Danone – Communication Financière

Conférence Analystes

20 June 2012

Participant

Good morning and thank you all for coming along. I am very pleased to welcome our next guest from Danone, Emmanuel Faber, the co-COO. We also have the IR team led by Antoine Guttinger.

Market Overview and Outlook

Emmanuel FABER

Co-Chief Operating Officer, Danone

I will use most of the next 30 minutes to convince you of Danone's unparalleled potential for growth, which it continues to maintain, and will explain to you why the adjustment in our margin target for this year is the right way to address the value creation agenda, whether short-, mid- and long-term.

Value creation is the core of what we do every day, and we do so because we believe this is the best long-term security for ensuring growth, given all the macroeconomic issues linked to obesity, nutrition and malnutrition around the world. Focusing on bringing health through food to as many people as possible has been the motto of this company for years and will continue to be.

The journey over the last 10-15 years has been one of significant transformation, with our historical base camp in Western Europe accounting for 80% of sales of 1997, but only 38% last year and even less in 2012, and we have grown to a point where last year emerging countries accounted for more than 50% of our total sales.

Everything on paper and in reality tells us that we should be poised both for superior top-line and margin growth, because we are positioned in the fastest growing categories of the food and beverage universe on a global basis. We are profitable because we have added to the portfolio a number of categories and built geographies that are ultimately bringing higher margins than our initial starting point.

We have managed a complex environment over the last four years, which I think you are more expert in than I am. Basically, what it means for us is that unemployment rates in the base camp of Europe are growing significantly, particularly in Spain, with continued reduction of employment and growth in the BRICs and emerging countries. That translates very clearly into an unbalancing of where growth is in the world, and this complex environment basically means for us inflation in commodities, and beyond inflation, volatility, which has significantly increased over the last couple of years.

The way we have managed this equation so far has been to set clear priorities. We have been seeing inflation to the tune of about 10% over each of the last few years since 2008, which we have managed so far and will continue to manage. Secondly, we are facing sluggish growth in Europe, and our commitment since the reset in the fresh dairy business three years ago has been to manage our pricing in a very competitive manner. We do not want the gap with our competitors to go back to what it was in the previous years, because we do not believe that is the appropriate way of driving value for both our consumers and shareholders in Europe today.

Thirdly, we have continued to push emerging countries as much as we can, developing our categories, benefiting from the positive mix in most of these geographies, and obviously benefiting from operational leverage linked to growth.

Countering inflation has been an everyday job at Danone, and let me repeat that most of the inflation has been countered in our accounts through productivity. We have basically doubled the amount of productivity we are able to deliver year after year from where we were about five years ago, from about EUR300 million at group level to well above EUR500 million, and this year will be no exception to that, and given the slightly higher inflation we are seeing, we will also push productivity higher.

What did we deliver over the last four years of this complex environment? First of all, we continued very solid like-for-like top-line growth; that is the basic thing for Danone. Secondly, our trading margin has been improving regularly on a like-for-like basis over the last four years, with 53 basis points to 2008, 60 in 2009, three in 2010, and 20 last year. Finally, in these difficult times in terms of volatility and financing markets, we have put increased emphasis on free cash flow generation, which has grown 17% year on year over the last four years.

Let us turn to how it was powered. It was basically powered by our geographical mix of countries. We have been able to maintain Europe at a steady growth rate, and I have to say, for those unfamiliar with us, that Europe includes Russia and CIS. Asia has been growing rapidly year on year over the past four years, and it is obviously an increasing part of our portfolio, and the rest of the world has also been delivering in the region of double-digit growth in sales on a like-for-like basis.

This has also been a function of the evolution of the margin, where Europe has been increasing by about 20 bps year on year; Asia had a fantastic ride, as we very significantly improved profitability, or I should say transformed it, on a like-for-like basis over the last four years. There was 100 bps improvement year on year for the rest of the world as well for the four last years.

What about 2012? I remember when we shared our guidance and targets for this year, when we told you that we had built a scenario for Europe that was basically consistent with the scenario we set in 2008. This was we did not believe that there would be a turnaround in macros, and certainly not consumption, for the foreseeable future. We believe that if there is a curve in the crisis Europe entered in 2008, it will be an L-curve, so we have to live in this new normal.

We told you that our targets were set within this L-curve scenario, and we had a bandwidth. The fact is that Spain fell out of the bandwidth very recently, and we had to take measures to address this issue. Let me talk about Spain very briefly. It is obviously a very big country for us, with more than 10% of our profits, about 8% of our sales, and one of our two large historic countries along with France. Therefore, we have a huge heritage in Spain, with profitable and very strong businesses.

We have seen unemployment skyrocketing in Spain, reaching 25%, 27% and 50% for the young population in the recent months and weeks. More than that, we have seen that there is a direct correlation between the level of unemployment and the level of depression of consumption region by region; and you know there is a pretty varied spectrum of regions in Spain in macro terms. Therefore, unemployment has started to significantly impact consumption patterns in Spain.

Finally, the striking factor about consumer confidence is that, between March and April's statistics, which were made available in May, you can see a downturn of 50% in only one month. This is just about global consumer confidence. Looking at the future confidence, the dive is even bigger; it starts from 97% in April 2011, goes down to 77% in March, and is down to 67% in April. This consumer confidence has directly affected all of our categories.

Looking at food retail, the only growing segment is Mercadona, a low-priced supermarket chain in Spain, which has been growing for a number of years. This growth has accelerated to date in 2012, whereas the other segments are flat. Secondly, in the dairy category, Mercadona is obviously pushing private label growth as part of the overall market segment, and you can see that our own brands have declined in market share.

The result is that Q1 this year was pretty stable, at minus 1% in sales for Spain, with minus 5-6% for Q2. This is clearly outside the bandwidth we defined earlier this year for our targets. The result is that, if we want Spain back in the bandwidth, we have to take action, and these actions are as follows. We need to continue to support and differentiate our brands; we launched a new cup two years ago that added 20 points in consumer preference in all our tests, so we have rolled it out in Spain in all the product ranges and continue to do so.

We work on increasing the competitiveness of our offer, entering into more promotions and multipacks to address the change and shift in consumption patterns. We continue to innovate, believing that the Danone brand name is linked to innovation in Spain, and we need to bring innovation to our consumers. We are accelerating a few innovations, and obviously, as for the rest of the world but even more so in Spain, we continue to address our cost by increased productivity. That is basically what has driven the adjustment of our margin target for this year, coming from a stable target to minus 50 bps for the full year 2012 at group level.

Let me come back to our way of managing. First of all, inflation for the first half of this year is higher than we expected for our commodities and road maps. That is not something unmanageable for us, and it will be addressed through higher productivities we had initially anticipated; these are already in place and will be working for the rest of the year. Secondly, we had to address the specific situation in Spain, with targeted, pragmatic, specific support of our brands there. Thirdly, we continue to grow rapidly in emerging countries, and I would like to look briefly at some of the growth engines that continue to develop beyond the historical base camp of Danone in Western Europe.

Let me remind you that emerging countries are 51% of our sales. We consider North America as a developing country as far as the fresh dairy category is concerned, and everything that develops in this country these days shows that we are right to do so. Thirdly, the growth is there in Asia and the rest of the world, whether it is Q1 2012 or full-year 2011, and I can tell you it will be there in the second quarter of this year and will be there during the rest of this year and the years to come.

Let me explain why we are very confident on this. The first stop is fresh dairy in CIS; that is a country where there is still a low per-capita consumption of fresh dairy. The acquisition of Unimilk is bringing us fantastic market share position in fresh dairy, at 40%, 15% more than the number two

company. We are on track to deliver top-line growth this year in Russia, and we will be exiting this year with high single-digit like-for-like sales growth in Russia and CIS. The Prostovashino brand, the biggest brand of Unimilk which we acquired in late 2011, is already growing at 12% in the first quarter, and you should expect these numbers to continue to grow in the second quarter given the re-launch of the Prostovashino brand, with a new identity and significant and positive consumer acceptance of this re-launch of the Prostovashino cat, which has become an icon; it is already the biggest brand in fresh dairy in the whole consumer space in Russia. I have to say that we have a commitment to improve our margin in Russia steadily over the years to come to the tune of 200-250 basis points every year; we will do that, and we are doing that right now.

The second stop is fresh dairy in the US, a market that has experienced long-term growth of 8-10%. Fresh dairy sales for Danone in the US in the period 2005-2010 grew by 10%. The per capita consumption of only six kilograms of yogurt, which is very low compared to 25 countries around the world which are above it, so there is a big space for us. There is some very interesting news to confirm: Oikos, our re-launched Greek brand, is growing steadily, and we are now clearly number two in the Greek segment, which continues to grow very rapidly.

Our market share is about 20% as we speak, and we are catching up every day against Chobani, which continues to be the leader with 50% market share, but declining month after month and week after week. That does not account for the warm-up sales, including which we are even beyond the 20% mark. Therefore, we are growing rapidly on the Greek; we have new industrial capacities allowing us to double our production as soon as July and August, when it will be implemented. We are the only player that has an offer in all segments of the market in fresh dairy; in 2009 General Mills and ourselves had the same market share in the US, but now we are close to ten points above General Mills-Yoplait in terms of market share in the US. This is thanks to the strength of our brand, and in particular our reaction and execution in the Greek segment.

Therefore, growth is there in the US and is going to stay; this is why I wanted us to stop by the US market before turning to other places, because there are also other places where we see significant growth in our dairy operations. Brazil is another example. You can see how quickly the pyramid of population and income has changed in Brazil, with a huge middle class emerging. We have driven extremely strong growth of our volumes with Danoninho and Activia over the last several years in Brazil, delivering an improvement of 100 basis points in margin year after year.

Ultimately, from a position where we had the same market share as our next competitor about ten years ago, we have close to a 20-point difference in market share, nearly double that of our nearest competitor in Brazil. We have opened a factory in the northeast, because it is one of the white spots, as in the western US and eastern Russia, where we have to continue to push our presence and grow our dairy markets.

Another example is a smaller country, Egypt, where what we have basically done in executing our strategy and our brands there is to nearly double the per capita consumption of yogurt in four years from 0.7% to 1.5%, and we have accounted for more than 50% of that increase in per capita consumption.

Let me turn to water. We have two fast-growing engines, emerging countries and Aquadrinks, and Indonesia is a fantastic example of what we are currently doing, with our Aqua brand at 50% market share, and the largest bottled water operation in the world producing more than nine billion litres of water last year, up 13%. This will continue to improve, because it is one of the first countries in which hydration, through our dialogue with authorities, is now at the base of pyramid

in the food pyramid recommendations. This means that safe drinking bottled water is poised for long-term growth in Indonesia.

The other engine is Aquadrinks, at about 26% of our total water business, and will probably grow beyond 30% at some point, 15% over the last few years, and you will not be disappointed by this growth either.

Turning to baby nutrition, it has changed the face of Danone through the acquisition of Numico in 2007. Let me remind you that we have doubled the cash flow generation of this company in four years, and clearly Asia has been an incredible engine for growth for our baby food business, and will continue to be, with 15% over the last three years, and very strong market share. There has actually been a very strong increase in market share in all of these countries, with a few points' improvement in market share in only a couple of years.

Another very interesting example is Turkey, where we have been working with the authorities to ensure that paediatricians are aware that most babies do not get the amount of milk that they should according to the WHO recommendations, which is 500 ml per day, whereas on average they get 300, most of which is cow's milk, which is not appropriate for their health. Through this campaign, we actually radically changed the level of HDP recommendation by more than 5-6%, driving further growth in the category and driving our market share by another 5% in just 18 months. There are many other examples in baby nutrition.

The last of our engines for growth is medical nutrition, and I chose to share with you the example of emerging countries, although you know that medical nutrition is still very skewed towards Europe for us. However, China is already our first contributor to medical nutrition growth on a worldwide basis. We are, as you know, the clear leader in China, growing 30% last year, and you should not be disappointed by this year's growth either in our Chinese medical nutrition business.

Summarising, the picture has not changed. 51% of our sales are in emerging countries, and 10% are in North America with this incredible engine for growth in the long term provided by fresh dairy. Mexico, Indonesia, Russia, the US, Brazil and China already account for 60% of our sales growth and more than three-quarters of our improvement in EBIT in 2011. This is a very important way for us to manage our growth equation.

I would like to offer you, in the light of yesterday's announcement, an additional way of looking at how we grow our business. There are three areas, the first one being our historical base camp at 45% globally in 2011, a shrinking proportion of our total sales because of the delta of organic sales growth, and because of acquisitions and the way we have been building emerging countries over time.

Growth prospects for this year are flat, with a margin close to average or slightly above; as part of this, we see margin in this zone as declining this year, and obviously Spain will be a big drive in the decline of our margin in Western Europe this year.

The second zone is CIS and North America, a very old alliance. We put them together because they account for 20% of our total sales, a big EUR4 billion chunk of business, and if you listened carefully to what I said earlier about these two markets, you would see many things that are very comparable. There is low per-capita consumption of fresh dairy, and for us these are two fresh dairy markets, as most of our presence there is fresh dairy. There has been long-term growth in the past in both of these markets, with a very strong competitive position for Danone. Lots of things are happening in the short term, which basically means that growth prospects for this year are in the

high single digits for both markets globally. We will exit 2012 with high single-digit growth in those markets.

We have a commitment on market expansion for Russia. What I can share with you today is that the margin for these countries is below the average of the group, and it is gradually improving year after year in a disciplined way.

The third area is really what we have built over the last ten years going into emerging countries. That is already 35% of our total sales, which is growing in double digits as we speak, in terms of the short-term growth prospects. It is very comparable to what you have seen in terms of the past few years in these countries, and margin is already above the average for the group. This margin means that we basically have a strong layer with the rest of the world, Asia, Africa, South Africa and Middle East business, which provides a double accretive engine, both in terms of top line and margin, given what I just shared.

Regarding North America and CIS, we are working to build a very long-term presence in fresh dairy, dominating the business gradually and in a disciplined fashion, improving the margin from a low base, which means a negative mix wherever we grow these countries faster than the average of the group.

Then you have Europe, and as part of Europe you have Spain, where due to deleveraging and the need to react to that deleveraging, we decided to spend more money in order to get Spain back into the bandwidth.

Here is what I have to say to you this morning by way of conclusion. We continue to invest in the emerging countries and wherever we see our growth platforms. We have to address the specific situation of southern Europe and particularly Spain, meaning that for 2012 we reconfirm both our sales growth and our free cash flow targets, and we adjust our margin by minus 50 bps. We believe this value creation agenda is the right one, not only for the long term but also for the short term. Finally, that does not change anything in what we are building and in the way we believe the model for Danone is working.

Questions and Answers

From the floor

Last year at this conference you talked about how confident you were in the dairy business having reset the prices, so I am just wondering why you are losing share in Spain and other people are not, given that, I assume, it is not a pricing issue.

Emmanuel FABER

I think the situation in Spain was very much in the bandwidth until the first quarter, and it is only since April and May that we are seeing a significant change in the overall position. It is no secret, and we discussed this in recent years, in 2009, that Spain is the country where we have the biggest gap, both because of the mix of our products and because of the value of the brand equity, specifically in a country where all competitors have disappeared except Danone and private labels.

Therefore, we have not changed the price index for the fresh dairy business overall, at about 120 compared to the average market. This delta is significantly higher than 120 in Spain because we have the most valorised portfolio compared to Mercadona and the overall situation where private labels are the biggest.

This clearly means we have to adjust further. Because Spain has fallen out of the bandwidth, the competitiveness of our product offering may not actually mean price decreases, but it means promotional activities, it means a different set of SKUs such as multipacks, etc., whereby we will transfer value back to the consumer, because we see trading going back to private labels.

From the floor

Could you just compare the operational gearing of the North America and CIS business to the rest of the world? You talked about building sustainable market share and the very big market opportunity for dairy in North America and CIS. Is there greater reinvestment associated with that in order to achieve it and therefore less operational leverage?

Emmanuel FABER

I think the answer is yes. There is a need to build the category from where it is in both countries, and just to give you an example of that, the next barrier to growth in the category in the US is the shelf, because we need chilled cabinets, and for the retailers to invest in chilled cabinets they need to push sauces, cereals, ketchups and whatever. They basically need to make an investment. Walmart has paved the way, because they have invested in this and they are showing the rest of the retail space in the US that this is a profitable category for them to grow in.

However, the fact is that we need to co-build this, and the result is that you can probably think of high single-digit growth for the years to come and some leverage, so there will be positive margin expansion in these countries, but not the sort of thing you have seen in Asia, for example, or in baby food categories.

From the floor

Can you give us some more details about commodity increases and the way you deal with this?

Emmanuel FABER

Basically, we started this year with a basic assumption that there would not be sequential inflation in our raw materials. We had positive or very efficient H1 2011 hedging strategies, particularly in PET in water, which meant that we were expecting a year-on-year drag effect and therefore inflation inherited from 2011. What happened is that there was sequential inflation; so there was further inflation in PET in 2012 compared to what the prices were in 2011, as well as in a few important components, particularly baby food with milk derivatives, whey serum and others.

The way we have addressed this over-inflation compared to our basic scenario is that we now have higher productivities in place than we had anticipated at the back-end of last year, most of the increased inflation compared to our scenario will be covered by higher productivities. We have made a conscious choice that we want to continue to have competitive price management, and therefore not to transfer prices to our consumers unless we believe it is perfectly acceptable from a

competitive standpoint, or that is the last resort, so there will not be much transfer to our consumers.

From the floor

Will you take a margin decline and not increase prices if commodity prices keep increasing beyond your ability to cut costs?

Emmanuel FABER

I think we are in a scenario where we see a long-term increase in commodity prices. That is our basic scenario. There may be some downturns, because of the European crisis, lower consumption and so on, but our basic scenario is that the price of commodities will rise over time, so we have built that into our model. That means we are gradually building fundamentally different ways of sourcing and fundamentally different ways of formulating our products so that we can address that without changing the overall financial equation of the group. That is what we are working on, year on year.

There are good years and bad years with milk in particular, but as you know, most of the milk we supply for dairy is actually coming from a fresh milk collection that we have, which allows a much longer-term relationship and allows us to capture the improvement in farm productivity and feed productivity. For example, we are now co-buying feed, along with big companies like Cargill and others, from four of our small farmers which we grouped together.

Therefore, we are revisiting the whole to ensure we properly address the gradual increase that we see in food commodity prices for the long term, without altering the business model from a financial standpoint.

From the floor

I am a bit sceptical about that you said has happened in Spain. This movement outside the bandwidth you mentioned could translate to France as well. Can you explain what you are doing there?

Emmanuel FABER

We are obviously looking very closely at what is happening in Europe, market by market. There is absolutely no indication in France that consumption is turning to anything that is close to what Spain is doing, and that is a function of a number of things. One is that the structure of retail is different; there is only one Mercadona, and that is in Spain. That is a big difference from the way people shop and want to shop in France and many others compared with Spain.

Secondly, the price gap we have with the competition is very different. Thirdly, there are categories which are more and less sensitive to consumption patterns and confidence patterns. We have a baby food business in France, as we have in Italy, which could be another part of your question, and it has been our experience over the last several years that medical and baby are very resilient categories given the sheer nature of their business.

Beyond that are foremost, although the overall macro situation in France is a difficult one, it has nothing to do with the situation in Spain, not only in the short term but also, I believe, in the long

term as well. Therefore, we are not seeing much growth in France, and for us France is part of this sluggish growth, L-curve kind of scenario that we have for Europe, but it does not have the ingredients to fall as Spain has.

From the floor

Regarding balance sheet structure, what sort of headroom do you think you have to undertake large-scale M&A at the moment?

Emmanuel FABER

There is large-scale M&A in view. We are committed to the current rating that we have. The way we allocate cash is first to growing our businesses in an organic CAPEX, and secondly in add-on acquisitions. Let me say again that when we went through the Unimilk deal in 2011, we said that this was the high end of what we would call add-on, but you may expect smaller acquisitions that would continue to grow the story that I described earlier in the coming months and years.

Thirdly, whenever we felt it was appropriate, we have been running share buyback programmes since 1997, and this is always something which we believe is available when we want to net the overall balance sheet.

From the floor

Regarding the guidance of minus 50 basis points, can you elaborate on the business mix driver, the inflation of raw material costs and the investment impact?

Emmanuel FABER

Looking at it simply, most of the guidance change is linked to Spain. We are facing headwinds that are beyond what we expected in raw materials, but we are also addressing them through productivities. Beyond Spain, there may be a couple of adjustments in southern Europe, but the absolute core of the issue is Spain. There is no other reason for the change in guidance for the middle of this year than what has happened in Q2 in Spain.

Part of this impact of 50 basis points is the volume deleveraging and the mix impact, although I confirm that Activia is standing well in Spain, which might be counterintuitive given its price position. However, it is doing well, and the tremendous work that has been done on the execution of the product, including the new cup and many other things, is working well, and the balance of the 50 bps is the new resources we need to put in place, have already started to put in place, and will continue to put in place until the end of this year and beyond in addressing the point that I mentioned.

Therefore, it is Spain and the balance of volume, mix and more actions requiring to be implemented.