Nestlé

Hold

Food & Beverage/Switzerland

7 March 2002

Rating changes

New	Hold
Old	Hold
Price target	400

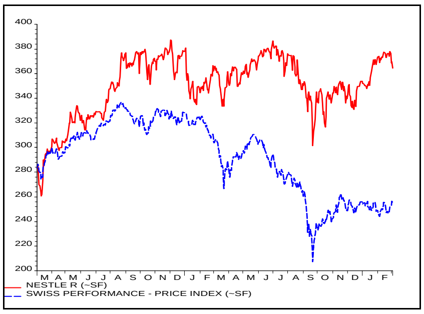
EPS changes

	2001	2002E	2003E
New	17.2	15.7	18.0
Old	17.2	15.7	18.0

Stock market data

Price (CHF)			366
Market cap. (CHFm)			141'882
Free float (%)			100
SPI			4380
Reuters/Bloomberg		NESZn	NESN
Perf. abs. (%)	1m -3	3m 3	12m 1
Perf. rel. (SPI,%)	1m -4	3m 3	12m 13

Performance



Source: Datastream

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Earnings data

	2000	2001E	2002E	2003E	2004E	2005E
Sales	81422	84698	93930	100036	106838	114103
EBITDA	12560	12515	14384	15973	17653	19281
EPS	14.9	17.2	15.7	18.0	20.9	23.6
EV/EBITDA	11.2	12.4	10.7	9.5	8.4	7.4
P/E	24.5	21.2	23.4	20.4	17.5	15.5
Dividend per share	5.5	6.4	7.0	7.6	8.4	9.4
Dividend yield (%)	1.5	1.7	1.9	2.1	2.3	2.6
P/B (2002E)	3.6		CAGR EPS (2000-2005E)			9.6%
ROE (2002E)	16		PEG (2001E)			2.2

Nestlé is outpacing its peers

The same picture as in H1 2001

Nestlé's FY 2001 result showed exactly the same picture as in H1 2001. Nestlé reported an impressive volume growth, net profit was stronger than we expected, but the strong volume growth did not fight its way through to the trading profit.

A fairly convincing result

The volume growth of 4.4% was outstanding, especially compared to its peers (Danone: 3.2%, Unilever 2.1%). In 2001 Nestlé overtook Danone as the company with the highest volume growth. Given Nestlé's broad geographical and category portfolio and its strong focus on growth areas such as water, nutrition, pet care and ice cream, we see no reason why Nestlé's volume growth should not outperform its peers in the coming years as well. On the other hand, the strong growth rate was not reflected in the trading profit. Granted, the bare EBIT figure was somewhat disappointing, but especially given the difficult economic environment the quality was nevertheless fairly convincing. The much lower than expected tax rate – which is only about 40% sustainable – has lead to a positive surprise in net profit.

Nestlé is our European sector favourite

Nestlé's major themes in 2002 are among others the IPO of Alcon, the integration of Ralston Purina and Schoeller and the different cost-savings programmes. The outlook for Nestlé remains sound. But we have to bear in mind that in the short term especially the GLOBE project will run up costs before it produces benefits, which could have a psychologically negative impact. In addition, there is a short-term risk that the integration of Ralston Purina and Schoeller will not run smoothly in every aspect. We believe the food sector as a whole is fairly valued and we cannot see much upside potential. Therefore we recommend underweighting the sector in our Industry Group Allocation. Taking into account Nestlé's outstanding top-line growth and its potential for significant cost savings over the next few years, Nestlé remains our European sector favourite. We reiterate our Hold rating with a price target of CHF 400.

Equity Note

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Equity Note

Activity

Nestlé is the world's largest foodstuffs producer. The company pursues a portfolio strategy across diversified lines of business. It aims to become or remain number one or number two in terms of market share in most of the markets where it has a presence. Nestlé is in a process of evolution. The company is on the way to focusing more on growth categories such as water, ice cream, pet care and food services and is selling off some low-growth activities. In 2001 Nestlé generated 93.9 % of revenue and 88.9 % of operating profit from the sale of foodstuffs. The other stakes are in pharmaceutical products. The Pharma division mainly consists of Alcon, the world's biggest manufacturer of ophthalmic products and Galderma, a joint venture between Nestlé and L'Oréal that specialises in dermatological products. Through its 49 % stake in the holding company Gesparal, Nestlé also owns outside the foodstuffs sectors 26.3 % of L'Oréal's share capital.

By the end of 2001, Nestlé operated 468 factories in 81(E) countries, generated about 30 % of revenue in emerging markets and earned about 40 % of sales with the Nestlé brand.

Nestlé's strategic priorities are focused on delivering shareholder value through the achievement of sustainable, capital efficient and profitable long-term growth.

Nestlé's sale split

	2000	H1	9M	2001	2002E
Real internal growth	4.4	4.6	4.2	4.4	4.0
Selling prices	1.0	5.5	5.5	5.3	1.5
Exchange rate	5.0	-2.7	-3.7	-4.7	-2.7
Acquisitions/Disposals	-1.3	-1.1	-1.1	-1.0	8.1
Total	9.1	6.3	4.9	4.0	10.9

Source: Nestlé, Sarasin

Outstanding RIG

Nestlé surprised the markets with a very strong volume growth (RIG) of 4.4%. Consensus estimates were clearly expecting a slower rate of growth in Q4. But Nestlé was able to enhance the rate to 4.9% in Q4 compared to a rate of 4.2% after 9 months. This is especially impressive given the strong base from the previous year and compared to its peers, which noted a slowdown in Q4. The impact of disposals of –1% and exchange rates of –4.7% was in line with our expectations. Selling prices increased by 5.3%, of which the one-time influence of the trade spend review was 3.3%.

Good performance in America

From a geographic standpoint, the biggest surprise was the strong growth in North America. There, the RIG bounced back from 1.6% after nine moths to 3.4% for the full year, implying that Nestlé obtained a RIG of about 8.8% despite weak petfood sales, slowing demand in foodservice and the negative impact of the loss of the Ben & Jerry ice cream distribution contract. But according to the management, Nestlé benefited strongly from a change in consumer behaviour after the September 11 attack. Americans are staying at home and spending their money in the supermarkets instead of going to restaurants and tourism. In the region South America, the sales development was also satisfying given the difficult economic situation. A strong performance stems especially from Brazil where RIG 2001 was 5.2% vs. 2.0% in 2000. On the other hand, the weaker economy squeezed Mexico's RIG from 9.5% in 2000 to 2.7% in 2000. Western Europe benefited from a RIG recovery in Germany. In the UK, the business was still hit by the launch of Procter & Gamble's pet food business IAMS. In Eastern Europe the RIG was still high, at 14.1% in 2001. Nestlé's management stated that Eastern Europe has also enjoyed strong growth in the current year to date. The zone AOA benefited from a strong performance in China, Africa and several Asian markets. Given the disappointing development of the Japanese economy, the slowdown of the RIG in Japan from 3.6% in 2000 to 1.5% comes as no surprise. The other activities continued to perform strongly, especially noticeable is the strong performance of the joint ventures in Q4.

RIG by geographic area

	2000	9m01	2001
Food Europe	2.5	1.9	2.1
- Western Europe	1.6	1.0	1.2
- Eastern Europe	18.0	14.8	14.1
Food Americas	4.4	2.9	3.9
- North America	3.5	1.6	3.4
- South America	5.8	4.7	4.7
Food Asia, Africa & Oceania	6.0	6.1	5.6
Others Activities	6.9	8.3	8.0
- Water	5.7	7.3	7.1
- Alcon	7.1	9.7	9.2
- Joint ventures	8.2	5.5	8.2
Total	4.4	4.2	4.4

Source: Nestlé, Sarasin

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The RIG of Chocolate was a sweet surprise

In Beverages, Nestlé suffered somewhat from the weaker food service sales, but the RIG growth rate remained stable with an increase of 5.8%. Particularly impressive was the RIG of 16.3% of bottled water in the United States, the market where its competitors Danone got into trouble due to stiff competition from Coca-Cola and PepsiCo. In the Milk / Nutrition division there was still an impact from a negative RIG in Ice Cream. That is attributable to the loss of the Ben & Jerry ice cream distribution contract. In Culinary, the flat RIG of Pet care attracts attention. The cause of the disappointing development in Pet care was weak volume growth, especially in the UK and in the USA where the business was hit by the launch of Procter & Gamble's pet food business IAMS or where the previous year's introduction of IAMS still had a negative impact. The Chocolate/Confectionery division benefited from a good performance in Chocolate. With a worldwide increase in chocolate consumption of roughly 2%, Nestlé has gained market share, with a RIG of 4.4%. Nestlé took advantage of its strong position in Russia, where it was able to increase the RIG in Chocolate by 13%. Pharma was able to maintain its strong performance.

RIG by product group

	2000	9m01	2001
Beverages	5.6	6.1	5.8
Milk / Nutrition	3.2	3.6	3.5
Culinary	4.0	1.9	2.9
Chocolate / Confectionery	1.7	3.0	3.7
Pharma	7.3	9.1	9.2
Total	4.4	4.2	4.4

Source: Nestlé, Sarasin

Best in class

All in all, the volume growth was outstanding, especially compared to its peers. In 2001 Nestlé overtook Danone as the company with the highest volume growth. Given Nestlé's broad geographical and category portfolio and its strong focus on growth areas such as water, nutrition, pet care and ice cream, we see no reason why Nestlé's volume growth rate should not outperform its peers in the coming years as well.

Peer comparison 2001

	Volume	Price	Total
Cadbury Schweppes	1.9	1.9	3.8
Danone	3.2	1.9	5.1
Nestlé	4.4	2.0	6.4
Unilever	2.1	2.0	4.1

Source: Companies, Sarasin

Operating profit somewhat disappointing

The trading profit was not as convincing as the rest of the income statement. EBIT was up 0.3% to CHF 9 218m, in line with our estimates but well below the market consensus. The EBIT margin dipped from 11.3% to 10.9% but was stable after the rebooking of the trade spends. The cost of the GLOBE project has amounted to CHF 250m. Excluding the GLOBE costs, EBIT would have increased by 3.1%. Nevertheless, given the stronger than expected volume growth, the operating margin was somewhat disappointing. Obviously, as in H1 2001 the strong volume growth did not fight its way through to the trading profit. But we also have to bear in mind that the result was achieved in a difficult economic environment.

Quality not poor

The quality of the trading profit is not poor. Nestlé was once more able to reduce the **cost of goods sold** as a percentage of sales by 70 basis points (all comparisons on a like-for-like basis after the rebooking of the trade spend). The cost-savings programme Market Heads 97 produced an additional saving of CHF 900m in 2001, easily outstripping the original target of CHF 600m. On the other hand, the higher milk and packaging prices had a negative effect.

Distribution costs rose by 70bp mainly due to higher energy costs in H1 and the strong growth of distribution-intensive businesses such as water and ice cream. The distribution costs of bottled water are, at 17% of sales, more than twice the group average, while those in the Home & Office segment are double again. Nestlé also tries to reduce the influence of third-party distributors and get closer to the consumer.

R & D costs increased by a remarkable 20bp, although they are comparatively small compared to total costs.

Marketing and administration costs dropped by 10bp. Positive was the proportioning that administra-

Equity Note

tion costs declined by 40bp but marketing expenses rose by 30bp. Media spend decreased slightly.

The examination of all these figures shows that a bulk of the maybe somewhat disappointing development of the EBIT margin can be attributed to investment in the future. To sum up, the bare EBIT figure was a little disappointing, but the quality is fairly convincing.

Development of EBITA & EBIT margins

	1999	2000	2001	2002E	2003E
EBITA margin	11.1	11.8	11.5	12.0	12.5
EBIT margin	10.6	11.3	10.9	10.5	11.1

Source: Nestlé, Sarasin

Net profit supported by one-time items

The net profit increase of 15.9% exceeded our expectations of 9.6%. Beside the somewhat better financial result, the main factor responsible for this positive earnings surprise was the much lower than expected tax rate, which plunged from 33.1% to 27.7%. In H1 the tax rate already was surprisingly low, at 29.4%. But we have to bear in mind that according to Nestlé only about 40% of this decrease is sustainable in the future. In addition, the income from associated companies rose by 35.4%. The reasons were another strong result from L'Oréal, the increased stake in Dreyer's (ice cream) and the fact that Dalmayr (coffee) is new put in with the associated companies. But again there is an underlying one-time positive impact. Nestlé benefited from disposals made by L'Oréal.

Cash flow: Improvement compared to H1

A major concern in the H1 result was the drop in the operating cash flow of 24%. The cause was the substantial increase in working capital of CHF 2.56bn. Now, the situation for the full year has clearly improved. The decrease in the operating cash flow is only 2.7%, and the increase in working capital fell to CHF 870m. Capital expenditures increased as a percentage of sales from 4.1% in 2000 to 4.3% in 2001. Nestlé's management communicated that there should be no further increase in the coming years.

Outlook

Nestlé expects the current year to deliver a continued positive trend for its business. According to Nestlé, economic indicators point to an overall acceleration in North America as well as in parts of Europe. Further on Nestlé said that Latin America, some isolated areas excepted, appears to be making progress, whilst the economic situation in most of Asia is satisfactory. As usual, the only published financial target is the 4% RIG objective.

Short-term risk: Ralston Purina integration

One source of disappointment this year could be that the Schoeller and especially the Ralston Purina integration may not run as smoothly as expected in every aspect. With Schoeller, the risk is small because Nestlé will leave it as an independent unit until the summer. The motive is that the height of the ice cream season is approaching and that the integration can be completed better in the low season. The Ralston Purina integration was a major subject at the Analyst presentation on 5 March in Zurich. Although the management was very optimistic that it can push through the integration without any friction, we are not as optimistic. Granted, the management had plenty of time to prepare the integration. But we have to keep in mind that it is an immense challenge and that almost no integration can be carried out without any friction. Recent examples are among others Danone (United Biscuits), PepsiCo (Quaker Oats), General Mills (Pillsbury). In addition, Nestlé's own pet care business was under pressure this year from the stiff competition.

IPO Alcon

As announced in October 2001, Nestlé will undertake an IPO of a minority stake in Alcon, its wholly-owned eye care business. At the moment, the IPO process is under way. The offering will be completed by the end of the first quarter of 2002. After the IPO there will be 300m shares outstanding. Nestlé currently estimates that the IPO price will be between USD 31 and USD 35 per common share. The announcement of the offer price will be on 20 March. A share price of between USD 31 and USD 35 would give a market capitalization of between USD 9.3bn and 10.5bn. Calculated at the current USD exchange rate of 1.6975 and adding the net debt of USD 1.6bn, this gives an enterprise value of between CHF 18.5 and CHF 20.6bn, which is more or less in line with our expectations. In our Equity Note of 5 November 2001 we estimated an enterprise value of CHF 21.4bn.

Enterprise value Alcon (in m)

	Market cap. in USD m	Net debt in USD m	EV* in CHF m
Share price USD 31	9 300	1 624	18 543
Share price USD 35	10 500	1 624	20 580
*CHF/USD 1.6975			

Source: Sarasin

What is the effect of the IPO on Nestlé? Alcon's profitability is above average, but it is somewhat hidden within the Nestlé group. The IPO will thereby improve the visibility of its true value. We have not yet included in our estimates the impact of the partial IPO of Alcon. In the income statement there will be an impact on the net financing cost, the net non-trading items (almost tax-free capital gain) and the minority interests, but there will be no impact on the trading profit because Alcon will remain fully consolidated. We will integrate the impact of the IPO as soon as we have more details such as the offering price, date of execution etc.

Cost-savings programmes

Another major theme is the different cost-savings programmes in 2002. In 1997 Nestlé introduced the very successful cost-savings programme Market Head 97. This programme has squeezed the cost of goods sold by CHF 4bn since its launch. At the beginning of this year Market Head 97 was replaced by the Target 2004 cost-savings programme, which according to Nestlé should produce total cost savings of at least CHF 1.5bn from 2004 onwards. Very important for Nestlé is the GLOBE business project, which will cost an average CHF 250m per year until 2006, while the benefits should reach roughly CHF 3bn by 2006. With both the restructuring programmes "GLOBE" and "Target 204", the underlying idea is that the company can be managed more centrally and systems can be more standardised. Further down the line, Nestlé wants to eliminate costs of 1% of sales by improving white-collar productivity with the programme "Fitness". All in all, Nestlé wants to eliminate costs of more than CHF 5bn from 2006 ownwards. Experiences show that about 30% of the savings find their way down to the bottom line, the rest is absorbed by the retailers and the consumers. We also have to bear in mind that in short term especially the GLOBE project will run up costs before it produces benefits, which could have a psychologically negative impact.

Costs and savings from GLOBE, Target 2004 and Fitness in CHF m

Name	2001E	2002E	2003E	2004E	2005E	2006E
GLOBE's cumulative costs*	500	1000	1500	2000	2500	3000
- of which incremental*	250	500	750	1000	1250	1500
GLOBE's cumulative benefits*	0	0	100	400	1200	3000
Target 2004 cumulative costs**		300	600	900		
Target 2004's cumulative benefits*		500	1000	1500		
Fitness cumulative benefits		250	500	750	1000	1000
Cost of goods sold in % of sales	44.6	43.6	43.1	42.8	42.3	41.8
Mark. & Adm. costs in % of sales	34.7	34.9	35.0	35.1	35.2	35.3
EBITA-margin (%)	11.5	12.0	12.5	13.0	13.4	13.9

Source: Sarasin

* Nestlé estimates or estimated from points of graph from a Nestlé presentation
** is equivalent to Nestlé's sustainable restructuring costs

A Chocolate acquisition in Brazil

With the 2001 results, Nestlé simultaneously announced the purchase of Brazilian chocolate and confectionery manufacturer Garoto. The company generates yearly sales of slightly more than CHF 310m. The deal would increase Nestlé's chocolate market share in Brazil from the current 30% to more than 50%. Due to this dominant market share, the acquisition is to be referred to the Brazilian competition authorities. The competitors in the Brazilian chocolate market are Kraft and Hershey.

What we expect

According to our estimates, sales should rise by 10.9% in 2002 mainly due to the impact of acquisitions. We forecast a RIG of 4%. Anyway, the consolidation of the main acquisitions (Ralston Purina, Schoeller and the 50% stake in Ice cream Partners USA) will influence the whole financial statements in 2002. We expect that Nestlé can enhance its EBITA by 15.7% despite an increase in restructuring costs from CHF 275m to CHF 498m. The increase in EBIT will be substantially lower due to the rise in amortisation of goodwill of 175%. We forecast an increase in EBIT of 7.1% and a consequently a drop in the EBIT margin from 10.9% to 10.5%. Net financial costs will also increase substantially to CHF 1.28bn, in parallel with the tax rate, which will pick up again from 27.7% to 33.8%. A part of the increase is attributable to the one-time effect in 2001, the other part to the fact that goodwill amortisation is almost not tax deductible. That all leads to a net profit forecast of CHF 6.1bn, which is equivalent to a decline of 9.1%.

Valuation

We believe the Food sector as a whole is fairly valued and we cannot see much upside potential. Therefore we recommend underweighting the sector in our Industry Group Allocation.

We explicitly prefer Nestlé to Unilever and Danone at the moment. All three are valued at about the same level on 2003 estimates. Taking into account Nestlé's broad geographical and category portfolio and its strong focus on growth areas such as water, nutrition, pet care and ice cream, it should trade at a premium to Unilever and Danone. A further argument to support this statement is that Danone faces different company-specific problems, while Unilever's forecasting risk is in our opinion substantially higher mainly due to its ambitious restructuring measures.

We have adjusted our estimates after the announcement of the result 2001 and the analyst presentation, but there was only a slightly impact on the bottom line. We reiterate our Hold rating. We have increased our price target to CHF 400 from CHF 380, reaffirming our confidence in Nestlé, although we believe the Food sector as a whole is fairly valued and we cannot see much upside potential.

Valuation comparison

	P/E 2003E	P/E b. Am. 2003E	EV/EBITDA 2003E
Nestlé	20.4x	16.9x	9.5x
Unilever	30.1x	18.5x	10.2x
Danone	19.8x	17.1x	9.1x
Cadbury Schweppes	15.1x	13.8x	8.2x

Source: Sarasin

Next announcements

- 11 April: First quarter 2002 sales figures & Ordinary General Meeting
- 21 August: Half-year results 2002
- 24 October: Nine months 2002 sales figures

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Equity Note

P&L account

CHFm	2000	2001E	%	2002E	%	2003E	%	2004E	%	2005E	%
Sales to customers	**81422**	**84698**	**4.0**	**93930**	**10.9**	**100036**	**6.5**	**106838**	**6.8**	**114103**	**6.8**
Cost of goods sold	38121	37756	-1.0	40954	8.5	43095	5.2	45673	6.0	48300	5.8
Distribution expenses	5884	6421	9.1	7176	11.8	7603	5.9	7906	4.0	8444	6.8
Marketing and administration expenses	26467	29372	11.0	32782	11.6	35012	6.8	37500	7.1	40164	7.1
Research and development costs	1038	1162	11.9	1287	10.7	1380	7.3	1496	8.3	1620	8.3
Restructuring costs	312	275	-11.9	498	81.1	407	-18.3	350	-14.0	339	-3.1
EBITA	**9600**	**9712**	**1.2**	**11234**	**15.7**	**12538**	**11.6**	**13913**	**11.0**	**15236**	**9.5**
Amortisation of goodwill	414	494	19.3	1360	175	1410	3.7	1440	2.1	1473	2.3
EBIT	**9186**	**9218**	**0.3**	**9874**	**7.1**	**11128**	**12.7**	**12473**	**12.1**	**13763**	**10.3**
Net financing costs	746	407	-45.4	1280	214	1100	-14.1	900	-18.2	690	-23.3
Net non-trading items	99	44	-56	-90	-305	15	-116.7	1	-93.3	1	0.0
EBT	**8341**	**8767**	**5.1**	**8684**	**-0.9**	**10013**	**15.3**	**11572**	**15.6**	**13072**	**13.0**
Taxes	2761	2429	-12.0	2935	20.8	3384	15.3	3853	13.9	4288	11.3
Net profit of consolidated companies	**5580**	**6338**	**13.6**	**5749**	**-9.3**	**6628**	**15.3**	**7718**	**16.4**	**8784**	**13.8**
Minorities	212	192	-9.4	220	14.6	255	15.9	290	13.7	355	22.4
Share of results of associated companies	395	535	35.4	542	1.3	590	8.9	660	11.9	725	9.8
Net profit	**5763**	**6681**	**15.9**	**6071**	**-9.1**	**6963**	**14.7**	**8088**	**16.2**	**9154**	**13.2**

Key figures

	2000	2001E	2002E	2003E	2004E	2005E
P/E	24.5	21.2	23.4	20.4	17.5	15.5
Dividend per share (%)	5.50	6.40	7.00	7.60	8.40	9.40
Dividend yield (%)	1.50	1.75	1.91	2.08	2.30	2.57
Pay-out-ratio (%)	36.9	37.1	44.7	42.3	40.3	39.8
Tax rate (%)	33.1	27.7	33.8	33.8	33.3	32.8
Gearing (%)	0.09	0.53	0.45	0.35	0.24	0.14
Operating margin (%)	11.3	10.9	10.5	11.1	11.8	12.1
EBITDA margin (%)	15.4	14.8	15.3	16.0	16.5	16.9
Net profit margin (%)	7.08	7.89	6.46	6.96	7.57	8.02

Cash flow statement

CHFm	2000	2001E	2002E	2003E	2004E	2005E
Net profit of consolidated companies	5580	6338	5749	6628	7718	8784
Depreciation of tangible fixed assets	2737	2581	2920	3200	3500	3800
Impairment of tangible fixed assets	223	222	230	235	240	245
Amortisation of goodwill	414	494	1360	1410	1440	1473
Depreciation of intangible assets	179	150	200	210	220	230
Impairment of goodwill	230	184	250	260	270	280
Increase in provisions and deferred taxes	-4	-92	-10	-10	-10	-10
Decrease in working capital	-368	-870	-600	-250	-325	-425
Other movements	-140	-393	-200	-205	-210	-215
Operating cash flow	**8851**	**8614**	**9899**	**11478**	**12843**	**14162**
Expenditure on tangible fixed assets	3305	3611	4039	4302	4594	4906
Expenditure on intangible assets	188	288	220	240	260	280
Sale of tangible fixed assets	355	263	150	150	150	150
Acquisitions	2846	18766	3000	2500	2500	2500
Disposals	780	484	1000	800	800	800
Income from associated companies	107	133	135	150	165	180
Other movements	39	143	1	1	1	1
Free cash flow	**3793**	**-13028**	**3926**	**5538**	**6605**	**7607**