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Nestlé: CEO & CFO Unplugged…an exclusive Q&A with Paul Bulcke and Wan Ling Martello

Ticker	Rating	CUR	26 Sep 2014 Closing Price	Target Price	YTD Rel. Perf.	EPS 2013A	EPS 2014E	EPS 2015E	P/E 2013A	P/E 2014E	P/E 2015E	Yield
NESN.VX	O	CHF	69.60	78.00	4.4%	3.50	3.54	3.94	19.9	19.7	17.6	3.2%
NSRGY	O	USD	73.38	85.00	-7.6%	3.92	3.90	4.35	18.7	18.8	16.9	3.2%
MSDLE15			1384.94			86.48	91.52	103.17	16.0	15.1	13.4	3.2%
SPX			1982.85			108.62	117.36	131.47	18.3	16.9	15.1	1.9%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

Highlights

- We recently hosted Paul Bulcke and Wan Ling Martello, CEO and CFO of Nestlé, for an exclusive Q&A session/conference call. We have held a number of "CEO Unplugged" calls with our European Food & HPC CEOs but this was our inaugural "CEO & CFO Unplugged" call. This report contains the transcript.
- We believe we covered most of the key current controversies concerning Nestlé, and, while there was clearly no groundbreaking news (which we could not really expect in this forum) here is a summary of 12 key takeaways, with a few selected quotes from Bulcke and Martello...
  - ***A strong relationship between the CEO and CFO.*** The chemistry, ready repartee and mutual respect between Bulcke and Martello was clearly apparent. It was interesting how well they complement each other which was great to see given the importance of the relationship between any CEO and CFO, and given that we do not have many opportunities to see them naturally side-by-side.
  - ***The biggest challenges are focus and making choices.*** After joking that his biggest challenge was "*to learn how to work with Wan Ling*" Bulcke explained that he tries to keep a long-term focus while dealing with short term challenges and delivering short term performance. Additionally, both Bulcke and Martello highlighted that Nestlé will be defined not just by what it chooses to do, but also by what it chooses not to do...so where it accelerates and where it pulls back are key.
  - ***Food & Beverages continues to be Nestlé's key priority.*** However, through Nestlé Health Science and Nestlé Skin Science, Nestlé is exploring opportunities and building for the future on two strategically aligned and complementary platforms…and extending the boundaries of nutrition through science.
  - ***Current market conditions remain tough.*** There was no comment on short-term trading, but Bulcke did comment that the EMs are softer than they used to be and the DMs have not yet picked up...*"it is a tough world out there"*. But, while these challenges make it harder to consistently achieve the Nestlé model (5-6% top-line growth, margin and EPS growth in constant FX, improved capital efficiency) we sensed an air of optimism and determination, with the CEO commenting "*we have more headwinds, we just have to wake up half an hour earlier*".
  - ***The dynamics in the US remain difficult.*** The US is a tough market with low consumer confidence, but it continues to have fantastic growth potential. Nestlé may be losing share in some categories, but this is partly due to Nestlé actively backing off from certain categories which do not add value given the high levels of deals...Nestlé does not want to participate in categories that will destroy value.

European Food

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– ***There is still further runway for margin growth.*** Despite close to top-of-class margins, Martello insisted that Nestlé's margins are not close to any natural limit. She sees a lot of potential for growth through further innovation and mix improvement, pulling back on commoditised categories, increasing premiumisation in the EMs, leveraging scale, etc.

– ***The composition of media spend is changing in a digital world.*** Nestlé's consumer facing investment is increasing, despite increased efficiency, reflecting the changing nature of Nestlé's products...more value-added, science based products require more communication. Meanwhile social media provides new ways to connect with customers and e-commerce is increasingly important too. This is particularly true in the EMs which are adapting quickly. In some regions the market is jumping over the traditional distribution stages: rather than having stores on every corner the market is going straight to e-commerce, so there are advantages to being the prime mover here.

– ***Working capital improvements are sustainable and can continue.*** Many investors appreciate Nestlé's renewed focus on the importance of cash, evidenced by strong improvements in working capital over recent years, driven by the introduction of working capital and free cash flow metrics as part of management's short-term bonus targets. Martello's comments highlight how important this metric is to management: "*we are talking about it...whether it is the finance folks or the operational people…at every executive board meeting...so there is clearly a focus on working capital"* and she believes the improvements are sustainable and insists *"we will continue to improve"*.

– ***Nestlé has not closed the door on two important strands of Nutrition.*** Nestlé has previously described the four areas of Nutrition as Infant Nutrition, Medical Nutrition, Performance Nutrition and Weight Management. But, despite selling Power Bar (Performance Nutrition) and Jenny Craig (Weight Management), Bulcke made it clear that this does not mean Nestlé has exited two of the four areas...he highlighted that Nestlé continues to operate within Weight Management via its Lean Cuisine brand, and does not have to operate in every single category within the various areas of Nutrition: "*when we say weight management we do not want to embrace everything that has to do with weight management – the business model has to fit our DNA"*.

– ***We should expect further divestments.*** Despite a number of divestments recently, Martello asserted that this is *"definitely ongoing"*. Nestlé is defined not only by what it does, but also by what it does not do. It does not want to be involved in categories where it cannot win or do as well as it would like to. But, similarly, if it can improve a business and extract value, it will not simply sell it.

– ***The L'Oréal stake has a strategic dimension.*** With respect to Nestlé's 23% stake in L'Oréal, Bulcke's comments were quite limited, but he highlighted that the relationship has been "*productive"* and "*enriching*" for both companies. He also commented that the stake has a certain strategic dimension given the size of the interest plus the length of time Nestlé has held this investment (40 years).

– ***Share buybacks are ad hoc rather than routine.*** Nestlé's priorities for use of cash are investing in the future (via R&D, brand building, increasing capacity), ensuring sufficient flexibility for M&A; and ensuring a consistent dividend policy for its investors. Only once these priorities have been met will it consider further share buybacks. Given the conditions that must first be met before a buyback, they cannot be routine, and therefore must be ad hoc.

Investment Conclusion

Nestlé has historically demonstrated its ability to deliver strong, consistent, stable operating performance over the long-term. Yet some short-term weakness in 2012 and 2013 has led to concerns that Nestlé had lost its way…but we now see positive momentum across most operating metrics and more reasonable relative valuations vs. the time of our downgrade in 2011. We upgraded Nestlé from Market-Perform to Outperform in April, and we have a price target of CHF78.

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Details

Set out below is the full transcript of our recent exclusive Q&A conference call with Paul Bulcke (CEO) and Wan Ling Martello (CFO) of Nestlé.

Note: The transcript has been slightly edited (with the addition/removal of some words) in order to ease reading, but is substantially the same as the live call.

Andrew Wood, Sanford C. Bernstein

Good afternoon everybody, and welcome to Sanford Bernstein's 11th Annual Pan-European Strategic Decisions Conference (SDC) in London. I am Andrew Wood, Bernstein's European Food and HPC Analyst, and I have with me today Paul Bulcke, the CEO of Nestlé and Wan Ling Martello, the CFO of Nestlé.

Nestlé as a company does not need much of an introduction, but I am still going to give a little one. It is the world's largest Food and Beverage company, the largest consumer staples company in the world, and, currently, the 4th biggest company in Europe in terms of market cap. Its operating performance has been very strong for quite some time...it has averaged +6% organic growth since 2000 and grown its margins by +25bps per year over that period of time...very much in-line with the Nestlé model, which is 5-6% top-line growth per annum, growing earnings and margins in constant FX and improving capital efficiency.

This is the 9th time that Nestlé have been at our Strategic Decisions Conference in the 11 years that we have been holding it. The only 2 occasions they did not come was because there was a Board meeting at precisely the same time. So, this year, I am pleased to have both Paul and Wan Ling with me. Paul has been the CEO of Nestlé since 2008, having been with Nestlé for over 35 years. Wan Ling has been the CFO since 2011, and has therefore been at Nestlé for less than 3 years. She joined from Wal-Mart.

I have 15 questions to go through today. They are a mixture of my questions and questions that I have been asked to ask by investors. Hopefully we will get through them over the next 45-50 minutes. I will ask my questions in 5 broad areas: management, strategy, top-line growth, margins and cash.

So, let us start with a very generic question. Paul, you have been the CEO now for 6 years...what has been the biggest challenge that you have had over those 6 years, and, looking forward, what is the biggest challenge still ahead of you?

Paul Bulcke, CEO, Nestlé

Andrew, thank you. Good to be back. We both came to your conference this year because we had to compensate for the two years we did not come.

The biggest challenge I had was to learn how to work with Wan Ling! Seriously though, it is always hard to say "the most challenging thing"...but I took over 6 years ago as CEO, at the same time as the financial crisis. And it is a long crisis...it is still here. Everybody talks about that, and I do believe we have selective memory, but still. To keep the long-term perspective for a company like ours, and yet having these pressures that are inducing short-termism is a challenge...to stay with the long-term course, to stay with the strategy. You have to adapt some things, yes; you have to give certain things new priorities because of externalities that are conditioning your environment...but you have to stay on course, stay on the line you want to walk, and keep that going. There are 10,000 reasons to soften for some things...do not do that. I think that is a big challenge, and that is actually my job...to keep the framing, to give strategic direction, and to continue building for the future...and yet, at the same time, deliver in the short-term too. That is the challenge.

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And future challenges...the industry. Our industry, Food and Beverages, and society and societal issues such as non-communicable diseases...and being pushed in a corner that you do not want to be in, because apparently it is all your fault. And actually, we see that we are a big part of the solution. You see what the Food and Beverage industry has done...starting with the industrial revolution many, many years ago. And the intention to handle this over the long-term is something that is on my agenda.

Andrew Wood, Sanford C. Bernstein

I understand that Nestlé's rules on age limit will force Peter Brabeck-Letmathe to retire as Chairman in 2017. Is there any chance that these age limits might change? And, if not, in 3 years' time, is it conceivable the Board asks you to become the Chairman? Or is the joint role of Chairman and CEO a possibility, as Peter once was? Then, related to that, how is the succession planning for your role coming along?

Paul Bulcke, CEO, Nestlé

Quite a few questions and quite a few speculations there. Indeed, 72 years is something that is fixed by us. That is a very respectable age, if you think about it...although because of our society at 72 you are still young. But that is 3 years out...3 years with many things to do. I love what I do. There are so many things to do, so I will leave it there.

Andrew Wood, Sanford C. Bernstein

Let us move to Wan Ling then...we will get an answer out of Wan Ling. You have been with Nestlé since 2011, a much shorter time than Paul, obviously. What has been the biggest challenge that you have experienced as you have moved into Nestlé? What is your biggest challenge going forward?

Wan Ling Martello, CFO, Nestlé

Unlike Paul, working with Paul has not been the biggest challenge, even though he can be very hard work.

It is amazing...it has been almost 3 years and a lot of credit is due to the organisation because I have never felt like an outsider from day one.

We celebrate 150 years in 2 years, and I would say the great thing about Nestlé is the breadth and depth of categories and products and its geographic footprint, with operations in some 180 countries and we sell everywhere. So one of the challenges that we always have or, rather, something that we always have to stay focused on, is what Paul calls "making choices"...because we will be shaped and we will be defined not just by what we choose to do, but also by what we choose not to do. So, where do we accelerate? Where do we pull back? So, making choices is obviously a challenge.

But the other thing is what Paul touched on a little bit. We are obviously a company known to be very long-term, or to have a very long-term orientation. So, balancing the short-term and the long-term is the notion that Paul always talks about...Nestlé being an "and" company. We cannot allow people to come in and say "I can deliver top-line, but not the bottom-line". It is top-line and bottom-line; it is developed markets and emerging markets. So, it is about balancing what might, for some, appear to be trade-offs.

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Andrew Wood, Sanford C. Bernstein

Moving onto strategy. Your strategy, both organically and through M&A, is very focused on Nutrition, Health and Wellness. Recent deals, including the acquisition of Novartis Medical Nutrition and the full acquisition of Galderma, have allowed you to establish two fairly independent subsidiaries, Nestlé Health Science and Nestlé Skin Science...which I have always felt takes Nestlé further into a blending of Food, Pharma and HPC. I frequently get questions from investors that this is moving Nestlé too far away from Food...and too close to those adjacent industries. How do you see this strategic evolution...both today, and in the future?

Paul Bulcke, CEO, Nestlé

First of all, we are not moving from or towards that...we are just complementing and adding growth platforms for the future that are complementing our strategic direction. Nestlé is all about enhancing people's quality of life, through Nutrition, Health and Wellness. And we are going to do that driven by a permanent and more science-based innovation. That is what we are...quality of life; Nutrition, Health and Wellness; science-based innovation.

We do that with Food and Beverages big time. You have to maintain proportions of things, too. We were CHF92 billion in sales last year, of which CHF90 billion was Food and Beverages. So, that agenda has to be translated in Food and Beverages. That is what we do with our famous 60/40+...driving taste while balancing it with nutritional augments such as vitamins and minerals, better formulations, more nutrients. That is big time what we are.

It is also thanks to the needs of society, aging and many other needs…and thanks to science…that there is a new area forming. It is not a market yet, but it is going to be a big market...and a company like ours can really play there because we can bridge the today with tomorrow. That is Nestlé Health Science...extending the boundaries of Nutrition.

And then there is Skin. Skin, to a certain extent, is the biggest barometer of your health status. That is how you feel. There are many scientific platforms that are converging with nutrients and how you nurture your skin. So, that is another platform. We had 50% of Galderma, and we had the possibility to bring it back in. So, we said, longer-term that is going to be part of enhancing the quality of life, Nutrition, Health and Wellness…and that is a science-driven business that we have there.

So, what we do is care about our main business, Food and Beverages...yet, explore and build for the future on two platforms that are so close to our strategic direction. So, for me, it just makes coherent sense.

Andrew Wood, Sanford C. Bernstein

A couple of years ago, you described the four areas of Nestlé's focus on Nutrition as being Infant Nutrition, Medical Nutrition, Performance (or Sports) Nutrition and Weight Management. Since then you have actually disposed of your Performance Nutrition business (Power Bar) and your Weight Management business (Jenny Craig). Firstly, what happened...was there something inherently problematic in these areas of Nutrition...or were there business-specific issues, and might the door open to a return to these areas in the future?

Paul Bulcke, CEO, Nestlé

Well, we never closed the door. We did not sell the businesses or categories per se. We sold two brands, two businesses linked to that...because Nestlé Nutrition is all about specific solutions for specific needs.

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Infant Nutrition...infants and babies have specific needs. Weight Management...there are specific weight management needs and Jenny Craig was an answer to that. But we still have Weight Management...we have Lean Cuisine, we have many areas where we reduce calorie content. Medical Nutrition...we found it was so big that we have Nestlé Health Science built specifically for it.

So, there is little bit of pragmatism with which we go about that. So we did not engage with the specific needs. And actually, we are now engaging even deeper with aging population through other, different platforms. We sold these two brands because we felt they were better served in the hands of people who have the DNA to manage that kind of business model, which was a little bit harder for Nestlé...that is why. It is also pragmatism. When we say Weight Management, we do not want to embrace everything that has to do with Weight Management. The business model has to fit our DNA.

Andrew Wood, Sanford C. Bernstein

So, your view is that you have not actually left those businesses?

Paul Bulcke, CEO, Nestlé

Not whatsoever, no, because Nestlé Nutrition was nutrition specially engineered for specific needs...infants, aging, etc. We are going to play it through different businesses that we have now.

Andrew Wood, Sanford C. Bernstein

And then a further move into those areas is still a possibility?

Paul Bulcke, CEO, Nestlé

Always.

Andrew Wood, Sanford C. Bernstein

I have got another question for Wan Ling, although I am sure Paul might have a point of view as well. The Nestlé Model of 5-6% top-line growth, improvement in margins and earnings, and improved capital efficiency is now very entrenched and understood both internally and, I think, externally. Over time, has this model become easier or harder for Nestlé to achieve? And which aspects of the model do you think Nestlé might have to work hardest to achieve consistently over the next 5-10 years...which are the toughest of those challenges?

Wan Ling Martello, CFO, Nestlé

It is interesting, Andrew, that is actually a question I get a lot from investors as I go on road shows, and I also sometimes get the same question internally, from our own colleagues. First of all, it is interesting because...should that not be everybody's model? I mean, growing the top-line nicely, improving bottom-line margin and improving capital efficiency.

We actually think there is a lot of runway for the Nestlé Model.

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First I will step back...Nestlé has a great track record of moving up the value chain. It was not even 10 years ago – Paul, correct me if I am wrong here – that we were the biggest seller of canned tomatoes. Was it Contadina?

Paul Bulcke, CEO, Nestlé

More than 10 years ago.

Wan Ling Martello, CFO, Nestlé

More than 10 years ago. So, we continue to move up…from Food and Beverage going onto Nutrition, Health and Wellness...and so, increasing value to the consumer. You can therefore grow faster and get better margins.

We also have a very good track record in terms of research-based, science-based products. Take a commodity like coffee (you cannot get more of a commodity than coffee) and yet we were able to transform coffee drinking to something like a Nespresso or a Nescafé Dolce Gusto. So, we have got a track record for that.

The other thing too is if you think about great global companies, what they do well is knowing local consumers really well, and Paul always talks about privileging our business through decentralisation. So, we do that. The thing that we can step up and do more is leveraging globally. That is something that we will be doing more, and so that should also help in terms of allowing us to continue to have a lot of runway for all elements of the Nestlé Model.

Paul Bulcke, CEO, Nestlé

But on that model, you asked us is it harder? It is harder. It is a crisis out there, there are no tailwinds.

First of all on the Nestlé Model, we are privileged that you call it the Nestlé Model...it is the basic model of success of a company. You call it the Nestlé Model, so that is really flattering.

The 5-6% line is the boundary you want to walk over time. We do not want to do that every quarter, every minute, every day. It is a line we want to walk, because it is linked with a logic. Where in the world is a market growing all the time? Markets have ups and downs. But actually the model was how we framed our internal aims, and we have been explicit and quite transparent and we shared it with the outside world and then it started to be named the "Nestlé Model".

But, it is clear that even if you have headwinds, I am the last to say to an organisation like Nestlé, or it is not my style to say, let us give this a sabbatical. You may do that because you have many reasons and explanations, but if you do that in an organisation that is decentralised like our company you will get in trouble, because you may get what you wish for, or aim for.

That is why we keep the strength. I always said, if we have more headwinds, we are going to wake up half an hour earlier. Or we are going to step harder on the wheels. And that is a little bit why we stick to it. But it is harder, yes it is.

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Andrew Wood, Sanford C. Bernstein

I do have a slightly shorter term question for you now. Nestlé has traditionally delivered double-digit growth in the emerging markets...even this slowed to +8% in H1 2013. Since then, you have delivered once again, +10% in H2 2013 and +10% in H1 2014...suggesting that growth has picked up a little bit in these markets, despite all of the talk of an emerging market slowdown. What are you currently seeing in these markets? Are there signs of a slight recovery? Is low double-digits growth a sustainable level of growth going forward for your business?

Paul Bulcke, CEO, Nestlé

These are difficult questions, because emerging markets...what is that? That is an aggregation of countries...and these countries have ups and downs, and actually we are lucky to be a company that is present in all these markets, because it levels out. But in the years to come, half of worldwide growth is going to come from developed markets...what shall we do then? Always talk about emerging markets? That is why we always say we are an "and" company. That is why we kept focus on the developed markets through innovation, through new ideas, and we always had growth...through the whole crisis, we never stopped growing in Europe.

Now, emerging markets are getting a little bit of a tailwind...that is true. When you have big countries like China growing at double-digits, even more than just double-digits...that is good to have. It gives you some possibilities to invest. Yet, we always knew that a country like China (but other countries too) that grew at 15-17%...the social fabric of a country does not follow that growth. Economical growth should be followed at the same time with societal growth, the middle class has to adapt and adjust. So, at the end of the day, there is some balancing out here of things.

There is quite a lot of softening though in big chunks because China, through all that growth, has become a certain weight now. Now, it may be lower growth, but they say it is still 7-7.5%. But, first of all, we do not sell GDPs, so in other words we do not use that as a yardstick for judging us...we have to do better, or more. But, that is a sizeable growth on a much bigger size already. So, you have to see how you level things out. Emerging markets are 44-45% of our sales now. Why? Because we also embrace the developed markets. But, what you are hearing from other companies...we are living in the same environment. It is not an easy world out there...the emerging markets are a little bit softer than we used to have, and the developed markets have not picked up yet. Our aim is to go after what we intend to do…outperform the market, and that is what we are looking for.

Andrew Wood, Sanford C. Bernstein

So the markets are slowing, but your outperformance is therefore increasing?

Paul Bulcke, CEO, Nestlé

We are looking for that, Andrew. It is a tough world out there.

Andrew Wood, Sanford C. Bernstein

You mentioned the developed markets. I want to ask you a question about the US, which has been tougher than most.

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Paul Bulcke, CEO, Nestlé

You see, your question is going to be it is a difficult market.

Andrew Wood, Sanford C. Bernstein

Yes, the most difficult, including for Nestlé. Our work on market data suggests that you have been losing share in many of your categories in the US...why is that? It is not just a market issue...Nestlé has actually been losing share. What measures are you putting in place to track that, and to turn that around, and how long will it be before you get the US back on track?

Paul Bulcke, CEO, Nestlé

There are two reasons on the market shares to get that part sorted. First of all, you measure part of retail. So, when you measure part of retail we may be growing on the other side. As you do not measure that, I can tell you that as you are not going to check on me. But it is true that you have to watch what you measure, and then we can have an interesting discussion. But that is one thing, because we have quite a lot of our sales going into special channels or convenience stores that are not as covered as they should be.

Secondly, in certain categories we backed off from going on deal. When you start having categories that are going on deal for 80%, watch out what you do here. You go into value destruction mode or commoditisation mode. That is where we backed off, and we are going for part of re-segmenting certain parts. If you measure the same category, you are losing market share, but that is intentional for value. So, you actually segment more.

But, the US is a tough market too. Consumer confidence is down. You see it and you hear it...you hear it over and over again. We used to see the US, when they had a crisis, rebound pretty fast. That is what the US was...they would spend themselves out of trouble. But this crisis is a little bit deeper…and it is going to take more time. Also, if you see the leadership there, it is not really inspiring. So, that is the environment there.

But I truly believe the US has fantastic growth potential...the population is young and growing, there is entrepreneurship...so this is a country where we believe there is going to be a much brighter future in, maybe a little bit longer, maybe a few more years.

Andrew Wood, Sanford C. Bernstein

One specific area that people have been worried about has been your Frozen Ready Meals business in the US. What are its prospects there? Is that a category issue, or is that a Nestlé issue?

Paul Bulcke, CEO, Nestlé

It is a combination, because we are very important in that category, so there is a coincidence there. The category is actually questioned in the sense of, is that a real thing? But I think it is the best way of providing freshness for food, and we have to do a better job there in transmitting that category as such, and us in that category. We must say, when I said backing off on deal that was partly there. We have to watch out that that whole category is not commoditising. We want to go after the part that is added value-driven. So, we are a little bit in between two chairs right now, and it is an issue. But there are solutions coming in. This has been an issue now for 2-3 years, so we have been working on it. But, you do not just turn that huge category just like that. So, it is going to take some time.

Andrew Wood, Sanford C. Bernstein

We are about halfway through the questions, and we are about halfway through the time. So we are doing quite well.

Now, a question on China. You bought Wyeth Nutrition for $12 billion. It was the biggest acquisition, I think, Nestlé has ever made... indeed beating Ralston Purina. Obviously, that has a heavy focus on China, with one-third of sales over there. And there have been a number of issues in Infant Milk Formula in China over the last 12-15 months (not related to Nestlé...but accusations of price fixing, bribery claims, product safety, and so on in the market). The market growth has deteriorated quite dramatically from strong double-digits down to low single-digits. Some data even suggests negative growth. How concerned are you about this market and your businesses? Are these just transitory issues before we see a return to growth?

Wan Ling Martello, CFO, Nestlé

First of all, it was not $12 billion, it was $11.85 billion. It has been two years now with the Wyeth Nutrition acquisition and I am very happy to report that it has met and exceeded our expectations. And you are right...a big percentage of that business is in China.

First of all, let me step back and say that any acquisition target that we pursue has to check three boxes: a) there has to be a strategic rationale, and in this case you cannot get more strategic than being in a category where Nestlé was born out of, Infant Nutrition; b) financially it makes sense; and c) culture...and I cannot emphasise that enough, and we see it in the Wyeth Nutrition example. Our colleagues from Wyeth Nutrition feel very much at home within the Nestlé organisation. So, that is a big reason why it is doing really well.

For Infant Nutrition in general, but China specifically...we continue to grow, we continue to gain share. That speaks to the fact that when we bought the business, we had very complementary benefit platforms. So, whether it is brain health or it is gut comfort, it complements very well. We have product lines in that category that meet the different consumer segments. So, whether it is imported products, or it is locally manufactured, all of those come into play. Then, as a corporate citizen in China, we have been and continue to be part of the solution vs. part of the problem. So we are happy with that.

Paul Bulcke, CEO, Nestlé

I let Wan Ling answer that because after only a few weeks in the job, that was her first task...and not a small one. Actually the culture of Wyeth Nutrition was so close to us, that you see John Cheung, who was leading Wyeth in China and Asia, is now our market head in China...and that is the second biggest market we have. So, that was a fantastic deal. We brought together but did not mix up anything...so it is fantastic how they complement each other and how they reconfirm what we are all about...Nutrition, Health and Wellness. What a better expression than in embracing that with infants, where a healthy life starts.

Andrew Wood, Sanford C. Bernstein

I would like to move track now and talk about media spend...marketing spend and brand support. Many companies, and yourselves as well, have been commentating that they are spending more on digital media in the new digital world and perhaps spending less on traditional media. I am just interested where you think the equilibrium might be between traditional and digital? Many companies are suggesting that the move to digital is providing a good opportunity to reduce their media spend because digital seems to be cheaper or more efficient...do you concur, or do you think that companies will end up eventually just spending the same, but just differently?

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Paul Bulcke, CEO, Nestlé

First of all, where is the equilibrium? There is no such thing as a stable equilibrium. It is like a bicycle...only in equilibrium when it moves. This is the dynamic. You have to also look at what the consumer is doing? We are using it to get something. Actually, 2-3 years ago in London, part of my presentation was about how Nestlé goes to digital, and how we use it. We called it ROBBI, which is Return on Brand Building Investment.

Yes, indeed, you can get efficiency, but from communication you get engagement, you get dialogue. That is the new consumer...he just does not want to listen, he wants to talk, he wants interaction. So, you are seeing how we have to engage with our new consumers, changing. Is that to reduce costs? If you are a first mover, daring to do some things, you get a good return. That is why our consumer-facing investment is increasing in spite of that increased efficiency. Also, because our product mix is changing...the more value-added, the more science you have in your product, the more you have to communicate to connect.

So, it is just not measurable and it is just the dynamics of wanting to be the prime mover in many things there too. I really believe in this whole thing and we said one of our priorities was digital. Digital has two dimensions...social media and all these new ways of connecting with consumers, and then also e-commerce. And I really feel that e-commerce is an extremely important channel, not in the developed world...I see it as a more important channel in the developing world, where they are going to jump stages. They are not going to have stores on every corner, but they are going to have e-commerce. If you have travelled around in Africa, you will understand what I mean. There is no infrastructure, no roads. E-commerce is the best way to get everywhere. So, these are the things we embrace, and the prime mover has a certain advantage. You may remember Kit Kat and Google, what we did there. These are little things that go a long, long way.

Andrew Wood, Sanford C. Bernstein

Another question for Wan Ling. Nestlé's margins have been growing consistently over many years, as I mentioned. A number of your peers actually have seen their margins contract recently. Now you have margins over 16%, and you are close to top-of-class in the Global Food industry. Is there a natural limit as to how high margins can go? Are you close? Presumably you will say not, so what will be the drivers of your margin growth going forward?

Wan Ling Martello, CFO, Nestlé

Well, thanks for the acknowledgement and the compliment. We cannot get 100% margins.

But my answer is along the same lines as my answer to your question about the Nestlé Model…if we continue to grow in a healthy fashion and continue to innovate (with Food and Beverage going down the path of Nutrition, Health and Wellness) but also pull back in categories where we just cannot add a lot more (and walk away from the categories that are commoditised). We also need to leverage scale. These would be the things that we can continue to do to improve our margin. Like I said before, I see a lot of runway.

Andrew Wood, Sanford C. Bernstein

And how about emerging markets margins...is there more runway there from increased scale, would you say?

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Wan Ling Martello, CFO, Nestlé

The thing that is interesting is we are seeing our consumers increasing their demand for premium products in our emerging markets. So, that is an interesting dynamic to see.

Andrew Wood, Sanford C. Bernstein

And e-commerce...is that margin-enhancing as well?

Paul Bulcke, CEO, Nestlé

Well, we have to see. E-commerce has so many faces, so many dimensions. Again, I would not say we have to go to e-commerce because then we save. You are going to have competition. You are going to have also costs of that. But anyhow, it is a channel to connect and sell, and so it is always a combination. It is for growth and margin.

Is there a limit for margin? There is always a limit, but we should not talk about that...there is still upside. We have our Nestlé Continuous Excellence program, and part of that is to drop down costs, just as Wan Ling has said. But there is a fundamental thing too: we are living in a riskier place...higher risk, higher margin.

Andrew Wood, Sanford C. Bernstein

I am going to move on to cash and working capital now, which I know is a topic that is close to Wan Ling's heart. Historically, Nestlé has trailed its peers in terms of working capital management.

Paul Bulcke, CEO, Nestlé

That is not true.

Andrew Wood, Sanford C. Bernstein

On my figures.

However, in the last couple of years, coinciding with Wan Ling's appointment, there has been a sudden and dramatic reduction in your working capital...and this continued into H1 2014. What specifically has driven this change...is it a change in mentality, a change in process, or a change of incentives? And, perhaps much more importantly, is that sustainable and are there further improvements to come, Wan Ling?

Wan Ling Martello, CFO, Nestlé

First let me answer the last bit of your question. Is it sustainable? Absolutely.

You look at working capital at a point in time. For instance, we report working capital in the first half or end of the year, and sometimes that can be distorting. But I can tell you that, absolutely, we continue to improve working capital as a percentage of sales. That is because the organisation continues to be very focused on it from an operational standpoint.

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Now, it is really interesting because this is an organisation that is amazing to watch in terms of alignment. Once every two years we have a Market Manager Conference. When we, as an Executive Board, and the CEO says "look, this is what we are going to focus on", it is amazing to watch 330,000 people line up and march to the priorities. And, so we did, from an incentive standpoint, two years ago, change to free cash flow, actually. So it is not just working capital, but also free cash flow is an element of people's short-term bonus.

We are talking about it...whether it is the finance folks or the operational people; we talk about it at every Executive Board meeting. So, there is clearly a focus on working capital.

Andrew Wood, Sanford C. Bernstein

Are there more opportunities for improvements from here?

Wan Ling Martello, CFO, Nestlé

Yes, we will continue to improve.

Paul Bulcke, CEO, Nestlé

You have to watch out there again, because you make a snapshot at the end of the year. The high season in the Southern Hemisphere is in December, and if you have a one-week-earlier summer, you have stock. So, I always said you have to work efficiently with working capital. And you also have to watch out with working capital. Suppliers can help a lot there…but then your margin may suffer, and you just said that we have a nice, handsome margin. So, these are the things you have to combine…it is an "and" dimension. But, you are totally right…that is one of the focus areas. You have sharpened the pen in Nestlé to really go after that and systematise it. So, credit to you.

But, I remember when I came to Nestlé, with an inflation in Latin America of something like 1000% a month, I can tell you working capital was very high on the agenda, too, at the time.

You can hardly have everything on the same priority, but it is important. Cash is important.

Andrew Wood, Sanford C. Bernstein

You mentioned free cash flow as being a target. And, obviously, working capital plays a role in that. Capital expenditure does as well. Are you being more stringent in assessing projects? How are you achieving that?

Wan Ling Martello, CFO, Nestlé

Yes, we have always had the cell methodology, but what we have done is introduce capital to the denominator of that equation. So, it is not just growth and margin, but also in terms of return. We look at what we are doing not just in terms of allocation of capital in the front-end, whether it is capital expenditure, R&D or marketing. We have stepped up to being a lot more discerning in terms of allocating at the front-end...but, we are also doing the back-end. We have always had it...it is just that now we are doing it on every single project. Whether it is capital expenditure or M&A, we are doing post-project evaluation or post-acquisition audits. So, lessons learned...we are doing it both front-end and back-end.

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Paul Bulcke, CEO, Nestlé

It is resource efficiency as we call it. It is an interesting thing, resource efficiency. Capital is a resource...capital efficiency. But so is management time...that is why we say why would we lose so much time on laggards? Be it marketing spend or resources or management time. Resource efficiency has a fundamental concept in an organisation as a very useful thing that we are really exploring, and capital is definitely one of the most important ones.

Andrew Wood, Sanford C. Bernstein

This is one of the most popular questions I was asked to ask by investors. Following the sale of 8% of L'Oréal's shares earlier this year, it appears investors still have a sense that Nestlé will sell its remaining 23% stake. So, it is a question of "when, not if". Can you give us a sense of the level of commitment Nestlé has to retaining its 23% stake in L'Oréal? Or, asking the question slightly differently, why do you feel €17 billion is better invested in L'Oréal vs. elsewhere in Nestlé or returned to shareholders?

Paul Bulcke, CEO, Nestlé

Look, our link with L'Oréal has been quite handsome financially, and the value is there. Now, when you have that amount of financial commitment in an organisation like that for so long...it is not only financial, there is a certain strategic dimension too. We have a sizeable interest, which is financial, and given the length of the time we have had that, almost 40 years, it is like a strategic link with the company. It has been enriching for both. This has been a very productive relationship. So, I will leave it there.

Andrew Wood, Sanford C. Bernstein

We have got a couple of questions left, so we are doing quite well.

One for Wan Ling, and talking about divestments, there has been quite some activity in the last year or so, again, coinciding with your appointment...the disposal of Power Bar and Jenny Craig, as I mentioned, and recently you announced the disposal of the Nestlé Waters Direct business in Europe. You have mentioned in the past that this is part of the process of cleaning up the business and improving returns...so I am intrigued if this is an ongoing process, or is there a finite timeline? More specifically, is there more news to come in this area?

Wan Ling Martello, CFO, Nestlé

Yes, it is definitely an ongoing process. Like I said earlier, we are defined by not just what we decide to do, but by what we decide not to do. So in categories where we just cannot win, or cannot win as much as we would like to, or cannot do as well as we would like to do...then it is time to let it go to somebody else.

But it is an ongoing process, and we will continue to do that. I get questions from investors...they go what about this, what about that? We also have to be prudent as we look at the divestiture process. When we have a challenged business, if we can improve it and extract better value, why divest it overnight? Let us do that, and do the right thing in terms of maximising the value we can get. But it is definitely an ongoing process.

Andrew Wood, Sanford C. Bernstein

There is more to come?

Wan Ling Martello, CFO, Nestlé

Yes.

Andrew Wood, Sanford C. Bernstein

One final question is related to share buybacks...another popular question from investors. Of course, a couple of months ago, you announced a CHF8 billion share buyback for 2014-15, which investors clearly appreciated. I was just wondering how you viewed this plan...would you say it is more ad hoc, or could it form part of a broader plan as you continue to make improvements in your working capital, improve your cash flow, continue to dispose of businesses, and re-assess your financial structure? What role do buybacks play at Nestlé into the medium-term?

Paul Bulcke, CEO, Nestlé

Well, I would say it is ad hoc. Because it is a decision at a certain moment of time, that is conditioned. Because, the first priority for cash is to invest in our future...that is investing in industrial setup, capacity, R&D and brand building. There is a huge amount of investment there, and that has priority because that is our continuum...that is our future. Then the next priority is to potentially invest in M&A, and to have the capacity to go after what we really think makes sense strategically and financially. Then, also we care about our investor base, which means we have a very consistent and explicit dividend policy. And, then if you still have a strong balance sheet, which we value, then when there is cash, then yes, we will do a share buyback. That is what we have done now. But, that is conditional on quite a few other things, so that is why we say it is not part of our strategy to have share buybacks every year. I do not believe that would be wise. So, we try to be wise.

Andrew Wood, Sanford C. Bernstein

Well, that is perfect timing. Time is up. Thanks, everybody.

Paul Bulcke, CEO, Nestlé

Thank you all. Thank you very much.

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Valuation Methodology

We value the Food sector at a 17.0x absolute PE. We then value each of the companies in the sector using an anticipated premium/discount to the sector multiple…derived from consideration of historical ratings and current growth dynamics. We then apply 24-month EPS to this company-specific multiple to derive our price targets.

Risks

The key downside risk to our price target on Nestlé would be a renewed and sustained downturn in organic growth driven by weakness in the US, Europe or the Emerging Markets. This could lead to weak margin and earnings growth too. Should this develop, investors could de-rate the stock in the medium-term.

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12-Month Rating History as of 09/28/2014

Ticker	Rating Changes	
NESN.VX	O (RC) 04/02/14	M (RC) 08/30/11
NSRGY	O (RC) 04/02/14	M (RC) 08/30/11

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated
Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

NESN.VX / Nestle SA

Date	Rating	Target(CHF)
06/24/11	O	64.00
08/30/11	M	52.00
01/11/12	M	55.00
04/04/12	M	58.00
07/05/12	M	60.00
10/10/12	M	65.00
01/14/13	M	65.50
04/16/13	M	71.00
07/03/13	M	67.50
04/02/14	O	78.00

NSRGY / Nestle SA

Date	Rating	Target(USD)
05/26/11	O	72.00
08/08/11	O	83.00
08/30/11	M	65.50
10/19/11	M	58.00
02/20/12	M	60.00
04/23/12	M	64.00
08/10/12	M	61.50
10/19/12	M	70.00
02/15/13	M	71.00
04/19/13	M	76.00
08/09/13	M	73.50
02/19/14	M	75.50
04/02/14	O	85.00

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