Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Nestle's efforts to rationalize its product mix should free up funds to invest behind core brands.

Updated Forecasts and Estimates from 07 Nov 2014

Erin Lash, CFA
Senior Analyst
erin.lash@morningstar.com
+1 (312) 384-5435

The primary analyst covering this company does not own its stock.

Research as of 07 Nov 2014
Estimates as of 07 Nov 2014
Pricing data through 19 Dec 2014
Rating updated as of 19 Dec 2014

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Contents

Investment Thesis 07 Nov 2014

As the largest packaged food and beverage firm in the world by revenue, Nestle is one of the leading players in several categories, including beverages, dairy products, confectionery, and pet care. The breadth of its product portfolio makes Nestle a core supplier to grocery stores across the world, and its distribution network is extensive. More than 20 of Nestle's brands each generate in excess of CHF 1 billion in annual sales, and the firm is particularly dominant in the bottled water category, fending off competition from beverage behemoths Coca-Cola and PepsiCo. As a result, Nestle is in a relatively strong position to negotiate with retailers for primary shelf space in stores, and we've afforded the firm a wide moat.

Even with its leading position, the firm is not content with the status quo, but continues to seek opportunities to enhance its competitive positioning. For instance, in 2012 Nestle acquired Pfizer's infant nutrition business (which generates about 85% of its sales from faster-growing emerging markets and realizes solid profitability with EBITDA margins in the mid-20s) for 5 times fiscal 2012 sales and nearly 20 times EBITDA. Despite the rich price tag, we think Nestle was all too aware of the attractiveness of this asset and sought to ensure it didn't lose out to its competitors (namely Danone and Mead Johnson). We expect Nestle will remain a consolidator in the global consumer product industry, particularly in light of its pristine balance sheet.

We're also encouraged that Nestle isn't looking to prop up growth just for the sake of it. Efforts to rationalize its product set--even after shedding 30% of its SKUs over the past two years while at the same time bringing new products to market--are likely to continue, and should further focus resources (both personnel and financial) on the highest return opportunities (similar to actions taken by its peers). Following the announced sales of its Jenny Craig, Power Bar, Juicy Juice businesses, we wouldn't be surprised to see other underperforming businesses, like portions of the frozen food business, as next on deck to get the ax.

Vital Statistics

Market Cap (CHF Mil)	230,449
52-Week High (CHF)	73.30
52-Week Low (CHF)	63.45
52-Week Total Return %	15.2
YTD Total Return %	12.8
Last Fiscal Year End	31 Dec 2013
5-Yr Forward Revenue CAGR %	4.0
5-Yr Forward EPS CAGR %	7.8
Price/Fair Value	0.93

Valuation Summary and Forecasts

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Price/Earnings	—	20.9	*20.9*	*19.7*
EV/EBITDA	12.3	13.7	*14.4*	*13.6*
EV/EBIT	15.1	17.0	*17.4*	*16.4*
Free Cash Flow Yield %	5.2	5.7	*3.9*	*4.1*
Dividend Yield %	3.2	3.2	*3.0*	*3.1*

Financial Summary and Forecasts (CHF Mil)

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Revenue	92,324	92,373	*92,182*	*96,265*
Revenue YoY %	10.2	0.1	*-0.2*	*4.4*
EBIT	13,932	13,068	*14,362*	*15,258*
EBIT YoY %	9.4	-6.2	*9.9*	*6.2*
Net Income, Adjusted	10,611	10,015	*10,972*	*11,532*
Net Income YoY %	9.6	-5.6	*9.6*	*5.1*
Diluted EPS	3.32	3.13	*3.45*	*3.66*
Diluted EPS YoY %	9.9	-5.8	*10.1*	*6.2*
Free Cash Flow	-465	12,290	*14,760*	*10,535*
Free Cash Flow YoY %	285.5	-2,740.7	*20.1*	*-28.6*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

Profile

With a history that dates back more than 150 years, Nestle has grown to be the largest food and beverage company in the world. The firm generates annual sales of about CHF 90 billion through its diverse product portfolio, which includes brands such as Nestle, Nescafe, Perrier, and Pure Life. Nestle also owns just less than 25% of French cosmetics firm L'Oreal. In January 2010, the firm sold its 52% stake of Swiss eye-care company Alcon to Novartis in a $28 billion deal.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Morningstar Analysis

Valuation, Growth and Profitability 07 Nov 2014

We're bumping up Nestle's fair value to CHF 78 per share, from CHF 71. Almost half of the increase was driven by additional cash generated since our last update. Further, we now believe an 8% cost of equity, down from 10% previously, is warranted in light of Nestle's consistent cash flows and competitive clout, in the form of solid brands combined with vast geographic reach. Supporting our stance that below-average systemic risk has merit is the fact that the firm's leverage tends to be modest relative to peers. We also We have valued the firm's stake in L'Oreal (23%) separately from the core food and beverage business, and we estimate the value of the investment to be CHF 6 per share. We value Nestle's core food and beverage business at CHF 71 per share. Our revised fair value estimate implies forward 2015 price/earnings of 21 times, enterprise value/EBITDA of 14 times, and a free cash flow yield of 4%.

We expect uncertain economic conditions and austerity measures will continue to weigh on the spending of a strained developed-market consumer, but with increased earnings power, emerging-market consumers (which account for about 40% of Nestle's consolidated sales) are likely to pick up some of the slack. Despite the more muted growth that we anticipate from mature developed markets, we were encouraged by management's commentary that investments in product innovation are what will drive sales in these regions (rather than promotional spending), which we believe is the right strategy to drive profitable, long-term growth. However, because Nestle operates as the 800-pound gorilla in consumer products with about CHF 90 billion in annual sales, we think it will deliver top-line growth at the low end of management's ambitious 5%-6% sales target longer term. Despite investments behind its brands, we think Nestle's efforts to drive further cost savings in the business will result in modest margin expansion over the next five years. We forecast operating margins to approximate 17.5% during our explicit forecast, about 300 basis points above the average level of profitability over the past five years. Our valuation does not take into account potential acquisitions, which might cause future results to deviate materially from our estimates.

Scenario Analysis

From our perspective, the biggest risks to our valuation for Nestle are erratic changes in commodity costs and competitive pressures. However, we assign Nestle a low uncertainty rating, given the firm's consistent cash flow generation. A perfect storm for Nestle would be weaker-than-expected per capita consumption growth in developing markets, strengthening private-label penetration in mature markets, and rising commodity costs in a competitive environment in which passing through increases in raw material costs to customers is difficult. Under this set of assumptions, Nestle's revenue increases just 3.5% on average annually during the next 10 years (compared with 4.5% growth in our base case), with an average annual operating margin 14.6% (versus 16.6% in our base case). Our fair value estimate under these conditions would be CHF 63 per share.

On the other hand, if per capita consumption in developing markets increases at a faster rate than we forecast in our expected scenario, we may be underestimating the intrinsic value of Nestle. We assume that revenue grows 5.5% per year on average through fiscal 2023, driven by volume growth in emerging markets and weak private-label penetration in developed economies. Price increases, a more benign commodity cost environment, and cost savings in excess of our base case assumptions mean that Nestle's operating margin expands to 18.6%. In this scenario, our fair value estimate would be CHF 95 per share.

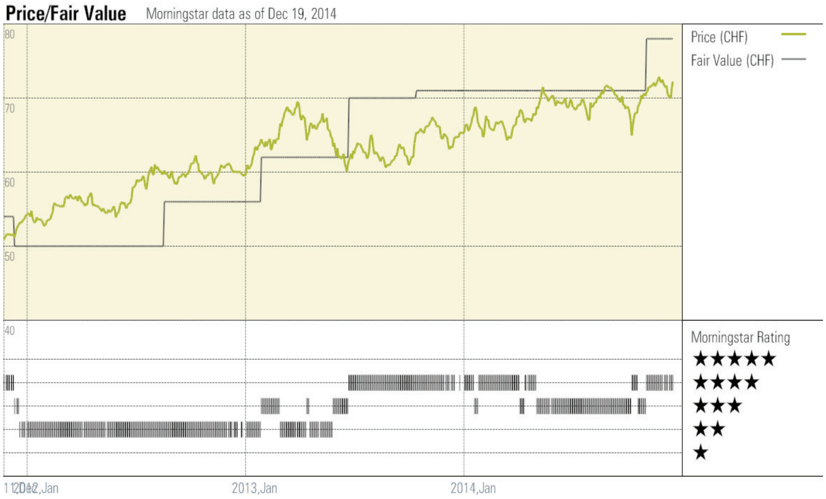
Economic Moat

Given its expansive global distribution platform, diverse product portfolio that spans the grocery store, and renewed emphasis on driving cost savings, we expect Nestle will continue generating solid cash flows and returns for

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Price/Fair Value Morningstar data as of Dec 19, 2014



shareholders over the longer term. As such, we have afforded the firm a wide moat. With more than 20 brands that each generate in excess of CHF 1 billion in annual sales, the company has been able to gain favorable shelf space at retailers and charge premium prices for many of its products. The significant economies of scale the firm enjoys because of its vast global operations, as the largest packaged food firm in the world with more than CHF 90 billion in annual sales, enable it to manufacture and distribute its offerings at a lower cost per unit than its much smaller peers, resulting in a cost advantage. Competitive pressures (from other branded players as well as lower-priced private-label offerings) persist, but we contend that Nestle possesses a high degree of pricing power, as volume has held up despite the fact that the firm has raised prices across its product portfolio over many years. Even when the firm isn't actively increasing prices to offset higher commodity costs, new products tend to come with a higher price tag, and in general, volume has not suffered. Further, Nestle has consistently generated returns on invested capital in excess of our cost of capital estimate, and we're confident this will continue over the next 20 years.

Moat Trend

Nestle's moat trend is stable, evidenced by the fact that underlying volume has held up even though the firm has been raising prices at the shelf over multiyear periods, whether by increasing prices on existing products or due to the higher price tag associated with new product introductions. For example, in fiscal 2013, constant currency sales increased 4.6%, reflecting fairly balanced growth between volume (up 3.1%) and prices (up 1.5%). We expect persistent competitive pressure on consumer packaged food companies from direct peers, private-label offerings, and a consolidating retail industry constantly looking for lower prices. In our view, the possible loss of some market share over time is likely to be too small to dent Nestle's wide economic moat. The diversity of Nestle's product portfolio, with 20 brands that have more than CHF 1 billion in annual sales, protects the firm's overall financial performance from weakness in any single category. As a result, we forecast returns on invested capital (including goodwill but excluding excess cash) to average 19% through fiscal 2023, well in excess of our 7.9% cost of capital estimate.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Bulls Say/Bears Say

Bulls Say

- Nestle's brand investments are paying off in spades. For example, KitKat is now the number 1 chocolate brand in Japan, posting quite impressive global underlying sales growth of nearly 9%.
- For investors wishing to gain broad exposure to the consumer staples industry, Nestle may be an appropriate holding.
- We're encouraged by management's reference to a pullback in its own promotional spending in the frozen foods category and its focus on bringing new products to market, which we think will ultimately drive profitable sales growth longer-term.

Bears Say

- The tough economic climate is causing consumers around the globe to rein in spending, and this could cause a significant short-term reduction in consumers' impulse purchases of products such as chocolate.
- Foreign currency movements have turned more unfavorable over the past few months (detracting 7.5% from sales in the first nine months of fiscal 2014, which is more pronounced than the 3.7% negative hit during fiscal 2013).
- We think Nestle was forced to pay a rich premium for Pfizer's infant nutrition business or risk this valuable asset ending up in the hands of its competitors.

Nestle SA NESN (XSWX) | ★★★★

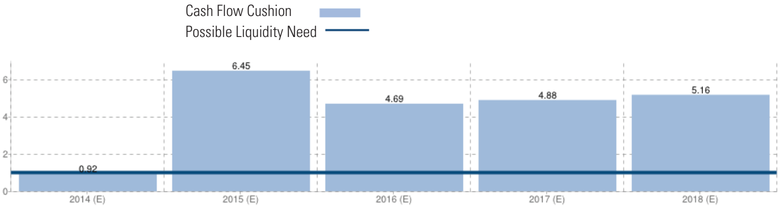
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Credit Analysis

Five Year Adjusted Cash Flow Forecast (CHF Mil)

	2014(E)	2015(E)	2016(E)	2017(E)	2018(E)
Cash and Equivalents (beginning of period)	6,415	10,615	11,225	11,619	12,240
Adjusted Available Cash Flow	5,685	3,124	3,080	3,394	3,751
Total Cash Available before Debt Service	12,100	13,739	14,306	15,012	15,990
Principal Payments	-11,774	-849	-1,902	-1,902	-1,902
Interest Payments	-790	-781	-803	-825	-847
Other Cash Obligations and Commitments	-621	-499	-347	-347	-347
Total Cash Obligations and Commitments	-13,185	-2,129	-3,053	-3,075	-3,097

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	CHF Millions	% of Commitments
Beginning Cash Balance	6,415	26.1
Sum of 5-Year Adjusted Free Cash Flow	19,034	77.6
Sum of Cash and 5-Year Cash Generation	25,449	103.7
Revolver Availability	10,000	40.8
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	35,449	144.5
Sum of 5-Year Cash Commitments	-24,538	—

Credit Rating Pillars – Peer Group Comparison

	NESN	Sector	Universe
Business Risk	2		
Cash Flow Cushion	7	—	—
Solvency Score	3	—	—
Distance to Default	2	—	—
Credit Rating	—	—	—

Source: Morningstar Estimates

Note: Scoring is on a scale 1-10, 1 being Best, 10 being Worst

Financial Health & Capital Structure

Nestle has a very strong capital structure that we expect to be leveraged in the medium term in order to boost growth. The company received an aftertax cash windfall of around CHF 22 billion following the sale of its Alcon stake to Novartis, which it has used to pay down debt, repurchase shares, and pursue small bolt-on acquisitions. However, following the acquisition of Pfizer's infant nutrition business in fiscal 2012, Nestle's debt/adjusted EBITDA increased to 1.6 (from 1.3 on average during the prior three years). We think that debt paydown will be a priority for cash, though, and expect the debt/EBITDA ratio will fall to 1.1 on average over the next five years. Further, we forecast free cash flow to amount to more than 10% of revenue on average over the next five years, and as a result, we don't anticipate that Nestle will struggle to service its debt load, as we forecast EBITDA to cover interest expense by an average of 24 times through fiscal 2018. However, in light of our view that Nestle's size is likely to make organic growth more difficult to achieve, we doubt the firm will stay on the sidelines, but rather will remain a consolidator in the global food and beverage arena (with a focus on acquiring other health and wellness brands as well as building out its position in faster-growing emerging and developing markets). Finally, Nestle announced that it was liquidating a portion of ownership stake in L'Oreal (reducing its ownership from nearly 30% to 23% of shares outstanding), and we expect the firm will utilize the more than EUR 3 billion of cash generated from this transaction to pay down debt, repurchase shares, or pursue other strategic deals.

In that light, Nestle recently acquired the U.S. and Canadian commercial rights to five aesthetic dermatology products (Restylane, Perlane and Emervel, Dysport and Sculptra

which Nestle already sells outside of North America) from Valeant Pharmaceuticals for $1.4 billion, or more than five times sales, which strikes us as a rich price given that

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Credit Analysis

Valeant was likely looking to offload these assets quickly in light of its pursuit of Allergan. Allergan is far and away the leading player in the category (with more than 80% share); however, even operating as the number-two player in the attractive aesthetics market can be quite lucrative,

as the industry boasts high returns on invested capital and operating margins and no generic competition. Further, because these products cater to an affluent customer base,

industry players tend to possess a high degree of pricing power. This news builds off Nestle's deal earlier this year to take over the Galderma dermatology joint venture from L'Oreal

(which is expected to close in July). While food, beverage, and snack sales have historically made up about three fourths of Nestle's annual sales, the combination of these two events provides evidence of Nestle's desire to be a leading player in a broader array of health and wellness categories. We think this is a sensible strategy given the strong demand from millennials for healthy, functional products, for which they are willing to pay a premium.

Enterprise Risk

Nestle's greatest operational risk is the threat of volatile commodity costs, which could squeeze margins. Although the rate of input cost inflation has moderated, the prices for several raw materials (including dairy, cocoa, and resin) remain elevated and show little signs of abating. Nestle operates in some competitive categories and faces stiff competition from companies such as Coca-Cola and Pepsi in bottled water, Kellogg in breakfast cereal, and Mondelez in confectionery. In addition, the quality of lower-priced products has improved in the past several years, and this could erode the premium that consumers are willing to pay for branded food products. Amid an environment of elevated unemployment and austerity measures, consumers are still price-sensitive in grocery stores. The frozen food category in particular has been a fierce battleground. Further, we recognize that Nestle's growth could slow because consumers who switched to private-label products during the downturn may not revert to leading brands as the economy recovers; however, the potential loss of any market share over time is unlikely to dent Nestle's wide economic moat, given the strength of its brands and the diversity of its product set.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
NA	NA	NA	NA	NA

*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
Vanguard Total Intl Stock Idx Fund	0.64	1.15	358	30 Nov 2014
CSIF Switzerland Total Market Index	0.55	18.09	1,668	31 Oct 2014
L&G Pension PMC Europe(Ex UK) Inx Acc	0.49	4.13	-212	31 Aug 2014
Undrly Fid DC L&G Eur (ex UK) Eq Idx T	0.49	4.02	-599	30 Sep 2014
VA CollegeAmerica EuroPacific Growth	0.49	0.99	—	30 Sep 2014
Concentrated Holders				
Plyzosmar SICAV	0.01	—	185	30 Jun 2014
Fonmoba SICAV	—	—	103	30 Jun 2014
Hedge Inversiones SICAV	—	—	79	30 Jun 2014
Álava Inversiones SICAV	—	—	154	30 Jun 2014
Nolita 2005 SICAV	—	—	74	30 Jun 2014

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Government Pension Fund of Norway - Global	2.32	0.78	11,203	31 Dec 2011
Baillie Gifford Overseas Limited	0.16	1.31	3,383	30 Sep 2014
Morgan Stanley Investment Management International Equity Trust	0.09	3.89	2,924	31 Dec 2010
Pictet Asset Management Ltd	0.26	11.43	2,769	31 Oct 2014
Top 5 Sellers				
T. Rowe Price Associates, Inc.	0.26	1.24	-1,498	30 Sep 2014
Harris Associates L.P.	0.25	1.61	-1,413	30 Nov 2014
Capital Research and Management Company	2.05	0.68	-809	30 Sep 2014
BlackRock Advisors LLC	0.20	0.57	-790	31 Oct 2014
Newton Capital Management Limited	0.07	1.41	-532	30 Nov 2014

Management 25 Apr 2014

Although we harbor some concerns about the strength of the firm's corporate-governance structure, Nestle's stewardship of shareholder capital is standard. Returns on invested capital have historically exceeded our cost of capital estimate, and the firm shrewdly garnered a sweet price for its stake in Alcon a few years ago. However, Nestle hasn't shied away from paying a pretty penny for acquisitions. For example, in 2012 it acquired Pfizer's infant nutrition business for 5 times fiscal 2012 sales and nearly 20 times EBITDA--a lofty premium despite the strategic rationale of the purchase. We applaud Nestle's separation of the roles of chairman and CEO, but CEO Paul Bulcke has had a 30-year career at Nestle and rose through the ranks while former CEO and current chairman Peter Brabeck-Letmathe was at the helm. We are concerned that the two may have formed a close professional relationship that may jeopardize the independence of the board from management. In addition, more disclosure regarding management compensation would be highly valued on our end so that we could better assess whether the financial incentives of the executives are truly aligned with shareholders' interests. Having said that, we think the board includes a number of directors with impressive executive, financial, and legal experience, and we like that 12 of the 14 members are independent. Further, we are encouraged that Nestle is moving to declassify its board by implementing annual elections for all directors.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Analyst Notes

With a Portfolio of Solid Brands, Nestle Muddles Through Murky Waters; Shares Mildly Undervalued 16 Oct 2014

Nestle's 4.5% underlying sales growth through the first nine months of the year lagged its 5%-6% long-term forecast. However, given the tough competitive and consumer spending landscape--pressures which have plagued firms throughout the space--we view these results as decent. For one, we're encouraged that this top-line growth was balanced between volumes (up 2.3%) and prices (up 2.2%), evidence that core brand investments are resonating with consumers. With a solid brand mix, which when combined with its low-cost global sales and distribution network drives our wide economic moat, we believe Nestle will navigate these challenges.

Management reaffirmed its forecast for 5% organic sales growth in fiscal 2014 and an improvement in underlying margins, both of which are in line with our outlook. However, because Nestle operates as the 800-pound gorilla in consumer products with about CHF 90 billion in annual sales, we expect it will deliver top-line growth at the low end of its long-term target, and forecast operating margins will expand to 17.5%, about 300 basis points above the average level of profitability over the past five years. Shares trade at a slight discount to our CHF 71 and $78 fair value estimates (which remain in place). As such, investors seeking to gain broad exposure to the consumer staples industry may want to consider an investment in the leading global packaged food firm.

Emerging markets (which account for 40% of sales) again drove the bulk of the top-line increase, up 9.5% and well in excess of the muted 0.5% growth realized in developed. Despite these pressures, efforts to rationalize its product set--even after shedding 30% of its SKUs over the past two years while at the same time bringing new products to market--are likely to continue, and should further focus resources (both personnel and financial) on the highest return opportunities, which we view favorably.

From a regional perspective, performance in Europe remained subdued, as internal sales grew just 1%, which is particularly lackluster when considering that lower prices is what prompted higher volumes. We think this speaks to the tough competitive and consumer spending environment, pressures that we don't anticipate will ease over the near term. While the Americas segment posted 4.8% underlying sales growth (3.7% higher prices combined with a modest 1% uptick in volumes), the frozen aisle was again a point of weakness. However, we're encouraged by management's reference to a pullback in its own promotional spending in the category and its focus on bringing new products to market, which we think will ultimately drive profitable sales growth longer-term.

Despite Unfavorable Foreign Exchange, Nestle Chalked Up a Solid First Half; Shares Fairly Valued 07 Aug 2014

Nestle echoed the comments of a number of consumer product firms surrounding soft consumer spending, volatile input costs, and heightened competition. However, we view its performance against this tough backdrop favorably. Organic first-half sales jumped nearly 5%, reflecting 3% higher volumes and a 2% increase in prices. Further, underlying operating margins ticked up 30 basis points to 15%. Foreign currency movements weighed on reported results, though, amounting to a nearly 9% drag on the firm's top line and a 40-basis-point hit to margins. While this is far from a positive, we don't believe this signals any deterioration in the firm's underlying business.

Rather, we continue to think the breadth of Nestle's product portfolio--which spans the coffee, bottled water, ice cream, confectionery, and pet-care aisles--and its low-cost global sales and distribution network (the basis for our wide economic moat) will enable it to bear these headwinds. In

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Analyst Notes

addition, we remain encouraged that in spite of the promotional spending that is running rampant in the industry, management seems committed to bringing new products to market to win favor with consumers, which we believe is the right strategy to drive profitable, long-term growth.

Management reaffirmed its forecast of full-year 5% organic growth (at the low end of its 5%-6% long-term target) and an improvement in underlying margins, both of which are in line with our outlook. As such, we don't expect to make any material changes to our CHF 71 and $78 fair value estimates. Longer-term, we think Nestle will deliver top-line growth just north of 5% annually, and operating margins will expand to 17.5%, about 300 basis points above the average level of profitability over the past five years. At around 18 times our fiscal 2015 earnings estimate, the shares look fairly valued, but Nestle offers broad exposure to the consumer staples industry and may be an appropriate holding at a slightly larger margin of safety.

Nestle Continues to Slim Down; Shares Fairly Valued 02 Jul 2014

Following its decision to shed the PowerBar and Jenny Craig businesses late last year, Nestle has announced the sale of the Juicy Juice brand to Brynwood Partners. Financial terms of the transaction weren't disclosed. Juicy Juice has been a laggard in the firm's portfolio for quite some time, with annual sales dropping to just around $275 million from more than $500 million seven years ago, according to The Wall Street Journal citing Henk Hartong, a senior managing partner at Brynwood. As such, we doubt the loss of this business will move the needle on our fair value estimates of CHF 71 per share and $78 per ADR. This isn't the first time the buyout firm has looked to scoop up lackluster brands from Nestle, including Bit-O-Honey, Joseph's Pasta, and Flipz chocolate pretzels.

Management has openly discussed its strategic intent to dispose of underlying brands over the past several years--a move we view as appropriate (and not dissimilar to those taken by its peers, like Unilever, over the past several years). Given Nestle's vast portfolio, we think it's essential that the firm's resources--both financial and personnel-related--are focused on the highest-return opportunities. We wouldn't be surprised to see other underperforming businesses, like portions of the frozen food business and Ovaltine malted milk powder, next on the docket to be cut.

We continue to believe that with a diversified product portfolio that includes 20 brands with more than CHF 1 billion in annual sales, plus vast economies of scale as the largest packaged food firm in the world, Nestle's overall financial performance is protected from weakness in any single category; the depth and breadth of its product set have enabled the company to gain favorable shelf space at retailers and charge premium prices for many of its products, supporting our wide moat rating.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2011	2012	2013	Forecast 2014	Forecast 2015	5-Year Proj. CAGR
Revenue	-0.3	-10.0	10.2	0.1	-0.2	4.4	4.0
EBIT	-4.3	-14.6	9.4	-6.2	9.9	6.2	7.2
EBITDA	-3.6	-13.5	9.1	-5.0	6.8	5.8	6.3
Net Income	-7.5	-23.5	9.6	-5.6	9.6	5.1	6.9
Diluted EPS	-5.8	-19.2	9.9	-5.8	10.1	6.2	7.8
Earnings Before Interest, after Tax	-30.0	-69.6	3.0	9.2	-4.4	4.5	3.6
Free Cash Flow	-38.4	-100.2	285.5	-2,740.7	20.1	-28.6	0.1

Profitability	3-Year Hist. Avg	2011	2012	2013	2014	2015	5-Year Proj. Avg
Operating Margin %	14.8	15.2	15.1	14.2	15.6	15.9	16.0
EBITDA Margin %	18.3	18.7	18.5	17.6	18.8	19.1	19.2
Net Margin %	11.3	11.6	11.5	10.8	11.9	12.0	12.2
Free Cash Flow Margin %	4.2	-0.1	-0.5	13.3	16.0	10.9	11.9
ROIC %	14.5	14.3	13.2	15.8	15.0	15.2	15.8
Adjusted ROIC %	14.6	14.4	13.4	16.1	16.1	16.7	17.4
Return on Assets %	8.5	8.4	8.8	8.1	9.1	9.4	9.8
Return on Equity %	16.7	16.0	18.0	16.2	17.3	17.6	18.2

Leverage	3-Year Hist. Avg	2011	2012	2013	2014	2015	5-Year Proj. Avg
Debt/Capital	0.29	0.28	0.31	0.27	0.25	0.25	0.24
Total Debt/EBITDA	1.49	1.42	1.61	1.42	1.27	1.20	1.13
EBITDA/Interest Expense	25.74	29.22	28.90	19.10	21.94	23.48	24.17

Valuation Summary and Forecasts

	2012	2013	2014(E)	2015(E)
Price/Fair Value	—	—	—	—
Price/Earnings	—	20.9	20.9	19.7
EV/EBITDA	12.3	13.7	14.4	13.6
EV/EBIT	15.1	17.0	17.4	16.4
Free Cash Flow Yield %	5.2	5.7	3.9	4.1
Dividend Yield %	3.2	3.2	3.0	3.1

Key Valuation Drivers

Cost of Equity %	8.0
Pre-Tax Cost of Debt %	4.0
Weighted Average Cost of Capital %	8.0
Long-Run Tax Rate %	27.0
Stage II EBI Growth Rate %	4.5
Stage II Investment Rate %	20.5
Perpetuity Year	20

Additional estimates and scenarios available for download at http://select.morningstar.com.

Discounted Cash Flow Valuation

	CHF Mil	Firm Value (%)	Per Share Value
Present Value Stage I	86,846	36.5	27.41
Present Value Stage II	62,287	26.2	19.66
Present Value Stage III	88,558	37.3	27.95
Total Firm Value	**237,691**	**100.0**	**75.03**
Cash and Equivalents	7,053	—	2.23
Debt	-23,130	—	-7.30
Preferred Stock	—	—	—
Other Adjustments	14,138	—	4.46
Equity Value	**235,752**	—	**74.42**
Projected Diluted Shares	3,168		
Fair Value per Share (CHF)	—		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Morningstar Analyst Forecasts

Income Statement (CHF Mil)
Fiscal Year Ends in December

				Forecast	
	2011	2012	2013	*2014*	*2015*
Revenue	**83,770**	**92,324**	**92,373**	***92,182***	***96,265***
Cost of Goods Sold	44,127	48,398	48,111	*47,474*	*49,480*
Gross Profit	**39,643**	**43,926**	**44,262**	***44,708***	***46,785***
Selling, General & Administrative Expenses	5,164	5,612	6,815	*6,222*	*6,257*
Research & Development	1,423	1,544	1,503	*1,567*	*1,636*
Advertising & Marketing	17,395	19,688	19,711	*19,589*	*20,552*
Depreciation & Amortization (if reported separately)	2,925	3,150	3,165	*2,968*	*3,081*
Operating Income (ex charges)	**12,736**	**13,932**	**13,068**	***14,362***	***15,258***
Restructuring & Other Cash Charges	265	—	—	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**12,471**	**13,932**	**13,068**	***14,362***	***15,258***
Interest Expense	536	591	850	*790*	*781*
Interest Income	115	110	219	*130*	*130*
Pre-Tax Income	**12,050**	**13,451**	**12,437**	***13,702***	***14,607***
Income Tax Expense	3,112	3,451	3,256	*3,563*	*3,944*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	549	611	834	*832*	*869*
(Preferred Dividends)	—	—	—	—	—
Net Income	**9,487**	**10,611**	**10,015**	***10,972***	***11,532***
Weighted Average Diluted Shares Outstanding	3,205	3,195	3,200	*3,184*	*3,152*
Diluted Earnings Per Share	**2.96**	**3.32**	**3.13**	***3.45***	***3.66***
Adjusted Net Income	9,684	10,611	10,015	*10,972*	*11,532*
Diluted Earnings Per Share (Adjusted)	**3.02**	**3.32**	**3.13**	***3.45***	***3.66***
Dividends Per Common Share	1.85	1.94	2.05	*2.15*	*2.27*
EBITDA	**15,396**	**17,082**	**16,233**	***17,330***	***18,338***
Adjusted EBITDA	**15,661**	**17,082**	**16,233**	***17,330***	***18,338***

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Morningstar Analyst Forecasts

Balance Sheet (CHF Mil)

Fiscal Year Ends in December	2011	2012	2013	*Forecast 2014*	*2015*
Cash and Equivalents	4,938	5,840	6,415	*10,615*	*11,225*
Investments	—	3,585	638	*638*	*638*
Accounts Receivable	13,340	13,404	12,206	*12,244*	*12,852*
Inventory	9,255	9,125	8,382	*8,317*	*8,715*
Deferred Tax Assets (Current)	—	—	—	—	—
Other Short Term Assets	5,830	2,458	2,143	*2,139*	*2,233*
Current Assets	**33,363**	**34,412**	**29,784**	***33,952***	***35,664***
Net Property Plant, and Equipment	23,971	26,903	26,895	*28,370*	*29,910*
Goodwill	29,008	32,615	31,039	*26,439*	*26,439*
Other Intangibles	9,356	13,643	12,673	*12,378*	*12,089*
Deferred Tax Assets (Long-Term)	2,476	2,903	2,243	*2,131*	*2,024*
Other Long-Term Operating Assets	7,161	5,003	4,550	*4,541*	*4,742*
Long-Term Non-Operating Assets	8,756	10,750	13,258	*13,258*	*13,258*
Total Assets	**114,091**	**126,229**	**120,442**	***121,068***	***124,126***
Accounts Payable	13,584	14,455	16,072	*15,762*	*16,326*
Short-Term Debt	16,100	18,568	11,380	*13,000*	*13,000*
Deferred Tax Liabilities (Current)	—	—	—	—	—
Other Short-Term Liabilities	5,548	5,729	5,365	*5,354*	*5,591*
Current Liabilities	**35,232**	**38,752**	**32,817**	***34,116***	***34,917***
Long-Term Debt	6,207	9,009	11,750	*9,000*	*9,000*
Deferred Tax Liabilities (Long-Term)	2,060	2,276	2,643	*2,696*	*2,750*
Other Long-Term Operating Liabilities	5,213	5,033	2,714	*2,708*	*2,828*
Long-Term Non-Operating Liabilities	7,105	8,555	6,379	*6,379*	*6,379*
Total Liabilities	**55,817**	**63,625**	**56,303**	***54,899***	***55,874***
Preferred Stock	—	—	—	—	—
Common Stock	330	322	322	*322*	*322*
Additional Paid-in Capital	—	—	—	—	—
Retained Earnings (Deficit)	80,116	80,626	85,260	*89,374*	*93,763*
(Treasury Stock)	-6,722	-2,078	-2,196	*-4,276*	*-6,652*
Other Equity	-16,927	-17,923	-20,811	*-20,811*	*-20,811*
Shareholder's Equity	**56,797**	**60,947**	**62,575**	***64,609***	***66,622***
Minority Interest	1,477	1,657	1,564	*1,561*	*1,630*
Total Equity	**58,274**	**62,604**	**64,139**	***66,169***	***68,252***

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Morningstar Analyst Forecasts

Cash Flow (CHF Mil)

Fiscal Year Ends in December	2011	2012	2013	*Forecast* 2014	*Forecast* 2015
Net Income	8,966	10,000	10,445	*10,140*	*10,663*
Depreciation	2,422	2,711	2,864	*2,673*	*2,792*
Amortization	503	439	301	*295*	*289*
Stock-Based Compensation	158	157	154	*141*	*141*
Impairment of Goodwill	—	14	114	—	—
Impairment of Other Intangibles	—	75	143	—	—
Deferred Taxes	-301	—	657	*165*	*160*
Other Non-Cash Adjustments	1,079	-80	776	—	—
(Increase) Decrease in Accounts Receivable	-628	-219	-257	*-38*	*-608*
(Increase) Decrease in Inventory	-1,280	268	-157	*65*	*-399*
Change in Other Short-Term Assets	-1,113	122	-48	*4*	*-95*
Increase (Decrease) in Accounts Payable	-746	807	1,585	*-310*	*564*
Change in Other Short-Term Liabilities	687	1,010	237	*-11*	*237*
Cash From Operations	**9,747**	**15,304**	**16,814**	***13,124***	***13,745***
(Capital Expenditures)	-4,779	-5,368	-4,928	*-4,148*	*-4,332*
Net (Acquisitions), Asset Sales, and Disposals	-3,624	-10,644	186	*4,600*	—
Net Sales (Purchases) of Investments	—	1,994	2,800	—	—
Other Investing Cash Flows	-2,140	-569	336	*4*	*-81*
Cash From Investing	**-10,543**	**-14,587**	**-1,606**	***456***	***-4,413***
Common Stock Issuance (or Repurchase)	-4,953	667	-421	*-2,080*	*-2,376*
Common Stock (Dividends)	-5,939	-6,213	-6,552	*-6,858*	*-7,143*
Short-Term Debt Issuance (or Retirement)	3,504	2,312	-6,063	*1,620*	—
Long-Term Debt Issuance (or Retirement)	-1,156	3,546	1,543	*-2,750*	—
Other Financing Cash Flows	6,186	-369	-665	*688*	*797*
Cash From Financing	**-2,358**	**-57**	**-12,158**	***-9,380***	***-8,722***
Exchange Rates, Discontinued Ops, etc. (net)	19	-226	-226	—	—
Net Change in Cash	**-3,135**	**434**	**2,824**	***4,200***	***610***

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Valuation Analysis

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	1.02	21.6	19.8	17.7	9.5	11.1	10.3	23.3	24.3	18.6	2.9	2.9	2.8	1.4	1.5	1.4
General Mills Inc GIS USA	1.03	16.8	19.9	19.4	10.8	11.9	12.3	13.0	17.9	19.2	4.5	5.1	5.3	1.7	1.9	1.8
The Hershey Co HSY USA	1.18	26.5	26.1	23.4	14.5	14.7	13.5	26.0	29.0	25.7	13.6	13.8	13.0	3.0	3.1	2.9
Average		21.6	21.9	20.2	11.6	12.6	12.0	20.8	23.7	21.2	7.0	7.3	7.0	2.0	2.2	2.0
Nestle SA NESN CH	**0.93**	**20.9**	**20.9**	**19.7**	**13.7**	**14.4**	**13.6**	**17.5**	**25.7**	**24.5**	**3.3**	**3.6**	**3.5**	**2.3**	**2.5**	**2.4**

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	30,928 EUR	7.2	8.6	9.1	8.7	9.8	10.8	12.4	14.7	15.5	4.7	5.2	5.5	2.8	2.6	2.7
General Mills Inc GIS USA	— USD	11.4	11.8	10.7	11.3	11.7	10.6	28.3	27.6	26.0	8.5	8.0	7.1	2.9	2.9	3.0
The Hershey Co HSY USA	5,357 USD	20.0	24.3	26.2	27.0	25.6	28.3	62.1	53.1	55.9	16.2	16.1	17.4	1.8	2.0	2.1
Average		12.9	14.9	15.3	15.7	15.7	16.6	34.3	31.8	32.5	9.8	9.8	10.0	2.5	2.5	2.6
Nestle SA NESN CH	**120,442** CHF	**15.8**	**15.0**	**15.2**	**16.1**	**16.1**	**16.7**	**16.2**	**17.3**	**17.6**	**8.1**	**9.1**	**9.4**	**3.2**	**3.0**	**3.1**

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	21,298 EUR	2.1	0.4	6.1	-22.5	28.6	9.0	-12.8	13.5	11.1	-86.9	483.1	24.7	4.1	0.6	5.1
General Mills Inc GIS USA	17,774 USD	6.7	0.8	2.9	7.8	0.8	-2.6	14.4	-1.7	-0.2	162.1	38.0	-50.1	8.6	16.8	-0.2
The Hershey Co HSY USA	7,146 USD	7.6	5.0	7.0	17.5	7.0	9.0	21.3	8.4	11.7	32.9	-64.8	204.8	16.0	14.6	11.7
Average		5.5	2.1	5.3	0.9	12.1	5.1	7.6	6.7	7.5	36.0	152.1	59.8	9.6	10.7	5.5
Nestle SA NESN CH	**92,373** CHF	**0.1**	**-0.2**	**4.4**	**-6.2**	**9.9**	**6.2**	**-5.8**	**10.1**	**6.2**	**-2,740.7**	**20.1**	**-28.6**	**5.3**	**5.2**	**5.2**

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods

Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

		Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
Company/Ticker	Last Historical Year Net Income (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	1,422 EUR	48.5	*49.0*	*49.1*	13.3	*16.0*	*16.4*	10.0	*12.8*	*13.2*	6.7	*7.5*	*7.8*	6.2	*6.2*	*7.7*
General Mills Inc GIS USA	1,869 USD	36.1	*35.6*	*35.5*	19.5	*19.4*	*18.5*	16.2	*16.2*	*15.3*	10.5	*10.0*	*9.5*	13.0	*10.5*	*9.1*
The Hershey Co HSY USA	833 USD	45.9	*45.8*	*46.1*	21.8	*22.5*	*22.9*	19.0	*19.4*	*19.7*	11.7	*11.9*	*12.2*	11.7	*10.6*	*11.1*
Average		43.5	*43.5*	*43.6*	18.2	*19.3*	*19.3*	15.1	*16.1*	*16.1*	9.6	*9.8*	*9.8*	10.3	*9.1*	*9.3*
Nestle SA NESN CH	**10,015** CHF	**47.9**	***48.5***	***48.6***	**17.6**	***18.8***	***19.1***	**14.2**	***15.6***	***15.9***	**10.8**	***11.9***	***12.0***	**12.9**	***9.7***	***9.8***

Leverage Analysis

		Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
Company/Ticker	Last Historical Year Total Debt (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	8,671 EUR	81.1	*77.9*	*74.1*	44.8	*43.8*	*42.6*	10.6	*12.1*	*12.8*	3.1	*2.5*	*2.3*	2.9	*2.8*	*2.8*
General Mills Inc GIS USA	7,969 USD	119.4	*134.5*	*154.2*	54.4	*57.4*	*60.7*	10.4	*10.8*	*8.3*	2.3	*2.5*	*2.8*	3.4	*3.5*	*3.8*
The Hershey Co HSY USA	1,962 USD	122.3	*114.3*	*105.2*	55.0	*53.3*	*51.3*	17.0	*18.4*	*19.6*	1.3	*1.1*	*1.0*	3.3	*3.3*	*3.2*
Average		107.6	*108.9*	*111.2*	51.4	*51.5*	*51.5*	12.7	*13.8*	*13.6*	2.2	*2.0*	*2.0*	3.2	*3.2*	*3.3*
Nestle SA NESN CH	**23,130** CHF	**37.0**	***34.1***	***33.0***	**27.0**	***25.4***	***24.8***	**19.1**	***21.9***	***23.5***	**1.4**	***1.3***	***1.2***	**1.9**	***1.9***	***1.9***

Liquidity Analysis

		Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
Company/Ticker	Market Cap (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Danone BN FRA	32,452 EUR	1.65	*1.83*	*2.57*	0.74	*0.75*	*0.77*	0.62	*0.63*	*0.66*	0.46	*0.51*	*0.71*	59.6	*52.9*	*50.0*
General Mills Inc GIS USA	32,307 USD	1.11	*1.34*	*0.35*	0.81	*0.81*	*0.68*	0.52	*0.52*	*0.40*	0.36	*0.37*	*0.09*	46.8	*53.9*	*58.7*
The Hershey Co HSY USA	22,922 USD	4.92	*2.12*	*1.77*	1.77	*1.27*	*1.20*	1.30	*0.81*	*0.74*	6.70	*2.39*	*1.95*	48.0	*51.5*	*51.2*
Average		2.56	*1.76*	*1.56*	1.11	*0.94*	*0.88*	0.81	*0.65*	*0.60*	2.51	*1.09*	*0.92*	51.5	*52.8*	*53.3*
Nestle SA NESN CH	**230,449** CHF	**2.00**	***3.33***	***3.56***	**0.91**	***1.00***	***1.02***	**0.65**	***0.75***	***0.77***	**0.56**	***0.82***	***0.86***	**65.4**	***62.5***	***61.9***

Research Methodology for Valuing Companies

Components of Our Methodology

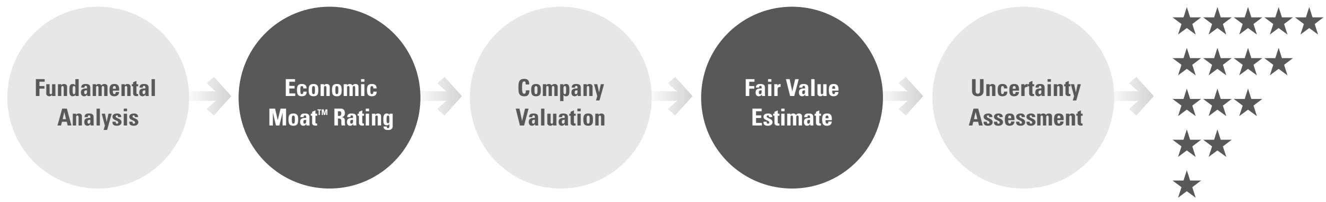
- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

The Morningstar Rating for stocks identifies companies trading at a discount or premium to our analysts' assessment of their fair value. A number of components drive this rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's intrinsic value based on a discounted cash-flow model, (3) the margin of safety bands we apply to our Fair Value Estimate, and (4) the current stock price relative to our fair value estimate.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our valuation process. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. There are two major requirements for firms to earn either a narrow or wide moat rating: (1) the prospect of earning above-average returns on capital; and (2) some competitive edge that prevents these returns from quickly eroding. The assumptions we make about a firm's moat determine the length of "economic outperformance" that we assume in the latter stages of our valuation model. We also quantify the value of each firm's moat, which represents the difference between a firm's enterprise value and the value of the firm if no future net investment were to occur. Said differently, moat value identifies the value generated by the firm as a result of any future net new investment. Our Moat Trend Rating reflects our assessment of whether each firm's competitive advantage is either getting stronger or weaker, since we think of moats as dynamic, rather than static.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from 0 years (for no-moat firms) to 20 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard

Morningstar Research Methodology for Valuing Companies



Analyst conducts company and industry research:

- Financial statement analysis
- Channel checks
- Trade-show visits
- Industry and company reports and journals
- Conference calls
- Management and site visits

Strength of competitive advantage is rated: None, Narrow, or Wide

Advantages that confer an economic moat:

High Switching Costs (Microsoft)

Cost advantage (Wal-Mart)

Intangible assets (Johnson & Johnson)

Network Effect (Mastercard)

Efficient Scale (Lockheed Martin)

Analyst considers past financial results and focuses on competitive position and future prospects to forecast future cash flows.

Assumptions are entered into Morningstar's proprietary discounted cash-flow model.

Analyst uses a discounted cash-flow model to develop a Fair Value Estimate, which serves as the foundation for the Morningstar Rating for stocks.

The analyst then evaluates the range of potential intrinsic values for the company and assigns an Uncertainty Rating: Low, Medium, High, Very High, or Extreme.

The Uncertainty Rating determines the margin of safety required before we would recommend the stock. The higher the uncertainty, the wider the margin of safety.

The current stock price relative to Morningstar's Fair Value Estimate, adjusted for uncertainty, determines the Morningstar Rating for stocks.

The Morningstar Rating for stocks is updated each evening after the market closes.

Research Methodology for Valuing Companies

Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

* Please contact a sales representative for more information.

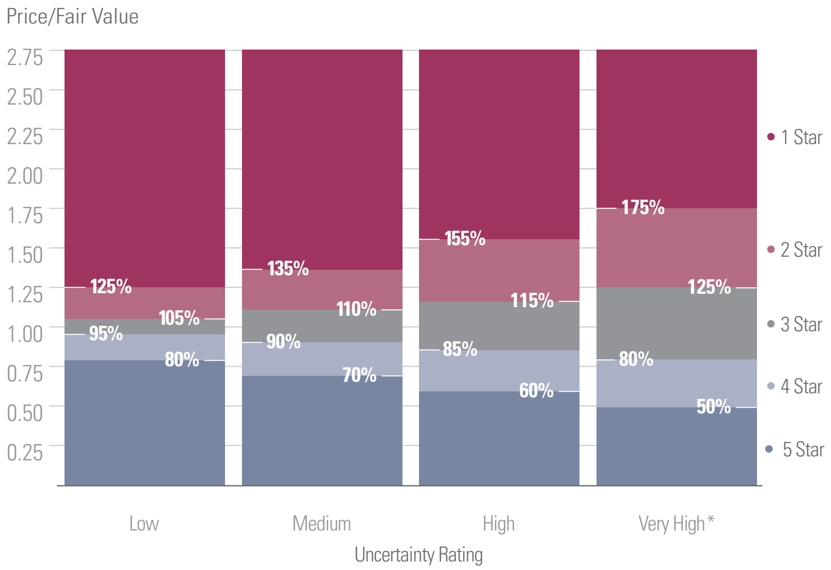
perpetuity formula. In deciding on the rate at which to discount future cash flows, we ignore stock-price volatility. Instead, we rely on a system that measures the estimated volatility of a firm's underlying future free cash flows, taking into account fundamental factors such as the diversity of revenue sources and the firm's fixed cost structure.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts typically model three to five scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of these potential fair values, based on an assessment of a company's future sales range, the firm's operating and financial leverage, and any other contingent events that may impact the business. Our analysts use this range to assign an appropriate margin of safety—or the discount/premium to a fair value we apply in setting our consider buying/consider selling prices. Firms trading below our consider-buying prices receive our highest rating of five stars, whereas firms trading above our consider-selling prices receive our lowest rating of one star.

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Morningstar Margin of Safety and Star Rating Bands



* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Morningstar's Approach to Rating Corporate Credit

- Offers a proprietary measure of the credit quality of companies on our coverage list.
- Encapsulates our in-depth modeling and quantitative work in one letter grade.
- Allows investors to rank companies by each of the four underlying components of our credit ratings, including both analyst-driven and quantitative measures.
- Provides access to all the underlying forecasts that go into the rating, available through our institutional service.

Purpose

The Morningstar Corporate Credit Rating measures the ability of a firm to satisfy its debt and debt-like obligations. The higher the rating, the less likely we think the company is to default on these obligations.

The Morningstar Corporate Credit Rating builds on the modeling expertise of our securities research team. For each company, we publish:

- Five years of detailed pro-forma financial statements
- Annual estimates of free cash flow
- Annual forecasts of return on invested capital
- Scenario analyses, including upside and downside cases
- Forecasts of leverage, coverage, and liquidity ratios for five years
- Estimates of off balance sheet liabilities

These forecasts are key inputs into the Morningstar Corporate Credit Rating and are available to subscribers at select.morningstar.com.

Methodology

We feel it's important to perform credit analysis through different lenses—qualitative and quantitative, as well as fundamental and market-driven. We therefore evaluate each company in four broad categories.

Business Risk

Business Risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. Key components of the Business Risk rating include the Morningstar Economic Moat™ Rating and the Morningstar Uncertainty Rating.

Cash Flow Cushion™

Morningstar's proprietary Cash Flow Cushion™ ratio is a fundamental indicator of a firm's future financial health The measure reveals how many times a company's internal cash generation plus total excess liquid cash will cover its debt-like contractual commitments over the next five years. The Cash Flow Cushion acts as a predictor of financial distress, bringing to light potential refinancing, operational, and liquidity risks inherent to the firm.

Morningstar Research Methodology for Determining Corporate Credit Ratings

Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade show visits
- Competitor, supplier, distributor, and customer interviews
- Assign Economic Moat™ Rating

Analyst considers company financial statements and competitive dynamics to forecast future free cash flows to the firm.

Analyst derives estimate of Cash-Flow Cushion™.

Analysts run bull and bear cases through the model to derive alternate estimates of enterprise value.

Based on competitive analysis, cash-flow forecasts, and scenario analysis, the analyst assigns Business Risk.

We gauge a firm's health using quantitative tools supported by our own backtesting and academic research.

- Morningstar Solvency Score™
- Distance to Default

Senior personnel review each company to determine the appropriate final credit rating.

- Review modeling assumptions
- Approve company-specific adjustments

AAA	Extremely Low Default Risk
AA	Very Low Default Risk
A	Low Default Risk
BBB	Moderate Default Risk
BB	Above Average Default Risk
B	High Default Risk
CCC	Currently Very High Default Risk
CC	Currently Extreme Default Risk
C	Imminent Payment Default
D	Payment Default
UR	Under Review
UR+	Positive Credit Implication
UR-	Negative Credit Implication

Morningstar's Approach to Rating Corporate Credit

The advantage of the Cash Flow Cushion ratio relative to other fundamental indicators of credit health is that the measure focuses on the future cash-generating performance of the firm derived from Morningstar's proprietary discounted cash flow model. By making standardized adjustments for certain expenses to reflect their debt-like characteristics, we can compare future projected free cash flows with debt-like cash commitments coming due in any particular year. The forward-looking nature of this metric allows us to anticipate changes in a firm's financial health and pinpoint periods where cash shortfalls are likely to occur.

Morningstar Solvency Score™

The Morningstar Solvency Score™ is a quantitative score derived from both historical and forecasted financial ratios. It includes ratios that focus on liquidity (a company's ability to meet short term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how does the company finance its operations), and interest coverage (how much of profit is used up by interest payments).

Distance to Default

Morningstar's quantitative Distance to Default measure ranks companies on the likelihood that they will tumble into financial distress. The measure is a linear model of the percentile of a firm's leverage (ratio of Enterprise Value to Market Value), the percentile of a firm's equity volatility relative to the rest of the universe and the interaction of these two percentiles. This is a proxy methodology for the common definition of Distance to Default which relies on option-based pricing models. The proxy has the benefit of increased breadth of coverage, greater simplicity of calculation, and more predictive power.

For each of these four categories, we assign a score, which we then translate into a descriptive rating along the scale of Very Good / Good / Fair / Poor / Very Poor.

Overall Credit Rating

The four component ratings roll up into a single preliminary credit rating. To determine the final credit rating, a credit committee of at least five senior research personnel reviews each preliminary rating.

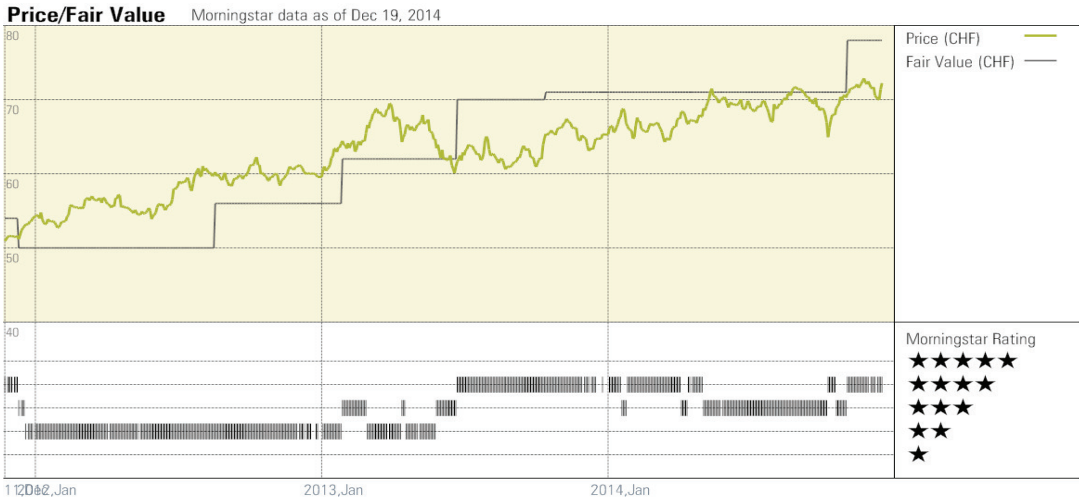
We review credit ratings on a regular basis and as events warrant. Any change in rating must be approved by the Credit Rating Committee.

Investor Access

Morningstar Corporate Credit Ratings are available on Morningstar.com. Our credit research, including detailed cash-flow models that contain all of the components of the Morningstar Corporate Credit Rating, is available to subscribers at select.morningstar.com.

Nestle SA NESN (XSWX) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
72.25 CHF	78.00 CHF	62.40 CHF	97.50 CHF	Low	Wide	Stable	Standard	—	Consumer Packaged Goods



The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic value.

Five-star stocks sell for the biggest risk-adjusted discount whereas one-star stocks trade at premiums to their intrinsic value. Based on a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's Equity Analysts, four key components drive the Morningstar Rating: 1. Assessment of the firm's economic moat, 2. Estimate of the stock's fair value, 3. Uncertainty around that fair value estimate and 4. Current market price. Further information on Morningstar's methodology is available from http://global.morningstar.com/equitydisclosures.

This Research Report is current as of the date on the report until it is replaced, updated or withdrawn. This report may be withdrawn or changed at any time as other information becomes available to us. This report will be updated if events affecting the report materially change.

Conflicts of Interest:

-No material interests are held by Morningstar or the Equity Analyst in the financial products that are the subject of the research reports or the product.

-Equity Analysts are required to comply with the CFA Institute's Code of Ethics and Standards of Professional Conduct.

-Equity Analysts' compensation is derived from Morningstar's overall earning and consists of salary, bonus and in some cases restricted stock.

-Equity Analysts do not influence Morningstar's investment management group's business arrangements nor allow employees from the investment management group to participate or influence the analysis or opinion prepared by them. Morningstar will not receive any direct benefit from the publication of this report. Morningstar does not receive commissions for providing research and does not charge companies to be rated.

-Equity Analysts use publicly available information.

-Morningstar may provide the product issuer or its related entities with services or products for a fee and on an arms length basis including software products and licences, research and consulting services, data services, licences to republish our ratings and research in their promotional material, event sponsorship and website advertising.

-Further information on Morningstar's conflict of interest policies is available from http://global.morningstar.com/equitydisclosures.

If you wish to obtain further information regarding previous research reports and recommendations and our services, please contact your local Morningstar office.

Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based.

The original distributor of this document is Morningstar Inc. The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any Redistribution is prohibited without written permission.