

**Nestlé Nigeria Plc | Company Note**

6 months ended 30<sup>th</sup> June, 2017

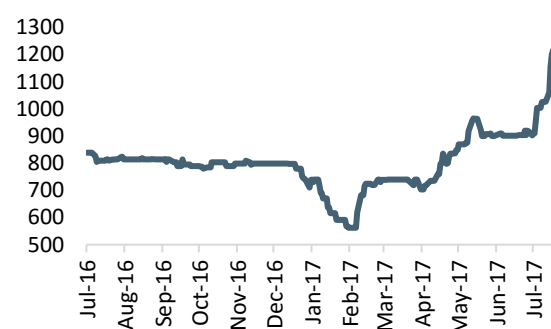
**Has the bull run its course?**
**(SELL: ₦ 879.93)**

- Seven-months ago, Nestle's share price hovered around a five-year low of ₦591.95, which we linked to a combination of fundamental concerns and absence of portfolio flows (See report: *Nestle Nigeria Plc: Short on foreign love*). Fast-forward to current period, the company's stock price now trades at an unprecedented high of ₦1,208. In terms of fundamentals, the company has witnessed a marked turnaround in operating performance—a consequence of price hikes across product portfolio, operational efficiency, and tempered FX loss. In addition to these, the current share price rally appears to have benefited from improved foreign appetite for naira equities which greeted CBN's introduction of the Investors and Exporters Window (IEW) in April – Nestle has gained 63% post the introduction of the I&E window.
- Given the foregoing, we review our models to reflect the company's improved earnings picture with a view to ascertaining the possibility of further upside. Going forward, we are concerned that a still depressed real income level would leave volume growth subdued across Nestle's product portfolio while the improved FX supply creates leg-room for more competition from imported brands. Beyond 2017, we view price-induced revenue growth as unsustainable and project a volume led-increase in turnover over our forecast horizon (2018-2022).

Income Statement Data			
	2017 – 6M	2016 – 6M	%chg
<b>Revenue</b>	121,920	80,443	52%
<b>PBT</b>	24,460	896	2628.5%
<b>Tax</b>	7,912	361	2093.7%
<b>PAT</b>	16,548	536	2988.4%

Balance Sheet Data			
	2017-Jun 'm	2016- Dec 'm	%chg
<b>Inventory</b>	23,392	20,638	13.3%
<b>Receivables</b>	22,091	24,035	-8.1%
<b>Cash</b>	56,995	51,351	11.0%
<b>Payables</b>	66,306	64,662	2.5%
<b>Net Assets</b>	39,503	30,879	27.9%

Stock Data	
<b>Price</b>	₦1208.10
<b>52-week range</b>	₦562.35 – ₦1216.01
<b>Market Cap. (N'm)</b>	957,529
<b>1-month Avg. Vol</b>	318,167
<b>Curr. PE</b>	40x
<b>Bloomberg Ticker</b>	NESTLE:NL
<b>Nestle Nigeria Plc- Share Price Trend</b>	


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However, we think revenue growth momentum over the forecast horizon will be tamer relative to current run rate.

#### *Price hikes and lower FX losses shore up earnings*

- Over H1 17, Nestle's revenue surged 52% YoY to ₦121.9 billion largely reflecting the impact of price hikes across product portfolio (YoY: 40%-70%). That said, an upswing in prices of key inputs (YoY: Maize: +110%, Sorghum: +109%, Refined sugar: +99.5%) drove a 26.1pps YoY rise in COGS (H1 17: +54.2%). Consequently, gross margin contracted 100bps YoY to a low of 39.7% in H1 17 (6-year H1 average: 42%).
- Further down, Nestle recorded lower FX losses in the review quarter (-60% YoY to ₦5.2 billion) which was underpinned by a softer YoY depreciation of the naira. Despite the improved year-on-year picture, Nestle's Q2 17 FX loss of ₦4.1 billion was 3.4x higher QoQ. We attribute this quarterly jump to a revaluation of the company's dollar-denominated shareholder loans at the recently introduced NAFEX rate. Overall, Nestle reported net finance expense of ₦2.2 billion (YoY: -84%, Q1 17: ₦1.1 billion in net finance income) in the review period.
- In addition, Nestle also effected a part repayment of ₦20.8 billion on FCY loans owed (₦38.3 billion due in 2017) that drove its cash balance lower to ₦57 billion (-17% QoQ).<sup>1</sup>
- The foregoing combined with lower effective taxes paid over H1 17 (-7pps YoY to 32.3%) underpinned a 29.9x YoY jump in earnings to ₦16.5 billion. (EPS: ₦20.88)

#### *Earnings momentum tapers beyond FY 17*

- Going into H2 17, we expect depressed real income to leave volume growth subdued across the product portfolio even as improved FX supply provides impetus for higher competition from imports and smaller domestic competitors. However, as in H1 17, Nestle's upward price adjustment should keep revenue at elevated levels relative to 2016 albeit with tamer growth in YoY revenue

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<sup>1</sup> As at H1 17, Nestle's net cash position stood at N14 billion (H2 16: N681.9 million).

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given the base effect from prices over H2 16. As such, we expect Nestle's top-line to rise 37.5% YoY to ₦250.1 billion (H1 17: +39.7% YoY) over FY 17.

- For input costs, we expect a more modest rise as lower diesel prices taper transport-induced food inflation pressures with improved market supply in the seasonal main harvest of Q4 16 also expected to moderate prices of farm produce. Against this backdrop, we project a COGS to sales ratio of 59.1% over 2017 (H1: 60.3%, H2 17: 58.1%) which translates to a gross profit of ₦102.05 billion with corresponding margin of 41%.
  - We have similarly revised our projections for Nestle's interest income more than two-fold higher YoY to ₦10.2 billion (H1 17: ₦5.2 billion) owing to the company's sizeable cash balances (+55% YoY to ₦57 billion) while finance expense has been upwardly reviewed (-48% YoY to ₦10.8 billion) to reflect higher run rate on interest payments over H1 17. On balance, we forecast FY 17 net finance income of ₦590 million (FY 16: net finance expense: ₦16.7 billion). Cumulative impact of our adjustments translates to FY 17E PBT and PAT of ₦57.4 billion (2.7x YoY) and ₦39.1 billion (4.9x YoY) respectively.
  - Beyond 2017, we view price-induced revenue growth as unsustainable and project a volume-led increase in turnover over our forecast horizon (2018-2022). On this wise, we note rising cost of living and weak consumer income as potential drags to growth. Hence, we project a 9% revenue CAGR over our forecast horizon, which is much lower than the 13% in the five years ending December 2015. Whilst we project a slowdown in COGS (CAGR: +7%) over our forecast horizon, as the transitory nature of transport-induced food inflation wanes, the deceleration in top-line should apply downward pressure on gross profit (2017-2022 CAGR: +11% vs. 13% between 2010 and 2015). In addition, we have revised our projections for net finance expense lower over our forecast horizon as Nestle repays its outstanding FX debt to its parent (2017-2022 CAGR: +30% vs. 45% between 2010 and 2015). Leaving our OPEX growth unchanged at 14%, we project slower rise in earnings (2017-2022 CAGR: +7%) going forward.
  - Nestle trades at current and forward P/Es of 40x and 24.79x respectively vs. 29x and 17.4x for its Bloomberg MEA peers. Relative to its five-year historical
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average, the stock's P/E is also higher. Given the more subdued economic picture (IMF's average five-year growth forecast: Nigeria: 1.6%, MENA: 3.1%), we think that the premium is unjustified. We have a SELL rating on the stock with a FVE of ₦879.93.

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## Summary of Results and Forecasts (₹ million)

### QUARTERLY

Income Statement (₹mln)*	Q1 2017A	Q2 2017A	Q3 2017E	Q4 2017E
Sales	61,152	60,768	64,317	63,879
COGS	37,668	35,909	37,818	36,673
Gross profit	23,483	24,860	26,499	27,206
Operating cost	10,274	11,370	11,744	11,133
Operating profit	13,210	13,490	14,754	16,073
Net finance cost	1,073	3,313	840	680
<b>Profit before taxation</b>	14,283	10,177	15,594	16,753
Tax	5924	1988	4545	5722
<b>Profit after taxation</b>	8,359	8,189	11,050	11,031
<b>Earnings per share</b>	10.55	10.33	13.94	13.92

### ANNUAL

Income Statement (₹mln)	FY 2014A	FY 2015A	FY 2016A	FY 2017F	FY 2018F
Sales	143,329	151,272	181,911	250,116	278,347
COGS	82,099	83,926	106,583	148,068	158,658
Gross profit	61,230	67,346	75,328	102,047	119,689
Operating cost	32,030	33,598	37,114	44,521	57,896
Operating profit	29,200	33,747	38,213	57,527	61,793
Net Interest Expense	4,754	4,425	16,665	719	4,211
<b>PBT</b>	24,446	29,322	21,548	56,807	57,582
Tax	2,210	5,586	13,623	18,178	18,426
<b>PAT</b>	22,236	23,737	7,925	38,629	39,156
Earnings per share	28.05	29.95	10.00	48.73	49.40
Dividend per share	27.50	29.00	10.00	43.86	46.93

Balance Sheet (₹mln)	FY 2014A	FY 2015A	FY 2016A	FY 2017F	FY 2018F
<b>Assets</b>					
Fixed assets	68,673	70,500	71,850	72,874	74,849
Inventories	10,956	10,814	20,638	28,873	30,145
Trade debtors	22,729	24,971	25,747	18,759	19,484
Cash and other bank balances	3,705	12,930	51,351	17,975	5,380
<b>Total Assets</b>	106,062	119,215	169,586	138,481	129,858
<b>Liabilities</b>					
Trade Creditors	26,657	36,662	64,662	59,227	47,597
Long Term Liabilities	25,484	21,476	17,674	16,237	16,684
<b>Total liabilities</b>	70,122	81,208	138,708	103,895	93,314
<b>Shareholders' fund</b>	35,940	38,007	30,878	34,710	36,668

Key Ratios	FY 2014A	FY 2015A	FY 2016A	FY 2017F	FY 2018F
Gross margin	43%	45%	41%	41%	43%
Operating margin	20%	22%	21%	23%	22%
PBT margin	17%	19%	12%	23%	21%
Net margin	16%	16%	4%	15%	14%
P/E	43.06	40.34	120.82	24.79	24.45
EV/EBITDA	28.18	24.56	21.65	15.31	14.47
ROA	21%	21%	5%	25%	29%
ROE	58%	64%	23%	118%	110%

Source: ARM Research

## ARM ratings and recommendations

ARM now employs a two-tier rating system which is based on systemic importance of the security under review and the deviation of our target price for the stock from current market price. We characterize systemic importance as a function of a stock's ranking among the group of top 20 stocks by NSE market capitalization over a trailing 6-month period (minimum) to the review date. We adopt a 5-point rating system for this category of stocks and a 3 point rating system for stocks outside this group. The choice of top 20 stocks arises from the consideration that this group of stocks constitutes >75% of overall market capitalization and stocks outside this group are generally less liquid and individually account for <<1% of market capitalization. For stocks in both categories, the basis for ratings subject to target price deviation is outlined below:

TOP 20		NON-TOP 20	
Rating	Deviation	Rating	Deviation
<b>STRONG BUY</b>	>20%	<b>BUY</b>	>20%
<b>OVERWEIGHT</b>	10% — 20 %	<b>NEUTRAL</b>	5% — 20 %
<b>NEUTRAL</b>	0% — 10 %	<b>SELL</b>	<5%
<b>UNDERWEIGHT</b>	-5% — 0%		
<b>SELL</b>	<-5%		

RECOMMENDATION KEY	
Rating	Recommendation
<b>BUY</b>	Accumulate security to a substantial extent constrained only by portfolio diversification considerations
<b>OVERWEIGHT</b>	Accumulate security to an extent moderated by cognizance of its benchmark weight
<b>NEUTRAL</b>	Maintain status quo for security with respect to current holding—i.e. keep if already holding and don't buy otherwise—subject to reasonable portfolio constraints
<b>UNDERWEIGHT</b>	Minimise exposure to security taking cognizance of its index weighting
<b>SELL</b>	Sell-off security completely from portfolio

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