

**Nestlé Nigeria Plc. | Earnings Report**

6 months ended 30<sup>th</sup> June, 2016

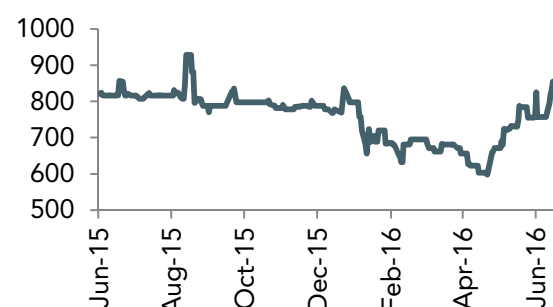
**FX Loss on dollar debt swings earnings negative (₦618.73- SELL)**

- Nestlé Nigeria Plc (Nestlé) released unaudited results for 6 months ended 30<sup>th</sup> June 2016 wherein revenue rose 22% YoY to ₦80.4 billion; however PBT and PAT plunged 92% and 94% YoY to ₦896 million and ₦535 million respectively. The sharp contraction in earnings stems from FX losses on Nestlé's dollar loans (FY 15: \$120million) following the 43% NGN depreciation in June 2016. The losses offset strong sales growth during the period and largely accounts for the company's underperformance over the period.

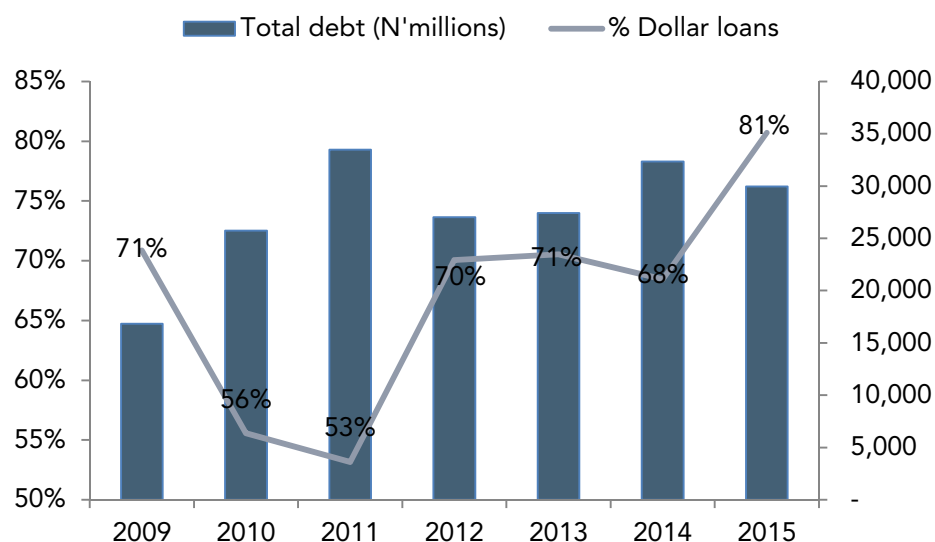
**FX losses on dollar debt underpin negative Q2 16 earnings**

- In our report, **(A new dawn for naira: bullish or bearish for coverage sectors)** we identified a net short FCY position on Nestlé's balance sheet (81% of FY 15 net assets) as raising prospect for sizable FX losses post the NGN depreciation. Thus, rising finance costs resulted in a fourfold surge in interest expense to ₦14.1 billion while interest coverage ratio collapsed 95% to 0.42x. The elevated finance expense largely underpinned Q2 16 pre-tax and post-tax losses of ₦7.8 billion and ₦6.2 billion respectively. Excluding the impact of net foreign exchange losses, Nestlé should have reported PAT of ₦15.4 billion (+73.7% YoY growth).

Income Statement Data			
	2016 – 6M'm	2015 – 6M'm	%chg
Revenue	80,443	65,924	22%
PBT	897	10,607	-92%
Tax	361	1719	-79%
PAT	536	8,887	-94%
Balance Sheet Data			
	2016-June 'm	2015-Dec 'm	%chg
Inventory	13,839	11,265	23%
Receivables	24,293	23,604	3%
Cash	35,549	8,737	318%
Payables	57,912	25,663	126%
Net Assets	38,007	35,180.5	14%
Stock Data			
Price	₦837.5		
52 week range	₦598.3-₦927.9		
Market Cap. (N'm)	663,850		
1-month Avg. Vol	237,401.2		
Curr. PE	43.8		
Bloomberg Ticker	NESTLE:NL		
Nestlé Nigeria Plc- Share Price Trend			


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**Figure 1: Proportion of Dollar Loans in Nestlé's Total Debt Portfolio**



Source: Company financials, ARM Research

***Elevated domestic grain prices mute impact of price hikes on margins***

- In addition to FX issues, Nestle, as with other FMCGs, grappled with a rising cost environment on several fronts. First, domestic input prices tracked higher during the period (YoY sorghum: +66%, Maize: +70%) pushing production costs on Nestle's food products higher. Second, following several disruptions to gas supplies, Nestle as with other manufacturing companies likely substituted with more expensive LPFO to power its plants. Though Nestle tried to pass on these inflationary pressures by raising prices on some products during the period, we believe constrained consumer purchasing power limited the scale of price hikes. Consequently, while revenue growth was strong (+15.5% YoY to ₦ 44.3billion), cost pressures drove a faster rise in Q2 16 COGS (+34.2% YoY to ₦29.4 billion) resulting in a decline in gross profit to ₦15 billion and a 9pps YoY slide in related margins to 34% (Q2 16E: 44%).
- In a similar vein, there was no let-up on other cost items with strong increases in Admin costs (+23.1% YoY to ₦2.9 billion) driving opex higher to ₦9.1 billion (Q2 16E: ₦9.0 billion).

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### *Input cost pressures and FX concerns dim earnings outlook*

- In the second half of 2016, currency weakness which has resulted in increased cross border purchases of domestic grain and increased local import substitution speaks to elevated input cost prices. In addition, persisting gas issues and USD/NGN depreciation should drive higher COGS in subsequent quarters. The aforementioned suggests that Nestle should continue to rely on price increases to offset cost challenges. The strong H1 16 sales reading and prospect of further hikes drive upward revisions to our FY 16E sales forecasts to ₦173 billion (+ 15% YoY). That said, in the aftermath of electricity and tariff hikes in H1 16, we think weak consumer incomes should continue to constrain scope for complete pass-through of inflationary pressures. Thus, the outlook speaks to sustained gross margin contraction over the rest of 2016. Consequently, we have lowered our FY 16E for gross margins to 41% (-3pps from prior).
  - Given Nestlé's net short FCY positions on dollar-denominated loans (FY 15: \$120 million) and maturity of \$94 million loan principal payable to related parties in 2016, the company remains susceptible to sizable foreign currency losses in the near term which should impact negatively on earnings. In addition, recent monetary policy tightening should drive higher interest expense on LCY loans (19% of total loans). In sum, the FX losses and higher domestic interest rates drive our expectations for FY 16E interest expense to rise six-fold YoY to ₦24.5 billion. Cumulative impact of these adjustments lowered our 2016E operating and net income margins to 17.9% and 3.4% respectively (vs. 20.9% and 14.7% previously) and our FVE to ₦618.73 from prior.
  - Largely reflecting the loss in Q2 16, Nestle now trades at a current P/E of 43.8x relative to 24.6x for Bloomberg Middle East & Africa peers. Given the increased prospects for earnings deterioration and 35% premium of last trading price to our FVE we retain our **SELL** rating on the Nestle.
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## Summary of Results and Forecasts - Naira (₦ million)

QUARTERLY					
Income Statement (₦'mln)*	Q1 2016A	Q2 2016A	Q3 2016E	Q4 2016E	
Sales	36,131	44,312	47,235	45,343	
COGS	18,350	29,361	27,868	26,502	
Gross profit	17,781	14,951	19,366	18,841	
Operating cost	8,755	9,005	10,911	11,296	
Operating profit	9,026	5,945	8,455	7,545	
Net finance cost	300	13,774	5,806	3,343	
<b>Profit before taxation</b>	8,725	7,829	2,649	4,202	
Tax	2044	1683	609	812	
<b>Profit after taxation</b>	6,681	6,146	2,040	3,390	
<b>Earnings per share</b>	8.43	(7.75)	2.57	4.28	
ANNUAL					
Income Statement (₦'mln)	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
Sales	143,329	151,272	173,021	188,332	213,648
COGS	82,099	83,926	102,082	105,466	119,643
Gross profit	61,230	67,346	70,938	82,866	94,005
Operating cost	32,030	33,598	39,968	42,563	47,216
Operating profit	29,200	33,747	30,971	40,303	46,789
Net finance cost	4,754	4,425	23,223	2,534	2,551
<b>PBT</b>	24,446	29,322	7,747	37,769	44,238
Tax	2,210	5,586	1,782	9,442	12,387
<b>PAT</b>	22,236	23,737	5,966	28,327	31,851
Earnings per share	28.05	29.95	7.53	35.74	40.18
Dividend per share	27.50	29.00	6.77	32.16	36.16
Balance Sheet (₦'mln)					
	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
<b>Assets</b>					
Fixed assets	67,515	69,148	73,775	78,769	84,637
Inventories	10,956	10,814	13,320	13,762	15,611
Trade debtors	22,729	24,971	27,683	30,133	34,184
Cash and other bank balances	3,705	12,930	23,293	20,113	17,922
<b>Total Assets</b>	106,062	119,215	139,424	144,129	153,707
<b>Liabilities</b>					
Trade Creditors	26,657	36,662	44,593	46,071	52,264
Borrowings	32,354	29,944	42,029	42,423	42,623
<b>Total liabilities</b>	70,122	81,208	101,224	103,096	109,490
<b>Shareholders' fund</b>	35,940	38,007	38,200	41,032	44,218
Key Ratios					
	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
<b>Profitability margins</b>					
Gross margin	43%	44.5%	41.0%	44%	44%
EBITDA margin	24.4%	26.2%	20.7%	24.2%	24.7%
Operating margin	20.4%	22.3%	17.9%	21.4%	21.9%
PBT	17.1%	19.4%	4.5%	20.1%	20.7%
Net margin	15.5%	15.7%	3.4%	15.0%	14.9%
<b>Valuation multiples</b>					
EV/EBITDA	19.8	17.2	19.0	15.0	13.1
P/CF	28.3	16.6	48.9	20.6	17.5
P/B	18.5	17.5	17.2	16.0	14.9
P/E	29.9	28.0	111.3	23.4	20.8

Source: ARM Research \*unless otherwise stated

## 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 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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