The Big Read Nestlé S.A.

Nestlé: Betting on big brands

The fate of the Swiss group will be a defining test for an industry under pressure from changing consumer tastes

Ralph Atkins in Zurich and Scheherazade Daneshkhu in London 2 HOURS AGO

Mark Schneider pours a can of cold brew Nitro Nescafé coffee in the company's head office overlooking Lake Geneva, Switzerland. He points out the distinctive cream "head" on the dark liquid. "You see that foam building up!" he exclaims.

Testing new products is the fun part of heading the world's largest food and drinks company. More difficult for Nestlé's 52-year old German chief executive is rebuilding sales growth and profits in an industry roiled by rapid changes in consumer tastes, increasingly severe cost competition and a plethora of mergers and acquisitions.

With annual revenues last year of SFr90bn ($91bn), Nestlé is larger than Google's owner Alphabet and just smaller than Russian energy producer Gazprom. Its best-known brands include KitKat chocolate bars, Perrier bottled water and Purina pet food.

Nestle has a SFr1.7bn annual budget to research and develop products, such as new ways of serving coffee © Company; CC

But size per se is looking less attractive. Nestlé's sales growth has slowed substantially , smaller rivals and start-ups have taken market share and the company's shares have fallen more than 9 per cent during the past year.

To fight back, Nestlé is trimming costs and buying up smaller rivals. But crucial to its success will be products that excite the next generation of consumers.

The group has a SFr1.7bn annual budget to research and develop products, such as new ways of serving coffee. Others in the industry might see this as something to cut to boost profitability. "I just want payback," says Mr Schneider. "I want a steady stream of must-have winning products."

Nestlé's fate will serve as an important test for consumer goods companies at a time when the multinationals which have dominated the industry for decades are under threat like never before.

Feedback

Some of Nestlé's competitors are taking radical action. Procter & Gamble has cut prices and sold off more than half its brands. Unilever is reducing bureaucracy and costs.

But Nestlé is betting that a more incremental approach will pay dividends. Three years ago Peter Brabeck-Letmathe, Nestlé's former chairman, attacked 3G Capital, the private equity group founded by Brazilian investors, for having "pulverised the food industry with serial acquisitions and ruthless cost-cutting". Last year, Kraft Heinz, controlled by 3G and Warren Buffett's Berkshire Hathaway investment group, launched an audacious $143bn bid for Nestlé's Anglo-Dutch rival Unilever. That bid flopped — but had it succeeded, Nestlé itself could have been next in private equity's crosshairs, despite its size.

Nestlé has not been immune to these pressures: last September it added profit margin targets to growth objectives. Such targets were a main demand of US investor Daniel Loeb, whose Third Point activist hedge fund a year ago revealed a 1.25 per cent stake in Nestlé, worth $3.5bn.

However, Nestlé is sticking largely to its traditional reliance on leveraging its size. Mr Schneider has announced bolt-on deals in high-end US coffee and food and a $7.2bn tie-up with Starbucks, but "he is still at the beginning of what could be a long journey", says Celine Pannuti, an analyst at JPMorgan.

Nestlé M&A and selected investments, 2017-18

Feb 17 **Materna** (infant nutrition products). **Value** $165m
June 17 Stake in **Freshly** (US ready meals start-up). **Value** na
Sep 17 **Blue Bottle** (US coffee brewery and shops). **Value** na
Dec 17 **Atrium Innovations** (nutritional and healthcare products). **Value** $2.3bn
May 18 **Starbucks** (licensing deal). Value $7.2bn*
*Nestlé paid Starbucks $7.2bn for rights to distribute the US chain's packaged coffee.

Founded in the 1860s as a baby food manufacturer in the lakeside town of Vevey, near Lausanne, Nestlé has faced criticism that it was too slow to adapt to a digital age which has cut the cost of market entry for media savvy start-ups.

"Nestlé and other global players have left smaller competitors to grow for too long before reacting . . . It's the old Nestlé thinking, 'we're number one, we're the best'," says Jean-Philippe Bertschy, an analyst at Vontobel bank. "The world has changed for good."

Mr Schneider was the first outsider to be appointed Nestlé chief executive in almost a century, joining from German healthcare group Fresenius.

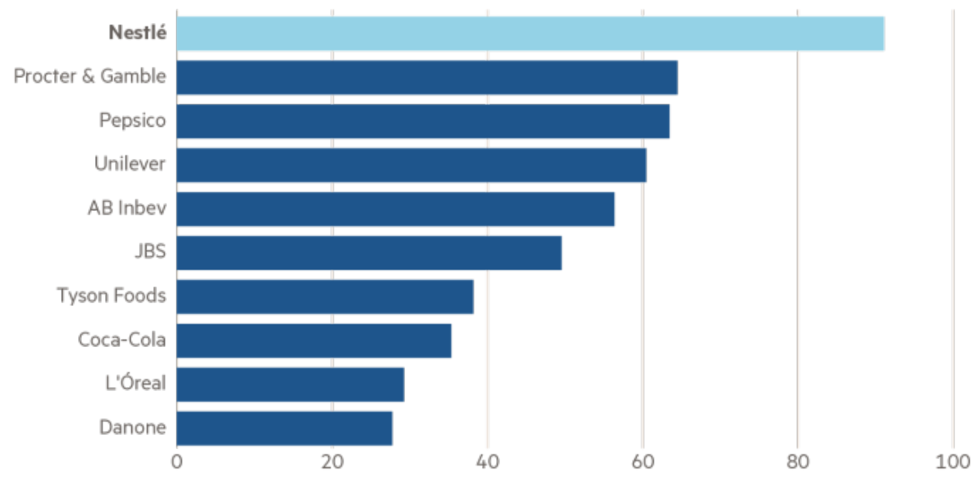
His diagnosis is that there is no specific Nestlé problem. Rather, the entire food industry had "collectively" overlooked a revolution in consumer behaviour after "a history of 30, 40 years of almost uninterrupted success".

Mr Schneider adds: "Many of these changes have been under way for the better part of a decade, but it's only now that they really come to the surface and are plainly visible."

Consumers have moved away from traditional packaged foods, preferring less processing and more artisanal, fresher options. A plethora of smaller companies have sprung up to cater to them. New foods and beverages have become "almost as a form of entertainment", Mr Schneider says.

The top 10 fast-moving consumer goods companies*

By sales ($bn), 2017



*Excludes tobacco
Source: OC&C Strategy Consultants
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Nestlé has more than 30 brands with more than SFr1bn of sales. "Can these big brands grow, given brand fragmentation and the desire of millennials for smaller brands?" asks Warren Ackerman, an analyst at Société Générale.

The Swiss group's answer is, Yes. "'Too big' is a notion I disagree with," Mr Schneider says. "Size, if you can handle it, should be nothing to be afraid of; in fact size gives you a whole lot of good things."

Nestlé, which is organised to keep operations close to local markets, has tried to "handle" its size in the past. A decade ago, Mr Brabeck pushed through a programme to speed up decision-making. But Andrew Wood, an analyst at Bernstein, says Nestlé missed important consumer trends. "Just because something is decentralised, it doesn't mean it will be successful if the culture is risk-averse or the organisation doesn't want to disrupt itself," he argues.

He estimates Nestlé's sales should be growing at above 5 per cent based on its size in the categories in which it operates, instead of half that rate. "The world has moved on a lot quicker than Nestlé. It needs a fundamental change in the way it runs its businesses — a change of culture," says Mr Wood. One investor adds: "No one expects them to be as nimble as a start-up. But there's a gap between being nimble and asleep."

Mark Schneider has announced bolt-on deals in high-end US coffee and food and a $7.2bn tie-up with Starbucks

Nestlé admits some weaknesses. In the US, it was slow to introduce organic versions of its Gerber baby food, allowing smaller rivals to enter the market. Critics say it missed the fashion for flavoured waters and premium frozen foods. Mr Schneider is careful, however, not to criticise past Nestlé managers — his immediate predecessor, Paul Bulcke, is now chairman of its board and Mr Brabeck-Letmathe is chairman emeritus.

In any case, he argues, Nestlé does not need a radical overhaul. Although it has underperformed rivals in terms of profit margins, its organic, or like-for-like, sales growth has been at the top of the industry range. "We are not a turnround story . . . we're talking about adjusting to a changing industry."

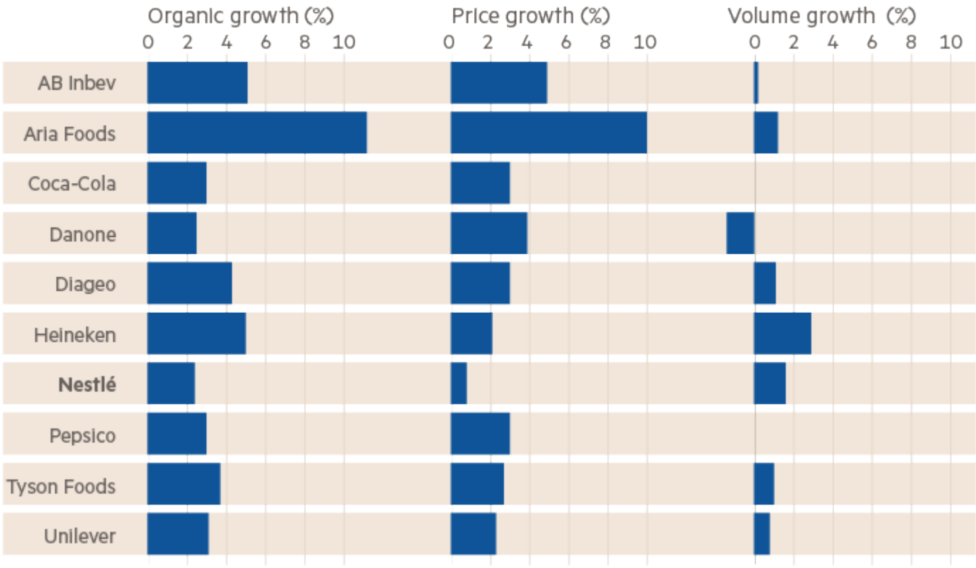
Some changes at Nestlé have been small but symbolic. Mr Schneider has torn up the seating plan for meetings of his top executives and allowed them to sit where they want — a revolutionary move in conservative Swiss business.

More strikingly, Nestlé has hired expertise from other fast-changing retail industries: Pablo Isla, chief executive of Inditex, owner of the Zara clothes chain, and Kasper Rorsted, chief executive of Germany's Adidas sportswear group, have been added to the board.

Nestlé's most important task is to adjust its portfolio faster, in line with consumer trends. "Over 150 years, that has been our job," Mr Schneider says. "It just now happens at a faster pace." Nevertheless, Nestlé can afford to be a "fast follower" of fashion — waiting for others to establish a concept before adopting it. "Sometimes it is actually good to have entrepreneurs test out trends first."

In the past year, coffee has been an important battleground for Nestlé and one of four priority, fast-growth markets — the others are bottled waters, baby food and pet foods. The Swiss company has a global lead thanks to Nescafé, a brand which this year marks its 80th anniversary. But JAB Holdings, the Luxembourg-based family investment group, which owns Keurig Green Mountain, has moved fast over the past five years to assemble a coffee empire that is challenging its global dominance.

Margins and sales growth for leading FMCG companies in 2017*



*Excludes tobacco
Source: OC&C Strategy Consultants
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To keep its advantage, the Nescafé brand is being overhauled. “You can play it by region, you can play it by coffee type,” Mr Schneider says. “There’s Nescafé Arabian coffee, there’s Nescafé Nitro cold coffee, there’s all sorts of things that play extremely well under the Nescafé brand. What’s important is that you keep innovating, you keep offering something new.”

In the US, where soluble coffee has never taken off, the group has expanded its Nespresso coffee capsule business and has launched a series of high profile acquisitions. Last year, it bought the California-based hipster Blue Bottle coffee store chain and Chameleon cold brew coffee company. In May, it struck a $7.2bn deal with Starbucks for the rights to sell the US brand’s packaged coffee outside its café chain — Nestlé’s third-biggest acquisition ever. “Before last year, Nestlé had never done an M&A deal in coffee — Starbucks will be its third in a year,” says Mr Ackerman of Société Générale.

Underperforming US confectionery businesses were sold last year, but Nestlé remains committed to other sweets markets and has introduced new ruby and wasabi KitKats © Nestle SA/CC

JAB is pursuing opportunities in casual dining and food — as highlighted by its Pret A Manger purchase last month. In contrast, “we’re pursuing a very coffee centric strategy,” Mr Schneider says. “This town is big enough for the two of us — and several more,” he says. This is not “an epic fight".

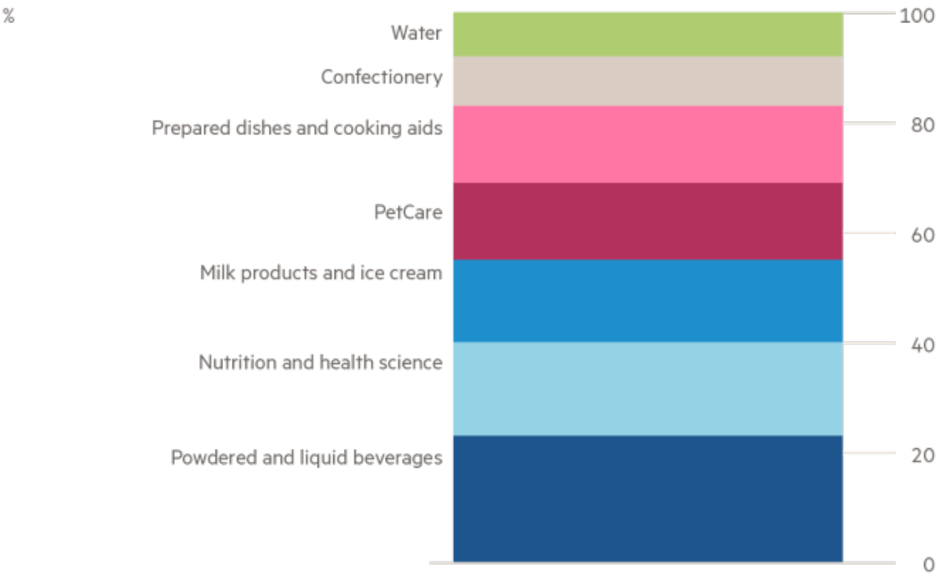
In other areas, however, Mr Schneider has so far been less radical. Underperforming US confectionery businesses were sold last year, but Nestlé remains committed to other sweets markets — relying largely on its flagship KitKat brand. Mr Schneider points to the new variations of the snack bar — his favourite is a pink version made from newly-invented "ruby" chocolate.

Analysts are more sceptical. "Asian millennials want to try new, innovative, funky products but in Europe, it's going to be difficult to sell pink or wasabi KitKats," says Mr Bertschy of Vontobel.

Similarly, Mr Schneider has so far disappointed those calling for Nestlé to dispose of its US frozen food business. Nestlé has a 29.6 per cent share of the US frozen food market, according to Société Générale, but would be overtaken by the proposed $10.9bn merger between ConAgra and Pinnacle.

Despite Mr Schneider's reputation for deals at Fresenius, he is cautious about M&A at Nestlé and agrees that its record is not stellar. A lesson from his Fresenius days is that "an organisation can only do so much at the same time", he says.

Nestlé's businesses by sales



: Morgan Stanley
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Nestlé has long identified consumer healthcare — covering skincare, nutrition and other products sold in chemists — as an area for future growth. But in the past year, it has spurned the opportunity to buy healthcare units put up for sale by Germany's Merck and Pfizer in the US, although it spent $2.3bn buying Atrium Innovations, a Canadian nutritional products company, from private equity group Permira.

Also unresolved is Nestlé's remaining 23 per cent stake in L'Oreal, worth about €27bn, a remnant of a deal stuck in 1974 when L'Oréal heiress Liliane Bettencourt feared nationalisation by France. Third Point has called for it to be sold.

Recommended

"They should and will sell it sometime, most likely to fund a larger acquisition," says Christopher Rossbach, chief investment officer at J. Stern & Co, whose clients include Nestlé shareholders. "If there is no obvious way to spend the proceeds within a reasonable period of time. Our long term preference would be for Nestlé to buy back shares."

Since last year's failed Kraft Heinz bid for Unilever, some believe opinion is shifting in Mr Schneider's favour. "There is a change of wind among investors," says Ms Pannuti at JPMorgan. "A lot of them are pushing back on the idea that margins are everything. The most highly rated companies are those delivering top-line growth."

Mr Schneider prefers constant innovation over drama. "I never saw any benefits in creating fear and havoc . . . with massive organisational announcements that really take people's eye of the ball. It's about evolving to basically be in lockstep with the times, and that to me is a continuous job."

Nestlé performs admirably compared to peers

It was in 1867 by the shores of Lake Geneva that Henri Nestlé developed an instant milk formula for infants. Today infant formula is still one of the fastest-growing segments of the food industry, along with coffee and water, which are also core Nestlé products.

Since then Nestlé has grown to dominate the food industry with annual sales last year of Sfr90bn. But the last time it achieved its organic sales target of 5-6 per cent growth was in 2012. The rate of growth has fallen steadily since, reaching 2.4 per cent last year — the lowest anyone can remember and the target has since been abandoned.

Compared to peers, this was actually not a bad performance. Danone, Tyson Foods of the US and Unilever, the Magnum ice-cream and Lipton tea producer, all grew faster, but mainly driven by price rises. Nestlé outperformed these companies in terms of volumes sold, according to OC&C, the consultants.

The worst-performing food companies are in the US. Kraft Heinz, Campbell and General Mills all reported a fall in organic sales last year.

However, Nestle's profitability has been one of the main criticisms of activist investor Third Point. Operating profit margins were stuck at about 16 per cent for the best part of a decade, which is below the industry average, according to analysts at Morgan Stanley. Margins ticked up last year as they must continue to do if they are to reach the 17-18 per cent target by 2020 which Nestlé, under pressure from Third Point, promised to investors last year.

Where Nestlé scores highest over most rivals is in the amount it spends on research and development — Sfr1.7bn, equating to 2 per cent of sales — and on marketing and promotion. The strength of the Swiss franc has been a drawback as the group only makes 1.4 per cent of its sales in its home country. According to Morgan Stanley, Nestlé would have generated an additional CHF28bn of revenues over 2010-2017, had the Swiss franc remained at 2010 levels. *Scheherazade Daneshkhu*

Latest on Nestlé S.A.