Company In-Depth

2 May 2007 | 12 pages

Nestle India (NEST.BO)

Upgrade to Buy: 1Q07 Ahead by a Mile

Rating change ☑
Target price change ☑
Estimate change ☑

- Upgrade to Buy (1L) — We upgrade Nestle to Buy (1L), following much better than expected 1Q07 results. The stock has underperformed the Sensex by 31% over the last 12 months; a trend that we expect to reverse as sales momentum has picked up and input cost related margin pressure is abating.
- Raising target price - We are raising our target price to Rs1244 from Rs916 based on 1) increase in 2007E-08E EPS estimates by 12.4%-20% following a strong 1Q and 2) roll forward target P/E to Jun-08. Our price target is based on 25x P/E, supported by 25.5% EPS CAGR over 2006-09E.
- Solid sales growth momentum — Sales growth momentum for Nestle is picking up, driven by pickup in volumes and price increases across all its product segments. Nestle continues to roll out innovative new products/variants which is enhancing its growth profile. We estimate sales CAGR of 15% over FY06-FY09E.
- Reversal in margin trend — Margins have been under pressure owing to raw material cost pressures, but this trend is reversing. Prices of some key inputs like sugar and wheat flour have been softening. Price hikes across segments and cost-cutting measures are also aiding margins. EBITDA margin contraction trend of the last 5 quarters was reversed in 1Q07.
- 1Q results beat expectations by a mile — 1Q07 net profit (pre-exceptional) growth of 52.1% YoY was 42% ahead of our expectations. Key positive surprises were 27.7% sales growth (against our estimate of 12%) and 90bps EBITDA margin expansion against our estimate of slight contraction.

Buy/Low Risk	**1L**
from Sell/Low Risk	
Price (30 Apr 07)	Rs1,007.65
Target price	Rs1,244.00
from Rs916.00	
Expected share price return	23.5%
Expected dividend yield	3.2%
Expected total return	**26.6%**
Market Cap	Rs97,153M
	US$2,367M

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

See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	3,096	32.11	22.9	31.4	27.4	91.9	2.5
2006A	3,151	32.68	1.8	30.8	26.6	87.7	2.8
2007E	4,318	44.78	37.0	22.5	21.7	106.2	3.2
2008E	5,278	54.75	22.2	18.4	16.6	102.2	3.6
2009E	6,190	64.20	17.3	15.7	13.4	94.5	4.4

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	31.4	30.8	22.5	18.4	15.7
EV/EBITDA adjusted (x)	18.3	17.8	13.6	11.1	9.4
P/BV (x)	27.4	26.6	21.7	16.6	13.4
Dividend yield (%)	2.5	2.8	3.2	3.6	4.4
Per Share Data (Rs)					
EPS adjusted	32.11	32.68	44.78	54.75	64.20
EPS reported	32.11	32.68	44.78	54.75	64.20
BVPS	36.73	37.82	46.51	60.63	75.19
DPS	25.00	28.00	32.00	36.00	44.00
Profit & Loss (RsM)					
Net sales	24,769	28,161	33,074	37,798	42,685
Operating expenses	-20,117	-23,439	-26,778	-30,098	-33,604
EBIT	**4,652**	**4,722**	**6,296**	**7,700**	**9,081**
Net interest expense	-2	-4	-4	-4	-4
Non-operating/exceptionals	41	88	250	301	301
Pre-tax profit	**4,691**	**4,805**	**6,542**	**7,997**	**9,378**
Tax	-1,595	-1,654	-2,224	-2,719	-3,188
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**3,096**	**3,151**	**4,318**	**5,278**	**6,190**
Adjusted earnings	3,096	3,151	4,318	5,278	6,190
Adjusted EBITDA	5,221	5,385	6,996	8,424	9,830
Growth Rates (%)					
Sales	11.2	13.7	17.4	14.3	12.9
EBIT adjusted	15.8	1.5	33.3	22.3	17.9
EBITDA adjusted	15.8	3.1	29.9	20.4	16.7
EPS adjusted	22.9	1.8	37.0	22.2	17.3
Cash Flow (RsM)					
Operating cash flow	**3,067**	**4,270**	**4,686**	**5,962**	**6,889**
Depreciation/amortization	568	663	700	724	748
Net working capital	-374	571	-332	-41	-49
Investing cash flow	**-1,812**	**-117**	**-1,074**	**-806**	**-1,645**
Capital expenditure	-1,000	-622	-400	0	0
Acquisitions/disposals	-812	504	-674	-806	-1,645
Financing cash flow	**-2,684**	**-3,089**	**-3,481**	**-3,916**	**-4,786**
Borrowings	64	-43	0	0	0
Dividends paid	-2,748	-3,046	-3,481	-3,916	-4,786
Change in cash	**-1,430**	**1,064**	**131**	**1,241**	**458**
Balance Sheet (RsM)					
Total assets	**10,637**	**11,231**	**12,527**	**14,608**	**16,749**
Cash & cash equivalent	1,411	1,773	2,579	4,224	5,927
Accounts receivable	305	366	430	491	555
Net fixed assets	4,966	4,925	4,625	4,301	3,953
Total liabilities	**7,096**	**7,584**	**8,043**	**8,762**	**9,500**
Accounts payable	3,198	3,384	3,643	4,163	4,700
Total Debt	143	100	100	100	100
Shareholders' funds	**3,541**	**3,647**	**4,484**	**5,846**	**7,249**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	21.1	19.1	21.2	22.3	23.0
ROE adjusted	91.9	87.7	106.2	102.2	94.5
ROIC adjusted	152.8	138.0	194.9	nm	nm
Net debt to equity	-35.8	-45.9	-55.3	-70.5	-80.4
Total debt to capital	3.9	2.7	2.2	1.7	1.4

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Powered by: dataCentral

Upgrade to Buy. Price Target Rs1244

We are upgrading Nestle to Buy (1L) from our earlier Sell (3L) rating and increasing our price target to Rs1244 from Rs916 earlier. Our upgrade follows much better than expected 1Q07 results, and reversal in EBITDA margin trend, which expanded in 1Q, following a contraction for 5 consecutive quarters. Margins have been under pressure owing to raw material cost pressures, but this trend is reversing. Prices of some key inputs like sugar and wheat flour have been softening. Price hikes across segments and cost-cutting measures are also aiding margins.

We are raising our EPS estimates for 2007E-2008E by 12.4%-20.2%. Our increase in earnings estimates is driven by an increase in sales growth estimates (17.4% for 2007 and 14.2% for 2008), against 27.7% growth in 1Q07) as well as an increase in our margin assumptions.

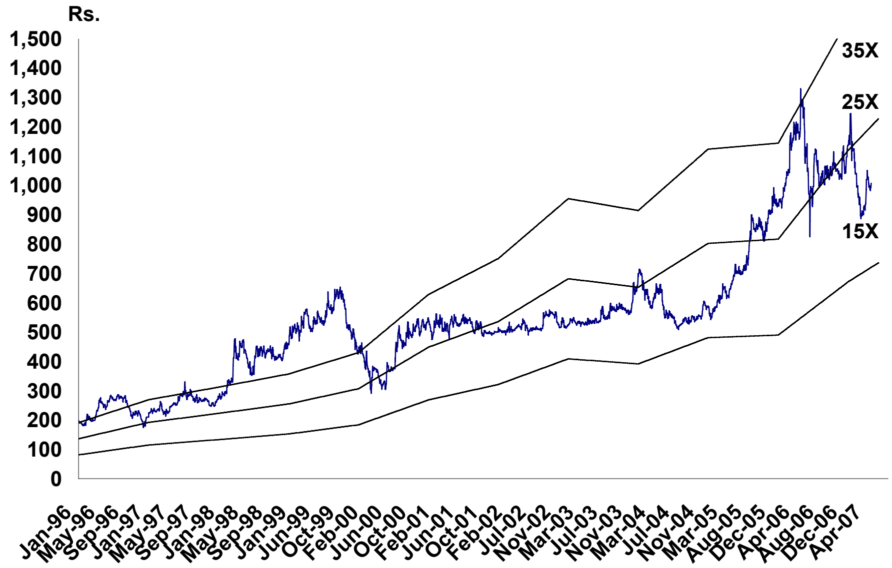
Figure 1. Earnings Revision Summary

	Profits (Rsm)			EPS (Rs)			DPS (Rs)		
	Old	New	% Chg.	Old	New	% Chg.	Old	New	% Chg.
2007E	3,841	4318	12.4	39.84	44.8	12.4	32	32.0	0.0
2008E	4,391	5278	20.2	45.55	54.7	20.2	36.0	36.0	0.0

Source: CIR estimates

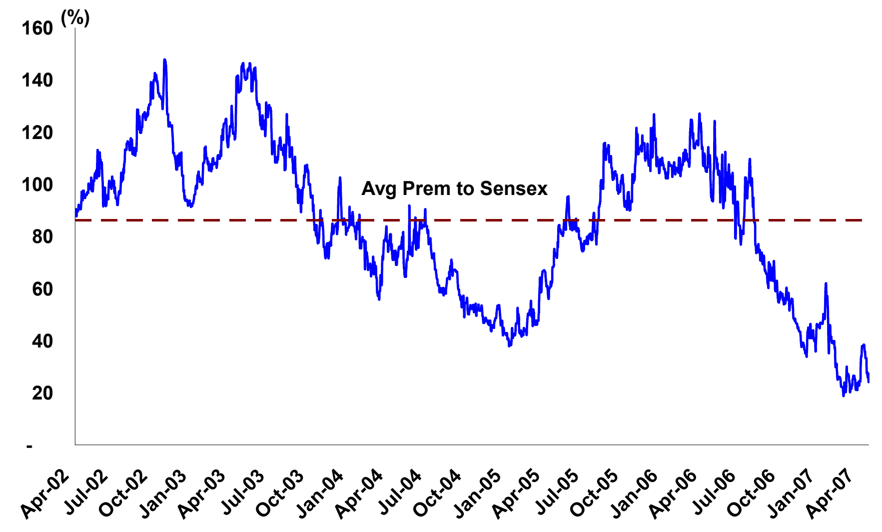
We also increase our target price to Rs1244 from Rs912. Our increase in target price is driven by 1) Increase in EPS estimates 2) Rolling forward our target P/E multiple to 1-year forward from 2007 and 3) Increase in our target P/E from 23x to 25x. We are lifting our target P/E for Nestle from 23x to 25x, on account of an increase in our estimated EPS growth CAGR over FY06-FY09E to 25.2%. With both sales growth and margins picking up, we believe that Nestle is a re-rating candidate. As such, our 25x P/E target is close to the mid-point of Nestle's historical P/E bands, which we believe is conservative. At 25x P/E, Nestle would trade at almost a 60% premium to Sensex P/E, which we believe is sustainable given its better relative earnings profile and significantly higher capital efficiency ratios (close to 100% ROE).

Figure 2. Nestle: P/E Band Chart



Source: Citigroup Investment Research

Figure 3. Nestle: P/E Relative to Sensex



Source: Citigroup Investment Research

Nestle has underperformed the Sensex by 31% over the last 12-months, a trend that we believe is set to reverse as sales growth momentum is improving and margin pressure is abating due to a cool-off in prices of some key ingredients such as sugar and wheat. Also, recently taken price hikes are aiding to mitigate the cost pressure in some of the input items.

Figure 4. Nestle: Relative price performance to Sensex

(%)	3M	6M	12M
Absolute	(9.2)	(4.5)	(20.8)
Relative. to .BSESN	(6.6)	(10.3)	(31.2)

Source: dataCentral

Solid Sales Growth, Margin Contraction trend Reversed

Sales growth momentum for Nestle remains strong, with double-digit top-line growth over the last 9 quarters. The company has been able to drive strong sales growth through strong volumes, price hikes and new product introductions. Over the last 12 months, the company has rolled out new variants for its flagship brand Maggi noodles (whole wheat and rice noodle variants), which have been well accepted by the market. In addition, the company has also started to address health conscious urban consumers through products like ‘Kit Kat lite’ chocolate (less sugar) and low-fat yogurt. We believe that new product pipeline will continue to drive above sector average growth rates for Nestle. We forecast sales growth CAGR of 15% over FY06-FY09E. Our key sales growth assumptions are enumerated below:

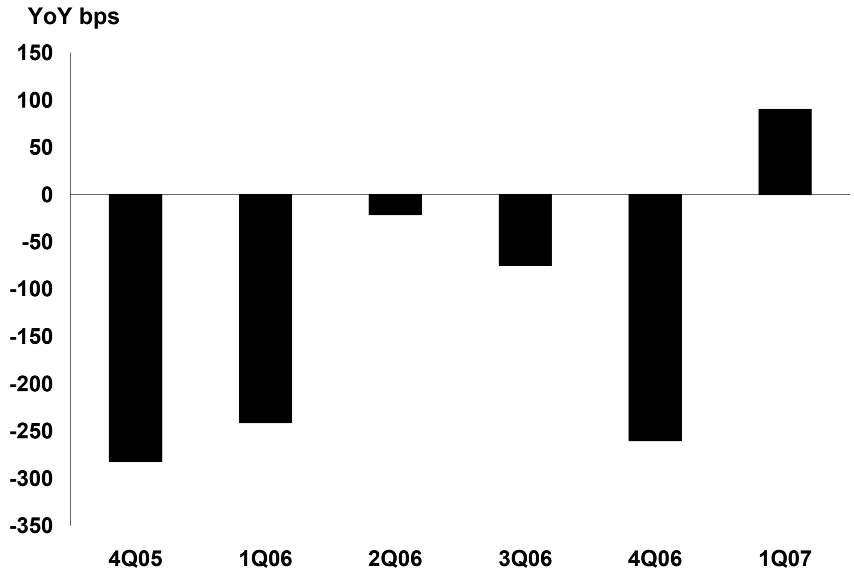
Figure 5. Nestle Sales Growth Drivers (Rupees in Million, Percent)

	2005	2006E	2007E	2008E	2009E
Milk Products and nutrition					
Sales	7611.4	8270.5	9552.4	10631.8	11721.6
Quantity (MT)	58827.0	60474.2	63497.9	66672.8	70006.4
Realization (Rs/MT)	129385.6	136760.5	150436.6	159462.8	167435.9
Increase in realization	1.5	5.7	10.0	6.0	5.0
Increase in quantity	7.9	2.8	5.0	5.0	5.0
Beverages	**5821.5**	**5925.6**	**6636.7**	**7300.3**	**8030.4**
Quantity (MT)	24606.0	21628.7	21628.7	21628.7	21628.7
Realization (Rs/MT)	236588.6	273969.6	306846.0	337530.6	371283.7
Increase in realization	12.1	15.8	12.0	10.0	10.0
Increase in quantity	-1.6	-12.1	0.0	0.0	0.0
Prepared dishes and cooking aids	**5017.3**	**5932.2**	**7403.4**	**8910.7**	**10452.3**
Quantity (MT)	65603.0	77411.5	92893.8	109614.7	126057.0
Realization (Rs/MT)	76479.0	76631.9	79697.2	81291.2	82917.0
Increase in realization	9.9	0.2	4.0	2.0	2.0
Increase in quantity	8.5	18.0	20.0	18.0	15.0
Chocolate and confectionery	**3845.5**	**4469.0**	**5242.1**	**6042.0**	**6902.4**
Quantity (MT)	26246.0	30366.6	34921.6	39461.4	44196.8
Realization (Rs/MT)	146516.5	147167.1	150110.4	153112.6	156174.9
Increase in realization	-0.3	0.4	2.0	2.0	2.0
Increase in quantity	11.3	15.7	15.0	13.0	12.0
Others	**4140.8**	**4844.7**	**5751.6**	**6643.1**	**7533.3**
Quantity (MT)	40544.0	42165.8	44695.7	46930.5	49277.0
Realization (Rs/MT)	102130.3	114896.6	128684.2	141552.6	152876.8
Increase in realization	12.5	12.5	12.0	10.0	8.0
Increase in quantity	-4.0	4.0	6.0	5.0	5.0
Total	**26436.4**	**29441.9**	**34586.2**	**39528.0**	**44640.0**

Source: Company Reports and CIR Estimates

Nestle's margin contraction trend from the last few quarters is reversing. The company had been facing margin contraction over the last few quarters on account of rising raw material costs, primarily driven by higher prices for milk and milk solids, raw coffee, sugar and wheat flour. Prices for some of these inputs, especially sugar and wheat, have started to cool off. In addition, the company has taken price hikes across the board to mitigate raw material cost pressure.

Figure 6. Nestle YoY EBITDA Margin Change Trend (bps)



Source: Company Reports

1Q07 Results Beat Expectations by a Mile

Pre-exceptional net profit growth of 52.1% was significantly ahead of our expectations. The key surprise was 90bps EBITDA margin expansion and solid 24.3% domestic sales growth. Sales were driven primarily by a pickup in volumes and price increases across all its product segments. While raw material cost pressure continues, price increases and operating cost savings initiatives resulted in 90bps EBITDA margin expansion, driving 33.6% EBITDA profit growth.

Figure 7. Nestle 1Q07 Results Summary (Rupees in Million, Percent)

	1Q06	1Q07	% YoY
Domestic Sales	6,251.6	7768.4	24.3
Export Sales	507.6	862.4	69.9
Net Sales	**6,759.2**	**8630.8**	**27.7**
Operating Expenses	-5,421.0	-6842.5	26.2
EBITDA	**1,338.2**	**1788.3**	**33.6**
EBITDA Margin (%)	*19.8*	*20.7*	
Interest	-0.3	-1.9	533.3
Depreciation	-157.1	-179.3	14.1
Other Income	50.4	69.5	37.9
PBT	**1,231.2**	**1676.6**	**36.2**
Tax	-498.9	-562.5	12.7
Tax Rate (%)	*28.1*	*33.6*	
Net Profit	**732.3**	**1114.1**	**52.1**
Exceptional Items	153.8	-29.6	-119.2
Net Profit Post Exceptional	**886.1**	**1084.5**	**22.4**

Figure 8. Nestle 1Q07 Key Costs (Rupees in Million, Percent)

	1Q06	1Q07	% YoY
Net Sales	6,759.2	8,630.8	27.7
Raw Material Costs	3050.9	4080.8	33.8
% of Sales	*45.1*	*47.3*	
Staff Costs	542.8	646.1	19.0
% of Sales	*8.0*	*7.5*	
Other Expenditure	1827.3	2115.6	15.8
% of Sales	*27.0*	*24.5*	

Source: Company Reports

Nestle India

Company description

Nestle India, a 57% 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 Nestle'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 thesis

We have a Buy/Low Risk rating on Nestle, which we recently upgraded from a Sell. Nestle is the best play on urban consumption growth in Indian consumer sector universe, and has grown much ahead of the consumer sector growth average, driven by rising urban demand for processed foods. 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 2005-06 raw-material prices firmed up, which hurt margins for the company. However, key raw material prices like sugar and wheat flour have started to ease, which coupled with price hikes is likely to drive margin expansion. In addition, Nestle continues with new product launches and has an impressive pipeline of products, which continue to drive above sector average growth for the company

Valuation

Nestle is a steady growth company, and hence P/E in relation to expected growth appears best suited to value it. We believe Nestle India should trade at Rs1244, based on 25x Jun08E P/E - at the mid-point of its recent trading bands. We are lifting our target P/E for Nestle from 23x to 25x, on account of increase in our estimated EPS growth CAGR over FY06-FY09E to 25.2%. With both sales growth and margins picking up, we believe that Nestle is a re-rating candidate. As such, our 25x P/E target is close to mid-point of Nestle's historic P/E bands, which we believe is conservative. At 25x P/E, Nestle would trade at almost 60% premium to Sensex P/E, which we believe is sustainable given its better relative earnings profile and significantly higher capital efficiency ratios (close to 100% ROE). On and EV/EBITDA basis, Nestle could trade between 15x-18x, a significant premium to the Sensex as the company enjoys strong cash flows as well as among the highest capital-efficiency ratios. Our price target of Rs1244 implies an EV/EBITDA of about 15x Jun-08E

Risks

We rate Nestle Low Risk based on our quantitative models. The key downside risks to our target price include: (1) fluctuations in commodity prices could affect profitability prospects; (2) Nestle may not gain significantly in an economic recovery led by the rural sector given its high urban exposure; and (3) supply constraints on raw materials, particularly milk solids, could stifle growth. The key upside risks to our target price include: (1) better-than-expected sales growth performance; (2) favorable agri-product prices; and (3) any fiscal benefits offered by the government to the food processing industry.

Appendix A-1

Analyst Certification

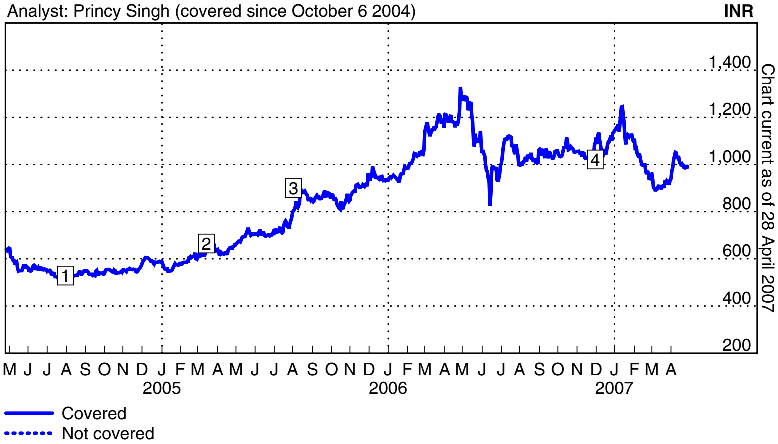
I, Princy Singh, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Nestle India (NEST.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since October 6 2004)



#	Date	Rating	Target Price	Closing Price
1:	30 Jul 04	2L	*600.00	521.75
2:	15 Mar 05	*1L	*710.00	637.35
3:	2 Aug 05	*3L	*776.00	804.95
4:	30 Nov 06	3L	*916.00	1,093.50

*Indicates change.

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Citigroup Investment Research Global Fundamental Coverage (3215)	45%	40%	15%
% of companies in each rating category that are investment banking clients	45%	42%	32%
India -- Asia Pacific (130)	58%	14%	28%
% of companies in each rating category that are investment banking clients	42%	50%	42%

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