9 August 2010 | 7 pages

Nestle India (NEST.BO)

Equity

Analyst Meeting Takeaways: Near-Term Margin Pressures

- **Steady volumes...** — 2Q revenue growth was healthy (+21% Y/Y) owing to: a) ~20% Y/Y domestic growth (volume led) driven by strong growth in the Maggi portfolio and chocolates/confectionaries; while beverages underperformed, b) 36% Y/Y growth in exports (7% of revenues); management booked some advance sales during the Q, and, c) buoyed by the inclusion of Specialty Foods acquisition.
- **...however food inflation concerns remain** — Prices of key inputs – fresh milk, wheat and sugar are higher by ~27%, 14% and 53% Y/Y respectively. We believe the sharp uptick in wheat and green coffee over Jul-Aug, coupled with Nestlé India's existing high price sugar inventory will offset benefits in other agri commodities. Milk prices remain sticky. Evidently, the staggered price hikes and cost control measures have not completely made up for the firming input costs.
- **Cost pressures outweigh healthy demand** — Margins are likely to be under pressure given: a) gross margin decline, b) heightened brand building – we think ad spends are likely to be higher than 1H trends (+22% Y/Y), given the rising competition in processed foods (GSK Consumer's Foodles, HLL's Soupy Noodles), and investments behind Nescafe & chocolates (Bar One re-launch), and, c) escalating power, fuel and distribution costs – these had a negative 150bps impact on EBITDA margins in 1HCY10 as average oil prices soared ~50% Y/Y.
- **Investing for the future** — Capex is expected to rise as the company expands capacities over the medium-term. Management noted that it has commitments of ~Rs3.6bn in place as of 1HCY10 (1HCY09 commitments were ~Rs0.7bn). It also mentioned that it is currently evaluating forays into new categories.
- **Valuations are rich; Reiterate Sell** — While Nestle India has strong fundamentals and is well positioned to benefit from the long-term India consumption theme, we think its valuations at ~32x one yr forward P/E capture the growth prospects. Near-term margin pressures don't provide much comfort.

Sell/Low Risk	**3L**
Price (06 Aug 10)	Rs2,766.10
Target price	Rs2,648.00
Expected share price return	-4.3%
Expected dividend yield	1.8%
Expected total return	**-2.4%**
Market Cap	Rs266,696M
	US$5,800M

Price Performance (RIC: NEST.BO, BB: NEST IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	5,341	55.39	9.2	49.9	56.3	119.8	1.5
2009A	6,550	67.94	22.6	40.7	45.9	124.2	1.8
2010E	7,517	77.96	14.8	35.5	35.0	112.0	1.8
2011E	9,117	94.56	21.3	29.3	27.2	104.7	2.2
2012E	10,905	113.11	19.6	24.5	21.5	98.2	2.7

Source: Powered by dataCentral

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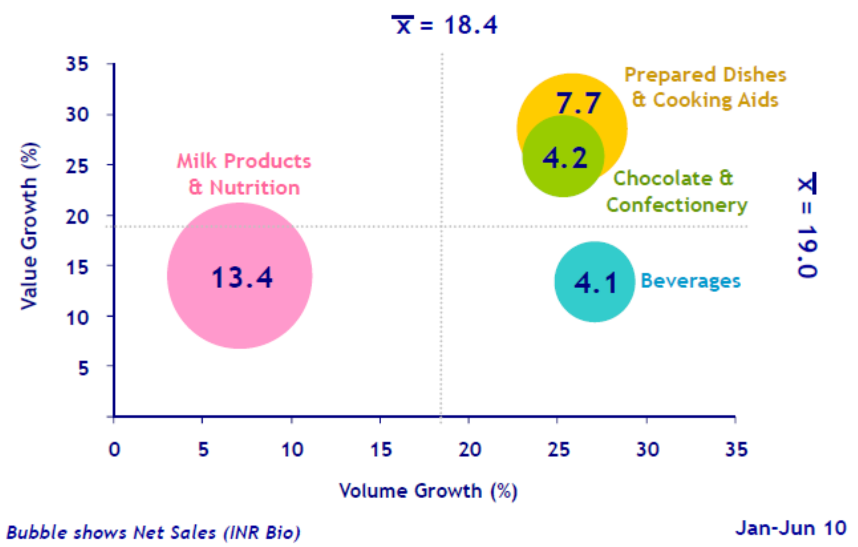
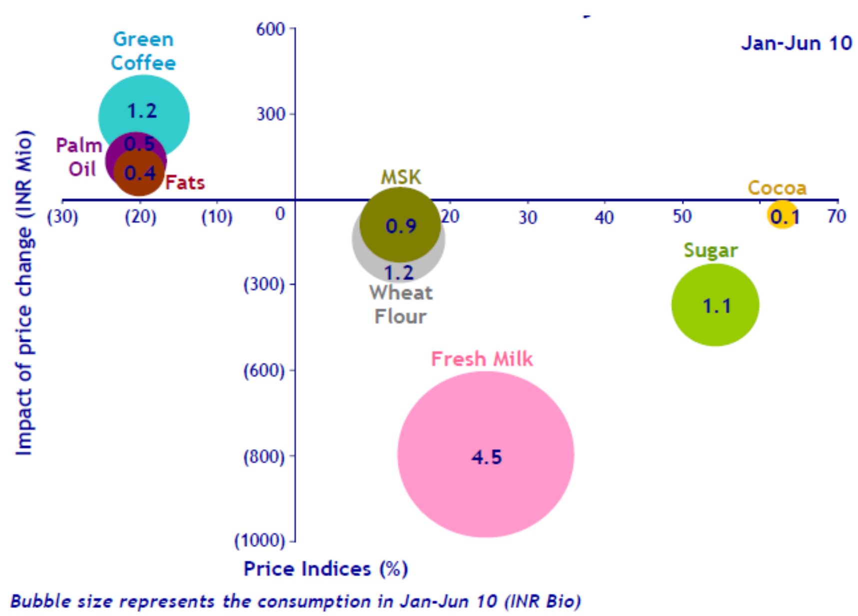
Figure 1. Nestle India: 1HCY10 Revenue Mix and Growth



Source: Company Reports

Figure 2. Nestle India: 1HCY10 Material Cost Mix & Impact of Price Movement



Source: Company Reports

Nestle India

Company description

Nestle India, a c61% subsidiary of Nestle SA, is the largest and most diversified food and beverage company in India. The group has a dominant market position in infant food, cereals, and instant coffee and culinary products, and is No.2 in the chocolate market. Its product portfolio comprises some of Nestlé's best-known global brands - Nescafe, Lactogen, Cerelac, Maggi and Kit Kat. The company has a strong focus on adding value to basic commodities, and has an extensive distribution network, covering most of the urban and semi-urban areas.

Investment strategy

We have a Sell/Low Risk (3L) rating on Nestle India shares. While we view Nestle as the best play on urban consumption growth in the Indian consumer sector universe, and it has in the recent past grown much ahead of the consumer sector growth average, its valuations are capturing this growth premium, in our view. The stock is currently trading at the higher end of the current trading range, and we do not see any further re-rating triggers. Historically, Nestle has benefited on two counts - on the demand side from its urban exposure, which was driven by high service sector growth, and on the costs side through its agri-product exposure, where raw-material prices remained soft over a long period. However, over the last two years, raw material costs have been firming up, which has put pressure on margins. While Nestle has been able to mitigate margin pressure through price hikes, we believe that, if raw material costs keep firming, it will be difficult to hike prices without sacrificing volumes. Additionally, like the rest of consumer universe, ad spends are likely to increase in the near-term, depressing operating margins.

Valuation

We value Nestle India using a P/E based methodology, given its steady growth characteristics and non cyclical revenue streams. Our target price of Rs2,648 is based on a target P/E multiple to 28x Dec 11E. We peg the target multiple at the middle end of the current trading band. Our target multiple is at a premium to what we ascribe to Hindustan Unilever, given Nestle India's superior growth profile, benefiting from nascent recovery in urban consumption in India. We also attempt to maintain parity in Nestlé's relative P/E multiples vs. the broad market - the stock is trading near its trailing 10-year average relative P/E of 2.4x (vs. the broader market). At current valuations of 35x one-year forward, Nestle is trading at a ~30% premium off its long-term P/E multiple; which we think is very rich and leaves no room for disappointment.

Risks

We rate Nestle shares Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key upside risks that could sustain the shares above our target price include: (1) better-than-expected revenue growth; and (2) favorable agri-product prices. Key downside risks include: (1) fluctuations in commodity prices could affect profitability prospects; (2) supply constraints on raw materials, particularly milk solids, could stifle growth.

Appendix A-1

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Ratings and Target Price History
Fundamental Research
Analyst: Jamshed Dadabhoy
Covered since May 6 2008

	Date	Rating	Target Price	Closing Price
1	31-Oct-07	*3L	*1,341.00	1,562.75
2	26-Jun-08	3L	*1,581.00	1,624.15
3	8-Mar-09	3L	*1,395.00	1,417.25
4	1-Nov-09	3L	*2,306.00	2,573.45
5	22-Apr-10	3L	*2,441.00	2,865.05
6	2-Aug-10	3L	*2,648.00	3,016.80

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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