

Strong long-term story, but valuations high Q3 performance solid, but valuations already reflect improving trends

November 7, 2011

Rating Remains	Neutral
Target price Increased from 3800	INR 4345
Closing price November 4, 2011	INR 4497
Potential downside	-3.4%

Action: Maintain Neutral with an increased TP of INR4,345

Nestle India delivered another strong quarter of earnings growth with EBITDA margins surprising on the upside. Improving trends provide a more favourable backdrop for 2012, in our view, but current valuations at 34x 2012F already factor in robust medium-term growth. We continue to like Nestle India as one of the strongest names in the consumer space in the long term, but current valuations leave little upside room, in our view. We increase our TP from INR3,800 to INR4,345 on account of roll forward, but maintain Neutral rating and would look for a better entry point.

Catalysts: Fall in input prices and further pricing action

We believe a fall in input prices over the next few months will be one of the key catalysts in the short term for the stock. Sugar prices have seen some softening, with milk and milk solid prices stable, but at current elevated levels. Pricing action taken by company should be another positive catalyst, as we believe this will help the company improve margins from current levels. On the downside, increased levels of A&P spending will likely be a negative for margins.

Valuation: Near-term improvement already reflected in valuations

Nestle India trades at 34x 2012F earnings. This is a 30%+ valuation differential to the average consumer company in our universe. While Nestle India has always traded at a premium to other consumer companies, current valuations do not leave any upside room from current levels, in our opinion. We maintain our Neutral rating and would wait for a better entry point. Nestle India remains one of the most attractive stories in the consumer sector in the long term, in our view.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	62,547	76,380	76,380	93,521	93,531	112,199	112,456
Reported net profit (mn)	8,187	10,256	10,265	12,563	12,764	15,306	15,476
Normalised net profit (mn)	8,371	10,256	10,265	12,563	12,764	15,306	15,476
Normalised EPS	86.83	106.37	106.47	130.30	132.38	158.75	160.51
Norm. EPS growth (%)	20.0	22.5	22.6	22.5	24.3	21.8	21.2
Norm. P/E (x)	51.8	N/A	42.2	N/A	34.0	N/A	28.0
EV/EBITDA (x)	34.0	23.8	27.6	19.2	21.9	15.8	17.8
Price/book (x)	50.7	N/A	32.5	N/A	21.9	N/A	15.6
Dividend yield (%)	1.3	N/A	1.3	N/A	1.5	N/A	1.7
ROE (%)	114.0	93.7	93.7	76.4	77.1	65.2	65.1
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart.

Anchor themes

In the long term, we prefer food names in the consumer sector vs HPC names. The food subsector will grow faster led by lower penetration levels and increased consumption, we believe.

Nomura vs consensus

We are largely in line with consensus on CY12 earnings but are ahead of consensus on CY13. We believe Nestle will deliver >20% earnings growth each year over the next three years.

Research analysts

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Nestle India

Income statement (INRmn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	51,294	62,547	76,380	93,531	112,456
Cost of goods sold	-26,982	-33,953	-41,855	-51,113	-61,356
Gross profit	24,312	28,594	34,525	42,418	51,100
SG&A	-10,550	-12,851	-15,224	-18,698	-22,541
Employee share expense	-4,324	-4,334	-5,106	-6,036	-7,050
Operating profit	9,438	11,409	14,194	17,684	21,508
EBITDA	10,550	12,686	15,641	19,720	24,083
Depreciation	-1,113	-1,278	-1,446	-2,036	-2,575
Amortisation					
EBIT	9,438	11,409	14,194	17,684	21,508
Net interest expense	-14	-11	-30	0	0
Associates & JCEs					
Other income	172	238	500	550	600
Earnings before tax	9,596	11,636	14,664	18,234	22,108
Income tax	-2,620	-3,264	-4,399	-5,470	-6,632
Net profit after tax	6,976	8,371	10,265	12,764	15,476
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	6,976	8,371	10,265	12,764	15,476
Extraordinary items	-426	-185	0	0	0
Reported NPAT	6,549	8,187	10,265	12,764	15,476
Dividends	-5,471	-5,448	-5,462	-6,363	-7,424
Transfer to reserves	1,079	2,738	4,803	6,400	8,052

Valuation and ratio analysis

FD normalised P/E (x)	62.2	51.8	42.2	34.0	28.0
FD normalised P/E at price target (x)	59.4	49.5	40.4	32.5	26.8
Reported P/E (x)	66.2	53.0	42.2	34.0	28.0
Dividend yield (%)	1.3	1.3	1.3	1.5	1.7
Price/cashflow (x)	48.8	40.4	38.2	28.9	26.2
Price/book (x)	74.6	50.7	32.5	21.9	15.6
EV/EBITDA (x)	41.0	34.0	27.6	21.9	17.8
EV/EBIT (x)	45.8	37.8	30.5	24.4	20.0
Gross margin (%)	47.4	45.7	45.2	45.4	45.4
EBITDA margin (%)	20.6	20.3	20.5	21.1	21.4
EBIT margin (%)	18.4	18.2	18.6	18.9	19.1
Net margin (%)	12.8	13.1	13.4	13.6	13.8
Effective tax rate (%)	27.3	28.1	30.0	30.0	30.0
Dividend payout (%)	83.5	66.5	53.2	49.9	48.0
Capex to sales (%)	4.0	7.7	9.3	8.1	6.3
Capex to depreciation (x)	1.9	3.8	4.9	3.7	2.7
ROE (%)	124.2	114.0	93.7	77.1	65.1
ROA (pretax %)	55.8	54.5	53.0	51.4	51.6

Growth (%)

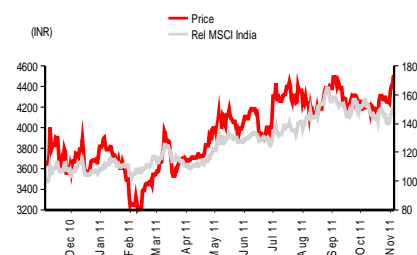
Revenue	18.6	21.9	22.1	22.5	20.2
EBITDA	19.9	20.2	23.3	26.1	22.1
EBIT	19.9	20.9	24.4	24.6	21.6
Normalised EPS	22.9	20.0	22.6	24.3	21.2
Normalised FDEPS	22.9	20.0	22.6	24.3	21.2

Per share

Reported EPS (INR)	67.93	84.91	106.47	132.38	160.51
Norm EPS (INR)	72.35	86.83	106.47	132.38	160.51
Fully diluted norm EPS (INR)	72.35	86.83	106.47	132.38	160.51
Book value per share (INR)	60.29	88.72	138.54	204.92	288.42
DPS (INR)	56.74	56.51	56.65	66.00	77.00

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	7.2	4.6	23.2
Absolute (USD)	7.8	-5.2	10.8
Relative to index	-3.8	5.1	40.8
Market cap (USDmn)	8,823.4		
Estimated free float (%)	38.0		
52-week range (INR)	4520.5/3160		
3-mth avg daily turnover (USDmn)	2.07		
Major shareholders (%)			
Nestle	62.8		
LIC of India	2.7		

Source: Thomson Reuters, Nomura research

Notes

Cashflow (INRmn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F	Notes
EBITDA	10,550	12,686	15,641	19,720	24,083	
Change in working capital	1,417	1,575	-337	240	-1,465	
Other operating cashflow	-3,073	-3,523	-3,943	-4,941	-6,044	
Cashflow from operations	8,894	10,739	11,361	15,019	16,574	
Capital expenditure	-2,064	-4,832	-7,072	-7,579	-7,063	
Free cashflow	6,830	5,907	4,289	7,440	9,511	
Reduction in investments	-1,684	526	0	0	0	
Net acquisitions						
Reduction in other LT assets	0	0	0	0	0	
Addition in other LT liabilities	-49	13	0	0	-88	
Adjustments						
Cashflow after investing acts	5,098	6,445	4,289	7,440	9,423	
Cash dividends	-5,471	-5,448	-5,462	-6,363	-7,424	
Equity issue	0	0	0	0	0	
Debt issue	-8	0	750	-750	0	
Convertible debt issue	0	0	0	0	0	
Others						
Cashflow from financial acts	-5,479	-5,448	-4,712	-7,113	-7,424	
Net cashflow	-381	997	-423	327	1,999	
Beginning cash	1,937	1,556	2,553	2,130	2,456	
Ending cash	1,556	2,553	2,130	2,456	4,455	
Ending net debt	-1,556	-2,553	-1,380	-2,456	-4,454	

Source: Nomura estimates

Balance sheet (INRmn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F	Notes
Cash & equivalents	1,556	2,553	2,130	2,456	4,454	
Marketable securities	0	0	0	0	0	
Accounts receivable	642	633	773	946	1,138	
Inventories	4,987	5,760	7,041	8,622	10,367	
Other current assets	1,380	1,514	1,920	2,352	2,827	
Total current assets	8,566	10,460	11,863	14,376	18,786	
LT investments	2,033	1,507	1,507	1,507	1,507	
Fixed assets	9,758	13,616	19,256	24,821	29,321	
Goodwill						
Other intangible assets						
Other LT assets	0	0	0	0	0	
Total assets	20,356	25,583	32,626	40,703	49,614	
Short-term debt						
Accounts payable	5,876	7,617	9,387	11,496	13,822	
Other current liabilities	8,348	9,079	8,799	9,117	7,738	
Total current liabilities	14,224	16,696	18,186	20,613	21,560	
Long-term debt	0	0	750	0	0	
Convertible debt						
Other LT liabilities	320	333	333	333	245	
Total liabilities	14,544	17,029	19,269	20,946	21,805	
Minority interest	0	0	0	0	0	
Preferred stock	0	0	0	0	0	
Common stock	964	964	964	964	964	
Retained earnings	4,848	7,590	12,393	18,793	26,845	
Proposed dividends						
Other equity and reserves						
Total shareholders' equity	5,813	8,554	13,357	19,758	27,809	
Total equity & liabilities	20,356	25,583	32,626	40,703	49,614	

Liquidity (x)

Current ratio	0.60	0.63	0.65	0.70	0.87
Interest cover	674.8	1,061.8	473.1	na	na

Leverage

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

Activity (days)

Days receivable	3.9	3.7	3.4	3.4	3.4
Days inventory	63.1	57.8	55.8	56.1	56.5
Days payable	74.0	72.5	74.1	74.8	75.3
Cash cycle	-7.0	-11.0	-15.0	-15.3	-15.4

Source: Nomura estimates

Q3 results largely inline

Nestlé India reported Q2 CY11 results that were marginally below our estimates at the top line owing to slower-than-expected growth in the domestic market and the impact of the ban on milk powder impacting revenue growth in the exports division. EBITDA was ~4% below our expectations on higher employee costs and some impact from higher input costs. While Q2 has slightly undershot our expectations, we remain confident that the company will deliver on our CY11 numbers.

Fig. 1: Nestle India Q311 result highlights

(INR mn)	Quarter Ended				
	Sep-11	Sep-10	YoY % Chg	Jun-11	QoQ % Chg
Net Sales	19,631	16,373	19.9	17,631	11.3
EBIDTA	4,103	3,219	27.5	3,445	19.1
Other income	121	95	27.3	80	51.5
PBIT	4,224	3,314	27.4	3,525	19.8
Depreciation	394	306	28.7	367	7.3
Interest	12	1		6	
PBT	3,819	3,008	27.0	3,152	21.2
Tax	1,134	840	35.0	956	18.6
Adjusted PAT	2,685	2,168	23.9	2,196	22.3
Extra ordinary income/ (exp.)	(74)	18		(58)	
Reported PAT	2,612	2,186	19.5	2,138	22.1
Nb. of shares (mn)	96	96		96	
EBIDTA margin (%)	20.9	19.7		19.5	

Source: Company data, Nomura Research

- Net sales were +19.9% at INR19.6bn. This was led by a mix of volume growth across categories with some selective price increases across the chocolates and milk portfolio. Export growth at 4.7% was impacted by a ban on the export of milk powder during the quarter.
- Material prices, especially milk, continued to remain at high levels. Sugar prices have seen downward movement. Together with price increases, mix benefit and some cost efficiency plans, gross margins for the quarter improved by 90bps y-y. This was much better than our expectation. With input prices remaining stable, albeit at elevated levels, the company should achieve another quarter of gross margin improvement in Q411.
- EBITDA came in at INR4.1bn, ~5% ahead our expectation. This was on account of higher gross margins, although employee costs saw a significant 37% jump this quarter. EBITDA margins for the quarter came in at 20.9% 140bps ahead of our expectation.
- Reported PAT came in at INR2.6bn growing by 19.5%, which was 4% ahead of our expectation.

Marginal changes to earnings estimates

We have made some marginal changes to our estimates most essentially for CY12, when we expect margin improvement to be 60bps y-y vs our earlier expectation of a 30bps improvement. However, we are also toning down our expectation for margin performance in CY11 to 20bps from our earlier expectation of a 50bps margin improvement.

Other income numbers that have been delivered so far in 2011 means that we have now bump up the other income. This flows through to our 2012 numbers as well.

Net change to our number in 2011 is minimal, but for 2012, there is a marginal 2% upgrade to our numbers.

Change in target price

We are also increasing our target price from INR3,800 to INR4,345. This change is largely on account of roll forward of our TP. Our valuation methodology remains unchanged at 27x one-year forward earnings.

Valuation too high to push for a buy case

Post the marginal changes in our earnings, Nestle India trades at 34x CY12F earnings. While Nestle has typically traded at a premium to other consumer companies, we believe on account of its superior growth profile, current valuations are higher than its own long-term average of 27x.

Additionally, our estimates are already building in an average 23%+ earnings growth over the next couple of years. This is despite additional investments made to increase capacity, which means an additional hit on the depreciation line. We are also building in a margin improvement in each of the next two years led by strong pricing power, improving mix benefit and continued strong cost efficiency programs. We remain confident that Nestle will deliver 20%+ earnings growth in the medium term.

However, we do not see any significant upside risk to our estimates from these levels. In that scenario with stock already trading at 34x2012F earnings, we do not see a buy case for the stock at current levels.

Continue to like the long term story

As we have highlighted several times in the past, longer term, we like the food subsector within the consumer space vs the HPC (hygiene and personal care) space. We believe the food sub sector will report higher growth led by stark under-penetration in several categories and rising propensity among consumers for packaged goods. In our view, Nestle will be one of the beneficiaries of this growth as the market leader in several segments that it operates in. The company also has the lever of bring-in products from the parent company's portfolio to India. This should help to establish them further as market leaders in packaged food segments, in our view.

Maintain Neutral and look for a better entry point

Although we like the long term story at Nestle India, we believe valuations at current levels remain above the long-term average. We expect Nestle to deliver earnings growth higher than the consumer average over the medium term, but the valuation differential of >30% means we would wait for a better entry point to add to positions. Maintain Neutral at these levels.

Appendix A-1

Analyst Certification

We, Manish Jain and Anup Sudhendranath, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Nestle India	NEST IN	INR 4497	04-Nov-2011	Neutral	Not rated	

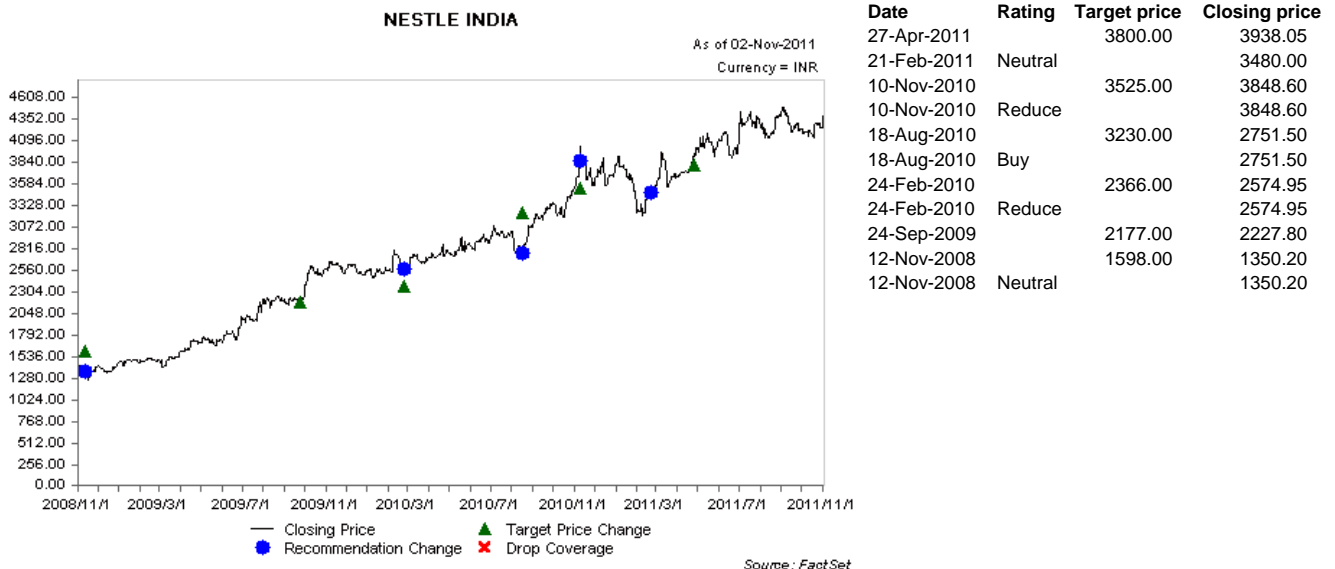
Previous Rating

Issuer name	Previous Rating	Date of change
Nestle India	Reduce	21-Feb-2011

Nestle India (NEST IN)

INR 4497 (04-Nov-2011) Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our INR4,345 target price is based on 27x our CY13F EPS estimate of INR160.5

Risks that may impede the achievement of the target price Negative risks arise from further increases in input prices and higher A&P spending. Positive risks come from better price/mix improvement vs our expectations.

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As at 30 September 2011. *The Nomura Group as defined in the Disclaimer section at the end of this report.

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STOCKS

A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of '**Suspended**', indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including, but not limited to, when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.

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SECTORS

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Benchmarks are as follows: **United States**: S&P 500; **Europe**: Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Target Price - Current Price) / Current Price, subject to limited management discretion. In most cases, the Target Price will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc.

A '**Buy**' recommendation indicates that potential upside is 15% or more. A '**Neutral**' recommendation indicates that potential upside is less than 15% or downside is less than 5%. A '**Reduce**' recommendation indicates that potential downside is 5% or more. A rating of '**Suspended**' indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009

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Target Price

A Target Price, if discussed, reflect in part the analyst's estimates for the company's earnings. The achievement of any target price may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings differ from estimates.

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