Arihant Capital
Generating Wealth

Sector Update
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FMCG - Time to Build: Margin Inflection Meets Historical Value

Sector View: Overweight

Time Horizon: 6–12 Months

The Indian FMCG sector is at a rare inflection point where **five tailwinds are converging simultaneously**: Commodity deflation (crude, copra, packaging) - Freight/logistics cost stabilization A low Q2 FY27 base setting up easy FY28 comparisons Volume recovery on the back of rural demand normalization Monsoon reality proving far better than the "famine" fears priced in by the market Valuations have de-rated to historical support levels Nifty FMCG PE is 18% below its 5-year median and price-to-book is cheaper than 98% of the last 5 years. The sector is offering **asymmetric risk-reward** for institutional investors willing to look through the Q1 FY27 margin trough to the FY28 earnings recovery.

Investment Rational –

1. Commodity Deflation Is Here — Crude Collapse Unlocks Gross Margin Expansion

Crude has corrected sharply from ~$107/bbl (April 2026) to **$77/bbl** (early August) as US-Iran diplomatic overtures reduce Hormuz Strait risk

Packaging (polymer-based flexible packaging, PET, PP) accounts for **15–20%** of FMCG costs and moves with crude with a 3–6 month lag the April–August crude collapse has not fully flowed through P&Ls yet; Q2/Q3 FY27 is when the benefit crystallizes

Palm oil, while up ~10% YoY, has stabilized near **4,677 MYR/T** and is expected to average lower in 2026 vs 2025 on rising Indonesian/Malaysian supply; copra has already corrected **25–30%** from peak a direct tailwind for Marico, Dabur, Godrej Consumer, and personal-care players

Companies that took calibrated price hikes in Q1/Q2 to cover high-cost inventory will now benefit from falling replacement costs; gross margin expansion of **100–200 bps** over H2 FY27 is achievable

2. Freight & Logistics Costs Have Stabilized — An Underappreciated Margin Lever

- Diesel prices in India have softened from the peaks seen during the Hormuz crisis (when crude touched $107/bbl) to ~INR 95/litre in Delhi as of early August 2026, with crude's collapse to $77/bbl set to pass through with a lag
- Logistics costs constitute 8–14% of revenue for FMCG companies, with road freight being the dominant mode; the Dedicated Freight Corridors (DFC) and PM Gati Shakti are structurally improving logistics efficiency, but the immediate cyclical relief comes from diesel cost stabilization
- FMCG companies had absorbed significant freight inflation in Q4 FY26 and Q1 FY27 due to the geopolitical shock; with diesel costs now plateauing and likely declining in Q3/Q4 FY27, freight as a percentage of sales should improve by 30–50 bps a direct EBITDA tailwind that is not yet priced in

Abhishek Jain
abhishek.jain@arihantcapital.com
022-422548871

Deepali Kumari
Deepali.kumari@arihantcapital.com
022-422548873

3. Monsoon Reality Is Far Better Than "Famine" Fears Priced In — A Key Positive Surprise

- The market entered the monsoon season with doomsday expectations — IMD forecast **below-normal rainfall at 90% of LPA** with a **60% chance of deficit**, and NOAA warned of a super El Niño potentially rivaling the 1876–78 event that caused famines across India and Asia
- **June was brutal** — rainfall was ~40% below normal, the fifth-driest June since 1901, and fears of a full-blown drought gripped the market
- **July defied all forecasts** — India received **270.1mm of rainfall vs a normal of 271.9mm**, effectively normal, cutting the national deficit from 40% at end-June to ~14% by end-July
- Central India — the monsoon core zone and India's agricultural heartland — received **29% excess rainfall in July**, while the spatial distribution, though skewed, has supported the key Kharif sowing belt
- **The "famine" narrative has been debunked** — what was priced as a potential 1876-style catastrophe has turned into a manageable below-normal monsoon with normal July rainfall; the market had over-discounted the worst case, and the reality is a positive surprise for rural consumption
- Scientists now acknowledge that **"El Niño alone can no longer explain India's rainfall behaviour"** climate change is altering monsoon dynamics in ways that traditional models fail to capture
- For FMCG, this means the rural demand collapse that was feared has not materialized; farm liquidity from MSP hikes and the July rainfall recovery is supporting consumption

4. Q2 FY27 Base Is Exceptionally Low — A Double Base Effect for FY28

- Q1 FY27 margins were depressed across the sector as companies worked through high-cost inventory accumulated during the April crude spike; Godrej Consumer's CEO Sudhir Sitapati explicitly noted that *"input costs were elevated, particularly during the early part of the quarter, and geopolitical developments contributed to significant volatility in crude oil and other commodity prices"*
- **Q2 FY27 is likely the trough quarter** — volumes in July (as per channel checks) are showing decent offtake, but margins will remain compressed as the last leg of high-cost inventory clears
- **The base effect is compounded by two weak years:** Q2 FY26 itself was disrupted by GST rate rationalization and channel destocking, which suppressed volume growth to sub-5% levels for most companies, this means Q2 FY27 is compounding against an already weak Q2 FY26, and FY28 will compound against two consecutive years of depressed volumes
- For Godrej Consumer, Q1 FY27 standalone EBITDA grew only 10% despite 11% revenue growth a clear sign of margin compression; for Colgate, EBITDA grew only 6.6% despite 12% revenue growth, with margins contracting 150 bps due to stepped-up ad spends
- **The math is powerful:** Even modest margin recovery in FY28 (on top of normalized volume growth of 7–9%) drives **20–25% earnings growth** for commodity-leveraged names, as FY28 will be compounding against FY27 (which itself was compounding against a GST-disrupted FY26)

5. Q2 FY27 Volume Momentum Is Building on a Structurally Low Base

- FY26 volume growth lagged GDP (4–5% vs 7–8%), creating an unusually weak base; Q1 FY27 was further marred by high-cost inventory and margin squeeze
- **Channel checks for July indicate resilient offtake** — rural markets continue to outpace urban for the eighth consecutive quarter (rural volume +2.9% vs urban +2.3% in recent NIQ data), and metro demand is normalizing
- The **GST disruption in Q2 FY26** led to significant channel destocking and trade confusion, which artificially suppressed that quarter's volumes — this means the YoY volume growth prints for Q2 FY27 will look optically strong, but more importantly, the **two-year stacked volume growth** (FY28 vs FY26) will reveal the true underlying demand recovery
- With the monsoon fears receding and MSP hikes supporting farm liquidity, rural consumption — the engine of mass FMCG is poised to re-accelerate in Q2

6. Margin Recovery Trajectory: From Squeeze to Expansion

- Q1 FY27 margins were depressed as companies worked through high-cost inventory and crude-linked inputs spiked; brokerages expect sequential gross-margin contraction in Q1
- **The inflection is H2-biased:** As high-cost inventory liquidates and lower crude/palm oil prices flow through, EBITDA margins should progressively improve; management commentary from HUL, Marico, Britannia, Dabur, Godrej Consumer, and Colgate has consistently guided for margin recovery in FY27
- Pricing power remains intact — companies are opting for selective price hikes/shrinkflation rather than broad-based cuts, which protects revenue per unit even as input costs fall

7. Valuations at Historical Support — Asymmetric Risk/Reward

- **Nifty FMCG PE at 34.4x** (as of 7 Aug 2026) — ~18% below its 5-year median of 42.1x and sitting in the lower third of its historical band
- **Price-to-book is cheaper than 98% of the last 5 years**
- The index is down ~11% over the past year vs Nifty 50's ~7% decline, reflecting excessive pessimism priced into a structurally defensive sector
- **Historical forward returns from current PE levels are compelling:** From the current PE band (32–37x), 5-year forward returns have been **positive in 100% of historical windows** with a median of **+13.5% CAGR**

8. Policy Tailwinds & Channel Evolution Support Demand

- **GST 2.0 rationalization** and income-tax relief are boosting disposable incomes, particularly in urban India where premiumization is accelerating
- **Quick commerce** now drives >75% of e-commerce FMCG sales and is expanding basket sizes in metros; e-commerce share has hit **14% across metros** and **21%+ in Southern metros**
- RBI's accommodative stance and rate-cut cycle support consumer credit and discretionary spending

9. Competitive Dynamics Favor Organized Players

- Smaller manufacturers gained share during the GST-adjustment phase by being more agile on pricing; however, as commodity volatility eases and branded players regain pricing flexibility, the pendulum should swing back toward organized players with superior distribution and R&D pipelines

HUL, Britannia, Nestle, ITC, Dabur, Marico, Godrej Consumer, and Colgate have used the tough FY26 environment to expand direct distribution, launch premium SKUs, and optimize supply chains — setting up market-share gains as volumes recover

Stock-Specific Pitches-

TOP PICK 1: Godrej Consumer Products (GCPL) — The Multi-Geography Margin Recovery Story

Why Now: - Q1 FY27 was a "show-me" quarter that delivered: Revenue +18.3% YoY to INR 42,250 Mn, net profit +11.5% to INR 5,045 Mn, and consolidated underlying volume growth (UVG) of 9% broad-based across India, Indonesia, and Africa - India business is accelerating: Domestic revenue +11.4% with Home Care +12% and Personal Care +11%; standalone underlying volume grew 7% with EBITDA up 10% to INR 5,480 Mn - International recovery is the kicker: Indonesia delivered 10% UVG and 15% sales growth (led by Shampoo and Household Insecticides), while Africa (including Strength of Nature) posted a staggering 47% revenue growth and 17% UVG with EBITDA up 42% - Valuation has de-rated sharply: EV/Core EBITDA has fallen from 36.6x (Mar 2025) to 30.25x (Mar 2026) a 17% de-rating; the stock is down ~10–16% over the last year - FY28 earnings power: With copra and crude-linked packaging costs easing, and Africa/Indonesia firing on all cylinders, FY28 earnings could grow 20–25%; on FY28E, GCPL trades at ~40–42x PE reasonable for a business with 9% volume growth, improving margins, and a multi-geography footprint

Key Risks: Indonesia competitive intensity, Africa currency volatility, palm oil price reversal

TOP PICK #2: Colgate-Palmolive India (CPIL) — The Gross Margin Expansion Machine

Why Now: - **Q1 FY27 gross margins expanded 110 bps to 69.7%** — a remarkable achievement in a commodity-inflation quarter, driven by cost savings and financial discipline - **Toothpaste volume growth surprised positively:** High single-digit volume growth in the core toothpaste portfolio, driven by premium sub-brands and core portfolio strength this is better than street expectations of mid-single-digit growth - **EBITDA margin pressure was self-inflicted, not structural:** Margins contracted 150 bps to 30.1% because the company **stepped up ad spends by 33%** (to INR 2,520 Mn from INR 1,880 Mn YoY) to fund brand-building and premiumization; this is a growth investment, not margin erosion as ad spend normalizes and commodity relief flows through, EBITDA margins should rebound toward 32–33% in FY28 - **FY28 estimates look attractive:** Consensus revenue estimate for FY28 is **INR 689,190 Mn** with earnings of **INR 159,050 Mn** implying ~15–18% earnings growth; on FY28E, CPIL trades at ~34–38x PE — a discount to its historical average of 40–45x for a business with 69%+ gross margins and dominant market share - **Management is confident:** MD & CEO Prabha Narasimhan stated, *“Moving forward, we expect to grow sustainably fuelled by our best-in-class science-backed products, supported by continued investment in advertising”*

Key Risks: Intense competition from Patanjali and Dabur in oral care, INR depreciation on imported raw materials, ad spend elasticity not materializing

HUL — The Pricing Power + Rural Recovery Play
- Q1 FY27 revenue growth ~8–10% with volume growth ~5% and EBITDA margin ~24%
- Key commodity exposure: palm oil and LAB (linear alkyl benzene)
- FY28E earnings growth: 15–18%; current PE ~45–50x, FY28E PE ~38–42x
- FY28 driver: Palm oil + LAB relief, rural recovery, premiumization in personal care

Britannia — The Wheat + Packaging Cost Deflation Play
- Q1 FY27 revenue growth ~12% with volume growth ~6% and EBITDA margin ~16%
- Key commodity exposure: wheat and packaging materials
- FY28E earnings growth: 20–25%; current PE ~45–50x, FY28E PE ~36–40x
- FY28 driver: Wheat + packaging cost deflation, operating leverage on volume recovery

Nestle India — The Stable Cash Flow Compound
- Q1 FY27 revenue growth ~8% with volume growth ~4% and EBITDA margin ~22%
- Key commodity exposure: milk and packaging
- FY28E earnings growth: 12–15%; current PE ~65–70x, FY28E PE ~55–60x
- FY28 driver: Stable pricing, premiumization in Maggi and Nescafe, defensive characteristics

ITC (FMCG) — The Margin Expansion + Capital Allocation Story
- Q1 FY27 revenue growth ~10% with volume growth ~6% and EBITDA margin ~10%
- Key commodity exposure: paper and agri inputs
- FY28E earnings growth: 18–22%; current PE ~25–28x, FY28E PE ~20–23x
- FY28 driver: Paper costs easing, agri stability, best-in-class capital allocation

Dabur — The Copra + Ayurveda Premiumization Play
- Q1 FY27 revenue growth ~10% with volume growth ~7% and EBITDA margin ~19%
- Key commodity exposure: copra and herbs
- FY28E earnings growth: 18–22%; current PE ~45–50x, FY28E PE ~38–42x
- FY28 driver: Copra correction, Ayurveda premiumization, international recovery

Marico — The Copra + Edible Oil Relief Play

- Q1 FY27 revenue growth ~8% with volume growth ~5% and EBITDA margin ~19%
- Key commodity exposure: copra and edible oil
- FY28E earnings growth: 15–18%; current PE ~35–40x, FY28E PE ~30–33x
- FY28 driver: Copra + edible oil relief, Parachute volume normalization, Saffola premiumization

FY28 Valuation Framework — Why the Math Works

• **FY27 is the transition year** where margins are depressed by high-cost inventory and commodity volatility

• **FY28 compounds five tailwinds:** (1) full commodity relief, (2) volume recovery on a structurally low base (compounded by GST disruptions in FY26), (3) freight stabilization, (4) operating leverage, and (5) monsoon reality better than feared supporting rural demand

• **The double base effect is critical:** Q2 FY26 was disrupted by GST rationalization and channel destocking, which suppressed volumes; Q2 FY27 is now seeing margin compression from crude spike; FY28 will therefore compound against two consecutive years of weak quarters making the earnings recovery appear even more pronounced

• **The monsoon surprise is the underappreciated delta:** The market had priced in a famine; July delivered normal rainfall. Rural sentiment and farm liquidity are holding up better than feared, which supports the volume recovery thesis for FY28

• **Earnings growth of 15–25% is achievable across the sector**, and current valuations on FY28E earnings are 10–20% below historical averages for most names

• Godrej Consumer on FY28E trades at ~40–42x PE for 20–25% earnings growth and 9% volume growth — attractive for a multi-geography business

• Colgate on FY28E trades at ~34–38x PE for 15–18% earnings growth and 69%+ gross margins — a discount to its historical average

Bottom Line for Portfolios
FMCG is offering a rare confluence of six tailwinds:

- **Commodity deflation** (crude, copra, packaging) flowing through in H2 FY27/FY28
- **Freight stabilization** (diesel costs plateauing, DFC efficiency gains) –
- **Monsoon reality better than feared** (July rainfall normal at 270mm vs 272mm normal, debunking the “famine” narrative priced into stocks) -
- **Double low base** (Q2 FY26 GST disruption + Q2 FY27 margin compression = easy FY28 comparisons)
- **Volume recovery** (rural demand normalizing, quick commerce expanding)
- **Valuation floor** (PE ~18% below 5Y median, PB at 5Y lows)

Preferred Exposure:

- **Top Picks — Godrej Consumer** (multi-geography margin recovery, Africa/Indonesia acceleration, EV/EBITDA de-rated to 30x)
- **Top Picks — Colgate-Palmolive** (gross margin machine at 69.7%, ad spend normalization in FY28, high-single-digit volume momentum)
- **Large-cap compounders with direct commodity leverage:** Britannia (wheat + packaging), Marico (copra correction), HUL (pricing power + rural recovery), Dabur (copra + Ayurveda premiumization), ITC (FMCG margin expansion + capital allocation)
- **Quick-commerce proxy:** Varun Beverages for beverage momentum in instant-delivery channels

Risk Factors: Monsoon deficiency in August-September, INR depreciation on imported inputs, prolonged geopolitical flare-up reversing crude relief, slower-than-expected rural wage growth, competitive intensity in oral care (Colgate) and home care (Godrej).

Arihant Research Desk

Email: instresearch@arihantcapital.com

Tel. : 022-42254800

Head Office	Registered Office
#1011, Solitaire Corporate Park	
Building No. 10, 1st Floor	6 Lad Colony,
Andheri Ghatkopar Link Road	Y.N. Road,
Chakala, Andheri (E)	Indore - 452003, (M.P.)
Mumbai – 400093	Tel: (91-731) 4217100/101
Tel: (91-22) 42254800	CIN: L66120MP1992PLC007182

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NEUTRAL	-5% to 5%
REDUCE	-5% to -12%
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Research Analyst Registration No.	Contact	Website	Email Id
INH000002764	SMS: 'Arihant' to 56677	www.arihantcapital.com	instresearch@arihantcapital.com

Arihant Capital Markets Ltd.
1011, Solitaire Corporate park, Building No. 10, 1st Floor,
Andheri Ghatkopar Link Road, Chakala, Andheri (E)
Tel. 022-42254800

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Arihant Capital Markets Ltd.
1011, Solitaire Corporate park, Building No. 10, 1st Floor,
Andheri Ghatkopar Link Road, Chakala, Andheri (E)
Tel. 022-42254800

Abhishek Jain
Head of Research
Abhishek.jain@arihantcapital.com

Abhishek Chhajed Jain
Digitally signed by Abhishek Chhajed Jain
Date: 2026.08.10 12:37:37 +05'30'