

1 April 2010

Nestlé India

Key highlights from CY09 annual report; Sell

- **Strong fundamentals, steep valuations.** Though Nestlé reported one more excellent year (it posted 24% net profit growth), we believe valuations are stretched. Hence, we retain our Sell rating. We raise CY10 earnings 3% to factor in housekeeping changes, post-updation of CY09 annual report.
- **Volume growth in three segments except coffee.** Nestlé India reported over 10% volume growth in three major segments. Fresh launches and higher promotion helped improve volume. The coffee segment, however, posted 3% volume decline. A mild monsoon and winter and lower exports rolled back volumes.
- **Upgrading and lower excise driving realizations.** The focus on expanding revenue of premium products (Maggi Pazzta) and those under chocolates are driving up average realizations. Lower excise and select price hikes of chocolates are also driving up realizations.
- **Focus on distribution and the nutrition business.** The company has indicated it would drive revenue by expanding its distribution network and promoting price-point SKUs. With rising health awareness, it expects the acquired healthcare-nutrition business to do well.
- **Valuation.** Our target price of Rs2,075 (earlier Rs2,003) is at a target PE of 25x CY10e earnings. Our target PE is at a 65% premium to the Nifty. The average premium of Nestle to Nifty in the last 10 years was 65%.

Rating: **Sell**

Target Price: Rs2,075

Share Price: Rs2,712

Shirish Pardeshi+9122 6626 6730
shirishpardeshi@rathi.com**Aniruddha Joshi**+9122 6626 6732
aniruddhajoshi1@rathi.com

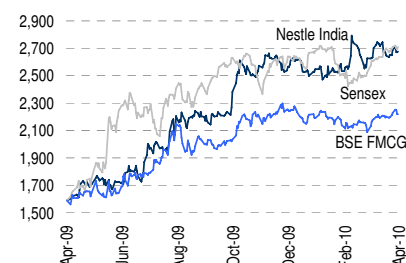
Key data	NEST IN/NEST.BO
52-week high/low	Rs3,025/Rs1,409
Sensex/Nifty	17693/5291
3-m average volume	US\$2.2m
Market cap	Rs262bn/US\$5.8bn
Shares outstanding	96m
Free float	38.1%
Promoters	61.9%
Foreign Institutions	10.0%
Domestic Institutions	9.7%
Public	18.4%

Key financials

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Sales (Rsm)	35,044	43,242	51,294	60,436	71,114
Net profit (Rsm)	4,292	5,539	6,851	7,974	9,319
EPS (Rs)	44.5	57.4	71.1	82.7	96.7
Growth (%)	36.0	29.1	23.7	16.4	16.9
PE (x)	60.9	47.2	38.2	32.8	28.1
PBV (x)	58.5	51.2	42.6	35.6	28.0
RoE (%)	100.4	115.7	122.0	118.4	111.8
RoCE (%)	147.5	167.6	171.0	164.4	155.3
Dividend yield (%)	1.2	1.3	1.8	2.2	2.4
Net gearing (%)	(21.7)	(49.2)	(34.8)	(33.8)	(28.9)

Source: Company, Anand Rathi Research

Relative price performance



Source: Capitaline, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Net sales	35,044	43,242	51,294	60,436	71,114
Sales growth (%)	24.4	23.4	18.6	17.8	17.7
- Op. expenses	28,081	34,605	40,949	48,641	57,514
EBIDTA	6,963	8,637	10,345	11,795	13,600
EBITDA margins (%)	19.9	20.0	20.2	19.5	19.1
- Interest	9	16	14	-	-
- Depreciation	747	924	1,113	1,300	1,493
+ Other income	233	339	378	581	837
- Tax	2,148	2,497	2,745	3,101	3,624
PAT	4,292	5,539	6,851	7,974	9,319
PAT growth (%)	36.0	29.1	23.7	16.4	16.9
Consolidated PAT	4,292	5,539	6,851	7,974	9,319
FDEPS (Rs/share)	44.5	57.4	71.1	82.7	96.7
CEPS (Rs/share)	52.3	67.0	82.6	96.2	112.1
DPS (Rs/share)	33.0	35.0	48.5	60.0	65.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Share capital	964	964	964	964	964
Reserves & surplus	3,116	3,507	4,138	5,168	6,375
Shareholders' fund	4,471	5,102	6,133	7,339	9,326
Debt	29	8	-	-	-
Minority interests	-	-	-	-	-
Capital employed	4,500	5,110	6,133	7,339	9,326
Fixed assets	6,755	8,622	9,758	10,458	11,465
Investments	944	349	2,033	4,533	7,733
Working capital	(3,577)	(5,797)	(7,214)	(8,491)	(10,153)
Cash	378	1,937	1,556	839	281
Capital deployed	4,500	5,110	6,133	7,339	9,326
No. of shares (m)	96	96	96	96	96
Net Debt/Equity (%)	(21.7)	(49.2)	(34.8)	(33.8)	(28.9)
W C turn (days)	(34.8)	(39.6)	(46.3)	(47.4)	(47.8)

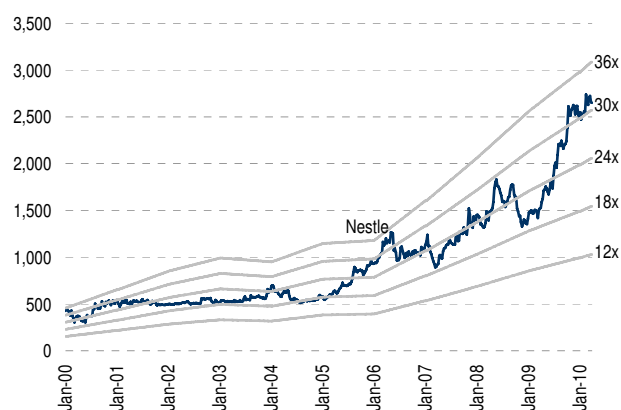
Source: Company, Anand Rathi Research

Fig 3 – Cash flow statement (Rsm)

Year end 31 Dec	CY07	CY08	CY09	CY10e	CY11e
Consolidated PAT	4,292	5,539	6,851	7,974	9,319
+Depreciation	843	1,005	1,064	1,300	1,493
Cash profit	5,135	6,544	7,915	9,274	10,813
- Incr/(Decr) in WC	(478)	(2,220)	(1,417)	(1,277)	(1,662)
Operating cash flow	5,613	8,765	9,332	10,552	12,474
-Capex	1,702	2,790	2,249	2,000	2,500
Free cash flow	3,911	5,974	7,083	8,552	9,974
-Dividend	3,843	4,792	5,471	6,768	7,332
+ Equity raised	-	-	-	-	-
+ Debt raised	(134)	(21)	(8)	-	-
-Investments	166	(595)	1,684	2,500	3,200
-Misc. items	154	198	301	-	-
Net cash flow	(386)	1,559	(381)	(717)	(558)
+Opening cash	764	378	1,937	1,556	839
Closing cash	378	1,937	1,556	839	281

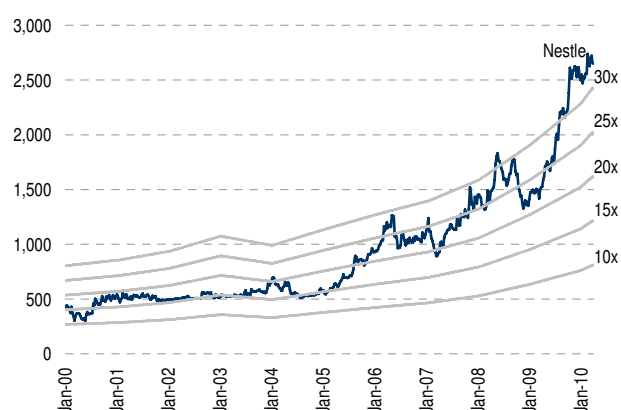
Source: Company, Anand Rathi Research

Fig 4 – PE Band



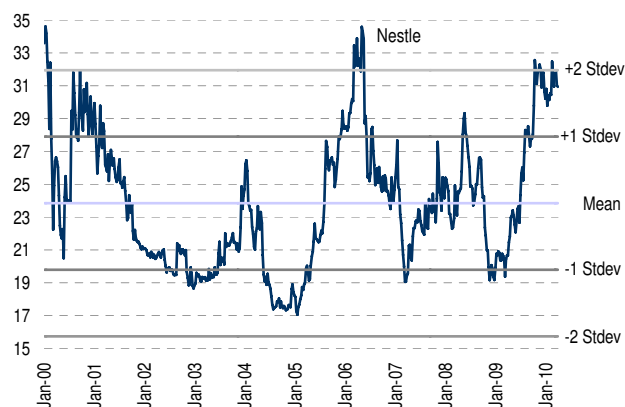
Source: Capitaline, Anand Rathi Research

Fig 5 – Price to Book value band



Source: Capitaline, Anand Rathi Research

Fig 6 – Mean PE(x) and standard deviations



Source: Capitaline, Anand Rathi Research

Highlights from CY09 annual report

Nestlé India’s volume growth came in double digits in three segments except coffee. Uptrading and lower excise helped improve realizations. The company has focused on expanding distribution and pricepoint-based products.

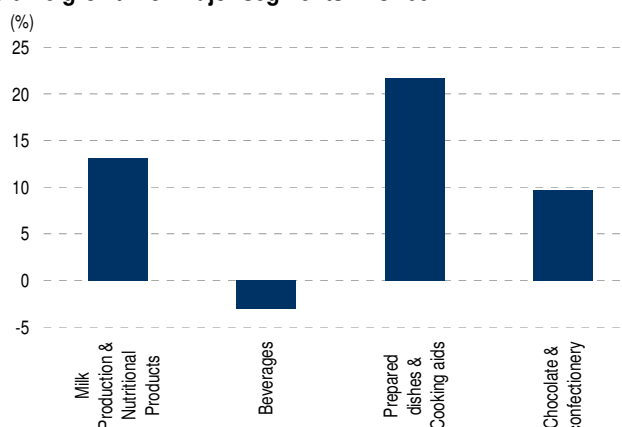
Volume growth in all segments, except coffee (beverages)

Nestle reported double-digit volume growth in three of four major segments

Nestlé India reported strong volume growth in all three major segments. Milk and nutritional products reported 13% volume growth. Volumes have improved despite the company raising prices of milk and *dabi* (yoghurt) by over 10%. Prepared dishes and cooking aids reported 22% volume growth. Launch of various products such as Maggi Pazzta, Maggi cooking aids and greater promotion in its 25th year of launch helped grow volume. Nestlé is investing aggressively into distribution of these products.

Chocolates and confectionery reported 10% volume growth. This segment saw continuous changes in price points and grammage throughout CY09. Despite such issues, Nestlé has managed to post strong volume growth. The coffee segment declined 3% due to a mild winter and lower exports.

Fig 7 – Volume growth for major segments in CY09



Source: Company, Anand Rathi Research.

Coffee sales down due to mild winter and deficient monsoon

Coffee sales rise in the monsoons and in winter as consumers do not prefer hot beverages in summer. As the monsoon was weak (as also the winter), volumes of coffee dropped. With cost-cutting measures at various call centers, BPOs and IT companies, out-of-home consumption (OOH) also suffered. At institutions, coffee off-take was less. Coffee exports to Russia were lower due to adverse economic conditions.

Fig 8 – Reasons for lower coffee volumes

Coffee sub-segments	Reasons for volume decline
Coffee beverages	Deficient monsoon and mild winter
Out-of-home consumption	Cost-cutting by institutional clients
Exports	Lower exports due to adverse economic conditions

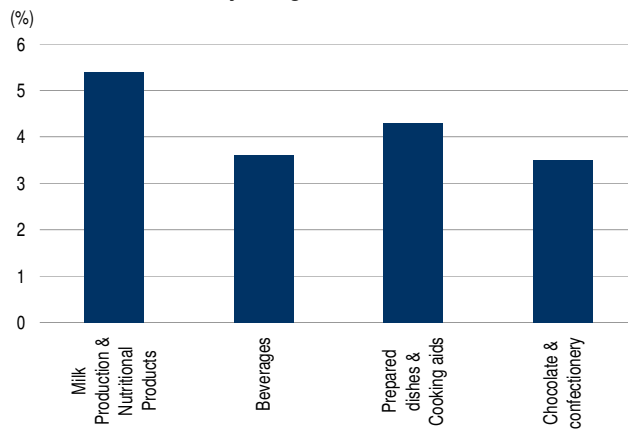
Source: Company, Anand Rathi Research

Realizations have risen despite small price hikes (indicating uptrading)

Higher realizations indicate uptrading by consumers

Realizations in most segments have gone up despite fewer and smaller price hikes. The uptrading of portfolio has helped the company to improve the realizations. We reckon the realizations have improved 4.3% in Prepared dishes and cooking aids mainly due to uptrading, despite losing market share in soups. The realizations in milk and nutritional products have improved 5.4%. The company has raised prices of some products in this segment by around 10%. Coffee realizations have improved 3.6% due to a better sales mix. Revenue in low-margin sub-segments of coffee, out-of-home consumption and exports have slipped. Price hikes in chocolates and confectionery helped improve realizations 3.5%.

Fig 9 – Better realizations in major segments in CY09

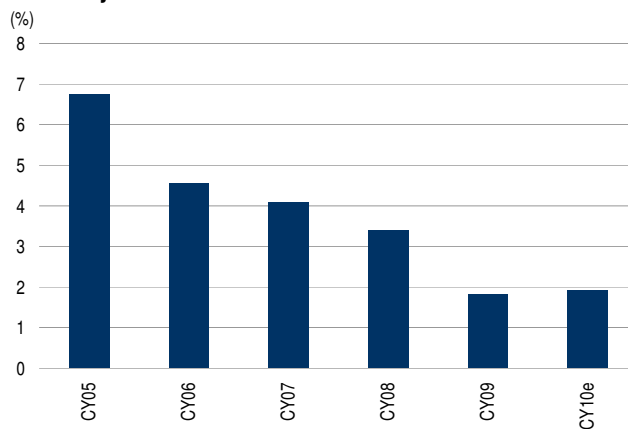


Source: Company, Anand Rathi Research

Lower excise helping improve net realizations

The 6% excise duty cut has been helping the company improve realizations and maintain EBITDA margins. Nevertheless, excise as percent of net sales now stands at only 1.8%. In Budget FY11, excise duty has been hiked 200bps. We expect this to impact realizations and margins, unless the company decides to raise prices.

Fig 10 – Excise duty as % of net sales



Source: Company, Anand Rathi Research

Focus on improving distribution and price points

In the SWOT analysis, a clear focus emerges regarding improving distribution and price-point-based products. For the last three years the company has been adding around 200,000 retail outlets annually. It is also focusing on products priced below Rs10. Products at prices lower than Rs10 help add customers and drive penetration in rural areas. This also helps expand OOH consumption.

Focus on driving the new acquired healthcare nutrition business

In CY09 the company acquired the healthcare nutrition business of Speciality Foods India Pvt. Ltd., for Rs67m. It acquired three brands: RESOURCE, OPTIFAST and SPERT. With rising health awareness in India, Nestlé India sees a marvelous opportunity. As these three brands focus on a nutrition supplement, management hopes that the products launched under these sub-segments would see healthy growth ahead.

Fig 11 – Details about the acquired brands in healthcare nutrition

Acquired Brands	Focus areas
RESOURCE	Management of malnutrition, products for consumers with diabetes
SPERT	Protein supplement
OPTIFAST	Nutrition supplement for overweight people

Source: Company, Anand Rathi Research

Change in Estimates and Valuation

We raise CY10 net profit estimates 3.3% to factor in housekeeping changes after the CY09 annual report updation. We retain our Sell on Nestlé India but raise the target to Rs2,075 (earlier Rs2,003).

Change in estimates

We increase CY10 PAT estimates by 3.3%. As we classify some of the expenses in CY09 as extraordinary items, the house keeping changes have resulted in expanding earnings estimates by 3.3% for CY11 and 3% for CY12.

Fig 12 – Change in estimates

Rsm	CY10e			CY11e		
	Old	New	Change (%)	Old	New	Change (%)
Revenues	60,414	60,436	0.0	70,913	71,114	0.3
Net Profit	7,723	7,974	3.3	9,046	9,319	3.0

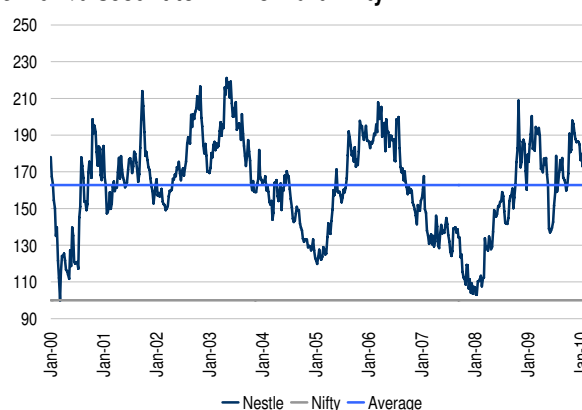
Source: Anand Rathi Research.

Valuation

We value Nestlé at Rs2,075 (earlier Rs2,003) at a target PE of 25x CY10e earnings. We retain our target PE at 25x, a 65% premium to the Nifty. The average premium to the Nifty in the past 10 years has been 65%. The current premium is 85%.

*We retain our target PE at 25x
but raise the target to factor in
better earnings*

Fig 13 – Premium/discount to 12M forward Nifty PE



Source: Capitaline, Anand Rathi Research

Relative Valuation

Fig 14 – India Consumer- Relative valuation matrix

Company	Price (Rs)	M.Cap (US\$m)	RoE (%)		EPS Growth FY10-11 (%)	PE (x)		Div Yield FY10e (%)
			FY11e	FY11e		FY10e	FY11e	
Nestlé*	2,712	5,811	118.4	164.4	16.4	38.2	32.9	1.8
ITC	264	22,264	21.5	28.4	(2.5)	24.6	25.3	1.4
HUL	231	11,196	95.4	81.0	(2.3)	22.4	22.9	3.5
Asian Paints	2,025	4,316	40.0	48.3	13.2	26.0	23.0	0.9
Dabur	158	3,040	48.8	53.0	17.0	26.6	21.1	1.1
Colgate	677	2,046	184.4	148.8	14.5	24.1	20.2	2.2
Marico	109	1,475	46.3	45.0	28.1	24.3	19.0	0.6
GCPL	261	1,786	25.0	21.1	22.9	22.3	18.1	2.3
GSKCH*	1,502	1,405	31.1	34.1	36.6	27.1	19.9	1.2
Britannia	1,612	856	62.8	35.5	12.5	20.3	18.1	2.5
Emami	629	1,057	26.4	29.0	35.0	27.0	20.0	0.7

Source: Bloomberg, Anand Rathi Research *Year Ending Dec.

Risks to valuation

Lower prices of raw materials

Lower raw-material prices would result in expanding margins and earnings.

Better pricing power

If the company is able to raise prices without affecting volume, it would report revenue and earnings better than our estimates.

Fig 15 – Income statement (Rsm)

YE 31 Dec	CY06	CY07	CY08	CY09	CY10e	CY11e
Gross Sales	29,442	36,472	44,711	52,224	61,588	72,470
Less: Excise Duty	1,281	1,428	1,468	930	1,152	1,356
Net Sales	28,161	35,044	43,242	51,294	60,436	71,114
Growth (%)	13.7	24.4	23.4	18.6	17.8	17.7
Expenditure						
Cost of Goods Sold	13,201	16,850	21,041	24,484	29,029	34,437
Staff Cost	2,162	2,694	3,146	4,324	4,986	5,867
Advt & Sales Promotion	1,388	1,722	1,944	2,675	3,324	3,911
Freight & Distribution	1,337	1,608	2,036	2,404	2,840	3,342
Power & Fuel	1,156	1,239	1,598	1,589	1,934	2,276
Other Expenses	3,646	3,967	4,841	5,474	6,527	7,680
EBITDA	5,270	6,963	8,637	10,345	11,795	13,600
Growth (%)	5.5	32.1	24.1	19.8	14.0	15.3
EBITDA Margin (%)	18.7	19.9	20.0	20.2	19.5	19.1
Depreciation	663	747	924	1,113	1,300	1,493
EBIT	4,607	6,215	7,714	9,232	10,495	12,107
Interest Expense	4	9	16	14	-	-
Other Income	206	233	339	378	581	837
Profit Before Tax	4,809	6,440	8,036	9,596	11,076	12,944
Total Taxes	1,654	2,148	2,497	2,745	3,101	3,624
Income Taxes	1,562	1,981	2,497	2,745	3,101	3,624
Deferred Taxes	92	167	-	-	-	-
Income Tax Rate (%)	5.9	6.1	5.8	5.4	5.1	5.1
Profit After Tax	3,155	4,292	5,539	6,851	7,974	9,319
Share of Profit From Associates	-	-	-	-	-	-
Prof. Dividends/Minority Interest	-	-	-	-	-	-
Profit Before X/O	3,155	4,292	5,539	6,851	7,974	9,319
Growth (%)	2.8	36.0	29.1	23.7	16.4	16.9
PAT Margin (%)	11.2	12.2	12.8	13.4	13.2	13.1
Extraordinary Items	(4)	(154)	(198)	(301)	-	-
Profit for Shareholders	3,151	4,138	5,341	6,550	7,974	9,319
Number of Shares (m)						
Number of Shares (m)	96	96	96	96	96	96
Earnings Per Share Bef X/O (Rs)	32.7	44.5	57.4	71.1	82.7	96.7
Earnings Per Share Aft X/O (Rs)	32.7	42.9	55.4	67.9	82.7	96.7

Source: Company, Anand Rathi Research

Fig 16 – Balance Sheet (Rsm)

YE 31 Dec	CY06	CY07	CY08	CY09	CY10e	CY11e
Sources of Funds						
Share Capital	964	964	964	964	964	964
Reserves and Surplus	2,925	3,220	3,769	4,848	6,055	8,042
Deferred Tax Liability	192	287	369	320	320	320
Net Worth	4,080	4,471	5,102	6,133	7,339	9,326
Net Worth Net of Rev. Res.	4,080	4,471	5,102	6,133	7,339	9,326
Prof.Capital/Minority Interest	-	-	-	-	-	-
Secured Loans	163	29	8	-	-	-
Unsecured Loans	-	-	-	-	-	-
Total Loans	163	29	8	-	-	-
Total	4,243	4,500	5,110	6,133	7,339	9,326
Application of Funds						
Fixed Assets Gross Block	10,583	11,798	14,048	16,408	19,204	21,704
Less: Depreciation	5,165	5,780	6,519	7,446	8,746	10,239
Net Block	5,418	6,018	7,530	8,962	10,458	11,465
Capital WIP	382	737	1,092	796	-	-
Gross Block-Brand value	10,583	11,798	14,048	16,408	19,204	21,704
Goodwill	-	-	-	-	-	-
Liquid Investments	778	944	349	2,033	4,533	7,733
Other Investments	-	-	-	-	-	-
Current Assets	5,354	6,379	7,980	8,566	8,967	9,684
Inventories	2,762	4,012	4,349	4,987	5,862	6,898
Sundry Debtors	558	535	456	642	786	924
Cash & Bank Balances	764	378	1,937	1,556	839	281
Loans & Advances	1,270	1,454	1,238	1,380	1,480	1,580
Current Liabilities	7,689	9,578	11,840	14,224	16,620	19,556
Liabilities	3,736	4,600	5,066	5,876	6,950	8,178
Provisions	3,953	4,978	6,773	8,348	9,670	11,378
Net Current Assets	(2,335)	(3,199)	(3,860)	(5,658)	(7,652)	(9,872)
Total	4,243	4,500	5,110	6,133	7,339	9,326

Source: Company, Anand Rathi Research

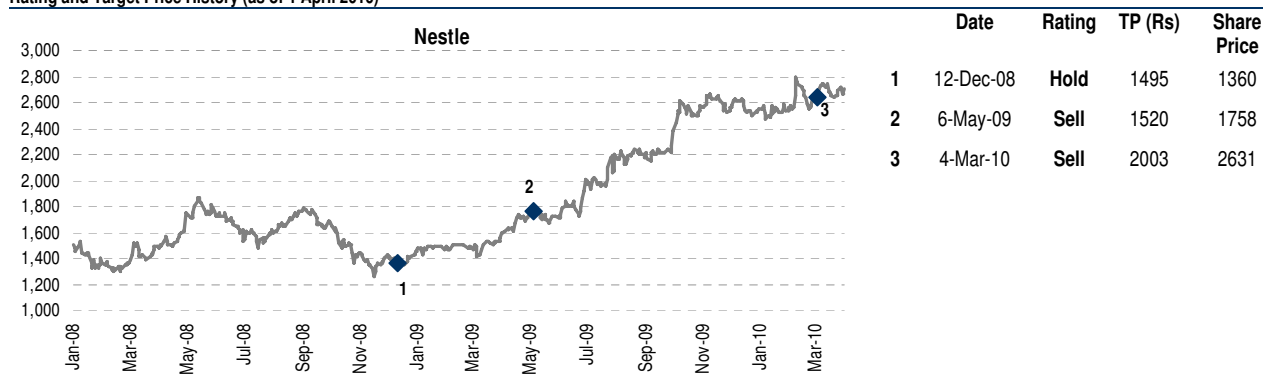
Appendix 1

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