FLASH NOTE - NESTLÉ

MAY 8TH, 2019

Nestlé	
Ticker Site BiG	NESN
Ticker BiGlobal Trade	NESN
Ticker BT24	NESN
Ticker BiG Power Trade	NESN
P/E Ratio 2018E	22.61
P/BV Ratio	5.07
EV/EBITDA	15.19

Source: Bloomberg;

Price and Performance (Values in CHF)	
Price	97.80
52 week high	98.16
52 week low	72.92
YTD	22.6%
Average daily volume (un)	4,954,277
Market Capitalization (mn)	299,561
Beta	0.78
Dividend	2.45
EPS	3.36

Source: Bloomberg;

Analysts Consensus (last 3 months)	
Buy	18
Hold	12
Sell	2

Source: Bloomberg;

Financial Data	
Sales (CHF mn)	91,750
EBITDA (CHF mn)	17,676
Number of Employees	308,000
ROA	7.5%
ROE	17.1%
D/E	0.69
Dividend Yield	2.51%

Source: Bloomberg;

Notes:
All quotes were updated in Bloomberg at 08h32 of May 7th, 2019.

Relevant Information:
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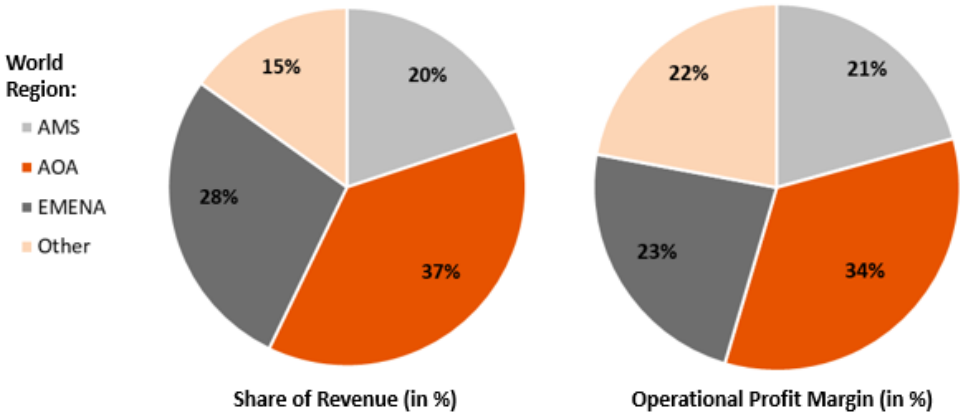
Nestlé (Ticker: NESN SA)

Description

Nestlé is a Swiss multinational company belonging to the Food and Beverage sector. Founded in 1866 it is, in the present, one of the largest food company in the world and one of the biggest companies in general. It is headquartered in Vevey, Switzerland. It employs more than 300000 people. As most companies in its sector, its success is due to the extent of its offering of products. It owns over 2000 different brands, spread through more than 150 countries, and just last year it created over 1300 new products. Its focus is on quality and innovation so as to build confidence with its consumers. Last year it spent CHF 1687mn in research and development. It is involved not only in the final stages of its products but throughout the supply chain (notably in its collaboration with cocoa plantations in Africa and South America).



Investment Points

- **Monopoly on Coffee –** Nestlé owns the brands Nespresso, Nescafé, Blue Bottle Coffee and has the perpetual rights to produce and commercialize Starbucks products.
- **Conglomerate Power, Innovation and Brands** – Nestlé is the world's biggest food and beverage company. Its brand is known throughout the world as a seal of quality allowing it to enter any markets and industries with immediate recognition. Its size and cash flows allow it acquire or disrupt any competition and to constantly innovate and create products, constantly adapting to new consumer trends.
- **Potential Growth** – Nestlé is already highly present in developing regions (such as China or India) and this strategic position will allow it to capture the extra profits that will come from these regions becoming more prosperous and being able to spend more in premium brands.
- **Operational Improvements** – Nestlé has plans to increase its underlying operating profit margin to 18% by 2020, from 16.5% in 2017. For this it has been improving the efficiency of administrative centers and operational logistics and cutting excessive workforce.
- **E-commerce** – This segment of Nestlé's business has already grown organically by 25% in 2018. It offers the possibility of greater margins with more customized products (as is the case of Tails.com) and less spending on storage and transports.

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Investment Case

Monopoly on Packaged Coffee Goods: With the recent acquisition of both the rights to sell Starbuck's products worldwide and the Blue Bottle Coffee company, and with the ownership of Nescafé and Nespresso, Nestlé has deeply consolidated its premium coffee offering, bringing together some of the most iconic brands. The Powdered and liquid beverages segment represents almost 25% of Nestlé's revenues already and have had a strong organic growth of 3.3% in the last year. Developing market's taste for coffee is growing and this could prove to be very profitable for Nestlé in the future. With the global market forecasted to grow between 4-5% into the future.

Conglomerate Power, Innovation and Diversification of Brands: Nestlé is the biggest conglomerate in the food and beverage sector. Its high market capitalization, large cash flows and low debt allow it to quickly acquire any potentially threatening competitors as well as continuously develop and produce new products to adapt to market preferences, divesting from brands that show weakness and investing on those that show growth. It owns thousands of brands and products which strongly diversifies it and protects against any risks. Furthermore, the sector as a whole is not prone to large disruptions, in the way that, for example, the tech sector is. Consumer's tastes do change but not quickly enough to jeopardize Nestlé's business model, in particular because they recognize Nestlé's brands as a seal of quality. Nestlé is, therefore, very likely to maintain or increase its size as it goes into the future being, therefore, an interesting long-term investment.

Growth Factors: Nestlé's business model is very connected to demographic factors in the regions it operates. While developed countries have entered a period of stability, with low levels of population increase, developing countries have created a great opportunity for Nestlé to grow. The two factors of high natality rates, which mean an increase in the consumer base (in particular because Nestlé focus a lot of its products on infants), together with an increase in quality of life and GDP per capita, which implies a likely larger willingness to spend on the type of premium products Nestlé offers, can greatly improve Nestlé's profits.

Increasing Profit Margins: Nestlé has committed to improving operational efficiency going into the future. It has increased its shared service centers from 17% to 35% with 50% planned for 2020, reducing its administrative costs. At the same time, it leveraged its size and scale further by sourcing 55% of the purchasing needs, for its products, through 3 global purchasing mega-hubs and planning to reach 60% by 2020. In the manufacturing it has also increased its capacity utilization. Due to this, in 2018 it increased underlying trading profit (which is a measure that best represents profits outside of non-operational events such as currency fluctuations) from 16.5% to 17% and it plans to reach 18% by 2020.

The Rise of E-commerce: Sales for the E-commerce business grew organically by +18% (+25% excluding Nespresso) and reached 7.4% of total Nestlé sales in 2018. Not only is this a business segment that is growing very quickly, especially in markets such as China, but it is also the perfect market for Nestlé to increase its profit margins further as the products can be better adapted to the consumer's specific characteristics. A perfect example of this is Tails.com, which profiles a consumer's pet and offers the most adequate product for it, making the consumer more willing to pay for the experience.

Share Buybacks and Dividends: Nestlé has a moderate dividend yield, which sits between 2% and 3%, with a payout ratio of 60%. However, it also performs a significant number of share buybacks. For example, during the year of 2018 it returned, in dividends and buybacks, over CHF 14 billion to shareholders (which represents a payment of around 4.7% of its market cap). It plans to continue this practice into the future with CHF 10 billion of share buybacks already committed until 2020.

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Income Statement (CHF mn.)	2018	2017
Revenues	**91439**	**89590**
Other Revenue	2,883	823
COGS	-46,070	-45,571
Distribution Expenses	-8,469	-8,023
Marketing and Administrative	-20,003	-19,818
R&D	-1,687	-1,739
Other Expenses	-4,341	-5,106
Operating Expenses	**-80570**	**-80257**
EBIT	**13752**	**10156**
Net Interest	-761	-696
EBT	**12991**	**9460**
Taxes	-3,439	-2,773
Others	916	824
Net Income	**10468**	**7511**
Earnings per share	**3.36**	**2.31**

Source: Company's data

Free Cash Flow (USD mn)	2018	2017
Operational Cash Flow	**15,398**	**14,199**
Operating Profit	13752	10156
Depreciation and amortization	3924	3934
Impairments	1248	3,582
Interest Paid	-684	-609
Interest and dividends Received	192	119
Taxes	(3,623)	(3,628)
Change Working Capital	472	(244)
Others	117	889
Investment Cash Flow	**(14,266)**	**(4,950)**
Capex	(4,470)	(4,707)
Net Treasury Investments Inflow	(5,159)	587
Acquisitions	(9,512)	(696)
Disposals	4,310	140
Others	565	(274)
Financial Cash Flow	**(4,117)**	**(9,084)**
Debt change	10,708	2,205
Share buyback	(6,854)	(3,295)
Dividends	(7,443)	(7,468)
Others	(528)	(526)
Change in free cash flow	**(2,985)**	**165**
Other and forex	**(313)**	**(217)**
Cash and equivalents at end	**4,640**	**7,938**

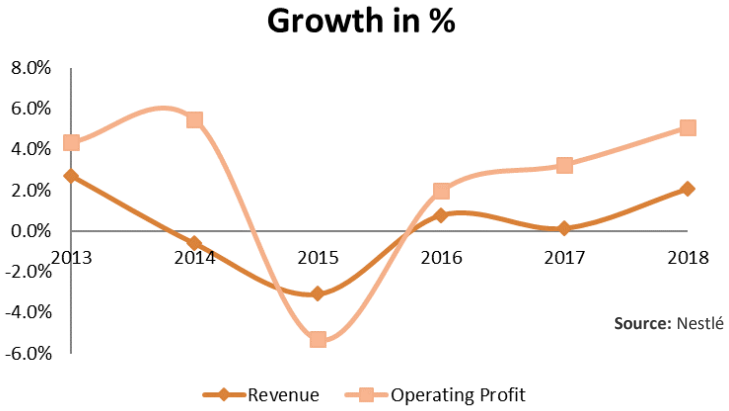
Source: Company's data

Balance Sheet (CHF millions)	2018	2017
Assets	**137015**	**133210**
Cash & Equivalents	4500	7938
Short term investments	5801	655
Goodwill	31702	29746
Receivables	11167	12036
Inventories	9125	9177
Property Plant & Equipment	29956	30777
Intangible Assets	18634	20615
Joint Ventures & Associates	10,792	11,628
Other Assets	15338	10638
Liabilities	**78612**	**70981**
Short term Debt	15142	11718
Long term Debt	25700	18566
Payables	17800	18864
Accrued Expenses	4075	4299
Other liabilities	15895	17534
Total Shareowner's Equity	**58403**	**62229**
Total Equity and Liabilities	**137015**	**133210**

Source: Company's data

Income Statement

Reported revenues increased by 2.1% in 2018 with internal operational profits increasing by 5.1%. Accounting operating profits, on the other hand, increased by more than 35% with net income increasing by 39%. These significant changes in the income statement came from the other revenues line which increased significantly due to the disposal of the US confectionary business and Gerber Life Insurance. Distribution expenses also increased, around 5%, due to higher water distribution costs. Effective tax rates decreased from 29% to 26% although paid taxes were higher due to a higher EBT.



Free Cash Flow

As discussed, Nestlé increased its operating profit significantly in 2018. However, this increase was not as significant on a cash flow basis. Operating cash flow, for example, only increased by 8.4%. Investment cash flow outflow, on the other hand, increased by almost 3 times when compared to 2017 due to the larger degree of acquisitions made by Nestlé. The inflow from disposals helped to contain this imbalance.

Balance Sheet

The increase in acquisitions has taken its toll on Nestlé's balance sheet. Long-term debt increased by 38% while short-term debt increased by 29%. Net debt is now sitting at CHF 30.3 billion. The ratio of net debt to EBITDA is now around 1.6, which is the highest in Nestlé's history.

Guidance

As of its most recent 3-month sale presentation, Nestlé estimates that it achieved a solid organic growth in sales of 3.4% YoY, for the first three months of 2019. As a comparison, the last 8 quarter organic growth averaged at 2.77%. The company also reports strong growth in the AMS and AOA region (with an averaged organic growth of 4.0%) with EMENA, on the other hand, only growing 2.0%. If only emerging markets are considered, the organic growth is 6.3%. Brazil, in particular, grew more than 10%, with China growing in the mid-single digits. As for operational improvements, management aims to reach an underlying operating profit margin of 17.5% in 2020 (the 2018 margin was 15%) by reducing structural costs and freeing up resources. The plan is also to continue to invest in high-growth categories and regions while embracing digital opportunities and trying to innovate its products.

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Management

Ulf Mark Schneider (CEO): The former CEO of Fresenius (a healthcare company) he joined Nestlé in early 2017. Ulf is an MBA graduate from Harvard. The aim in his appointment was to continue organic growth in the food and beverage products but also to expand Nestlé's small but highly profitable healthcare business (an example being skin health products). At the same time, to increase the pursuit of meaningful and prudent acquisitions across the world, as was the case with Starbucks products and Tails.com, as part of a business model of being a growing company.

The board is committed to executing a CHF 20 billion repurchase and dividend program.

Main Segments

Nestlé, as many companies in the Food & Beverage sector, offers a wide range of products that are hard to properly define, in particular, because it often offers unique products for the different regions it covers. Nonetheless, it can be segmented as such:

Powdered and liquid Beverages: (23% of sales, operational margin 21%, growth +6%) Represents the coffee, cocoa and malt beverages and tea categories. Some iconic brands within this segment are: *Nescafé*, *Nespresso* and *Milo*. It also includes the recently acquired perpetual global license for *Starbucks* consumer packaged goods and foodservice products. Nestlé strategy is the continuous development of country and market specific brands and products that appeal to specific tastes (an example of this is the increased offering of sugar-free products in the USA and Europe or the offering of ready-to-drink coffee products to the Chinese market). Nestlé has a strong branding and presence within this segment growing 6% last year in sales and 5.9% in operating profits. Forecasts for the future are also positive.

Nutrition and health science: (18% of sales, operational margin 17.5%, growth +6%) This segment includes nutritive drinks and food as well as baby food products. It has grown significantly in the last year, more than 6% in sales YoY, even with a decreased use of investment spending (reduced -8.43% YoY), and 11.3% in operating profits. This is mostly due to the strong growth within emerging markets. Focus is on the research and development of quality nutritional products. Examples of such are herbal supplements and fruit or plant drinks and products that appeal to new dietary tastes: non-GMO, gluten-free and vegan. For the baby food sub-segment examples are the S-26 brand, which has key nutrients to support brain development, or HMO powder, which replicates the immune system properties of natural breast milk and had a highly successful launch. People are willing to spend much more on baby food if they believe it will impact the health of their children which means better margins.

Milk products and ice cream: (14.5% of sales, margin 18%, growth -1.6%) It is composed of such brands as *Nido*, which sells ambient dairy products (stored at room temperature), and *Natural Bliss*, a brand of coffee creamers. It also includes a spectrum of different ice cream products, from affordable to premium brands such as *Häagen-Dazs*. This segment has been struggling to increase revenues with a YoY fall of -1.59% although with a positive increase in operating profits of 3.39% YoY.

PetCare: (14.0% of sales, margin 20%, growth +3.3%) A segment that is focused on pet food and pet dietary supplements (mainly cats and dogs). The *Purina* brands comprises multiple product offerings, from canned food for cats and dogs to probiotic dry food for digestive health. As before, focus is on ensuring product quality with significant research done on developing the best tasting and healthy products. There has also been a large focus on the e-commerce and Direct-to-Consumer side of the business. Example of this is the recent acquisition of a majority stake in the *Tails.com* website which offers a digital pet personalized business model. Performance has been moderate, with a 3.31% YoY

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growth, albeit at a decrease in operating profits of -1.87% YoY. As developed and developing regions grow more attentive to their pet's diet there is a case for continuous growth.

Prepared dishes and cooking aids: (13.2% of sales, margin 17%, growth +1%) A category which contains mostly pre-packaged food for retail. Examples are *Buitoni*, which offers quality packaged frozen pizza, or *Maggi*, who packages pastas, noodles, soup and local dishes. Innovation has come mostly from redesigning brands and offer more varied and higher quality products. With most of the market power coming from brand as a seal of quality. It is a hard segment on which to create business process innovation. Nonetheless, revenues have grown a moderate 1.06% YoY with a 5.47% YoY increase in operating profits.

Confectionery: (8.9% of sales, margin 16%, growth +3%) This segment contains food that is rich in sugar such as candies, chocolates and chewing gum. Nestlé owns the *KitKat* brand which has an almost worldwide presence. As before, it also tries to appropriately adapt these products to each market's respective tastes (offering, for example, chocolates with nuts and fruits in Brazil). It also strives for great visual differentiation in packaging. Despite the richness in sugar of these products, Nestlé has been developing healthier options, with reduced sugar or using substitutes. These products also suffer from strong seasonality (as they are less sough-after in the summer especially in warm climates). A divestiture of U.S. business has harmed revenues which have decreased by almost 9% YoY although operating profit has grown by 3.86%.

Water: (8.1% of sales, margin 8%, growth +0.4%) This segment offers not only regular clean water but different flavored drinks. Nestlé's *Pure Life* brand is the world's biggest bottled water brand. In the sparkling water business, premium brands *S.Pellegrino* and *Perrier* continue to enjoy a strong growth. Some new interesting product developments include bio-infused water, which preserves fruit's natural taste in the drink and functional mineral water, which replenishes mineral salts in the body. Kid friendly water bottles are also being tested on more than 15 countries. The water segment has suffered greatly due to high energy prices and distribution costs which led to low growth in revenues, 0.37% YoY change, and a significant decrease in operating profits of -34.1%.

M&A

Nestlé uses acquisitions as part of its growth strategy. In the last two years, it has done 10 different acquisitions of different sizes. Some of the most recent and significant ones are described below. Going into the future, Nestlé has its sights on possible key European markets acquisitions due to the disappointing growth in this market.

Atrium: Bought in the end of 2017 for USD 2.3 billion in cash. Atrium is a global leader in nutritional health products with sales of around USD 700 million. Its most well-known brand is Garden of Life which produces health focused vitamins, dietary supplements and herbal products and other products which are sold without prescription and are made with strictly organic materials.

Starbucks: Bought for USD 7.5 billion the exclusive rights to sell Starbucks packaged products, such as coffee and teas, worldwide. With the intention of increasing sales in the US and introducing these products in China. It must, however, pay royalties for product sales.

Terrafertil: With the aim of widening its presence in Latin America and its organic food offering, Nestlé bought Terrafertil for an undisclosed amount. Terrafertil produces unique products from Latin America in an organic manner with high levels of quality and nutrition.

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Blue Bottle Coffee: This California-based company sells specialty coffee directly to customers online and it also operates around 40 shops in the U.S. and it was purchased for USD 425 million. Its business model is somewhat similar to Starbucks.

Relative Valuation

Nestlé is not very attractive in terms of P/E as it is above average when compared to peers. The dividend yield is also slightly below average, which is bad. However, in terms of its net debt to EBITDA it is quite lower than its peers which is good. Margins are also slightly above average.

Ticker	Name	Country	Market Cap (mn)	Currency	P/E 2019E	Div. Yield	1 Yr. Price Δ	NetDebt/ EBITDA	Margin EBITDA
KHC US Equity	KRAFT HEINZ CO/THE	UNITED STATES	39,961	USD	11.2	6.9%	-44.3%	4.8	24.8%
MDLZ US Equity	MONDELEZ INTERNATIONAL INC-A	UNITED STATES	74,326	USD	19.2	1.9%	33.4%	4.6	15.7%
HRL US Equity	HORMEL FOODS CORP	UNITED STATES	21,106	USD	20.4	2.0%	10.9%	0.1	14.2%
KO US Equity	COCA-COLA CO/THE	UNITED STATES	206,779	USD	21.4	3.2%	15.0%	2.7	37.0%
PEP US Equity	PEPSICO INC	UNITED STATES	178,410	USD	21.3	2.9%	29.6%	2.1	19.6%
ABF LN Equity	ASSOCIATED BRITISH FOODS PLC	BRITAIN	20,196	GBp	16.7	1.8%	-5.7%	-0.2	11.6%
KYGa LN Equity	KERRY GROUP PLC-A	IRELAND	17,820	EUR	23.7	0.7%	13.5%	2.0	13.3%
BN FP Equity	DANONE	FRANCE	49,625	EUR	17.2	2.7%	11.1%	2.9	17.6%
GIS US Equity	GENERAL MILLS INC	UNITED STATES	30,808	USD	15.6	3.8%	21.5%	4.8	18.1%
MKC US Equity	MCCORMICK & CO-NON VTG SHRS	UNITED STATES	20,199	USD	27.0	1.4%	47.2%	4.3	19.8%
K US Equity	KELLOGG CO	UNITED STATES	19,545	USD	14.0	3.9%	-5.1%	4.5	15.3%
CPB US Equity	CAMPBELL SOUP CO	UNITED STATES	11,506	USD	15.0	3.7%	-6.9%	13.2	7.2%
NESN SW Equity	NESTLE SA-REG	SWITZERLAND	299,561	CHF	20.7	2.5%	26.1%	1.7	19.3%
	Average exc. Nestlé		66,476		18.6	2.9%	10.0%	3.8	17.9%

Source: Company's data

Risks

Bad Publicity: Nestlé has been deeply focusing on its public image throughout the last years. However, markets tend to punish companies with bad publicity more than they do those that act good. Nestlé has a long list of controversies: using forced child labor, deforestation of national parks, food contamination, etc. Nestlé is a massive conglomerate with various business entities and proper ethical oversight of all of these is complicated, particularly those in the developing world, one overlap could quickly turn public opinion against the firm and its products. Especially with the tendency of social media to build up sentiments very quickly. This also includes a risk for potential litigation.

The growth of E-commerce: While E-commerce has been positive for Nestlé, with the segment growing 18% last year, the increase in this method of shopping may impact Nestlé's ability to charge premium prices for its brands as clients can much more easily compare prices between different brands. A race to the bottom, as suppliers undercut each other, may be a reality.

Dependence on raw materials: Nestlé is reliant on a number of raw and packing materials. The most relevant of these are: coffee, cocoa, dairy (the highest by volume), palm oil, paper, soya, sugar and grain. If any situation was to severely impact their price or availability (such as changes in weather or production patterns), Nestlé could suffer capacity constraints.

Macroeconomic Events: With businesses and factories spread throughout the world, Nestlé has a significant exposure to various macroeconomic events. Large movements in currencies, interest rates and costs of capital could impact results. Furthermore, Nestlé is also exposed to political events such as wars, natural disasters, tariffs and regulatory actions (as was the case recently when India banned Maggi noodles, Nestlé's highest revenue earner in the region, as it alleged it contained excess chemicals).

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Rating		
Agency	**Rating**	**Outlook**
S&P	AA-	STABLE
Moody's	Aa2	NEG
Fitch	AA-	NEG

Source: Bloomberg

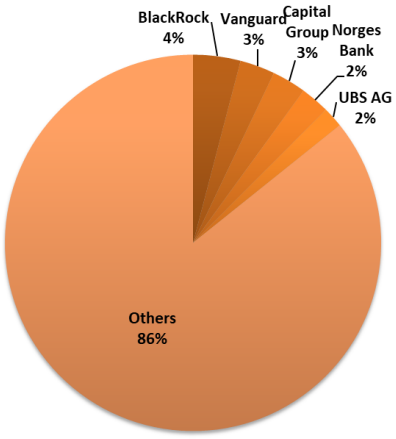
Graph

Source: BiGlobal Trade (partner Saxo Bank); BiG Research

Calendar

July 26th, 2019: 2Q19 earnings
October 17th, 2019: Nine-month sales

Shareholders



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• Clarification of the qualitative terms implied in the recommendations:
○ Buy, expected absolute return above 15%;
○ Accumulate, expected absolute return between +5% and +15%;
○ Keep/Neutral, expected absolute return between -5% and +5%;
○ Reduce, expected absolute return between -5% and -15%;
○ Sell, expected absolute return below -15%;
The investment framework aforementioned is merely indicative and not globally strict.

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• The update of the investment recommendations models and respective price-targets will occur, usually, in a period of 6 to 12 months.

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• The records of the investment recommendations of the Research Team are provided below. The detailed external consultation of the respective performances may be provided if so requested.

PSI20 Notes in the last 12 months as of 31st of December of 2018:

	Number of Recomendations	%
Accumulate/Buy	2	66,7%
Keep/Neutral	1	33,3%
Reduce/Sell	0	0,0%
Total	3	100,0%

Trading Ideas in the last 12 months as of 31st of December of 2018:

	Number of Recomendations	%
Profit Taking	9	56,3%
Stop Loss	7	43,8%
In Place	0	0,0%
Total	16	100,0%

Pair Trades in the last 12 months as of 31st of December of 2018:

	Number of Recomendations	%
Profit Taking	0	0%
Stop Loss	0	0%
In Place	0	0%
Total	0	0%

Source: BiG Research

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