Company Focus

31 October 2007 | 14 pages

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑
Results ☑

Nestle India (NEST.BO)

Downgrade to Sell: 3Q07 – Great Run, But Valuations Catch Up

- **Valuations factor in growth** — Nestle has had a great run and is up 52% over the last 6 months, outperforming our Indian consumer universe by 30%; it is trading at 29x08E P/E, at the higher end of its historical trading band. Valuations have caught up with fundamentals, capturing the strong growth profile that Nestle offers. Downgrading our rating to Sell (3L) from Buy (1L).

- **Less expensive plays available** — We prefer less expensive F&B names like GSK Consumer, Britannia and Tata Tea to play the F&B margin turnaround in India. While we do not undermine Nestlé's superior profitability, brand strength and product width, its premium valuations already capture this. Other F&B names in our universe are trading between 42%-60% discount to Nestlé's valuations and offer relatively stronger earnings growth.

- **Strong 3Q07** — 3Q07 results were solid – sales grew 25.5% yoy, with domestic sales growing 30% yoy. Nestles' product extensions are driving strong growth, which we expect to continue. In addition, the company has been able to defy raw material cost pressures through price hikes; EBITDA margins in 3Q increased by 140bps, while net profit increased 37% yoy.

- **Revising estimates, price target** — Revising EPS estimates for Nestle, tweaking assumptions following 9m07 results. We cut 2007E-09E EPS estimates by 6.9%-2.8%. However, we raise our target price to Rs1341, as we roll forward our 25x P/E target multiple to Dec-08. Despite our TP increase, there is still 12% downside to the stock price from current levels.

Sell/Low Risk	3L
from Buy/Low Risk	
Price (31 Oct 07)	Rs1,562.75
Target price	Rs1,341.00
from Rs1,244.00	
Expected share price return	-14.2%
Expected dividend yield	2.0%
Expected total return	**-12.1%**
Market Cap	Rs150,674M
	US$3,830M

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

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	3,096	32.11	22.9	48.7	42.5	91.9	1.6
2006A	3,151	32.68	1.8	47.8	38.7	84.8	1.6
2007E	4,020	41.70	27.6	37.5	34.0	96.7	2.0
2008E	5,175	53.68	28.7	29.1	26.5	102.3	2.3
2009E	6,014	62.38	16.2	25.1	21.8	95.5	2.8

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	48.7	47.8	37.5	29.1	25.1
EV/EBITDA adjusted (x)	28.6	27.7	22.8	18.0	15.4
P/BV (x)	42.5	38.7	34.0	26.5	21.8
Dividend yield (%)	1.6	1.6	2.0	2.3	2.8
Per Share Data (Rs)					
EPS adjusted	32.11	32.68	41.70	53.68	62.38
EPS reported	32.11	32.68	41.70	53.68	62.38
BVPS	36.73	40.33	45.93	58.98	71.71
DPS	25.00	25.50	32.00	36.00	44.00
Profit & Loss (RsM)					
Net sales	24,769	28,161	34,630	40,788	46,545
Operating expenses	-20,117	-23,439	-28,836	-33,312	-37,809
EBIT	**4,652**	**4,722**	**5,793**	**7,476**	**8,735**
Net interest expense	-2	-4	-7	-7	-7
Non-operating/exceptionals	41	88	250	301	301
Pre-tax profit	**4,691**	**4,805**	**6,036**	**7,770**	**9,029**
Tax	-1,595	-1,654	-2,016	-2,595	-3,015
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**3,096**	**3,151**	**4,020**	**5,175**	**6,014**
Adjusted earnings	3,096	3,151	4,020	5,175	6,014
Adjusted EBITDA	5,220	5,385	6,531	8,218	9,501
Growth Rates (%)					
Sales	11.2	13.7	23.0	17.8	14.1
EBIT adjusted	15.8	1.5	22.7	29.0	16.8
EBITDA adjusted	15.8	3.2	21.3	25.8	15.6
EPS adjusted	22.9	1.8	27.6	28.7	16.2
Cash Flow (RsM)					
Operating cash flow	**3,067**	**3,808**	**4,808**	**5,803**	**6,686**
Depreciation/amortization	568	663	737	741	765
Net working capital	-374	109	51	-114	-93
Investing cash flow	**-1,812**	**-738**	**199**	**-1,598**	**-1,886**
Capital expenditure	-1,000	-1,242	-68	-400	-400
Acquisitions/disposals	-812	504	267	-1,198	-1,486
Financing cash flow	**-2,684**	**-2,784**	**-3,543**	**-3,916**	**-4,786**
Borrowings	64	20	-63	0	0
Dividends paid	-2,748	-2,803	-3,481	-3,916	-4,786
Change in cash	**-1,430**	**286**	**1,464**	**290**	**14**
Balance Sheet (RsM)					
Total assets	**10,637**	**11,932**	**12,734**	**14,870**	**16,931**
Cash & cash equivalent	1,411	1,541	2,030	3,517	5,016
Accounts receivable	305	558	450	530	605
Net fixed assets	4,966	5,800	5,131	4,789	4,424
Total liabilities	**7,096**	**8,043**	**8,306**	**9,183**	**10,016**
Accounts payable	3,198	3,736	3,814	4,492	5,125
Total Debt	143	163	100	100	100
Shareholders' funds	**3,541**	**3,889**	**4,429**	**5,687**	**6,914**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	21.1	19.1	18.9	20.1	20.4
ROE adjusted	91.9	84.8	96.7	102.3	95.5
ROIC adjusted	152.7	120.9	140.1	189.5	nm
Net debt to equity	-35.8	-35.5	-43.6	-60.1	-71.1
Total debt to capital	3.9	4.0	2.2	1.7	1.4

For further data queries on Citigroup's full coverage universe please contact CIR Data Services Asia Pacific at CitiResearchDataServices@citigroup.com or +852-2501-2791

Powered by: dataCentral

Valuations Catch Up With Fundamentals

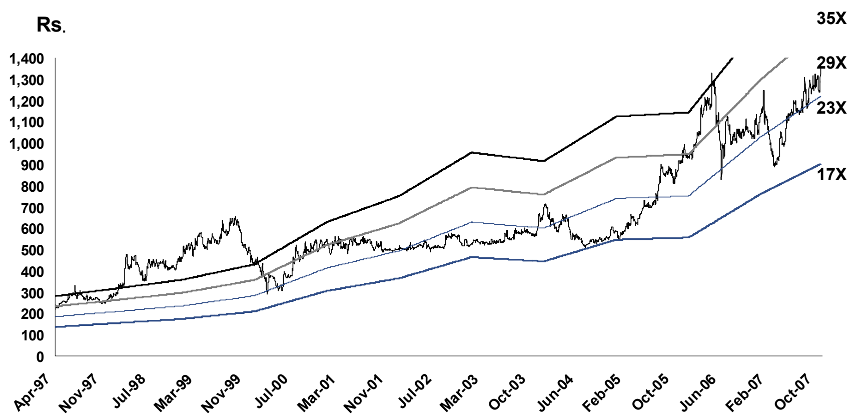
Figure 1Nestle India: Absolute & Relative Performance to Sensex

(%)	3M	6M	12M
Absolute	29	52	45
Rel. to .BSESN	1	6	(5)

Source: Powered by dataCentral

We downgrade our rating on Nestle from Buy (1L) to Sell (3L) following a strong 52% run in the stock price over the last 6 months. While Nestle is among the fastest growing F&B companies in our Indian consumer universe, we believe that valuations have now caught up with fundamentals and do not leave much scope for further upsides. The stock is trading at 29.1x08E P/E, which is at the higher end of its historical trading band. While we are cognizant of Nestlé's superior margins, capital efficiency and brand strength, we believe that is already being captured in its premium valuations, and we do not see any further reasons that warrant a valuation multiple re-rating on the stock. We therefore maintain out 25x target P/E multiple, though we increase our price target to Rs1341 from Rs1244 earlier as we roll forward our target P/E from Jun-08 to Dec-08. We are already in 4Q07 and expect the stock valuations to increasingly start reflecting Dec-08 earnings estimates.

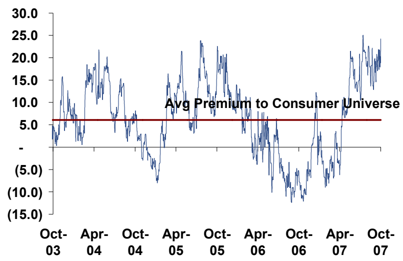
Figure 2. Nestle P/E Bands



Source: DataStream; Citi Investment Research

Less Expensive F&B Plays Available

Figure 3. Nestle PE relative to Consumer PE



Source: Citi Investment Research

We advocate investors to look at less expensive F&B plays that are available in our Indian Consumer universe. We would like to concede up front that Nestle offers the best brand profile and width of products compared with the other F&B plays in our universe. However, we also attribute a premium to Nestle to account for its relatively better positioning, and we believe that currently Nestlé's valuation gap vs. peers has increased substantially. Nestlé's stock has strongly outperformed the CIR India consumer universe average, and its current valuation premium to the sector is at a historically high level. As such, we believe that from a risk-return perspective, there are other plays available in the Indian F&B space.

Our picks in the Indian F&B space would be GSK Consumer, Britannia and Tata Tea (though Tata Tea is not strictly a pure Indian play). Indian F&B companies offer strong sales growth and are also at the cusp of a margin turnaround that will accelerate near-term earnings growth. Currently, these stocks are trading at 42%-60% valuation discount to Nestlé's valuations, and we believe offer superior risk-return profiles compared with Nestle.

Please see our recent notes on these companies for more details. The links to these are appended below (no password required)

Britannia: https://www.citigroupgeo.com/pdf/SAP10323.pdf

GSK Consumer: https://www.citigroupgeo.com/pdf/SAP10338.pdf

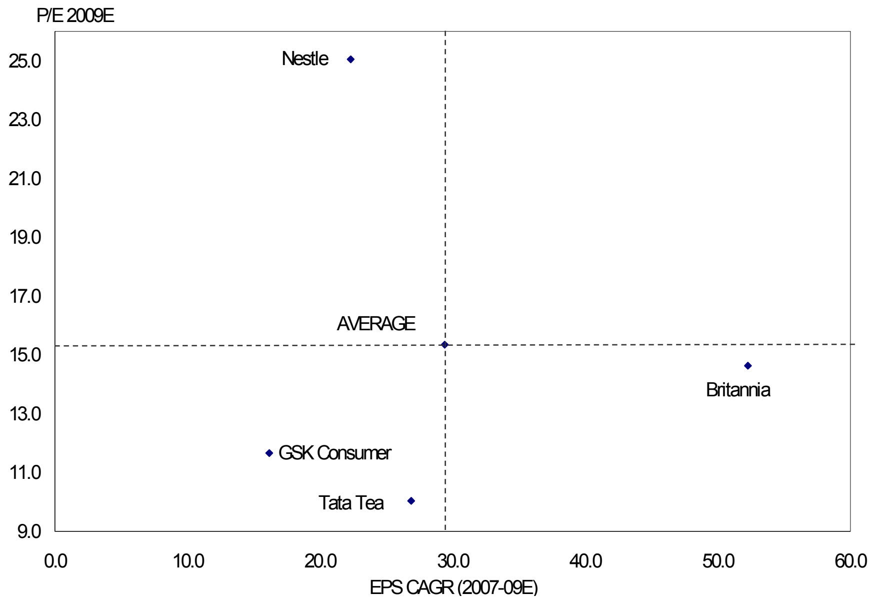
Tata Tea: https://www.citigroupgeo.com/pdf/SAP10565.pdf

Figure 4. Food & Beverages Valuations

Company	RIC Code	Rating	Mkt Cap (LCM)	Target Price	P/E (x) 2008	P/E (x) 2009	EV/EBITDA (x) 2008	EV/EBITDA (x) 2009	Dvd Yield (%) 2008	RoE (%) 2008	RoCE (%) 2008	EPS CAGR 2007-09E
Britannia Industries	BRIT.BO	1L	36,409	1,825.00	19.6	14.6	15.0	10.7	1.2%	27.3%	42.3%	52.3
GSK Consumer	GLSM.BO	1L	27,757	980.00	13.4	11.7	8.4	7.0	4.1%	31.7%	24.9%	16.2
Nestle India	NEST.BO	3L	136,433	1,341.00	29.1	25.1	16.4	14.2	2.6%	102.3%	189.5%	22.3
Tata Tea	TTTE.BO	1L	50,526	1,045.00	14.2	10.0	5.4	4.1	1.9%	52.9%	8.1%	26.9
Average					**19.1**	**15.3**	**11.3**	**9.0**	**2.5%**	**53.5%**	**66.2%**	**29.4**

Source: Citi Investment Research

Figure 5. P/E 2009E versus 2 year EPS CAGR (2007-09E) of Indian F&B Companies



Source: Citi Investment Research

Revising Estimates, Price Target

Following 9m07 results, we are tweaking our earnings model for Nestle and cutting our 2007E-09E EPS estimates by 6.9%-2.8%. Our earnings revision summary is enumerated below:

Figure 6. Earnings Revision Summary

	Net income (Rsm)			EPS (Rs)			DPS (Rs)		
	Old	New	% Change	Old	New	% Change	Old	New	% Change
2007E	4318.0	4020.2	-6.9	44.8	41.7	-6.9	32.0	32.0	0.0
2008E	5278.4	5175.2	-2.0	54.8	53.7	-2.0	36.0	36.0	0.0
2009E	6190.1	6013.9	-2.8	64.2	62.4	-2.8	44.0	44.0	0.0

Source: Citi Investment Research

Despite cutting EPS estimates, we are increasing our target price to Rs1341 based on 25x08E P/E. Our increase in target price is based on the rolling forward of our target P/E multiple to end 2008, given that we are already approaching end-2007 and expect the stock valuations to start reflecting 2008 earnings.

3Q07 Results Tables

Figure 7. Nestle India 3Q 2007 Results Review (Rupees in Million, Percent)

	3QCY06	3QCY07	%yoy
Net Sales	**7,226.6**	**9,067.4**	**25.5**
Expenditure	-5,802.0	-7,151.7	23.3
EBITDA	**1,424.6**	**1,915.7**	**34.5**
EBITDA Margin (%)	*19.7*	*21.1*	*141 bps*
Interest	-0.4	-0.7	75.0
Depreciation & Amortisation	-167.9	-184.3	9.8
Other Income	46.7	56.6	21.2
PBT	**1,303.0**	**1,787.3**	**37.2**
Tax	-431.2	-597.3	38.5
Tax Rate (%)	*33.1*	*33.4*	*33 bps*
PAT	**871.8**	**1,190.0**	**36.5**
Exceptional items	-42.0	-29.4	-30.0
PAT after Exceptionals	**829.8**	**1,160.6**	**39.9**
No of shares	96.4	96.4	
EPS	**8.6**	**12.0**	
Cost Details			
Total Raw Material Cost	3,402.2	4,329.3	27.3
% of Sales	*47.1*	*47.7*	*67 bps*
Employee/Staff Cost	538.9	692.6	28.5
% of Sales	*7.5*	*7.6*	*18 bps*
Other Expenditure	1,860.9	2,129.8	14.4
% of Sales	*25.8*	*23.5*	*-226 bps*

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 Nestlé's best-known global brands — Nescafe, Lactogen, Cerelac, Maggi and Kit Kat. The company has a strong focus on adding value to basic commodities, and has an extensive distribution network, covering most of the urban and semi-urban areas.

Investment strategy

We have a Sell/Low Risk rating on Nestle, which we recently revised from a Buy (1L). While Nestle is the best play on urban consumption growth in the Indian consumer sector universe, and has grown much ahead of the consumer sector growth average, its valuations are capturing this growth premium. The stock is currently trading at the higher end of its historic valuation multiples, and we do not see any further re-rating triggers. Historically, Nestle has benefited on two counts – on the demand side from its urban exposure, which was driven by high service sector growth, and on the costs side through its agri-product exposure, where raw-material prices remained soft over a long period. However, over the last 2 years, raw material costs have been firming up, which has put pressure on margins. While Nestle has been able to mitigate margin pressure through price hikes, we believe that if raw material costs keep firming up, it will be difficult to hike prices without sacrificing volumes.

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 Rs1341, based on 25x Dec08E P/E - at the midpoint of its recent trading bands. At 25x P/E, Nestle would trade at almost 25% 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 an 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 Rs1341 implies an EV/EBITDA of about 15x Dec-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.

Britannia Industries (BRIT.BO - Rs1,518.00; 1L)

Valuation

At current valuations we rate the Britannia Buy (1L). Our Rs1,825 target price is based on 20x mid-FY09E P/E, at the higher end of its recent trading band. Our target P/E reflects new top management appointments that should quell corporate governance concerns and ensure strong business growth, as well as recent resurgence in sales growth and margins. We expect a 42% EPS CAGR over FY07-10E. At 20x mid-FY09E P/E, Britannia would trade at a 20% premium to the market average P/E. We use P/E as our base valuation methodology, as Britannia has steady earnings growth. At our target price, the stock would trade at 15x 12-month forward EV/EBITDA, which is at about 20% premium to the average market multiple.

Risks

We rate Britannia Low Risk based on our quantitative risk-rating system, which tracks 260-day share price volatility. The key downside risks that could impede the stock from reaching our target price are: 1) continuation of the inflationary trends in raw-material prices, which could put further pressure on margins; 2) slowing demand resulting in poor top- line growth; 3) and increased competitive intensity, which could restrain pricing power. The key upside risks that could prevent the shares attaining our target are: further pick-up in volume growth on the back of resurgence in rural demand; rationalization of competition allowing for price increases in biscuits especially in the high volume glucose biscuits where prices have not seen increases in the last three years; a potential stake sale by the Wadias to Danone International which along with the Wadias is an equal majority stake holder in Britannia; turn in the agri-commodity price trend which could mitigate raw-material cost pressure.

GlaxoSmithKline Consumer (GLSM.BO - Rs665.00; 1L)

Valuation

GSK Consumer is likely to have steady growth in earnings despite some minor hiccups in the past 24 months, and we believe P/E is best suited to value the company. Our target price of Rs980 is based on 20x CY08E P/E. The stock has historically traded at a range of 12x to 21x, with an average of about 15x, over the past seven years. We feel a 20x multiple is warranted given relatively better earnings profile and higher capital-efficiency ratios. It currently has the lowest PE among our Indian consumer universe and above average EPS growth, which makes it an attractive buy, in our view. A higher dividend payout is likely to help stock valuations and should provide downside support.

Risks

We rate GSK as Low Risk because the company operates in a branded segment in which earnings visibility is high and earnings follow a secular trend. The key downside risks to our target price include: (1) the re-launch of Horlicks could confuse users and lead to brand switches; (2) a rural recovery may not fully manifest into additional sales for GSK; and (3) competition.

Tata Tea (TTTE.BO - Rs821.45; 1L)

Valuation

Our target price for Tata Tea shares is Rs1,045 based on 15x mid-FY09E P/E. We use P/E as our primary valuation tool given the steady state of the business and no major changes in the investment profile. We believe Tata Tea's stock warrants a re-rating due to a pickup in growth and margins for its domestic business, and given that it has reduced its commodity linkages with 88% of its global business now being branded. Our target multiple is at par with the market P/E, which we believe is justified given these factors.

We have also valued Tata Tea on an EV/EBITDA basis. Our target price pegs the stock at 11-12x mid-FY09E EV/EBITDA, in line with our implied target multiple for the market taking into consideration the above factors.

Risks

We rate Tata Tea shares Low Risk given the steady state of the business and no major changes in the investment profile. The key downside risks that could prevent the shares from reaching our target price include: (1) declines in domestic tea prices, and/or increases in international prices; (2) appreciation of the INR vs. the GBP; (3) a slowdown in domestic market sales; and (4) investing in Tetley brands in new markets like Pakistan and Bangladesh.

Appendix A-1

Analyst Certification

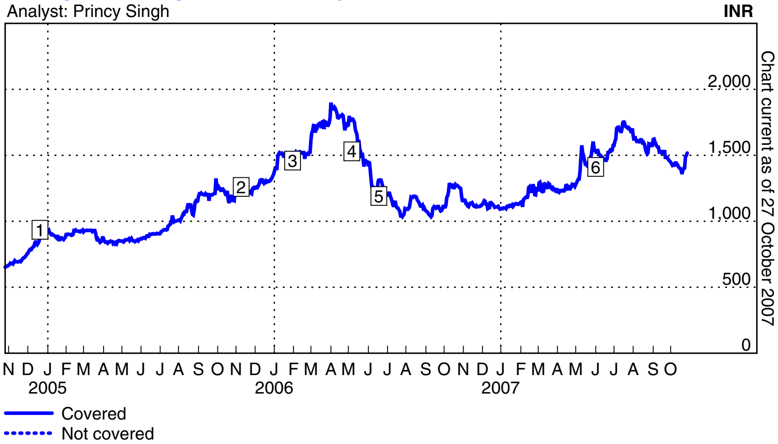
Each research analyst(s), strategist(s) or research associate(s) responsible for the preparation and content of this research report hereby certifies that, with respect to each issuer or security that the research analyst, strategist or research associate covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) strategist(s) or research associate(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst, strategist or research associate in this research report.

IMPORTANT DISCLOSURES

Britannia Industries (BRIT.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh



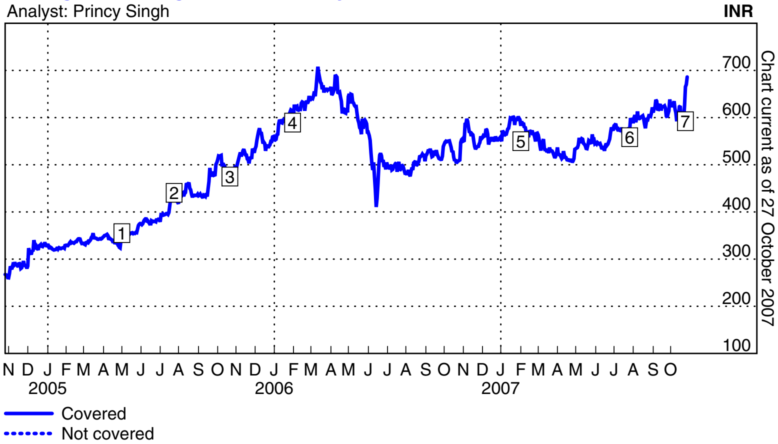
#	Date	Rating	Target Price	Closing Price
1:	21 Dec 04	1L	*1,100.00	888.20
2:	9 Nov 05	1L	*1,480.00	1,249.90
3:	31 Jan 06	1L	*1,720.00	1,459.95
4:	5 May 06	*3L	1,720.00	1,775.00
5:	19 Jun 06	*1L	1,720.00	1,319.80
6:	1 Jun 07	1L	*1,825.00	1,538.65

*Indicates change.

GlaxoSmithKline Consumer (GLSM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh



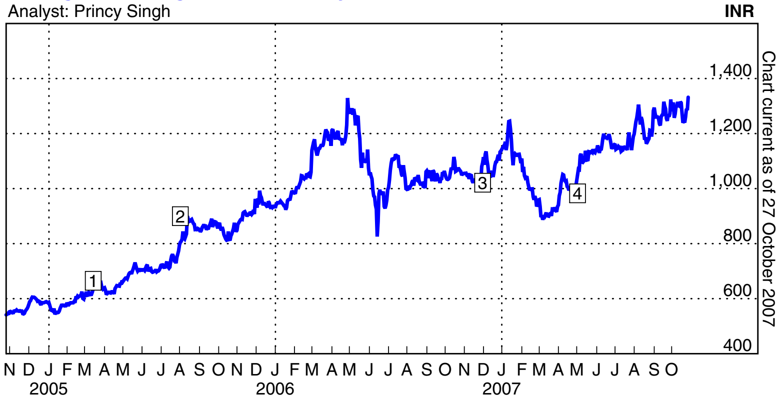
#	Date	Rating	Target Price	Closing Price
1:	2 May 05	1L	*395.00	341.35
2:	25 Jul 05	1L	*500.00	434.80
3:	21 Oct 05	1L	*540.00	478.35
4:	31 Jan 06	1L	*725.00	607.75
5:	1 Feb 07	1L	*675.00	582.60
6:	26 Jul 07	1L	*770.00	574.15
7:	24 Oct 07	1L	*980.00	665.45

*Indicates change.

Nestle India (NEST.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh



#	Date	Rating	Target Price	Closing Price
1:	15 Mar 05	*1L	*710.00	637.35
2:	2 Aug 05	*3L	*776.00	804.95
3:	30 Nov 06	3L	*916.00	1,093.50
4:	2 May 07	*1L	*1,244.00	NA

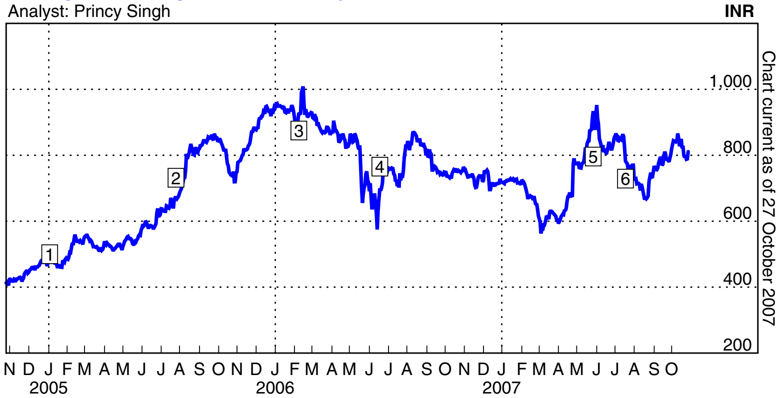
*Indicates change.

Covered
Not covered

Tata Tea (TTTE.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh



#	Date	Rating	Target Price	Closing Price
1:	4 Jan 05	3L	*412.00	499.85
2:	26 Jul 05	3L	*500.00	671.20
3:	8 Feb 06	3L	*680.00	928.55
4:	19 Jun 06	*1L	*960.00	699.35
5:	27 May 07	1L	*1,150.00	934.10
6:	18 Jul 07	1L	*1,045.00	782.45

*Indicates change.

Covered
Not covered

Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of Britannia Industries. This position reflects information available as of the prior business day.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from GlaxoSmithKline Consumer and Nestle India.

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Citi Investment Research Ratings Distribution

Data current as of 30 September 2007	**Buy**	**Hold**	**Sell**
Citi Investment Research Global Fundamental Coverage (3358)	50%	38%	12%

% of companies in each rating category that are investment banking clients	53%	55%	42%

Guide to Fundamental Research Investment Ratings:

Citi Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citi Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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