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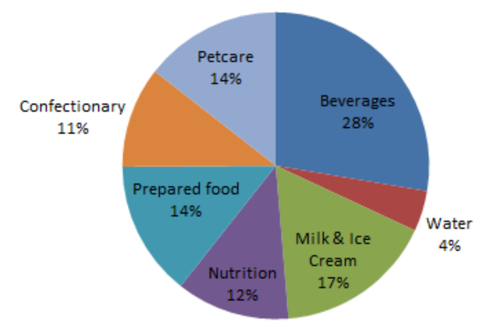
Nestlé : Hitting the sweet spot

Background

Nestle is the world's largest nutrition, health and wellness company, selling its products globally. The company's product line includes milk, chocolate, confectionery, bottled water, coffee, creamer, food seasoning and pet foods. In FY12, it generated CHF92bn in sales with 41% of sales coming from the Americas, 27% from Europe and the rest of the world comprising the balance. 43% of group sales comprise emerging markets (EM), and the company aims to grow this to 50% in time.

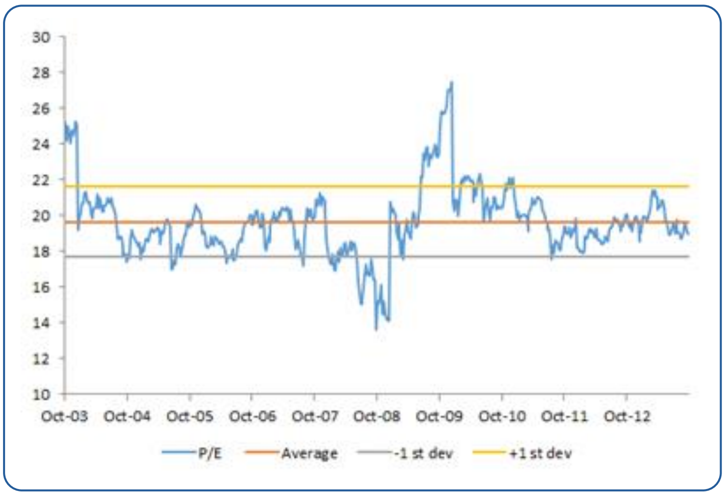
Figure 1: Nestlé EBIT by product:



Source: Company data, Anchor Capital

Given the scale and penetration of the group's products worldwide, it should come as no surprise that growth is likely to be incremental and high double-digit increases cannot be expected to be sustained. From a valuation perspective, Nestle trades broadly in line with the average of its long-term P/E multiple range (average = trailing 19x) – on the face of it, it seems neither cheap nor overly expensive.

Figure 2: : Nestlé trailing P/E multiple:



Source: Company data, Anchor Capital

As can be seen from Figure 3 below, Nestle has sustained average EPS growth of more than 8% p.a. in Swiss franc over the past 8 years. This year, growth will be somewhat slower due to soft demand across most regions, with 1H13 diluted EPS rising 3.9%.

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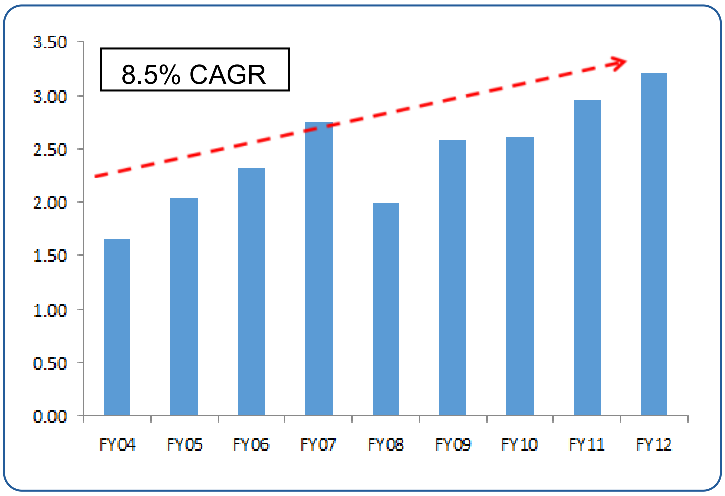
Organic sales growth during the half year was 4.1%, driven by 2.7% volumes and 1.4% pricing gains – while the volume number looks reasonable, this rate of price increase is indicative of heightened consumer sensitivity around pricing. The group's trading margin rose by 20 bpts to 15.1%, largely helped by lower input costs. Management targets increasing margins over time, driven in part by higher-margins products (e.g. Nespresso – 4% of Nestlé revenue and growing 15-20% p.a.) and effective portfolio management (e.g. the group has a number of water brands, not all of which are performing and they may look to rationalise some of these in time).

Figure 3: Nestlé EPS track record:



Source: Company data, Anchor Capital

For the full-year, management has guided to delivering "around" 5% organic growth with improved margins and underlying EPS in **constant** currencies. Consensus estimates imply 4.5% EPS growth for the full year to December 2013, no doubt blunted in part by weak FX. Thus expectations are not high in the near term following weak demand conditions this year. The analyst community remain fairly constructive on Nestlé's longer-term prospects, expecting trend EPS growth of ~8% p.a. for the next 3 years. The group's full-year dividend declaration in FY12 amounted to CHF2.05/share, representing cover of 1.6x. Assuming similar cover is applied in future, the **forward dividend yield (FY14) amounts to 3.7%** - we view this as a pretty attractive yield.

Figure 4: Nestlé consensus EPS estimates and valuation

Consensus estimates				Share price (CHF)	61.95
	EPS	% growth	P/E, x		
FY13	3.48		17.8		
FY14	3.74	7.5	16.6		
FY15	4.07	8.8	15.2		
FY16	4.36	7.1	14.2		

Source: Bloomberg consensus estimates, Company data, Anchor Capital

Stake in L'Oreal

Nestlé owns 29.4% of L'Oreal, the cosmetics firm. This investment is valued at EUR22bn based on the current L'Oreal share price, and accounts for approximately 15% of Nestlé's current market cap. Stripping out L'Oreal's contribution to value and earnings, **Nestlé trades at a forward P/E multiple of 16x** – this looks like reasonably good value in the context of the group's long-term growth track record and breadth of brands. Nestlé has been a major shareholder in L'Oreal since 1974, and according to a shareholders' agreement Nestlé has to offer its stake to Lilian Bettencourt (the other major shareholder of L'Oreal at 30%) before selling to third parties – this lock-up expires in April 2014 and some analysts speculate that Nestlé may look to sell down its stake. This could potentially be a catalyst for a moderate re-rating in the stock.

Figure 5: Nestlé valuation ex-L'Oreal stake:

Nestlé :	
Share price (CHF)	61.95
Shares in issue (mn)	3 205
Market Cap (CHFmn)	**198 710**
L'Oreal stake	
Share price (EUR)	123.05
Diluted shares in issue (mn)	605
Market Cap (EURmn)	74 445
Nestlé 29.4% stake (EURmn)	21 887
in CHF	**26 921**
Nestlé mkt cap ex-L'Oreal (CHF)	**171 789**
Nestlé FY14E earnings (CHFmn)	11 604
Less: share of L'Oreal earnings (CHFmn) *(as per Bloomberg consensus)*	796
Nestlé FY14E earnings ex-L'Oreal (CHFmn)	**10 808**
Nestle FY14E P/E ex-L'Oreal (x)	15.9

Source: Bloomberg, Company data, Anchor Capital

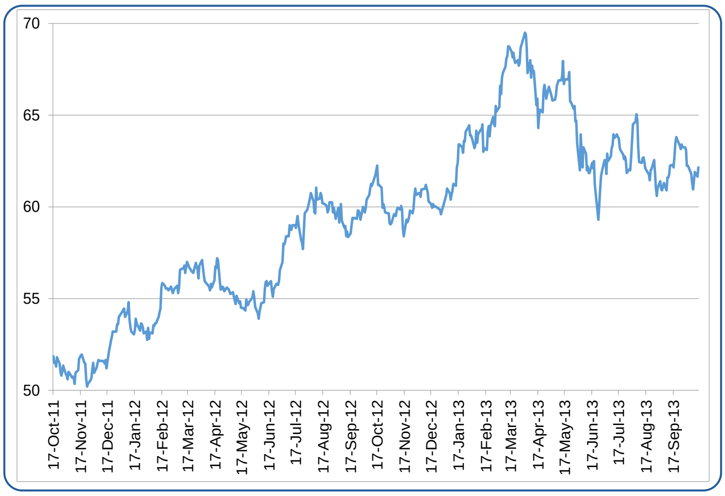
Conclusion

We believe Nestlé is a top-quality business that generates attractive margins (EBIT margin=15%) and returns (RoE=20%), and this has historically translated into a pretty decent growth profile coupled with good cash (dividend) returns to shareholders. EM currency weakness could prove to be a persistent drag against the model of delivering mid-late single-digit EPS growth in Swiss franc, but forecasting this is always a lottery. After what will be a fairly muted FY13, we would back this business to sustain 5-8% EPS growth in Swiss franc on a trend basis (simplistically, if a 20% RoE is sustained and you retain 40% of earnings, this translates into sustainable EPS growth of 8% p.a.).

Added to this is a starting forward dividend yield of 3.7%, and you're looking at 9-12% annual total returns in Swiss franc before changes in the P/E rating – this is a pretty good starting point, in our view. Regarding rating, the share is not expensive relative to history or in absolute terms (forward 16.6x P/E multiple), while a potential sale of L'Oreal (this is not a certainty, management is "keeping options open") could result in some value being unlocked (share buyback? Special dividend? Reinvestment into growth initiatives?). We think a re-rating is more likely than a de-rating from current valuation levels.

The share has not performed well this year, with a capital gain of only 3% YTD – it initially ran up to close to CHF70, but has since fallen back to CHF62. This was largely on the back of disappointingly slow sales momentum, but we would argue this is now well-known by the investment community and largely in the price. We are happy with this investment and the stock will likely remain a core holding in our model portfolio for now, reasonable valuation permitting.

Figure 6: Nestlé share price performance (CHF):



Source: Bloomberg, Anchor Capital

Nestlé will release a 9-month sales update tomorrow (17 October).

Sean Ashton

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