

23 April 2010

Nestlé India

Second straight weak quarter; reiterate Sell

- **Weak performance, high valuations; Sell.** Nestlé India reported 2% yoy net profit growth on a 277-bp EBITDA margin drop. Given its second straight weak quarter, we expect its premium valuation to come under pressure, and retain a Sell with a target price of Rs2,416.
- **Steady revenue growth.** The company's revenue grew 16.9% yoy. Domestic revenue rose 16.7%; exports 20.4%. Nestlé indicated that volume growth was strong. Rising inflation and intensifying competition held it back from raising prices.
- **Higher raw material prices holding down margins.** Raw material costs as percent of net sales has increased 263bps. Due to higher raw material costs, EBITDA margin has decreased 277bps. Higher adspend also impacted margins. Net profit is up just 2% due to a lower tax rate (down 100bps).
- **Outlook.** We expect high food inflation to continue to impact margins for the next 2-3 quarters. The impact of higher excise will also be felt in coming quarters. We expect revenue and net profit CAGR of 18% and 17%, respectively over CY09-11.
- **Valuation.** We value the stock at a target price of Rs2,416 at PE of 25x CY11e earnings. Our target PE is at a 65% premium to 12M forward Nifty PE (last 10 and five year average premium: 65% and 62%, respectively). The current premium is 94%.

Rating: **Sell**

Target Price: Rs2,416

Share Price: Rs2,865

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Key data	NEST IN /NEST.BO
52-week high/low	Rs3,025/Rs1,652
Sensex/Nifty	17694/5304
3-m average volume	US\$1.6m
Market cap	Rs276bn/US\$6bn
Shares outstanding	96m
Free float	38.1%
Promoters	61.9%
Foreign Institutions	10.4%
Domestic Institutions	9.6%
Public	18.1%

Quarterly results

Year end 31 Dec	1QCY09	1QCY10	% yoy/bps	CY08	CY09	% yoy
Sales (Rsm)	12,659	14,798	16.9	43,242	51,294	18.6
EBITDA (Rsm)	2,992	3,088	3.2	8,637	10,345	19.8
EBITDA margin (%)	23.6	20.9	277 bps	20.0	20.2	(19) bps
Interest (Rsm)	2	6	243.8	16	14	(14.9)
Depreciation (Rsm)	256	310	21.1	924	1,113	20.5
Other income(Rsm)	103	91	(11.4)	339	378	11.5
PBT (Rsm)	2,837	2,864	0.9	8,036	9,596	19.4
Tax (Rsm)	864	845	(2.2)	2,497	2,745	9.9
Tax rate (%)	30.5	29.5	(100) bps	31.1	28.6	(247) bps
PAT (Rsm)	1,973	2,019	2.3	5,539	6,851	23.7

Source: Company, Anand Rathi Research

Financials

Year end 31 Dec	CY10e	CY11e
Sales (Rsm)	60,436	71,114
Net profit (Rsm)	7,974	9,319
EPS (Rs)	82.7	96.7
Growth (%)	16.4	16.9
PE (x)	34.6	29.6
PBV (x)	37.6	29.6
RoE (%)	118.4	111.8
RoCE (%)	164.4	155.3
Dividend yield (%)	2.1	2.3
Net gearing (%)	(73.2)	(85.9)

Source: Company, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Net sales	35,044	43,242	51,294	60,436	71,114
Sales growth (%)	24.4	23.4	18.6	17.8	17.7
- Op. expenses	28,081	34,605	40,949	48,641	57,514
EBIDTA	6,963	8,637	10,345	11,795	13,600
EBITDA margins (%)	19.9	20.0	20.2	19.5	19.1
- Interest	9	16	14	-	-
- Depreciation	747	924	1,113	1,300	1,493
+ Other income	233	339	378	581	837
- Tax	2,148	2,497	2,745	3,101	3,624
PAT	4,292	5,539	6,851	7,974	9,319
PAT growth (%)	36.0	29.1	23.7	16.4	16.9
Consolidated PAT	4,292	5,539	6,851	7,974	9,319
FDEPS (Rs/share)	44.5	57.4	71.1	82.7	96.7
CEPS (Rs/share)	52.3	67.0	82.6	96.2	112.1
DPS (Rs/share)	33.0	35.0	48.5	60.0	65.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

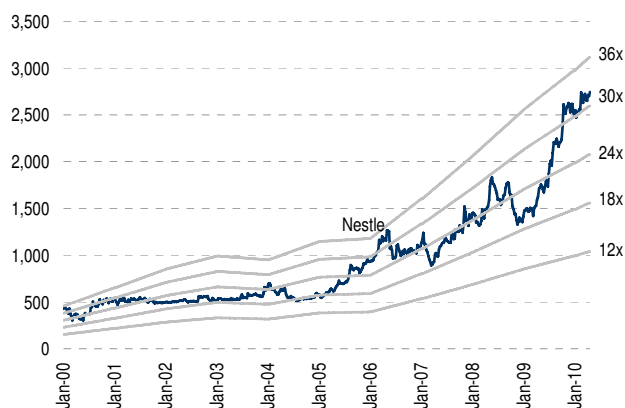
Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Share capital	964	964	964	964	964
Reserves & surplus	3,116	3,507	4,138	5,168	6,375
Shareholders' fund	4,471	5,102	6,133	7,339	9,326
Debt	29	8	-	-	-
Minority interests	-	-	-	-	-
Capital employed	4,500	5,110	6,133	7,339	9,326
Fixed assets	6,755	8,622	9,758	10,458	11,465
Investments	944	349	2,033	4,533	7,733
Working capital	(3,577)	(5,797)	(7,214)	(8,491)	(10,153)
Cash	378	1,937	1,556	839	281
Capital deployed	4,500	5,110	6,133	7,339	9,326
No. of shares (m)	96	96	96	96	96
Net Debt/Equity (%)	(21.7)	(49.2)	(34.8)	(33.8)	(28.9)
W C turn (days)	(34.8)	(39.6)	(46.3)	(47.4)	(47.8)

Source: Company, Anand Rathi Research

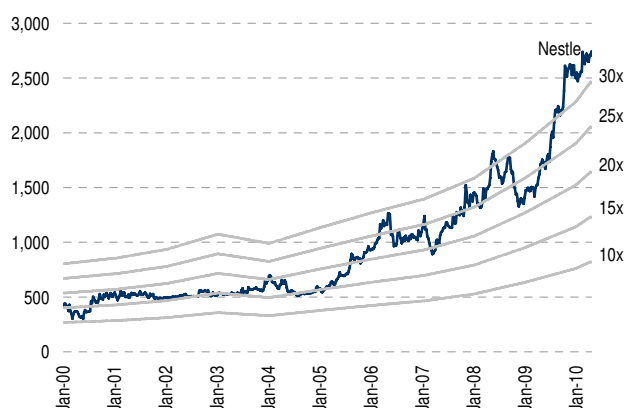
Fig 3 – Cash flow statement (Rsm)

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Consolidated PAT	4,292	5,539	6,851	7,974	9,319
+ Depreciation	843	1,005	1,064	1,300	1,493
Cash profit	5,135	6,544	7,915	9,274	10,813
- Incr/(Decr) in WC	(478)	(2,220)	(1,417)	(1,277)	(1,662)
Operating cash flow	5,613	8,765	9,332	10,552	12,474
- Capex	1,702	2,790	2,249	2,000	2,500
Free cash flow	3,911	5,974	7,083	8,552	9,974
- Dividend	3,843	4,792	5,471	6,768	7,332
+ Equity raised	-	-	-	-	-
+ Debt raised	(134)	(21)	(8)	-	-
- Investments	166	(595)	1,684	2,500	3,200
- Misc. items	154	198	301	-	-
Net cash flow	(386)	1,559	(381)	(717)	(558)
+ Opening cash	764	378	1,937	1,556	839
Closing cash	378	1,937	1,556	839	281

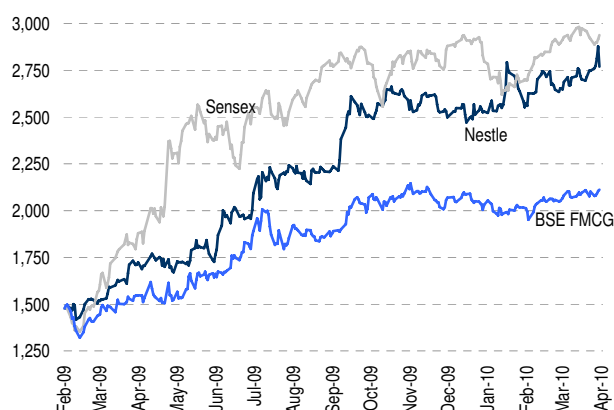
Source: Company, Anand Rathi Research

Fig 4 – PE Band


Source: Bloomberg, Anand Rathi Research

Fig 5 – Price-to-Book Band


Source: Bloomberg, Anand Rathi Research

Fig 6 – Relative comparison


Source: Bloomberg

Results Review

Nestlé India reported revenue growing 16.9% yoy, largely volume-led. The EBITDA margin, however, was down 277bp chiefly due to higher raw material costs. Net profit was up 2.3% mainly due to the lower tax rate.

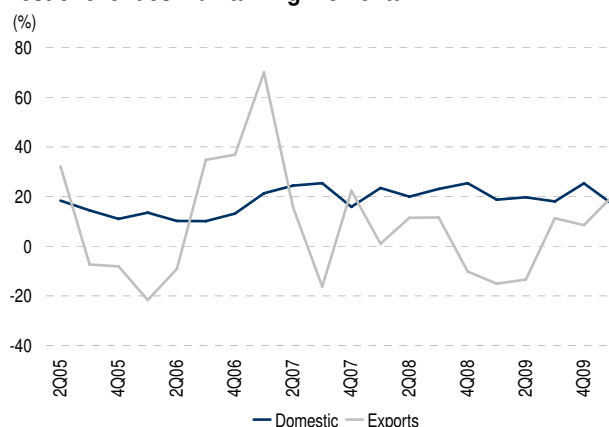
Domestic revenues steadily growing

Nestlé India reported revenue growing 16.9% yoy. Domestic revenue was up 16.7%, exports 20.4%. Domestic revenue growth is consistent with company maintaining growth of over 15% for the 13th consecutive quarter. Exports have grown on a smaller base as 1QCY09 exports revenue was down 15%. The company indicated that volume growth was better and contributed significantly to the revenue growth.

Domestic revenue grew over 15% for the 13th consecutive quarter

Exports have grown on a smaller base

Fig 7 – Domestic revenues maintaining momentum



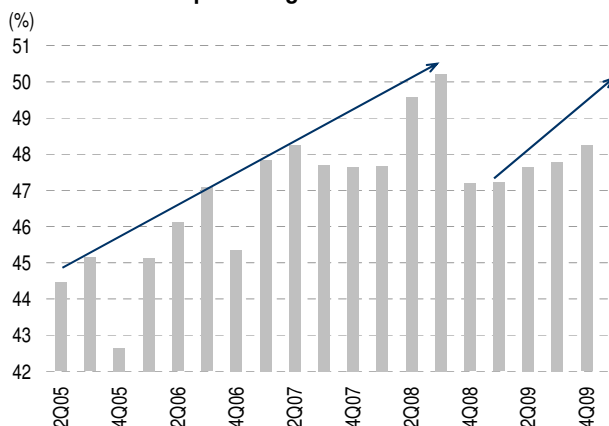
Source: Company

Higher raw material cost

Raw material cost (as percent of net sales) has increased 263bp yoy. Higher prices of wheat, milk and sugar led to higher raw material costs. With rising prices of crude oil, prices of packaging materials have also risen. With exports growing faster, the change in revenue-mix has also resulted in higher raw material costs.

Most of the major raw material prices were up 20%

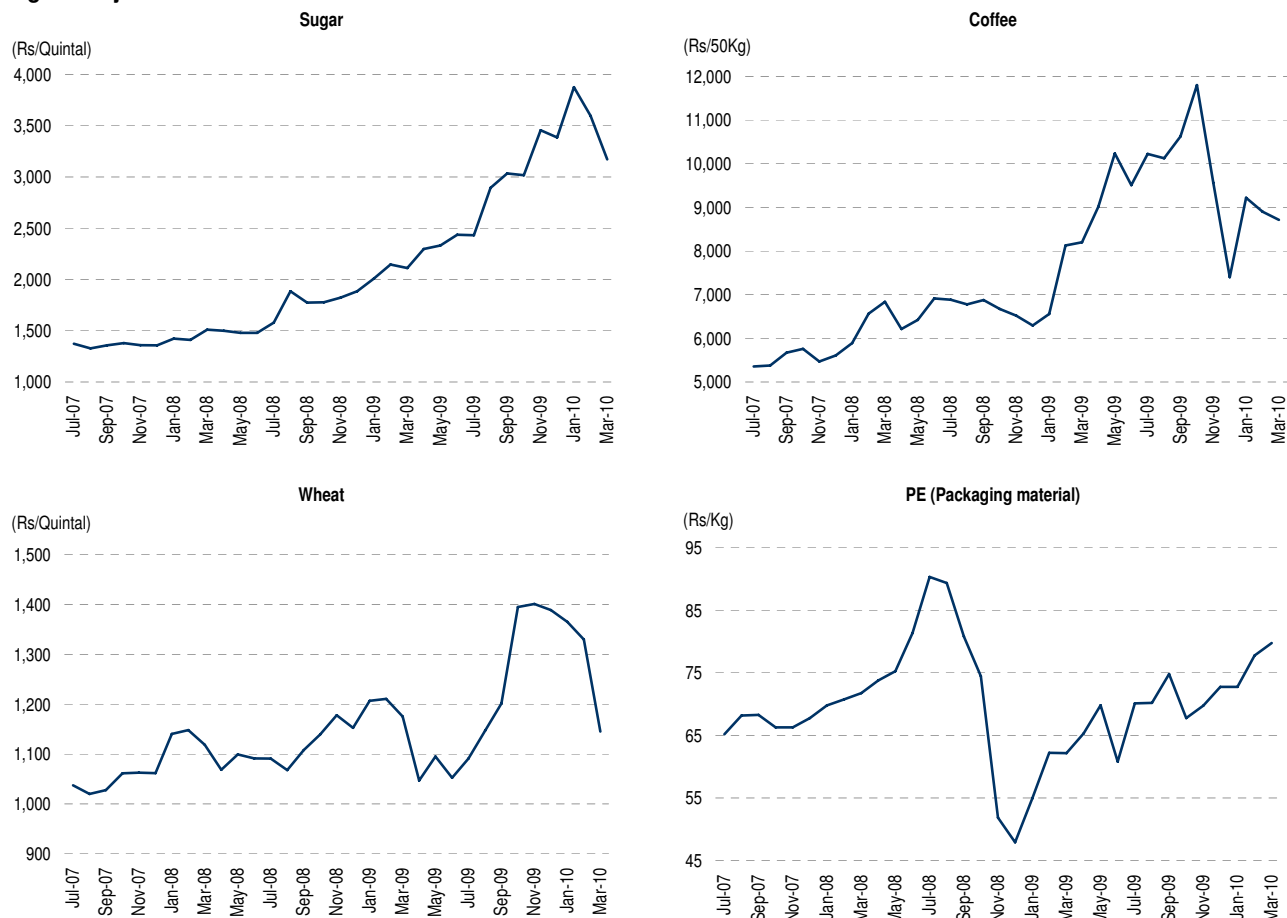
Fig 8 – Raw material cost as percentage of net sales



Source: Company

Major raw material costs

Fig 9 – Major raw material costs

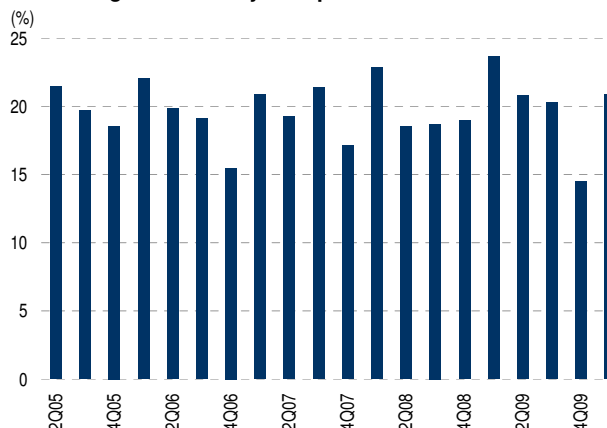


Source: Bloomberg, RIL, CMIE

EBITDA margin 277-bp lower

The EBITDA margin was down 277bp yoy. Higher raw material costs have weighed down on the EBITDA margin. Because of the inflationary situation, especially in foods, the company has not raised prices of most of its SKUs. A lower EBITDA margin naturally resulted. Management has indicated that higher advertising and transportation costs have held down the EBITDA margin.

Fig 10 – EBITDA margin is lower by 277bps

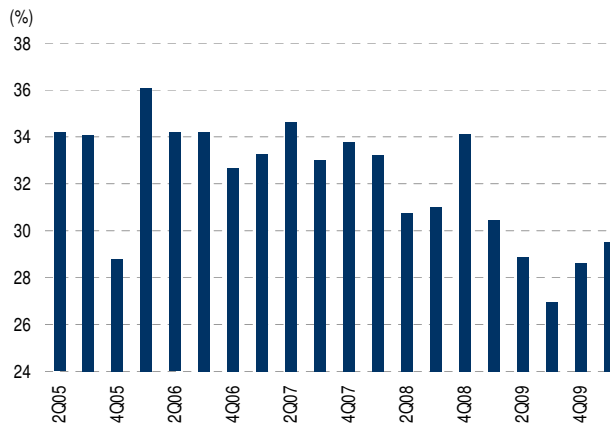


Source: Company

Tax rate lower by 100bps

The tax rate has slid 100bp (from 30.5% in 1QCY09 to 29.5% a year on). Higher production of Maggi noodles at the Pantnagar tax-exempt unit in has helped lower the income-tax rate.

Fig 11 – Effective income tax rates

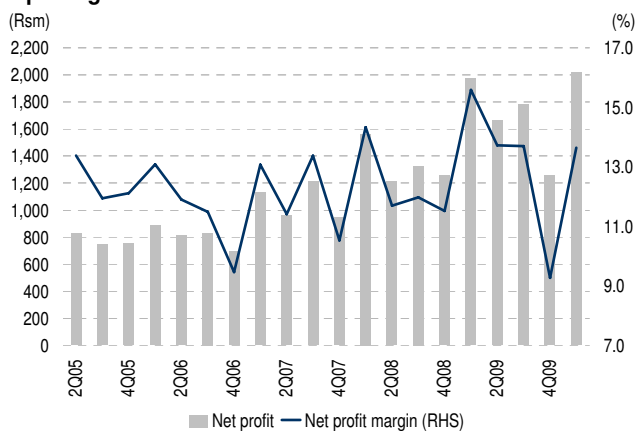


Source: Company

Net profit growth

Net profit is up 2.3% yoy. Despite revenue growing 16.9%, the lower EBITDA margin has resulted in paring net profit growth to 2.3% yoy. With the lower interest rates, ‘other income’ has stepped down.

Fig 12 – Net profit growth



Source: Company

Reducing food inflation

Food prices have continued to soften from their peaks. Inflation in food articles is expected to be below 5% in Mar '11. That would help Nestlé India, we expect, to cut raw material costs.

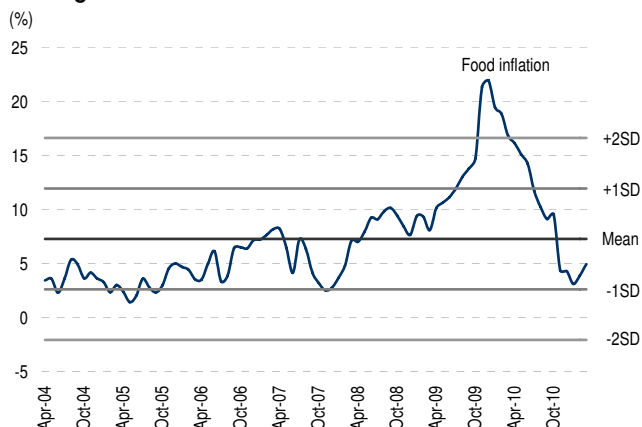
Inflation in food articles softening

Prices of food articles have been softening in the past three months. Our economist Sujan Hajra reckons that inflation in foods has peaked and would slide down to single digits in the months ahead. Inflation in food is expected to slip below 5% in Mar '11.

Such lower food inflation would help Nestlé India reduce raw material cost and allow for better realizations.

From their Dec '09 21.9% highs, food prices are now softening

Fig 13 – Reducing food inflation



Source: RBI, Anand Rathi Research

Valuation

We retain our Sell rating on Nestlé with a target price of Rs2,416. Our target is at PE of 25x on CY11e earnings.

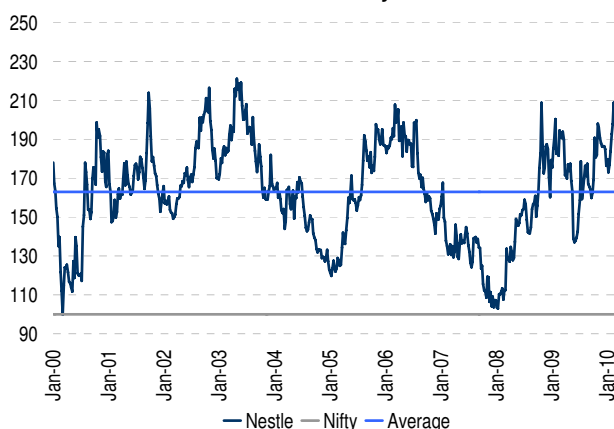
Valuation

We retain our Sell rating on Nestlé India, with a target price of Rs2,416 (earlier Rs2,075). Our target price is at PE of 25x on CY11e earnings. In the last 10 years, the stock has traded at an average premium of 65% to the Nifty and at premium of 62% over last 5 years. (It now trades at a 94% premium.) Our target PE of 25x is also at a 65% premium to the 12M-forward Nifty PE.

The stock has traded at a 65% premium in the past

That has now expanded to 94%

Fig 14 – Premium/discount to 12M forward Nifty PE

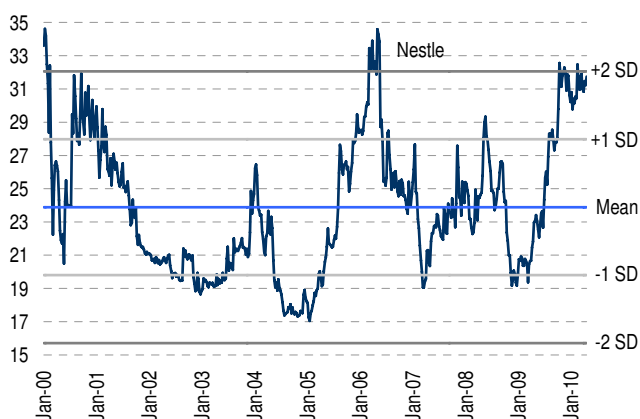


Source: Capitaline, Anand Rathi Research

Mean PE and standard deviations

In the past, the stock has traded at average forward PE of 24x over the last 10 years. It now trades at a 12M-forward PE of 32x and is near the mean and two standard deviations. We expect valuations to correct in coming quarters.

Fig 15 – Mean PE and standard deviations



Source: Capitaline, Anand Rathi Research

Relative valuation

Fig 16 – Relative Valuation

Company	Price (Rs)	M.Cap (US\$m)	RoE (%)	RoCE (%)	EPS CAGR FY09-11 (%)	PE (x)		Div Yield
			FY11e	FY11e		FY10e	FY11e	FY10e (%)
Nestle*	2,885	6,182	118.4	164.4	16.6	40.6	34.6	1.7
ITC	264	22,264	21.5	28.4	8.9	24.6	25.3	1.4
HUL	237	11,487	95.4	81.0	5.0	23.0	23.5	3.4
Asian Paints	2,070	4,411	40.0	48.3	41.2	26.6	23.5	0.9
Dabur	176	3,386	48.8	53.0	16.2	29.7	23.5	1.0
Colgate	735	2,221	184.4	148.8	21.5	26.2	21.9	2.7
Marico	113	1,529	46.3	45.0	32.2	25.2	19.7	0.6
GCPL	306	2,094	25.0	21.1	46.4	26.1	21.3	2.0
GSKCH*	1,579	1,477	31.1	34.1	29.9	28.5	20.9	1.1
Britannia	1,657	880	62.8	35.5	20.8	20.9	18.6	2.4
Emami	689	1,158	26.4	29.0	42.2	29.6	21.9	0.7

Source: Anand Rathi Research * Dec ending

Risks to our valuation

Lower prices of raw materials

Lower raw material prices would result in expanding margins and earnings.

Better pricing power

If the company is able to raise prices without affecting volumes, it would report revenue and earnings better than our estimates.

Fig 17 – Income Statement (Rsm)

Year end 31 Dec	CY06	CY07	CY08	CY09	CY10e	CY11e
Gross Sales	29,442	36,472	44,711	52,224	61,588	72,470
Less: Excise Duty	1,281	1,428	1,468	930	1,152	1,356
Net Sales	28,161	35,044	43,242	51,294	60,436	71,114
Growth (%)	13.7	24.4	23.4	18.6	17.8	17.7
Expenditure						
Cost of Goods Sold	13,201	16,850	21,041	24,484	29,029	34,437
Staff Cost	2,162	2,694	3,146	4,324	4,986	5,867
Advt & Sales Promotion	1,388	1,722	1,944	2,675	3,324	3,911
Freight & Distribution	1,337	1,608	2,036	2,404	2,840	3,342
Power & Fuel	1,156	1,239	1,598	1,589	1,934	2,276
Other Expenses	3,646	3,967	4,841	5,474	6,527	7,680
EBITDA	5,270	6,963	8,637	10,345	11,795	13,600
Growth (%)	5.5	32.1	24.1	19.8	14.0	15.3
EBITDA Margin (%)	18.7	19.9	20.0	20.2	19.5	19.1
Depreciation	663	747	924	1,113	1,300	1,493
EBIT	4,607	6,215	7,714	9,232	10,495	12,107
Interest Expense	4	9	16	14	-	-
Other Income	206	233	339	378	581	837
Profit Before Tax	4,809	6,440	8,036	9,596	11,076	12,944
Total Taxes	1,654	2,148	2,497	2,745	3,101	3,624
Income Taxes	1,562	1,981	2,497	2,745	3,101	3,624
Deferred Taxes	92	167	-	-	-	-
Income Tax Rate (%)	5.9	6.1	5.8	5.4	5.1	5.1
Profit After Tax	3,155	4,292	5,539	6,851	7,974	9,319
Share of Profit From Associates	-	-	-	-	-	-
Profit Before X/O	3,155	4,292	5,539	6,851	7,974	9,319
Growth (%)	2.8	36.0	29.1	23.7	16.4	16.9
PAT Margin (%)	11.2	12.2	12.8	13.4	13.2	13.1
Extraordinary Items	(4)	(154)	(198)	(301)	-	-
Profit for Shareholders	3,151	4,138	5,341	6,550	7,974	9,319
Number of Shares (m)	96	96	96	96	96	96
Earnings Per Share Bef X/O (Rs)	32.7	44.5	57.4	71.1	82.7	96.7
Earnings Per Share Aft X/O (Rs)	32.7	42.9	55.4	67.9	82.7	96.7

Source: Company, Anand Rathi Research

Fig 18 – Balance Sheet (Rsm)

Year end 31 Dec	CY06	CY07	CY08	CY09	CY10e	CY11e
Sources of Funds						
Share Capital	964	964	964	964	964	964
Reserves and Surplus	2,925	3,220	3,769	4,848	6,055	8,042
Deferred Tax Liability	192	287	369	320	320	320
Net Worth	4,080	4,471	5,102	6,133	7,339	9,326
Net Worth Net of Rev. Res.	4,080	4,471	5,102	6,133	7,339	9,326
Secured Loans	163	29	8	-	-	-
Unsecured Loans	-	-	-	-	-	-
Total Loans	163	29	8	-	-	-
Total	4,243	4,500	5,110	6,133	7,339	9,326
Application of Funds						
Fixed Assets Gross Block	10,583	11,798	14,048	16,408	19,204	21,704
Less: Depreciation	5,165	5,780	6,519	7,446	8,746	10,239
Net Block	5,418	6,018	7,530	8,962	10,458	11,465
Capital WIP	382	737	1,092	796	-	-
Gross Block-Brand value	10,583	11,798	14,048	16,408	19,204	21,704
Liquid Investments	778	944	349	2,033	4,533	7,733
Current Assets	5,354	6,379	7,980	8,566	8,967	9,684
Inventories	2,762	4,012	4,349	4,987	5,862	6,898
Sundry Debtors	558	535	456	642	786	924
Cash & Bank Balances	764	378	1,937	1,556	839	281
Loans & Advances	1,270	1,454	1,238	1,380	1,480	1,580
Current Liabilities	7,689	9,578	11,840	14,224	16,620	19,556
Liabilities	3,736	4,600	5,066	5,876	6,950	8,178
Provisions	3,953	4,978	6,773	8,348	9,670	11,378
Net Current Assets	(2,335)	(3,199)	(3,860)	(5,658)	(7,652)	(9,872)
Total	4,243	4,500	5,110	6,133	7,339	9,326

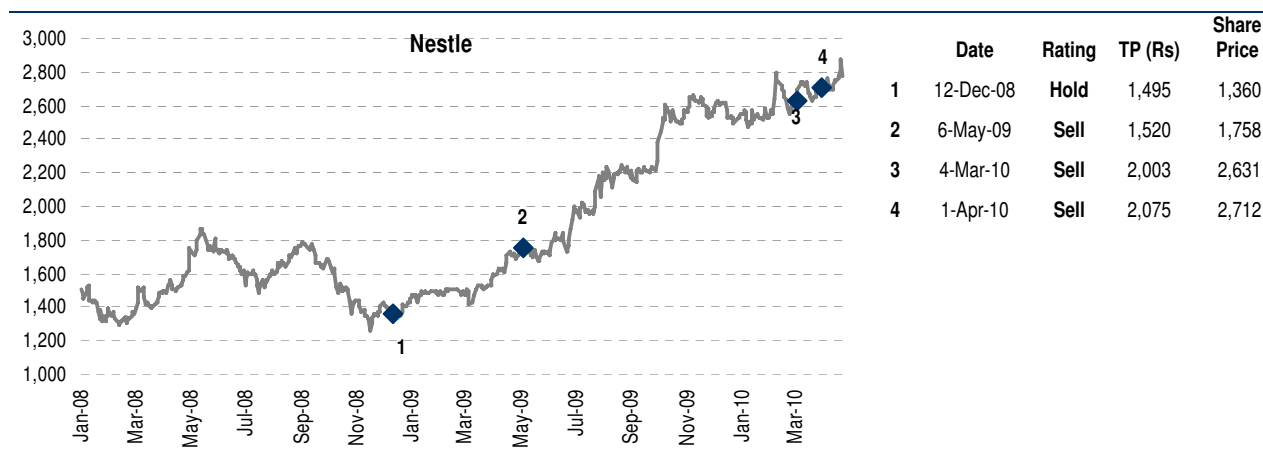
Source: Company, Anand Rathi Research

Appendix 1

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	Buy	Hold	Sell
Large Caps (>US\$1bn)	>20%	5-20%	<5%
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% who are investment banking clients	8%	0%	0%

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