



Nestle India

STOCK INFO.	BLOOMBERG
BSE SENSEX: 15,588	NEST IN
	REUTERS CODE
S&P CNX: 4,710	NEST.BO

8 April 2008

Buy

Rs1,558

Previous Recommendation: Buy

Equity Shares (m)	96.4
52-Week Range	1,676/956
1,6,12 Rel. Perf. (%)	6/35/30
M.Cap. (Rs b)	150.2
M.Cap. (US\$ b)	3.8

YEAR	NET SALES	PAT *	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
12/06A	28,247	3,386	35.1	2.9	44.4	24.7	55.7	80.9	5.3	27.1
12/07A	35,131	4,401	45.6	30.0	34.1	25.7	75.2	111.5	4.2	21.1
12/08E	42,013	5,439	56.4	23.6	27.6	23.1	83.7	119.1	3.5	17.7
12/09E	49,967	6,849	71.0	25.9	21.9	18.1	82.3	117.2	2.9	14.1

* Excluding extraordinary items and provisions

Nestle India has reported 13.8% volume growth in CY07 (up from 8.3% in CY06), the first year of double-digit volume growth after CY03. The growth rate has been broadbased, with 5.4% volume growth in Milk Products, 7.9% in Beverages, 24.8% in Prepared Dishes & Cooking Aids, and 17.6% in Chocolates & Confectionery. Dairy Products have reported 8.2% volume growth after negative growth in the last two years. Beverages have recorded volume growth of 8.2%, a six-year high and only the second occasion of positive volume growth.

Nestle believes that the growing middle class and rising consumer confidence is resulting in consumers looking at improving the quality of life. Nestle is uniquely placed to tap this potential due to strong brands, R&D support of the parent, external benchmarking and SBU focus, which will enable it to tap the huge growth opportunity. The company has stated that CY08 has started on a good note.

Raw material costs continue to be a concern, as prices of all the major inputs like wheat flour, coffee, milk, etc. have remained strong. In CY07, prices of milk, coffee, vegetable oils, and wheat were higher by 15%, 32%, 11.8%, and 8.2%, respectively. The company has successfully demonstrated its brand strength by showing realization growth of 17.7% in Infant Nutrition, 14.4% in Dairy, 10% in Beverages, 4.6% in Prepared Dishes and 6% in Chocolates. Raw material scenario continues to be challenging; prices of agro-based inputs are likely to remain strong.

Nestle has reported 130bp decline in gross margins in CY07. Scale efficiencies, cost reduction and strategic transformation enabled EBITDA margin expansion of 60bp. We expect volume growth to accelerate to 15% in the coming year; gross margins would decline 100bp in CY08 while EBITDA margins are expected to remain flat. Gross and EBITDA margins are likely to increase by 40bp and 90bp in CY09. We factor in lower tax rate of 30% due to benefits from higher capacity utilization in the Pantnagar facility (Prepared Dishes).

The company continued to focus on innovation and renovation, which has enabled it to launch new products like *Milkmaid Funshake*, *Polo Zero*, *Cerelac Multigrain*, orange and lemonade juice concentrates, and *Nescafe Mild Coffee*, in the past few months.

We believe that Nestle is one of the best plays on the huge growth potential in the food processing sector in India. We expect growth rates to accelerate due to rising disposable incomes of the middle class due to lower taxes and implementation of the Sixth Pay Commission recommendations. We expect shareholders to receive Rs50/share in dividends in the coming 12 months (including Rs7.6/share as one-time payment from reserves and share premium). We expect the company to post sales and PAT growth of 19.3% and 24.8%, respectively over CY07-09. The stock trades at 27.6x CY08E and 21.9x CY09E EPS. **Buy** with target price of Rs1,770, a 14% upside.

Well placed to tap the huge opportunity in processed foods

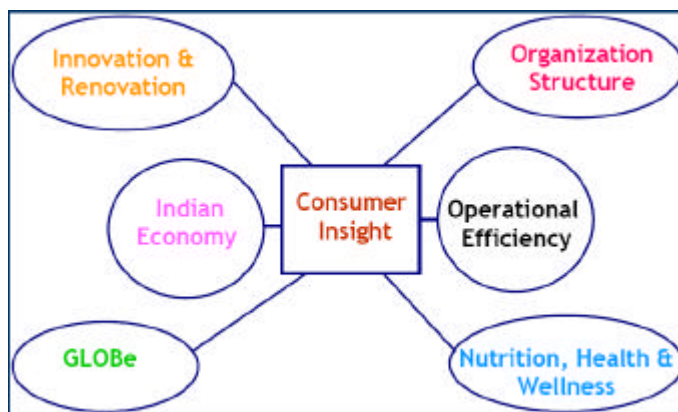
A growing middle class and rising consumer confidence is resulting in more and more consumers looking at improving the quality of life. Food processing is likely to emerge as one of the fastest growing areas due to lifestyle and trend changes. Nestle is uniquely placed to exploit this growth opportunity on account of strong brands, technology support from the parent and ability to launch a variety of nutritional products. The company has a well diversified product portfolio, efficient supply chain and wide reach in target markets. Potential for expansion in smaller cities and towns, development of modern retail formats, low product penetration, growing out-of-home consumption and rising per capita income present a huge opportunity.

Nestle is well placed to tap this growth opportunity due to:

- ✦ Low cost and highly efficient operations
- ✦ Continuous innovation and renovation
- ✦ Product availability
- ✦ Consumer communication

Nestle has undergone a mindset change in the organization with focus on external benchmarking rather than being a more inward looking organization. This coupled with innovation and renovation of products, global ERP initiative and SBU focus has pushed the company into a new growth trajectory. Continued focus on innovation and renovation has enabled Nestle to launch new products such as *Milkmaid Funshake*, *Polo Zero*, *Cerevita Multigrain*, and *Nescafe Mild Coffee* in the past few months. The company has launched *Maggi Rice Mania*, *Dal Atta Noodles*, variants in ketchup and soups in the culinary range. It has also launched a range of products across segments on the health platform — these include *Slim milk* and *dahi* (curd), *Probiotic dahi*, fruit yogurt, and sugar-free chocolates, confectionery and drinks. We expect Nestle to focus on new product launches and leverage the strong R&D support of its parent, which would push its growth up further.

KEY DRIVERS OF GROWTH MOMENTUM

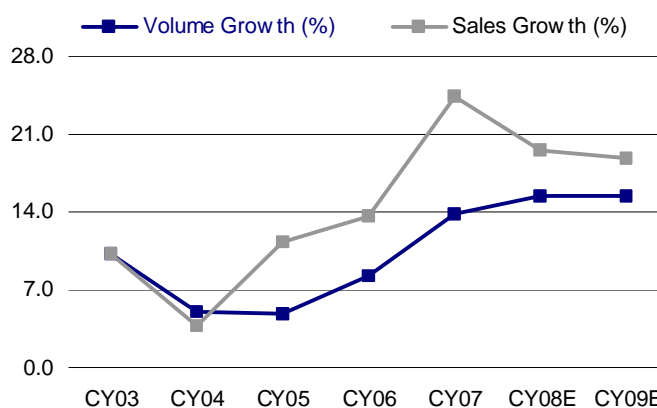


Source: Company/Motilal Oswal Securities

Strong pick up in growth; further acceleration likely

Sales volume and value growth during CY07 was 13.8% and 24.4%, respectively, which reaffirms our bullish view. This compares favorably with 9% CAGR in sales in the past five years. We believe that Nestle would not only be able to sustain but can even accelerate growth from current levels; growth in historically low-growth segments like Milk Products and Beverages seems to be catching up now.

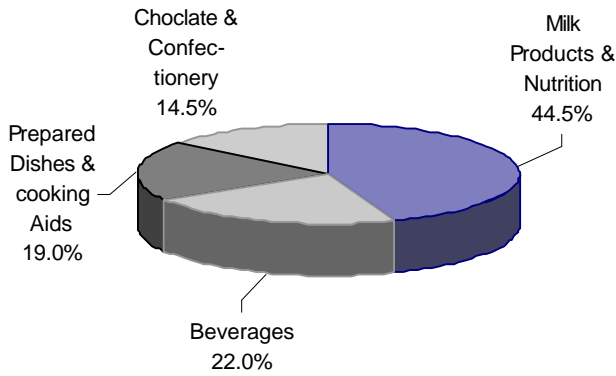
VOLUME GROWTH INTO A NEW ZONE



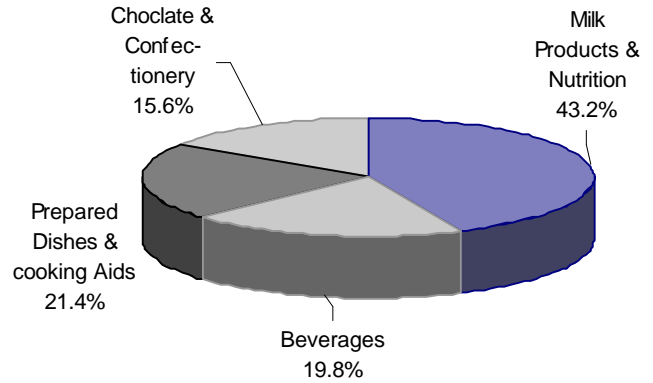
Source: Company/Motilal Oswal Securities

NESTLE INDIA: SALES MIX

CY05



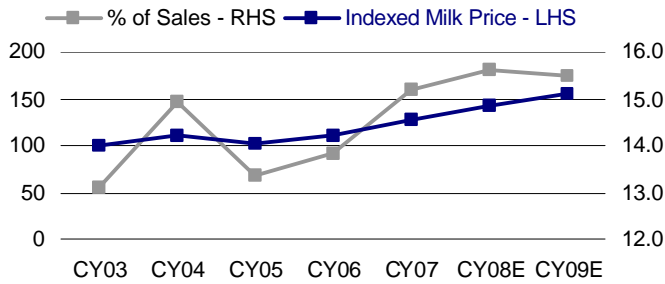
CY07



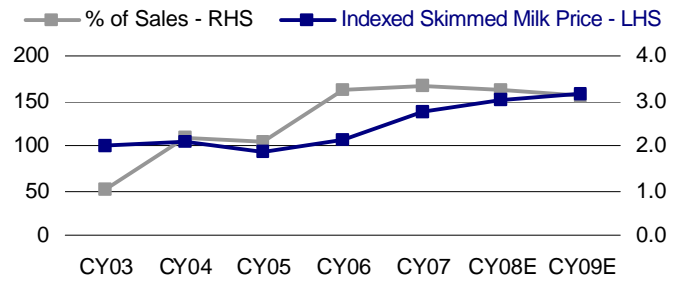
Source: Company/Motilal Oswal Securities

RAW MATERIAL PRICES CONTINUE TO HEAD NORTH

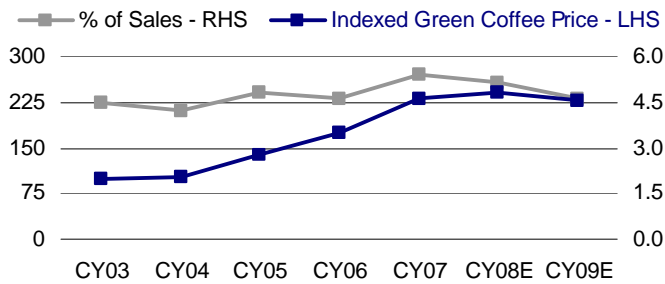
MILK PRICE: STEADY INCREASE LIKELY



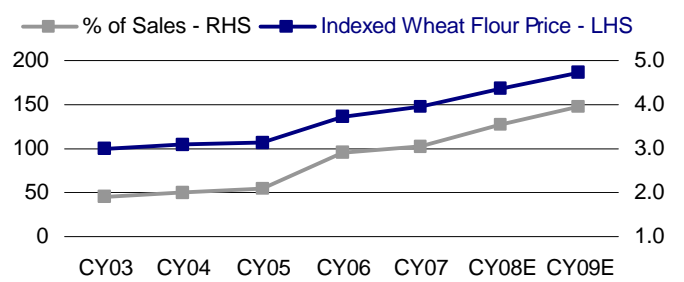
SKIMMED MILK POWDER PRICE TREND



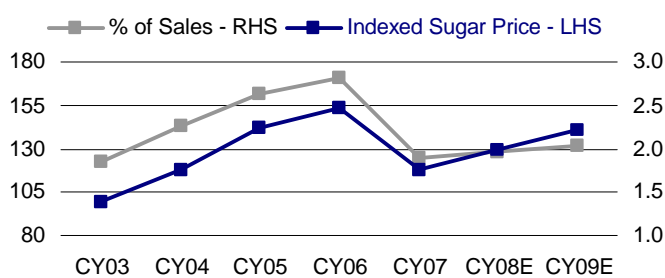
INDIAN GREEN COFFEE PRICES: LIKELY TO REMAIN FLAT



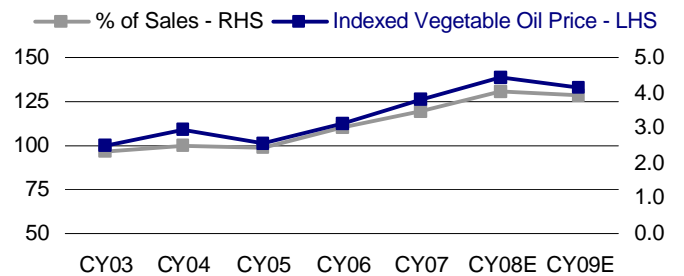
WHEAT FLOUR: GLOBAL SHORTAGE TO KEEP PRICES HIGH



SUGAR: PRICES SEEM TO HAVE BOTTOMED OUT



VEGETABLE OIL: PRICES LIKELY TO INCH HIGHER

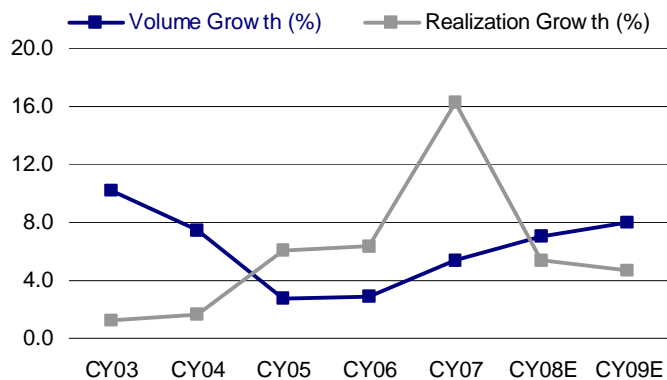


Source: Company/Motilal Oswal Securities

Milk Products and Nutrition

- 5.4% volume growth in CY07 v/s 2.8% volume growth in last two years, 16.3% increase in realization
- Volume growth suffers due to ban on export of skimmed milk products, adjusted volume growth in mid-teens
- Infant nutrition launches include *NIDO* milk powder, *Cerelac Stage 4* and *Nestle Nan*. *Nan* has DHA, a fatty acid naturally found in breast milk which improves the immune system
- Dairy segment launches include *Nestle Milkmaid Funshake*, *Nestle Fresh* and *Pure Slim Dahi*, *Nesvita Probiotic Dahi* and *Cerevita Multigrain* breakfast cereal

MILK PRODUCTS

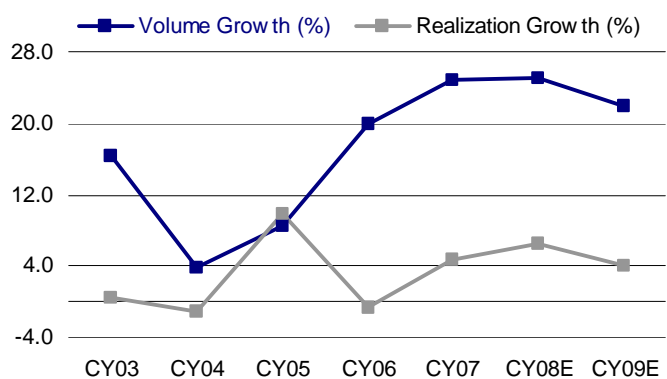


Source: Company/Motilal Oswal Securities

Prepared Dishes and Cooking Aids

- 24.8% increase in volumes and 30.6% increase in sales value for CY07, led by *Maggi Noodles and Soups*, v/s 11% CAGR in volumes in last three years
- New variants of *Maggi Noodles* i.e. *Maggi Vegetable Dal Atta Noodles* and *Rice Noodles* launched successfully
- New soup variants like sweet corn veg, sweet & sour noodles, and hot & sour chicken, and *Sanjeevni Soups*
- Strong growth trend to continue in coming years

PREPARED DISHES AND COOKING AIDS

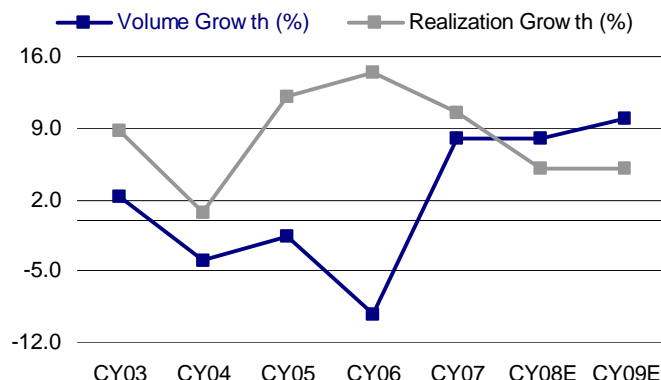


Source: Company/Motilal Oswal Securities

Beverages

- 7.9% increase in volumes and 19.4% increase in CY07 sales v/s 5% CAGR decline in volumes in last three years
- Double-digit volume growth in domestic market; maintains market leadership in 100% pure instant coffee
- Success of *Nescafe Mild*, a select Robusta and Arabica blend; sachets launch at Re1
- Milo* being test marketed with new formulation
- Tapping increasing opportunities in out-of-home segment with *Café Nescafe* and *Nestle Consumption Zones* in offices, colleges and other high footfall places

BEVERAGES

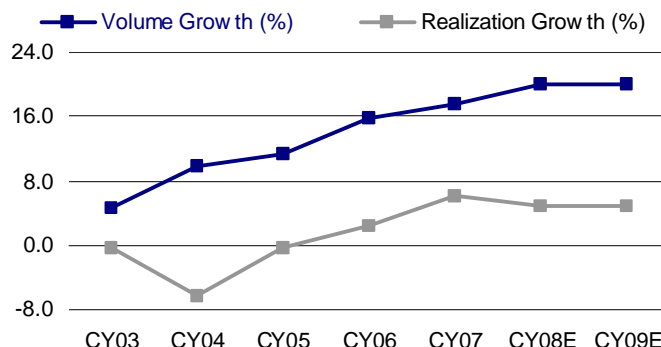


Source: Company/Motilal Oswal Securities

Chocolates and Confectionery

- 17.6% increase in volumes and 24.8% increase in sales value for CY07 v/s 12.3% volume CAGR in last three years
- Maintains market leadership in light wafers, white chocolates and *Éclairs* and *Mint Rolls*
- Focus on expanding distribution in chocolates and confectionery segment
- New launches include *Polo Sugar Free*, *Tang Eez*, *Polo Cinnamon*, *Butter Scotch Éclairs*, *Munch Pop Chocos*, *Kit Kat Mini* and *Kit Kat Crunchy*

CHOCOLATES AND CONFECTIONERY

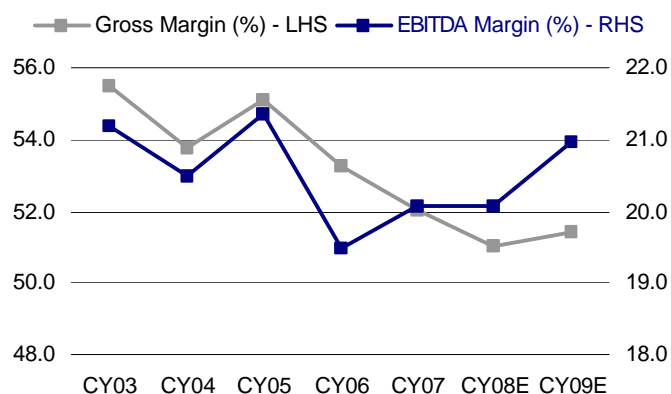


Source: Company/Motilal Oswal Securities

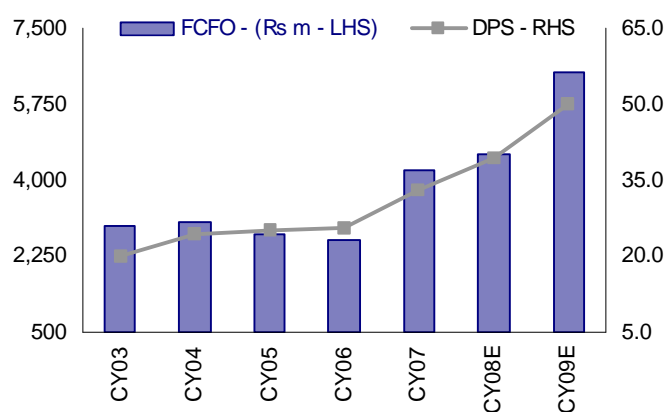
Gross margins under pressure; cost efficiencies boost EBITDA margins

Gross margins declined 130bp in CY07 while EBITDA margins expanded 60bp due to various cost control measures adopted by the company. We expect gross margins to decline 100bp in CY08 due to firm prices of wheat flour, milk, coffee and sugar. Nestle has strong brands and has been able to increase prices in categories of Milk Products and Coffee. Noodles remain the fastest growing product and use wheat flour and rice as key inputs. The prices of both these agro-products are expected to remain firm, which could drag down gross margins. Cost control and efficiency improvement measures would enable Nestle to maintain EBITDA margins in CY08. Free cash flow generation is strong and dividend payout has been maintained at 74%.

GROSS MARGINS UNDER PRESSURE; STEADY EBITDA MARGIN



FCFO TO GROW STEADILY

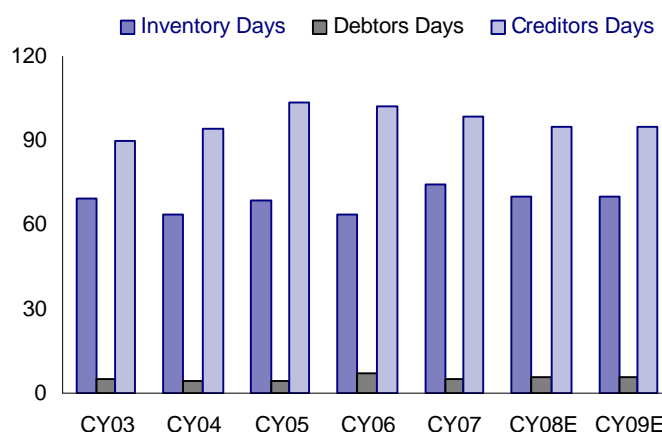


Source: Company/Motilal Oswal Securities

Inventories increase working capital; no naked exposure in forex derivatives

Core working capital has increased from Rs17m to Rs499m. Both debtor and creditor days have declined during the year. Inventory has increased sharply from 63.4 days to 74.2 days. Raw material inventory has increased by 63% while finished goods stock has gone up by 41%. We believe that the increase in raw material inventory is due to rising prices and the need to increase inventory due to volatile prices. Finished goods inventory increase indicates attempts to push more products into the system and presence of the rising number of SKUs.

INVENTORY RISE INCREASES WORKING CAPITAL



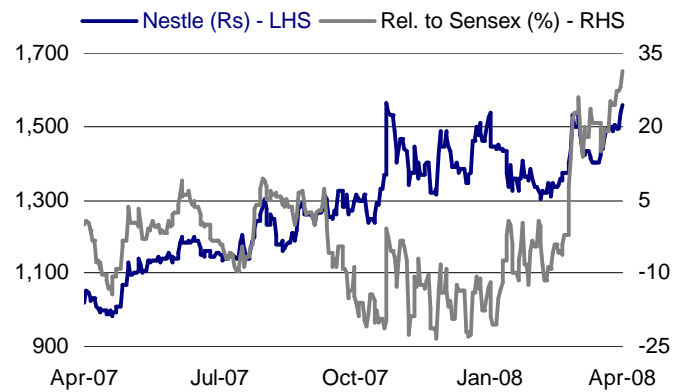
Source: Company/Motilal Oswal Securities

Nestle has also declared details of forex derivatives. The company has stated that all derivative instruments are for hedging foreign exchange exposure against firm commitments or forecast transactions. The company has contracts worth USD9.95m and EUR3m against exports. It also has forward contracts worth USD6.1m and EUR1.45m against imports. Un-hedged forex exposure was up to AUD\$4.8m and JPY4.1m.

Valuation and view

We believe Nestle is one of the best plays on the healthy growth potential in the food processing sector in India. We expect growth rates to accelerate due to rising disposable incomes of the middle class based on lower taxes and implementation of the Sixth Pay Commission recommendations. We expect the company to post sales and PAT growth of 19.3% and 24.8%, respectively over CY07-09. The stock is trading at 27.6x CY08E and 21.9x CY09E earnings. We maintain **Buy** with target price of Rs1,770, a 14% upside.

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(RS MILLION)					
Y/E DECEMBER	2005	2006	2007	2008E	2009E
Domestic Sales	23,930	26,646	33,174	39,811	47,625
Export Sales	2,509	2,796	3,298	3,698	4,141
Net Sales	24,858	28,247	35,131	42,013	49,967
Change (%)	11.3	13.6	24.4	19.6	18.9
Total Expenditure	-19,549	-22,745	-28,081	-33,581	-39,490
EBITDA	5,310	5,501	7,050	8,432	10,477
Change (%)	16.1	3.6	28.2	19.6	24.3
Margin (%)	21.4	19.5	20.1	20.1	21.0
Depreciation	-568	-663	-747	-826	-922
Int. and Fin. Ch.	-2	-4	-9	-3	-3
Other Inc.- Rec.	145	206	254	166	232
PBT	4,884	5,040	6,549	7,770	9,784
Change (%)	17.5	3.2	29.9	18.6	25.9
Margin (%)	19.6	17.8	18.6	18.5	19.6
Tax	-1,483	-1,562	-1,981	-2,144	-2,701
Deferred Tax	-112	-92	-167	-186	-235
Tax Rate (%)	-32.7	-32.8	-32.8	-30.0	-30.0
Adjusted PAT	3,289	3,386	4,401	5,439	6,849
Change (%)	17.1	2.9	30.0	23.6	25.9
Margin (%)	13.2	12.0	12.5	12.9	13.7
Non-rec. (Exp)/Inc.	-197	-119	-175	-185	-204
Reported PAT	3,092	3,267	4,225	5,253	6,645

BALANCE SHEET					
(RS MILLION)					
Y/E DECEMBER	2005	2006	2007	2008E	2009E
Share Capital	964	964	964	964	964
Reserves	4,649	5,111	4,887	5,532	7,355
Net Worth	5,613	6,075	5,851	6,496	8,319
Loans	143	163	29	29	29
Capital Employe	5,756	6,238	5,880	6,525	8,348
Gross Block	9,494	10,583	11,798	13,232	14,704
Less: Accum. Depn.	-4,757	-5,165	-5,780	-6,606	-7,528
Net Fixed Asset	4,738	5,418	6,018	6,626	7,177
Capital WIP	228	382	737	553	580
Investments	1,044	778	944	884	2,131
Curr. Assets, L&	4,627	5,354	6,379	7,719	9,383
Inventory	2,531	2,762	4,012	4,896	5,677
Account Receivable	305	558	535	656	780
Cash and Bank Bal	366	764	378	425	830
Others	1,424	1,270	1,454	1,742	2,097
Curr. Liab. and P	4,781	5,502	7,911	8,783	10,216
Account Payables	3,165	3,697	4,556	5,353	6,320
Other Liabilities	34	39	44	52	62
Provisions	1,583	1,766	3,311	3,378	3,834
Net Curr. Assets	-155	-149	-1,532	-1,064	-832
Def. Tax Liability	-100	-192	-287	-473	-708
Appl. of Funds	5,756	6,238	5,880	6,525	8,348

E: M0St Estimates

RATIOS					
Y/E DECEMBER	2005	2006	2007	2008E	2009E
Basic (Rs)					
EPS	34.1	35.1	45.6	56.4	71.0
Cash EPS	40.0	411	52.5	65.0	80.6
BV/Share	58.2	63.0	60.7	67.4	86.3
DPS	25.0	25.5	33.0	39.5	49.9
Payout %	73.3	72.6	72.3	70.0	70.2
Valuation (x)					
P/E		44.4	34.1	27.6	21.9
Cash P/E		37.9	29.7	24.0	19.3
EV/Sales		5.3	4.2	3.5	2.9
EV/EBITDA		27.1	21.1	17.7	14.1
P/BV		24.7	25.7	23.1	18.1
Dividend Yield (%)		16	2.1	2.5	3.2
Return Ratios (%)					
RoE	58.6	55.7	75.2	83.7	82.3
RoCE	84.9	80.9	111.5	119.1	117.2
Working Capital Ratios					
Debtor (Days)	4	7	6	6	6
Asset Turnover (x)	4.3	4.5	6.0	6.4	6.0
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(RS MILLION)					
Y/E DECEMBER	2005	2006	2007	2008E	2009E
OP/(loss) before Ta	4,741	4,838	6,303	7,606	9,555
Int./Div. Received	145	206	254	166	232
Depreciation and Ar	568	663	747	826	922
Interest Paid	-2	-4	-9	-3	-3
Direct Taxes Paid	-1,483	-1,562	-1,981	-2,144	-2,701
(Incr)/Decr in WC	-326	392	245	-420	172
CF from Operati	3,643	4,532	5,560	6,031	8,178
Extraordinary Items	0	0	0	0	0
(Incr)/Decr in FA	-1,000	-1,242	-1,570	-1,250	-1,500
(Pur)/Sale of Invest	504	267	-166	60	-1,247
CF from Invest.	-496	-976	-1,736	-1,190	-2,747
Issue of Shares	0	0	0	0	0
(Incr)/Decr in Debt	-64	-20	134	0	0
Dividend Paid	-2,748	-2,803	-3,704	-4,405	-5,568
Others	-63	-336	-640	-388	542
CF from Fin. Act	-2,875	-3,159	-4,210	-4,793	-5,026
Incr/Decr of Cas	272	397	-386	48	405
Add: Opening Balan	94	366	764	378	425
Closing Balance	366	763	377	426	830



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Nestle India

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|---|----|
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| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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