23 March 2024

India | Equity Research | Sector Update

Consumer Staples & Discretionary

Prefer DMart over Nestle

We expect DMart to outperform Nestle in the medium term, driven by (1) valuation turning palatable; premium over Nestle has reduced from ~50% over the last two years to ~8% now, (2) known problems with limited downside business risk w.r.t. underperformance in apparel segment; DMart can choose not to sell what doesn't sell well (benefit of being a platform company), (3) revenue outperformance, while it appears to have been marked down to 18-21% CAGR (vs ~30% during pre-covid quarters), it is still much higher (consistently; 6-10% SSSG) compared to most other FMCG/retail companies, (4) healthy net profit margin despite subdued performance in the margin-accretive apparel, general merchandise segments. Upgrade DMart to **ADD** (from HOLD) and maintain **HOLD** on Nestle.

Consistent revenue performance

DMart's revenue performance has been stable at ~18-21% 4Y CAGR (driven by 6-10% SSSG) since last nine plus consecutive quarters compared to other FMCG/retail companies that reported (relatively) unexciting revenue growth impacted by consumption slowdown.

Known problems: Underperformance in apparels, slower retail expansion rate

We do reckon that this (revenue performance) is lower than 25-30% CAGR revenue growth delivered by DMart pre-covid. However, the underperformance has been largely driven by 1) below-expected performance in the apparel business (see report link); 2) challenges in real estate execution; retail expansion rate stood ~12% (since last three quarters) vs 20-30% during pre-covid and consensus expectations of >15%.

Net profit margin is intact despite under recovery in apparels

Despite lower contribution from margin-accretive apparel segment, net profit margin for DMart remained stable at 5.6% in 9MFY24; in the range of medium term guidance of 5-6%. This was driven by premiumisation in non-food segment and improvement in distribution efficiency, higher share of products being directly distributed by DMart from its own DC (distribution centre).

Prudent conservatism in geographical expansion

Also, to re-highlight the point on DMart turning conservative in offline retail expansion: it added ~65% stores in the top-4 states during 9MFY24 (vs. 73% in FY23 and 54% during FY18-22). This is prudent as it may help drive the operating cost efficiency.

Prudent conservatism in optimising store sizes

Interestingly, the average size of the newly-added stores (17 stores added in 9MFY24) has been conservatively reduced to ~45k sq. ft. since last three quarters compared to 50-60k sq. ft. size stores being added during previous eight quarters. Now, ~60% of DMart's total retail area represents large size stores (45-50k sqft stores vs 30-35k sqft pre-covid).

We believe this is prudent given (1) lower-than-expected business economics (profitability) of large-size stores that were added over the past 4-5 years and (2) execution challenge (of availability) in acquiring large size real estate.

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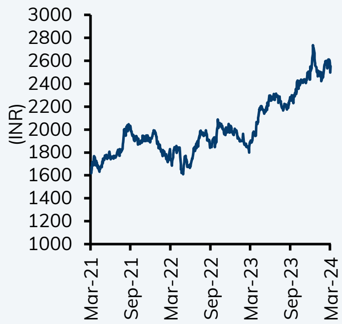
Nestle India (HOLD)



Avenue Supermarts (ADD)

Valuation turning palatable; premium over Nestle is now 8%

We note the valuation premium that DMart used to command earlier has significantly reduced over the last two years. One-year forward P/E multiple for DMart used to trade at ~50% premium to Nestle during FY23. It has now reduced to ~8%.

Hence, given the relative strength in the DMART's underlying business – (1) well poised in both inflationary or deflationary time periods, given it is just a pass-through model. (2) In fact, DMart can leverage such difficult times to **upsell its private label brands**., (3) There are optionalities; as a platform it can enter into new margin-accretive segments (foray into pharmacy is tracking well). (4) Most efficient e-commerce model (least cash-burn vs peers) which enhances the TAM (convenience driven customers) – we would prefer DMART over NESTLE at current valuation.

Nestle; positives have played out, expect time correction in stock price

In the near term, revenue growth outperformance (vs peers) in Nestle is likely to decelerate with anniversarisation of price hikes, though margin expansion may continue with stability in input cost (except green coffee) and Nestle's price retention power (see our report). Hence, while our long-term positive view is intact, we see limited upside with deceleration in revenue outperformance (vs peers) and stock price performance of 34%+ over the last 12 months.

Upgrade to DMART to ADD

Avenue Supermarts: We increase our earnings estimates for FY25E/FY26E by 2%/4%, modelling revenue/EBITDA/PAT CAGR of 23%/27%/30% over FY24E-26E. Upgrade to ADD (from HOLD) with a DCF-based revised target price of INR 4,800 (was INR 4,100 earlier). Key downside risks are higher-than-expected competitive intensity in food and non-food segments; and slower turnaround of e-commerce operation. Key upside risk is significant improvement in the recovery of general merchandise and apparel.

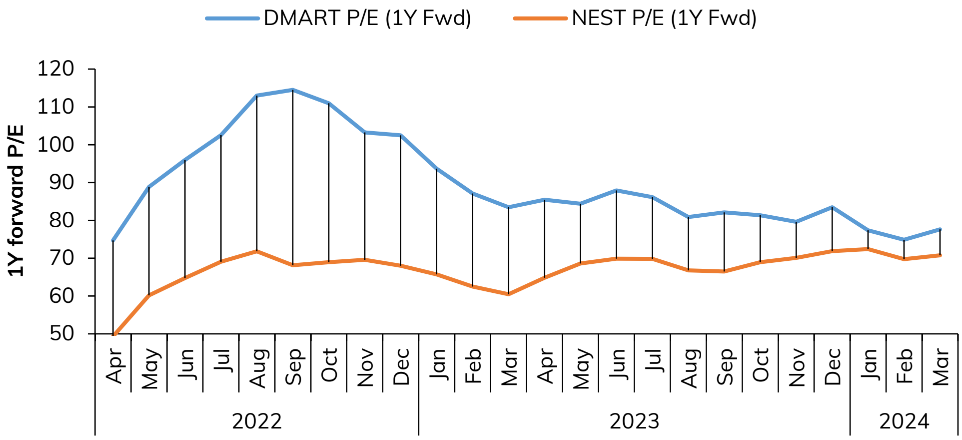
Nestle India: Our earnings estimates remain unchanged, modelling revenue / EBITDA / PAT CAGR of 11 / 16 / 17 (%) over CY23-25E. Maintain HOLD with a DCF-based unchanged target price of INR 2,600. Upside risk: Faster-than-anticipated recovery in demand environment. Downside risk: Higher-than-expected inflation in key raw material prices.

Exhibit 1: Revenue performance trend (%, YoY)

	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24	2QFY24	3QFY24
4Y CAGR	**Jun-22**	**Sep-22**	**Dec-22**	**Mar-23**	**Jun-23**	**Sep-23**	**Dec-23**
DMART	21	21	20	20	19	20	18
Nestle	11	12	11	13	12	12	11
%YoY							
DMART	95	36	25	20	18	19	17
Nestle	16	19	14	21	15	10	9

Source: I-Sec research, Company data

Exhibit 2: Valuation of DMart is turning palatable



Source: I-Sec research, Company data

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