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Nestlé / Out of the comfort zone: A Swiss giant awakens with a start

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In uncertain times, food companies are always in fashion: No matter what happens, the market reckons, people have to eat. One of the likelier candidates for a defensive portfolio would certainly have to be Nestlé SA, the Swiss food giant — boasting an AAA credit rating and thousands of familiar products ranging from Perrier water and Friskies pet food to Nescafé instant coffee and Kit Kat chocolate bars.

But Nestlé shares have lost a quarter of their value over the past 12 months, and a week and a half ago it reported disappointing sales of 19.7 billion Swiss francs ($14.68 billion) in the first quarter, down 6.3 percent from a year earlier. Revenue was held back by a 13.8 percent currency hit from the strong Swiss franc, and a late Easter, which pushed results from its profitable candy business into the second quarter. Real internal growth, which measures only sales volumes, rose just 2.5 percent, well below the 4 percent long-term target set by the company.

The quarterly results have at least temporarily deflected attention from a much more important, longer-term story underway at Nestlé. Led by its chief executive, Peter Brabeck, a 35-year veteran of the company, it is transforming itself from a stodgy giant into a more profitable company through a carefully orchestrated restructuring program that stretches into 2006.

"The real story is that Nestlé is making the transition from what was a supranational company to a truly global company," said ***James Amoroso***, an analyst at Bank Pictet in Zurich.

Amoroso went on to explain the difference: "Historically, it has operated as a group of large, important national companies, each run by a market head who is like a CEO, responsible for all products, production and purchasing.

"The change is that now it will be more global and regional. Their margins are below that of their peer group, because they haven't yet got the big regional economies of scale that others have."

Indeed, progress in improving profit margins is what many analysts are watching closely.

They now have some help from Nestlé, which has long played it close to the vest with its financials, and still reports earnings only twice a year. In what some interpreted as a possible cultural change, it announced at its recent analysts' meeting that it would place less emphasis on the 4 percent target for real internal growth, which measures only sales volume, and more on organic growth, a combination of sales volume and price.

The move was welcomed by analysts. "Investors focus too much on the 4 percent target, and that's a shame," said Richard Withagen, an analyst with Delta Lloyd Securities in Amsterdam. "It's a target, but it's not the only one." The downplaying of the real internal growth measurement might even help the share price. A major factor in its weakness, Withagen said, was that Nestlé has only hit the 4 percent target in two years since 1997 when it was set by the company.

While Nestlé reported overall margins of 12.3 percent for 2002, its rival Unilever NV, which started cost-cutting earlier and has been more aggressive, reported 14.9 percent. By contrast, the steady-asyou-go, Swiss way prevails at Nestlé. Brabeck has repeatedly emphasized that the process will not be rushed.

Indeed, improving margins involves a huge cultural change for this 136-year-old company. Nestlé still has its headquarters in Vevey, Switzerland, where Henri Nestlé produced the baby formula that started the company on its way to become the largest food company in the world, with revenues of 89.16 billion Swiss francs in 2002. It has factories in more than 80 countries, 260,000 employees and thousands of products.

Nestlé is ahead of plan on the cost-cutting side, having already saved 4 billion francs since 1997, and with more to come. Initiatives run the gamut from closing inefficient plants and improving procurement practices to selling off underperforming assets.

Another component of the plan is Project Globe, which will link operations around the world with common information technology systems instead of the unmatched systems of the past.

"Regionalization has already started, especially in Southeast Asia, where Malaysia and Thailand are much more connected because of Globe," said Rene Weber, who follows Nestlé for Bank Vontobel.

Nestlé is not neglecting the growth side, either. It has spent heavily on acquisitions in the United States, in a drive to beef up its once-small presence there. In the last two years, it has forked over $10.3 billion for Ralston Purina Co. to become a major pet food maker.

Another $2.6 billion, a rich four times sales, was spent for Chef America Inc., which makes Hot Pockets frozen sandwiches. Nestlé said at the time that the premium price it paid for Chef America was justified because the company was a perfect fit with Nestlé’s frozen food business, and boasted fat margins of more than 20 percent.

Its latest deal is a $2.8 billion agreement to increase its stake to 67 percent in Dreyer's Grand Ice Cream Holdings Inc., a challenge to Unilever's leadership in the U.S. ice cream market. The Dutch giant owns the Breyers and Ben & Jerry's brands.

Brabeck is also building dominant positions in Nestlé’s fastest-growing and most profitable products. Nestlé has bought no less than 32 water companies since 1999. It now dominates Europe's water delivery business to homes and offices, which is growing at a clip of 25 percent to 30 percent annually. It also leads the equally robust market for bottled water in North America.

Another product group Brabeck plans to grow is nutritional supplements used in clinics and hospitals, where margins are as wide as 25 percent.

Clouding the picture is the status of the Dreyer's deal. To win approval from the antitrust watchdogs at the U.S. Federal Trade Commission, Nestlé has planned to sell off some products. But the FTC has opposed the plan, and Nestlé and Dreyers are negotiating with regulators over concessions. ***Amoroso***, who has a buy rating on Nestlé, is betting that it will do what it takes to satisfy the FTC — namely, sell more brands.

Withagen is taking a wait-and-see attitude, but some observers believe the deal is in jeopardy. Wolfgang Reichenberger, Nestlé’s chief financial officer, has said that it should be resolved by June.

The big $2.8 billion price tag on the Dreyer's deal raises another issue: Nestlé has been roundly criticized for overpaying for acquisitions.

"Dreyer's is the one that I feel the least comfortable defending," acknowledged ***Amoroso***, who otherwise contends that Nestlé has not overpaid.

Despite Nestlé’s AAA rating, some observers blame its high level of debt from making acquisitions as contributing to the performance of Nestlé shares, which are down 27 percent over the last 12 months. Groupe Danone, by comparison, is down 15 percent.

On the other hand, the deals demonstrate Nestlé’s determination to stick with its plan. Brabeck has made it clear that it will pay up for companies that fit well with existing businesses, even if it means temporarily sacrificing its cherished credit rating.

Investors should also be prepared for fairly flat profit margins in the current year — one that will see more implementation of cost savings plans, with the real payoffs starting to come in 2004. "That's why I'm not looking at the short-term results closely, other than to monitor the progress of the projects," ***Amoroso*** said.

"The savings will come just as Unilever's cost-cutting is having less of an effect," Weber said, "so Nestlé has the potential to pass them in 2004."

Withagen is concerned about more hits to revenues from the strong Swiss franc, although it is expected to ease later this year. "Danone and Unilever are affected by that as well," he said, "but Nestlé is much bigger in the U.S., so they are more hit by the currency."

Nevertheless, patient investors have the opportunity to get into a blue-chip company that by many analysts' estimates is trading at a discount to its competitors, with plenty of opportunities remaining for margin improvement.

Investors and analysts will know more at the end of August, when half-year earnings will be revealed. Those who applaud Nestlé’s long-term view and slow but steady progress are satisfied to wait.

"Nestlé," ***Amoroso*** said, "will take its time."