol.com
4. Annual reports
5. Industry and Analysts Reports:
    a. Batlivala & Karani
    b. India Info Line
    c. B&K research
    d. Lotus Strategic Management Consultants, "The Indian Paint Industry report"