



NESTLE LANKA PLC [NEST.N0000]

MAINTAIN BUY

STRONGER MARGINS, BOOMING GROWTH

Fair Value: 2018E – 1,800 [+10%], 2019E – LKR 2,050 [+25%]

Total Return 2018E - with DPS 13% [AER 182%], 2019E – with DPS 29% [AER 26%]

NEST earnings for 3Q2018 improved by 16%YoY to LKR 941Mn on the back of falling global and local commodity prices. With the expectation of volumes continuing to pick-up, we maintain 2018E and 2019E revenue at LKR 42.0Bn (+12%) and LKR 49.2Bn (+17%) respectively. Post April 2018 company profits are being liable to an effective tax rate of 28%. Prior to April 2018, concessionary tax rates of 12% for exports, 10% RTD milk and exception to off-shore business earned from foreign currency were exempt from income tax. Thereby, on the back of increase in the effective rate of taxes, we downgrade earnings for 2018E to LKR 3.9Bn from previous forecasts of LKR 4.2Bn but we maintain 2019E earnings on the back of stronger than expected EBIT margins. Our previous fair value for 2018E LKR 1,800 was achieved in mid-August while price has significantly declined afterwards. We rollover our fair value for 2019E which we maintain at LKR 2,050. **MAINTAIN BUY**

LKR (Mn)	3Q2017	3Q2018	YoY	9M2017	9M2018	YoY
Earnings (LKR 'Mn)						
Revenue	9,637	9,300	-3%	27,624	27,950	+1%
Gross Profit	3,281	3,711	+13%	9,670	10,599	+10%
EBIT	1,123	1,375	+22%	3,317	3,882	+17%
PBT	1,061	1,307	+23%	3,204	3,743	+17%
Net Profit	814	941	+16%	2,457	2,620	+7%
Balance Sheet (LKR 'Mn)						
Shareholder's Equity	3,640	4,716	+30%	3,640	4,716	+30%
Borrowings	10,159	13,011	+28%	10,159	13,011	+28%
NAVPS	67.8	87.8		67.8	87.8	

Bottom line up +16%YoY, amidst stronger GP and EBIT margins

NEST's earnings for 3Q2018 were recorded at LKR 941Mn, +16%YoY mainly contributed by the lower costs which outweighed the dip in sales for the quarter by a mere 3%YoY. Cost of sales for 3Q2018 dipped by 12%YoY, mainly driven by the fall in coconut and wheat prices in addition to the fall in global milk prices which benefitted the imported products (such as Kit Kat). GP margin for 3Q2018 was recorded at 40% in line with the fall in cost of sales. EBIT margin for 3Q2018 was recorded at 15% despite the rise in marketing, selling and distribution expenses by +45%YoY. The gains in the EBIT margin are also attributed to lower costs and operational efficiencies.

GP margin at 40%, introduction of a new range of products

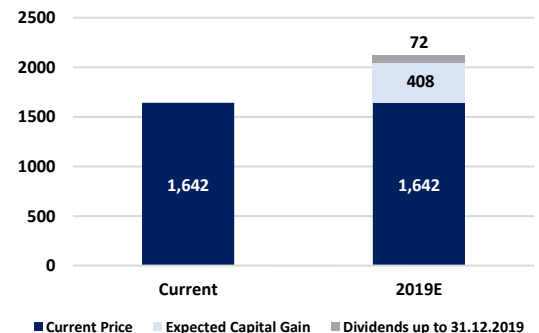
Nestle GP margins strengthens to 40% on the back of gains made by the crash in local and global commodity prices. Revenue dropped by 3%YoY, due to volume dip owing to price revisions done on a range of products. We expect volumes to pick up and for consumers to adjust to the price increases at a faster pace; hence, we maintain our revenue targets for 2018E and 2019E at LKR 42.0Bn and LKR 49.2Bn respectively. Further, as a strategy over the last 10 months NEST shifted focus to a more healthy and qualitative product mix, the most recent additions being Nestle a+ full cream UHT milk and Nescafe Hazel-Ice (a new RTD pack).

Tax rate at 28%, tax concessions/exceptions no longer apply

The effective tax rate for NEST in 2017 was 23% however; from April 2018 tax concessionary rates on exports and exceptions on foreign currency are no longer applicable. Therefore, we downgrade earnings for 2018E to LKR 3.9Bn from previous forecast of LKR 4.2Bn. However, we maintain earnings for 2019E due to strengthening of EBIT margins which outweigh the impact of the rise in effective tax rate to 28%.

NEST maintain BUY on new capacity for 2019E

With new capacity being available from 4Q2018 (capacity expansion project of LKR 5.0Bn at Pannala, first phase expected to come into operation end of 2018) coupled with possible rise in consumer demand in 2019E, we maintain BUY on 2019E valuation at a fair value of LKR 2,050.



FIRST CAPITAL RESEARCH

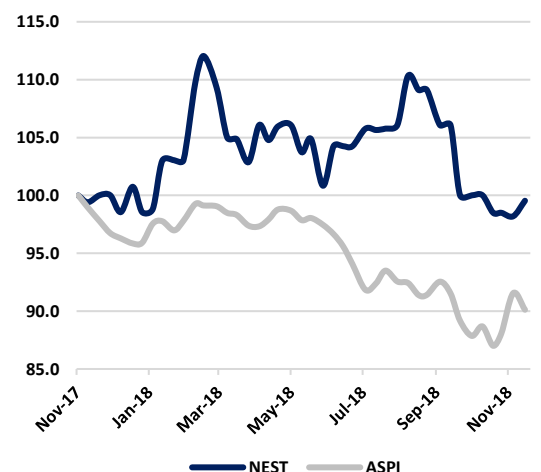
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KEY DATA

CSE Ticker	NEST.N0000
Bloomberg Ticker	NEST SL
Share Price (LKR)	1,642
52w High (LKR)	1,852
52w Low (LKR)	1,620
Avg. Daily Volume (Shares)	6,217
Avg. Daily Turnover (LKR)	10,457,824
Issued Share Capital (Shares 'Mn)	54
Market Cap (LKR 'Mn)	88,228
Market Cap (USD 'Mn)	501

*1 USD = LKR 176

Price Performance (%)	1 mth	3 mths	12mths
NEST	1%	-9%	0%
ASPI	3%	-2%	-8%



Source: CSE

Minimum Return for BUY:

Buy Below 2019E - [17.46% "criteria B"]: LKR 1,773.0

NEST categorized as 'Grade B' counter (Refer page 09 for Recommendation criteria of Grade A, B & C Stocks)

Disclosure on Shareholding:

First Capital Group does 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	42,031	42,031	0%	49,197	49,197	0%
Gross Profit	14,711	14,711	0%	17,809	17,809	0%
EBIT	5,954	5,953	-0%	7,102	7,757	+9%
Profit before Tax	5,455	5,467	+0%	6,859	7,526	+10%
Net Profit	4,201	3,936	-6%	5,281	5,419	+3%
Adjusted EPS	78.2	73.3		98.3	100.9	
Growth YoY	16%	8%		26%	38%	
Balance Sheet Estimate						
Shareholders' Equity	6,327	6,063	-4%	7,492	7,624	+2%
Borrowings	2,136	2,136	0%	1,636	1,636	0%
Adjusted NAVPS	117.8	112.8		139.4	141.9	
Ratio Estimate						
ROE (%)	66%	65%		70%	71%	
PER (x)	21.9	22.4		17.4	16.3	
PBV (x)	14.6	14.6		12.3	11.6	

Valuation Table

P/E 31 December	2014	2015	2016	2017	2018E	2019E	2020E
Estimates (LKR 'Mn)							
Revenue	32,903	34,703	36,462	37,601	42,031	49,197	56,281
Net Profit	3,787	4,124	4,399	3,634	3,936	5,419	6,429
EPS (LKR)	70.5	76.8	81.9	67.6	73.3	100.9	119.7
YoY % Growth	14%	9%	7%	-17%	8%	38%	19%
Valuations							
PER (x)	23.3x	21.4x	20.1x	24.3x	22.4x	16.3x	13.7x
PBV (x)	21.6x	19.5x	16.1x	18.3x	14.6x	11.6x	10.1x
Div Yield (%)	4.2%	3.9%	4.9%	3.0%	4.4%	6.0%	7.1%

Valuation Summary

Expected NEST price for 2019E	
PER based target price	2,159
DCF Valuation based target price	1,941
Average Target Price	2,050
Target Price after Rounding off	2,050

Return	
Target Price	2,050
Current Price	1,642
Capital Gain (LKR)	408
*Dividend upto 31.12.2019 (LKR)	72
Capital Gain %	25%
Dividend Yield %	4%
Total Return %	29%
Annualized Return %	26%

*paid in 2019E March and May

Discounted Cash flow Valuation

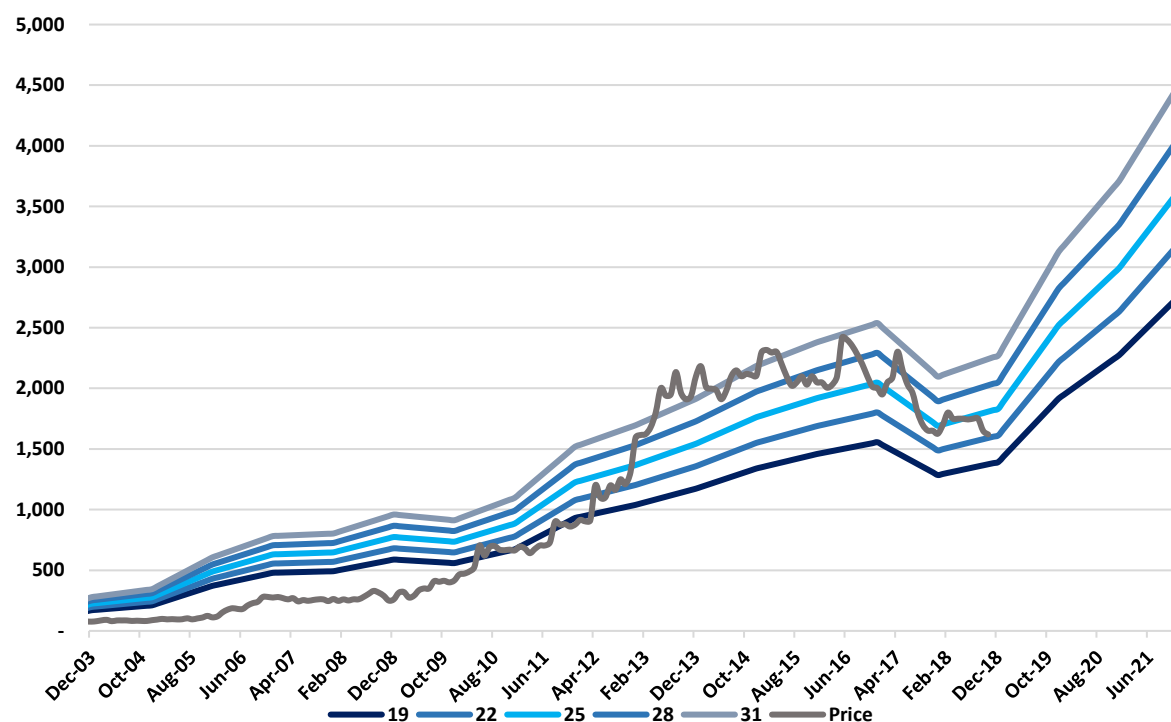
DCF based Valuation	
Enterprise Value	104,287
(-) Debt	(1,636)
(+) Cash	1,652
Total Value of Equity	104,303
No. of shares (Mn)	54
Target Price	1,941

WACC	
Ke	12%
Kd	11%
D/E Assumption	40 / 60
Terminal Growth (%)	3%
WACC	11%

COE	
R _f	9.5%
R _m	14.5%
Growth %	3.0%
β	0.57
$K_e = R_f + \beta (R_m - R_f)$	12%

PER Valuation

Price LKR



Source: CSE, Company annual reports and First Capital Research Estimates

PER based Valuation	
2019E Earnings (LKR 'Mn)	5,419
No. of Shares ('Mn)	54
2019E EPS	101
Expected PER	21x
Price at 21x 2019E Earnings	2,159

Appendix I: Statement of Income and Expenses

Income Statement (LKR Mn)	2014	2015	2016	2017	2018E	2019E	2020E
Y/E 31st December							
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	-6,725	-7,871	-8,724
Administrative Expenses	-1,966	-2,125	-2,188	-2,349	-1,987	-2,136	-2,425
Results from Operating Activities	4,759	5,418	5,723	4,876	5,953	7,757	9,067
Finance Income	33	38	33	31	47	47	47
Finance Expenses	-27	-31	-44	-174	-534	-278	-185
Net Finance Expense	7	8	-11	-143	-487	-231	-138
Profit Before Taxation	4,766	5,426	5,712	4,733	5,467	7,526	8,929
Income Tax Expense	-979	-1,301	-1,313	-1,099	-1,531	-2,107	-2,500
Profit for the Year	3,787	4,124	4,399	3,634	3,936	5,419	6,429
EPS	70.5	76.8	81.9	67.6	73.3	100.9	119.7

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	339	1,652	2,514
	5,356	6,501	7,306	7,726	6,943	9,252	11,155
Total Assets	10,771	12,122	13,287	15,520	16,698	19,265	20,697
EQUITY AND LIABILITIES							
Equity							
Stated Capital	537	537	537	537	537	537	537
Retained Earnings	3,551	3,984	4,945	4,276	5,525	7,087	8,205
	4,088	4,522	5,483	4,813	6,063	7,624	8,742
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	900	1,203	1,481
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	9,342	10,348	10,661
Total Liabilities	6,683	7,600	7,804	10,707	10,635	11,641	11,955
Total Equity and Liabilities	10,771	12,122	13,287	15,520	16,698	19,265	20,697
NAVPS	76.1	84.2	102.0	89.6	112.8	141.9	162.7

Source: Company annual reports and First Capital Research Estimates

Appendix III: Statement of Cash flow

Cash flow Statement (LKR Mn)	2014	2015	2016	2017	2018E	2019E	2020E
Y/E 31st December							
Cash Flow from Operating Activities							
Profit Before Taxation	4,766	5,426	5,712	4,733	5,467	7,526	8,929
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	-47	-47	-47
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	8,699	10,239
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	7,933	8,906	9,633
Interest Paid	-25	-31	-44	-174	-534	-278	-185
Income Tax Paid	-692	-1,000	-1,357	-1,146	-1,350	-1,804	-2,222
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	6,049	6,823	7,226
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	47	47	47
Net Cash Flows Used in Investing Activities	-1,101	-767	-960	-2,460	-2,753	-1,153	-653
Cash Flow from Financing Activities							
Dividends Paid	-3,853	-3,001	-3,451	-4,281	-2,686	-3,857	-5,310
Net Cash Flows Used in Financing Activities	-3,853	-3,001	-3,451	-4,281	-2,686	-3,857	-5,310
Net Decrease in Cash and Cash Equivalents	193	342	-339	-2,488	610	1,813	1,263
Cash and Cash Equivalents at the Beginning of the Year	-116	77	419	81	-2,408	-1,797	16
Cash and Cash Equivalents at the End of the Year	77	419	81	-2,408	-1,797	16	1,278

Source: Company annual reports and First Capital Research Estimates

Appendix IV: Top 20 Shareholders

Top 20 shareholders - (% held)	3Q2018	2Q2018	QoQ	3Q2017	YoY
Nestle S.A	90.8%	90.8%	-	90.8%	-
Citi Bank New York S/A Norges Bank Account 2	0.9%	0.9%	-	0.0%	0.9%
RBC Investor Services Bank - Coeli Sicav I-Frontier Markets Fund	0.6%	0.6%	-	0.5%	0.0%
Deutsche Bank AG-London	0.5%	0.5%	-	0.0%	0.5%
Ms. Neesha Harnam	0.4%	0.4%	-	0.4%	-
Sri Lanka Insurance Corporation Ltd - Life Fund	0.3%	0.3%	-	0.3%	-
HSBC International Nominees Limited - SSBT - Deutsche Bank AG Singapo	0.3%	0.3%	-	0.3%	-
SEB AB-Tundra Frontier Opportunities Fund	0.2%	0.0%	0.2%	0.0%	0.2%
BBH - Fidelity Funds	0.2%	0.2%	-	0.4%	-0.2%
Employee Provident Fund	0.2%	0.2%	-	0.2%	-
HINL - SSBT - AI Mehwar Commercial Investments L.L.LC	0.2%	0.0%	0.2%	0.0%	0.2%
BNYH RE-GHI Holdings Maruitius	0.1%	0.0%	0.1%	0.0%	0.1%
HSBC International Nominees Limited - SSBT - Frank Russel Trust Compar	0.1%	0.2%	-0.1%	0.2%	-0.1%
Union Assurance PLC/ Account No.5	0.1%	0.1%	-	0.0%	0.1%
Mrs. Singh Jasbinderjit Kaur Piara	0.1%	0.1%	-	0.1%	0.0%
Mr. Subasinghe Prabhash	0.1%	0.0%	0.1%	0.0%	0.1%
Colombo Investment Trust PLC	0.1%	0.1%	-	0.1%	-
HSBC International Nominees Limited - SSBT - Russel Investments Institu	0.1%	0.1%	-	0.1%	0.0%
Mr. Udeshi Morajinmeghji joint Mrs. Merchant Asha Ajay	0.1%	0.0%	0.1%	0.0%	0.1%
Mr. Hidramani Anil Kumar Lalchand	0.1%	0.0%	0.1%	0.1%	-

Appendix V: Recommendation criteria

Categorization	Company Category	Buy	Hold	Sell
Grade A	S&P SL20 Companies	T.Bill + 5% & Above	T.Bill + 1% & Above	Below T.Bill + 1%
Grade B	Rest of the Companies	T.Bill + 8% & Above	T.Bill + 3% & Above	Below T.Bill + 3%
Grade C	Companies less than LKR 1Bn Market Cap	T.Bill + 11% & Above	T.Bill + 6% & Above	Below T.Bill + 6%

Categorization	Company Category	Buy	Hold	Sell
Grade A	S&P SL20 Companies	14.46%	10.46%	10.46%
Grade B	Rest of the Companies	17.46%	12.46%	12.46%
Grade C	Companies less than LKR 1Bn Market Cap	20.46%	15.46%	15.46%

Weighted Average 1 year T-bill rate during Jun 2018: 9.46%



First Capital

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RESEARCH

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GOVERNMENT SECURITIES SALES

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Anushka Dissanayake	+94 77 2220 021	Arun Kandasamy	+94 75 4861 506
Anushi Ranawaka	+94 77 3876 819		

CORPORATE DEBT SALES

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Nethalie De Mel	+94 11 2639 854	Dharshanie Vasanthajothy	+94 77 9159 878

EQUITY SALES

CEO	Jaliya Wijeratne	+94 70 2910 042	Negombo	
			Priyanka Anuruddha	+94 70 2910 035
Colombo			Priyantha Wijesiri	+94 70 2910 036
Damian Le Grand		+94 70 2910 032		
Nishantha Mudalige		+94 70 2910 041		
Isuru Jayawardana		+94 70 2910 034		
Ifadh Marikar		+94 77 9625 679		
Thushara Pathiraja		+94 70 2910 037		
Anushka Buddhika		+94 70 2910 030		
Gamini Hettiarachchi		+94 70 2910 039		

UNIT TRUST SALES

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Imali Abeygunawardena	+94 77 1764 799		

BRANCHES

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