

Nestlé India

BUY
 Maintained

On an accelerated growth path

Rs900

Reason for report: Q4CY06 results review and earnings revision

Nestlé's Q4CY06 performance underscores sales growth acceleration and we expect this strong growth to sustain going ahead. Moreover, the worst of margin declines seems to be behind the company and OPMs are likely to stabilise at 19% levels. We are lowering earnings estimates by a marginal 5-7% for CY07-08E to factor in the high input price scenario. With Nestlé being one of the best positioned companies to leverage on the opportunities in the Indian processed foods industry, we maintain BUY on the stock, which trades at 21.8x CY07E P/E.

- ▶ **Acceleration of sales growth, yet margin decline continues in Q4CY06.** Nestlé's domestic net sales growth accelerated to 16.4% YoY (highest in the past six quarters). However, with a sharp fall in OPM by 263bps YoY to 16.3%, the company registered a modest 1.8% YoY and 3.4% YoY growth in operating and recurring profits.
- ▶ **Margins on YoY basis to stabilise from Q1CY07E onwards.** Post ban on milk powder export (imposed on February 1, '07), the input price-related inflationary concern has reduced to some extent. Besides, Nestlé continues to undertake direct and indirect (through pack weight reduction) hikes in product prices across most categories. We believe that, as a consequence, Q4CY06 was possibly the final quarter for Nestlé to see a significant YoY OPM decline. Moreover, decline in effective tax rates on the back of benefits from the Uttaranchal unit would accelerate net profit growth.
- ▶ **Earnings revision** In light of Nestlé's initiatives resulting in acceleration of sales growth, we are increasing our revenue estimates by 4-7% for CY07-08E. With input prices expected to sustain at higher levels and the company increasing investments for accelerating growth, OPMs are unlikely to expand soon. Consequently, we are lowering our earnings estimates by 7.2% and 4.8% for CY07E and CY08E respectively, translating into 20% earnings CAGR through CY06-08E.
- ▶ **Maintain Buy.** We believe that Nestlé is well positioned to leverage its strengths to capitalise on the growth opportunities in the Indian processed foods segment, especially post the structural changes undertaken over the past couple of years. The stock has become attractive after the recent 27% decline from peak levels; we maintain BUY on the stock, which trades at 21.8x CY07E P/E.

FMCG

Earnings revision

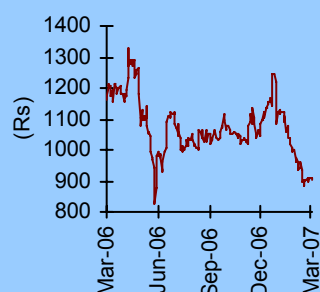
(%)	CY07E	CY08E
Sales	↑ 3.8	↑ 6.9
EBITDA	↓ 4.2	↓ 1.3
EPS	↓ 7.2	↓ 4.8

Shareholding pattern

(%)	Jun '06	Sep '06	Dec '06
Promoters	61.9	61.9	61.9
Institutional investors	18.8	18.4	18.6
MFs and UTI	4.0	4.0	3.8
Insurance Cos.	6.1	5.8	5.7
FIs	8.7	8.6	9.1
Others	19.3	19.7	19.5

Source: www.nseindia.com

Price chart



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Market Cap	Rs86.7bn/US\$1.95bn
Reuters/Bloomberg	NEST.BO/NEST IN
Shares Outstanding (mn)	96.2
52-week Range (Rs)	1329/826
Free Float (%)	38.1
FII (%)	9.1
Daily Volume (US\$'000)	810
Absolute Return 3m (%)	(18.0)
Absolute Return 12m (%)	(24.9)
Sensex Return 3m (%)	(3.9)
Sensex Return 12m (%)	19.4

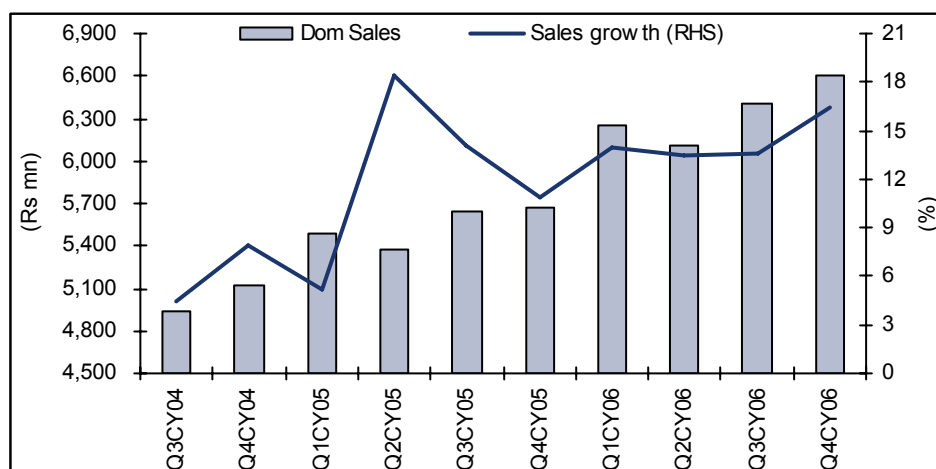
Year to Dec	CY05	CY06	CY07E	CY08E
Revenue (Rs mn)	24,770	28,161	32,822	37,935
Net Income (Rs mn)	3,227	3,229	3,981	4,673
EPS (Rs)	33.5	33.5	41.3	48.5
% Chg YoY	18.9	0.1	23.3	17.4
P/E (x)	26.9	26.9	21.8	18.6
CEPS (Rs)	39.4	40.4	48.3	55.8
EV/E (x)	16.4	15.9	13.7	11.7
Dividend Yield	2.6	2.8	4.1	4.0
RoCE (%)	91.7	81.6	99.4	113.7
RoE (%)	95.8	85.8	103.2	117.9

Q4CY06 results review

Acceleration in sales growth. Nestlé's domestic net sales growth accelerated to 16.4% YoY (highest in the past six quarters). The acceleration clearly reflects the benefits from structural changes (viz. realignment of internal company structure into a multi-focused business entity and reorganisation of sales force) undertaken by the company over the past couple of years. The company's Q4CY06 sales witnessed a smarter pickup on the back of these initiatives and continuing efforts to improve availability and visibility. We believe that while chocolate and vermicelli contributed to the strong volume growth, the revenue growth has been supported by increase in realisations across most categories. Recent launches such as *KITKAT Lite*, *Everyday Slim*, *Maggi Rice Mania* and *Fresh and Natural Slim Dahi*, have primarily focused on the 'wellness' aspect.

Further, exports registered a strong 36.9% YoY growth in Q4CY06 on account of better realisations and higher volumes. As a result, Nestlé's overall sales growth accelerated to 18.2% YoY in Q4CY06 (Rs7.4bn) as compared with 12.2% YoY growth in 9MCY06.

Chart 1: Acceleration of sales growth highest since past six quarters



Source: Company data, i-SEC Research

Regaining market share in key categories. After a decline in market share till September '06 in a number of key categories (except weaning foods), Nestlé recently regained market share in most (viz. noodles, coffee and chocolates). While the company's market share in noodles, weaning foods, coffee and milk powder improved on a YoY basis; its share in milk foods, ketchup and éclairs continued to decline.

Table 1: Market share decline arrested in key categories

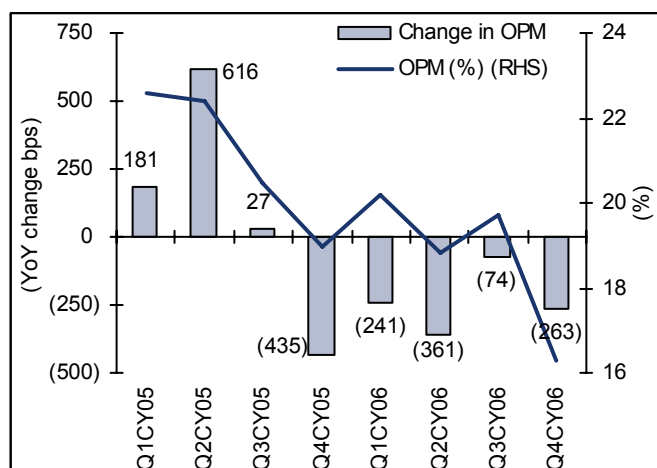
(Percentage)

	% of domestic retail sales	Q1CY06	Q2CY06	Q3CY06	Q4CY06	Jan'07	Trend	YoY bps change for Jan'07
Noodles	21.6	59.2	57.8	57.5	59.6	60.5	↑	238
Weaning foods	16.8	91.5	92.2	92.7	92.6	92.6	↑	143
Milk foods	15.5	48.4	44.3	45.8	44.5	42.8	↓	(521)
Chocolate	15.0	24.6	25.8	24.3	23.5	24.6	↓	(45)
Coffee	11.7	43.0	35.5	34.4	39.8	45.1	↑	209
Milk Powder	6.9	35.7	32.4	31.6	31.8	32.9	↑	94
Ketchup	4.0	39.1	36.1	35.2	34.7	33.4	↓	(263)
Eclairs	3.8	34.9	34.2	32.4	28.5	25.2	↓	(594)

Source: AC Nielsen Retail Sales Audit

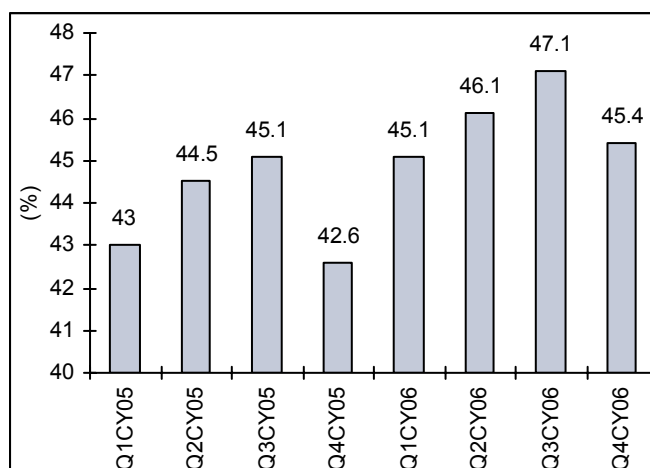
Decline in OPM continues. After registering low OPM decline (74bps) in Q3CY06, Nestlé's Q4CY06 OPM fell sharply by 263bps YoY to 16.3% (lowest in the past ten quarters). This indicates that staggered price hikes undertaken by the company were unable to offset the steep increase in input prices. Nestlé has been witnessing increased cost pressure due to substantial upsurge in commodity prices, especially milk (which accounts for nearly half the raw material cost). Further, fuel price rise and higher operating costs associated with upgraded formulations and manufacturing processes of infant nutrition products (for quality enhancement) added to the decline. Material cost to sales ratio increased 270bps YoY to 45.4%. However, it must be noted that material cost as a percentage of sales has been lower in Q4CY06 as against the previous two quarters'. As the quarter-ended December is characterised by higher A&P spends on account of the festive season, the OPM (at 16.3%) has been at lower levels as compared with the earlier quarters'. Further, inferior revenue mix along with strong growth of the low margin export business and higher than normal 29% YoY increase in staff cost adversely impacted margins. As a consequence of this decline in margins, the company registered a modest 1.8% YoY and 3.4% YoY growth in operating and recurring profits to Rs1.2bn and Rs794mn respectively. Due to excess provisions for contingencies during the quarter, the reported profits declined 15.8% YoY to Rs625mn.

Chart 2: OPM declines



Source: Company data

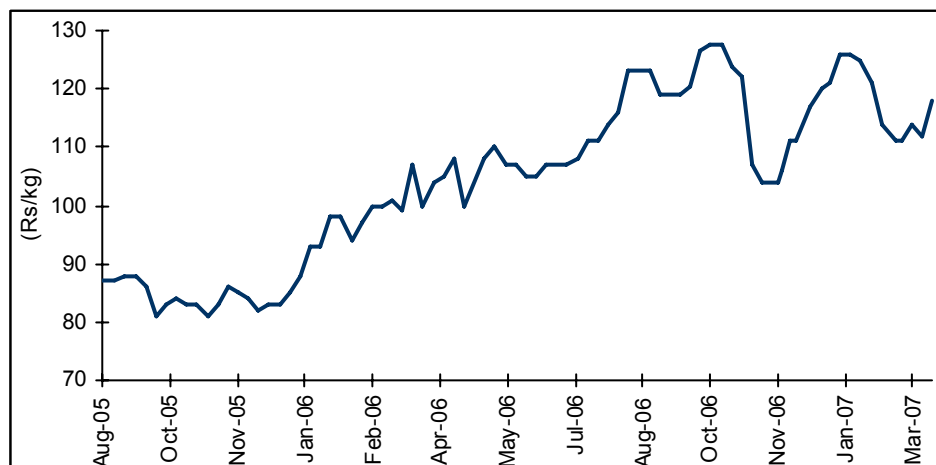
Chart 3: Material cost to sales in Q4CY06 has been lower than the previous two quarters'



Source: Company data

Margins expected to stabilize on YoY basis from Q1CY07E. Post ban on milk powder export (imposed on February 1, '07), the input price-related inflationary concern has reduced to some extent. Besides, the company continues to undertake direct and indirect (through pack weight reduction) hikes in product prices across most categories. For example, in Q1CY07, the company has reduced weight of a number of *Maggi* noodles SKUs by 10%. We believe that as a consequence, Q4CY06 was possibly the final quarter for Nestlé to see a significant YoY OPM decline. Moreover, decline in effective tax rates on the back of benefits from the Uttaranchal unit would accelerate net profit growth.

Chart 4: Milk powder prices have stabilised after ban on milk exports



Source: Commodities India

Table 2: Q4CY06 results review

(Rs mn, year ending December 31)

	Q4CY06	Q4CY05	% chg. (YoY)	CY06	CY05	% chg. (YoY)
Domestic Sales	6,929	6,125	13.1	26,646	23,847	11.7
Excise	326	452	(28.0)	1,281	1,670	(23.3)
Net Domestic Sales	6,603	5,673	16.4	25,365	22,177	14.4
Export Sales	760	555	36.9	2,796	2,592	7.9
Net Sales	7,363	6,228	18.2	28,161	24,769	13.7
Material Cost	3,339	2,656	25.7	12,934	10,876	18.9
Staff Cost	569	441	29.2	2,162	1,833	17.9
Other Expenditure	2,252	1,950	15.5	7,681	6,840	12.3
Total Expenditure	6,160	5,047	22.1	22,776	19,549	16.5
Operating Profit	1,203	1,181	1.8	5,385	5,220	3.1
Other Income	73	58	27.0	206	237	(13.2)
Interest	1	0	250.0	4	2	109.5
Depreciation	177	154	15.2	663	568	16.6
PBT	1,097	1,084	1.2	4,924	4,887	0.7
Provision for contingencies and impairment of asset	169	38	350.3	119	197	(39.8)
Provision for Taxation	303	305	(0.7)	1,654	1,595	3.7
Reported Profit	625	742	(15.8)	3,151	3,096	1.8
Recurring PAT	794	768	3.4	3,269	3,292	(0.7)
OPM (%)	16.3	19.0	(263)	19.1	21.1	(195)
NPM (%)	10.8	12.3	(155)	11.6	13.3	(168)
Effective Tax Rate (%)	32.7	29.2	352	34.4	34.0	42
Material cost to sales (%)	45.4	42.6	270	45.9	43.9	202
Staff cost to sales (%)	7.7	7.1	66	7.7	7.4	28
Other expenditure to sales (%)	30.6	31.3	(73)	27.3	27.6	(34)

Source: Company data, i-SEC Research

Earnings revision

In light of Nestlé's initiatives resulting in sales growth acceleration, we are increasing our revenue estimates by 3.8% & 6.9% for CY07E & CY08E respectively. With input prices expected to sustain at higher levels and the company increasing investments for accelerating growth, OPM is unlikely to increase over the medium term. We now expect the company's OPM to stabilise at ~19% for CY07-08E as against the 20.6% average through CY02-05 when commodity inflation was benign. Consequently, we are lowering our earnings estimates by 7.2% and 4.8% for CY07E and CY08E respectively, which translate into 20% earnings CAGR through CY06-08E.

Table 3: Earnings revision

(Rs mn, year ending Dec 31)

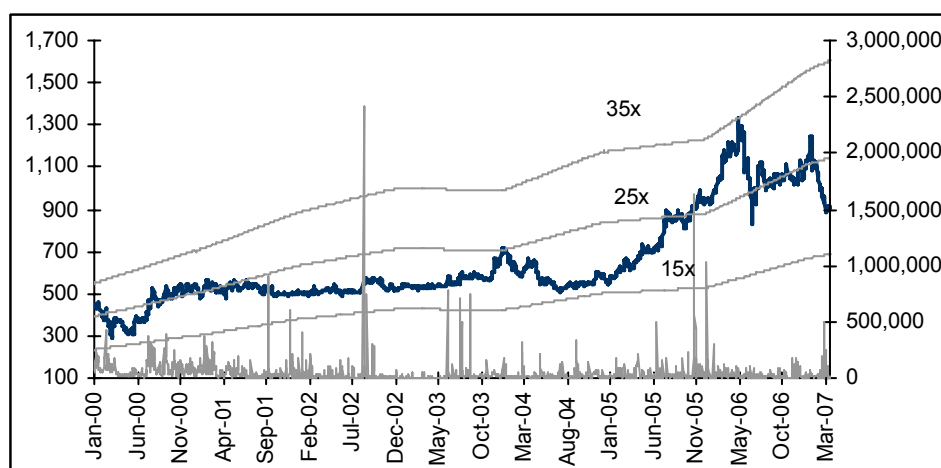
	CY07E			CY08E		
	Old	Revised	% change	Old	Revised	% change
Sales	31,628	32,822	3.8	35,473	37,935	6.9
EBITDA	6,512	6,238	(4.2)	7,373	7,278	(1.3)
PAT (Recurring)	4,288	3,981	(7.2)	4,910	4,673	(4.8)
Diluted EPS (Rs)	44.5	41.3	(7.2)	50.9	48.5	(4.8)

Source: Company data, i-SEC Research

Valuation

The Indian processed foods segment is likely to register accelerated growth on the back of sustained economic expansion and scaling up of modern retail trade. We believe that Nestlé is well positioned to leverage its strengths to capitalise on growth opportunities, especially after structural changes undertaken over the past couple of years. Further, margin pressures resulting from the lag effect of passing on the increase in input prices was merely transitory in nature and the company's margins are expected to stabilise soon. On the back of the high, long-term growth potential of the company, strong free cash flow generation and strong parentage, the stock would continue to trade at premium valuation to the market. The stock has become attractive after the recent 27% decline from peak levels. We maintain BUY on the stock, which trades at 21.8x CY07E P/E.

Chart 5: P/E bands



Source: CMIE, i-SEC Research

Financial Summary

Table 4: Profit and Loss Statement

(Rs mn, year ending December 31)

	CY05	CY06	CY07E	CY08E
Operating Income (Sales)	24,770	28,161	32,822	37,935
of which Exports	2,592	2,796	3,118	3,414
of which Domestic	22,178	25,365	29,704	34,521
Operating Expenses	19,548	22,775	26,584	30,657
EBITDA	5,222	5,385	6,238	7,278
% margins	21.1	19.1	19.0	19.2
Depreciation & Amortisation	568	663	672	710
Gross Interest	2	4	2	2
Other Income	237	206	205	207
Recurring PBT	4,889	4,924	5,769	6,773
Add: Extraordinaries	(197)	(119)	(150)	(250)
Less: Taxes	1,595	1,654	1,742	2,022
- Current tax	1,483	1,654	1,742	2,022
- Deferred tax	112	-	-	-
Net Income (Reported)	3,097	3,151	3,877	4,501
Recurring Net Income	3,227	3,229	3,981	4,673

Source: Company data, i-SEC Research

Table 5: Balance Sheet

(Rs mn, year ending December 31)

	CY05	CY06	CY07E	CY08E
Assets				
Total Current Assets	4,627	5,274	6,075	6,997
of which cash & cash equivalents	366	400	425	515
Total Current Liabilities & Provisions	6,853	7,141	7,982	8,969
Net Current Assets	(2,226)	(1,867)	(1,906)	(1,972)
Investments				
of which	1,044	1,000	850	1,500
Other Marketable	1,044	1,000	850	1,500
Net Fixed Assets	4,966	5,003	4,932	4,821
of which				
intangibles	0	0	0	0
Capital Work-in-Progress	228	228	228	228
Total Assets	3,784	4,136	3,875	4,350
Liabilities				
Borrowings	143	50	50	50
Deferred Tax Liability	100	100	100	100
Equity Share Capital	964	964	964	964
Face Value per share (Rs)	10	10	10	10
Reserves & Surplus*	2,577	3,022	2,762	3,236
Net Worth	3,541	3,987	3,726	4,200
Total Liabilities	3,784	4,136	3,875	4,350

Source: Company data, i-SEC Research

*excluding revaluation reserves; # = not written off

Table 8: Quarterly trends

(Rs mn, year ending December 31)

	Mar-06	Jun-06	Sep-06	Dec-06
Net sales	6,759	6,812	7,227	7,363
% growth (YoY)	10.2	10.6	15.7	18.2
EBITDA	1,365	1,279	1,425	1,203
Margin (%)	20.2	18.8	19.7	16.3
Other income	50	44	47	73
Add: Extraordinaries	127	71	(42)	(169)
Net profit	803	739	858	794

Source: Company data, i-SEC Research

Table 6: Cash Flow Statement

(Rs mn, year ending December 31)

	CY05	CY06	CY07E	CY08E
Operating Cash flow	3,516	3,727	4,494	5,254
Working Capital Changes	167	(298)	171	266
Capital Commitments	(1,000)	(700)	(600)	(600)
Free Cash Flow	2,683	2,728	4,064	4,920
Cash flow from Investing				
Activities	472	223	248	(553)
Issue of Share Capital	0	0	0	0
Buyback of shares	0	0	0	0
Inc (Dec) in Borrowings	64	(93)	0	0
Dividend paid	(2,556)	(2,803)	(4,138)	(4,026)
Extraordinary Items	(197)	(119)	(150)	(250)
Chg. in Cash & Bank balance	272	34	25	90

Source: Company data, i-SEC Research

Table 7: Key Ratios

(Year ending December 31)

	CY05	CY06	CY07E	CY08E
Per Share Data (Rs)				
EPS (Basic Recurring)	33.5	33.5	41.3	48.5
Diluted Recurring EPS	33.5	33.5	41.3	48.5
Recurring Cash EPS	39.4	40.4	48.3	55.8
Dividend per share (DPS)	23.0	25.5	37.0	36.0
Book Value per share (BV)	36.7	41.3	38.6	43.6
Growth Ratios (%)				
Operating Income	11.2	13.7	16.6	15.6
EBITDA	15.8	3.1	15.8	16.7
Recurring Net Income	18.9	0.1	23.3	17.4
Diluted Recurring EPS	18.9	0.1	23.3	17.4
Diluted Recurring CEPS	18.4	2.5	19.5	15.7
Valuation Ratios (x)				
P/E	26.9	26.9	21.8	18.6
P/CEPS	22.9	22.3	18.7	16.1
P/BV	24.5	21.8	23.3	20.7
EV / EBITDA	16.4	15.9	13.7	11.7
EV / Operating Income	3.5	3.0	2.6	2.2
EV / Operating FCF	31.9	31.3	21.0	17.2
Operating Ratio				
Raw Material/Sales (%)	45.0	45.9	46.1	46.2
SG&A/Sales (%)	16.1	16.3	16.3	16.1
Other Income / PBT (%)	4.9	4.2	3.6	3.1
Effective Tax Rate (%)	34.0	34.4	31.0	31.0
NWC / Total Assets (%)	(68.5)	(54.8)	(60.2)	(57.2)
Inventory Turnover (days)	60.7	61.2	62.6	63.0
Receivables (days)	4	4	4	4
Payables (days)	54	53	51	52
D/E Ratio (x)	0.1	0.1	0.1	0.1
Return/Profitability Ratio (%)				
Recurring Net Income Margins	12.9	11.4	12.1	12.3
RoCE	91.7	81.6	99.4	113.7
RoNW	95.8	85.8	103.2	117.9
Dividend Payout Ratio	82.5	88.9	106.7	89.5
Dividend Yield	2.6	2.8	4.1	4.0
EBITDA Margins	21.1	19.1	19.0	19.2

Source: Company data, i-SEC Research

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