BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

13th January 2016

Food & Beverages

Nestlé

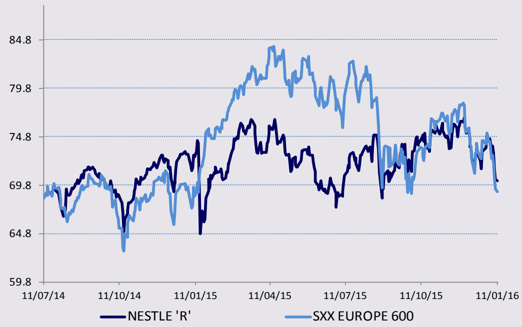
Sleeping beauty

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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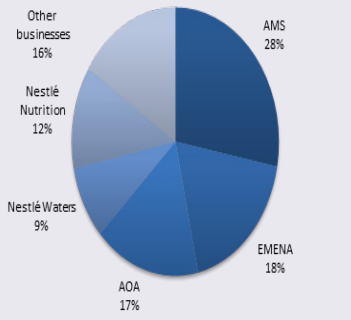
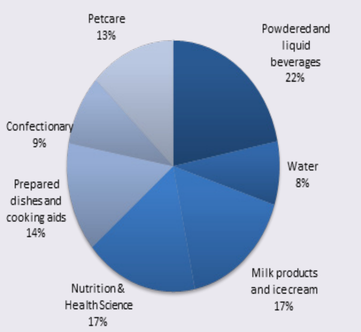
Breakdown of group's sales by division, 2015e



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.

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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

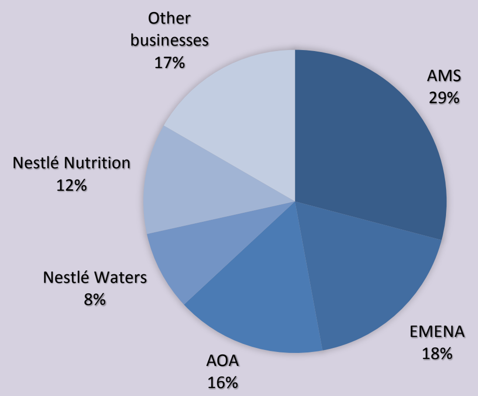
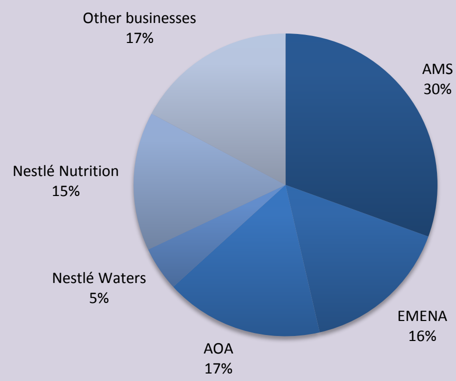


Fig. 2: Breakdown of EBIT by division, 2015e



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

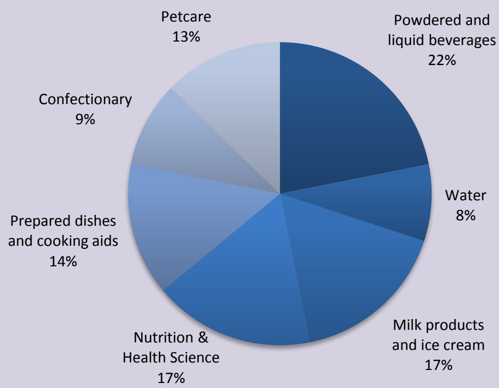
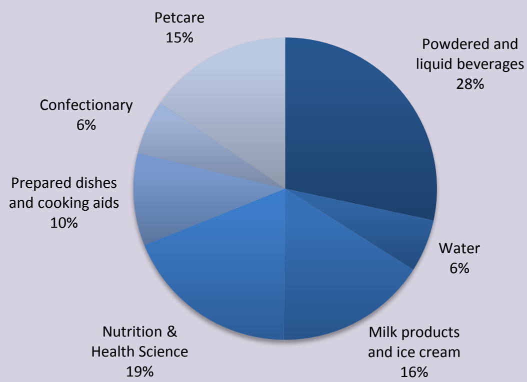


Fig. 4: Breakdown of EBIT by product, 2015e



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

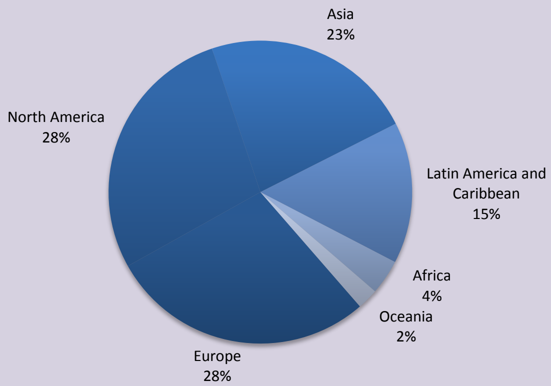
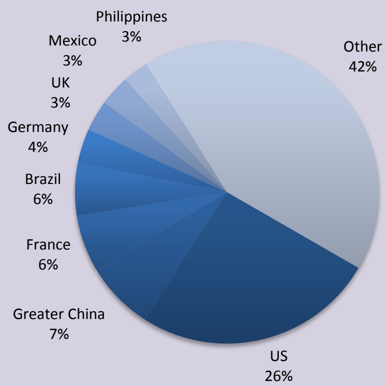


Fig. 6: Breakdown of group sales by country, 2015e



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

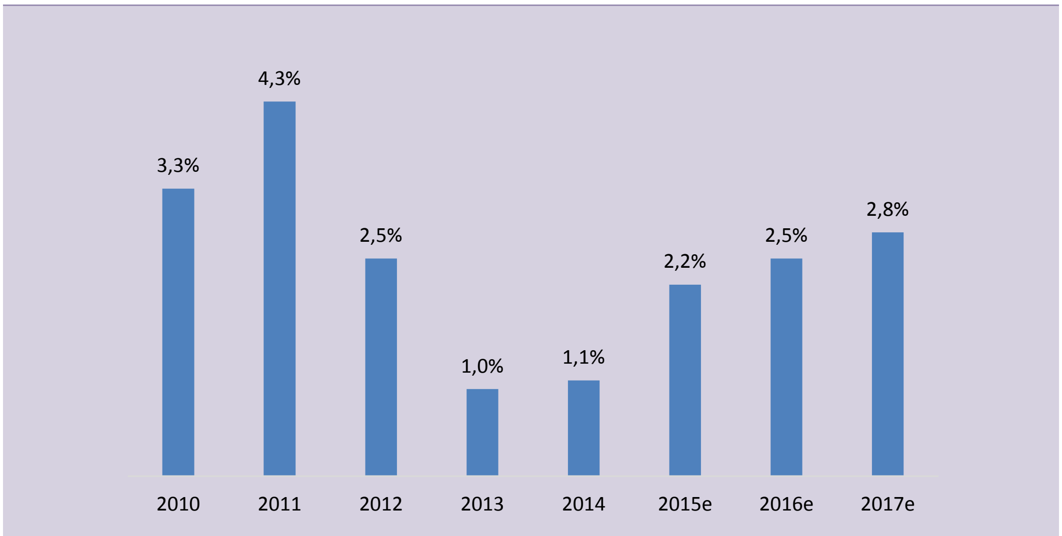
3. Persistent difficulties in 2016

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

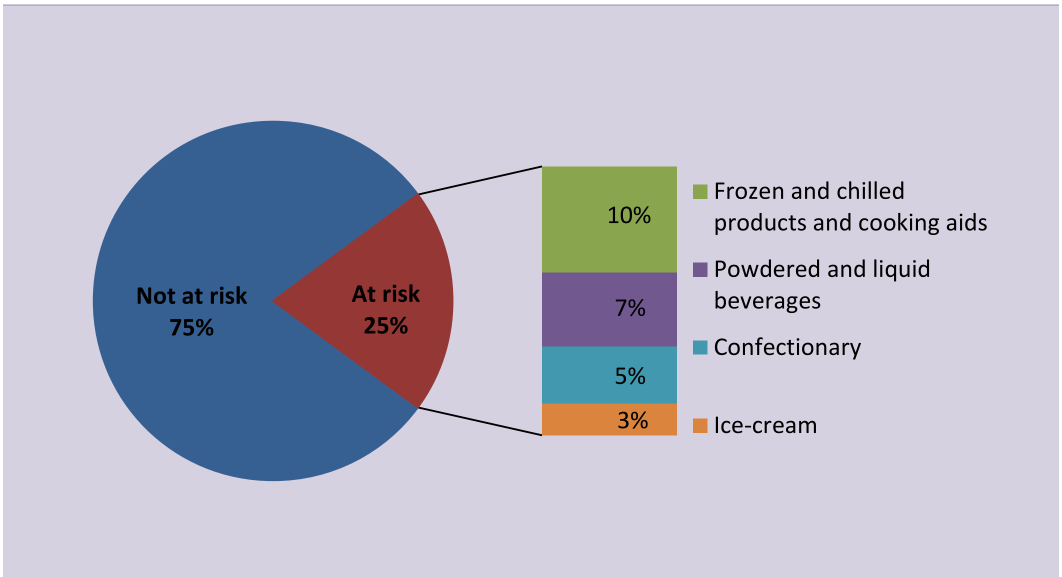


Source: Nestlé, Bryan, Garnier & Co

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

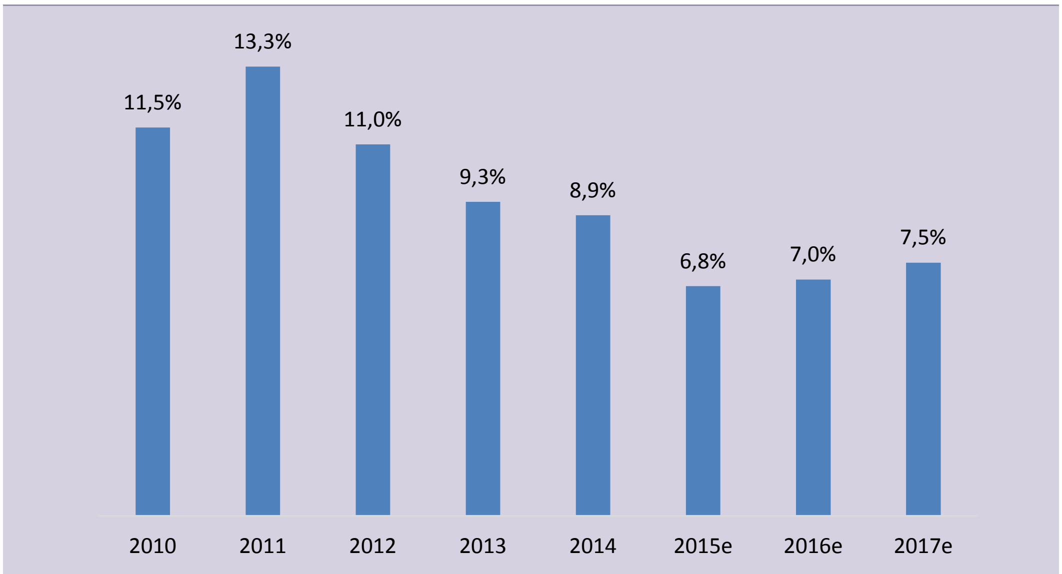
According to our estimates, the strong measures implemented by the company only concern 8% of sales: frozen products in the US (5%), and ice-creams/frozen products in Europe (3%). Other initiatives are headed in the right direction but their impact is minimal (launch of Cailer chocolate) or uncertain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



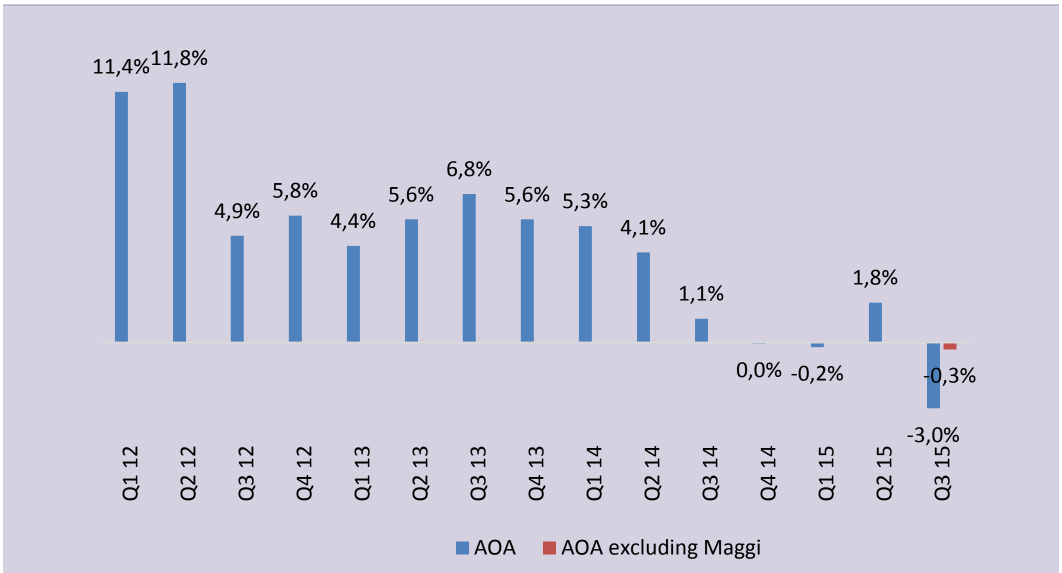
Source: Nestlé, Bryan, Garnier & Co

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.

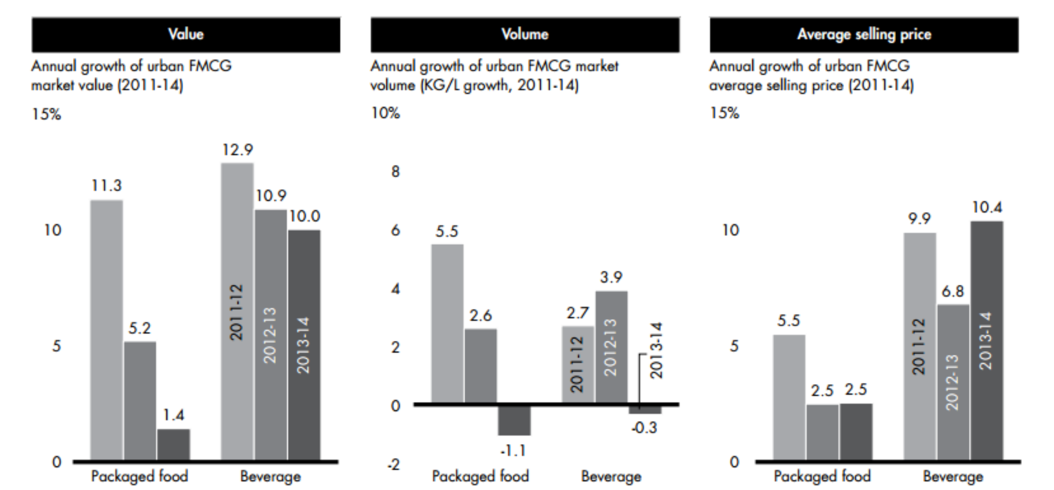
Fig. 11: Organic sales growth in AOA



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).

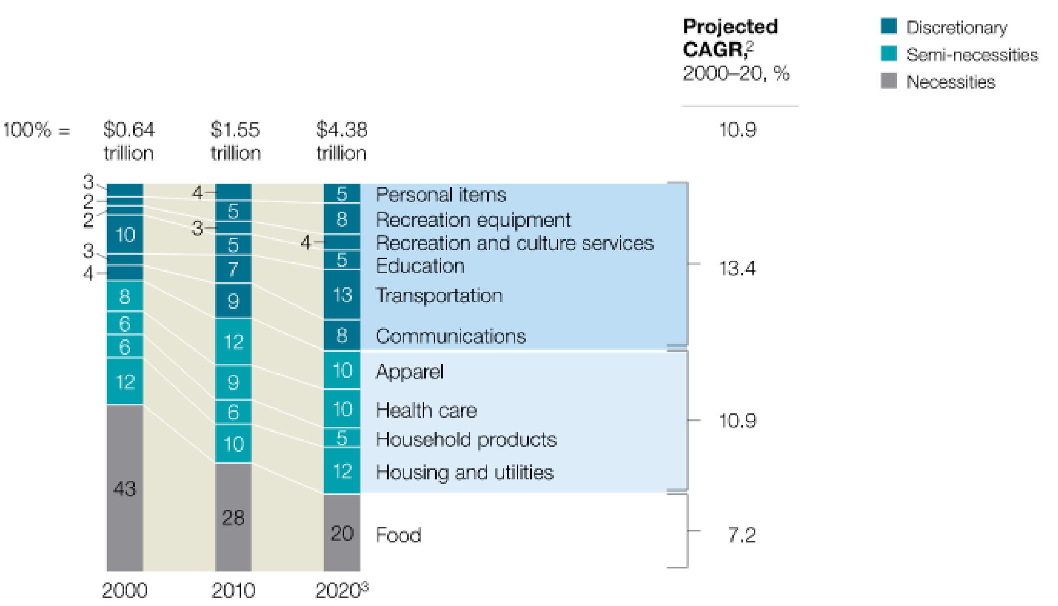
Fig. 12: Growth in food and beverage market in China



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.

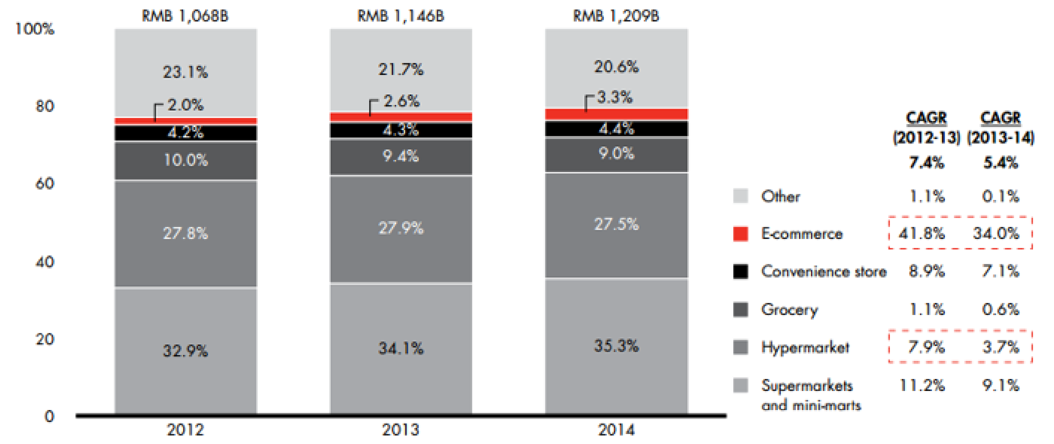
Fig. 14: A changing backdrop

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).

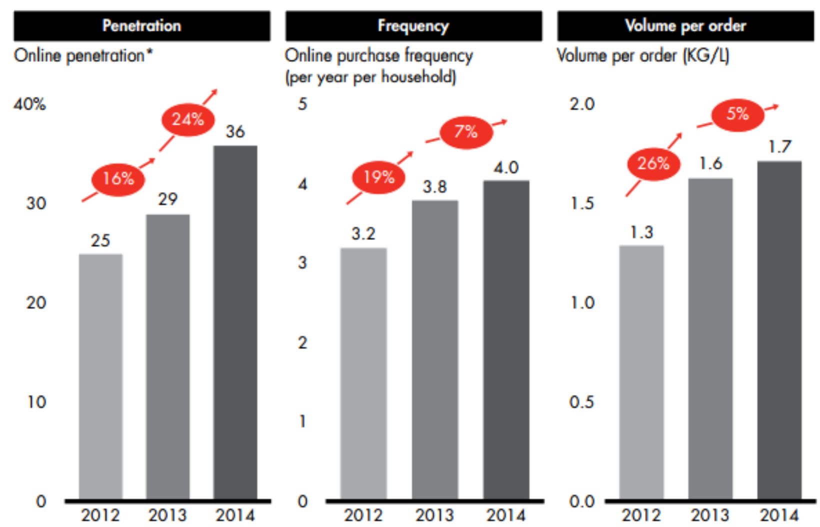
Fig. 15: Growth in Chinese cities and food and beverage sales by distribution channels



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).

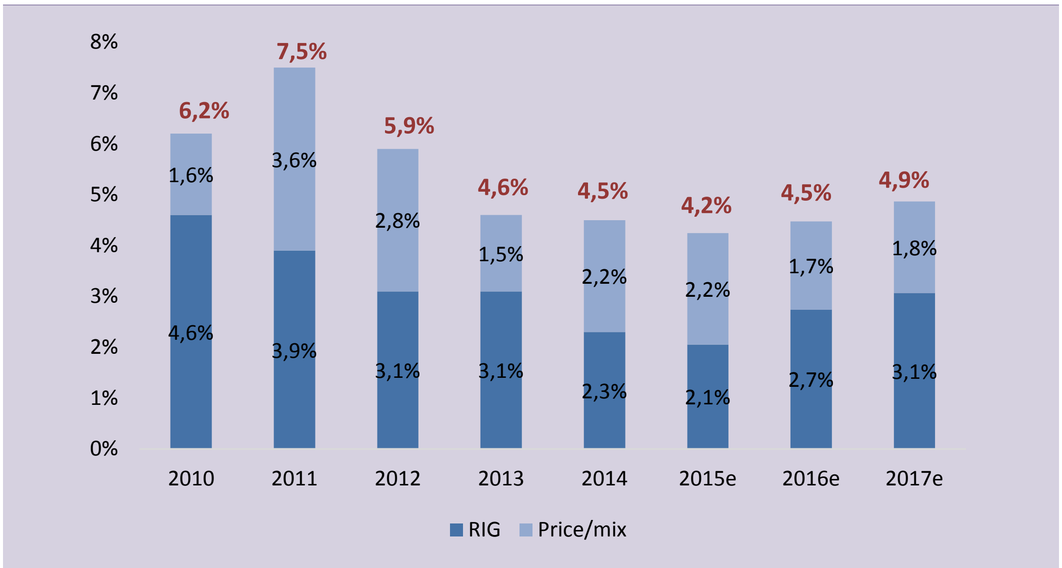
4.1. Organic sales growth of 4.5% in 2016

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

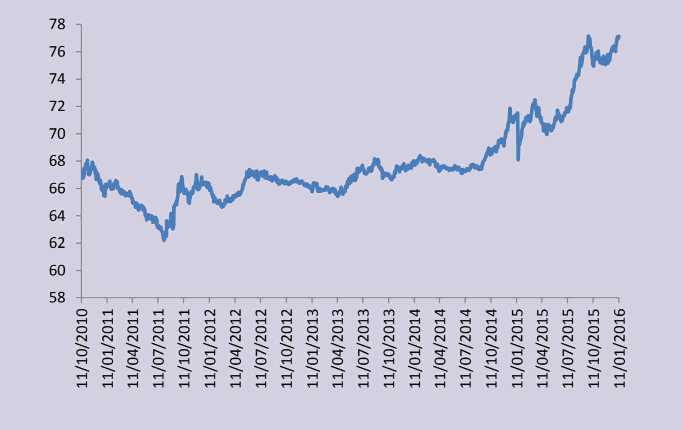
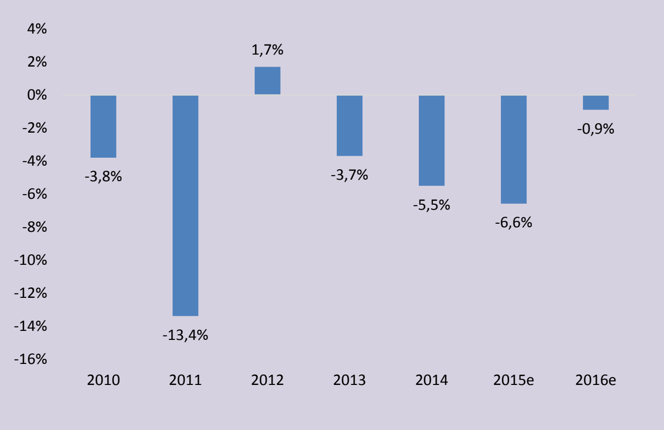


Fig. 19: Forex effects on Nestlé sales



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 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".

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 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".

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

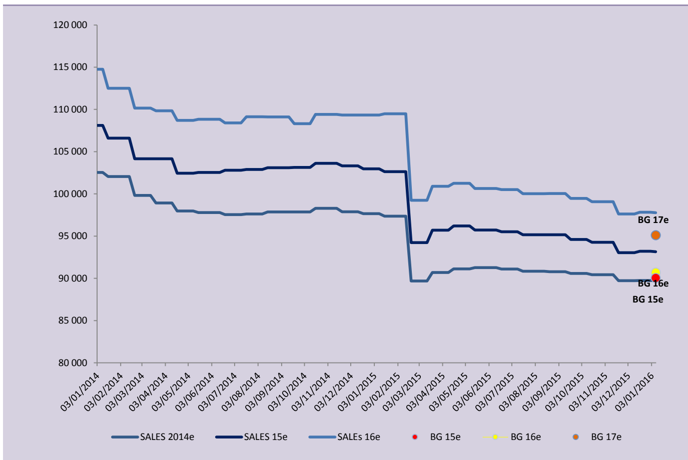
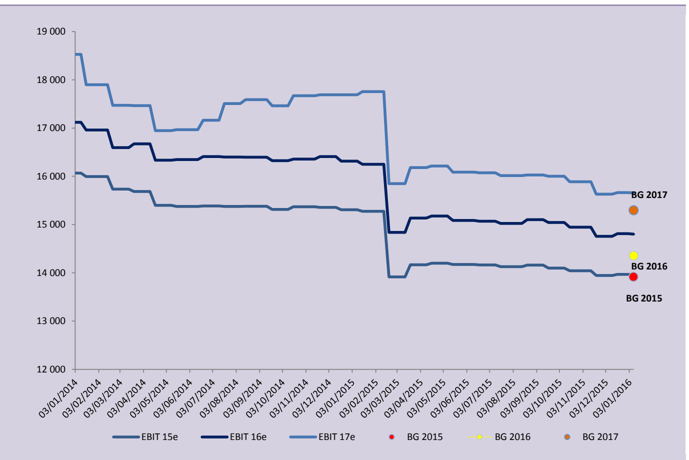


Fig. 25: Consensus-EBIT



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

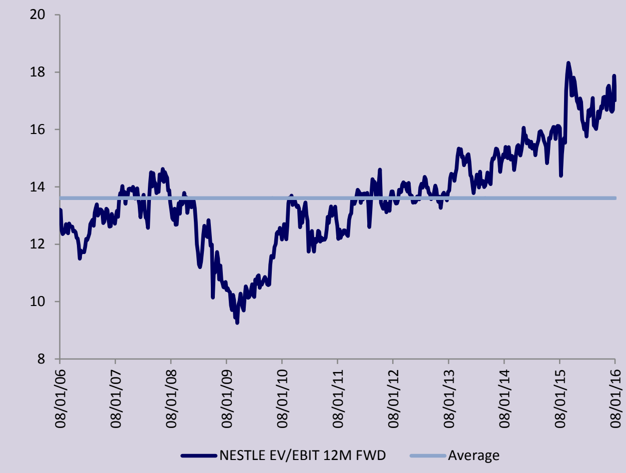
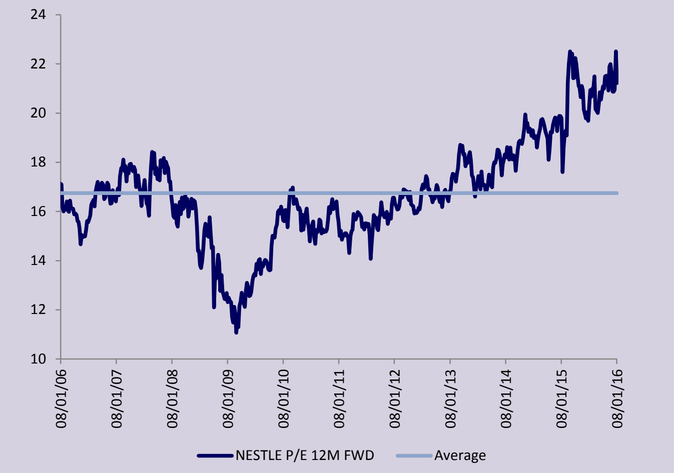


Fig. 27: Nestlé P/E since 2006



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)

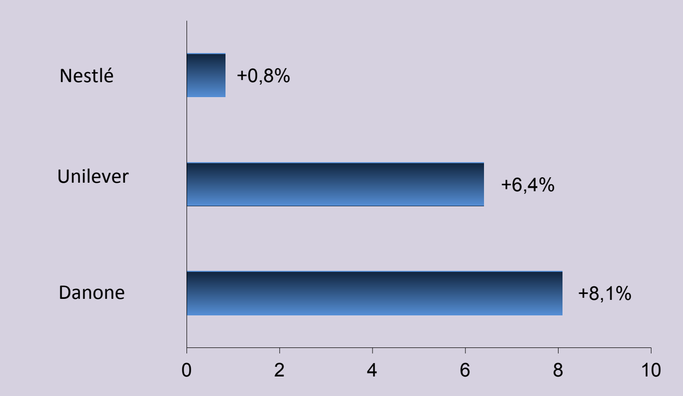
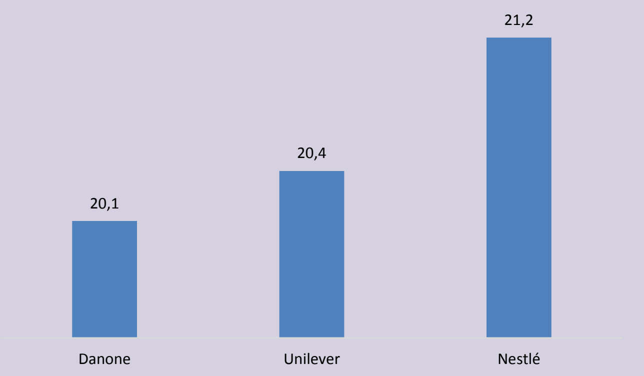


Fig. 29: 12-month forward P/E



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%
WACC	6,2%	80	87	94	104	116
	6,5%	75	81	87	95	106
	6,8%	71	76	81	88	97
	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

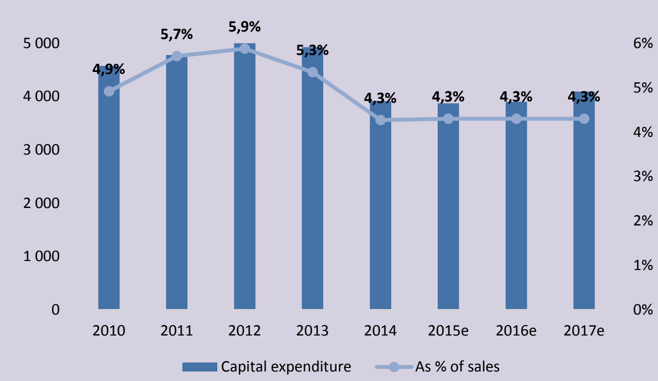
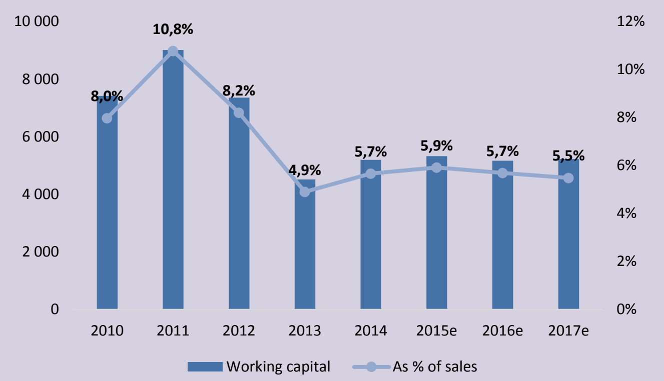


Fig. 34: Working capital requirements as % of sales



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

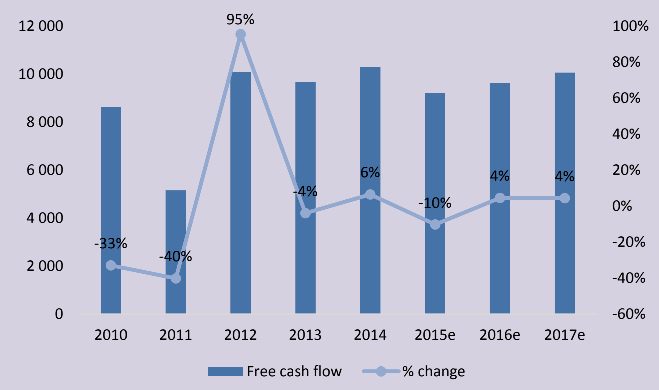
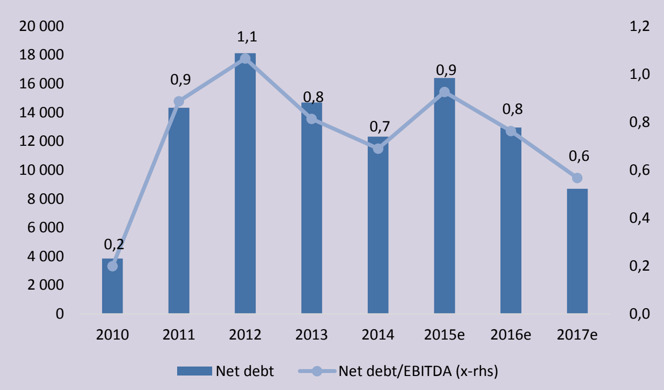


Fig. 36: Net debt



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.**

Fig. 38: Simulation of share buyback programme in 2016-17

	2016e	2017e	2016e	2017e	2016e	2017e
Amount (CHFm)	**10 000**		**15 000**		**20 000**	
Number of repurchased shares (in millions)	135		202		269	
New net debt	**18 761**	**15 886**	**21 261**	**18 386**	**23 761**	**20 886**
Net debt/EBITDA (x)	**1,0**	**0,8**	**1,2**	**1,0**	**1,3**	**1,1**
New diluted EPS	**3,45**	**3,79**	**3,47**	**3,86**	**3,48**	**3,92**
Accretive impact	**0,5%**	**2,7%**	**1,0%**	**4,5%**	**1,6%**	**6,3%**

Source: Nestlé, Bryan, Garnier & Co

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 72%   NEUTRAL ratings 0%   SELL ratings 28%

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