Company Focus

5 March 2008 | 9 pages

Nestle India (NEST.BO)

Results

Sell: In-Line 4Q07

- **Strong 4Q07 –** 4Q07 net profit grew a strong 24% YoY. Sales growth of 22% and 90bps EBITDA margin expansion were key positive surprises. Sales growth was driven by 21.6% domestic sales growth and 22.3% growth in export sales.
- **Improved growth outlook –** Income tax cuts in the recent budget and impending increase in government employee salaries (on pay commission recommendation) will boost urban consumption. We believe, with Nestlé's leverage to urban growth and a strong product portfolio, it is well positioned to benefit from this growth. Nestles' sales growth momentum is at a 12-year high, and could accelerate further.
- **Urban consumption play –** Nestle is strongly leveraged to urban demand and is the market leader in key processed foods segments in India. Urban incomes are growing at a steady 10%+ driven by the services sector, which bodes well for long-term growth for Nestle. In addition, the company has been consistently expanding its product portfolio, aiding market share gains.
- **Coping well in an inflationary environment –** Nestle has maintained margins in an inflationary environment through consistent innovations and price increases. Nestle recently embarked on an organizational restructuring program, which has started to drive cost savings through operational efficiencies. Challenges on raw materials are, however, likely to persist.
- **Maintain Sell (3L) –** Nestle is the best play on urban consumption but current valuation of 29x CY08E fully reflects its growth potential. Maintain Sell (3L).

Sell/Low Risk	3L
Price (05 Mar 08)	Rs1,530.65
Target price	Rs1,341.00
Expected share price return	-12.4%
Expected dividend yield	2.1%
Expected total return	**-10.3%**
Market Cap	Rs147,579M
	US$3,669M

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	47.7	41.7	91.9	1.6
2006A	3,151	32.68	1.8	46.8	37.9	84.8	1.7
2007E	4,020	41.70	27.6	36.7	33.3	96.7	2.1
2008E	5,175	53.68	28.7	28.5	26.0	102.3	2.4
2009E	6,014	62.38	16.2	24.5	21.3	95.5	2.9

Source: Powered bv dataCentral

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

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	47.7	46.8	36.7	28.5	24.5
EV/EBITDA adjusted (x)	28.0	27.2	22.3	17.6	15.1
P/BV (x)	41.7	37.9	33.3	26.0	21.3
Dividend yield (%)	1.6	1.7	2.1	2.4	2.9
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

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4Q07 Result Review

Net profit growth of 24% was broadly in-line with our expectation. Sales growth of 21.6% was driven by a 21.6% increase in domestic sales and 22.3% export sales growth. EBITDA margin expansion of 127bps came despite an increase in raw material prices. This was achieved on the back of lower employee costs and reduced other expenses as the company focused on increasing operational efficiency through savings, etc., and price hikes undertaken.

Figure 1. Nestle India: 4Q07 Results Summary (Rupees in Million, Percent)

	4QCY06	4QCY07	% Change
Net Sales	**7,362.9**	**8,956.5**	**21.6**
Expenditure	-6,160.3	-7,380.2	19.8
EBITDA	**1,202.6**	**1,576.3**	**31.1**
EBITDA Margin (%)	*16.3*	*17.6*	*127 bps*
Interest	-1.4	-2.2	57.1
Depreciation & Amortisation	-177.1	-205.6	16.1
Other Income	73.0	96.5	32.2
PBT	**1,097.1**	**1,465.0**	**33.5**
Tax	-303.2	-481.0	58.6
Tax Rate (%)	*27.6*	*32.8*	*520 bps*
PAT	**793.9**	**984.0**	**23.9**
Exceptional items	-169.3	-47.9	-71.7
PAT after Exceptionals	**624.6**	**936.1**	**49.9**
Cost Details			
Total Raw Material Cost	3,339.2	4,267.7	27.8
% of Sales	*45.4*	*47.6*	*230 bps*
Employee/Staff Cost	569.4	658.9	15.7
% of Sales	*7.7*	*7.4*	*-38 bps*
Other Expenditure	2,251.7	2,453.6	9.0
% of Sales	*30.6*	*27.4*	*-319 bps*

Source: Company Reports

Sales growth has picked up in the last four quarters averaging at 25%, and is the highest over the last 12 years. With an expanded product pipeline, growing spending on convenience and health foods by India's urban population and rising urban incomes will help Nestle in sustaining this strong sales momentum. Also, we believe the personal tax benefits announced in the recent budget will boost demand in the short term, which bodes well for Nestles' sales growth.

In addition, Nestle has been able to mitigate the raw material cost pressure to a large extent through price hikes without adversely affecting the volumes. Given Nestlé's dominance in its product categories, we expect it will continue to protect its margins through continued price hikes. In addition, higher volumes are driving strong operating leverage, and an organizational restructuring program is driving cost savings. As such, we expect Nestle to deliver improved margins despite raw material cost pressures.

CY07 sales and net profit growth beat our forecast by 3-5%. Nestle paid a dividend of Rs2.5 this quarter taking the total payout for CY08 to Rs33.

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. 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.

Appendix A-1

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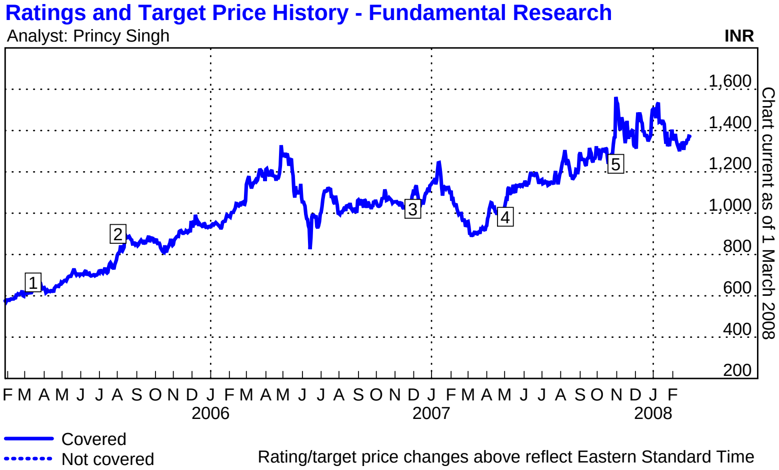
Nestle India (NEST.BO)

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
5:	31 Oct 07	*3L	*1,341.00	1,562.75

*Indicates change.

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