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NESTLÉ AND L'ORÉAL: THE "ELEPHANT IN THE ROOM"[1]

On July 26, 2018, Ulf Mark Schneider, was the chief executive officer (CEO) of the Switzerland-based Nestlé S.A. (Nestlé). For the first time in his 18-month tenure as the head of the global consumer-packaged goods company, Nestlé's results indicated the positive effects of the many strategic changes he had spearheaded. Organic growth had shown a period-to-period increase of 2.6 per cent (versus 2.4 per cent for 2017) and operating margin had risen to 16.1 per cent (versus 15.9 per cent in 2017).[2] The company was midway through its US$20 billion[3] share buyback[4] and, in March 2018, had signed a $7 billion contract to sell Starbucks-branded coffee and tea in retail stores globally.[5] Schneider had divested the company's US confectionary business and made several key acquisitions in its branded foods business.[6] However, Nestlé had not publicly responded to a hedge fund's insistence that the company sell its nearly $32 billion[7] stake in the French cosmetics company, L'Oréal S.A. (L'Oréal).[8]

In a June 2017 communication, and later in a July 1, 2018, public letter to Nestlé's shareholders, Third Point LLC (Third Point), a hedge fund based in New York City, made the L'Oréal divestment a core piece of its rationale for strategic change at the company. Arguing that it was a passive investment that confused the identity of Nestlé and affected its stock price, Third Point indicated that the right strategic path for Nestlé was to use the proceeds from divesting the L'Oréal stake to buy back stock, make key acquisitions in its current food and nutrition businesses, and fund operational improvements.[9]

Third Point's call on the L'Oréal investment was only one of two related issues that Schneider and Nestlé's board of directors faced. The other matter involved a six-month moratorium on any actions by Nestlé regarding its stake in L'Oréal, which had been enacted after the death of Lillian Bettencourt in September 2017. Before her death, Bettencourt had been one of the principal shareholders in L'Oréal. However, the moratorium ended on March 21, 2018. Therefore, L'Oréal had publicly requested clarity from Nestlé on its intentions regarding the French cosmetic company.[10] So, Schneider and his team needed to address Third Point's call and respond to L'Oréal's request.

ABOUT NESTLÉ

In 1867, Henri Nestlé founded a company in Vevey, Switzerland, to develop and sell his infant formula. He ran it independently until merging it in 1905 with the Anglo-Swiss Condensed Milk Company to form the modern-day food and nutrition multinational. Over the years, Nestlé grew both organically and via acquisitions. At the end of fiscal 2017, Nestlé had $90.28 billion in revenues, sold its products in 189 countries, produced its goods in 413 factories that were located in 85 countries, employed 323,000 people, and owned over 2,000 brands. CEO Schneider reported to a board of directors that was led by chairman Paul Bulcke, who took office in fiscal 2018.[11]

In a presentation to investors, Schneider underscored Nestlé's presence as a key global competitor in the nutrition, health, and wellness (NHW) market. In this market, Nestlé's strengths included a strong portfolio with a presence in the market's growth segments, brands names that global consumers trusted, and a track record of successfully adapting to marketplace changes. Schneider indicated that food and beverage would be Nestlé's core focus for the future, with a 27 per cent global market share in coffee, a 27 per cent global market share in infant nutrition, and a 10 per cent global market share in bottled water (Nestlé Pure Life was the number one bottled-water brand worldwide). The consumer health-care segment was also Nestlé's growth platform (see Exhibit 1).[12]

Given its broad portfolio of products, Nestlé competed globally with a variety of major companies. The Hoover's Company Records market research service[13] identified 43 Nestlé competitors, ranging from Abbott Laboratories and Procter & Gamble Company in the health category to Danone S.A.; The Coca-Cola Company; Mondelēz International, Inc.; General Mills, Inc.; and Kraft Heinz Company in the packaged foods market. Nestlé encountered competition in multiple markets, from major multinationals competitors to local companies, in each product category where Nestlé was active. Nestlé's largest market was North and South America, accounting for over 30 per cent of 2017 revenues. Coffee accounted for CHF17 billion[14] in 2017 revenues, with Nescafé and Nespresso as its two leading brands.[15]

In its financial statements, Nestlé classified its stake in L'Oréal as an investment in "Associates and Joint Ventures." Because of its 23.2 per cent stake, the L'Oréal investment was accounted for using the equity method. With this method, Nestlé initially recorded its investment at cost. Each year, it adjusted for its share of L'Oréal's total profits and then deducted the dividends received. At the beginning of fiscal year (FY) 2017, the L'Oréal stake was valued at $7.493 billion; at the end of FY 2017, the value was $8.228 billion (see Exhibit 2).[16]

In a statement to analysts, Schneider pointed out that Nestlé's stake in L'Oréal had a 42-year annual return on investment of 12 per cent. For the period 2007–2017, the annual return on investment was 14 per cent. In addition, Schneider indicated that L'Oréal dividends had accounted for 9 per cent of Nestlé's earnings per share between 2007 and 2017.[17]

BRIEF HISTORY OF NESTLÉ'S INVESTMENT IN L'ORÉAL

On April 2, 1974, France's president, Georges Pompidou, died in office. French voters were thus called upon to elect his successor. A coalition of left-wing and left-leaning parties led by François Mitterand appeared to be in position to come into power over the right-leaning group led by Valéry Giscard d'Estaing.[18]

Over a decade earlier, in 1963, L'Oréal had gone public, and Bettencourt, the founder's daughter, had retained a majority share of the company. Bettencourt had inherited the company upon her father's death in 1957.[19] Both Bettencourt's father and her husband had been strong supporters of the French far right.[20]

Therefore, in 1974, Bettencourt feared that if left-leaning Mitterand came into power, her company (along with others) would be nationalized. As a pre-emptive move, Bettencourt decided to sell 30 per cent of L'Oréal to the Swiss multinational corporation Nestlé in return for a small stake in that company.[21]

Bettencourt's rationale was that Mitterand's government would be less likely to nationalize L'Oréal if it was partly owned by a Swiss company.[22] However, in the 1974 elections prompted by Pompidou's death, French voters elected right-leaning d'Estaing—not Mitterand.[23] Nevertheless, Nestlé continued to own its stake in L'Oréal. Peter Brabeck-Letmathe, who was Nestlé's CEO until 2008 and chairman of the board until 2017, suggested that Nestlé was in fact seeking to increase its stake in L'Oréal.[24]

In 2014, buoyed by support from the French government, which regarded leading French companies such as L'Oréal as national treasures, the L'Oréal board of directors sought and obtained an agreement with Nestlé that forbade it from attempting to increase its stake in L'Oréal until at least six months after the death of Bettencourt. In addition, as part of the agreement, L'Oréal bought back a part of Nestlé stake, which dropped Nestlé's ownership in L'Oréal to 23.29 per cent.[25] On September 21, 2017, Bettencourt died, which prompted the start of Nestlé six-month moratorium on L'Oréal shares.[26]

THIRD POINT

Founded by Daniel S. Loeb in 1995, Third Point was an "event-driven, value-oriented" hedge fund from New York City that had approximately $17 billion in assets under management at the end of 2016.[27] In the past, Third Point had mounted activist campaigns against companies such as Yahoo! in 2012 (when Loeb was instrumental in hiring Marissa Mayer as CEO)[28], Sony Corporation in 2013,[29] and Sotheby's in 2013 (when Third Point succeeded in getting three board appointees).[30]

On June 25, 2017, Third Point communicated publicly about its $3.5 billion investment in Nestlé. In an eight-page letter to Nestlé's investors, Loeb called for various changes at the Swiss company. In putting forth the rationale for the changes that he sought, Loeb made the following arguments:

> Despite having arguably the best positioned portfolio in the consumer packaged goods industry, Nestlé shares have significantly underperformed most of their US and European consumer staples peers on a three year, five year, and ten year total shareholder return basis. One year returns have been driven largely by the market's anticipation that with a newly appointed CEO, Nestlé will improve.[31]

In addition to urging Nestlé to publicly set a more ambitious productivity goal, the Third Point letter talked specifically about both reshaping the portfolio and monetizing the L'Oréal stake. Third Point pointed out that Nestlé owned over 2,000 brands in the food and beverage and in the health sciences categories, and that managing a large number of brands could lead to suboptimal capital allocation. The letter called for a review and eventual sale of underperforming brands and a simultaneous augmentation of the portfolio via "accretive, bolt-on acquisitions in high growth and advantaged categories."[32]

While acknowledging the contribution of the L'Oréal stake over the years, Third Point was emphatic in demanding that Nestlé sell its stake. The firm's rationale was that "having L'Oréal in the portfolio is not strategic and shareholders should be free to choose whether they want to invest in Nestlé or some combination of Nestlé and L'Oréal."[33] Third Point reiterated this stand in its July 2018 letter:

> It is clear that the Company's non-core financial stake in L'Oréal should be sold since the Board remains unable to articulate a compelling long-term strategic rationale for its continued ownership. Nestlé should use the proceeds from these [L'Oréal and other suggested divestments] sales to do more M&A [mergers and acquisitions] in key areas or engage in expedited share buybacks.[34]

Third Point also provided a comparison of Nestlé with its peers (see Exhibit 3).

THE "ELEPHANT IN THE ROOM"

In September 2017, shortly after being appointed as the company's CEO, Schneider laid out Nestlé's strategy in an investor conference in London. In his presentation, Schneider stressed Nestlé's identity as a global NHW company and indicated that portfolio management and capital allocation would be among his key priorities for the future.[35] He indicated that his team would use four criteria for future acquisitions and divestments: fit with NHW strategy, attractive categories in terms of growth and margin, ability to win, and resource intensity (required capital and human resource investment).[36]

Schneider had already spearheaded two major portfolio moves. In December 2017, he had led the acquisition of Atrium Innovations Inc., a global leader in nutritional health products, for $2.3 billion in cash. The company had sales of around $700 million and boasted double-digit cumulative annual sales growth in the period 2015–2017. The second move was the January 2018 divestment of Nestlé's US confectionery business for $2.8 billion in cash. The business had sales of approximately $900 million and had suffered negative cumulative annual growth for the period 2015–2017.[37]

In 2007, Nestlé acquired Gerber Products Company (Gerber) from Novartis International AG for $5.5 billion in cash[38] and folded it in its infant nutrition business. As part of the acquisition, Nestlé acquired the Gerber Life Insurance Company (Gerber Life) business. Gerber Life sought to parlay the Gerber brand name among young parents to sell both term and whole life insurance policies. In FY 2017, Gerber Life accounted for CHF850 million in revenues. In an effort to stem declining sales growth, Nestlé repositioned the Gerber baby foods brand as an organic option and supported the relaunch with a major marketing campaign. As part of the review of the Gerber acquisition, Schneider's team decided that Gerber Life was a non-strategic business for Nestlé and indicated in mid-2018 that it was looking at all possible alternatives, including an outright sale.[39]

In an interview following the release of the financial results for the first half of 2018, Schneider defended the company's strategic direction:

> Let me underscore my strong working relationship with our chairman. [The two of us are in] full agreement [on Nestlé's current direction and are] unanimous in our commitment to analyze all aspects of our strategy. . . . As CEO, I have full authority to undertake this [strategic] analysis and implement the right actions to meet our objectives.[40]

However, Schneider and his team had yet to address Nestlé's 23.2 per cent stake in L'Oréal, which an analyst referred to as the "elephant in the room."[41]

EXHIBIT 1: NESTLÉ S.A. PRODUCT PORTFOLIO (SELECTED) AND REVENUES BY PRODUCT CATEGORY, 2017

Product Category	2017 Revenues (in € billions)	Example Brands
Powdered and Liquid Beverages	17.63	Nescafé, Nespresso, Nestea
Nutrition and Health Sciences	13.22	Gerber, Boost
Milk Products and Ice Cream	11.58	Häagen-Dazs, Dreyer, Mövenpick
Pet Care	10.80	Purina
Prepared Dishes and Cooking Aids	10.37	Maggi, Buitoni, DiGiorno
Confectionery (non-US)	7.61	KitKat
Bottled Water	6.48	S. Pellegrino, Perrier, Nestle Pure Life

Note: € = European euro; €1 = US$1.13 on average in 2017.
Source: Nestlé S.A., *2017 Annual Review*, accessed July 30, 2018, www.nestle.com/asset-library/ documents/ library/ documents/ annual_ reports/ 2017- annual- review-en.pdf.

EXHIBIT 2: NESTLÉ S.A. SUMMARY FINANCIALS, 2016–2017

	2017	2016
Revenues	€77.60 billion	€77.32 billion
Net Profit	€6.21 billion	€7.37 billion
Earnings per Share	€2.00	€2.39
Dividend per Share	€2.03	€1.99
Operating Cash Flow	€11.67 billion	€13.48 billion
Net Financial Debt	€15.45 billion	€12.02 billion
Capital Expenditure	€3.40 billion	€3.47 billion
Debt-to-Equity Ratio	29.1%	21.5%
Nestlé S.A.'s price-to-earnings ratio (on July 20, 2018) was 29.29, compared with Danone S.A. at 19.01, Unilever at 21.79, Reckitt Benckiser Group plc at 14.45, and L'Oréal S.A. at 28.82.		

Note: € = European euro; €1 = US$1.11 on average in 2016; €1 = US$1.13 on average in 2017.
Source: Nestlé S.A., *2017 Annual Review*, accessed July 30, 2018, www.nestle.com/asset-library/ documents/ library/ documents/ annual_reports/2017-annual-review-en.pdf; "Nestle S.A.," Yahoo! Finance, accessed July 30, 2018.

EXHIBIT 3: THIRD POINT'S COMPARISON OF NESTLÉ WITH ITS PEERS (TOTAL STOCKHOLDER RETURNS, IN %)

Metric	Nestlé S.A.	Reckitt Benckiser Group plc	L'Oréal S.A.	Unilever	Danone S.A.	US Staples
10-year TSR	149	291	165	215	61	168
Five-Year TSR	72	166	132	130	61	87
Three-Year TSR	28	65	55	69	34	34
One-Year TSR	18	16	17	31	14	7

Note: "US Staples" refers to an index of a basket of consumer staples companies; TSR = total stockholder returns
Source: Third Point LLC, letter to investors, June 25, 2017, accessed July 30, 2018, www.thirdpointpublic.com/wp-content/uploads/2017/06/Third-Point-Nestle-Letter.pdf.

ENDNOTES

[1] This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Nestlé S.A and/or L'Oréal S.A. and/or any of its employees.
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