OMS
Organizational Maturity Services LLP

Organizational Maturity Rating (OMR)

Nestlé SA OMR: **BBB-**
"Significant unrealized value from human capital with unmitigated underlying material human capital risk"

Research Note

Organizational Maturity Rating (OMR) is an analytical methodology that specifically assesses corporate Human Governance and the extent to which an organization is aiming to achieve maximum value from its human capital while consciously and explicitly managing and mitigating human capital risk.

Any conventionally managed company may be producing relatively high financial returns based on conventional criteria (EBITDA, ROCE, RONA etc.) but OMR identifies additional value creation opportunities that arise from greater integration of human capital management (HCM) into business strategy and operational planning. OMR captures a holistic, whole system view of the organization revealing whether HCM is fully integrated and linked to business value and risk.

Our methodology (see OM30) covers the key criteria for determining the quality of leadership and management capability with respect to HCM. Markets will change, economic cycles will come and go and business models may have a natural life cycle but maturity analysis identifies the fundamentals that should remain constant. OMR is therefore designed to be a reliable and predictive indicator of relative competitive advantage and future performance. OMS LLP is approved by the Maturity Institute to carry out Organizational Maturity Ratings (OMR) and analysis.

Maturity Institute

November 2015
Organizational Maturity Services LLP
www.omservices.org

Nestlé

OMR rating BBB- (3 November 2015)

An OMR rating of BBB- denotes an organization whose approach to HCM remains rooted in conventional human resource management practice (see Appendix 1 for ratings scale). Our analysis shows that there is negligible competitive advantage being gained from Nestlé's human capital and significant value opportunities are likely to be realized by improvements in HCM. Conversely, underlying business risk relating to human capital remains as a consequence of inadequate human governance and is neither properly understood nor effectively mitigated.

Human Capital value – **significantly unrealised**
Human Capital risk **– material & unmitigated**

Financial indicators

Operating Margin

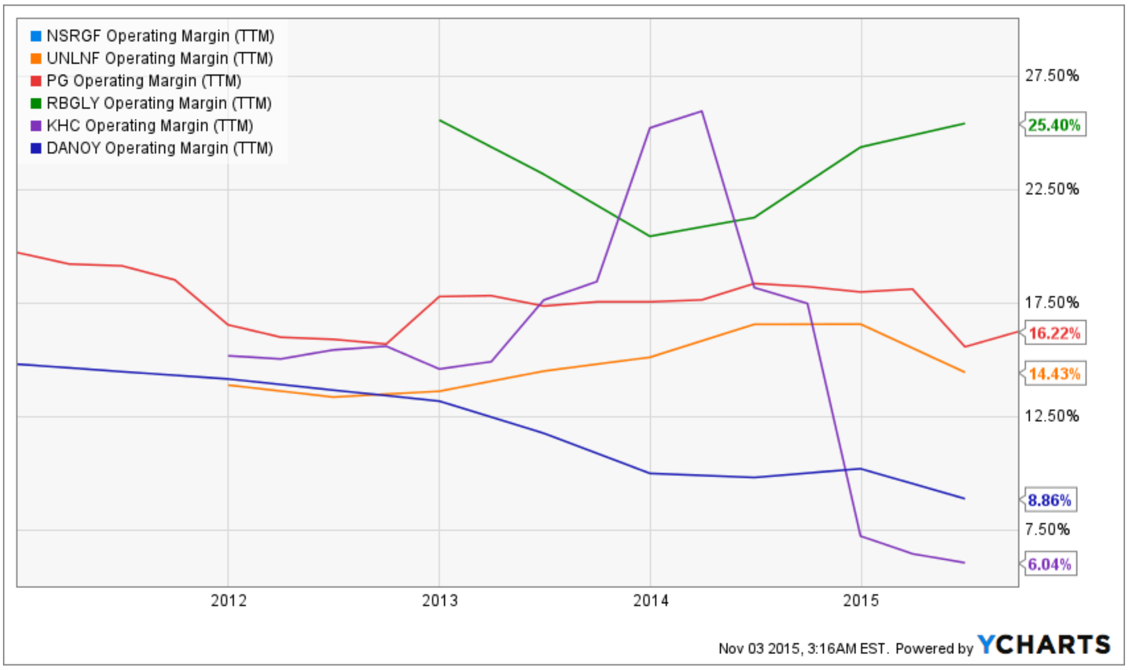
OMR analysis views effective human capital management as most directly visible in financial terms through operating margin: highly rated firms tend to significantly outperform peers. This is because these companies ensure that their human capital is *proactively and systemically engaged* in constantly driving superior revenue generation and cost efficiency. We do not see any evidence of this at Nestlé (see OMR analysis section below) and view this as a sustainable value opportunity.

Nestlé's current **operating margin is 11.80%[i].** Chart 1 below highlights operating margin among other comparator firms. Reckitt Benckiser currently receives our highest rating for this sector and produces the highest margin (Op Margin 25.39%; BBB+). Even companies on the same rating, such as Unilever, currently produce significantly more margin (Op Margin 16.38%; BBB-)[ii].

Nestlé's big opportunity

From 2013 to 2014 Nestlé's operating profit margins fell from 14.18% (CHF 13.068 billion) to 11.90% (CHF 10.905 billion). Research conducted by OMS LLP, in conjunction with the Maturity Institute[iii], shows that organizations below a BBB- level of maturity have huge gains awaiting them if the Executive team adopts a strategy to utilise mature HCM practices. In Nestlé's case, we are confident that an extra 5-10 percentage points on operating margins are achievable within 2 to 3 years. Based on Nestlé's 2014 figures, a 16.90-21.90% operating margin would equate to an additional operating profit of CHF 4.58 to 9.16 billion. While these figures might appear ambitious, they are in line with margin differentials achieved by companies with high value HCM. For example, A+ rated Toyota has a significant margin difference with its main competitors and has a market capitalization 3 to 4 times that of both GM and VW, while all companies produce similar volume.

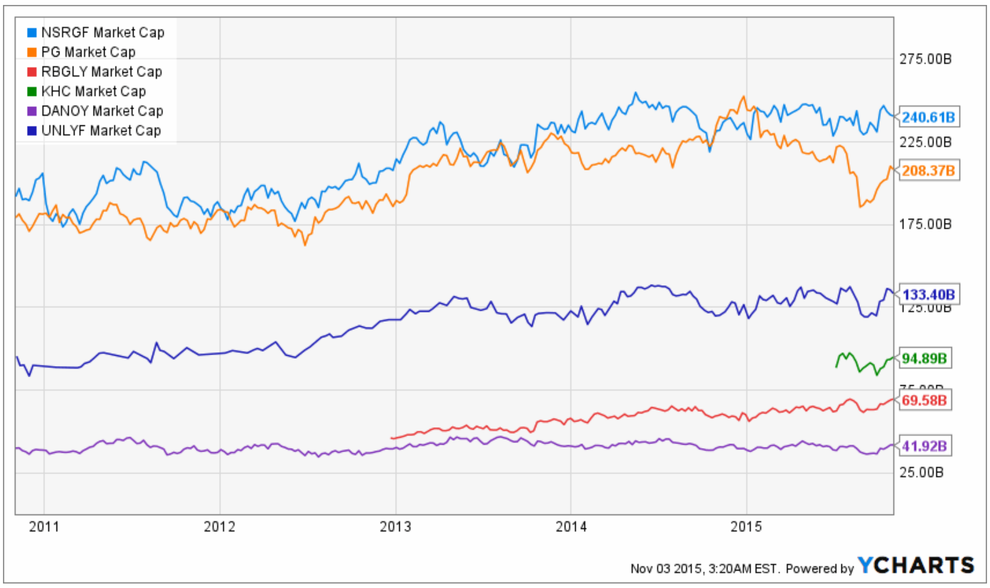
Chart 1: Operating margin of Nestle comparator group (Danone, Unilever, P&G, Kraft, Heinz & Reckitt Benckiser)



Market Value

Nestlé's market value has seen an upward although somewhat volatile trend over a 5-year view. While investors have seen returns in market value terms, we see that significant additional value opportunities that are being unrealised as outlined above. Conversely, we also conclude that Nestle is carrying material risk from poor Human Governance and HCM. We note in our analysis below that Nestle has little understanding of how risk may manifest in this regard and has no systemic approach to assessment and mitigation. The recent Maggi noodles problem, which materially impacted Nestlé's financial performance[iv], has a causal connection to inadequate human governance and poor HCM (see OMR analysis below) and highlights the nature and magnitude of risk in this respect.

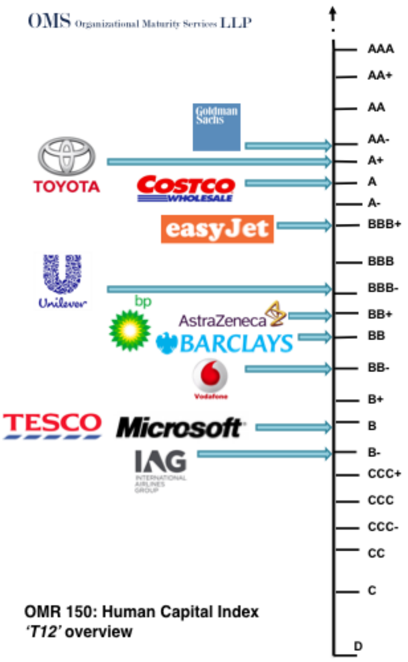
Chart 2: Market Cap of Nestle & comparator group (Danone, Unilever, P&G, Kraft Heinz & Reckitt Benckiser)



OMR analysis and key indicators

What does value mean to Nestlé?

Evidence from our Global OMI (www.omservices.org) highlights our underlying premise that companies with a purpose of societal value creation are much more likely to generate sustained value for all stakeholders.



OMR defines value very clearly as:

"…the provision of the best possible quality product or service at the best possible cost (and demands that environmental and other externalities are openly acknowledged and fully factored in)".[v]

Nestlé currently subscribes to the notion of "Creating Shared Value", which offers little clear or coherent reassurance to investors such that it creates market differentiation and leads to sustained market value increase over time. Moreover, despite significant investment in its pursuit of being perceived as a 'shared value' company, Nestlé remains a conventional global FMCG business, which seems unable to adequately reconcile its traditional approach of seeking profitable growth and exclusively shareholder returns, with increasingly changing societal value trends. The challenges ahead are openly acknowledged by its Chief Technology Officer, Stefan Catsicas.[vi]

"The reality is that we have no choice. I don't think that the food and beverage industry as we know it will still be there in 20 years from now."

For example, while its extensive 284 page 2014 CSV report[vii] describes in detail a number of laudable achievements, Nestlé's focus here appears largely risk and compliance driven and a necessity for a business of its size and nature (e.g. food safety to avoid adverse health outcomes, human rights, building a network of reliable and trusted suppliers, environmental actions to drive down costs). In other words, these are neither ethical actions, per se, nor do they offer any distinctive competitive advantage. Recent corporate problems arising from water use in California and the company's reaction to its potentially toxic noodles in India undermine the notion that Nestlé puts societal value at the heart of its business.[viii] Rather, we see that CSV is more intended to counter the litany of reputational issues that have dogged the company for many years (which still includes baby milk products, with long running campaigns continuing to find apparent contradictions between corporate rhetoric and reality). [ix]

We should emphasize here that our concerns are primarily focused on the long-term performance and value of Nestlé. The OMR definition of value is at once both high value and intrinsically ethical - the basis for the most sustainable business models in the light of likely further developments in societal views of corporate behaviour.

We also note that executive reward is geared to conventional financial targets intended to deliver short-term shareholder value, with an absence of broader value based incentives.[x] Consequently, with underlying reward based on shareholder return for the Exco, conflicts with long-term value creation can skew behaviour towards short-term financial goals. From a risk perspective, shareholder return primacy can often be a source of short-term decision-making and behaviour at both leadership and management levels that may not be in the long-term interests of the organization, investors, and wider stakeholders.

Value orientation

OMR is acutely focused on measuring added value. Maximum value can only be added by management that has the capability to ensure every single person within and outside the organization (e.g. supply chain, outsourced operations etc.) is equally focused on the interdependent variables of Output (O), Revenue (R), Cost (C) and Quality (Q). Our analysis examines the extent to which a company understands and manages its organisation according to this value definition and, more importantly, whether it understands and manages the relationship between its human capital and the ORCQ factors.

It is evident that Nestlé understands that its business value has to be linked to ORCQ[xi] although, as outlined above, we view its orientation as geared and focused more on narrow financial calculations, despite narrative that seeks to present a balanced picture. It is also clear that the organisation has little innate understanding of how HCM should be part of both its business model and competitive strategy. Nestle still views people as predominantly a cost, rather than an underutilised investment, and matters such as motivation and talent management are communicated and reported under the auspices of reputational importance rather than as core business value drivers.

There is no evidence that Nestlé manages its human capital towards value outcomes as shown in the company's 2014 Performance Indicators[xii]. For example, the key (sic) HCM metrics provided include training hours, which in OMR analysis are a clear and indisputable contra-indicator of performance; suggesting that the time spent in the classroom is more important than whether any lessons were learned or applied in the workplace to create value.

Human capital risk

With respect to the Principal Risks and Uncertainties that Nestlé state in their 2014 annual report[xiii], the company's only material risk with respect to human capital is limited to the health & safety and wellbeing of staff and contractors. This demonstrates Nestlé's narrow, conventional view with respect to managing human capital and shows no appreciation of the nature and huge potential impact of human capital risk; despite mounting evidence over the past decade that this is indeed material to company value.

Human capital risk permeates all company systems: from resourcing, reward, learning and performance management to quality assurance. A mature corporation ensures that such risk is constantly assessed and mitigated where necessary. There is no evidence that Nestlé recognizes such risk factors or is actively engaged in effective human capital risk management.

Conversely, there are symptoms evident of a culture that, in the light of material problems, responds by hiding or denying inherent risk rather than responding to it in a positive and transparent way (e.g. its response to the Indian noodles issue). In OMR analysis, such symptoms, when observable, point to an underlying organisational culture that is likely to continue to give rise to corporate misbehaviour (when viewed with respect to societal values) and material risk.

OMR also examines the nature of any Board level or Exco accountability for human governance (accepting responsibility for all aspects of company human systems management). As the

Principal Risk areas highlight, we find no evidence of any Board or Exco level accountability for human governance or even acknowledgement that such a role and discipline should exist.

Business vision & strategy

There is growing evidence that organizations who provide a clear a long term vision with an integrated and coherent business strategy are more likely to foster an environment within which all human capital (workforce, suppliers etc.) work towards shared goals. We see little evidence of a long-term vision and strategy to connect human capital to sustained value creation. Nestlé is being run as a brand-led business model, applying corporate gloss when faced with the complexities and risks that arise today with running a global organization in a globalized world. There are two fundamental questions here:

1. How long can such business models afford to ignore or fail to integrate the value implications of societal pressures for their business strategies?

2. How prepared are they to respond to any of their competitors who take these issues more seriously and start to address Human Governance and HCM issues more effectively?

Embedded cultures, reinforced by traditional business models that drive low cost/high profit thinking, are human organisms that cannot be re-shaped easily or quickly. Nestlé would do well to acknowledge that these are live concerns today and identify strategic solutions for the long term.

Whole system

It is self-evident that organizations can only create maximum value when they are viewed and managed as a coherent, whole system. Within the whole system are myriad sub-systems. If human capital systems are not designed to ensure the whole system is working to full capability and capacity then the whole system is undermined. A ‘rogue trader’ or whistleblower can cause significant damage. An incompetent employee’s actions can damage the reputation of the whole organization. Therefore OMR analysis seeks clear evidence of the recognition and identification of human systems thinking.

In terms of Nestlé’s business model there is evidence of coherence in terms of operational systems. However, from a human capital perspective, whole system thinking is only applied to a very limited extent. These include key risks identified in terms of compliance systems with respect to health & safety and human rights, and HR practices that have a limited bearing on value generation.

Evidence-based decision-making

We see no evidence of human capital metrics and analytics that can provide leaders and managers with good management insight to aid decision-making. Most companies may argue that they would not want to communicate such metrics externally. This is short sighted, as recent developments in human capital reporting are starting to be perceived as positive indicators that bring reputational and marketing benefits. With its limited human capital perspective, there is no evidence that Nestlé is seeking to reap the value of such potential benefits.

Knowledge, Innovation and 'never ending improvement'

OMR looks specifically at the cost and rate of innovations relative to key indicators, including market value. We see no evidence of internally driven knowledge acquisition and management systems that drive innovation or improvement measures on a whole system operational basis.

Nestlé have clearly invested heavily in a variety of research and development centres, and indeed new human capital[xiv], to drive *product innovation*. However, as with the Pharma sector, there is no evidence of how human capital is being managed within these centres to maximise value-creating innovations.

There also appears to be little evidence of a culture of never ending improvement that drives efficiency and innovation across entire operations. A declared management philosophy of never-ending improvement is a cornerstone of mature, high value, sustainable organizations.

Key questions for Nestlé

In addition to the standard questions we already use to undertake an OMR assessment, we identify here a selection of key questions specifically aimed at Nestlé's current situation and circumstances: -

- In the light of recent corporate failures arising from human governance issues, what steps are Nestlé taking to assess, manage and mitigate whole system human capital risk beyond health & safety and human rights?

- What is the company's financial estimate of the total value impact (in OCQR terms) of recent issues with respect to bottled water in California and Maggi noodles in India?

- Why does Nestlé measure training hours and what evidence is there that training investment yields value outcomes? Why does it not report on learning, application or employee innovation? Is there a measurement of internal innovation that generates value and, if so, what was it for 2014 and what is expected in 2015?

- What evidence is there that Nestlé has generated greater knowledge sharing and collaboration across its workforce and its supply chain in the pursuit of improving the OCRQ value variables?

- What evidence is there to show that the company's significant investment in its CSV initiative has already yielded and is expected to yield sustained higher value? To what extent is this factored into its business planning?

- Why is senior executive pay geared so heavily to short-term stock price improvement; what steps are in place that simultaneously encourage longer term, shareholder value and higher market capitalization?

- How does Nestlé ensure effective management decision making, which includes all key contributors?

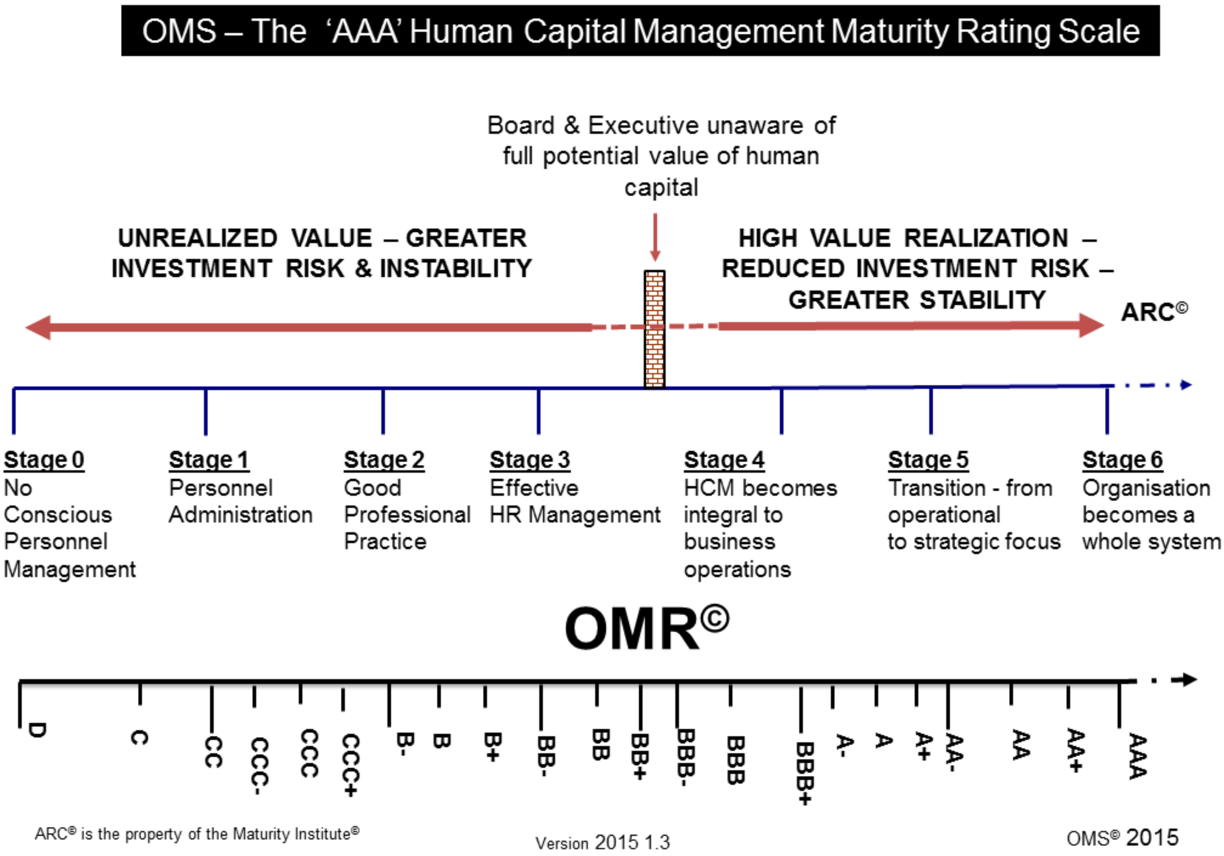
- Do all Nestlé Executives subscribe to a philosophy of never-ending improvement? What indicators would they offer to demonstrate that this is now the culture of the whole company and its supply chain?

- In making acquisitions, how does the company assess human capital value and risk issues that may impact on success? What evidence is there that recent skincare acquisitions have been effectively integrated from a human governance and HCM perspective?

APPENDIX 1

OMR "AAA" Ratings scale

The graphic below illustrates the OMR "AAA" ratings scale for companies rated on the Global OMI to date. Most organizations still do not understand the nature of their own human capital and its link to value and are situated at BBB- or below.



Our work

OMS LLP incorporates the very best financial ratings expertise with unique human capital insight and knowledge gained from rare exemplars in high performance cultures. We serve the investment community through:

- Using our Organizational Maturity Ratings (OMR) to provide comparative analysis of fund holdings and identifying company risk/value profiles with respect to human capital, as well as benchmarking against our Global OMR Index
- Providing in-depth company analysis (for existing or potential holdings) and sector reports of human capital management issues that have material impact on company value
- Advising on engagement with companies with respect to human governance and management

www.omservices.org
November 2015

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[i] http://markets.ft.com/research/Markets/Tearsheets/Financials?s=NESN:VTX
[ii] Yahoo Finance at 3 November 2015
[iii] http://www.hrmaturity.com/the-evidence-is-plain-human-governance-is-material-to-corporate-performance/
[iv] "Since the fiasco began, Nestle India has seen its sales decline by almost 30% and its profits fall by more than 60%." http://qz.com/541113/indians-are-craving-for-maggi-noodles-but-not-as-desperately-as-nestle/
[v] http://www.hrmaturity.com/is-the-social-responsibility-of-business-to-increase-its-profits/
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