

Nestlé Is Starting To Slim Down At Last

But can the world's No. 1 food colossus fatten up its profits as it slashes costs?

By Carol Matlack in Vevey, Switzerland

An avid mountain climber, Peter Brabeck-Letmathe has scaled peaks from the Alps to the Andes. But his job as chief executive of Nestlé is more akin to moving a mountain. It's not just that \$60 billion-a-year Nestlé is the world's biggest food company, with some 8,000 brands ranging from Nescafé instant coffee to Purina pet food to KitKat candy bars. While other food companies in recent years have scrambled to slash costs, Nestlé has stood pat, insisting that robust sales growth was its top priority. The result: Operating margins at Nestlé have trailed those at rivals such as Unilever, Group Danone, and Kraft Foods by as much as 50%. So it's no surprise that, based on their price-earnings ratio, Nestlé shares have long underperformed those of most rivals.

Now, however, there are rumblings of change inside Mt. Nestlé. In the past two years, Brabeck has delivered more than \$1.5 billion in cost savings by streamlining and integrating the far-flung Nestlé operations, while pushing the company toward business lines that yield wider margins. First-half operating profits rose to \$3.7 billion, 15% more than the same period in 2002. And operating margins reached 12.3% -- still less than Unilever's 14.5%, but well above the 10.3% that Nestlé was delivering five years ago. And Brabeck is just getting started, with a further \$2.5 billion in cost cuts planned over the next three years. "The company is getting fitter and fitter every day," the CEO says in an interview at his office overlooking Switzerland's Lac Lemán.

Brabeck's key challenge has been to gain control of the company's decentralized structure, in which country managers have traditionally been given wide leeway on everything from purchasing to capital investment. It's an arrangement that has helped Nestlé on the marketing side, since local managers can tinker with a product's flavoring, portion size, and packaging to suit local tastes. But from an efficiency standpoint, it has been a disaster. For example, internal reviews ordered by Brabeck found that in Switzerland, each candy and ice cream factory was ordering its own sugar. Moreover, different factories were using different names for the identical grade of sugar, making it almost impossible for bosses at headquarters to track costs. "It was basically a holding company, with hundreds of companies reporting in," says analyst **James Amoroso** at Swiss bank Pictet & Co.

ACCENT ON NUTRITION

To tighten things up, Brabeck did away with country-by-country responsibility for many functions. For example, he established five centers worldwide to handle most coffee and cocoa purchasing. He is also overhauling the information-technology systems at Nestlé to give management the data it needs to compare the performance of units worldwide and identify those needing a tune-up. Managers' bonuses are now linked to improvements in profit margins. And Nestlé factories are making more efficient use of manpower and technology. The Nescafé instant-coffee factory at Cagayan de Oro in the Philippines has boosted efficiency 15% over the past three years by retraining maintenance teams to work faster and by increasing the amount of coffee treated in each production batch.

At the same time, Brabeck has pushed Nestlé into new, higher-margin businesses. In Europe over the past two years, it has introduced such products as Nesvital, a high-energy cereal bar aimed at fitness buffs, and Innéov, a nutritional supplement that was developed as a joint venture with cosmetics giant L'Oréal to improve the health of skin. Brabeck says such products are vital to the future profitability of Nestlé. For more than 50 years, he says, the key to food-industry profits has been improved convenience, from instant coffee

in the 1930s to microwave-ready meals in more recent years. "But now, it's difficult to create additional value from convenience. The biggest area of value creation is nutrition and wellness."

The Austrian-born Brabeck seems an unlikely figure to shake Nestlé out of its settled ways. A company lifer, he joined at 24 as driver of an ice-cream truck. He spent more than a decade working in Latin America, where he rose through the ranks to become general manager of Nestlé operations in the region, before returning to corporate headquarters and becoming CEO in 1997. Indeed, progress during the first few years of his tenure seemed glacial, largely because of the time required to reorganize and streamline a company as big as Nestlé. But most analysts expect Nestlé profits to top 13% next year, as the global economy starts to recover and Brabeck's cost-cutting measures bear more fruit. "A lot of the benefits won't kick in, in earnest, until 2004 to 2006," says Julian Hardwick, an analyst at ABN Amro in London.

Certainly, Brabeck has big challenges ahead. For one thing, he still needs to prove that he spent wisely on acquisitions over the past two years, including \$10.3 billion for pet-food giant Ralston Purina, \$2.6 billion for frozen-food company Chef America Inc., and \$2.6 billion for a controlling stake in Dreyer's Grand Ice Cream Inc. Nestlé paid top dollar for all three, largely to boost its presence in the crucial U.S. market, where it has long been an also-ran. With Ralston, it's now No. 1 globally in pet food and tied with Unilever for first place in the U.S. in ice cream, where the Dreyer's deal gave it a big piece of the lucrative market for premium ice cream.

PET PROJECTS

Nestlé faces tough competition from pet-food competitors such as Mars Inc., maker of Whiskas cat food and Pedigree dog food. Nestlé water brands such as Pure Life also are struggling in the U.S., as Coca-Cola Co. and PepsiCo Inc. have moved aggressively into bottled water, slashing prices to gain market share. Some industry-watchers fret that the savings from Brabeck's efficiency push may never reach the bottom line if Nestlé begins pouring more into marketing to protect its market share.

Brabeck declines to specify what margins he's aiming for, saying he doesn't want the quest for profitability to hamper the Nestlé push for 5%-to-6% currency-adjusted annual sales growth. Unlike companies such as Unilever, which have sold off scores of brands to focus on a relatively small group of more profitable products, Brabeck says Nestlé can improve performance while maintaining a large and diverse portfolio. Investors seem to be warming to the idea: Nestlé's share price has risen 28% since early March, to \$228, as it reported better-than-expected sales and profit figures during the global downturn. If Brabeck can keep the cost savings coming, investing in Nestlé could soon be as tempting as a box of Swiss chocolates.

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