



Nestlé

Good Food, Good Life

TO: MCINTIRE INVESTMENT INSTITUTE

FROM: ALEXIS HE

SUBJECT: MII Long Fund Election Memo

DATE: November 29, 2009



Good Food, Good Life

NESTLE S.A. (OTC: NSRGY)

RECOMMENDATION – LONG

The world's leading Health, Nutrition and Wellness company

I. FINANCIAL SUMMARY



Price (29 Oct 2009):	\$ 48.34
52-week Range:	\$ 29.12 – 50.19
EBIT Margin (08A):	14.3%
EV/EBITDA (x):	8.65
Market Cap:	176.4 B
Div & Yield (08A):	\$1.47/3.0%
PEG Ratio:	5.77
FCF Yield:	3.26%
Dbt to Equity (08A):	0.289
Net interest cover (x):	16.3
EPS (09E):	\$ 2.9
Sales Rev (09E):	\$ 108.77 B

NSRGY.PK against Consumer Staples Index and KFT (Kraft Foods Inc)

II. BUSINESS OVERVIEW

Nestle SA is a company engaged in the nutrition, health and wellness sectors. It is the holding company of the Nestle Group, which comprises subsidiaries, associated companies and joint ventures throughout the world. Nestlé products are manufactured by over 480 plants all over the world. It has such business units as Food and Beverage, Nestle Waters and Nestle Nutrition. It is also active in the pharmaceutical sector.

“Bite into a piece of chocolate, drink a glass of water, prepare your family's evening meal, end the evening with an ice cream and feed your baby, your dog or cat... There is every likelihood that, without realizing it, you have chosen a Nestlé product.” (Yahoo Finance)

Product categories & Brands

PREPARED DISHES AND COOKING AIDS Lean Cuisine, Hot Pockets, Maggi, Stouffer's, Thomy, Herta, and Buitoni; For professionals, Nestle owns Chef, Chef-Mate, Davigel Davifrais, Minor's, and Trio

BEVERAGES Drinks include Milo, Nescafe, Nesfrappe, Nescafe Takumi, Nescafe Xpress, and Nescau; Coffee types include Nescafe Cappuccino, Nescafe Classic, Nescafe Decaff, Nescafe Dolce Gusto, and Nescafe Gold

CONFECTIONERY Kit Kat (rights in U.S. owned by Hershey's), Butterfinger, Smarties, Wonka, Orion, Crunch, Cailler and Aero

ICE CREAM Antica Gelateria del Corso, Dibs, Dreyer's Edy's, Drumstick, Extreme, Haagen-Dazs, La Cremeria, Maxibon, Movenpick, Nero

WATER Arrowhead, Deer Park, Perrier, Poland Spring, Pure Life, S.Pellegrino, Vittel

PETCARE Alpo, Beneful, Cat Chow, Dog Chow, Fancy Feast, Felix, Friskies, Gourmet, One, Pro Plan

MILK PRODUCTS Cerevita, Coffee-Mate, La Laitiere, Nido; Cereals include Cheerios, Chocapic, Cini Minis, Cookie Crisp, Estrelitas, Fitness, and Nesquik

NUTRITION Boost, Clinutren, Impact, Jenny Craig, Nutren, Optifast, Peptamen, PowerBar, Resouce; Baby Foods include Gerber, Gerber Graduates, Cerelac, Mucilon, NaturNes, Nestum

PHARMA is mainly consisted of Alcon

Nestle also has numerous subsidiaries engaged in various areas of activity, including Alcon Ophthalmika GmbH (Austria), Alcon Bulgaria EOOD (Bulgaria) and Galderma Laboratorium GmbH (Germany) for pharmaceuticals; Novartis Nutrition GmbH (Austria) and Hjem-IS A/S (Denmark) for food and beverages, and Galderma International SAS (France) and Galderma Laboratorium GmbH (Germany) for health and beauty activities. In July 2008, Novartis AG acquired a 25% stake in Alcon, Inc. from Nestle SA. It also owns 28% of cosmetic giant L'Oreal.



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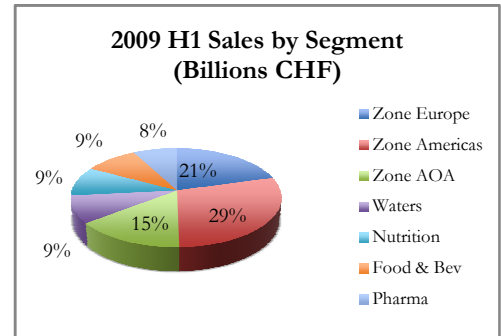
Industry & Competition

Nestlé's PetCare has been in leading position since 2001 when it bought American company Ralston Purina. It is also currently second in the candy business world-wide with 7% in market share. Its Water business has been gaining market share in North America as well, and it is the only non-alcoholic beverage growing in this region at the moment.

Nestlé has no major competitor of its particular kind, but competition most certainly exist across the different segments that it operates. In coffee, Starbucks had just put out Via after 20 years of secretive internal R&D. The low profitability in the water business can be attributed to competition that extends to Coca Cola and PepsiCo, which have better distribution channels as beverage it is their specialty. In terms of cereals, Kellogg is far less diversified and much slower in developing countries – Kellogg cereal in China are still mostly imported, while Nestlé processes most of its food in the China. Nestlé Group's Food and Beverage turnover in emerging markets alone (35% of total revenue) is roughly CHF 35 B, which is more than the total turnover of The Coca-Cola Company, or about 80% of total turnover of Kraft Foods.

III. MISPERCEPTIONS

- Nestlé's market in developed countries are already saturated and left with no potential for Nestlé – This delusion is caused by the Nestlé products that surround our everyday lives in the United States. What many tend to forget is that, just because we already consume so many Nestlé products, it doesn't mean that the rest of the world is. The markets have made this kind of mistake countless times, but perhaps the most well-known instance is with Coca-Cola
- Nestlé's growth is mostly from derived from developing countries, which will take much time to recover from the financial crisis – While emerging markets deliver growth rates that are higher than that of the Group, it does not account for anything near "most" of Nestlé's growth.
- A vast number of investors have not looked into Nestlé because they think they know what it does – "Nestlé, which makes Nescafe coffee and Kit Kat chocolate bars." This is an oversimplified description that does not do justice to the diversification of Nestlé
- Nestlé grows too slow for the taste of many investors – But changes are about to take place. Nestlé has possibilities for great returns with comparatively little risk.



IV. THESES – DRIVERS OF GROWTH

DEMAND

- Huge Market Share to Capture, contrary to popular belief

Zone Africa, Oceania and Asia (AOA) is compressed largely of developing countries that are huge potential markets. It is where 77% of the world's population inhabits (the figure will be 90% by 2010) – and yet sales in AOA only accounted for 35% of revenue in 2008. As Nestlé captures more these countries raise standard of living more, there will be a move away from inferior goods and towards quality brands like Nestlé, which has already established its solid brand image long ago.

- Huge Potential Demand in Developing Countries

As standard of living improves in emerging markets, owning pets is becoming more and more popular. The demand for milk products and cereals are also bound to increase in Asian countries as lifestyles become more westernized. Nestlé is an industry leader in all of those aspects – Real Internal Growth in Zone AOA was 6.6% for the first half of 2009 despite tough economy.

A simple survey among high school and college students on cereals showed that, which the majority actually likes a certain non-mainstream product, not many thinks it will become popular due to cultural differences. This shows that the market in general is underestimating the potentials of many Nestlé products that are not yet mainstream. But before KFC, McDonald's and Pizza Hut all became successful, who had thought Asian culture could accept fast food so well? Other products like Kit Kat have just entered these markets 4 years ago (est), and it takes time to become a trend, as we have seen in many cases

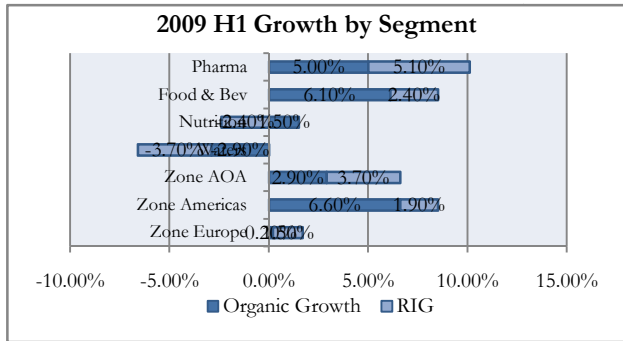
Instant coffee, one of Nestlé's specialties, generates \$21 billion in worldwide sales – more than 40% of the total coffee market. The U.S. only accounts for 5% of the instant market. Chinese city habitants only consume 8 cups of coffee per year, but demand is growing at 10–15% every year. Nestlé has entered most markets far earlier than Starbucks, and it offers much more varieties that extend to hazelnut and vanilla flavors, where as Starbucks is limited to Italian Roast and Colombia.



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• Brand Image & Targeting Different Market Segments

When those huge potential are finally being realized, Nestlé will be the one consumers look to – because it has been in those emerging markets the longest and has already establish solid brand image. For example, Nestlé was already selling products in places as far afield as Egypt, Russia, Mexico and Indonesia in the 1870s; it had also pushed Nescafe in China right after the civil wars ended, imprinting its image into even the oldest generation and becoming a part of the culture. It is obvious that



Nestlé's management is aware of the growth opportunity, hence the high CAPEX there.

• Don't Forget – Developed Countries

It is easy to forget Nestlé's presence in developed countries. But as shown in the figure above, Zone Europe will delivered 1.7% growth during the first half of 2009, compressed of 0.2% organic growth and 1.5% RIG, indicating that much of the low growth had been caused by pricing, not volume (1.5% RIG is comparable to 1.9% in Zone Americas as Europe is generally more developed, whereas Americas include many S. American emerging markets).

Market may have saturated for certain specific products, but Nestlé can always push new products, which is has been doing continuously. With its solid brand image and channel of distribution, Nestlé will be able to push through new brands much quicker at much lower cost than its competitors.

PROFITABILITY & HIGHER MARGINS

• Distribution Channel and “Pricing the Nestlé Way” (Consumer-Value Based Pricing)

Nestlé need to grow profitably in emerging markets as any other in the Group, and this takes time because of the highly fragmented distribution in some countries. This can be taken as a barrier to entry for other food companies, as Nestlé has the best chance of gaining those market shares because of its capital and experience. By establishing itself with less profitable products, Nestlé will be able to push higher end products with higher margins to follow.

Nestlé targets different markets with different products that are mainly categorized as PPP (lower end), Mainstream (middle) and Premium (higher end). It usually enters emerging markets with its PPP products that bring both quality and affordability to establish its presence. As those markets develop, it will push different products to satisfy new demand. This has proven to be very successful, and Nestlé's timing is very sound for the most part.

• “War on Waste”, An Efficiency Effort

Nestlé constantly works on lowering costs while being environmental. It has achieved 5% Water usage reduction and 3% Energy usage reduction every year so far. Through lowering packaging costs for lower-end markets, Nestlé could not only reduce carbon footprint but ensure profitability at the same time.

• Nestlé as Nutrition Expert, R&D Network

Though all Nestlé products are based on a nutrition concept, some are more for this particular purpose than others. Its nutrition products tend to yield higher profit margins, and usually higher growth, but because of its more discretionary nature, growth for the first half of 2009 was poor (-0.9%). However, other products recently released from Nestlé's R&D network have generated big growth in sales. Nespresso grew 28%, Dolce Gusto over 50%, and Beneful (PetCare) is likely to become a billionaire product in a couple of years, according to management.

MANAGEMENT

Nestlé's management team understands the dynamic differences between the cultures that they operate the company's business in, and take very different approaches to cater to different regions. Their understanding of their consumer base can be seen through the various strategies that they employ. At the same time, a consistent theme throughout Nestlé's development is also easy to make out – health, nutrition, and wellness are emphasized throughout every single product, even those that have traditionally been deemed as unhealthy, e.g. ice cream. Nestlé also consistently hold conference discussing progress in nutrition across the world. The News section of its Chinese website, for example, is 80% about nutrition. The management has always set their goal to be recognized as the number one wellness company, through “creating hard-to-copy, clearly differentiated products that can bring new and lasting impetus to a market, or perhaps even can redefine the market on a sustained basis.”

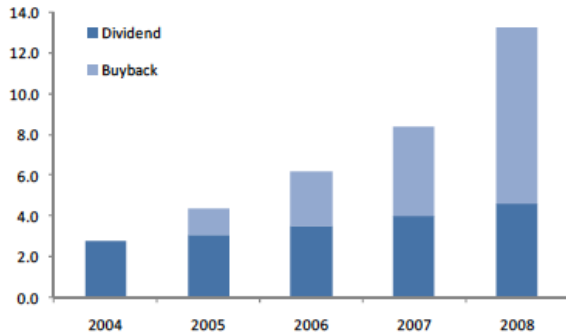


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Some of the management have not only been with Nestle for a long time, many have also grew up with Nestle. The current CEO Paul Bulcke even collected Nestle logos in his teenage years. With such loyalty and sentiment toward the company, the management can surely be trusted with the responsibility to create value for Nestle and its shareholders.

CASH RETURNED TO SHAREHOLDERS – “BIGGEST CASH RETURN IN CONSUMER STAPLES HISTORY?”



Nestle's Share Repurchase program is a clear sign that it views its own business confidently as the most attractive option for its free cash flow. So far it has completed the majority of its CHF 25B share repurchase, and the remaining CHF 7B is to be completed by early 2010. Dividend has also steadily increased over the years to a yield of 3%.

At the same time, Nestle has put options to sell to Novatis AG the remaining 52% of its stake in Alcon, its eye care firm. This put is valid starting 1 January 2010, and Nestle will be able to sell those share at the lower of 181 USD or the average price of preceding week with premium of 20.5%, meaning that if Nestle were to sell its Alcon shares, it will only do so when prices reach 150.2 USD.

Alcon is currently trading around 148 USD, and Novatis AG also has call options to buy those shares at 181 USD, so it is likely that Nestle will use its puts when prices reach 150.2 USD. Although this possibility is most likely already priced in, I am personally more concerned about the implications it hold for the future growth of Nestle. Alcon does not create any synergies with Nestle, and only barely fits into the concept of Health, Nutrition and Wellness. Taking out Alcon will not hurt Nestle's profits by significant amounts, but the proceeds from the transaction can be put to good use – either to extend its share repurchase program, or to acquire assets that *will* operate with Nestle in synergy. Some analysts are betting on Nestle not participating in any acquisition with the proceeds and returning a large amount of cash to shareholders. While that may be a favorable solution for short-term investment, I believe both outcomes would be beneficial to Nestle's growth, granted that the management makes sensible decision on its acquisitions.

On a side note, on 18 November 2009, it was reported that Buffett bought 3.4 mil of Nestle SA. Despite the media coverage on this matter, the stock still remains at an acceptable price. Though not a bargain, the stock's stability on top of its potential for accelerated growth gives it uneven risk and return, with a huge upside with a small downside.

V. CATALYSTS:

- Share buyback for 2010 was originally planned to be CHF 4B but was changed to CHF 7B at 9 month sales conference call. Any changes in this aspect should be monitored not just for short-term cash return purposes, but also to gain a good understanding of the company's financial standings. Any dividend changes should be an indicator as well.
- Recently Cadbury had just rejected Kraft's bid. There is a possibility of Nestle buying certain assets of Cadbury, although management had expressed a few days ago that Nestle would not participate in major acquisitions in 2009 and 2010.
- Selling Alcon shares, likely beginning 1 January 2010.
- Full year result will be released 19 Feb, 2010
- In the longer term, it would also be great to see something being done about Nestle's unprofitable water business. Management seems to have confidence, but margins have been low for many years. Given Nestle's track record with making creating efficient distribution channels, the water business should become profitable in a few years. However, Nestle does own very well-known brands, and there is always the last option to sell them if things do not work out.

VI. RISKS

Nestle is subject to currency risks. In fact, exchange rates have had over 4% negative impact on Nestle's growth numbers in the first half of 2009.

Operating in so many dynamic environments, Nestle will definitely continue to encounter both natural and man-made disasters in many developing countries, as well as some developed countries. However, Nestle has experienced over 30 disasters in 2009 and has delivered growth despite of those conditions.

Should Kraft Foods be successful in acquiring Cadbury, it will have a leading market share of 15% in the candy business, and could potentially squeeze Nestle's margins.



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Nestlé is also susceptible to rising prices of its raw material for food processing. Labor costs could increase too.

VII. VALUE ADDED RESEARCH

I have created a survey on cereal product in Chinese market, to research the awareness and acceptability of cereal in China. It is definitely not a mainstream consumer good yet, but a significantly larger number of people are aware of and occasionally buy cereal. There are still some misperception that cereals are unhealthy snack. As mentioned before, while 31 out of 60 buy cereal sometimes/very often, 34 out of 60 thinks that it's too different for Asian culture to succeed, versus 10 who think it will become popular. The actions of the majority contradicts their opinion, because oftentimes people do not realize the possibilities for things until those possibilities are realized.

Another survey on ice cream product in the Chinese market reflected that Nestlé's products are often consumed by 32 out of 68, and Haagen-Dazs, owned by Nestlé (a fact known by few) is often consumed by 20. Wall's products are often consumed by 55 out of 68. Dairy Queen was not one of the options, but some have pointed out that it should be. This is reflective of the importance on trends in emerging markets, where the younger generation tend to move away from products that have been omniscient in everyday lives and toward new and "hip" products like DQ (which is fairly new in China), or higher end products (e.g. Haagen-Dazs).

I have also contact Investor Relations Analyst Silvan Burri twice through e-mail to clarify and get a better understanding of certain information, and he has been very quick in response (it took only one day).

I have also talked to many about their perception of Nestlé, and the general feedback reflected that, though Nestlé is a household name, most people do not know nearly enough about it, including the extent to which Nestlé penetrates out daily lives through its many many brands. It would be safe to say that the majority of the population never bothered to look into Nestlé, perhaps until news broke out that Warren Buffett had bought into it.

VIII. RECOMMENDATION

The recommendation on NSRGY.PK is long, while the price is still fair, without "Buffett premium". I do not have a target price for Nestlé, as I believe its long term competitive advantage is sustainable and will continue to create value, as it not only has a large amount of market share to capture, but can also grow further with the development of the emerging markets that it establishes itself in, as well as continue to develop great products for developed markets through its R&D Network.

IX. LAST BUT NOT LEAST, FOR MII...

- I think the mentorship for Long Fund Elections is a wonderful idea, it was very helpful and a good learning experience. I know that such mentorship also exist for analysts who wish to present. However, I think MII could extend its mentorship to all members, or at last all associates, to foster better learning and a sense of community.
- I believe all associates should attend a certain number of manager meetings on Sunday to increase participation. Learning is a very organic process and should not take place in only a limited amount of time, and attending these meetings throughout the semester will definitely be helpful to the associates. It will also be beneficial for MII to be associates who become very knowledgeable through this kind of participation as it enhances MII's brand image, attracts and keeps talent, and may add valuable input to managers' decisions.
- It is great that MII now has an application process. To further this notion of protecting MII's image from being diluted by random students who never participates and uses MII's name for various purposes, I believe a system of required participation should be implemented. It doesn't have to be too rigorous, but should ask for at least a certain number of attendances at meetings throughout the academic year.
- To ask more of its members, MII should also provide more in terms of training. I have not come up with any idea that would be most effective, but I think MII could experiment with this. Maybe add a 10-minute section to every meeting, except when there are guest speakers? I don't know – but MII has 4 resourceful student-instructors and TAs who probably would.

At last I'd just like to thank all of you for a great semester! It's been wonderful, and I'm very much looking forward to the next