19 April 2017

Annual Report | Sector: Consumer

Nestle India

BSE SENSEX	S&P CNX
29,337	9,104

CMP: INR6,301 TP: INR6,665(+6%) Neutral

Non-Maggi volumes continue to be tepid

Increasing cash and cash equivalents restricting RoCE improvement

Stock Info

Bloomberg	NEST IN
Equity Shares (m)	96.4
52-Week Range (INR)	7390 / 5490
1, 6, 12 Rel. Per (%)	3/-12/-11
M.Cap. (INR b)	607.5
M.Cap. (USD b)	9.4
Avg Val (INRm)/Vol m	255
Free float (%)	37.2

Financials Snapshot (INR b)

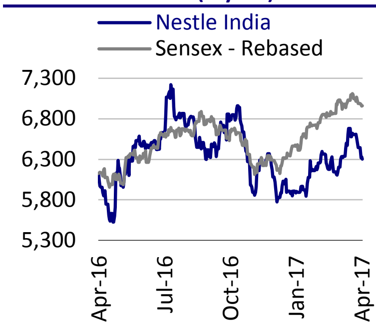
Y/E Dec	2016	2017E	2018E
Net Sales	91.6	104.5	119.3
EBITDA	18.0	21.2	24.6
PAT	11.4	13.4	15.7
EPS (INR)	118.0	139.2	163.3
Gr. (%)	-1.6	18.0	17.3
BV/Sh (INR)	312.6	360.1	419.7
RoE (%)	39.0	41.4	41.9
RoCE (%)	38.8	41.0	41.6
P/E (x)	53.4	45.3	38.6
P/BV (x)	20.2	17.5	15.0

Shareholding pattern (%)

As On	Dec-16	Sep-16	Dec-15
Promoter	62.8	62.8	62.8
DII	6.8	6.0	5.4
FII	13.3	14.2	14.9
Others	17.2	17.1	17.0

FII Includes depository receipts

Stock Performance (1-year)



Key takeaways from Nestle India's (NEST) CY16 annual report:

- **Continued poor volumes in non-Maggi portfolio**
- **Blended realization growth lower than earlier years**
- **A&P to sales declines YoY, remains well below that of FMCG/food peers**
- **Continued moderate dividend payout restricts RoCE expansion, despite increasing balance sheet efficiency**

- **Maggi sales rise, but still below historical levels**: NEST's annual report highlighted disappointing segmental performances (these details are not disclosed in its quarterly results), particularly on the volumes front. **Prepared dishes and cooking aids** sales increased 74.9% YoY (primarily led by Maggi noodles) to INR23b in CY16 (24.2% of overall annual sales), but were 22% lower than INR29.6b recorded by the segment in CY14 (pre-Maggi crisis period). In its August 2016 analyst meet, management had admitted that there is still some residual stigma associated with this category due to rising competitive intensity and some people moving to other snacking options. While the market share is gradually recovering, the pace of recovery is slower – at 60%, its market share is considerably lower than the historical levels of 80%.
- **Non-Maggi volumes flat YoY**: The largest segment **milk and nutrition** (49.7% of CY16 sales) grew only 0.9% YoY in value terms – the lowest level of growth since the turn of the millennium. Even this increase was mainly led by realization growth of 2.5%, with volumes of the segment declining (-1.5% YoY) for the fifth consecutive year. In metric tonnes, volumes in this segment in CY16 were even lower than those reported in CY09. **Beverages** sales declined 3.1% in CY16 – the worst performance since CY04. Volumes were flat at 1.3% YoY (even on a low base of double-digit volume decline in the preceding two years), while realizations fell 4.3% in this segment. **Chocolate & confectionary** sales growth of 6.6% (7.7% volume growth and 1% realization decline) may appear decent amid other disappointments, but even this has to be seen in context of a low base of sales (-2.6% and -11.4%) and volumes (-12.5% and -19.5%) in the preceding two years. Absolute segment volumes in CY16 were lower than CY07 levels.
- **Realization growth muted:** There was one bright spot amid the gloomy numbers, i.e. weighted-average realization growth (which had been inordinately high in the preceding years) was the lowest in many years. This may be a function of low material costs, but that has not dissuaded the company from taking price increases earlier, even at the cost of volumes.

Krishnan Sambamoorthy (Krishnan.Sambamoorthy@MotilalOswal.com); +91 22 3982 5428
Vishal Punmiya (Vishal.Punmiya@MotilalOswal.com); +91 22 3980 4261

- **Spate of new launches a positive; A&P to sales disappointing**: The most interesting aspect of NEST's CY16 performance was the sharp increase in new launches. The annual report mentions 39 new products/re-launches/variants under existing brands, which is far higher than the preceding years. However, we also note that domestic sales were very weak despite these launches. While it is true that some launches were back-ended, a few like 'Grekyo' are niche and others may take some time to attain significance for the company with ~INR94b of gross sales, it is also not incorrect to state that the noise on new launches has not heralded any material reversal in volume growth trends as yet. Interestingly, A&P increased only 8% YoY and declined by 30bp as a percentage to sales to 6.2% in CY16. NEST has always had weak A&P to sales compared to peers. This is particularly surprising given that high/consistently expanding gross margins provide greater room for A&P spends. Volume growth across categories has been poor for many years, with new launches probably not receiving the required A&P support.
- **Balance sheet efficiency not translating to RoCE growth due to low dividend payout:** Net cash and cash equivalents have increased very sharply over past three years from INR3.6b to INR25.4b, mainly due to (i) improved fixed asset turns over this period, (ii) improvement in cash conversion cycle from 8 days to 10 days and (iii) reduction in other assets to total assets from 3.6% in CY13 to 3.2% in CY16. Thus, while adj. PAT has reduced to INR11.4b in CY16 from INR11.8b in CY13, we note that cash generation has been strong. The rise in cash and cash investments dilutes RoE and RoCE, in our view. While RoIC has nearly tripled from 63% in CY13 to nearly 200% in CY16, we note that RoE has declined from 56% to 39% and RoCE has remained flattish at 38-39%. Despite large cash generation through balance sheet efficiency, dividend payout has been a meager 40%-55% over past seven years, diluting RoE and RoCE.
- **Valuation and view:** While the new CEO taking over in June 2015 has brought much-needed improvements in terms of stakeholder communication and new launches, there have been other areas of disappointments, such as (i) no sharp A&P increases to spur growth and (ii) lack of efforts to cut prices in categories where volumes have scope to increase (an area that management had stated that it may look into). The frequently stated double-digit volume-led sales growth is taking more time to come through compared to initial expectations. We have cut our numbers by 3.3% and 4.5% for CY17E and CY18E, respectively. Still our forecasts are fairly aggressive, with (i) 14% sales growth for CY17E and CY18E and (ii) operating margin improvements, which may be at risk if milk procurement prices increase steeply. Valuations are not cheap at 38.6x CY18E EPS. While valuations are lower than historical levels, we believe this is not the business that it previously was (it used to report consistent double-digit volume growth with over 100% RoCEs). Maintain **Neutral** with a revised target price of INR6,665 (39x March 2019 EPS, 20% discount to 3Y average multiple).

Exhibit 1: Nestle's segment-wise performance

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Volume (MT)										
Milk Products	107,736	118,651	134,142	144,397	147,984	140,386	138,772	135,591	131,980	129,963
Beverages	24,107	24,114	23,369	26,458	26,692	25,353	27,717	24,673	22,130	22,411
Prepared Dishes & Cooking Aids	98,259	127,835	155,555	193,494	219,041	236,554	245,443	254,553	103,138	178,467
Chocolate & Confectionery	35,752	40,200	44,116	53,483	52,678	47,745	46,718	41,080	33,083	35,615
Total	**265,854**	**310,800**	**357,182**	**417,832**	**446,395**	**450,038**	**458,650**	**455,897**	**290,331**	**366,456**
Volume (as a % of total)										
Milk Products (MT)	41%	38%	38%	35%	33%	31%	30%	30%	45%	35%
Beverages (MT)	9%	8%	7%	6%	6%	6%	6%	5%	8%	6%
Prepared Dishes & Cooking Aids (MT)	37%	41%	44%	46%	49%	53%	54%	56%	36%	49%
Chocolate & Confectionery	13%	13%	12%	13%	12%	11%	10%	9%	11%	10%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Volume Growth (%)										
Milk Products	5.4%	10.1%	13.1%	7.6%	2.5%	-5.1%	-1.1%	-2.3%	-2.7%	-1.5%
Beverages	7.9%	0.0%	-3.1%	13.2%	0.9%	-5.0%	9.3%	-11.0%	-10.3%	1.3%
Prepared Dishes & Cooking Aids	24.8%	30.1%	21.7%	24.4%	13.2%	8.0%	3.8%	3.7%	-59.5%	73.0%
Chocolate & Confectionery	17.6%	12.4%	9.7%	21.2%	-1.5%	-9.4%	-2.2%	-12.1%	-19.5%	7.7%
Total	**13.8%**	**16.9%**	**14.9%**	**17.0%**	**6.8%**	**0.8%**	**1.9%**	**-0.6%**	**-36.3%**	**26.2%**
Weighted average volume growth	**14.4%**	**17.9%**	**15.3%**	**17.5%**	**7.2%**	**1.3%**	**2.0%**	**-0.3%**	**-25.3%**	**35.8%**
Price (INR/Kg)										
Milk Products	146	163	172	192	226	275	293	337	354	363
Beverages	299	332	344	340	400	443	478	543	604	578
Prepared Dishes & Cooking Aids	79	82	86	89	98	103	110	116	127	129
Chocolate & Confectionery	159	169	175	182	209	245	275	305	336	333
Total	**137**	**144**	**146**	**153**	**172**	**191**	**205**	**222**	**290**	**259**
Price Growth (%)										
Milk Products	16.3%	11.7%	5.4%	11.6%	17.8%	21.4%	6.7%	15.0%	4.9%	2.5%
Beverages	10.6%	10.9%	3.6%	-1.2%	17.8%	10.6%	7.9%	13.7%	11.2%	-4.3%
Prepared Dishes & Cooking Aids	4.6%	3.5%	4.3%	3.9%	10.3%	4.4%	7.0%	5.8%	9.5%	1.1%
Chocolate & Confectionery	6.1%	6.3%	3.5%	4.3%	14.4%	17.3%	12.4%	10.8%	10.1%	-1.0%
Total	**8.9%**	**4.9%**	**1.6%**	**4.4%**	**12.6%**	**10.9%**	**7.2%**	**8.6%**	**30.7%**	**-10.8%**
Weighted average price growth	**11.1%**	**8.8%**	**4.6%**	**6.6%**	**15.2%**	**14.6%**	**7.7%**	**11.6%**	**7.3%**	**0.8%**
Gross Sales (INR m)										
Milk Products	15,756	19,388	23,113	27,763	33,510	38,594	40,712	45,752	46,694	47,137
Beverages	7,219	8,009	8,042	8,994	10,684	11,227	13,241	13,398	13,360	12,949
Prepared Dishes & Cooking Aids	7,811	10,519	13,350	17,250	21,545	24,302	26,982	29,613	13,141	22,989
Chocolate & Confectionery	5,686	6,795	7,719	9,759	10,997	11,696	12,864	12,532	11,109	11,843
Total	**36,472**	**44,711**	**52,224**	**63,766**	**76,736**	**85,819**	**93,799**	**101,295**	**84,304**	**94,917**
Gross Sales (as a % of total)										
Milk Products	43%	43%	44%	44%	44%	45%	43%	45%	55%	50%
Beverages	20%	18%	15%	14%	14%	13%	14%	13%	16%	14%
Prepared Dishes & Cooking Aids	21%	24%	26%	27%	28%	28%	29%	29%	16%	24%
Chocolate & Confectionery	16%	15%	15%	15%	14%	14%	14%	12%	13%	12%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Gross Sales Growth (%)										
Milk Products	22.6%	23.0%	19.2%	20.1%	20.7%	15.2%	5.5%	12.4%	2.1%	0.9%
Beverages	19.4%	10.9%	0.4%	11.8%	18.8%	5.1%	17.9%	1.2%	-0.3%	-3.1%
Prepared Dishes & Cooking Aids	30.6%	34.7%	26.9%	29.2%	24.9%	12.8%	11.0%	9.7%	-55.6%	74.9%
Chocolate & Confectionery	24.8%	19.5%	13.6%	26.4%	12.7%	6.4%	10.0%	-2.6%	-11.4%	6.6%
Total	**23.9%**	**22.6%**	**16.8%**	**22.1%**	**20.3%**	**11.8%**	**9.3%**	**8.0%**	**-16.8%**	**12.6%**

Source: Company, MOSL

Exhibit 2: Financial overview of Nestle India

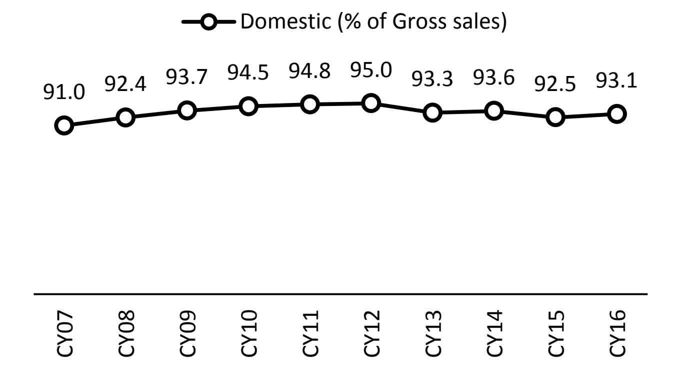
	CY11	%	CY12	%	CY13	%	CY14	%	CY15	%	CY16	%
Total Revenues	**74,908**	**100.0**	**83,023**	**100.0**	**90,619**	**100.0**	**98,063**	**100.0**	**81,233**	**100.0**	**91,593**	**100.0**
Raw Material Consumed												
Milk/SMP	9,044	12.1	9,215	11.1	8,281	9.1	11,202	11.4	9,309	11.5	8,848	9.7
Raw coffee/Green Coffee	3,091	4.1	3,257	3.9	3,714	4.1	3,783	3.9	3,718	4.6	3,239	3.5
Sugar	1,863	2.5	2,067	2.5	1,961	2.2	1,778	1.8	1,387	1.7	1,753	1.9
Wheat flour	3,106	4.1	3,698	4.5	4,306	4.8	4,468	4.6	1,914	2.4	3,485	3.8
Vegetable Oils	3,235	4.3	3,261	3.9	3,373	3.7	3,509	3.6	1,997	2.5	2,859	3.1
Packaging Material	5,907	7.9	6,300	7.6	7,034	7.8	7,582	7.7	5,483	6.8	6,632	7.2
Others	9,705	13.0	9,965	12.0	12,556	13.9	12,918	13.2	10,882	13.4	11,981	13.1
Gross Profit	**38,957**	**52.0**	**45,259**	**54.5**	**49,396**	**54.5**	**52,823**	**53.9**	**46,544**	**57.3**	**52,796**	**57.6**
Employee Benefit Expense	5,717	7.6	6,877	8.3	7,672	8.5	8,706	8.9	9,516	11.7	11,132	12.2
Other Expenses												
Power and Fuel	2,958	3.9	3,709	4.5	3,854	4.3	3,843	3.9	2,220	2.7	2,328	2.5
Repairs	754	1.0	930	1.1	962	1.1	1,031	1.1	1,056	1.3	1,213	1.3
Advertising and Sales Promotion	3,226	4.3	3,559	4.3	3,955	4.4	4,455	4.5	5,252	6.5	5,670	6.2
Freight and Transport	3,525	4.7	3,842	4.6	4,374	4.8	4,795	4.9	3,870	4.8	4,556	5.0
Royalty	2,832	3.8	3,173	3.8	3,396	3.7	3,863	3.9	3,342	4.1	3,980	4.3
Others	4,416	5.9	4,912	5.9	5,379	5.9	5,603	5.7	5,343	6.6	5,960	6.5
EBITDA	**15,528**	**20.7**	**18,257**	**22.0**	**19,804**	**21.9**	**20,527**	**20.9**	**15,946**	**19.6**	**17,958**	**19.6**
Less: Interest Expense	51		266		365		142		33		35	
Less: Depreciation	1,533		2,772		3,300		3,375		3,473		3,536	
Add: Other Income	509		633		1,222		1,359		1,621		2,139	
Profit before Tax (PBT)	**14,452**	**19.2**	**15,852**	**19.0**	**17,362**	**19.1**	**18,368**	**18.6**	**14,062**	**17.2**	**16,526**	**17.9**
Tax	4,264		4,847		5,609		5,897		2,504		5,150	
Profit after Tax (PAT)	**10,189**	**13.6**	**11,006**	**13.2**	**11,753**	**12.9**	**12,472**	**12.7**	**11,558**	**14.1**	**11,376**	**12.3**

Source: Company, MOSL

Domestic sales increase, mainly led by a weak Maggi base

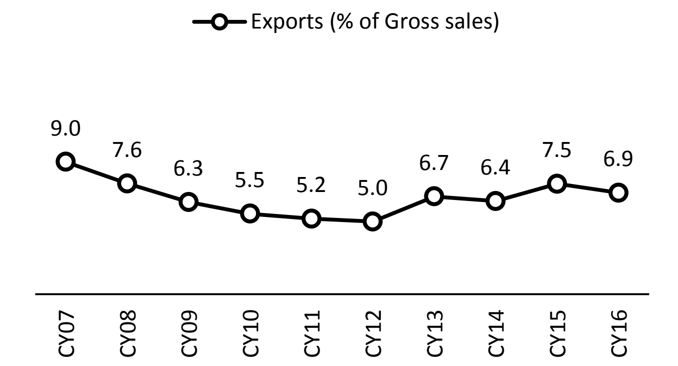
- Net sales increased 12.8% to INR91.6b in CY16 from INR81.2b in the previous year. However, we note that the recovery has come on the back of a very low base (Maggi sales were affected for nearly six months in CY15). We also note that net sales in CY16 were much below INR98.1b reported in CY14 (the year before the Maggi crisis).
- Exports increased marginally by 3.5% YoY to INR6.6b in the year. INR exports to Nepal and Bhutan (~27% of exports) increased 18.4% YoY, while exports to other countries declined 1.1% YoY. Exports as a proportion of gross sales declined YoY as domestic sales were adversely affected in CY15. Domestic gross sales increased 13.3% YoY to INR88.3b (again much behind INR94.9b recorded in CY14). Exports accounted for 6.9% of sales in CY16.

Exhibit 3: Domestic sales increased 13.3% YoY in CY16



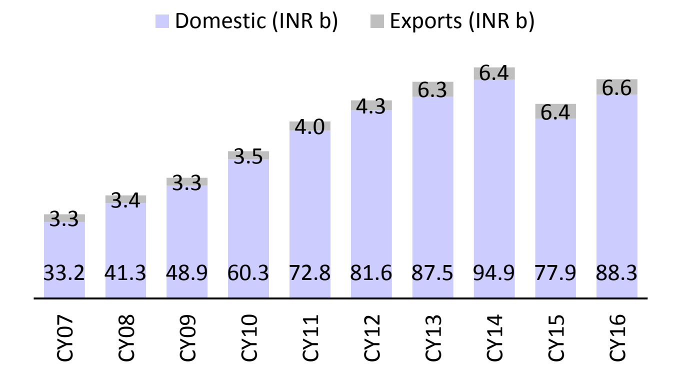
Source: Company, MOSL

Exhibit 4: …while exports rose marginally by 3.5% YoY



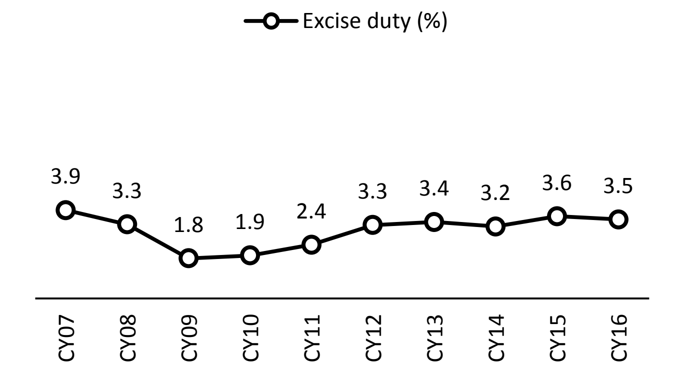
Source: Company, MOSL

Exhibit 5: Exports proportion was lower in CY16



Source: Company, MOSL

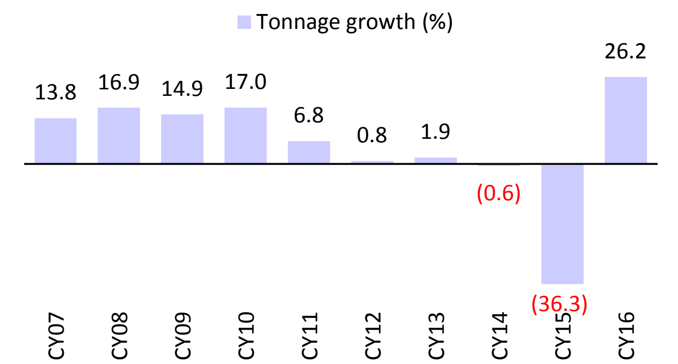
Exhibit 6: Excise duty was at 3.6% of sales in CY16



Source: Company, MOSL

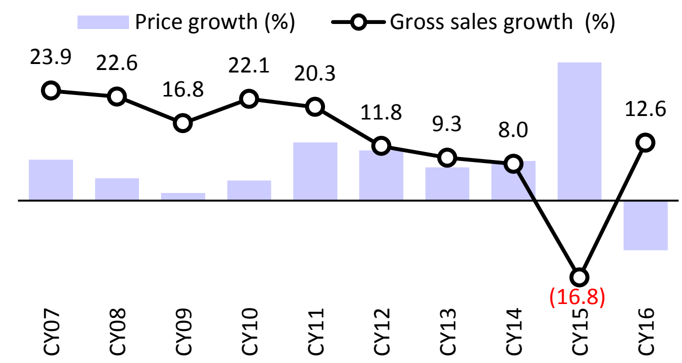
- The company exports its products to 35 markets, with the top 5 being Turkey, Bangladesh, Nepal, Bhutan and Taiwan. Growth in exports, albeit moderate at 3.5%, was led by a recovery in Maggi sales and increased confectionary sales to eight new markets in the Middle East and Ghana. While tea exports were flat, coffee exports increased led by higher demand from Romania and Bangladesh.
- Excise duty to gross sales was stable at 3.5% in CY16 v/s 3.6% in CY15. Excise to sales has been increasing gradually from 1.8% in CY09.

Exhibit 7: Overall tonnage grew 26.2%, majorly due to Maggi issue in the base…



Source: Company, MOSL

Exhibit 8: …leading to gross sales growth of 12.6% YoY

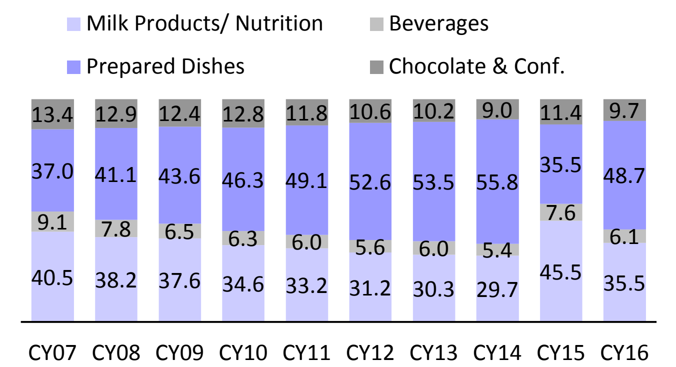


Source: Company, MOSL

Non-Maggi sales and volumes disappoint again

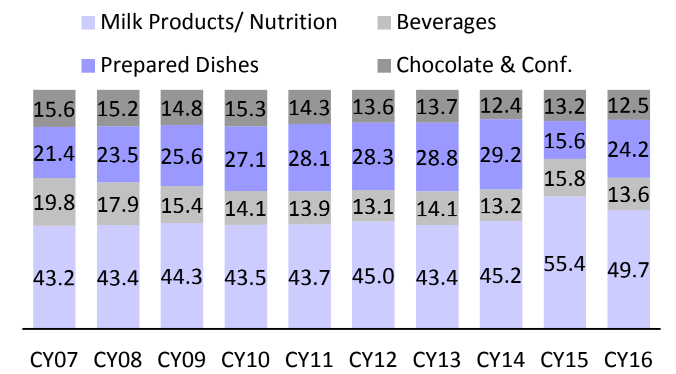
- NEST's annual report highlighted disappointing segmental performances (these details not disclosed in its quarterly results), particularly on the volumes front. Prepared dishes and cooking aids sales increased 74.9% YoY (primarily led by Maggi noodles) to INR23b in CY16 (24.2% of overall annual sales), but were 22% lower than INR29.6b recorded in CY14 (pre-Maggi crisis period). In its August 2016 analyst meet, management had admitted that there is still some residual stigma associated with the category due to rising competitive intensity and some people moving to other snacking options. While the market share is gradually recovering, the pace of recovery is slower – at 60%, its market share is considerably lower than the historical levels of 80%. From a category salience point of view, the contribution of the prepared dishes and cooking aids segment to sales of 24.2% is the lowest since CY08 (barring CY15, when Maggi sales fell off a cliff).

Exhibit 9: Volume contribution



Source: Company, MOSL

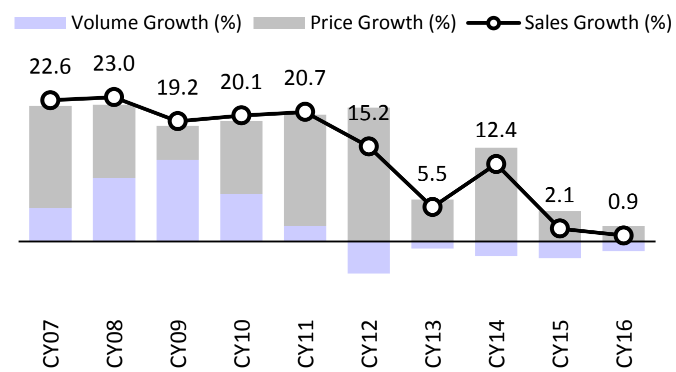
Exhibit 10: Sales contribution



Source: Company, MOSL

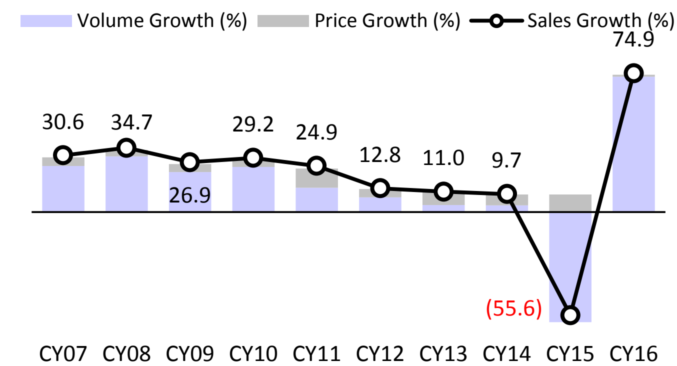
- From a segmental sales perspective, the bigger disappointment continues to be the non-Maggi portfolio. The largest segment milk and nutrition (49.7% of CY16 sales) grew only 0.9% YoY in value terms – the lowest level of growth since the turn of the millennium. Even this growth was mainly led by realization growth of 2.5%, with volumes of the segment declining (-1.5% YoY) for the fifth consecutive year. In metric tonnes, volumes in this segment in CY16 were even lower than those reported in CY09.

Exhibit 11: Milk Products/Nutrition



Source: Company, MOSL

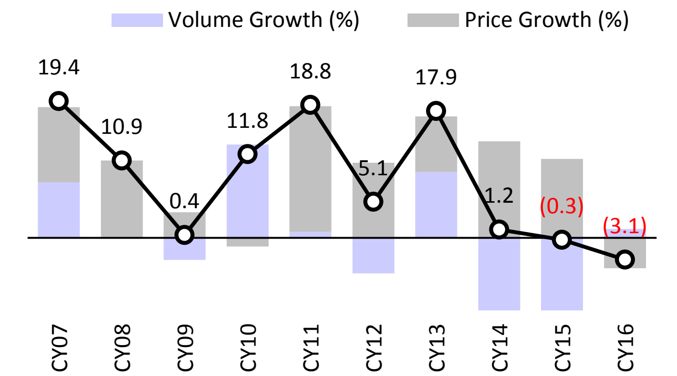
Exhibit 12: Prepared Dishes and Cooking Aids



Source: Company, MOSL

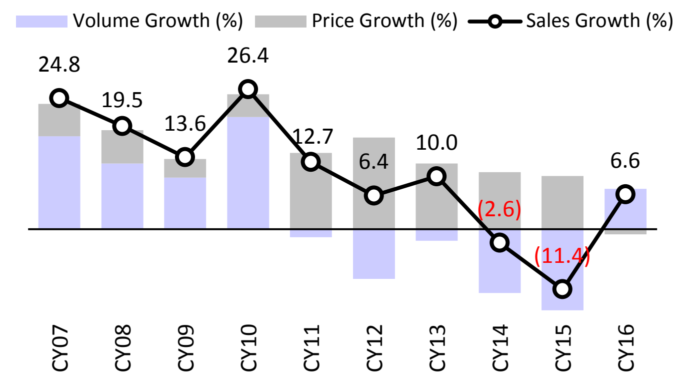
- The other two non-Maggi segments – beverages and chocolate & confectionary – also reported tepid numbers in CY16.
- Beverages sales declined 3.1% in CY16, the worst performance since CY04. Volumes were flat at 1.3% YoY (even on a base of double-digit volume decline in the preceding two years), while realizations declined 4.3% in this segment. NEST has lost considerable market share in Nescafe to Hindustan Unilever's Bru. TGBL has also forayed in this space recently with its premium coffee brand. According to management, intensifying competition and a volatile external environment were the key causes of a challenging year.
- Chocolate & confectionary sales growth of 6.6% (7.7% volume growth and 1% realization decline) may appear to be decent amid other disappointments, but even this has to be seen in the context of low base of sales (-2.6% and -11.4%) and volumes (-12.5% and -19.5%) in the preceding two years. Absolute segment volumes in CY16 were lower than CY07 levels.

Exhibit 13: Coffee & Beverages



Source: Company, MOSL

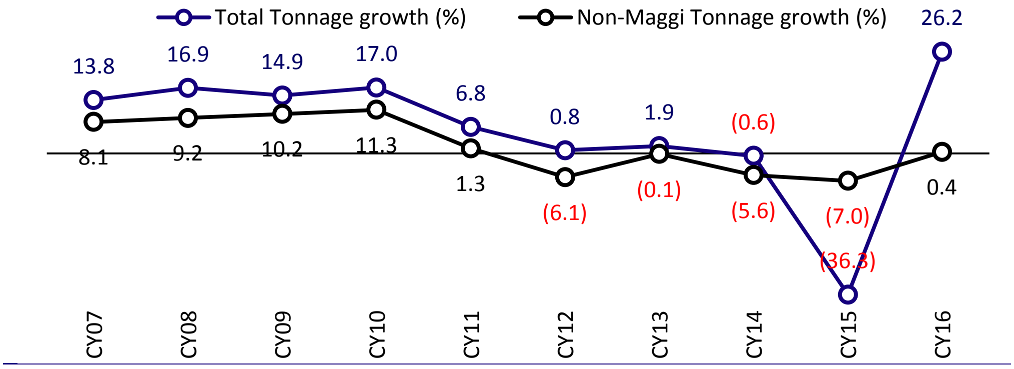
Exhibit 14: Chocolates & Confectionary



Source: Company, MOSL

- In chocolates & confectionary, the performance on volumes/sales appears particularly disappointing, given the consistent and far healthier performance of both Mondelez (erstwhile Cadbury's) and Perfetti. Also, Ferrero Rocher India has exhibited strong growth in this category – previously this company's revenues were only a third of NEST's in this segment, but it has now reportedly surpassed NEST in terms of comparable sales.
- Demonetization did have some impact toward the end of the year; however, what makes the underperformance in the non-Maggi categories particularly glaring is that management had stated that in CY15 that the Maggi crisis had also affected sales of other segments to some extent (as top management was inordinately devoted to resolving the Maggi crisis), and hence, the low base should have proved favorable this year. Instead, the milk & nutrition segment reported the worst performance on sales in the millennium, while the beverages segment exhibited the worst performance on sales since CY04.
- The overall non-Maggi portfolio witnessed 0.4% volume growth. While this is disappointing, we think it is still better than volume declines in many of the previous years.

Exhibit 15: Non-Maggi portfolio witnessed 0.4% volume growth compared to overall tonnage growth of 26% in CY16



Source: Company, MOSL

- There was one bright spot amid the gloomy numbers, though – weighted-average realization growth (which had been inordinately high in preceding years) was the lowest in many years. This may be a function of low material costs, but that has not dissuaded the company from taking price increases earlier, even at the cost of volumes.

Brand extensions/product launches

- The most interesting aspect of NEST's CY16 performance was the sharp increase in new launches. The annual report mentions 39 new products/re-launches/variants under existing brands, which is far higher than the preceding years.

Exhibit 16:

Year	CY10	CY11	CY12	CY13	CY14	CY15	CY16
No. of launches	**6**	**4**	**9**	**6**	**7**	**3**	**19 (39 including variants and re-launches)**
1	Nestle Dahi in pouches	Nestle a+ Milk	Nestle Baby & Me	NAN PRO 1	Maggi Oats Noodles	Relaunched Maggi Noodles	Maggi Hot Heads 4 variants
2	Maggi Vegetable Multigrainz Noodles	Nestle a+ Dahi	Cerelac Shishu Aahar	Maggi Hungrooo	Nestlé KitKat Senses Milk	Munch Nuts	Maggi No Onion No Garlic Masala
3	Nestle Milkybar Choo-Choko	Maggi Dumdaar Noodles	Renovation of Lactogen	Maggi Magical Masala Noodles	Nestlé KitKat Senses Dark	Cerelac Stage 5	Maggi Hot Heads Cuppa Noodles
4	Nestle Milky Bar Crispy	Nestle Dark Chocolate	Renovation of Cerelac	Nestle Munch 4*4	Nestlé KitKat Senses Extra Smooth		Maggi Cuppa Masala
5	Nestle Munch Guru pack		Maggi Healthy Soups	Nestle Munch convenient share bag pack	Nestle Masala Buttermilk		Maggi Cuppa Chilly Chow
6	Nestle Kitkat Single finger		Nestle Kitkat Dark Crisp Wafer Fingers	Nestle Alpino	Nestle Lassi		Maggi Cup-a-licious Soups 6 variants
7			Munch Rollz Wafer Tube		NAN Lo-Lac		Nestle a+ Grekyo 4 variants
8			Relaunch of Nescafe Classic in a unique jar				Nestle Everyday Masala Fusion Dairy Whitener 6 variants
9			Sunrise Strong				Nescafe RTD 3 variants
10							Ceregrow
11							Nestle a+ Pro-grow
12							Renovation of Cerelac with Iron
13							Nescafe Sunrise Insta-filter
14							Nestea Iced Tea 3 variants
15							Nescafe Latte
16							Kitkat Duo
17							Nestle Munch Trio
18							Barone Charge
19							New Alpino

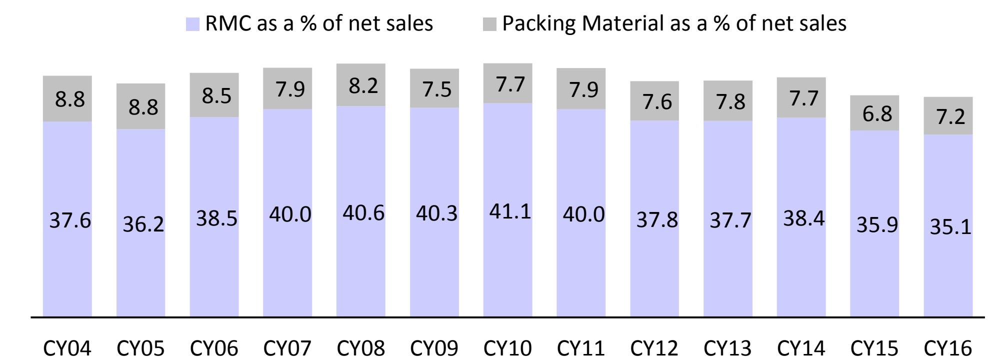
Source: Company, MOSL

- New launches is one area where management has clearly walked the talk on its intention after the change of guard in July 2015. Stakeholder interaction is another. The subsequent track record on price declines (to boost consumption, if required) and advertising has been less unequivocal. We will cover these two aspects later in the report.
- We also note that domestic sales were very weak despite these launches. While it is true that some launches were back-ended, a few like ‘Grekyo’ are niche and others may take time to attain significance for the company with ~INR94b of gross sales, it is also not incorrect to state that the noise on new launches has not heralded any material reversal in volume growth trends as yet.

Gross and operating margins

- Net sales increased 12.8% YoY to INR91.6b in CY16 from INR81.2b in the previous year on the back of a low base. Material costs, on the other hand, increased at a slower pace of 11.8% YoY, leading to gross margins of 57.6% in CY16 – perhaps the highest-ever level. Decline in material costs to sales was witnessed mainly in raw materials consumed (+10.7% YoY, saving of 60bp YoY on material costs). Raw materials consumed account for 80% of total material costs. On the other hand, packing material costs increased 20.9% YoY in CY16, surprising in a weak crude price environment. Contributing 17% of total materials costs, packing material added 50bp to material costs. Change in inventory led to 20bp savings on material costs.

Exhibit 17: RM scenario continues to be benign

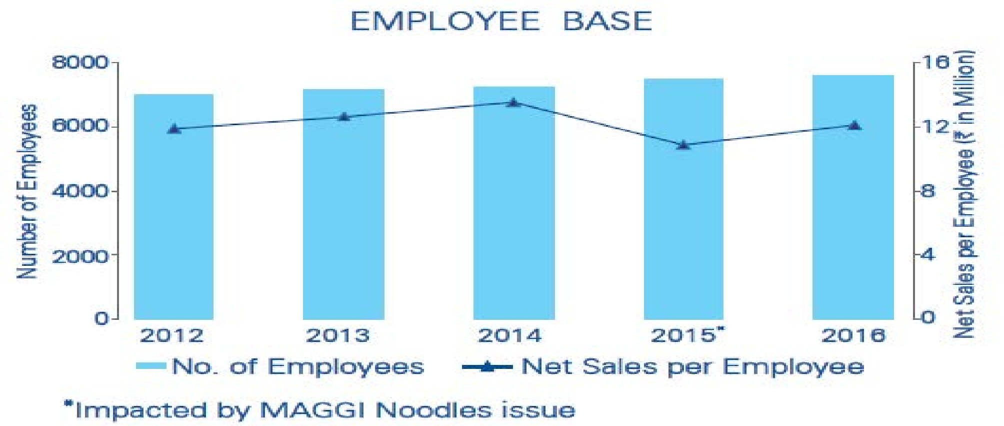


Source: Company, MOSL

- Among major raw materials consumed, fresh milk costs declined 5% YoY, while milk derivatives costs were up by 4.6% YoY. Growth in both of these raw materials was lower than sales growth of 12.8% for the year. This led to a positive impact on gross margin of 180bp and 50bp from fresh milk costs and milk derivatives, respectively, which together contribute 38% of total material cost. While we do not have cost per ton details, we reckon that since the milk & nutrition segment (the main segment using these products; chocolates & confectionary is much smaller) grew 0.9% YoY and these costs declined on absolute numbers put together, there has been a substantial per unit cost reduction of milk in CY16. This is unlikely to be the case in CY17E due to an increase in procurement costs over past six months.
- Material costs on green coffee also declined 12.9% YoY, leading to 100bp savings on gross margins. Beverages sales (largely Nescafe) witnessed 3.1% decline YoY, but volumes increased 1.3% in CY16.
- On the other hand, there was a steep increase in absolute material costs in the form of edible oils, grain flour and others, which grew by 43.2%, 82% and 48.9% YoY, respectively. The former two products are mainly used in the prepared dishes and cooking aids (mainly in Maggi Noodles and Pasta) segment, which explains the sharp YoY increase. The three items form 23.5% of total raw material costs, contributing 70bp, 140bp and 70bp, respectively to sales.
- Staff costs (including employee benefit expense due to passage of time) increased 17.0% YoY to INR11.1b (+40bp to 11.7% of sales) in CY16. Interestingly, staff costs to sales have increased 310bp YoY over past two years,

and by 28% over CY14-CY16 (at a time when sales actually declined). The total number of permanent employees (7,588 as on Dec 2016) does not appear to have increased sharply – there may have been some rise in remuneration of employees who enabled the company tide over the Maggi crisis.

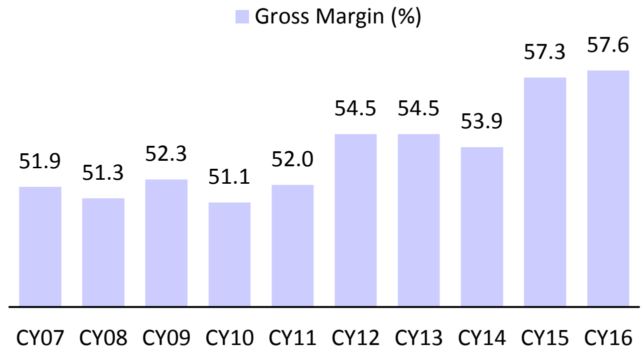
Exhibit 18: Employee costs increased by 17% YoY in CY16



Source: Company, MOSL

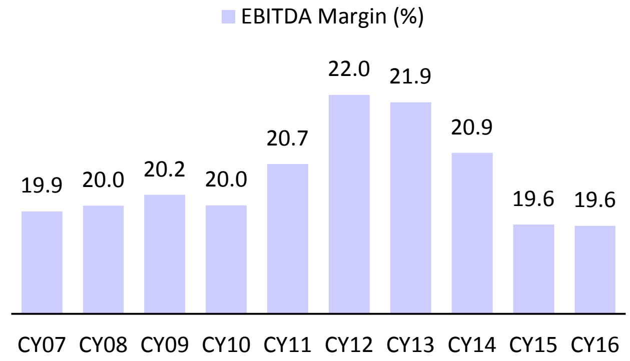
- Advertisement and sales promotion costs were up 8% YoY to INR5.7b in CY16. This was the second lowest YoY increase in A&P over past 10 years. On a percentage to sales basis, A&P to sales declined 30bp YoY to 6.4%. While 6.4% A&P to sales in CY16 is the third highest since CY02 (after 6.7% in CY15 and CY03), it is far lower than other FMCG companies as well as food peers like Glaxo Consumer and Britannia. With an unprecedented 39 variants launched in CY16, the decline in A&P to sales was a surprise.
- As indicated by the company earlier, royalty or general license fees (including withholding tax on general license fees) increased 20bp in CY16 as well, a process that is likely to continue every year until CY18. For CY16, royalty (+19.1% YoY) increased to 4.2% of sales.
- The company did well to control other expenses (excluding A&P and royalty), which were similar as a proportion of sales compared to CY15. No item within other expenses varied more than 20bp of sales either way during the year.
- EBITDA margin was flat YoY at 19.6% YoY in CY16. The 30bp gains each on gross margins and from A&P to sales were offset by a 40bp increase in staff costs to sales and a 20bp increase in royalty to sales. Absolute EBITDA at INR17.96b (second lowest level since CY11) increased 12.6% YoY v/s 12.8% growth in sales.

Exhibit 19: Gross margin for CY16 stood at 57.6%



Source: Company, MOSL

Exhibit 20: EBITDA margin stood at 19.6%



Source: Company, MOSL

- Mainly due to a sharp increase in capital goods imports from INR149m in CY15 to INR772m in CY16 and a slight decline in non-rupee denominated exports, net forex expenses to sales increased 120bp YoY to 4.7% of sales.

Exhibit 21: Components of net forex expenses

INR m	CY07	CY08	CY09	CY10	CY11	CY12	CY13	CY14	CY15	CY16
Total Foreign expenses	2,973	4,050	4,979	6,767	13,995	9,066	8,950	9,040	7,713	9,068
Total foreign income	2,790	2,704	2,454	2,475	3,097	2,929	4,867	4,898	4,828	4,773
Net foreign expense/ (income)	183	1,346	2,525	4,292	10,898	6,137	4,083	4,141	2,885	4,295
Net foreign expense/ (income) to sales	0.5%	3.1%	4.9%	6.9%	14.5%	7.4%	4.5%	4.2%	3.6%	4.7%

Source: Company, MOSL

Capex, fixed assets, working capital and cash flows

- Capex stood at INR2.1b in CY16. There were sale of fixed assets of INR937m in CY16. Depreciation was INR3.5b for the year. Capital work in progress also reduced YoY. This was the third year in which depreciation was well ahead of annual capex, leading to a reduction in net fixed assets for three years in a row. Net fixed asset turns have thus gone up from 2.7x in CY13 to 3.4x in CY16.
- Yet, fixed asset turns on net block declined from 2.9x in CY14 to 2.6x in CY15 due to sales decline. Fixed asset turns on gross block declined from 1.9x to 1.5x during this period.
- Debtor days remained at historical average of ~4 days. Inventory days reduced by 2 days to 35 days (led by lower finished good days) and creditor days also came down by 2 days YoY to 31 days. Net working capital (NWC) days at 8 days were therefore similar to CY15 levels. NWC days remain inferior to FMCG peers, particularly MNC peers like HUL, Colgate and GSK Consumer.
- Other assets declined YoY, mainly due to lower short-term loans and advances YoY. At 3.2%, other assets form a small part of total asset base.
- Operating cash flow increased to INR14.7b in CY16 from INR11b in CY15, but was lower than INR16.4b in CY14. Free cash flow was INR12.6b in CY16, compared to INR9.5b in CY15 and INR14.5b in CY14.
- Net cash and cash equivalents have increased sharply over past three years (from INR3.6b to INR25.4b), mainly due to better fixed asset turns, improvement in cash conversion cycle from 8 days to 10 days and a reduction in other assets to total assets from 3.6% in CY13 to 3.2% in CY16. Thus, while

adjusted PAT has reduced in CY16 to INR11.4b from INR11.8b in CY13, we note that cash generation remains strong.

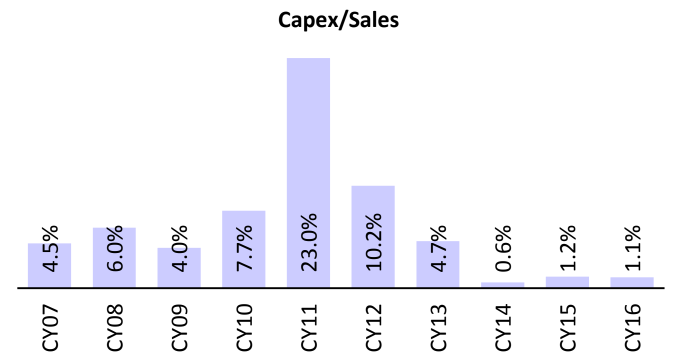
- The rise in cash and cash investments dilutes RoE and RoCE, in our view. While RoIC has nearly tripled from 63% in CY13 to nearly 200% in CY16, we note that RoE has declined from 56% to 39% and RoCE has remained flattish at 38-39% over this period. Despite large cash generation through balance sheet efficiency, dividend payout has been a meager 40%-55% over past seven years, diluting RoE and RoCE.

Exhibit 22: Cash conversion cycle remains stable

Cash Conversion Cycle	CY07	CY08	CY09	CY10	CY11	CY12	CY13	CY14	CY15	CY16
Inventory Days	35	35	33	31	32	33	30	29	37	35
Add: Trade Receivable Days	6	4	4	4	4	4	3	3	4	4
Less: Trade Payable Days	43	40	39	39	30	22	24	25	33	31
Cash Conversion Cycle	**-2**	**-1**	**-1**	**-4**	**6**	**15**	**10**	**7**	**8**	**8**

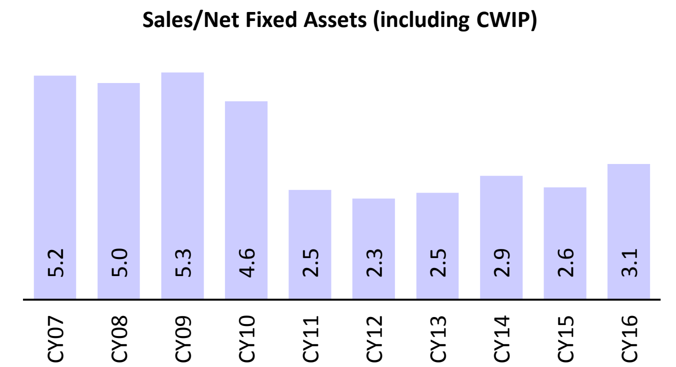
Source: Company, MOSL

Exhibit 23: Capex spends to increase over next two years



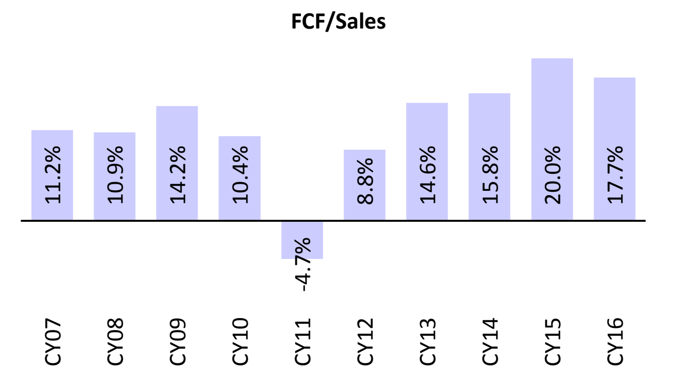
Source: Company, MOSL

Exhibit 24: Asset turnover increased YoY



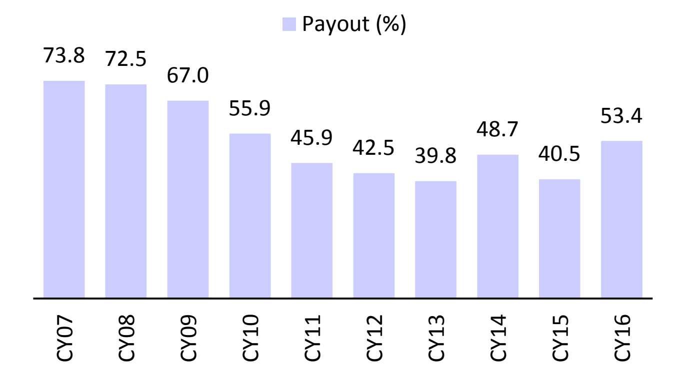
Source: Company, MOSL

Exhibit 25: FCF to sales up YoY



Source: Company, MOSL

Exhibit 26: Payout ratio



Source: Company, MOSL

Other salient points

- Surprisingly for a company that parks its cash balance in tax free bonds, there was INR200m diminution in value of non-current investments in CY16.
- After the Maggi crisis, the brand had slipped to 95th rank in the Brand Equity Most Trusted Brands survey in CY15. In CY16, however, the brand has been able

to claw back 70 paces to 25th rank and is ranked 3rd on brands in the foods segment.

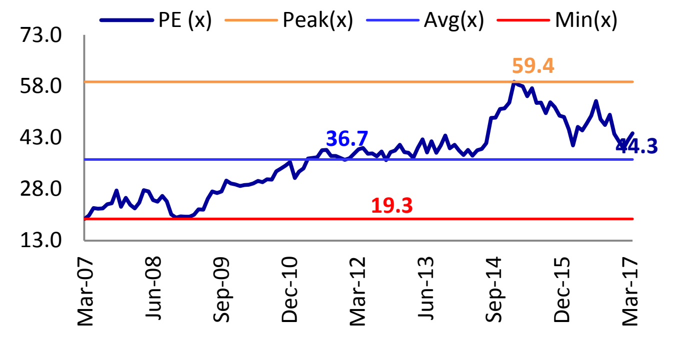
- Management mentioned that higher asset intensity has been attained due to the implementation of Total Performance Management and focus improvement projects.
- There was a special focus to improve the cool chain effectiveness of confectionary products in CY16.
- Between CY01 and CY16, the company reduced usage of energy for every ton of production by 47%, water usage by 53%, waste water generation by 55% and specific direct greenhouse gas emissions by 55%.
- The company launched a 'Logistics Excellence' review program for the supply chain team to build logistics capability and also to become GST-ready. This has led to identification of waste across the value chain, leading to cost-efficient operations and faster speed to market.
- Increase in cash equivalents was invested largely in certificate of deposits in commercial banks and government-backed tax free bonds.
- Contingent liabilities and commitments at the end of CY16 include INR12m of claims against the company not acknowledged as debt, INR543m capital expenditure commitments remaining to be executed and not provided for, and INR260m on CSR expense commitment.
- The company met its CSR commitment spend of INR313m for CY16 and also fulfilled CY15 unmet commitment of INR29m.

Exhibit 27: Change in numbers have resulted in 3%/4.5% change in CY17/18 EPS

	New		Old		% Change	
INR M	**2017E**	**2018E**	**2017E**	**2018E**	**2017E**	**2018E**
Net Sales	104,511	119,339	108,965	124,994	-4.1%	-4.5%
EBITDA	21,235	24,567	22,179	25,888	-4.3%	-5.1%
Adjusted PAT	13,423	15,749	13,883	16,489	-3.3%	-4.5%

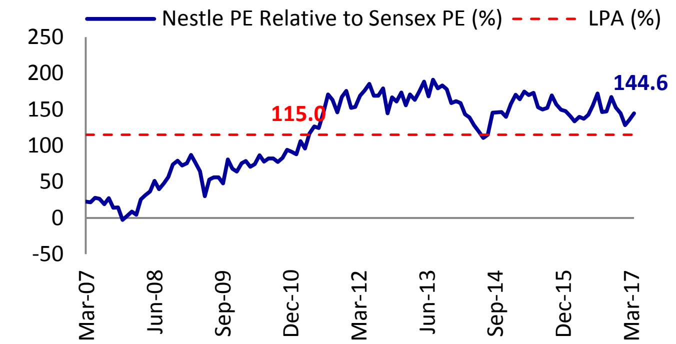
Source: Company, MOSL

Exhibit 28: Nestle P/E (x)



Source: Company, MOSL

Exhibit 29: Nestle P/E premium v/s Sensex



Source: Company, MOSL

Exhibit 30: Valuation matrix of coverage universe

Company	Reco	Price	Mkt Cap	EPS Growth YoY (%)			P/E (x)			EV/EBITDA (x)			RoE (%)	Div.
		(INR)	(USD M)	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY17E
Consumer														
Asian Paints	Neutral	1,049	15.5	9.5	10.2	18.0	51.2	46.4	39.4	32.3	29.8	25.4	32.8	1.1
Britannia	Buy	3,428	6.3	3.0	15.5	22.0	47.5	41.1	33.7	34.5	29.5	23.2	43.1	0.7
Colgate	Buy	988	4.2	-4.4	18.9	22.7	45.6	38.3	31.2	27.7	23.1	19.0	54.9	1.5
Dabur	Neutral	290	7.9	2.7	13.3	16.9	39.7	35.1	30.0	32.6	28.8	24.4	28.3	0.9
Emami	Buy	1,020	3.6	-2.9	22.0	20.6	41.7	34.2	28.3	30.4	26.4	22.2	33.8	1.1
GCPL	Neutral	1,646	8.7	11.9	15.6	15.9	44.3	38.3	33.1	31.9	27.9	24.3	22.5	0.7
GSK cons.	Neutral	5,226	3.4	-1.7	12.5	10.3	34.0	30.2	27.4	22.4	19.5	17.4	24.6	1.0
HUL	Neutral	909	30.6	1.1	11.7	15.4	47.2	42.3	36.6	32.9	29.8	25.8	67.6	2.1
ITC	Buy	279	52.1	8.6	11.6	18.1	33.3	29.9	25.3	22.5	20.0	16.6	28.4	1.9
Jyothy Labs	Neutral	388	1.1	94.5	12.8	16.5	48.7	43.2	37.1	27.4	25.0	22.3	16.4	1.0
Marico	Buy	301	6.0	8.5	15.3	20.1	49.5	43.0	35.8	34.2	29.9	25.0	33.3	1.0
Nestle	**Neutral**	**6,301**	**9.4**	**-1.0**	**21.3**	**18.8**	**53.1**	**43.8**	**36.8**	**32.8**	**26.2**	**22.0**	**38.8**	**1.0**
P&G Hygiene	Buy	7,321	3.7	12.1	15.0	18.6	50.2	43.7	36.8	32.8	28.0	23.3	29.0	0.9
Page Industries	Buy	14,059	2.4	12.9	29.5	27.3	59.7	46.1	36.2	37.3	28.7	22.7	41.3	0.7
Parag Milk	Neutral	250	0.3	-87.9	756.4	79.4	308.4	36.0	20.1	28.0	15.3	10.5	1.3	0.0
Pidilite Inds.	Neutral	713	5.6	12.5	10.1	12.3	43.0	39.0	34.8	28.7	25.3	22.1	27.9	0.7
United Brew.	Buy	741	3.0	-5.4	34.3	28.2	69.5	51.7	40.4	28.6	25.4	20.0	12.6	0.2
UNSP.	Neutral	1,900	4.2	71.2	47.2	39.1	66.4	45.1	32.4	31.9	25.5	19.8	20.8	0.0
Retail														
Jubilant works	Neutral	1,017	1.0	-17.6	76.4	34.0	82.5	46.8	34.9	25.9	17.6	13.4	10.1	0.2
Titan Company	Neutral	472	6.5	17.1	10.8	13.5	50.2	45.3	39.9	36.1	32.0	27.6	21.5	0.6

Note: For Nestle FY17 means CY16

Source: Company, MOSL

Financials and Valuations

Income Statement						(INR Million)
Y/E December	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
Net Sales	**90,619**	**98,063**	**81,233**	**91,593**	**104,511**	**119,339**
Change (%)	9.1	8.2	-17.2	12.8	14.1	14.2
Total Expenditure	70,815	77,536	65,287	73,634	83,276	94,772
EBITDA	**19,804**	**20,527**	**15,946**	**17,958**	**21,235**	**24,567**
Change (%)	8.5	3.7	-22.3	12.6	18.2	15.7
Margin (%)	21.9	20.9	19.6	19.6	20.3	20.6
Depreciation	3,300	3,375	3,473	3,536	3,628	3,745
Int. and Fin. Ch.	365	142	33	35	36	36
Other Inc.- Rec.	1,222	1,359	1,621	2,139	2,463	2,721
PBT	**17,362**	**18,368**	**14,062**	**16,526**	**20,034**	**23,506**
Change (%)	9.5	5.8	-23.4	17.5	21.2	17.3
Margin (%)	19.2	18.7	17.3	18.0	19.2	19.7
Tax	5,609	5,897	2,504	5,150	6,611	7,757
Tax Rate (%)	32.3	32.1	17.8	31.2	33.0	33.0
Adjusted PAT	**11,753**	**12,472**	**11,558**	**11,376**	**13,423**	**15,749**
Change (%)	6.8	6.1	-7.3	-1.6	18.0	17.3
Margin (%)	13.0	12.7	14.2	12.4	12.8	13.2
Non-rec. (Exp)/Inc.	582	625	5,925	2,111	972	985
Reported PAT	**11,171**	**11,847**	**5,633**	**9,265**	**12,450**	**14,764**

Balance Sheet						(INR Million)
Y/E December	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
Share Capital	964	964	964	964	964	964
Reserves	22,723	27,408	27,214	29,173	33,760	39,499
Net Worth	**23,687**	**28,372**	**28,178**	**30,137**	**34,724**	**40,463**
Loans	11,872	196	177	332	332	332
Capital Employed	**35,559**	**28,568**	**28,356**	**30,469**	**35,055**	**40,794**
Gross Block	49,032	50,090	51,174	52,600	54,100	56,050
Less: Accum. Depn.	15,339	18,323	22,195	25,305	28,933	32,678
Net Fixed Assets	**33,693**	**31,766**	**28,979**	**27,295**	**25,167**	**23,372**
Capital WIP	2,947	2,448	2,308	1,882	1,882	1,882
Investments	8,511	8,118	13,249	17,494	19,406	21,606
Current	6,270	5,074	9,831	12,750	14,663	16,862
Non-current	2,241	3,045	3,418	4,743	4,743	4,743
Curr. Assets, L&A	**17,992**	**15,863**	**16,269**	**21,390**	**29,195**	**40,148**
Inventory	7,359	8,441	8,208	9,432	11,218	12,915
Account Receivables	843	991	784	979	1,191	1,369
Cash and Bank Balance	7,494	4,458	4,996	8,800	13,762	22,368
Others	2,296	1,972	2,281	2,179	3,026	3,496
Curr. Liab. and Prov.	**25,429**	**27,400**	**30,720**	**36,049**	**38,854**	**44,240**
Account Payables	6,330	7,287	7,435	7,992	8,888	10,260
Other Liabilities	5,026	4,096	4,659	5,128	4,346	4,998
Provisions	14,073	16,017	18,625	22,929	25,621	28,981
Net Curr. Assets	**-7,437**	**-11,537**	**-14,451**	**-14,659**	**-9,659**	**-4,091**
Def. Tax Liability	-2,155	-2,227	-1,729	-1,542	-1,740	-1,973
Appl. of Funds	**35,559**	**28,568**	**28,356**	**30,469**	**35,055**	**40,794**

E: MOSL Estimates

Financials and Valuations

Ratios						
Y/E December	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
Basic (INR)						
EPS	**121.9**	**129.4**	**119.9**	**118.0**	**139.2**	**163.3**
Cash EPS	156.1	164.4	155.9	154.7	176.8	202.2
BV/Share	245.7	294.3	292.2	312.6	360.1	419.7
DPS	48.5	63.0	48.5	63.0	70.0	80.0
Payout (%)	39.8	48.7	40.5	53.4	50.3	49.0
Valuation (x)						
P/E	51.7	48.7	52.6	53.4	45.3	38.6
Cash P/E	40.4	38.3	40.4	40.7	35.6	31.2
EV/Sales	6.7	6.1	7.3	6.3	5.5	4.7
EV/EBITDA	30.5	29.0	37.0	32.4	27.1	23.0
P/BV	25.6	21.4	21.6	20.2	17.5	15.0
Dividend Yield (%)	0.8	1.0	0.8	1.0	1.1	1.3
Return Ratios (%)						
RoE	56.4	47.9	40.9	39.0	41.4	41.9
RoCE	37.5	39.2	40.7	38.8	41.0	41.6
RoIC	62.7	77.2	96.1	196.7	1,026.0	-552.0
Working Capital Ratios						
Debtor (Days)	3.3	3.6	3.4	3.8	4.0	4.0
Asset Turnover (x)	2.7	2.9	2.7	3.0	3.1	3.0
Leverage Ratio						
Debt/Equity (x)	0.5	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement						(INR Million)
Y/E December	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
OP/(loss) before Tax	16,505	17,152	12,473	14,422	17,607	20,822
Int./Div. Received	1,222	1,359	1,621	2,139	2,463	2,721
Depn. and Amort.	3,106	2,985	3,872	3,110	3,628	3,745
Interest Paid	365	142	33	35	36	36
Direct Taxes Paid	5,075	5,824	2,899	5,337	6,413	7,524
Incr in WC	3,536	1,065	3,451	4,013	-39	3,039
CF from Operations	**17,214**	**14,161**	**15,308**	**14,104**	**12,357**	**17,397**
Extraordinary Items	0	0	0	0	0	0
Incr in FA	4,262	559	944	1,000	1,500	1,950
Free Cash Flow	**12,952**	**13,602**	**14,364**	**13,104**	**10,857**	**15,447**
Pur of Investments	4,862	-393	5,131	4,244	1,913	2,199
CF from Invest.	**-9,125**	**-166**	**-6,075**	**-5,244**	**-3,413**	**-4,149**
Issue of Shares	0	0	0	0	0	0
Incr in Debt	1,370	-11,676	-18	154	0	0
Dividend Paid	5,471	7,166	5,633	7,311	7,863	9,025
Others	1,136	1,812	-3,045	2,101	3,880	4,384
CF from Fin. Activity	**-2,965**	**-17,030**	**-8,696**	**-5,056**	**-3,983**	**-4,641**
Incr/Decr of Cash	**5,124**	**-3,035**	**537**	**3,804**	**4,962**	**8,607**
Add: Opening Balance	2,370	7,494	4,458	4,996	8,800	13,762
Closing Balance	**7,494**	**4,458**	**4,995**	**8,800**	**13,762**	**22,368**

E: MOSL Estimates

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Varun Kumar
Varun.kumar@motilaloswal.com
Contact : (+65) 68189232
Office Address:21 (Suite 31),16 Collyer Quay,Singapore 04931