13th January 2016

Sector View

Food industry

A spicer dish (NESTLE coverage initiation)

	1 M	3 M	6 M	31/12/14
Food & Bev.	-3.4%	1.3%	-1.7%	11.3%
DJ Stoxx 600	-4.4%	-6.2%	-12.5%	-0.7%

*Stoxx Sector Indices

Companies covered

DANONE		**BUY**	**EUR74 vs EUR69**
Last Price	EUR58,74	*Market Cap.*	EUR38,472m
NESTLE		**NEUTRAL initiation**	**CHF76**
Last Price	EUR70,25	*Market Cap.*	*EUR223,985m*

The business environment has deteriorated for major food groups that are facing constant political intervention, an accumulation of regulations and sociological changes. Only 16% of Danone's portfolio is based in high-risk categories (yoghurts sold in Europe excluding CIS). The group has mapped out a specific plan to restore its performance and has set credible financial targets. The first results have been positive. 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 mainly to take account of the roll-over of our estimates. We are initiating coverage of Nestlé with a Neutral recommendation and a Fair Value of CHF76.

ANALYSIS

- The food industry is the focus of much attention, notably from politicians. 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 away-from-home 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. Above all, they offer products that meet consumer demands as major groups have failed to do.
- 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 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).

VALUATION

- 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 good 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).

NEXT CATALYSTS

- Nestlé’s 2015 results due on February 18th / Danone’s 2015 results due on February 23rd

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BUY ratings 72% NEUTRAL ratings 0% SELL ratings 28%

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