

FDC Economic Bulletin

June 21, 2016

Equity Report : Nestle Nigeria Plc

Analyst Recommendation: HOLD

Recommendation Period: 365 days

Industry: Consumer Products

Market Capitalization: N600.07 billion

Current Price: N757.03

Target Price: N728.75

Analyst Note

Nestlé's recent Q1 2016 result shows its resilience in a period of declining consumer demand and negative GDP growth. Its share price has spiked by approximately 26% in the last eight weeks from N600 to N757.03, as investors are impressed by the improved results. In Q1'16, Nestlé's sales, profit before tax and profit after tax increased year-on-year (YoY) by 31%, 150% and 126%, respectively. This performance was driven by growth in unit sales volume and reduced reliance on imported raw materials. The company also managed its cost effectively as cost of sales as a percentage of revenue declined from 55.8% to 50.8% while operating profit margin and net profit margin increased from 20.5% to 25% and 10.7% to 18.5%, respectively in Q1'16. This was a resurgent performance for a company that experienced sluggish sales and weak earnings for most of 2015.

In view of Nestlé's impressive Q1'16 result and decent FY 2015 performance, we review our previous rating of the company's stock price. However, there are still several factors that could limit Nestlé's future earnings and share price. First is Nigeria's enduring economic woes of increasing inflation, declining forex earnings, depleting external reserves and a weak currency which have curtailed the purchasing power of the average Nigerian. Consumer resistance is increasing as pricey products are being replaced with cheaper alternatives. Disposable income in Nigeria is expected to decline in the short-run, thus impacting sales of FMCGs. Though Nestlé's management has shown its capacity to steer the company in trying economic times, the uncertainty will pose a hindrance to the performance of the food giant. Secondly, its Q1'16 revenue growth is being compared to a low base due to poor sales recorded in Q1'15, in which revenue declined by 17.6%. Thirdly, it is likely that the market has already factored its improving prospects into its

current share price, thereby limiting the extent of its upside. Accordingly, we place a HOLD rating on Nestlé. This is an upgrade from our last SELL rating on the company's stock.

Profile

Nestlé Nigeria Plc is a leading food manufacturing and marketing company. The company commenced trading operations in Nigeria in 1961, and has been listed on the Nigerian Stock Exchange since 1979. Over the years, Nestlé has invested heavily in research and development, which has resulted in a wide range of very successful products under its strategic business units: food and beverages.

Business Segment	Product lines
Food	Cerelac, Golden Morn, Lactogen, Maggi, Nutrend and NAN
Beverages	Chocomilo, Milo, Nescafe, Nestle Pure Life and Nido

Nestlé Nigeria is grouped under the Central and West African Region, which is managed through Nestlé Central & West Africa Limited based in Accra, Ghana.

The company is a proponent of long-term sustainable business practices, and nearly all of its key ingredients are sourced locally through farmers and suppliers where available. This has reduced the company's exposure to the volatile forex market. The company's growth over the years can be seen in the snapshot of its financials shown below.

NESTLE NIGERIA PLC	2015 N'000	2014 N'000	2013 N'000	2012 N'000	2011 N'000	CAGR %
ASSETS						
Non-current assets	70,500,367	68,672,737	66,451,672	62,607,073	55,517,888	6.15%
Current assets	48,714,686	37,389,330	41,755,808	26,356,145	22,210,405	21.70%
Total non-current liabilities	(21,476,122)	(25,484,372)	(34,379,584)	(29,598,012)	(29,703,474)	-7.79%
Total current liabilities	(59,731,857)	(44,638,052)	(33,233,095)	(25,179,644)	(24,814,835)	24.56%
Net Assets	38,007,074	35,939,643	40,594,801	34,185,562	23,209,984	13.12%
CAPITAL AND RESERVES						
Share capital	396,328	396,328	396,328	396,328	396,328	0.00%
Share premium	32,262	32,262	32,262	32,262	32,262	0.00%
Share based payment reserve	150,466	44,637	26,585	49,543	76,903	18.27%
Retained earnings	37,428,018	35,466,416	40,139,626	33,707,429	22,704,491	13.31%
Total Equity	38,007,074	35,939,643	40,594,801	34,185,562	23,209,984	13.12%
COMPREHENSIVE INCOME						
Revenue	151,271,526	143,328,982	133,084,076	116,707,394	97,961,260	11.47%
Profit Before Taxation	29,322,477	24,445,978	26,047,590	25,050,172	18,199,249	12.66%
Taxation	(5,585,700)	(2,210,338)	(3,789,311)	(3,912,897)	(1,702,796)	34.58%
Profit After Taxation	23,736,777	22,235,640	22,258,279	21,137,275	16,496,453	9.52%



Who We Are

Avant-garde Academia Limited (AAL) is an education advisory and counseling service organization that was incorporated in July of 2013. AAL was incorporated as an educational aggregator in grooming candidates to be potential global citizens who will reinvest their acquired skills in Nigeria in future. It is positioned to provide support, assistance and guidance to potential candidates and entrants to Ivy League, Elite and premium academic institutions in America. Our target market comprises parents of children in identified elite Nigerian secondary schools and/or top executives in the business community, who have a strong need for our services.

The market also extends to Nigerians resident in Diaspora, and expatriates resident in Nigeria. In Partnership with Ascent Education Advisors, a reputable Education Advisory Services firm, we have designed a range of admissions solutions to cater for children in different stages of secondary school education.



OUR STRATEGIC PARTNER – ASCENT EDUCATION ADVISORS

A reputable education advisory service firm, the lead consultant Ms. Peggy Hanefors has over 10 years experience in admissions; including a position as the Assistant Director of International and Transfer Admissions at the University of Pennsylvania. She was first reader and evaluator of about 3,000 applications for students from across the globe.

What We Offer

- Information and advice about the American University System and its application process.
- Evaluation of student's record prior to application.
- Assistance in selecting curriculum and summer activities that will match the student's desired course of study and also highlight his/her personality and interests.
- Development of personal application timeline, that includes standardized testing, college visits, application deadlines, etc.
- Help in selecting teachers for recommendations
- Guidance in presenting extracurricular record
- Guidance in putting together an overall great college application that highlights the unique attributes of the applicant
 - Essay topic brainstorming
 - Editing
 - Proof-reading
- Guidance in choosing the most suitable college among acceptances.
- Interview preparation

Our Packages

Package 1: 8th to 10th Grade (Final 3-5 Years)

This package is a program designed for candidates from as early as the 8th grade (Junior Secondary School - JSS 2) of high school. This is a full package with the benefits of all the services we offer in addition to education and assistance with entire college admission process, including an unlimited number of applications.

Package 2: 11th and 12th Grade (Final 1-2 Years)

This package is similar to Package 1 but is designed for students in the final two years of high school.

Package 3: (Per Application)

Unlike packages 1 and 2, package 3 only provides unlimited assistance with applications to pre-determined universities.

We host a Parents Admission Support Forum in Lagos bi-annually with the aim of giving parents the information they need to ensure their child(ren)/wards gain admission into reputable universities in United States of America.

To attend one of our events, kindly contact or visit us at 9a Idejo Street, Victoria Island Lagos.

For more information about Avant- Garde Academia Limited please go to our website: www.avant-gardeacademia.com

For enquiries or consultation E-mail us: info@avant-gardeacademia.com Or call Chinyere Ubani 08039238138 | Tope Vincent 08034017603

Management

The board is led by Mr. David Ifezulike, who joined Nestlé in 1980 and worked for over 26 years in various capacities and locations. The management of Nestlé Nigeria is made up of accomplished individuals who are led by the Managing Director, Mr Dharnesh Gordhon. Mr Gordhon joined the Nestlé Group in South Africa in 2004 as a Category Sales Development Manager prior to taking over as Business Executive Manager, Dairy in 2005. He was head of sales for the South African region before joining the Board of Nestlé Nigeria as Managing Director in June 2013.

The company's executive management team comprises of individuals who have worked in Nestlé for a considerable time in various capacities. They bring a wealth of experience that can help propel the company to further success.

The Bulls Say and the Bears Say

Bulls Say:

- Superior brand value in both food and beverages segment
- Continuous investment in innovation, research and development provides Nestlé with an immense opportunity to diversify its revenue base and satisfy dynamic consumer taste
- Robust distribution network and a talented sales force
- Lower exposure to the vagaries of the forex market as Nestle sources for about 65% of its raw materials locally
- Experienced management team

Bears Say:

- Increasing consumer resistance due to lower disposable income could restrain Nestlé's sales potential
- Higher interest payments on dollar-denominated borrowings due to the continued depreciation of the naira
- Insecurity in the northern region of the country has affected distribution and sales
- Intense competition in the food nutrition segment of the consumer goods industry

Investment Thesis

FDC places a HOLD recommendation on Nestlé Nigeria based on a detailed analysis of the company's intrinsic valuation, dampened consumer demand, deteriorating macroeconomic conditions and improving earnings prospects. This is an upward review on the previous SELL rating at the price of N632.02 that we placed on our last Nestle equity report in August 2015. The company's share price eventually declined from N794 in August to N632 in February 18, 2016 and its YTD low of N598.02 in April 2016. The 26.6% appreciation of Nestle's stock in the last seven weeks is due to the positive sentiments following its Q1'16 result in which revenue and net income grew by 31% (YoY) and 126% (YoY), respectively.

Nestlé Nigeria's relentless investment in expansion and efficiency position it for sustainable economic growth. The immense growth of its sales in Q1'16 was driven by an increase in sales unit volume growth given that its product pricing did not change. This revenue growth underscores the effectiveness of Nestlé's sales force reflected in the improvement in its cost of sales as a percentage of revenue, improvement in operating margin, and its diversified product range. All these bolster its position as a market leader in consumer goods sector while hedging its revenue base. The recently opened ultra-modern Nestlé water factory in Abaji, Abuja further enhances the company's revenue-generating potential. In addition, the capacity expansion of the Agbara and Flowergate factories shows Nestlé's plan to benefit from the potential increase in consumer demand when the economy recovers from its current downward spiral.

However, despite the positives going for Nestle, there are several factors that could undermine its growth potential. Nigeria's macroeconomic headwinds may persist into the future given declining oil production despite recovering oil prices, weak economic fundamentals, and declining consumer demand. Brand loyalty is also facing pressure (nearly decimating), as consumers succumb to current economic realities. Furthermore, the continued depreciation of the naira may continue to negatively affect Nestlé's earnings due to increasing finance charges (approximately 82% of Nestlé's loans are dollar-denominated), despite management's efforts towards cutting administrative expenses. Net finance costs declined by 6.9% in FY 2015.

We believe that Nestlé's investments in its operations and product development will ensure that it remains a leader in the consumer goods space. However, the unfavorable macroeconomic condition could encumber its ability to grow its revenues and earnings. Accordingly, we believe that Nestlé Nigeria Plc is slightly overvalued, and therefore recommend a HOLD as we do not foresee a significant upside or downside in its share price.

Valuation

We derived our valuation for Nestlé Nigeria Plc by using the Discounted Cash Flow (DCF) and Dividend Discount Model (DDM) methodologies. Our fair value estimate for Nestlé Nigeria Plc is N728.75, which is a 3.74% downside on the current price of its share as at June 16 2016. This estimate represents the average of the values derived from using the DCF and DDM methods. Based on the DCF method, Nestlé's intrinsic value is N648.32. On the other hand, the value of the company using DDM is N809.18. The discount rate

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FOR LEASE

MARIYA COURT

Location: 2B, Probyn Close, Ikoyi, Lagos

Amenities:

1. All rooms fitted with new air conditioners
2. Intercom system
3. Equipped kitchen with electrical cooker/oven, fridge, deep freezer and washing/drying machine.

Other Facilities:

1. Gym, squash court, steam bath, sauna, swimming pool with bar and barbeque stand
2. 24hrs power supply
3. 24hrs security/CCTV/Alarm system
4. 24hrs Technician on duty
5. Fully equipped play area for children



RHAMA GARDEN

Location: 28, Gerard Road, Ikoyi, Lagos

Amenities:

1. All rooms fitted with new air conditioners
2. Intercom system
3. Equipped kitchen with electrical cooker/oven, fridge, deep freezer and washing/drying machine.

Other Facilities:

1. Gym, squash court, steam bath, sauna, swimming pool with bar and barbeque stand
2. 24hrs power supply
3. 24hrs security/CCTV/Alarm system
4. 24hrs Technician on duty
5. Fully equipped play area for children



(weighted average cost of capital (WACC)) of 12.2% is derived using an 11.81% risk free rate (the rate for the 10 year FGN Bond maturing on August 2017), a beta of 1.04, an after-tax cost of debt of 5.4%, and a market risk premium of 6%. The long term cash flow growth rate to perpetuity calculated is 5.1%. For the DDM method, a dividend growth rate of 8.2% is calculated.

Taking into account Nestlé's expansion plans, increasing consumer resistance, the prevailing macroeconomic conditions and an impressive Q1 2016 result, we forecast a four-year revenue growth CAGR of 11.1%.

Nestlé Valuation using DCF

NESTLE NIGERIA PLC	2016E N'000	2017E N'000	2018E N'000	Terminal Value N'000
Revenues	168,822,078	188,408,849	207,429,041	
Cost of Sales	(95,850,674)	(106,971,288)	(117,770,221)	
Gross Profits	72,971,404	81,437,561	89,658,820	
General & Administration Expenses	(28,206,079)	(30,094,491)	(33,518,368)	
EBITDA	44,765,326	51,343,069	56,140,453	
Depreciation & Amortisation	(5,558,337)	(5,703,190)	(5,893,150)	
EBIT	39,206,989	45,639,880	50,247,303	
Less: Taxes	(4,900,874)	(5,704,985)	(6,280,913)	
EBIAT (Unlevered Net Income)	34,306,115	39,934,895	43,966,390	
Plus: Depreciation Expense	5,558,337	5,703,190	5,893,150	
Less: CAPEX	(6,752,883)	(7,536,354)	(8,297,162)	
Less: Change in working capital	3,464,372	(566,301)	348,000	
Unlevered Free Cash Flow (FCF)	36,575,941	37,535,430	41,910,378	618,983,705
Discounting Period	1	2	3	5.1% long term cash flow growth rate to perpetuity
Discount Rate (WACC)	12.2%	12.2%	12.2%	
Discounting Factor	0.89	0.79	0.71	
Present Value of Unlevered FCF	32,605,085	29,827,788	29,688,693	438,478,913
Enterprise Value	530,600,479			
Net Debt	16,709,638			
Equity Value	513,890,841			
Shares Outstanding ('000)	792,656			
Price per share (N)	648.32			

Risk

The major risks that Nestlé Nigeria Plc faces are markets risks and the security challenges in the country. Markets risks include currency risks, impending recession, and changes in the prices of raw materials. The company has been exposed to currency risks on sales, purchases and borrowings that are denominated in foreign currencies, predominantly US dollars, euros, pounds sterling and Swiss francs. The currency risk, which is one of Nestlé's most important risks, could make borrowings more expensive even though its foreign denominated loans were secured at a decent rate from the Nestlé Treasury Centre-Middle East &

Africa Limited. A depreciation of the naira could also make cost of funds prohibitive. Furthermore, commodity prices are increasing. The global price of cocoa, one of Nestlé's main raw materials, has increased by 6.47% YoY and 7.54% month-on-month (MoM). The price of sugar has increased by 26.4% YoY and by 53.4% MoM. Additionally, with Nigeria recording a negative growth of -0.36% in Q1 2016, it is at the brink of a recession. Any further economic setback could further weaken the dampened consumer confidence.

The security challenges in the country, especially in the south-south and north-east regions have limited Nestlé's sales and distribution. Sustained attacks from Boko Haram have affected various sales and marketing initiatives that would have taken Nestlé closer to consumers in the northern area of the country.

In spite of Nestlé Nigeria's management's ability to manage the macroeconomic challenges it faces in the near future, the intensity of the macro headwinds could challenge the company's performance. While first quarter results of 2016 were remarkable, several macroeconomic factors and risks may reduce its potential performance.

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