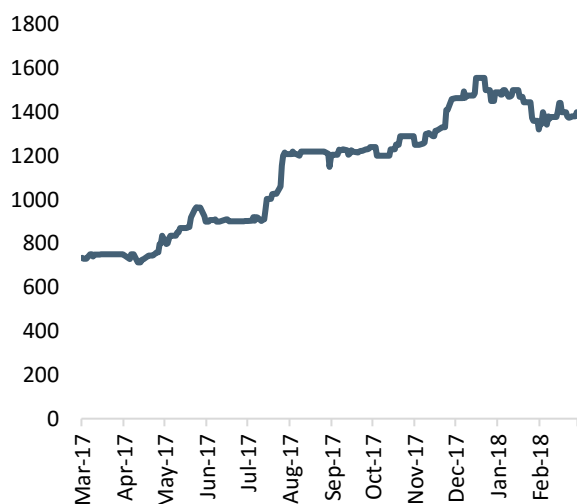


Rating	<b>SELL</b>
Price	₦1,380.00
FVE	<b>₦998.21</b>
52-week range	₦712.79-1,555.99
Market Cap. (₦tn)	1.110
1-month Avg. Vol	379,752
Curr. PE	26.4x

Quarterly EPS	Q1	Q2	Q3	Q4
<b>2016 A</b>	8.43	7.75	0.06	9.39
<b>2017 A</b>	10.55	10.33	8.11	9.37
<b>2018 F</b>	12.48	12.49	12.18	15.17

#### NESTLE:NL - Share Price Trend



#### Analyst(s)

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## Nestle Nigeria Plc. (NESTLE.NL)

### Stock Report

#### *A compelling but expensive growth story*

- Following a dismal 2016, when earnings fell to an eight-year low of ₦7.4 billion, Nestle Nigeria Plc (Nestle) returned strong in 2017, with earnings rising to a record ₦33 billion, a four-fold increase from the prior year. The big question now is, what happens next and are the drivers of 2017 earnings sustainable to deliver another sturdy earnings in 2018? In this note, we update our views on Nestle as well as revise our forecasts on the company.
- Going into 2018, we remain broadly positive on Nestle and expect the company to sustain earnings growth, albeit at a much slower pace than 2017. Specifically, we see volume induced revenue growth and lower FX losses as key drivers of earnings in FY 18. Irrespective, downside risk to earnings will likely emanate from a subsisting input cost pressure which will hurt margins and, by extension, earnings. In addition, a further rise in operating expenses, particularly administrative expenses also pose downside risk to earnings in 2018.
- In terms of equity market performance, Nestle is down 10% Year-to-Date (YTD), weaker than the return on the food sub-segment (-1.8% YTD) and NGSE All Share Index (+12.6% YTD). On our 2018 numbers, Nestle trades at a forward P/E of 26.4x relative to Bloomberg Middle-East and Africa peers of 20.5x. We retain our SELL rating on the stock with our revised FVE estimate of ₦998.21 (Previous: ₦879.62).

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### *Lower effective tax offset cost pressures on Q4 earnings*

- Full-year 2017 earnings rebounded to its strongest level on record underpinned by improved operating performance and lower FX losses. However, we saw a deviation to the downside in Q4 17 despite a 44% YoY expansion in earnings to ₱12.3 billion. For context, while PBT declined 23% YoY to ₱10.3 billion, lower effective tax of 13% in the period (versus 53% in Q4 16) supported the expansion in earnings. Parsing through the numbers indicates earnings pressure stemmed from the mix of input and operating cost pressures as well as lower finance income.
  - First off, despite a 12.4% YoY expansion in revenue in Q4 17, gross profit rose mildly by 6.8% YoY with related gross margin contracting by 220bps to 42% (below 5-year Q4 trend level of 43.5%). The margin pressure reflected a faster increase in input cost (+16.8% YoY) which stemmed from unfavourable price movements for locally sourced raw materials particularly Salt (+25% YoY) which is a major input in the production of its popular brand – Maggi. On topline, the slower rise in topline reflected the tapering out of the low pricing base. Like the prior quarter, the beverage segment was the primary driver of Q4 revenue with a YoY increase of 21% underpinned by volume, in our view. Over 2017, the company optimized its route-to-market as well as automated its sales force to make them more efficient in a bid to protect volume growth during periods of price hikes. We believe this investment also benefited the food segment which rose 7.8% YoY and accounted for the largest share (62.7%) of Q4 revenue.
  - Further down, the company reported a faster increase in operating expense (+17.3% YoY) relative to sales with both selling & distribution expense (+11.3% YoY) and admin expenses (+49.2% YoY) rising double-digit during the period. The sharp increase in admin expenses was due to an upward review in staff salaries, reflecting the strong union to which its staff belong to. Consequently, operating expense to sales ratio rose 89bps to 21%. This, combined with weakness in gross margin, led to a 309bps contraction in operating margin to 21.4%. Further down, although net finance expense of ₱263 million was much lower than ₱6.4 billion reported in Q3 17, it paled in comparison to net finance income of ₱3.2 billion reported in Q4 16. The foregoing combined with margin contraction on both gross and operating level underpinned the 23% drop in before-tax earnings.
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### *Softer FX losses guides to earnings growth*

- Going into 2018, as with most consumer companies, Nestle's management guides to sustained investment in its route-to-market and innovative marketing strategies to drive volume growth particularly for its leading products – Maggi, Milo and Golden Morn. This is coordinated with our view that volume led strategies will take center stage farther out given the unsustainability of the price-led revenue growth of 2017. Specifically, for revenue, we look for a growth of 9.2% YoY to ₦267 billion in FY 18, supported by the food segment through Maggi which has retained its leading position in Nigeria's seasoning market. Over our five-year forecast horizon, we project revenue CAGR of 8.2% (vs. 16% in the five years ending December 2017).
  - In terms of input costs, according to FEWSNET, cross border demand for cereals remains above average although, the impact is being offset by robust market supplies from the dry season harvest. This, in our view should ensure price stability for Maize and Sorghum in H1 18. However, in the early months of H2 18, which is typically the lean season, we expect the combination of regional demand for local grains and limited market supply to put an upward pressure on cereal prices which we expect would ease in Q4 18 due to the peak harvest season. The aforementioned coupled with our view of currency stability over FY 18 underpins our expectation for an expansion (+109bps) in FY 18 gross margin to 42.4% relative to prior year (5-year average: 42.5%). We also project a slowdown in COGS (CAGR: +7%) over our forecast horizon as the transitory nature of food inflation wanes.
  - On finance expense, we envisage tamer finance expense in FY 18. To add, Nestle is expected to pay \$33 million in FY 18 which we estimate is valued at around ₦370/\$ on its books. Our view is for the currency to range between ₦360/\$ and ₦370/\$ in 2018 hence, we foresee minimal FX losses in the preview period. Overall, we project net finance expense of ₦2.8 billion (-69% YoY) in 2018.
  - Net impact of these revisions translates to PBT and PAT of ₦61 billion (+30% YoY) and ₦41.5 billion (+23% YoY) respectively with the later translating to an EPS of ₦52.31. We project a 5-year EPS CAGR of 12% (vs. 8% in the five years ending December 2017) as finance expense moderates further over our forecast horizon.
  - On our 2018 earnings, Nestle trades at a current P/E of 26.4x vs 20.5x for Bloomberg Middle East and Africa peers. We have a SELL rating on the stock with our revised FVE of ₦998.21 (Previous: ₦879.62).
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## Summary of Results and Forecasts - Naira (₦)

ANNUAL					
Income Statement (₦' m) *					
	2016A	2017A	2018E	2019E	2020E
Revenue	181,911	244,151	266,640	291,861	315,933
COGS	106,583	143,280	153,585	164,901	176,923
Gross Profit	75,328	100,871	113,055	126,959	139,011
Operating Cost	37,114	45,173	49,328	54,578	60,659
Operating Profit	38,213	55,698	63,727	72,381	78,351
Net finance Cost	16,665	8,870	2,756	1,996	2,199
PBT	21,548	46,829	60,971	70,386	76,153
Tax	13,623	13,105	19,511	22,523	24,369
PAT	7,925	33,724	41,460	47,862	51,784
Balance Sheet (₦ '000) *					
Fixed Assets	71,850	74,299	75,874	77,187	78,421
Stocks	20,638	23,910	24,574	24,735	26,538
Trade debtors	25,747	33,456	23,998	26,267	28,434
Cash & other bank balances	51,351	15,139	20,446	21,796	9,098
Total Assets	169,586	146,804	144,892	149,986	142,491
Liabilities					
Trade Creditors	64,662	49,056	46,075	49,470	44,231
Non-current Liabilities	17,674	22,245	22,724	23,226	23,437
Total liabilities	138,708	101,926	99,970	105,013	97,463
Shareholders' fund	30,878	44,878	44,922	44,973	45,028
Key Ratios					
Gross Margin	41%	41%	42%	44%	44%
EBIT Margin	21%	23%	24%	25%	25%
PBT Margin	12%	19%	23%	24%	24%
Net Margin	4%	14%	16%	16%	16%
EPS	10.00	42.55	52.31	60.38	65.33
P/E	147.53	36.57	29.75	25.77	23.82
EV/EBITDA	26.44	19.98	17.85	15.80	14.74
ROA	5%	21%	28%	32%	35%
ROE	23%	89%	92%	106%	115%

Source: ARM Research \*unless otherwise stated

**Ratings, Disclosure & Disclaimer** – [Click here](#)