INDEPENDENT RESEARCH

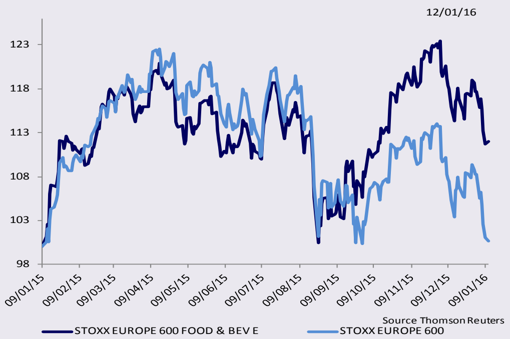
13th January 2016

Food industry

A spicier dish

Food industry

DANONE		**BUY**	**FV EUR74 vs. 69**
Bloomberg	BN FP	Reuters	DANO.PA
Price	EUR58.74	High/Low	67.48/53.1
Market cap.	EUR38,472m	Enterprise Val	EUR45 484m
PE (2015e)	20.0x	EV/X (2015e)	15,6x
NESTLE		**NEUTRAL initiated**	**CHF76**
Bloomberg	NESN VX	Reuters	NESZn.VX
Price	CHF70.25	High/Low	76.75/64.8
Market cap.	CHF223,985m	Val. Entreprise	240 353 MCHF
PE (2015e)	21,2x	EV/X (2015e)	17,3x



- **The business environment has deteriorated for major food groups that are facing constant political intervention and an accumulation of regulations. They are also overwhelmed by sociological changes** with the ramp-up in e-commerce and e-advertising, the increase in away-from-home consumption (AFH) and above all the emergence of the Millennial generation. **In contrast, some newly created brands have managed to make the most of these developments.** In order to face these challenges, major groups in the sector have two options that have mixed results: reformulating products or acquiring small, dynamic companies.

- **Only 16% of Danone's portfolio is based in high-risk categories**, i.e. those affected negatively by the above-described changes in the food industry. **This concerns yoghurts sold in Europe (excluding CIS). The group has mapped out a specific plan to restore their performance and has set credible financial targets. The first results have been positive** with a return to growth for Actimel, a stabilisation in trends for Activia and an increase in the gross margin of the yoghurts division in Europe (+140bp in H1 2015 excluding the milk price effect). **In contrast, Nestlé is not only exposed to risk categories for 25%, but the strong measures implemented by the Swiss group only concern 8% of its sales.**

- **This analysis strengthens our positive conviction on Danone. We reiterate our Buy recommendation and have increased our Fair Value to EUR74** in order to take account of the roll-over of our estimates and the 1% increase in our EPS forecasts for the next three years. **The Swiss group seems to be facing far larger challenges. Besides, its theoretical upside (+8%, Fair Value of CHF76) is low. So we are initiating coverage of the stock with a Neutral recommendation.** Despite the excellent performance enjoyed over the past three months, Danone's 12m forward P/E only stands at 20.1x (based on a consensus 2.5% lower than our estimates) compared with 20.4x for Unilever and 21.2x for Nestlé (our expectations are 1.6% below consensus).

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1. Overview of investment case

Food companies under pressure

The food industry is the focus of much attention, notably from politicians, aiming to make the fight against obesity a priority and to increase food safety measures as the number of scandals in the industry has multiplied. **Regulations are mounting**: taxes on calories, increasingly strict standards in terms of product labelling, advertising etc. **The backdrop is less beneficial for major groups, who are also under pressure by certain sociological developments:** the ramp-up in e-commerce and online advertising, an increase in AFH consumption and above all, the emergence of the Millennial generation. **In contrast, some newly created brands are very dynamic.** They have managed to make the most of new technologies in order to publicise their products and distribute at a low cost. Their smaller size enables them to adapt more easily to new regulations. Above all, they offer products that meet consumer demands as major groups have failed to do.

Solutions with mixed results

The major groups are reformulating their products: reducing the size of portions, reducing salt, sugar and saturated fat levels, or on the contrary adding beneficial ingredients (vitamins and minerals etc.). This approach has its downsides since it involves additional costs, technical obstacles and above all, a possible rejection by consumers who could be disappointed by the resulting taste or worried about the ingredients used as substitutes. **An alternative solution for groups is to acquire a small brand (ex: acquisition of Annie's by General Mills in September 2014)** in a bid to strengthen their innovative capacity and efficiency, while enhancing their reputation. However, this strategy also carries risks such as the loss of customer confidence, and retaliatory measures by mass-market retailers. In addition, these acquisitions are too small to really make a difference.

Danone is the best positioned

The French group only derives 16% of its portfolio from risk categories, namely those negatively affected by the changes in the food industry we described above. **This concerns yoghurts sold in Europe (excluding CIS). The group has mapped out a specific plan to restore their performance and has set credible financial targets. The first results have been positive** with a return to growth of Actimel, a stabilisation in trends of Activia and an increase in the gross margin (+130bp in H1 2015 excluding the impact of milk prices). **Nestlé is more exposed. We estimate that 25% of its portfolio is at risk,** corresponding to sales in western countries of frozen and chilled products, cooking aids, liquid and powdered beverages, confectionary and ice-creams. **The strong measures implemented by the Swiss group only concern 8% of its sales:** frozen products in the US (5%) and ice-creams/frozen products in Europe (3%). Other initiatives are headed in the right direction, but their impact is minimal (launch of Cailler chocolate) or uncertain (reformulation).

This analysis strengthens our positive conviction on Danone. We reiterate our Buy recommendation and have increased our Fair Value to EUR74 in order to take account of the roll-over of our estimates and the rise in our EPS forecasts (+1%) for the next three years. **We are also initiating coverage of Nestlé with a Neutral recommendation and a Fair Value of CHF76.**

2. Food companies under pressure

The food industry is the focus of much attention (2.1), firstly from politicians aiming to make the fight against obesity a priority and to increase food safety measures as scandals in the industry have multiplied (2.1.1). Regulations are mounting (2.1.2) including taxes on high-calorie products, stricter standards in terms of product labelling and advertising etc. The backdrop is less beneficial for major groups. At the same time, these groups are under pressure by sociological changes (2.1.3): the ramp-up in e-commerce and e-advertising, the increase in AFH consumption and above all, the emergence of the Millennial generation. In contrast, newly created brands are very dynamic (2.2).

2.1. Food: a subject too serious for groups to decide on alone

2.1.1. Political pressure

A number of organisations and public personalities are intervening in the food industry in order to address **public health issues, including primarily the fight against obesity and the strengthening of requirements in terms of food safety**.

Obesity: a global pandemic focusing political attention

Global obesity prevalence more than doubled between 1980 and 2014 with 13% of the global adult population now in the obese category. The percentage of overweight adult people stands at 39%.

13% of the global adult population is now in the obese category

The increase in obesity has stemmed from a number of societal changes:

- A lack of physical activity due to the increasingly sedentary nature of many types of work, development in transport means and urbanisation.
- However, it primarily stems from changes in eating habits:
  - ✓ Less home cooked produce and more ready-made dishes and snacks. In the US, children eat around three snacks a day compared with only one 30 years ago.
  - ✓ Increased portion sizes.
  - ✓ The higher calorie count provided by food products.

Faced with this scourge, politicians are now speaking out. **Michelle Obama's "Let's Move"** programme to tackle obesity in children has celebrated its fifth anniversary. America's First Lady stated *"The physical and emotional health of an entire generation and the economic health and security of our nation is at stake"*. The website dedicated to the campaign estimates that the obesity rate in the US has tripled over the past three decades to the extent that one child in three is now obese or overweight. "Let's Move" aims to promote healthier eating habits by providing advice to parents, improving the quality of meals served in schools and encouraging physical activity.

The Pan American Health Organisation has also stepped up its efforts in the fight against obesity. This organisation challenges governments, the scientific community and civil society organisations over the need to implement policies aimed at promoting healthier eating habits. Volumes of processed food and beverages increased by 48% between 2000 and 2013 in Latin America.

Fig. 1: The Pan American Health Organisation and its fight against bad eating habits

Source: Danone

<u>**In view of the number of food industry scandals, public authorities react:**</u>

A multitude of food scandals have been uncovered, the main ones including:

- **Mad cow disease (1996).** The epidemic emerged in 1986 but the first cases of contamination in humans were detected in 1996 after people had consumed beef.
- **The bird flu epidemic (2003).** After emerging in Asia, bird flu spread across the Middle East, Europe and Africa between 2003 and 2006. It caused 240 deaths and led to the slaughter of millions of livestock.
- **Adulterated powdered milk (2008).** The scandal erupted at Chinese company Sanlu, which was accused of adding melamine to its milk in order to simulate the product's protein richness. Around 300,000 babies became ill resulting in the death of at least six of them.
- **Dioxin contamination (2008 and 2010).** Dioxins are pollutants that are classed as carcinogenic and stem primarily from industrial processes. In 2008, Irish pork was recalled due to the discovery of a dioxin concentration of up to 200 times over the limit. Italian mozzarella cheese was also infected due to contamination of buffalo milk in the Naples region where the environment is polluted by waste. In 2010, German eggs were contaminated.
- **Contaminated sprouted seeds (2011).** The E.coli bacteria caused around 40 deaths and almost 4,000 illnesses in Europe. Sprouted seeds produced in the north of Germany are thought to have been the cause.
- **The Spanghero affair (2013).** The scandal of horsemeat being sold as beef broke out in Ireland in June 2013 before affecting a number of European countries and especially France.

A large number of companies such as Picard, Findus and retailers' own-brands were implicated. French company Spanghero, which supplied the meat, was accused. Almost a year after the scandal, the authorities highlighted a fraud consisting of the re-introduction of laboratory horses into the food industry after their traceability books were falsified.

2.1.2. Pressure from watchdogs

Regulations are becoming stricter partly due to the increased concern shown by states authorities.

Tax on high-calorie products. In October 2011, Denmark imposed a tax on foods in which the level of trans fat (produced from unsaturated fats via an industrial process known as hydrogenation and aimed at replacing saturated fats) exceeds 2.3%, thereby resulting in a price increase of about 10%. This tax was finally abandoned following pressure from industrialists. However, a number of countries have followed Denmark's example. At end-2013, Mexico adopted a tax of 8% on foods containing more than 275 calories per 100 grams and a tax of 1 peso per litre on sodas.

Stricter requirements in terms of product labelling. In the European Union, the INCO regulation took effect in December 2014:

- Compulsory indications must have a minimum character size of 1.2mm.

- Allergenic substances present in pre-packaged products must be highlighted in the list of ingredients, by the use of bold or italic characters for example. The obligation to indicate the presence of allergens also applies to non-pre-packaged products. However, the way information on these products is presented is left to the discretion of the member states.

- The origin of certain products such as beef, honey, olive oil, fresh fruit and vegetables must already be indicated on the label. It is also obligatory for foodstuffs, which unless they show this indication, could mislead consumers. In addition, since April 2015, the obligatory indication of origin has been extended to other food categories such as fresh or frozen pork, mutton, goat and poultry.

- A nutritional declaration is to become compulsory as of 2016 in the European Union. The energy value and quantities of lipids, saturated fatty acids, carbohydrates, sugars, proteins and salt must be presented where they can be seen altogether in a legible table placed on the packaging.

Greater regulation of advertising for processed foods and drinks. In France, adverts must be accompanied by a message indicating the benefits of a balanced diet ("eat at least five pieces of fruit and vegetable a day"). In Mexico, advertising for certain products (chocolate, sweets, crisps, sodas, cookies) are banned from television during times when the majority of spectators are under the age of 12 and in cinemas if the film projected is destined for children.

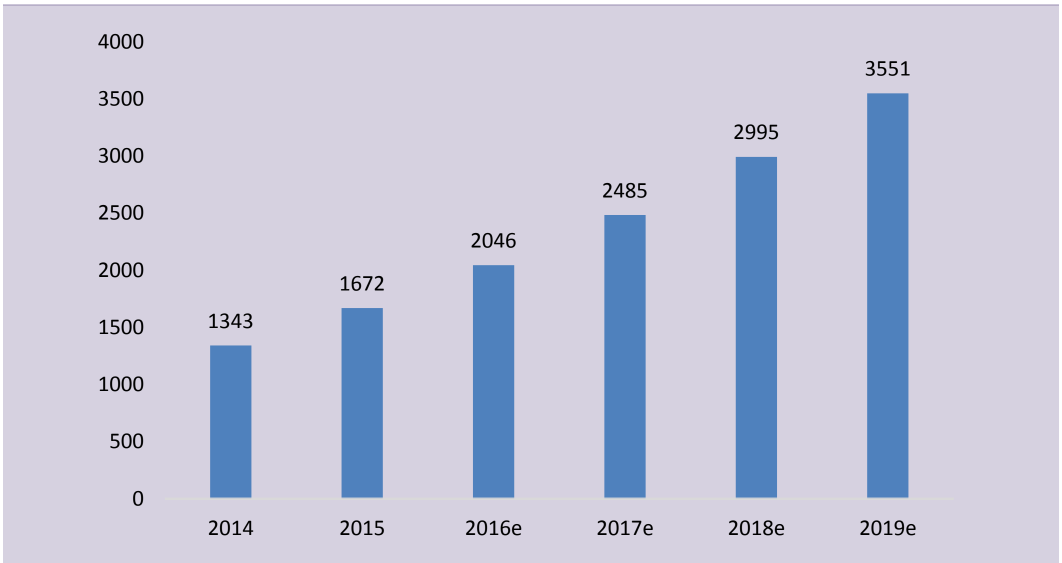
2.1.3. Pressure from changes in society

A ramp-up of e-commerce/online advertising

Retail sales on the internet are set to rise by an average 21% over the next four years.

Changes in society such as the aging population and urbanisation have favoured the ramp-up in e-commerce. Retail sales on the internet are set to rise by an average 21% over the next four years. The internet is also an increasingly favoured circuit for product advertising.

Fig. 2: Global retail sales in online commerce (USDt)

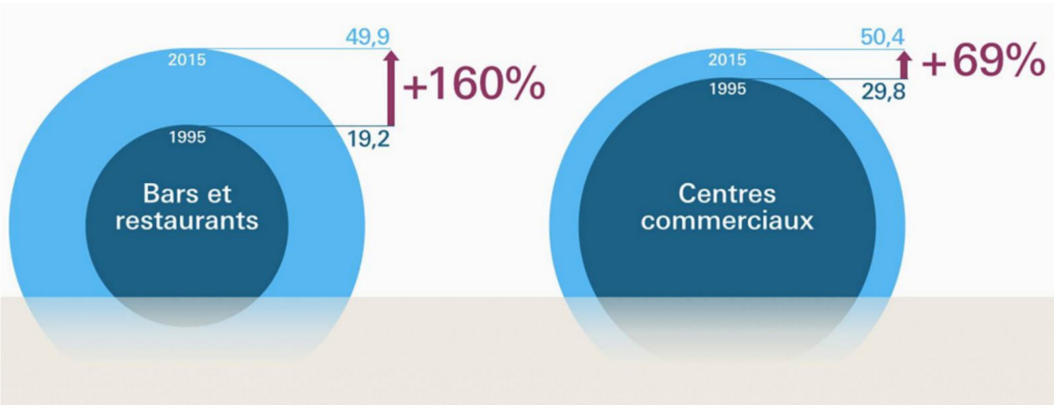


Source: Statista

An increase in away-from-home consumption

The increase in disposable income in western countries is at the root of this trend. However, contrary to other segments of the consumer goods industry such as drinks, tobacco and cosmetic products, a large number of food products are not consumed away from home.

Fig. 3: Monthly spending in the US (USDbn)

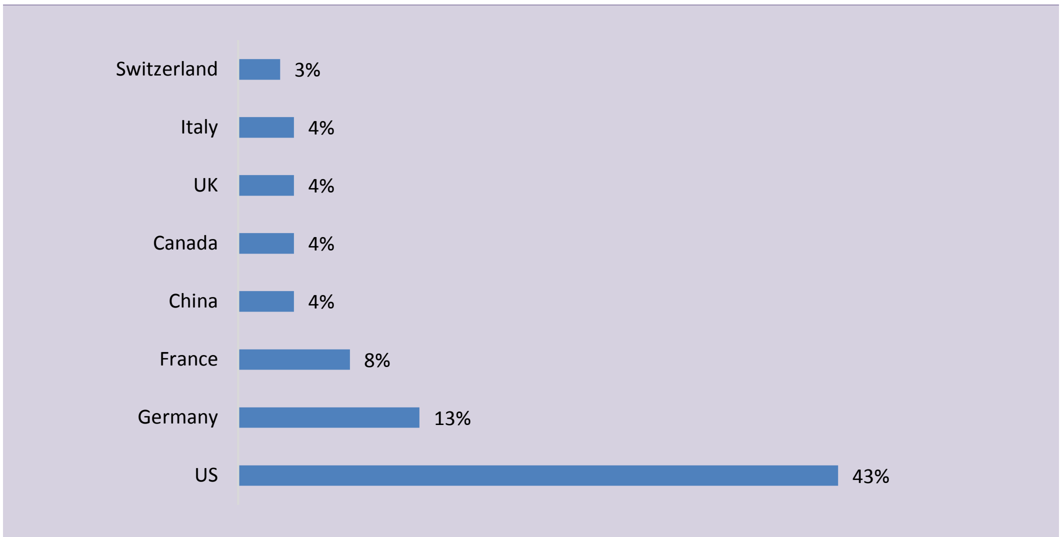


Source: Nestlé

<u>**The emergence of the Millennial generation**</u>

This generation favours more quality than brand image. Sensitive to ethical and environmental challenges, Millennials attach great importance to the origins of a product, to fair trade and to free-range goods. This age-group is more concerned about its health and favours healthy and balanced food, thereby explaining the success of products containing fewer "damaging" ingredients (sugar, salt, fat etc.), hand-made goods and organic products. **In the US, the leading global market for organic foods (43% of global sales), sales are set to grow by 14% a year on average until 2018.**

Fig. 4: The main markets for organic products (as a percentage of sales)



Source: Statista 2015

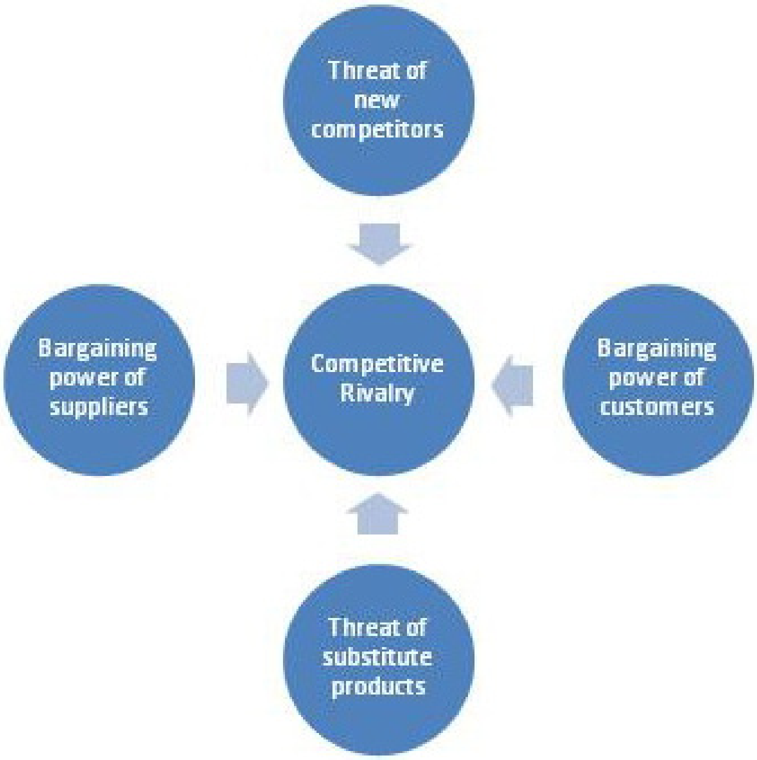
2.2. Long live small players!

The works of Michael Porter shed an interesting theoretical light on changes in the food industry. Five forces determine the competitive structure of an industry of goods or services:

The works of Michael Porter shed an interesting theoretical light

1. The bargaining power of customers
2. The bargaining power of suppliers
3. The threat of substitute products
4. The threat of new competitors
5. The intensity of competitive rivalry

Fig. 5: The five Porter forces



Source: Porter

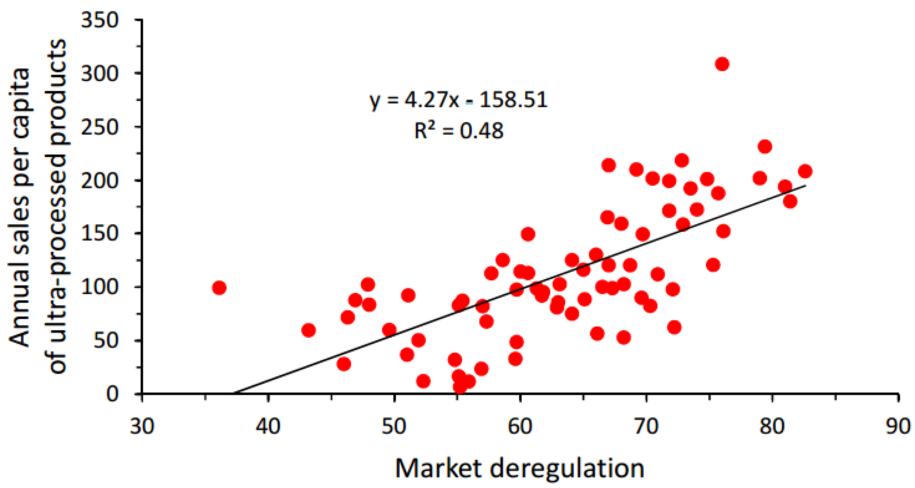
The food industry has always been characterised by high competitive intensity:

- **The threat of substitute products is high** given the fragmented nature of players.
- **The bargaining power of customers is significant** as it exists alternative supply sources, the cost of transfer is low and an upstream integration is possible (some products can be homemade).

The developments described above have weakened the industry's structure and for major groups, have created additional difficulties on the back of which a number of smaller brands have prospered:

- **The threat of new competitors has increased with the internet** and new technologies are helping them. **E-commerce** offers them an extensive distribution network that is easily accessible (unlike referencing with classic retailers) and the possibility of **advertising on the internet** enables them to extend their consumer base without incurring high costs.
- **Customer bargaining power has strengthened with the Millennial generation.** This generation is more demanding than previous generations and is not as loyal in terms of brands. This age-group is quick to sanction companies that do not meet their demands for healthier, more balanced food with more organic ingredients and less sugar and salt. Aware of this opportunity, smaller brands are manufacturing products that directly appeal to these consumer expectations (possible outsourcing of production). At the same time, major groups are struggling to adapt, penalised by the size of their production facilities and logistical chain (sometimes global).
- **Toughening of regulatory backdrop taking a toll on food companies.** Although Porter did not originally mention the role of public authorities, in our view there is no doubt that they have a direct impact on an industry's structure. Increased regulatory requirements slow sales. The Pan American Health Organisation studied the correlation between market deregulation and sales per capita of processed products in 74 countries.

Fig. 6: Correlation between market deregulation and sales per capita of processed products

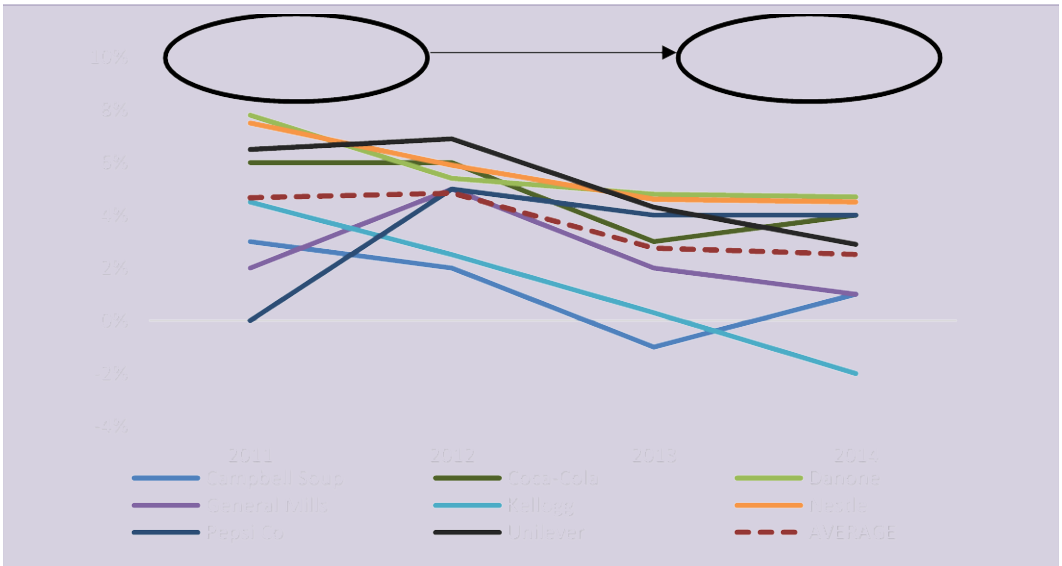


Source: Pan-American Health Organisation

However, newly created brands have an advantage in their small size that enables them to adapt their organisation to new regulations more easily.

The number of companies present at the Natural Products Expo West exhibition in the US, where food product manufacturers exchange with distributors with a view to becoming listed, has increased by more than 70% since 2005. In the US, the growth rate of small brands has been high over the past three years: Chobani (Greek yoghurt) +80%, Quest (protein bars) +57%, Wright Foods (packaged foods with no preservatives) +12%, SweetFrog (frozen yoghurts) +10% and Artic Zero (diet ice-creams with no gluten or lactose) +175%! Over the same period, the major groups (see sample below) have posted average organic sales growth of just 3.5%.

Fig. 7: Change in organic sales growth



Source: Sociétés, Bryan, Garnier & Co

These different growth levels would not be worrying (easy to explain by size effect) if they did not go hand in hand with market share losses. The cereal bars market is a good example. Euromonitor estimates that General Mills and Kellogg's incurred market share losses of 3bps and 190bps points respectively in 2014 whereas the private companies Clif Bar & Co and Kind gained 100 point and 210 points respectively. This goes beyond the framework of the food industry. A report published in March 2015 written by IRI and the Boston Consulting Group, shows that small and medium-sized companies in the consumer goods industry have dented sales at major groups in the US by USD18bn since 2009, the equivalent of 2% market share.

3. Solutions with mixed results

In order to resolve their problems, the major groups have two solutions that are not perfect:

- Reformulating their products (3.1) by reducing the size of portions, by eliminating ingredients that are "bad" for health and, on the contrary, adding beneficial ingredients.
- Acquiring small brands (3.2) that are dynamic and well positioned in the latest consumer trends.

3.1. Reformulating products

3.1.1. Reducing the size of portions

The major groups have taken note of their own deficiencies and are formulating or reformulating products in order for them to better meet consumer expectations. **They are especially trying to reduce the size of portions.** Below are a few examples of their achievements:

- MacDonald's has halted the Supersize option in its menus in the US and the UK.
- Mars has replaced a number of large individually wrapped chocolate bars by smaller products that are aimed to be shared.
- Coca-Cola now offers bottles of 250ml or less in more than 125 countries.

Fig. 8: Extension of Coca-Cola range to include smaller formats

Source: Coca-Cola

3.1.2. Limiting "bad" ingredients

Here there are three main focuses: salt, fat (trans and saturated) and sugar. The majority of efforts by companies have focused on the first two.

Reducing salt content:

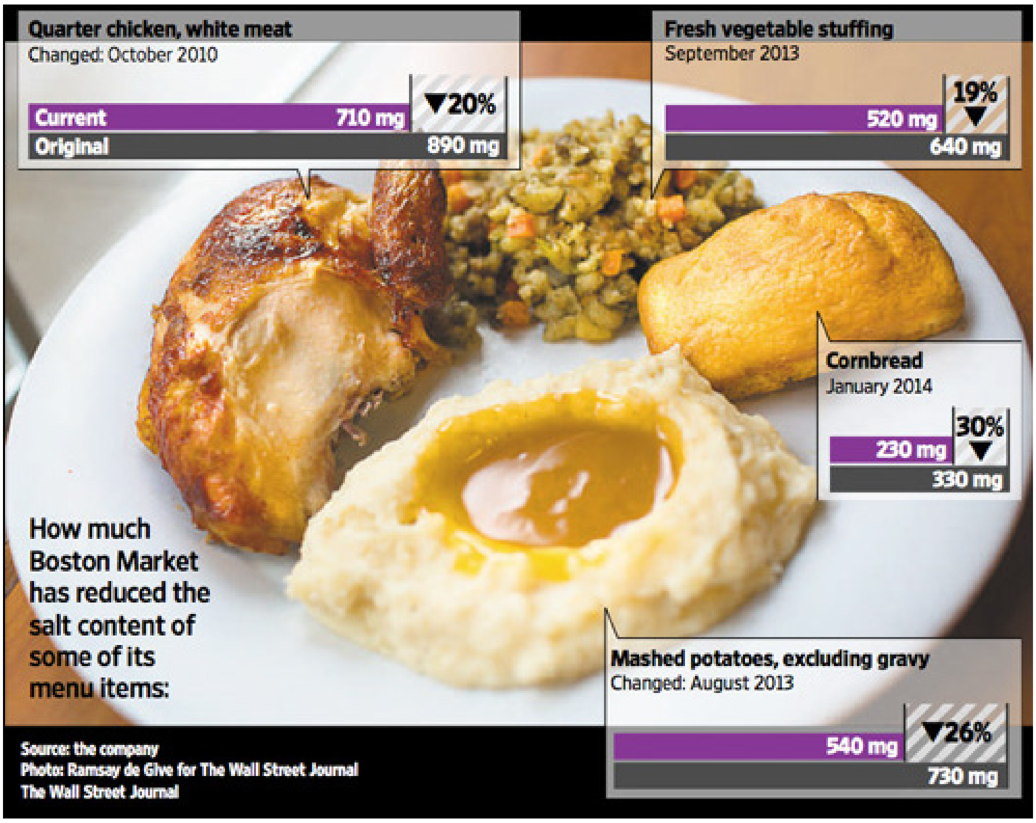
- Nestlé is continuing to reduce the amount of sodium contained in its products. For 2025, it is targeting average consumption per person and per day of less than 5g, corresponding to the recommended daily dose. In 2012, it reported that its cooking preparations and breakfast cereals contained 14,043 fewer tonnes of salt than in 2005.

- Unilever also aims to help consumers not exceed the limit of 5g of salt per day. The group is nevertheless more ambitious concerning the deadline and has set it for 2020. In 2013, it reported that 55% of its food product portfolio already met this requirement.

- General Mills has reduced sodium content by 10-50% in more than 27 varieties of the Helper brand over six years.

- Boston Market, a fast-food chain in the US, has made substantial progress concerning the decline in salt levels. A typical dish now contains 2g compared with 2.59g previously.

Fig. 9: The Boston Market example



Source: Boston Market

Reducing saturated fats and eliminating trans fats

Trans fats are omnipresent in processed foods and help make their texture smoother. Produced from unsaturated oils via an industrial process known as hydrogenation, they are accused of presenting a cardiovascular health risk even higher than that of saturated fats. As such, groups are now aiming to eliminate trans fats while reducing saturated fatty acids. Nestlé has pledged to eliminate trans fats (from partially hydrogenated oils) from its products by 2016 and to reduce saturated fats by 10%. In order to reduce saturated fat levels, Unilever is aiming to promote consumption of margarine rather than butter. Since 2012, only 33% of the fat contained in 92% of the group's flagship margarine brands (Flora, Becel, Rama and Blue Band) is saturated. Besides, the group completely removed trans fats from its product portfolio. In September 2015, Nestlé and Unilever offered their support to the European federation of consumer organizations (*Bureau européen des unions de consommateurs)* for its campaign aimed at banning trans fats in the European Union.

Reducing sugar content

Over the coming years, the groups should intensify their efforts to reduce the proportion of sugar in their products

Unilever has already reduced sugar levels in its ready-to-drink teas and is to eliminate a further 25% between now and 2020. Since 2014, children's ice-creams contain 110 calories or less per portion. Meanwhile, Grupo Bimbo has set 2015 as its deadline for reducing the sugar content of is main brands by 10%. Coca-Cola has been a pioneer in this field: 25% of its drinks are reduced-sugar or sugar-free.

Fig. 10: Coca-Cola light drinks in France: numerous choices

Source: Coca-Cola France

3.1.3. Adding beneficial ingredients

Reformulating products also consists of adding ingredients that are good for health. Coca-Cola regularly launches products enriched with vitamins, minerals and other products, such as Minute Maid Antiox for example (multi-fruit juice sold in Spain and containing antioxydants) or Minute Maid Kids+ (orange juice with added vitamins A, C, D, E and calcium which is on sale in the US). Kellogg's started to enrich its cereals with vitamin D in 2011 in the UK and extended this initiative to a number of European countries. Unilever offers products such as margarines enriched with vitamin A and D, stock-cubes with iodised salt and iodised salt on its own.

The table below sets out additions and reductions in nutriments made by the food industry depending on the food category.

Fig. 11: Reformulations made by the industry

Food category	Food items	1. Trans fatty acids (TFA)	2. Saturated fatty acids (SFA)	3. Salt	4. Sugar	5. Fibre
Cereals and cereal products	Bread			Reduced by 25%		
	Breakfast cereals			Reduced by 15-38%		Whole grain ranging from 15-100%
Meat	Processed meat			Reported reductions		
Milk and milk products	Milk		Reported reductions			
	Cheese		Reported reductions	Reported reductions		
	Yoghurt				Reported reductions	
Fats and oils	Margarines	Elimination				
	Fats	Elimination	Reduced by 20 to 80%			
Beverages	Sugary drinks				Reduced by 10-40% in light products	
Other foods	Snacks		Reduced by 30-70% in chips	Reduced by 25% in chips		
	Sweets					
	Soups			Reduced by 10-30%		
	Sauces			Reduced by 30%		
	Cakes and biscuits	Reduced below 1g/100g	Reduced by 15-18% in biscuits	Reduced by 20-40%		

Source: Van Raaij et al.

3.1.4. The limits of this approach

The limits of reformulation lie in acceptance by consumers, the costs generated by the industry and by technical obstacles.

Acceptance by consumers

Consumers could reject a reformulated product because:

- They don't like the product. In particular, the palate struggles to get used to low salt levels. Although it is possible to change people's habits, this requires the cooperation of all players in the industry.

- They think they don't like the product. This is a psychological barrier: the consumer knows there is less sugar or salt and believes that this affects the taste.

- They worry about substitute products and prefer natural products, therefore rejecting products with low fat, sugar or salt since this points to the presence of artificial ingredients.

- They refuse to pay more. The products offered in a smaller format are very often more expensive relative to their weight. This is also often the case for those containing reduced levels of fat/salt or sugar.

Costs generated by the industry

In order to ensure that the reduction in salt, fat or sugar levels does not compromise the taste, texture or safety of the product, groups use a number of ingredients such as iodised salt, herbs and spices. As such a number of tasting tests are carried out. Finally, machines need to be changed, staff trained and labelling modified. Reformulation therefore often implies additional costs.

Technical obstacles

The ingredient that substitutes salt, sugar or fat must meet a number of criteria since it must: 1/ improve the nutritional qualities of the product, 2/ fill the same functional role (salt is a preservative for example) and 3/ be authorised in all countries where the product is sold. The table below illustrates the complex nature of the task by showing the various approaches used to reduce salt, depending on the food category.

Fig. 12: Salt reduction strategy depending on food category

Food category	Approaches
Bread	Small stepwise reduction of sodium (5% per week until 25%) Substitution of sodium chloride by potassium chloride (up to 10%) Use of magnesium salt mixtures Inhomogeneous distribution of salt increases saltiness perception Encapsulated salt enables a reduction of up to 50% Use of organic acids such as acetic and lactic acid Use of soy sauce
Meat	Replacement of sodium chloride up to 50% by other salts/salt mixtures (potassium chloride, magnesium chloride, potassium lactate, sodium diacetate) Substitution of salt by naturally brewed soy sauce Use of phosphates to promote water binding capacity of the proteins Use of flake salt in dry-cured meat products
Cheese	Salt reduction by increasing the moisture content and decreasing the fat content Use of potassium chloride 1:1 mixture of sodium chloride with potassium chloride Use of potassium based emulsifying salts (DPP, TPC) in processed cheese Saltiness enhancement by specific odors (cheese/sardine aroma)
Soups	General reduction of sodium by almost 50% without affecting consumer acceptance Sodium reduction of 17%–33% by the use of naturally brewed soy sauce Salt reduction of 15% can be compensated by savory aroma compounds (beef/chicken flavor) Water-in-oil-in-water emulsions
Ready meals	Reduction of sodium by 30–40% without affecting consumer preference Use of salt substitutes (e.g. potassium chloride) and flavor enhancers (e.g. yeast extract) Natural flavor enhancers such as garlic, rosemary, oregano and sage
Snacks	Alteration of crystal size: smaller salt particles induce an increased initial perception of saltiness Use of spices Replacement of salt by starch in extruded snacks

Source: NFS Journal.

Companies could choose to introduce new products rather than reformulate existing ones, which requires a lot of time and investment. However, success is far from guaranteed. A recent report by Nielsen states that three quarters of innovations made by companies in the consumer goods industry fail to make GBP100,000m in the first year and end up being delisted by distributors.

3.2. Making acquisitions

Not all companies have the will or the resources to make internal changes. A number of them prefer to acquire or merge with high-growth small and medium-sized companies. Brian Todd, Chairman and CEO of the Food Institute, stated in New Hope 360: "Companies find it more economical to purchase existing entities in these markets than start new ones. It is viewed as a much more cost-effective entry point and one that has already been vetted." Small brands present a number of advantages for major food groups:

- **They strengthen their positions in the health-food and hand-made segments.** Even if the large groups are successful in reformulating their products, they often fail to change their image. Acquiring small brands that are popular with clients who focus on more healthy eating could be a solution.

- **They provide the innovative ability that large groups lack.** Majors groups are not dynamic enough and tend to rely on what they have already built up. In contrast, smaller structures are more agile, have a good understanding of the latest trends and offer products that appeal to the Millennial generation.

- **They help improve reputation.** A company's social responsibility has become more important (the quality of ingredients, staff wages and transparency among others). Consumers do not want to just consume products that taste good and are healthy, they also want their spending to reflect their values. By acquiring small entities that are socially committed, major groups hope that the positive reputations of these companies will benefit their own.

- **They strengthen their efficiency.** Small brands are often created from scratch with a low budget and are steered by the obligation to succeed. As such, they often show greater efficiency than the major groups, especially in terms of distribution channels (e-commerce- and marketing methods (using social networks).

- **They help better interact with consumers.** Small companies manage to establish an intimate relation with consumers who have the feeling of knowing the brand, its history and the people behind it very well. The major groups would like to learn from their techniques in order to improve consumer commitment.

A few recent examples:

- **General Mills acquired Annie's in September 2014.** Specialised in natural and organic products, the brand is known especially for its healthier alternatives to Mac and Cheese and salad dressings. Growth is robust thanks to its portfolio that meet consumers' needs, its solid competitive position and a good pipeline of innovations. The deal amounted to USD820m.

- **Mondelez International bought Enjoy Life in February 2015**. Enjoy Life offers allergen-free products (no gluten or casein for example). In the US, the "free-from" market is valued at USD12bn and is growing in double digits in view of the increase in allergies and food intolerances as well as consumer aims not to eat certain products as part of a healthy lifestyle. CEO of Mondelez, Irène Rosenfeld, stated: "We are certainly seeing that there is a pronounced consumer trend toward health and wellness initiatives. As the world's largest snacking company, it is our desire to be meeting those needs". The price-tag for the transaction was not communicated.

But acquiring a small brand is not the miracle solution:

- **Size counts**. Acquisitions are too small to make the difference.

- **Loss of customer confidence.** The acquisition of a small brand that is well positioned can fail to change the negative perception that consumers have of the acquiring group.

- **A dissonance between the philosophy of the small brand and that of the parent company.** For example, whereas Applegate and Annie's do not use genetically modified ingredients and state that they favour labelling of GMO food, their buyers, namely Hershey and General Mills, respectively, are firmly against this prospect.

- **Retaliatory measures by the mass retailing sector.** The risk is higher in the case of organic food retailers. Indeed, in 2008, the Park Slope Food Coop delisted Honest Tea, an organic tea brand bought by Coca Cola, accused by the retailer of violating worker's trade union freedom.

- **Economic logic unclear.** The supply of ingredients (organic etc), product manufacturing and the specific marketing tools used in a small company prompt additional costs for a buyer, thereby compromising the initial strategy to reduce spending by resorting to acquisitions.

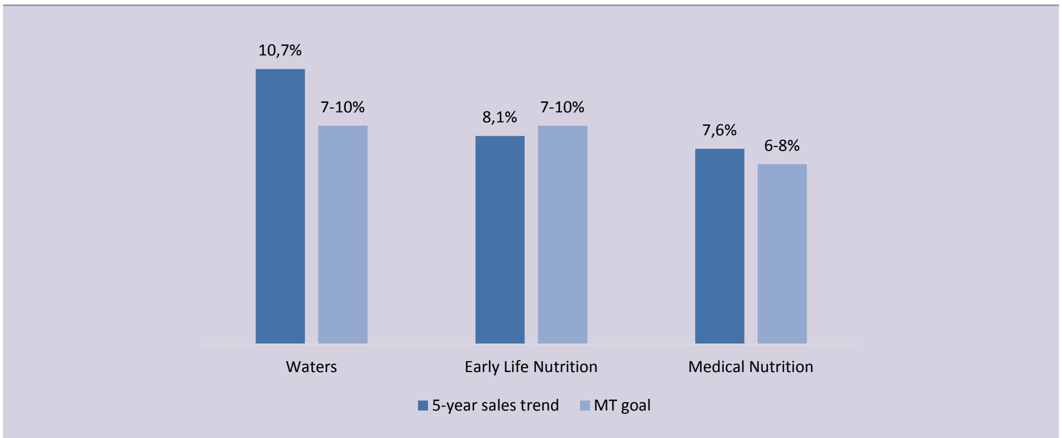
4. Danone is the best positioned

Faced with these challenges, we consider that Danone is the best positioned. Indeed, only 16% of its portfolio is at risk (4.1). In addition, the group is rolling out significant measures to resolve the problem (4.2) and the first positive results are materialising (4.3). This analysis strengthens our positive conviction on Danone (4.4).

4.1. Only 16% of the portfolio is at risk

Three out of the four food categories in which Danone is positioned are not affected by the trends described above and their growth potential remains intact. The group believes it can grow the water and baby-food segments by 7-10% over the medium term and medical nutrition by 6-8%. We are confident in these targets, which are generally in line with the trends seen over the past five years.

Fig. 13: Medium-term targets and trends seen over the past five years



Source: Danone, Bryan, Garnier & Co

Yoghurts: a division under strain

However, the yoghurts division has witnessed major difficulties in recent years. **It is the group's first division. It represents 49% of sales and 36% of EBIT.**

Fig. 14: Yoghurts: organic sales growth

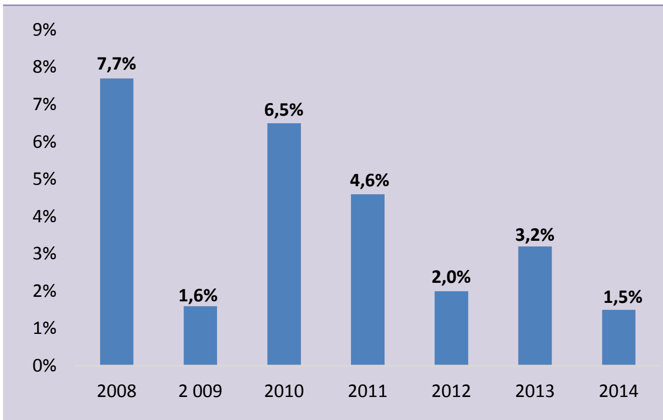
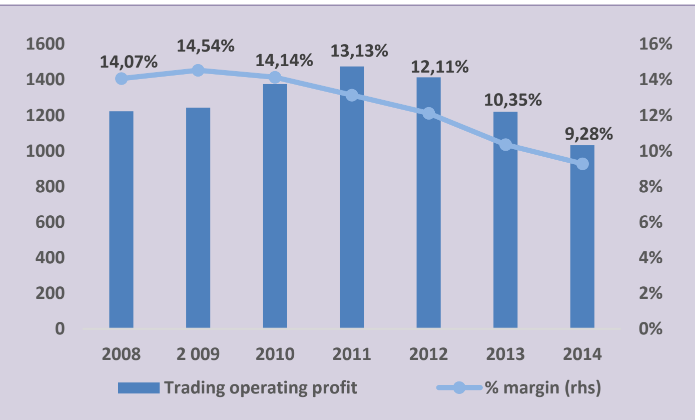


Fig. 15: Yoghurts: underlying EBIT margin



Source: Danone, Bryan, Garnier & Co

The US, Asia Pacific/Latin America (ALMA), and CIS can grow by 4-5% over the medium/long term. Current problems do not concern changes in the industry but are more circumstantial:

- The Greek yoghurt segment is currently stabilising. But its success has introduced yoghurts to the US and their consumption should increase. Danone has multiplied innovations (Oikos Triple Zero) and strengthened segmentation of the category by developing the Light & Fit and Kids segments. Its market share has increased to reach 27.9% and is currently 5 points and 10 points higher than levels for its first and second main competitors respectively.

- Consumption in Asia Pacific and Latin America should be underpinned by economic fundamentals and the low penetration of the category. In 2015, Latin America slowed due to Brazil and Argentina. However, growth remained robust in Asia (>20% in H1).

- The situation in CIS remains difficult but the restructuring is continuing. Danone's strategy to withdraw from low value-added products remains unchanged. The weight of modern brands therefore increased by 150bp per year between 2012 and 2015. The group is also looking to improving operating efficiency by adapting manufacturing facilities and logistics and by simplifying its organisational structure. Since the integration of Unimilk, average annual growth has run at 7% in organic terms and underlying EBIT margin has increased by 60bp a year on average.

However, in Europe (excluding CIS), the crisis at Danone is more structural and finds its roots in the discomfort of consumers relative to this category. The withdrawal of health allegations concerning Activia and Actimel under pressure from the European Union in 2010 undoubtedly contributed to this. Clearly, the situation was worsened by the deterioration in the backdrop with the hike in milk prices at the end of the 2000s and the decline in the macroeconomic environment in 2012 etc. **In all, the yoghurts business in Europe excluding CIS accounts for 16% of the group's sales (40% of sales of fresh dairy products).**

Fig. 16: 16% of Danone's portfolio is at risk

Source: Danone, Bryan, Garnier & Co

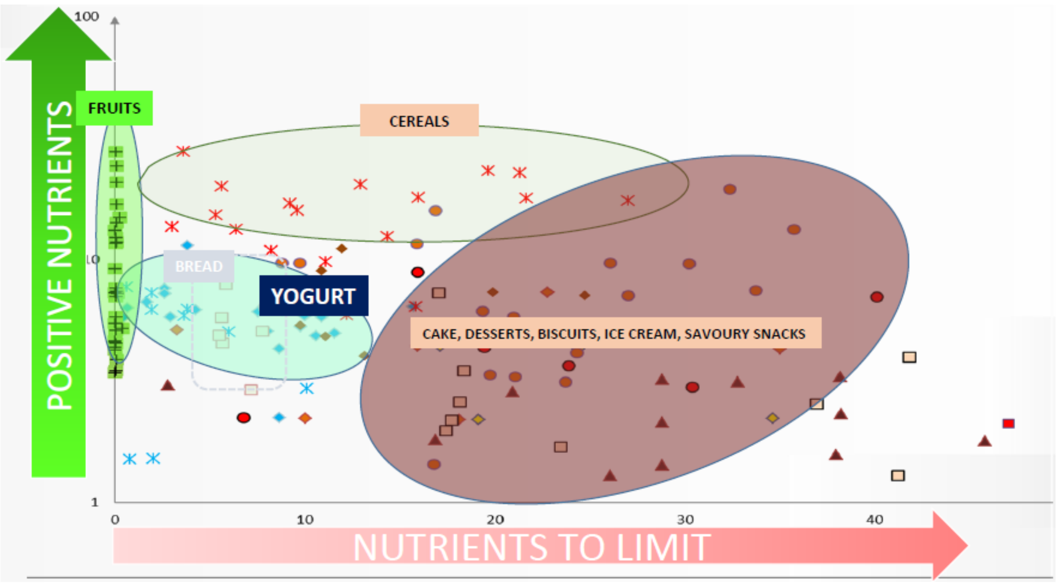
4.2. Strong measures

4.2.1. Growth is possible

It is always easier for a company to improve poor execution than to generate growth in a category where there is none. We think that the yoghurt category does harbour potential for two reasons:

- **Yoghurt meets consumer desires for well-balanced food.** Indeed, it is part of a healthier diet and reduces the risk of diabetes and obesity.

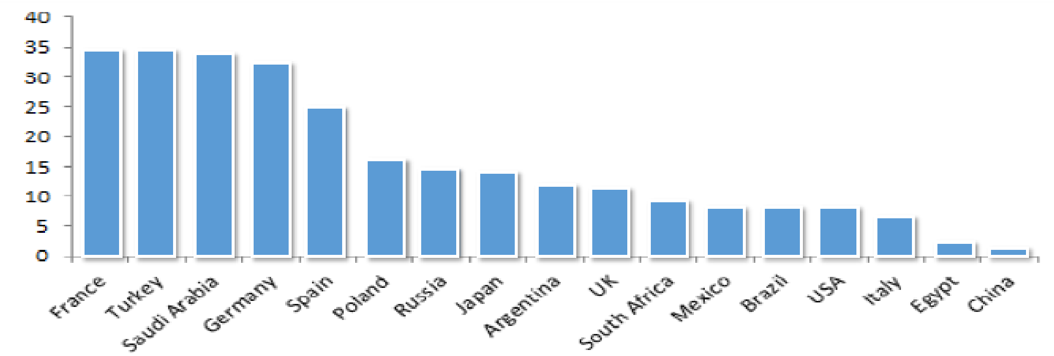
Fig. 17: Nutritional value of yoghurt relative to other snacks



Source: Danone

- **The penetration rate remains low in some European countries.** Yoghurt is consumed at the end of a meal in Spain and France, but this is not the case in Italy and the UK for example.

Fig. 18: Per capita consumption of fresh dairy products in 2014 (kg)

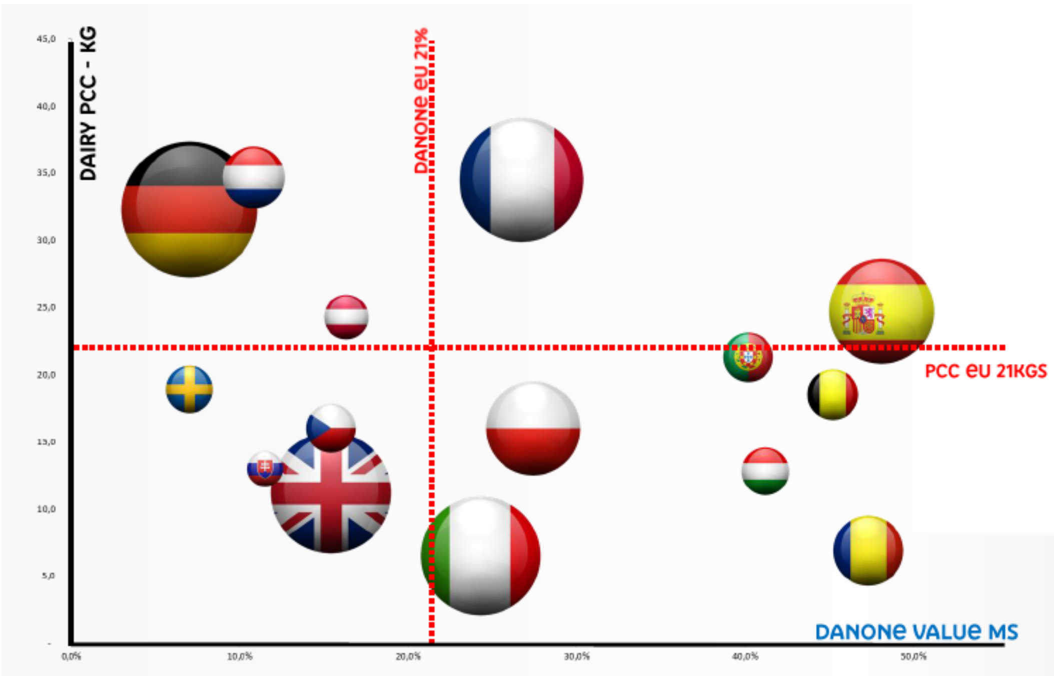


Source: Danone

4.2.2. A leadership position

Danone has the means to turn around the situation. Indeed, it boasts a leadership position. Its global market share stands at 26% whereas levels for its top two rivals do not exceed 5%. The countries where it is the no. 1 player account for 84% of its sales, compared with 78% in 2011. In Europe, its market share is particularly high in geographies that harbour the highest potential in view of low per capita consumption (see chart below).

Fig. 19: Group market share and per capita consumption of yoghurts



Source: Danone

4.2.3. Precise targets and a plan to reach them

Targets by 2020 for the yoghurts division:
- Organic sales growth of 3-5%
- Improvement in the trading operating margin of 200bps (ex-FX)

During its Investor Day, Danone upgraded its non-official guidance for medium-term growth in fresh dairy products of 2-4%. It is now forecasting **organic sales growth in the division of 3-5% by 2020.** The group also indicated that it was planning **to improve the trading operating margin of the division by 200bp (excluding forex) between 2015 and 2020.**

To stimulate growth, Danone…

- **…is making intelligent changes to its marketing model**

Although consumers would like to eat healthily, they do not really want a yoghurt that is presented as being a medicine. Danone has therefore decided to refocus its advertising campaigns on emotion rather than reason. Actimel is a very good example of this. Instead of communicating on the presence of a L.Casei, a bacteria that strengthens the immune system, the group is now putting the focus on how consumption of Actimel helps to stay strong whatever the circumstances.

Fig. 20: Refocusing of Actimel marketing campaign on emotion

Source: Danone

- **…is using innovation**

The group has renewed the packaging for Actimel and has aimed to grasp new consumption occasions with the Danonino snacking pouch.

Fig. 21: The new Actimel packaging

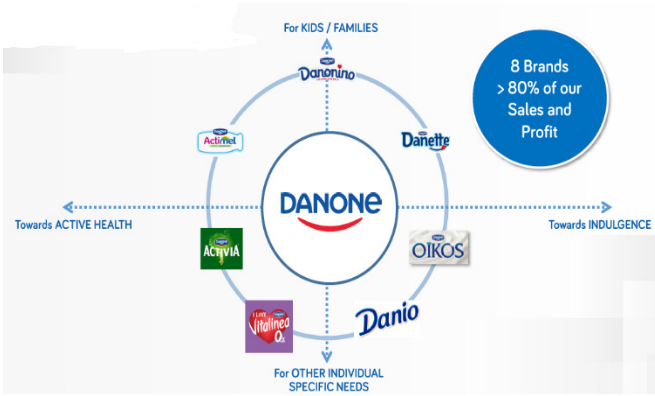
Fig. 22: Danonino snacking pouch

Source: Danone

- **…is focusing its resources on eight of its brands**

Although Danone's portfolio of fresh dairy products includes around 65 brands, eight of these generate more than 80% of sales and profits, namely Activia, Actimel, Vitalinea, Danio, Oikos, Danette, Danonino and Danone. The group has expressed its aim to focus on these brands, which should benefit from more advertising spend in particular.

Fig. 23: The brands in the portfolio **Fig. 24: Focus on eight of them**



Source: Danone, Bryan, Garnier & Co

In order to grow margins, Danone…

- **…is rationalising its portfolio**

Danone has used processes to stimulate demand: it played on prices, held promotional campaigns and launched formats and assortments which were dilutive. It is currently reviewing its portfolio and eliminating a number of SKUs through its product revenue growth management programme (PRGM).

- **…is optimising its operations**

The group has streamlined its manufacturing facilities in Europe by ending its one country-one plant model. Since 2013, it has reduced the number of plants from 24 to 15 in the region. Support functions have been centralized and the distribution network (six sites were closed in 2015) and sales force reorganised.

- **…is saving on supplies**

The group has implemented new supply measures and identified EUR100m in savings out to 2020.

Danone should be helped in its project to improve margins by a more advantageous price backdrop. The decline in milk prices has not yet been passed onto retail prices. In addition, growth in retailers' private labels has slowed considerably, thereby reducing the downward pressure they caused.

4.3. The first positive results

Sales of fresh dairy products are showing signs of improvement, and rose by 0.6% organically in Q3 2015. **In Q4, we estimate a clear acceleration in organic growth to +2.5%.** Streamlining of the portfolio in Europe (PRGM) is now almost complete and is no longer taking a significant toll on the division's performance. **The underlying trend in the region is improving from one quarter to the next. Signs are encouraging in markets such as Spain and Italy (both are stable), Germany, Poland and Belgium. In terms of brands, Actimel, Danette and Oikos have made clear progress.**

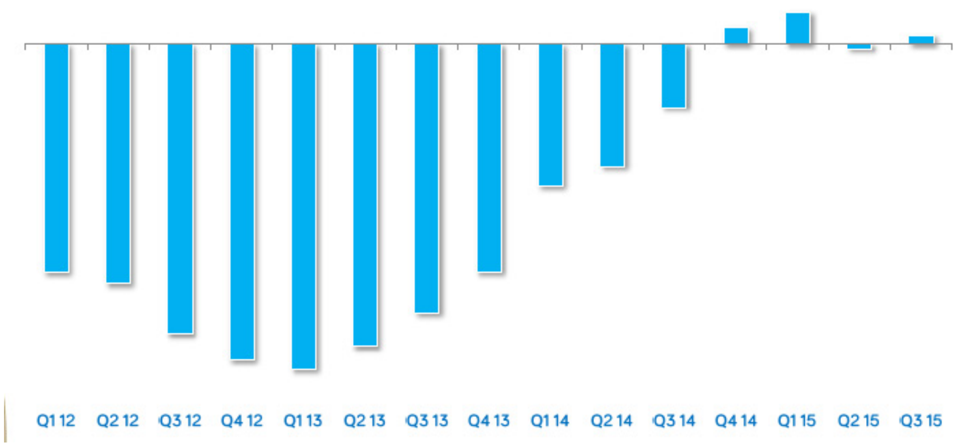
Fig. 25: Review by country

Fig. 26: Review by brand

Source: Danone

The recovery in Actimel (15% of yoghurt sales in Europe) is taking shape. The group has confirmed that results have been better than expected. Since Q4 2014, the brand has reported growth in three quarters.

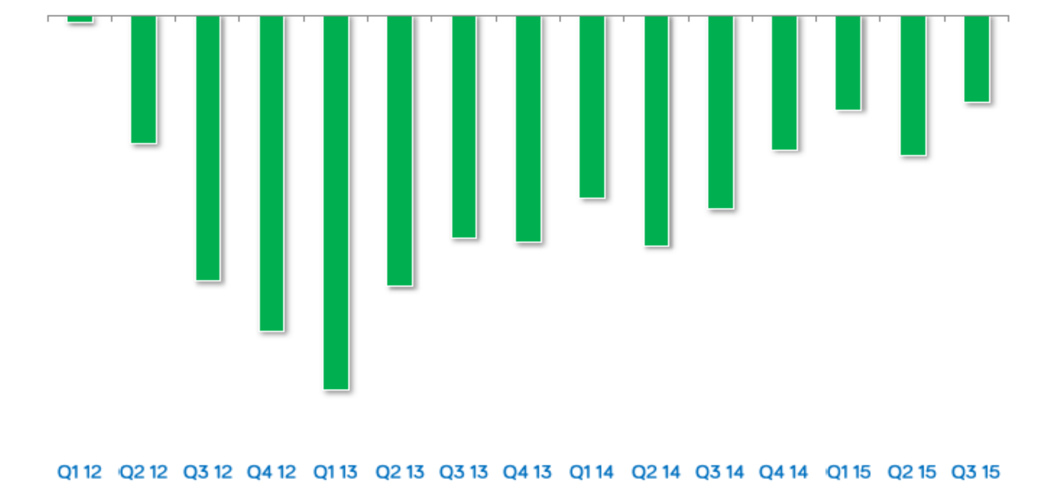
Fig. 27: Change in Actimel sales



Source: Danone

Activia has noted a stabilisation in trends but remains in negative territory. The weight of the brand (30% of yoghurt sales in Europe) leaves no room for a *laissez-faire* attitude. **Danone has already planned a number of measures: marketing activation in 2016, repositioning, further elimination of some SKUs…**

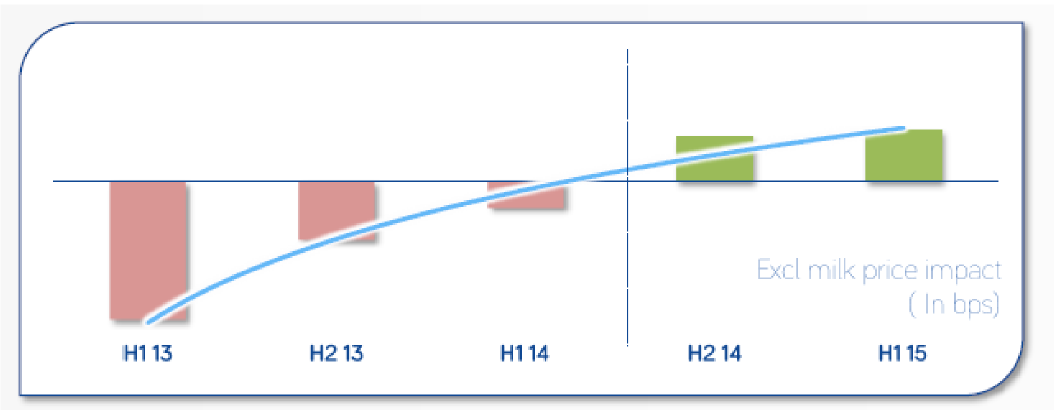
Fig. 28: Change in Activia sales



Source: Danone

The gross margin of the yoghurts division increased by 130bp in H1 2015 excluding the impact of milk prices! This was the result of initiatives taken in Europe: improvement in **operating efficiency** in particular by cutting the number of plants from 24 to 15 and **streamlining of the portfolio** with a view to matching sales growth with value creation. **Adjusted for the milk price effect, the gross margin in the region therefore rose by 140bp in H1.**

Fig. 29: Change in gross margin in Europe



Source: Danone

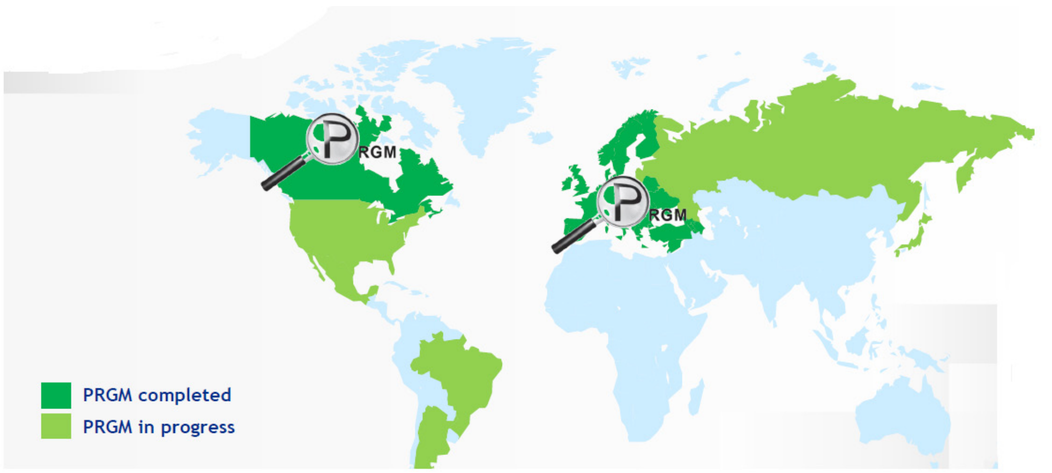
4.4. An optimistic vision

We are optimistic on the outlook for Danone, for several reasons:

- **Only 16% of its portfolio, corresponding to yoghurt sales in Europe (excluding CIS), is facing rejection by consumers**.
- **Concerning this section of the portfolio that is suffering, Danone has drawn up a precise plan that should help it reach well-defined objectives:** sales growth in the yoghurts division of 3-5% and growth in underlying EBIT margin of 200bp (excluding forex).
- **The first results are encouraging.** The trends have improved considerably at Actimel. The brand has posted growth in three quarters since Q4 2014. Although progress of Activia is slower, the sales decline has nevertheless stabilised. Efforts made in terms of profitability are beginning to pay off: gross margin in fresh dairy products in Europe increased by 140bp in H1 2015 excluding the impact of milk prices.

We also note that the group's guidance is cautious. Indeed, in order to reach the low end of the group's sales guidance (+3%), Europe simply needs to stabilise and the other regions (AMLA/CIS/US) post mid-single digit growth. Furthermore, the 200bp increase in underlying EBIT margin (excluding forex) also seems very reasonable given that the recovery measures in the yoghurts division go beyond the European framework: 1/ cost savings are also generated in CIS and in other emerging markets such as Brazil and 2/ the portfolio is being optimised on a global level.

Fig. 30: Progress in the product revenue growth management programme



Source: Danone

We do not believe that a stabilisation in Europe is possible next year given the efforts still to be made in terms of streamlining the portfolio (the majority of which has nevertheless been completed). We are forecasting a decline in the region of 2%. Assuming growth of 3% in the US and in CIS, and 5% in Asia-Pacific/Latin America, we estimate that organic growth in yoghurt sales should stand at 2% in 2016. In the following year, sales in the division should rise by 3.5%, thanks to a stabilisation in Europe and a mid single digit growth in other regions. Therefore, the group will reach its 2020 target. We have increased our estimates for underlying EBIT margins in fresh dairy products over the next three years and are now forecasting a 40bp increase to 9.7% for 2015 (v. 9.5% previously). Over the following two years, the margin should rise by respectively 30bp and 50bp to 10% and 10.5%. In 2020, this is set to reach 11.7%, pointing to an increase of 200bp (excluding forex) relative to 2015, in line with the group's guidance.

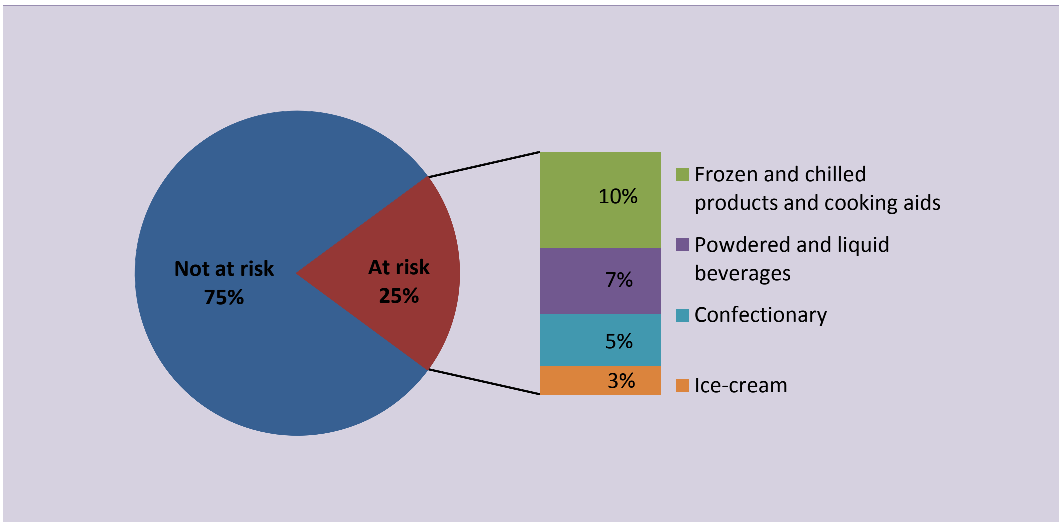
5. Nestlé is at greater risk

We estimate that 25% of Nestlé's portfolio is at risk (5.1), this corresponding to sales in developed countries of some: frozen and chilled products and cooking aids/liquid and powdered beverages/confectionary/ice-creams. **The strong measures implemented by the company only concern 8% of its sales (5.2):** frozen products in the US (5%) and ice-creams/frozen products in Europe (3%). Other initiatives are headed in the right direction but their impact is minimal (launch of Cailler chocolate) or uncertain (reformulation).

5.1. 25% of the portfolio is at risk

Our estimate is that changes in the food industry affect 25% of Nestlé's sales. This corresponds to sales in developed countries of some: frozen and chilled products and cooking aids (10% of group's sales)/liquid and powdered beverages (7%)/confectionary (5%)/ice-creams (3%).

Fig. 31: Nestlé's portfolio

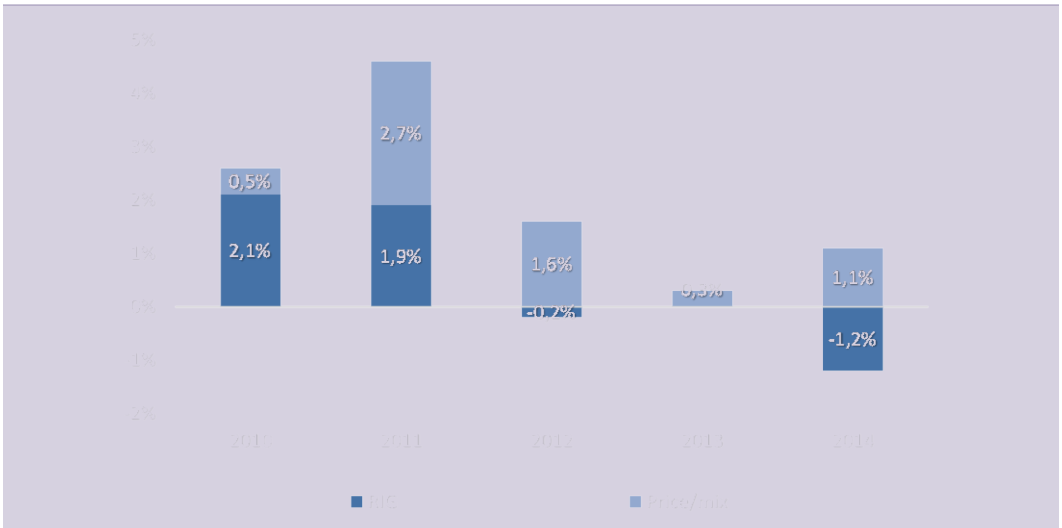


Source: Nestlé, Bryan, Garnier & Co

5.1.1. Frozen and chilled products and cooking aids: 10%

This category is suffering from the increase in away-from-home consumption and above all changes in consumer tastes. Favouring the quality of food rather than its practical nature, consumers prefer fresh products to processed foods that often contain preservatives, a higher number of calories... In 2014, Nestlé sales of prepared dishes and cooking aids fell by 0.1% in organic terms.

Fig. 32: Change in organic sales in the prepared dishes and cooking aids division

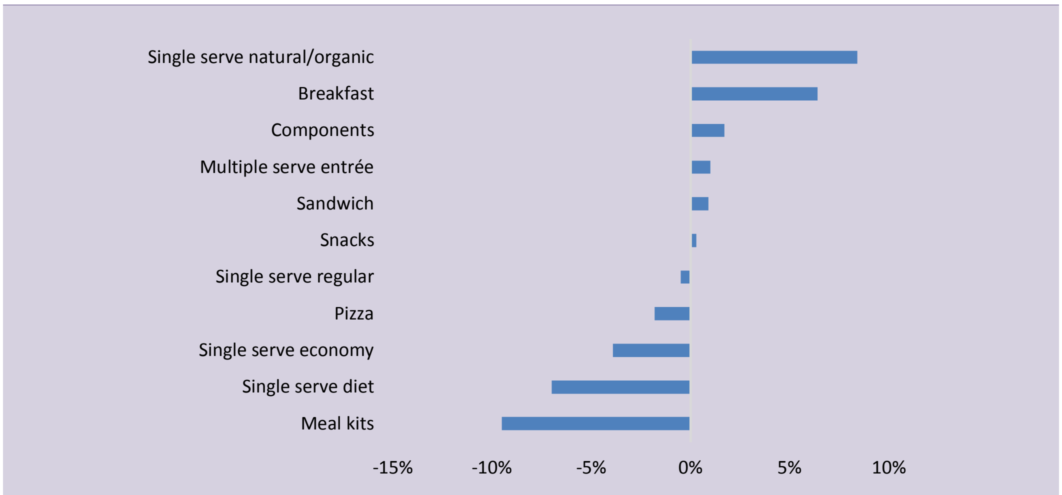


Source: Nestlé, Bryan, Garnier & Co

The slowdown in this division has stemmed from difficulties in developed countries in the chilled food segments (in Western Europe, primarily Herta) and cooking aids, which each account for 2% of the group's sales. However, it above all concerns frozen foods, which represent a hefty 6% of the portfolio.

The frozen foods market in the United States has posted an average annual low single digit decline in recent years. In this country, the group's leading market in sales terms (26%), Nestlé generates 17% of sales in the frozen food category and has seen its difficulties worsened by its product positioning. Pizzas (Di Giorno, Tombstone…) account for 38% of frozen product sales in the US, and sales in the segment dropped by 2% on average between 2012 and 2014. Other ready-meals (47% of sales) include regular formats (Stouffer's brand) and diet meals (Lean Cuisine), which have lost 0.5% and 7% respectively. In contrast, the group is underexposed to the snack segment, which has shown greater resilience and its portfolio does not include organic and breakfast meals, two segments that rose by 8.4% and 6.4% respectively over 2012-14.

Fig. 33: Market: change in frozen product sales (2012-14 CAGR)

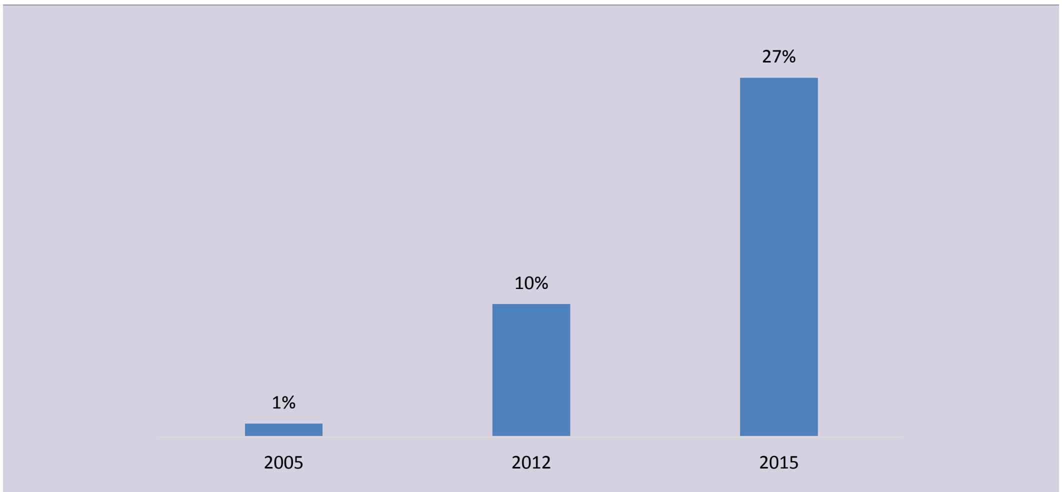


Source: Bryan, Garnier & Co

5.1.2. Liquid/powdered drinks: 7%

In western countries, consumers have moved away from ready-drinks such as Nesquik, Milo and Nestea. They also favour coffee capsules rather than soluble and powdered coffee. In 2015, 27% of the US population owned a capsule coffee machine (1% in 2005). Capsule sales in the US are set to rise by 25% by 2019, whereas the coffee market as a whole is expected to grow by 9%. As such, we estimate that 7% of Nestlé's sales are at risk. This figure naturally excludes Nespresso and Dolce Gusto.

Fig. 34: Percentage of US consumers owning a capsule coffee machine

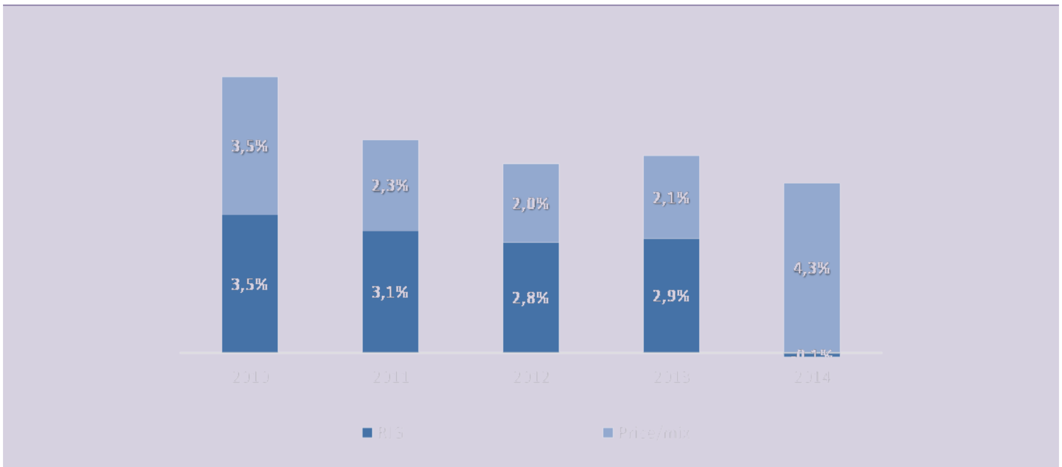


Source: Statista 2015

5.1.3. Confectionary: 5%

While price hikes have enabled the group to maintain a fairly healthy pace of sales growth, Nestlé's confectionary volumes have slowed virtually constantly since 2010.

Fig. 35: Organic sales growth in the confectionary division



Source: Nestlé, Bryan, Garnier & Co

Sales of sweets in western countries (1% of group sales) have been sluggish for obvious reasons given their mismatch with consumer trends to seek healthier and better-balanced foods. Chocolate sales in the US and, above all, in Europe, have taken a toll (4% of the group's sales). Nestlé missed out on the emergence of the premium segment, which meets the most demanding consumer requirements. Quality, diversity of origins and originality of savours (chia, pomegranate etc) have become important criteria for choice. Growth of 10% in the premium chocolate segment is far higher than that in the mid-range segment (+5%) on which Nestlé remains very dependent, primarily via its KitKat brand (40% of the group's chocolate sales). In contrast, chocolate maker Lindt, which boasts a portfolio full of premium products, has enjoyed excellent performances in its main markets. In H1 2015, its organic sales grew 6.9% in Europe and 10.3% in NAFTA.

5.1.4. Ice-creams: 3%

Ice-cream manufacturers have witnessed a structural decline in their sales volumes in western countries. This has stemmed from an increase in away-from-home consumption and above all, changes in consumer tastes to now favour smaller and healthier formats such as frozen yoghurts and hand-made ice-creams. Competition has therefore increased massively, especially from smaller brands. Nestlé is underperforming Unilever, particularly in Western Europe where the Anglo-Dutch group was very successful in the premium segment with Magnum, Carte D'Or and Ben & Jerry's. Nestlé's global market share has dropped two points since 2010 from 13% to 11% at present whereas over the same period, Unilever's market share has risen from 21% to 23%.

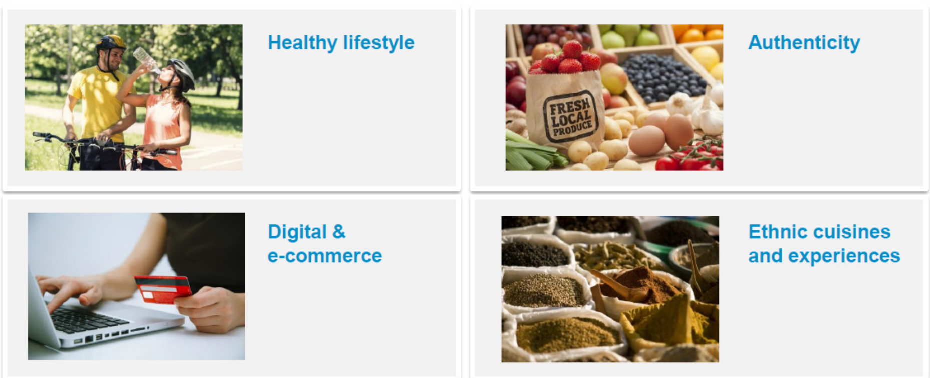
5.2. Strong measures which concern 8% of the portfolio

The strong measures implemented by Nestlé only concern 8% of its portfolio out of the 25% that we estimate is at risk: frozen products in the US (5%) and ice-creams/frozen products in Europe (3%). The group has taken a certain number of other initiatives that are headed in the right direction but for which we consider the impact minimal or uncertain.

5.2.1. Recovery in frozen products in the US (5%)

One of Nestlé's major aims has been and is still to restore performances in frozen products in the US. In February 2015, Paul Bulcke mentioned the need to reconnect with the consumer base by taking their concerns more into account.

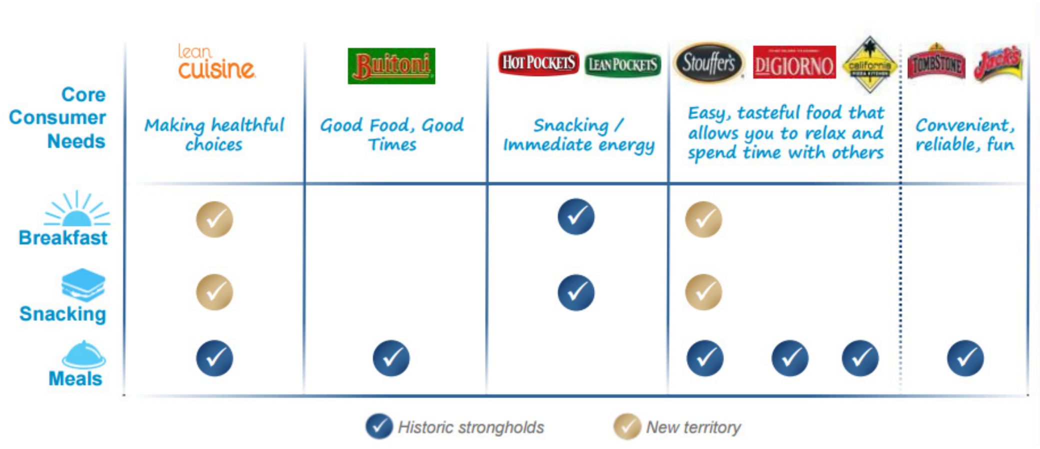
Fig. 36: Consumer concerns



Source: Nestlé

In order to achieve this, the group has relaunched its line of frozen products with improvements focusing primarily on **enhancing the quality of ingredients, reformulating** (reducing/eliminating toxic ingredients such as salt and artificial flavours etc.) and **developing new consumption occasions** (breakfast, snacking).

Fig. 37: New consumption occasions



Source: Nestlé

However, the measures are different depending on the brand:

- **Lean Cuisine.** Nestlé is favouring innovation and development of new consumption occasions (snacks and breakfast) to turn around Lean Cuisine. The group has also aimed to change the brand's outdated positioning by shifting it from a diet concept to a healthy eating concept.

Fig. 38: Change in positioning of Lean Cuisine

Source: Nestlé

- **Stouffers.** Nestlé is seeking to improve the brand's image by reformulating products (eliminating artificial flavourings and salt etc.) and placing the focus of advertising campaigns on heritage.

- **Hot Pockets**. Reformulation has also been significant for this brand: use of higher quality ingredients, reduced salt content, elimination of artificial flavourings and colourings etc. Nestlé has also made efforts to optimise its portfolio (reducing the number of SKUs, better targeted promotional campaigns etc.). At the same time, it has launched new products that better meet the tastes of the Millennials for ethnic food.

- **Di Giorno.** The group has focused on improving consumer perception by communicating more in terms of emotion and via digital channels. Reducing salt content and eliminating preservatives have also been among the measures implemented by the group, as well as reducing the number of SKUs.

Frozen products in the US rose 8-10% in Q3

In addition to this work on reviewing the product portfolio, Nestlé has implemented a number of changes in its management team in the US. The first results are positive. **During the nine-month sales presentation, the group stated that frozen product sales in the US had increased over the past seven months.** In Q3, sales growth reached 8-10%. **Nestlé is winning back market share** and is extremely confident in its ability to grow on a sustainable basis.

5.2.2. Frozen products and ice-creams in Europe (3%): disposal and partnership

In October 2015, Nestlé announced the creation of a joint venture with R&R. The activities concerned are primarily frozen products (excluding pizzas) and ice-creams in Europe (and also Egypt, the Philippines, Brazil and Argentina). These account for 2.2% of group sales. Nestlé and R&R have complementary profiles, especially in terms of distribution since Nestlé is mainly exposed in bars/restaurants while R&R is present mostly in retail stores. In addition, R&R boasts significant expertise in terms of production optimisation (lean manufacturing). The new structure is to be run by R&R's CEO, Ibrahim Najafi, although the Board of Directors is to be chaired by Luis Cantarell, the CEO at Nestlé for Europe/Middle-East/Africa, and the seats are to be divided equally between Nestlé and PAI, R&R's current majority shareholder.

Fig. 39: Complementary profiles

Source: Nestlé

This operation should help Nestlé resolve its difficulties in frozen products and especially ice-creams in Western Europe. The group will be better equipped to face competition from Unilever, which has managed to make the most of growth in the premium segment thanks to its existing brands Magnum, Carte D'Or and Ben & Jerry's and smart acquisitions (manufacturers of premium ice-creams Grom in October 2015 and TalentiGelato e Sorbetto in December 2014). The pairing is to become world no. 2 in ice-creams behind the Anglo-Dutch group. We estimate that the deconsolidation which should take place in H2 2016 should boost the organic sales growth and the margin by respectively 10bp and 15bp.

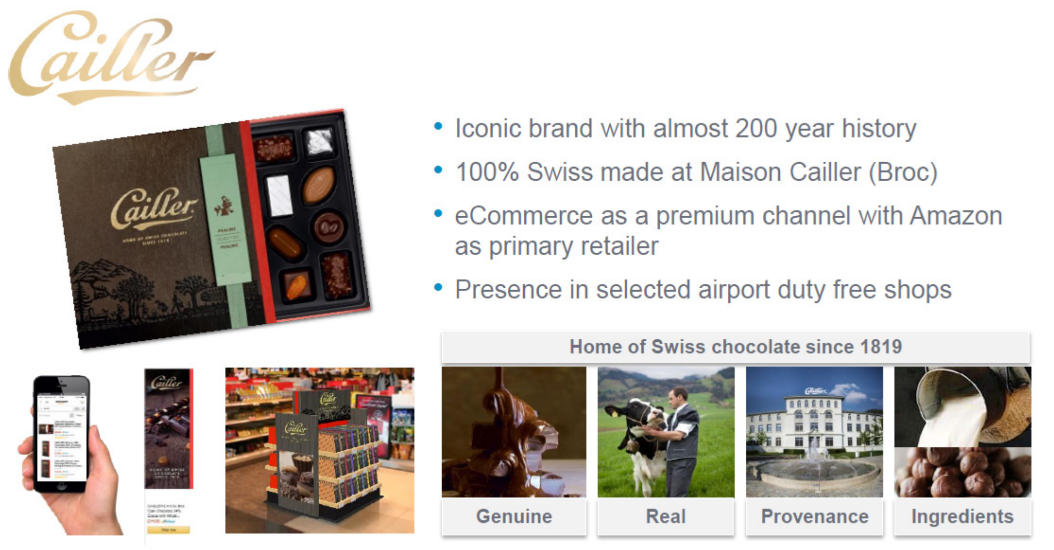
In November 2015, Nestlé also finalised the disposal of Davigel (0.8% of group sales), a company specialised in frozen and chilled products for collective and commercial catering.

5.2.3. Initiatives with a minimal or uncertain impact

Nestlé has made considerable efforts to reformulate its products. Some 44,000 products have been reformulated in recent years, including 22,000 in order to reduce sugar, salt and fat, calorie content and artificial colourings, and 27,000 with the aim of improving the nutritious profile. The group is permanently reviewing a third of its SKUs for reformulation purposes. However, the results of this are uncertain. Consumers may not like the change in taste or the increase in prices. Some could worry about the presence of artificial ingredients.

The group has decided to use one of its existing brands, Cailler, in order to tackle its under-exposure to premium chocolate in Western Europe and North America and to compete with Godiva and Lindt. Distribution is primarily set to take place via the internet (mainly Amazon). The initiative is interesting but could take some time to pay off. A brand image cannot be created overnight and the group's competitors are well-established.

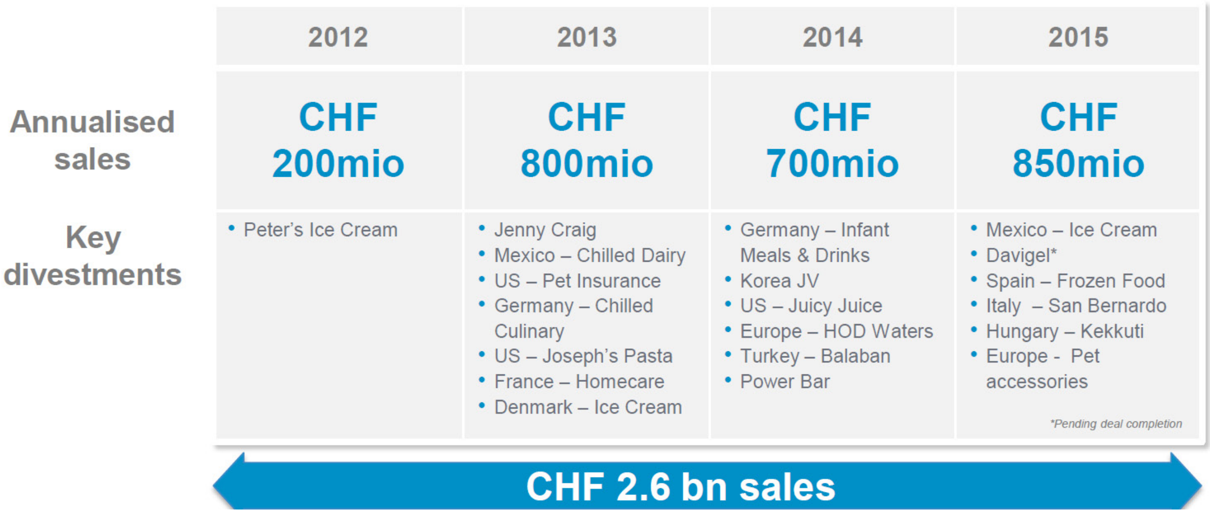
Fig. 40: Cailler chocolate



Source: Nestlé

These measures are headed in the right direction but we think that their impact is minimal or uncertain. The disposals made over the past four years for an overall amount of CHF2.6bn represented less than 1% of the group's sales! These concerned Jenny Craig diet meals, Power Bar energy bars, fresh dairy products in Mexico, ice-creams in South America and Juicy Juice fruit juices among others.

Fig. 41: Nestlé disposals



Source: Nestlé

6. Pick Danone

6.1. Food & Beverage sector well valued

In 2015, the Food & Beverage sector outperformed the DJ Stoxx 600 by 9%. After the upheaval seen in August, investors took positions in defensive stocks. Brewers have posted the best performance (+18% over the year relative to the DJ Stoxx), driven by the acquisition of SABMiller by ABI. They were followed by distillers (+15%), while **the Food segment lagged behind (+6%).**

Fig. 42: Performances on the Stoxx Europe 600 Food & Beverage and the DJ Stoxx

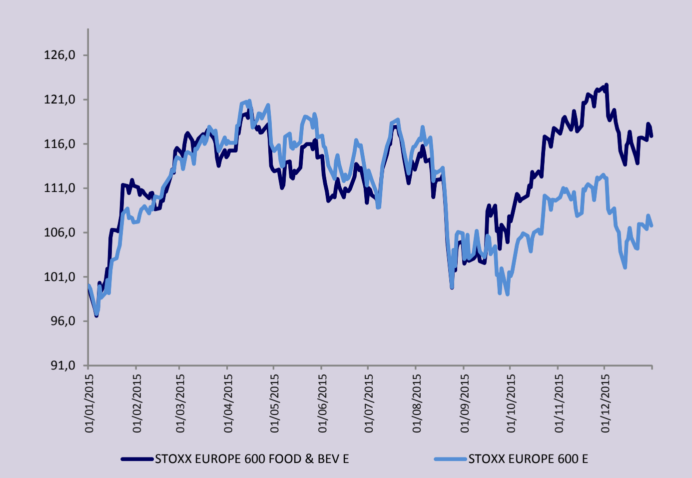
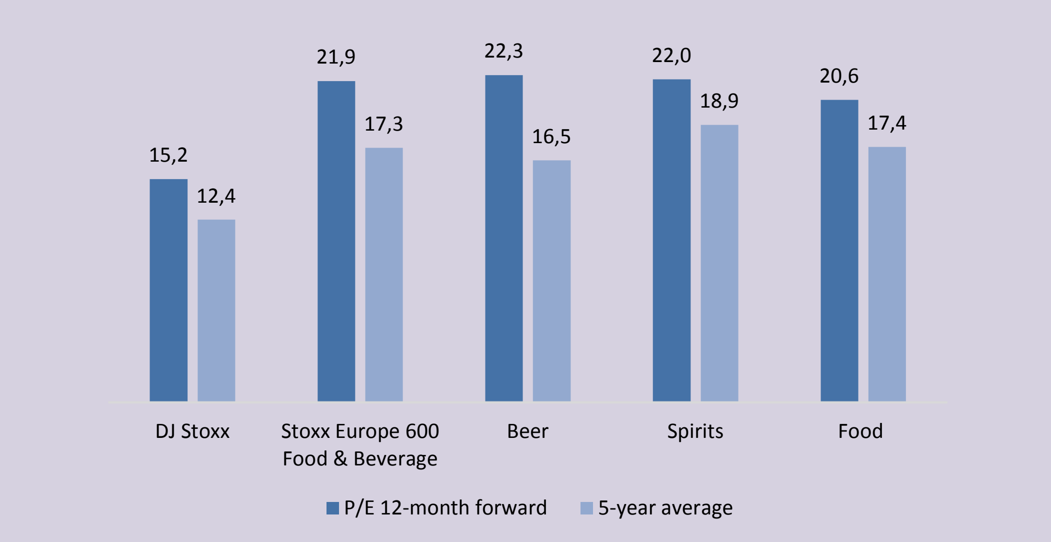


Fig. 43: Relative performances of distillers, brewers and Food segments relative to DJ Stoxx

Source: Thomson Reuters

The Food & Beverage sector is currently trading on 12m forward P/E of 21.9x, namely a premium of 26% relative to its average level of the past five years. The premium for our three Food stocks stands at 18% compared with 35% for brewers and 16% for distillers.

Fig. 44: 12-month forward P/E



Source: Thomson Reuters

6.2. Comparative valuation of food players

Despite the good performance of the past three months, Danone's 12-month forward P/E is only at 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. Danone is also less expensive than Nestlé in terms of 12-month forward EV/EBIT (16.0x vs. 17.0x). But it is trading at a premium vs Unilever (14.7x).

Fig. 45: Groups' performances in 2015

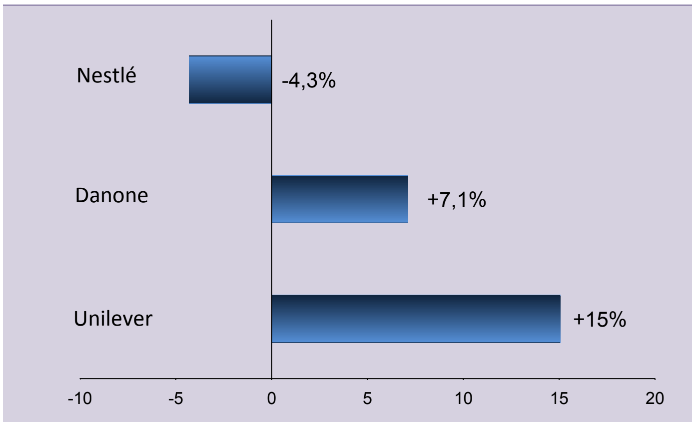
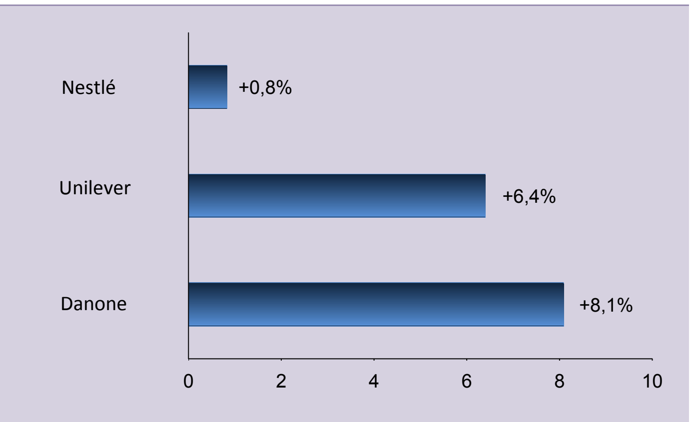


Fig. 46: Groups' performances over the past three months (vs DJ Stoxx)



Source: Thomson Reuters

Fig. 47: 12-month forward P/E

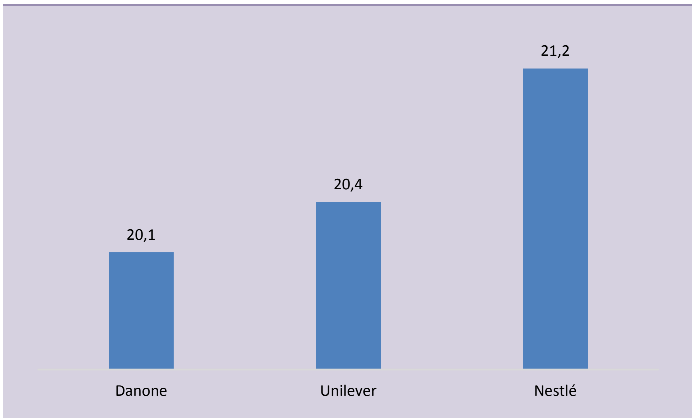
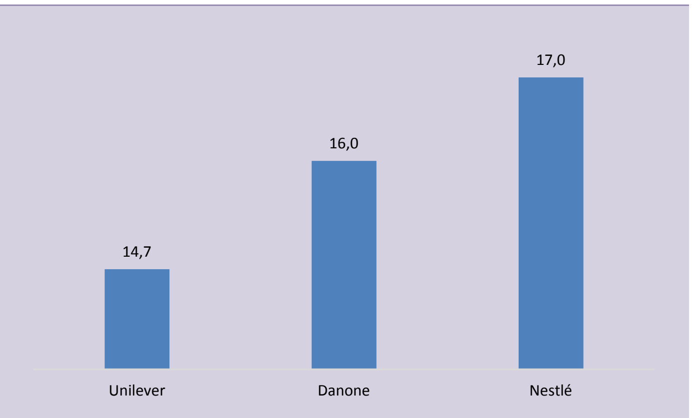


Fig. 48: 12-month forward EV/EBIT



Source: Thomson Reuters

6.3. Our Top Pick

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.** Growth potential in the other divisions remains generally intact. Danone has indicated that over the medium-term, the water and early life nutrition segments should grow by 7-10% and medical nutrition by 6-8%.

- **The group has set precise financial targets.** The yoghurts division should restore a growth level of 3-5% by 2020. Underlying EBIT margin should increase by 200bp (excluding forex) over the same period.

- **It also has a plan in order to deliver them**: changing the marketing model, using innovations, streamlining the portfolio and refocusing resources on eight key brands (Activia, Actimel, Vitalinea, Danio, Oikos, Danette, Danonino, Danone), optimising operations…

- **The first results are positive**. Markets such as Spain and Italy (both stable), Germany, Poland and Belgium are showing signs of improvement. The recovery at Actimel is continuing. Since Q4 2014, the brand has posted sales growth in three quarters. Gross margin on fresh dairy products in Europe rose by 140bp in H1 2015 excluding milk price effects.

The organic sales growth of the yoghurts division should reach the lower range of the guidance in 2017. We are forecasting growth of 3.5%, implying a stabilisation in Europe, growth of 3% in the US and CIS and 5% in Asia-Pacific/Latin America. In 2016, sales should be up 2% organically. We have increased our trading operating margin estimates for fresh dairy products over the next three years and now expect growth of 40bp to 9.7% in 2015 (vs. 9.5% previously). For the following two years, the margin is set to rise by 30bp and 50bp to 10% and 10.5% respectively.

We estimate that group's organic 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 margin should be up 50bp in 2016** (+40bp in 2015). **Our forecasts remain generally unchanged (2015-17 EPS up by 1%)** since although we have increased the margin on yoghurts, we have reduced our organic sales growth estimate for water.

Our Fair Value is revised upwards from EUR69 to EUR74 due to the roll-over. Despite the robust performance of the past three months, Danone's 12-month forward P/E only stands at 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.

BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

13th January 2016

Food & Beverages

Nestlé

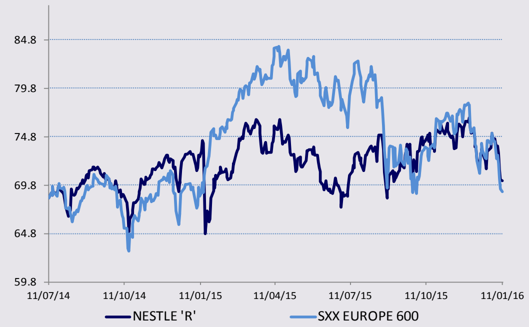
Sleeping beauty

Fair Value CHF76 (price CHF70.25)

NEUTRAL
Coverage initiated

Bloomberg	NESN VX
Reuters	NESZn.VX
12-month High / Low (CHF)	76.8 / 64.8
Market capitalisation (CHFm)	223,985
Enterprise Value (BG estimates CHFm)	240,353
Avg. 6m daily volume ('000 shares)	5,755
Free Float	100%
3y EPS CAGR	2.4%
Gearing (12/14)	1%
Dividend yield (12/15e)	3.20%

YE December	12/14	12/15e	12/16e	12/17e
Revenue (CHFm)	91,612	90,038	90,695	95,109
EBIT (CHFm)	14,019	13,917	14,356	15,298
Basic EPS (CHF)	3.44	3.32	3.44	3.70
Diluted EPS (CHF)	3.43	3.31	3.43	3.69
EV/Sales	2.58x	2.67x	2.62x	2.47x
EV/EBITDA	13.2x	13.6x	13.2x	12.2x
EV/EBIT	16.9x	17.3x	16.6x	15.4x
P/E	20.5x	21.2x	20.5x	19.0x
ROCE	12.1	12.0	12.4	13.5



■ **Not only does the group have mixed prospects in developed and emerging markets but its valuation is also fairly unattractive. A share buyback programme nevertheless looks very likely and justifies our Neutral recommendation. Our Fair Value stands at CHF76.**

- **Western countries facing structural challenges.** Nestlé is confronted with changes in the economic and regulatory framework and in consumer tastes, with a tendency to reject industrial products and brands and favour home-made food. We estimate that 25% of the group's portfolio is exposed to these new trends and is therefore at risk. The strong measures implemented by the group only concern 8% of sales.

- **A slowdown in emerging markets.** In Q3 2015, organic sales growth in these countries reached a low point of 5.8%. The recovery was slower than expected in China where Nestlé was affected by a slowdown in the Food & Beverage sector and the mismatch between its offer and changes in consumer tastes in terms of both products and distribution channels.

- **Mixed prospects.** 2016 is likely to be the fourth year in a row where the so-called "Nestlé model", namely for annual organic sales growth of 5-6%, is not delivered. The need for investments in China and the US and a lack of restructuring measures is likely to weigh on the improvement in underlying EBIT margin in organic terms (+24bp in 2015 and +23bp in 2016).

A fairly unattractive valuation. Nestlé's 12-month forward P/E stands at 21.2x (based on a consensus 1.6% ahead of our estimates), compared with 20.4x for Unilever and 20.1x for Danone (our expectations are 2.5% below market expectations). Our DCF-derived Fair Value stands at CHF76, implying limited upside (+8%). Our Neutral recommendation is warranted by the strong likelihood of a share buyback programme being announced at the full-year earnings publication.

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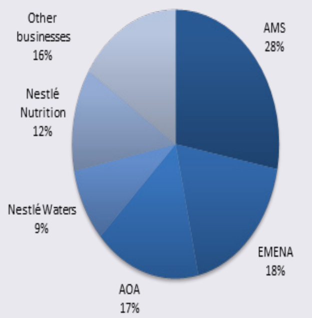
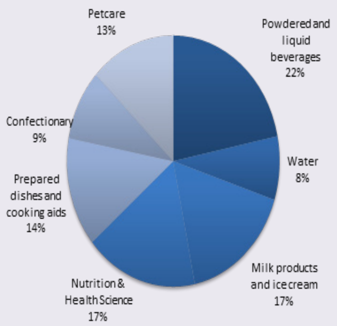
Breakdown of group's sales by division, 2015e



Breakdown of group's sales by food category, 2015e



Company description

Nestlé is one of the main global players in the food industry. Its product portfolio is very comprehensive: powdered and liquid beverages, water, milk products and ice-creams, nutrition and health science, prepared dishes and cooking aids, confectionary and pet care.

Simplified Profit & Loss Account (CHFm)	**2012**	**2013**	**2014**	**2015e**	**2016e**	**2017e**
Revenues	89,721	92,158	91,612	90,038	90,695	95,109
Reported change (%)	*7.3%*	*2.7%*	*-0.6%*	*-1.7%*	*0.7%*	*4.9%*
Organic change (%)	*5.9%*	*4.6%*	*4.5%*	*4.2%*	*4.5%*	*4.9%*
Adjusted EBITDA	17,009	18,057	17,874	17,670	18,025	19,185
Trading operating profit	13,464	14,047	14,019	13,917	14,356	15,298
Change (%)	*7.4%*	*4.3%*	*-0.2%*	*-0.7%*	*3.2%*	*6.6%*
Financial result	(705)	(631)	(637)	(659)	(603)	(551)
Pre-Tax profits	13,388	13,068	10,905	13,417	13,856	14,798
Tax	(3,259)	(3,256)	(3,367)	(3,401)	(3,560)	(3,835)
Profits from associates	1,253	1,264	8,003	870	920	990
Minority interests	(449)	(430)	(448)	(470)	(485)	(500)
Net profit	10,677	10,445	14,904	10,227	10,614	11,402
Adjusted net profit _ group share	10,371	11,175	10,968	10,379	10,694	11,510
Change (%)	*5.4%*	*7.8%*	*-1.9%*	*-5.4%*	*3.0%*	*7.6%*
Cash Flow Statement (CHFm)						
Cash flows from operating activities	16,605	17,420	17,228	16,298	16,577	17,652
Working capital variation	2,015	1,360	(114)	(134)	176	(55.2)
Capex, net	(5,598)	(5,330)	(4,423)	(3,872)	(3,900)	(4,090)
Other						
Free cash flow	10,070	9,662	10,277	9,215	9,635	10,043
M&A	(10,774)	100	2,293	0.0	0.0	0.0
Dividends	(6,213)	(6,552)	(6,863)	(6,904)	(7,020)	(7,176)
Other	3,125	220	(3,342)	(6,355)	0.0	0.0
Net debt	18,120	14,690	12,325	16,368	13,753	10,886
Balance Sheet (CHFm)						
Property, plant and equipment	26,576	26,895	28,421	27,853	28,688	29,549
Intangibles assets	45,706	43,712	54,357	53,270	52,684	50,251
Cash & equivalents	5,713	6,415	7,448	2,595	4,180	5,354
current assets	34,020	30,066	33,961	27,483	29,023	31,403
Other assets	34,020	30,066	33,961	27,483	29,023	31,403
Total assets	19,575	19,769	16,711	18,767	17,328	16,299
L & ST Debt	27,416	21,743	21,206	19,223	18,193	16,499
Others liabilities	35,796	34,460	40,187	34,933	34,827	35,823
Shareholders' funds	61,007	62,575	70,130	71,337	72,846	73,295
Total Liabilities	63,213	56,303	61,566	54,256	53,070	52,373
Capital employed						
Ratios						
Trading operating profit	15.20	15.20	15.30	15.46	15.83	16.09
Underlying tax rate	(27.30)	(27.00)	(27.10)	(28.00)	(28.00)	(28.00)
Adjusted net profit _ group share	11.56	12.13	11.97	11.53	11.79	12.10
ROE (after tax)	17.00	17.86	15.64	14.55	14.68	15.70
ROIC (after tax)	12.65	14.11	12.05	12.01	12.40	13.49
Net debt/EBITDA	1.07	0.81	0.69	0.93	0.76	0.57
Pay out ratio	63.15	61.57	64.11	68.03	67.10	63.70
Number of shares, diluted	3,195	3,200	3,196	3,138	3,120	3,120
Data per Share (CHF)						
Adjusted basic EPS	3.26	3.50	3.44	3.32	3.44	3.70
Adjusted diluted EPS	3.25	3.49	3.43	3.31	3.43	3.69
% change	*5.7%*	*7.6%*	*-1.7%*	*-3.6%*	*3.6%*	*7.6%*
BVPS	19.09	19.55	21.94	22.73	23.35	23.49
Operating cash flows	5.20	5.44	5.39	5.19	5.31	5.66
FCF	3.15	3.02	3.22	2.94	3.09	3.22
Net dividend	2.05	2.15	2.20	2.25	2.30	2.35

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

Table of contents

1. Investment Case

Pourquoi investir maintenant?

Pourquoi s'intéresser au dossier maintenant :

Our initiation of Nestlé aims to broaden our coverage of the sector. Changes in the food industry and the lack of sufficient measures implemented by the group to adapt to the situation are likely to take a toll on developed markets during 2016. In emerging markets, the situation in Brazil, India and especially China, remains difficult.

Attractif ou non?

Valorisation

Our Fair Value of CHF76 stems from a DCF valuation and points to upside potential for the share of 8%. Nestlé's 12-month forward P/E stands at 21.2x (based on a consensus 1.6% ahead of our estimates), compared with 20.4x for Unilever and 20.1x for Danone (our expectations are 2.5% below market expectations)

Horizon d'investissement?

Catalyseurs

We do not believe the full-year earnings publication on 18th February can provide a catalyst for the share price: 1/ organic sales growth is set to total 4.2%, at the low end of guidance (growth of around 4.5%), 2/ trading operating margin is only set to rise by 16bp (+24bp in LFL) over the year, and 3/ the group is likely to communicate 2016 guidance for organic sales growth of around 4.5%, below its model (annual organic growth of 5-6%).

Valeur ajoutée?

Différentiation face au consensus :

Our 2015 estimates are generally in line with the market's forecasts. For the following two years, we are 2.6% and 2.7% below the consensus in sales terms and 2.9% and 2.2% lower for trading operating profit.

Quels risques?

Risques

The announcement of a share buyback program at the release of the full-year results will positively impact the share price. In contrast, a hike in the Swiss Franc is a downside risk.

2. Company overview

Nestlé is one of the main global players in the food industry. The group is divided into six divisions: AMS (Americas), EMENA (Europe, Middle East and North Africa), AOA (Asia, Oceania, Sub-Saharian Africa), Nestlé Waters, Nestlé Nutrition and Other Businesses.

Fig. 1: Breakdown of sales by division, 2015e

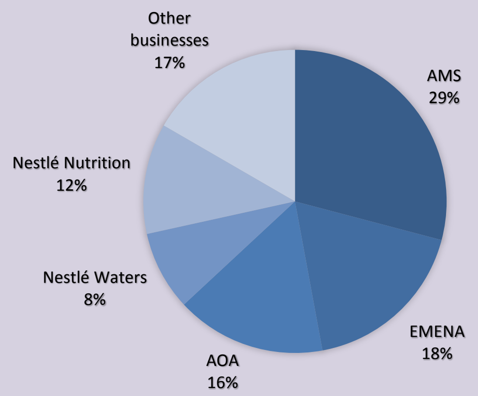
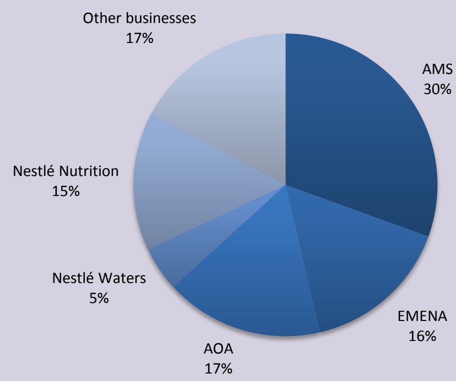


Fig. 2: Breakdown of EBIT by division, 2015e



Source: Nestlé, Bryan, Garnier & Co

Its product portfolio is very comprehensive: powdered and liquid beverages, water, milk products and ice-creams, nutrition and health science, prepared dishes and cooking aids, confectionary and pet care.

Fig. 3: Breakdown of sales by product, 2015e

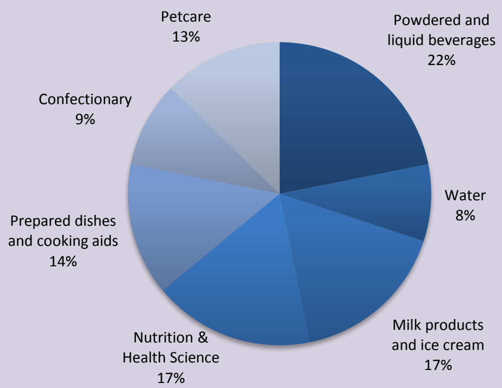
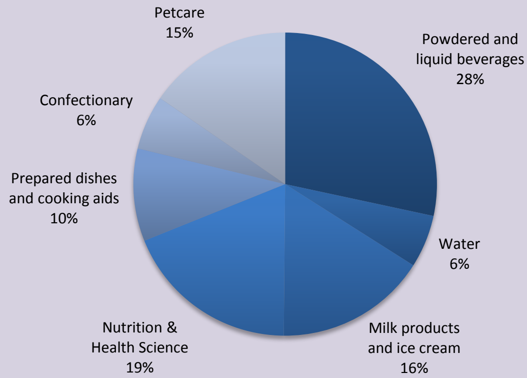


Fig. 4: Breakdown of EBIT by product, 2015e



Source: Nestlé, Bryan, Garnier & Co

The group is very exposed to North America (28% of group sales), Europe (28%) and Asia (23%). Its top three countries are the US (26% of group sales), Greater China (7%) and France/Brazil (6%).

Fig. 5: Breakdown of group sales by region, 2015e

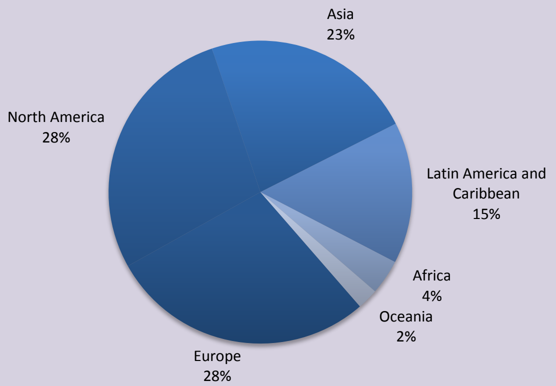
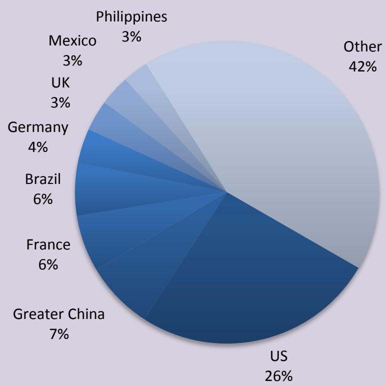


Fig. 6: Breakdown of group sales by country, 2015e



Source: Nestlé, Bryan, Garnier & Co

Fig. 7: SWOT analysis

Strengths	Weaknesses
A very diversified portfolio: large number of categories, local and international brands	**Heavy decision-making process:** due to the group's size...
Balanced geographical exposure: US/Canada, Europe, Asia, Latin America/Caribbean, Africa, Oceania	**Limited acquisition possibilities:** few sufficiently sized targets
Famous brands: Perrier, KitKat, Nespresso, Nescafé, Nesquik…	
Stable management: Only two CEO's over the past 18 years	
Opportunities	**Threats**
Economies of scale: efficiency gains possible	**Currency fluctuations:** highly exposed to the Swiss Franc
Expansion in the portfolio: extension to include natural or organic products etc.	**Exposure to commodities:** price fixing power linked to commodities prices
Montée en gamme: dans certaines catégories telles que le chocolat…	**Security of supply chain**: threat to the brand's equity

Source: Nestlé, Bryan, Garnier & Co

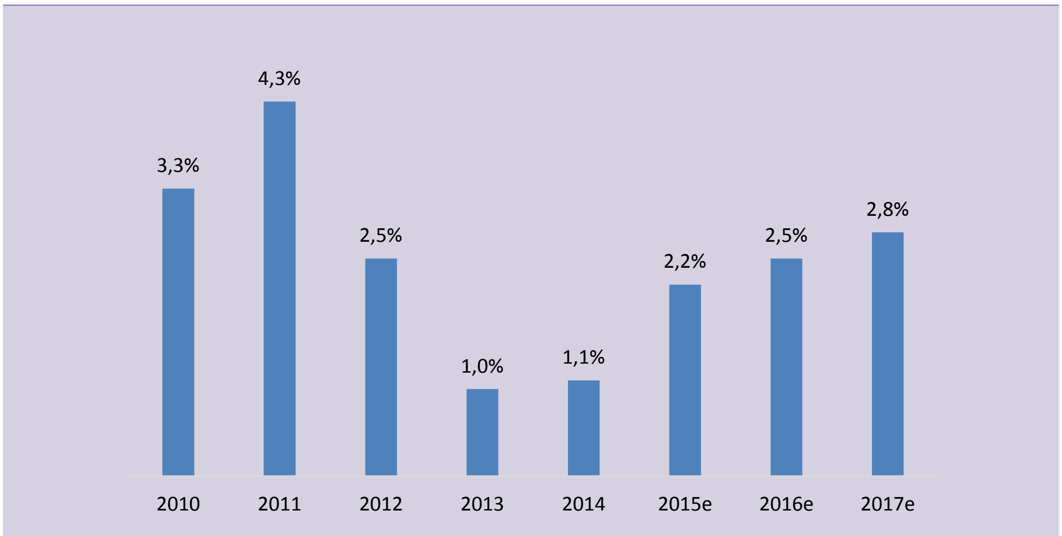
3. Persistent difficulties in 2016

Developed markets should continue to suffer from changes in the food industry (3.1). In emerging markets, Brazil, India and above all China remain difficult (3.2).

3.1. Western markets up 2.5%

We estimate that Nestlé sales in western countries should grow by 2.5% in 2016, a slight improvement relative to growth in 2015 of 2.2%.

Fig. 8: Group's organic sales growth in developed markets

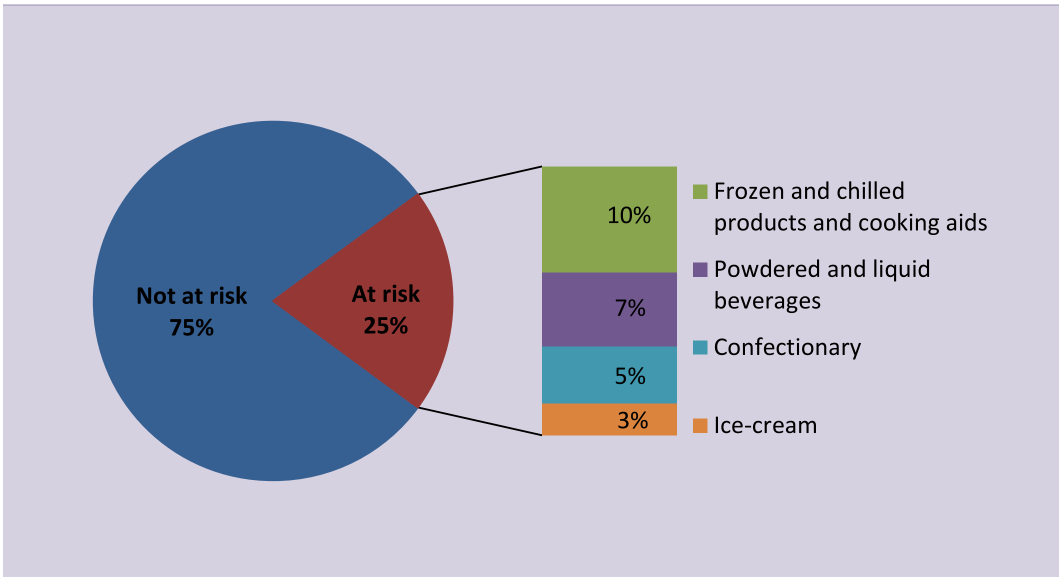


Source: Nestlé, Bryan, Garnier & Co

The environment has deteriorated for major food companies, which are facing constant attention from politicians, aiming to make the fight against obesity a priority and to increase food safety measures as the number of scandals in the industry has multiplied. Regulations are mounting: taxes on high-calorie products, increasingly strict standards in terms of product labelling, advertising etc. In addition, these groups are also finding themselves overwhelmed by certain sociological developments: the ramp-up in e-commerce and e-publicity, an increase in AFH consumption and above all, the emergence of the Millennial generation. In contrast, newly created brands are very dynamic. They have managed to make the most of new technologies in order to publicise their products and distribute them at a low cost. Their smaller size enables them to adapt more easily to new regulations. Above all, they offer products that meet consumer demands as major groups have failed to do.

25% of Nestlé's portfolio is at risk. These sales correspond to activities in developed markets in frozen and chilled products and cooking aids (10%), powdered and liquid beverages (7%), confectionary (5%) and ice-creams (3%).

Fig. 9: Nestlé's portfolio



Source: Nestlé, Bryan, Garnier & Co

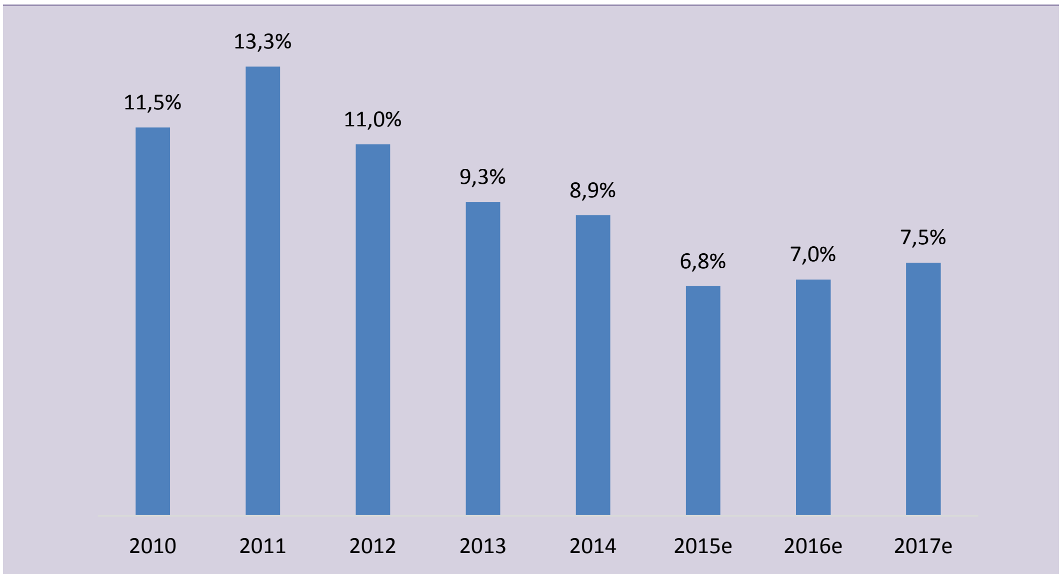
According to our estimates, the strong measures implemented by the company only concern 8% of sales: frozen products in the US (5%), and ice-creams/frozen products in Europe (3%). Other initiatives are headed in the right direction but their impact is minimal (launch of Cailer chocolate) or uncertain (reformulation).

The details of our analysis are set out in our sector report "A spicier dish".

3.2. Emerging markets up 7%

Nestlé's growth in emerging markets remains solid but has been constantly slowing since 2011, reaching a low point of 5.8% in Q3 2015. The group, like its peers in the consumer goods industry, has suffered from the deterioration in macro-economic fundamentals and more recently, political instability in the Middle East (Iraq, Yemen etc.). **In 2016, we estimate organic sales growth at 7%, generally in line with 2015 (+6.8%). The situation in Brazil, India and above all China, should continue to take a toll**.

Fig. 10: Group's organic growth in emerging markets



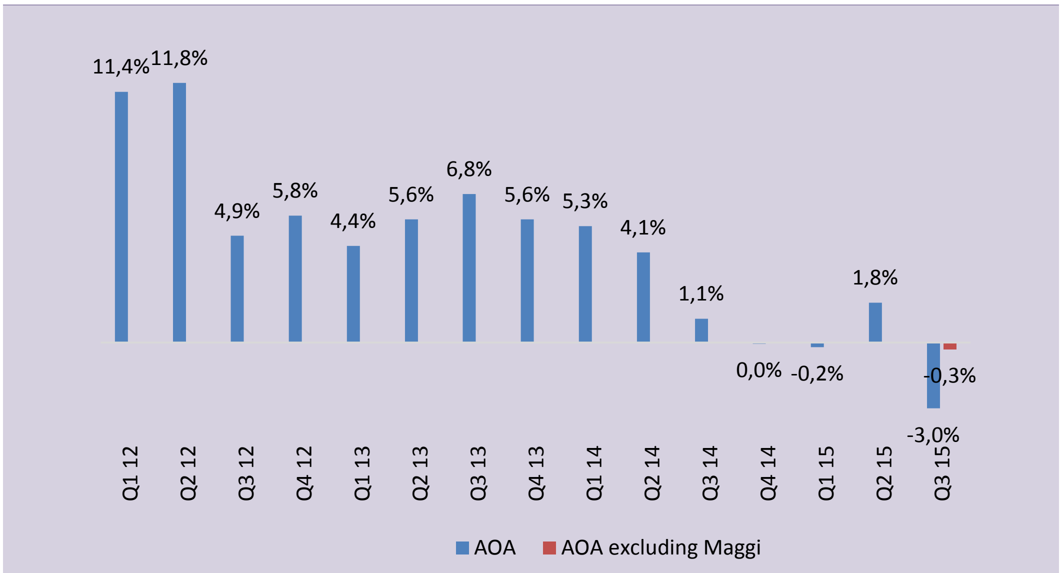
Source: Nestlé, Bryan, Garnier & Co

Brazil represents 6% of Nestlé's sales, making the country the group's third-largest market behind the US and Greater China. **The country decelerated significantly in Q3 2015,** with the group posting stable sales while it had so far shown resilience.

In India, the impact of the false health scare concerning Maggi noodles is still likely to be felt in 2016. In May 2015, the authorities indicated they had detected traces of lead in the product and banned its sales. The Indian media went on a very damaging campaign against Nestlé. The group indicated that the issue had dented 9M organic sales growth by 30bp (-170bp in the Asia, Oceania, Sub-Saharan Africa region). The impact was worse during Q3 (-50bp at the group level and -270bp for AOA), since the products were recalled as of the second half of Q2. All of the tests undertaken later denied the presence of lead. Although the group was allowed to resume sales of the product earlier than expected in early November, we fear a long-term impact on the brand's equity.

However, the difficulties in AOA run far deeper. Even after adjusting for the impact of Maggi noodles, sales showed a decline (-0.3% vs. the -3% reported). The recovery in China is proving longer than expected.

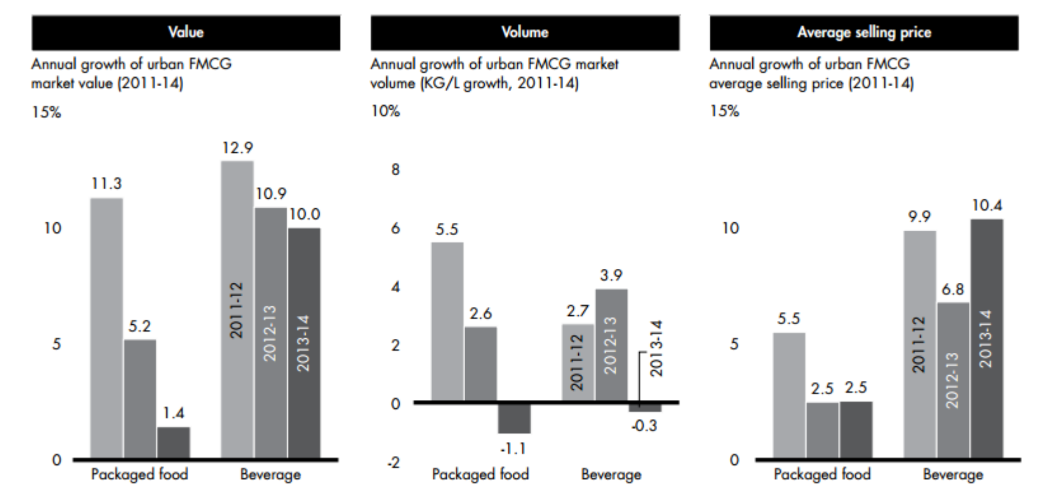
Fig. 11: Organic sales growth in AOA



Source: Nestlé, Bryan, Garnier & Co

China accounts for 7% of the group's sales, making it the group's second largest market exposure after the US (26%). **Growth in the food and beverage sector has been weakening for several years in the country.** Price hikes have not managed to offset the decline in volumes (-1.1% for food and -0.3% for beverages on average between 2011 and 2014).

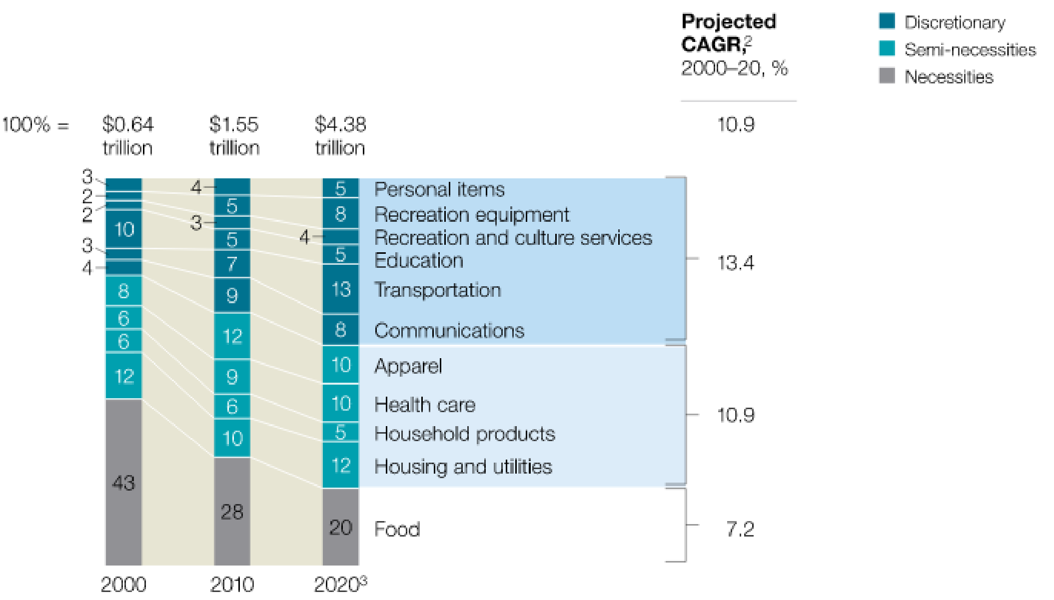
Fig. 12: Growth in food and beverage market in China



Source: Bain Capital

This decline has not only stemmed from the economic slowdown and the anti-extravagance policy, but also from changes in consumer spending as the market has matured. Chinese consumers now spend less on basic necessities and more on travel, cars, smartphones, air/water purifiers…

Fig. 13: Change in urban household spending in China



Source: Mc Kinsey

However, Nestlé needs to adapt not only to this slowdown but also to the change in consumer tastes in terms of products and distribution channel.

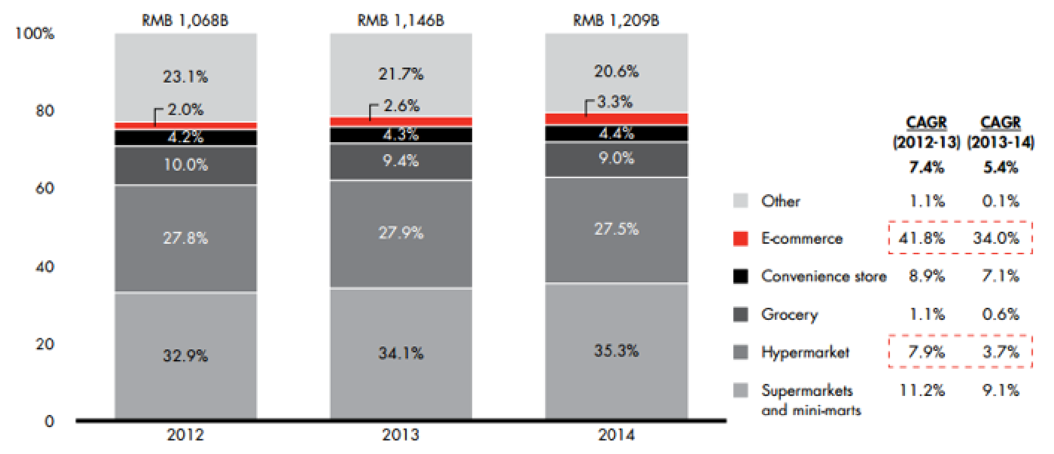
Fig. 14: A changing backdrop

Source: Nestlé

Chinese consumers have become post modern. Their concerns are similar to those of consumers in developed countries. They are more sophisticated, more concerned about the origins of products and more interested in the price-quality ratio.

The e-commerce channel, which makes purchases easier (city sizes make travel by car difficult) and enables comparison of product prices, has benefited from this development to the detriment of modern trade and especially hypermarkets. E-commerce sales rose 42% in 2013 and 34% in 2014. This channel now accounts for 3% of sales. In contrast, growth in hypermarkets fell by half (3.7% vs. 7.9% in 2013).

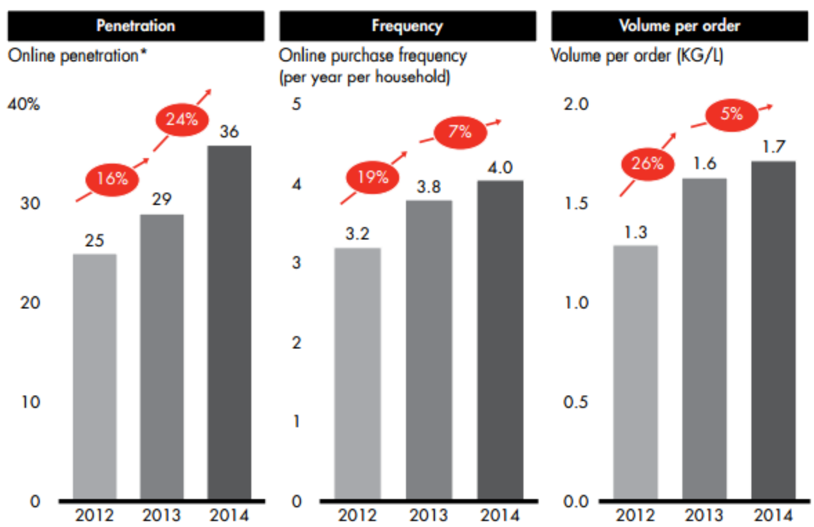
Fig. 15: Growth in Chinese cities and food and beverage sales by distribution channels



Source: Bain Capital

The penetration of e-commerce rose from 25% in 2012 to 36% in 2014. The frequency of purchases and volumes by order have risen each year (respectively +7% and +5% in 2014).

Fig. 16: Penetration, frequency, volume per order



Source: Bain Capital

In order to resolve these difficulties, **Nestlé made changes to the management team** in the AOA region. Nandu Nandkishore took early retirement and was replaced by former finance director Wang Ling Martello. The group is also working on **extending its distribution network in China**. In particular, it is stepping up efforts in e-commerce. Mrs Martello was recently nominated to the Board of Directors of Alibaba. Finally, **investments in innovation and reformulation** have been undertaken in order to improve the relevance of products and to reconnect with consumers. For example, Nestlé is currently focusing on the nutritional properties of its milk products in its adverts.

During the latest conference call, Mrs Martello was optimistic on the outlook for China, but recognised that the recovery was taking longer than initially expected. The country returned to negative territory in Q3. Weak coffee and milk prices recently forced the group to adjust its selling prices in order to remain competitive. Nescafé (ready-to-drink and soluble) and confectionary (Hsi Fu Chi) have showed signs of improvement but milk products (Yinlu) remain very difficult.

4. A mixed outlook

The group is unlikely to restore its organic sales growth model (+5/6%) in the next three years (4.1). In addition, with the lack of strong restructuring measures, growth in trading operating margin is set to remain sluggish (4.2).

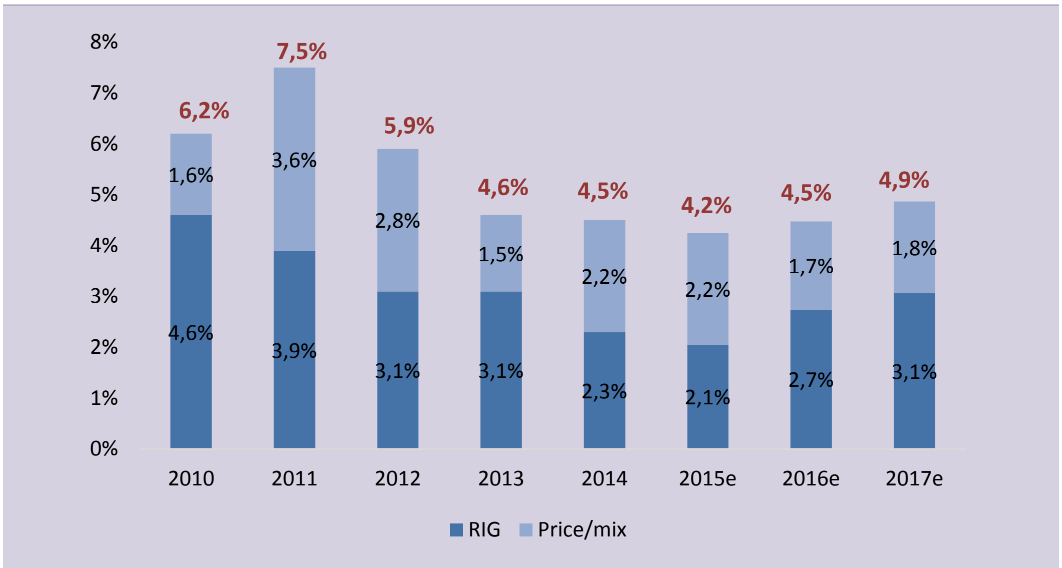
4.1. Organic sales growth of 4.5% in 2016

During the Q3 sales publication, Nestlé downgraded its organic sales growth target for 2015 and is now looking for growth of around 4.5% vs. around 5% previously. The company mentioned one-off reasons such as the recall of Maggi noodles in India and a retroactive rebate adjustment in Nestlé Skin Health. Note nevertheless that adjusted for these two effects (-50bp for Maggi and -60bp for the retroactive adjustment for rebates), organic sales growth in Q3 came in at only 4.8%, below the consensus forecast of 5.1%.

In Q4 2015, sales are set to rise by 4.4% in organic terms, enabling the group to post growth of 4.2% over the year, decelerating vs 2014 (+4.5%) and slightly below guidance (+4.5%). Delivering sales increase of 4.5% over the year would imply growth of 5.2% in Q4, well ahead of the performance in recent quarters.

We estimate organic sales growth in 2016 at 4.5%. Developed and emerging countries should rise by respectively 2.5% and 7%. **As such, this should be the fourth year in a row where the group fails to deliver its model of annual organic sales growth of 5-6%.**

Fig. 17: Nestlé organic sales growth

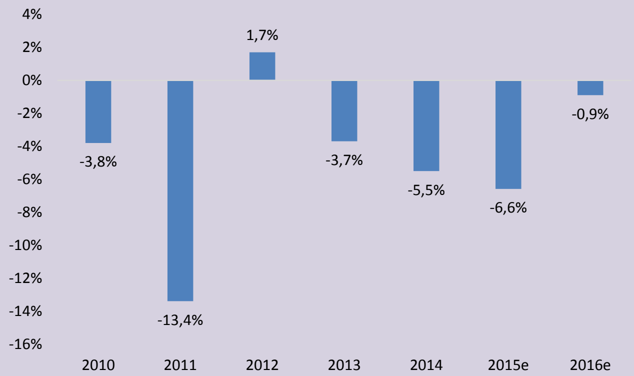


Source: Nestlé, Bryan, Garnier & Co

Forex effects are negative. Nestlé publishes its accounts in Swiss Francs although only 2% of its sales are generated in the country. Between 2010 and 2014, negative forex effects dented sales by an average annual 5%. **In 2015 and 2016, we estimate FX headwinds of 6.6% and 0.9% respectively.**

Fig. 18: Change in Swiss Franc relative to Nestlé's basket of currencies

Fig. 19: Forex effects on Nestlé sales



Source: Nestlé, Bryan, Garnier & Co

Reported sales should drop by 1.7% in 2015. In 2016, growth is only set to stand at 0.8%, in view of a negative perimeter impact of 2.8% (disposal of Davigel and JV with R&R).

Our estimates by division are set out below:

Fig. 20: Sales by division

CHFm	2014	2015e	2016e	2017e
GROUP				
Sales	**91 612**	**90 038**	**90 758**	**95 176**
% reported	-0,6%	-1,7%	0,8%	4,9%
% FX	-5,5%	-6,6%	-0,9%	0,0%
% perimeter	0,4%	0,6%	-2,8%	0,0%
% organic	**4,5%**	**4,2%**	**4,5%**	**4,9%**
% real internal	*2,3%*	*2,1%*	*2,7%*	*3,1%*
% price/mix	*2,2%*	*2,2%*	*1,7%*	*1,8%*
AMERICAS (AMS)				
Sales	**26 625**	**26 207**	**26 967**	**28 126**
% reported	-6,1%	-1,6%	2,9%	4,3%
% organic	**5,0%**	**5,8%**	**4,0%**	**4,3%**
% real internal	*1,1%*	*1,2%*	*2,0%*	*2,3%*
% price/mix	*3,9%*	*4,6%*	*2,0%*	*2,0%*
EUROPE, MIDDLE EAST, NORTH AFRICA (EMENA)				

Sales	**17 965**	**16 193**	**13 871**	**14 274**
% reported	15,4%	-9,9%	-14,3%	2,9%
% organic	**1,5%**	**4,1%**	**2,7%**	**2,9%**
% real internal	*2,2%*	*2,5%*	*1,7%*	*1,9%*
% price/mix	*-0,7%*	*1,6%*	*1,0%*	*1,0%*
ASIA, OCEANIA, SUB-SAHARAN AFRICA (AOA)				
Sales	**14 792**	**14 395**	**14 886**	**15 482**
% reported	-21,5%	-2,7%	3,4%	4,0%
% organic	**2,6%**	**-0,5%**	**3,5%**	**4,0%**
% real internal	*-0,3%*	*-1,2%*	*1,0%*	*1,2%*
% price/mix	*2,9%*	*0,7%*	*2,5%*	*2,8%*
NESTLE WATERS				
Sales	**7 390**	**7 626**	**8 072**	**8 556**
% reported	1,8%	3,2%	5,8%	6,0%
% organic	**5,4%**	**6,3%**	**6,0%**	**6,0%**
% real internal	*6,3%*	*6,5%*	*6,0%*	*6,0%*
% price/mix	*-0,9%*	*-0,3%*	*0,0%*	*0,0%*
NESTLE NUTRITION				
Sales	**10 915**	**10 627**	**11 094**	**11 760**
% reported	11,1%	-2,6%	4,4%	6,0%
% organic	**7,7%**	**3,4%**	**5,0%**	**6,0%**
% real internal	*3,6%*	*1,3%*	*3,0%*	*4,0%*
% price/mix	*4,1%*	*2,1%*	*2,0%*	*2,0%*
OTHER BUSINESSES				
Sales	**13 925**	**14 991**	**15 867**	**16 978**
% reported	13,2%	7,7%	5,8%	7,0%
% organic	**7,1%**	**6,1%**	**7,0%**	**7,0%**
% real internal	*5,6%*	*4,7%*	*5,0%*	*5,0%*
% price/mix	*1,5%*	*1,4%*	*2,0%*	*2,0%*

Source: Nestlé, Bryan, Garnier & Co

4.2. Limited growth in trading operating margin

The merger between Kraft and Heinz in March 2015 radically changed the food industry. The group became the no. 3 player in the US after PepsiCo and Nestlé but ahead of Coca-Cola, General Mills and Kellogg's. Its capital is 51%-owned by Heinz shareholders, the 3G Capital and Berkshire Hathaway funds that entered the capital in June 2013. 3G stands out for having improved the profitability of groups in which it is shareholder (notably AB InBev, Burger King and Tim Hortons) thanks to massive cost-cutting plans. As such, the EBITDA margin of Heinz rose 800bps between 2013 and 2014.

Nestlé is aware of the need to step up efforts on its cost structure. During the annual shareholders meeting in April 2015, Peter Brabeck underscored the turmoil caused by the intervention of 3G and its cost-cutting policy:

"Swiss-Brazilian Jorge Paulo Lemann's New York-based investment fund 3G Capital and Warren Buffett's Omaha-based Berkshire Hathaway have pulverised the food industry market, particularly in America, with serial acquisitions, first in the beverages sector with the creation of the world's largest brewery, AnheuserBusch/InBev, then in the foodstuffs sector with the purchase of Burger King, Tim Hortons and Heinz…3G's partners are known in our industry for ruthless cost-cutting and have already proven numerous times that <u>they are capable of reducing operating costs in particular by between 500 and 800 basis points, which has a revolutionary impact on all the other members of the industry".</u>

Mr Brabeck also highlighted the importance for Nestlé of adapting to this new landscape by placing the focus on operating efficiency:

"With regard to the effectiveness and efficiency of your company, we firmly believe that we continue to benefit from its decentralised structure, which enables key decisions to be taken as close as possible to consumers; but we also believe that we can and, particularly given the new competitive situation, that <u>we are obliged to make better use of our size. Our CEO has already spoken to you about management's plans in this area, with the creation of "Nestlé Business Excellence" as the backbone, in order to enable operating units to focus more on generating demand".</u>

While we view the group's motivation positively, the Nestlé Business Excellence plan is simply a mixture of several pre-existing programmes:

- Continuous Excellence (2008): aiming to reduce losses in the value chain.
- GLOBE (2000): aiming to standardise data and IT systems within the group (roll-out of SAP in all subsidiaries).
- Nestlé Business Services (2008): aiming to pool transactional services.

Implying only low restructuring costs, the new plan's aim is above all to shake up sales and is likely to have a very limited impact on underlying EBIT, contrary to previous Nestlé plans (MH 97, Target 0.4, and Operation Excellence 2007). The improvement in profitability is also likely to be restricted by the investments that the group needs to make in China and the US in order to restore its performance. We estimate an organic increase in trading operating margin of 24bp in 2015 and 23bp in 2016. Our estimates by division are set out below:

Fig. 21: Trading operating profit by division

CHFm	2014	2015e	2016e	2017e
GROUP				
EBIT	**14 019**	**13 917**	**14 367**	**15 311**
% reported	-0,2%	-0,7%	3,2%	6,6%
Margin	**15,3%**	**15,5%**	**15,8%**	**16,1%**
Reported variation in bps	10	16	37	26
LFL variation in bps	30	24	23	26
AMERICAS (AMS)				
EBIT	**4 940**	**4 922**	**5 084**	**5 338**
% reported	-4,3%	-0,4%	3,3%	5,0%
Margin	**18,6%**	**18,8%**	**18,9%**	**19,0%**
Reported variation in bps	60	23	7	13
EUROPE, MIDDLE EAST, NORTH AFRICA (EMENA)				
EBIT	**2 735**	**2 553**	**2 388**	**2 490**
% reported	17,3%	-6,7%	-6,5%	4,3%
Margin	**15,2%**	**15,8%**	**17,2%**	**17,4%**
Reported variation in bps	30	54	145	23
ASIA, OCEANIA, SUB-SAHARAN AFRICA				
EBIT	**2 834**	**2 715**	**2 795**	**2 906**
% reported	-20,4%	-4,2%	2,9%	4,0%
Margin	**19,2%**	**18,9%**	**18,8%**	**18,8%**
Reported variation in bps	-20	-30	-9	0
NESTLE WATERS				
EBIT	**714**	**763**	**820**	**881**
% reported	7,4%	6,9%	7,3%	7,5%
Margin	**9,7%**	**10,0%**	**10,2%**	**10,3%**
Reported variation in bps	50	35	14	14
NESTLE NUTRITION				
EBIT	**2 343**	**2 388**	**2 517**	**2 693**
% reported	19,5%	1,9%	5,4%	7,0%
Margin	**21,5%**	**22,5%**	**22,7%**	**22,9%**
Reported variation in bps	80	101	22	21
OTHER BUSINESSES				
EBIT	**2 651**	**2 771**	**2 961**	**3 198**
% reported	21,9%	4,5%	6,8%	8,0%
Margin	**19,0%**	**18,5%**	**18,7%**	**18,8%**
Reported variation in bps	140	-55	17	17

Source: Nestlé, Bryan, Garnier & Co

5. Neutral, Fair Value: CHF76

The share lacks catalysts (5.1). In addition, our estimates are not only below those of the consensus (5.2) but the group's valuation is not particularly attractive relative to peers or its historical average (5.3) and the share looks fully valued based on a DCF valuation (5.4). Clearly identified upside risk is the announcement of a share buyback programme at the full-year earnings presentation and this justifies our Neutral recommendation (5.5).

5.1. A lack of catalysts

We do not believe the full-year earnings publication on 18th February can provide a catalyst for the share price:

- **Over the year, we estimate that the group should post organic sales growth of 4.2%, slightly below its guidance for "around 4.5%".** Q4 should show an improvement (+4.4%), after a Q3 (+3.7%) affected by non-recurring factors, albeit without justifying an increase in valuation multiples for the share from a short-term perspective.

Fig. 22: Organic growth in Nestlé sales

	2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015e	2015e
AMS	5,0%	3,7%	6,6%	6,9%	5,8%	5,8%
EMENA	1,5%	5,3%	2,4%	4,7%	4,0%	4,1%
AOA	2,6%	-0,2%	1,8%	-3,0%	-0,5%	-0,5%
Nestlé Waters	5,4%	7,3%	3,7%	9,5%	4,5%	6,3%
Nestlé Nutrition	7,7%	4,3%	3,5%	2,4%	3,5%	3,4%
Other businesses	7,1%	8,1%	8,1%	1,2%	7,5%	6,1%
GROUP	**4,5%**	**4,4%**	**4,6%**	**3,7%**	**4,4%**	**4,2%**

Source: Nestlé, Bryan, Garnier & Co

- **The increase in underlying EBIT margin is likely to be limited to +16bp (24bp in LFL) over the year.** After a stable H1, H2 should benefit from a small decline in raw materials prices.

- **We believe the guidance communicated by the group for 2016 should be for organic sales growth of around 4.5% over the year.** As such, we should not see the Nestlé model restored (annual organic growth of 5-6%).

5.2. Estimates below the consensus

Our 2015 estimates are generally in line with the market's forecasts. For the following two years, we are 2.6% and 2.7% below the consensus in sales terms and 2.9% and 2.2% lower for trading operating profit.

Fig. 23: Consensus / Bryan, Garnier & Co

	2015		2016		2017	
	Bryan, Garnier	**Consensus**	**Bryan, Garnier**	**Consensus**	**Bryan, Garnier**	**Consensus**
Sales	90 038	89 748	90 758	93 159	95 176	97 773
Difference	*0,3%*		*-2,6%*		*-2,7%*	
EBIT	13 917	13 968	14 367	14 803	15 311	15656,4
Difference	*-0,4%*		*-2,9%*		*-2,2%*	
EPS	3,32	3,30	3,44	3,50	3,70	3,77
Difference	*0,6%*		*-1,6%*		*-1,8%*	

Source: Thomson Reuters, Bryan, Garnier & Co

Fig. 24: Consensus-sales

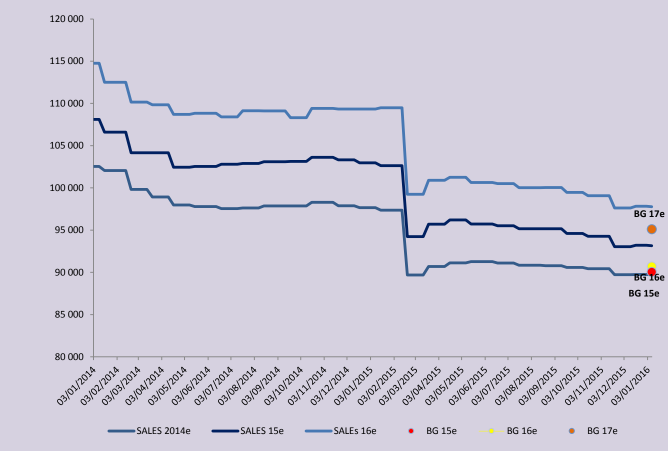
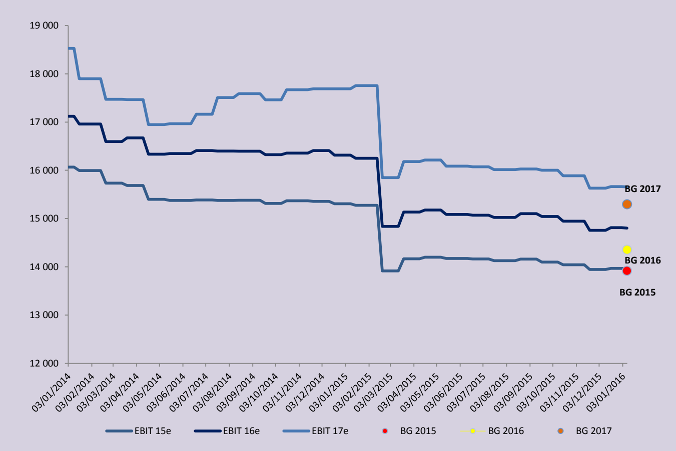


Fig. 25: Consensus-EBIT



Source: Thomson Reuters, Bryan, Garnier & Co

5.3. Unflattering multiples comparison

Nestlé is trading on a significant premium relative to its historical average multiples over the past 10 years (25% in terms of EV/EBIT and 27% in terms of P/E).

Fig. 26: Nestlé EV/EBIT since 2006

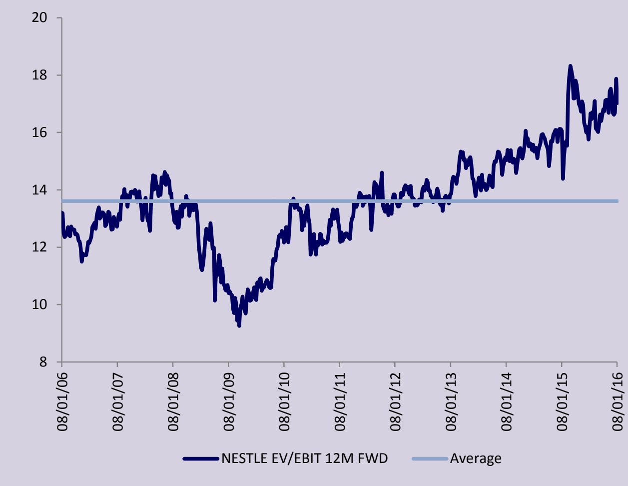
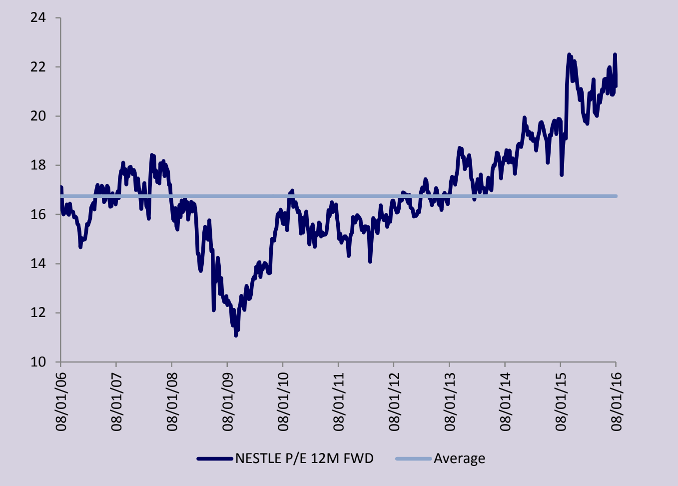


Fig. 27: Nestlé P/E since 2006



Source: Thomson Reuters

Despite the dismal performance of the past three months, Nestlé's 12-month forward P/E stands at 21.2x (based on a consensus 1.6% ahead of our estimates), compared with 20.4x for Unilever and 20.1x for Danone (our expectations are 2.5% below market expectations).

Fig. 28: Groups' performances over the past three months (vs DJ Stoxx)

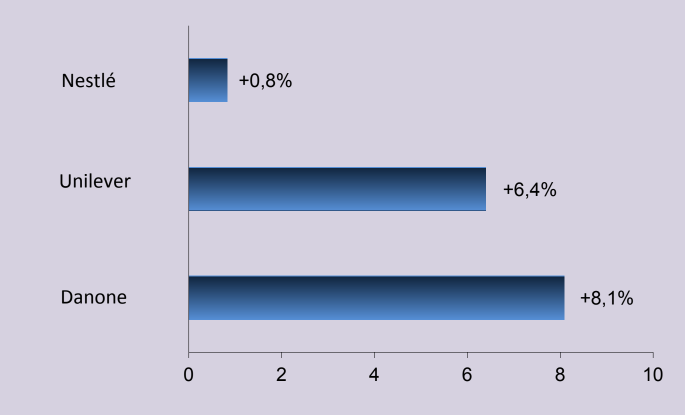
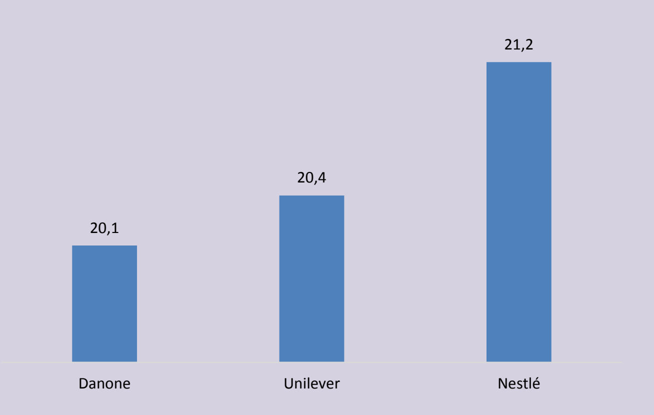


Fig. 29: 12-month forward P/E



Source: Thomson Reuters

5.4. Share price close to Fair Value

A discounted cash flow valuation yields a per share value of CHF76, pointing to upside of 8%. In addition to our 2015-17 estimates presented above, we have assumed the following:

- WACC of 7.1% stemming from a cost of equity of 7.5% with:
  - A risk-free rate of 2%
  - A market risk premium of 6.4%
  - Levered beta of 0.9
- A growth rate to infinity of 2% as of 2025
- An average recurring tax rate of 28%
- A medium-term growth rate of 5.5% and a trading operating margin widening by 10bp a year until 2025

Fig. 30: DCF model (1)

CHFm	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e
Sales	90 758	95 176	99 999	105 267	111 023	116 316	121 048	125 125	128 463	130 991
% change	*0,8%*	*4,9%*	*5,1%*	*5,3%*	*5,5%*	*4,8%*	*4,1%*	*3,4%*	*2,7%*	*2,0%*
EBIT	14 367	15 311	16 187	17 145	18 193	19 177	20 078	20 879	21 565	22 120
EBIT margin	*15,8%*	*16,1%*	*16,2%*	*16,3%*	*16,4%*	*16,5%*	*16,6%*	*16,7%*	*16,8%*	*16,9%*
-Income taxes	-3562	-3839	-4063	-4303	-4566	-4813	-5040	-5241	-5413	-5552
+Depreciation	3 177	3 331	3 600	3 895	4 219	4 536	4 842	5 130	5 395	5 633
as % of sales	*3,5%*	*3,5%*	*3,6%*	*3,7%*	*3,8%*	*3,9%*	*4,0%*	*4,1%*	*4,2%*	*4,3%*
+Change in WC	160	-56	-100	-105	-111	-116	-121	-125	-128	-131
as % of sales	*0,2%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*	*-0,1%*
Operating cash flows	**14 142**	**14 747**	**15 624**	**16 631**	**17 734**	**18 783**	**19 759**	**20 643**	**21 419**	**22 069**
-CAPEX	-3 903	-4 093	-4 300	-4 526	-4 774	-5 002	-5 205	-5 380	-5 524	-5 633
as % of sales	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*	*-4,3%*
Free cash flow	**10 239**	**10 654**	**11 324**	**12 104**	**12 960**	**13 782**	**14 554**	**15 263**	**15 895**	**16 437**
Discount coefficient	0,93	0,87	0,81	0,76	0,71	0,66	0,62	0,58	0,54	0,50
Discounted FCF	**9 558**	**9 284**	**9 210**	**9 190**	**9 185**	**9 117**	**8 988**	**8 798**	**8 553**	**8 256**

Source: Nestlé, Bryan, Garnier & Co

Fig. 31: DCF model (2)

Sum of discounted cash flows	90 140
+Terminal value	164 201
+Financial assets	6 042
-Net debt	-16 368
-Minorities	-1 780
-Provisions	-3 533
Equity value	**238 701**
Number of shares (m)	3 138
Fair Value (CHF)	**76**

Source: Nestlé, Bryan, Garnier & Co

Fig. 32: Sensitivity table

		Growth rate				
		1,0%	1,5%	2,0%	2,5%	3,0%
	6,2%	80	87	94	104	116
	6,5%	75	81	87	95	106
	6,8%	71	76	81	88	97
WACC	7,1%	67	71	76	82	89
	7,4%	64	67	71	77	83
	7,7%	60	63	67	72	77
	8,0%	57	60	63	67	72

Source: Nestlé, Bryan, Garnier & Co

5.5. Upside risk: share buybacks

Nestlé has decided to focus on free cash flow generation:

- Investment spending (excluding intangible assets) currently represents 4.3% of sales, which is far lower than in previous years.
- The group's WCR should remain positive but is expected to fall in 2016 and 2017.

Fig. 33: Investment spending (excluding intangible assets) as a % of sales

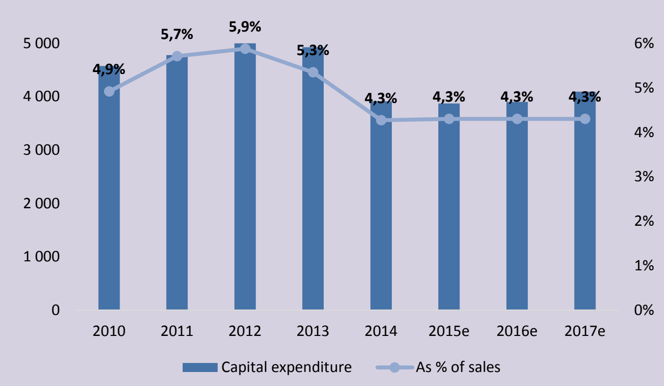
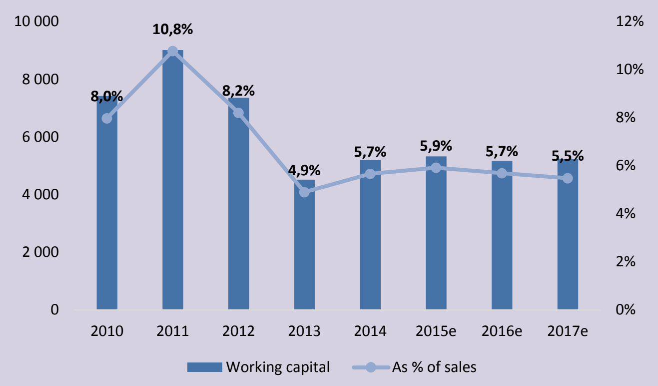


Fig. 34: Working capital requirements as % of sales



Source: Nestlé, Bryan, Garnier & Co

After dropping by 10.3% in 2015, FCF should increase by 4.5% in 2016. In 2015, we expect a rise in the net debt/EBITDA ratio from 0.7x to 0.9x due to the CHF8bn share buyback programme that has been undertaken in full (GBP6355m in 2015 after GBP1645m in 2014, following the disposal of 6% of the stake in l'Oréal). This ratio should fall back to 0.8x in 2016 and 0.6x in 2017.

Fig. 35: Free cash flow

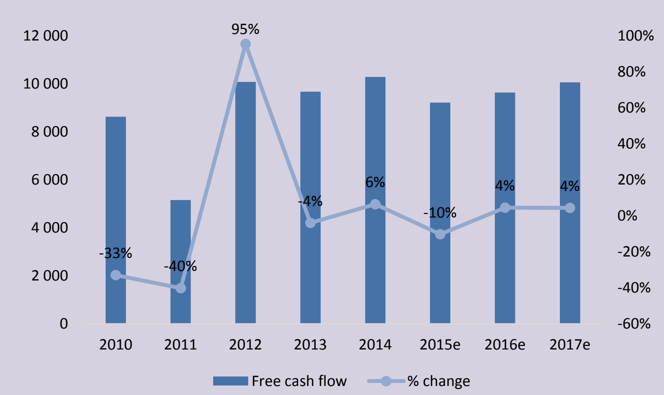
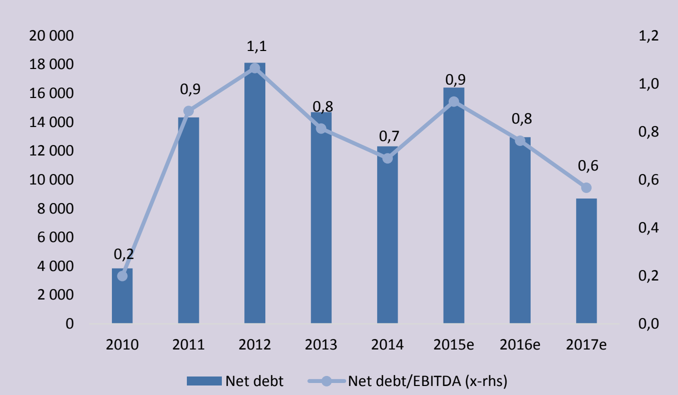


Fig. 36: Net debt



Source: Nestlé, Bryan, Garnier & Co

Nestlé's net debt/EBITDA ratio should be below 1.0x, which could imply a rating change from AA+ to AAA. The group has expressed its aim to maintain its AA+ rating and needs to find a way to use its cash in 2016 and especially in 2017. As such a share buyback programme seems to be the most likely choice. From an historical perspective, the group is used to this procedure having implemented programmes as of 2005.

Fig. 37: Share buyback programmes

Date	End	Amount (CHFm)
July 2005	October 2005	1,000
November 2005	October 2006	3,000
August 2007	July 2009	15,000
August 2009	June 2010	10,000
June 2010	September 2011	10,000
August 2014	December 2015	8,000

Source: Nestlé, Bryan, Garnier & Co

Our central scenario presumes an announcement is made at the full-year earnings presentation for a programme of CHF15bn. Assuming that half of this takes place in 2016 and the other half in 2017, and that the average share price is CHF74.3 (average price of the past three months), we calculated a net debt/EBITDA ratio of 1.2x for the first year and 1.0x for the second. The group would therefore avoid an upgrade to its credit rating to AAA. **EPS would increase by 1% the first year and 4.5% the second.**

BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

13th January 2016

Food & Beverages

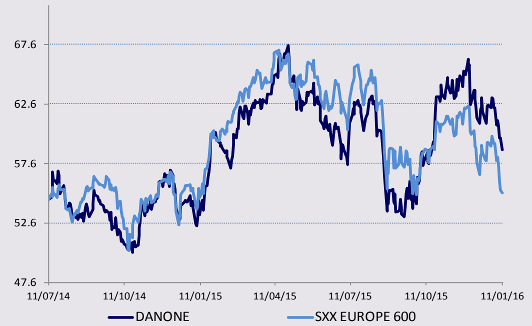
Danone

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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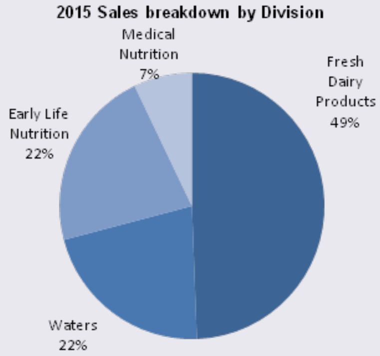

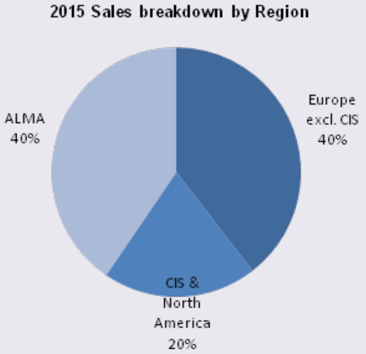

Company description

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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Bryan Garnier stock rating system

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.

Distribution of stock ratings

BUY ratings 58.5%   NEUTRAL ratings 32.3%   SELL ratings 9.2%

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10	Corporate finance client	In the past twelve months a member of the Bryan Garnier Group has been remunerated for providing corporate finance services to the issuer or may expect to receive or intend to seek remuneration for corporate finance services from the Issuer in the next six months.	No
11	Analyst has short position	The investment analyst or another person involved in the preparation of this Report has a short position in the securities or derivatives of the Issuer.	No
12	Analyst has long position	The investment analyst or another person involved in the preparation of this Report has a long position in the securities or derivatives of the Issuer.	No
13	Bryan Garnier executive is an officer	A partner, director, officer, employee or agent of the Bryan Garnier Group, or a member of such person's household, is a partner, director, officer or an employee of, or adviser to, the Issuer or one of its parents or subsidiaries. The name of such person or persons is disclosed above.	No
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15	Other disclosures	Other specific disclosures: Report sent to Issuer to verify factual accuracy (with the recommendation/rating, price target/spread and summary of conclusions removed).	Yes

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Please see the section headed "Important information" on the back page of this report.

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the Financial Conduct	and the Autorité de Contrôle		FINMA	
Authority (FCA)	prudential et de resolution (ACPR)			

Important information