NESTLE S.A.

NESN-VX **JULY 2015**

PORTLAND INVESTMENT COUNSEL™

Business Description:

Nestlé SA is involved in the manufacturing and commercialization of a large selection of packaged food and beverage products including: powdered and liquid beverages, water, milk products and ice cream, nutrition and health science, prepared dishes and cooking aids, confectionery and pet care. At more than 145 years old, Nestlé is headquartered in Vevey, Switzerland and employs 339,000.

Overview and Investment Thesis:

- Nestlé is the largest food producer in the world accounting for roughly 6% of the sector.
- Its billionaire brands (brands which account for more than 1 billion Swiss francs in revenue) account for roughly 70% of the revenues and include: Nescafé, Nestea, Nespresso, KitKat, Carnation, Maggi, Nan, Gerber, Purina, Aclon, Hot Pockets, Lean Cuisine, Stouffer's and Dryer's. Nestlé was named the World's 41st most valuable brand in 2013 by Forbes.
- In our view, Nestlé is set to be one of the main beneficiaries of the soaring demand for food, driven by the global population growth and the increase in nutritional awareness of the average consumer.
- Its cutting edge research capabilities and a research and development expenditure of CHF 1.6B in 2014 allow it to lead the market through extensive product innovation and rejuvenation and respond quicker to the increased sophistication of the modern day consumer. Its products are not only an affordable and convenient source of food but also come with increased nutritional benefits.
- Nestlé has a very strong presence in growing emerging markets, taking advantage of increased demand for its key food categories as well as the increased nutritional awareness. Nestlé derives more than CHF 40B of sales in emerging markets, which represents 44% of the company's 2014 sales. Its most popular positioned products (high quality low cost food items) have had a great success opening up new consumer segments.
- The company has consistently achieved superior results delivering on its promise of increased year over year sales growth and trading operating profit margin improvement, also known as the Nestlé model. For 2014, Nestlé experienced an 4.5% organic revenue growth and a 30bp increase in trading operating profit margin to 15.3%. The company targets an organic growth rate of around 5% together with an improvement in the trading operating profit margin in constant currencies.
- Nestlé's operating success translates into sustainable free cash flow generation and consistent returns to shareholders. Over the course of the last five years, Nestlé returned CHF 54B to its shareholders under the form of dividends and share buy-backs. Nestlé is estimated to return a further CHF 7B over the 2015 fiscal year in the form of dividends.
- In our view, Nestlé's business portfolio and superior management capabilities allows the company to navigate through downturns and also to take advantage of the growth opportunities in the marketplace. This makes it an attractive investment for a large array of mandates which helps ensure stock price resilience.
- Nestlé is focused on unlocking an additional CHF 4 to 6 billion of free cash flow in 2015 through an increased focus on improving working capital by de-layering the organization and through unlocking synergies between its corporate functions of HR, finance and IT.

Competitors:

- Food and Beverage: The Procter & Gamble Company, Mars Incorporated, Danone SA, The Kraft Heinz Company, ConAgra Foods Inc., Tyson Foods Inc., The Kellogg Company, Unilever PLC.
- Commercial Products and Pharmaceuticals: Johnson & Johnson, Novartis AG, Bayer AG, The Procter & Gamble Company.
- Private Label: Costco Wholesale Corporation (Kirkland's Signature), Wal-Mart Stores Inc. (Sam's Choice, Great Value), Loblaw Companies Limited (President's Choice), ALDI Group, TESCO PLC.
- Regional and Local Manufacturers: Tingyi (Cayman Islands) Holding Corporation, China Yurun Food Group Limited, Nissin Foods Holdings Co. Ltd., Indofood Agri Resources Ltd., Illovo Sugar Limited, Marfrig Global Foods SA.

Industry Growth Drivers/Trends:

- The food and beverage industry is subject to very strong secular growth trends lead by the increase in the world population. While the current challenging global macro-economic environment could slow down the growth pace, the underlying need for food and nutrition, accentuated by the convergence of consumers in developing countries, is still strong and poised to push the market forward. Euromonitor International reports that the growth in packaged food sales from 2010 to 2015 has been 2.5% in Latin America, 3.5% in the Middle East and Africa and 0.8% in North America.
- Recent developments in the food retail space point to a strengthening of the generally cheaper private label products (packaged food branded by retailers) to the detriment of the manufacturer branded products. In this environment, temporary and even permanent market share decrease is likely to be experienced by the food manufacturers; in particular the ones who have brands similarly positioned to the private label challengers. We believe that Nestlé's brand management, supported by a policy of continuous innovation and rejuvenation and increased commitment to consumer facing marketing spend, will allow the company to preserve its leading positions and likely benefit in the long term by taking away market share from other, less proactive at the market manufacturers.
- Nestlé is also present in the health and beauty space through its significant equity stake in L'Oreal Group and a joint venture with Cereal Partners Worldwide. While being a natural complement to Nestlé's nutritional portfolio, these businesses also delivered very lucrative margins and growth in excess of the market.

Competitive Advantages:

- Leading overall market position and number one or two brands in most areas.
- The extraordinarily large scope of Nestlé's business provides for significant economies of scale in manufacturing, marketing and administration.
- The research and development capabilities allow the company to lead the way in innovation and provides for maximum portfolio flexibility.

Barriers to Entry:

- Economies of scale - To be successful in today's food and beverage sector the cost component is critical and economies of scale are a main cost driver.
- Shelf space - Between the shelf share of multi-billion dollar brands and the recent push of retailer driven private-label products; a new entrant would be challenged to execute a successful distribution strategy.

Customers:

- Nestlé's customer base is atomized, providing little bargaining power to any individual customer.
- The industry as a whole is very fragmented and as such regional and local manufacturers could represent feasible substitutes to Nestlé's brands in niche markets.

Officers and Directors:

Leadership team: Chairman, Peter Brabeck-Letmathe (70); Chief Executive Officer, Paul Bulcke (61); Chief Financial Officer, Wan Ling Martello (56); Executive VP Zone Europe, Middle East and North Africa, Luis Cantarell (63); Executive VP Zone Americas, Laurent Freixe (53); Executive VP Zone Asia, Oceania and Africa, Doreswamy (Nandu) Nandkishore (57)

Corporate Governance:

- 13 member board - 12 directors are external, the Chairman of the Board and the CEO of the Company functions have been separated since 2008.
- Corporate Governance - Nestlé utilizes 10 fundamental corporate business principles and has developed these principles through published, demonstrable policies. These corporate business principles pertain to: 1. Nutrition, Health and Wellness, 2. Quality Assurance and Product Safety, 3. Consumer Communication, 4. Human Rights in Our Business Activities, 5. Leadership and Personal Responsibility, 6. Safety and Health at Work, 7. Supplier and Customer Relations, 8. Agriculture and Rural Development, 9. Environmental Sustainability and 10. Water.
- Nestlé is committed to the UN Global Compact sustainable business practices; as a result the group adopted a supplier code which promotes fair and sustainable business practices throughout the entire supply chain.
- Nestlé has made significant efforts to manage risks related to environment and human rights concerns such as bottled water, slave labour and improper use of baby formula in developing countries; the company's Chairman and former Chief Executive Officer, Peter Brabeck-Letmathe has consistently championed water sustainability issues.
- The compensation of the 14 members of the executive committee amounted to 0.35% of the group's trading operating profit.
- The executive compensation policy has changed significantly starting with fiscal year 2015. At the end of a three year vesting period for the performance share unit plan, the Nestlé shares delivered to executives will be subject to an additional two year blocking period. This change was made to emphasize that compensation is linked to unlocking shareholder value in not just the short term but most importantly in the long term.

Ownership:

Insiders own 0.18% of outstanding shares. Institutions own 28.5% of outstanding shares. Notable holders include: BlackRock, Inc. 3.7%, Norges Bank Investment Management 2.72%, Capital Group Companies Inc. 2.03%, Vanguard Group Inc. 1.73% and UBS AG 1.61%.

Capital Allocation/Uses:

- Nestlé's management is aware of the challenges raised by the current global macro-economic environment and is emphasizing cost-cutting and cash preservation measures while at the same time staying committed to its goal of returning value to shareholders through its dividend payments and share buy-backs.
- The company reported a strong operating cash flow figure in 2014 of CHF 14.7B in comparison to net income of CHF 14.5B showing low accruals in its earnings.
- An improvement of CHF 1.4B in working capital was delivered in 2013 and the management targets further improvements.
- The company has reduced capital expenditures in 2014 compared to 2013 by CHF 1.0B bringing total capital expenditures to CHF 3.9B for 2014.
- The company has outstanding debt in currencies including USD, AUD, NOK, CHF, GBP, and EUR. Its debt issues are rated Investment Grade AA.
- Nestlé recognized the opportunity to acquire the remaining 50% stake in Galderma in July 2014. In addition to the company's previous 50% stake, this gives the company full control over Galderma's operations. This investment should help fuel organic growth and contribute to free cash flow growth over the coming years.
- The proposed dividend was increased from CHF 2.15 to CHF 2.20 for 2015. This represents a 2.3% dividend increase from 2014.

Business Segments:				
Product Mix	**Revenues (%)**		**Operating Profit Margin (%)**	
	2014	**2013**	**2014**	**2013**
Powdered and Liquid Beverages	22.2	22.2	33.4	33.1
Water	7.5	7.4	5.1	4.8
Milk Products and Ice Cream	18.3	18.8	19.3	18.7
Nutrition and Health Science	14.2	12.9	19.4	15.9
Prepared Dishes and Cooking Aids	14.8	15.4	12.9	13.4
Confectionery	10.7	11.2	9.6	11.6
Pet Care	12.4	12.2	16.0	15.4
Unallocated Items	-	-	-15.7	-12.9

Operating Segments:				
Product Mix	**Revenues (%)**		**Operating Profit Margin(%)**	
	2014	**2013**	**2014**	**2013**
Zone Europe	16.6	16.9	16.6	16.6
Zone Americas	29.8	30.8	36.5	36.8
Zone Asia, Oceania and Africa	19.9	20.5	24.3	25.4
Nestlé Waters	8.1	7.9	5.1	4.7
Nestlé Nutrition	10.5	10.7	14.2	14.0
Other Businesses	15.2	13.4	18.9	15.5
Unallocated Items	-	-	-15.7	-12.9

Financial Statement Summary: (CHF Millions, years ended December 31)					
	2014	**2013**	**2012**	**2011**	**2010**
Income Statement					
Total Revenue	91,612	92,158	89,721	83,642	93,015
Operating Income	14,019	14,047	13,464	12,538	14,832
Net Income, continuing operations	14,456	10,015	10,228	9,487	9,048
Fully Diluted EPS, continuing operations	4.52	3.13	3.20	2.96	2.60
ROE	20.61%	16.00%	16.77%	16.70%	55.33%
Balance Sheet					
Net Debt	12,325	14,690	18,120	14,319	3,854
Common Equity	70,130	62,575	61,007	56,797	61,867
Net Debt: Common Equity	17.57%	23.48%	29.70%	25.21%	6.23%
Key Profitability Ratios and Figures					
Operating Margin	15.30%	15.24%	15.01%	14.99%	15.95%
Interest Coverage	18.73x	11.78x	12.40x	17.70x	10.68x
Return on Equity, continuing operations	20.61%	16.00%	16.77%	16.70%	14.62%
S&P Credit Rating	AA	AA	AA	AA	AA

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