

1 November 2016

**Nestlé Nigeria Plc. | Earnings Report**

9 months ended 30<sup>th</sup> September, 2016

**Another quarter, another loss...same FX story**
**(₦612.87 - SELL)**

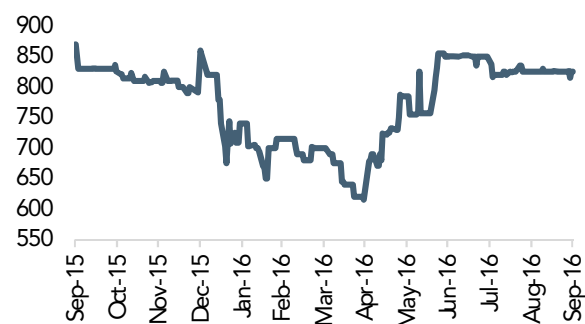
- Nestlé Nigeria Plc (Nestlé) released unaudited results for 9 months ended 30th September 2016 wherein revenue rose 16.6% YoY to ₦49 billion while PBT and PAT declined 74% YoY and 97% YoY to ₦5.5 billion and ₦485 million respectively. As in the last quarter, naira depreciation continues to adversely impact Nestlé due to its net short FCY position from its dollar loans. In Q3 16, the company reported FX losses of ₦6.3 billion while higher tax charges following the expiry of pioneer tax on Nestlé's Flowergate factory underpinned a second consecutive quarter of losses.

**FX pressures underpin negative Q3 16 earnings**

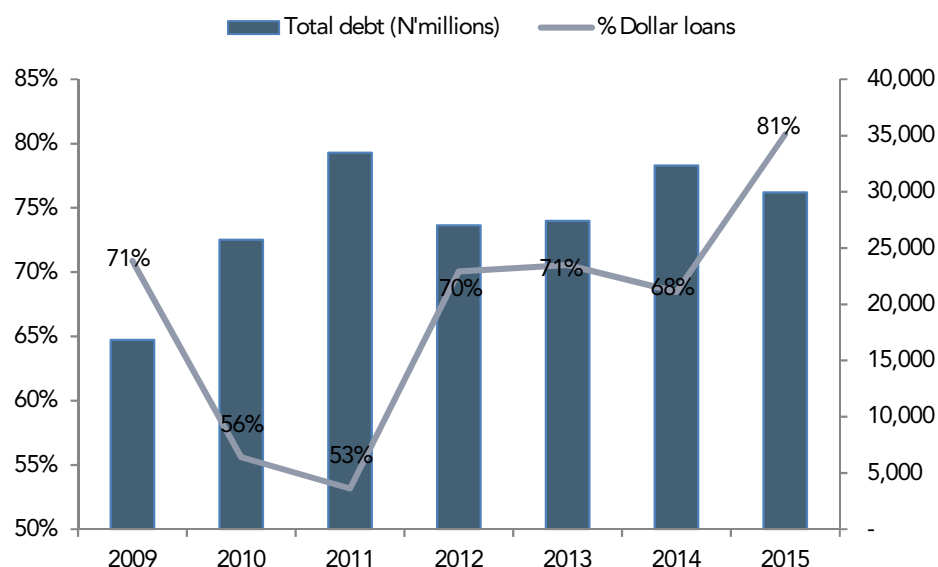
- Akin to Q2 16, when NGN depreciation drove a surge in interest expense associated with Nestlé's dollar loans, continued naira weakness resulted in a five-fold YoY jump in finance expense to ₦7.1 billion (Q3 2016E: ₦6.1 billion) driving further deterioration in interest coverage ratio (-86% YoY to 1.5x)<sup>1</sup>. Nestlé's short term borrowings also spiked 159% YoY to ₦41.7 billion which management attributed to the revaluation of FX loans. In addition, we attribute the surge in loan book to higher borrowings within the quarter. Excluding the impact of net foreign exchange losses, Nestlé should have reported PAT of ₦6.2 billion (-25.2% YoY growth).

<sup>1</sup> FX losses accounted for 88% of the jump in finance expense over the quarter.

Income Statement Data			
	2016 – 9M'm	2015 – 9M'm	%chg
Revenue	129,492	107,986	20%
PBT	5,504	20,814	-74%
Tax	5,019	3,577	40%
PAT	485	17,237	-97%
Balance Sheet Data			
	2016-Sept 'm	2016-Dec 'm	%chg
Inventory	18,506	12,603	47%
Receivables	25,447	23,604	8%
Cash	45,483	10,479	334%
Payables	59,097	29,077	103%
Net Assets	50,709	104,739	14%
Stock Data			
Price	₦795.00		
52-week range	₦615.26-₦869.99		
Market Cap. (N'm)	663,850		
1-month Avg. Vol	215,899.4		
Curr. PE	90.2x		
Bloomberg Ticker	NESTLE:NI		
Nestlé Nigeria Plc- Share Price Trend			


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**Figure 1: Nestlé's dollar debt**

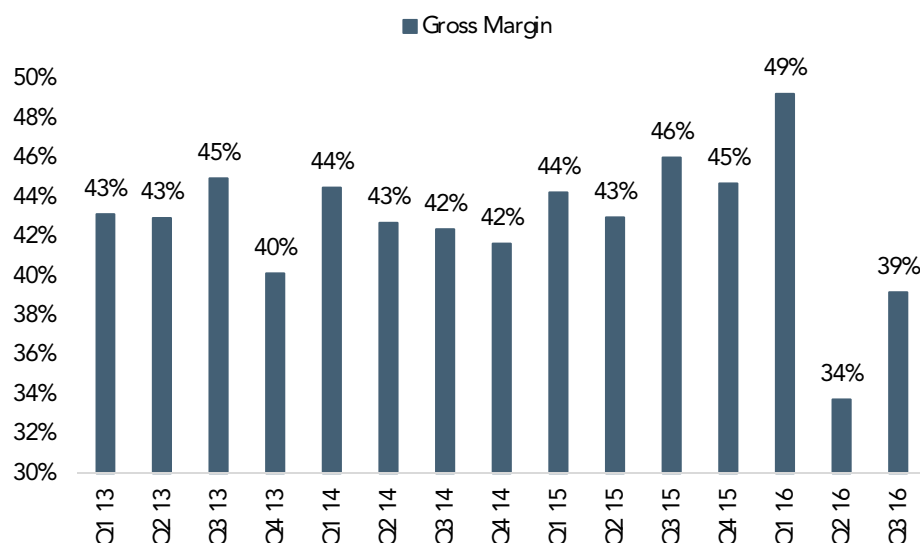


Source: Company financials, ARM Research

***Input cost pressures offset impact of price hikes on gross margin***

- As in H1 16, when revenue rose 22% YoY, Nestlé continued to record strong growth with Q3 16 sales up 17% YoY to ₦49 billion (Q3 16E: ₦47.2 billion). Our channel checks reveal Nestlé raised prices of key products by an average of 10% which drove increases across both Food (+21% YoY) and Beverage (+9% YoY) segments. However, as in Q2 16, Nestlé, grappled with a rising cost environment (YoY: CPO: +41%, Refined sugar: +83%, sorghum: +106%, Maize: +159%, Cocoa: +4.5% YTD) which offset the impact of strong revenue growth. In addition, currency weakness (+57% YoY) negatively impacted prices of milk and packaging inputs with imported components. Given the steep cost pressures, gross margin slid 7pps YoY to 39.2%.

**Figure 2: Nestlé's gross margin**



Source: Company financials, ARM Research

- Another pressure point over Q3 16 was a spike in effective tax to 101% which in notes provided stem from expiration of pioneer tax status on its Flower gate factory located in Ogun State. A breakdown of taxes remitted attributes the surge to the payment of deferred taxes (Q3 16: ₦2.3 billion) in the quarter. Overall largely reflecting the aforementioned pressures (FX, input cost and taxes), Nestlé departed from its usual practice of announcing interim dividends.

#### ***Elevated input costs drive soft earnings outlook***

- Going into the last quarter, whilst the onset of harvest season should result in improved supplies, domestic cereal prices remain elevated relative to 2015 levels. In our view, the input cost inflation stokes prospects for Nestlé to further raise prices in a bid to offset cost pressures as in the past three quarters (9M 16: +20% YoY). The foregoing drives upward revisions to our FY 16E sales forecasts 20% YoY (vs prior: 15.6% YoY) to ₦182 billion. Nonetheless, we expect that weakened consumer purchasing power will constrain Nestlé's ability to implement a complete pass-through of inflationary pressures. Consequently, we have lowered our FY 16E for gross margins to 40% (-1pps from prior).

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- Given the expiry of Nestlé's pioneer tax status on its Flowergate plant, we revised tax payments for FY16E to accommodate the impact of higher statutory tax rate. Consequently, we revise our tax rate on Nestlé's operations higher to 32% (vs. prior estimates of 23%) to ~~₦~~2.3 billion. Cumulative impact of these adjustments translates to 2016E PBT and PAT of ~~₦~~9.3 billion (-68% YoY) and ~~₦~~6.5 billion (-73% YoY) respectively (vs. ~~₦~~ 7.8 billion and ~~₦~~ 6 billion previously) and our FVE to ~~₦~~612.87 from prior.
  - Nestlé trades at a 2016E P/E of 72.4x vs. 23.6x for its Bloomberg Middle East & Africa peers. Given the weak earnings outlook and premium of last trading price to our FVE we retain our **SELL** rating on the stock.
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## Summary of Results and Forecasts - Naira (₦ million)

### QUARTERLY

Income Statement (₦'mln)*	Q1 2016A	Q2 2016A	Q3 2016A	Q4 2016E
Sales	36,131	44,312	49,040	52,025
COGS	18,350	29,361	29,838	31,355
<b>Gross profit</b>	<b>17,781</b>	<b>14,951</b>	<b>19,202</b>	<b>20,670</b>
Operating cost	8,755	9,005	8,803	9,920
<b>Operating profit</b>	<b>9,026</b>	<b>5,945</b>	<b>10,399</b>	<b>10,750</b>
Net finance cost	300	13,774	5,791	3,274
<b>Profit before taxation</b>	<b>8,725</b>	<b>7,829</b>	<b>4,608</b>	<b>7,475</b>
Tax	2044	-1683	4659	-866
<b>Profit after taxation</b>	<b>6,681</b>	<b>6,146</b>	<b>51</b>	<b>8,342</b>
<b>Earnings per share</b>	8.43	7.75	0.06	10.52

### ANNUAL

Income Statement (₦'mln)	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
Sales	143,329	151,272	181,507	197,130	211,670
COGS	82,099	83,926	108,904	116,307	122,768
<b>Gross profit</b>	<b>61,230</b>	<b>67,346</b>	<b>72,603</b>	<b>80,823</b>	<b>88,901</b>
Operating cost	32,030	33,598	36,483	41,594	46,779
<b>Operating profit</b>	<b>29,200</b>	<b>33,747</b>	<b>36,120</b>	<b>39,229</b>	<b>42,122</b>
Net finance cost	4,754	4,425	23,140	5,912	5,528
<b>PBT</b>	<b>24,446</b>	<b>29,322</b>	<b>12,980</b>	<b>33,317</b>	<b>36,594</b>
Tax	2,210	5,586	4,154	10,662	11,710
<b>PAT</b>	<b>22,236</b>	<b>23,737</b>	<b>8,826</b>	<b>22,656</b>	<b>24,884</b>
Earnings per share	28.05	29.95	11.14	28.58	31.39
Dividend per share	17.50	19.00	9.32	23.92	26.28

Balance Sheet (₦'mln)	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
<b>Assets</b>					
Fixed assets	68,673	70,500	74,687	79,201	83,949
Inventories	10,956	10,814	14,210	15,176	16,019
Trade debtors	22,729	24,971	30,856	31,541	31,750
Cash and other bank balances	3,705	12,930	23,340	21,112	20,713
<b>Total Assets</b>	<b>106,062</b>	<b>119,215</b>	<b>143,094</b>	<b>147,030</b>	<b>152,431</b>
<b>Liabilities</b>					
Trade Creditors	26,657	36,662	47,573	48,849	51,563
Borrowings	25,484	21,476	25,862	25,016	24,695
<b>Total liabilities</b>	<b>70,122</b>	<b>81,208</b>	<b>104,204</b>	<b>105,874</b>	<b>108,788</b>
<b>Shareholders' fund</b>	<b>35,940</b>	<b>38,007</b>	<b>38,890</b>	<b>41,155</b>	<b>43,644</b>

Key Ratios	FY 2014A	FY 2015A	FY 2016F	FY 2017F	FY 2018F
<b>Profitability margins</b>					
Gross margin	43%	45%	40%	41%	42%
Operating margin	20%	22%	20%	20%	20%
PBT margins	17.1%	19.4%	7.2%	16.9%	17.3%
Net margin	15.5%	15.7%	4.9%	11.5%	11.8%
ROE	61.2%	66.1%	24.8%	55.8%	58.0%
ROA	20.8%	21.1%	6.7%	15.6%	16.6%
<b>Valuation multiples</b>					
EV/EBITDA	19.06	16.52	16.03	14.80	13.77
P/CF	27.2	16.0	41.6	23.1	19.7
P/B	17.8	16.8	16.4	15.5	14.6
P/E	28.7	26.9	72.4	28.2	25.7
<b>Liquidity Ratios</b>					
Current ratio (x)	0.84	0.82	0.87	0.84	0.81
Quick ratio (x)	0.59	0.63	0.69	0.65	0.62
Cash ratio	0.08	0.22	0.30	0.26	0.25

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 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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