BRYAN, GARNIER & CO

INDEPENDENT RESEARCH

8th July 2015

Food & Beverages

Danone

Redemption

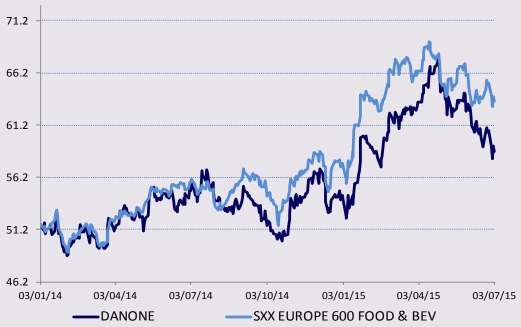
Fair Value EUR71 (price EUR58.09)

BUY
Coverage initiated

Bloomberg	BN FP
Reuters	DANO.PA
12-month High / Low (EUR)	67 / 50
Market capitalisation (EURm)	38,046
Enterprise Value (BG estimates EURm)	45,127
Avg. 6m daily volume ('000 shares)	1 918
Free Float	98.0%
3y EPS CAGR	11.5%
Gearing (12/14)	66%
Dividend yields (12/15e)	2.92%

YE December	12/14	12/15e	12/16e	12/17e
Revenue (EURm)	21,144	22,797	24,382	25,886
EBIT(EURm)	2,662	2,984	3,230	3,496
Basic EPS (EUR)	2.63	2.97	3.29	3.64
Diluted EPS (EUR)	2.62	2.96	3.28	3.63
EV/Sales	2.17x	1.98x	1.81x	1.67x
EV/EBIT	17.2x	15.1x	13.7x	12.3x
P/E	22.2x	19.6x	17.7x	16.0x
ROCE	9.5	11.0	12.0	13.1

Price and data as at close of 6th July



We are initiating coverage of Danone with a buy recommendation and a fair value of EUR71, which implies an upside potential of 22%. Based on Monday's closing price, the stock is trading at EV/EBIT 2015e and EV/EBIT 2016e multiples of 14.0x and 12.6x, that is, 10% and 12% below the peers' average. After a series of challenging years, in 2015 the group is finally on the road to redemption, which will come mainly from an improved profitability.

- **Since 2008, Danone experienced many difficulties:** increasing milk prices, late introduction of a Greek yoghurt to the US market, economic crisis in Europe (profit warning in 2012 due to Spain) and Fonterra false alert in Asia. In the past seven years, the group has underperformed the Stoxx Europe 600 Food & Beverage index by 45%.

- Between 2010 and 2014, the group recorded a solid LFL growth of 5.9% on average. During the same period, its recurring operating margin declined constantly, with a total decline of 268bps. **But profitability is expected to improve in 2015. We anticipate a 50bp margin increase (+27bps on an LFL basis), mostly due to falling milk prices, as well as FX tailwinds and the deconsolidation of dairy operations in China and Indonesia. EPS should rise by 12.9% (+11.5% on average in the next three years) after two years of decline.** Besides, we do not rule out the possibility of a positive surprise, as milk powder prices continued to decline in Q2, suggesting that the group's guidance of a slight improvement in LFL recurring operating margin might turn out to be too conservative.

- Based on Monday's closing price, the stock is trading at EV/EBIT 2015e and EV/EBIT 2016e multiples of 14.0x and 12.6x, respectively, that is, 10% and 12% below the peers' average. **Our DCF-based fair value stands at EUR71, which implies an upside potential of 22%.**

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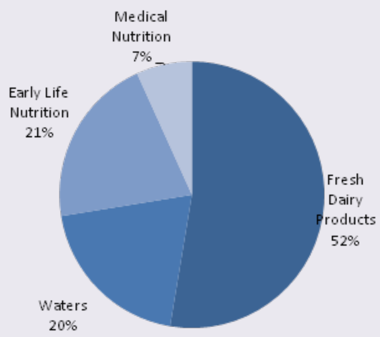
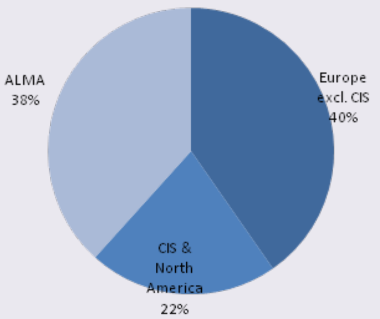
Sales breakdown by division 2015e



Sales breakdown by region 2014



Company description

Born in 1972 thanks to the merger of BSN and Gervais Danone, Danone has refocused on four core activities (Fresh Dairy products, Waters, Early Life Nutrition and Medical Nutrition) in a limited number of markets in which it intends to be the leader.

Simplified Profit & Loss Account (EURm)	**2012**	**2013**	**2014**	**2015e**	**2016e**	**2017e**
Sales	20,869	21,298	21,144	22,797	24,382	25,886
Change (%)	*8.0%*	*2.1%*	*-0.7%*	*7.8%*	*7.0%*	*6.2%*
Like-for-like change (%)	*5.4%*	*4.8%*	*4.7%*	*4.1%*	*5.4%*	*6.2%*
Trading operating profit	2,959	2,809	2,662	2,984	3,230	3,496
Change (%)	*4.1%*	*-5.1%*	*-5.2%*	*12.1%*	*8.2%*	*8.2%*
Total financial expenses	(302)	(263)	(312)	(319)	(287)	(257)
Income before taxes	2,445	1,865	1,839	2,636	2,908	3,199
Reported income tax	(712)	(604)	(599)	(751)	(834)	(923)
Share of profit of associates	54.0	289	14.0	55.0	63.0	73.0
Net profit	1,787	1,550	1,253	1,940	2,137	2,349
Non-controlling interests	115	128	134	138	145	148
Net profit Group share	1,672	1,422	1,119	1,802	1,992	2,201
Underlying net income_group share	1,818	1,636	1,561	1,763	1,955	2,164
Change (%)	*3.9%*	*-10.0%*	*-4.6%*	*13.0%*	*10.9%*	*10.7%*
Cash flows from operating activities						
Working capital variation	(333)	(217)	(57.0)	(119)	(92.6)	(139)
Capex, net	(976)	(1,039)	(984)	(1,071)	(1,146)	(1,217)
Other	206	113	59.0	0.0	0.0	0.0
Free cash flow excluding exceptional items	2,088	1,549	1,401	1,791	2,006	2,306
Exceptionals	0.0	(121)	(123)	0.0	0.0	0.0
Free cash flow reported	2,088	1,428	1,277	1,791	2,006	2,306
M&A	(300)	(1,330)	(1,404)	0.0	0.0	0.0
Dividends	(1,083)	(953)	(417)	(894)	(1,010)	(1,120)
Other	(365)	(819)	746	(215)	0.0	(200)
Net debt	6,292	7,966	7,764	7,081	6,085	5,099
Property, plant and equipment						
Intangibles assets	16,265	16,308	16,234	16,385	16,538	16,693
Cash & equivalents	1,269	969	880	230	727	787
current assets	6,923	7,850	7,449	7,059	7,807	8,113
Total assets	29,537	30,928	31,747	31,499	32,316	32,605
L & ST Debt	9,522	11,927	11,142	9,427	8,927	8,001
Others liabilities	7,761	8,272	8,860	10,102	10,627	10,968
Shareholders' funds	12,191	10,694	11,696	11,921	12,713	13,586
Total Liabilities	17,283	20,199	20,002	19,529	19,554	18,970
Trading operating margin						
Reported tax rate	29.10	32.40	32.60	28.48	28.67	28.84
Underlying net income_group share	8.71	7.68	7.38	7.73	8.02	8.36
ROE	13.72	13.30	9.57	15.12	15.67	16.20
ROIC	11.55	10.52	9.49	10.96	11.99	13.06
Gearing based on net debt	51.35	74.25	66.10	59.23	47.75	37.46
Gearing based on net financial debt	24.65	44.01	44.33	43.33	32.84	23.51
Pay out ratio	48.09	52.11	57.27	57.27	57.27	57.27
Number of shares, diluted	603	588	596	596	596	596
Basic underlying EPS						
Diluted underlying EPS	3.01	2.78	2.62	2.96	3.28	3.63
% change	*4.3%*	*-7.7%*	*-5.9%*	*13.0%*	*10.9%*	*10.7%*
BVPS	20.22	18.19	19.62	20.00	21.33	22.80
Operating cash flows	4.19	3.84	3.81	4.60	5.13	5.68
FCF	3.46	2.63	2.35	3.01	3.37	3.87
Net dividend	1.45	1.45	1.50	1.69	1.88	2.08

Source: Company Data; Bryan, Garnier & Co ests.

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1. Investment Case

Why the interest now?

The reason for writing now

Between 2010 and 2014, the recurring operating margin declined 268bps. But 2015 looks set to be a year of change. We anticipate a 50bp margin increase (+27bps on an LFL basis), mostly due to falling milk prices, as well as FX tailwinds and the deconsolidation of dairy operations in China and Indonesia. Besides, Danone renounced to sale its medical nutrition division in December 2014, which considerably reduces the M&A risk and implies an improvement in ROIC between 2014 and 2017 (+120bps on average each year) after two years of decline.

Cheap or Expensive?

Valuation

Our DCF-based fair value implies a 22% upside potential. Furthermore, based on Monday's closing price, the stock is trading at EV/EBIT 2015e and EV/EBIT 2016e multiples of 14.0x and 12.6x, respectively, that is, 10% and 12% below the peers' average.

When will I start making money?

Catalysts

Danone is due to release H1 results on July 24, 2015. We anticipate sales growth of 3.8% in organic terms and 8.6% in reported terms. In H1, the recurring operating margin is expected to rise by 103bps thanks to a decrease in milk prices and the comparison base (-207bps in H1 2014).

What's the value added?

Difference from consensus

For the next three years, we are slightly above market expectations, both in terms of sales and recurring operating profit. In our view, the consensus figures does not show any downside risk. However, a positive surprise is possible. Indeed, the group's guidance of a slight improvement on an LFL basis of the recurring operating profit margin could be too conservative because milk powder prices continued to decline in Q2, suggesting that those of liquid milk should remain weak in 2015.

Could I lose money?

Risks to our investment case

More stringent regulations in emerging countries (China and Indonesia) and lower dairy product prices in Europe and the US (if falling liquid milk prices are passed on to consumers) might impact negatively our estimates.

2. Overview of Danone

Fig. 1: History of the group

Date	Event
1919	Mr Isaac Carasso founds Danone in Barcelona
1966	Mr Antoine Riboud founds BSN from the merger of Boussois and Verreries Souchon-Neuvesel
1968	Launch of a takeover bid for Saint Gobain
1972	Merger of BSN and Gervais Danone
1980	The sale of flatglass operations allows the group to further expand in the food industry, with the acquisition of Amora, Maille, Vandamme, La Pie Qui Chante, Liebig, Galbani and Volvic
1986	BNS-Gervais Danone acquires Générale Biscuit and its famous LU brand
1989	The group continues its expansion in the biscuits segment through the acquisition of Nabisco's European subsidiaries: Belin in France, Jacob's in the UK and Saiwa in Italy
1994	BSN-Gervais Danone becomes Danone
1996	Mr Franck Riboud succeeds his father Mr Antoine Riboud
1997	Grocery brands such as Panzani, Amora, Maille and William Saurin are sold to Paribas Affaires Industrielles and Liebig is sold to Campbell
1998	Danone sells La Pie Qui Chante, Carambar and Vandamme to Cadbury
2000	The group divests all of its brewery operations, with the sale of Kronenbourg Brewery and Alken-Maes to the Scottish Newcastle group
2005	A takeover bid for the group by PepsiCo fails during the same year.
2007	Biscuits operations (LU, Petit Déjeuner, Cracotte) are sold to Kraft Foods, while the acquisition of Royal Numico allows the group to expand into the infant and medical nutrition markets
2009	Danone terminates the Wahaha joint venture in the non-alcoholic beverage segment after becoming aware that its Chinese partner Zhong was illegally selling products under the Wahaha brand.
2010	The group is forced to withdraw its health claims for Activia and Actimel
2013	Fonterra, a New Zealand dairy co-operative, sets off a false alert for botulism in infant formulas sold in China and supplied to Danone
2014	Mr Emmanuel Faber succeeds Mr Franck Riboud as CEO of Danone

Source: Danone

Fig. 2: Danone's competitors

Fresh products	Waters	Early life nutrition	Medical nutrition
MDD	MDD	Nestlé	B.Braun
Muller	Nestlé	Mead Johnson	Abbott
Yoplait	PepsiCo	Abbot	Nestlé
General Mills	Coca-Cola	Heinz	
JV Nestlé/Lactalis		Hipp	
		Hero	

Source: Bryan, Garnier & Co

Fig. 3: Breakdown of revenues by region, 2014

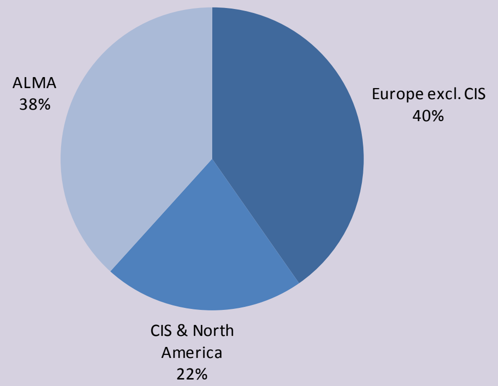


Fig. 4: Breakdown of recurring operating profit by region, 2014

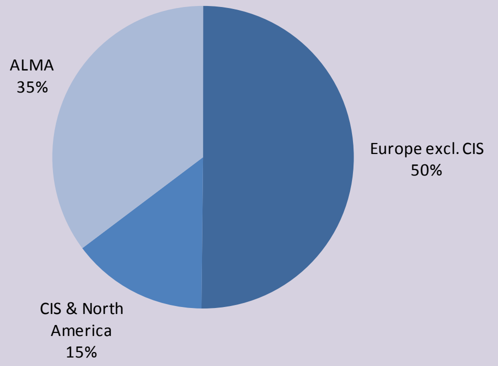


Fig. 5: Breakdown of revenues between developed and emerging countries, 2014

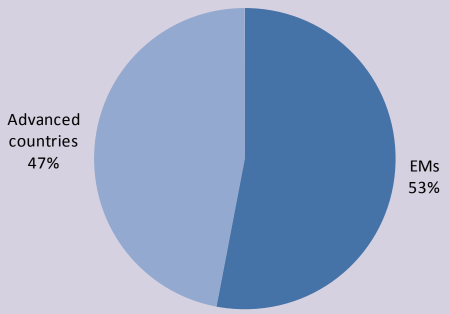


Fig. 6: Breakdown of revenues by country, 2014

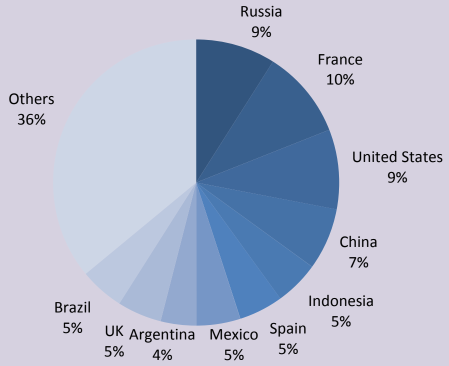


Fig. 7: Breakdown of revenues by division, 2015e

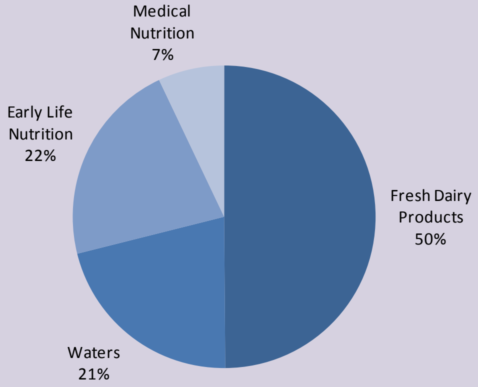
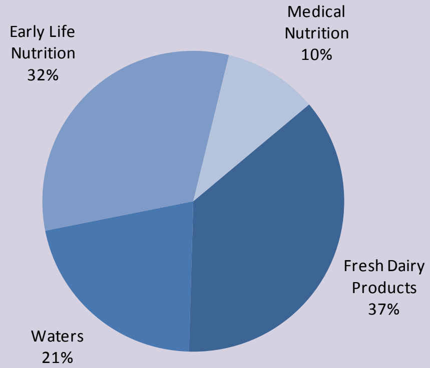
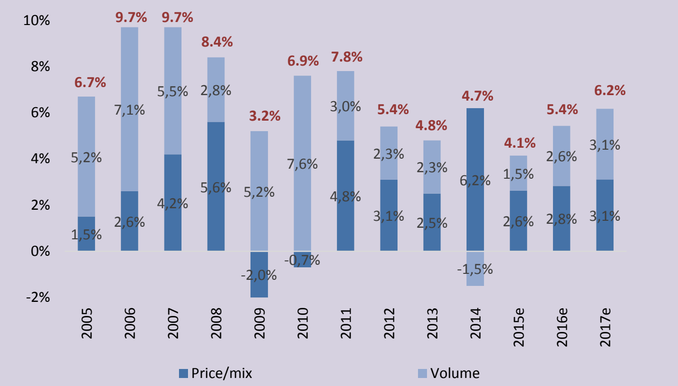


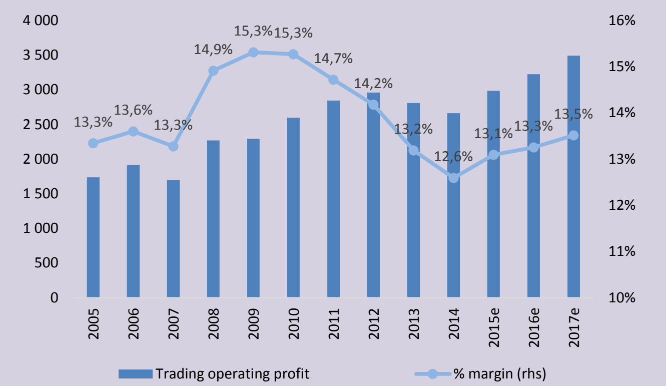
Fig. 8: Breakdown of recurring operating profit by division, 2015e



Source: Danone, Bryan, Garnier & Co

Fig. 9: Organic sales growth | **Fig. 10: Recurring operating profit**





Source: Danone, Bryan, Garnier & Co

Fig. 11: SWOT analysis

Strengths	Weaknesses
Low pressure from suppliers due to a very fragmented livestock market	High dependence on milk and plastic prices, which account for 40% and 20% of production costs, respectively
Discriminating ‘experience curve effects (marketing, cold chain, milk collection in emerging countries) and high capital intensity in the water division	Many substitutes: private labels, tap water, non-alcoholic beverages, breastfeeding, homemade food…
Strong brand image in infant nutrition	Low diversification in terms of geographic areas and categories
Portfolio focused on the most dynamic food segments (bottled water, infant nutrition, medical nutrition)	

Opportunities	Threats
Low penetration of yoghurts in emerging markets and in the US	Maturation of the Greek yoghurt category in the US
Changes in consumers’ tastes towards a healthier, more balanced diet	Regulatory risk (Indonesia, China…)
	Pressure on public budgets in the EU

Source: Danone, Bryan, Garnier & Co

3. A weak stock performance

The group has experienced many difficulties over the past seven years:

- From 2008, the combined effects of the economic crisis and rising milk prices in Europe caused a decrease in sales volumes and a margin squeeze. At the same time, Chobani benefited from Danone's delay in the Greek segment.
- In 2010, the group was forced by European regulations to withdraw its health claims for Activia and Actimel.
- In 2012, the deterioration of the macroeconomic environment in Spain led to a revision of annual targets.
- In 2013, botulinum toxin traces were detected in products delivered in Asia by Danone's supplier Fonterra.
- In 2014, the group was directly impacted by the crisis in Russia as the country accounts for 9% of group's sales.

Overall, this resulted in weak stock performance in the past few years. Since 2008, the group has underperformed the Stoxx Europe 600 Food & Beverage index by 45%. During over three years, between June 2011 and November 2014, the stock showed little movement. In the past six months, it rose by 11.0% in absolute terms but declined by 2.3% in relative terms, despite positive news (new management and the end of milk quotas).

Fig. 12: Stock price: Danone

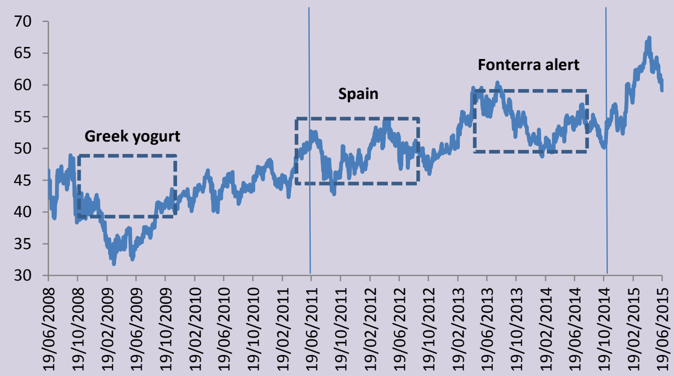
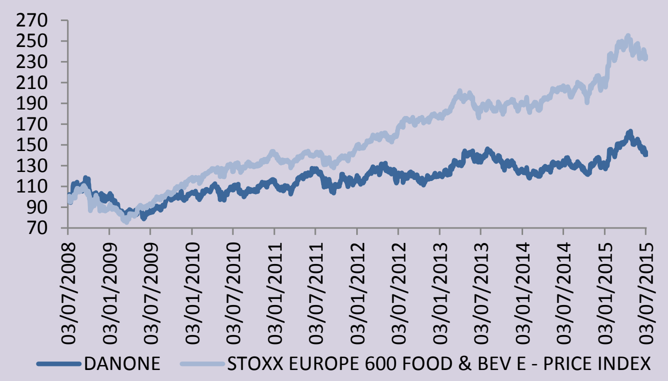


Fig. 13: Danone vs. Euro Stoxx 600 Food & Beverage



Source: Thomson Reuters

However, Danone should regain recognition by the market in 2015 due to the improvement in profitability.

4. Yoghurts: things are changing

Fig. 14: Breakdown of revenues by region, 2014

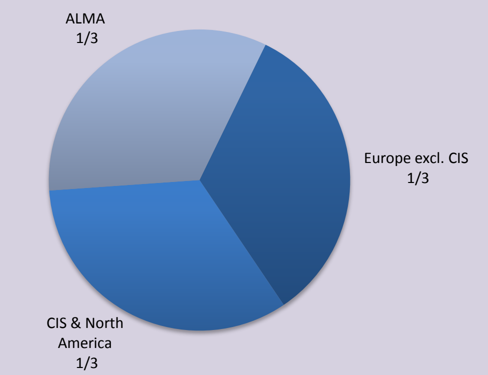


Fig. 15: Breakdown of revenues by country, 2014

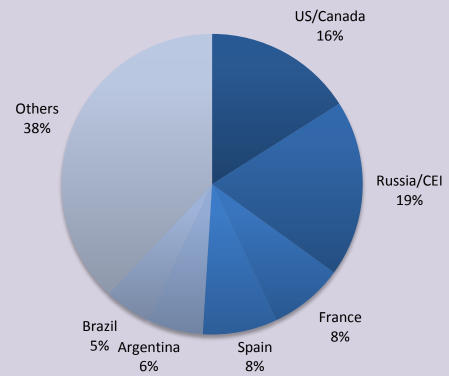


Fig. 16: Breakdown of recurring operating profit by region, 2014

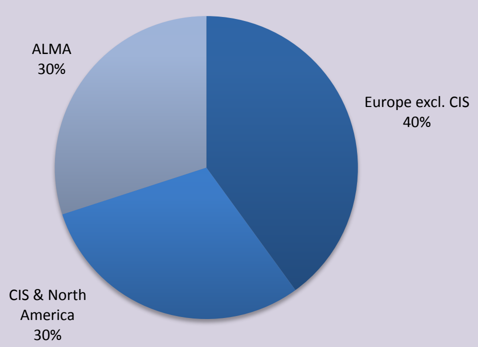


Fig. 17: Danone is the world No.1 player in the fresh dairy products market

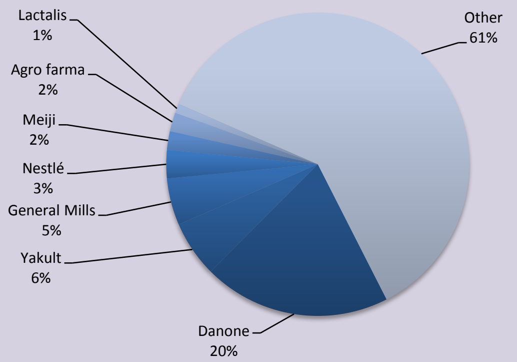


Fig. 18: Organic sales growth

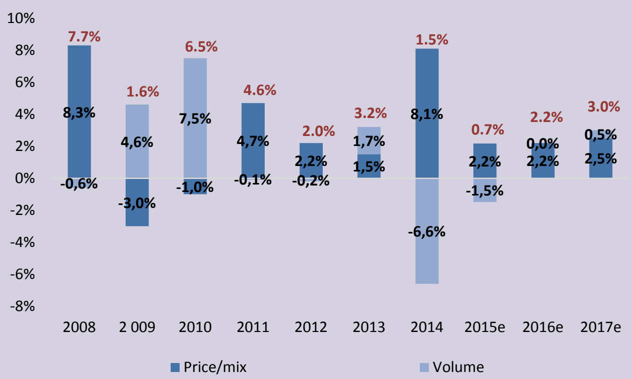
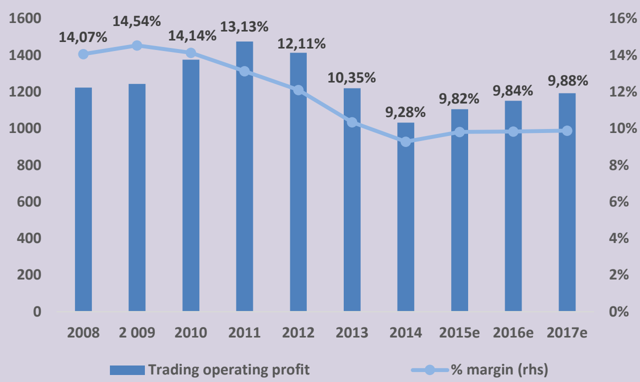


Fig. 19: Recurring operating profit



Source: Danone, Bryan, Garnier & Co

While lfl sales growth should moderate in 2015 (4.1), we expect a 54bp increase in recurring operating profit margin (4.2), mostly due to decreasing milk prices and the deconsolidation of dairy operations in China and Indonesia.

4.1. LFL sales growth of 0.7% in 2015

4.1.1. Sequential improvement in Europe and Russia

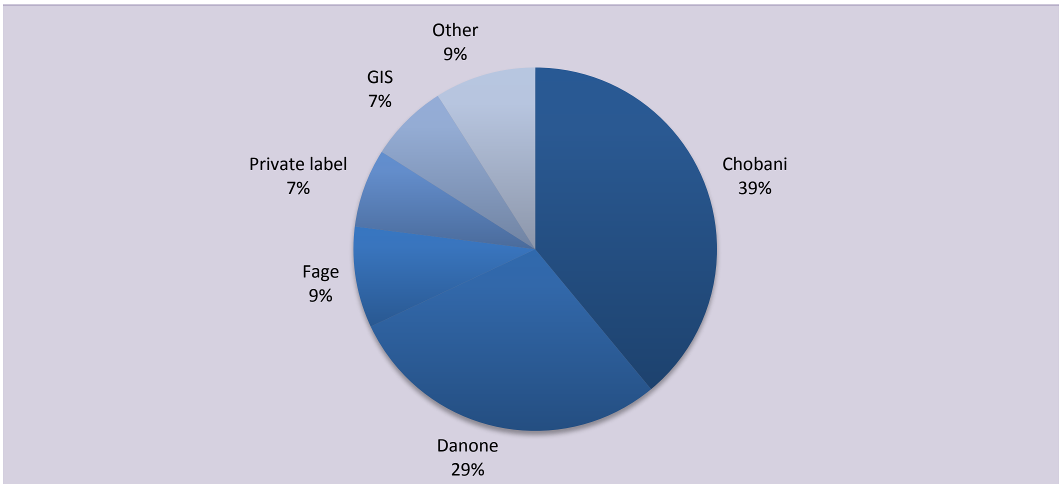
In Europe, revenues were affected by the deterioration in the macroeconomic environment from 2008 and the fact that health claims for Activia and Actimel were withdrawn in 2010. In Q1 2015, European sales dropped 4% (-7/8% in volume terms). Q2 2015 should be slightly below Q1 due to the rationalisation of the product portfolio last year. These negative effects will diminish in Q3 and Q4, allowing for better performance in the region. We estimate that volumes should stabilize in 2016, partly due to the reinvestment of the gains from the decline in milk prices.

In Russia, Danone made most of its price hikes in the lower end of the portfolio (60% in volume terms but 30% in value terms) because this price segment was the most impacted by the depreciation of the rouble and the increase in milk prices (+25% on average in 2014). This also gave a competitive advantage to modern brands. In Q1 2015, these ones continued to grow with Tema, Danissimo and Prostokvashino recording lfl sales growth in excess of 25%, 15% and 10%, respectively. But this performance was not enough to offset the difficulties experienced by low-added-value brands. In Q1, Russian volumes further declined, although with a sequential improvement. We anticipate that Danone's operations will continue to show resilience in 2015 (sales growth estimated between 0 and 3%).

4.1.2. Stabilisation in the US after several years of double-digit growth

The Greek yoghurt trend was launched by Chobani in 2007 based on the benefits of high protein and low fat content. If Danone was lagging behind, it ended up developing a similar product that allowed it to grow its sales by double digits between 2011 and 2013. The group is now the No.2 player in this segment, with a market share of 29%.

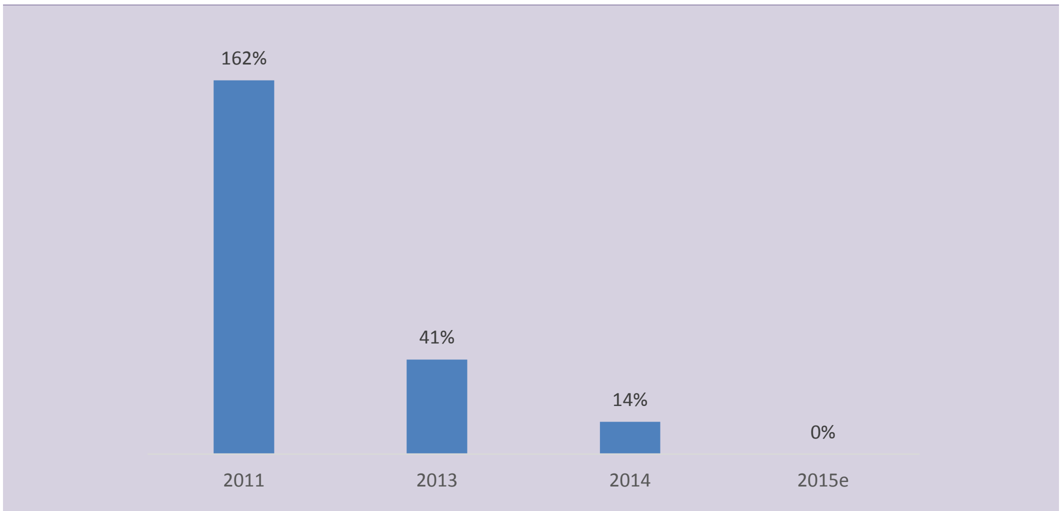
Fig. 20: Greek yoghurt: value market shares of US players



Source: Statista

However, the segment is close to maturation. We expect group's sales in the US to remain stable in 2015, in line with the market performance.

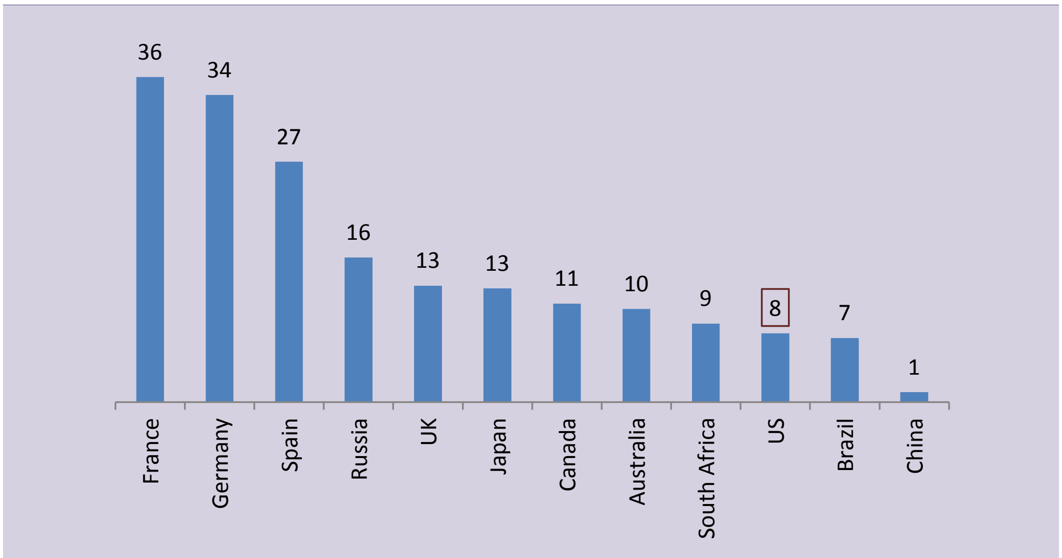
Fig. 21: The Greek yoghurt market in the US: change in sales



Source: Statista, Bryan, Garnier & Co

In the medium term, there are growth opportunities in the US. Indeed, the yoghurt market is still not very mature and the Greek segment accounts for 52% of sales. The development of other yoghurt segments could be facilitated by the maturation of the Greek that should lead to a rationalisation of the shelf space: exit of some players, reduction in the number of SKU's available and better display in stores.

Fig. 22: Consumption of fresh dairy products (kg) per person



Source: Danone

The group is innovating to counter the maturation of the Greek yoghurt market

Danone seeks to exploit these opportunities by focusing on innovation, with the development of the "indulgent" (yoghurt-based desserts), "kids", "flavoured" and "snacking" desserts. The group also intends to increase the penetration of its products in new distribution channels, as illustrated by its partnership with Starbucks (three products available in 4300 Starbucks stores since March).

In 2015, LFL sales should grow by 0.7% in view of persisting difficulties in Europe, the macroeconomic environment in Russia and the maturation of the Greek yoghurt market in the US. H2 performance should be better thanks to a more favourable comparison base in Europe (higher prices in H1 2014 but lower volumes in H2 2014 with fewer special offers). We do not share the view that falling milk prices might result in price reductions in the yoghurt category and negatively impact sales growth. Since 2008/2009, despite a significant increase in milk prices, producers have refused to increase the prices of fresh dairy products due to the economic crisis. Therefore, they will likely try to take advantage of the trend reversal by not reducing their prices. The gains on falling milk prices should be partly reinvested in Europe, allowing LFL sales to increase 2.2% in 2016. Within three years, Danone should return to 3% LFL growth.

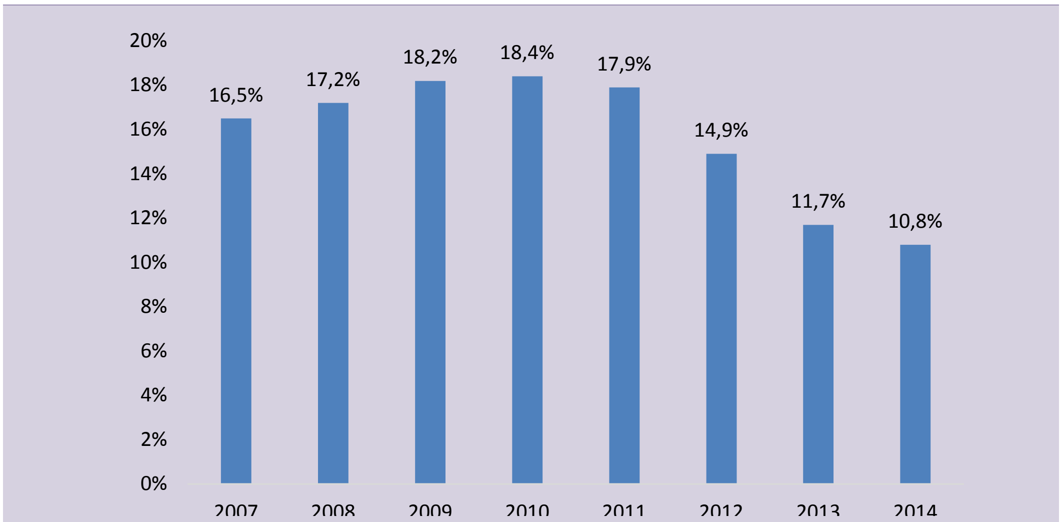
4.2. But the recurring operating profit should rise 30bp on an LFL basis

4.2.1. A reorganization in Europe

In H2 2014, the group managed to grow its operating margin in Europe, after almost four years of decline resulting from the impossibility to pass on to consumers the increase in milk prices and from a negative product mix (decline of Activia and Actimel). In order to do this, the group has launched a process to optimise its European operations with the aim of creating the conditions for a return to growth and profitability:

- Rationalisation of the product portfolio. As an example, there are now only 11 Activia recipes vs. 24 earlier.
- More selective management of promotional sales. The group focused these sales on high-value-added segments of its portfolio and cut 10% of volumes in France (15% for Activia).
- Greater operational efficiency. The group reduced its number of dairy product manufacturing plants from 24 to 16, implemented a group purchasing organisation (except for milk) and terminated some distribution agreements.
- Simpler organisational structure. Europe is now divided into 11 entities vs. 22 previously.

Fig. 23: Operating margin in Europe



Source: Danone, Bryan, Garnier & Co

4.2.2. Falling milk prices

A positive surprise is possible

The decline in milk prices (particularly in Europe and the US) should have a positive impact on the recurring operating profit margin, especially in H2 (+129bps) due to the comparison base. But the favourable impact could exceed what was previously anticipated. Indeed, between Q1 and Q2, the prices of whole milk powder and skimmed milk power and kept declining, respectively by 13% and 20%.

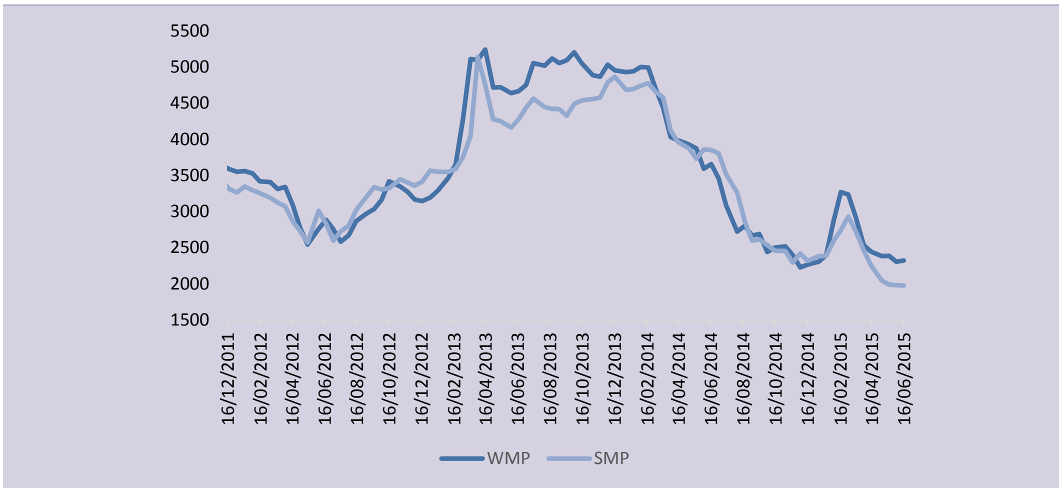
Fig. 24: Prices of dairy products

	% change Q2 2015 vs. Q1 2015	% change Q2 2015 vs. Q2 2014
Anhydrous milk fat	-21.8%	-18.9%
Butter	-22.4%	-25.0%
Butter milk powder	-26.4%	-51.0%
Cheddar	-4.1%	-32.3%
SMP	-19.7%	-46.3%
WMP	-12.8%	-37.7%

Source: Global Dairy Trade

The same observation can be made by looking at the auction prices of Fonterra, the first world producer of dairy products. The combination of increased production and high inventories are causing a decline in the prices of milk powders.

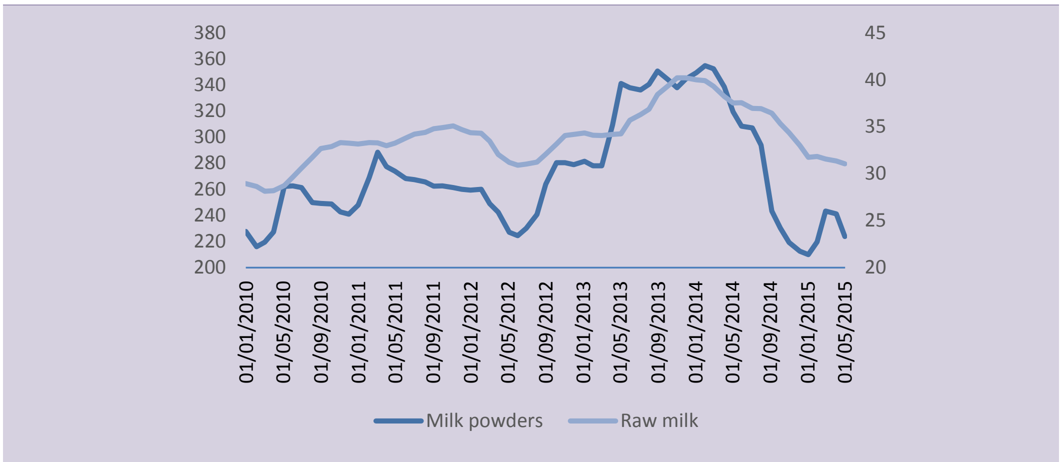
Fig. 25: Fonterra's auction prices (USD per tonne)



Source: AHDB

But powder prices are considered as a leading indicator of liquid milk prices. Indeed, power are derivatives and, consequently, their variations are magnified in case of shortage or excess production. Consequently, liquid prices could remain low in 2015.

Fig. 26: Change in prices of liquid milk and powder milk



Source: European Commission

We expect margin to be up 54bps in 2015 due to falling milk prices, the reorganization in Europe and the deconsolidation of dairy activities in Indonesia and China. This estimate might turn out to be too conservative if milk prices remain weak as we anticipate and the group does not reinvest all additional savings.

5. Water: still a solid segment

Fig. 27: Geographic breakdown of revenues, 2014

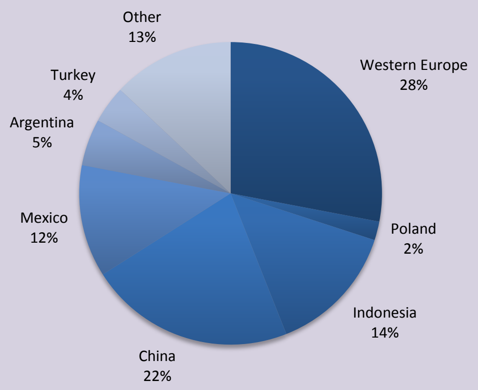


Fig. 28: Geographic breakdown of recurring operating profit, 2014

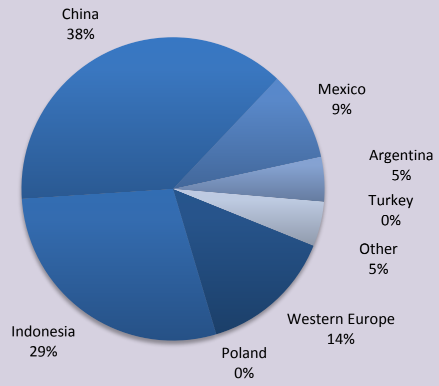


Fig. 29: Breakdown of revenues by segment, 2014

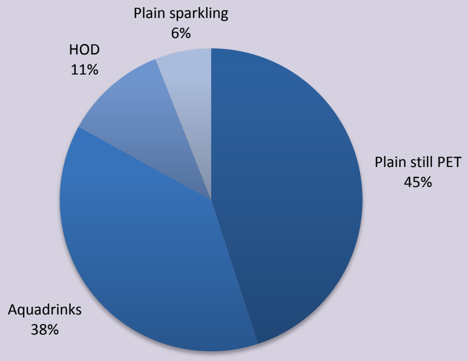


Fig. 30: Danone is the world No.1 player in value terms

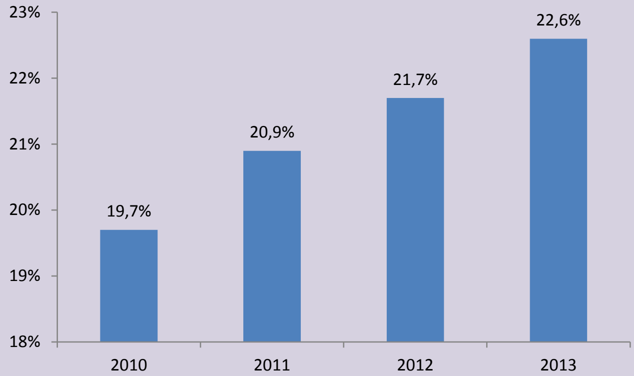


Fig. 31: Organic sales growth

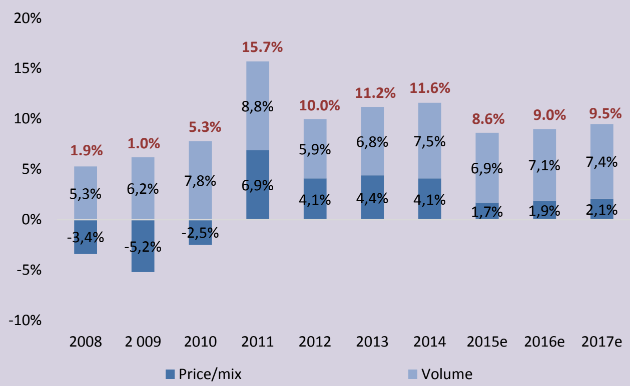
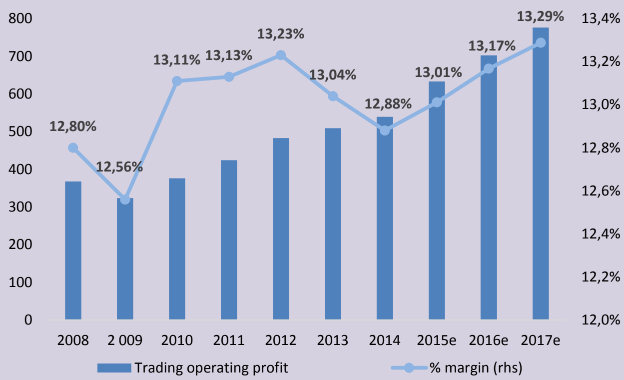


Fig. 32: Recurring operating profit



Source: Danone, Bryan, Garnier & Co

After an average LFL sales growth of 10.8% over the past five years, the pace should normalize in 2015 (+8.6% expected). But bottled water is still a fast-growing category (5.1) and the group has two growth drivers: flavoured waters (5.2) and significant exposure to emerging markets (5.3). They are also profit centres. The recurring operating margin for the division should increase on an LFL basis in 2015 for the sixth year in a row (+11bps expected and +13bps in reported terms).

5.1. L' or bleu

Bottled water sales CAGR of 8.7% expected for the period 2013-2020

According to a report from Transparency Market Research, the global bottled water market should grow by an 8.7% CAGR to USD279.65bn in 2020. In volume terms, this growth rate is estimated at 8.3% for the period. This category benefits from a growing awareness of health issues and from innovation made in the field of water portability.

Fig. 33: The bottled water market in value terms (USDbn)

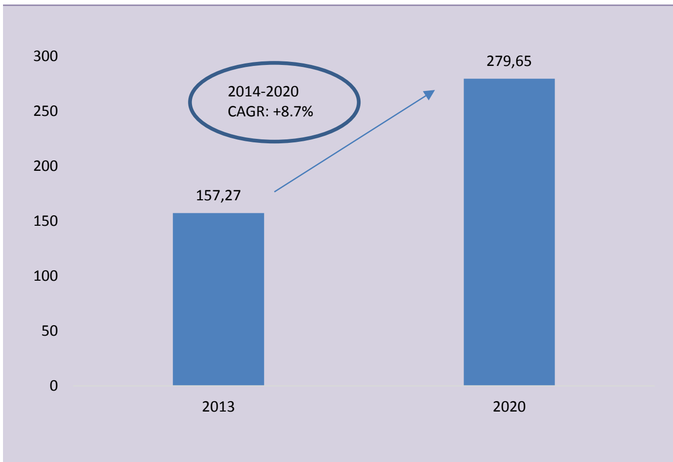
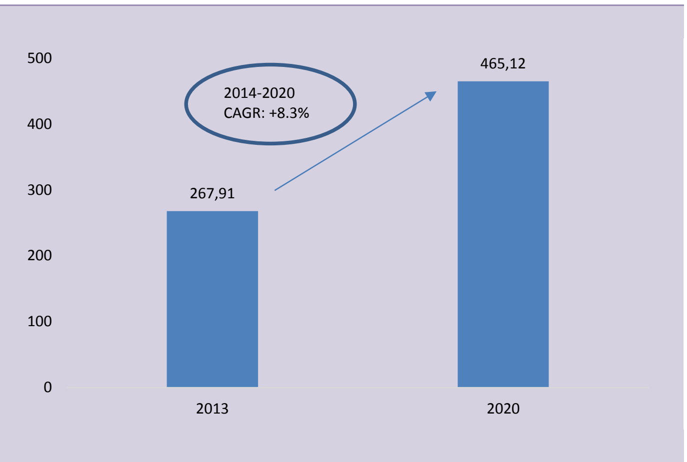


Fig. 34: The bottled water market in volume terms (billion litres)



Source: Transparency Market Research

5.2. Niche positioning in the flavoured water segment

Danone has developed a solid expertise in the flavoured water or "aquadrinks" segment (Mizone, Volvic Juicy and Bonafont with fruit), a segment the group was able to develop almost without any competition. Flavoured waters are waters supplemented with fruit juice. They make up 7% of the bottled water market but as much as 38% of Danone's water sales. These waters are growing at a fast rate. **In 2014, the group's flavoured water sales rose by around 20%, in line with the 2008/2013 CAGR for the segment, clearly outperforming still and sparkling water, which were up 5% and 3%, respectively.** In the coming years, the growth of flavoured waters should be driven by innovation in terms of bottling but most of all by consumers' growing health concerns, which explains why they prefer "aquadrinks" to sodas. **Besides, this segment generates high profitability. We estimate that the operating margin of Danone's flavoured water segment at 25% vs. 13.01% (2015^{e}) for the water division.** The risk of increased competition is not significant, for two reasons: 1/ Danone was able to build a strong brand image; 2/ while flavoured waters are accretive to the French group, they are dilutive to soda manufacturers, which are the most likely to be interested in penetrating this segment.

5.3. Significant exposure to emerging countries

The water division has regained attractiveness as its geographic mix has rebalanced towards emerging markets, which now account for 68% of sales vs. 52% in 2008. A lack of access to drinking water in a number of these markets is forcing consumers to turn to bottled water and creating a positive correlation between bottled water sales and population increase. But other factors have a positive impact: rise in disposable income, changes in consumer habits towards higher quality…

Danone holds strong positions in a number of fast-growing emerging markets. **In China, which represents 22% of the group's water sales, bottled water consumption should grow by double digits to 20% of global consumption by 2020. Danone derives 14% of the division's sales from Indonesia, which is expected to record 5-10% growth on average between 2015 and 2020.** Danone is the leader in the country, with a market share of around 50% in the off-trade market (in volume terms). Its Aqua and VIT brands, which are positioned in different price segments, allow the group to target a wide consumer base. In 2014, Aqua recorded an organic sales growth of 19%. **We estimate the operating margin generated in China and Indonesia at 22% and 24%, respectively, which is higher than group average (13.01% in 2015e).**

6. Medical nutrition: still in a good shape

Fig. 35: Breakdown of revenues by region, 2014

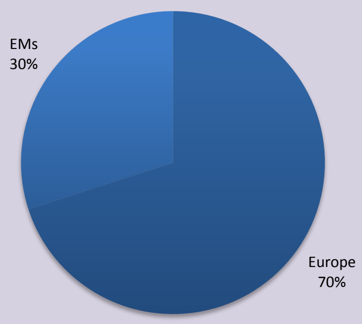


Fig. 36: Breakdown of recurring operating profit by region, 2014

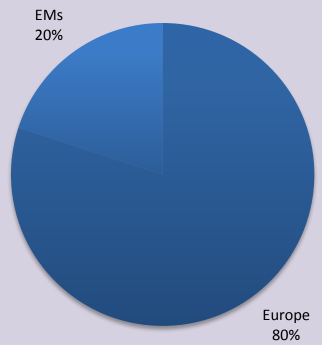


Fig. 37: Breakdown of revenues by segment, 2014

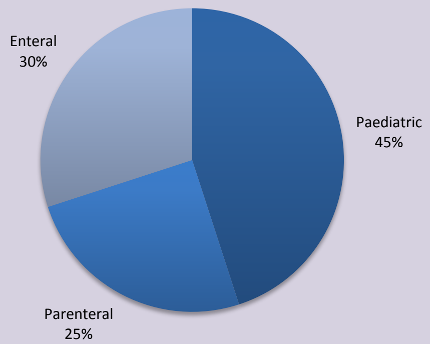


Fig. 38: Number of people over 50 in 2025 (in millions)

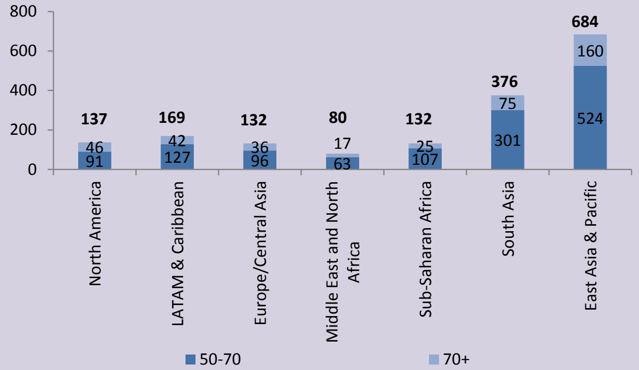


Fig. 39: Organic sales growth

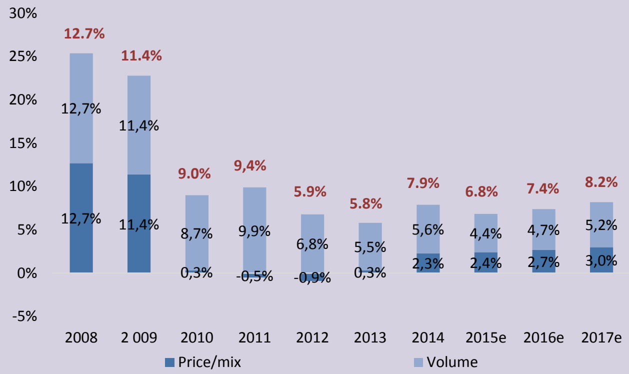


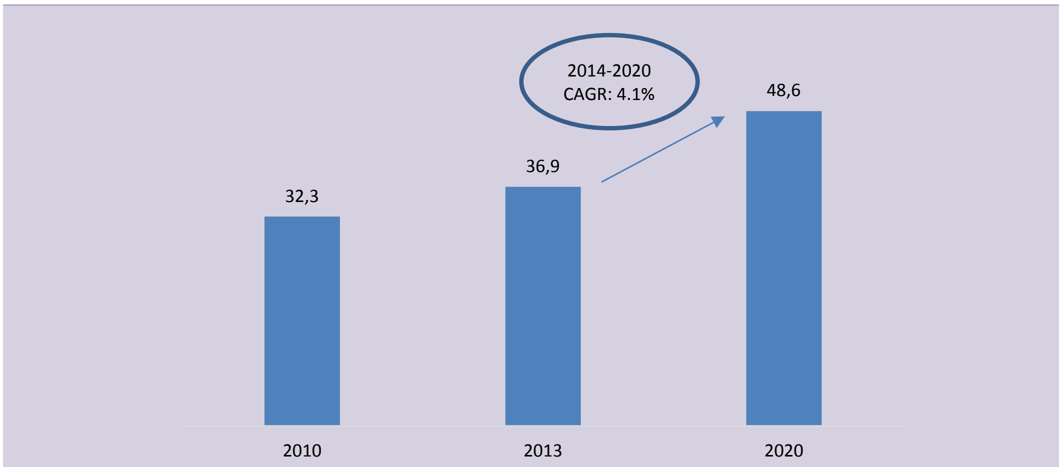
Fig. 40: Recurring operating profit

Source: Danone, Bryan, Garnier & Co

Medical nutrition refers to all food products designed to address the dietary needs caused by specific pathologies or special situations. The term covers oral, enteral (tube feeding) and parenteral (intravenous feeding) nutrition. The market is dominated by a limited number of players, mainly large food or pharmaceutical companies. Danone holds a 20% market share in value terms, but at group level, this division only represents 7% of revenues and 10% of recurring operating profit. The specificities of this division are: 1/ to have a lower level of internationalisation than other divisions, with 70% of sales and 80% of its recurring operating profit coming from Europe; and 2/ to use other distribution channels (hospitals and pharmacies) than convenience goods, which strongly limits the opportunities for synergies with the group's other divisions.

Sales growth is still solid in 2015, despite a minor slowdown. Since Danone entered the market with the acquisition of Numico in 2007, the division's LFL growth has been robust, with an average of 8.9%, despite the economic crisis in Europe and the resulting tightening of healthcare spending. In 2014, the division's revenues rose by 7.9% on an LFL basis, driven by emerging markets (double-digit growth in China, in Turkey and Brazil) while Europe grew at a reasonable rate of around 5%. **We anticipate that this geographic trend will be similar in 2015, resulting in 6.8% LFL sales growth, slightly decelerating vs 2014**. Prospects for the medium term are quite promising: according to Persistence Market Research, the medical nutrition market should grow by a 4.1% CAGR (in value) during the period 2014-2020, thanks to a combination of several factors: 1/ the increasing number of people suffering from malnutrition and receiving treatment; 2/ increase in birth rate; 3/ increase in the number premature births; and 4/ growth of the geriatric population.

Fig. 41: Medical nutrition market (in USDbn)



Source: Persistence Market Research

Since 2008, the division's operating margin tumbled due to the situation in Europe. However, the medical nutrition business is still very profitable, with an operating margin of 18.44% in 2015 (+34bps on an LFL basis) vs. 13.09% for the group as a whole, and implying a 16bps rise (+34bps on an LFL basis) in margin over the year.

7. Baby food: the recovery

Fig. 42: Breakdown of revenues by region, 2014

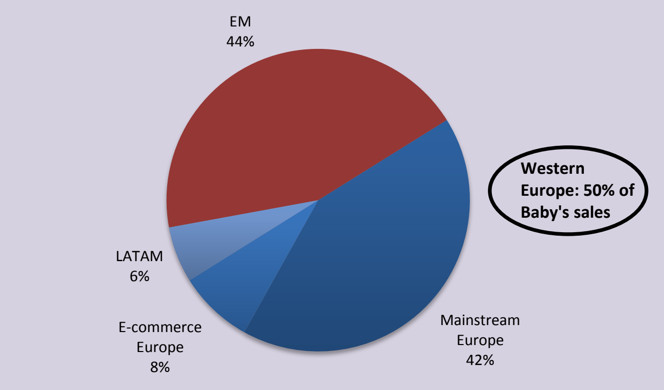


Fig. 43: Breakdown of recurring operating profit by region, 2014

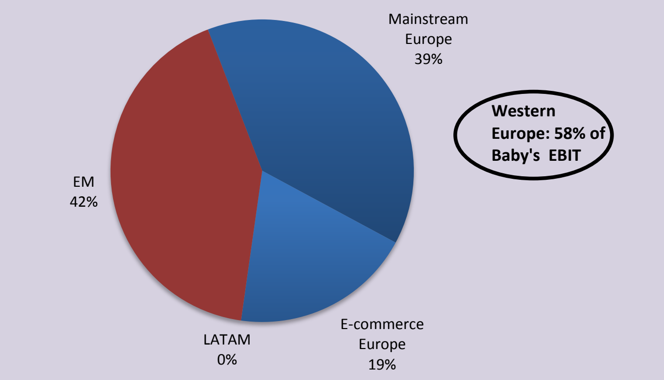


Fig. 44: Breakdown of revenues by country, 2014

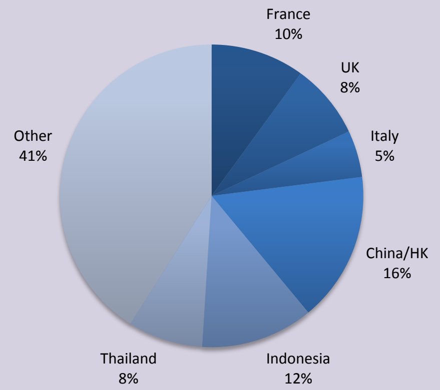


Fig. 45: Breakdown of revenues by segment, 2014

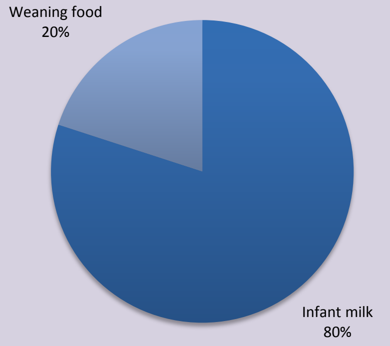


Fig. 46: Organic sales growth

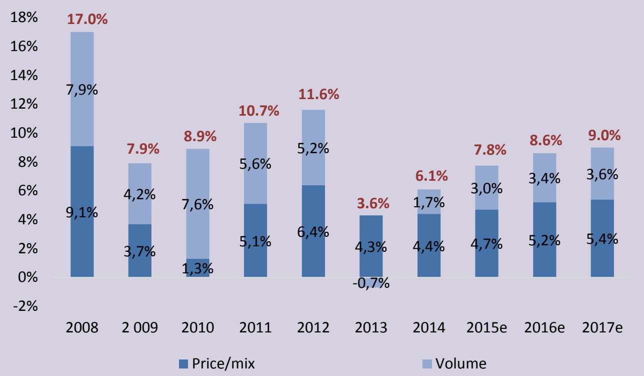
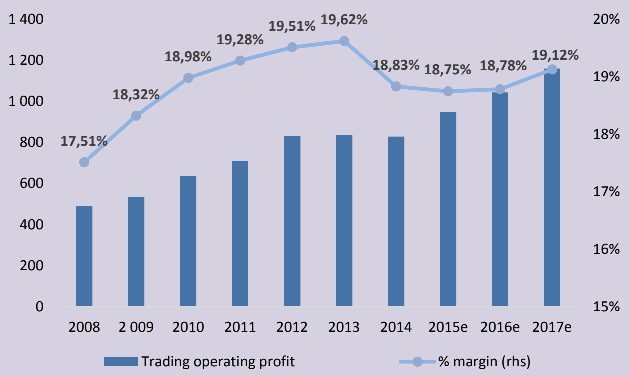


Fig. 47: Recurring operating profit



Source: Danone, Bryan, Garnier & Co

The early life nutrition is the only division that should register a drop in recurring operating profit margin in 2015 (-8bps in reported terms and -19bp on an LFL basis) because of the decline in sales of Dumex that is leading to a low absorption of fixed costs and ongoing investments in Brazil. But sales should increase 7.8% on an LFL basis this year, which is higher than the 6.1% growth posted in 2014. Indeed, the trend remains strong in the global market (7.1) and China is recovering (7.2).

7.1. A leading position in a fast-growing market

7% average growth in the next four years

Infant nutrition is one of the strongest food categories. This market, which is valued at USD50bn (according to Zenith International), should grow by an average 7% in the next four years thanks to: 1/ increased birth rate; 2/ increased female labour market participation; and 3/ economic growth which should allow a rise of the middle class and thus an increase of premium product purchases.

Whereas most food corporations are under the pressure of mass retailers and are facing competition from private labels, infant nutrition players hold a significant pricing power thanks to:

- Brand loyalty, as shown by the low penetration of private labels, below 1%. Consumers believe branded products are of greater quality and are reluctant to save money on their children's food.
- High barriers to entry, due to significant R&D and advertising costs. External growth is crucial in order to acquire a significant market share.

World No.2 player

Danone has a leading position in this category. With a global market share of 13%, it is the world No.2 player behind Nestlé (23%). The group is No.1 in Western Europe, its first market with 50% of sales, and No.2 in Australasia (No.1 before the Fonterra false warning).

With the acquisition of Numico (which will allow Danone to heighten its exposure to infant nutrition) and Fonterra, the division has recorded 22 consecutive quarters of LFL growth. Average growth stood at 11.2% between 2008 and 2012 and was well balanced between volumes (6.1%) and price mix (5.1%). During that period, operating margin oscillated between 17.5% and 19.6%, above the group's level.

7.2. Ongoing recovery in China

The Chinese market was deeply transformed by two food scandals. In 2008, the melamine crisis put consumers off buying local products, leading to a domination of imported brands whose market share increased from 40% to 80%. The Fonterra false warning happened in mid-2013: Danone's New Zealand supplier indicated it found traces of botulinum toxin in some of its products, leading to a partial suspension of Chinese imports of milk powder. Danone had to issue a recall of its products in eight Asian markets (including China) and it led to an 8.6% LFL sales decrease in the division in Q3 2013 and to a downward revision of its annual objectives.

However, the Chinese market still offers opportunities (4.2.1) and we believe the group has adopted an adequate strategy in an environment that has become more challenging for foreign groups. It implemented a strategic repositioning in terms of distribution channels and products (4.2.2) and was able to establish local partnerships allowing it to maintain good relationships with public authorities (4.2.3).

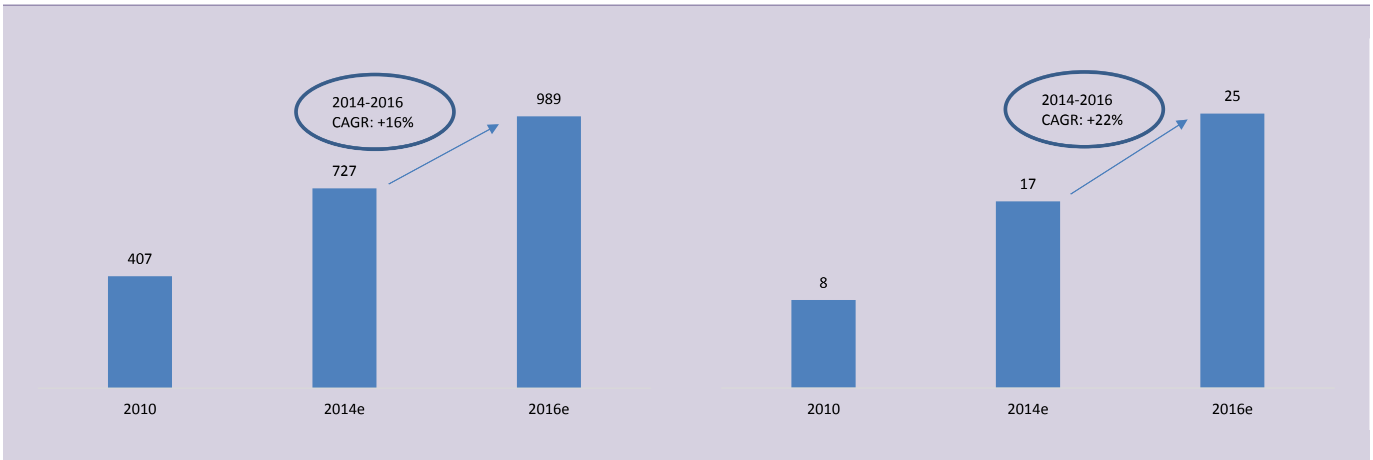
7.2.1. Still an attractive market

22% CAGR in value terms

The fundamentals of the Chinese market remain strong. According to Euromonitor, infant milk sales volumes should increase by an average 16% over the next two years, partly due to the relaxation of the one-child policy since November 2013. In value terms, the compound annual growth rate could reach +22% due to: 1/ economic growth, which goes hand in hand with a move upmarket; but also 2/ currently low penetration of premium products in lower tier cities. However, price increases should remain limited as 1/ it is necessary to justify price increases to the authorities since imported brands were under investigation for price fixing in 2012 and 2/ Chinese consumers now use the internet to find special offers and seek out the best bargains.

Fig. 48: Chinese infant milk market in volume terms ('000 MT)

Fig. 49: Chinese infant milk market in value terms (USDbn)



Source: Euromonitor, September 2014

The infant milk market has returned to its level from before the Fonterra scandal. However, the trend between local and imported brands has reversed and now local brands post higher growth than imported brands. In this context, Danone adopted an adequate strategy.

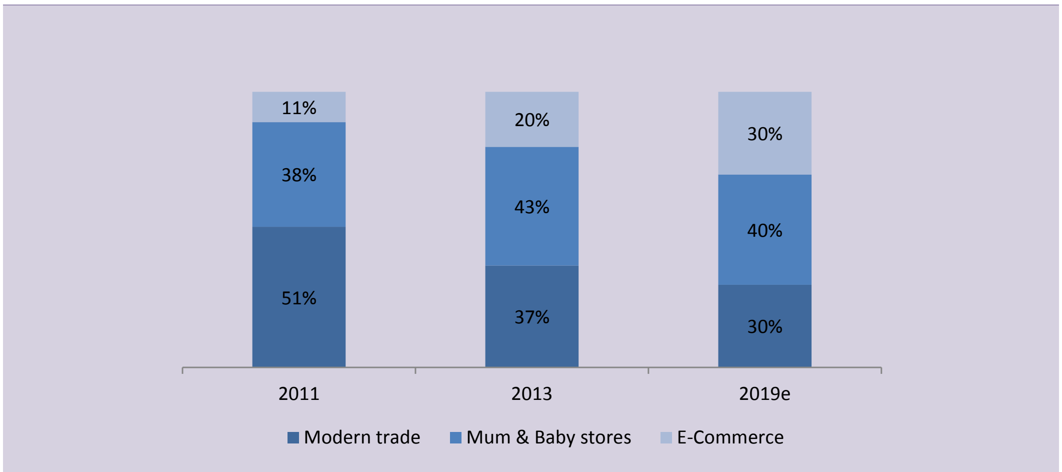
7.2.2. Smart repositioning

Before the Fonterra alert, Dumex was Danone's flagship brand in the Chinese market. Nowadays, it only represents 20% of its Chinese infant nutrition sales, vs. 75% previously. Its performance is not showing any signs of improvement (still declining in Q1 2015) mainly due to its strong presence in the modern trade channel, which has experienced a steady decline for the past 5 years. To tackle this issue, the group is trying to find a new positioning in terms of distribution channels and products.

The group intends to intensify its presence in the "Mum & Baby" channel (specialised stores) and capitalise on its online sales.

Online sales should record the highest growth in the coming years, for two reasons: 1/ lower prices than other channels; and 2/ increased number of available brands. In 2019, its market share is expected to reach 30%, vs. 20% currently. The positive trend observed in "Mum& Baby" stores should also speed up, partly due to public authorities' favourable attitude, as they believe this channel helps raise consumers' awareness of product quality. But households themselves tend to favour them for reasons of proximity. They are expected to represent 40% of the market by 2019 (43% in 2013). Nevertheless, the outlook remains gloomy for the "modern trade" channel, whose share should fall from 37% in 2013 to 30% in 2019.

Fig. 50: Chinese infant milk market by distribution channel



Source: AC Nielsen, SmartPath, DBN GC

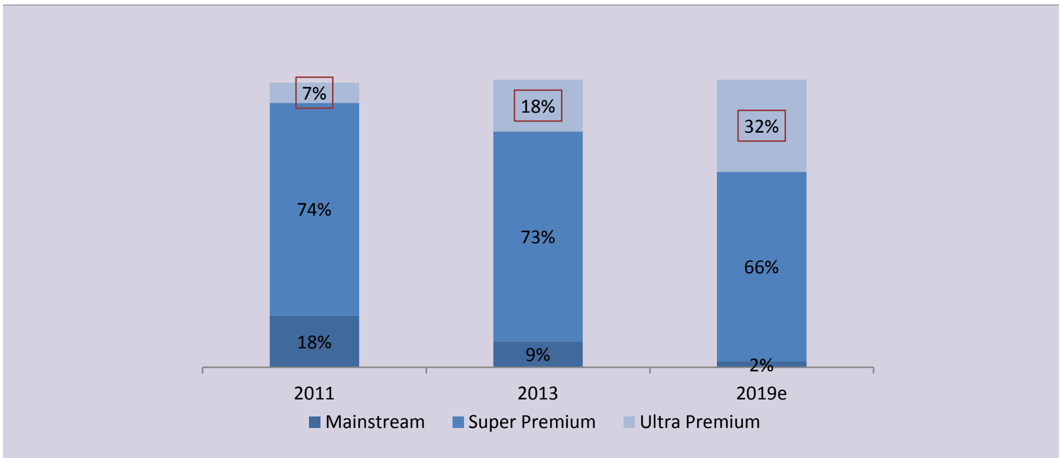
Online sales = a major contributor

In China, following the Fonterra scandal which steered consumers towards safer products, imports from Europe now account for two thirds of online sales. Since mid-2014, these imports have been very favourable for Danone and they ended up being very profitable as the resulting sales volumes have been achieved without any additional investments in the brands. We estimate that this channel generates a 40% operating margin, which is 200bps above the division's level. There are two issues with the grey market: 1/ potential shortage for European consumers; and 2/ no import taxes are paid to Chinese authorities. We believe the latter will find a way to legalise these transactions without going against consumers' wishes, and this should ensure this distribution channel's sustainability. A possible solution could be the creation of free trade zones, for instance.

The group increased portfolio segmentation while strengthening exposure to the "ultra-premium" segment.

China's move upmarket is expected to continue. By 2019, the ultra-premium segment should represent 32% of the infant milk market in value terms, vs. 18% in 2013.

Fig. 51: Chinese infant milk market by price range



Source: AC Nielsen, SmartPath, DBN GC

With Nutrilon Platinum, Danone widened its "ultra-premium" product portfolio. The group also increased the segmentation of its portfolio by dividing Dumex into two sub-segments: Dumex "core" whose prices dropped by 10% and Dumex "international" which was launched in the premium category. These initiatives should allow the group to take advantage of all growth opportunities in an environment with low visibility.

Fig. 52: Danone's product portfolio

Brand	Price range
Nutrilon Platinum	Ultra-premium
Nutrilon	Super-premium
Karicare	Super-premium
Aptamil	Super-premium
Dumex International	Premium
Dumex "core"	Standard

Source: Danone, Bryan, Garnier & Co

7.2.3. Local partnerships

The regulatory environment has toughened since Fonterra. In December 2013, several rules were introduced regarding the purchase of raw materials, product inspection, traceability and safety. The government also restricted imports and prohibited the repackaging of imported products into smaller presentations. Besides, in May 2014, Chinese authorities reduced the number of manufacturing licences from 133 to 82. The aim is to increase barriers to entry and market concentration in order to restore public confidence in local brands. The void left by the exit of some local players explain that local brands currently outperform.

Yashili and Mengniu = Danone's two key partners in China

Once the consolidation has been completed, the two segments (local and imported brands) should grow in a more balanced manner. But it is key to form alliances with local players in order to strengthen the relationship with the government and increase exposure to local brands. With this in mind, Danone acquired 25% of Yashili, one of the Chinese infant nutrition companies which were given priority by the government. The French group also has a partnership with Mengniu, one of the leaders in the country's dairy products market whose portfolio includes milk, yoghurts, ice cream and infant milk.

8. Consolidator or potential target?

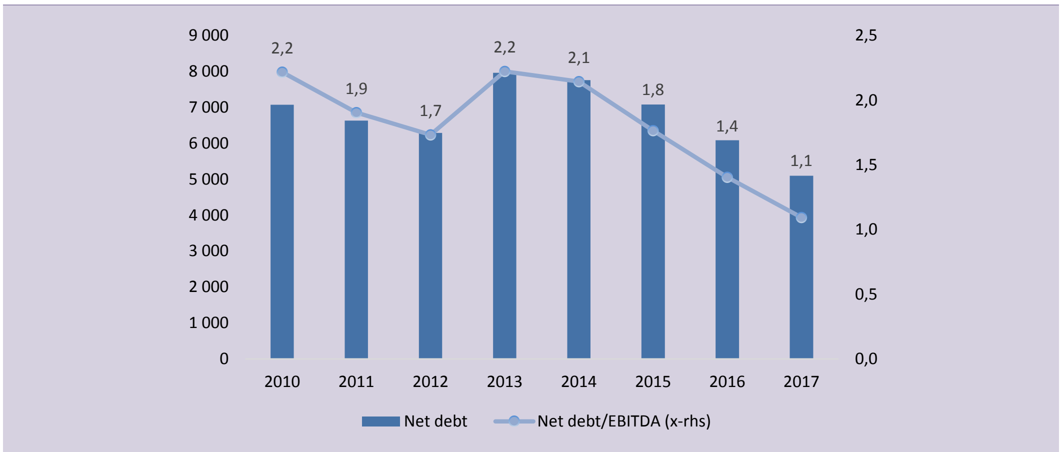
We consider that M&A risk has been significantly reduced (7.1) in recent times. Besides, the group is still a potential acquisition target (7.2).

8.1. The M&A risk has been reduced

8.1.1. The group should give priority to LFL growth

At the end of 2015, Danone's net debt/EBITDA ratio should reach 1.8x (vs. 2.1x in 2014).

Fig. 53: Change in net debt



Source: Danone, Bryan, Garnier & Co

The table on the next page shows potential acquisition targets for Danone, assuming that the target has an EBITDA margin of 18%; the acquisition price is 2.8x in 2015, 2.7x in 2016 and 2.6x in 2017; and Danone does not want its net debt/EBITDA ratio to exceed 4.0x. The group will be able to acquire a target whose sales will be equal or lower than:

- EUR4bn in 2015
- EUR5bn in 2016
- EUR7bn in 2017

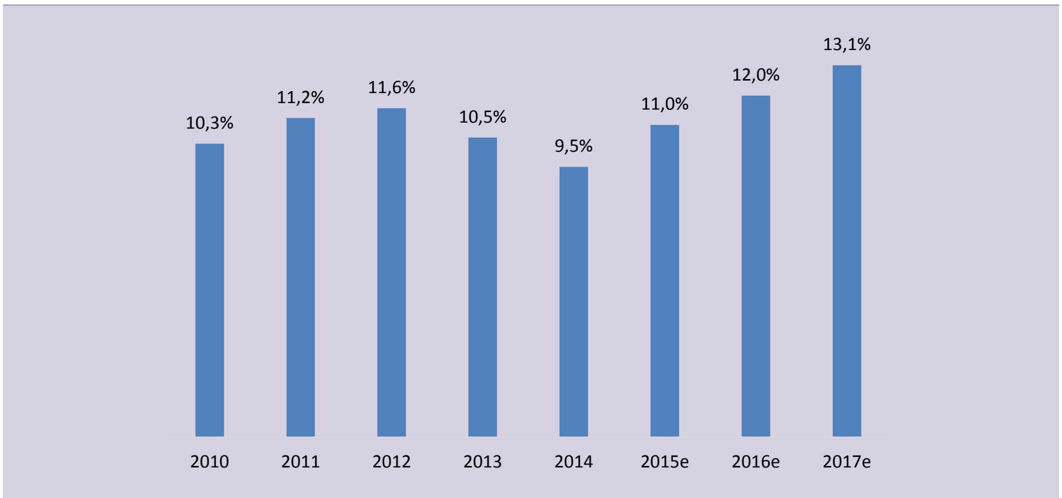
Fig. 54: Simulation of the group's acquisition capacity

EURm	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Assumption of sales	4 000	5 000	6 000	7 000	8 000
EBITDA margin	18%	18%	18%	18%	18%
EBITDA (EURm)	720	900	1080	1260	1440
			2014/15e		
Sector average 2015e EV/sales			**2.8x**		
EV of the target	11 200	14 000	16 800	19 600	22 400
Net debt	18 284	21 084	23 884	26 684	29 484
Consolidated EBITDA	4730	4910	5090	5270	5450
Net debt/EBITDA (EURm)	**3,9**	**4,3**	**4,7**	**5,1**	**5,4**
			2015/16e		
Sector average 2015e EV/sales			**2.7x**		
EV of the target	10 800	13 500	16 200	18 900	21 600
Net debt	16 882	19 582	22 282	24 982	27 682
Consolidated EBITDA	5 046	5 226	5 406	5 586	5 766
Net debt/EBITDA (EURm)	**3,3**	**3,7**	**4,1**	**4,5**	**4,8**
			2016/17e		
Sector average 2015e EV/sales			**2.6x**		
EV of the target	10400	13000	15600	18200	20800
Net debt	15 060	17 660	20 260	22 860	25 460
Consolidated EBITDA	5 380	5 560	5 740	5 920	6 100
Net debt/EBITDA (EURm)	**2,8**	**3,2**	**3,5**	**3,9**	**4,2**

Source: Danone, Bryan, Garnier & Co

Danone have some acquisition capacity in the years to come. **However, Danone has asserted a couple of times that its priorities are internal and the deals should be more tactical than strategical, which seems confirmed by the fact that the group has abandoned the idea of selling its medical division in December 2014. The reduction of the M&A risk should be well perceived by the market which saw two consecutive years of decline in ROIC (+150bps estimated in 2015).**

Fig. 55: Change in ROIC



Source: Danone, Bryan, Garnier & Co

8.1.2. Acquiring Mead Johnson would be difficult

Mead Johnson: the ideal acquisition target

Mead Johnson would be an ideal target (free float of 100%). This acquisition would allow Danone to reach a 26% share in the global infant milk market, vs. 14% as of today, and to fiercely compete with Nestlé (22%), especially in emerging countries, from where Mead Johnson derives 70% of its revenues. **The US company would achieve a dominant position in China, where it is already a leader.** Nevertheless, Danone would still be the No.2 player in the infant nutrition market (market share of 22%).

Fig. 56: Infant milk: global market shares as of today…

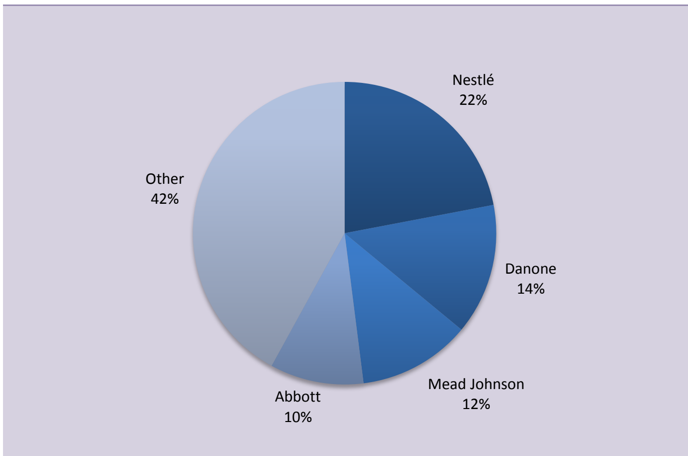
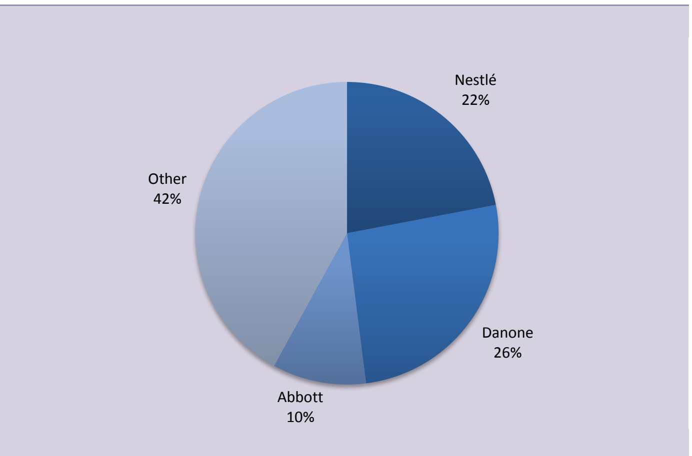


Fig. 57: …and after acquiring Mead Johnson



Source: Euromonitor, Bryan, Garnier & Co

Fig. 58: Infant nutrition: global market shares as of today…

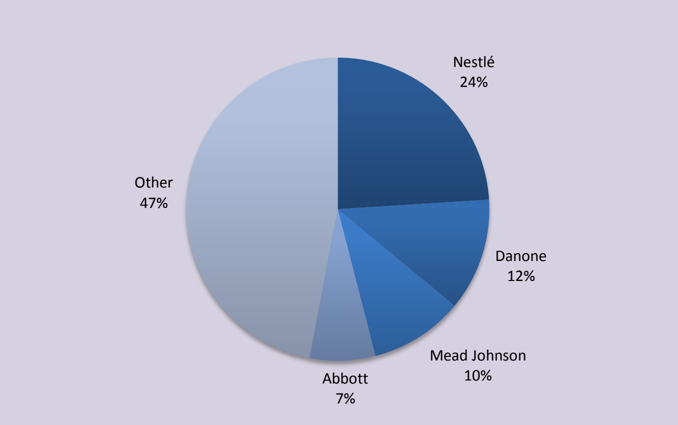
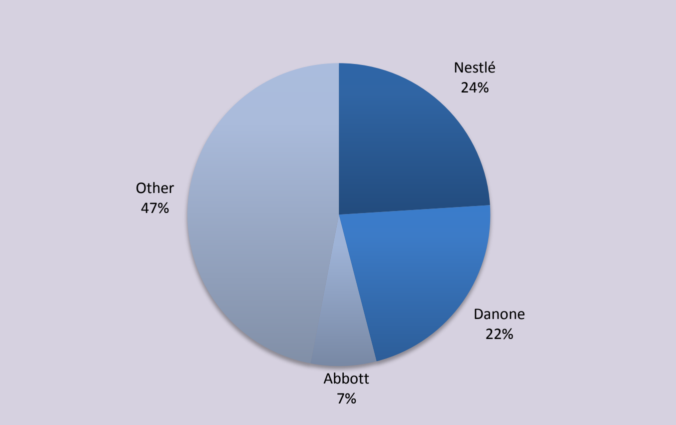


Fig. 59: …and after acquiring Mead Johnson



Source: Euromonitor, Bryan, Garnier & Co

Moreover, Danone's growth rates and profitability would be higher, as infant nutrition would account for 34% of group sales (vs. 21%) and 51% of recurring operating profit (vs. 31%). In LFL terms, this division has higher growth (in 2015: +7.8% vs. +4.1% for the group as a whole) and operating margin (18.75% vs. 13.09% for the group as a whole).

Fig. 60: Share of Danone's divisions (as a % of sales) before and after the potential acquisition of Mead Johnson

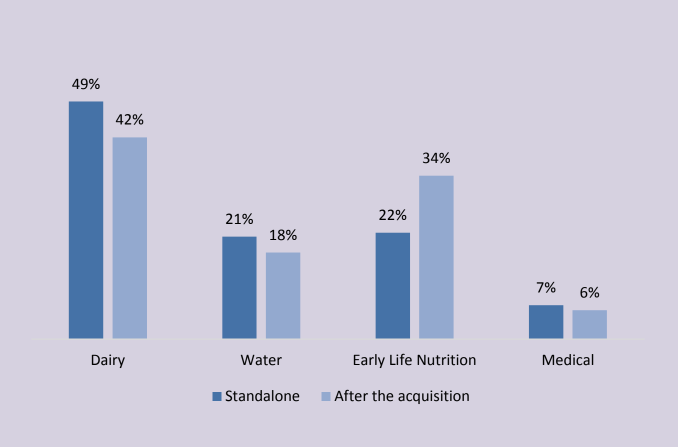
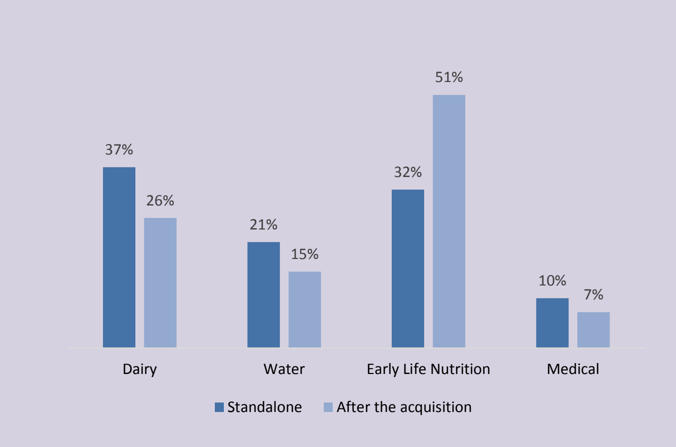


Fig. 61: Share of Danone's divisions (as a % of operating profit) before and after the potential acquisition of Mead Johnson



Source: Danone, Bryan, Garnier & Co

An accretive impact on operating margin of 230bps

In 2015, we estimate that the acquisition would increase group sales and recurring operating profit by 17% and 38%, respectively. **Assuming EUR160m synergies, which is equivalent to 4% of group sales, the accretive impact on margin would reach 230bps (+440bps for the infant nutrition division).**

Fig. 62: Impact of a potential combination of Danone and Mead Johnson, 2015e

	Baby	Group
Sales		
Danone	5 051	22 797
Mead Johnson	3 982	3982
Combined	**9 033**	**26 779**
EBIT		
Danone	947	2 984
Mead Johnson	984	984
Synergies	160	160
Combined	**2 091**	**4 128**
EBIT margin		
Danone	18,7%	13,1%
Mead	24,7%	24,7%
Combined	**23,2%**	**15,4%**
Sales uplift	17%	
EBIT uplift	38%	
Infant margin uplift	440	
Group margin uplift	**230**	

Source: Danone, Bryan, Garnier & Co

There are two types of obstacles: financial and regulatory.

However, Danone might have to deal with the opposition from Chinese authorities, which tend to give preference to local players. In addition, such an acquisition would have challenging financing requirements. Assuming a 30% premium, Danone would have to pay USD24bn (EUR21bn), i.e. USD118 per share. **In 2015, the net debt/EBITDA ratio (including put options on minority interests) would stand at 5.5x, a level that will not be easily sustainable for the group**. We assume that the group does not want to exceed a net debt/EBITDA ratio of 4.0x. In 2015, Danone would have to issue shares for a total amount of EUR9,702m, i.e. 46% of the acquisition price of Mead Johnson. We expect a 3-for-1 rights issue at a price of EUR49 (20% discount to average stock price in the past 30 days). We rule out the possibility that Danone funds this acquisition through the sale of the medical nutrition division, since the group abandoned this idea in December 2014.

Fig. 63: Impact of the acquisition of Mead Johnson on the net debt/EBITDA ratio, 2015e

EURm	**100% debt**	**54% debt**
Net debt	7 081	7 081
Acquisition Mead Johnson	21 000	11 298
Total net debt after the acquisition	28 081	18 379
Equity issue	0	9 702
EBITDA_combined	5 084	5 084
Net debt/EBITDA (x)	**5,5**	**3,6**

Source: Danone, Bryan, Garnier & Co

However, in the event of a share issue, the dilutive impact on EPS would be 5%, vs. an accretive impact of 14% if the acquisition is entirely financed by debt.

Fig. 64: Impact of an acquisition entirely financed by debt on 2015e EPS

EURm	**Current**		**Pro forma**
EBIT	2 984	984	3 968
Net interest	-316	-630	-946
Pre-tax	2668	354	3 022
Taxation	-801	-106	-907
Associates	40		40
Minorities	145		145
Net income _ group share	1762		2010
Number of shares	594		594
Basic EPS	2,97		3,38
Accretive impact			**14%**

Source: Danone, Bryan, Garnier & Co

Fig. 65: Impact of an acquisition 46% financed by a share issue on 2015e EPS

EURm	**Current**		**Pro forma**
EBIT	2 984	994	3 978
Net interest	-316	-339	-655
Pre-tax	2668	655	3 323
Taxation	-801	-197	-997
Associates	40		40
Minorities	145		145
Net income _ group share	1762		2221
Number of shares	594	198	792
Basic EPS	2,97		2,80
Dilutive impact			**-5%**

Source: Danone, Bryan, Garnier & Co

We doubt that Danone will be ready to make such an acquisition. Danone's Dumex brand and Mead Johnson's Enfa brand are direct competitors in China, which poses a **risk of cannibalisation that Danone is not ready to assume, now that the group has to focus on improving Dumex's performance. In any case, there is no hurry for this acquisition**, as the company is not for sale at the moment and, even if it were, we believe the competition would be limited for anti-trust reasons. Nestlé, for instance, would find very difficult to acquire this company.

8.2. Danone is vulnerable to takeover bids

Danone has never been the subject of a takeover bid, although PepsiCo was rumoured to be interested in bidding for the French group in 2005. **Theoretically, however, the possibility of Danone being an acquisition target cannot be ruled out:**

- **Due to its shareholding structure**

MFS (Massachusetts Financial Services) has become the major shareholder of Danone, with a 12.6% stake while the share of its historical friendly block of shareholders (Eurazeo, CDC, Sofina, Predica) has decreased significantly.

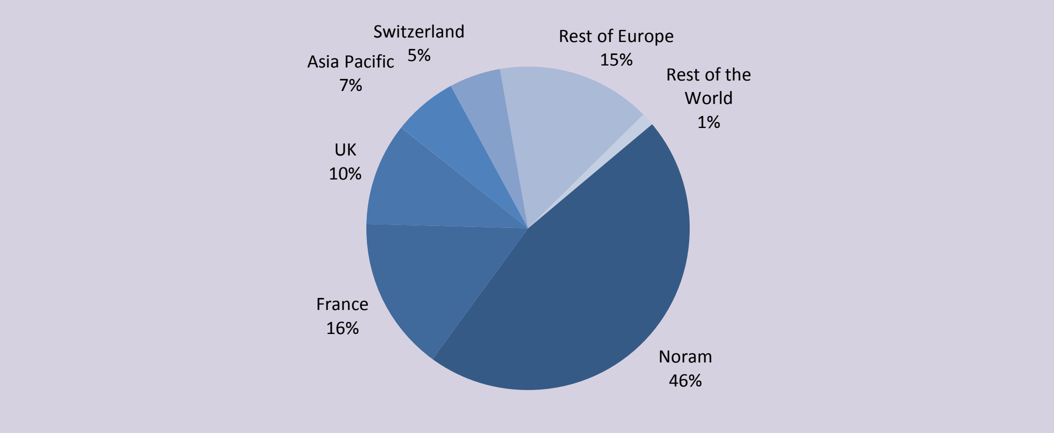
Fig. 66: Shareholding structure

Shareholders	% of capital	% of net voting rights
MFS Group	12.6%	10.3%
Sofina & Henex group	2.2%	4.4%
Harris Associates L.P.	3.0%	3.1%
Amundi Asset Management	2.1%	2.1%
First Eagle Investment Management	2.0%	2.0%
CDC Group	1.6%	1.7%
Norges Bank	1.5%	1.5%
Natixis Asset Management	1.9%	1.1%
Employee shareholding	1.3%	2.6%
Treasury shares_group	5.9%	
Treasury shares_ Danone Spain subsidiary	0.9%	
Others	65.0%	71.3%

Source: Danone

Moreover, Anglo-saxon shareholders now account for 56% of the capital held by institutional investors.

Fig. 67: Geographic breakdown of capital held by institutional investors



Source: Danone

- **Due to the absence of any obvious political obstacles.** There has been an increasing number of mergers and takeover bids for French groups lately. Furthermore, in the past, the government has allowed a number of asset purchases from French food companies. For example, Panzani was bought out by Ebro (2005), LU by Kraft (2007) and Yoplait by General Mills (2011).

We valued Danone using a sum-of-parts analysis in order to analyse the possibility of a takeover. We assumed an EV/EBITDA multiple of 15.1x for the early life and medical nutrition divisions, in line with the valuation of Mead Johnson. 12.5x and 13.5x multiples were obtained for the fresh dairy products and water divisions, respectively, based on sector average (consensus data). We obtained a value of EUR81 per share.

Fig. 68: Enterprise value based on a sum-of-parts analysis

EURm	EBITDA 2015e	% EBITDA	EV/EBITDA	EV
Fresh Dairy Products	1 709	43%	12,5	21 364
Waters	795	20%	13,5	10 732
Early Life Nutrition	1 113	28%	15,1	16 805
Medical Nutrition	358	9%	15,1	5 402
				54 302

Source: Danone, Bryan, Garnier & Co, Thomson Reuters

Fig. 69: Value per share

EURm	
EV	54 302
-Net debt	7 081
-Minorities	49
-Other liabilities	818
+Financial assets	2 146
Theoretical market capitalization	48 500
Number of shares	596
Value per share	**81**

Source: Danone, Bryan, Garnier & Co

9. The catalyst: an increase in profitability

9.1. 4.1% organic growth, slightly lower than in 2014

We anticipate an organic growth of 4.1%, in the low range of Danone's estimates of 4-5% mainly due to the Fresh Dairy Products. Growth should be evenly distributed between H1 and H2, although with a lower contribution from the infant nutrition division in H2. The trend is expected to remain solid, but to decelerate vs 2014 (+4.7%). The management has indicated that, on an LFL basis and in the medium term, the PLF division should grow by 2-4%, waters by 7-10%, infant nutrition by 8-10%, and medical nutrition by 6-9%. Therefore, Danone's positioning in the fastest-growing categories of the food industry should allow for an LFL sales growth around 7% in the medium term.

Fig. 70: Sales estimates by division

EURm	**2014**	**2015e**	**2016e**	**2017e**
GROUP	21 144	22 797	24 382	25 886
Reported variation	-0,7%	7,8%	7,0%	6,2%
FX variation	-5,5%	4,0%	1,5%	0,0%
External variation	0,1%	-0,3%	0,0%	0,0%
Organic variation	4,7%	4,1%	5,4%	6,2%
FRESH DAIRY PRODUCTS	11 129	11 261	11 718	12 069
Reported variation	-5,6%	1,2%	4,1%	3,0%
Organic variation	1,5%	0,7%	2,2%	3,0%
EARLY LIFE NUTRITION	4 397	5 051	5 559	6 060
Reported variation	3,1%	22,2%	22,8%	23,4%
Organic variation	6,1%	7,8%	8,6%	9,0%
WATERS	4 186	4 870	5 345	5 853
Reported variation	7,3%	16,3%	9,8%	9,5%
Organic variation	11,6%	8,6%	9,0%	9,5%
MEDICAL NUTRITION	1 432	1 615	1 760	1 905
Reported variation	6,7%	12,8%	9,0%	8,2%
Organic variation	7,9%	6,8%	7,4%	8,2%

Source: Danone; Bryan, Garnier & Co

9.2. But with an increase in operating margin and EPS

We anticipate an increase in LFL recurring operating margin of 27bps, mainly in H1 thanks to a more favourable comparison base. Danone's guidance of a slight improvement in LFL operating profit might turn out to be too conservative if, as we believe, the prices of liquid milk remain weak in 2015 and the group does not reinvest all the gains. The margin should also benefit from 1/ FX as profitability in Indonesia, China, and Mexico is well higher than average while Russia's is lower and 2/ the deconsolidation of milk operations in China and Indonesia. **In reported terms, this increase should thus reach 50bps, which is likely to be applauded by the market after a 5-year period of decline.**

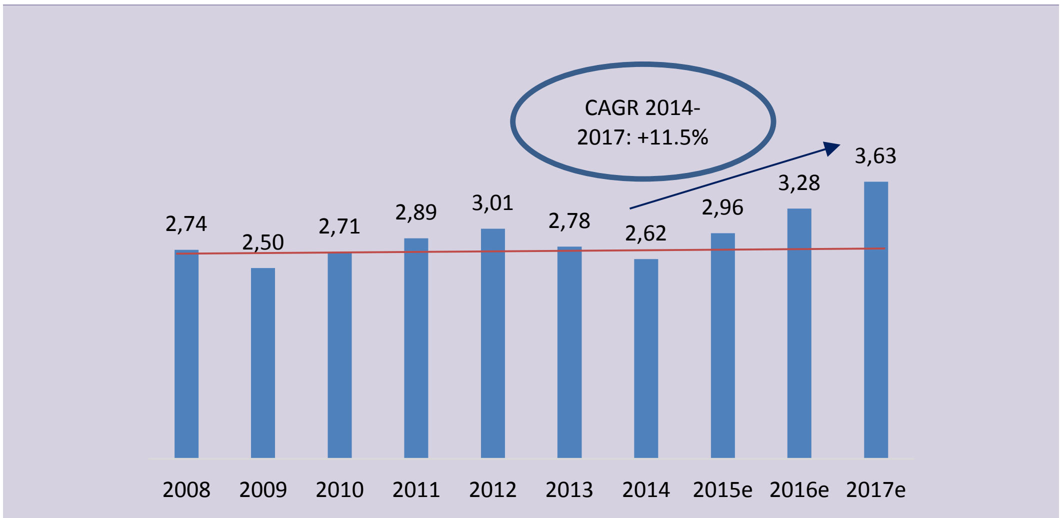
Fig. 71: Recurring operating profit estimates by division

EURm	2014	2015e	2016e	2017e
GROUP	2 662	2 984	3 230	3 496
Reported variation	-5,2%	12,1%	8,2%	8,2%
Margin	12,59%	13,09%	13,25%	13,50%
Change in bp	-60	50	15	26
lfl	-12	27	14	26
FRESH DAIRY PRODUCTS	1 033	1 106	1 153	1 193
Reported variation	-15,4%	7,1%	4,2%	3,5%
Margin	9,28%	9,82%	9,84%	9,88%
Change in bp	-107	54	2	5
lfl	-67	30	-2	5
EARLY LIFE NUTRITION	828	947	1 044	1 159
Reported variation	-1,0%	14,4%	10,3%	11,0%
Margin	18,83%	18,75%	18,78%	19,12%
Change in bp	-79	-8	4	34
lfl	-40	-19	0	34
WATERS	539	634	704	778
Reported variation	5,9%	17,5%	11,1%	10,5%
Margin	12,88%	13,01%	13,17%	13,29%
Change in bp	-16	14	17	12
lfl	93	11	12	12
MEDICAL NUTRITION	262	298	329	365
Reported variation	7,4%	13,8%	10,3%	11,2%
Margin	18,28%	18,44%	18,67%	19,18%
Change in bp	12	16	22	52
lfl	89	34	45	52

Source: Danone, Bryan, Garnier & Co

In 2014, diluted EPS went down by 5.9% due to unfavourable currency impacts, the increase in milk prices, and the impact from the Fonterra false warning in the Asian infant nutrition division. It fell below the level reached in 2008, meaning that it was almost stable in the past 6 years. However, in 2015, it is expected to grow for the first time in two years (est. +12.9%), thanks to a reversal in currency trends and milk prices. We anticipate a 11.5% CAGR for the period 2014-2017.

Fig. 72: Diluted EPS



Source: Danone, Bryan, Garnier & Co

9.3. Adjusted consensus

Our estimates for the next three years are slightly above consensus. The market seems to have adequately factored in the downside risks. However, the milk prices remain low, which could imply that the group's guidance of a slight improvement in recurring operating margin on an LFL basis is too conservative.

Fig. 73: Consensus / Bryan, Garnier & Co's estimates

	2015		2016		2017	
	BG	CS	BG	CS	BG	CS
Sales	22 797	22 723	24 382	24 012	25 886	25 482
Difference	*0,3%*		*1,5%*		*1,6%*	
EBIT	2 984	2 955	3 230	3 196	3 496	3421,1
Difference	*1,0%*		*1,0%*		*2,2%*	
EPS	2,96	2,93	3,28	3,22	3,63	3,53
Difference	*0,9%*		*1,9%*		*2,9%*	

Source: Danone, Bryan, Garnier & Co

10. Valuation

10.1. A cheap stock compared to peers

The stock is trading at significant discounts: 6% and 8% for 2015 and 2016 P/E ratios, and 10% and 12% for 2015 and 2016 EV/EBIT ratios.

Fig. 74: Multiples table

At July 6th	P/E			EV/EBIT		
	2015e	2016e	2017e	2015e	2016e	2017e
ASSOCIATED BRITISH FOODS	29,6	27,8	23,7	20,9	17,8	15,2
COCA COLA	19,7	18,5	17,3	16,8	16,0	14,9
DANONE	19,6	17,7	16,0	14,0	12,6	11,4
EBRO	16,7	15,0	14,1	11,1	10,1	-
GENERAL MILLS	19,0	17,8	16,7	14,2	13,6	11,7
KELLOGG	17,6	16,7	20,3	14,4	13,9	12,1
KERRY	21,9	19,8	17,9	16,7	14,7	-
MONDELEZ INTERNATIONAL	23,9	20,5	18,5	18,2	16,3	16,1
NESTLE	20,4	19,2	17,8	15,4	14,3	13,4
PEPSICO	20,9	19,3	17,8	15,6	14,9	14,7
UNILEVER	20,2	18,7	17,4	13,6	12,5	11,3
Average sector (x)	20,9	19,2	18,0	15,5	14,3	13,4
Danone vs sector (x)	**-6%**	**-8%**	**-11%**	**-10%**	**-12%**	**-15%**

Source: Thomson Reuters

10.2. Fair value of EUR71

Our DCF-based fair value for Danone is based on the following assumptions:

- Risk-free rate of 2%
- Equity risk premium of 6.4%
- Levered beta of 1.1
- Our estimates for the period 2015-2017

We obtain a fair value of EUR71 per share

Fig. 75: DCF valuation

EURm	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e
Gross cash flow	3 260	3 492	3 737	4 007	4 288	4 595	4 852	5 070	5 241	5 361
CF variation		7,1%	7,0%	7,2%	7,0%	7,2%	5,6%	4,5%	3,4%	2,3%
-Capital expenditure	-1072	-1145	-1216	-1293	-1348	-1407	-1485	-1552	-1604	-1641
-WCR variation	-119	-96	-138	-173	-185	-197	-208	-217	-225	-230
=Operating free cash flow	**2 069**	**2 252**	**2 383**	**2 541**	**2 755**	**2 992**	**3 159**	**3 300**	**3 412**	**3 490**
Discounting rate	7,7%									
Perpetual growth rate	2,0%									
Discounted free cash flow	1921	1941	1908	1889	1902	1917	1880	1824	1751	1663
Discounted free cash flow sum	18 596									
+Discounted terminal value	29 777									
=Total	**48 373**									
-Minority interest	49									
+Financial assets	2 146									
-Net debt	7 081									
-Provisions	818									
=Total	**42 572**									
Number of shares	596									
DCF per share	**71**									

Source: Danone, Bryan, Garnier & Co

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Stock rating

BUY — Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

NEUTRAL — Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

SELL — Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

Distribution of stock ratings

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