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EDITED TRANSCRIPT

BN.PA - Q3 2014 Danone SA Corporate Sales Call

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OVERVIEW:

Co. reported 3Q14 reported sales growth of 3%. YTD 2014 reported sales growth decline was 2.7%. Expects 2014 sales growth of 4.5-5.5%.



CORPORATE PARTICIPANTS

Pierre-Andre Terisse *Danone SA - CFO*

CONFERENCE CALL PARTICIPANTS

David Hayes *Nomura - Analyst*

Warren Ackerman *Societe Generale - Analyst*

Jon Cox *Kepler Cheuvreux - Analyst*

Erik Sjogren *Morgan Stanley - Analyst*

Celine Pannuti *JPMorgan - Analyst*

Alain-Sebastian Oberhuber *MainFirst - Analyst*

PRESENTATION

Operator

Good day and welcome to the 2014 third-quarter sales conference call. Today's conference is being recorded. At this time I would like to turn the conference over to Pierre-Andre Terisse, Chief Financial Officer.

Pierre-Andre Terisse - Danone SA - CFO

Thank you. Thank you very much and good morning to you all, I am happy to be with you again, although from the distance. I'm here in Paris with Regis and Marion, here to talk to you about a pretty straightforward quarter, helped by the basis for comparison but showing solid underlying trend, confirming in fact the solid underlying trends we have seen in our portfolio since the beginning of the year and building well what we are trying to do for the year. So I invite you to look at the disclaimer, page 2.

And once you've gone through it I will move to page 3 immediately to have a look at the bridge of our sales growth, which is up 3% on a reported basis, and that's obviously important as it was not the case in previous quarters. There are two reasons for that.

The first is that the currency impact, which was negative 8% or more in the first half, has reduced to a negative 3.7%, which remains negative under the effect of the devaluation of some currencies. But some of them have been plateauing in terms of depreciation and therefore the FX is progressively limiting.

Scope is flat.

And the second difference is therefore the like-for-like evolution of our sales, which is close to 7%, entirely driven by value, value being price and mix, while the volume has remained stable at minus 0.1% with, on the one hand, and you will see that, a negative dairy, and on the other a positive early life nutrition in particular, but also water, and medical on the volume side.

If you turn to page 4 and have a look at the same picture for the nine months, so for the year to date, you will see a similar pattern with, however, some differences.

The first one is that on a reported basis for the year to date, will remain negative at minus 2.7%. This is attributable to a currency effect which is negative 6.8%, which is an improvement versus H1. And we expect it to further improve as we move into the rest of the year and to have a full-year impact of around 6% full year and slightly more on the EBIT side. So currency 6.8% negative.



Scope is limited as well. And the like-for-like is 3.8% on the year-to-date basis, still very much value-driven, with negative volume coming essentially from dairy. And you see that the 3.8% is showing improvement versus the previous year to date. H1 we had 2.2%, 2.3% like-for-like growth. Therefore we are moving up and we will continue moving up as we move into the rest of this year.

In terms of dynamics, this is very clear, page 5. You see a net improvement versus not only the previous quarter but the previous quarters as the past four of them were marked by the Fonterra issue and high comps which has resulted from that.

If you try to de-pollute the performance and have a look at the underlying grading of the performance, in reality the performance remains solid and it keeps progressing along our priorities for the year. We'll come back to those one by one in a minute. This is despite consumption trends throughout the world which are continuing to be tough in Q3. And you've seen that there have been a number of elements in some of our key markets, whether we are talking in the CIS, talking of Latin America or talking of the continued deflationary pressure in Europe, which renders all that extremely difficult.

Still, turning to page 6, our geographical dynamics keep going in a consistent and in the right direction. Looking at Europe, we are positive for the third quarter in a row. And this is particularly strong this quarter, helped by water on the one hand, by baby, including some exports and helped as well by medical nutrition. So Europe positive.

CIS and NORAM is obviously reflecting specific dynamics of these markets and slowing down at 3.3%, broadly stable in the US and growing mid-single-digit or above in the CIS.

And ALMA, which is essentially the emerging market, is, as you can see on this chart, reaccelerating at 13.5% growth, which is interesting because it shows both that it is strongly up against performance of the previous quarters obviously. But even against the performance excluding the eight recall markets of Fonterra, this is showing acceleration. So altogether positive geographical dynamics.

I'll now move into the analysis by division. And to start this, to fresh dairy, page 8. For fresh dairy products it's really a question of focusing on key battles and you need to go into details to understand the performance. Before I do so, a few comments on the performance overall.

It's obvious that milk has played a role in the volume/value element and in the overall performance of this business line this year. The tensions which have been extremely strong in the first half are lowering at the moment. They are lower than in H1.

They still remain meaningful, however, as, while we have seen some decrease of the cost of milk in the European Union, as we have seen decrease of the cost of milk as well in the US, despite the fact that it remains higher than a year ago, there are other areas in which we continue to see growth of the cost of milk. And this is in particular the case of rest of the world and Latin America on the one hand, and of the CIS where the ban is having an impact on the cost of milk, which has started growing again.

So this has played a role obviously in the balancing of the equation between a strong positive value element at 7.8% across markets, reflecting mix but also price increases, and a volume element which remained negative at 7.1% and has in particular been negative in EU and in the CIS.

So that's for dairy as a whole. Again, the best way to understand what we are doing in this division is to perhaps have a look at each of the markets. And I'll now move to Europe, page 9.

Europe, you see that the performance, the evolution of sales is pretty much in line with the one we had in the second quarter. So we were negative 5%. We are negative 5%. The easy way is to say that nothing is moving. In reality there are important moving pieces and there are two essentially which are offsetting one with the other.

The positive element is that Germany and Italy are now showing meaningful properties. They remain negative but at a pace which is definitely much better than what we have seen in the previous quarters and years. They are improving. And there have been some more positives, this is in particular the case of Germany, which is clearly helped by the good performance of Actimel, which has now been back to positive territory. So these two markets are progressively converging towards stability and positive territory. And obviously this is helping the equation.

On the other hand, we have, as you know, engaged into an operational streamlining of our portfolio in Europe with choices made to discontinue some SKU reference foods in function of their level of profitability, with the clear goal to make it more solid, to have a portfolio which is fit enough to be pushing it and to be investing behind it in the coming year, and with a clear objective as well, which is to stabilize the profitability in the second half. And this is very much what we expect to do, so to stabilize the margins and even to grow them a little bit in the second half versus the previous half of this year.

So it means that Q3 is still at minus 5% versus Q2, but in reality on trends which are better building or increasingly building a good equation, a good recovery equation for the coming quarters and years. And therefore we are really making interesting progress.

Second market important in dairy is the US, as we move to page 10. So there are two things happening at the same time. On the one hand the category has now clearly stabilized. There is no category growth at the moment. It is slightly negative volume-wise, slightly positive value-wise, but it's around zero. This is clearly driven by a growth of the Greek, which has slowed down versus the pace of the previous quarters. Danone is growing in line with the market or is stable in line with market, which means that we are confirming our leaderships. And when I say leaderships I'm talking of the leadership on the category but also the leadership on the Greek segment.

And at the same time the second element in US is that we have, as you know, since the end of the first half started reopening the portfolio and trying to push levers for continuous growth of the category with different ways. One is obviously working with the resellers. Another one is exploring partnerships, either with a way to increase the relevance of the category -- this is Healthier America -- or with a way to expand the boundaries of the category, and these are the partnerships with YoCrunch, as well as with Kellogg's, which is pretty different.

And the last one is innovations. There are good first signs of what we have launched. Dannon Creamery in particular is showing interesting signals. It's far too early to comment about whether or not these are going to be the future tools for strong growth of the category, but there are interesting positive signals from these innovations. We'll continue to launch some of them as we move forward into 2015.

Russia, page 11. Obviously you have seen this summer a tough market and a tough environment. This has been true twofold. On the one hand, in Ukraine we've some areas where basically there is no possibility to deliver any more. And on the other hand, with consumption trends which are being impacted by the devaluation of the currency and by inflation which we have seen for the past now one year, more than one year in this country.

In this context our trend remains solid. I told you we're talking of mid-single-digit growth with behavior of the different parts of the portfolio which is very much in line with what we have seen in the previous quarter. The brands are progressing well. The value-added part is progressing well. You have some examples here, with Actimel, Aktual or Tema, or even Danissimo. And on the other hand, the low value-added part of the portfolio being the milk and the fermented products, the kefir, is still under pressure from a volume standpoint and we keep adapting the portfolio and the production to this.

So continuous positive trends in a market which is obviously a bit difficult to manage given the context, but which remains a key for Danone dairy development going forward.

To finish with dairy, a word about innovations. You have some selections of them, page 12. You can see that what I was telling you about North America is confirmed. The first innovation at the top of this page, being Light & Fit Protein Shake, so it's a drink, Greek somehow with YoCrunch Greek, with Danette in Canada, which is another declination of the French Danette versus Dannon Creamery in US. So all those start from US and aim at expanding the category in this part of the world.

And on the other hand you see in Europe that we keep renovating the portfolio or expanding it with a new version of Activia, Fruit Fusion, for Europe, in fact for Europe as a whole. And on the other hand, a declination of multipack of the Danio, which is the Greek for Europe in France with the Danio minis.

So that's what I wanted to tell you for dairy. I'll move to waters now, page 13. It's another good quarter, 12% top-line growth, with the usual drivers. It's positively driven volume-wise and value-wise. Solid volume growth in all regions.



In Europe we had a difficult summer from the weather standpoint in July/August, but September has been helpful and overall within H2 delivered growth. In addition to that obviously the aquadrinks in Europe have kept developing and this is particularly the case in the UK. In the rest of the world, what keeps growing very well is Asia in particular, with Mizone, both in China and Indonesia, and Aqua, our brand in Indonesia, which have continued growing double digits. And this altogether translates into another good quarter of our water division.

And you can see page 14, on the following page, that we keep trying to bring value addition to continue through our innovation process twofold again. One with drinks, and you see examples in Turkey, in Mexico, in Indonesia and in the case of Volvic as well, with the aquadrink Volvic. And another one with more convenience, you see two examples here. One is Zywiec Zdroj with a new format, in Poland. And the other one is the Gotta by Bonafont, so it's a kind of machine, which is instead of the classical HOD ugly device, something which is nice and convenient to be put in a kitchen and which we think will help the development of this part of the category. So that's for waters.

Early life nutrition, baby now, page 15. So it's obviously a strong performance and we all expected a very strong performance given the comps, close to 20%. There is obviously a strong base impact from August 1, so for part of the quarter, in fact two-thirds of the quarter.

If I try to have a look at the performance, except these good performance, Asia first. What I find interesting, if put on the side China, is that the rest of Asia overall is back to where it was before the Fonterra crisis, with some plus and minuses, some countries which are even higher and some countries which are not fully yet at the right level. But overall Asia has bounced back and this is obviously a very, very positive achievement from the team after a year of very heavy work. China, I'll come back to it, but it's progressing, although a very different feel from our initial expectations.

Europe is positive on a solid base. And maybe two additional things. One, we are gradually stabilizing food, which had been negative for several quarters and is showing real sign of improvement. So the baby food, the jars, the dry food and the wet food, with interesting progresses on the sustainability side. And on the other hand there has been very good performance of export as well.

The rest of the world remains strong. Africa and Latin America keep growing double digits and there is very satisfaction for this division.

So a word about early life nutrition in China, page 16. It's a very different performance from what we expected in the way it is built, although it's really going in the right direction. Dumex, and you see that on the bottom right of the chart, is not progressing for now, not many fully. We will continue working obviously as we move into the rest of the year and 2015 on what is an important brand for the Group.

On the other hand, Nutrilon, and you see that on the bottom left, as well as the international brands are doing well. And they are doing well on two factors, on two drivers.

One is the building of a super-premium reference, in particular in the mum-and-baby stores in China, with precisely the box you can see on your screens, so Nutrilon, which is gradually gaining a position the ultra-premium. And the second element, as you see, the international brands, which benefit from the expansion of the online channel. You can see that on the top left of your screen. The ecommerce line is progressively getting an increasing stake of the market and this is obviously benefiting more international brands.

So altogether we are in China building a good creative portfolio, with some short-term profit pressure, however, due to the way we do invest to build a brand like Nutrilon, on the one hand, and on the other hand the different level of leverage of the platforms we have. Dumex is clearly not gaining leverage. And on the other hand we need to keep growing the other brands. So short term this is something we have to manage and again medium term it's definitely a portfolio which is going to be increasingly of quality as we move forward into China.

A word about innovation, page 17. So it's no coincidence that we're improving on food. You see three innovations in this field on this page, and pouches in particular in the Netherlands and in Switzerland are bringing some addition to what we are doing. You see that on the right side. And we are on nearside deploying our Precinutri engine in Argentina and we also keep innovating as well obviously in the field of early life nutrition.

Medical nutrition, page 18. This is a strong performance at 10.1% top-line growth, with two elements maybe to be noticed. The first one is about the performance in Europe, which has been particularly strong. The teams are doing fantastic work in this part of the world and in the rest of the world as well, but specifically in Europe. And the second one is the very good performance of pediatrics and energy, which are not only adding to

the volume growth but also generating some positive mix effect. I don't expect that kind of growth obviously to be continuing going forward. But overall we are showing that we are getting renewed traction in medical nutrition this year.

And this is obviously thanks to a continuous effort of innovations. You'll see page 19 that we continue to again bring value to the consumer as we have improved formula, improved recipes or increased convenience, as you can see with the above examples.

So that's really it for the performance of the third quarter, which, as I said, is very straightforward and very much in line with the solid trends we have been seeing previously, but were a little bit hidden by the comparison bases.

With respect to the rest of the year, and I'll start with page 21, the agenda for the rest of the year is essentially going to remain the same of course. We keep the same priorities. In Europe, we are going to continue in Europe dairy to continue the streamlining of our portfolio and making sure that we stabilize margin in this half, the second half versus the second half of last year.

In the North America and CIS region we will keep working on consolidating our leadership, growing the category through innovation and at the same time managing input cost issues which are still pretty volatile and a bit tough.

In ALMA, which is the emerging world, we are going to keep growing and leverage dynamics, which, as you have seen with the 13-point-something percent top-line growth, as shown, yet making sure we keep navigating the events which we are seeing popping up each and every week in the world.

And baby China, we'll keep developing overall our portfolio with, in the specific case of the local sales of Dumex and Nutrilon, which are covered by the chart you see on this slide, sales which are expected to be within the target but rather at the bottom end of the target, so close to the yellow -- to the pink, sorry, the pink bar. And this is obviously complemented by the performance on online, which is not captured by this measure.

All this is overall very solid dynamics yet it is a context which is not making our targets very easily achievable. We continue working to achieve those though and we continue working to achieve 4.5% to 5.5% top line, to achieve a trading operating margin stable plus or minus 20bps and to achieve a free cash flow of EUR1.5bn. This is going to be our target for the rest of the year.

Knowing that, and I'm turning to page 23, more specifically for H2, and this is obviously very important, Q3 confirms that we are now back to a strong, profitable, sustainable growth equation. And as we are progressively now moving towards the building of 2015 we are going to continue building this equation the very same way we are getting this this second half.

So that's really what I wanted to tell you about the third quarter and I'm sure you have a few questions and we can move to them now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). David Hayes, Nomura.

David Hayes - Nomura - Analyst

Good morning gentlemen. Thank you. Hi. Two areas from me if I can. Just firstly some clarity I guess on the margins in Europe in dairy, which you discussed, talking about it becoming stable in the second half. I guess the two questions were, when you say that, do you mean by the end of the second half you hope margins will be stable or that the whole of the second half the margin will be stable?

And then just again some clarity whether that's a sequential stabilization, i.e. first half to second half, or whether you're talking about year on year, so the second half would be higher than second half of 2013.



And then the second area was just on medical nutrition. Obviously a big step up, which I think you made the point isn't the new level, the 10% level. But I just wonder whether you could be more specific about what drove that level of performance, particularly around the pediatric side and what you think maybe that comes back into.

And then I guess just related to the same area, lots of speculation in the press about potential sale of that unit. I don't know if you can say anything on whether there is a review of medical nutrition, either part or in its entirety. Thank you very much.

Pierre-Andre Terisse - Danone SA - CFO

Thank you David. And I'll move backward in fact, starting with easier question, which is the one about the sale of medical. And I have basically no comment to add to that. So I'm not going to comment on that.

On the performance, again, we are benefiting from an increase volume or an improvement of the underlying performance, but also some exceptional effects in terms of sale of in particular pediatric and the energy side. So that's a division which given its size can have that kind of volatility in the performance.

I don't expect, as I said, the 10% will be reproduced. But at the same time it clearly shows that when you look at the evolution of sales quarter by quarter that we're in the right direction. And in particular we are in the right direction in Europe and some countries have been really performing better than they had been in the past few quarters. I have in mind Spain, for instance. And in again energy, pediatrics overall, which as we build the brand Neocate have continued progressive, gradually better and better since for the past few years now. So not much unfortunately to say, just to confirm that the 10% is not any normal but that yet it shows improvement.

On the margin dairy, so I'm not talking sequentially; I'm talking half to half, so I'm talking H2 versus H2 of last year. This is what we are aiming at in terms of stabilization. And when I'm talking stabilization I'm talking the whole half compared to the whole half. So I expect the margin of the second half of 2014 in dairy to be up versus the same period of the previous year.

And this is very much driven by four parts. An improvement in the condition of the cost of milk, but for another one, maybe more important to see, the improvement of supply, both in terms of ample and in terms of quality, and the streamlining of the portfolio which we are operating at the moment. Plus all the savings which you have been seeing quarter after quarter, with the announcement of the streamlining of factory costs and so on, which are producing effects.

So we are basically getting to it. The next step is going to be once we have streamlined the portfolio, to grow again. This is clearly going to be the agenda for the following quarters. But all that, all that gives me a sense that we are really moving in the right direction and we are getting first results which are in line with what we wanted to see in terms of size.

David Hayes - Nomura - Analyst

And just following up on that question in terms of cost base, you mentioned some of the benefits. A&P-wise, is there any -- can you give us any detail about whether, from an advertising and promotional perspective, I know you mentioned promotion being down a little bit but obviously that could be at two different levels, just wondered whether you can be specific about whether A&P is up as a percentage of sales year on year within that second-half performance. Thank you.

Pierre-Andre Terisse - Danone SA - CFO

There will be a time when we need to be able to reinvest and to re-increase overall the amount of A&P in Europe. We're not yet there. And one of the reasons why we are streamlining the portfolio is so our investment in that in an efficient manner and not to disburse it over a too high number of priorities, some of them not bringing value to anyone, neither the consumer nor the retailer nor ourselves. So the priority is really stabilizing the



margins, streamlining the portfolio and then we will have the ability to push again. And push again will translate into increased A&P. We are not there yet.

David Hayes - *Nomura - Analyst*

Okay. That's great. Thanks very much.

Pierre-Andre Terisse - *Danone SA - CFO*

Thank you David.

Operator

Warren Ackerman, Societe Generale.

Warren Ackerman - *Societe Generale - Analyst*

Good morning Pierre-Andre. Good morning Regis. It's Warren Ackerman here at SocGen. I've got two questions for you. The first one is I just wanted to do a bit of a deeper dive on China baby. It's obviously hard to see the underlying picture because of the comps. Just wondering, what do you think the market growth is in China baby at the moment in terms of volume and value, and what do you think your market shares are doing in the quarter?

And I just want to ask again related on Dumex, you said that Dumex was not progressing. It used to be I think two thirds of your China baby portfolio. How much does Dumex make up now of China baby and can you say what the Dumex growth was in the actual isolated quarter?

And I'm just wondering, similar, how do you actually fix this issue with Dumex? Is it just the basic Dumex that's the problem or is it the Dumex International? So the whole question around what's happening in China baby.

And then just secondly, on dairy volumes, down now 7% for the second consecutive quarter, do you still expect down 7% again in Q4, Pierre-Andre, or are there any factors in Q4 why the volumes will be better in your key geographies of either the US, Russia, Western Europe?

And I guess a similar question to David. Do you think you need to spend more on A&P and innovation to actually get that dairy volume number back into a better place? Thank you.

Pierre-Andre Terisse - *Danone SA - CFO*

Okay. So two small questions. No, seriously, I'll start with China baby. We see the market growing value high-single-digit, I would say. We see our market share moving up total. We see our market share still a way from the level we had in July 2013 but gradually moving up with different paces of recovery. Dumex, as I said, is not meaningfully moving up. Talking of rate of growth for Dumex is meaningless, by the way, because we have to base to a base which was sometimes zero.

But, to give you an idea, Dumex now would represent about, what, 20% of our sales in China. So it remains meaningful. At the same time it's not regained the traction we think it can regain one day.

I'm not going to enter into the specifics of this, of the reasons why we think this is the case and find a solution, but clearly we think there are things to be made and we are going to continue working on this brand. There are positive signals at the same time in terms of reputation of the brand,



which mean that the equity is still there. We just need to transform the renewed equity into renewed preference by the consumer and this is where we are not completely getting the results, but again we'll keep working.

So when I said that the market's growing and our market share is up, it's predominantly coming from the rest of the portfolio. And there are, as you understand, if I move from brand to general distribution, it's very much the online and the mom-and-baby stores and it's, in the case of the brand, the ultra-premium, with our Nutrilon brand, we had no ultra-premium brand within China a year ago and we are progressively now building one. This is Nutrilon Platinum and this is in the mom-and-baby stores where we are still not yet strong or not enough strong, but we are improving.

And the second part is obviously the online channel for Nutrilon, Aptamil and all the international brands, which is definitely happening. And you just need to have a look at the evolution of the channel to understand that we are benefiting from channel mix somehow with that.

So that's the way to have a look at the baby, which again fundamentally means that we have Dumex as the only brand or the main brand by far a year ago. Today we are having more brands, which are going to help us making the portfolio more sustainable. It is not yet fully, because we need to rebuild position in the modern trade because we need to really increase our positions in the mom-and-baby stores, but it's going in the right direction, with some profitability issues in short term. But it's definitely very good work, leading us to the right direction. So that's for China baby.

On the question of the volumes of dairy, again you have to -- it's very difficult to -- you can get scared if you look at volumes overall and say, well, minus 7%, they're really an issue. In fact when you are looking at the detail of that you see that it's in North America some small negative, which is the translation of a flat category, slightly positive in value and slightly negative in volume. So it's a question of evolution of the category overall.

And we are still believers that the category is going to be on a medium-term perspective growing. This is what it has shown in the past 5, 6, 7, 8, 9, 10 years. It's a question of innovation and we are working on that.

In Russia there are strongly big volumes but this is coming from the low-value-added part and it's a bit chosen in the way that we have chosen to find on the value-added part of the portfolio. And on this part of the portfolio we are doing well because we are getting stable volume despite a strong level of price increase. And in some cases we are getting positive volumes. You have some examples on the page.

And in Europe it's about the streamlining of the portfolio. So don't expect that these trends one by one are going to meaningfully change.

We'll have some phenomenon of improved base of comparison in the CIS as we are watching the price increase and we are watching the comps. So there will be some improvement in the CIS in Q4.

There will, we expect, be some improvement in North America as we get the result of the innovations. In Europe we have started work, which is a very important work which is the one I describe of streamlining the portfolio and we are going to continue that, so I would not expect improvement. So net I expect volume to remain negative, maybe slightly better in Q4, but still to remain negative.

Warren Ackerman - *Societe Generale - Analyst*

Okay. Thank you.

Pierre-Andre Terisse - *Danone SA - CFO*

Thank you Warren.

Operator

Jon Cox, Kepler.



Jon Cox - *Kepler Cheuvreux - Analyst*

Yes, good morning Pierre-Andre. Just given the fact that the Q3 figure looks a bit better than probably most people are anticipating, maybe excluding that dairy volumes, you seem somewhat cautious in your outlook statement, talking about trying to get to these targets. I'm just wondering which one worries you more because the top line looks doable after that Q3. Is it the profitability one that is a worry? That's the first question.

The second one is just on the European restructuring and the collapse of the supply chain closing the factories. I wondered if you would just give us an update where you are exactly in that process. Thanks very much.

Pierre-Andre Terisse - *Danone SA - CFO*

You're much welcome. On the restructuring aspects with this, one, following the announcement we had in June about the three further factories in Eastern Europe, Italy and Germany, we had to conduct negotiation of course with the unions and we are almost there. The last round of negotiations is taking place at the moment, but it's going to be completed very soon. So we'll have the ability to pass to the phase of intermediation.

The important note is that while we are downsizing our presence in, industrial presence in Germany and Italy, yet the situation in these markets has improved, showing that what we are trying to do is well-understood both by the managers of these markets and by the consumer overall, i.e. we are certainly not, it is certainly not a symbol of getting out of these countries, but it's a symbol of increasing the collective efficiency we have in Europe in order to be performing better in these markets, and in the rest of the markets, but in these markets as well. So it's moving as planned.

On the guidance there is a bit of paradox. So you are right to say, sorry, that the top line given the trends of Q3 looks probably easier to achieve than the margin, for which you have no additional elements. The paradox is that we are both extremely focusing on the stabilization of profitability. That has been and remains as I talk a key item of work of this group of people and of the Company. So we are very much into that and you see that in some parts of the world we are really making strong progress against that. I'm thinking of Europe in particular.

But at the same time we have to recognize that the sequence of events we've been dealing since the beginning of the year, starting with the very meaningful inflation of the cost of dairy at the beginning of the year, continuing with the slide of the Argentinian peso and the increased devaluation, continuing with Russia, the disruption in Ukraine and later on the ban, the impact it has again on the increase of the cost of milk, continuing with an overall environment in Europe which frankly is not getting better. And if you have a look at the situation of the retail in France there are some very key exceptions.

All that is creating an environment which is volatile and adverse, and has progressively been putting additional difficulties as we have been moving forward and keeps doing so. So that's what I'm trying to say when I'm saying that achieving this guidance for the year is not going to be easy, that in particular on this front, no impact in addition to that. We are building very good or very well for the medium term in China, but at the same time the mix of the channel in which we are building is short-term-wise again not helping the profitability.

So all these elements are making the equation complex. As I said, getting to delivering that has been and remains a very high priority for us so we keep working on that. And we keep working as well, that's equally important, in making sure that we are not just building a strong rebound in the second half, but we are also preparing 2015 and 2016, and 2017 and the following years.

Because one word in our ambition is important, this is the word sustainability. And when I am talking of sustainability in this case, I'm not talking of the green things, which are important, but I'm talking of the ability to re-produce several quarters in a row, several years in a row, the same performance year after year. So that's really what I wanted to say on that and to qualify what I've said during the call.

Jon Cox - *Kepler Cheuvreux - Analyst*

Just to add maybe just a follow up on that sustainability comment you have in terms of future earnings growth, which you would aspire to be best-in-class I guess compared to your European peers just given the overall portfolio.

Pierre-Andre Terisse - *Danone SA - CFO*

It's going to be up to you to say that. I'm not monitoring their performance.

Jon Cox - *Kepler Cheuvreux - Analyst*

Okay. Thanks.

Pierre-Andre Terisse - *Danone SA - CFO*

Welcome.

Operator

Erik Sjogren, Morgan Stanley.

Erik Sjogren - *Morgan Stanley - Analyst*

Yes, good morning. It's Erik Sjogren at Morgan Stanley. A couple of quick questions from me. First, on the European dairy business, you're saying that the volumes will gradually -- will remain negative. Are you thinking more this, for the organic growth this mid-single-digit decline also in Europe in the coming quarter at least? Is that how you look at it?

Secondly, on the baby food business, obviously very strong growth in the third quarter. You've highlighted the investment in China, but do you expect this at the divisional level to have a positive margin effect from the leverage on the growth here?

And then finally, just on China, can you give us a little bit more of an indication on the split of your business right now between the grocery and the specialty channels? Thanks.

Pierre-Andre Terisse - *Danone SA - CFO*

Sorry, we've tried to interrupt you several times because you are talking very close to the mic' and we basically could understand about 50% of what you've said. So if you would be kind enough to speak a bit further from the mic' and repeat your question or the main points of your question, that would be helpful please.

Erik Sjogren - *Morgan Stanley - Analyst*

Of course, yes. Sorry, does this work better?

Pierre-Andre Terisse - *Danone SA - CFO*

Yes.



Erik Sjogren - Morgan Stanley - Analyst

Thank you. So first, my first question is about the European dairy business. You said that the volume growth will remain negative in the fourth quarter. So are you essentially thinking in terms of organic growth of around this mid-single-digit decline that we're seeing 4Q and then into early 2015?

Secondly, obviously very strong growth in the baby, in early life nutrition. You've highlighted the investment in China, but are you expecting the strong growth to have a positive effect on the margin?

And then finally, could you give us a little bit more color on the split of your business as it stands right now between the grocery and the specialty channels? Thank you.

Pierre-Andre Terisse - Danone SA - CFO

Yes, maybe, well, I'll start with the first. Euro dairy, I'm not going to give you further guidance on the pace of volume growth in the coming quarter and quarters in Europe, quarters, because we are just in the process of building 2015 so I want to go on that front. And Q4 I don't want to be more precise than what I've already said. Just to remind, we have started and we will continue streamlining the portfolio. And since we have started this basically at the end of Q1, beginning of Q2, you can expect that obviously the effect of those changes are going to continue as we complete the one-year lapsing of these starts.

Again, it is extremely important for us that we build in Europe the condition, not only for a short-term rebound but for a portfolio which is going to be a winning one in the future, i.e. one which is sustainable in terms of performance, which is balanced, and one behind which we can positively invest and, in any case, win against competition because we won't expect that competition and retail pressure are going to get any easier as we move forward in the coming two to three years in Europe.

On China, yes, of course. Yes, of course, simply because the level of margin we had in China a year ago was -- or following the Fonterra crisis issues at the beginning of the year, beginning of 2014, was depressed to extent which means that any volume addition, any additional sales is helping, so it's pushing the margin up. The question is at what pace and to what extent with respect to what we are trying to build this year and the following years.

And what I have been trying to do or to state several times during this call is that the evolution of the different brands and different channels, and I'll come to it in a minute, is obviously causing some less-than-anticipated leverage in some instances. And we have to adjust costs, but it's not something we do just like that, in a minute. And on the other hand we need to invest behind what's working well and this is triggering additional investment.

So I'm not putting that as complaint or anything of that kind. I'm just saying that short term we have to make decisions in spite of what we see as very positive dynamics overall for our portfolio and in front of an opportunity to build again something solid for the coming quarters, which obviously given the weight of the category on one hand, the potential of the category overall, but also the weight and the potential of China within the category, as you would recognize, continuing.

In terms of channel, one word. We are making progress, and that was your question, but we are making progress both on the online and the MBS, not so much on the modern trade. So modern trade has now become the weak point in our portfolio in terms of distribution. That was the strong point before Fonterra. Now it's the weak point. MBS, on the contrary, we were specialized distribution. On the mums and baby stores we were largely absent and we are progressively catching back. And the other channel, which was answering your question, which is making the difference, is the online one.

Hope this helps. Thank you.



Erik Sjogren - *Morgan Stanley - Analyst*

That's great. Thank you very much.

Operator

Celine Pannuti, JPMorgan.

Celine Pannuti - *JPMorgan - Analyst*

Yes, good morning. Bonjour. Just have in fact two follow-up questions. The first one is on early life nutrition. It seems that you had a strong performance in Western Europe and when I look at the Nielsen data effectively we've seen a growth going from mid-single-digit to 20%. I would like to understand why you've seen such a pick up. I understand that it's export demand to China, but why there has been a pick up of that magnitude quarter over quarter.

And I also wonder why are you selling through the grey market as opposed to filling yourself, your blue export platform. So that's my first question.

My second question, there were some questions about the outlook already, but I was wondering why is it that you kept to your -- the outlook as of February 2014, while in your commentary, Pierre-Andre, you also mentioned that I think that's been difficult through the year. We've seen Russia being more difficult than anticipated, the US has weakened, you mentioned milk crisis, so I just wondered if you could explain that.

And does it mean what you said about China Dumex being a bit lower than expected that on the plus/minus 20 bps like for like we should go for the minus 20 bps?

And just one little question on that front. Can you give us an indication on the FX and M&A impact for the year? It was minus 50% at H1. Thank you.

Pierre-Andre Terisse - *Danone SA - CFO*

Yes. On the FX and M&A.

Celine Pannuti - *JPMorgan - Analyst*

On the margin.

Pierre-Andre Terisse - *Danone SA - CFO*

If currency (inaudible), that will be around minus 6 that time-wise and I said it will be -- for the full year. And I said it will be slightly more for the margin ?- I mean for the operating income. I'll leave it to, if you don't mind, I'll leave it to Regis and the team to come back to you more precisely on those.

On your first question about early life nutrition, so there are several elements in the good performance of Europe. As I said, there is a good performance that, as it has been often the case in the past few years, on the growing of (inaudible). That remains a segment which is doing well.

The second element is the jars, food, so wet food and dry food, as we call in internally, performance, which after several quarters of decline is improving and it's improving in particular with respect to efforts we have been doing about the sustainability, authenticity, transparency of the product and the ingredients, plus the taste. So we are seeing progresses.



And the last one is, you rightly mentioned, is the comments of what I call export and which you call the grey market, which is indeed part of the shipment of Europe which are being exported to Asia.

One of the stake we have, as you rightly noted, is progressively transforming those.

Sorry, before that you asked a question about why is it specifically strong this quarter. I think it's probably in line with the previous one. There is maybe one particular element, which is the fact that there is a specific event called the November 11, 11/11 in China, which is triggering some loading on the side of the online channels and which is probably giving a bit of a boost of the performance. But we are not talking of this making disruption, if you want, of the performance. It remains strong, as it has been in the past few quarters.

And back to my previous point, one of the challenges or objectives we have in front of us is the gradual transformation of these sales into local sales, into local distribution, into more mon-and-baby stores, into more Nutrilon. And this is progressing so we are gradually getting traction on the Nutrilon side and on the sales of our imports -- of our international brands locally, but with a pace which is basically shaped by our ability to produce with different standards of labeling and so on, with different characteristic of the product and with our ability to roll it out basically in channels which are not exactly the same.

So this is something we are working on. This is something which is progressing at a pace which I think is satisfactory overall, but which leaves for the time being, you're right, some of the volumes of our international brands on the European performance. So that was your question about year-end.

The last one is, well, it's the other side of the question of Jon. I think it is important that we keep working with the same target and objective for two reasons. The first one is that I consider, we consider that they are achievable. I'm not saying they are not achievable. I think they are achievable. I just think they are not easily achievable and there are a number of constraints which make it sometimes more difficult to achieve. But I think they are achievable and this is the reason why we have kept the same target.

The second reason is that I think internally after two difficult years, four specific events, whether you are talking of Spain or you are talking of the Fonterra story, after these two years we feel it is very important that we don't let ourselves move or change quarter after quarter with the events and what is happening outside, but that we keep the same direction, the same targets and we keep consistency.

We obviously need to make judgments every week, every month, every year, every day, sorry, about what are the trade-offs to be made to make sure that we continue building Danone not only for the next quarter, but for the next years and delivering what our objectives are for the year. But part of this trade-off, part of this equation is internally we want to have everybody keeping being aligned against or behind the four priorities which I've mentioned. And which for some of them are showing very good progress, for some of the less-good progress, for different reasons, but we need to keep working in a consistent manner.

So that's what we're doing. I'm just extremely fair and open about the fact that it's not always easy and I'm sure some other people in the market would share the same, but we are sticking to it.

We'll take a last question.

Operator

Alain Oberhuber, MainFirst.



Alain-Sebastian Oberhuber - *MainFirst - Analyst*

Good morning gentlemen. Good morning Marion. Just three questions. First one on Russia. If we see now this gradual improvement as well in Russia, could we also -- and a slight decline in the input cost, could we expect that you could achieve this 5 to 80 basis points improvement on margins you are always highlighting, either over the next 12 months or even in Q4?

The second is on water, base effect. You had a high base last year in Q3. Seasonality was weak. Could we expect an acceleration in Q4 in organic growth, given that Q4 last year base was low?

And in input costs, if input costs stay as currently they are, what could be then the impact? In H1 you said single digit. Do you expect a low-single-digit increase for this year?

Pierre-Andre Terisse - *Danone SA - CFO*

Sorry, your last question was about the input costs and what we expect for the year.

Alain-Sebastian Oberhuber - *MainFirst - Analyst*

Yes, exactly.

Pierre-Andre Terisse - *Danone SA - CFO*

Okay. So I'll start with Russia, maybe. Sorry, one minute. Sorry, so I start with the water impact because then Russia and the input costs probably have some link together.

Water base effect, I would not read too much into it. If you take the presentation and you have a look at the charts you will see that, for instance, the third quarter, this quarter, is very high on a very high base. And you see on the other hand that the first quarter of 2014 was not particularly high; it was not double digit on a not particularly high base, i.e. the first quarter of 2013 was 8.6%. So the team keeps working on targeting something which is close to double digit. That's what we want to produce. It doesn't mean that we meet every quarter. Some quarters we do, some quarters we don't do, and the reality when you look at the comps is that it doesn't really say much.

On Russia, a very important element to have in mind is that so what's been helping on the profitability side is clearly the mix, the fact that we have been passing -- we have been performing much better on the high-value-added brands versus the low-value-added part of the portfolio. What has been playing against has been the increase of the cost of milk, which has been covered by a price increase but obviously with some delay effect, plus the de-leverage which we have seen on the milk. Overall we had an equation which was the one we wanted until I would say December.

Further difficulties are coming with the ban. The ban is marginally positive on the top-line side because it has made the presence of some of our competitors more difficult and therefore this has represented some gain of market share on side. So it has helped overall the top line to be sustained above the mid-single-digit threshold.

But on the other hand the other impact of the ban is that it is fueling pressure. It is fueling pressure in particular on the cost of milk, which we expect now to be up again in the second part of this year yet -- in the second part, sorry, of this -- in the last part of this year. I'm sorry; I'm getting tired.

And that's an element which you need to have in mind as well when you want to assess the inflation of the cost of milk. It was significantly above 10% in the first half. It's getting smoother in the second half but yet the situation is not completely stabilized when you think about countries outside Europe and outside North America. So I would not give you a guidance for the performance of -- for the evolution of our cost of milk for the year.

Okay. I think we'll have to stop here. Before I close, just to thank you for attending this call for what has been again a solid quarter. To tell you that we remain on priorities for the rest of the year and on building in the future, that we have an increased confidence in our plans given the number of things we have been building this year and we are getting prepared to build for the future quarter and years. Thank you all. Have a good day and I'll see you on the road. Bye-bye.

Operator

That will conclude today's conference call. Thank you for your participation ladies and gentlemen. You may now disconnect.

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