Nestle India

Buy

CMP: Rs1,442

Target Price: Rs1,699 (12 Months)

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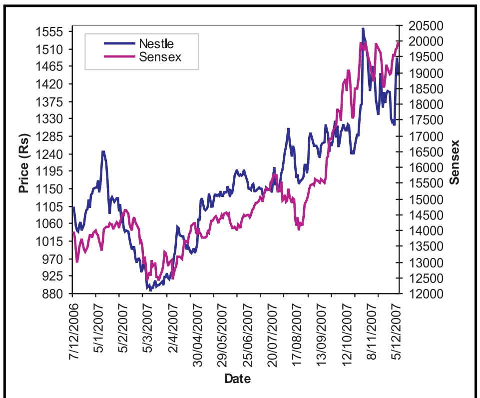
Stock Info

Sector	FMCG
Market Cap (Rs cr)	13,905
Beta	0.5
52 Week High / Low	1,663 / 876
Avg Daily Volume	45,185
Face Value (Rs)	10
BSE Sensex	19,966
Nifty	5,974
BSE Code	500790
NSE Code	NESTLE
Reuters Code	NEST.BO
Bloomberg Code	NEST IN

Shareholding Pattern (%)

Promoters	61.9
MF / Banks / Indian FIs	13.0
FII / NRIs / OCBs	8.2
Indian Public / Others	16.9



'Munch' in on the good times

We believe Nestle offers the most superior opportunity to play out the growing Food Processing theme in India owing to its diversified product portfolio of established brands, strong parent support and superior distribution reach. Further, Nestle's focus to develop products around the Nutrition, Health & Wellness platform, a re-organised management structure and pickup in consumer demand indicates a stronger growth phase for the food behemoth, which was reflected in its better-than-expected 9MCY2007 results as well. At Rs1,442, the stock trades at 22.1x CY2009E Earnings and 13.8x EV/EBITDA. ***We Initiate Coverage on the stock, with a Buy recommendation and 12-month Target Price of Rs1,699 (based on our DCF model).***

- **Best play on the Food Processing theme in India:** A huge base of consumers powered by rising disposable incomes and growing popularity of processed and packaged foods are indicative of the better times ahead for the US $70bn Food Processing industry in India. Nestle India is well positioned to capture this growth owing to its global parent support, strong set of core brands, wide distribution network and established sourcing relationships for raw materials through initiatives like Nestle Milk Districts.
- **Diversified Product Portfolio of established brands:** Nestle enjoys a strong position across categories in the Food & Beverage space through a diversified portfolio of established brands like Maggi, Nescafe, Everyday, Kit Kat, Milkmaid, etc. We are particularly bullish on under penetrated categories like instant noodles, value-added dairy products, chocolate and confectionery, which are witnessing an uptrend in consumer demand.
- **Better-than-expected 9MCY2007 results:** A re-organised management and sales team has started reflecting in the company's improved turnover. During 9MCY2007, Nestle witnessed a sharp uptrend in domestic sales registering a 25.6% overall growth aided by a steady 15.5% growth in volumes. A broad-based growth across categories reaffirms our view that Nestle will be able to maintain this momentum in the future as well.

Key Financials

Y/E December (Rs cr)	CY2006	CY2007E	CY2008E	CY2009E
Net Sales	**2,816**	**3,455**	**4,037**	**4,615**
% chg	*13.7*	*22.7*	*16.9*	*14.3*
Net Profit	**315.1**	**420.5**	**517.8**	**627.7**
% chg	*1.8*	*33.4*	*23.1*	*21.2*
OPM (%)	19.1	20.2	20.9	21.7
EPS (Rs)	**32.7**	**43.6**	**53.7**	**65.1**
P/E (x)	44.1	33.1	26.9	22.1
P/BV (x)	35.8	31.7	28.1	24.7
RoE (%)	81.0	96.0	104.5	111.4
RoCE (%)	111.3	131.8	143.0	151.7
EV/Sales (x)	4.9	4.0	3.4	3.0
EV/EBITDA (x)	25.7	19.8	16.4	13.8

Source: Company, Angel Research

Business Overview

Nestle India, 61.9% subsidiary of Nestle SA, is one of the largest F&B player in India

Nestle India, a 61.9% subsidiary of its global parent Nestle SA, is one of the largest and most diversified Food and Beverage (F&B) company in India. While Nestle entered the Indian market way back in 1912, when it began as a trading company, its real activity in the country started in 1961 when it set up its first factory at Moga, Punjab to develop milk. Nestle has seven factories across the country and is now involved in manufacturing and marketing a range of quality products across F&B segments. Nestle has well established brands including *Maggi, Nescafe, Lactogen, Kit Kat, Milkmaid,* etc.

Exhibit 1: Nestle's Product Segments

Category	Key Brands	% of Sales in CY07E	CAGR% CY07E-09E
Milk Products & Nutrition	*Lactogen, Cerelac, Nestle, Nesvita, Everyday, Milkmaid*	42.8	13.0
Beverages	*Nescafe, Nestea, Sunrise, Milo*	19.8	11.1
Prepared Dishes & Cooking Aids	*Maggi - Noodles, Ketchups & Sauces*	21.4	21.4
Chocolate & Confectionery	*Kit Kat, Munch, Milkybar, Eclairs, Polo*	16.0	18.6

Source: Company, Angel Research

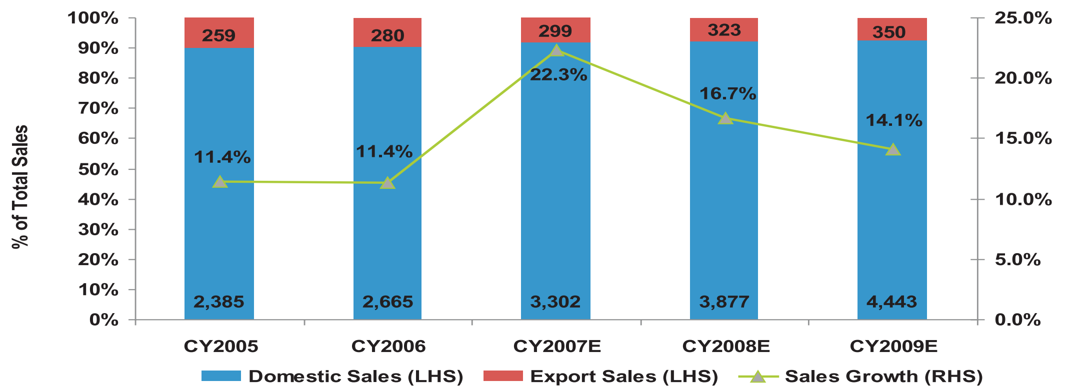
Nestle enjoys distinct competitive advantage owing to strong parent support

Nestle operates in four key segments viz., Milk Products & Infant Nutrition, Prepared Dishes & Cooking Aids, Beverages and Chocolate & Confectionery. The company enjoys leadership position in its core categories like Baby Foods, Instant Noodles and Instant Coffee. Nestle enjoys distinct advantage over its competitors in the F&B space on account of its strong focus on developing products around the Nutrition, Health and Wellness platform and a culture of renovation and innovation in its offerings backed by strong parent support (largest Food company in the world).

Domestic business, accounting for 90% of sales, is exhibiting an upward growth trajectory

The company earns majority of its revenues from its domestic business (90% of total sales), which is exhibiting an uptrend boosted by strong consumer demand across categories, rising health awareness and growing modern retail trade. In terms of exports (account for 10% of total sales), the company's mainstay is coffee exports. During the last couple of years, the company has made conscious efforts to reduce its dependence on markets like Russia (which witnessed a decline after direct entry of Nestle SA) by entering new geographies (South Asia and Europe) and developing new products for the export market like *Maggi* noodles, chocolates and confectionery. Going ahead, we expect the company's exports to grow at a moderate pace owing to pressure from currency appreciation and ban on export of certain milk products by government.

Exhibit 2: Nestle's Sales Mix



Source: Company, Angel Research

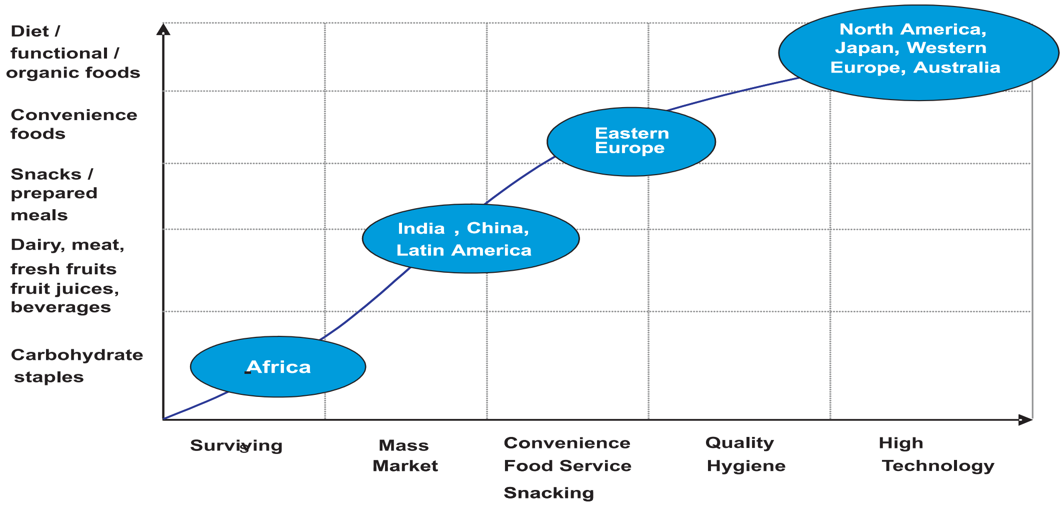
Investment Argument

Best play on the Food Processing theme in India

Indian F&B market is moving from sustenance to convenience foods

A huge consumer base powered by rising disposable incomes, evolving food consumption patterns and growing trend towards nuclear dual-income families are indicative of the better times ahead for the Food Processing industry in India. The Indian F&B market is still a mass market where majority of the demand comes from basic foods like carbohydrates, staples, dairy, fruits and meat. However, owing to a growing urban class and rising per capita income, the demand pattern is expected to shift from sustenance to convenience foods like snacks, packaged foods and value-added processed foods, which are expected to benefit established players like Nestle.

Exhibit 3: Evolution of global food demand



Source: Rabobank International, Angel Research

Food - the largest consumption category in India

The importance of Food and its role in Indian culture can be well understood by its sheer size. According to a recent McKinsey report, Food, Beverages and Tobacco (FB&T) constitutes the largest consumption category in India. FB&T is estimated at US $155bn (Rs7.1 trillion) and accounts for almost 40% of the total consumer spending.

The $22bn Value-added processed food industry is still at a nascent stage of development

Out of the total food market, the Indian Processed Food market stands at US $70bn while the Value-added Processed Food segment is around US$22bn. The Food Processing industry in India is one of the largest in terms of production, consumption, export and growth prospects. While the overall market size is significant, the Indian F&B category is still at a very nascent stage of development. Consider the following:

- With 70% of India's population still living in the rural areas, the urban populace accounts for a mere third of the total food consumption currently.
- Only a third of the Food Processing and Packaging industry in India is organised.
- Almost all agricultural production is unorganised.
- Less than 10% of the Food market is branded.
- Organised Food Retailing constitutes less than 1% of the Food distribution market.

Food Processing sector expected to grow at a CAGR of 12-15% over the next decade

Buoyed by favourable government policies, growing modern Retail trade and demand-push impact of a large youth consuming population, the Food Processing sector is expected to register a CAGR growth of 12-15% over the next decade. Value addition in food products is expected to increase from current levels of 8% to 35% by 2025.

Nestle is the best play on the food processing theme in India

We believe Nestle India is best positioned to capture this growth owing to its strong core brands, wide distribution network and established sourcing relationships for raw materials through initiatives like *Nestle Milk Districts*. Nestle's special relationship with the farming community via social initiatives like education, providing water and women empowerment programs have been instrumental in aiding the company source a steady supply of milk, its key raw material, at cheaper rates. Its world class factory at Moga, Punjab sources milk from more than 9,80,000 farmers through 2,250 collection centers. Moreover, R&D support from a committed global parent Nestle SA to consistently launch innovative products and brand extensions is a huge plus in combating competition. Nestle SA, with a group turnover of US $80bn in CY2006, is a global leader in the Food and Beverages category. The group's strong brands across categories and its expertise in understanding changing consumer preferences coupled with its deep financial muscle power provides Nestle with a unique position in the Indian market. Some of the key categories in the group's global portfolio like ice creams, water, biscuits, RTD coffee & tea, ready-to-eat meals and breakfast cereals provide ample opportunity for Nestle India to grow in the future.

Diversified Product Portfolio of established brands

Nestle's diversified product portfolio and strong brand recall are its key strengths

Nestle's established and balanced product portfolio (brands like *Lactogen*, *Maggi, Nescafe, Everyday, Kit Kat, Milkmaid,* etc.,) coupled with its long standing presence in India and strong brand recall make it one of the best bets to play out the growing Food Processing theme in India. Over the years, Nestle has leveraged on the strength of its existing brands and R&D capability to launch various brand and product extensions to enter new categories and tap a different set of customers. Even though the company's products are largely urban centric targeting middle to higher end consumers, Nestle has developed products at attractive price points to tap the rural consumers by leveraging on its distribution muscle and introducing lower priced units of its popular products in segments like coffee, chocolate, confectionery, ketchup and noodles. This has enabled the company to widen its consumer base. Moreover, management's consistent focus to develop products around the Nutrition, Health and Wellness platform provides for long-term visibility in terms of acceptability of its offerings.

Exhibit 4: Nestle's Product Portfolio

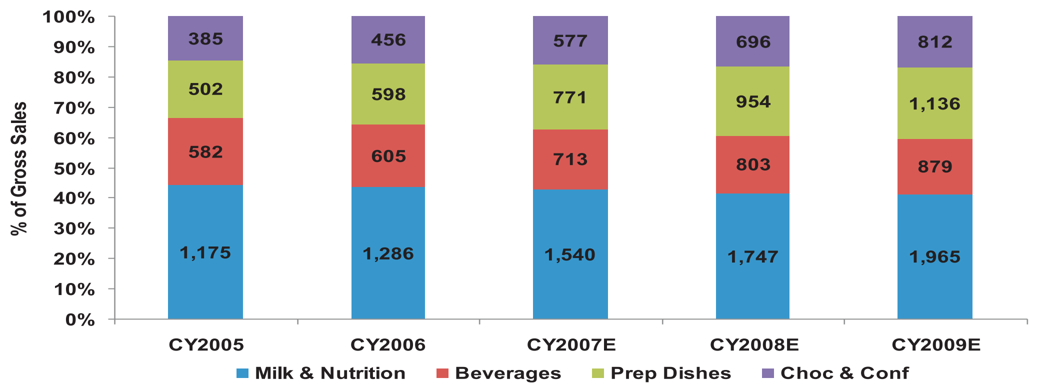
Category	Size (Rs cr)	Major Brands	Position	Competitors
Infant Nutrition	465	*Nestum, Lactogen, Cerelac, NAN, Nestogen*	No1	Amul, Wockhardt
Fresh Milk	20,000	*Nestle Milk, Slim Milk in Tetrapaks*	-	Amul, Mother Dairy
Curd/ Yoghurt	400	*Nestle Fresh N Natural, Nesvita Dahi/ Yoghurt, Milkmaid flavoured Yoghurt, Nestle Fresh N Jeera Raita*	-	Amul, Mother Dairy
Sweetened Milk	-	*Milkmaid*	No1	Amul
Dairy Whitener	-	*Everyday, Everyday Slim*	No2	Amul
Instant Coffee	450	*Nescafe, Sunrise, Nescafe 3-in-1*	No1	HUL, Tata Coffee
Malted Beverages	1,600	*Milo*	No3	GSK Cons, Cadbury
Chocolate	1,400	*Kit Kat, Munch, Milkybar*	No2	Cadbury
Confectionery	1,800	*Polo, Eclairs*	-	Perfetti, ITC, Godrej
Instant Noodles	730	*Maggi*	No1	Indo Nissin Foods
Ketchups	280	*Maggi*	No1	HUL, Heinz
Soups	75	*Maggi - Sanjeevni*	No2	HUL

Source: Company, Angel Research

No single category contributes significant amount to Nestle's topline

Nestle operates in the four key segments ie., Milk Products & Infant Nutrition (Baby Foods & Nutrition contributes 29% and value-added dairy products contribute 13.8% to the Topline), Prepared Dishes & Cooking Aids (21.4%), Beverages (19.8%) and Chocolate & Confectionery (16%). Thus, no single category contributes significant amount to the topline. Moreover, as most categories are witnessing steady growth pattern, we don't expect the sales mix to exhibit any significant changes.

Exhibit 5: Nestle's presence across F&B categories



Source: Company, Angel Research

Low penetrated categories like Noodles and Chocolate offer maximum potential

We are particularly bullish on under penetrated categories like instant noodles, value-added dairy products, chocolate and confectionery, which are witnessing an uptrend in consumer demand and offers tremendous growth potential owing to their low penetration levels. Moreover, as per capita income levels in India rise, we expect demand for other categories of higher end products like Baby Foods & Nutrition, Value-added dairy products and packaged foods to pickup helping Nestle to achieve consistent revenue growth in the future.

Milk Products & Nutrition (42.8% of sales) - Nestle's cash cow

Milk Products & Nutrition is the largest contributor to the Topline accounting for almost 43% of total gross sales. Under this category, the company operates in two sub segments - Infant Nutrition and Dairy products. Nestle is the market leader in the Baby Foods and Sweetened Condensed Milk category and a strong No2 in the Infant formula and dairy whitener business. While Baby Foods, Milk and Dairy Whitener are the company's cash cows generating steady returns, we expect the value-added dairy products to be the key growth driver for Nestle in this category.

Nestle leads the Rs465cr Baby Food segment with 85% marketshare

Infant Nutrition: According to Euromonitor, the market for Baby Foods stood at Rs465cr in 2006 and is expected to grow in mid single digits over the next five years. The Infant Nutrition market in India is at an extremely nascent stage of development. The high price of baby food brands, combined with government measures to promote breastfeeding and prohibit baby food promotion have limited the volume and value growth of baby food, especially in the smaller towns and cities, and rural areas. Nestle is the clear market leader in the Infant Nutrition category with a marketshare of 85% via its popular brands like *Cerelac* and *Nestum* (weaning foods) and *Lactogen, Nestogen* and *Nan* (baby milk powder). The company's main competitor is Wockhardt (*Farex, Protinex*) which relies almost completely on the recommendation of its brands by doctors and retail volume sales through pharmacies. Going forward, we expect Nestle to continue dominating the category and leverage on its parent's strong R&D capability in baby foods to consistently launch improved formulations. Rising per capita income coupled with growing awareness for health and wellness products would be the key growth drivers for the category in the future.

Dairy Products: Nestle is one of the biggest players in the organised dairy market in India with product offerings like milk powder, UHT milk, dahi, flavoured yoghurt, condensed milk and more recently a range of probiotic dairy products. The overall packaged dairy business in India is estimated at Rs25,000cr (including fresh milk, which is Rs20,000cr). Amul and Mother Dairy along with regional players dominate this space. Milk powder constitutes a large chunk of the dairy business, with the *Everyday* Dairy Whitener, launched in 1986, being the second largest brand after *Maggi* for the company. Liquid milk and fresh products are relatively smaller businesses for the company. In the fresh milk category, Nestle is only present in the ultra heat treated (UHT) milk segment – the milk sold in tetrapaks which fetch better margins.

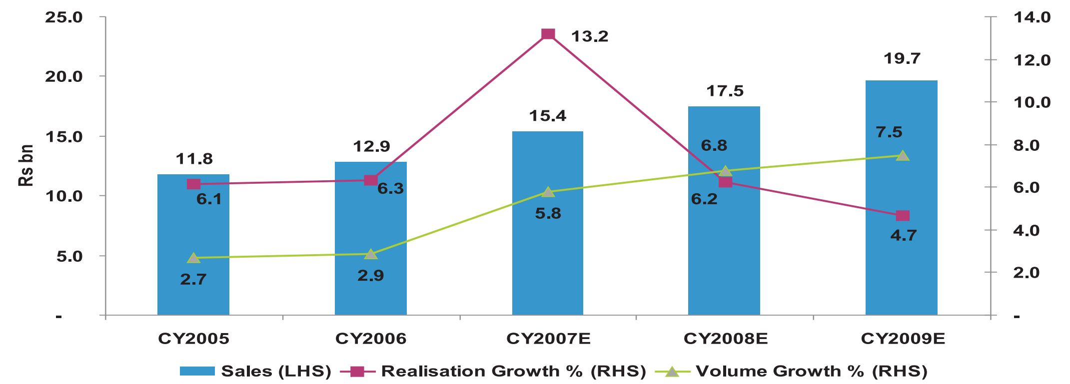
Value-added dairy products to be the key growth driver for the category

Traditionally, Nestle has targeted the upper end of the market with its range of dairy products. Going forward, we expect the company to launch extensions within its existing portfolio of liquid milk, milk powder and fresh products focusing on the Nutrition, Health and Wellness platform rather than diversifying into allied products such as butter or cheese. Nestle's recent product launches in value-added dairy products like *Nesvita* probiotic curd, *Nestle Fresh N Natural* slim dahi and *Nesvita* probiotic fruit yoghurt have met with encouraging response doubling the volumes in this sub segment.

Expect Nestle to deliver 13.1% CAGR in revenue during CY2007E-09E in the category

In the last couple of years, the category has been reporting slack volume growth of 2-3% owing to poor offtake of value-added dairy products and withdrawal of certain products from the market (eg., butter). However, the category has now picked up in terms of both volume and value growth owing to launch of new value-added dairy products and price hikes. Over CY2007E-09E, we expect Nestle to register 13% CAGR growth in revenues aided by 7.1% CAGR in volumes in the category.

Exhibit 6: Milk and Nutrition Category growth



Source: Company, Angel Research

Beverages (19.8% of sales) - Growth driven by better realisations

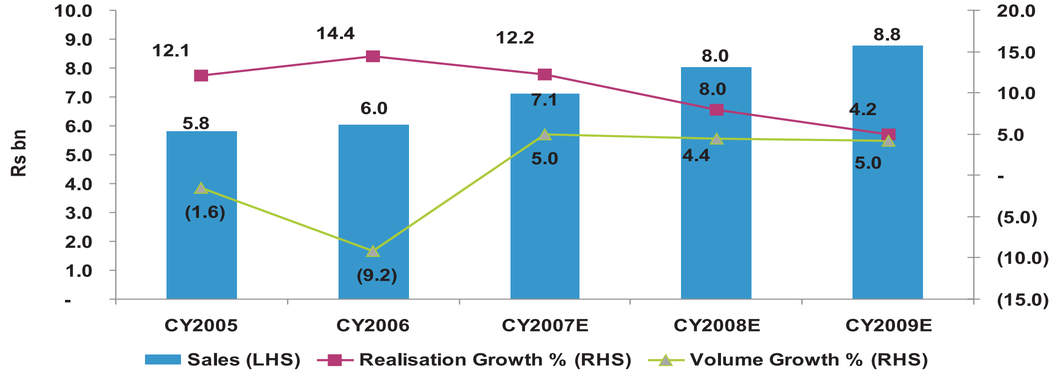
Nestle leads the Rs450cr Instant Coffee segment with 50% marketshare

Nestle is in the beverages business via its brands like *Nescafe* (instant coffee), *Nestea* (iced tea) and *Milo* (malted beverages) and several variants like *Nescafe Classic*, *Nescafe Sunrise* (blended coffee) and *Nescafe 3-in-1* (coffee, whitener and sugar mix). Nestle, with a 50% marketshare, leads the Rs450cr instant coffee market which is expected to grow by 12-15% CAGR over the next five years. Nestle's main competitors include HUL (*Bru*) and Tata Coffee (*Tata Kappi* and *Tata Café*). The company is also engaged in export of coffee, which accounts for almost 65% of its total export revenue. However, the company's volumes in the export business have witnessed a steady decline after the parent Nestle SA entered the Russian market (Nestle India's key export market) directly. The company's malted beverage offering *Milo* hasn't been able to scale up in the Indian market, despite being the largest selling malted drink in the world, owing to stiff competition from GSK Consumer (*Horlicks* and *Boost*) and Cadbury (*Bournvita*).

Expect Nestle to deliver 11.1% CAGR in revenue over CY2007E-09E in the category

Nestle's Out-of-Home segment offers significant potential to leverage its skills and competencies in vending and using its product portfolio to address consumer needs. Nestle has the highest number of vending machines installed in the market and sells over 700mn cups per annum. During the last couple of years, the category has witnessed a decline in volumes, and growth has been largely supported by price hikes owing to rise in prices of green coffee. However, the category has picked up in terms of volume growth owing to launch oflower priced sachets and new variants like *Nescafe Mild*. During CY2007E-09E, we expect Nestle to register 11.1% CAGR in revenue aided by 4.3% CAGR in volumes in the category.

Exhibit 7: Beverages Category growth



Source: Company, Angel Research

Prepared dishes and Cooking aids (21.4% of sales) - Maximum Potential

Nestle's Iconic brand 'Maggi' offers immense potential in the Culinary space

Nestle is present in the Prepared dishes & Cooking aids segment through its iconic brand *Maggi*, in its various avatars of instant noodles, sauces and soups. Nestle launched *Maggi* in India almost 25 years ago with the launch of '2-minute noodles'. The culinary brand now comprises nine instant noodle products, eight different sauces and twelve variants of soups.

Nestle is the leader in the instant Noodles and Ketchup market and is No2 in the Soups market

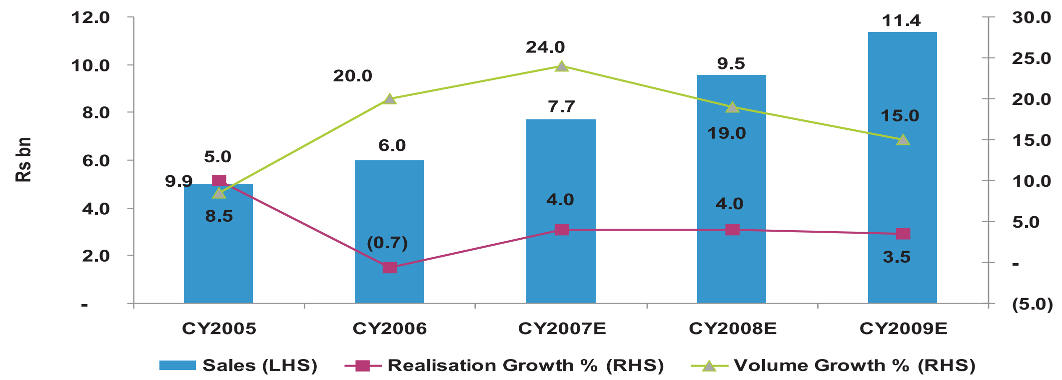
Nestle is the clear market leader in the Rs730cr pouch based instant noodles category through its flagship product of instant noodles and various *desi* sub-segments such as the traditional *Dal Atta*, *Veg Atta* and *Rice noodles Mania* along with their various variants. The company enjoys almost 90% share facing competition from only Indo Nissin Foods (*Top Ramen*). We expect the instant noodles market to grow at 15-17% CAGR over the next five years driven by launch of healthier varieties, more convenient formats (smaller pouches) and lower pricing strategies. The company also enjoys market leadership position in the Rs280cr Ketchup market with 39% share facing competition from players like Heinz and HUL. Nestle has been able to maintain its position in the category through a series of innovative product launches at premium price points enabling Nestle to achieve better margins.

In the Rs75cr Soups category, Nestle enjoys a strong No2 position after market leader HUL (*Knorr*). Nestle has re-launched the *Maggi* soup under the healthy soup banner – *Sanjeevni* in line with its trend to launch products on the health platform and benefit from lower excise rates. Furthermore, it has revamped its distribution, catering to the smaller towns and cities, which has helped increase its sales.

Expect Nestle to deliver 21.4% CAGR in revenue during CY2007E-09E in the category

We are extremely bullish on the Prepared dishes & Cooking aids category owing to its low penetration levels, increasing usage due to urbanization. We believe that Nestle has immense potential to leverage its core brand *Maggi.* Innovative brand positioning, new variants, renewed focus through lower price points and continued emphasis on promotions and incentives for both retailers and consumers will enable *Maggi* to stay at the top. During CY2007E-09E, we expect Nestle to register 21.4% CAGR in revenue aided by a healthy 16.9% CAGR in volumes in the category.

Exhibit 8: Prepared dishes & Cooking aids Category growth



Source: Company, Angel Research

Chocolate & Confectionery (16% of sales) segment- Nestle's potential 'star'

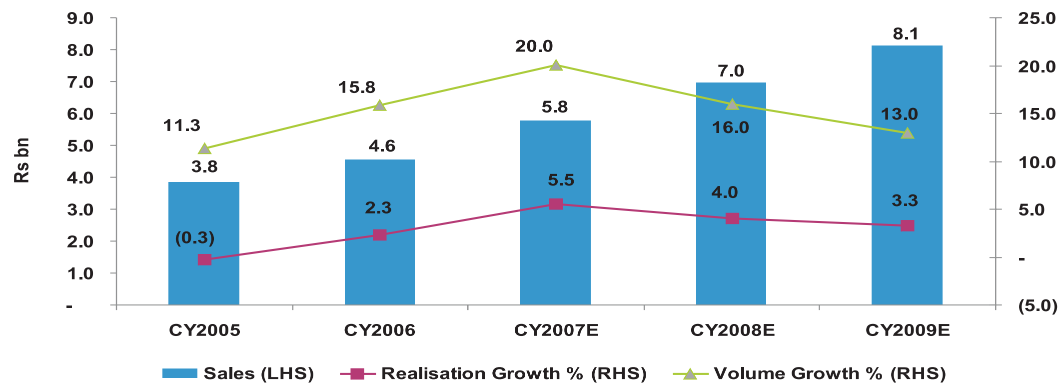
Nestle is a strong No2 in the Rs1,400cr chocolate market with brands like 'Kit Kat' and 'Munch'

Nestle is the second largest player in the Rs1,400cr Chocolate segment with almost 25% marketshare, second only to Cadbury. Nestle's brands include *Kit Kat* and *Munch* (wafer segment), *Milkybar* (white chocolate) and *Nestle Milk* & *Bar one* (milk chocolate). We expect the Chocolate segment to grow at 12-15% CAGR over the next five years owing to lower penetration levels (20%), a large youth population and recent entry of global players like *Hersheys,* which is expected to improve the market size. Moreover, value sales are expected to benefit immensely from rising disposable incomes as well as increasingly Western consumer lifestyles. These are expected to spur consumers to opt for chocolates over traditional Indian sweets. We believe Nestle is well positioned to tap this growth opportunity through lower price offerings (*Munch*) for the mass market, healthy offerings (*Kit Kat Lite*) for the health conscious urban market and gift packs (*Nestle Selections*) for consumers looking for a replacement to sweets.

Expect Nestle to deliver 18.6% CAGR in revenue during CY2007E-09E in the category

In the Rs1,800cr organised domestic confectionery market, Nestle is present through *Polo* (mint) and *Nestle Eclairs* (tofee). However, the confectionery market in India is extremely competitive and operates on thin margins as it is highly volume driven. Players like Perfetti, ITC, Cadbury and Godrej dominate the segment. Almost 80% of this market comprises products at the 50-paise price point. We believe the confectionery market in India is highly underdeveloped and offers tremendous potential. Innovation and value-added products are the key trends driving this category. During CY2007E-09E, we expect Nestle to register 18.6% CAGR in revenue aided by healthy 14.5% CAGR in volumes in the category.

Exhibit 9: Chocolate & Confectionery Category



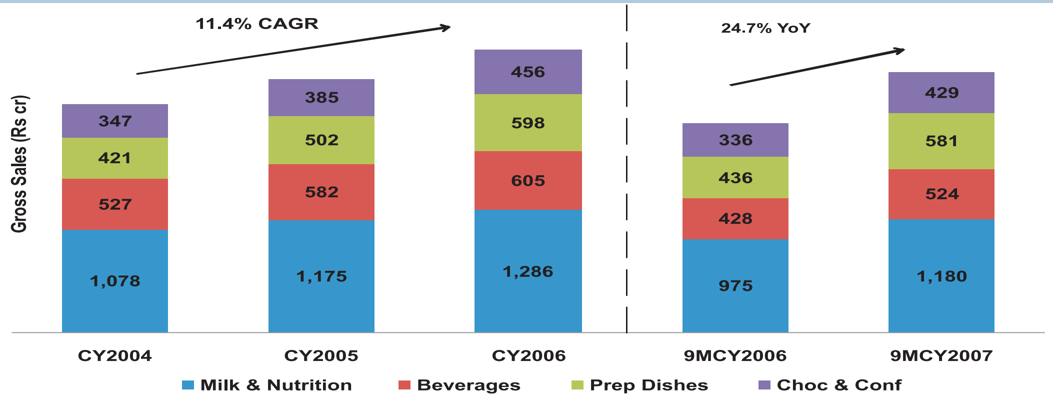
Source: Company, Angel Research

Better-than-expected 9MCY2007 results

Nestle is witnessing accelerated growth momentum

During the past couple of years, Nestle has made conscious efforts both internally (via management reorganisation and processes) and externally (via stronger consumer focus and product innovations) to reap better rewards from the growing consumer demand for processed and packaged food in India. These efforts have started translating into impressive Topline growth as observed in higher volume growth across categories and better pricing power.

Exhibit 10: Sales Growth (Including 9Months performance)



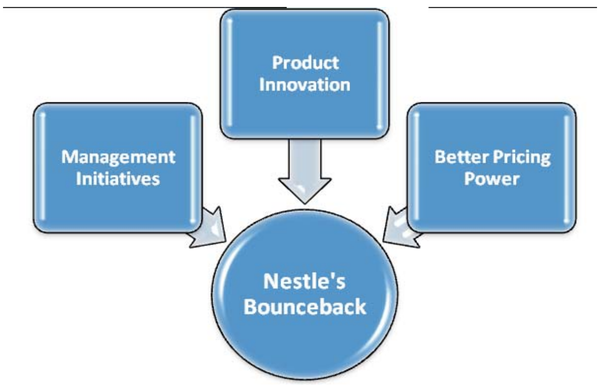
Source: Company, Angel Research

Domestic revenue growth of 25.6% in 9MCY2007 is extremely impressive

Thus, while Nestle registered a Sales CAGR growth of 11.4% during CY2004-06 (aided by 6.6% volume growth), it witnessed sharp acceleration in 9MCY2007 registering an impressive 24.7% yoy Topline growth (aided by 14.5% volume growth). The performance was even more impressive when seen in the domestic context as Nestle registered a stronger 25.6% domestic sales growth aided by a steady 15.5% volume growth. However, on the exports front, the company witnessed a moderate Sales growth of 16.3%, owing to a decline in beverage exports to the US, currency appreciation and restriction on export of certain milk-based products by the government.

While a buoyant economy, steady demand for branded food products and growing modern retail trade have played their part in this bounceback, we believe Nestle's efforts to re-organise its management structure and draw on its strengths in product innovation coupled with an improved pricing power are the core reasons behind this turnaround.

Exhibit 11: Key reasons for Nestle's Bounceback



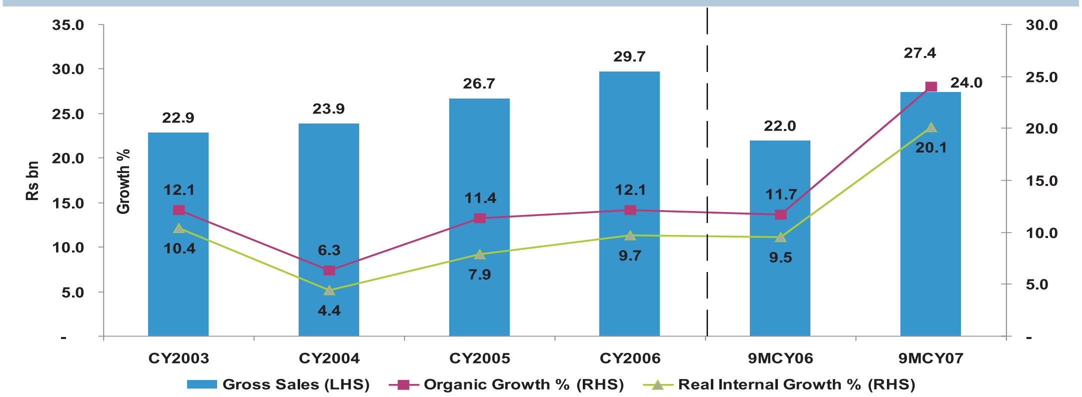
Source: Company, Angel Research

Management re-organisation initiatives - the key reason for the bounceback

While Nestle has constantly endeavoured to leverage on its core strengths to clock consistent growth, in CY2006 Nestle's initiatives to re-align its internal structure to become a multi-focal company with category specific business units (SBUs) and processes have now resulted in the company bouncing back to the forefront. To strengthen its focus on individual brands, each unit was assigned a brand manager. Further, to tap the growing potential of the smaller towns and development of modern retail formats, Nestle embarked on another management exercise whereby it created two new divisions viz., 'Channel and Category Sales Development' (CCSD) and 'National Key Accounts Management Organisation'. We expect Nestle to benefit positively from these management initiatives on account of better accountability and a more focused approach towards meeting consumer expectations and build a solid platform for accelerated growth in the coming years.

In fact, such management restructuring initiatives have already started yielding results as witnessed in the accelerated growth momentum during 9MCY2007. Both, real internal growth (RIG) based on volume and sales mix, and organic growth (including price hikes) have exhibited extremely positive signs. This indicates that Nestle is not only witnessing stronger volume growth across categories, but also reflects its premium pricing power.

Exhibit 12: Growth trends



Source: Company, Angel Research

Product innovations lead the way for growth momentum

Over the years, Nestle has been constantly adapting and extending its product portfolio and brands to meet changing consumer preferences. In the eighties Nestle had pioneered the launch of *Maggi 2-minute* noodles in the ready-to-eat segment. The recent extension of the *Maggi* brand to a range of ketchup and soups along with the recent launch of healthy variants like Atta and Rice noodles indicate Nestle's ability to adapt and innovate.

Leveraging on its access to world class technology from the Nestle Group, the company has achieved significant success in developing products around its focus platform of Nutrition, Health and Wellness enabling it to charge a premium for its offerings and accelerate the value growth across categories. The *Kit Kat Lite* variant in the wafer chocolate segment, *Polo* sugar free in the confectionery segment, *Everyday Slim* dairy whitener and range of probiotic products like *Nesvita* dahi and yoghurt as well as *Nestle Fresh N Natural Slim* dahi in the Dairy segment are some examples of the company's efforts to develop healthy offerings and which sustain the growth opportunities. We expect this trend of launching new products/brand extensions to continue and even accelerate in the coming years.

Exhibit 13: Nestle's Innovation and Renovation trends

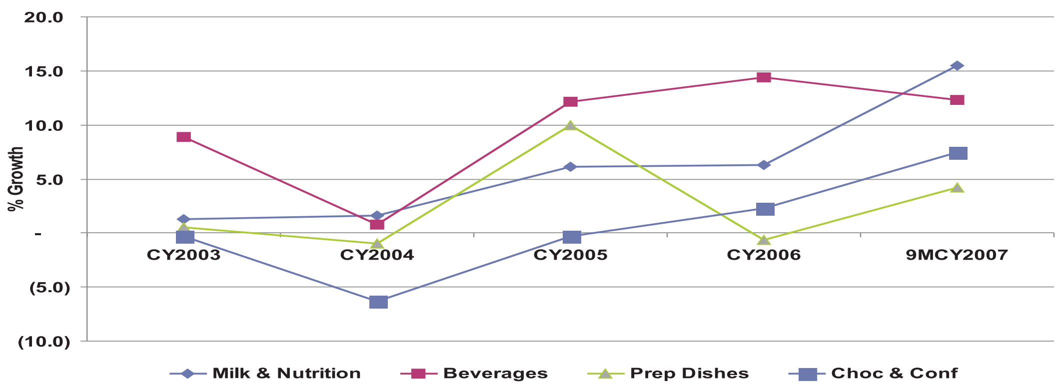
Categories	2005	2006	2007
Milk Products/ Nutrition			
Infant Nutrition	*Cerelac* 123 (wheat based), *Nestum* 123 (rice based), *Nestle Ceremeal Daliya*	Renovated the premium formula NAN	
Other Dairy Products	Nestle Jeera Raita, Nestle Butter discontinued	*Everyday Slim, Milkmaid* flavoured Yoghurt	*Nesvita Dahi* and *Nesvita Fruit Yoghurt, Slim Dahi, Milkmaid Funshakes*
Milk Products/ Nutrition			
Coffee & Beverages	Relaunched *Nescafe Sunrise*	*Nescafe 3-in-1, Milo* Energy drink renovated	*Nescafe Mild*
Prepared Dishes & Cooking Aids			
Noodles	*Maggi* Veg Atta Noodles, enhanced *Maggi 2-Minute* Noodles	*Maggi* Dal Atta Noodles and variant - 'No Onion, No Garlic'	*Nestle Rice Noodles Mania*
Ketchups	*Maggi* Tomato Pudina Sauce, *Maggi* Tomato Chatpat Sauce	*Maggi* Teekha Masala, Oriental Chilli Sauce and Pizza Maaza	
Soups	New range of *Maggi* Healthy Soups	*Maggi* Healthy Soups - *'Sanjeevni'*	Sweet Corn Soup
Chocolate & Confectionery			
Chocolates	Nestle *Milkybar* Choo Strawberry, Nestle *Maha Munch* and Nestle *Coconut Munch* at Rs5	Nestle *Kit Kat Lite,* Nestle *Funbar*	Nestle *Selections*
Confectionery	Nestle Coconut *Eclairs*	Nestle *Polo* Powermint at 50 paise price point	*Polo* Sugar free, *Tang eeZ*

Source: Company, Angel Research

Expect Nestle's pricing power to improve significantly

In terms of pricing power, Nestle has been extremely conservative during the past five years implementing a mere 2.5-3% average price hike across categories (except beverages). However, a buoyant economy, rising input cost inflation and an improved product mix (more value added products) have improved Nestle's pricing power significantly and we expect realisations to grow at a much faster pace during the period CY2007E-09E.

Exhibit 14: Nestle's growth in realisation (better pricing power)



Source: Company, Angel Research

Financial Outlook

Revenue growth of 15.6% CAGR during CY2007E-09E

Over CY2007E-09E, we expect Nestle to post a CAGR growth of 15.6% in revenue on the back of strong growth in its domestic business (expected to grow by 16.3% CAGR to Rs4,265cr in the mentioned period) supported by renewed consumer demand across categories, innovative product launches and better pricing power. Nestle's RIG (based on volume and sales mix) is exhibiting extremely positive signs and we expect the trend to continue as the growth is broad based.

Exports not to be a key growth driver

On the export front, growth continues to be largely driven by higher realisations in instant coffee owing to higher green coffee prices. However, the company's efforts to reduce its dependence on Russia by entering new geographies and developing new categories to export (instant tea, products for the Indian diaspora abroad like *Maggi* noodles and sauces and chocolate & confectionery to Asia Pacific) seem to be paying off. We have factored in a moderate CAGR growth of 8.2% in exports to Rs350cr over CY2007E-09E owing to currency appreciation and ban of exports of certain milk-based products by the government.

Exhibit 15: Revenue Growth

	CY2005	CY2006	CY2007E	CY2008E	CY2009E
Gross Sales (Rs cr)	**2,644**	**2,944**	**3,600**	**4,201**	**4,792**
Milk Products & Nutrition	1,175	1,286	1,540	1,747	1,965
Beverages	582	605	713	803	879
Prepared dishes & Cooking aids	502	598	771	954	1,136
Chocolate & Confectionery	385	456	577	696	812
Value Growth (%)	**11.4**	**11.4**	**22.3**	**16.7**	**14.1**
Milk Products & Nutrition	9.0	9.4	19.8	13.5	12.5
Beverages	10.4	3.9	17.8	12.8	9.4
Prepared dishes & Cooking aids	19.3	19.2	29.0	23.8	19.0
Chocolate & Confectionery	11.0	18.5	26.6	20.6	16.7
Volume Growth (%)	**4.9**	**8.3**	**13.7**	**12.3**	**10.9**
Milk Products & Nutrition	2.7	2.9	5.8	6.8	7.5
Beverages	(1.6)	(9.2)	5.0	4.4	4.2
Prepared dishes & Cooking aids	8.5	20.0	24.0	19.0	15.0
Chocolate & Confectionery	11.3	15.8	20.0	16.0	13.0

Source: Company, Angel Research

We have factored in an 11.6% CAGR volume growth over CY2007E-09E

We have factored in an overall volume growth of 11.6% CAGR over CY2007E-09E backed by steady growth in the Milk/Nutrition category and higher offtake in segments like Prepared dishes, Culinary products, Chocolates and Confectionery, which have the potential for higher growth owing to their low penetration levels. Moreover, Nestle's efforts to tap this potential via lower priced units have helped the company improve its presence in the rural segment leading to higher volumes.

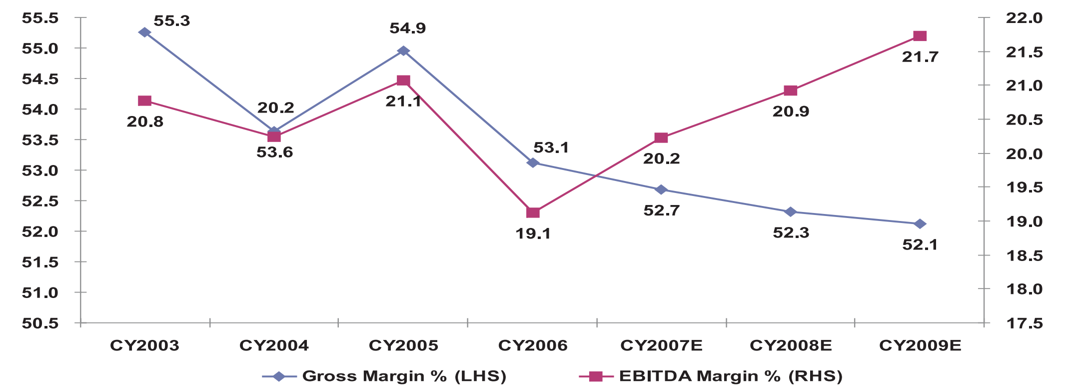
Expect Gross Margins to stabilse around 52.5% levels

On the operating front, Nestle has witnessed a contraction of 180bp in its gross margin during the last couple of years from its average level of 55% owing to rising input cost pressure particularly in raw materials like milk, green coffee, vegetable oils and wheat. However, going forward, we expect gross margin to stabilise at around 52.5% levels as we expect Nestle to reap benefits of premium product portfolio and take selective price hikes to mitigate the impact of input cost inflation.

Nestle's premium positioning to aid EBITDA expansion of 150bp over CY2007-09E

In terms of EBITDA, we expect Nestle to register a 19.8% CAGR over CY2007E-09E driven primarily by Margin expansion of 150bp on account of better volume growth, rising sales of value-added products and higher operating leverage. Moreover, Nestle also benefits from its premium positioning as reflected in its high EBITDA Margins at 20% which are superior to most of its FMCG peers owing to a strong urban centric portfolio, dominant marketshare in select categories (noodles and instant coffee) and high-end product offerings (baby nutrition, malted beverages and value added dairy products).

Exhibit 16: Operating Margin Trend

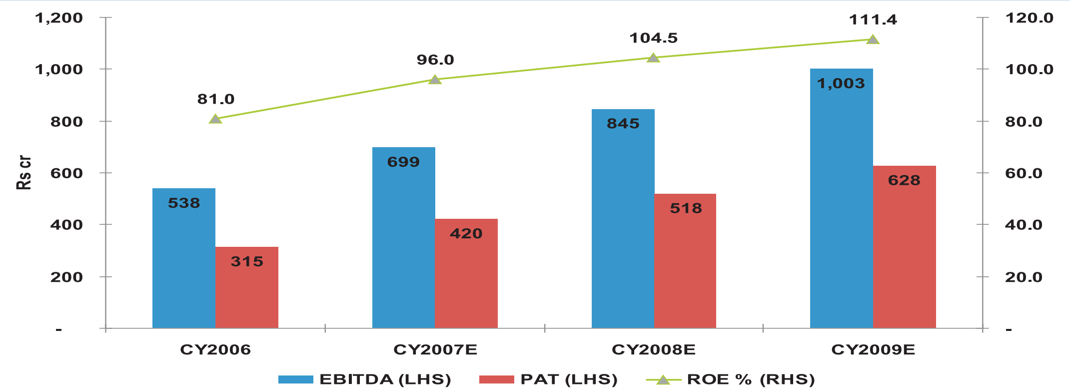


Source: Company, Angel Research

Bottomline expected to grow by 22.2% CAGR during CY2007E-09E

On the Earnings front, we expect Nestle to report a CAGR growth of 22.2% in Bottomline (post provisioning Earnings) over CY2007E-09E boosted by a buoyant Topline and Margin expansion. Moreover, the company has already commissioned its seventh manufacturing plant at Uttrakhand for culinary products. We expect the benefits of the same to start accruing Q4CY2007E onwards yielding positive surprise on the Earnings front. In our Earnings growth, we have assumed that Nestle would continue to provide for contingencies to the tune of Rs12cr, Rs13.5cr and Rs15cr in CY2007E, CY008E and CY009E respectively, as part of its prudent policy.

Exhibit 17: Financial Performance



Source: Company, Angel Research

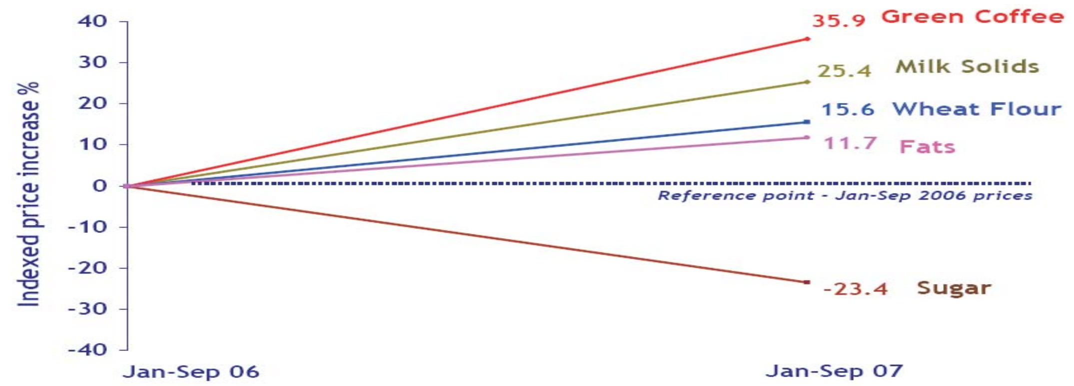
Nestle is extremely efficient in terms of capital efficiency

Nestle is extremely efficient in terms of capital efficiency as reflected in its zero debt Balance Sheet, high Return Ratios (in excess of 100%) and negative Working Capital requirements. Moreover, as the company distributes majority of the Earnings in form of dividends (dividend payout at 89%) and maintains low cash levels on the Balance Sheet, its effective Asset Turnover (calculated as sales/invested capital) is extremely high in the range of 10-11x.

Key Concern - Input cost inflation

During the last couple of years, Nestle has witnessed a sharp rise in its key raw materials particularly green coffee and milk solids. The impact of the inflation in input costs is clearly visible in Nestle's Gross Margins, which have witnessed a contraction of 180bp in the last couple of years from its average level of 55%.

Exhibit 18: % Rise in raw material prices (9MCY2007 - Indexed)



Source: Company, Angel Research

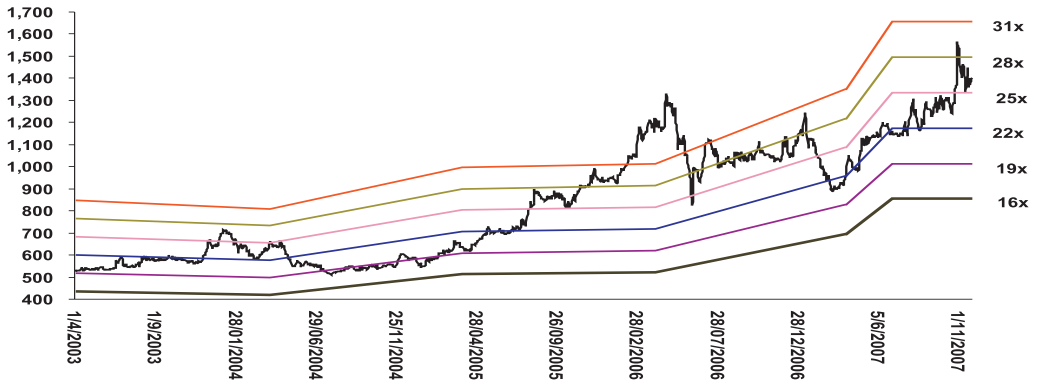
Going forward, we expect this trend to continue owing to demand-supply mismatch conditions in most agri-based commodities. However, selective price hikes taken by the company coupled with wider base of value-added products will help Nestle mitigate the pressure arising from such sharp rise in raw material prices.

- **Milk Prices:** Milk solids and powder together constitute almost 47% of the total raw material cost. The milk prices have witnessed a rise of more than 25% during the last nine months and are expected to continue its uptrend in the near future due to limited supply from Australia and New Zealand and lift on ban of milk powder exports. We have factored in a 17% rise in milk prices in CY2007E followed by a 9% rise in CY2008E.
- **Green Coffee:** Green Coffee constitutes almost 13% of the total raw material cost. The Green coffee prices have also witnessed a constant rise during the last couple of years including a 35%+ rise during the last 9 months owing to a draught in Brazil and rising exports. However, Nestle has been able to pass on the rise in coffee prices via higher realisations in its instant coffee products owing to a strong brand equity and leadership position. We have factored in a 27% rise in coffee prices in CY2007E followed by a 16.5% rise in CY2008E.
- **Wheat Flour:** Wheat constitutes around 9% of the total raw material cost. India is the 2nd largest consumer of wheat at over 75MT in 2006. Wheat prices have risen sharply including a 15%+ rise during the last 9 months owing to strong domestic demand and supply shortage. We have factored in a 16% rise in coffee prices in CY2007E followed by a 9% rise in CY2008E.

Valuation

Historically, Nestle has traded at an average premium of almost 65-70% to Sensex valuations given its strong free Cash flows, superior Return Ratios (in excess of 100%), high Dividend payout (90%) and excellent Capital efficiency. Moreover, Nestle's accelerated growth momentum coupled with better pricing power, Margin expansion and Earnings growth of 22% CAGR over CY2007E-09E justifies its superior valuations. However, in terms of YTD performance relative to Sensex, the stock has underperformed by almost 15.3% to the Sensex. This has led to a sharp fall in Nestle's premium to Sensex, which now stands at close to 30%. However, going ahead, we expect Nestle to sustain its premium valuations and recover its relative premium to the Sensex and trade in the P/E band of 25-28x aided by superior fundamentals and growth prospects.

Exhibit 19: P/E Band Chart



Source: Company, Angel Research

We believe Nestle offers the best opportunity to play out the growing Food Processing theme in India. At the CMP of Rs1,442, the stock trades at 22.1x CY2009E Earnings and 13.8x EV/EBITDA. Nestle justifies its premium valuations in comparison to its peers on account of its global parent support, strong brand recall, excellent Return Ratios and superior EBITDA Margins. On a PEG valuation basis, the stock trades at 1x CY2007-09E Earnings growth, which we believe is extremely reasonable given the long-term growth opportunity the company offers.

Exhibit 20: Peer Comparison

	CMP	RoE (%)	EPS (Rs)		CAGR(%)	P/E (x)		EV/EBITDA (x)	
	(Rs)	FY09E	FY08E	FY09E	FY07-09E	FY08E	FY09E	FY08E	FY09E
Nestle*	1,442	104.5	43.6	53.7	28.2	33.1	26.9	19.8	16.4
ITC	189	25.5	8.1	9.5	15.0	23.3	19.9	14.9	12.8
HUL*	208	61.6	7.9	9.1	14.0	26.4	22.9	21.0	18.4
Dabur	121	55.4	4.0	4.6	20.8	30.6	26.1	24.9	21.3
GSK Consumer*	731	25.1	38.8	45.1	22.2	18.8	16.2	13.3	11.7

*Source: Angel Research, Note: * Indicates companies with calendar year ending*

We have used the DCF methodology to value the company. As the company is debt free, we have used free cash flow to equity (FCFE) method to derive the fair value. Assuming a cost of equity of 11.5% and a terminal growth rate of 5%, our Target Price based on CY2009 estimates works out to Rs1,699 at which the stock would trade at a P/E of 26.1x and EV/EBITDA of 16.3x in line with its average P/E band of 25-28x. **We Initiate Coverage on the stock, with a Buy recommendation potential upside of almost 18% from current levels.**

Exhibit 21: DCF Model (Based on FCFE Method)

PAT	**627.7**	**704.5**	**781.3**	**865.7**	**971.3**	**1,071.1**	**1,315.5**	**1,629.6**
Depreciation	84.3	88.3	93.7	99.4	103.9	108.4	119.0	129.3
(Inc)/ Dec in Working Capital	29.1	31.9	30.1	28.9	20.3	25.7	21.2	13.4
Capex	111.2	96.2	94.4	99.0	79.1	79.5	97.6	95.0
Net Cash Flow	**630.0**	**728.6**	**810.7**	**894.9**	**1,016.4**	**1,125.7**	**1,358.1**	**1,677.3**
Additional Debt	2.3	-	-	-	-	-	-	-
Free Cash Flow to Equity	**632.2**	**728.6**	**810.7**	**894.9**	**1,016.4**	**1,125.7**	**1,358.1**	**1,677.3**
Years Discounted	1.1	2.1	3.1	4.1	5.1	6.1	8.1	10.1
Discount Factor	0.99	0.89	0.80	0.71	0.64	0.57	0.46	0.37
Discounted Cash Flow	**627.3**	**648.0**	**646.5**	**639.8**	**651.5**	**646.7**	**627.2**	**622.5**

Beta	0.51
Risk free return (%)	8.0
Market Risk Premium (%)	7.0
Terminal growth rate (%)	**5.0**
Cost of equity (%)	**11.5**
Terminal Value	**26,950**
PV of terminal value	10,002
NPV of cash flows	6,381
Equity Value of Firm	**16,383**
No of Shares	9.64
Fair Value/Share (Rs)	**1,699**
CMP (Rs)	1,442
Upside (%)	**17.8**

Exhibit 22: Sensitivity Analysis

		Terminal Growth Rate (%)					
	1,699	**4.3%**	**4.5%**	**4.8%**	**5.0%**	**5.3%**	**5.5%**
COE (%)	**10.3%**	1,916	1,971	2,031	2,097	2,170	2,250
	10.7%	1,792	1,839	1,890	1,946	2,007	2,073
	11.1%	1,683	1,723	1,767	1,814	1,866	1,922
	11.5%	1,586	1,621	1,659	**1,699**	1,743	1,790
	11.9%	1,499	1,530	1,562	1,597	1,635	1,676
	12.3%	1,421	1,448	1,476	1,507	1,540	1,575
	12.7%	1,350	1,374	1,399	1,426	1,454	1,485

Source: Company; Angel Research

Profit & Loss Statement

Rs crore

Y/E December	CY2006	CY2007E	CY2008E	CY2009E
Net Sales	**2,816.1**	**3,454.6**	**4,036.9**	**4,615.1**
% chg	*13.7*	*22.7*	*16.9*	*14.3*
Total Expenditure	2,277.6	2,755.9	3,192.3	3,612.5
EBIDTA	**538.5**	**698.7**	**844.6**	**1,002.6**
(% of Net Sales)	*19.1*	*20.2*	*20.9*	*21.7*
Other Income	20.6	22.2	26.5	35.3
Depreciation& Amortisation	66.3	72.7	79.4	84.3
Interest	0.4	0.9	1.1	1.4
PBT	**492.4**	**647.3**	**790.6**	**952.2**
(% of Net Sales)	*17.5*	*18.7*	*19.6*	*20.6*
Extraordinary Expense/(Inc.)	11.9	12.6	13.5	15.0
Tax	165.4	214.3	259.3	309.5
(% of PBT)	*33.6*	*33.1*	*32.8*	*32.5*
Adjusted PAT	**327.0**	**433.0**	**531.3**	**642.7**
% chg	*(0.7)*	*32.4*	*22.7*	*21.0*
Reported PAT	**315.1**	**420.5**	**517.8**	**627.7**
% chg	*1.8*	*33.4*	*23.1*	*21.2*

Balance Sheet

Rs crore

Y/E December	CY2006	CY2007E	CY2008E	CY2009E
SOURCES OF FUNDS				
Equity Share Capital	96.4	96.4	96.4	96.4
Reserves& Surplus	292.5	341.5	399.1	466.9
Shareholders Funds	**388.9**	**437.9**	**495.5**	**563.3**
Total Loans	16.3	18.0	20.5	22.8
Deffered Tax Liability (net)	19.2	19.2	19.2	19.2
Total Liabilities	**424.3**	**475.1**	**535.2**	**605.2**
APPLICATION OF FUNDS				
Gross Block	1,058.3	1,212.1	1,345.6	1,453.6
Less: Acc. Depreciation	516.5	588.8	668.2	752.5
Net Block	**541.8**	**623.3**	**677.4**	**701.1**
Capital Work-in-Progress	38.2	42.4	40.4	43.6
Investments	**77.8**	**92.8**	**117.8**	**152.8**
Current Assets	535.4	598.7	694.8	816.8
Current liabilities	768.9	882.1	995.1	1,109.0
Net Current Assets	**(233.5)**	**(283.4)**	**(300.4)**	**(292.2)**
Total Assets	**424.3**	**475.1**	**535.2**	**605.2**

Cash Flow Statement

Rs crore

Y/E December	CY2006	CY2007E	CY2008E	CY2009E
Profit before tax	480.5	634.7	777.1	937.2
Depreciation	66.3	72.7	79.4	84.3
(Inc)/Dec in Working Capital	15.1	17.9	34.6	33.3
Interest (Net)	(4.7)	(3.7)	(5.2)	(9.4)
Direct taxes paid	165.4	214.3	259.3	309.5
Others	24.1	(6.3)	(3.6)	(4.2)
Cash Flow from Operations	**415.9**	**501.1**	**623.0**	**731.7**
Inc./ (Dec.) in Fixed Assets	124.3	158.1	131.4	111.2
Free Cash Flow	**291.6**	**343.0**	**491.6**	**620.6**
(Inc)/Dec in Investments	26.7	(15.0)	(25.0)	(35.0)
Issue of Equity/ Buyback	-	-	-	-
Inc./(Dec.) in loans	2.0	1.8	2.5	2.3
Dividend Paid (Incl. Tax)	285.3	371.5	460.2	560.0
Interest (Net)	(4.7)	(3.7)	(5.2)	(9.4)
Cash Flow from Financing	**(278.6)**	**(366.1)**	**(452.5)**	**(548.3)**
Inc./(Dec.) in Cash	39.7	(38.0)	14.1	37.3
Opening Cash balances	**36.6**	**76.4**	**38.3**	**52.4**
Closing Cash balances	**76.4**	**38.3**	**52.4**	**89.7**

Key Ratios

Y/E December	CY2006	CY2007E	CY2008E	CY2009E
Per Share Data (Rs)				
EPS	32.7	43.6	53.7	65.1
Cash EPS	39.6	51.2	61.9	73.8
DPS	25.5	33.5	41.5	50.5
Book Value	40.3	45.4	51.4	58.4
Operating Ratio				
Sales/ Invested Capital (x)	10.4	10.0	11.1	12.7
Inventory (days)	35.8	35.1	34.3	33.5
Debtors (days)	7.2	7.7	8.1	8.7
Creditors (days)	48.4	47.5	47.0	46.5
Returns (%)				
RoE	81.0	96.0	104.5	111.4
RoCE	111.3	131.8	143.0	151.7
RoIC (Pre Tax)	174.8	182.0	209.6	253.1
Dividend Payout	89.0	88.3	88.9	89.2
Valuation Ratio (x)				
P/E	44.1	33.1	26.9	22.1
P/E (Cash EPS)	36.5	28.2	23.3	19.5
P/BV	35.8	31.7	28.1	24.7
EV / Sales	4.9	4.0	3.4	3.0
EV / EBITDA	25.7	19.8	16.4	13.8

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