

Nigerian Consumers

Nestle and Unilever: Underlying fundamentals remain solid

NESTLE: NL

Rating	SELL
Price	₦1,430.00
FVE	₦1,287.54
52-week range	₦1,200 - ₦1,645.00
Market Cap. (₦'bn)	1,135
1-month Avg. Vol	116,622
Curr. PE	29.3x

UNILEVER: NL

Rating	OVERWEIGHT
Price	₦42.50
FVE	₦50.98
52-week range	₦36.10 - ₦65.00
Market Cap. (₦'bn)	346.80
1-month Avg. Vol	540,498
Curr. PE	24.9x

Analyst(s)

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- We make changes to our valuation for Nestle Nigeria (Nestle) and Unilever Nigeria (Unilever). We use a blend of DCF and relative valuation (PE and EV/EBITDA) with equal weighting and arrive at a target price of ₦1,287.54 (previous: ₦998.21) and ₦50.98 (previous: ₦34.30) for Nestle and Unilever respectively. Accordingly, we maintain our **SELL** rating on Nestle while we upgrade our recommendation on Unilever to an **OVERWEIGHT** rating. Earnings growth for the two companies averaged 17.4% as at H1 18 and we remain optimistic on the companies' ability to sustain earnings momentum in FY 18 and FY 19. We forecast EPS of ₦59.87 (+40.7% YoY) for Nestle and ₦2.13 (+19.7% YoY) for Unilever in FY 18.
- **Topline expected to remain resilient:** For FY 18, we forecast revenue growth of 12.3% and 13.1% to ₦274.3 billion and ₦102.7 billion for Nestle and Unilever. Over our forecast horizon (FY 18-22), we expect revenue to grow by a 5-year CAGR of 7.4% and 8.1% for the respective companies. Across our consumer coverage universe, Nestle and Unilever were the only two companies to report revenue¹ growth as at H1 18. Particularly, we estimate that Nestle and Unilever reported volume growth of 5% and 6% respectively during the first half amidst increased importation of imported substitutes² as well as still pressured consumer wallets which combined depressed revenue for other consumer companies. In our view, this speaks to strong consumer loyalty for their brands, enhanced route-to-market, product innovation (particularly Nestle) and product repackaging to capture the low-end of the market.
- **Unilever's FY18 EBIT margin will be weaker, but only temporary.** Supported by lower input costs and stable foreign exchange, we forecast EBIT margin of 25.4% (+259bps) and 14.1% (-15bps) for Nestle and Unilever respectively. We note that Unilever's 15bps margin contraction is largely driven by

¹ Revenue growth for the two companies averaged 11.9%

² Fallout of improved FX availability and increased smuggling activities – particularly in the North

the unusual increase in operating expense in Q2 18 (OPEX to sales ratio printed 24.1% in Q2 18 vs. 14% and 16.8% in Q1 18 and Q4 17 respectively) which we believe is related to the sale of its spread business³. We therefore view this as a one-off increase and do not expect a re-occurrence. Over our forecast horizon, we forecast an average EBIT margin of 15.7% for Unilever and 26.4% for Nestle.

- **Still a strong balance sheet:** For the two companies, we observed further balance sheet deleveraging in H1 18. Nestle total debt is down 27.7% to ₦17.4 billion (₦24.1 billion as at FY 17) while Unilever's debt is down to ₦4.3 billion (₦6.7 billion as at FY 17). While Nestle's lower debt was the result of repayment of due debt obligations using its robust cash – particularly from operating activities, Unilever used proceeds from its right issue of Q3 17⁴ to repay ~₦20 billion worth of borrowings. Accordingly, Unilever's debt-to-equity ratio in H1 18 declined to 0% from 0.89% in FY 17 while Nestle's D/E ratio declined to 39% in H1 18 from 54% in FY 17. With lower debt and relatively higher cash for the companies, Nestle reported a net cash of ₦8.5 billion (vs. net debt of ₦9.0 billion as at FY 17) while Unilever reported net cash of ₦47.9 billion (vs. ₦49.8 billion as at FY 17).
- **Valuation:** We have a TP of ₦1,287.54 and ₦50.98 on Nestle and Unilever translating to a **SELL** and **OVERWEIGHT** rating respectively. On our numbers, Nestle and Unilever trades at a forward P/E of 23.9x and 21.1x compared to historical 5-year average of average of 28.1x and 33.5x and Bloomberg MENA peers of 24.9x and 21.4x respectively. In terms of EV/EBITDA, Nestle and Unilever trades at 16.8x apiece, compared to MENA peer average of 11.9x and 13.6x respectively.

Table 1: Valuation Summary

	DCF	P/E	EV/EBITDA	FVE	Curr Price	Up/downside	Rating
<i>Weight</i>	33%	33%	33%	100%			
NESTLE	932.89	1,795.96	1,133.42	1,287.54	1,430.00	-10%	SELL
UNILEVER	36.03	70.43	46.49	50.98	42.50	19%	OVERWEIGHT

Source: Company Financials, ARM Research

N'Million	NESTLE FY 18	NESTLE FY 17	UNILEVER FY 18	UNILEVER FY 17
Revenue	274,284	244,151	102,689	90,771
Gross profit	118,765	100,871	33,171	28,943
Operating profit	69,668	55,698	14,501	12,950
Net profit	47,453	33,724	12,261	7,450
EPS	42.55	59.87	1.78	2.13

³ The increase came from Admin which rose 64%, and our finding reveals that the white-collar workers who moved to the new business were paid bonuses and allowances that would have accrued if they had remained in Unilever.

⁴ Unilever raised ₦58.9 billion via a rights issue in September 2017

Unilever Nigeria (₦50.98, OVERWEIGHT)

We leave our revenue estimate unchanged but raise our operating expenses estimate up by 9.7% to capture the surprise increase in OPEX in Q2 18. Hence, we forecast EPS to rise 19.7% to ₦2.23 in FY 18E but a 7.7% increase in FY 19F.

- Sale of its spread business completed:** In its H1 18 result, Unilever Nigeria reported its spread business (Blue Band margarine) as a discontinued operation. In terms of impact, its spread's business contributes 4.9% and 2.1% to revenue and earnings respectively (see table below). Hence, we believe the asset sale will have no material impact on earnings in 2018 and beyond. The assets of the spread business was classified as Assets Held for sale in the balance sheet with a book value of ₦2.7 billion.

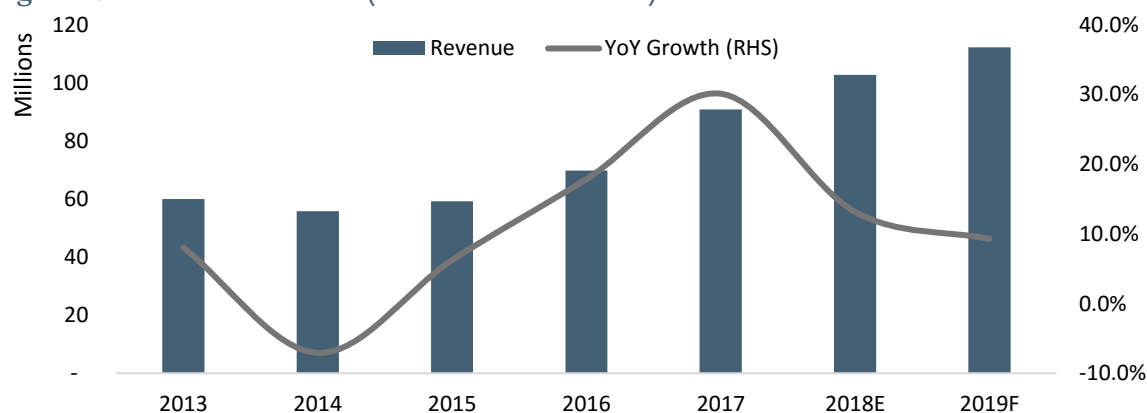
Table 2: Key financial highlight of Unilever Nigeria spread performance in 2018

₦'000	2018	2017	YoY
Revenue	2,344,435	2,475,387	-5.3%
Cost of sales	(1,814,954)	(1,843,602)	-1.6%
Gross profit	529,481	631,785	-16.2%
Operating expenses	(432,855)	(328,892)	31.6%
Operating profit	96,626	302,893	-68.1%
Net finance expense	65,103	(74,102)	-187.9%
Profit After Tax	119,679	167,017	-28.3%

Source: Company's report

- Sturdy revenue and lower costs to bolster earnings in FY 18:** In terms of our outlook, discussions with management revealed that they have received approval from their parent company to market its deodorant product under the brand name "SURE" from current "Rexona". Hence, going forward its deodorant products will carry the SURE name, phasing out Rexona out of the market. The brand name SURE is a popular within the deodorant category hence, we expect this development to drive volume growth for the category and, by extension, revenue. Thus, despite the sale of its spread business and slight underperformance of revenue to our estimate in H1 18, we have left our FY 18 revenue expectation unchanged at ₦102.7 billion (+13.1% YoY).

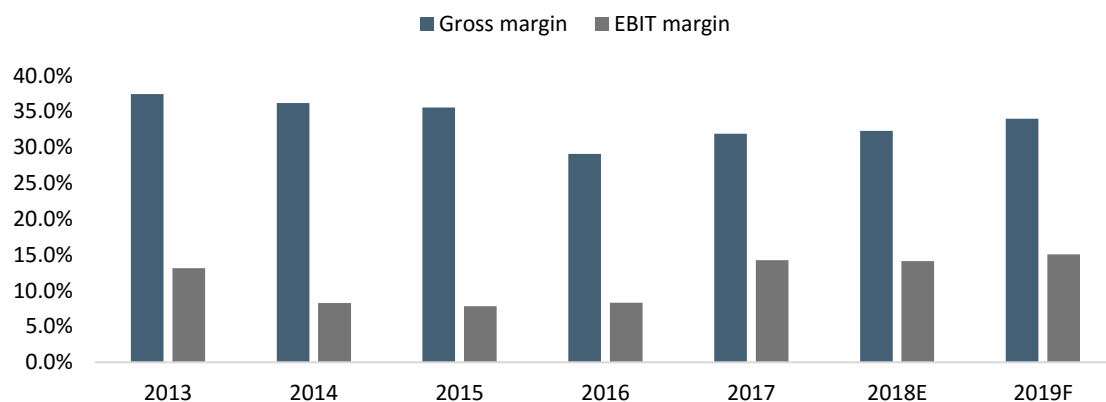
Figure 2: Trend in revenue (Actual and Forecast)



Source: Company Financials, ARM Research

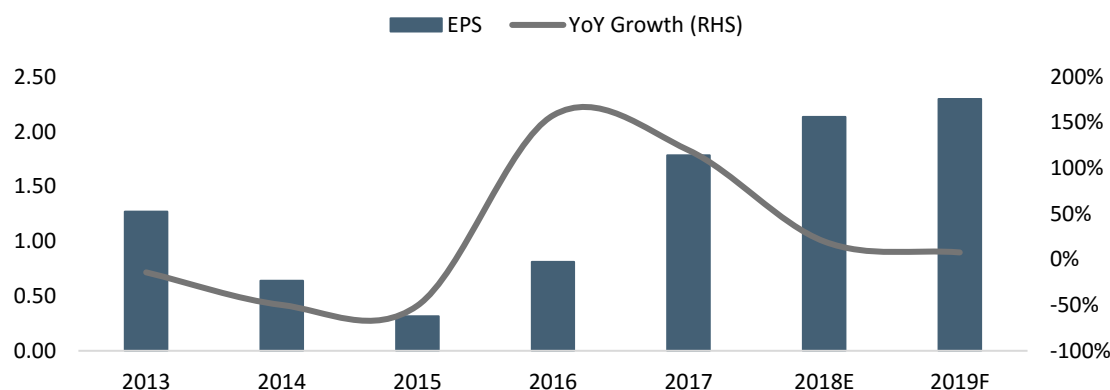
- While we have revised our cost of sales estimate lower by 4% to ₱69.5 billion (+12.5% YoY) to capture the benefit of lower global Crude Palm Oil prices, we have raised our operating expenses higher by 9.7% to capture the surprise in Q2 18 where OPEX came in 41% higher than our estimate. For us, the increase is sharp and might be a one-off transaction, possibly related to the sale of its spread business. Accordingly, we project EBIT to rise 12% YoY to ₱14.5 billion with a 15bps contraction in related margin to 14.1% (vs. 5-year average of 10.4%).
- On balance, the foregoing combined with our net finance expense estimate of ₱2.5 billion translates to a PAT of ₱12.3 billion (+64.6% YoY) and EPS at ₱2.23 (vs. ₱1.78 in FY 17). Accordingly, having adjusted our valuation methodology, we raise our FVE to ₱50.82 (previous: ₱34.30) which is at a 12.9% premium to current pricing thus, we upgrade our recommendation to an **OVERWEIGHT**. With the idle cash of ₱47 billion on its books, management guides to possible acquisitions of businesses that either align with the group's product categories or supplies its key raw materials. While the former would be supportive of higher revenue, the latter would be beneficial in terms of lower costs. Irrespective, we view these benefits as long term and potential upside to earnings and stock rating.

Figure 3: Trend in gross and EBIT margin (Actual and Forecast)



Source: Company Financials, ARM Research

Figure 4: Trend in EPS (Actual and Forecast)



Source: Company Financials, ARM Research

Summary of Results and Forecasts - Naira (₦) – Unilever Nigeria

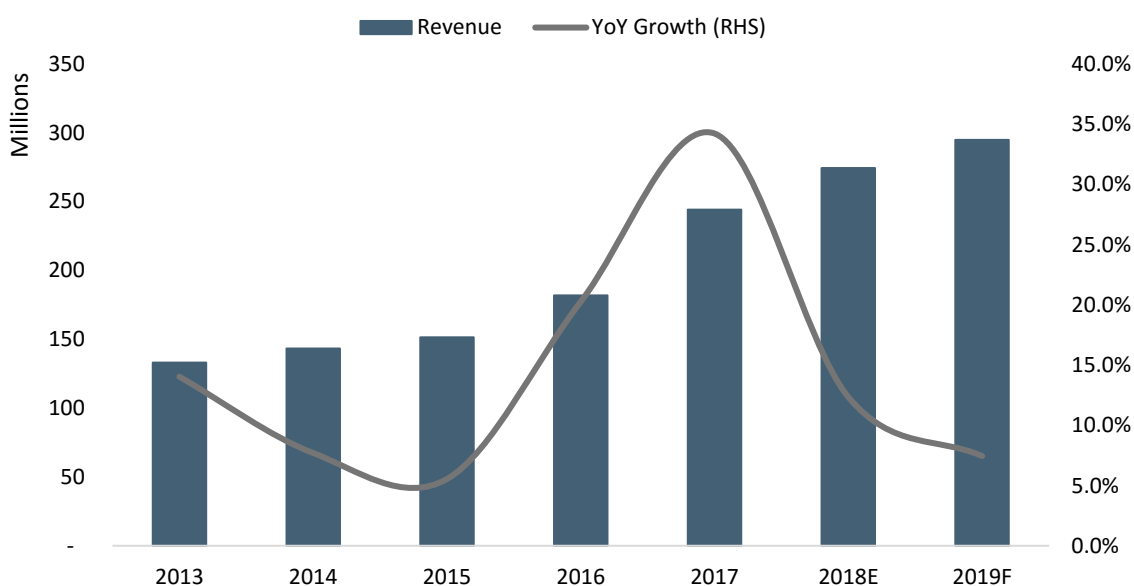
ANNUAL					
Income Statement (₦' m) *					
	2016A	2017A	2018E	2019F	2020F
Revenue	69,777	90,771	102,698	112,217	121,711
COGS	49,481	61,828	69,526	74,063	79,112
Gross Profit	20,296	28,943	33,171	38,154	42,599
Operating Cost	14,615	15,976	18,691	21,321	23,125
Operating Profit	5,805	12,950	14,501	16,889	19,535
Net finance Cost	(1,699)	(1,743)	2,528	2,527	2,223
PBT	4,106	11,207	17,029	19,415	21,757
Tax	1,035	3,757	4,768	6,213	6,962
PAT	3,072	7,450	12,261	13,202	14,795
Balance Sheet (₦ '000) *					
Fixed Assets	29,272	29,881	30,887	32,174	33,433
Stocks	9,878	11,479	13,210	14,072	15,031
Trade debtors	18,946	27,621	35,944	39,276	42,599
Cash & other bank balances	12,474	50,494	54,583	59,901	69,626
Total Assets	72,491	121,084	136,234	147,032	162,299
Liabilities					
Trade Creditors	32,477	33,409	39,630	40,735	43,512
Non-current Liabilities	7,288	8,481	8,995	9,581	10,237
Total liabilities	53,513	36,695	42,906	44,009	46,783
Shareholders' fund	11,690	75,908	84,614	93,723	105,559
Key Ratios					
	2016A	2017A	2018E	2019F	2020F
Gross Margin	29.1%	31.9%	32.3%	34.0%	35.0%
EBIT Margin	5.9%	12.3%	16.6%	17.3%	17.9%
PBT Margin	5.9%	12.3%	16.6%	17.3%	17.9%
Net Margin	8.3%	14.3%	14.1%	15.1%	16.1%
EPS	0.81	1.78	2.13	2.30	2.58
P/E	43.11	23.00	19.21	17.84	15.92
EV/EBITDA	17.35	7.13	9.90	8.31	6.84
ROA	5.0%	7.7%	9.5%	9.3%	9.6%
ROE	26.3%	9.8%	14.5%	14.1%	14.0%

Nestle Nigeria (₦1,287.54, SELL)

We cut our revenue and cost of sales estimate modestly by 1.6% and 4.1% respectively following H1 18 results. However, with our 52% cut to our interest expense forecast, we expect EPS to rise 40.7% to ₦59.87 in FY 18E but a 10.2% increase in FY 19E.

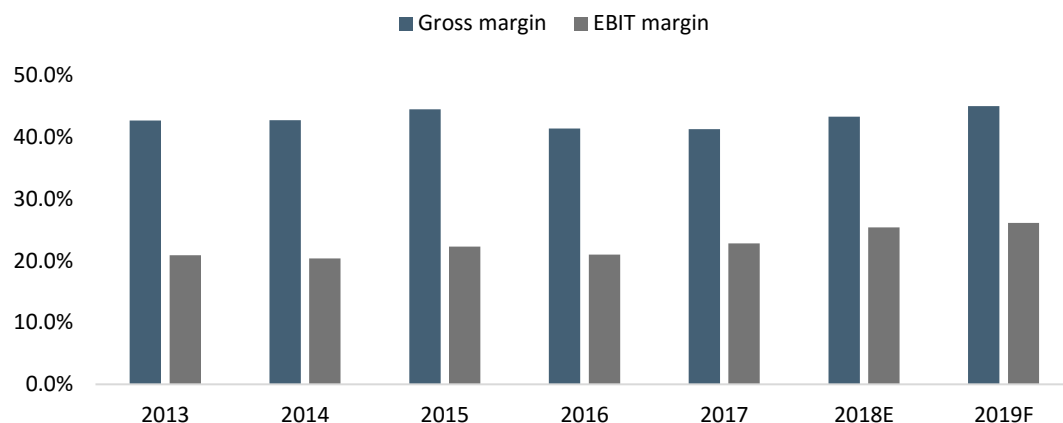
- **Nestle on track to post record profit in 2018:** For FY 18, supported by Nestle's strong market position for its brands and new product additions, we expect the company to maintain volume growth over the rest of 2018. We therefore look for sales growth of 12.3% YoY to ₦274 billion with much of the growth expected to come in Q4 18 supported by the festive season. In the medium term, we expect revenue to rise by a 5-year CAGR of 7.4% (FY 2018-2022), driven by volume as we envisage slower price increases over our forecast horizon. On cost of sales, the robust FX reserves at \$45 billion guides to the apex bank ability to continue to intervene at all FX segments hence, we expect the naira to remain stable over the FY 18. This alongside moderation in key inputs costs including sugar and Maize drives our cost of sales expectation of ₦155.5 billion (+8.5% YoY). This translates to a 2018E gross margin of 43.3% (FY 17: 41.3%) with gross margin over our forecast horizon (FY 18 - 22E) expected to average 45%.
- Supported by slower rise in input costs and sustained operating efficiency, we have modelled an operating profit growth of 25.1% YoY to ₦69.9 billion in FY 18E translating to an EBIT margin of 25.4% which is a 259bps expansion from FY 17. Over our forecast horizon, we project EBIT margin to average 26% compared to average margin of 21.5% over FY 2013 – 2017.

Figure 5: Trend in revenue (Actual and Forecast)



Source: Company Financials, ARM Research

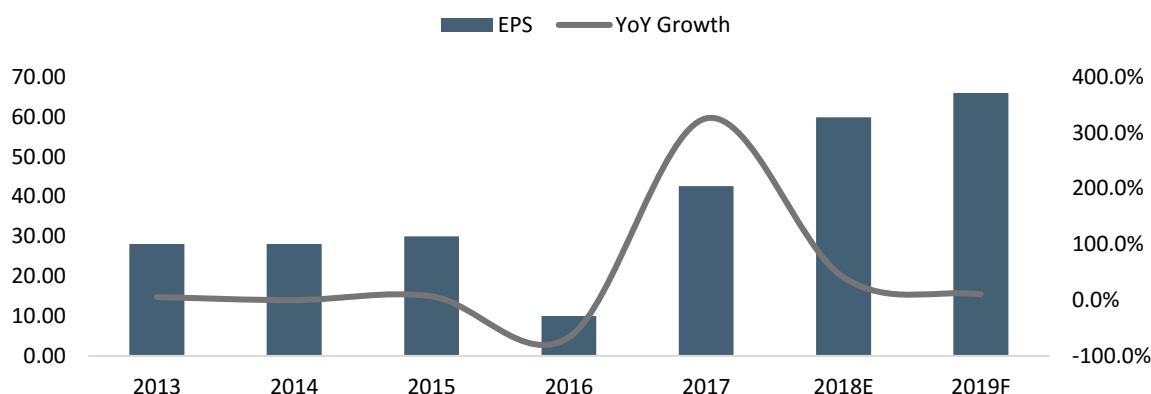
Figure 6: Trend in gross and EBIT margin (Actual and Forecast)



Source: Company Financials, ARM Research

- On finance costs, Nestle is due to pay \$26 million in 2018 however, with the FX debt already valued at ~₦360/\$ in its balance sheet and our expectation of exchange rate stability, we do not envisage any material FX loss when the debt is settled. Our expectation going forward is for finance costs to be more reflective of interest expense which guides to our FY 18 estimate of ₦2.3 billion compared to ₦15.1 billion in FY 17. Additionally, we expect the company to generate finance income of ₦2.4 billion on its robust cash, translating to a net finance income of ₦115 million over FY 18 (net finance cost of ₦8.9 billion in FY 17).
- Given the above, our EPS forecast over FY 18 comes to ₦59.87, implying a 40.7% YoY increase from last year. We note that much of the growth stems from our expectation of a marked decline in finance cost. On our EPS forecast, we expect the company to pay an interim and final dividend of ₦21 and ₦38.80, translating to a dividend yield of 1.5% and 2.7% respectively based on Nestle last closing price. Over our forecast horizon, we model EPS growth of 14% compared to 16.3% over FY 2012 – 2017 driven by a combination of stronger revenue, lower input and finance costs. We have a TP of ₦1,287.54 which represents a 10% decline from current price and thus, maintain our **SELL** recommendation.

Figure 7: Trend in EPS (Actual and Forecast)



Summary of Results and Forecasts - Naira (₦) – Nestle Nigeria

ANNUAL					
Income Statement (₦' m) *					
	2016A	2017A	2018E	2019F	2020F
Revenue	181,911	244,151	274,284	294,709	316,695
COGS	106,583	143,280	155,519	162,090	174,182
Gross Profit	75,328	100,871	118,765	132,619	142,513
Operating Cost	37,114	45,173	49,097	55,700	60,172
Operating Profit	38,213	55,698	69,668	76,919	82,341
Net finance Cost	16,665	8,870	(115)	30	450
PBT	21,548	46,829	69,783	76,889	81,891
Tax	13,623	13,105	22,331	24,604	26,205
PAT	7,925	33,724	47,453	52,284	55,686
Balance Sheet (₦ '000) *					
Fixed Assets	71,850	74,299	71,105	72,739	74,483
Stocks	20,638	23,910	25,953	27,049	29,067
Trade debtors	25,747	33,456	37,585	40,384	43,396
Cash & other bank balances	51,351	15,139	17,352	14,607	12,581
Total Assets	169,586	146,804	151,994	154,778	159,528
Liabilities					
Trade Creditors	64,662	49,056	62,208	64,836	69,673
Non-current Liabilities	17,674	22,245	21,767	22,222	22,412
Total liabilities	138,708	101,926	107,066	109,794	114,485
Shareholders' fund	30,878	44,878	44,929	44,984	45,043
Key Ratios					
	2016A	2017A	2018E	2019F	2020F
Gross Margin	41%	41%	43%	45%	45%
EBIT Margin	21%	23%	25%	26%	26%
PBT Margin	12%	19%	25%	26%	26%
Net Margin	4%	14%	17%	18%	18%
EPS	10.00	42.55	59.87	65.96	70.25
P/E	81.02	36.57	25.99	23.59	22.15
EV/EBITDA	14.51	19.98	16.08	14.68	13.73
ROA	5%	21%	32%	34%	35%
ROE	23%	89%	106%	116%	124%

ARM ratings and recommendations

M 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
STRONG BUY	>20%	BUY	>20%
OVERWEIGHT	10% — 20 %	NEUTRAL	5% — 20 %
NEUTRAL	0% — 10 %	SELL	<5%
UNDERWEIGHT	-5% — 0%		
SELL	<-5%		

RECOMMENDATION KEY	
Rating	Recommendation
BUY	Accumulate security to a substantial extent constrained only by portfolio diversification considerations
OVERWEIGHT	Accumulate security to an extent moderated by cognizance of its benchmark weight
NEUTRAL	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
UNDERWEIGHT	Minimize exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio
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