

India

REDUCE (previously HOLD)

Consensus ratings*:	Buy 10 Hold 6 Sell 5
Current price:	Rs464
Target price:	Rs432
Previous target:	Rs500
Up/downside:	-6.9%
InCred Research / Consensus:	-20.0%
Reuters:	
Bloomberg:	KNPL IN
Market cap:	US\$3,446m Rs250,247m
Average daily turnover:	US\$2.3m Rs168.4m
Current shares o/s:	538.9m
Free float:	25.0%
*Source: Bloomberg	

Key changes in this note

- Downgrade rating to REDUCE from HOLD.
- Reduce target price to Rs432 from Rs500.
- Reduce FY23F/24F EPS by 13.6%/4.2%.

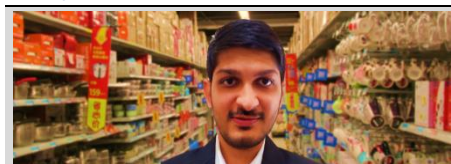


Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	(5.9)	(7.4)	(18.5)
Relative (%)	(10.2)	(11.2)	(19.6)

Major shareholders	% held
Promoter & Promoter Group	75.0
LIC	3.4
Aditya Birla Sunlife AMC	2.1

Analyst(s)



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Kansai Nerolac Paints Limited

Taking right steps but timing not on its side

- KNPL's 2Q decorative paint sales (flat volume) was up 10% yoy (vs. 19%/24% of Asian Paints/Indigo Paints, respectively). Near-term demand seen subdued.
- Regaining market share in the decorative paints segment is a tough task and we expect KNPL to operate at a lower margin band for a prolonged period.
- Despite the right steps, given the changing industry landscape, we downgrade rating on KNPL to REDUCE with a lower TP of Rs432 (32x Sep 2024F EPS).

Taking right steps but timing not on its side

Kansai Nerolac Paints' (KNPL) focus under its new MD Mr. Anuj Jain on the decorative paints side has been in 1) investing on brand equity/media communication, 2) increasing the engagement with the influencer community, and 3) enhancing salience of premium/super-premium paints, while on the industrial side it has been on 1) exiting low-margin business, 2) entering newer segments in the automobile OEM space, and 3) provide technologically advanced superior products that give higher margins. While we believe that these steps are in the right direction, the timing, given the emerging industry landscape, is not on KNPL's side. In retrospect, had KNPL taken these steps, let's say, a few years ago, when the market leader was not as aggressive as it is today, an incumbent was losing market share and the industry landscape was benign, KNPL would have been a rerating candidate. However, the competitive intensity is likely to be much higher than it was ever before, and we feel it will be a tall task for KNPL to regain lost market share in the decorative paints segment. We estimate FY22-25F sales CAGR of 12.9%.

Likely to operate in a lower margin band

In 2QFY23, KNPL's consolidated gross margin contracted by 110bp qoq to 28.8% (down 10bp yoy) while EBITDA margin contracted by 210bp qoq to 10.3% (up 30bp yoy). With KNPL envisaging to (or rather having to) spend a higher sum on brand/media to maintain its share of voice at the pre-Covid level of 15% (which fell to 6-7%), rebate and discount intensity continuing at a high level (expected to sustain or even increase over time) will more than offset the benefits accruing from product mix change on the automobile/industrial paints side. Also, in our view, benefits which the market leader will gain from its supply side initiatives (backward integration) will be reinvested, exerting even more pressure on industry margins. Hence, we believe KNPL will operate in a lower EBITDA margin band for a sustained period. We estimate FY25F EBITDA margin at 13.2%.

Downgrade to REDUCE

KNPL, in the near term, should benefit from cyclical uptick in auto demand (c.25% of sales) led by easing of semiconductor shortage. However, our apprehension on KNPL regaining market share in the decorative paints segment and operating at lower margin band for a prolonged period makes us downgrade KNPL to REDUCE (vs. HOLD earlier) with a lower target price of Rs432 (32x Sep 2024F EPS). Upside risk: Market share gain in the decorative paints segment and/or sharp decline in crude oil prices

Financial Summary	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
Revenue (Rsm)	50,743	63,694	75,942	84,445	91,780
Operating EBITDA (Rsm)	8,633	6,494	8,054	11,393	12,123
Net Profit (Rsm)	5,258	3,432	4,647	7,075	7,560
Core EPS (Rs)	9.8	6.4	8.6	13.1	14.0
Core EPS Growth	1.9%	(34.7%)	35.4%	52.2%	6.8%
FD Core P/E (x)	47.60	72.92	53.85	35.37	33.10
DPS (Rs)	4.4	4.0	4.7	5.6	6.6
Dividend Yield	0.95%	0.86%	1.02%	1.20%	1.42%
EV/EBITDA (x)	28.42	38.57	30.54	21.41	19.88
P/FCFE (x)	150.76	94.54	36.76	50.24	38.76
Net Gearing	(13.0%)	0.1%	(10.1%)	(13.6%)	(18.2%)
P/BV (x)	6.17	6.06	5.74	5.24	4.83
ROE	13.5%	8.4%	10.9%	15.5%	15.2%
% Change In Core EPS Estimates			(13.59%)	(4.21%)	(3.58%)
InCred Research/Consensus EPS (x)					

SOURCE: INCRED RESEARCH, COMPANY REPORTS

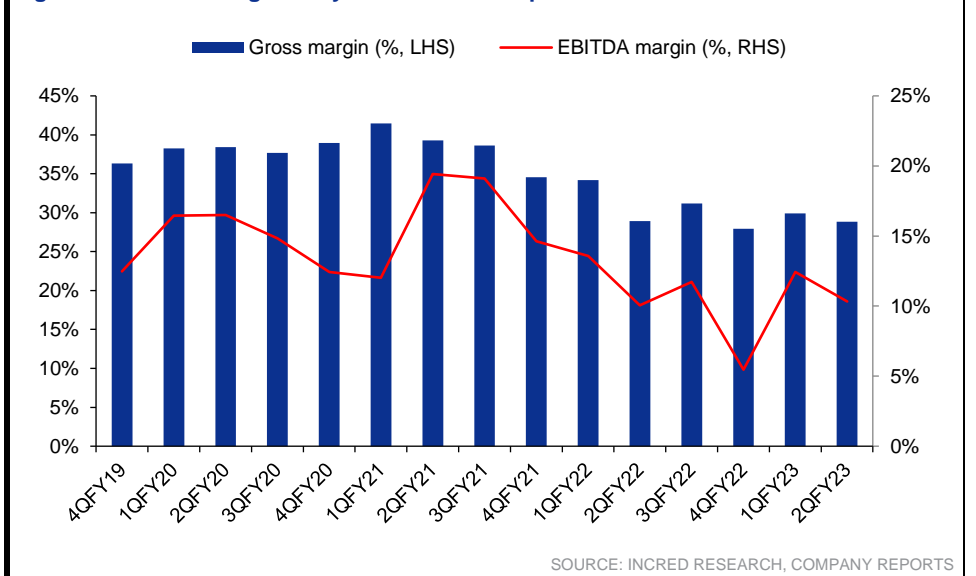
Taking right steps but timing not on its side

Figure 1: Quarterly results summary - consolidated

Y/E, Mar (Rs. m)	2QFY22	1QFY23	2QFY23	YoY (%)	QoQ (%)	1HFY22	1HFY23	Gr (%)
Revenue	16,196	20,514	19,310	19	-6	30,224	39,823	32
Expenditure	14,569	17,963	17,316	19	-4	26,691	35,279	32
Consumption of RM	11,514	14,379	13,744	19	-4	20,744	28,123	36
as % of sales	71.1%	70.1%	71.2%			68.6%	70.6%	
Employee cost	801	884	940	17	6	1,621	1,824	13
as % of sales	4.9%	4.3%	4.9%			5.4%	4.6%	
Other expenditure	2,255	2,700	2,632	17	-3	4,326	5,332	23
as % of sales	13.9%	13.2%	13.6%			14.3%	13.4%	
EBITDA	1,628	2,550	1,994	22	-22	3,533	4,544	29
Depreciation	421	431	451	7	5	838	883	5
EBIT	1,207	2,119	1,542	28	-27	2,695	3,661	36
Other income	65	48	41	-37	-16	164	89	-46
Interest	69	85	63			135	148	
PBT	1,203	2,083	1,520	26	-27	2,724	3,602	32
Total tax	330	562	408	23	-27	737	970	32
Adjusted PAT	873	1,521	1,112	27	-27	1,987	2,633	33
Minority interest	-47	-43	-24			-74	-66	
APAT after MI	920	1,563	1,136	23	-27	2,061	2,699	31
Extraordinary items	0	0	0			0	0	
Reported PAT	920	1,563	1,136	23	-27	2,061	2,699	31
Adjusted EPS	1.6	2.8	2.1	27.4	-26.9	3.9	4.0	2.2
Margins (%)	2QFY22	1QFY23	2QFY23	YoY (bp)	QoQ (bp)	1HFY22	1HFY23	(bp)
Gross margin	28.9%	29.9%	28.8%	-10	-110	31.4%	29.4%	-200
EBITDA	10.0%	12.4%	10.3%	30	-210	11.7%	11.4%	-30
EBIT	7.5%	10.3%	8.0%	50	-230	8.9%	9.2%	30
EBT	7.4%	10.2%	7.9%	40	-230	9.0%	9.0%	0
PAT	5.4%	7.4%	5.8%	40	-170	6.6%	6.6%	0
Effective tax rate	27.5%	27.0%	26.8%	-60	-20	27.1%	26.9%	-20

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 2: EBITDA margin likely to remain under pressure



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Key takeaways from the earnings call

Decorative paints

- **Focusing on increasing salience in premium/super premium segments and looking at higher brand/media investments.**
- Decorative paint segment's growth was in **double digits in value terms (flat in volume terms). Downtrading visible. Rebates were higher in 2QFY23.**
- T2-3 towns' growth was closer to that of T-1 cities, **but rural markets (having population less than 20,000) are still impacted.**
- **The focus is on growing market share in the premium segment.** Nerolac Impression Kashmir brand launched in 1QFY23 has been scaled up pan-India. It was received well by the network. KNPL's salience in the super premium category vs. industry is low, and hence the focus is on expanding distribution. Salience is up by 2%. Some products in the wood finish and polyethylene categories and TrueSheen Emulsion under Soldier brand have led to premiumization.
- **Overall industry volume was driven by putty.** KNPL will remain selective in the putty segment. Usually, by Jul channel stocks enamels and distempers. By Sep, channels stock up on more of the premium range. A similar trend was seen in Oct 2022.
- To support Paint+, KNPL ran campaigns on its premium products (the advertisements are still running).
- A range of products launched under the **Nxt range** (launched 50 in 1QFY23, finalized 25 more in 2Q) for select dealers and retailers. Nxt stores have been set up as experience stores with the focus on showing product superiority.
- **KNPL aims to maintain its share of voice (SOV) at 15% (historically at 15-20%, then fell to 6-7% and started recovering).** Decorative paints' market share is slightly below SOV. The drop to 6-7% was because KNPL was impacted during the Covid-19 pandemic (initially lost main seasons) and hence, the company is driving it back irrespective of the pressure from other categories.
- **KNPL added 3,000 retail outlets in 1HFY23.**
- **Project business:** KNPL is increasing its presence in key towns and to cover all emerging towns by the end of the year.
- **New business contribution rises to 5% of sales** (10-12% for industry) led by construction chemicals. These products have caught up with market growth as the market is expanding. Management is confident of growth in this segment. 35% of the distribution network has started buying these products (30% in 1QFY23).
- New products have been launched under the economy range across primer and emulsion segments, as consumers shift towards the economy range.
- **Services with five-day painting proposition:** KNPL expanded its reach to 50 towns in 2QFY23.
- **NeroFix adhesives:** This segment will ride on the company's existing distribution channels and unlock synergies.
- North and East India are strong markets for KNPL while South India is a weak market. However, South India performed the strongest during the quarter, followed by North, West and East India.
- The focus is on creating long-term value creation by taking its board's approval for employee stock option plan or ESOP to key employees (the scheme to be announced soon), capability building (skill enhancement for employees) and brand building.

Industrial segment

- **Exiting low-margin business and focusing on tech-led product development (high margin).** EBITDA margin differential to narrow (vs. 700-800bp earlier) due to higher margins in the industrial segment being offset by higher investments in the decorative paints segment.
- **Automobile paints market share:** It continued to grow led by passenger vehicles. Production growth of passenger vehicles (PVs) was more than 20% in 1HFY23 and hence, growth of the PV segment was higher.
- **Enters new segments in automobile paints:** KNPL has developed products for the decal, PV sealer, and alloy wheel markets, and also high-end anti-corrosive coatings.
- **Non-auto segments:** The focus is on **increasing the mix of premium products**. KNPL has been exiting low-margin products. It requires approvals from the infrastructure, oil and gas sectors, which are underway. 40% of approvals have been obtained (Mumbai-Ahmedabad bullet train project, Vande Bharat trains, and some refineries).
- **Coil coatings:** The appliances segment is better placed on the margins front compared to roof coatings. This segment now contributes 10% to coil coating segment's revenue. The focus will be on growing its premium range.

Input cost and margins

- 7-8% inflation in 1HFY23 vs. 3% price hikes taken (for both decorative and industrial paints segments). KNPL is continuing to negotiate with its customers for taking further price hikes.
- In the decorative paints segment, there is a sequential deterioration in the mix due to higher salience of emulsions during the Diwali festival season. Salience of the premium mix in the industrial paints segment has gone up, but industrial paints have a lower share in total sales of KNPL, which led to margin pressure as the company continued to spend on its brands.
- Employee cost was up owing to salary hikes (which happened in Jul 2022).

Outlook

- The focus remains on **increasing investments in the decorative paints segment and increasing margins in the industrial paints segment** (by focusing on premiumization and price hikes).
- **Margin outlook:** Raw material prices have cooled off slightly, but the situation isn't clear yet. May see some improvement in 4QFY23F. Margins are expected to improve gradually but as KNPL invests in the decorative paints segment, the improvement may get offset. Gross-level focus is on growing the industrial paints segment's profitability (can aid 2-3% improvement).

Other highlights

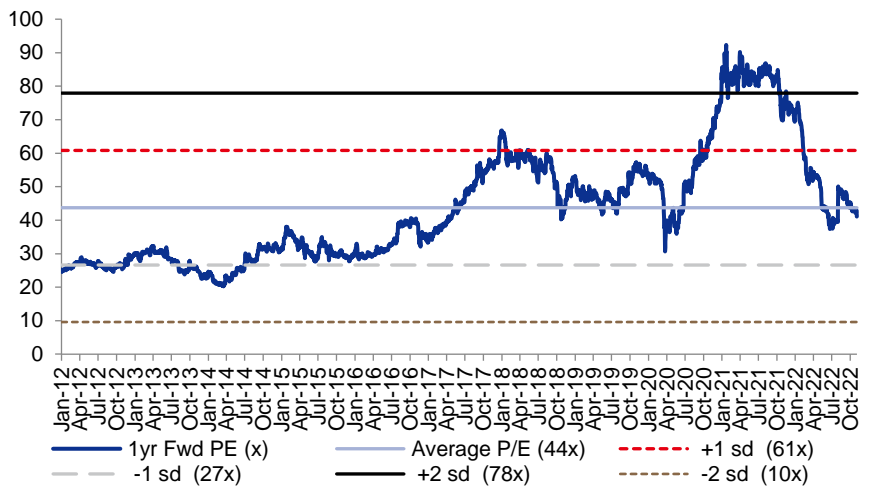
- **Asian Paints' capacity expansion and backward integration:** KNPL already has backward integration for resin (used in automobile paints) and emulsions (used in decorative paints). Asian Paints is likely to use vinyl acetate monomer / vinyl acetate ethylene to improve low VOC (volatile organic compound) products.

Figure 3: Our revised earnings estimates

Y/E, Mar (Rs. m)	FY23F			FY24F			FY25F		
	Earlier	Revised	% change	Earlier	Revised	% change	Earlier	Revised	% change
Revenue	77,386	75,942	(1.9)	86,106	84,445	(1.9)	93,175	91,780	(1.5)
EBITDA	9,022	8,054	(10.7)	11,799	11,393	(3.4)	12,487	12,123	(2.9)
EBITDA margin (%)	11.6%	10.6%	-100 bp	13.7%	13.5%	-20 bp	13.4%	13.2%	-20 bp
APAT	5,378	4,647	(13.6)	7,386	7,075	(4.2)	7,841	7,560	(3.6)
EPS	10.0	8.6	(13.6)	13.7	13.1	(4.2)	14.5	14.0	(3.6)

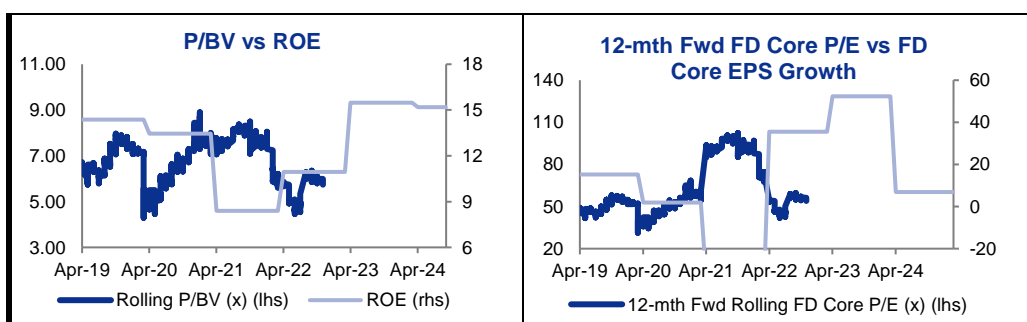
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 4: KNPL's one-year forward P/E trades close to its 10-year average P/E



SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS



Profit & Loss

(Rs mn)	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
Total Net Revenues	50,743	63,694	75,942	84,445	91,780
Gross Profit	19,277	19,421	23,306	28,343	30,435
Operating EBITDA	8,633	6,494	8,054	11,393	12,123
Depreciation And Amortisation	(1,653)	(1,698)	(1,827)	(1,918)	(2,002)
Operating EBIT	6,980	4,796	6,227	9,475	10,121
Financial Income/(Expense)	145	(32)	(3)		3
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)					
Profit Before Tax (pre-EI)	7,125	4,764	6,224	9,475	10,123
Exceptional Items					
Pre-tax Profit	7,125	4,764	6,224	9,475	10,123
Taxation	(1,867)	(1,333)	(1,577)	(2,400)	(2,563)
Exceptional Income - post-tax					
Profit After Tax	5,258	3,432	4,647	7,075	7,560
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	5,258	3,432	4,647	7,075	7,560
Recurring Net Profit	5,258	3,432	4,647	7,075	7,560
Fully Diluted Recurring Net Profit	5,258	3,432	4,647	7,075	7,560

Cash Flow

(Rs mn)	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
EBITDA	8,633	6,494	8,054	11,393	12,123
Cash Flow from Invt. & Assoc.	157				
Change In Working Capital	54	(4,912)	1,933	(2,413)	(1,756)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow					
Net Interest (Paid)/Received	(237)	(286)	(260)	(260)	(260)
Tax Paid	(1,867)	(1,333)	(1,577)	(2,400)	(2,563)
Cashflow From Operations	6,739	(37)	8,150	6,321	7,543
Capex	(2,089)	(2,715)	(1,600)	(1,600)	(1,350)
Disposals Of FAs/subsidiaries					
Acq. Of Subsidiaries/investments	(3,631)	4,585			
Other Investing Cashflow	382	254	257	260	263
Cash Flow From Investing	(5,337)	2,124	(1,343)	(1,340)	(1,087)
Debt Raised/(repaid)	257	560			
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid	(2,371)	(2,156)	(2,544)	(3,001)	(3,542)
Preferred Dividends					
Other Financing Cashflow	194	(834)	205	95	31
Cash Flow From Financing	(1,920)	(2,430)	(2,339)	(2,907)	(3,511)
Total Cash Generated	(518)	(343)	4,468	2,074	2,945
Free Cashflow To Equity	1,660	2,647	6,806	4,981	6,456
Free Cashflow To Firm	1,640	2,373	7,066	5,241	6,716

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS...cont'd

Balance Sheet					
(Rs mn)	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
Total Cash And Equivalents	7,926	3,155	7,622	9,697	12,642
Total Debtors	9,564	10,933	10,712	11,815	12,816
Inventories	11,979	16,296	13,959	15,399	16,736
Total Other Current Assets	4,517	4,492	6,222	6,885	7,451
Total Current Assets	33,985	34,876	38,516	43,796	49,645
Fixed Assets	20,993	22,010	21,783	21,465	20,813
Total Investments	10	11	11	11	11
Intangible Assets	198	198	198	198	198
Total Other Non-Current Assets	148				
Total Non-current Assets	21,348	22,218	21,991	21,673	21,021
Short-term Debt	1,684	2,157	2,157	2,157	2,157
Current Portion of Long-Term Debt					
Total Creditors	10,499	10,898	12,659	13,475	14,646
Other Current Liabilities					
Total Current Liabilities	12,183	13,054	14,815	15,632	16,803
Total Long-term Debt	943	1,031	1,031	1,031	1,031
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities					
Total Non-current Liabilities	943	1,031	1,031	1,031	1,031
Total Provisions	1,316	1,494	1,065	1,065	1,065
Total Liabilities	14,442	15,579	16,911	17,727	18,898
Shareholders Equity	40,529	41,322	43,631	47,799	51,848
Minority Interests	363	193	193	193	193
Total Equity	40,892	41,515	43,824	47,992	52,041

Key Ratios					
	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
Revenue Growth	(3.9%)	25.5%	19.2%	11.2%	8.7%
Operating EBITDA Growth	7.3%	(24.8%)	24.0%	41.5%	6.4%
Operating EBITDA Margin	17.0%	10.2%	10.6%	13.5%	13.2%
Net Cash Per Share (Rs)	9.83	(0.06)	8.23	12.08	17.54
BVPS (Rs)	75.21	76.68	80.96	88.70	96.21
Gross Interest Cover	29.44	16.78	23.95	36.44	38.93
Effective Tax Rate	26.2%	28.0%	25.3%	25.3%	25.3%
Net Dividend Payout Ratio	45.1%	62.8%	54.7%	42.4%	46.8%
Accounts Receivables Days	62.70	58.73	52.02	48.69	48.98
Inventory Days	127.97	116.55	104.90	95.50	95.60
Accounts Payables Days	103.70	88.20	81.68	85.01	83.66
ROIC (%)	18.9%	11.1%	15.5%	22.4%	23.3%
ROCE (%)	16.4%	10.7%	13.3%	18.9%	18.7%
Return On Average Assets	9.8%	6.2%	7.9%	11.2%	11.1%

Key Drivers					
	Mar-21A	Mar-22A	Mar-23F	Mar-24F	Mar-25F
Decorative paints revenue growth	N/A	27.0%	19.0%	9.0%	6.0%
Industrial paints revenue growth	(12.4%)	23.2%	26.6%	15.3%	13.0%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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