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Nestle Plans For L'Oreal In Focus As Deadline Nears

04 Feb 2009 14:15 GMT

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ZURICH (Dow Jones)--A crucial part of Swiss food company Nestle SA's (NESN.VX) ownership contract regarding L'Oreal SA (12032.FR) will soon expire, potentially leaving Nestle free to sell its stake of around 29% in the French cosmetics company.

The relevant clause in Nestle's agreement with the French Bettencourt family will expire April 29. If it isn't renewed, Nestle and the Bettencourts will be free to divest part or all of their stakes. Nestle's stake is worth more than EUR9 billion, based on L'Oreal's market capitalization of EUR32 billion. The Bettencourts hold around 30% of L'Oreal.

Speculation that Nestle may ultimately wish to buy the rest of L'Oreal has resurfaced as the deadline approaches. But a ban on any increase in either partner's stake as long as L'Oreal heiress Liliane Bettencourt is alive will remain in place.

Selling its L'Oreal shares would be in line with Nestle's recent concentration on its core business, such as the divestment of its eye-care unit Alcon to Novartis AG (NOVN.VX) last year, according to observers such as food consultant analyst James Amoroso.

"My standard scenario says that Nestle will sell its one-quarter stake rather than go for the remaining three-quarters," Amoroso said.

Nestle and L'Oreal declined to comment. The Bettencourt family couldn't be reached for comment.

The partnership between the two companies began 35 years ago. At that time, Nestle was invited by the French side to enter L'Oreal's shareholder base because there was a threat that many French businesses might be nationalized.

Nestle and L'Oreal have delegates on each others' supervisory boards and collaborate on areas such as dermatology and nutritional supplements.

To be sure, it's possible the April deadline won't prompt any action.

ING's Marco Gulpers said he expects Nestle and the Bettencourts to preserve the status quo or rewrite the contract.

However, a disposal of the L'Oreal stake would result in a huge capital gain, because the book value of the holding in Nestle's balance sheet is CHF839 million, Bank Vontobel analyst Claudia Lenz said in January.

The proceeds from a divestment could be used to fund share buybacks, analysts say. In 2007, Nestle decided to return CHF25 billion to shareholders over a three-year period, and is expected to announce similar such moves in the future.

Nestle's exit could take various forms, for example a spin-off of the L'Oreal stake to Nestle shareholders or a placement with institutional investors, analysts have said.

L'Oreal may play a role in a placement, acquiring up to one third of Nestle's 29% stake and later canceling the shares, Bank Sal. Oppenheim analyst Vincent Hamel said last year. L'Oreal could finance such a move by selling its 8.7% stake in French drugmaker Sanofi-Aventis (SNY), Hamel said.

Meanwhile, speculation that Nestle could acquire L'Oreal, a theme industry observers have discussed for years, has reemerged.

Nestle's hands are tied as long as Liliane Bettencourt is in good health, but given her advanced age of 86, questions regarding Nestle's options are gaining importance. What's more, Nestle's coffers will be full in 2010, the year the company is set to conclude the \$39 billion disposal of Alcon to Novartis.

A purchase of L'Oreal would catapult the food giant into a new consumer goods category.

Exane BNP Paribas analyst Xavier Croquez said in November a deal would make sense. Hair care, a L'Oreal domain, and Nestle's fur-related petcare are closer in terms of research, development and marketing than some of Nestle's businesses such as water and ice cream, he said, estimating annual cost synergies from a merger at EUR1.1 billion.

Croquez said Nestle and the Bettencourts could then take L'Oreal private at a price of around EUR90 per share, applying multiples of a similar deal in 2008 involving cosmetics company Clarins.

Bernstein Research said in a study a Nestle-L'Oreal transaction would meet some of Nestle's acquisition criteria, such as achieving the number one or number two position in beauty products, and enhance the focus on value-added growth.

However, the risks that would come with a merger of the two consumer goods titans make a deal unlikely, said Bernstein analyst Andrew Wood, citing unclear integration prospects and a likely dilution of Nestle's earnings per share.

Moreover, L'Oreal has lost much of its earlier drive, with organic sales and earnings growth weakening in the past few years, the Bernstein analysts said.

The financial implications of a L'Oreal takeover would be massive and Nestle might face opposition from its shareholders, Wood said.

The food company could face a bill of some CHF61.4 billion, or \$53 billion, for the remainder of L'Oreal, Wood calculated, pegging L'Oreal's equity value at around EUR58.5

billion in two years' time. JP Morgan analyst Pablo Zuanic in January estimated Nestle would need CHF50 billion for a L'Oreal takeover.

Other experts have also voiced doubts over the rationale of a Nestle-L'Oreal tie-up, highlighting the limited potential for cutting costs and Nestle's clear positioning as a nutrition company.

A combination of Nestle and L'Oreal would dwarf all Nestle's past takeovers, which include the \$10 billion acquisition of pet-food maker Ralston Purina in 2001 and the purchase of the Gerber baby-food brand for around \$5.5 billion in 2007.

In the past few years, Nestle has concentrated on organic growth, foregoing huge deals: In 2007, Nestle rejected a merger proposal by PepsiCo Inc. (PEP) because of Pepsi's focus on snacks and soft drinks, the Wall Street Journal reported. In 2002, it backed off from a possible takeover of Hershey Inc. (HSY), partly due to antitrust concerns.

Given the ties between Nestle and the Bettencourts, any future moves on L'Oreal are likely to be closely coordinated. The two parties have a right of first refusal through 2014 should one of them want to sell.

The Bettencourts haven't made clear their long-term intentions. A letter to L'Oreal's shareholders in mid-2008 said Liliane Bettencourt's daughter Francoise Bettencourt Meyers had expressed her attachment to L'Oreal.

"I therefore have no reason to think that there will be any difference in attitude between the generations," L'Oreal Chairman Lindsay Owen-Jones said in the letter. He also said at the time he hoped that Nestle wouldn't sell its shares in 2009 when the contract expires.

At 1300 GMT, Nestle shares were around CHF39.90, slightly above a 12-month low of CHF38.02 reached in October 2008.

L'Oreal shares were around EUR53.0 after falling to a 12-month low of EUR50.0 on Jan. 23.

Many analysts expect Nestle to clarify its position before April.

Nestle's will report 2008 earnings on Feb. 19. L'Oreal's 2008 report is due on Feb. 16.

Company Web site: <http://www.nestle.com> <http://www.loreal.com>

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(Ruth Bender in Paris also contributed to this report.)