

MERISTEM EQUITY RESEARCH REPORT



REPORT DATE: JUNE 08, 2007

12-Month Target Price = N206.54

EXECUTIVE SUMMARY AND INVESTMENT RATIONALE

- Nestle Nigeria Plc commenced operations in 1961 and was listed on the Nigerian Stock Exchange on April 20, 1979. The company is a subsidiary of Nestle S.A. of Switzerland, which together with Nestle CWA Limited own 62% of Nestle Nigeria Plc.
- It has a well-diversified products portfolio ranging from baby foods, dairy products, beverages, chocolates, bottled water, prepared foods and the Maggi range of seasonings is set to ensure a continuous stream of profitability capable of absorbing potential shocks caused by loss of business in one area.
- Nestle has recorded a **Compounded Annual Growth Rate-CAGR** in revenues and **Profit After Tax (PAT)** of 18.47 per cent and 15.51 per cent respectively for past 5 years. Our 2007 forecasts for revenues and earnings are N46.11bn and N6.51bn respectively with a projected **Sustainable Growth Rate (SGR)** of 6 percent
- The company has made bonus declarations ten times in the last 20 years and has consistently paid dividend to shareholders every year for the past 10 years
- Risk attached to our analysis is the degree of competition within the industry, exchange rate risk as the company is exposed to foreign transactions, policy risk that involve possible reversal of ban on importation of selected infant products and confectionaries which may compete away the company's market share. Other considerations include macroeconomic variables that directly impact on disposable income and consumers' purchasing power. The availability of substitute products also presents greater challenge to our valuation. The fact that the company hardly retains its earnings has affected its potential upside growth. This has more implication when industry rivalry

increases due to new entrants.

- The Company ROE is very attractive at 86 per cent in FY 2006 (CAGR of 160 per cent) which is far above the estimated cost of equity of 12 per cent. This indicates excess return on investment over costs. However, entrance of new companies into the industry with new technology may pose serious challenges to the sustainability of the residual income.
- We therefore make a **Hold** recommendation on NESTLE NIGERIA PLC.

The Economy

The Nigerian Economy has been beset with problems over the past four decades. Mismanagement of oil revenues, inept power supply and poor infrastructure facilities have led to decreased output from the real sector and losses in per capita income from US\$1,000 in 1965 to just above US\$300 in 2006. The return to democracy in 1999 brought with it antecedent reforms which are geared towards returning the country to its lost glory. Programs such as NEEDS, SEEDS and NEPAD are creating macroeconomic empowerment and providing a platform for economic growth and poverty reduction in the country. An increased level of fiscal reform and transparency has been observed as well as renewed investment in the manufacturing and non-oil sectors, which have produced burgeoning opportunities for private sector enterprise. Debt relief by international agencies has freed up much needed funds which the Government has ploughed back into the economy. Nigeria is also witnessing a wave of foreign investment from large multinationals and private equity investment firms, which has traversed various sectors of the economy from Breweries to Banking and Agriculture. Government reforms in the Banking and Insurance sectors have created a larger, more stable and viable financial sector. Dwindling inflation (currently at 4.2 per cent), stable interest and foreign exchange rates are further evidence that the economy is on the right track.

The Industry

The Food and Beverage industry in Nigeria is laced with potentials given the size of the country's population of 140million people. However, low capacity utilization, competition from foreign imports, erratic power supply and poor water supply has plagued the industry in recent times. The problems of power and supply of clean water have added an estimated 20%

- 25% to the cost of production, which has to be passed on to the consumer especially when the product is inelastic. Poor road networks, weak telecommunications and lack of a viable railways system has also contributed to costs of input. Dearth of raw materials input and obsolete processes and machinery are other examples of challenges facing the industry. Another allegation leveled against the industry is the non- provision of a wide array of quality products which puts the industry at risk to foreign imports. The industry is still very viable as seen by the recent foreign investments in some companies in the sector. The main driver for change and continued profitability will be infrastructural development and advances in production methods.

NESTLE RISK PROFILE

The company faces competitive risks from its main rival **Cadbury Nigeria Plc** and from other imported substitutes for its products. Nestle allays these fears by its consistent product improvements through huge investments in research and development (R&D) which have differentiated them from others in the market and made them a preferred choice by a segment of consumers. Foreign exchange risk also exists as Nestle Nigeria Plc is involved in inter-company trading with other international Nestle subsidiary companies. Government policy risk exists for the company, as any attempt by the Federal Government to liberalise the sector will compete away the market share from Nestle. Adulteration of Nestle brands is a factor for consideration. The brands are fast moving and adulteration is not uncommon. The company mitigates this risk with continuous product differentiation, proper packaging and metallic security seals on some products.

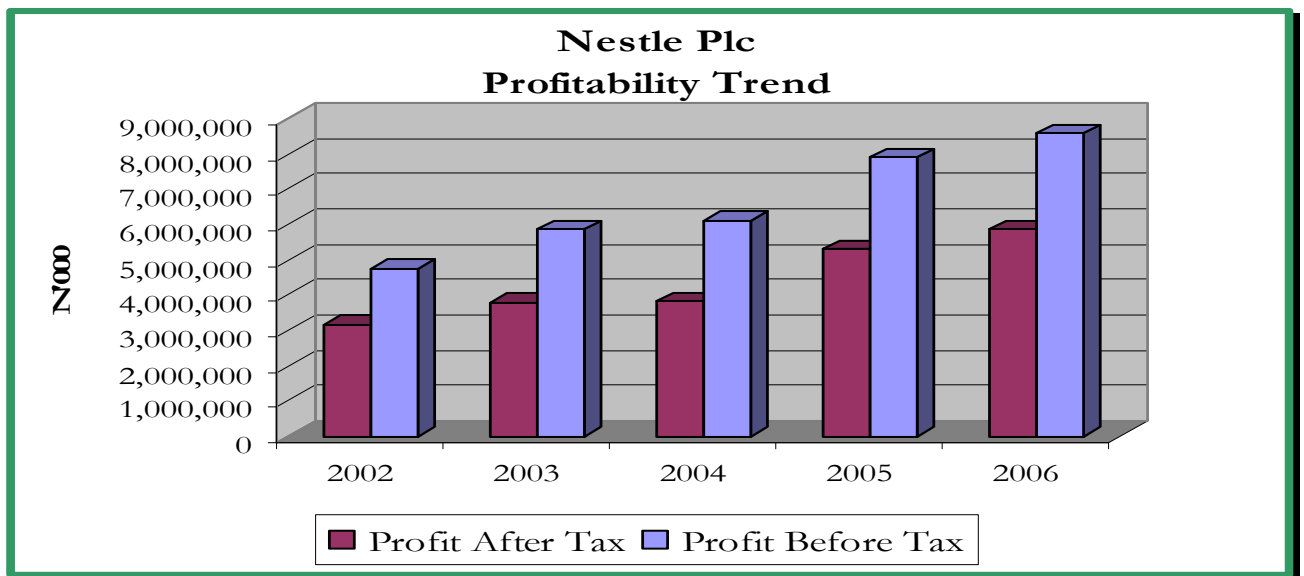
FUTURE OUTLOOK:

The company is well positioned to take up new opportunities in the Nigerian market. It has, in conjunction with its parent company, Nestle, a variety of products that can be introduced for the local consumer. The future looks very bright for Nestle as it is well entrenched in the industry not only to sustain profitability but also to boost it. The key determinants for sustainable growth and profitability will be how quickly social infrastructure such as roads, water and electricity are put in place as well as increase in consumers' disposable income.

Growth and Profitability

Nestle Plc operates a stable and matured business as reflected by its growth indices. The **Fast Moving Consumer Goods (FMCG)** industry, to which **Nestle** belongs, is in its maturity stage with stable sales and declining margins. The company recorded the lowest growth in revenue of 11.9 per cent (year-on-year) in the 2006 financial year-end with a modest 5-year average annual growth rate (CAGR) of 18.47 per cent, which is just a little above the inflation rate (year-on-year). Nestle turnover increased from N19.6bn in 2002 to N38.4bn in the year ended December 31, 2006. Unilever Nigeria Plc and Cadbury Nigeria Plc with some similar business class, especially product lines, recorded dwindling average annual turnover growth. Unilever recorded a 5-year average annual turnover growth rate (CAGR) of 16.8 per cent, down from 25 per cent in 2003 & 2004 and 40 per cent in 2005. However, the recently released first quarter results of Unilever for the period year ended March 31, 2007 revealed resurgence in performance as the company's turnover rose by 74% while Profit After Tax (PAT) grew to N300m from a loss status of N980m in the corresponding period of prior year, a leap by 130.6 per cent.

Figure 1:



In the face of increasing production costs, evidenced by steady increases in cost of sales relative to sales, the company has been able to record a constant contribution to sales with gross profit margin ranging between 36 per cent and 39 per cent over the 5 years covered. Gross profit margin increased slightly from 36.3 per cent in 2004 to 38.5 per cent in 2005 while it remained at 38.3 per cent in 2006. In line with the growth rate in turnover, Nestle Plc

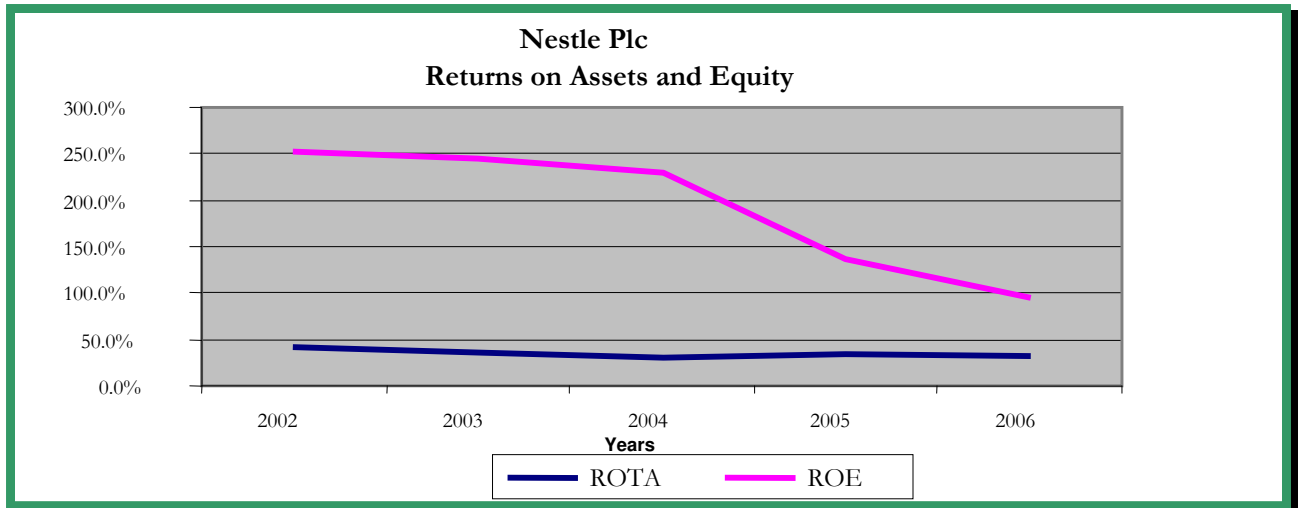
has a Profit Before Tax (PBT) growth rate (CAGR) of 18.61 per cent, as the PBT rose from N7.4bn in 2002 to N14.71bn in 2006. Similarly, Operating profit grew by 15.24 per cent (CAGR) from N4.54bn in 2002 to N8.0bn in 2006, with a slightly lower growth over the years relative to turnover and gross margin growth. The declining operating margins is traceable to increase in marketing, distribution and other administrative expenses. Operating margin dropped from 23.3 percent in 2002 to 20.6 percent in 2004 before it picked up to 22.3 percent in 2005 with a marginal dip to 20.9 percent in 2006.

Nestle maintained an average of 15.2 percent after tax margin. The company's after tax margin nosedived from 16.2 percent in 2002 to 15.4 percent in 2003 and 13.5 percent in 2004 and rose to 14.7 percent in 2006. **(after tax Margin in 2005 was 15.4 per cent)**. Nestle After Tax Profit reflects the pattern of the operating profit and fluctuation in interest income, which amounted to N185.3m in 2006 as against N266.2m in 2005. In 2006, it received a boost from the Liquidation proceeds of N191m, which arose from the completion of the voluntary liquidation exercise of Nestle Products Limited, a process that commenced in February 2003. After Tax Profit was however, adversely affected by an additional charge of N425m resulting from the change in the accounting policy **of provision for gratuity**. This charge represented 4.8 percent of the After Tax Profit before the charge.

The Return on Average Total Assets (ROTA) and Return on Average Equity (ROE) for Nestle Plc have been on the high side, though, facing a downward trend. Nestlé's ROTA averaged 35.0 percent from 2002 to 2006. In 2002, it was 41.1 percent growth but later dropped to 36.9 percent and 30.3 percent in 2003 and 2004 respectively. The index rose again in 2005 to 35 percent but slumped to 31.6 percent in 2006. The dwindling nature of ROE is not peculiar to Nestle alone; Cadbury and Unilever Plc witnessed similar trend. Cadbury's ROE index plummeted from 72.8 percent to 35.5 percent over 5 years (2001-2005) with Unilever reporting a negative ROE of 53.7 percent in 2006 as against 71.1 percent in 2003.

The trend in Nestlé's ROE has been remarkable and unprecedented. The company recorded a 5-year average of 192.2 percent (though with a decline from 253 percent in 2002 to 94 percent in 2006). Nestlé's high indices of ROTA and ROE can be traced to its high rate of asset turnover (which averaged 226.4 per cent in 5 years) and the high financial leverage especially from both long-term and short-term liabilities.

Figure 2:



Liquidity and Efficiency

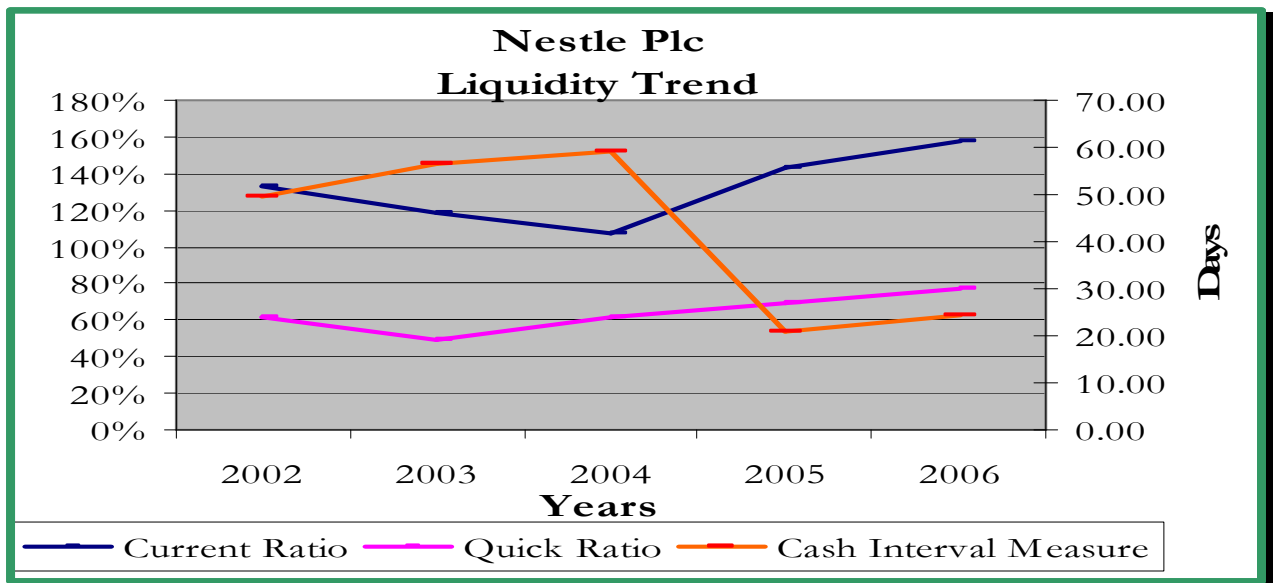
Nestle has always maintained a relatively convenient level of liquidity as shown by its current and quick assets indicators. The 5-year average current ratio for Nestle stands at 1.32 times, meaning the current assets of the company cover its short-term obligations by 132 per cent (though falls below the benchmark of 200%). Current ratio as at the recent year ended December 31, 2006 stands at 1.58 times, an improvement from 1.43 times in the prior year. A stricter liquidity measure also scores the company fairly, with the 5-year average Quick ratio of 0.64 times. This stands at 0.77 times as at December 31, 2006, a slight improvement from the preceding year figure of 0.69. **The liquidity index expresses how well a company can meet its short-term obligations from its short-term assets excluding inventories (the benchmark figure is 100 % /1.0 times).**

Our analysis of Nestlé's Cash Flow revealed sound liquidity management over the years (except for 2002 with an operating cash flow to After Tax Profit index of 0.98). The company's ratio of operating cash flow to profit after tax averaged 1.28 times in 5 years (2002-2006), with the recent figure for 2006 standing at 1.23 times. A high **Operating Cash flow to Profit After Tax** indicates healthy liquidity status and could be taken as a possible indication of positive Free Cash flow, which is a measure of investors' value. A further analysis of the company's efficiency indices (which bear positive correlation with its liquidity and overall performance) showed that its average receivables' period declined from 13 days in 2003 to 11 days in 2005 but increased to 12 days in 2006 while average payables period rose progressively from 34 days in 2003 to 49 days in 2006. The Inventory days also exhibited a

similar pattern moving from an average of 88 days in 2003 to 73 days in 2005 before moving up to 80 days in 2006. As one would have expected, the company makes good use of cheap short-term funds from creditors. Similarly, the Cash Operating Cycle (COC), which was 68 days in 2003 and 62 days in 2004, has reduced to 43 days and 42 days in 2005 and 2006 respectively.

The trend in these performance indices bears credence to improvement in operating efficiency, which has influenced the liquidity of the company, as the company now needs to maintain lesser cash as shown by the reduced Cash Interval measure. The Cash Interval Measure shows the number of days the year-end cash balance can last in the company's operations assuming no further inflows. The cash interval index dropped from an average of 55 days (2002-2004) to 23 days (2005-2006). The company is now using cash surplus to immediate requirement more productively, through its short-term deposits, which amounts to N2.45bn and N1.9bn in 2005 and 2006 respectively.

Figure 3:

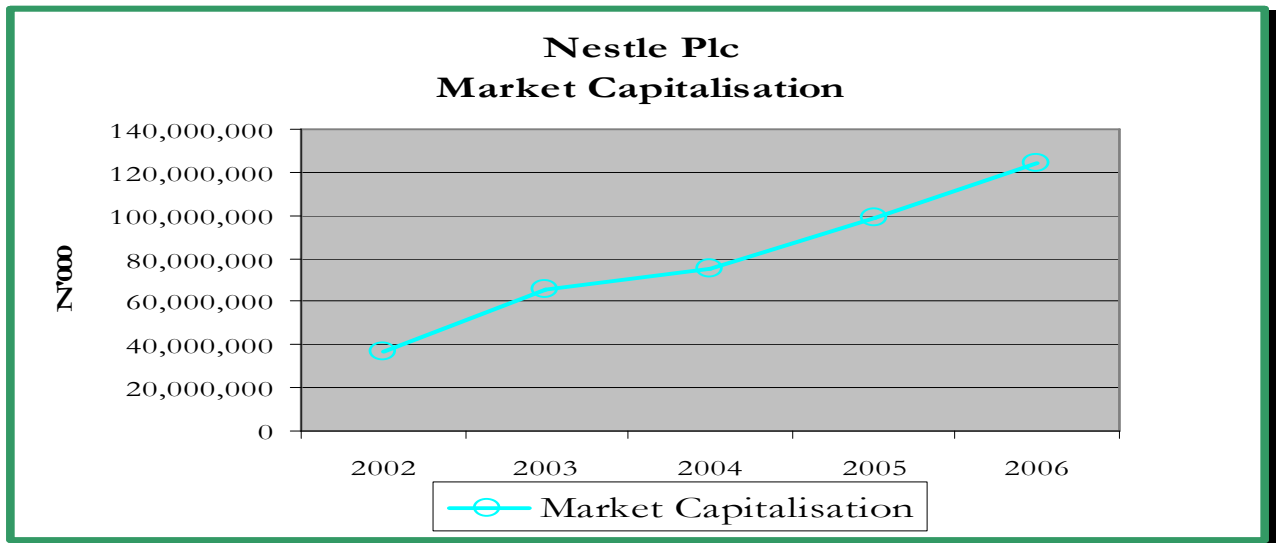


Financial Stability

Nestle Plc has recorded high earnings as a result of improved financial leverage over the years. The financial leverage of the company is one of the factors accounting for its astonishing Returns on Equity (ROE).

Nestle enjoys a reasonable amount of both short and long term finance from its various payables which include deferred payments and the balances in inter-company current accounts with which it conducts transactions with its related companies all over the world and other non-current, long term liabilities which includes different provisions. The company's 5-year average of Total Debt to Total Assets stands at 0.77. Put differently, 77% of its total assets is financed with funds outside the owners' investment in the company. This index was at the lowest level in 2005.

Figure 5:



Taking another view at leverage, we have computed the ratio of Debt to Total Equity for Nestle for 5 years. This ratio showed the relationship between total liabilities in relation to Equity, giving a clearer picture of the extent of financial leverage employed by the firm. Nestle employed 480% of its Equity as debt finance in 2002, 650% and 670% in 2003 and 2004 respectively but with a much lower leverage in recent years – 180% and 200% in 2005 and 2006 respectively. This corresponds to the periods of the lower Return on Equity (ROE).

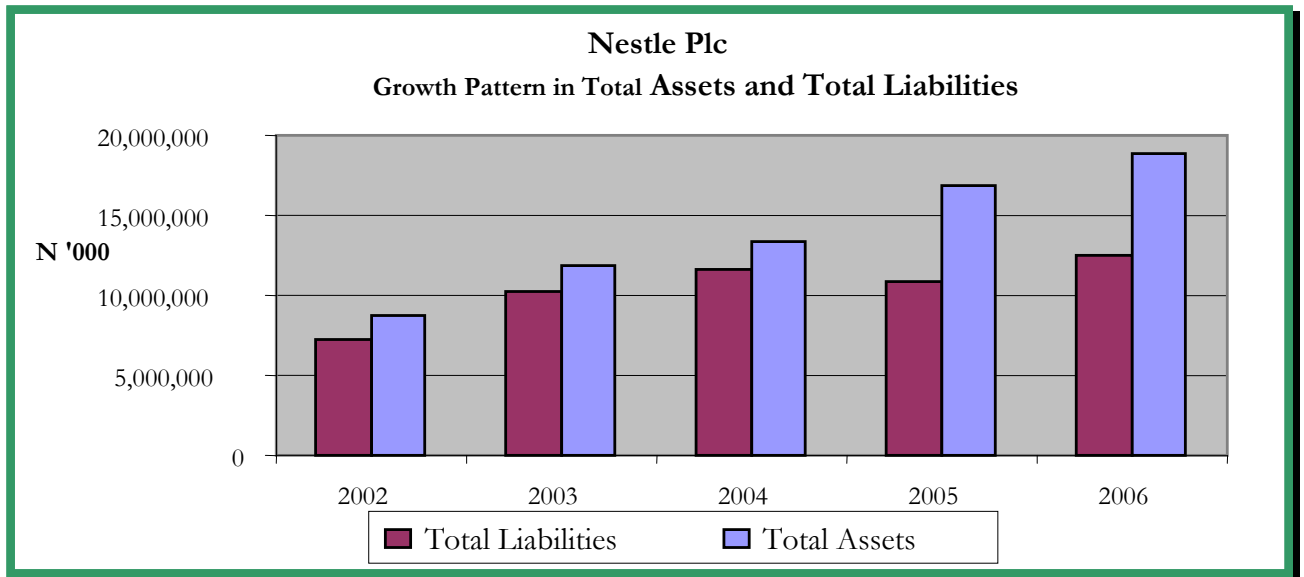
Though, financial leverage can be employed by firms to boost earnings, a relatively high exposure to debt capital poses more financial risks; the possibility of the company not being able meet up with the debt obligations particularly interest servicing and principal repayment. Interestingly however, Nestle debt financing attracts no interest as it is neither formal debt arrangement nor does it have a rigid or definite repayment plan since as it is made up of provisions and payables-i.e. short-term financing.

We also employed the Z-score to analyse the financial health status of an organization and to predict the probability of failure or insolvency.

Our analysis revealed that Nestlé’s Z-score averaged 11.52 between 2002 and 2006. However, its Z-score for FY 2006 was 14.06, up from 13.31 in the preceding year. Put differently, Nestlé’s financial soundness is overly strong with a little probability for failure.

A z score in the range of 1.80 and 2.99 is said to portray a high-risk financial zone while 3.00 and above implies a very low risk and safety/comfort zone as the company’s risk of failing due to financial weakness is very remote.

Figure 4:



Trends Analysis of Returns to Investment

Nestle Plc as one of the quoted companies on the floor of the Nigerian Stock Exchange is reputed for its stupendous returns to investors in terms of consistent capital appreciation, dividend payments (both interim and final) that guarantee constant cash flows and regular bonus history.

Nestle has a 5-year average earnings yield of 6%, with a high and low record of 8.6% and 4.6% in 2002 and 2006 respectively. The 5-year average dividend yield of the company stands at 5.4%, while it maintains an average payout of approximately 90%. Put differently, only 10% of its earnings is being retained. This unique and unprecedented dividend policy in the Nigerian

corporate history is attributable to the company's ownership structure, as the huge dividend payments are a way to repatriate profits offshore. Nestle recorded the lowest payout of 69.7% in FY 05 and the highest of 99.7% in 2002.

The Net Asset Per Share (NAPS) of the company soared from less than N4.00 (in 2002-2004) to N11.32 and N12.04 in 2005 and N12.04 respectively. The market capitalization of the company at the end of its financial year ended December 31, 2006 stood at N124.2bn (US\$0.97 bn) with an average annual increase of 36% over the years. This indicates the constant level of capital appreciation to investors annually over the years. Furthermore, with a year-end PE of 21.9 xs (FY 06), investors are highly optimistic of the future prospects of the company especially in respect of profit taking for speculators and capital accumulation for long-term investors.

Nestle has declared bonus nine (9) times since it became a listed company in 1979, the most recent being in the year ended December 31, 2006 when it declared a 1 for 4 bonus in addition to an interim and final dividend of N10.35.

NESTLE TECHNICAL CHART:



ANALYSIS OF THE TECHNICAL CHART:

The share price of Nestle opened at N150.45 on January 4, 2005 and closed at N187.5, translating to a capital appreciation of 25%. During the year however, it reached a High of

N199.00 (on October 31, 2005) and it recorded a Low of N128.51 (on June 30, 2005). Average Traded Volumes per month ranged between 95,000 Units and 280,000 Units, with the highest average traded volume (279,620 Units) recorded in October 2005 when the stock reach a new the resistance level (High). For 2005, the primary exhibited by Nestle shares was bullish.

In 2006, the share price of Nestle showed a fairly stable trend for a greater part of the year with the random walk of the share price having very mild amplitude. Throughout the period, the price hovered around N190. The resistance level was however broken when the stock crossed the N200 border in August, after which it traded between N200 and N250, with very sharp up and down fluctuations, which continued into 2007.

Nestlé's share price, which opened this year at N235, began a homeward run in February 2007, reaching a year High of N347.14 in February 28, 2007. It was propelled by the news of its performance, the bonus and dividend declaration, which were made on February 22, 2007. The share price then ranged between N347.14 and N298 before it was marked down at N298 to N 231.72 for a bonus of 1 for 4 and a dividend of N8.35. Average monthly volume traded has since doubled to over 240,000 units.

VALUATION:

We have employed a number of valuation metrics in arriving at an appropriate intrinsic value for Nestle Nigeria Plc. We used Dividend Growth/Discounted Cash Flow (DCF) Approach, and a couple of relative valuation metrics such as Price to Book Value (P/B), Price to Sales (P/S), and Price to Earnings (P/E) ratios.

From our Discounted Cash Flow Approach (DCF), we used a discount rate of 12 per cent and a perpetual growth rate of 6 per cent. We arrived at a share value of N190.66.

However, with a P/E ratio of 26.20 and forecast trailing EPS of N9.85, we arrived at a value of N259.19, while using the company's current P/B of N18.36 and an estimated book value per share (BVPS) of N10.40; we valued that stock at N190.96. Moreover, with a P/S value of N3.04 and forecast sales per share of N46.11; we arrived at a stock price of N140.15.

Meanwhile, after appropriate weighting for each valuation metric, we are more over weight on dividend valuation method (DCF) and P/E Multiple as better measures of Nestlé's intrinsic value. The fact that the company's dividend policy is stable with almost 100% pay out policy informs our greater weight in the valuation metric.

In our opinion and based on the above analysis, our fair valuation on Nestle shares is N206.54.

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