



NESTLE LANKA PLC [NEST.N0000]

DOWNGRADE TO SELL

ADVERSITY HINDERS GROWTH PROSPECTS

Fair Value: 2019E – LKR 1,200 [-21%]

Total Return with DPS -19% [AER -31%]

NEST earnings for 1Q2019 dipped by 39%YoY to record at LKR 573Mn on the back of a fall in revenue by 8% amidst the slower than expected improvement in consumer demand for branded F&B. Top line declined by 8% to record at LKR 8.9Bn due to tepid consumer demand coupled with sluggish market conditions. We upgraded NEST to a BUY on expectation of a gradual recovery in consumer demand towards the 3Q & 4Q. However, recent Easter Sunday attack has fueled an economic downturn, thereby, we revise our outlook on revenue and earnings targets downwards. We downgrade our revenue targets for 2019E to LKR 36.6Bn (-8% from previous forecast) and profit target to LKR 3.1Bn (-22% from previous forecast). A flash note was sent to clients on 9th May 2019 informing that NEST is downgraded to a SELL amidst a negative outlook on the F&B sector. Affirming the flash note we downgrade the TP of NEST to LKR 1,200 from previous price target of LKR 1,900 based on lower earnings and downward re-rating of the overall market. **DOWNGRADE TO SELL**

LKR (Mn)	1Q2018	1Q2019	YoY	2017	2018	YoY
Earnings (LKR 'Mn)						
Revenue	9,619	8,877	-8%	37,601	37,337	-1%
Gross Profit	3,446	2,921	-15%	13,333	13,972	+5%
EBIT	1,260	915	-27%	4,876	5,037	+3%
PBT	1,250	822	-34%	4,733	4,941	+4%
Net Profit	944	573	-39%	3,634	3,486	-4%
Balance Sheet (LKR 'Mn)						
Shareholder's Equity	4,402	4,823	+10%	4,801	5,635	+17%
Borrowings	12,342	12,967	+5%	10,776	12,024	+12%
NAVPS	81.9	89.8		67.7	64.9	

Bottom line dips by 39%YoY

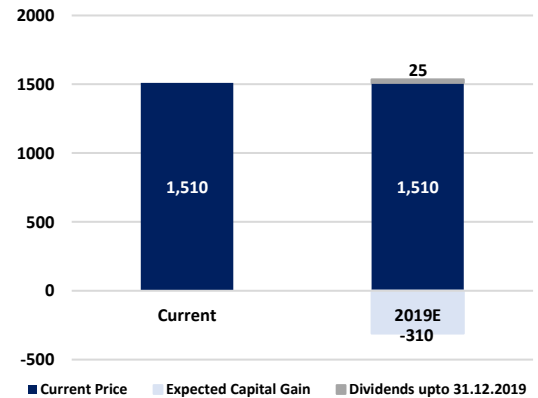
Nestle bottom line dipped by 39%YoY, on the back of a large volume drop which resulted as the lowest performed quarter for the past five years. Higher interest cost too contributed to the fall in earnings, mainly due to the substantial borrowings for significant capital expenditure and cessation of capitalization of borrowings costs on completion of a key project. NEST completed an expansion project of LKR 5.0Bn i.e. a coconut milk processing plant which is the single largest investment made in Sri Lanka by Nestle. NEST has an outstanding long-term loan of LKR 2.0Bn which resulted in a finance cost of LKR 94.2Mn, +405%YoY.

GP margin dips to 33% recording a 5-Yr low

Nestle GP margins for 1Q2019 recorded at 33%, despite the fall in cost of sales by 4%YoY, the gains were offset by the steep decline in revenue by 8%YoY. We anticipated a pick-up in consumer demand due to the expected increase in disposable income with island wide elections scheduled to be held 2H2019. However, with the attacks witnessed on Easter Sunday, a heavy economic downward spiral has struck. First Capital Research has a negative outlook on Food & beverage sectors in the short to medium term amidst weaker growth outlook. We downgrade our revenue targets for 2019E to LKR 36.6Bn from previous target of LKR 39.9Bn and expect a GP margin of 36% for 2019E.

EBIT margin under pressure for the near future

We expected an operating margin of 14% for 1Q2019 however, margins fell below expectation and was recorded at 10%. Operating expenses dipped by 8%YoY, the fall in EBIT margin is attributable to the significant drop in revenue. We expect EBIT margin for 2019E at 12% from 14% recorded in 2018.



FIRST CAPITAL RESEARCH

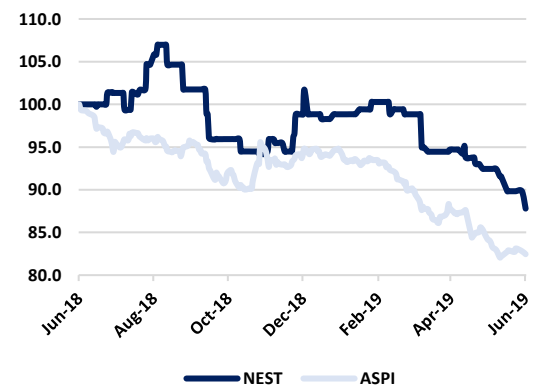
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KEY DATA

CSE Ticker	NEST.N0000
Bloomberg Ticker	NEST SL
Share Price (LKR)	1,510
52w High (LKR)	1,840
52w Low (LKR)	1,590
Avg. Daily Volume (Shares)	1,265
Avg. Daily Turnover (LKR)	2,194,869
Issued Share Capital (Shares 'Mn)	54
Market Cap (LKR 'Mn)	81,125
Market Cap (USD 'Mn)	461
*1 USD = LKR 176	

Price Performance (%)	1 mth	3 mths	12mths
NEST	-5%	-11%	-12%
ASPI	-2%	-8%	-18%

NEST vs ASPI



Source: CSE

Minimum Return for BUY:

Buy Below 2019E - [18.54% "criteria B"]: LKR 1,114.4
 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.

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

For 1Q2019 income tax expense was recorded at LKR 249.2Mn at an effective tax rate of 30%. The effective tax rate for NEST is 28%, however, after Apr 2018 tax concessionary rates on exports and exceptions on foreign currency are no longer applicable. Thereby, for 2019 PBT will have the full impact of the effective tax rate of 28%. Due to higher effective rate of taxation, PBT will be charged at 28% per annum thus diluting earnings by LKR 1.2Bn.

NEST downgraded to SELL, on the grounds of lack of consumer demand

Following the Easter Sunday terror attack we revised our short to mid-term outlook on the counter to negative. We derived a TP of 1,200 on 2019E valuation, thereby, we downgrade to SELL, providing an annualized return of -31%.

Estimate Revision

In LKR Mn	2019E-O	2019E-R	% Change	2020E - O	2020E - R	% Change
Earnings Estimate						
Revenue	39,988	36,590	-8%	42,467	38,054	-10%
Gross Profit	14,476	13,246	-8%	15,288	13,699	-10%
EBIT	5,752	4,430	-23%	6,557	4,559	-30%
Profit before Tax	5,545	4,317	-22%	6,419	4,511	-30%
Net Profit	3,993	3,108	-22%	4,622	3,248	-30%
Adjusted EPS	74.3	57.9		86.0	60.5	
Growth YoY	15%	-11%		16%	5%	
Balance Sheet Estimate						
Shareholders' Equity	6,919	6,057	-12%	7,627	6,725	-12%
Borrowings	1,636	1,024	-37%	1,236	624	-50%
Adjusted NAVPS	128.8	112.7		142.0	125.2	
Ratio Estimate						
ROE (%)	58%	51%		61%	48%	
PER (x)	21.9	26.1		18.9	25.0	
PBV (x)	12.6	13.4		11.4	12.1	

Valuation Table

P/E 31 December	2015	2016	2017	2018	2019E	2020E	2021E
Estimates (LKR 'Mn)							
Revenue (LKR mn)	34,703	36,462	37,601	37,337	36,590	38,054	39,957
Net Profit (LKR mn)	4,124	4,399	3,636	3,486	3,108	3,248	3,474
EPS (LKR)	76.8	81.9	67.7	64.9	57.9	60.5	64.7
YoY % Growth	9%	7%	-17%	-4%	-11%	5%	7%
Valuations							
PER (x)	19.7	18.4	22.3	23.3	26.1	25.0	23.4
PBV (x)	17.9	14.8	16.9	14.4	13.4	12.1	10.8
Div Yield (%)	4.3%	5.3%	3.3%	3.3%	3.2%	3.3%	3.6%

Valuation Summary

Expected NEST price for 2019E	
PER based target price	1,215
DCF Valuation based target price	1,184
Average Target Price	1,199
Target Price after Rounding off	1,200

Return	
Target Price	1,200
Current Price	1,510
Capital Gain (LKR)	-310
Dividend upto 31.12.2019 (LKR)	25
Capital Gain %	-21%
Dividend Yield %	2%
Total Return %	-19%
Annualized Return %	-31%

Discounted Cash flow Valuation

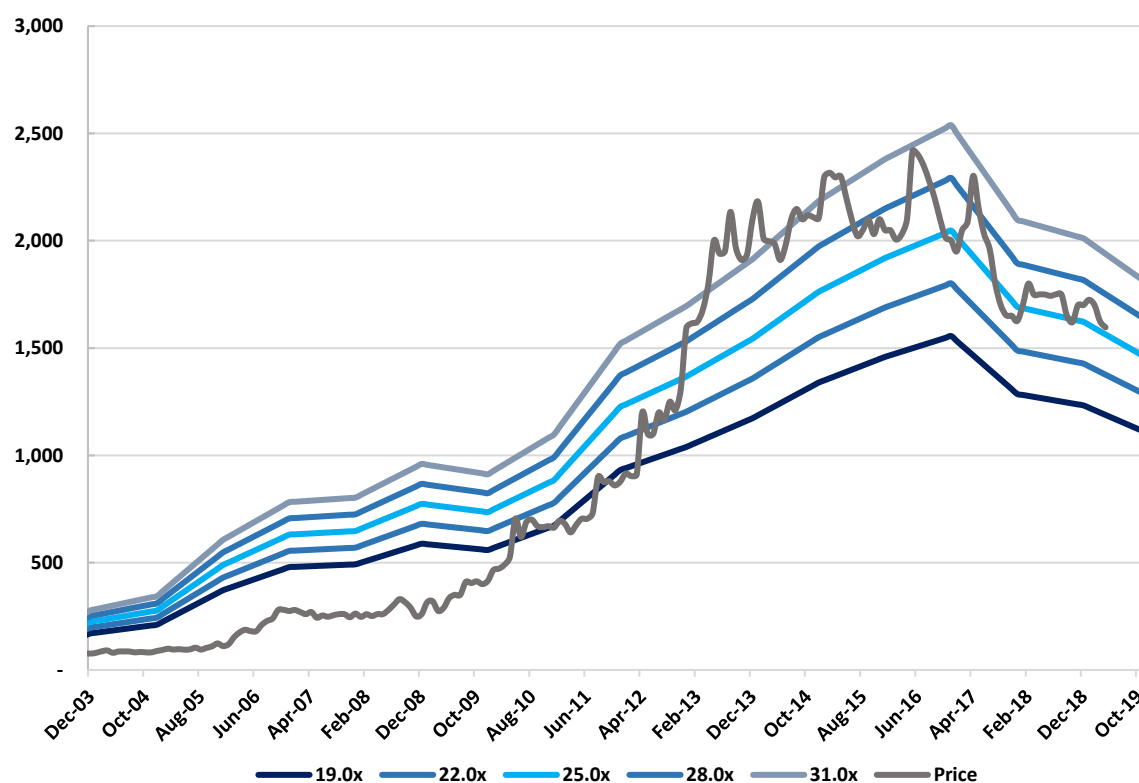
DCF based Valuation	
Enterprise Value	63,471
(-) Debt	(1,024)
(+) Cash	1,141
Total Value of Equity	63,588
No. of shares (Mn)	54
Target Price	1,184

COE	
R _f	10.5%
R _m	18.5%
Growth %	3.0%
β	0.10
K_e = R_f + β (R_m - R_f)	11.3%

WACC	
Ke	11.3%
Kd	12%
D/E Assumption	40 / 60
Terminal Growth (%)	3%
WACC	10%

PER Valuation

Price LKR



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

PER based Valuation	
2019E Earnings (LKR 'Mn)	3,108
No. of Shares ('Mn)	54
2019E EPS	57.9
Expected PER	21x
Price at 21.0x 2019E Earnings	1,215

Appendix I: Statement of Income and Expenses

Income Statement (LKR Mn)	2015	2016	2017	2018	2019E	2020E	2021E
Y/E 31st December							
Revenue	34,703	36,462	37,601	37,337	36,590	38,054	39,957
Cost of Sales	-21,381	-22,275	-24,525	-23,487	-23,345	-24,354	-25,572
Gross Profit	13,322	14,187	13,076	13,850	13,246	13,699	14,384
Other Operating Income / (Expense)	-13	-13	-45	-135	-135	-135	-135
Marketing, Selling and Distribution Expenses	-5,766	-6,263	-5,828	-6,086	-6,111	-6,317	-6,633
Administrative Expenses	-2,125	-2,188	-2,315	-2,483	-2,571	-2,689	-2,805
Results from Operating Activities	5,418	5,723	4,888	5,147	4,430	4,559	4,812
Finance Income	38	33	30	46	46	46	46
Finance Expenses	-31	-44	-183	-252	-159	-94	-32
Net Finance Expense	8	-11	-153	-206	-113	-48	13
Profit Before Taxation	5,426	5,712	4,735	4,941	4,317	4,511	4,825
Income Tax Expense	-1,301	-1,313	-1,099	-1,456	-1,209	-1,263	-1,351
Profit for the Year	4,124	4,399	3,636	3,486	3,108	3,248	3,474
EPS	76.8	81.9	67.7	64.9	57.9	60.5	64.7

Source: Company annual reports and First Capital Research Estimates

Appendix II: Statement of Financial Position

Balance Sheet (LKR Mn)	2015	2016	2017	2018	2019E	2020E	2021E
As at 31st December							
ASSETS							
Non-Current Assets							
Property, Plant and Equipment	5,477	5,525	5,366	9,210	9,264	9,295	9,235
Capital Work-in-Progress	144	456	2,486	673	873	823	673
	5,621	5,980	8,170	10,237	10,491	10,472	10,262
Current Assets							
Inventories	3,322	3,935	2,870	2,988	2,561	2,854	2,997
Trade and Other Receivables	2,107	2,730	3,647	3,362	2,525	2,473	2,597
Amounts Due from Related Parties	204	248	761	854	854	854	854
Cash and Cash Equivalents	868	393	129	218	1,141	1,119	745
	6,501	7,306	7,406	7,422	7,081	7,301	7,193
Total Assets	12,122	13,287	15,577	17,659	17,573	17,773	17,455
EQUITY AND LIABILITIES							
Equity							
Stated Capital	537	537	537	537	537	537	537
Retained Earnings	3,984	4,945	4,264	5,098	5,520	6,188	6,966
	4,522	5,483	4,801	5,635	6,057	6,725	7,504
Non-Current Liabilities							
Retirement Benefit Obligations	522	465	454	391	391	391	391
Deferred Tax Liabilities	699	802	839	1,001	1,001	1,001	1,001
	1,222	1,267	1,496	3,689	3,689	3,689	3,689
Current Liabilities							
Trade and Other Payables	4,137	4,368	4,770	4,635	4,552	4,433	3,580
Amounts Due to Related Parties	714	899	1,220	1,313	1,313	1,313	1,313
Income Tax Payable	942	806	529	681	756	808	864
Dividends Payable	137	151	168	182	182	182	182
Bank Overdrafts	448	313	2,592	1,524	1,024	624	324
Total Current Liabilities	6,379	6,537	9,280	8,335	7,827	7,359	6,262
Total Liabilities	7,600	7,804	10,776	12,024	11,516	11,048	9,951
Total Equity and Liabilities	12,122	13,287	15,577	17,659	17,573	17,773	17,455
NAVPS	84.2	102.0	89.4	104.9	112.7	125.2	139.7

Source: Company annual reports and First Capital Research Estimates

Appendix III: Statement of Cash flow

Cash flow Statement (LKR Mn)	2015	2016	2017	2018	2019E	2020E	2021E
Y/E 31st December							
Cash Flow from Operating Activities							
Profit Before Taxation	5,426	5,712	4,735	4,941	4,317	4,511	4,825
Adjustments for;							
Depreciation	603	625	724	754	773	819	860
(Gain) / Loss on Sale of Property, Plant and Equipment	-31	-15	8	-13	0	0	0
Amortisation of Staff Loan Interest	18	17	27	30	0	0	0
Interest Expense	31	44	183	252	159	94	32
Interest Income	-29	-27	-29	-31	-46	-46	-46
Provision for Obsolete Inventories and Inventory Written Off	120	153	193	270	0	0	0
Provision for Impairment of Trade Receivables	8	12	13	16	0	0	0
Provision for Retirement Benefit Obligations	99	105	103	104	0	0	0
Operating Profit Before Working Capital Changes	6,243	6,627	5,957	6,323	5,203	5,378	5,672
Working Capital Changes							
(Increase) / Decrease in Inventories	-462	-764	873	-388	427	-293	-143
(Increase) in Trade and Other Receivables	-197	-678	-1,250	314	837	51	-124
Increase / (Decrease) in Trade and Payables	310	414	402	-181	-83	-120	-852
Cash Generated From Operations	5,894	5,598	5,789	6,043	6,384	5,017	4,554
Interest Paid	-31	-44	-185	-226	-159	-94	-32
Income Tax Paid	-1,000	-1,357	-1,146	-1,057	-1,134	-1,211	-1,295
Retirement Benefit Obligations Paid	-115	-125	-121	-119	0	0	0
Net Cash Flows Generated from Operating Activities	4,110	4,073	4,337	4,641	5,183	3,712	3,226
Cash Flow from Investing Activities							
Purchase of Property, Plant and Equipment	-813	-1,008	-2,466	-2,609	-1,200	-800	-650
Proceeds from Sale of Property, Plant and Equipment	35	38	4	31	0	0	0
Interest Received	11	10	2	1	46	46	46
Net Cash Flows Used in Investing Activities	-767	-960	-2,459	-2,611	-1,154	-754	-604
Cash Flow from Financing Activities							
Dividends Paid	-3,001	-3,451	-4,281	-2,672	-2,686	-2,580	-2,696
Net Cash Flows Used in Financing Activities	-3,001	-3,451	-4,366	-848	-2,686	-2,580	-2,696
Net Decrease in Cash and Cash Equivalents	342	-339	-2,488	1,182	1,342	378	-74
Cash and Cash Equivalents at the Beginning of the Year	77	419	81	-2,408	-1,225	117	495
Cash and Cash Equivalents at the End of the Year	419	81	-2,408	-1,225	117	495	421

Source: Company annual reports and First Capital Research Estimates

Appendix IV: Top 20 Shareholders

Top 20 shareholders - (% held)	1Q2019	4Q2018	QoQ	1Q2018	YoY
Nestlé S.A.	90.8%	90.8%	-	90.8%	-
Citibank New York S/A Norges Bank Account 2	0.9%	0.9%	-	0.8%	0.1%
RBC Investor Services Bank-Coeli Sicav I-Frontier Markets Fund	0.6%	0.6%	-	0.6%	-
Deutsche Bank Ag-London	0.5%	0.5%	-	0.5%	-
Harnam Neesha Jasbinderjit Kaur Piara Singh	0.4%	0.4%	-	0.4%	-
SEB AB - Tundra Frontier Opportunities Fund	0.4%	0.4%	-	0.4%	0.0%
Sri Lanka Insurance Corporation Ltd-Life Fund	0.3%	0.3%	-	0.3%	-
SSBT - Deutsche Bank AG Singapore A/C 1	0.3%	0.3%	-	0.3%	-
SSBT - Al Mehwar Commercial Investments L.L.C	0.3%	0.3%	-	0.0%	0.3%
Employees Provident Fund	0.2%	0.2%	-	0.2%	-
Union Assurance PLC / Account No. 5 (Unit-Linked Life Insurance Fund)	0.1%	0.1%	0.0%	0.0%	0.1%
BNYM Re-Ghi Holdings Maruitius	0.1%	0.1%	-	0.0%	0.1%
SSBT - Frank Russel Trust Company Comingled Benefit Funds Trust GN	0.1%	0.1%	-	0.2%	-0.1%
Jasbinderjit Kaur Piara Singh	0.1%	0.1%	-	0.1%	-
Colombo Investment Trust PLC	0.1%	0.1%	-	0.1%	-
SSBT - Russell Investments Institutional Funds Public Limited Company	0.1%	0.1%	-	0.1%	-
Udeshi Morarji Meghji Asha Ajay Merchant	0.1%	0.1%	-	0.1%	-
Anil Kumar Lalchand Hirdaramani	0.1%	0.1%	-	0.1%	-
Radhakrishnan Maheswaran	0.1%	0.1%	-	0.1%	-
Miss. Radhakrishnan Meenambigai Priyadarshini	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%

Weighted Average 1-year T-bill rate during Apr 2019: 10.54%

Categorization	Company Category	Buy	Hold	Sell
Grade A	S&P SL20 Companies	15.54%	11.54%	11.54%
Grade B	Rest of the Companies	18.54%	13.54%	13.54%
Grade C	Companies less than LKR 1Bn Market Cap	21.54%	16.54%	16.54%



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CORPORATE DEBT SALES

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EQUITY SALES

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Colombo			Priyantha Wijesiri	+94 70 2910 036
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BRANCHES

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