INTERNATIONAL Herald Tribune

Nestlé focuses on health to fatten its profit

Bucking global trend, chief executive to take on chairman's seat

By Tom Wright Published: SATURDAY, APRIL 9, 2005

VEVEY, Switzerland: For years, Nestlé lived happily on a diet heavy on chocolate bars, frozen convenience food and instant coffee. But the company eventually became bloated and uncompetitive. When Peter Brabeck-Letmathe became chief executive in 1997, he moved to improve the company's financial health by getting rid of unprofitable businesses, cutting costs and building up faster-growing areas through billion-dollar acquisitions.

Now, as he prepares to also take the chairmanship on Thursday, Nestlé is in better shape, but facing a different set of problems. Because it is the largest food producer in the world, regulators are blocking it from expanding further in its core markets. And while sales have roared ahead, Nestlé's profit margins still lag behind those of its rivals.

So, Brabeck-Letmathe, who started out 30 years ago hawking Nestlé ice cream, is trying a new tack familiar to anyone trying to shape up: focusing on nutritious and "fitness" foods. The question, as for dieters, is how soon such steps to whip Nestlé into shape will start to show results.

Healthy food "clearly offers a good growth potential," said Brabeck-Letmathe, an Austrian native who stays tanned and lean climbing mountains. "We're not interested in commodity areas where price is the only factor."

Building up a healthier portfolio may be a tall order. Nestlé's new nutrition division, comprising foods for infants, people with medical conditions and athletes, accounts for about 5 percent of total sales, analysts say.

Convenience foods like Nescafé instant coffee, Häagen-Dazs ice cream and Buitoni pasta sauces still dominate the company's offerings on supermarket shelves. But Nestlé is trying to make other products like yogurt, cereal - and even water - healthier by adding "branded active ingredients." Things like "Calci-N," a milk-derived source of calcium, and "LC1," a lactic acid bacteria that is supposed to help the immune system, allow the company to charge more for basics - and thus, it hopes, improve profit.

"They want to get nutrition into every thing they do," said ***James Amoroso***, an analyst with Helvea, a brokerage firm in Zurich. The company's large research and development center in Lausanne, near its headquarters in the Swiss town of Vevey, gives it an edge to develop new products, he said.

After selling low-profit businesses like frozen vegetables, Brabeck-Letmathe went on a shopping spree. In 2002 alone he spent $18 billion to buy Ralston Purina pet food, the frozen-food maker ChefAmerica, and Dreyer's ice cream, bolstering the company's presence in the United States.

That lifted Nestlé's sales last year above $70 billion. By comparison, its closest rival, the British-Dutch company Unilever, had $52 billion in sales last year.

That growth has also attracted attention from antitrust regulators, which Nestlé says now block it from becoming any larger in its core markets.

U.S. regulators initially objected to the Dreyer's deal - which made Nestlé the largest ice cream producer in the United States - but signed off after Nestlé sold some brands. In Brazil, Nestlé is appealing an order to divest itself of Garoto, a chocolate company.

Such pressure is not the only challenge facing the Brabeck-Letmathe, 60.

At the shareholders' meeting Thursday, he is to take over the chairmanship from Rainer Gut, who is retiring. But a group of shareholders, led by Swiss pension funds, oppose the move. They say combining the posts of chief executive and chairman goes against a global trend for greater independent board control over managers.

"There is a concentration of power at Nestlé, which could be dangerous," said Dominique Biedermann, director of the Ethos Investment Foundation, which manages money for the Swiss pension funds. He notes, though, that his protest is unlikely to succeed.

In a written response to questions, Brabeck-Letmathe said that Nestlé favored keeping the roles separate "in principle," but not now. "We are currently in the midst of the strategic change to a nutrition, health and wellness company; strategic continuity is important," he said, adding that he would resign if his appointment as chairman was blocked.

Nestlé also often gives the impression of not caring what the outside world thinks, which partly comes from being the market leader. That also could be an attitude hardened over decades of criticism from nongovernmental organizations over the sale of baby-milk formula in poor, mainly African, countries.

These groups regularly attend shareholders' meetings to complain about Nestlé's marketing of the formula, which does not contain the natural antibodies of a mother's milk. Nestlé, clearly exasperated by the continued allegations, says it does not advertise the formula and supports only breast-feeding for newborns.

"Frankly I don't see an image issue," Brabeck-Letmathe said.

Other critics want Brabeck-Letmathe to focus more on profit, which has historically trailed those of competitors. Last year, Nestlé's profit margin was almost flat at 12.6 percent, lower than Unilever's 15.2 percent, for instance.

Nestlé is among the world's most decentralized companies, with more than 500 factories in 80 countries employing a quarter of a million people. Local managers are given a great amount of autonomy, which often leads to inefficiencies like factories paying different prices for raw materials from the same supplier.

Brabeck-Letmathe hired the German software company SAP to develop a companywide resource management system. By 2007, senior executives should have access to more reliable data on prices and inventory.

Although Nestlé has generated billions insavings - and expects a further $1 billion this year - the bulk of that has been plowed back into building the business, often through acquisitions, analysts say.

But in February, the company said it would return $830 million to shareholders. The buyback, set for the second half of the year, would mark the first time Nestlé has canceled shares in its 138-year history.

Investors took that as a sign that Nestlé was serious about focusing on lifting profitability rather than sales. The company's stock has gone up 4 percent since the start of 2004, outpacing other food companies.

"They're not just talking the talk, but walking the walk as well," said Julian Hardwick of ABN AMRO in London.

Nestlé is looking to prove it can rebound from a miserable 2004, when sales fell 1.4 percent, in large part because of problems in France and Germany, where it faces stiff competition from Danone, the market leader. Raw material costs, which hit 20-year highs last year, as well as a weak dollar and stepped-up competition from cheaper, store-label brands added to the gloom.

Now Nestlé has started doing more business with discount stores. Prices for commodities like sugar and cocoa could soften this year and - without expensive takeovers - profit should be on a par with other food companies in a couple years, ***Amoroso***, the analyst at Helvea, said.

But others say that Nestlé is still too diversified. Danone, for example, a French company, makes only water, dairy products and cookies, and it is doing better than Nestlé in all three sectors in Europe. Nestlé is not competitive in dairy and confectionery but has so far declined to sell those businesses.

Brabeck-Letmathe is no fan of financial analysts, arguing the pressure they put on managers to meet forecasts can lead to cutting corners. For these reasons, Nestlé does not publish quarterly financial statements - only every half year - and refuses to set profit targets.

Instead, Nestlé publishes a general goal of 5 percent to 6 percent internally generated growth. Although it narrowly missed that target last year, it has tallied a 5.7 percent average over the past 10 years, "which is a remarkable, industry-outperforming result," Brabeck-Letmathe said. By comparison, Unilever's sales have slumped in recent years after it decided to cut its brands and focus on profitability.

Rather than focusing on short-term goals, Nestlé is "building businesses for eternity," said Xavier Croquez, an analyst at BNP Paribas in Paris.

Analysts predict that future acquisitions, like for nutrition businesses, will be small. Brabeck-Letmathe insists that Nestlé still has room to grow, just in a more measured manner.

"With our strategic reorientation toward nutrition, we are looking for acquisitions in that area, and as long as they make economic sense, we will certainly consider them," he said.