Nestle Malaysia’s Business Model

- Nestle Malaysia is in the consumer staples industry
    - Demand is steady in most years, but growth is slower than most other sectors
    - Steady EPS = Steady dividends
        - Hence, investors treat Nestle’s dividend like a bond interest yield
        - Due to its earnings stability, investors bid up the share price to its current dividend yield of 2%. (i.e. 50x PE)

- Sales breakdown
    - 50% Milo, 30% Maggi, 15% Nescafe and the rest mostly Kit Kat.
    - Others misc: negligible % of sales

- Sales channel
    - Production (factories) -> Distribution (logistics) -> Retail (stores, online, marketing)

Author: Aaron Pek; special thanks to Chong Hwa (22.09.20)

SWOT

STRENGTHS

- Strong distribution channel
  - 80% of distributors only distribute Nestle products, i.e. no competition
  - Remaining 20% of distributors are the largest Malaysian distributors, e.g. Thong Thye Siang
  - Strong brand heritage (drink Milo when young, drink Nescafe when old)
  - Best talent sourcing company in Malaysia F&B industry with very high employee retention rate

WEAKNESSES

- Saturation of local market
  - Most of their sales come from Maggi & Milo (80% of revenue), both of which already have high market share
  - Future revenue growth is difficult
- High Valuations
  - At 50x FY19 historical P/E, and with low growth expectations, the stock is probably quite fairly valued
  - Valuation risk is high if things don't go according to plan
- Concentration of sales from two products
  - The majority of Nestle's revenue comes from only two products, i.e. Maggi & Milo
  - It will be difficult for a new product, e.g. Nescafe-Starbucks collaboration, to match existing revenues from Maggi + Milo.

OPPORTUNITIES

- Capacity expansion
  - Nestle can ramp up investments to produce more factories that will meet increasing demand from population growth
- New products
  - New venture with Starbucks (i.e. Via instant coffee & Starbucks Nespresso pods), could eventually offer a third alternative to Milo & Maggi as a potential new revenue stream
  - Coffee is a huge market, and this collaboration with Starbucks could potentially be enormous if executed successfully

THREATS

- Demographic risk to Milo
  - Most Milo consumers tend to be in the older demographic, while younger consumers are gradually more health-conscious
  - Nestle has identified that consumption of Milo will drop in the long-term, and has not found a suitable revenue replacement yet
  - Milo consumers tend to be Malays, and their population growth is slowing compared to before, which implies slower future revenue growth from Milo.

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Nestle Malaysia's Profit & Capital Position (2006 - 6M20)

Nestle Malaysia - (RM '000)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	6M20	*Ann.2020*
PROFIT & LOSS																
Revenue	3275	3416	3877	3744	4026	4246	4556	4788	4807	4837	5260	5260	5519	5518	2653	*5306*
Cost of sales				2463	2682	2862	3003	3090	3107	2972	3263	3309	3382	3445	1601	3202
Gross Profit				1281	1344	1384	1553	1698	1700	1865	1997	1951	2137	2073	1052	*2104*
Selling & distribution exp				698	750	671	759	824	844	927	1026	923	1023	977		
Admin exp				97	96	129	140	136	128	144	164	156	178	192		
Depn + Amtz + Imp	71	72	75	88	101	102	102	109	112	125	138	158	165	177	87	*174*
Operating Profit				461	487	579	657	734	725	760	799	847	914	912	529	*1058*
PBT	363	395	441	440	466	559	638	719	701	727	766	812	875	875	512	*1024*
Net Profit (PAT)	264	292	341	352	391	427	505	550	561	590	637	642	658	672	392	*784*
Cash Flow (FCF)	341	371	416	440	492	529	607	659	673	716	775	800	824	850	850	*1700*
CAPEX	79	103	188	257	144	93	158	212	361	191	123	164	145	183	34	*68*
Dividends	234	367	448	352	387	422	399	504	551	609	633	644	656	656	328	*656*
BALANCE SHEET																
ASSETS																
Fixed Assets	547	574	686	860	898	890	946	1046	1293	1369	1353	1432	1507	1532	1480	
Intangible Assets	66	61	61	61	61	61	61	61	61	62	62	62	67	65	65	
Fixed + Intangible Assets				**921**	**959**	**951**	**1007**	**1107**	**1354**	**1431**	**1415**	**1494**	**1574**	**1597**	**1545**	
Deferred tax assets	7	3	4	7	19	18	32	26	28	11	20	20	30	34	35	
Cash				26	49	52	34	15	15	14	24	12	7	10	16	
WORKING CAPITAL																
Receivables, deposits & prepayments	19	22	24	23	23	24	22	22	23	25	24	24	21	16	14	
Receivables (CA)				370	354	445	394	502	504	1370	1353	581	605	508	535	
Inventories (CA)				354	381	518	411	408	370	63	63	467	530	552	580	
Payables (CL)				622	623	878	872	1023	1170	1232	1393	1296	1527	1321	1313	
Working capital				**102**	**112**	**85**	**-67**	**-113**	**-296**	**201**	**23**	**-248**	**-392**	**-261**	**-198**	
FUNDING																
Share capital	235	235	235	235	235	235	235	235	235	235	235	268	268	268	268	
Reserves	325	403	281	333	420	418	517	582	542	474	413	368	387	397	364	
Total Equity	**559**	**637**	**516**	**567**	**654**	**653**	**751**	**816**	**777**	**709**	**647**	**636**	**654**	**665**	**632**	
Deferred tax liabilities	46	51	57	70	44	64	75	83	68	77	91	121	135	139	137	
Employee benefits	64	40	55	48	43	42	55	25	62	81	86	90	95	91	91	
CA - CL (net current asset)	134	70	-149	59	63	100	-88	-142	-413	-509	-546	-578	-566	-581		
Borrowings & financial liabilities	**107**	**5**	**3**	**328**	**414**	**342**	**99**	**100**	**174**	**96**	**93**	**119**	**180**	**177**	**303**	
Capital Employed				**869**	**1019**	**943**	**816**	**901**	**936**	**791**	**716**	**743**	**827**	**842**	**935**	
DE ratio				**58%**	**63%**	**52%**	**13%**	**12%**	**22%**	**14%**	**14%**	**19%**	**28%**	**27%**	**48%**	

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Nestle Malaysia's Performance (2006 - 6M20)

Nestle Malaysia - (RM '000)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	6M20	*Ann.2020*	5-year ave.	10-year ave.
Share statistics																		
Share price (RM)	24.80	26.25	27.00	33.10	43.34	56.20	62.84	68.00	68.50	73.00	78.00	103.00	147.40	147.00	139.90			
EPS (RM)	1.13	1.25	1.45	1.50	1.67	1.82	2.16	2.40	2.35	2.52	2.72	2.74	2.81	2.87	1.24	*2.49*		
PE (x)	22	21	19	22	26	29	31	28	29	29	29	38	52	51	112			
Dividend yield	4.0%	4.3%	7.1%	4.5%	3.8%	3.2%	3.3%	3.5%	3.4%	3.5%	3.5%	2.7%	1.9%	1.9%				
Divdend payout	89%	91%	132%	100%	99%	99%	97%	98%	100%	100%	100%	100%	100%	100%				
Dividend (net) (RM)	1.00	1.14	1.91	1.50	1.65	1.80	2.10	2.35	2.35	2.60	2.70	2.75	2.80	2.80	0.70			
NAV per share (RM)	2.38	2.72	2.20	2.42	2.62	2.78	3.57	3.48	3.31	3.02	2.76	2.71	2.79	2.84	2.69			
NTA per share (RM)	2.10	2.46	1.94	2.16	2.36	2.52	2.94	3.05	3.22	2.75	2.49	2.45	2.50	2.55				
No. of employees	4,151	4,685	5,293	5,442	5,284	5,731	6,159	5,976	5,905	5,578	5,505	5,338	5,267	4686			5,275	5,543
NP/employee (RM)	64	62	64	65	74	75	82	92	95	106	116	120	125	143				
No. of factories	7	7	7	7	7	7	7	7	7	8	8	7	7	6				
No. of shares ('m)	234	234	235	235	234	235	234	230	239	234	234	234	234	234				
Working capital																		
Receivable days				36	32	38	32	38	38	103	94	40	40	34		37	62	49
Inventory days				52	52	66	50	48	43	8	7	52	57	58		66	36	44
Payable days				92	85	112	106	121	137	151	156	143	165	140		150	151	132
Cash conversion cycle (days)				-4	-1	-8	-24	-34	-56	-40	-55	-51	-68	-48		-47	-52	-38
Growth																		
Revenue growth		4%	13%	-3%	8%	5%	7%	5%	0%	1%	9%	0%	5%	0%		*-4%*	3%	4%
Gross profit growth					5%	3%	12%	9%	0%	10%	7%	-2%	10%	-3%		*1%*	4%	5%
Selling and distribution exp growth					7%	-11%	13%	9%	2%	10%	11%	-10%	11%	-4%			3%	4%
Operating Profit growth					6%	19%	13%	12%	-1%	5%	5%	6%	8%	0%		*16%*	5%	7%
Net Profit growth					11%	9%	18%	9%	2%	5%	8%	1%	2%	2%		*17%*	4%	7%
Share price growth		5.8%	2.9%	22.6%	30.9%	29.7%	11.8%	8.2%	0.7%	6.6%	6.8%	32.1%	43.1%	-0.3%			13.9%	14.7%
Margins																		
Gross Margin				34%	33%	33%	34%	35%	35%	39%	38%	37%	39%	38%		40%	38%	36%
Operating Margin				12%	12%	14%	14%	15%	15%	16%	15%	16%	17%	17%		20%	16%	15%
Net Margin				9%	10%	10%	11%	11%	12%	12%	12%	12%	12%	12%		15%	12%	11%
Selling & distribution exp/Revenue				19%	19%	16%	17%	17%	18%	19%	20%	18%	19%	18%			18%	18%
Depn/CAPEX				34%	70%	110%	65%	51%	31%	65%	112%	96%	114%	97%	256%		97%	81%
Performance																		
ROA				38%	41%	45%	50%	50%	41%	41%	45%	43%	42%	42%		51%	43%	44%
ROIC				41%	38%	45%	62%	61%	60%	75%	89%	86%	80%	80%		84%	82%	68%
ROE				62%	60%	65%	67%	67%	72%	83%	98%	101%	101%	101%		124%	97%	82%
Earnings yield				4.5%	3.9%	3.2%	3.4%	3.5%	3.4%	3.5%	3.5%	2.7%	1.9%	2.0%	0.9%		2.7%	3.1%

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Main Financial Observations

- Sales growth has stagnated, along with Net Profit growth
  - Hence, 50x PE cannot be justified without a change in historical expectations
  - Fortunately, selling & distribution expenses as a % of revenue has not risen dramatically
    - This means that excessive marketing efforts (e.g. promotions & advertising) are not masking negative organic sales growth – as is the case with most declining businesses.
    - However, it also likely means that Nestle Malaysia hasn't yet taken advantage of Internet marketing channels (e.g. social media, youtube ads), which tend to have lower marketing costs vs legacy marketing channels.
- Negative cash conversion cycle
  - Nestle is collecting cash from customers before paying suppliers. This means approximately RM 500M of working capital (vs 2Q20 Total Equity of RM 632M) can be released in the form of dividends for investment elsewhere.
  - It also means bankruptcy risk is reasonably low.
- Margins (gross, operating, net) and ROI indicators (ROA, ROIC, ROE) have all been stagnant for the past 5 years:
  - Implying inability to adapt to the changing retail environment (e.g. taking advantage of the Internet's lower advertising costs); or
  - Business is still growing organically, but e-commerce has been eroding CPG's branding moat (e.g. Kraft-Heinz).
  - In CPG (consumer packaged goods), successful branding efforts over the past 5 years should have lead to higher ROI indicators (e.g. Coca Cola, Tealive), which is still not yet evident from Nestle Malaysia's results.
  - Consistent 100% dividend payout over the past 5 years seems to lend support to the assertion that further reinvestment is no longer fruitful.

Conclusion

- The apt comparison to draw is that Nestle Malaysia's stock has fixed income characteristics:
  - i.e. low risk of principal loss, reliable & relatively fixed coupon payments, negligible upside
  - Due to the absence of growth, improving ROI, or new avenues for business expansion
    - there are very little opportunities for an ex-ante surprise to the upside
  - Also taking into account the steady nature of the business
- You may consider buying the stock today, if:
  - you want equity exposure in your portfolio (in particular, exposure to consumer staples); and
  - you are comfortable with an "average" 2% yield
- Otherwise, it is likely you can find better risk:reward elsewhere.

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