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# EDITED TRANSCRIPT

BN.PA - Half Year 2014 Danone SA Sales & Earnings Call

EVENT DATE/TIME: JULY 25, 2014 / 7:30AM GMT

## OVERVIEW:

Co. reported 1H14 EPS of EUR1.16.



## CORPORATE PARTICIPANTS

**Pierre-Andre Terisse** *Danone SA - CFO*

**Regis Massuyeau** *Danone SA - IR Director*

## CONFERENCE CALL PARTICIPANTS

**David Hayes** *Nomura - Analyst*

**Warren Ackerman** *Societe Generale - Analyst*

**Eileen Khoo** *Morgan Stanley - Analyst*

**Mitch Collett** *Goldman Sachs - Analyst*

**Celine Pannuti** *JPMorgan - Analyst*

**Alain Oberhuber** *MainFirst - Analyst*

## PRESENTATION

**Pierre-Andre Terisse** - *Danone SA - CFO*

All right. Good morning, all of you. It's always a pleasure to be back here in London just before the summer holidays, a few days from there.

So I'm happy to be here with Regis, with Marion from Investor Relations. And this is Pierre-Andre Terisse speaking, Danone CFO. I want to start thanking again Nomura, for welcoming us. This is the third time. The first actually was during the Olympic Games here in London.

So I'll start with the results and we can get some questions afterwards. Maybe before we get into the details of the numbers, I would like to start with some highlights from the first half, starting with numbers which obviously look weak. This is not a surprise at all. I think all of us have been expecting that kind of numbers.

Reasons are obvious. This is about the bases of comparison in baby; this is about the devaluation and swing of the emerging currencies. This is about the milk inflation. I'll come back on that in details.

But before that, what I would like to do is to spend a bit of time on what we have built during this first half, and what we have built not only for the first half but also for the full year and for the rest of the year, because I think this is the most important. And this is saying more about the performance of the business, rather than the numbers I've just been showing you.

If we want to think about what we have achieved in this first half of 2014, there are three big blocks which I think are important to have in mind. The first of them is really on the left of this slide, which is page 5, overcoming the milk inflation. We'll come back to it again.

You will see that the milk inflation we've had has been at levels unprecedented. It's been amounting to 18%, half on half. And therefore this has been clearly, from the very beginning of the year, putting a lot of pressure on our margins; on our gross margin, to be precise, which has led us to try and put together a plan with various dimensions in order to address this point and to bring back the margins at the level where we wanted them to be.

So a lot of our actions in the first half have been about that. They've been about pricing, and we have different pricing in many different markets in fresh dairy where we thought that was necessary. It's been about cost management, and you have seen that we keep working on managing our cost base down in order to optimize the business. And it's been about mix in some markets in particular; I think about Russia where the management of the mix has been absolutely essential.



This has led us to have the margin in the dairy division bouncing back and coming back basically at the exit of this half to the level we want them to be for the rest of the year. I'm talking of gross margin. Therefore, putting this issue behind us, it has obviously and we'll see it had a total impact on the margins for the first half.

But this has been well managed. Milk prices are stabilized now. They're in fact down in some markets. And I think we can basically draw the conclusion from this first half that this is a point which has been managed and well managed.

The second important achievement of this first half has been innovation and mix in key markets. I'm not going to cite you all the innovations which we have been launching, but this is obviously key because what we are trying to do is to build value for consumers and value which we expect to be reflected in the P&L.

So in Europe we have been launching Danio in France, which has been a real success. You've seen the new bottles, packaging of bottle in Evian, including La Goutte. We have a wide new range of indulgent products in the US, and obviously the relaunch of the products around baby nutrition, sorry, in Asia, and in China in particular has been a problem.

So a lot of new things, a lot of new things which are obviously building the performance of the Group today but also tomorrow, and are going to keep contributing to the performance of the Group for the rest of the year.

The third element is a bit more long term, but it is important. We have completed transactions in two important geographies for the future of the Group. In China, we have increased our stake in Mengniu this first half, going to 10%. And at the same time we have completed, we have closed the transaction, the setup, sorry, of the JV in Fresh Dairy Products with Mengniu.

And therefore we are now, today, the core owner and the core operator of a fresh dairy business in China which sizes above EUR500m and which is profitable. And therefore this is putting us in a good position to address this market going forward.

The second element is Africa. We had done two transactions, one in North Africa and one in West Africa last year. We have done one in East Africa this year, taking 40% of Brookside. And therefore we start having a platform in Africa which is serious and reasonable for us to make of this continent a real point of development for the Group going forward.

So, a lot of good things behind the sales numbers. Maybe one way to look at it and to realize that we are indeed starting to see some progress, although they are from a quantitative standpoint not completely obvious enough, is the geographical dynamics.

In Europe, this is the second quarter in a row that we are positive, and obviously this is not the case in all business lines. This is the case in water, baby, medical; this is not the case in dairy yet. But it means that we are progressing towards the stabilization of sales in Europe.

In the CIS and NORAM, we remain with a solid performance. And again, we'll come back on that because the US and the CIS have not had the same trajectory, but we are basically within the range we wanted to be.

And in the emerging markets, you see that taking into account or not the disruption from Fonterra, we start seeing a bit of a pickup. So obviously the big difference is going to be made in Q3 and Q4 of this year, but we see already that we have been somehow bottoming at the very beginning of this year.

If I take all the streams, all the priorities we have for 2014 one by one and we go through it, I'll start with Europe dairy, maybe. We continue working with a team which is strong and increasingly focused. Some of you, most of you, have met Gustavo Valle. He has a very clear mind about what he wants to create for Europe, and this is expressed by the green spiral you see on the top right of the chart.

It simply means that he wants to go and get cost savings, optimize the cost base, in order to reinvest and to generate a stream of growth in value-added products; a very clear vision about driving gross margins up. And this has led his actions in the first half of this year where the priority



has been obviously given to the restoring of the margins, and to getting the margins in fresh dairy Europe for the second half up and we are well placed to achieve this objective.

On the top right side, what the actions we've taken in pricing have of course had some impact on volumes. We are not worried about that. We see positive trends in most of the markets. We know there is a long way for us to go before we get to any meaningful growth in fresh dairy in Europe, but we believe we are in the right trajectory and the stabilization of our market share is I think a good testimony of that.

CIS, CIS and NORAM, so CIS is frankly a real satisfaction; 10% top line growth in the first quarter, 10% top line growth in the second quarter as well. We basically confirm what we have seen at the end of March of this year, i.e. a performance of the fermented and milk which, given the level of price increase for the low value-added products in the red box, given the level of price increase we have taken in reaction to the increase of cost of milk, has been very meaningfully down in terms of volume.

And this has led us to start taking actions on the reduction of our cost base. We have announced the rationalization of three factories in Russia, one in Novosibirsk, Perm and Togliatti, and we are going to obviously monitor this very closely.

The very, very important part of the equation is that the modern dairy has not only grown in value, but it has stabilized or been slightly up for some brands in volume, despite the level of the price increases, which means that on top of the price we have an element of mix which is extremely strong in this business and which has been driving the top line again in continuous double-digit territory in Q2. It has, needless to say, as well helped the margins to recover within the first half, and therefore to be at an exit point which is consistent with what we want to do in the first half.

North America, there's no doubt and with sales since the beginning of the year there is a confirmation, there's no doubt now the market has become soft, soft to weak. It's growing low single digit, very low single digit in value now, slightly negative in volumes. The Greek is not driving the market as strong as it used to be.

In this context, we are doing two things. We are -- on the one hand, we keep competing on the Greek and we have reinforced our market share. We clearly are now at the same level as the leader of the Greek segment, and therefore we have the quality of the Greek segment, and at the same time we are trying to reinvent or reopen category innovation.

There's many things which again we have tried to show you in New York, a frozen version of Oikos; Danone Creamery, which is really trying to expand the category through the indulgent segment, which does not really exist in the US and is, as you know, quite strong in some of the markets in the world with the brand Danette, so here we'll have the brand Creamery. We're as well trying to leverage the acquisition we've made a year ago in baby with Happy Family, by putting new formats on Yobaby and trying to expand the range in a kind of yogurt for babies under the Stonyfield brand.

So other things obviously are going to come on the market. This is a very interesting year in the US, which is closing the period of the Greek somehow and reopening other levels of the growth of the category.

And emerging markets, third priority. Well, a lot of people say that this is going down, that it's unavoidable that it slows down. And yes, it has slowed down. If you look at the slide by geography, which I've shown you before, you will see that we were growing at 15% and we're now growing at 12%, 13%, so there is no doubt that we are several points below.

But it remains a very robust growth altogether, very strongly driven by Aquadrinks, very strongly driven as well by early life nutrition activities in countries outside Europe and China, but also dairy which is growing high single digit and medical which is growing in excess of 10%.

So, a lot of very positive news and still very strong trends in these markets, overall with, it is true, a bit more volatility here and some conditions from time to time which are more difficult to manage. But this is data or a fact of the markets which we have to live with, and these geographies remain geographies for the present and for the future of the Group.



As said, we are trying to complete them with Africa, which we were for a large part absent so far. Brookside, in which we'll get 40% stake, has revenues around EUR130m so it's a sizeable platform. It's covering several countries in East Africa, and to start with Kenya.

It has connections with 140,000 farmers, so it's really focusing milk in one of the areas of milk sourcing of Africa, one of the only areas of milk sourcing in Africa, so it's really opening up the possibility to source milk. And at the same time, it reaches 200,000 distribution points, and therefore it's important as well in terms of route to market.

Last, China. China is obviously one of the key objectives of the year. We have achieved two things during this first half. The first is that we needed to be a bit wider in the way we source base powder and ingredients, so to switch to other forms of supply, other sources of supply, which we have done. This has created some disruption on the supply chain within baby during the first semester, but this is behind us now and we have done that satisfactorily.

The second element is obviously the launch of three brands in the Chinese market; Dumex Mainstream which has been relaunched, Dumex International and Nutrilon. I've put Nutrilon at the top because this is the real success of the first half.

This brand has developed very well in the ultra-premium segment. It's obviously starting from a low base, really getting a lot of traction, and I think this is one of the very positive points of this first half. It's going to help us to be one of the tools -- one of the important tools to help us rebuilding China.

Dumex, conversely, has been a touch disappointing. The mainstream version is not completely taking off as we expected, though it's a bit early days, but it's fallen out a touch below what we expected. And Dumex International is showing a promising start, but again it's very early considering the fact that we have been launching that in May.

So, overall, a performance which is really where we want it to be and which makes us confirm this will be a year to recover levels, as shown in the blue bar, of close to 70% at the end of this year, which as you know was the assumption we took to give our guidance for the year.

So that builds an agenda for the second half which is basically unchanged. We will keep focusing on the same priorities, on winning in the CIS, winning in North America, with different agendas but important agendas, keep winning in Europe, keep -- in Europe, sorry, turning around the business and making sure that we progressively stabilize top line and margins, and we really have the teams and tools for that now.

Grow and navigating in ALMA; again navigate because there is relative growth because fundamentally this is one of the key growth engines for the Group, with 12.8% growth in the first half. And turn early life nutrition engine back to full speed in China. We have started achieving that in the first half; we'll continue in the second.

I'll go now a bit more into the figures and results, starting with the numbers so you have all seen them. Just to remind, sales are up 2.2% like-for-like for the first half, minus 5.3% in reported terms. This is mainly the foreign exchange, or almost only foreign exchange and evolution of currencies.

Trading operating income, underlying net income and underlying EPS all go down 10%, 11% on a like-for-like basis and 20%, 21% on a reported basis, again the currency playing a major role. And for the rest, we will see that margin is the main driver of that.

The margin, operating margin, therefore, is at 11.27%, going down 160 bps in like-for-like terms and 200 bps in reported terms. And the free cash flow is more than halved at EUR286m.

Starting with sales, minus 8.3% in currency after a first quarter which was in the region of minus 9% so it's improving a little bit, if I may say, but remains a very significant negative, driven by the devaluations in Argentina, in Russia, in Indonesia, in Brazil, and progressively we are going to complete the anniversary of this position and therefore the situation is going to stabilize. We expect the second half, if the current spot rates were to prevail for the rest of the year, to be at minus 4%, but it's going to remain negative for the rest of the year.

A slight positive scope effect, attributable to the integration of last year. And then 2.2% like-for-like, which is marked by a positive value at 5.2% and a negative volume at minus 3%.

You find the same picture, basically, page 17, on the second quarter, with a currency effect which is slightly better. I just mentioned that. Scope nil. Volume which are more negative at minus 3.9% and value which is more positive at 6.2%. Given the timing of the (inaudible) price increase, this is absolutely normal.

Similar to what I've shown you by geography, you'll see that we are somehow bottoming between Q1 and Q2. It's been four quarters now that we compare to a pre-Fonterra basis, and therefore starting from Q3 the numbers are going to look pretty different. We are going to come back quarter three on the trend of Q1 and Q2 of 2013, with the acceleration of the bases of comparison. The underlying top line, and I think that's one of my key messages of the day, is very solid with a lot of positive news in many countries.

If we go by division, fresh dairy basically reflects what I've already commented you, i.e. a Europe which we have chosen to manage through margin and costs in order to make any growth solid, and therefore which is slowing down from Q1 to Q2. Russia remains at the same level.

The US market is clearly weaker now. We are talking of a market which is between 0% and 5%, and we are for the second quarter, sorry, growing at mid-single digit.

And emerging markets, which remain at a high single digit in terms of growth. Obviously, volumes are significantly negative. The most of that is driven by the CIS, needless to say, with milk and low value-added products having decreased volume wise in the same quarter by close to 20%, the rest of the volumes being flat. This is the main reason for the variance. This is the main reason for the negative volumes as well.

Sequentially, the emerging markets have remained on the same volume trend and Europe has been weakening a bit in terms of volume. US is stable in the volume/value mix.

A lot of innovation, which we're trying to use to sustain that and to build the top line. As mentioned already, Oikos and Creamery in the US. You see Danoninho in Brazil. You see some additions to the portfolio in Spain, with drinks on Danet and drinks on the core with the Looney brand on the bottom right. And Tema in Russia, which continues its development of the very, very strong brands in the segment of this baby and dairy market.

So that is for fresh dairy. Waters, a very good performance; 13.1% top line in the second quarter, 11.2% in the first half all together, so that remains a very strong trend, in line with the trend of the previous quarters and years.

Still very much the same dynamics. We see waters and Europe being growing low single digit, the big additions coming from the Aquadrinks, and in particular from the Aquadrinks in Asia, which are driving the mix up, which are driving as well the value up all together, but on a volume base which starts growing, so it's really the ideal equation for this business.

And we keep sustaining it with additional launches. Again, two very interesting this quarter. A, we keep launching new initiatives in Aquadrinks, and you have seen Vit, V-I-T, which is the second water brand which we have launched in Aquadrinks in Indonesia. You have Bonafont Levite, you have Salus Y!, and you have a new cucumber and lime Mizone in China, which by the way is absolutely fantastic. If you have the opportunity to try that, that's a great product.

And then we keep innovating on the Evian side as well. Evian is very important. A lot of good things, and in particular the La Goutte format which is a [20 cl] (corrected by company after the call) format for EUR1, which is going to be very much rolled on the go and which I think is going to be one of the factors driving the performance of Evian going forward.

Early life nutrition, obviously important to look at both sides of the equation, i.e. to look at it in its entirety. And we deliver a quarter which is at minus 9.2% still very negative, driven by China, driven by Dumex and Karicare, to be precise in terms of brands. At the same time, the rest of the business remains strong. It's a touch down.



This is what we had in Q1 and in Q4 of 2013, but nothing which makes us worry about the future performance; a lot to do with the description of the supply which I've mentioned. There is a lot of very good traction in most of these geographies, and therefore a very solid and good performance.

With respect to China, I've already commented that. We'll keep following, by the way, the red dots in the coming quarters simply because the performance is very difficult to read without them today. But it will keep being difficult without them, to read without them tomorrow, because we'll have a very strong positive, but a very strong positive is going to be meaningless. So we'll keep following the trends and share that with you.

And again innovations in different fields. I just want to outline on this chart PreciNutri Dumex or the renovation of Dumex on the left side. But on the right side down, a fruit pouch product, which is one of the first steps we put in food in China, and this is part of the things we are going to try and build and leverage going forward.

And medical nutrition, last, delivers a good performance at 7.3% top line growth, positive volume, positive value, 6.2% plus 1.1%. A solid performance across the categories and the geographies. Europe is very solid and the neocate allergy product in particular has delivered a very, very good performance. So the business runs very well, with innovation as well, which combines, as usual, the convenience and consumer insight and the scientific engine of the division.

So that's it for the sales. I'm going to turn now to margins. You all know this table, which bridges from operating income, which is down EUR100m from EUR1.184b to EUR1.084b, which is split into two parts, one which is trading operating income, i.e. the recurring one, and the other one which is others, the non-recurring one.

On the non-recurring one, the EUR96m is almost in its entirety, I think EUR98m, attributable to the cost of -- the cost-saving plan which we have been putting into -- which we have announced a year ago, the EUR200m plan. Part of the costs are coming now, EUR96m.

On the trading operating income side, we therefore have a reduction of EUR295m, which drives a decrease of the trading operating margin by 207 basis points. This 207 basis points, page 29, is attributable to Forex for 12 bps, scope for 35 bps, with the integration of new operations which we are transitioning and adapting before they come into the full scope, and a like-for-like performance of 159 bps down.

Now, this slide is obviously very important, page 30. This shows the bridge of the like-for-like margin evolution, so the analysis of the minus 159 bps. You see, and this is not obvious at first glance, that the main factor for that is on the left side.

And this is called the crisis early life nutrition impact, simply because -- just to remind we have decided in the second half of last year to deal with all the costs relating with the crisis, including the under-absorption effects in non-recurring factors. We had said at that time that there would be none in non-recurring from January 1 and that we will be putting all the costs back normal to the margin, which we have done.

And we are gradually reabsorbing them, but obviously it takes a bit of time before we can fully rebuild the top line and before we can fully reabsorb. And therefore the impact is very meaningfully negative at minus 132 bps, which is, I believe, something like 80% of the 160 bps negative so most of it.

The second factor, which is extremely important, is obviously in the middle. It's the inflation of the input costs. We are talking again of a very meaningful number and a very meaningful increase, 18% all together. This plus the impact from the devaluation of the foreign currency, which has been adding to it, this represents a negative minus 331 bps after productivity, with about 100 bps of productivity, so mitigating factor to these market price increases, and most of that, the vast majority of it, is the milk.

In front of that, we have done what I told you at the beginning of this call, i.e. put in place action plans in order to correct that and to drive the margins back where we want them to be. We've taken the appropriate time to do so, and therefore there is a lagging time effect in the first half which is the difference between the 331 on one hand and the sum of the 241 and the 58 on the other.

On the A&P, it's clear that we keep asking and questioning about the use of A&P in Europe, which we want to fix and we have not completely fixed yet. But this is one of the priorities of Gustavo. You know that. I shared that with you.



But at the same time, we have also used this table as an alternative to a price increase in the first half, adjusting it, so clearly you have to have a look at the sum of the two effects. And this is basically the reason for the evolution of the margin.

Looking with the chart, I'm not going to try and enter into any quantification here, but it just shows that we are now at levels of the cost of milk which are far above the peak of the crisis of 2008, so a very meaningful effect on our costs which we have to pass to consumers but we just do it in a proper manner.

You find the impact I described to you very well by businesses. Fresh dairy -- sorry, I'll start with baby, which is down 270 bps at 17.4% margin, and this is very much the annual absorption of fixed costs in China and Asia, but in China in particular. The impact from the inflation of milk on one hand and foreign currency on the other is read predominantly in fresh dairy, but also in medical. And waters, on the other hand, is delivering a margin progression of 38 basis points.

We expect, obviously, all of these figures, all the margins, to be up in the second half of this year compared to the first half of last year, and up sequentially as well for all of them, so a strong rebound of margin in the second half, logically, because we'll have the carry over effect of pricing in dairy while the inflation of the cost of milk is cooling down now. We are going to reabsorb in baby and in waters. We just intend to carry on with our profitable growth equation.

Moving from operating margin and income to EPS, so trading operating income down from EUR1.475b to EUR1.180b. You see the underlying part on the left of the screen, page 33. On the right you have the non-current items. Frankly, on the non-current nothing to add except for the tax effect which relates to the EUR96m, so the taxability of restructuring charge.

On the rest of the P&L, financial expenses have been broadly stable. Income tax is stable in percentage terms at close to 30%, but it's obviously down together with the operating income. Net income of affiliates is down on high comps of Yakult, which had some exceptionals last year and doesn't have them this year.

And the non-controlling interests simply reflect the fact that there is also Spain down this first half versus last year, and since we still have a minority interest in it, this is driving the non-controlling interests down.

EPS on the registered number of shares is at EUR1.16 versus EUR1.48. If you look at the EPS bridge, you therefore see that the two real drivers of the decrease of EPS are the margin on the one hand for 11.4% and the currency for the other. Currency I told you we expect to be still negative, although less negative on the basis of current spot in the second half. Margin is going to be a completely different story, as will be top line, and therefore the EPS evolution in the second half is going to be very different.

Cash, the impacts are even bigger in terms of reading. To work you through it and make you understand, we go from EUR714m cash flow in the first half to EUR286m in the first half of this year. So, last year versus this year, that makes a difference of EUR430m, roughly speaking.

You have a bit of forex, which is playing for about EUR30m to EUR50m. You're left with EUR200m. EUR200m of it is net operating profit after tax, which you can find with one of the previous tables, so it's the direct impact of the performance in terms of sales and margin.

And the other EUR200m relates to working capital with three big blocks, one being the payment of tax provisions, the other one being again China and the deleveraging of China, and the re-leveraging is obviously going to have a reverse effect in the second half, and the last being some movement of inventories on the extreme side in the case of milk in Argentina and in other geographies, to try and optimize a bit the milk equation. And again, they are going to reverse in the second half.

So, all together, cash performance which is obviously weak and which will rebound as well in a very meaningful manner in the second half. This, by the way, EUR286m is before restructuring; after, it becomes EUR207m.

In front of that, we've done two things. We've had M&A. Most of it is with the acquisition of a drying tower in New Zealand and a packing line in New Zealand in baby, to supply our baby operations in Asia. And the other one is about our investment in Mengniu, EUR500m. And then we've



paid a dividend, a big part of it, by the way, having being paid through shares because our shareholders have elected for shares and this is the cash component.

So, a total increase of debt of EUR700m, for a debt which remains on the side of the balance sheet or in proportion to the balance sheet very much stable at EUR8.7b versus close to EUR8b, and no big event in terms of debt issuance or debt maturity this quarter. The rest of the balance sheet remains practically in line with what we had at the end of last year.

So that's it for 2013. We'll go now -- 2014 first half, sorry. I'm mixing up the dates. A few words of outlook for 2014. So, as I said, we are really at a pace in this first half which is consistent with the objective we had set for ourselves for the year. We expected, obviously, to have these comps not helping us in the first half. There are positives and negatives. But overall, this comforts us with the objectives of the year, and therefore we confirm them.

Top line, 4.5% to 5.5% for the entire year. Trading operating margin which we expect stable, plus or minus 20 basis points for the year. And free cash flow which we expect to be around EUR1.5b excluding exceptional items.

It obviously means that the second half is going to be very strong pipeline wise, very strong margin wise as well, and you see that the bases of comparison are going to be playing a key role in that. We should just be careful to look at the numbers in a very cold manner during the second half, to again as we have done in the first half, understand what is the real underlying trend and what we are building for next year.

And this is the mind we have when we look at the business, but no doubt that this implies a very strong second half on a weak basis of comparison.

We'll keep the same agenda. In fact, I've already said that. Keep focusing on CIS, NORAM, on Europe, on the growth in emerging markets which is key on turning back baby China to full speed, with the clear will to make of this a second half which is going to be strong and profitable in terms of growth, to make it sustainable, so to build this second half and the rest of the years, semester and years to come as well.

That's really what I'm going to end with. Thanks very much for listening to this not too long presentation. Actually, I was okay. And we can take questions now.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions).

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### David Hayes - Nomura - Analyst

Hi. It's David Hayes from Nomura. Two from me, please. I think you mentioned that the exit rate margin in dairy end of the first half was in line with what you were expecting in terms of for the second half. I was just wondered if you could be more specific about, with the gross margin where it is currently, what kind of margin you expect at the operating profit level in that division.

And then, secondly, there was an article in the Wall Street Journal, I believe, talking about a strategic review in September which one of your people confirmed was taking place. I just wondered whether you could be a bit more specific about whether that's something which is abnormal, what that's looking to address and what we might expect from that into next year. Thank you.

**Pierre-Andre Terisse** - *Danone SA - CFO*

Thank you, David. So, margin first, without being too precise or specific, we ended up last year with a level of gross margin in dairy which were in the region of 30%. The first quarter was more than 300 points below, and the second quarter is back to the level which we ended up the end of last year, so about 30%.

And I'm talking ballpark, just to give you the magnitude and tell you that, A, we did the job, and I think that it was extremely important for us to do it during the first half, to bring the margin back and not let them go to territories which really become a problem. And B, that we brought them back to levels which mean that we're equipped to go through the second half.

Equipped doesn't mean that everything is so we can go on holiday until the end of the year and do nothing, but they are fundamentally consistent with the numbers we have -- I have in mind that we have in our objectives in order to deliver the full year very logically. And that's where we stand today.

There are obviously many other parts of the P&L to be handled. There are cost savings which need to be completed and initiated for some other of them. There are potentially few to be injected in the equation, so many other parameters. But on the gross margin point, this is a very important one and we have raised that issue.

On the strategic review, so that -- I don't know how to qualify that. The only thing I can think about in terms of what it will be is Danone 2020. Danone 2020 is an internal discussion which we have shared with you for -- some bits of it in Manhattan during the investor seminar at the end of June.

Danone 2020 is about how do we in the future continue building strong, sustainable, profitable growth, and how do we do it in our current business and portfolio. So, how do we address, in a unique manner as much as possible, [alimente passion], as probably you heard Emmanuel saying, which is a bit different from food. How can we be specific to -- relevant to the local population and how can we do things different in order to conciliate health and what people want to have? How do we address cities versus countries, for instance? How do we go in rural areas?

It's about how do we manage our supply chain, and in particular how do we address the issue of scarcity of resource and volatility of resource. How do we deal with the milk? How do we make sure that we keep having access at an acceptable level of price and the right level of quality, so the right milk we want for our operation? All that in a sustainable way, i.e. aligned with the interests of the other stakeholders. How do we do with plastic? How do we do with fruit?

And it's about unique asset management. How do we perpetuate yet adapt the Danone model to the current challenge of the world? How do we, as Marc and I explained you, have a look at back office functions and try to do what other companies have done before; we are not inventing anything, but try to mutualize and to try and find some economies of scale while not putting away the Danone reactivity culture and ability to be close to consumers?

So, Danone 2020 is very much about that. It has absolutely no taste whatsoever of strategy review in the meaning which is usually the one accepted or commonly accepted by the bankers and the financial community, which is I'm going to sell this part of the portfolio or buy this part of the portfolio, whatever. It doesn't have any consequence in terms of I'm going to have a big plan of cost savings of EUR300m, EUR500m, EUR1b.

It's really about how do we keep adapting Danone to the current environment and make it increasingly relevant, because we think this is a condition for Danone to be able to sustainably deliver strong and profitable growth. I think what you have seen on the performance of the Group for the past five years clearly shows that we have a challenge to take in terms of sustaining positive results.

So we are talking that short term. We are addressing that long term as well, and this is the meaning of Danone 2020. There is no strategic review at Danone other than that, which is not one. There is no strategic review at Danone.

**Regis Massuyeau** - *Danone SA - IR Director*

Warren.

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**Warren Ackerman** - *Societe Generale - Analyst*

Can you hear me? Yes. Warren Ackerman at Soc. Gen. Can you talk a little bit about the volume/value equation in dairy, because obviously at the moment the pricing is 10%, roughly, and the volumes are down 7.5% in the quarter? With milk prices really coming down, do you think the pricing within the organic growth in dairy could actually maybe even turn negative from this very high level, as we've seen in the past? In other words, how much of the margin do you think you can retain, or should we expect that price increases that you've been taking in dairy quickly become price decreases as the retailers will ask for the lower dairy prices back?

And then, just secondly, just on European dairy, you've been very clear with all of us that you expect to get back to stability in European dairy roughly by Q4. Now, with Q2 a bit of a step back compared to Q1, the Nielson data showing that Western European dairy are down 10% in June, with markets like the UK very weak, for example, in Q2, do you think there's any risk around that objective of stability by Q4? Is there any risk that that could perhaps get pushed out a couple of quarters because the Q1 trends have not been confirmed, really, in Q2? Thanks.

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Yes, I think it's about the same topic. First of all, I would like to say and invite you to go and look back at the transcript, if necessary, that it was clear to us from the first quarter of this year that the negative volume would be higher in Q2 than in Q1 for one simple reason, which is that we started seeing the biggest driver of the negative volumes, being Russia, going down from February, March. So we knew that that we would have a full counter effect coming in April, May, June without knowing even what April, May, June would be.

So I'm not overly worried by that. I expect this time that it's unlikely to go further down. We'll clearly have to manage the question of the low value-added products and the milk. We have done that from the increase costs side by trying to decrease the costs and to make some restructuring, so to try and adapt the cost base we have.

We'll probably have at some stage to manage the reverse, because this is a specialty business and this is a business where having low level of margins you need to be able to be flexible, because competition is just flexible. That's the low value-added side of dairy in Russia.

Again, what I find more interesting, because this is really what we are good at and what we can do over the long term, is delivering good value added to the consumer and good margin on the value-added side of the portfolio. And here, I don't really see a risk that we will be strongly or significantly under pressure if the cost of the milk will go down. There are obviously some elements of cycles, but they are by definition of our construction, because with the margins on new products they are far less sensitive than in the case of milk.

Again, one of the things which I find very satisfactory in the case of Russia, and which applies to Europe as well, and I'll come back there and make the link between the two questions, is the fact that we have strong mix. It is the fact that the brand Prostokvashino, the brand Tema, the brand Bio Balance, the brand Actimel, the brand Activia, the product innovation which we have been building in the course of last year in Russia are bearing fruit.

We are generating positive mix, so to some extent we have to pass less price increases than we should just because we have positive mix, which is helping the equation. And that proves that we have in this specific case, and that's what we need to find back in Europe, the ability to create value to the consumer and therefore to drive the equation up.

Now, Europe, you've heard Gustavo is very clear about his priorities, and his priorities are the same; let's recreate value for the consumer. And in the let's recreate value for the consumer, there is certainly a top line driver, which is let's reinvest behind the brands and let's have the brands go up.

But there is as well not the total absence of complacency vis-a-vis products which would have at a certain point in time, or because of the increase of the costs which they are suffering, which would have a profitability which is not in line with what we want to do or which is artificially low or whatever.

So the step he has taken, and I believe it is the right one provided we take some measures, is that his main objective is to stabilize growth but really stabilize both, i.e. make the work on margin at the same speed as the job he makes on the top line. I said and I repeat that we therefore expect, reasonably, we are confident to see some margin improvement H2 to H2 in dairy Europe in the second half, which is frankly something which is extremely important.

On the top line side, we still target a stabilization of sales by the end of the year. I would not be completely surprised if we are minus 1%, minus 2%, instead of zero. But as long as we deliver a package which continues going to stabilization and which is balanced between top line and margin, I am absolutely fine with that because I think that's the most important. The most important is continue playing both, and he's doing it.

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**Eileen Khoo** - Morgan Stanley - Analyst

Hi. It's Eileen Khoo from Morgan Stanley.

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**Pierre-Andre Terisse** - Danone SA - CFO

Hi, Eileen.

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**Eileen Khoo** - Morgan Stanley - Analyst

Hi. Two questions. The first one is on early life nutrition in China. I was wondering, I know there are a lot of moving parts at the moment, but would you be able to give some color on whether there were perhaps any temporary short-term factors in the quarter that could have impacted your organic growth there, and also talk a little bit about the competitive dynamics that you're seeing and the underlying category growth, and also how your sell-out rates have evolved in the second quarter versus the first quarter?

And then could you talk a little bit on the supply side as well, because some of your competitors have done supply agreements in Australia and New Zealand, for example? How do you think about that in regard to your supply chain in China?

And then the second question is actually on Capex. Given that you now seem to have a bit more spare capacity than perhaps you have in the past, does that mean that your rate of Capex spend could fall in the coming years, or if not then where are the priorities? Thanks.

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**Pierre-Andre Terisse** - Danone SA - CFO

Okay. So China first, which is not a question but a mega-question. Supply has definitely been one of the key topics and key challenges of the first half, because you easily imagine that going from one supplier to trying and find different sources and different alternatives for base powder and a lot of ingredients for different products is not something which is easy. We have not made a lot of publicity around that. We've made the job, but it has indeed created some supply shortage.

This, plus on the other hand some change of regulation labeling which has -- in particular with respect to China, we have been going through but which has created as well some shortage. It is not something which is very meaningful, but it has altogether disrupted a bit the operation we've had in China and in Asia altogether. And the teams have really been putting a lot of time and efforts to solve that.

I think the result is absolutely valuable, because we have something which is far more sustainable now. We have, not working yet but it's going to be working very soon, our own supply of milk in New Zealand, with a dryer connected to a milk collection area. And with some packaging line and capacity in a meaningful manner, we have increased our capacity as well in Europe, so a lot of work.

And I'm sorry to insist on that but, yes, it's been a very big topic. And there's been some bits and pieces being negative in terms of shortage, but we are dealing with those and there's no fundamental impact on performance.

On the management of the brand, let me just repeat what I said. We said two things at the beginning of the year, and I just want to repeat it to make sure we are all clear about that. I said we are going to launch or to use a lot of different brands because we have a lot of different brands, and this is what makes me comfortable with the fact that we are going to succeed in China. But if you ask me which is going to work and which is not going to work, I don't know, or I don't know to what extent. We have people who are going to try and fix and it's going to be a try and correct.

And the second thing which was clear as well is that, we even wrote that in the outlook, we said we wanted to rebuild it but we wanted to give priority to strengthening or to building a strong base rather than recovering very fast, and this is exactly what we are doing. Both sides are.

When I say that some are going to be working very well, some others are going to be working less well, even if many brands which are doing well, like Family is doing well, probably better than expected, Karicare is doing a bit less well than expected, and in the big relaunch Nutrilon is a real satisfaction. Nutrilon Platinum in China is taking market share and it's building a position in ultra-premium so we have to keep building on that. It's certainly something we are going to bet more on in the second half than what we would have done in the beginning of the year, because it's working better.

And Dumex is in terms of sellout not satisfactory, and you see that to some extent. And it's always something I'm very careful with, because they reflect only part of the reality and sometimes they are a bit disconnected, but you see that in market share. The market share of Dumex is not really recovering, and that reflects the fact that the sellouts are progressing very modestly.

Dumex International is different. It's just been launched and again we have good promising signals, but we need to see. We'll see that from September, October and November, whatever.

And we continue. These are not all the launches we want to do. We have more launches to come and we'll keep the building the portfolio. And frankly, I have as little doubt as I had at the beginning of the year in our ability to succeed for the very same reason, i.e. we'll take the time, we have the brands, we have the capabilities, we have the organization, and you know it will come.

And at this stage, with respect to an important question, which is to what extent does it make us able or not to hold with the objective of the year for the Group, the answer is we stick to it and we believe we will do it.

Capex, you're right, and at the same time we have businesses which are growing. Yes, we have businesses which are growing like mad. We have businesses growing at a rate of 25%, and it's not been one year but it's been one year, two years, three years. I'm talking of the Aquadrinks, and Aquadrinks is certainly something which needs capacity. Water needs more capacity or costs more in terms of capacity than others. Brazil continued to grow.

So I prefer to make sure that we stay at all times in the 4.5% to 5% envelope. We try to optimize, if we can. And I can tell you, if there are possibilities of optimizing and being more selective in what we spend, we'll do it, but always in the range 4.5% to 5%, for the moment.

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**Regis Massuyeau** - Danone SA - IR Director

Yes, Mitch.

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**Mitch Collett** - *Goldman Sachs - Analyst*

Thank you. It's Mitch Collett from Goldman Sachs. Firstly, just coming back to margins again, if I may, you had a -- the chart of input costs obviously looks like it's moving more in your favor. Can you just confirm that the guidance is really predicated on that stability continuing, and that's the plus or minus 20%, rather than necessarily that absolutely falling?

Secondly, there was obviously some inorganic effects in the first half. Can you give us a sense for what the inorganic effects are likely to be on the margin for the second half? Should we just take the 50 basis points and half it for the full year, or is there perhaps more going on?

And then, finally, if we could just have a bit of context around why early life nutrition has slowed outside of the Fonterra recall affected region, that would be helpful. Thank you.

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Yes, I'll start with that. It's really a story of shipping in reference with some disturbance in the supply chain, true in Europe, true in some of the countries in Asia, untrue in Americas where it remained very strong, true in some countries in Africa as well, not in the Middle East. Again, there are a number of selective events which when you look at them one by one basically mean that it's a one-off and it's going to revert or -- but does not at all break any kind of trend. So we've just obviously revisited that or visited that very seriously, and no concern.

On the milk, yes, we assume parameter stability, with different assumptions by market. There are even some markets in which we know there is a delayed effect and therefore it's going to continue increasing. Some others were in decrease but it's also because of seasonality, which is the case of Russia. But we expect no change of trend, if you wish, on the milk side as our assumptions will complete the year.

And on the non organic, there are 12 bps of effects, which considering what we see I would expect to remain in the region of minus 10 bps. I'm talking under the control of Regis. And for the scope, I expect the negative effect will be reduced versus the minus 35 bps, so to be more in the range of minus 15 bps, 20 bps.

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**Regis Massuyeau** - *Danone SA - IR Director*

We'll take a question on the phone now.

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**Operator**

Celine Pannuti, JPMorgan.

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**Celine Pannuti** - *JPMorgan - Analyst*

Yes. Good morning. I would like to come back on the charge you put on the bridge for the margin. You just said that you expect -- the milk prices, your expectation is that it's flat. What does that mean in terms of this milk cost inflation that you have had in H1? Are we expecting it to be flat in H2 or you will still have a drag? If you could comment on that.

And same thing one of the drags you mentioned was the early life nutrition. You expect a reverse in the second half. How do we look at the extra exceptional cost that you had last year? Is there anything of that that should be back in the second -- last year after the recall you had exceptional costs. Will any of that in early life nutrition come back as well as a cost in your ongoing in the second half? That's my first question.

And my second question is just on China. Can you talk about the run rate? I don't think you -- or at least I didn't hear. Did you mention your run rate? I think you were at 35% at the end of Q1. Where are we now? Thank you.



**Pierre-Andre Terisse** - *Danone SA - CFO*

Yes. Sorry, on the last one I'm trying to just make sure I have noted all your questions, which is the fourth or the first one. China, yes, we're in the same kind of rates, a touch higher but not much. And you see that, by the way, when you look at the chart. We are very much what we expected to be, which is 35% to 40% in terms of offtake.

On the baby side, to continue, I'm not sure to fully understand your question. But if your question is are you going to have non-recurring impacts in the recurring operating margin in H2, the answer is no. In fact, we had some proceeds -- we'll have some proceeds of insurance coming as a result of this, something like EUR15m, if I'm not mistaken, in this -- well, we had in H1, in fact. And that's been one of the elements in non-recurring results, not in recurring results. So we've just put everything in non-recurring and then we start the year in a clean manner, so no trick; absolutely no trick.

And the last question was about the milk assumption for H2. Assuming it remains on the same trend now, stable sequentially, we think it's going to be a mid-single-digit plus in the second half. So we will still have an inflation of our cost of milk in the second half, but obviously it will be far, far below the one we have experienced in the first.

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**Celine Pannuti** - *JPMorgan - Analyst*

And just to follow up on that, on pricing, so does it mean there is another leg of pricing to be put through in the second half of the year as well?

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Not really. There are some countries for which we have positioned the implementation in the second half, but this is a small minority, so most of it is already in.

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**Celine Pannuti** - *JPMorgan - Analyst*

Okay. Thank you.

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Thank you.

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**Regis Massuyeau** - *Danone SA - IR Director*

A last question on the phone. I think he's cut off. Hello?

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**Operator**

Alain Oberhuber, MainFirst.

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**Alain Oberhuber** - *MainFirst - Analyst*

Good morning, everybody. Good morning, Pierre-Andre. Alain Oberhuber, MainFirst. I have two questions. The first question is about the margin discussion in medical nutrition. Is the strong decline in medical nutrition margin mainly based due to higher input costs? And if not, what are the other costs related to the lower margins?

And the second question is also about the margin development in waters. Given that you had strong volume growth rate there, could you explain us why the margin declined as well and what we could expect in waters on margins for the second half?

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Sorry, Alain. I got your first question. I'm not sure to know what you're talking about in the second one. Can you just repeat? We don't hear you very well here.

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**Alain Oberhuber** - *MainFirst - Analyst*

Sorry. Excuse me. Is it better now? Now, the second question is about the waters margin development. Margins were down in the second -- in H1 in margins. What was the reason for the lower margins, and what could we expect for the full year on margin development in waters?

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**Pierre-Andre Terisse** - *Danone SA - CFO*

Yes. I guess you're saying water is weak -- water margins are weak in this half, what do you expect for the rest of the year. They are actually up on a like-for-like basis. They're up by 38 basis points, and we expect this pace of increase to continue, broadly speaking, in the second half.

The reason why they are in margin terms, not in margin development terms, below is that you have obviously a negative foreign exchange effect in particular with respect to Indonesia. And as well we have integrated Sirma, which is a Turkish company which has margins which are below the division and which we are going to gradually move up. But margin dynamics in water are, I hope, to your satisfaction, positive and very solid.

The first question was about medical. The primary reason for the margin evolution in medical is the same as the one we had in the second half of last year, i.e. the evolution of the foreign exchange -- sorry, foreign exchange of the currencies outside Europe, which has impacted the costs of sourcing of medical in some of these important markets. I'm referring to Brazil, I'm referring to Russia, Turkey as well, which was an important one, and I probably forget one, UK. Not talking about emerging markets, obviously.

And Danone is basically taking measures to try and limit that, knowing that it's a business where you don't go asking consumers for price increases automatically, obviously, because you are in negotiation with the authorities. So this is an effect they had in H2, they have in H1 this year, they won't have any more, in principle, for the next half. And they have plans again to progressively re-increase the gross margins and they are very well on track for that.

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**Regis Massuyeau** - *Danone SA - IR Director*

Okay. Thank you very much, all of you.

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**Pierre-Andre Terisse** - *Danone SA - CFO*

All right. Well, so thank you. Thank you for your time. I wish you a very good summer holidays and I'll see you on the road in the conferences in September and then in October. Thank you. Bye.

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