

Q2 Ended June 30, 2014

Strong Company But Overpriced Stock:

1.0 Q2 2014 Performance Analysis:

The unaudited Q2 result of Nestle Nigeria Plc (Nestle) for the period ended June 30, 2014 shows that its Turnover (T/O) increased by 7.62% to N67.20bn, compared with N62.45bn recorded in the corresponding period of 2013. The increase in turnover was due to the improvement in the Nestlé's distribution network which boosted products sold. The cost of sales increased by 6.57% to N37.92bn from N35.58bn recorded in Q2 2013, leading to a gross profit of N29.28bn, an increase of 9.0% from N26.86bn in Q2 2013. The cost of sales as a percentage of T/O decreased marginally to 56.43% in Q2 2014 compared to 56.98% in Q2 2013. The administrative, selling and distribution expenses increased by 17.33% to N14.48bn. These expenses as a percentage of T/O decreased by 1.23% to stand at 22.03% in Q2 2014 from 23.26% in Q2 2013.

The Profit Before Tax (PBT) increased by 5.41% to N13.93bn from N13.22bn recorded in the corresponding period of 2013. The significant decrease of 33.31% recorded in its finance cost of N871mn in Q2 2014 from N1.31bn in 2013 contributed to the increase recorded in the PBT. The tax provision increased by 2.45% to N2.10bn from N2.05bn in 2013, leading to a Profit After Tax (PAT) of N11.84bn in Q2 2014 from N11.17bn in the corresponding period of 2013, representing a growth of 5.95%.

The company's profit margins decreased marginally in Q2 2014 compared with Q2 2013. This is a reflection of the increase in the operating expenses of Nestle.

Table 1:	SELL
Current Price	N1,050
Fair Value	N660.84

The turnover in Q2 June 2014 increased by 7.62% to N67.20bn.

PBT increased to N13.93bn in Q2 2014, while PAT increased to N11.84bn.

Table 2: Financial Performance (N'bn)

	Q2 2014	Q2 2013	Change (%)	FY 2013
T/O	67.20	62.45	7.62	133.08
GP	29.28	26.86	9.00	56.79
EBIT	14.80	14.52	1.92	27.83
PBT	13.93	13.22	5.41	26.05
PAT	11.84	11.17	5.95	22.26

Table 3: Quarterly Result Highlights (N'bn)

	Q2 2014	Q1 2014	Q4 2013	Q3 2013	Q2 2013
Turnover	33.78	33.43	37.67	32.97	31.75
PBT	6.86	7.07	5.67	7.16	6.16
PAT	5.83	6.00	5.16	5.93	5.18

Nestle is expected to meet and exceed its previous year's performance.

Despite the good absolute dividend payment, the dividend yield of about 2.5% is not attractive.

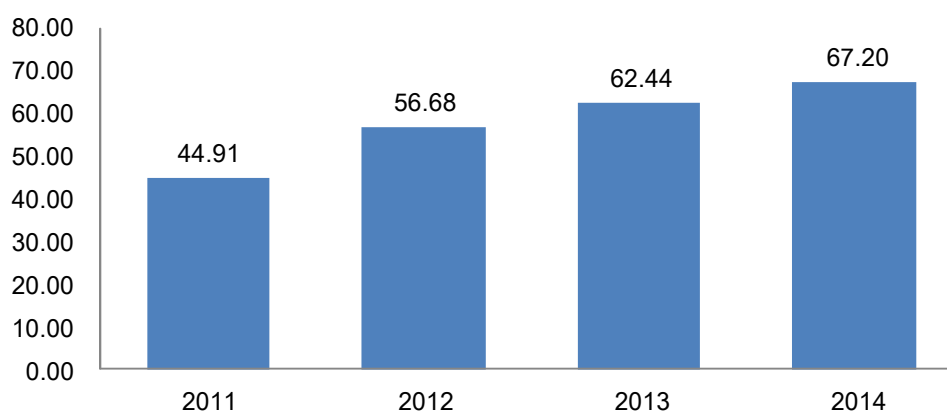
The PBT Margin in Q2 2014 decreased marginally over the Q2 2013 but higher than that of the Financial Year ended December (FY), 2013 figure. The PBT margin decreased to 20.73% in Q2 2014 from 21.17% as at Q2 2013, but up from 19.57% as at the end of FY December 2013. Also, the PAT margin currently stands at 17.61%, down marginally from 17.89% in the corresponding period of 2013, but up from 16.72% as at FY 2013. This result also indicates that the percentage of T/O, PBT, and PAT in the Q2 2014 to the Audited T/O, PBT and PAT for the period ended December 2013 are: 50.49%, 53.49% and 53.18%, respectively. Given the run rate, the company is expected to meet and possible exceed its previous year's performance. The company paid a total dividend of N25.50 (interim of N1.50 and final of N24) per share for the year 2013, representing a 27.50% increase over the N20 per share paid in 2012. Despite the good absolute dividend payment, the dividend yield of about 2.5% is not attractive.

The company's sales remain strong and improved consistently in the last four years due to continuous product innovation backed up with aggressive advertisement and supports given to the distributors of the company to boost sales.

Table 4: Profitability Margins

	Q2 2014	Q2 2013
GP* Margin	43.57%	43.02%
EBIT Margin	22.03%	23.26%
PBT Margin	20.73%	21.17%
PAT Margin	17.61%	17.89%
*GP – Gross Profit		

Q2 Revenue Trend (N'bn)

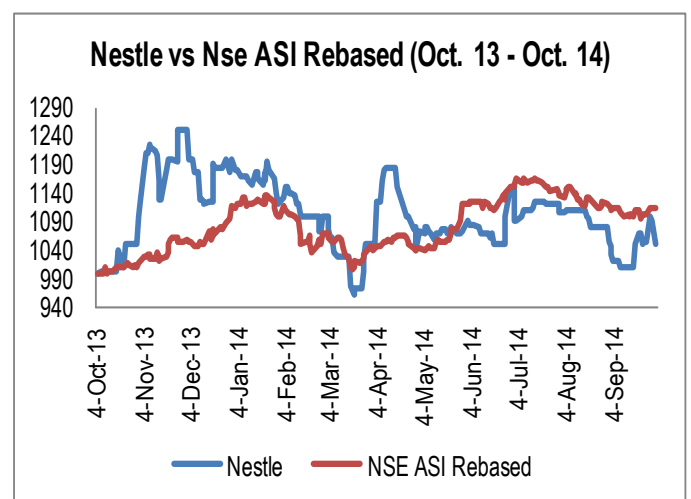
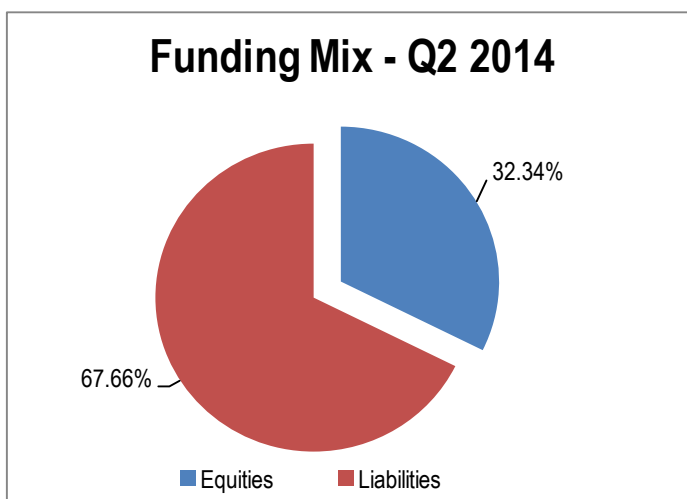


The company will need to devise measures to reduce its trade debtors and other receivables in order to limit bad debts and improve cash flow.

The total assets of the company which stood at N103.49bn as at Q2 2014 were financed by a mix of equities and liabilities in the ratio of 32.34% and 67.66% respectively.

A cursory look at the balance sheet position as at Q2 2014 compared with the position as at FY 2013 shows a marginal decrease in the company’s fixed assets. The fixed assets decreased by 1.42% to N65.51bn from N66.45bn in FY 2013. The stock increased to N10.09bn from N9.85bn in FY 2013. The cash and bank balances recorded an impressive increase of 185.92% from N300.64mn in FY 2013 to N859.58mn in Q2 2014. The trade debtors and other receivables increased in Q2 2014 by 42.95% to N25.57bn from N17.88bn in the FY 2013 period. The trade creditors and other payables decreased by 28.21% to N20.87bn from N29.07bn as at FY 2013. The working capital stood at N3.09bn from N8.52bn recorded in FY 2013, while net assets for the period decreased by 17.54% to stand at N33.47bn from N40.59bn as at FY 2013. The company will need to devise measures to reduce its trade debtors and other receivables in order to limit bad debts and improve cash flow.

The total assets of the company which stood at N103.49bn as at Q2 2014 were financed by a mix of equities and liabilities in the ratio of 32.34% and 67.66% respectively. Our analysis of the liabilities shows that the short-term liabilities stood at N34.89bn, accounting for 49.83% of the total liabilities, while the long-term liabilities stood at N35.13bn accounting for 50.17% of the total liabilities. The long-term liabilities constituted mainly of term loan, which stood at N26.35bn, decreasing marginally by 0.45% compared with the FY 2013. As at FY 2013, the term loan were owed to the CBN-related intervention funds of about N1.33bn at an interest rate of 7%; local banks of about N6.75bn at an interest rate of between 5.5% and 10%; and the balance of N19.34bn was owed to Nestle Treasury Centre – Middle East and Africa Limited, a nestle Group Company based in Dubai for general corporate services.



2.0 Drivers of Performance:

Nestlé Nigeria Plc's performance during the period was driven by the following factors:

- Diversified product portfolio which are essential for healthy living.
- Its backward integration strategy to secure raw materials locally by partnering with farmers to provide quality raw materials.
- Strategic partnership with distributors to boost sales.
- Investments in plants upgrade to produce products more efficiently.
- The drop in interest expenses.

However, the security challenges in the North East of Nigeria adversely affected sales.

2.1 Strategic Focus:

In furtherance of the company's commitment to the improvement of its earnings, it inaugurated an ultra-modern distribution centre in Agbara, Ogun State in 2013. The new facility is aimed at strengthening the company's role as the largest manufacturing operation for Nestle in the West and Central Africa region. Also, the new plant is aimed at reducing the environmental impact of Nestlé's operations, which is helping to eliminate the pollution, associated with the transportation of its raw materials and finished products from and to its distribution centre at Otta, Ogun State.

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To further reduce its environmental footprint and ensure efficient use of energy for manufacturing operation, Nestle has built a Tri-Generation power plant at its Agbara factory.

To further reduce its environmental footprint and ensure efficient use of energy for manufacturing operation, Nestle has built a Tri-Generation power plant at its Agbara factory. The plant generates electrical power, while chilled and hot water are generated using heat from the power plant exhaust gases. This enables the company to increase overall energy efficiency from 42% to 74% and to reduce carbon dioxide emissions by 5,000 tonnes per year.

3.0 Business:

Nestlé manufactures and markets a range of high quality brands: Infant Cereals - Nestlé Nutrend, NAN Lactogen and Nestlé Cerelac; Family Cereals-Nestlé, and Golden Morn; Beverage Drink - Nestlé Milo; Confectionary- Nestlé Chocomilo; Bullion-Maggi cube, Maggi Chicken, Maggi Crayfish, Maggi Mix'PY, and Nestlé Pure Life table water. Nestlé also markets Coffee - Nescafe Classic Coffee, Nescafe 3-in-1 Coffee and Nescafe breakfast, as well as Nestlé's Full Cream Milk product- Nestlé Nido. Globally, Nestle companies are organized into regional groupings to leverage expertise and the size of the company. In the case of Nigeria, the company is part of Central and West Africa region. The region is managed through Nestle Central & West Africa Limited, which is based in Accra. As at FY 2013, Nigeria contributed 98.96% to the turnover of the region, while Niger, Chad, Togo, Ghana and others contributed the balance of 1.04%.

On a continuing basis, the company explores the use of local raw materials in its production processes and has successfully introduced the use of locally produced items such as soya bean, maize, cocoa, palm oil and sorghum in a number of its products. Also, the company has successfully substituted imported corn starch with locally produced cassava starch.

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Table 5: Directors' Shareholding as at December 31, 2013

Director	Position	Holdings
Mr. David Ifezulike	Chairman	76,255
Mr. Dharnesh Gordhon	MD/CEO	Nil
Mr. Martin Kruegel	Non-Executive	Nil
Mrs. Iquo Ukoh	Non-Executive	37,500
Mr. Giuseppe Bonanno	Non-Executive	Nil
Mr. Kais Marzouki	Non-Executive	Nil
Mr. Gbenga Oyeboode	Non-Executive	Nil
Mrs. Ndidi Nwuneli	Non-Executive	Nil

Table 6: Shareholding Structure as at December 31, 2013

Name	No. Of Ordinary Shares	% of Shareholding
Nestle CWA Limited, Ghana	472,308,322	59.59
Nestle S.A., Switzerland	30,868,776	3.89
Others	289,479,154	36.52
Total Number of Shares	792,656,252	100.00

As at the year ended December 31, 2013, Nestle Switzerland, the ultimate holding company and Nestle CWA Limited, the parent, owned 3.89% and 59.59% respectively of the issued share capital of Nestle Nigeria Plc.

Nestle has two reportable segments (food products and beverages), which are its strategic business units.

The food products segment contributed 57.97% to the company's revenue in FY 2013, compared to the contribution of 42.03% by the beverages range.

Nestle maintains leadership positions in the food products segment, while it maintains good market share in the beverage segment.

4.0 Product Analysis

Nestle has two reportable segments, which are its strategic business units. The units are Food Products and Beverages. This strategic business units offer different products and services, and are managed separately because they require different technology and marketing strategies. The food products segment contributed 57.97% to the company's revenue in FY 2013, compared to the contribution of 42.03% by the beverages range.

4.1 Food Products

This includes the production and sale of Maggi, Cerelac, Nutrend, NAN, Lactogen and Golden Morn. The company launched the Nestle Golden Morn Millet in 2013; because of the need to provide consumers with high quality foods that provide nutritional value at an affordable cost. The product offers consumers the opportunity to increase their intake of two essential micronutrients (Iron and Vitamin A) as part of their daily breakfast. The introduction of millet variety expanded the product portfolio of Golden Morn to three in addition to maize enriched and maize cocoa. Products in this category compete with a lot of imported food products in the market. There are smaller competitors in the food products market in Nigeria but Nestle maintains the lead in the market. Nestlé's other products in this category includes: Maggi Cube, Maggi Mix'py, Maggi Arome, Maggi Chicken Tablet and Maggi Crayfish Tablet.

4.2 Beverages

This includes the production and sale of Milo, Chocomilo, Nido, Nescafe and Nestle Pure Life (water). The company launched 60cl Nestle Pure Life Protect in 2013, a variant of its bottled water brand fortified with zinc (an essential mineral to support the immune system). To further increase its market share, the company launched Nestle Pure Life 5litre family size bottle in 2013, the first of its kind in Nigeria. Some of the other competing products in the market are Bournvita, Ovaltine, Eva Water, Peak Milk, Cowbell Milk, RichChocó, etc.

Table 7: Company Summary

Ticker	Nestle
Sector	Consumer Goods
Sub-sector	Food Products - Diversified
Date of Incorporation	September 25, 1961
Date of Listing	April 20, 1979
Financial Year End	December
Number of Fully Paid Share	792,656,251
Current Capitalization(NGN)	832,289,063,550
NSE Capitalization (NGN)	13,572,534,758,845
% of NSE Capitalisation	6.13
52 Week high NGN	1,250.00
52 Week low NGN	958.80
YTD Return (%)	(10.38)
52 Weeks Average Volume Traded	288,437
Trailing EPS NGN	28.92
Trailing P/E Ratio (X)	36.31

5.0 SWOT ANALYSIS

<p>5.1 Strengths:</p> <ul style="list-style-type: none"> ○ Strong Brand name ○ Quality products in the market ○ Stable Board and Management ○ Technical partnership with parent company ○ Access to funding in the international financial market ○ Securing raw materials via backward integration ○ Consistent dividend payment ○ Energy efficient production process 	<p>5.2 Weaknesses:</p> <ul style="list-style-type: none"> ○ Declining margins ○ High price of shares on the Bourse may discourage wide-spread ownership ○ Low dividend yield ○ Low share float
<p>5.3 Opportunities:</p> <ul style="list-style-type: none"> ○ Large market size in Nigeria and neighbouring countries ○ The CBN efforts to improve funding to the agriculture sector ○ Improvement products regulations and enforcements 	<p>5.4 Threats:</p> <ul style="list-style-type: none"> ○ Security Challenges in the Northern region could greatly affect sales ○ Possible volatility in the international prices of food commodities ○ Strong competition in all its products

6.0 Forecast: Our Forecast Drivers

We considered the following factors in arriving at our 5-year forecasts:

- Large and growing market in Nigeria.
- The competitive position of the company in the industry.
- Introduction of new and exciting products.
- Improving consumer experience driven by excellent customer service.
- The various cost reduction strategy of the company.
- Strategic investment in backward integration activities to secure sources of raw materials.
- The adoption of an energy efficient and environmentally friendly production process for its products, and
- Stable macroeconomic indicators.

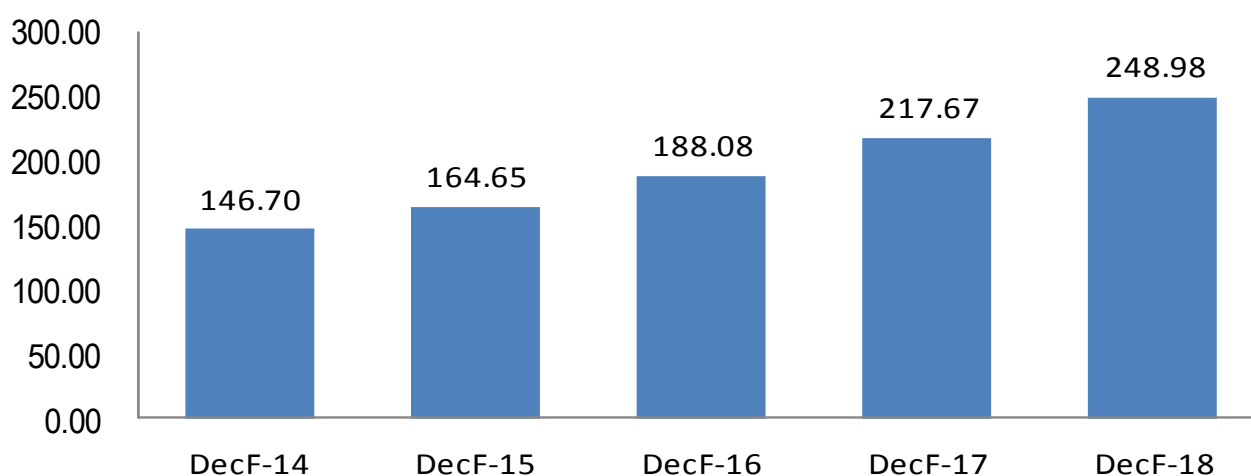
Taking the foregoing factors into consideration we estimate Turnover of N146.70bn, N164.65bn, N188.08bn, N217.67bn and N248.98bn for the periods ending December 2014, 2015, 2016, 2017 and 2018 using a revenue growth rate of 10.2%, 12.2%, 14.2%, 15.7% and 14.4% for 2014, 2015, 2016, 2017 and 2018, respectively. We estimate EBIT of N36.67bn, N49.06bn, N65.07bn, N80.75bn and N89.87bn, and EBITDA of N41.48bn, N54.01bn, N70.12bn, N85.91bn and N95.11bn for the same period using EBIT margins of 24.99%, 29.79%, 34.59%, 37.09% and 36.24% respectively. Our PBT forecasts for the periods are: N32.40bn, N38.69bn, N45.16bn, N50.50bn and N55.17bn. Adjusting for tax, our PAT forecasts are N25.28bn, N30.18bn, N35.23bn, N38.16bn and N39.91bn. PAT Margin for the period are 17.23%, 18.33%, 18.73%, 17.53% and 16.03%. The Dividend Per Share (DPS) is N28.96 based on dividend payout of 90.81%.

We estimate a DPS of N28.96 in 2014.

Table 8: FSDH Research Earnings Forecast for Nestle (2014-2018) – N'bn

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Turnover(N'mn)	146.70	164.65	188.08	217.67	248.98
EBIT(N'mn)	36.67	49.06	65.07	80.75	89.87
EBITDA(N'mn)	41.48	54.01	70.12	85.91	95.11
PBT(N'mn)	32.40	38.69	45.16	50.50	55.17
Tax(N'mn)	7.13	8.51	9.94	12.34	15.26
PAT(N'mn)	25.28	30.18	35.23	38.16	39.91
Dividend Payment(N'mn)	22.95	27.40	31.99	34.65	36.24
EBIT Margin (%)	24.99	29.79	34.59	37.09	36.09
EBITDA Margin (%)	28.28	32.80	37.28	39.47	38.20
PBT Margin (%)	22.09	23.50	24.01	23.20	22.16
PAT Margin (%)	17.23	18.33	18.73	17.53	16.03
EPS(N)	31.89	38.07	44.44	48.14	50.35
DPS(N)	28.96	34.57	40.36	43.71	45.72
Earnings Yield (%)*	4.83	5.76	6.72	7.28	7.62
Dividend Yield (%)*	4.38	5.23	6.11	6.61	6.92
P/E Ratio(x)*	20.72	17.36	14.87	13.73	13.13
Number of Shares (mn)	792.66	792.66	792.66	792.66	792.66
Dividend Payout (%)	90.81	90.81	90.81	90.81	90.81
*At Our Fair Value of N660.84					

Revenue Forecast (N'bn)



7.0 Valuation

The fair value for Nestle Nigeria Plc is N660.84.

In arriving at a fair value for the ordinary shares of Nestle, we used the Discounted Free Cash Flow (DCF) model. We applied a terminal growth rate of **6.54%**, which is the latest real GDP growth rate for the Nigerian economy as at Q2, 2014. We used a beta value of **0.50** based on the 5-year daily historical returns on the company share price and the Nigerian Stock Exchange All Share Index (NSE ASI). We used the yield of **12.46%** on the approximately 5-year tenor-to-maturity of the 7% FGN Bond October 2019 as our risk free rate, and market premium of **10.40%**, which is the equity market premium used for Nigeria based on its credit ratings. Applying foregoing parameters on the Capital Asset Pricing Model (**CAPM**), the cost of equity generates **17.66%**. The company has long term debt, with the weighted after tax cost of the debt estimated at 3.33% using a tax rate of 32%. The Weighted Average Cost of Capital (WACC), which is our discount rate, was estimated at 17.21%. Using **792mn** shares in issue, the DCF model generates **N660.84** per share, which is our fair value.

The current market price of Nestle share is N1,050. The highest and the lowest closing price in the last 52 weeks are N1,250 and N958.80 respectively. The 2014 forward earnings yield and dividend yield based on our fair value are: 4.83% and 4.38% respectively. The current price of N1,050 to our fair value of N660.84, the share of Nestlé is overvalued by 37.06%. We therefore place a **SELL** on the shares of Nestle Nigeria Plc at the current price.

Table 7 : Comparable Analysis (Nbn)

Company	T/O	GP	EBIT	PBT	PAT	GP Margin %	EBIT Margin %	PBT Margin %	PAT Margin %	ROE %	ROA %
Nestle	133	57	28	26	22	42.67	20.91	19.57	16.72	54.83	25.72
Cadbury	36	13	6	7	6	36.63	16.00	20.75	16.84	25.10	13.25

Source: Company Annual Reports, FSDH Research.

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