



NESTLE LANKA PLC [NEST.N0000]

UPGRADING TO BUY

GIANT STRIDES TOWARDS FAST FOOD

Fair Value: 2018E - LKR 1,800.0 [+6%], 2019E - LKR 2,050.0 [+20%]

Buy Below: LKR 1718.7

*NEST earnings grew 9%YoY to LKR 944Mn supported by enhanced margins and control efficiencies. With earnings falling marginally above our expectations, we upgrade earnings by +8% to LKR 4.2Bn. However, fair value is maintained at LKR 1800.0 for 2018E and LKR 2,050.0 for 2019E. With capacity expansion and possible pick-up in demand, we upgrade in advance to **BUY** on 2019E valuations.*

LKR (Mn)	1Q2017	1Q2018	YoY	2016	2017	YoY
Revenue	9,388	9,619	+2%	36,462	37,601	+3%
Gross Profit	3,369	3,556	+6%	14,187	13,333	-6%
EBIT	1,118	1,260	+13%	5,723	4,876	-15%
PBT	1,116	1,250	+12%	5,712	4,733	-17%
Net Profit	862	944	+9%	4,399	3,634	-17%
Borrowings	9,019	12,342	+37%	7,804	10,707	+37%
Shareholder's Equity	4,196	4,402	+5%	5,483	4,813	-12%
NAVPS	78.1	81.9		102.0	89.6	

Earnings up +9%YoY with stronger GP and EBIT margins

NEST's earnings was recorded at LKR 944Mn, +9% YoY mainly contributed by stronger GP margins and operational efficacies. Tight monetary conditions resulted in slower consumer demand as revenue only managed grow +2%YoY. The gains in the EBIT from operational efficiencies was partially offset by the rise in finance cost amidst a surge in short term borrowings to fund its LKR 5Bn expansion. With margins strengthening, economy showing signs of improvement and new capacity being available by 4Q2018, we've upgraded our revenue by +5% and +10% for 2018E and 2019E while earnings are upgraded by +8% and +1% respectively.

GP Margin grows to 37% despite new sugar tax, Range of New Products

Nestle GP margins was recorded at 37% for the 2nd consecutive quarter despite a sugar tax being incorporated from Nov 2017 budget (sugar tax of 50 cents per gram). GP Margins improved YoY to 37% from 36% in 1Q2017 while maintaining as at 4Q2017. NEST went through price revisions in a range of products over the last 6 months leading to improvement in margins and negating sugar tax impact. Further, as a strategy NEST over the last 6-8 months shifted focus to a more healthy and qualitative product mix in the beverage range introducing new products such as "Nestomalt Gold" (a new RTD pack), "Nestomalt Plus" (a new health drink with mixer of oats), "Nestle Coco up" (a new RTD pack, made from coconut water & fresh milk and first of its kind for Nestle Worldwide). New varieties were introduced for the food market with "Maggi Creations" (new nasigoreng and biriyani style noodle meals) and "Maggi Pazzta" (a new valued added pasta category).

EBIT Margins reach 13%YoY

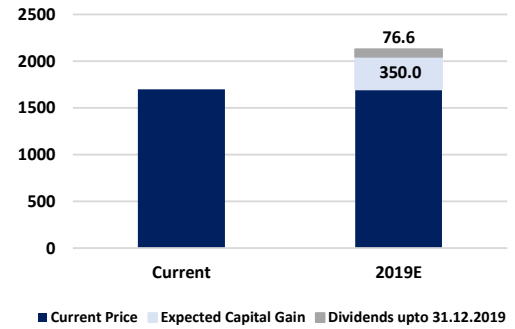
NEST's opex has remained broadly flat with only a marginal +2%YoY growth which has been the predominant factor in boosting bottom line. EBIT margins reached 13% from 12% in 1Q2017 on the back of greater focus on cost control measures with the support of operational efficiencies. But margins are down from 16% in 4Q2017 as NEST introduced a number of products (Nestle Coco up, Maggi Creations & Maggi Pazzta) in the 1Q2018.

Rising Finance cost with New Factory

Finance expenses increased by 55%YoY to LKR 19Mn amidst increase in borrowings by way of overdrafts due to the construction of its new manufacturing facility at Pannala. NEST's total capacity expansion project is worth LKR 5Bn and its first phase is expected to come into operation end of 2018. We expect total finance cost to rise to LKR 0.5Bn in 2018E.

NEST Upgrade to BUY on new capacity of 2019E

With new capacity likely to be fully available and possible rise in consumer demand in 2019E, we upgrade NEST in advance to BUY on 2019E fair value of LKR 2,050.0.



FIRST CAPITAL RESEARCH

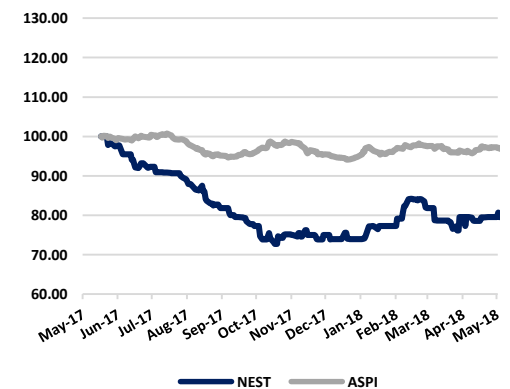
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KEY DATA

CSE Ticker	NEST.N0000
Bloomberg Ticker	NEST SL
Share Price (LKR)	1,700
52w High (LKR)	2,322
52w Low (LKR)	1,625
Avg. Daily Volume (Shares)	1,699
Avg. Daily Turnover (LKR)	3,571,329
Issued Share Capital (Shares 'Mn)	54
Market Cap (LKR 'Mn)	91,333
Market Cap (USD 'Mn)	582

*1 USD = LKR 157

Price Performance (%)	1 mth	3 mths	12mths
NEST	0.25%	-3.33%	-22.55%
ASPI	0.85%	-0.87%	-2.72%



Disclosure on Shareholding:

First Capital Group do not hold shares in NEST and will not trade in this share for three trading days following the issue of this document.

Estimate Revision

In LKR Mn	2018E-O	2018E-R	% Change	2019E - O	2019E - R	% Change
Earnings Estimate						
Revenue	39,931	42,031	+5%	44,810	49,197	+10%
Gross Profit	15,094	14,711	-3%	17,117	17,809	+4%
EBIT	5,492	5,954	+8%	7,037	7,102	+1%
Profit before Tax	5,137	5,455	+6%	6,880	6,859	-0%
Net Profit	3,904	4,201	+8%	5,229	5,281	+1%
Adjusted EPS	72.7	78.2		97.3	98.3	
Growth YoY	24%	16%		34%	26%	
Balance Sheet Estimate						
Shareholders' Equity	5,624	6,327	+13%	5,728	7,492	+31%
Borrowings	2,599	2,136	-18%	1,599	1,636	+2%
Adjusted NAVPS	104.7	117.8		106.6	139.4	
Ratio Estimate						
ROE (%)	69%	66%		91%	70%	
PER (x)	23.1	21.7		17.2	17.3	
PBV (x)	16.0	14.4		15.7	12.2	

Valuation Table

P/E 31 December	2014	2015	2016	2017	2018E	2019E	2020E
Estimates (LKR 'Mn)							
Gross Profit	12,135	13,322	14,187	13,333	14,711	17,809	20,261
Operating Profit	4,759	5,418	5,723	4,876	5,954	7,102	8,379
Net Profit	3,787	4,124	4,399	3,634	4,201	5,281	6,336
Adjusted EPS (LKR)	70.5	76.8	81.9	67.6	78.2	98.3	117.9
YoY Growth (%)	14%	9%	7%	-17%	16%	26%	20%
Valuations							
PER (x)	24.1x	22.1x	20.8x	25.1x	21.7x	17.3x	14.4x
PBV (x)	22.3x	20.2x	16.7x	19.0x	14.4x	12.2x	10.6x
DY (%)	4.0%	3.8%	4.7%	2.9%	4.5%	5.7%	6.8%

Valuation Summary

Expected NEST price for 2019E	
PER based target price	2,162.7
DCF Valuation based target price	1,888.8
Average Target Price	2,025.8
Target Price after Rounding off	2,050.0

Return	
Target Price	2,050.0
Current Price	1,700.0
Capital Gain (LKR)	350.0
Dividend upto 31.12.2019 (LKR)	76.6
Capital Gain %	20%
Dividend Yield %	5%
Total Return %	25%
Annualized Return %	15%

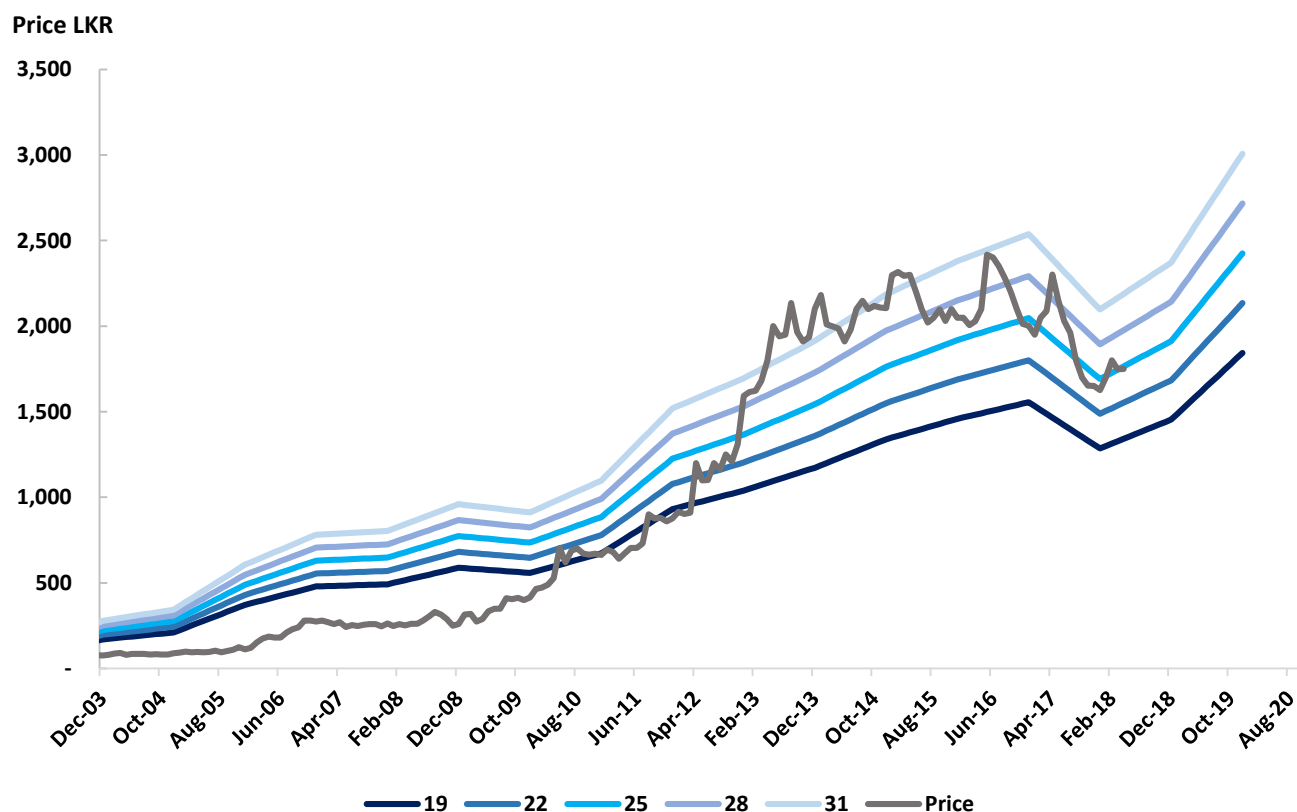
Discounted Cash flow Valuation

DCF based Valuation	
Enterprise Value	101,851
(-) Debt	(1,636)
(+) Cash	1,264
Total Value of Equity	101,479
No. of shares (Mn)	54
Target Price	1,888.8

WACC	
Ke	12.3%
Kd	11%
D/E Assumption	40 / 60
Terminal Growth (%)	3%
WACC	11%

COE	
R _f	9.1%
R _m	14.1%
Growth %	3.0%
β	0.46
Adjusted β	0.64
$K_e = R_f + \beta (R_m - R_f)$	12.3%

PER Valuation



Source: CSE, Company Annual Reports and First Capital Research Estimates

PER based Valuation	
2019E Earnings (LKR 'Mn)	5,281
No. of Shares ('Mn)	54
2019E EPS	98.30
Expected PER	22.0x
Price at 22.0x 2019E Earnings	2,162.7

Appendix I: Statement of Income and Expenses

Income Statement (LKR Mn) Y/E 31st December	2014	2015	2016	2017	2018E	2019E	2020E
Revenue	32,903	34,703	36,462	37,601	42,031	49,197	56,281
Cost of Sales	-20,767	-21,381	-22,275	-24,269	-27,320	-31,387	-36,020
Gross Profit	12,135	13,322	14,187	13,333	14,711	17,809	20,261
Other Operating Income / (Expense)	92	-13	-13	-45	-45	-45	-45
Marketing, Selling and Distribution Expenses	-5,502	-5,766	-6,263	-6,063	-6,094	-7,871	-8,724
Administrative Expenses	-1,966	-2,125	-2,188	-2,349	-2,617	-2,791	-3,113
Results from Operating Activities	4,759	5,418	5,723	4,876	5,954	7,102	8,379
Finance Income	33	38	33	31	35	35	35
Finance Expenses	-27	-31	-44	-174	-534	-278	-185
Net Finance Expense	7	8	-11	-143	-499	-243	-150
Profit Before Taxation	4,766	5,426	5,712	4,733	5,455	6,859	8,229
Income Tax Expense	-979	-1,301	-1,313	-1,099	-1,255	-1,578	-1,893
Profit for the Year	3,787	4,124	4,399	3,634	4,201	5,281	6,336
EPS	70.5	76.8	81.9	67.6	78.2	98.3	117.9

Source: Company Annual Reports and First Capital Research Estimates

Appendix II: Statement of Financial Position

Balance Sheet (LKR Mn)	2014	2015	2016	2017	2018E	2019E	2020E
As at 31st December							
ASSETS							
Non-Current Assets							
Property, Plant and Equipment	5,209	5,477	5,525	5,309	6,770	8,528	9,156
Capital Work-in-Progress	206	144	456	2,486	2,986	1,486	386
	5,415	5,621	5,980	7,795	9,755	10,014	9,542
Current Assets							
Inventories	2,953	3,322	3,935	2,870	2,942	3,444	4,221
Trade and Other Receivables	1,816	2,107	2,730	3,966	2,900	3,395	3,658
Amounts Due from Related Parties	305	204	248	761	761	761	761
Cash and Cash Equivalents	283	868	393	129	493	1,264	2,079
	5,356	6,501	7,306	7,726	7,097	8,864	10,720
Total Assets	10,771	12,122	13,287	15,520	16,852	18,877	20,262
EQUITY AND LIABILITIES							
Equity							
Stated Capital	537	537	537	537	537	537	537
Retained Earnings	3,551	3,984	4,945	4,276	5,790	6,955	8,115
	4,088	4,522	5,483	4,813	6,327	7,492	8,653
Non-Current Liabilities							
Retirement Benefit Obligations	515	522	465	454	454	454	454
Deferred Tax Liabilities	641	699	802	839	839	839	839
	1,156	1,222	1,267	1,294	1,294	1,294	1,294
Current Liabilities							
Trade and Other Payables	3,765	4,137	4,368	4,770	4,918	6,121	6,556
Amounts Due to Related Parties	749	714	899	1,220	1,220	1,220	1,220
Income Tax Payable	706	942	806	719	790	947	1,136
Dividends Payable	103	137	151	168	168	168	168
Bank Overdrafts	205	448	313	2,536	2,136	1,636	1,236
Total Current Liabilities	5,527	6,379	6,537	9,414	9,232	10,092	10,316
Total Liabilities	6,683	7,600	7,804	10,707	10,525	11,385	11,609
Total Equity and Liabilities	10,771	12,122	13,287	15,520	16,852	18,877	20,262
NAVPS	76.1	84.2	102.0	89.6	117.8	139.4	161.1

Source: Company Annual Reports and First Capital Research Estimates

Appendix III: Statement of Cash flow

Cash flow Statement (LKR Mn) Y/E 31st December	2014	2015	2016	2017	2018E	2019E	2020E
Cash Flow from Operating Activities							
Profit Before Taxation	4,766	5,426	5,712	4,733	5,455	6,859	8,229
Adjustments for;							
Depreciation	548	603	625	639	839	942	1,172
(Gain) / Loss on Sale of Property, Plant and Equipment	-47	-31	-15	8	0	0	0
Amortisation of Staff Loan Interest	17	18	17	27	0	0	0
Interest Expense	25	31	44	174	534	278	185
Interest Income	-33	-29	-27	-29	-35	-35	-35
Provision for Obsolete Inventories and Inventory Written Off	160	120	153	193	0	0	0
Provision for Impairment of Trade Receivables	11	8	12	32	0	0	0
Provision for Retirement Benefit Obligations	162	99	105	103	0	0	0
Operating Profit Before Working Capital Changes	5,612	6,243	6,627	5,880	6,793	8,043	9,551
Working Capital Changes							
(Increase) / Decrease in Inventories	-500	-462	-764	884	-73	-502	-777
(Increase) in Trade and Other Receivables	196	-197	-678	-1,782	1,066	-494	-264
Increase / (Decrease) in Trade and Payables	738	310	414	712	147	1,203	435
Cash Generated From Operations	6,046	5,894	5,598	5,694	7,934	8,250	8,945
Interest Paid	-25	-31	-44	-174	-534	-278	-185
Income Tax Paid	-692	-1,000	-1,357	-1,146	-1,184	-1,420	-1,704
Retirement Benefit Obligations Paid	-181	-115	-125	-121	0	0	0
Net Cash Flows Generated from Operating Activities	5,147	4,110	4,073	4,253	6,215	6,552	7,056
Cash Flow from Investing Activities							
Purchase of Property, Plant and Equipment	-1,166	-813	-1,008	-2,466	-2,800	-1,200	-700
Proceeds from Sale of Property, Plant and Equipment	49	35	38	4	0	0	0
Interest Received	16	11	10	2	35	35	35
Net Cash Flows Used in Investing Activities	-1,101	-767	-960	-2,460	-2,765	-1,165	-665
Cash Flow from Financing Activities							
Dividends Paid	-3,853	-3,001	-3,451	-4,281	-2,686	-4,117	-5,176
Net Cash Flows Used in Financing Activities	-3,853	-3,001	-3,451	-4,281	-2,686	-4,117	-5,176
Net Decrease in Cash and Cash Equivalents	193	342	-339	-2,488	764	1,271	1,215
Cash and Cash Equivalents at the Beginning of the Year	-116	77	419	81	-2,408	-1,643	-373
Cash and Cash Equivalents at the End of the Year	77	419	81	-2,408	-1,643	-373	843

Source: Company Annual Reports and First Capital Research Estimates

Top 20 Shareholders

Top 20 shareholders - (% held)	1Q2018	4Q2017	QoQ	1Q2017	YoY
Nestle S.A	90.8%	90.8%	-	90.8%	0.0%
Citi Bank New York S/A Norges Bank Account 2	0.9%	0.8%	0.1%	0.0%	0.9%
RBC Investor Services Bank - Coeli Sicav I-Frontier Markets Fund	0.6%	0.5%	0.0%	0.5%	0.0%
Deutsche Bank AG-London	0.5%	0.0%	0.5%	0.0%	0.5%
SEB AB-Tundra Frontier Opportunities Fund	0.4%	0.4%	-	0.0%	0.4%
Ms. Neesha Harnam	0.4%	0.4%	-	0.4%	0.0%
Sri Lanka Insurance Corporation Ltd - Life Fund	0.3%	0.3%	-	0.0%	0.3%
HSBC International Nominees Limited - SSBT - Deutsche Bank AG Singapo	0.3%	0.3%	-	0.3%	0.0%
HSBC International Nominees Limited - SSBT - Comingled Benefit Fund Tr	0.2%	0.2%	-	0.0%	0.2%
HSBC International Nominees Limited - BBH - Fidelity Funds	0.2%	0.4%	-0.2%	0.4%	-0.2%
Employee Provident Fund	0.2%	0.2%	-	0.2%	0.0%
Mrs. Singh Jasbinderjit Kaur Piara	0.1%	0.1%	0.0%	0.0%	0.1%
HSBC International Nominees Limited - UBS AG Singapore Branch (EX SBC	0.1%	0.2%	-0.1%	0.2%	-0.1%
Colombo Investment Trust PLC	0.1%	0.1%	-	0.1%	0.0%
HSBC International Nominees Limited - SSBT - Russell Investments Institu	0.1%	0.1%	0.0%	0.0%	0.1%
Mrs. Merchant Asha Ajay	0.1%	0.1%	-	0.1%	0.0%
Mr. Hirdaramani Anil Kumar Lalchand	0.1%	0.1%	-	0.1%	0.0%
Mr. Maheswaran Radhakrishnan	0.1%	0.1%	-	0.1%	0.0%
Miss. Radhakrishnan Andal	0.1%	0.0%	0.1%	0.0%	0.1%
Miss. Radhakrishnan Meenambigai Priyadarshini	0.1%	0.0%	0.1%	0.1%	0.0%

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