

Nestlé Navigating the Storm

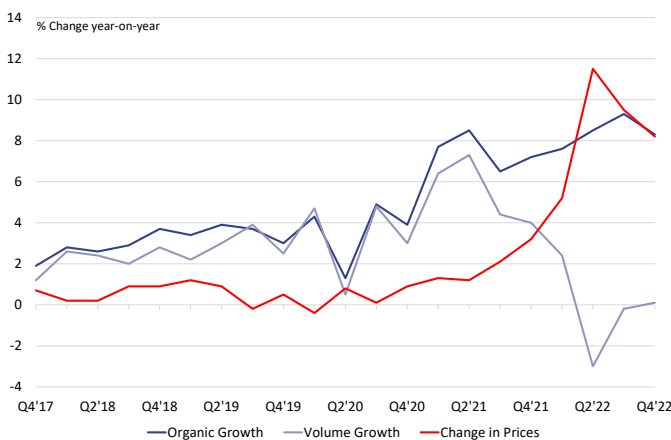
Established over 150 years ago, Nestlé is the largest and most diversified food and beverage company in the world. In 2022, the company's sales amounted to c\$100 billion versus PepsiCo, its closest competitor, at \$86 billion. Nestlé's products are recognized, consumed, and valued in all corners of the world and consequently, it has ingrained itself in the day-to-day life of people. Despite its size, Nestlé has achieved success by localizing its offerings and catering to the needs of each individual market. Last year, global CEOs had to navigate extremely stormy waters as energy and commodity price inflation hit multi-decade highs, sending input costs soaring. With 344 factories in over 186 countries, the company remains in the eye of the storm. This article will look at what actions were taken to mitigate the turbulence, namely pricing, brand rationalisation & innovation, as well as the outlook for 2023 and beyond.



**Nick
Rogers**

Food has a unique ability to forge powerful and long-lasting memories. Our sense of smell and taste can transport us back to the exact place, emotion and people who were present at the time. Choosing one's favourite coloured wrapper in the Quality Street box may evoke early memories of Christmas Day spent with family, a warm mug of Milo with a mother's love, condensed milk with the excitement of camping under the stars whilst one of SA's

COMPOSITION OF REAL INTERNAL GROWTH



Management has had to raise prices aggressively over 2022 to offset rampant input price inflation which has understandably impacted on volumes in the short term.

SPEED READ

- Over 5 billion bars of KitKat were sold across 87 countries last year. In fact, Nestlé has 31 "Billionaire" brands which add to the company's defensive characteristics.
- Petcare has increased from 12% of sales in 2002 to 19% in 2022. Nestlé is now the second-largest competitor globally with a 21% share.
- The new Nespresso Vertuo coffee machine spins the capsule at up to 7,000 rpm, faster than the engine of a propeller-driven plane. Nestlé remains the world's largest coffee company and the largest manufacturer of coffee machines.
- Nestlé holds a strategic 20.1% stake in L'Oréal whose share price has risen 30% since Oct '22, a useful cash-cow when times are tough.
- Nestlé has vowed that 95% of its plastic packaging will be recyclable by 2025.

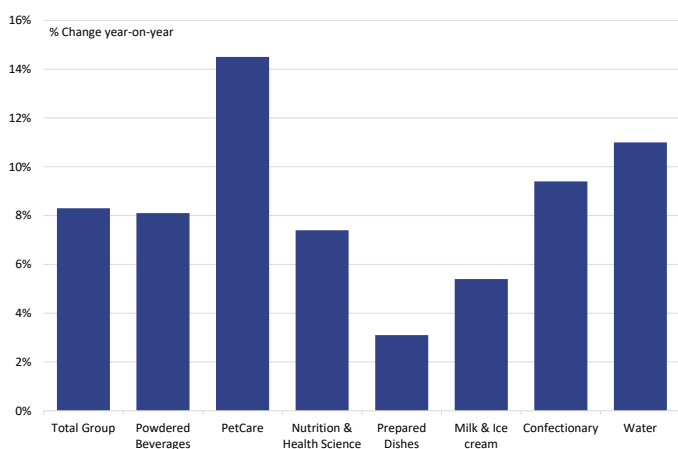
most memorable ads from the 1980's had the catchphrase, "It's not inside, it's on Top". Nestlé's 2,000 brands include KitKat, Aero, Smarties, Quality Street, Maggi, Purina Pet Food, Häagen Dazs, Milo, Nescafe, Nesquik, Cremora, Starbucks Coffee at Home, Vittel water & NAN baby food. Nostalgia is a powerful tool when times are tough. Companies with defensive brands tend to be able to weather storms more successfully thanks in part to brand-loyalty.

Within Nestlé's "Billionaire" brands which make up 70% of sales, 60% either gained or held market share in 2022, perfectly illustrating this point.

As a result of Nestlé's defensive brands, management was able to increase prices by 8.2%. Although higher raw material and shipping costs led to the weakest margins in four years, in absolute terms, they dropped just 0.3% to 17.1%. Management is targeting an improvement to between 17% - 17.5% in 2023. Nestlé's Real Internal Growth (RIG) measures the impact on sales of volume increases or decreases, weighted by the relative value per unit sold. This measurement strips out the effect of pricing (+8.2%) from organic growth (+8.3%) resulting in a meagre RIG of just 0.1% over 2022, highlighting the tough environment. Nestlé has forecast organic growth of 6% - 8% for the coming year which suggests prices may have to rise further given the deceleration in the last quarter. To quote the CEO, Mark Schneider, "We've been moving early with pricing. Sooner or later, gravity will catch up with some of our competitors. At that point, that situation will correct itself because they will also then have to take pricing action or live with permanent reductions in their profitability. 2023 price rises will be specific and justified by data otherwise retail partners and consumers will simply not accept price increases."

The downside of raising prices is that it invariably leads to lower volumes, -2.6% for FY22. However, one must bear in mind that volume growth in the previous year was almost 3x higher than historical levels thanks to heightened demand during the Pandemic as households and businesses stock-piled. Supply constraints on items including Perrier water also hurt volumes. As supply chains and freight rates ease there could well be reversals in 2023 which bodes well.

ORGANIC SALES GROWTH FOR FY22



PetCare has been the top driver of organic sales growth whilst Out-of-Home categories outpaced At-Home as lockdowns eased and people returned to work and travel.



Nestlé's headquarters in Vevey, Switzerland. From this building the world's largest food company directs its empire.

Another lever at management's disposal to improve profitability is the rationalisation of brands. Over the past six months, Nestlé started to trim underperforming brands, denting both volume and profitability in the short term. "Project Tasty" aims to eliminate the 34% of Stock-Keeping Units (SKUs) responsible for only 1% of sales. Simultaneously, management will use those cost savings to accelerate investment into high-margin SKUs, especially the 11% responsible for 80% of sales. Examples include Nescafé and Purina pet care. Project Tasty has delivered \$1 billion of savings in 2022. This is set to accelerate over the next two years.

As one would expect, there has been a category reversal since Covid lockdowns have eased and consumers have once again left the confines of their homes. "At Home" products like prepared dishes and cooking aids experienced sales declines whilst "Out-of-Home" consumption like confectionary grew 9.4%. Impulse buying leapt 23.5%. For example, over 5 billion bars of KitKat were sold across 87 countries last year alone. Petcare has increased from 12% of sales in 2002 to 19% in 2022 and Nestlé is now the second-largest competitor globally with a 21% share. Purina PetCare was the largest contributor to organic growth (+14.5%) highlighting the importance of diversification.

Innovation has always been at the heart of Nestlé's success. In 1938, the company pioneered a new method that captured the aroma and flavour of coffee in a soluble extract - Nescafé was born. Nespresso, the world's first coffee capsule system, followed in 1986. Today, the new Nespresso Vertuo coffee machine spins the capsule at up to 7,000 rpm - faster than the engine of a propeller-driven plane - to intensify the water flow, extract all the flavour and create a smooth and stable crema. Nespresso is the world's largest coffee brand and the largest manufacturer of coffee machines, providing an extremely defensive 'moat' to future earnings. Coupled with the strategic Starbucks alliance, the coffee business grew organic sales by 8.1%, a

very resilient performance in a year that saw coffee prices spike following poor weather conditions in Brazil, global supply chain turmoil and rising demand. What is clear is that innovation is at the heart of Nestlé. It serves as a lesson for brands in this modern digital age where you can only survive and succeed if you continue to innovate.

Turning to the financials, Nestlé has either maintained or increased its dividend in Swiss francs for the last 63 years, whilst 2022 marked the 28th consecutive annual dividend increase. That is a big tick from our point of view. Yet this increase in the dividend cannot be taken for granted. Debt levels have increased and now stand at 2.4x Net Debt / EBITDA, double the 10-year average. Free cash flow – cash from operations after capital expenditure – was weak last year, owing to an intentional increase in stocks to counter supply chain issues and possible disruptions from soaring energy prices. Consequently, the dividend totaled 125% of free cash flow, which is simply unsustainable over long periods. Whilst management has guided that this should reverse over the next two years, we will be more comfortable when we see it actually unfold.

L'ORÉAL SHARE PRICE



Nestlé has owned a stake in L'Oréal since 1974 but has sold down its stake at strategic moments to reinvest in its core business."

For many years, Nestlé has owned a strategic stake in L'Oréal, the French cosmetics giant. In 2021, Nestlé sold down its stake from 23.3% to 20.1%. In doing so, it raised CHF10 billion which it reinvested back into its core operations. With L'Oréal once again nearing all-time highs, this is a potentially lucrative source of funding for Nestle if conditions remain challenging.

In conclusion, 2022 saw many headwinds hit the company and management must be commended for the initiatives



Global superstar actor, George Clooney, promotes Nestlé's Nespresso range of pod-based espresso makers.

taken so far. However, challenges remain. Inflation remains sticky across the US, Europe and the UK, yet the recent fall in oil prices, whilst possibly indicative of a looming recession, will certainly drive energy costs down. Furthermore, China should hopefully start to provide a tailwind since Nestlé is more exposed to Out-of-Home there than in any other geography. Yet as long as interest rates remain high, consumers' disposable income will remain under pressure and hence so too will margins. That said, no matter where you live, or which flavour of KitKat you prefer, food will always have the ability to bring people together and create new memories. History has proved that Nestlé is a company that has continued to evolve and adapt with the times. This year will be a year where management will need to follow through on growth initiatives and prove their mettle to ensure the company remains in the sweet spot for years to come.

NESTLÉ'S LOGO



Henri Nestlé gave his company a logo symbolizing his family name that meant "Little Nest"



Our next Insight seminar will take place in June and provide an update on what has driven markets over the first six months of the year, and what might lie ahead for the balance of the year. We are very excited to be expanding our seminar program to Cape Town.



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Topic: **Mid Year Market Update**

Natal Midlands

Date: Thursday, 22nd June 2023

Venue: Oasis Conference Centre,
72 Main Road, Howick

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

Johannesburg

Date: Tuesday, 13th of June

Venue: Rosebank Union Church, Cnr
William Nichol and St Andrews
Road, Hurlingham

Time: 7am for 7.30am

Cape Town

Date: Wednesday, 14th of June

Venue: To Be Confirmed

Time: To Be Confirmed

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