

We had initiated coverage on Nestle India Ltd. in January 2008 at a price of Rs.1313 with an add recommendation at Rs.1215-1250 and a price target of Rs.1575. The stock touched a low of Rs.1, 200 on 22nd Jan 2008 and thereafter rose to Rs.1875 exceeding our target. In our Q1CY08 update we had asked fresh investors to buy the stock in the Rs.1, 520-1,585 band for a 12-month target of Rs.1, 850. It is currently quoting at Rs.1, 750 (15% upside). We present an update on the stock:

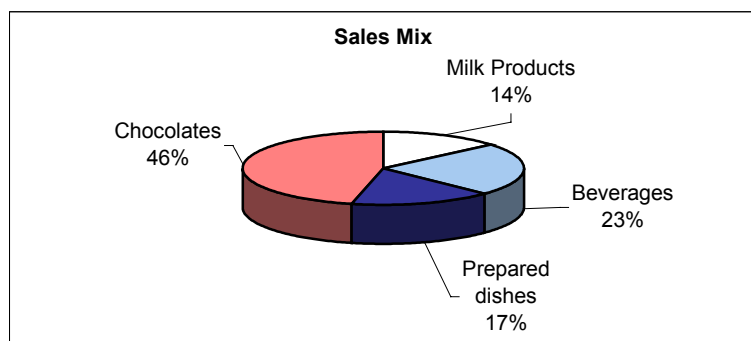
24.8% Sales growth, margins falls by 80 bps:

- Domestic sales grew by 24.8% in Q2CY08 to Rs.944.2 cr as against Rs.756.8 cr in Q2CY07, which was as per our expectations. This is attributable to healthy domestic growth across segments. Export sales has grown by 11.4% to Rs.91.4 cr.
- The OPM in the quarter on a like to like basis has fallen by 80 bps to 18.8%. This was primarily due to increase in raw material prices and higher advertising costs. Raw material as a percentage of net sales has gone up by 40 bps to 49.6% in Q2CY08 due to the unprecedented increase in the prices of the raw material like oil, green coffee, milk and wheat. Employee expenses as a percentage of net sales has decreased by 60 bps to 7.7% in Q1CY08 whereas the other expenditure has increased by 100 basis points to 23.9%. Increase in the other expenses was due to the higher advertising spend.

Cost Analysis as a percentage of Net Sales

Cost Analysis	Q2CY08	Q2CY07	Change in bps	CY07
Raw Material	49.6%	49.2%	-40	48.1%
Employee Cost	7.7%	8.3%	60	7.7%
Other Expenditure	23.9%	22.9%	-100	24.4%
Total Expenditure	81.2%	80.4%	-80	80.1%

- Interest cost stood at Rs.1.38 cr for the quarter under review whereas the depreciation was Rs.22.3 cr in Q1CY08. Income tax provision was on the lower side due to the accrual of tax holiday claim from the Pantnagar factory. Net profit has increased by 26.5% to Rs.121.1 cr, resulting into an EPS of Rs.12.6.
- With the consumer centric approach, Nestle continues to widen its product portfolio. It has launched new product variants like Nesvista Heart Milk, Maggi Cuppa Mania, Maggi Pichkoo and Polo Xtra Strong.



Quantity in MT	H1CY08	H1CY07
Milk Products	61300	55300
Growth%	10.8%	
Beverages	12250	12300
Growth%	-0.4%	
Prepared dishes	60300	46400
Growth%	30.0%	
Chocolates	20800	17300
Growth%	20.2%	

Recommendation:

With aggressive product launches, improved distribution reach, favourable demand scenario, we believe Nestle is poised to grow at a rapid pace in the future. Changing lifestyle, increasing number of nuclear families, changing consumer tastes, increasing disposable incomes could accelerate growth for Nestle. Earlier we had mentioned that usually second quarter on a sequential basis is a subdued quarter and we had expressed our concerns regarding Nestlé's ability to combat the increasing raw material prices. **The fall in the margins in the second quarter reaffirms our concerns and we believe that investors can take profits in the stock at these levels (with 15% upside for the fresh investors) ahead of the target price of Rs.1,850.** Premium in valuation of defensive stocks have expanded in recent times as market P/E has shrunk, while Nestle's P/E has remained constant. In a scenario where operating margins seems to be under pressure, this premium in valuation could narrow. We are still bullish on the medium term prospects of Nestle as its product range gives it a distinct position in the FMCG space and would advise investors to re - enter Nestle at a lower level in the coming months. At the current market price of Rs.1750, the stock is trading at a price/earnings ratio (PER) of 31x CY2008E EPS of Rs.56 and 25.8x CY2009E EPS of Rs.67.5.

Financial Estimates

In Cr.	CY06	CY07	CY08E	CY09E
Net Sales	2816.1	3504.4	3926.5	4501.5
PBDIT	559.1	696.3	823.9	969.3
PAT	326.9	413.8	540.7	651.0
Equity	96.4	96.4	96.4	96.4
EPS	32.7	42.9	56.1	67.5

Result Table:

Particulars (In Cr.)	Q2CY08	Q2CY07	YOY	Q1CY08	Q1CY07	YOY	CY07
Net Domestic Sales	944.2	756.9	24.8	1003.9	776.8	29.2	3174.6
Export Sales	91.4	82.0	11.4	87.1	86.2	1.0	329.8
Net Sales	1035.6	838.9	23.5	1090.9	863.1	26.4	3504.4
Other Income	6.7	3.2	111.0	6.3	7.0	-9.9	25.4
Total Income	1042.3	842.1	23.8	1097.2	870.0	26.1	3529.8
Inc/Dec in Stock	10.6	0.1	-	-35.0	-51.9	-32.7	-67.3
Raw Material	490.5	404.3	21.3	544.1	458.0	18.8	1717.6
Purchase of Traded Goods	12.4	8.4	48.3	10.9	6.8	60.2	34.7
Employee Cost	80.2	69.7	15.1	75.2	64.6	16.3	269.4
Other Expenditure	247.0	191.9	28.7	246.6	205.4	20.1	853.7
Total Expenditure	840.6	674.3	24.7	841.9	682.9	23.3	2808.1
PBDIT	201.7	167.8	20.2	255.3	187.2	36.4	721.7
Depreciation	22.4	17.8	25.5	21.1	17.9	17.5	74.7
PBIT	179.4	150.0	19.6	234.2	169.3	38.4	647.0
Interest	1.4	0.4	-	0.1	0.2	-	0.9
Provision For Contingencies	3.1	3.2	-2.2	10.0	4.4	128.4	16.3
PBT	174.9	146.4	19.5	224.2	164.7	36.1	629.8
Tax	53.8	50.7	6.1	64.0	56.3	13.8	214.8
PAT	121.1	95.7	26.5	160.2	108.5	47.7	415.0
Equity	96.4	96.4		96.4	96.4	-	96.4
EPS	12.6	9.9		16.6	11.2	-	43.0
OPM%	18.8%	19.6%	-80	22.8%	20.9%	+196	19.9%

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