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SELL

Sector: Paint
 CPM: Rs. 2841
 Target Price: Rs 1913
 Downside: -33%

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Time Period	Asian Paints	S&P BSE Sensex
YTD	2.9	2.16
1 month	16.64	6.96
3 months	36.2	21.4
1 year	64.32	19.51
3 years	33.97	12.39
5 years	26.57	14.35
10 years	26.17	9.49

FINANCIAL SUMMARY

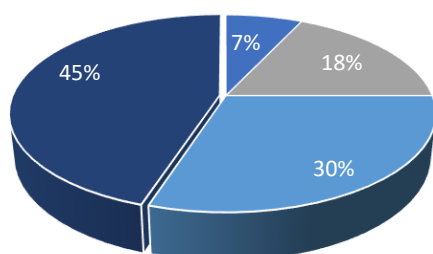
Profit and Loss (in ₹Cr.)	Estimates				
	FY18	FY19	FY20	FY21	FY22
Revenue	16,825	19,240	20,211	19,133	21,621
Revenue Growth (%)	11.7%	14.4%	5.0%	-5.3%	13.0%
GPM (%)	40.1%	39.4%	41.6%	41.0%	41.5%
Gross Profit	6,752	7,577	8,407	7,845	8,973
Employee Cost (%)	6.7%	6.5%	6.8%	6.8%	6.4%
Selling and admin (%)	13.4%	12.3%	13.0%	12.0%	12.3%
Other Expenses (%)	1.0%	1.1%	1.2%	1.2%	1.2%
EBITDA Margin (%)	19.0%	19.6%	20.6%	21.0%	21.6%
EBITDA	3,204	3,765	4,162	4,013	4,662
Depreciation (%)	2.1%	3.2%	3.9%	3.9%	3.9%
Other Income (%)	2.0%	1.4%	1.8%	1.7%	1.6%
Interest (%)	0.2%	0.6%	0.5%	0.5%	0.5%
PBT	3,138	3,306	3,629	3,503	4,065
Tax Rate	33.2%	33.2%	23.6%	25.2%	25.2%
PAT	2,098	2,208	2,774	2,621	3,042
EPS	21.87	23.02	28.92	27.33	31.71

SECTOR OVERVIEW

GLOBAL PICTURE OF PAINT INDUSTRY

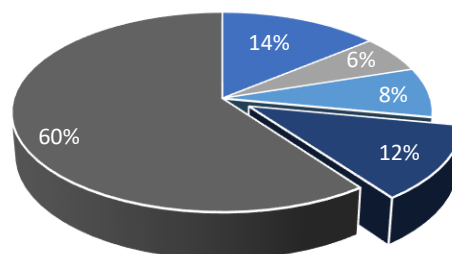
As against the worldwide paints industry, which generates revenue of ₹11,70,665 Cr., the Indian paint industry is valued at ≈₹50,000 Cr. as on FY20. Asia Pacific Region (APAC), the world's largest coatings market with 45% market share and valued at ₹5,00,000 Cr.+ in 2019, has been growing faster than the global markets on account of relatively higher growth in the economy, especially in China and India. China has the largest share in the APAC market of 60% in terms of volume and value followed by India and Japan with 12% and 8% share respectively.

Exhibit 1: Global – APAC Shares 45% of market share



■ Latin America ■ US and Canada ■ EMEA ■ Asia Pacific

Exhibit 2: APAC – Top 3 countries command 80% of market share



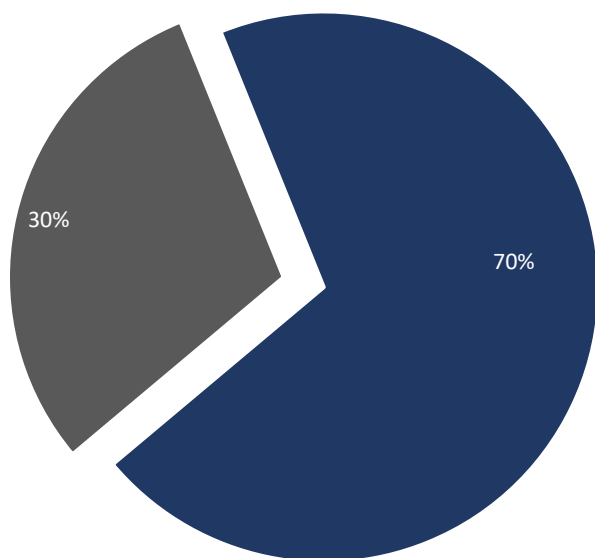
■ Others ■ Korea ■ Japan ■ India ■ China

Globally, the top 10 companies dominate the market with more than 50% market share. However, APAC and China remain fragmented with regional and international players co-existing in these markets. The Indian paint market, unlike APAC and China, is an **oligopolistic market** with the top 4 players controlling a little less than 70% market share of the overall domestic paint industry.

INDIAN PAINT INDUSTRY

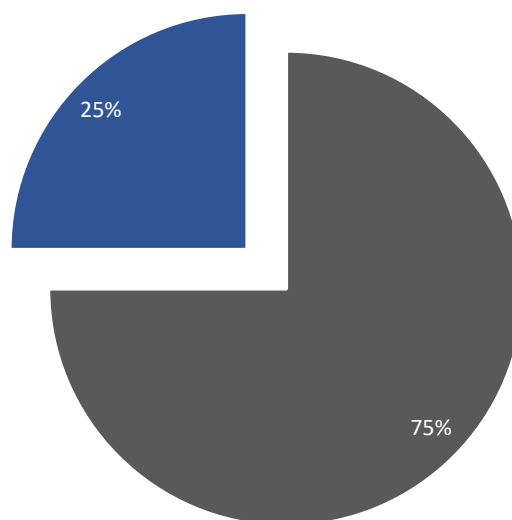
Indian Paint Industry is dominated by the decorative segment with 70% market share. Industrial paint's lower contribution in India's overall paint market is attributable to lower industrial and infrastructure development compared to other matured countries where both the segments hold almost equal share in the market.

Exhibit 3: Unorganized sector holds significant share in Indian paint industry



■ Organised Sector ■ Unorganised Sector

Exhibit 4: Decorative segment constitutes 3/4th of total paint market share

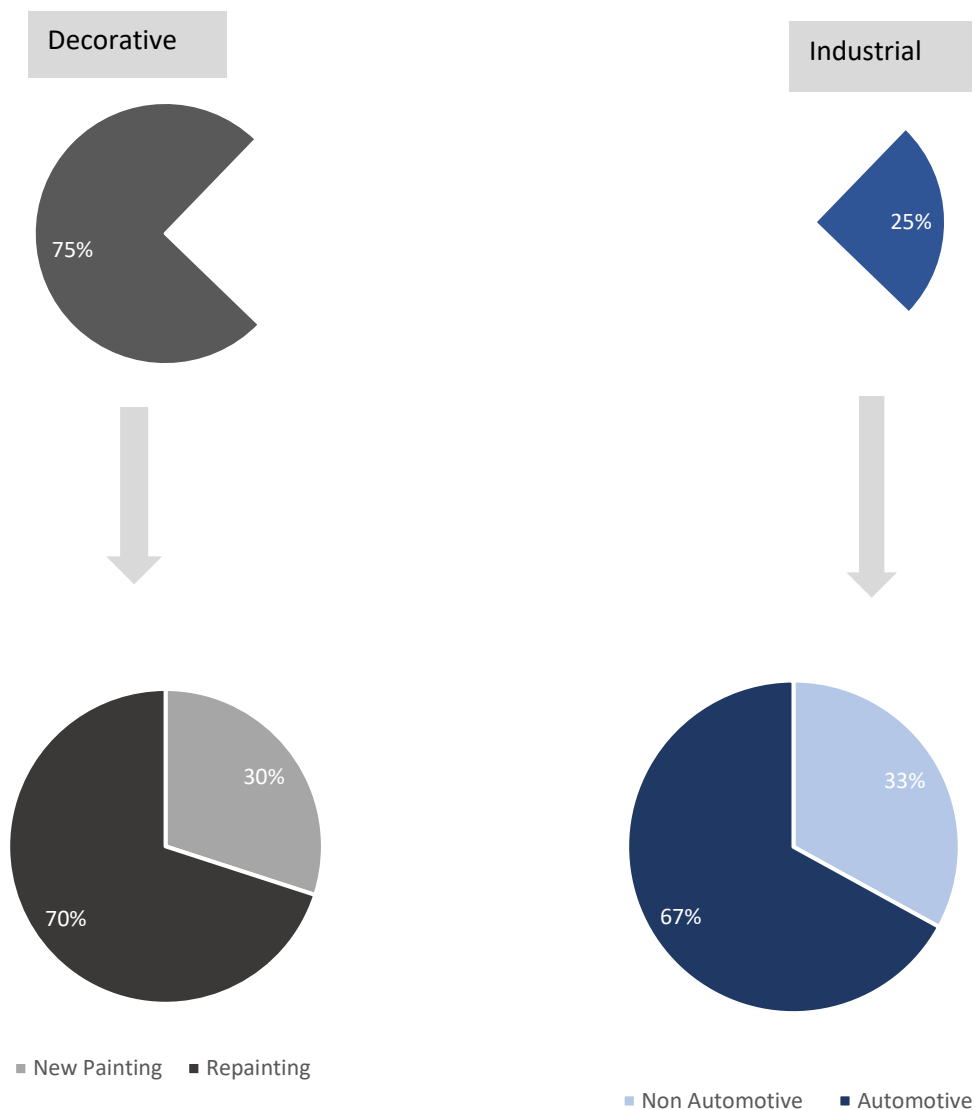


■ Decorative ■ Industrial

Unorganized sector plays a prominent role in meeting the demand of decorative segment of the paint industry. Owing to lack of penetration by big players in tier2/3/4 cities, unorganized players are able to fill the gap by reaching places big player could never reach. Also, since **decorative segment** is a B2C business involving negligible technical know-how requirement, it becomes easier for unorganized sector to operate with comparative ease.

Industrial segment dynamics differ from that of the decorative segment, making it difficult for unorganized player to gain any significant market share in this segment. B2B environment and high demand for product innovation becomes a barrier on entry for unorganized players.

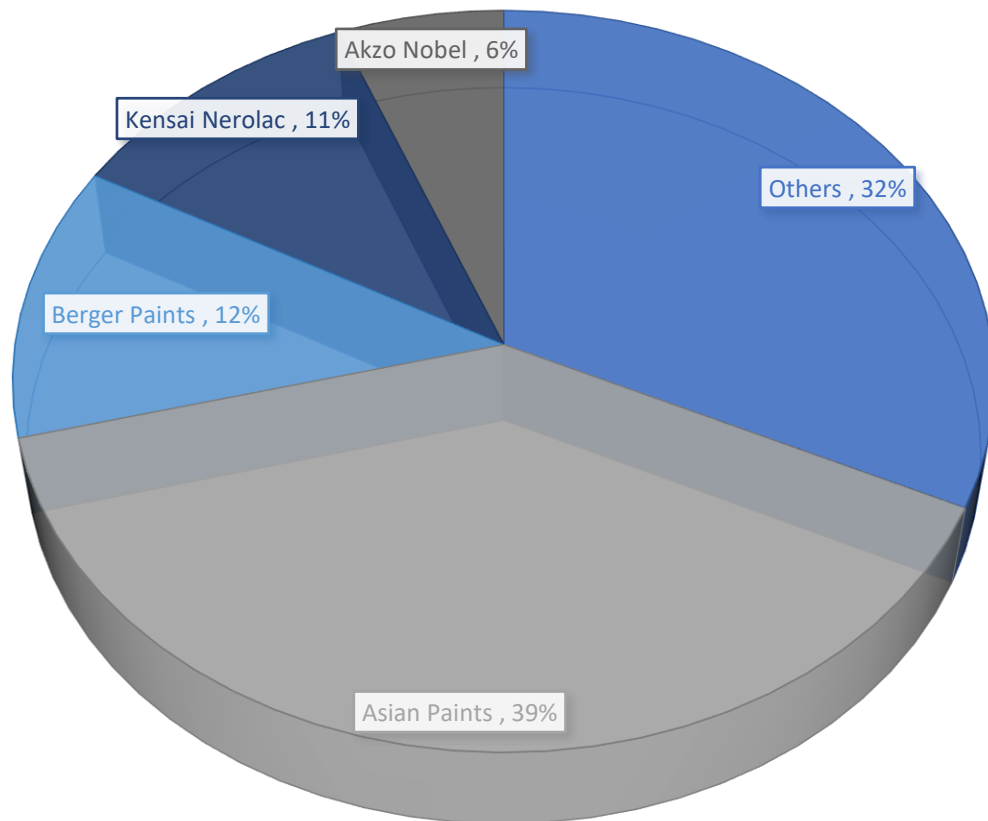
Exhibit 5: The decorative and industrial units are further divided into sub categories



70% of the decorative segment demand generates from repainting needs primarily during festive seasons while the rest of it is from new housing projects. This is why even with a depressed real estate market for last couple of years, volumes were consistently increasing in the décor segment.

Unlike décor segment, industrial segment greatly depends upon auto-sector of the economy, since ≈45% of the demand comes from auto-coating and auto-refinishing. Infrastructure projects and manufacturing industries too contribute towards industrial paint and coating demand.

Exhibit 6: India's Paint Industry is a textbook example of an Oligopolistic market with top 4 players holding roughly 70% of the market share



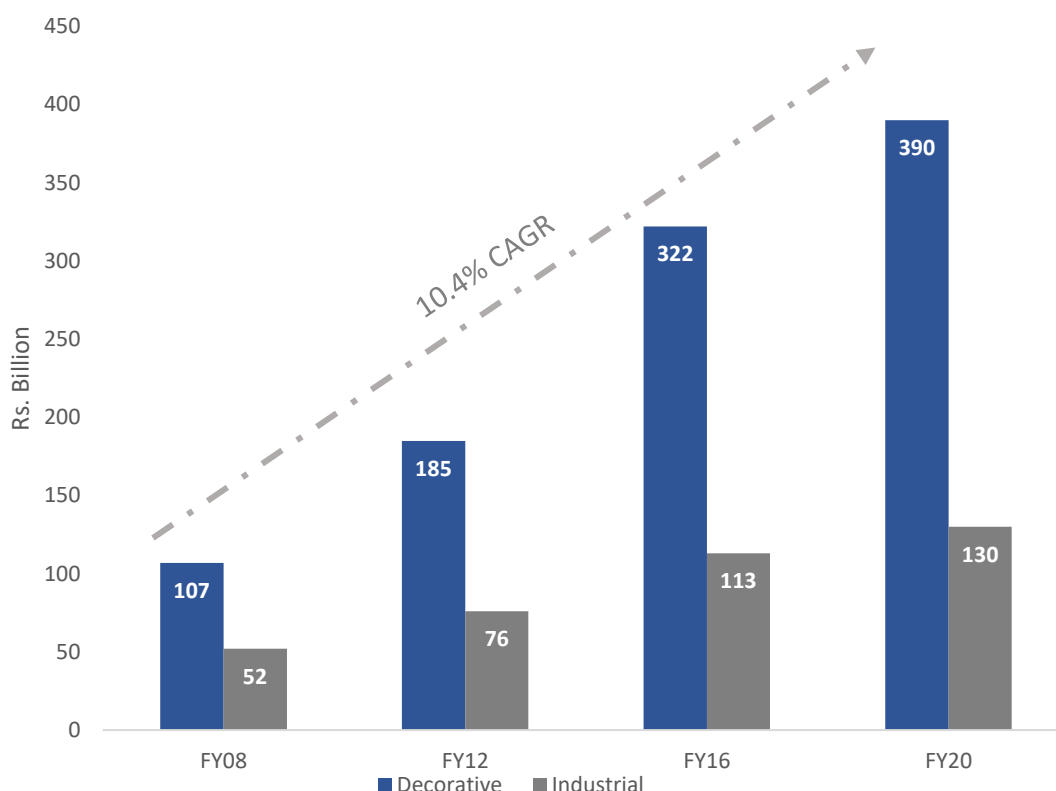
Indian paint industry is oligopolistic in nature. Oligopoly is a market structure with a small number of large sized firms, none of which can keep the others from having significant influence. The concentration ratio measures the market share of the largest firms. In India major share is dominated by Asian Paints, Berger Paints, Kensai Nerolac and Azko Nobel.

While competition is fierce, **none of them follow price war strategies** to compete but strive on product differentiation. This allows them to squeeze cash from the sector without hurting others profits. However, this creates a huge entry barrier for other players to establish footprint in the market.

The Indian Paint Industry has grown at a rate of 10.4% CAGR over the past decade. It grew from 2008, when the market was valued at Rs159bn, to FY20, when the market size reached Rs 520bn. Over the years, the decorative paint segment leads the way by growing in value terms at 11.4% CAGR while the industrial segment lags behind, but still keeps up with 7.9% CAGR.

In medium future too decorative segment is more likely to spearhead growth in the Indian paint industry.

Exhibit 7: Indian Paint Industry has grown at 10.4% CAGR over the past years



The contribution of decorative paints has also increased over the past years. The ratio of decorative to industrial paints has increased from 3:1 in FY08 to 2:1 in FY20.

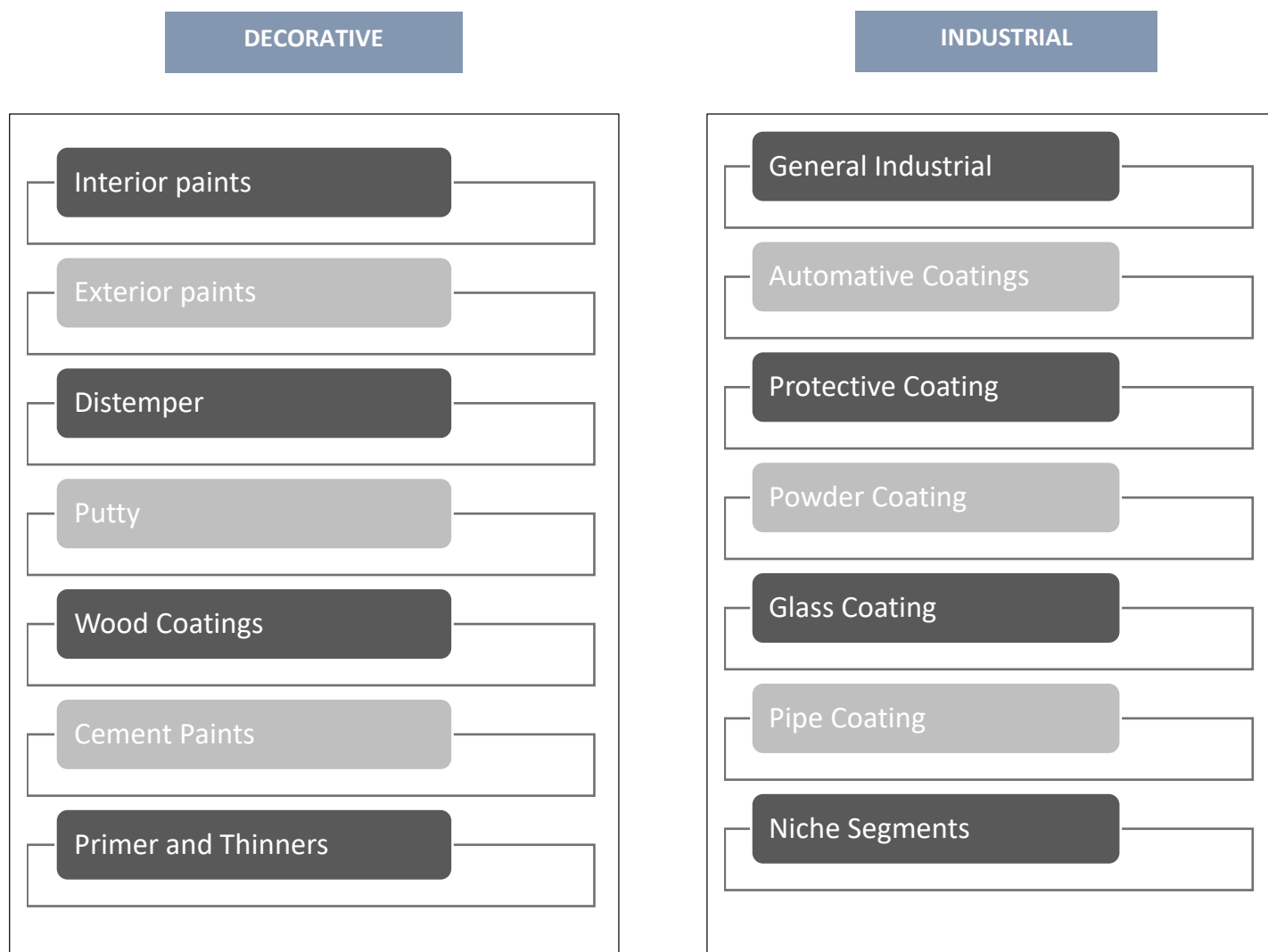
While the trend has been in favor of décor segment, it seems highly unlikely for the paint sector dynamics to skew towards décor segment even further.

COMPONENTS OF PAINT INDUSTRY IN INDIA

The decorative paint segment includes multiple categories depending on the nature of the surface like interior wall paints, exterior wall paints, wood finishes, enamels as well as ancillary products like primers, putties etc.

Industrial segment too has various sub-segments which are targeted by market players by offering innovative products fulfilling different requirements of manufacturing and infra projects.

Exhibit 8: Components of decorative and industrial paints in India



GROWTH DRIVERS

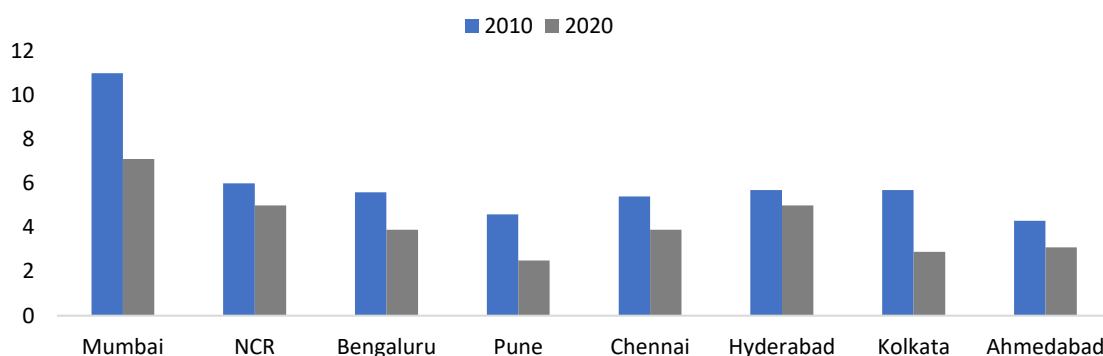
REAL ESTATE REVIVAL

AFFORDABLE RESIDENTIAL HOUSING PRICES

Since major chunk of revenue for Indian cos is attributed to décor segment, trend in realty sector can help us better forecast future paint sector outlook.

The **House Price to Income ratio** has decreased significantly in the past 10 years. Affordable housing coupled with all time low home loan interest rates is a positive sign in favour of demand revival in coming years.

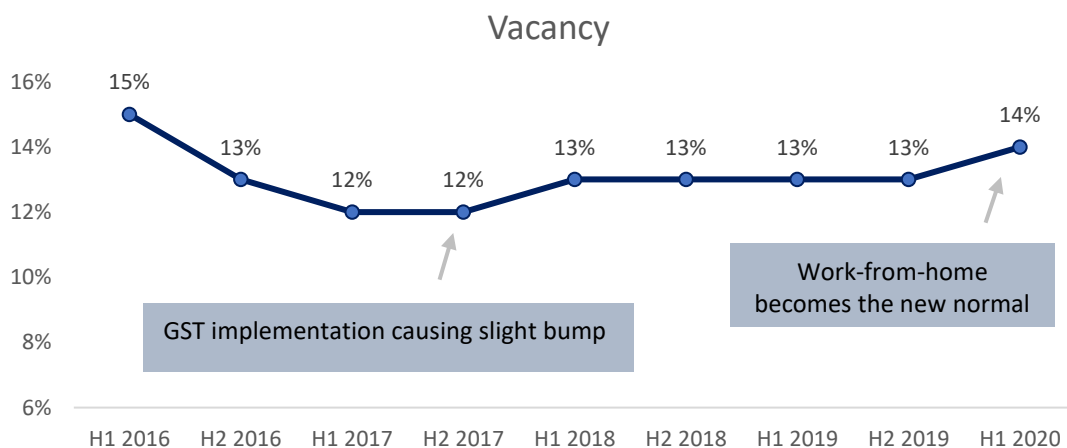
Exhibit 9: Decreasing House Price to Income ratio points at increasing affordability



FALLING OFFICE MARKET VACANCY

With general market vacancy trend going down, rental market looks bullish which can lead to more properties being built in the commercial sector therefore driving growth in demand for paints and coatings.

Exhibit 10: Falling office market vacancy points towards demand exceeding supply

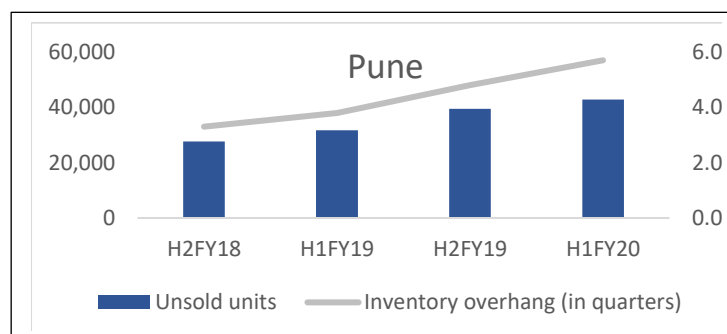
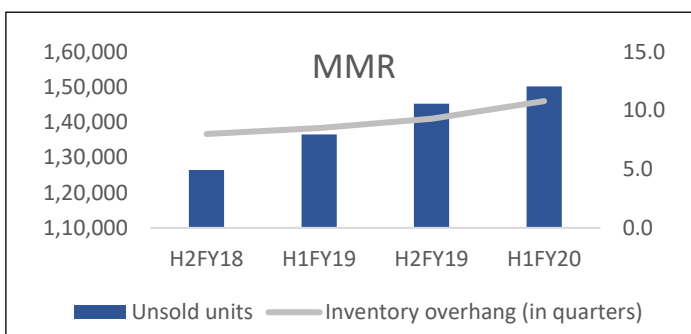
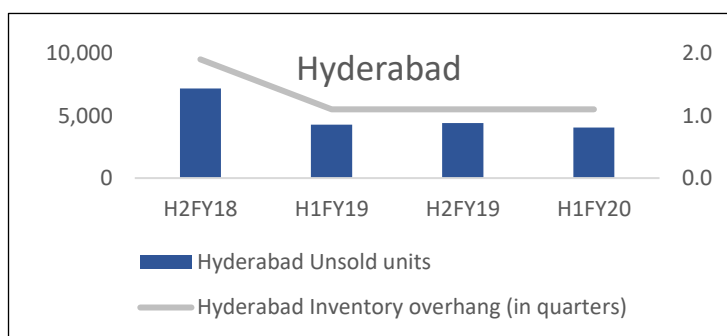
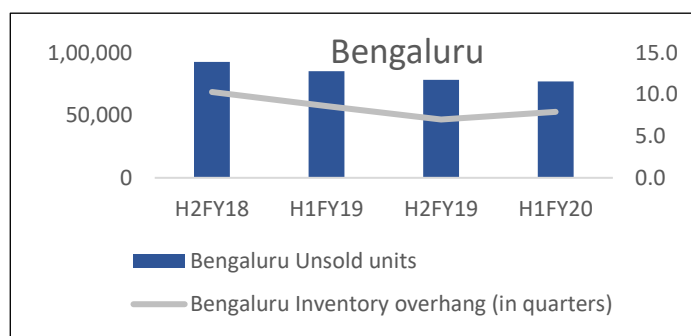
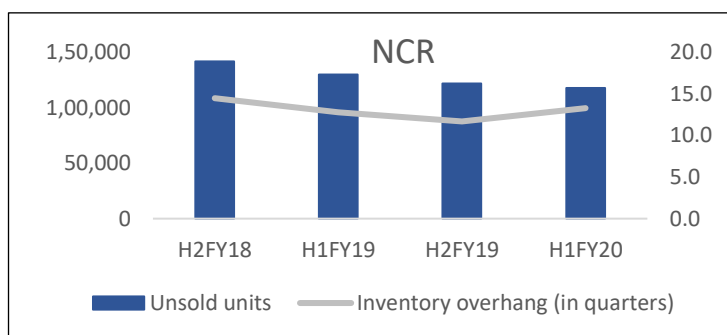
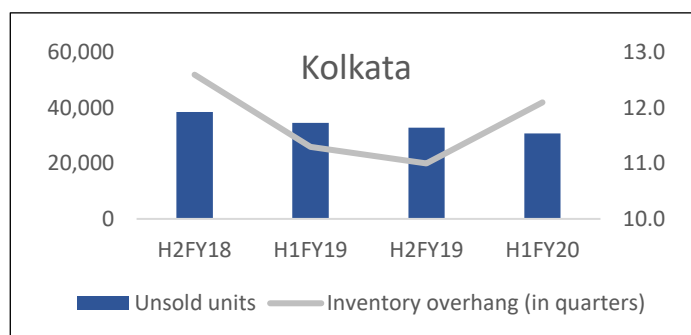
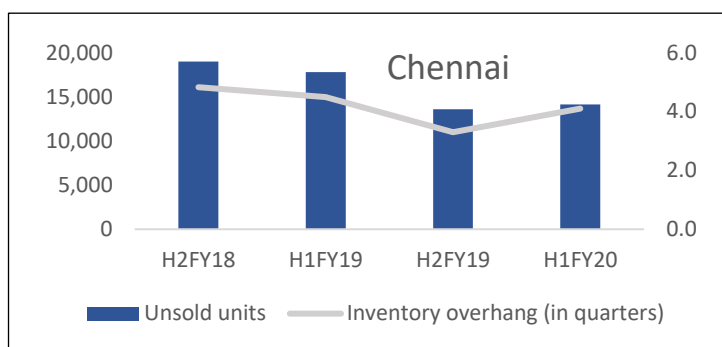
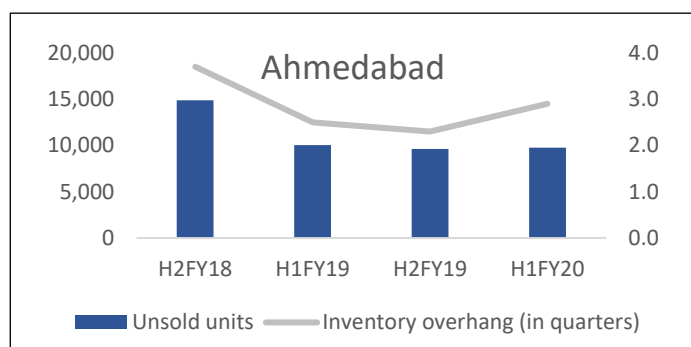


DECREASE IN UNSOLD UNITS OF HOUSING SECTOR

Falling stock of unsold inventory and declining inventory overhang (quarter-to-sale) is sign of increasing velocity of sales volume in the reality sector.

This trend has been witnessed after a very prolonged time of piled up inventory.

Exhibit 11: Decrease in inventory of unsold units of top 8 cities which will lead to a boost in paint industry



SHRINKING REPAINTING CYCLE

Since 70% of the décor segment demand is generated from repainting activities, observing the trend in repainting cycle becomes crucial.

Repainting cycle is much shorter than what it was a decade back and its more likely to shrink even further from 6.9 years to about 5.6 years by 2030, driven by numerous factors ranging from hygiene awareness, increased disposable income and new solutions like virtual painting tools and mechanized painting services.

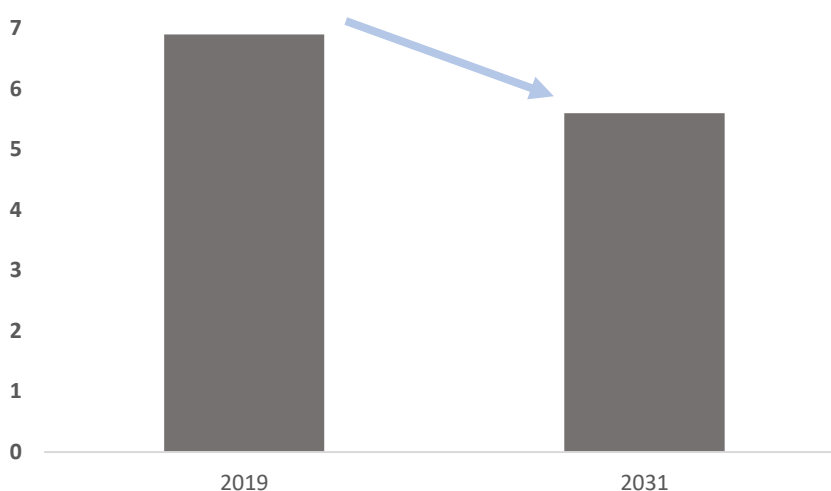
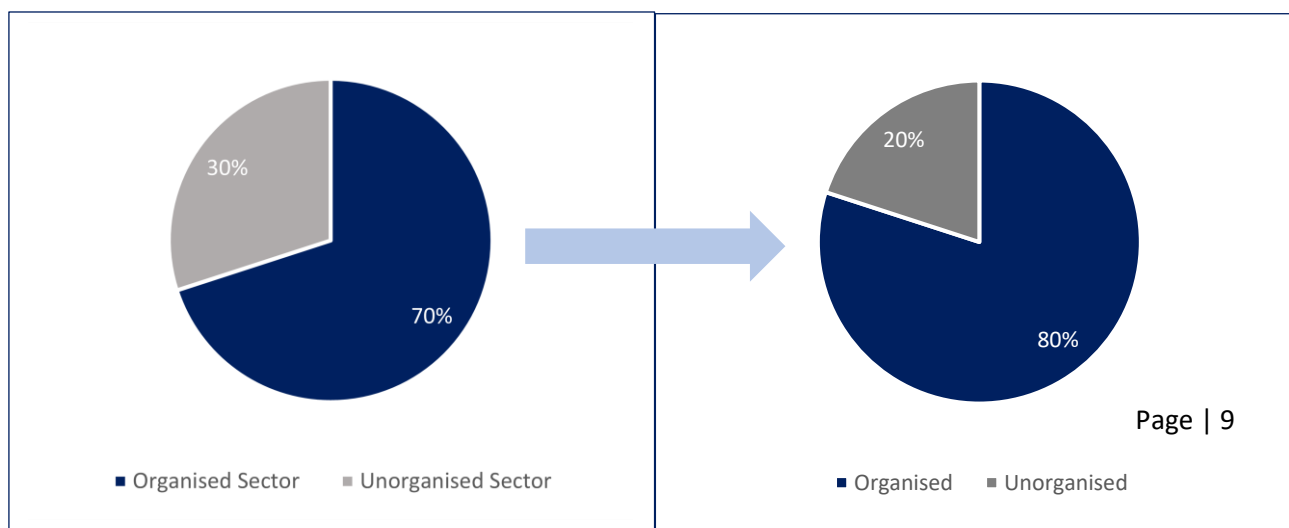


Exhibit 12: Estimated shortening of repainting cycle

INCREASE IN SHARE OF ORGANISED SECTOR

Although unorganized sector has constituted a fair chunk of the paint industry, as markets mature, organically organized sector continues to eat away share of the former. However, this process sped up owing to introduction of GST which hurt unorganized players immensely. Further slash of GST rates from 28% to 18% for paint products gave organized players a breathing room allowing them to capture the market even more. Deeper penetration of cos and cheap availability of tinting machines too has caused irreversible damage to unorganized player.

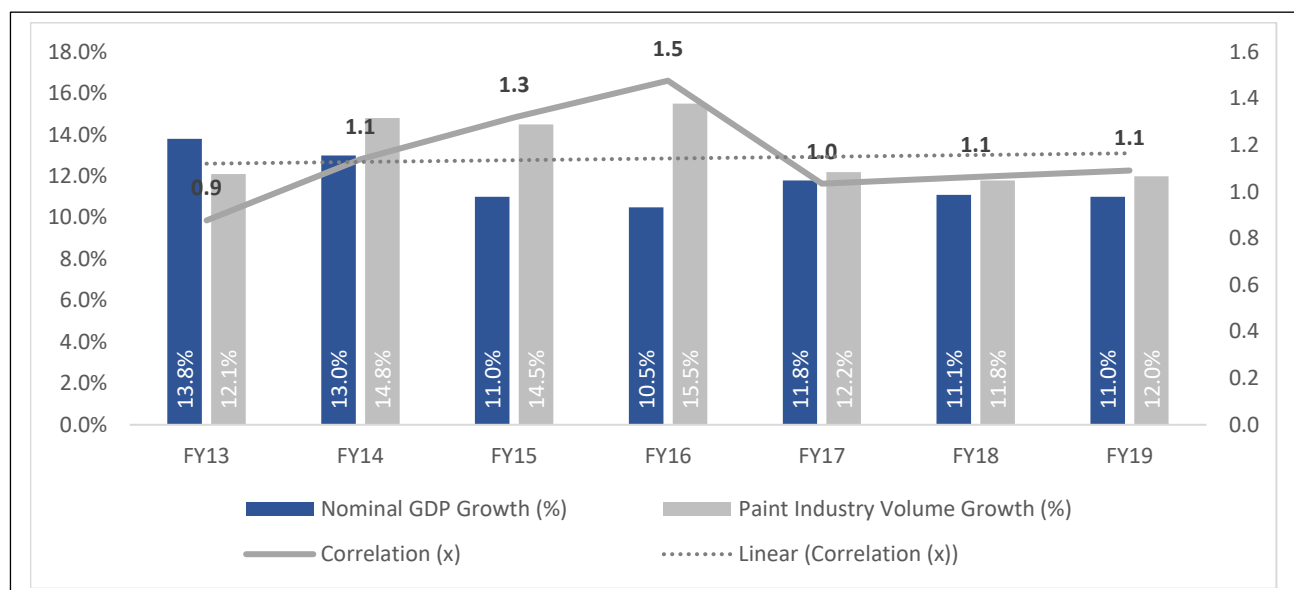
Exhibit 13: Market players expect organized share to increase owing to GST and Tinting machines



\$5 TRILLION INDIAN ECONOMY

Paint industry volume growth is strongly correlated with Nominal GDP growth. On an average, paint industry volume grows *1.14 times* the Nominal GDP growth rate.

Exhibit 14: Strong Correlation b/w Nominal GDP Growth and Paint Industry Volume



With analysts and government estimating Indian economy to reach \$5 trillion mark by 2025, it's safe to conclude that paint industry volumes will jump from 200 Cr. Ltr. to 422 Cr. Ltr. at a 16.1% CAGR. While the value surges from Rs. 50,000 Cr. to Rs. 1,13,745 Cr. by 2025, assuming the paint industry prices rise in tandem with historic WPI for paints and coatings of 1.5%.

With these estimates, the paint industry can grow at a **17.9% CAGR** for the next 5 years.

Exhibit 15: Future Industry Estimates look healthy assuming Paint Volume grows 1.14 times the Nominal GDP Growth

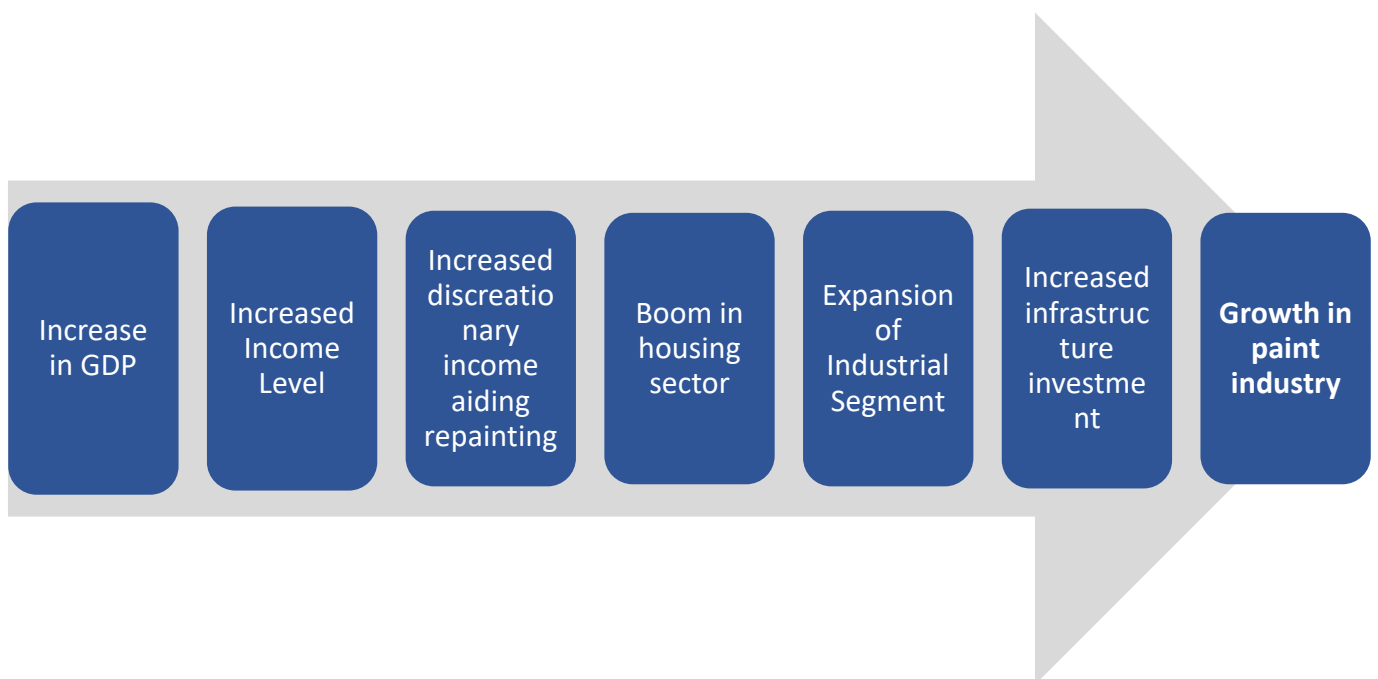
Year	Nominal GDP	Price per litre	Industry Volume	Industry Value
2020	\$2.7 trill.	Rs. 250	200 Cr. Ltr.	Rs 50,000 Cr.
2025	\$5.0 trill.	Rs. 269	422 Cr. Ltr.	Rs 1,13,745 Cr.
2030	\$8.3 trill.	Rs. 290	701 Cr. Ltr.	Rs 2,03,467 Cr.
5 yrs. CAGR	13.1%	1.5%	16.1%	17.9%
10 yrs. CAGR	11.9%	1.5%	13.4%	15.1%

Bloomberg Est.

Exhibit 16: Positive Correlation between GDP and Paint Industry

Relation between paint Industry and GDP

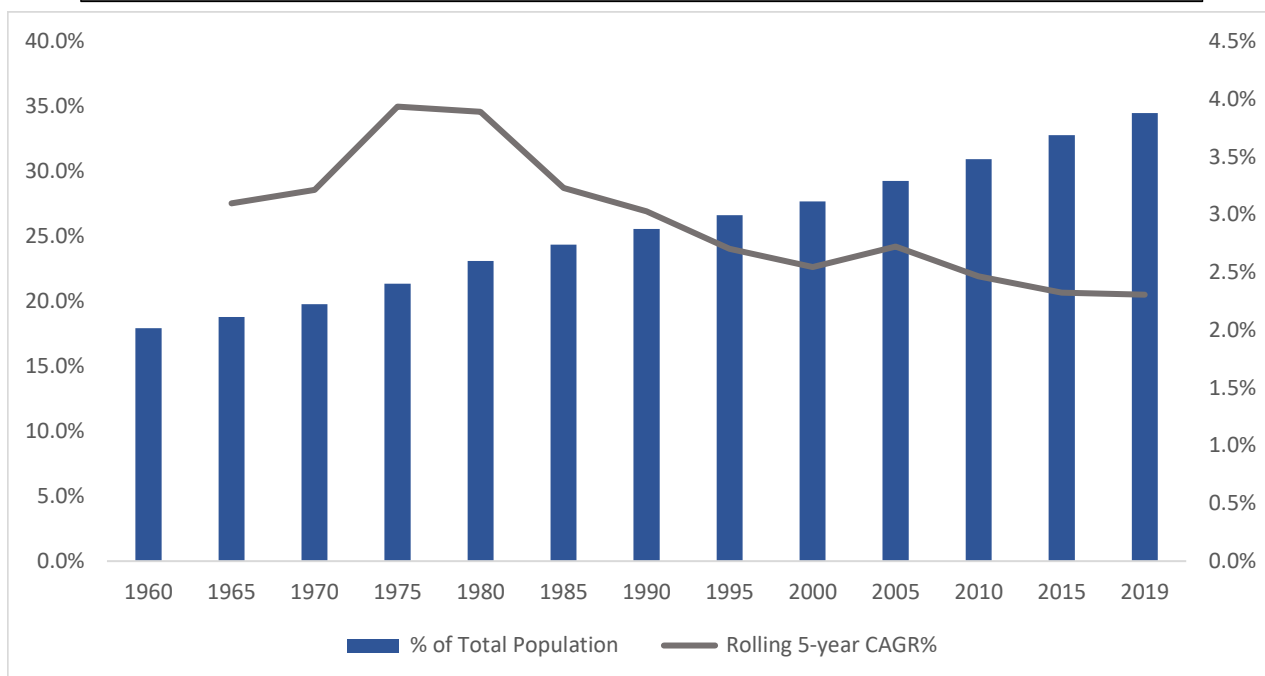
Income Level	Increase in GDP will increase the standard of living. With rise in income level, consumers will increase consumption which in turn will help the decorative segment.
Housing Sector	Growth in housing sector will increase urbanisation, provide cheaper loans and shift from semi - permanent to permanent housing structures will increase spending in the decorative segment.
Industrial Segment	The Industrial segment can be further broken down into protective, general industrial, automotive, powder and margin coatings. This segment accounts for 20% of the paint industry's revenue.
Infrastructure Investment	New projects in roads and ports will increase revenue of paint industry and drive the industrial segment.



URBANIZATION

The UN expects ~40% of India's population to reside in urban areas by 2030. Industry's long-term growth is attributable to many macro-economic and demographic factors, including rise in gross household income, increasing urbanization and rising nuclearization of families. Gross household income has been continuously increasing, albeit at a slower pace in the recent years. Consequent to the rise in disposable income, consumer spends have also been rising. However, the propensity to save (level of savings as a percentage of disposable income) has been gradually declining, thereby reflecting consumers' willingness to spend more than what they used to.

Exhibit 17: Growth of population resulting in increase in demand for household sector



India's urbanization trajectory has shaped well from 25.6% in 1990 to 34.5% in 2019 (34.9% 2020P). Rising urbanization, supported by real estate demand and improving infrastructure, have been boosting paint demand. The UN expects ~40% of India's population to reside in urban areas by 2030. Thus, even going ahead, increasing urbanization will aid the growth of the decorative paint industry. Rising number of households (on account of increasing nuclearization of families) has also been driving demand for housing. Another factor that partially corroborates increase in housing over the years is the rise in home loans. As on FY20, retail housing loans have grown at a 10-year CAGR of more than 16%, which shows consumer's growing aspiration to own a house. While the real estate sector has seen a slowdown in the last two years and may continue to be under stress in the near term, we believe that over the medium to long term the sector's outlook is positive.

UNTAPPED DISTRIBUTION NETWORK

When we talk about distribution network, FMGC has a total of 1.2 Cr. outlets which cater to 108 people per outlet and telecom has a total of 1 Cr. outlets catering to 130 people per outlet. However, the paint industry has 60,000 outlets which cater to 21,667 people per outlet. Since all three sectors are consumer goods, paint industry has a huge potential to grow and tap the distribution network in the coming years.

Exhibit 18: Potential of the Paint Industry to tap the untapped distribution network

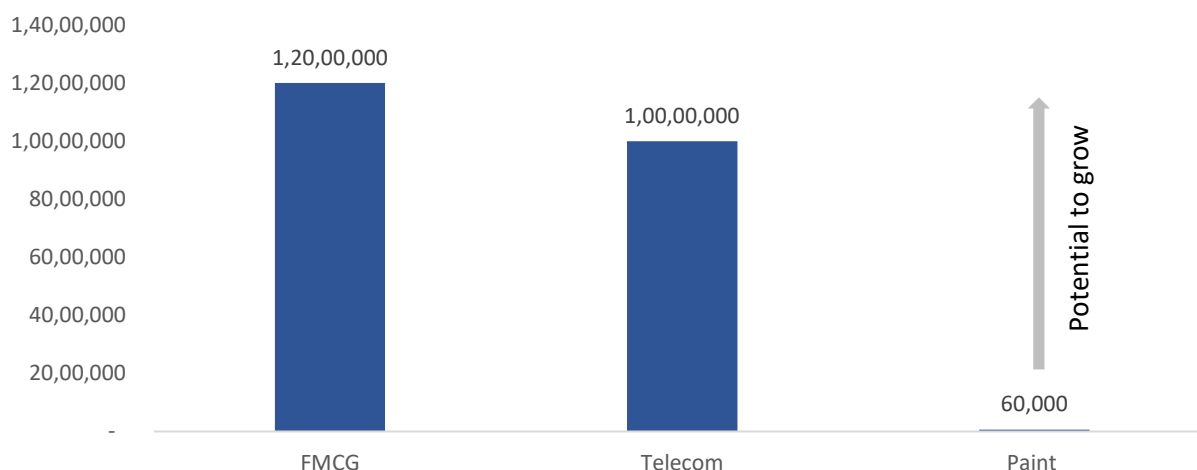
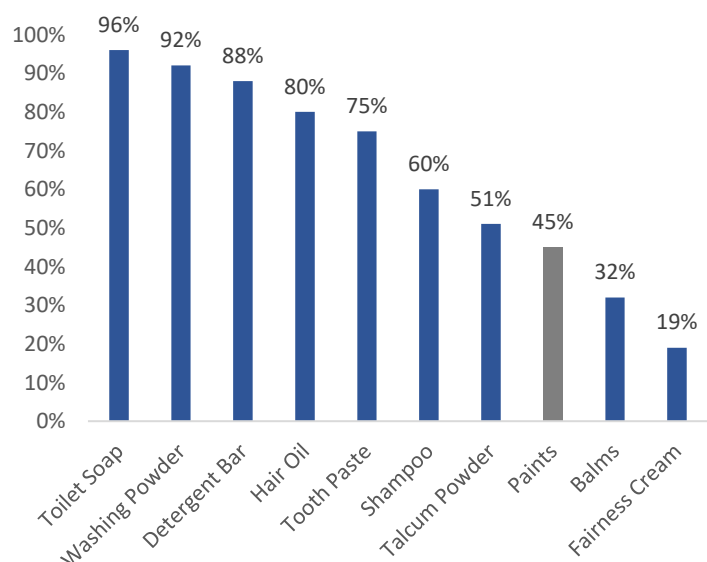


Exhibit 19: Penetration level vis-à-vis other FMCG product portfolio



Penetration of paints in India is at a low ~45% versus >75% penetration seen in other FMCG categories like tooth paste, toilet soap, hair oil, etc. Overall, there's immense scope for growth for the paint companies - estimate the companies to clock double-digit volume growth over at least next decade.

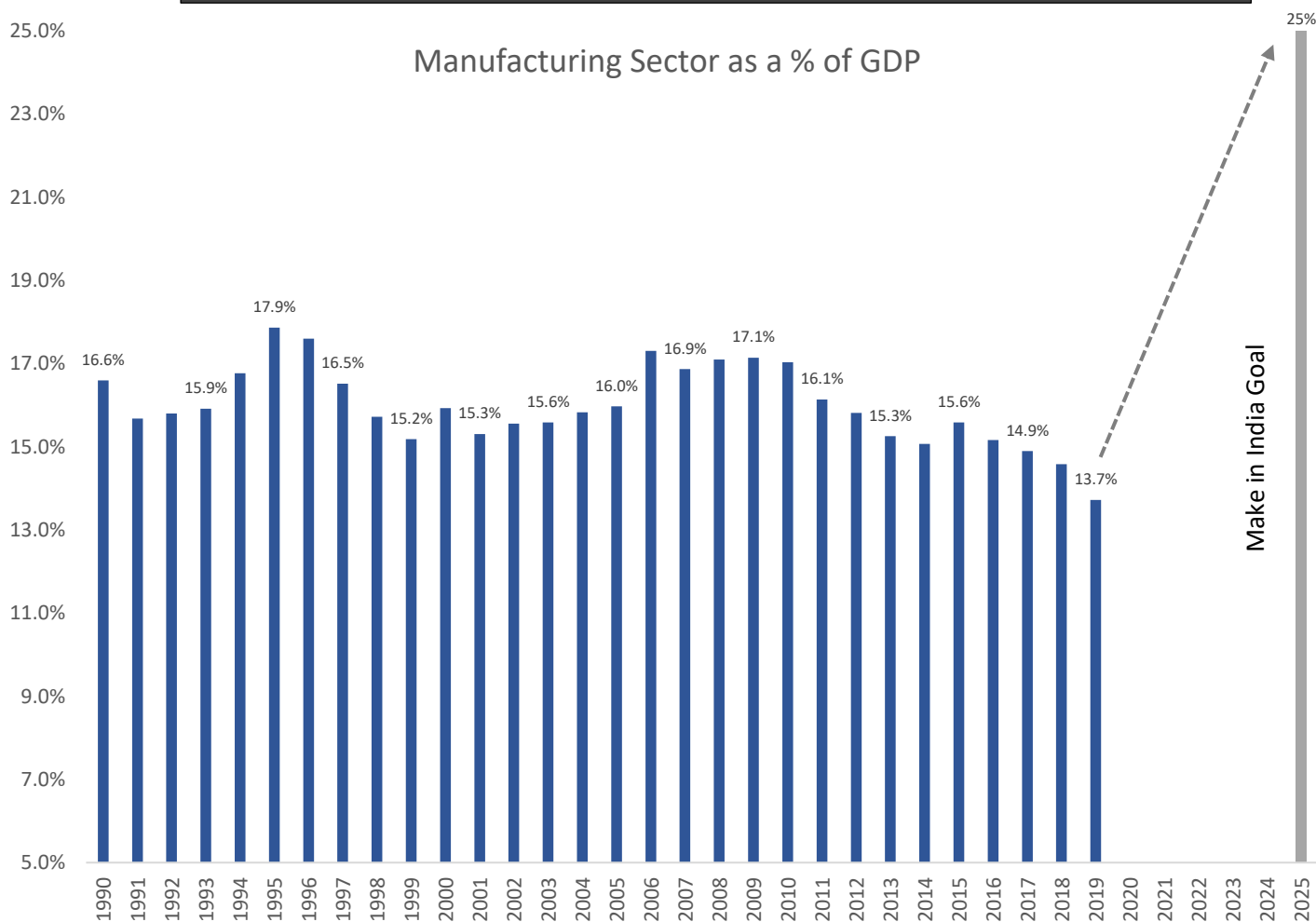
BOOST TO MANUFACTURING SECTOR

Under the Make in India initiative, Government aims to increase the share of the manufacturing sector to country's GDP to 25% by 2025

India is an attractive hub for foreign investments in the manufacturing sector. Several mobile phone, luxury and automobile brands, among others, have set up or are looking to establish their manufacturing bases in the country.

The manufacturing sector of India has the potential to reach US\$ 1 trillion by 2025. The implementation of the Goods and Services Tax (GST) will make India a common market with a GDP of US\$ 2.5 trillion along with a population of 1.32 billion people, which will be a big draw for investors.

Exhibit 20: The expected boost in manufacturing industry will boost the paint industry

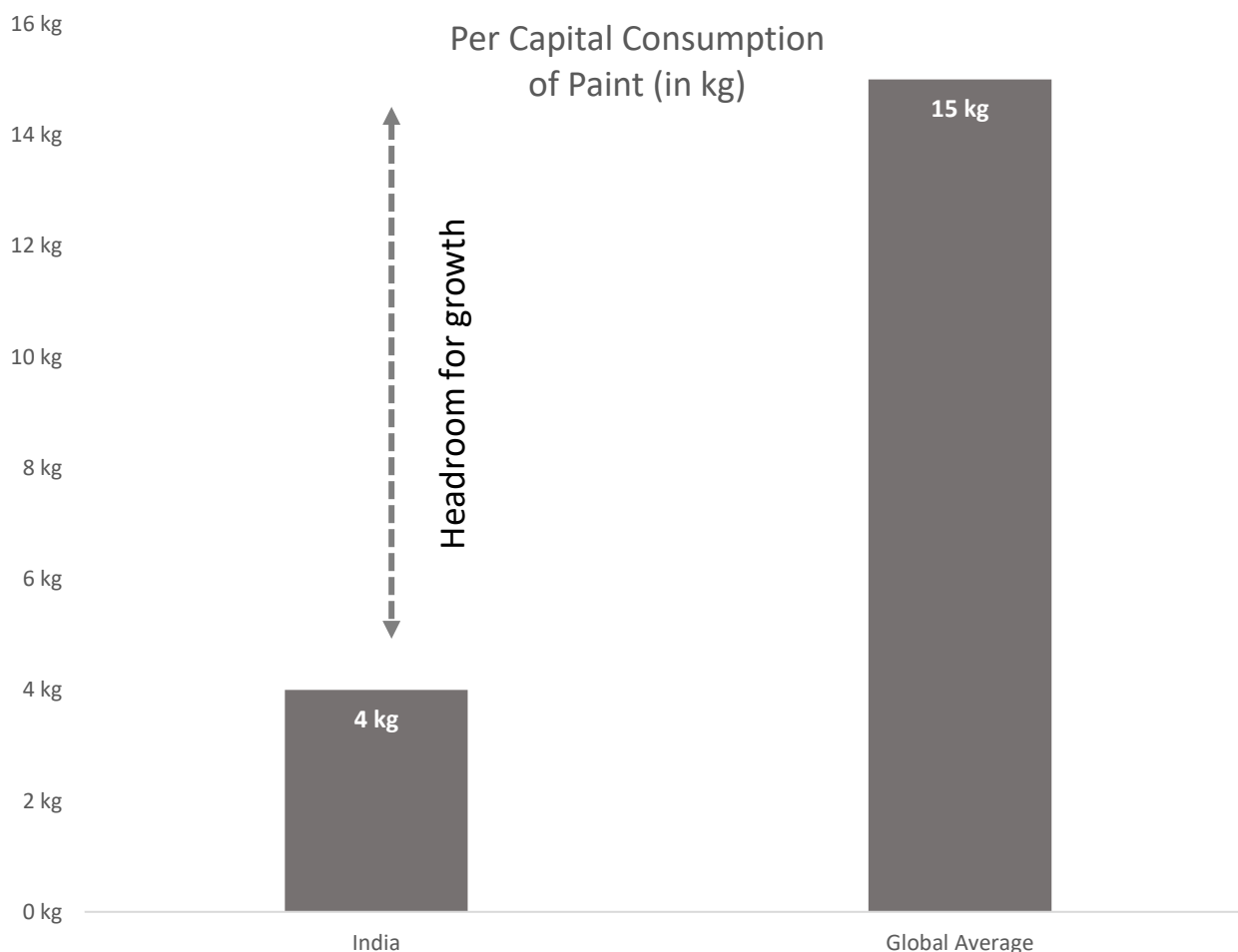


LOW PER CAPITA CONSUMPTION AS COMPARED TO WORLD AVERAGE

The per capita consumption of paints in India, at 4 kgs, is much lower in comparison to some of the other developed economies globally. However, current low per capita consumption is viewed by domestic paint producers as immense future growth opportunity for the paint industry.

The per capita consumption of paints and coatings at 4kg as against global per capita consumption of 15kg provides immense opportunity for market penetration in India. With an increasing disposable income, the percentage of middle class by 2020 would have expanded to 69 percent from 52 percent in 2015

Exhibit 21: Growth potential of per capital consumption

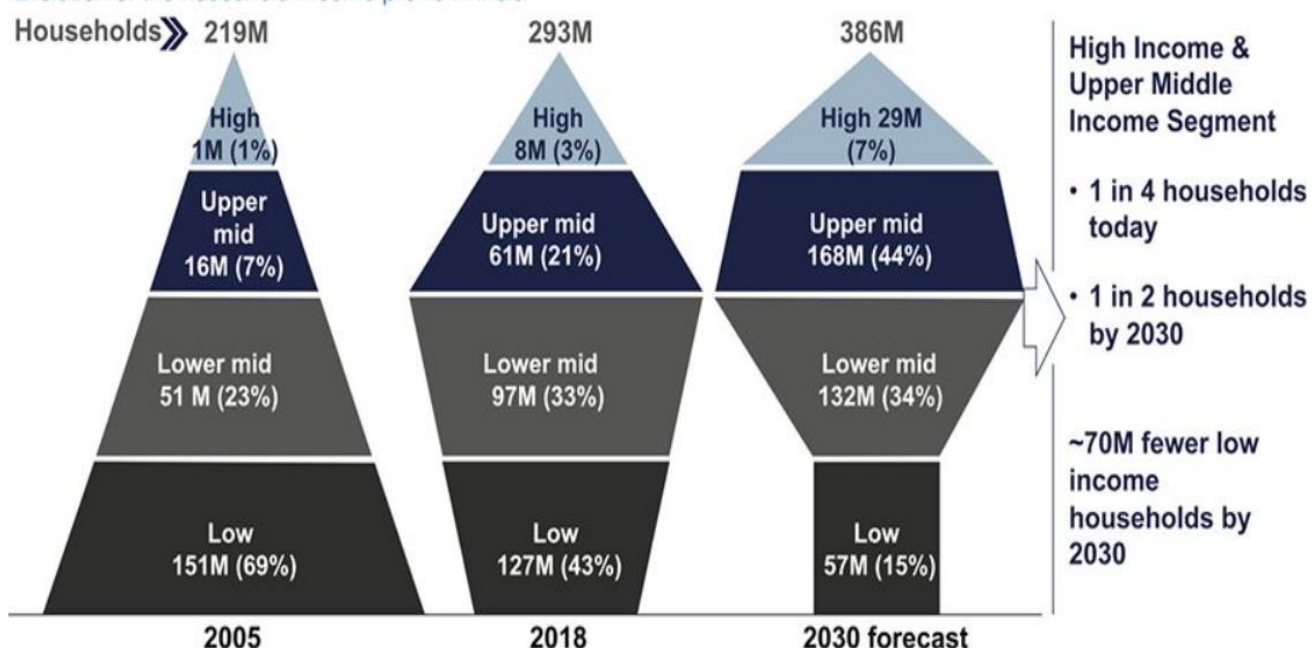


RIISING INCOME OF MIDDLE CLASS

Growing share of middle income coupled with rising urbanization sets foundation for high demand for paint in future.

Exhibit 22: Increase in income of middle class people by 2030 will be beneficial for the paint industry

Evolution of the household-income profile in India



MONSOON

The demand is influenced by monsoon as well. Good monsoon results in an increase in agricultural and industrial output. This has a positive impact on disposable income with people and hence a good demand. But if the monsoon is not good, then the demand will get affected especially in decorative paints segment.

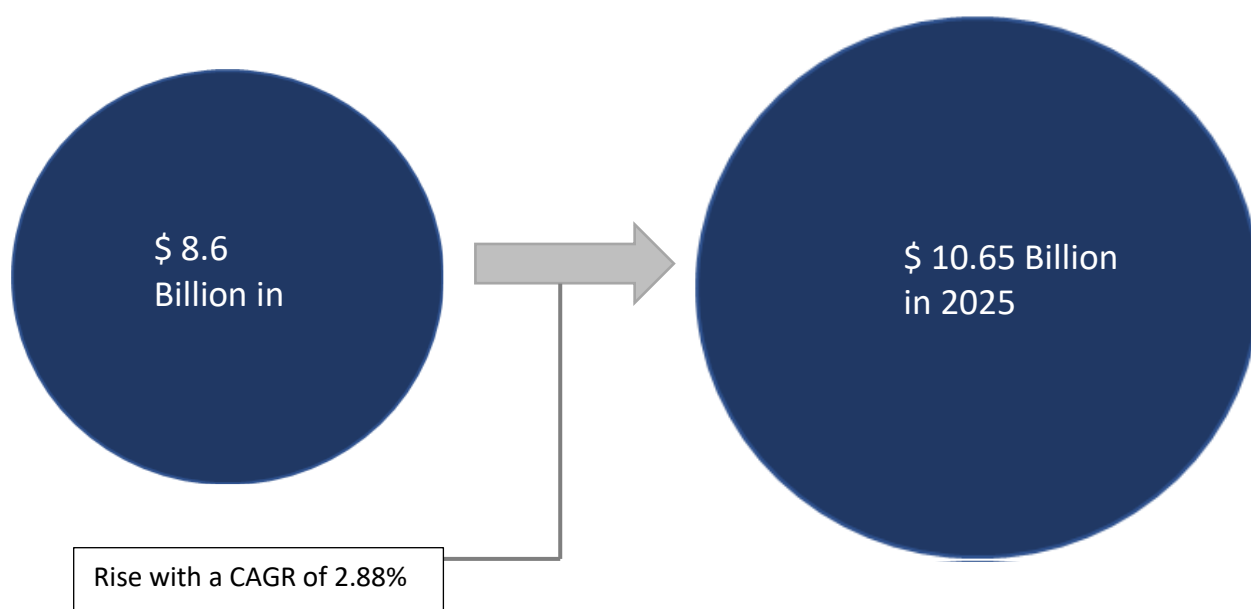
The predictions of a strong monsoon this year is really encouraging for the industry. The rural demand is expected to perk up, which will help to accelerate the growth of the industry, especially in the second half of this fiscal.

Asian Paints, the country's No. 1 player, too, expects the monsoon to boost rural demand. "The outlook on the monsoon appears encouraging and should provide the much-needed succour to the rural economy reeling under the impact of sub-normal rainfall for the past two years. This is also expected to lead to an improved consumer demand from this part of the economy," the company said.

AUTOMOTIVE SECTOR

The Global Automotive Paints Market is estimated to be USD 8.46 Billion in 2017 and is projected to reach USD 10.65 Billion by 2025, at a CAGR of 2.88%, during the forecast period. The automotive paints industry has evolved alongside the automotive industry. The demand for automotive paints and advancements within the paint technology is essentially influenced by factors like the demand trends within the automotive industry, environmental regulations, health & safety norms, buyers' preferences, lifestyle, and growing

Exhibit 23: Growth in automotive sector will lead to a growth in paint industry as well



Asia Oceania is predicted to be the most important marketplace for automotive paints thanks to huge vehicle production and improving the economy. The automotive paints industry has evolved alongside the automotive industry. Both industries are continuously progressing to provide advanced technologies and eco-friendly products to their customers. Passenger cars hold the largest share of total vehicle production globally and also in Asia Oceania.

Passenger cars are expected to be the largest share for automotive paints. Asia Oceania is estimated to be the most important marketplace for electric and hybrid vehicles also. The hybrid vehicle is estimated to be the most important marketplace for automotive paints thanks to the rapid acceptance of hybrid vehicle across the planet. This will help the automotive paint industry to prosper a lot in the coming years.

PEER MAPPING

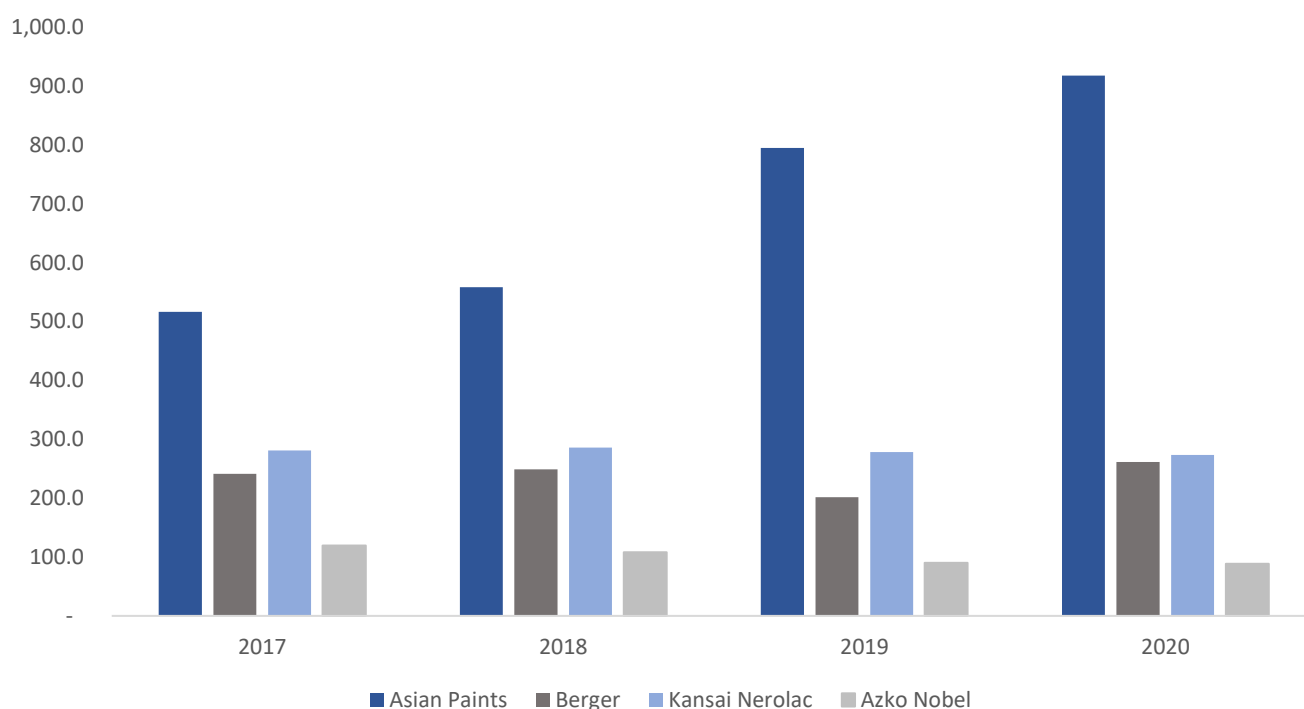
SPENDING ON ADVERTISEMENT

Companies in the sector are largely dependent upon their brand recall value as a source of moat. Especially in the décor segment, which is a B2C business, consumers are more likely to choose a brand that they would have heard of. With consumers becoming more and more aware, the importance of Advertising and Publicity becomes all the more important since now distributors' influence/say in the final decision making of the consumer has reduced significantly.

Exhibit 24: % of sales spent on advertisement

Ad Spend	2018	2019	2020
Asian Paints	3.3%	4.1%	4.5%
Berger	4.8%	3.3%	4.1%
Kansai Nerolac	6.1%	5.1%	5.2%
Azko Nobel	4.0%	3.1%	3.3%

Exhibit 25: Amount (in crore) spent by top four paint companies in advertisement in which Asian paints is leading building a good brand value for themselves



While industry dynamics of ad spend seem fairly stable, it is not shocking to see Indigo Paints, an outlier, aggressively spending towards ad spend to establish themselves as a dominant entity in rural and tier 3/4 markets. Kansai Nerolac too has been very active in ad spend to push their premium segment brand (Dulux) in the minds of final consumers. Since Asian Paints and Berger have already been old household names in the markets with well established distribution chains, 3-4% range seems justified.

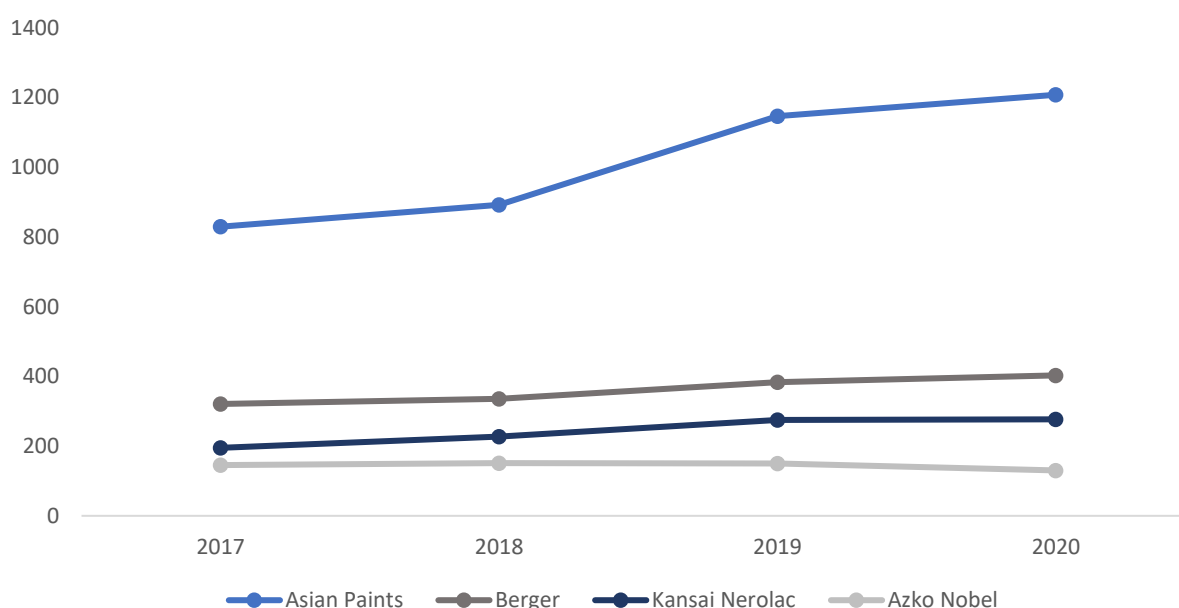
FREIGHT AND HANDLING CHARGES

Beside RM costs, freight and handling charges are a significant portion of expenses after ad spend. Lower % of costs points at operational efficiency and supply chain management, which remains a critical deciding factor in this industry.

Exhibit 26: % of amount spent on Freight and Handling

Freight and Handling Charges	2017	2018	2019	2020
Asian Paints	5.5%	5.3%	6.0%	6.0%
Berger	7.0%	6.5%	6.3%	6.3%
Kansai Nerolac	4.8%	4.9%	5.1%	5.2%
Azko Nobel	5.7%	5.6%	5.1%	4.9%

Exhibit 27: Amount of sales (in crore) spent by top four paint companies in freight and handling charges



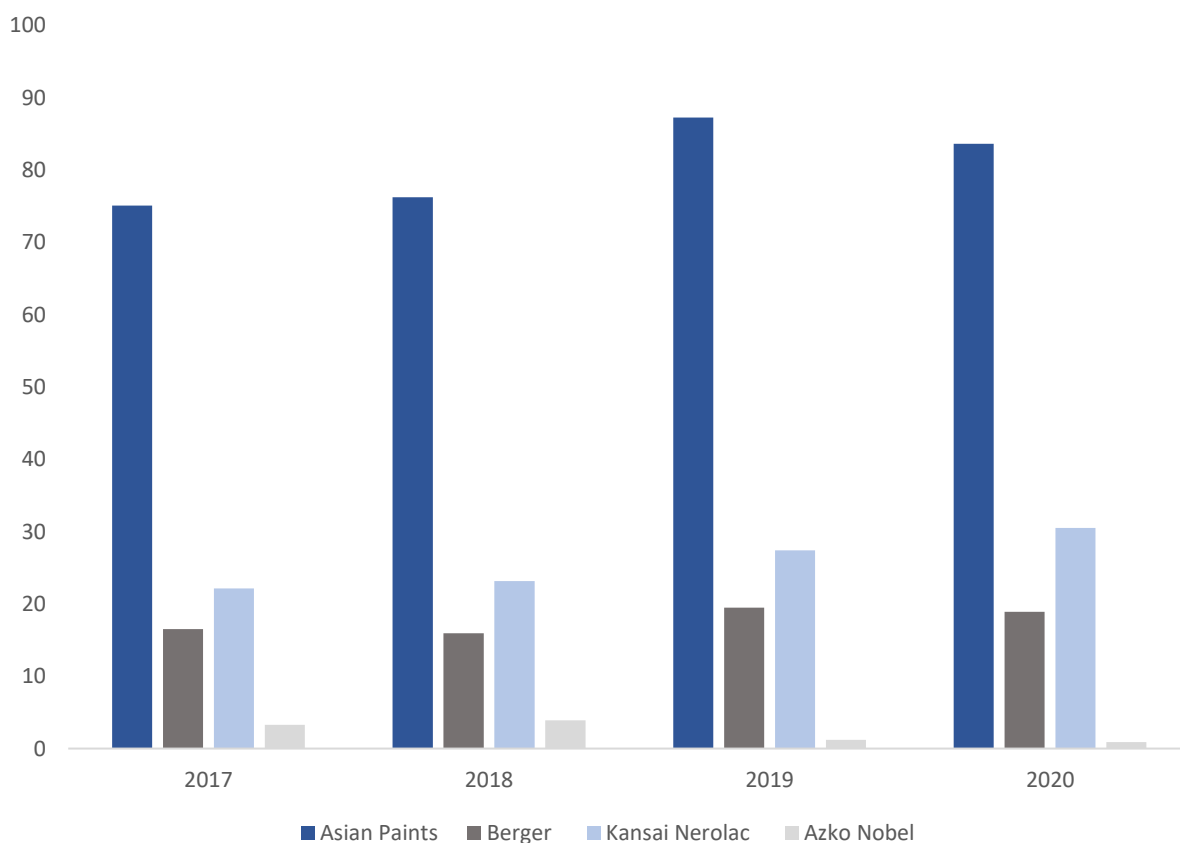
RESEARCH AND DEVELOPMENT SPEND

Development of paint technology has enabled the paint sector evolve over time and meet consumer's demands. Having a good R&D team, especially in the industrial segment, becomes a necessity in order to survive.

Exhibit 28: % of amount spent on Freight

R&D Cost	2017	2018	2019	2020
Asian Paints	0.50%	0.45%	0.45%	0.41%
Berger	0.36%	0.31%	0.32%	0.30%
Kansai Nerolac	0.55%	0.50%	0.51%	0.58%
Azko Nobel	0.13%	0.14%	0.04%	0.03%

Exhibit 29: Amount of sales (in crore) spent by top four paint companies in Research and development



PRODUCTION CAPACITY

With demand drivers of the sector skewing in favor of industry growth, companies cannot afford to lose out on meeting this demand owing to low production capacity. Companies have been in a capex cycle for past couple of years, increasing capacities of existing plants and adding new manufacturing plants in their asset base. This Capex cycle is also partially responsible for falling ROCE which will pick up soon enough once capacity utilization max out. Capacity utilization numbers clearly depict that all companies are ready up to meet the volume growth that picks up with economy growing at faster rate in coming short - medium years.

Exhibit 30: No. of production sites of top four companies in the paint industry

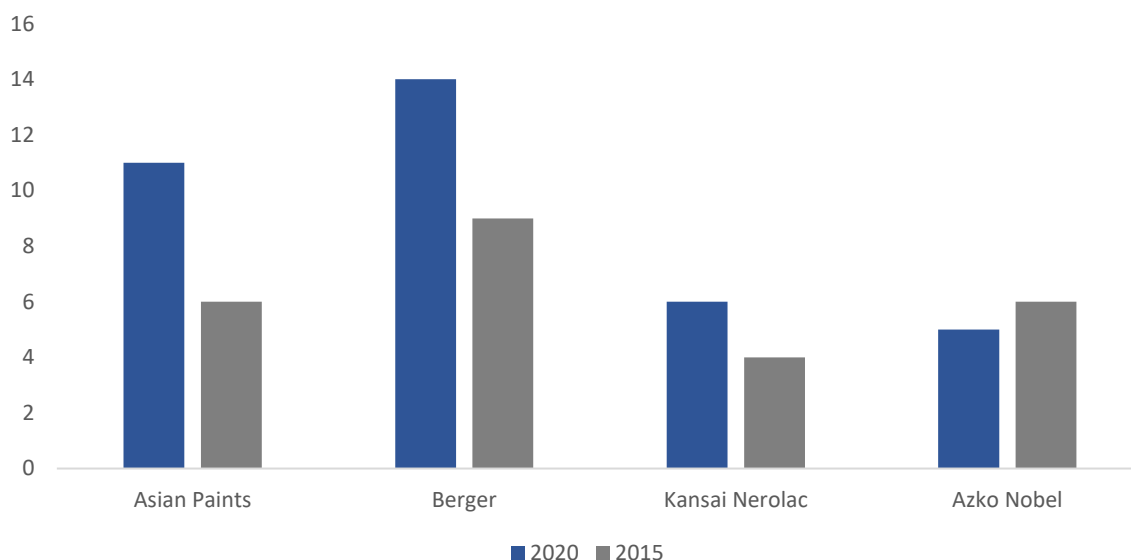


Exhibit 31: Capacity (in Kl/ annum) to produce for FY20

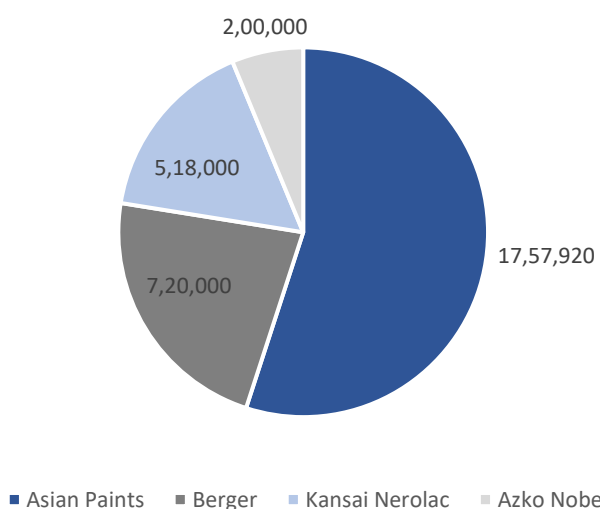
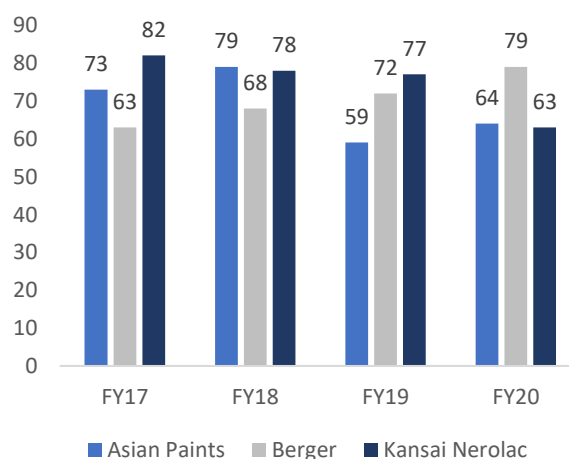


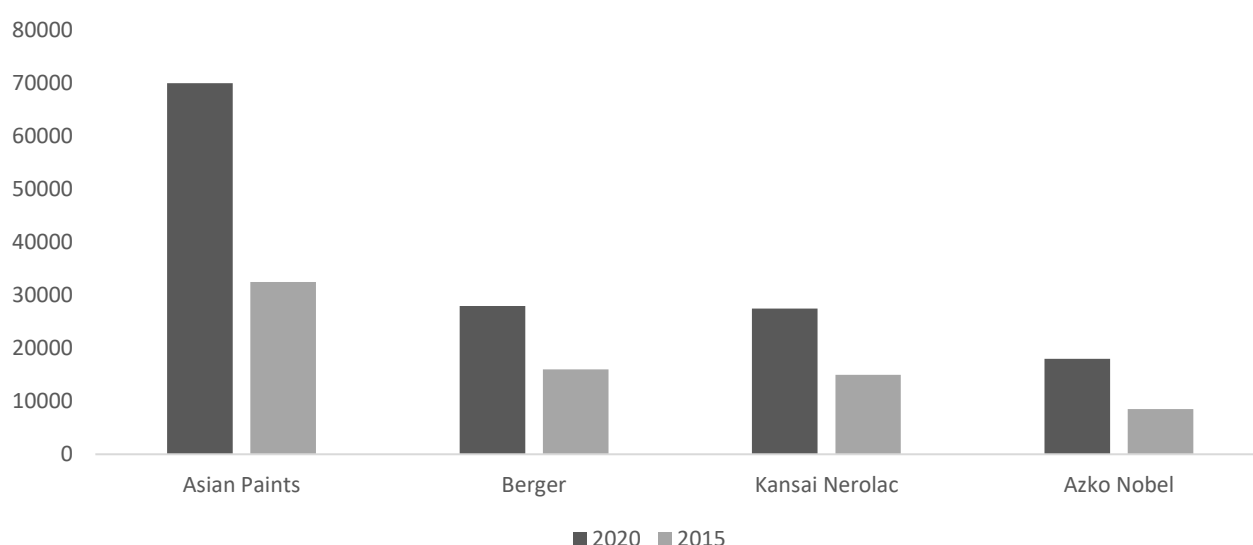
Exhibit 32: There is more room for growth of Asian paints due to low capacity additions (%)



DEALER NETWORK

As concluded earlier, distribution network of paint industry is largely under-penetrated in comparison to other consumer brands. This has been well accepted by these companies who are taking active steps to increase their distribution networks by building their dealers and depot numbers.

Exhibit 33: Potential of paint industry to grow its dealer network



Mere dealer network doesn't give a true picture of company penetration. Availability of tinting machines also is a crucial metric.

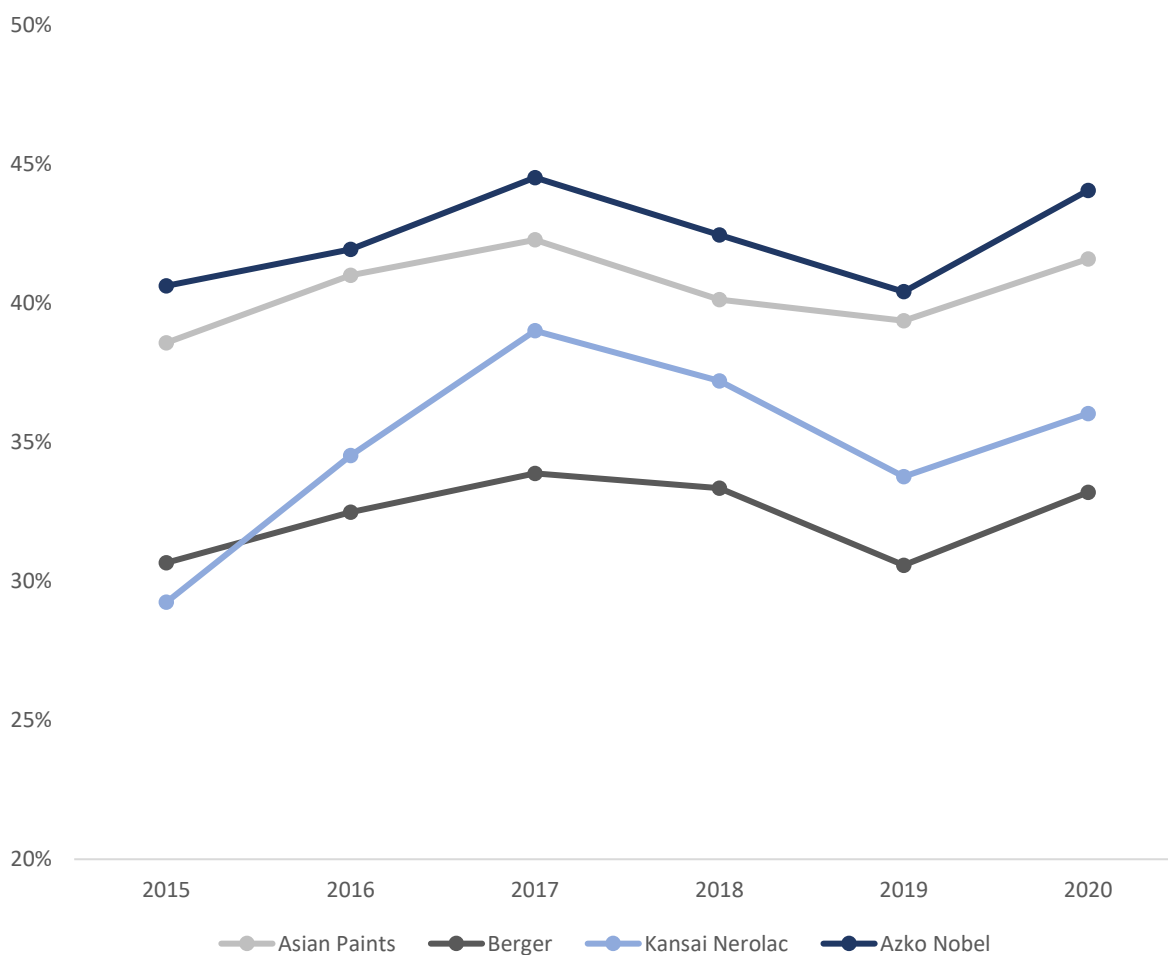
Exhibit 34: (Tinting Machine growth and penetration): Before 2000, machines used to cost approximately Rs. 1 million, due to being imported. With local manufacturing, the cost has decreased to Rs. 0.15 million, typically borne by the paint companies at Asian Paints and Berger Paints.

	Asian Paints	Berger Paints	Kansai Nerolac	Akzo Nobel
FY18	35	14	10	3.2
FY20	46	20	17	5.5
CAGR%	14.6	19.5	30.4	31.1
Tinting Machine to dealer ratio	0.66	0.67	0.62	0.37

GROSS PROFIT MARGIN

Being a raw material intensive industry, gross margins become a key metric to look at. Since 50% of the raw material are crude based derivatives, oil prices and forex rate are huge risks that an investor assumes in this sector. While at times raw material prices can be volatile, companies are able to pass it off to consumers with a few months lag.

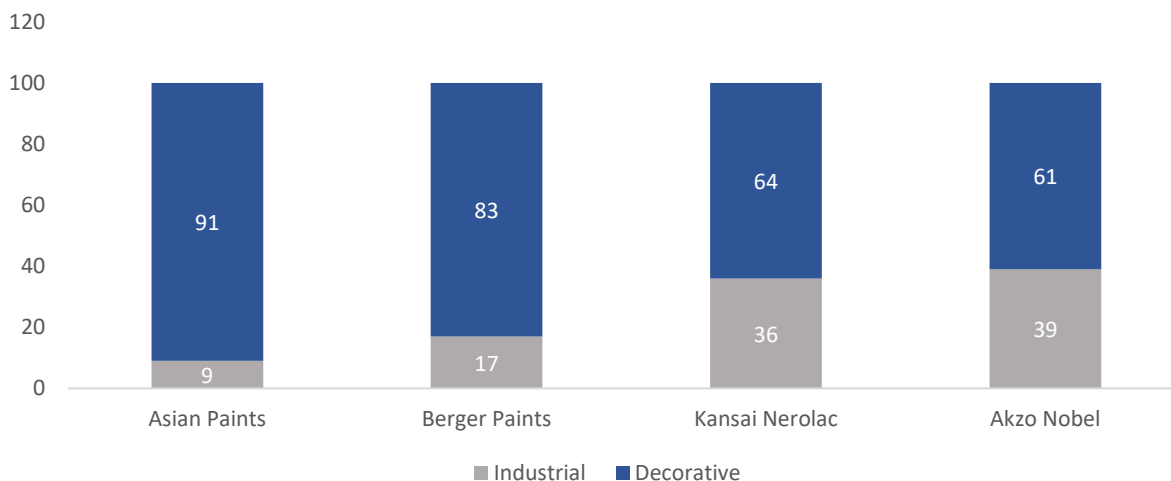
Exhibit 35: GPM of paint industry over a few years



REVENUE MIX

Asian Paints and Berger Paints are more close competitors since their revenue mix is identical to the other, while drawing comparisons between Kansai Nerolac and Akzo Nobel is apt owing large share of their topline being contributed by industrial coatings.

Exhibit 36: Revenue Mix of top four companies of paint industry

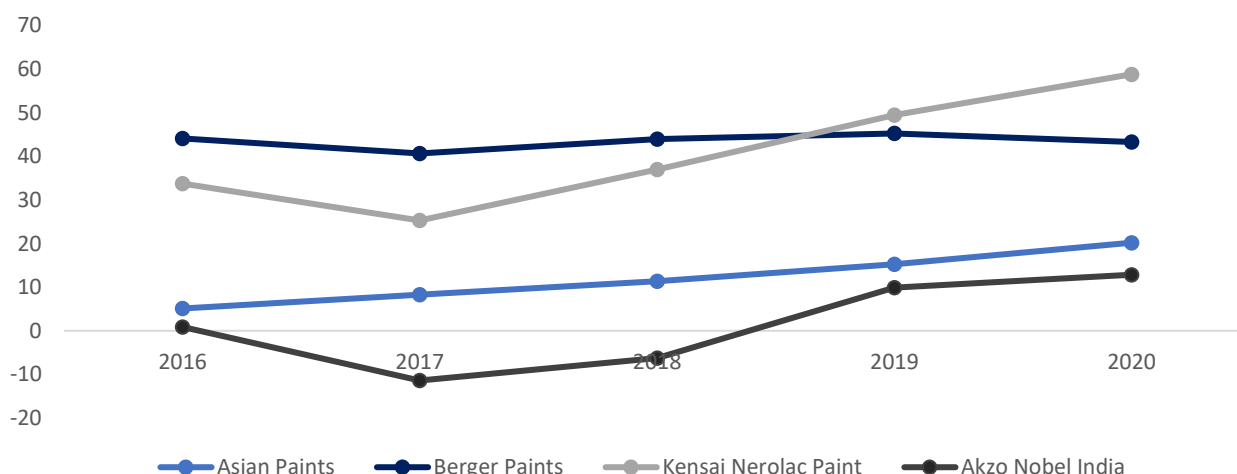


CASH CONVERSION CYCLE

All the efforts to maintain a good supply chain management and excellent distribution network can be reviewed using this metric of how fast is company able to convert its investment in inventory to cash through sales.

While Asian Paints and Berger are clearly efficient in their operations, Nerolac seems to be lagging behind. Since, Azko nobel has a completely different business model, consumer base and revenue mix, it isn't healthy to compare its cash conversion cycle with its peers.

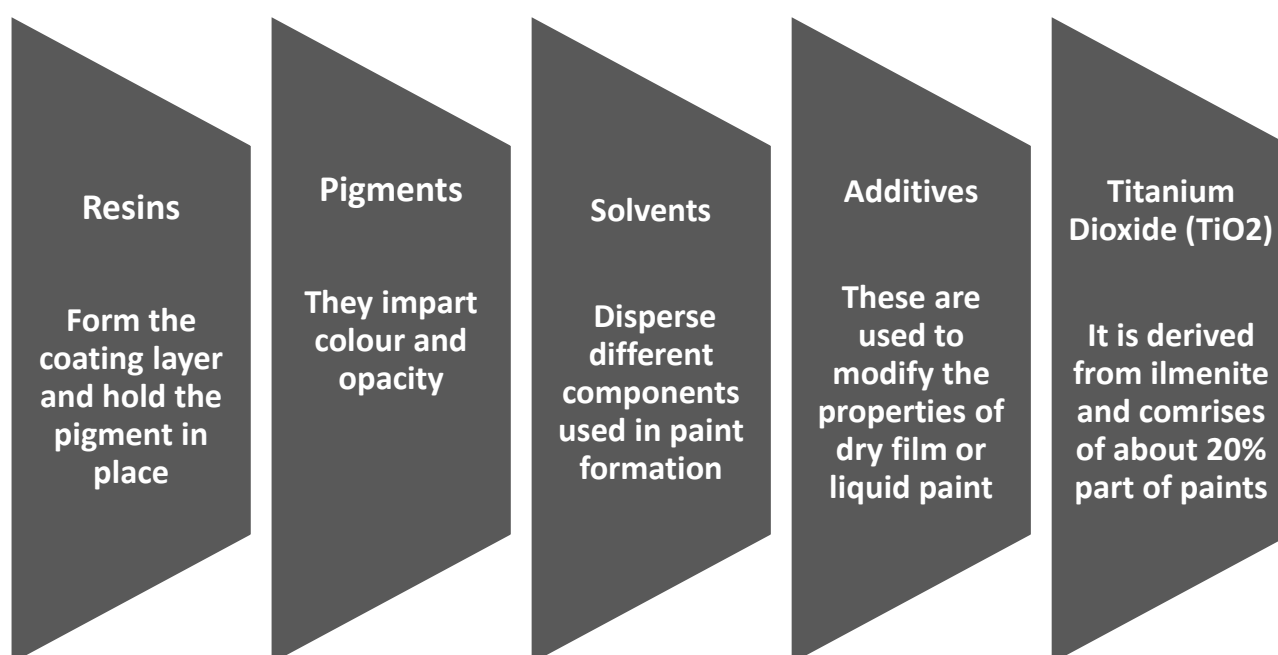
Exhibit 37: Asian Paints and Berger Paints are most efficient in converting inventory investment to cash



BUSINESS MODEL AND VALUE CHAIN

RAW MATERIALS CENTRICITY

The Industry uses 300 raw materials in its manufacturing process which account for almost 50% of all input costs. Major components involved in the manufacturing of paints are:



In general, since majority of the raw materials are crude based derivatives, and huge chunk of input costs are attributed to raw material costs, crude prices and forex rate is inherent risk in this sector. Although price inflation is almost negligible for paints and coating (1.5%-3% for last 5 years), it is definitely volatile owing to volatility in raw material costs. TiO₂ alone comprises of 15%-20% of paint constituents whose requirement is met by India through imports from China. Recently, owing to stricter regulations towards environmental issues, TiO₂ prices spiked, directly affects paint companies in India. Though companies are looking for domestic alternatives to this, they still largely are dependent on foreign countries.

Hence raw material management becomes crucial factor in success of a paint business. For a company to maintain healthy Gross Profit Margin, it must be able to accurately predict the requirement for raw materials so that the company can effectively hedge its exposure to crude prices and forex in the international markets. For this to happen, a company must have powerful supply chain management system with predictable cash conversion cycles.

FORAYING INTO ADJANCANCIES

Since the paint industry is maturing, it won't give high double digit growth rates, the way it did early on. This makes it challenging for company in paint sector to grow immensely unless they eat away market share from others. This is why, many companies are seen foraying into similar businesses to further open more growth options.

Exhibit 38: Contribution of decorative paints in the overall paint industry has evidently increased over the years

Waterproofing and Construction Chemicals

- There is a lot of headroom to grow in this segment in the next 15-20 years. So far, paint companies have been able to cross-sell their waterproofing products through their existing dealer network.

Adhesives

- During the past few years, along with construction chemicals, paint companies have also entered into adhesives market, which would enable them to tap into the vast B2B and B2C channels and also leverage their existing distribution network.

Painting Services

- To reduce the hassle of the painting process faced by the end consumer, paint companies have taken steps to make the process more organized by providing painting services.

Putty

- It is a soft, malleable greyish-yellow paste, made from ground chalk and raw linseed oil, that hardens after a few hours and is used for sealing glass in window frames and filling holes in wood.

Sanitizers and Disinfectants

- A range of quality hand sanitizers & surface disinfectants are produced to protect your home from harmful viruses.

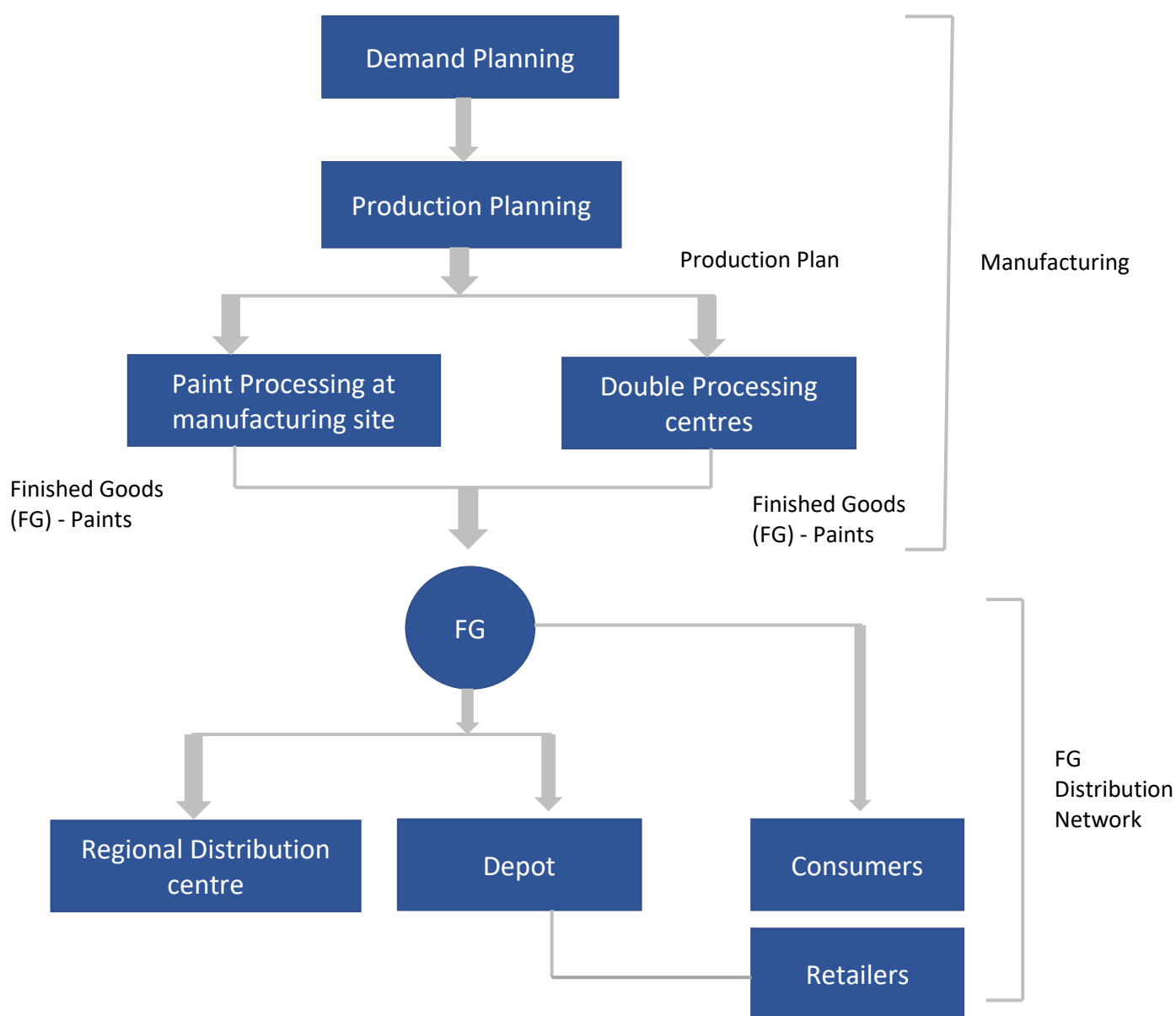
Home Improvement

- Most people buy paint for a home improvement projects and Significant innovations in painting have led to some fascinating interior and exterior applications.

SUPPLY CHAIN

Paints is the only sector in the country which delivers its final goods to its dealers almost every day, sometimes 4 times a day. While kirana shops replenish their FMCG stock once a week, delivery trucks of paint companies are on the road 365 days directly delivering to dealers. It's also important for us to understand the supply chain of this sector, because unlike any other consumer company, paint companies take away almost 97% of the MRP in their pockets, while FMCG companies lose 30%-40% of MRP to its distribution chain. This makes paint sector a more attractive investing avenue.

Exhibit 39: Supply Chain of paints



SECTOR DEVELOPMENTS

The sector has changed its face from its early days to what it is today. From times when distemper ruled the market, the paint industry has come a long way. We witnessed the gradual shift from paint being seen as a commoditized item, to becoming a consumer brand over the decades. All these shifts can be justified using a multitude of reasons from economic development to changing demographics of the country, but what's important for us is to observe how companies react to it in a way which generates maximum economic value for their shareholders.

Just like the shift from commodity to a consumer brand happened, the décor sector seems to be evolving into a **service-oriented model** wherein consumers are looking for a one-stop solution to meet their end-to-end service needs. Mere manufacturing and distribution of the paint at consumer doorsteps no more remain a differentiating factor ever since Asian Paints pioneered the supreme supply chain system integrated with ERP software and other brands started copying the process. Consumers want more value addition from the company's end and that's where "painting services" and "colour consulting" comes into play.

Though this trend still remains in its infant stage, there are strong reasons to believe that the industry could go through this disruption. This also seems a way for companies to provide a holistic experience to its customers when it comes down to painting their houses.

To explain this in numbers, consider this: The cost of labour involved in painting a home has increased to approximately 65 per cent of the project cost for a household from around 10 per cent in 1980. This is because labour costs have grown at 9–10 per cent CAGR over FY06–15 versus a mere 3 per cent CAGR in paint prices. With this trend likely to continue, there is a high likelihood that fifteen to twenty years from now, labour costs will be around 90 per cent of the overall paint project cost. Thus, in the future, it might make more sense to buy paint from a store and paint a home yourself rather than employ painters and laborer. Indeed, this is the practice in developed economies. Once this happens, new consumption patterns are likely to emerge.

Customers will be willing to pay for labour involvement if there is a service-oriented value addition attached to it. This could include décor consultancy services either on the shop floor or at your doorstep, or faster/ cleaner/ highly organized ways of executing the painting project.

Market players seem to be adapting to it well by experimenting Colour Ideas Store (Asian Paints) and Express Painting Solutions (Berger).

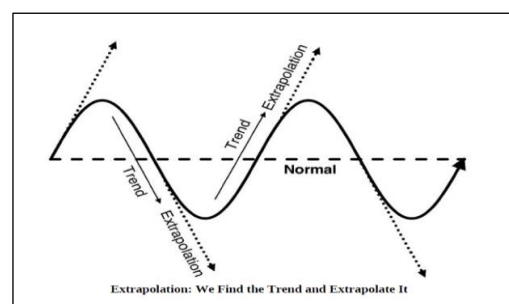
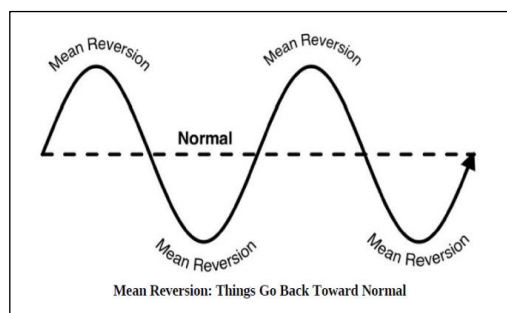
Besides this change in the perception of looking at paint industry from a service point of view, one more trend visible is that of **increasing consumer awareness**. Early on house owners' decision could easily be influenced by the distributors selling them paint owing to both unwillingness and inability on customer's part to choose what's best for them. Now the dynamics tend to skew in favour of a customer who is not only well informed and educated but also very active in deciding his paint choices. With this being the case, brands with the most recall value are more likely to sail through these hiccups.

Therefore, companies have started taking advertisement and publicity spends much more seriously. With these expenses going up, companies have started cutting back on discounts and rebates they have been giving to dealers for the past couple of years, since they no more influence final buying decisions.

SECTOR OUTLOOK

“Paint sector is an ideal place to park your funds if you want to bet on the growing economy and India’s consumption story for the next couple of years. Besides being a decent long-term bet, it provides huge stability to investor therefore limiting his risk.”

Be it economic cycles or stock prices we can observe a common theme in both, i.e., mean reversion, a technical name for a simple idea: things go back to normal. While mean reversion is the *expected outcome*, we don’t *expect* it. Instead, our instinct is to find a trend and extrapolate it.



Putting this in perspective, the last couple of years have been a rough patch for the Indian economy which witnessed its growth rates drop from 8.26% (2016) to 4.20% (2020). Too less for “one of the fastest-growing economies of the world”. From aspiring to achieve double-digit nominal GDP growth rates, we have come too far. But worse seems to be over for us. Reasons varying from Demonetization to poor implementation of GST to credit crunch of NBFI to NPA problem, there seems a silver lining. How?

GST collections recorded all-time high this December 2020 is testimony to the fact that finally, it’s paying off all the burden Indian people went through during its early days. Improving asset quality and public sector bank merger gives confidence about strengthening the financial sector. Beside general macro indicators, many sector-specific demand drivers too seem encouraging for investors.

Real estate sector is showing signs of revival after almost 8 years of stagnant state. With housing more affordable than it was a decade ago and home loans being made available so cheaply, demand picking up is only a matter of time. Manufacturing and Infrastructure sector too are in the limelight after Modi government’s “Make in India” goals of growing manufacturing sector’s contribution to GDP to 25%. While the auto sector registered degrowth for the last two years, positive YoY growth rates for December month from auto companies is a good sign.

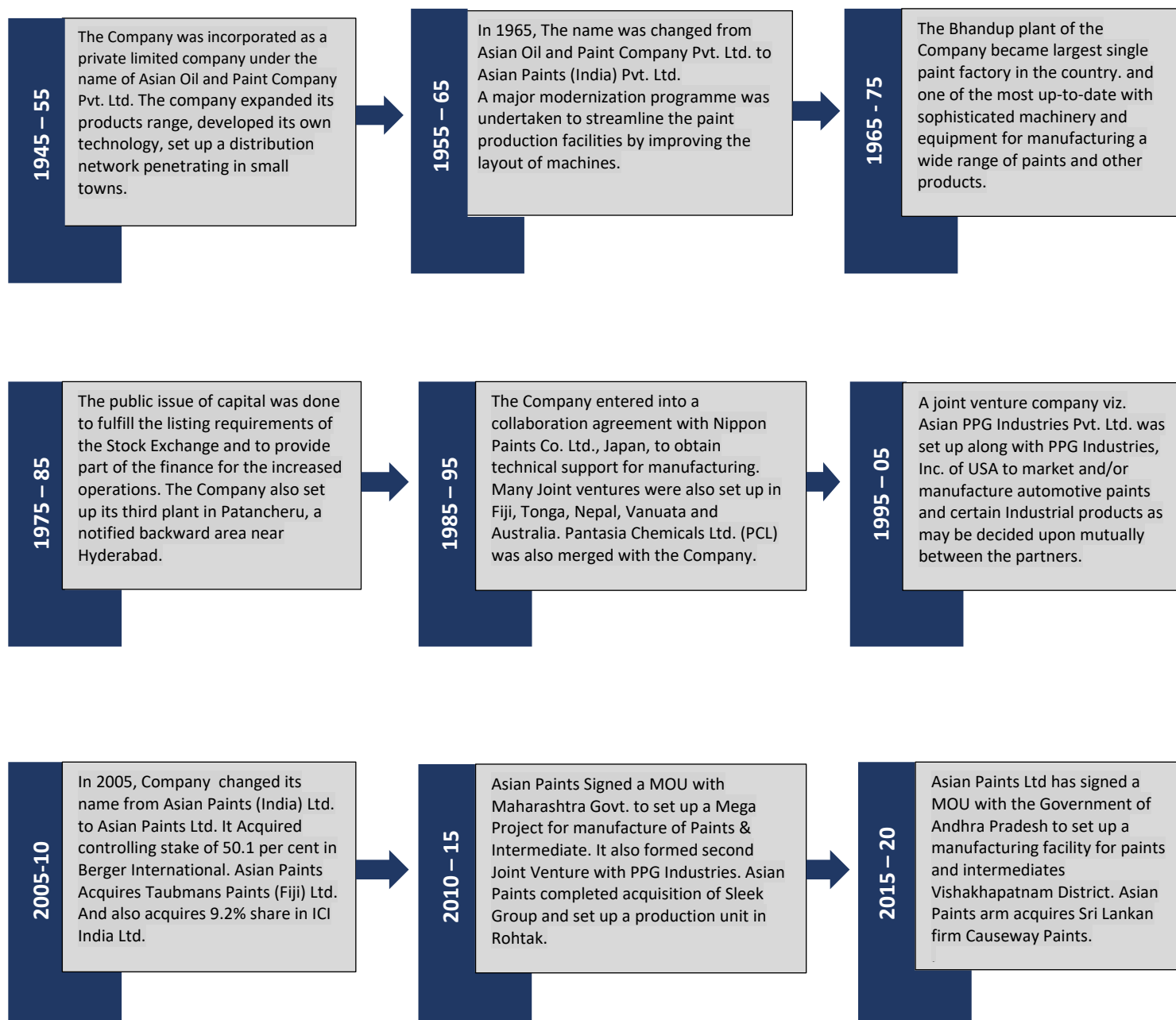
All in all, both general macro-economic indicators and sector-specific factors are pointing towards bullish future sector outlook making it a favourable investment avenue.

COMPANY OVERVIEW – ASIAN PAINTS

TIME LINE OF COMPANY

Asian Paints was Incorporated as Asian Oil and Paint Company Pvt. Ltd. In 1945. Exhibit 35 shows the timeline and history of the company.

Exhibit 40 – Timeline of Asian Paints



CURRENT BASE OF OPERATIONS

Asian Paint's operates in 15 countries of the world including India, with considerable presence in South Asia and the Middle East. They have steadily enhanced their global capacities and their facilities are equipped with technologies that ensure resolute focus on quality and consistently high productivity.

Exhibit 41: Domestic Division and Revenue generation

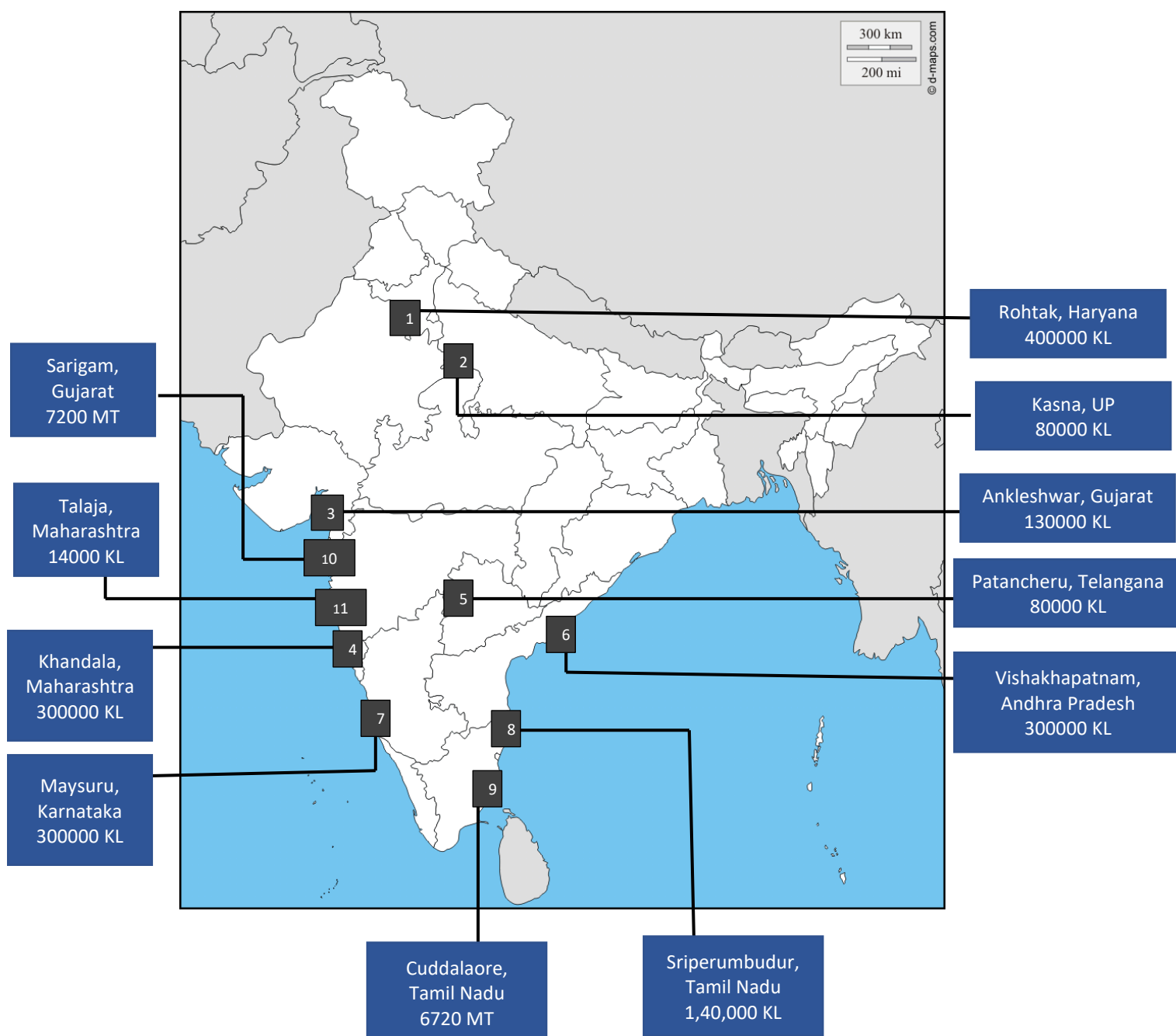
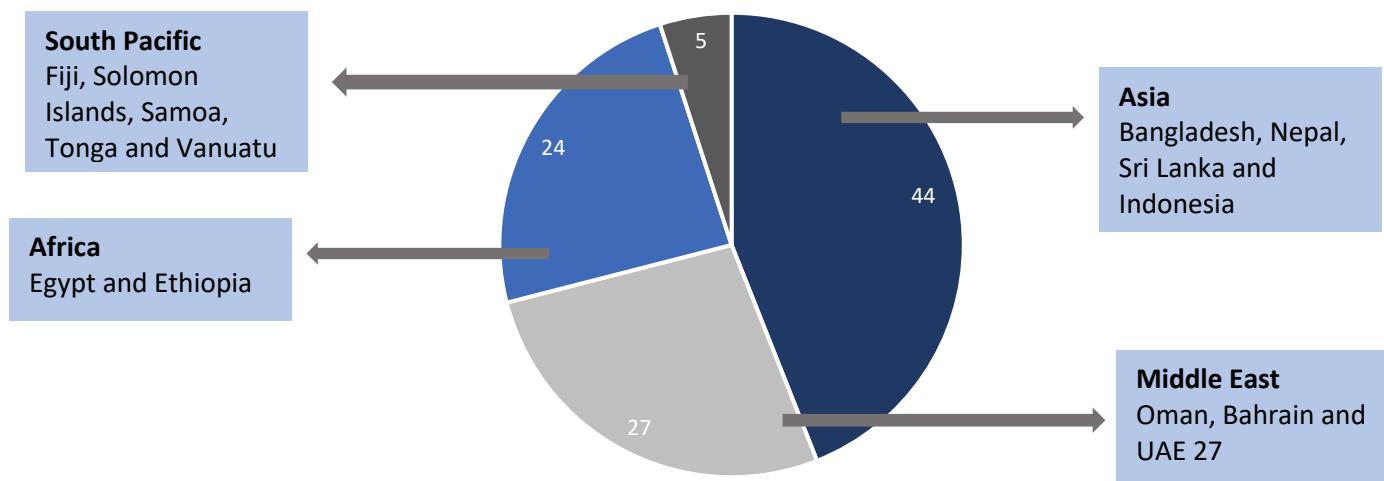


Exhibit 42: Region-wise revenue from international operations (%)



VALUE ACROSS OFFERINGS

- DECORATIVE COATINGS

Asian Paints have eight decorative paint manufacturing plants across the country, supporting an extensive distribution platform. Their products cater to varied price points and requirements, consisting primarily of four segments – interior walls, exterior walls, wood finishes and metal finishes.

- INTERNATIONAL OPERATIONS

Asian Paints operate in four regions across Asia, the Middle East, South Pacific and Africa through the seven corporate brands viz. Asian Paints, Apco Coatings, Asian Paints Berger, Causeway Paints, SCIB Paints, Taubmans and Kadisco Asian Paints.

- INDUSTRIAL COATINGS

They cater to the Indian industrial coatings market through two strategic joint ventures with PPG Inc. of USA, a global leader in coatings, offering the entire spectrum of industrial coatings.

- HOME IMPROVEMENT BUSINESS

Kitchen and Wardrobes

They offer kitchen and wardrobes solutions that can be customized to their customers' needs.

Bath fittings and Sanitaryware

Under this category, they offer bath fittings and accessories, curated washroom areas and smooth surface work with flawless finish.

Exhibit 43: % share of group revenue

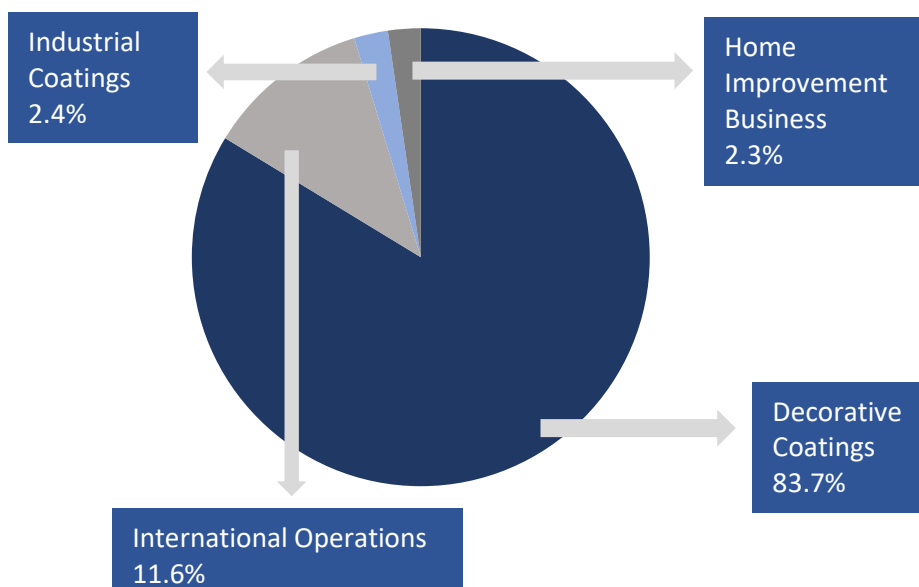


Exhibit 44: % demand of paint from different types of cities

Rural and Tier 2/3/4 Cities	50% - 60%
Metro Cities	40%-50%

PRODUCT MIX

DEMAND OF PRODUCTS

For the past few years, demand in smaller cities and towns has been growing at a faster pace than metro and urban areas. Rise in disposable income, incremental consumption expenditure, increase in awareness, development of rural markets and various launches have fueled the paint industry's growth.



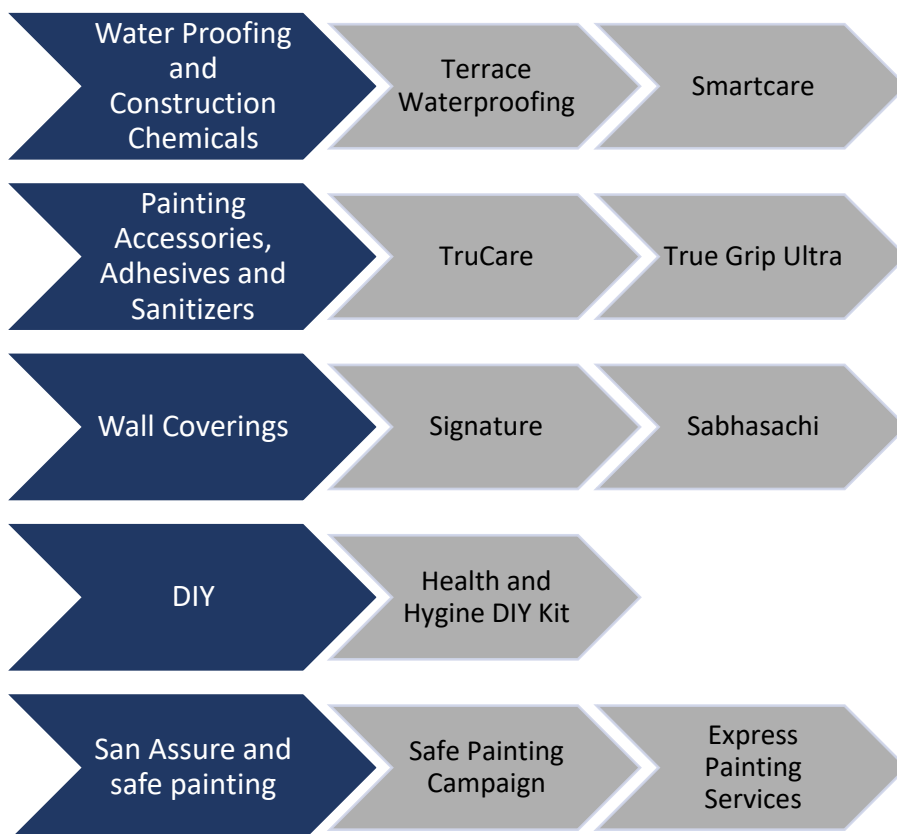
Exhibit 45: : Price range of paints, putty, distemper

APNT	Interior	Price Range	Exterior	Price Range
Top end/Luxury	Royale	420-1100	Ultima	330-460
Mid-segment	Apcolite	260-320	Apex	160-210
Bottom of pyramid/Economy/Value for money	Tractor/TruCare	60-160	Ace/TruCare	30-210

Under its institutional business, APNT provides painting solutions and waterproofing solutions to its customers, including co-operative housing societies, new buildings, institutes and government organizations. APNT is present in over 90 locations, including metros across the country. Over the past several years, the company has recorded healthy growth in this business along with market share gains. However, the margins in this segment are slightly lower than the retail business on account of its competitive intensity.

FORAYING INTO ADJENCIES

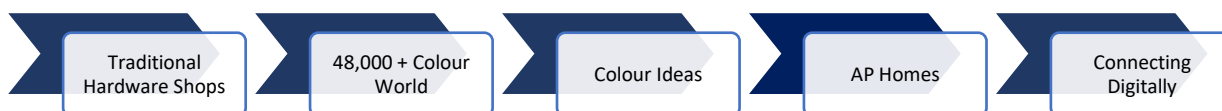
Exhibit 46: Products and different campaigns undertaken by the company



NETWORK DISTRIBUTION

There has been a transition from traditional hardware shops to many more different types of network distribution channels.

Exhibit 47: Network of distribution channel



MAJOR STAKEHOLDERS

It is very Important for the company to maintain good relations with the suppliers and stakeholders in order to run the business smoothly. The following exhibit shows the list of the suppliers of Asian Paints Ltd.

Exhibit 48: List Of major stakeholders of Asian Paints

Atul Limited	
IG Petrochemicals Limited	
Gulshan Polyols Limited	
Hitesh Corporation Limited	
20 Microns Limited	
Adi Finchem Limited	
Marine Electricals (India) Limited	
MMP Industries Limited	
Jocil Limited	
Sayaji Industries Limited	

Management Details

Board of Directors		
Name	Designation	Description
Mr. Ashwin Dani	Non-Executive Chairman	He joined APNT as a Senior Executive in 1968 and moved through successive senior positions like Director - R&D, Works Director and Whole-time Director. He served as Vice- Chairman and MD from Dec 1997 to Mar 2009 and presently holds the position of Non-Executive Chairman of the Company.
Mr. Amit Syngle	MD & CEO, Additional director	He has spent 30 years with the Company and has headed Supply Chain, Sales & Marketing and Research & Technology functions. In addition, he also spearheaded the acquired businesses of the Kitchens and Bath spaces in the Home Improvement venture of the Company. Before being appointed as an Additional Director/ Managing Director & CEO, Mr. Amit Syngle held the position of Chief Operating Officer of the Company.
Mr. Manish Choksi	Non-Executive Vice Chairman	He joined APNT in the year 1992 as an Executive and has grown in ranks by holding various positions across different functions of the Company. He has spearheaded the IT function of the Company.
Mr. Abhay Vakil	Non-Executive Director	He has been associated with the company since 1974 . Prior to becoming Managing Director in 1998, he was overseeing the Decoratives India SBU of the Company. He ceased to be the MD of APNT on FY09 and since then holds the position of Non-Executive Director on the Board of APNT.
Mr. Malav Dani	Non-Executive Director	He joined APNT as Manager-Quality in 2005 and worked on customer centricity initiatives. He was appointed as a Non-Executive Director on the Board of the Company, since 2013 and is also the Chairman of the CSR Committee of the Board from October, 2015.
Ms. Amrita Vakil	Non-Executive Director	She began her career at APNT in 2003 in the HR department and was responsible for end-to-end training of the Executives cadre of the Company. In the year 2005, she joined Frost & Sullivan as a Senior HR Executive and managed a Generalist HR profile where she spent a total of 5 years.
Mr. Jigish Choksi	Non-Executive Director	During his 5 year long stint with APNT which began in 2010 , he has worked as an Area Manager-Project Sales for 3 years and thereafter, he was a part of the Marketing team. Mr. Choksi is the Managing Director of M/s. Elf Trading & Chemicals Manufacturing Limited - an agro-chemical company.
Mr. Deepak Satwalekar	Independent Director	He has been a consultant to the World Bank, the Asian Development Bank, USAID and the UN HABITAT. He was also the MD & CEO of HDFC Standard Life Insurance Co. Ltd., before his retirement in Nov 2008, before which he served as the MD of HDFC Ltd. from 1993 to 2000.

Dr. S Sivaram	Independent Director	He has over 30 years of experience in research on polymer synthesis, high performance polymers and surface chemistry of polymers. He was bestowed with " Padma Shri " award by the President of India in January, 2006 for his outstanding contribution in the field of science and technology.
Mr. M K Sharma	Independent Director	Mr. M.K. Sharma began his career with DCM Limited and subsequently joined Hindustan Unilever Ltd. as Legal Manager. He retired as the Vice Chairman of Hindustan Unilever Ltd. of in May, 2007. He serves as a Director on the Boards of several companies of repute.
Ms. Vibha Paul Rishi	Independent Director	She started her career with the Tata Administrative Services and was part of the founding team of Titan Watches. She spent 17 years at PepsiCo in marketing and innovation roles in India, US and UK and was one of the founding team employees of PepsiCo when they set up in India.
Mr. R Seshasayee	Independent Director	He joined Ashok Leyland Ltd. in 1976 rose to Managing Director in 1998. He has served on the board of ICICI Bank from 1997 to 2003. The former chairman of Infosys Ltd. and Indusind Bank Ltd. is on the board of APNT since 2017.
Ms. Pallavi Shroff	Independent Director	She is the managing Partner of M/s. Shardul Amarchand Mangaldas, with extensive experience of over 37 years. Her broad and varied representation of public and private corporations and other entities before legal institutions, has earned her national and international acclaim.
Mr. Suresh Narayanan	Independent Director	Mr. Suresh Narayanan is currently the Chairman & MD of Nestle India Limited. He joined Nestle in the year 1999 and has been associated with the Company since then. He was the Chairman and CEO of Nestle Philippines, Inc. prior to joining Nestle India
Mr. R J Jeyamurugan	CFO & Company Secretary	Mr. R J Jeyamurugan, an associate member of the ICAI and ICSI, was appointed as the CFO & Company Secretary of the Company, w.e.f. 27th November, 2019. He heads the Finance, Accounts, Shared Service Centre, Tax, Legal, Secretarial & Investor relations functions of the Company.

Management Change

This year company witnessed a drastic change in its top management when Mr. KBS Anand stepped down as Managing Director and CEO after successful 8 years. Under his tenure, the stock price went 4.5x. He was replaced by equally competent Amit Syngle who joined as a Management Trainee 30 years back and climbed up the corporate ladder to become the CEO.

It appears that the transition would be smooth since both former and latter share very similar background. Both of them headed Sales and Marketing team after which they were given the onus of managing the Indian Decorative Business division of the company, which has proved to be the cash cow for it.

The CFO and Company Secretary of the company too changed on 27th November from Mr. Jayesh Merchant to Mr. R J Jeyamurugan. This change too won't impact the operations too much owing to similar background of these individuals.

REMUNERATION OF KMP

Remuneration of Directors and Key Managerial Personnel checks all boxes of a good management compensation practice. The increase in remuneration of employees other than the Key Managerial Personnel is considerably in line with the increase in remuneration of Key Managerial Personnel, which points at equality and fairness in corporate culture. It also is well within the ceiling prescribed under Companies Act, 2013.

The remuneration policies are also in line with its peers, which is a good sign for shareholders and speaks volumes about integrity of top management and their willingness to create shareholder value.

Exhibit 49: Ratio of Remuneration of KMP to median remuneration to employees

Company Name	2018	2019	2020
Asian Paints	139.62	141.52	160.96
Berger	48.52	55.09	69.30
Kansai Nerolac	94.14	102.00	120.27
Akzo Nobel	31.91	39.56	32.78
Industry Mean	78.55	84.54	95.83

While KMP and Director remuneration seems justified, this ratio helps us understand how skewed is the compensation policy in favor of KMP, i.e. MD and CEO of Asian Paints. It has been way above industry mean. While KMP deserves being rewarded for creating shareholder value, this certainly seems too overboard.

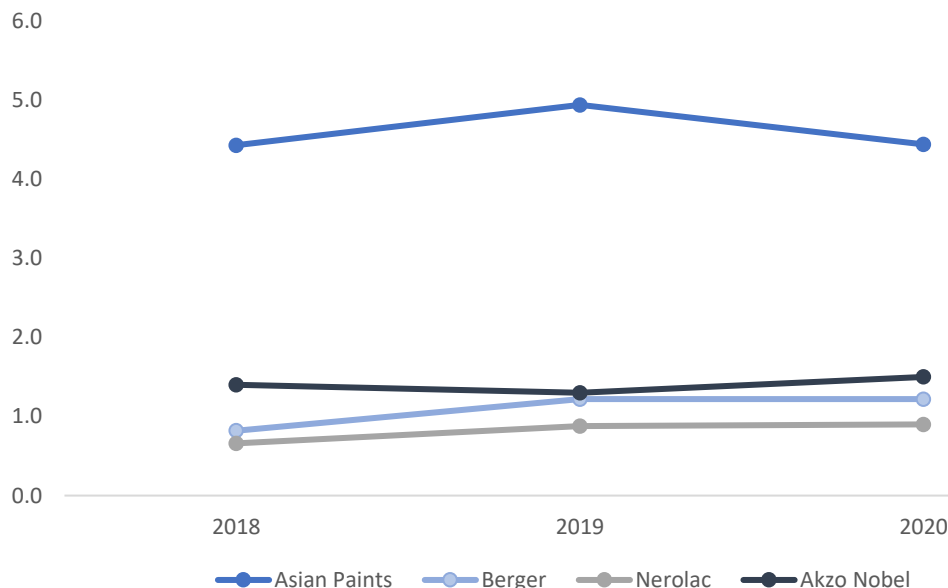
FORENSIC CHECKS

Financial Statements tell us the financial health of the company and they remain a primary source of information for us investors about the company. Hence, it becomes very important that the integrity of these statements is not compromised. If that is the case and there exist various red flags regarding reporting standards, reliability of these statements comes under question, therefore proportionately harming the quality of our analysis.

AUDITOR'S COMPENSATION

Auditor's quality can be checked by comparing the remuneration received by them with the profits earned. Any unusual anomaly must raise eyebrows of the investors, which certainly doesn't seem to be the case with Asian Paints.

Exhibit 50: Auditor's Compensation in crore



Auditor's Compensation as a % of Profit			
	2018	2019	2020
Asian Paints	0.22%	0.22%	0.16%
Berger	0.18%	0.25%	0.19%
Nerolac	0.13%	0.20%	0.17%
Akzo Nobel	0.68%	0.62%	0.63%

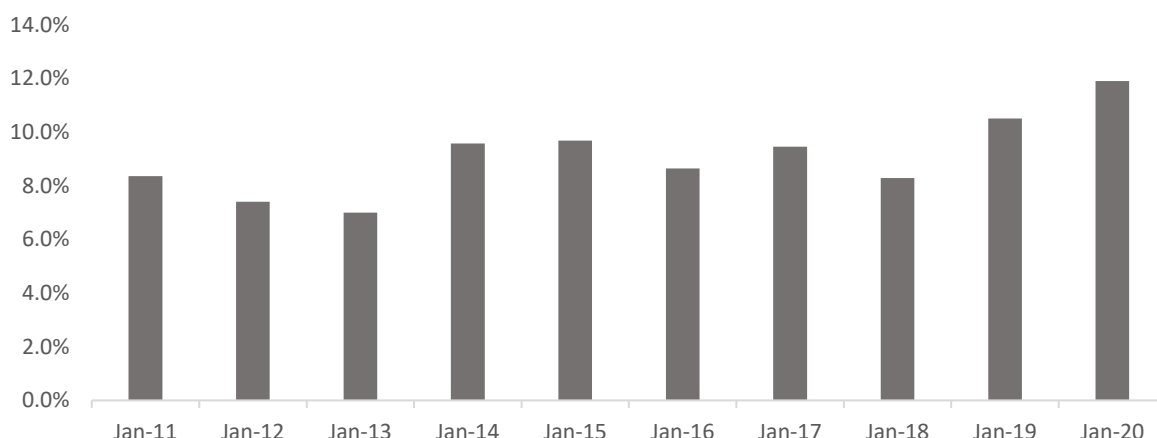
CUMULATIVE CASH FLOWS FROM OPERATIONS

This ratio helps in understanding whether the company is actually realizing its profits into cash and whether it's revenue recognition and accounting policies are not too aggressive. This ratio for Asian Paints is 1.0056 which depicts the company faces no problem in realizing cash to its recognized profits.

DEPRECIATION RATE

Ideally we should look out for consistencies in depreciation rates and be wary of any unusual spikes which can often be attributed to change in depreciation policies. While rates have been fairly stable until 2018, we see a sudden spike which can be attributed to two new plants which were commissioned in Vishakhapatnam and Mysuru. This trend is likely to stabilize since management doesn't plan to do expansion capex in coming years, as per concall reports.

Exhibit 51: Depreciation Rate in %



REVENUE GROWTH VS RECEIVABLES GROWTH

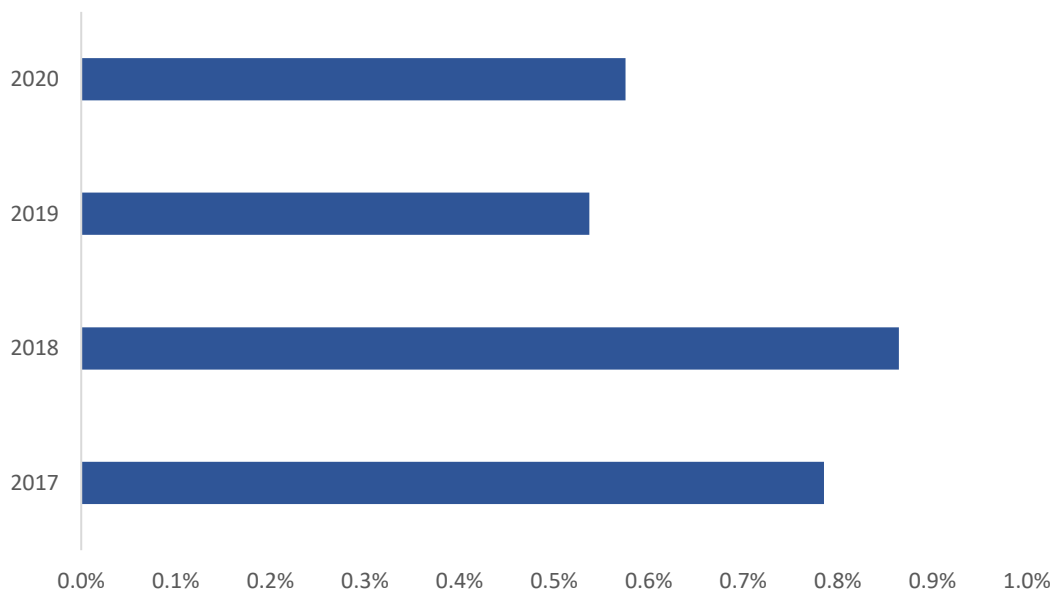
Receivables have grown at a rate faster than its revenue. Although this is not a healthy sign for a company, however the difference isn't too huge. While this can be ignored for now, however the investor must keep this in mind and be wary that this trend doesn't continue in future as well, because if it does, it can be because of company's changed attitude towards aggressive revenue recognition practices in order to keep up with Dalal Street's expectations.

Alternatively, this can be because of competition that Asian Paints is facing from its competitors, owing to which they have been pretty generous in extending credit periods to its dealers/distributors.

MISCELLANEOUS EXPENSES

Since these expenses are insignificant, they are clubbed under Miscellaneous Expense. However, if they become too big or see a spike, investors must keep themselves aware about the reasons. It has been well below 1% and further declined last couple of years which is fine.

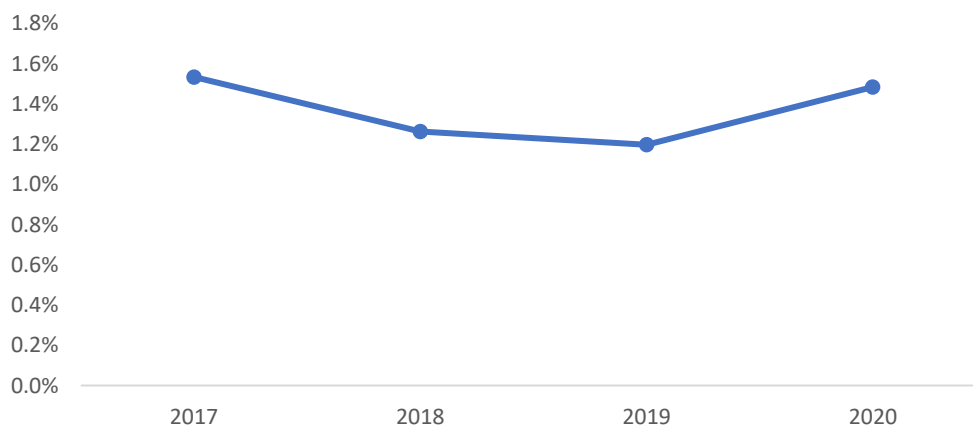
Exhibit 52: Miscellaneous Expense as a % of Revenue



OTHER INCOME AS A PROPORTION OF TOTAL REVENUE

Other incomes are non-recurring and non-operating in nature, and hence their contribution towards topline shouldn't be significant. If it is too huge portion of your topline, it becomes worth investigating. This doesn't seem to be the case with Asian Paints where it has stayed between 1.2% to 1.5% range consistently.

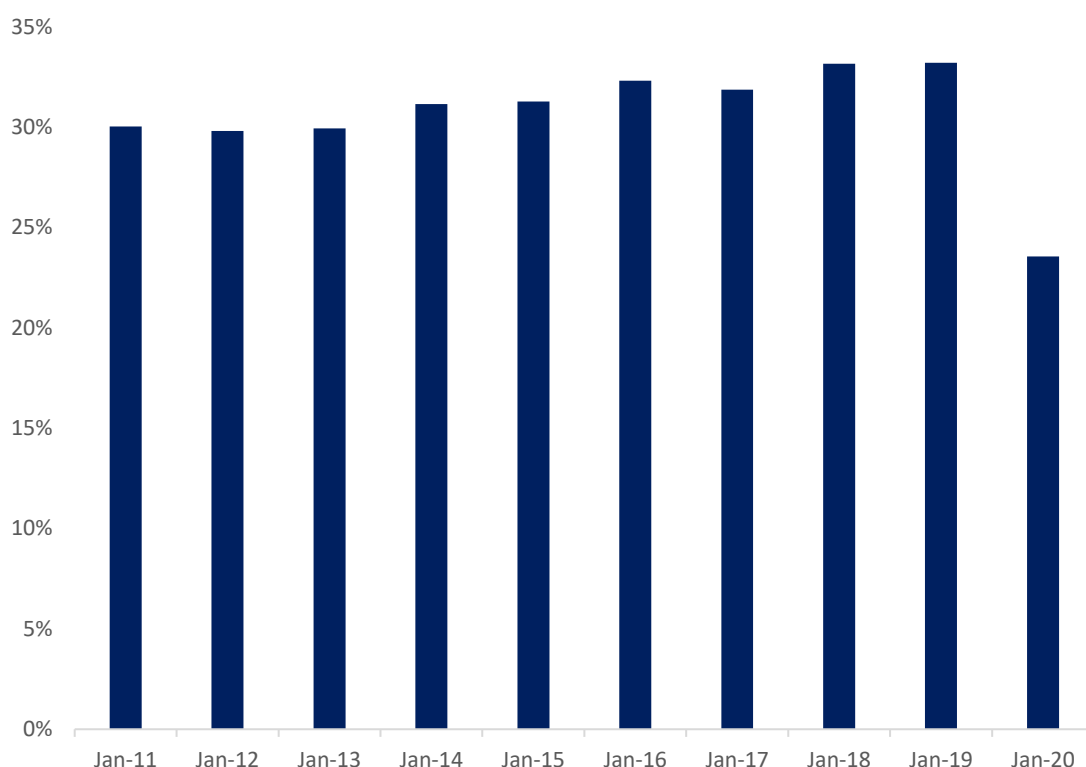
Exhibit 53: Other Income as a Proportion of Total in %



TAX RATE

Timely and correct Tax Payment can act as a proxy of management efficiency and honesty over years. If the management ends up paying too high tax, it probably has poor tax management practices and a major portion of their profits are earned from non-operating activities since they attract higher tax rates, while extremely low tax rates can be a result of tax subsidies being availed by the company or financial shenanigans being played out to avoid paying tax.

Exhibit 54: Tax payment by Asian Paints



Asian Paints' tax payments as a proportion of profit before tax has been fairly in line with corporate tax rates, which saw a decline in FY20 because it opted for lower tax rates of 25.168% (Previous Year 34.944%) u/s 115BAA of Income Tax Act, 1961 inserted vide Taxation Laws (Amendment) Act, 2019.

All in all, it will be prudent to conclude that financial statements are certainly of high reporting quality whose credibility can't be doubted. This process automatically reduces the risk of investing in poor quality businesses.

ROE PROFILING

RETURN ON EQUITY

Return on Equity is a comprehensive yet simple way to measure performance of the whole business. On the face of it, we can see Asian Paints' RoE falling consistently falling since the start of the last decade, eventually plateauing and then showing a sign of reversal as per latest FY20 results.

Exhibit 55: ROE Filing of Asian Paints

	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
Asian Paints	39%	36%	33%	30%	29%	27%	26%	24%	23%	27%

In order to dive deeper into understanding the reasons which are leading up to this situation, we use dupont analysis. We individually assess each component which constitutes RoE. We know $\text{RoE} = \text{Profit Margin} \times \text{Asset Turnover} \times \text{Leverage}$.

MARGINS OF THE COMPANY

We find that the margins for the company have fairly stable, rather only increased in recent years which is explainable owing to conscious efforts undertaken by the company management towards increasing efficiencies and cost cutting.

Leverage of the company has fallen though as it has constantly expanded its equity base and always aimed at funding its expansion through retained earnings except last two years wherein they took loan to fund its expansion projects in Vizag and Mysuru. Even after the loan, its leverage remained stable/decreased for better. While this somewhat explains possible fall in RoE, there still is a lot more.

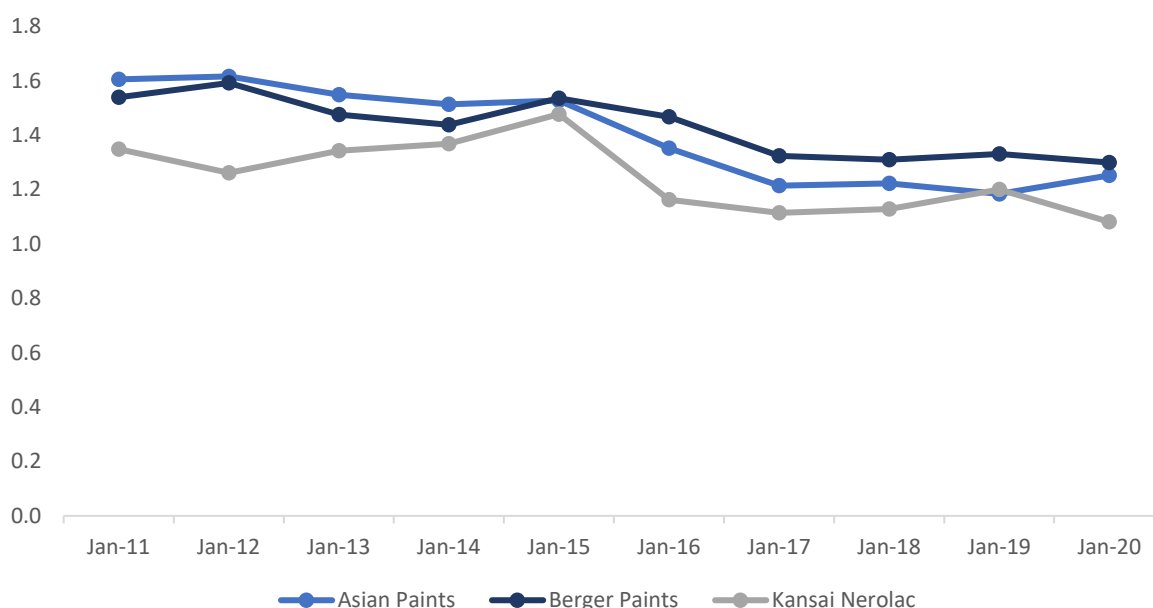
Exhibit 56: NPM and Leverage over the years

	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
NPM	11%	11%	11%	10%	10%	12%	13%	12%	11%	13%
Leverage	2.1	2.1	2.0	2.0	1.9	1.6	1.6	1.6	1.7	1.6

ASSET TURNOVER RATIO

Neither of the above metrics really help us understand why a drastic fall in RoE, until we look at Asset Turnover ratio, which reveals startling facts. Asset Turnover for Asian Paints has been falling since FY11 only to increase first time in FY20.

Exhibit 57: Falling Asset turnover ratio of the three companies



This falling asset turnover isn't just a case with Asian Paints, but a common theme amongst major paint industry players since FY15. This can be attributed to two major reasons:

- 1) Slowing growth rate in paint volumes and GDP. Indian economy has not grown as rapidly as it did before 2015. Depressed topline growth is partially responsible for falling asset turnovers.
- 2) Expanding asset bases of companies. In past years, they have gone through a capex cycle of capacity expansion. Owing to this, their asset base has grown at a faster rate than sales have grows leading to lower capacity utilization. Though predicting future is futile, it seems plausible that since capex cycle has ended capacity utilization ramps up and asset turnover improves.

COMPETITIVE ADVANTAGE

TRAILBLAZER IN IT INTEGRATION OF PAINT INDUSTRY

Ever since Mr. Choksi invested 8 Cr. back in 1974 to import India's first mainframe computer which was used for demand forecasting with the help of data analytics and improving service levels across the supply chain, Asian Paints have set foundation for IT innovation in the industry. They also adopted **automated storage and retrieval systems** (2008) and **S/4 HANA ERP Software** (2014) whose integration helped solve the problems of an overstuffed inventory, increased opex, supply chain efficiency and factory level losses, in one stroke.

All of these efforts enabled them develop a system which could foresee what its customers want before they even wanted. With Asian Paints truck delivering paints to its 60,000 distributors 4 times a day; 365 days a year, it has 8.76 cr. ($4 \times 365 \times 60,000$) data points to collect information in a year compared to its peers Berger Paints with 2 Cr. and Kansai Nerolac with 1Cr. data points.

	Delivery per day	Days Delivered P.A.	Distributors Delivered	Data Points
Asian Paints	4	365	60000	8.8 Crore
Berger	2	365	28000	2 Crore
Kansai Nerolac	1	365	28000	1 Crore

The richness and quantum of data that Asian Paints has hands on increases exponentially with each passing day helping them better forecast demands with > 99% accuracy. This moat, is an ever-growing moat for them.

In FY20 too company invested in digital technologies such as Artificial Intelligence, Machine Learning, Robotic Process Automation, security systems and advanced analytics which have been used to create immersive customer experiences, improve the operational productivity and aid in better decision making.

Quantitatively these actions have translated into improving operating profit margins for the company from 19.5% (FY11) to 24.5%(FY20). Besides, cash conversion cycles going down significantly help them free up capital which they otherwise would have invested in working capital management like its peers. With shorter cash conversion cycles, they have breathing space to increase credit periods to its distributors during distressed times which will help them sustain topline growth as well.

In years to come, we can expect margins to sustain at these levels if not increase owing to IT innovations and always stay ahead of its peers.

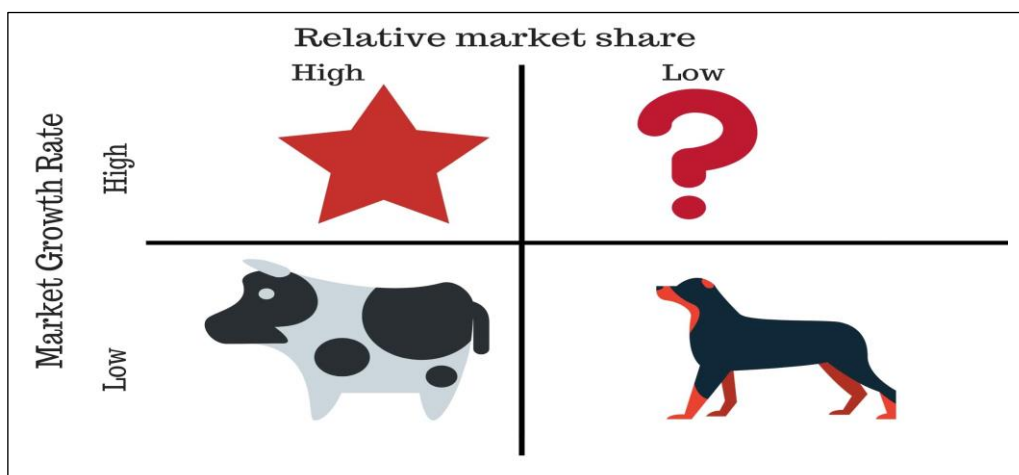
REBRANDING FROM BEING A PAINT COMPANY TO HOME IMPROVEMENT BUSINESS

Paint industry has been in existence and has started showing signs of maturity. While there still is huge headroom for growth as and when India progresses, but not as much as it did in the past. The only way for companies to grow exceptionally is eat away other's market share, which is simply not that easy in an oligopolistic market where companies compete in niche segments. Thus, existing players must foray into other ventures looking for growth.

While Asian Paints' competitors diversified into paint consulting services and construction chemical, it stands apart by setting foot in modular kitchen (Sleek) and bath fitting (Ess Ess) segments. While their contribution to topline have been non-significant, they are giving double digit growth at cost of their profitability.

It definitely is a better to look for opportunities in this segment rather than construction chemical business (waterproofing and adhesive) where high competition is given by established names like Pidilite. With majority of bath fitting and kitchen business dominated by unorganized fragmented sector, it appears Asian Paints are better off allocating their capital in this field.

This is a classic case where Asian Paints are using their Décor business (cash-cow) to fund their Sleek and Ess Ess business (question marks) to eventually gain share in high growing industry (star). [BCG Matrix]



Though currently this is negatively impacting company's bottom line, Ess Ess breaking even this December quarter owing to lower marketing spends and cost cutting is definitely worth noticing. Primarily there is definitely head room for expansion owing to low organized market share and growing urbanization, but it comes at cost of profitability.

	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
Sleek					
Revenue	135.1	157.6	173.4	214.4	238.3
<i>Growth (%)</i>	10.9%	16.7%	10.0%	23.6%	11.1%
PBT	-15.7	-20.2	-12.9	-22.8	-41
<i>PBT Margin (%)</i>	-12%	-13%	-7%	-11%	-17%
Ess Ess					
Revenue	119.0	150.3	161.7	202.1	219.4
<i>Growth (%)</i>	45.5%	26.3%	7.6%	25.0%	8.6%
PBT	-26.5	-18.5	-19	-30.3	-29.4
<i>PBT Margin (%)</i>	-22%	-12%	-12%	-15%	-13%
Total home improvement revenue	254.1	307.9	335.1	416.5	457.7
as a % of consolidated net revenue	1.8%	2.0%	2.0%	2.2%	2.3%

LOW EXPOSURE TO INDUSTRIAL COATING SEGMENT

Although 25% of paint industry's revenue comes from industrial segment, only 2.4% of Asian Paints' revenue come from coatings, which is very low in comparison to its peers like Berger Paints (20%), Kansai Nerolac (35%) and Akzo Nobel (39%). This makes Asian Paints different from its peers.

Industrial coatings is a tough place to be in with lower margins compared to décor segment, therefore Asian Paints is automatically positioned favourably in the market with very miniscule portion of its revenue coming from low margin segment. Though it may seem to be a good proposition for Asian Paints, it also makes Asian Paints inherently riskier being exposed just the décor segment. Décor segment is more cyclical in nature since final consumers treat it as a discretionary spend, however industrial coatings more of become a necessity for huge manufacturing and infra giants to prevent from corrosion.

Whatever the case may be, it has turned out pretty well for Asian Paints so far since it has managed to establish itself as a household brand name.

FUTURE GROWTH

Majority of capex that companies in this sector do pertain to capacity expansion. In recent years, Asian Paints launched its Rs. 4,000 Cr. capex cycle of establishing water-based facilities in Mysuru and Vishakhapatnam. They plan to carry it out in two phases, in Phase-I, two mega plants with initial capacities of 3 lakh kilo ltr per annum each of water-based paints were commissioned at Mysuru and Visakhapatnam in FY19. Phase two will include capacity expansion of both of these plants by 5 lakh kilo ltr per annum in total. Phase two is most likely to commence no sooner than FY22.

Though Asian Paints is a cash rich company, and can easily afford to fund these expansions, it decided to raise debt for the same so that it could respect its dividend policy and continue to pay dividends to its shareholders. Though debt was taken, it's interest coverage ratio is 31 times and Debt to EBITDA is 0.27.

As far as international operations is concerned, it has expanded in numerous geographies only to realize that low growth Caribbean markets do not offer much opportunity, eventually leading them to expand their portfolio in emerging markets of Asian and Africa. To embark on the journey towards a holistic home improvement business, it acquired a 51% equity stake in Sleek International Private Limited during FY14 for Rs. 120 Cr. post which they fully acquired it in FY18 for Rs. 50 Cr. During FY15, the company acquired the entire front-end sales business (including brands, network and sales infrastructure) of Ess Ess Bathroom Products Private Limited for a consideration of Rs 36.5 Cr.

Most of their growth plans have been aimed at fueling topline growth either through capacity expansion or venturing into other fields. Added capacity is yet to bear fruit as demand ramps up and capacity utilization number climbs, international operations and home-improvement business too have shown potential.

While sales trajectory looks good, international operations and home-improvement haven't contributed much to profits. Be it economic slowdown in African countries owing to political unrest or huge marketing spends being incurred for bath fitting business, they are yet to prove their worth to company management and shareholders. Overall, the company has definitely been aggressive in its approach, considering the industry it caters to has fairly matured, but this growth maybe hurting its current earnings.

KEY RISKS

SECTOR SPECIFIC

Being a raw material intensive business, it all comes down to how businesses are able to maintain their gross margins. With majority of inputs being crude derivatives and imported from abroad (TiO₂ – which was up 23% in December quarter), volatile crude prices and fluctuating USD/INR rates can always hurt them. Although it should act as a hedge in economic downturn, when crude prices fall and margins have scope of improvement, ideally companies have a tendency of passing on prolonged price drops to its customers.

Close correlation to GDP has proved bane for the industry for last couple of years when India has witnessed continuous fall in growth rates of GDP owing to multitude of factors. Lower growth rates resulting in lower-than-expected construction and infra projects eventually leading to lower growth rates in paint volumes. This further was aggravated by COVID-19, which as per latest quarters is showing good recovery signs. All of this was coupled with the prolonged real estate stagnation which otherwise proved catalyst during the 2000s rally for the sector.

COMPANY SPECIFIC

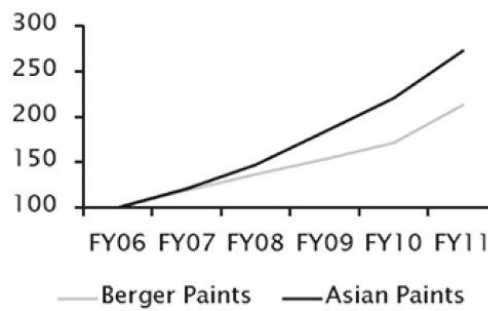
Biggest threat that Asian Paints faces today is it's competition from none other but Berger Paints. Though Berger is miniscule in size in comparison Asian Paints, it has always managed to shamelessly copycat all the actions latter has taken. For instance:

- Asian Paints has always focused on decorative side of paint business unlike its competitors like Akzo Nobel and Kansai Nerolac. Berger Paints too has positioned itself in a manner that its primary focus is on décor segment.
- Berger is one of only two companies (alongside Asian Paints) in the industry which has focused consistently on building supply chain efficiencies, consistently widening the distribution network, and effectively investing in branding and marketing initiatives.
- Whilst Asian Paints took the lead in installing a technologically advanced centralized supply chain management and ERP system over 1999–2002, Berger implemented a similar technological advancement in its distribution channel in 2012 in collaboration with Oracle for better demand forecasting.

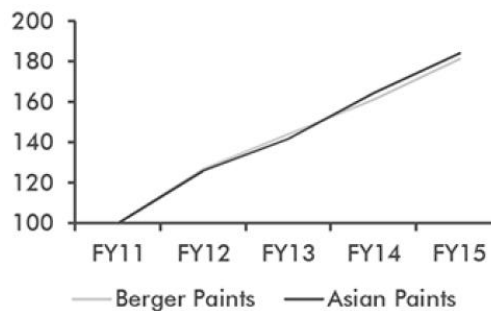
All of these reasons can explain how Berger Paints climbed ranks from being seventh largest paints company in 1980s to securing second position by 2000s.

To put this quantitatively in numbers, we can compare how both of these companies have grown their topline over last 15 years by breaking them in 3 time periods.

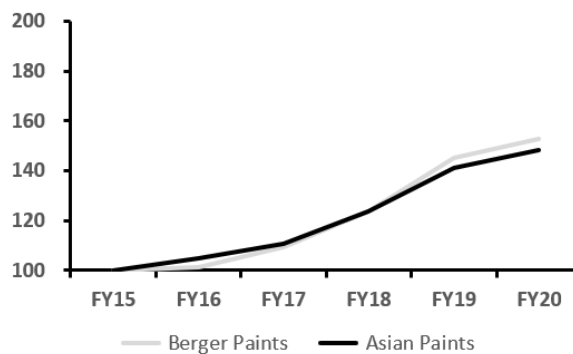
- 1) Asian Paints grew much faster than Berger during FY06–11



- 2) Berger matched pace with Asian Paints during FY11–15



- 3) Berger almost outpaced Asian Paints during FY15-20



Gone are the days when Asian Paints clearly dominated the Paint Industry. While it still continues to hold 39% of the total market, things are not same as they were.

While you can rely on Asian Paint's bet of transforming into a home décor solution considering fair amount of historic success they achieved whenever they tried something new, there does exist a big 'what-if' their home improvement business and international operations fail them and Berger Paints doesn't leave any stone unturned to capitalize upon their mistake.

We can establish the analogy of the Biblical story of David and Goliath, where Goliath (Asian Paints) is defeated by David (Berger Paints) even if odds were against him. All it requires is "David strategies" for underdog to beat the champion.

Besides, Berger Paints has been consistently and slyly poaching employees from its competitors. Dongargaokar and Bijji, the famous duo who changed the face of Berger Paints and successfully lead as CEO during their respective tenure were ex-employees of Asian Paints. Including them, following is the list of few Berger top management employees who earlier worked for Asian Paint's

- 1) Dongargaokar Madhukar (First Indian MD)
- 2) Bijji Kurien (CEO 1980 onwards)
- 3) Mr. Abhijit Roy (Current MD & CEO)
- 4) Mr. Tapan Kumar Dhar (Sr. Vice President - R&D)
- 5) Mr. Sanjay Chaudhary (Business Head – Protection)

Berger Paints has been building a reservoir of talent pool by headhunting potential recruits across paint industry, which again can be a potential threat for Asian Paints.

COMPANY OUTLOOK

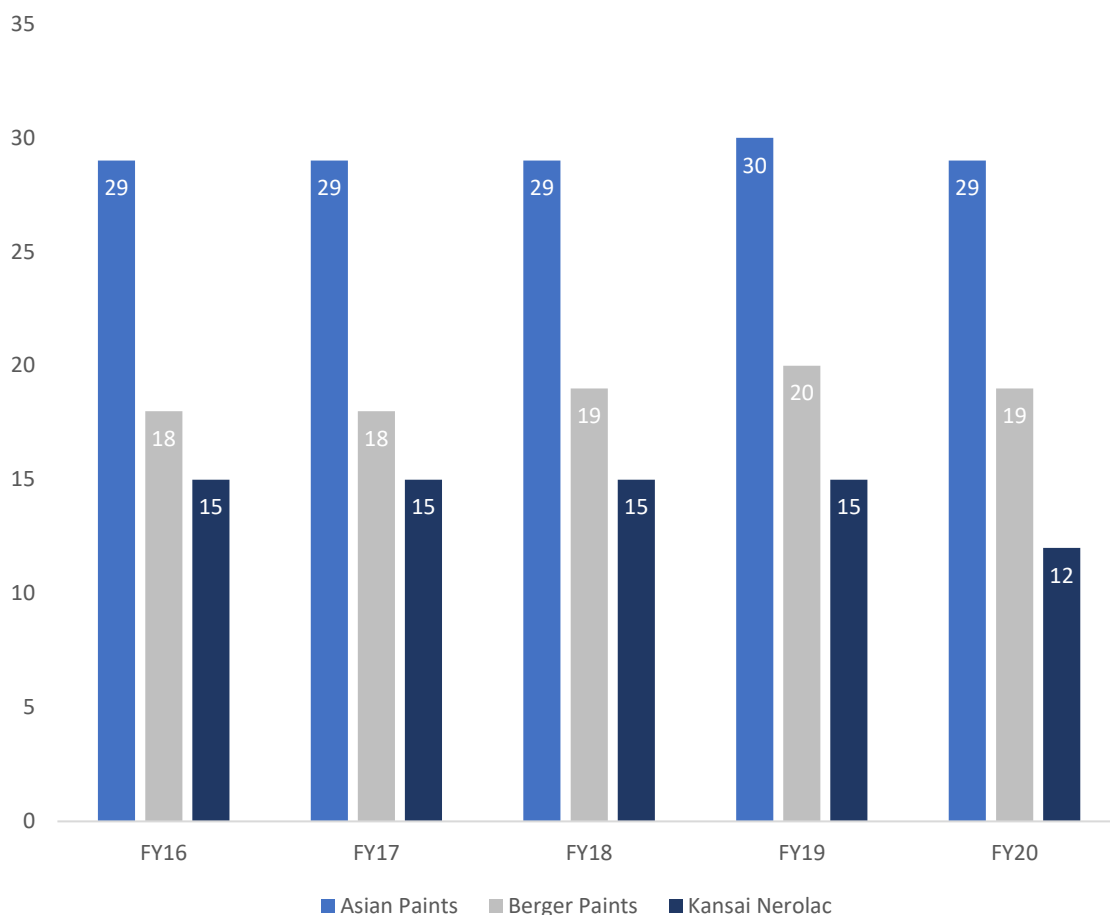
Historically we have seen that Oligopolistic markets are most profitable. Small number of large players in the market operate successfully in the market. They tend to be price setters and compete on differentiated products allowing them to maximize profits. In a scenario where you are the price setter and the lowest cost producer with fattest gross margins, you become a money printing machine and that is exactly what Asian Paints promises. With largest chunk in the décor segment pie, ability to charge premium pricing owing to brand equity and unbeatable margins, it has compounded wealth for its shareholders for decades.

It's dominance in décor segment can be accredited to huge dealer network, brand image and customer focussed approach, owing to which they have been milking its cash cow to fund expansions and paying out dividends which grew 15.8% CAGR over last decade. Asian Paint's management too have been great at allocating capital in efficient way by investing in latest IT innovations to strengthen their supply chain management system and sales forecasting. This decision of theirs is responsible for their cash conversion cycles being almost half of what their nearest competitor has.

They have also used portions of their FCF to establish their presence in i) construction chemical business, ii) colour consulting services, iii) home improvement and iv) international geographies, all of whom have huge potential to grow. By making such diverse bets, management wants to wait and let things unfold as time pass to know what worked and what didn't. They stepped aside from things that weren't living up to their expectations, like their Caribbean operations while double down on bets working out, like opening more AP homes. They have the most trustworthy and competent senior management working in a business culture established by Champaklal Choksi. Minority shareholder friendly management ensures that the value created by business is transferred to its owners without hiccups. Forensic checks too point at high standards of reporting quality with negligible chances of any financial shenanigans. With rich and long history of delivering value, it is a fairly stable business whose future is easier to predict, making it a favourable bet for most of the investors.

Beside all these factors, even from a distributor/dealer perspective, it makes more sense to be in business with Asian Paints than with its peers. Often they work at low margins with huge capital invested in buying tinting machines. In order for them to generate high RoCE for their respective businesses, they must have extremely high turnover to compensate for unfavourable previous factors, which is why they prefer selling products of the company which they don't have to hold for large number of days. In this regard Asian Paints is simply the best, since their accurate demand forecasting, automated supply chain system and 4-times delivery per day reduces the working capital requirement for these dealers. They are able to sell their inventory fast and replenish it in no time skewing unit economics in their favour. This can be proven if we compare revenue per dealer for all peers in the industry. It becomes a no-brainer decision for dealers to associate themselves with Asian Paints seeing such high revenue per dealer and lower working capital expenses due to reasons mentioned earlier.

Exhibit 58: Revenue per active dealer



All things aside, if asked one and only one reason for its supreme past performance, it won't be its brand equity or widespread distribution network, but its ability to leverage the power of data analysis in their business model. Mr. Champaklal Choksi was way ahead of the curve when back in 1974 he decided to buy India's first mainframe computer for "data analysis". While it is a buzz word for today's generation, back then people looked down to this decision as an act of stupidity. Ever since that day, they have been always ahead of its competition into introducing newer and better technologies to streamline their business operations. It's ERP implementation and collected data from large number of data points over past decades is a widening moat which increase as days pass making it virtually impossible for its competitors to think about competing against the champion.

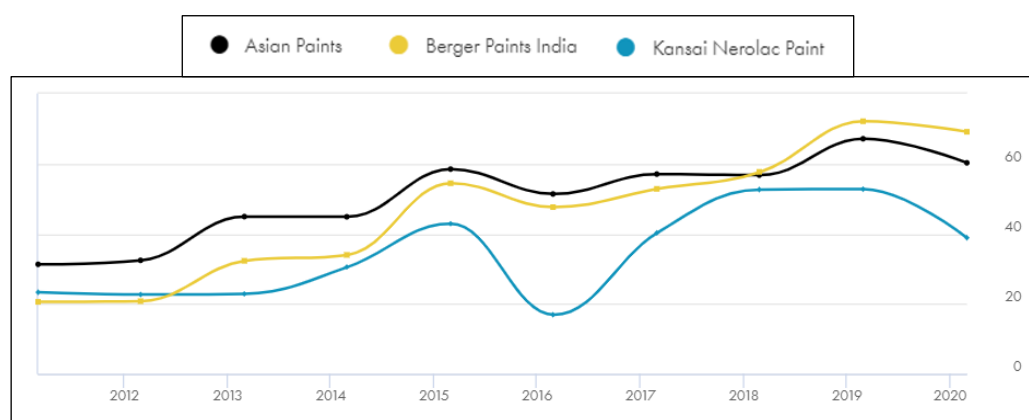
VALUATIONS

Paints Industry has always traded at expensive valuations and has seen continuous re-rating during the last decade. Expensive valuations always makes an investor hesitant to enter the stock freely, therefore enough attention must be given to valuations. Even though the sector is a traditional manufacturing business, it has high asset turnover ratio and extremely low debt which is why analysts prefer using P/E ratios for relative valuations.

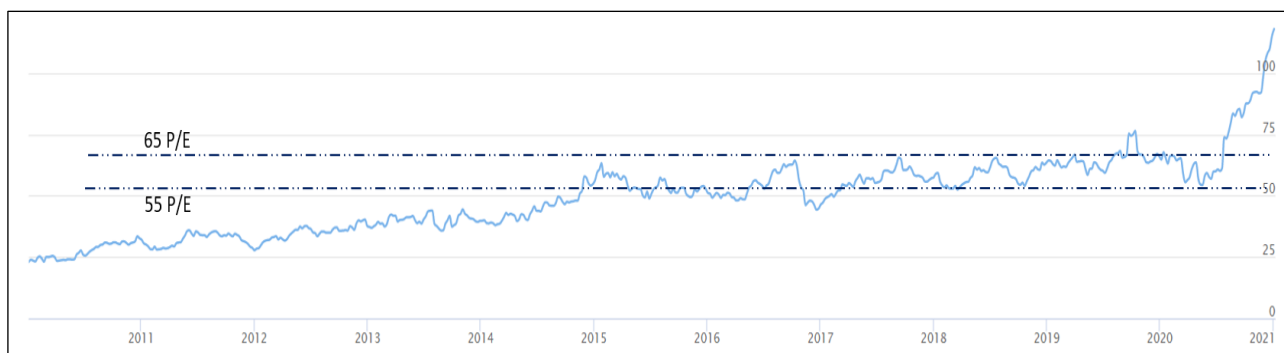
Deciding target P/E

From past data we can infer Asian Paints and Berger Paints have always traded at premium to its industry average and that the gap between their P/E ratios have been consistently decreasing. Finally, during 2018 period, Berger Paint's started trading more expensively than Asian Paints because of sporadic growth it showed in past and promised for future.

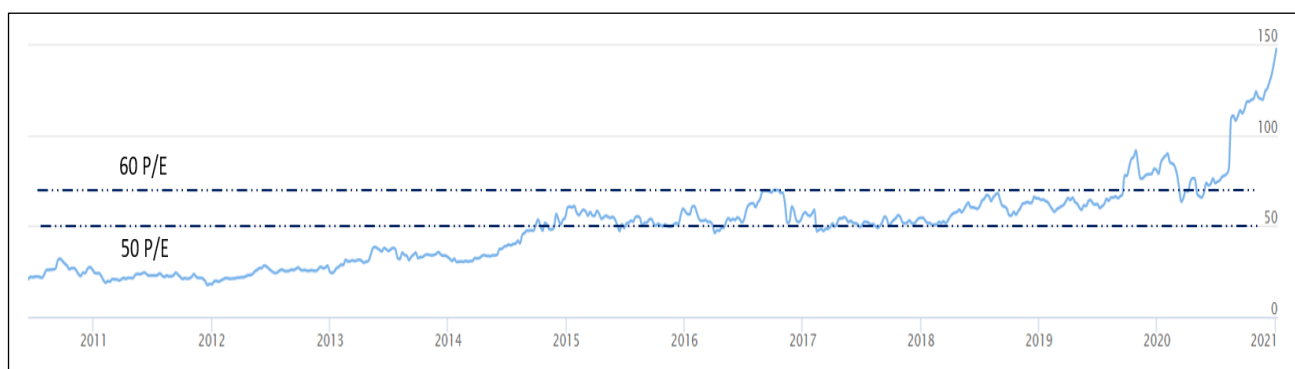
	Median P/E		
	3yrs	5yrs	8yrs
Asian Paints	62.62	59.93	55.33
Berger Paints	65.45	61.07	54.63
Kansai Nerolac	51.60	49.76	47.72
Industry Average	59.89	56.92	52.56



Individually talking about Asian Paints, it has been trading between 65-55 P/E range for past couple of years, up until 2020 bull rally fueled by liquidity and market sentiment, when it skyrocketed and currently trades north of 100 P/E. This phenomenon can be explained through the fact that markets have discounted its earnings 3-4 years in future already, which isn't healthy.



Similar is the case with Berger Paints which was trading between the range of 60-50 P/E up until Q2 FY20 when it started trading between 80-65 P/E range and witnessed a re-rating.



Though Berger Paints offers more growth on the face of it, Asian Paints still remains the market leader with huge margin. This is why, it seems plausible that both of them must ideally trade at similar P/Es.

ESTIMATING FUTURE EPS

Since Q1FY21 was a complete washout due to tight business conditions, it achieved 62% of base business volumes and 56% in value terms. Double digit growth in June set promising foundation for second quarter, which gave strong 11% volume growth and 6% value growth for the domestic decorative business. Similarly, awareness campaign of safe painting services was responsible for demand picking up, although metro cities still lag compared to tier 2/3/4 cities in terms of volume growth. With lockdown still imposed in various other countries, international operations too were heavily impacted. Though December quarter is doing fairly well owing to festive season, it is highly unlikely that it could have performed as per historic averages during the quarter.

Profit and Loss (in ₹Cr.)	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Estimates	
											Dec-20	Mar-21
Revenue	4,390	4,615	5,263	4,992	5,105	5,051	5,420	4,636	2,923	5,350	5,854	5,006
YoY Growth					16.3%	9.4%	3.0%	-7.1%	-42.7%	5.9%	8.0%	8.0%

These growth estimates have been taken, keeping in mind how well has company historically performed during these quarter.

YoY Growth Rates		
FY	Dec Quarter	Mar Quarter
13	18.8%	6.6%
14	14.9%	22.0%
15	5.8%	6.9%
16	5.0%	14.7%
17	11.4%	7.9%
18	-0.1%	2.7%
19	23.3%	11.1%
20	3.0%	-7.1%
Average	10.3%	8.1%

All of these estimates lead us to conclude that this year revenue may fall for the first time in the history of the company by around 5.3%, while it will compensate for that in FY22 by growing better than it has grown in last couple of years.

Gross margins will certainly get impacted owing to huge volatility in crude prices and USD/INR, but still above their historic averages. Employee cost will continue to be on a higher note during FY21, owing to new plants which were commissioned. While it is assumed that other expenses, other income and interest expense will remain constant, selling and admin expenses will definitely have reduced a lot owing to cost cutting during pandemic. Depreciation charged will continue to be high, since the two new plants are commissioned and in use. It is assumed that company will continue on its path of opting for lower tax rates as it opted this year.

All of these can be translated into these numbers.

Profit and Loss (in ₹Cr.)	Estimates				
	FY18	FY19	FY20	FY21	FY22
Revenue	16,825	19,240	20,211	19,133	21,621
Revenue Growth (%)	11.7%	14.4%	5.0%	-5.3%	13.0%
GPM (%)	40.1%	39.4%	41.6%	41.0%	41.5%
Gross Profit	6,752	7,577	8,407	7,845	8,973
Employee Cost (%)	6.7%	6.5%	6.8%	6.8%	6.4%
Selling and admin (%)	13.4%	12.3%	13.0%	12.0%	12.3%
Other Expenses (%)	1.0%	1.1%	1.2%	1.2%	1.2%
EBITDA Margin (%)	19.0%	19.6%	20.6%	21.0%	21.6%
EBITDA	3,204	3,765	4,162	4,013	4,662
Depreciation (%)	2.1%	3.2%	3.9%	3.9%	3.9%
Other Income (%)	2.0%	1.4%	1.8%	1.7%	1.6%
Interest (%)	0.2%	0.6%	0.5%	0.5%	0.5%
PBT	3,138	3,306	3,629	3,503	4,065
Tax Rate	33.2%	33.2%	23.6%	25.2%	25.2%
PAT	2,098	2,208	2,774	2,621	3,042
EPS	21.87	23.02	28.92	27.33	31.71

	Average			
	3yr	5yr	7yr	9yr
GPM (%)	40.8%	40.5%	39.5%	38.8%
EBITDA Margin (%)	19.7%	19.6%	18.7%	18.2%
Revenue Growth (%)	10.3%	8.2%	9.8%	11.8%

TARGET PRICE

With EPS estimated, and potential of PE being re-rated to 70-75 levels, we come to a conclusion that stock is overvalued, thus publish a **sell recommendation**.

	FY20	FY21	FY22
EPS	28.9	27.3	31.7
Target P/E		70	75
Target Price		1913	2378
Potential Return		-33%	-16%

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- z) <https://investorsareidiots.com/retirement-investments-equity-fixed-income-currencies-commodities-economy/home/home-2/homespage/2017/08/the-shortening-of-the-repainting-cycle-to-drive-demand-for-decorative-paints-in-india/>