

Nestlé SA — A sweet investment opportunity

Background

Nestlé SA (NESN) is a Swiss-based, multinational consumer goods company that manufactures and markets a wide range of food products. The company's product line includes milk, chocolate, confectionery, bottled water, coffee, creamer, food seasoning and pet foods. It was founded in 1866 and currently has 330,000 employees in over 150 countries, with 461 factories in 83 countries. The company has over 4,000 brands and more than 1bn Nestlé products are sold every day. It is also the world's biggest food company by revenue. Nestlé is in 33rd place on Forbes' most powerful brands list.

Nestlé's metrics are as follows:

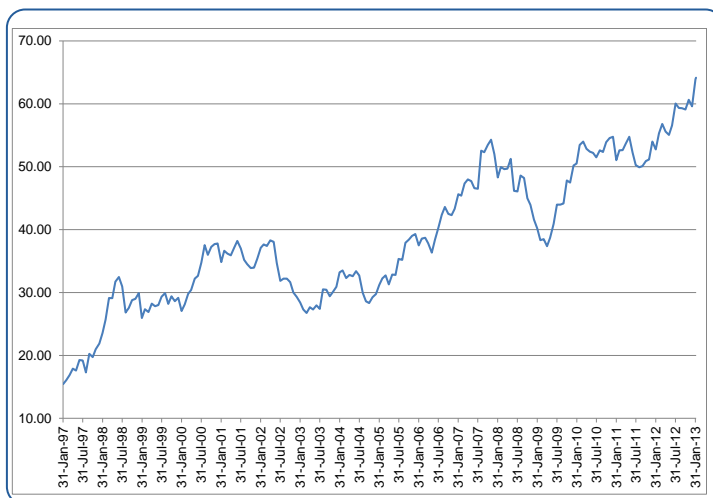
Spot (CHF)	64.15
Mkt Cap CHFmn	206 871
12M trailing P/E	19.76
12M fwd P/E	17.30
10-year average P/E	19.70
10-year average DY	2.59
FYE	31-Dec
P/Book Ratio	3.70
12M trailing DY	3.33
12M fwd DY	3.50

Source: Bloomberg, Anchor Capital

The group's products segment format is divided into the following seven product groups (segments):

- Powdered and Liquid Beverages (includes Nescafe, Milo, Nesquik, Nestea, Nespresso etc).
- Water (Nestle).
- Milk products and Ice Cream (Nestlé, Coffee mate, Dreyer's).
- Nutrition and HealthCare (Nestlé, Nan, Gerber, Galderma).
- Prepared dishes and cooking aids (Maggi).
- Confectionery (Nestlé, KitKat); and
- PetCare (Purina, Friskies).

Nestlé SA share price performance (CHF)

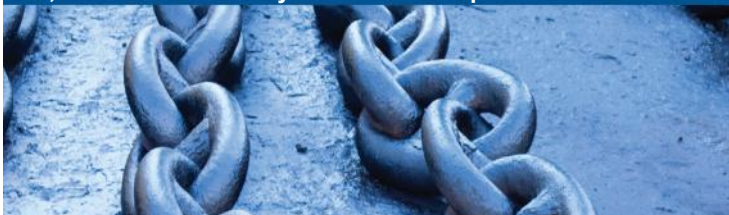


Source: Bloomberg, Anchor Capital



Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Twice-weekly (in the Monday and Thursday editions) we feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.



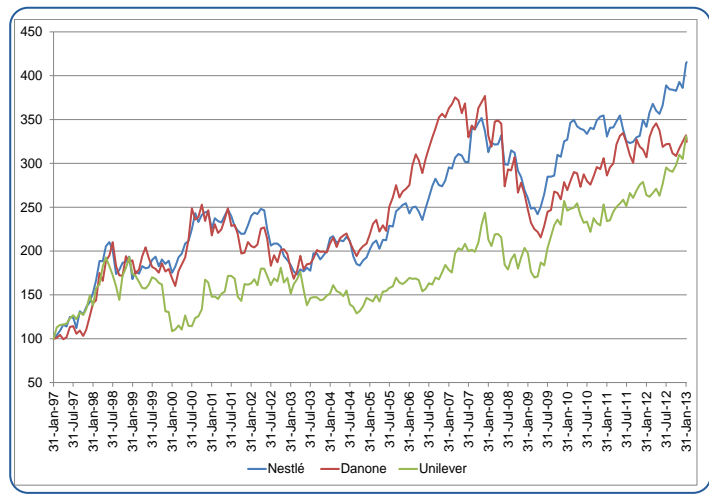
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Nestlé's share price gained 10.4% in 2012, while the group's share price has outperformed its peers (Unilever and Danone) over the past 46 months. The share price reached a 52-week high of CHF64.50 on 30 January 2013.

Nestlé SA share price vs peers, rebased to 100:

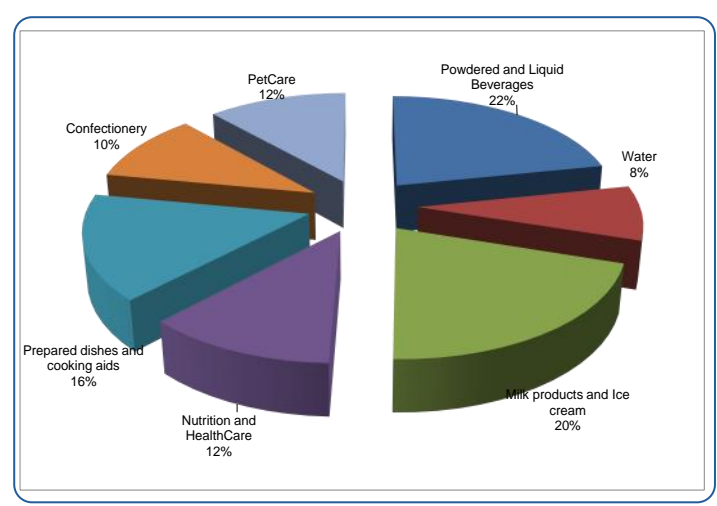


Source: Bloomberg, Anchor Capital

9M12 results

In October 2012, Nestlé released 9M12 results, which saw sales increase 11% YoY to CHF67.6bn. The results disappointed the market as Nestlé missed analyst expectations for the first time in several quarters. The company reported continued growth in developed, as well as emerging markets (EMs). EMs delivered double-digit growth with Africa growing at twice the zone average and the Middle East also performing well, while China and Indonesia were among the other markets contributing well. The categories that were the key growth drivers were dairy, powdered beverages and ready-to-drink, particularly Nescafé, ambient culinary with Maggi and Totole, chocolate including Shark in China, and ice cream.

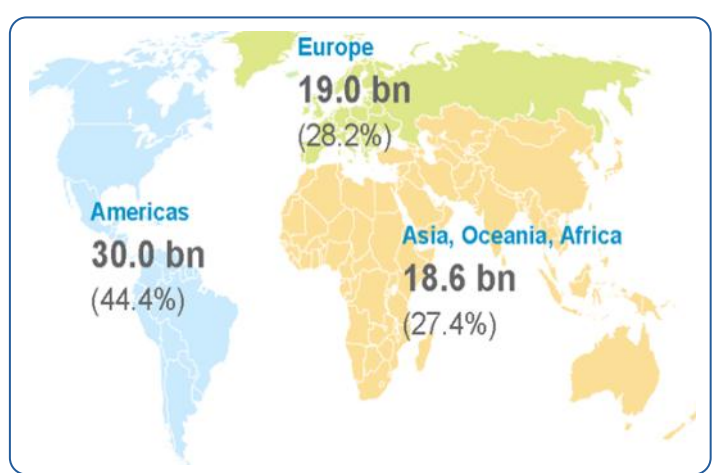
Divisional contribution to sales



Source: Company data, Anchor Capital

However, growth in its Asia Oceania and Africa (AOA) region, which accounts for c. 25% of its sales, fell to 9.4% from 11.6%. The company noted that its AOA sales were impacted by some one-offs including typhoons in the Philippines which closed production for a week, while demonstrations in Pakistan, elections in Egypt and sanctions in Iran also impacted 3Q12 sales.

Nestlé turnover by region (January-September 2012), CHF



Source: Company reports

The debt crisis in Europe saw Nestlé's growth in the region slow to 1.9% from 2.4%, while in the US sales growth was steady at 5.5%. Nestlé said that in many developed markets where consumer confidence is low, the trading environment remains subdued while in most EMs, conditions remain dynamic, with significant growth opportunities.

Nestlé's global presence



Source: Company reports

At its results the company noted that 3Q12 was "not a good guide to 4Q" but reiterated its "Nestlé Model" outlook of 5-6% organic growth, together with an improvement in margins and EPS in constant currencies.

Growth drivers:

We see the following as growth drivers for the company:

- **EMs:** Nestlé's presence in and strong demand from the high-growth EMs (which account for c. 40% of sales) has helped it (and Unilever) outperform its peers including Danone and Procter & Gamble in EMs.
- **Pfizer acquisition:** Nestlé is in the process of acquiring Pfizer's infant formula business for \$11.85bn (EUR9bn), subject to regulatory approval. The deal has been filed in 15 countries and cleared by authorities in 10, while Mexico has rejected it. Combining both companies' infant formula businesses will result in Nestlé dominating the market in up to 10 countries (Saudi Arabia, South Africa, Chile, Philippines, Hong Kong, Venezuela, Colombia, Egypt and possibly Britain). Thus, Nestlé will likely be forced to re-sell between 20%-40% of Pfizer's business. Pfizer's infant formula division made profit margins of 25% for FY11, an EBITDA of \$500mn on sales of \$2.2bn with Nestlé predicting an EBITDA of \$600mn for FY12 and saving \$160mn over the next two-to four-years if the deal is completed. Previously, Mead Johnson was the biggest instant formula producer with a 20% global market share, followed by Nestlé and Danone (between 18-20% each). However, if the deal goes ahead Nestlé will become the global leader in terms of market share, global brands and market penetration. Nestlé has said it expects the market to grow by 19% between 2010 and 2016. Pfizer's nutritional business operates in 60 countries with 85% of its sales in EMs and according to Nestlé this was one of the key attractions, as it offers increased scale in this high-growth, high-margin sector which is growing especially quickly in EMs.
- **China:** With a rising middle class in China expanding their tastes and becoming more interested in on-the-go foods and as dairy consumption in the Chinese market is expected to grow 43% by 2019 as its population of 1.3bn are viewing dairy proteins as an essential part of their kids' diet, there is significant opportunity for Nestlé to expand and profit in China. In 2011 it bought a 60% stake in Chinese candy company, Hsu Fu Chi, for \$1.7bn after acquiring a 60% stake in China's Yinlu Foods, maker of peanut milk and rice porridge. Speaking at a news conference following the release of 3Q12 results Nestlé Chief Executive Paul Bulcke noted that China was not meeting potential, but that he was optimistic for its future growth. Although the Chinese economy grew 7.4% in 3Q12, a sharp slowdown from previous years, provinces in China have a higher GDP than some emerging and developed economies. According to Bulcke "when a country's GDP goes up like China's...that's where we should grow..". He predicted double-digit growth for Nestlé in China in 2013.
- **Popularly Positioned Products (PPPs)** - PPPs meet specific needs of about 3bn consumers with lower income levels, many of whom are entering into the cash economy and buying branded goods for the first time. As such, PPPs are adapted in terms of nutritional composition, price, accessibility and format to meet the specific requirements of these consumers. Nestlé has reiterated its commitment to PPPs, one of its key growth drivers.

- **Ability to pass on price increases:** Nestlé manufactures a wide variety of consumer staples targeting the mass market where consumption has remained relatively stable. At the same time the company's dominant market position in terms of key products allows it some leeway in increasing prices and passing on costs to consumers. This has resulted in the group's operating margins remaining relatively stable during the global financial crisis and the commodity price boom.

Conclusion:

Nestlé has a significant global footprint with a much wider global reach than most of its competitors. However, besides its significant presence in high-growth EMs, Nestlé also has excellent (and well-known) brands. Thirty of its individual brands generate more than \$1bn in sales each year. In terms of brand weakness probably the worst criticism that can be leveled against Nestlé is that it has not come up with new product innovations and it has only made marginal changes to its older products. Nevertheless, the company also has an enormous collection of slow-to-moderate-growing businesses that churn out cash through growth and price increases, which management then returns to shareholders in the form of dividends and share buybacks. The group's growing dividend is an excellent way to benefit from the business, with Nestlé paying an always growing 3.3% cash dividend yield (Unilever and Danone pay a lower cash yield). We believe Nestlé is a stable cash flow generator which is growing hand-in-hand with the emerging middle class in countries such as Brazil, China and India, while at the same time carefully managing its cost structure. The company's diverse business line makes it less vulnerable to government regulations. Given the huge range of established products the company offers, its financial strength and pricing power are also unparalleled.

Nestlé is also growing faster and has a much wider global reach than its European peers while the company is trading at about 17x estimated 12m fwd P/E, broadly in line with Unilever and Danone. Although it might look slightly expensive on a 12m fwd P/E basis there aren't many companies around that have Nestlé's global reach, exceptional management and phenomenal brands and, in our view, Nestlé is an excellent addition to any long-term portfolio.

Nestlé vs peers P/E and DY comparatives

Name	Currency	Price	12M fwd P/E	Trailing DY	12M fwd DY	Mkt cap (mn)
Danone	EUR	49.90	17.8	2.6	3.0	30 310
Nestlé	CHF	64.15	17.3	3.3	3.5	206 871
Unilever	GBp	2 545.00	17.3	3.2	3.5	75 717

Source: Bloomberg, Yahoo Finance, Anchor Capital

Nestlé will release full-year results on Thursday, 14 February 2013.

Marco de Matos



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