ANANDRATHI

India I Equities

Consumer
Update

Change in Estimates ☑ Target ☑ Reco ☐

7 September 2012

Nestle India

Leader of the pack; Buy

Rating: **Buy**
Target Price: ₹5,220
Share Price: ₹4,598

Over the past 2-3 years, Nestle has invested aggressively in enhancing production as well as distribution. With most capex now over, we expect the EPS to post CAGR of 23% over CY11-14. Growth will be aided by thinning competition in noodles, the company's major segment. We retain a Buy, with a target of ₹5,220 (earlier ₹5,100).

- **Brand-building initiatives ready to take off.** With a large part of Nestle's capex already over, its capacities stand doubled across categories, except beverages. The company is, thus, set to launch new products and variants regularly. Also, it is now free to resume ad-spend and brand building activities for most of its product categories.
- **Margins to improve on back of premiumization.** The company has launched various products at premium price points to the base products. This helps it create new sub-segments and improve realizations, which will subsequently expand margins.
- **Distribution capacities doubled.** Over the past 3-4 years, number of retail stores has doubled to ~4m. We also see strong growth in rural sales, 20% of net sales, as a part of the company's conscious strategy. This, together with higher production capacities and constant brand-building activities, will aid the company to report stronger growth rates ahead.
- **Competition easing in noodles.** Limited success of HUL's Knorr, Capital Foods' Smith & Jones and Pantaloon's Tasty Treat have taken competitive pressure off Nestle. Also, we expect GSK to remain focused on Foodles as healthy noodles and not compete head-on with Nestle. Most of the competitors are not playing in the regular noodles segment such as Maggi Masala. Maggi, therefore, has a smooth ride ahead.
- **Valuation.** Our DCF-based valuation puts the stock at ₹5,220 (earlier ₹5,100) at a target PE of 36x CY13e earnings. Our target PE is the mean PE plus two standard deviations. **Risks:** higher raw material prices and delayed product launches.

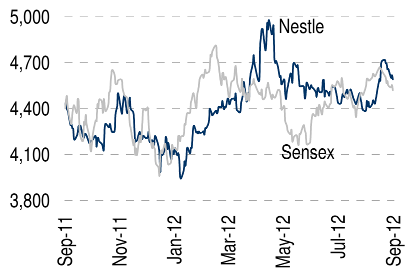
Key financials (YE Dec)	CY10	CY11	CY12e	CY13e	CY14e
Sales (₹m)	62,547	74,908	86,266	104,251	126,229
Net profit (₹m)	8,315	10,038	11,277	13,979	18,310
EPS (₹)	86.2	104.1	117.0	145.0	189.9
Growth (%)	21.4	20.7	12.3	24.0	31.0
PE (x)	53.3	44.2	39.3	31.7	24.2
PBV (x)	49.9	33.6	23.6	16.3	11.1
RoE (%)	110.7	91.0	70.5	60.8	54.7
RoCE (%)	149.4	88.1	58.1	53.2	52.2
Dividend yield (%)	1.1	1.1	1.1	1.1	1.1
Net gearing (%)	(45.7)	46.2	55.7	2.3	(36.6)

Source: Company, Anand Rathi Research

Key data	NEST IN / NEST.BO
52-week high / low	₹5024 / ₹3930
Sensex / Nifty	17684 / 5342
3-m average volume	US$2.5m
Market cap	₹443bn / US$8bn
Shares outstanding	96m

Shareholding pattern (%)	Jun' 12	Mar '12	Dec '11
Promoters	62.8	62.8	62.8
- of which, Pledged	0.0	0.0	0.0
Free Float	37.2	37.2	37.2
- Foreign Institutions	10.9	11.0	10.9
- Domestic Institutions	7.8	7.8	8.0
- Public	18.5	18.4	18.3

Relative price performance



Source: Bloomberg

Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Dec	CY10	CY11	CY12e	CY13e	CY14e
Net revenues	62,547	74,908	86,266	104,251	126,229
Revenue growth (%)	21.9	19.8	15.2	20.8	21.1
- Op. expenses	50,051	59,381	67,775	81,288	97,842
EBIDTA	**12,497**	**15,528**	**18,491**	**22,963**	**28,387**
EBITDA margin (%)	20.0	20.7	21.4	22.0	22.5
- Interest expenses	11	51	468	548	548
- Depreciation	1,278	1,533	2,407	3,433	3,733
+ Other income	427	509	494	988	2,051
- Tax	3,319	4,414	4,833	5,991	7,847
Effective tax rate (%)	28.5	30.5	30.0	30.0	30.0
Reported PAT	8,315	10,038	11,277	13,979	18,310
+/- Extraordinary items	(129)	(423)	-	-	-
+/- Minority interest	-	-	-	-	-
Adjusted PAT	8,187	9,615	11,277	13,979	18,310
Adj. FDEPS (₹/share)	86.2	104.1	117.0	145.0	189.9
Adj. FDEPS growth (%)	21.4	20.7	12.3	24.0	31.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: Dec	CY10	CY11	CY12e	CY13e	CY14e
Share capital	964	964	964	964	964
Reserves & surplus	7,590	11,775	17,412	25,751	38,420
Net worth	8,554	12,740	18,376	26,715	39,385
Minority interest	-	-	-	-	-
Total debt	-	9,709	13,709	13,709	13,709
Def. tax liab. (net)	333	435	435	435	435
Capital employed	8,887	22,883	32,520	40,858	53,528
Net fixed assets	13,616	29,944	42,537	44,104	45,372
Investments	1,507	1,344	2,344	12,344	20,344
- of which, Liquid	1,507	1,344	2,344	12,344	20,344
Net working capital	(8,789)	(10,676)	(13,249)	(16,341)	(20,142)
Cash and bank balance	2,553	2,272	888	751	7,955
Capital deployed	8,887	22,883	32,520	40,858	53,528
Net debt	(3,727)	6,528	10,912	1,049	(14,155)
WC days	(14.1)	(14.3)	(15.4)	(15.7)	(16.0)
Book value (₹/sh)	92.2	136.6	195.1	281.6	413.0

Source: Company, Anand Rathi Research

Fig 3 – Cash-flow statement (₹m)

Year-end: Dec	CY10	CY11	CY12e	CY13e	CY14e
PAT	8,315	10,038	11,277	13,979	18,310
+ Non-cash items	1,278	1,533	2,407	3,433	3,733
Cash profit	9,593	11,572	13,684	17,411	22,043
- Incr./(decr.) in WC	756	(163)	2,572	3,092	3,801
Operating cash-flow	10,357	11,863	16,256	20,504	25,844
- Capex	(4,456)	(15,552)	(15,000)	(5,000)	(5,000)
Free cash-flow	5,902	(3,689)	1,256	15,504	20,844
- Dividend	(5,430)	(5,407)	(5,640)	(5,640)	(5,640)
+ Equity raised	-	-	-	-	-
+ Debt raised	-	8,652	4,000	-	-
- Investments	-	-	(1,000)	(10,000)	(8,000)
- Misc. items	-	-	-	-	-
Net cash-flow	471	(444)	(1,384)	(137)	7,204
+ Op. cash & bank bal.	3,588	4,060	2,272	888	751
Cl. cash & bank bal.	4,060	3,616	888	751	7,955

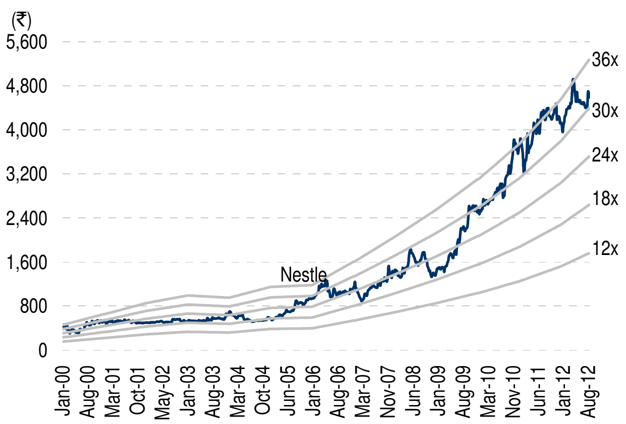
Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis @ ₹4598

Year-end: Dec	CY10	CY11	CY12e	CY13e	CY14e
P/E (x)	53.3	44.2	39.3	31.7	24.2
P/B (x)	49.9	33.6	23.6	16.3	11.1
EV/sales (x)	7.2	6.0	5.2	4.3	3.6
EV/EBITDA (x)	36.0	28.9	24.3	19.6	15.8
RoAE (%)	110.7	91.0	70.5	60.8	54.7
RoACE (%)	149.4	88.1	58.1	53.2	52.2
Dividend yield (%)	1.1	1.1	1.1	1.1	1.1
Dividend payout (%)	56.2	46.6	42.7	34.5	26.3
RM to sales (%)	48.9	47.9	47.1	46.2	45.8
Ad-spend to sales (%)	4.8	4.4	4.5	4.8	4.8
EBITDA growth (%)	20.8	24.3	19.1	24.2	23.6
EPS growth (%)	21.4	20.7	12.3	24.0	31.0
PAT margin (%)	13.3	13.4	13.1	13.4	14.5
Volume growth (%)	-	-	-	-	-
Realization growth (%)	-	-	-	-	-

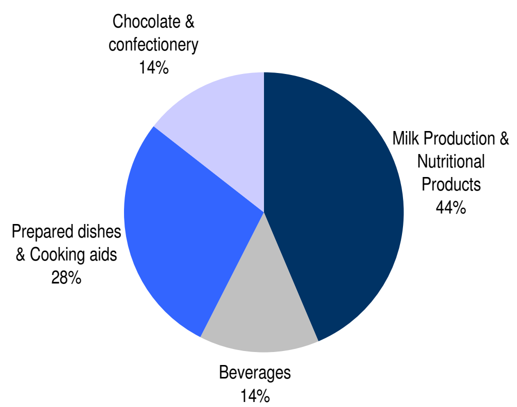
Source: Company, Anand Rathi Research

Fig 5 – PE band



Source: Bloomberg, Anand Rathi Research

Fig 6 – Indicative revenue breakdown (FY12)



Source: Company, Anand Rathi Research

Investment Argument

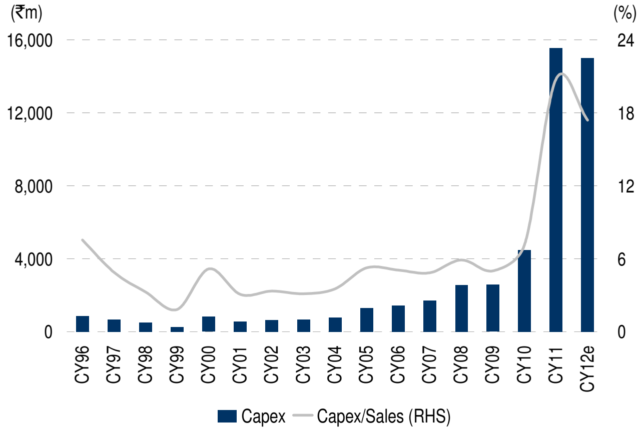
With a major part of Nestle's capex now over, the company is free to use its expanded distribution network to launch new products and variants. We expect its earnings growth momentum to be strong in the next two years. We retain a Buy, with a price target of ₹5,220 (earlier ₹5,100).

Large part of capex over

The company has completed a major part of its capex and created capacities for all fast growing sub-segments such as noodles, chocolates and pasta. Earlier, it had exhausted production capacities and was compelled to use them for higher-profit products. This resulted in volumes of some products (such as chocolates) declining. The company was also unable to advertise products and launch variants. Nor was it able to re-launch some products. It had stopped advertising chocolates such as Bar One and Milkybar. It also withdrew the 50 paise Eclairs.

We believe that with production capacities coming onstream, it will be able to launch products, SKUs and variants. We also expect it to resume its aggressive ad-spend on some products. It recently inducted Mr Amitabh Bacchan as brand ambassador for Maggi and is focusing on smaller SKUs such as Chhotu Maggi at ₹5. New production capacities will help reduce transportation and freight costs.

Fig 7 – Capital expenditure as percent of net sales



Source: Company, Anand Rathi Research

Margin improves on better product mix

Profit margins are improving due to the premiumization of products. In the past five years, Nestle has launched products at higher prices and greater profit margins. Some in the beverages segment are Nescafe Gold, Cold Coffee, Coffee Premixes and Iced Tea. It introduced Low-fat Dahi and milk, Fruit-flavoured Dahi in the milk products and nutrition segment. The company has entered Milkmaid creations segment by launching ready to cook products such as besan laddoo, kulfi and cake. As these markets are unorganised, we expect Nestle to grow at healthy rates over the medium term without facing much competitive pressure. Also, it launched premium products under the Maggi brand such as Maggi Pasta, Maggi Soupperoni, Maggi Atta noodles. It has also entered into Kitkat dark chocolates which are priced at premium to base Kitkat chocolate.

We believe its wider product mix is driving margins. It closed some losing/low-margin products such as Milo, Eclairs at 50 paise and Nescafe Mild. This is helping it improve profit margins.

Fig 8 – Launch of premium products in all segments

Segment	Premium products introduced
Milk Production & Nutritional Products	Slim Milk, Slim Dahi, Probiotic Dahi, Fruit Flavoured Dahi
Beverages	Nescafe Gold, Iced Tea, premixed coffee products
Prepared dishes & Cooking aids	Maggi Atta noodles, Soupperoni, Pasta
Chocolate & confectionery	Dark chocolate, Premium chocolates under Kitakat

Source: Company

Expanded distribution network to drive growth

The company has expanded its distribution network – from 2m outlets to ~4m. We believe its expanded distribution network has created huge capacity to market a large number of SKUs and variants. The launch of products and variants from its new production capacities can be easily marketed through its expanded distribution network.

Competition easing in instant food segment

The threat of losing market shares to various new players in the instant-noodles segment seems to have lessened now. GSK Consumer is looking at the business model of Foodles and is planning to showcase Foodles as a niche health platform. HUL's Knorr Souppy noodles has failed to gain market share. Also, Pantaloon's Tasty Treat has a limited product range and lacks innovation. ITC's Yippee noodles have however gained market share and now account for ~5% of the market. We believe most of the players in noodles segments are looking at creating niche for themselves and allowing Nestle to rule the basic noodles segment such Maggi Masala.

We believe easing competition is helping Nestle in the instant-foods sub-segment.

Fig 9 – Change in competitive pressure of noodles

Company	Brand	Focus	Pricing	Status
HUL	Knorr Souppy noodles	Soup and noodles	Premium	Not able to gain market share
GSK Consumer	Foodles from Horlicks	Health based multi grain noodles	Premium	May be re-launched
Capital Foods	Chings, Smith & Jones	Chinese tastes	Similar	Smith & Jones has failed.
Pantaloon	Tasty Treat	Similar product but only in Big Bazaar	Lower	Lack of distribution & 'me too' product
ITC	Sunfeast Yippee	Round noodles	Similar	Market share of ~5%.
Nissin Foods	Top Ramen	Different tastes	Premium	Lack of distribution

Source: Company

Change in estimates

We lower CY12 and CY13 revenue estimates 4.1% and 3.7% respectively. Also, to factor in the impact of higher raw material prices and greater effective income tax rates, we reduce CY12 and CY13 earnings estimates 17.6% and 15.8% respectively.

Fig 10 – Change in estimates

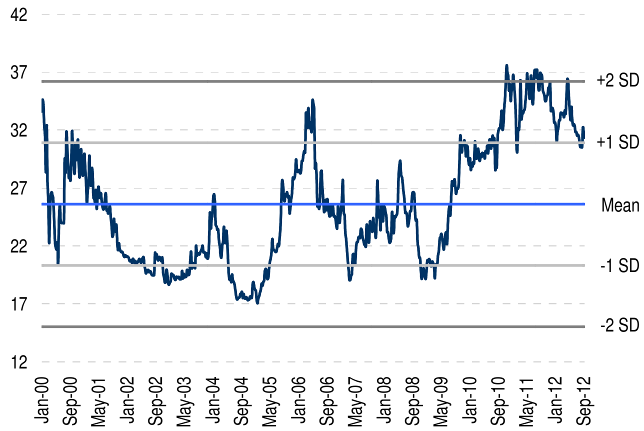
	CY11e			CY12e		
₹m	Old	New	Change (%)	Old	New	Change (%)
Revenues	89,920	86,266	(4.1)	108,226	104,251	(3.7)
Net Profit	13,686	11,277	(17.6)	16,599	13,979	(15.8)

Source: Anand Rathi Research

Valuation

We value the stock at a price target of ₹5,220 (earlier ₹5,100) according to the DCF-based valuation methodology. At our target price, it would trade at a target PE of 36x CY13e earnings. Our target PE is at the mean PE of 26x in the past 14 years plus 2 standard deviations. As we expect the long-term growth potential to be strong and return ratios to improve in coming years, we see the stock trading at premium valuations.

Fig 11 – Mean PE (x) and Standard Deviation



Source: Bloomberg, Anand Rathi Research

Risks

- Higher raw material prices
- Delay in launching products and expanding distribution.

Appendix

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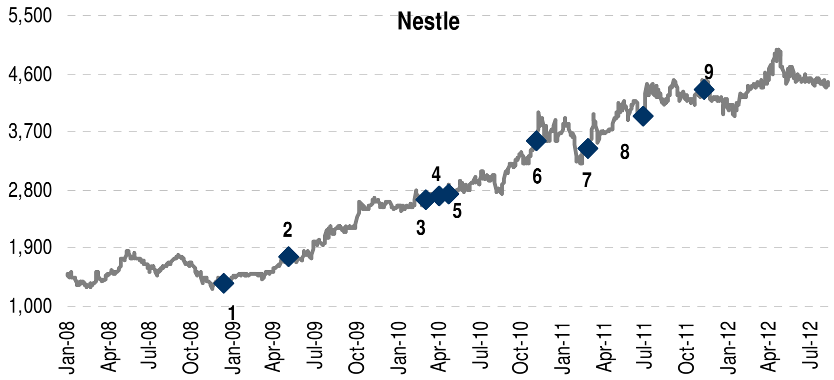

	Date	Rating	TP (₹)	Share Price (₹)
1	12-Dec-08	Hold	1,495	1,360
2	6-May-09	Sell	1,520	1,758
3	4-Mar-10	Sell	2,003	2,631
4	1-Apr-10	Sell	2,075	2,712
5	23-Apr-10	Sell	2,416	2,865
6	2-Nov-10	Sell	2,905	3,536
7	24-Feb-11	Buy	4,096	3,443
8	27-Jun-11	Buy	4,550	3,934
9	8-Nov-11	Buy	5,100	4,418

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Ratings Guide			
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