BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

13th January 2016

Food & Beverages

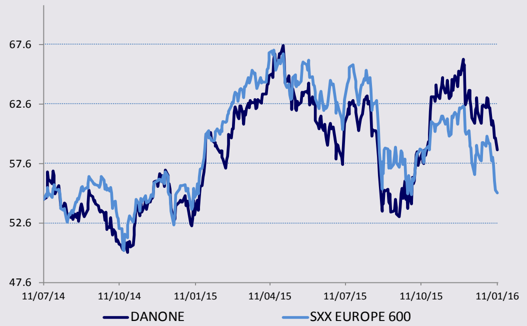
Danone

The best is still to come!

Fair Value EUR74 vs. EUR69 (price EUR58.74) **BUY**

Bloomberg	BN FP
Reuters	DANO.PA
12-month High / Low (EUR)	67.5 / 53.1
Market capitalisation (EURm)	38,472
Enterprise Value (BG estimates EURm)	45,484
Avg. 6m daily volume ('000 shares)	1,638
Free Float	98.0%
3y EPS CAGR	10.5%
Gearing (12/14)	66%
Dividend yield (12/15e)	2.86%

YE December	12/14	12/15e	12/16e	12/17e
Revenue (EURm)	21,144	22,430	23,157	24,529
EBIT (EURm)	2,662	2,922	3,120	3,407
Basic EPS (EUR)	2.63	2.94	3.20	3.54
Diluted EPS (EUR)	2.62	2.93	3.19	3.53
EV/Sales	2.19x	2.03x	1.94x	1.81x
EV/EBITDA	x	x	x	x
EV/EBIT	17.4x	15.6x	14.4x	13.0x
P/E	22.4x	20.0x	18.4x	16.6x
ROCE	9.8	10.8	11.5	12.6



Analysis of the challenges brought about by changes in the food industry strengthens our positive conviction on Danone. We estimate that only 16% of its portfolio, corresponding to yoghurts in Europe (excluding CIS), is at risk. We have lifted our Fair Value from EUR69 to EUR74 mainly to take account of the roll-over in our estimates.

- **Danone's portfolio is globally sheltered from upheaval in the food industry and as such, its growth potential remains intact.** The group has communicated a sustainable medium-term growth rate of 7-10% for water and early life nutrition and 6-8% for medical nutrition. Only 16% of total sales, corresponding to yoghurts in Europe (excluding CIS), are at risk. **The group has mapped out a specific plan to restore its performance and has set credible financial targets. The first results are positive.** Markets such as Spain, Italy (both stable), Germany, Poland and Belgium are showing signs of improvement. The recovery of Actimel is ongoing. Since Q4 2014, the brand has posted sales growth during three quarters. The gross margin of fresh dairy products in Europe increased by 140bp in H1 2015 excluding milk price effects.

- **This analysis strengthens our positive conviction on Danone.** We estimate that sales should increase by 4.5% in 2016 (+4.2% this year at the low-end of guidance for 4-5%), stemming from growth of 1.8% in fresh dairy products, 5% in water, 9% in early life nutrition and 7.5% in medical nutrition. The trading operating profit margin is set to rise by 50bp in 2016 (+40bp in 2015). **We have lifted our Fair Value from EUR69 to EUR74 mainly to take account of our estimates roll-over. The share still has a discount relative to peers.** It is trading on 12-month forward P/E of 20.1x (based on a consensus 2.5% below our estimates) compared with 21.2x for Nestlé (our expectations are 1.6% below consensus) and 20.4x for Unilever.

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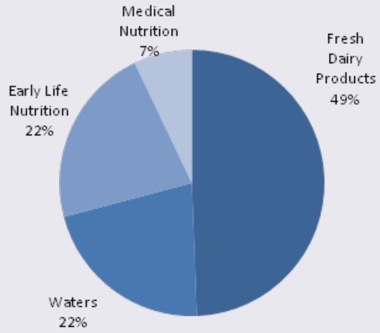
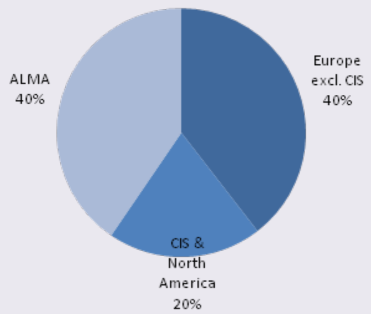
2015 Sales breakdown by Division



2015 Sales breakdown by Region



Company description

Born in 1972 thanks to the merger of BSN and Gervais Danone, Danone has refocused on four core activities (Fresh Dairy products, Waters, Early Life Nutrition and Medical Nutrition) in a limited number of markets in which it intends to be the leader.

Simplified Profit & Loss Account (EURm)	**2012**	**2013**	**2014**	**2015e**	**2016e**	**2017e**
Sales	20,869	21,298	21,144	22,430	23,157	24,529
Change (%)	*8.0%*	*2.1%*	*-0.7%*	*6.1%*	*3.2%*	*5.9%*
Like-for-like change (%)	*5.4%*	*4.8%*	*4.7%*	*4.2%*	*4.5%*	*5.9%*
Trading operating profit	2,959	2,809	2,662	2,922	3,120	3,407
Change (%)	*4.1%*	*-5.1%*	*-5.2%*	*9.7%*	*6.8%*	*9.2%*
Operating income						
Total financial expenses	(302)	(263)	(312)	(319)	(288)	(268)
Income before taxes	2,445	1,865	1,839	2,078	2,797	3,099
Reported income tax	(712)	(604)	(599)	(662)	(730)	(823)
Share of profit of associates	54.0	289	14.0	105	118	123
Net profit	1,787	1,550	1,253	1,522	2,184	2,399
Non-controlling interests	115	128	134	131	145	153
Net profit Group share	1,672	1,422	1,119	1,391	2,039	2,246
Underlying net income_group share	1,818	1,636	1,561	1,776	1,932	2,139
Change (%)	*3.9%*	*-10.0%*	*-4.6%*	*13.8%*	*8.8%*	*10.7%*
Cash flows from operating activities						
Working capital variation	(333)	(217)	(57.0)	(124)	(99.0)	(94.9)
Capex, net	(976)	(1,039)	(984)	(1,054)	(1,088)	(1,153)
Other	206	113	59.0	0.0	0.0	0.0
Free cash flow excluding exceptional items	2,088	1,549	1,401	1,603	1,737	1,945
Exceptionals	0.0	(121)	(123)	30.0	0.0	0.0
Free cash flow reported	2,088	1,428	1,277	1,603	1,737	1,945
M&A	(300)	(1,330)	(1,404)	(1,273)	0.0	0.0
Dividends	(1,083)	(953)	(417)	(311)	(1,017)	(1,107)
Other	(365)	(819)	746	732	(200)	(200)
Net debt	6,292	7,966	7,764	7,013	6,493	5,854
Property, plant and equipment						
Intangibles assets	16,265	16,308	16,234	16,385	16,538	16,693
Cash & equivalents	1,269	969	880	299	319	26.6
current assets	6,923	7,850	7,449	7,376	7,517	7,450
Total assets	29,537	30,928	31,747	31,833	32,101	32,094
L & ST Debt	9,522	11,927	11,142	10,121	9,621	8,690
Others liabilities	7,761	8,272	8,860	9,159	9,554	9,544
Shareholders' funds	12,191	10,694	11,696	12,504	12,878	13,810
Total Liabilities	17,283	20,199	20,002	19,280	19,175	18,235
Trading operating margin						
Reported tax rate	29.10	32.40	32.60	31.83	26.12	26.54
Underlying net income_group share	8.71	7.68	7.38	7.92	8.34	8.72
ROE	13.72	13.30	9.57	11.12	15.84	16.27
ROIC	11.36	10.42	9.77	10.77	11.49	12.58
Gearing based on net debt	51.35	74.25	66.10	55.87	50.23	42.24
Gearing based on net financial debt	24.65	44.01	44.33	41.32	36.10	29.07
Pay out ratio	48.09	52.11	57.27	57.27	57.27	57.27
Number of shares, diluted	603	588	596	606	606	606
Basic underlying EPS						
Diluted underlying EPS	3.01	2.78	2.62	2.93	3.19	3.53
% change	*4.3%*	*-7.7%*	*-5.9%*	*12.0%*	*8.8%*	*10.7%*
BVPS	20.22	18.19	19.62	20.65	21.27	22.81
Operating cash flows	4.19	3.84	3.81	4.18	4.50	4.96
FCF	3.46	2.63	2.35	2.65	2.87	3.21
Net dividend	1.45	1.45	1.50	1.68	1.83	2.02

Source: Company Data; Bryan, Garnier & Co ests.

1. Solid fundamentals

Analysis of the challenges brought about by changes in the food industry (see sector report: A spicier dish) strengthens our positive conviction on Danone. We estimate that only 16% of its portfolio, corresponding to yoghurts in Europe (excluding CIS), is at risk. The group has mapped out a specific plan to restore its performance and has set precise financial targets. It is now forecasting growth of 3-5% in fresh dairy product sales by 2020 thanks to changes in the marketing model (more focused on emotion), innovation (Danonino pocket etc.) and the refocusing of resources on eight of its brands (Activia, Actimel, Vitalinea, Danio, Oikos, Danette, Danonino, Danone) that generate more than 80% of sales and profits. Danone has also indicated that it is planning to improve underlying EBIT margin by 200bp (excluding forex) between 2015 and 2020, primarily by streamlining its portfolio and optimising operations. **The first results are positive.** Signs are encouraging in markets such as Spain, Italy (both are stable), Germany, Poland and Belgium. The recovery of Actimel is ongoing. Since Q4 2014, the brand has posted growth in three quarters. Trends at Activia have stabilised, although they remains in negative territory. The gross margin in fresh dairy products in Europe increased by 140bp in H1 2015, excluding the milk price effect! Danone should reach the low-end of its sales guidance in 2017. We are forecasting sales growth in yoghurts of 3.5%, implying a stabilisation in Europe, growth of 3% in the US and CIS and 5% in Asia-Pacific/Latin America. We have increased our underlying EBIT margin estimates for fresh dairy products over the next three years and now expect a 40bp increase to 9.7% in 2015 (vs. 9.5% previously). Over the following two years, the margin should rise by respectively 30bp and 50bp to 10% and 10.5%.

Other divisions are generally sheltered from upheaval in the food industry. We believe that early life nutrition should be the main growth driver in coming years. In China (22% of sales on our estimates), the group has restored its pre-Fonterra market share of 15%. It boasts very strong positions in e-commerce (legal in B2C and illegal in C2C) with market share of 50%! Consumer interest remains robust for international brands, especially those stemming from the Netherlands, Germany, Ireland and New Zealand. After the disposal of Dumex to Yashili, Danone will no longer be present in the declining modern trade circuit, contrary to Nestlé and Mead Johnson which are overexposed. Apart from possible synergies, this operation should enable Danone to deepen its relations with the Chinese government and extend its distribution to tier-4 cities and beyond the e-commerce channel. **In 2016, the water division is likely to slow due to destocking of the Mizone brand, which is suffering from the slowdown in the Chinese economy. However, the category's potential remains significant. The group communicated on a sustainable medium-term growth pace of 7-10% for water and baby-food and 6-8% for medical nutrition.**

In addition to the recovery plan for fresh dairy products, strong measures are be implemented at the group level in order to reach the 2020 target for profitable and sustainable growth:

- **Organisational changes.** The "One Danone" plan aims to integrate the support functions (HR, IT etc.) in order to reduce costs and enable better expertise. During 2016, 30 clusters are to be created. This new organisation should be fully operational in 2017.

- **Changes to variable remuneration criteria for managing directors**. At present, variable remuneration is two-thirds based on sales and one-third on margins. Although exactly what changes are to be made were not stated at the Investor Day, Emmanuel Faber clearly said that he would like to place the focus more on profitability.

- **Changes to budgeting systems.** Danone is to abandon its annual budget and adopt a quarterly budget on a rolling basis. The allocation of resources will be more dynamic, enabling the group to rapidly re-allocate funds depending on requirements.

2. Estimates

We estimate that sales should increase by 4.5% in 2016 (+4.2% this year at the low-end of guidance for 4-5%), stemming from growth of 1.8% in fresh dairy products, 5% in water, 9% in early life nutrition and 7.5% in medical nutrition. The trading operating profit margin is set to rise 50bp in 2016 (+40bp in 2015) and 40bp the following year. The decline in financial expenses should contribute to EPS growth of 8.8% in 2016 and 10.7% in 2017. These forecasts remain globally unchanged (2015-17 EPS estimates up 1%) since although we have raised the margins for yoghurts, we have reduced our organic sales growth forecast for water.

Fig. 1: Sales forecasts by division

EURm	2014	2015e	2016e	2017e
GROUP				
Sales	**21 144**	**22 430**	**23 157**	**24 529**
Reported variation	-0,7%	6,1%	3,2%	5,9%
FX variation	-5,5%	2,1%	-0,3%	0,0%
External variation	0,1%	-0,2%	-0,9%	0,0%
Organic variation	**4,7%**	**4,2%**	**4,5%**	**5,9%**
% price/mix	*6,2%*	*3,4%*	*2,3%*	*3,0%*
% volume	*-1,5%*	*0,8%*	*2,2%*	*2,9%*
FRESH DAIRY PRODUCTS				
Sales	**11 129**	**11 083**	**11 227**	**11 620**
Reported variation	-5,6%	-0,4%	1,3%	3,5%
Organic variation	**1,5%**	**0,6%**	**1,8%**	**3,5%**
EARLY LIFE NUTRITION				
Sales	**4 397**	**4 939**	**5 208**	**5 708**
Reported variation	3,1%	12,3%	5,5%	9,6%
Organic variation	**6,1%**	**8,6%**	**9,0%**	**9,6%**
WATERS				
Sales	**4 186**	**4 817**	**5 019**	**5 370**
Reported variation	7,3%	15,1%	4,2%	7,0%
Organic variation	**11,6%**	**8,2%**	**5,0%**	**7,0%**
MEDICAL NUTRITION				
Sales	**1 432**	**1 592**	**1 703**	**1 831**
Reported variation	6,7%	11,1%	7,0%	7,5%
Organic variation	**7,9%**	**7,5%**	**7,5%**	**7,5%**

Source: Danone, Bryan, Garnier & Co

Fig. 2: EBIT estimates by division

EURm	2014	2015e	2016e	2017e
GROUP				
EBIT	**2 662**	**2 922**	**3 120**	**3 407**
Reported variation	-5,2%	9,7%	6,8%	9,2%
Margin	**12,59%**	**13,02%**	**13,47%**	**13,89%**
Change in bp	-60	43	45	42
LFL	*-12*	*26*	*22*	*42*
FX	*-28*	*9*	*2*	*0*
Scope	*-20*	*10*	*21*	*0*
FRESH DAIRY PRODUCTS				
EBIT	**1 033**	**1 078**	**1 119**	**1 215**
Reported variation	-15,4%	4,4%	3,8%	8,6%
Margin	**9,28%**	**9,73%**	**9,97%**	**10,46%**
Change in bp	-107	45	24	49
EARLY LIFE NUTRITION				
EBIT	**828**	**912**	**1 022**	**1 119**
Reported variation	-1,0%	10,1%	12,1%	9,5%
Margin	**18,83%**	**18,45%**	**19,63%**	**19,61%**
Change in bp	-79	-39	128	-2
WATERS				
EBIT	**539**	**636**	**658**	**720**
Reported variation	5,9%	18,0%	3,4%	9,5%
Margin	**12,88%**	**13,20%**	**13,10%**	**13,41%**
Change in bp	-16	34	-10	31
MEDICAL NUTRITION				
EBIT	**262**	**296**	**321**	**352**
Reported variation	7,4%	13,0%	8,5%	9,8%
Margin	**18,28%**	**18,58%**	**18,84%**	**19,24%**
Change in bp	12	31	26	39

Source: Danone, Bryan, Garnier & Co

3. Valuation

We reiterate our Buy recommendation. We have lifted our Fair Value from EUR69 to EUR74 to take account of the roll-over in our estimates and the increase in our EPS forecasts over the next three years (+1%).

Fig. 3: DCF

EURm	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e
Gross cash flow	3 432	3 688	3 821	4 071	4 333	4 560	4 761	4 934	5 073	5 176
CF variation		7,5%	3,6%	6,6%	6,4%	5,2%	4,4%	3,6%	2,8%	2,0%
-Capital expenditure	1088	1153	1222	1296	1374	1446	1478	1531	1540	1571
-WCR variation	-99	-95	-101	-107	-113	-119	-124	-129	-132	-135
=Operating free cash flow	**2 442**	**2 630**	**2 699**	**2 882**	**3 072**	**3 233**	**3 408**	**3 532**	**3 666**	**3 740**
Discounting rate	7,9%									
Perpetual growth rate	2,0%									
Discounted free cash flow	2264	2260	2149	2127	2102	2050	2004	1924	1851	1751
Discounted free cash flow sum	20 483									
+Discounted terminal value	30 349									
=Total	**50 832**									
-Minority interest	49									
+Financial assets	2 146									
-Net debt	7 013									
-Provisions	818									
=Total	**45 098**									
Number of shares	606									
DCF per share	**74**									

Source: Danone, Bryan, Garnier & Co

Danone's 12-month forward P/E only stands at 20.1x (on the basis of a consensus 2.5% lower than our estimates) compared with 21.2x for Nestlé (our expectations are 1.6% below consensus), while **its metrics are more attractive:**

Fig. 4: Organic sales growth

	2015e	2016e	2017e
Danone	4.2%	4.5%	5.9%
Nestlé	4.2%	4.5%	4.9%

Fig. 5: EPS growth

	2015e	2016e	2017e
Danone	12%	8.8%	10.7%
Nestlé	-3.6%	3.7%	7.6%

Fig. 6: FCF yield

	2015e	2016e	2017e
Danone	4.4%	4.8%	5.4%
Nestlé	4.2%	4.4%	4.6%

Fig. 7: Change in ROIC

	2015e	2016e	2017e
Danone	10.8%	7.3%	9.8%
Nestlé	-0.4%	3.3%	8.8%

Source of all charts: Danone, Nestlé, Bryan, Garnier & Co

Price Chart and Rating History

Danone

Ratings		
Date	**Ratings**	**Price**
08/07/15	BUY	EUR58.09

Target Price	
Date	**Target price**
20/10/15	EUR69
08/07/15	EUR71

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For the purposes of this Report, the Bryan Garnier stock rating system is defined as follows:

Stock rating

BUY Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

NEUTRAL Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

SELL Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

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