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BN.PA - Half Year 2015 Danone SA Earnings Call

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OVERVIEW:

Co. reported 1H15 underlying fully diluted EPS of EUR1.37 and expects 2015 organic sales growth to be 4-5%.

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PRESENTATION

Operator

Good day and welcome to the H1 2015 results conference call. Today's conference is being recorded. At this time I would like to turn the conference over to Emmanuel Faber, CEO, and Cecile Cabanis, CFO. Please go ahead.

Regis Massuyeau - *Danone SA - IR Director*

Good morning everyone. Regis Massuyeau speaking. I'm in charge of Investor Relations. Thank you for joining Danone's second quarter and half semester results. With me today are Emmanuel Faber, CEO, and Cecile Cabanis, our CFO. As we start, let me just ask you to have a look at our disclaimer as usual, and I will now turn the call over to Emmanuel.

Emmanuel Faber - *Danone SA - CEO*

Thank you Regis. Good morning everyone. Thanks for joining this conference call. I'm with Cecile, Regis and Marion, the investor team. I'm very happy to introduce and open this call with you, in particular in the context of what I think is a very solid set of results for the first half of this year for Danone and a second quarter which is very much on track with what we have described to you over the last several months about our 2015 agenda, which I remind you, as you can see on page 4, is about creating profitable sustainable growth this year and going forward.

We have three priorities for the year. One is to ensure that our brands and businesses are even more competitive to serve our consumers' needs in a complex environment. Second, we want to continue to generate profitable growth, as we've done in the second half of 2014 and going forward and set the conditions for that growth to be sustainable. And third, preparing and gradually rolling out our Danone 2020 roadmap with a view to create a shared value agenda for all our stakeholders. And, as you know, we'll come back to that in November.

The first half of this year is very well aligned with this agenda, and before Cecile enters into the details of the results, I'd like to take a few minutes of your time to walk through a few of the key constituencies of this 2015 agenda and how H1 is contributing to this.

So page 5 you have a reminder of the four blocks that we've been talking to you about, optimize, invest, build and nurture. This is very much what the executive committee team of Danone and myself are focused on for this year. With a couple of examples of how this first half and the second quarter in particular have contributed in each of these boxes.

And optimize, I'd like to highlight the fact that the work in the portfolio reshuffle and optimization of dairy in Europe has continued and you will see the early results of this in our Q2 analysis through what Cecile is going to share with you. As much as CIS, which has been an area where circumstances led us to a lot of very quick and strong optimization of the platform in order to ensure that we have continued profitable growth in that big country for us.

In the invest box, I chose to talk to you about the fact that we've been able, through the generation of efficiencies, cost efficiencies, productivity, fixed cost reduction, reformulation and input price being less unfavorable than before we've been able to significantly reinvest in our dairy brands across the board to the tune of about 100 basis points as well as launching a number of innovations to develop our categories in dairy in particular in the US, in Latin America, in Europe.

In the build section, I'd like to remind you that underlying everything that you're seeing, there is a significant reorganization of Danone. You've heard about our One Danone organization initiative that we started to create the backbone of 30 clusters of geographies for Danone to have a safer growth model in the future than what we have today. That's also true in a number of structuring functions like food safety, quality, compliance and which we have further improved the design of our organization.

This first half as well we had new Comex members joining us or joining back which makes now the team around me covering the whole spectrum of the key areas that I think in the Company are needed to ensure our long-term success. We now have kick-started the Africa region, a region, as you know, that we consider as the new frontier of Danone. And, as you've seen in our results announcement this morning, one of the other important build points of the agenda for the first half of this year was the reorganization of our Chinese early life nutrition business, on which I will come back soon.

Not only we cover I think all spectrums of the horizon, but we also cover all the time horizon as well now and this is the last block, nurture, where the composition of the executive committee team as well as the organization of the Company, the resources that we invest allow me to be very excited about the prospect of sharing with you our Danone 2020 plans and details when we come back to you on this in November.

Let me turn to page 6 now and just re-highlighting the numbers that you've seen. Just to say again that on top line Q2 is obviously very much aligned with the overall trend that we've described so far. We consider that in this environment these are a very strong set of topline numbers and of course well aligned with our full-year guidance.

Margin is up 53 basis points on a like-for-like basis and a bit more in terms of history. We consider that it's been the right level of balance between all the efficiencies and contribution of operations that we've been able to generate and the reinvestment to continue to fuel the growth in H2 and beyond. And our EPS like-for-like is growing 7% which again is a sign for us of what we would call an overall across the P&L profitable growth. Cecile will obviously come back to this.

Let me comment on page 7 about the geographical dynamics. You see that Europe was close to 2% growth. Obviously that's slightly below the path of last quarter. This continues to be sequentially moving in the right direction in many ways. I'd like to highlight the fact that medical nutrition actually posted 4% growth on the first half of this year in Europe. You remember the discussions we had on the back of last year about resuming the growth in this important market for our medical nutrition, and it's a good contribution from medical for us this second quarter and the first half of this year in Europe.

North America and CIS, obviously very important area for us, 0.4% growth, so remains positive despite this transitional environment which we already described, which is quite different obviously in nature, and we'll come back to that in a minute, between the US and Russia. But overall I'm very confident as we pursue our initiative to build future growth as the leaders of the category in both these big regions that you will see this number grow again in the future quarters to come.

ALMA has continued to deliver nearly double-digit growth this quarter, which is a big achievement for us despite what we see as a general slowdown of macro-environment in various emerging countries.

Let me move now to three particular topics I'd like to highlight as they've been an important part of the Q2 agenda of the year. The first one is on page 8 which is the US dairy market. Just to share my optimism on how things are moving in the US for us in dairy, first of all remind you on the top left box of this page that the category continues to grow in aisle space. And, as you know, shelf space has been a challenge over time, but you can see that in two years it's been growing 10%. This is really the fact that Greek has opened a new growth momentum on the shelf and we expect now to be leveraging that.

In particular what remains to be done, on the left bottom quarter of this chart, you'll see that the yoghurt category has slowed down in terms of revenue per SKU or velocity basically on the shelf. This is essentially, as we shared a function of the overpopulation of Greek SKUs, more than 300 SKUs of Greek on the market. That's way too much and we expect consolidation to happen on the Greek segment on the shelf and as category advisors in many places this is going to be our role.

I think the good news on this chart is that if you look at 2014 to the first half of this year you can see that the overall yogurt category is plateauing. And, by the way, we have increased our own shelf space, which is now close to 30% with, by the way also, a record market share in July for Danone overall in the US of more than 35%. So we exit the growth wave of Greek with a reinforced leadership position, which in the context of still a low per capita and gradually recapturing growth per capita consumption, on the top right of this chart, is really paving the way for future growth.

And so through innovations and all the rest I think you will see sequentially an improvement of our top line in the US, which is very much the agenda that we are focusing on.

Page 9 is discussing our European dairy transformation. None of what you see here is new news. We have continued obviously to roll out all the actions that are led to create resources for reinvestment. One of the key is the PRGM program, revenue growth management, that is voluntarily limiting the volume growth in the first half of this year in order to ensure that we focus really on profitable growth. We've continued to work on our operations. As you know, we are basically going to a situation where we will have a third less factories in Europe at the end of the three-year plan and we are walking that path.

We've also expanded the DanTrade efficient sourcing organization that we are gradually expanding into Europe and actually beyond our dairy gradually too and continue to work hard on creating the right organization and simplifying the organization.

All of this has allowed us to reinvest in A&P about 150 basis points, which on the right part, allows us to be slightly ahead of our plan for Actimel. Actimel is now positive full H1 in Europe as a whole, which is, again, we are very pleased about these results. I'm not saying that this is the end of the story and we are fully satisfied with where we are, but at least that's one very important brand that we have turned around and I'm confident on its future now in Europe overall.

Activia, as you know, is slightly behind in terms of the timing of its turning around but in Spain, which is one of our key test markets for Activia given the competition that it faces there, has overall been positive in H1, is even more positive in Q2, and there are other countries as well where Activia is positive in Q2 and in particular in June.

And so I think the pace of the turnaround is slower than on Actimel but we are on the right direction and this focus on value creation I think makes me very confident on the fact that we will gradually get Europe dairy to the stabilization in top line like-for-like by the end of this year; towards the end of the year we should approach the zero line overall in Europe.

Last comment I would like to make about the few key topics for us in H1 and Q2 has been China early life nutrition, where we've been very active to work on strengthening the business model. I would like to say, and you've seen the strong numbers on Q2 as well as Q1 for our early life nutrition globally, double-digit growth like-for-like, of course China is a contributor, among others but a significant contributor to that.

I have to say that we are very confident on the strong fundamentals of this market for future growth. This is driven, even in a slower macroeconomic growth of China, by sociologic per capita changes in China. The growth in the market has been more than double digit in H1 in China. We continue to believe that there is a long-term growth potential, probably though through an increased tiering in the market in two ways between super and high premium brands and more mainstream brands on one side, and on the other with a clear tiring in the channels.

And we have seen the traditional modern trade big volume channel actually negative again in the second quarter as a full channel in China, same trend as on the first quarter, even sometimes accelerated. So that continues as last year with a decline of that channel. Mum and baby stores and ecommerce on the other side have continued to grow very, very significantly in the first half and actually in the second quarter as well.

The conclusion that we have driven, and you heard me say already earlier this year that we were working at really inventing our Chinese business model overall, has led us to really now having a two-tier strategy.

One is that we have decided to merge our Dumex business with our partner company, Yashili. Yashili is one of the top three domestic brands, one of the eight Chinese domestic champions elected by the Government of China for the long-term consolidation of the 600 domestic brands that are overcrowding the market and in particular the modern trade. Dumex is extremely skewed towards modern trade. We recognize the complexity of competing in the modern trade right now, in particular because the short-term relief on the price of milk in China is creating opportunities for the smaller players to play with price and therefore it's pretty heavily promoted.

As a result of that we are going to create a very powerful slate of brands under the leadership of Yashili. We own 25% of Yashili together with our partner company Mengniu that owns 51% of that company. As you may remember, when we acquired that 25% we were offered to propose the appointment of the CEO of Yashili so the CEO of Yashili continues to be a guy that's been proposed by Danone and who was actually running our ELN business before in China.

And we are going to use the proceeds of this disposal and merger to increase our shareholding in Mengniu as part of the strengthening of our partnership with COFCO in supporting Mengniu's long-term growth as already the leader in the dairy and in the fresh dairy category in China. So that will mean that we are now going to compete with a renewed momentum on the domestically produced brands in China.

On the right side of this chart you'll see basically that we will continue to leverage the success of our international brands and the overall Internet dynamics in China where our market share has continued to strengthen. We have a lot of demand-generating activities and the popularity of our brands continues to grow, even actually in the very nascent channel of free trade zone on which we might come back in the Q&A session if you are interested in more details about it.

So I have to say that after nine months of heavy work on the portfolio through creating this new leg of our alliance with COFCO Mengniu in baby food with Yashili, that was the first tranche of the agreement, and now we have the second tranche where we bring together Yashili and Dumex, and on the other side continue to strengthen the ecommerce-based platforms that we have. And also I should mention the mum and baby stores in which we have increased our market share in the course of Q2 this year.

I think we are really addressing the Chinese business model of ELN in the appropriate way. I can't say I'm fully satisfied with it yet. As you know, there is a question of how far, how much, how fast free trade zone or any other really sustainable solutions can be found to the booming ecommerce market. And we will not or, I will not remain or, I will not be satisfied until we are at this stage and we are not yet. So this is still work in progress on the free trade zone.

Overall, I think this again is a good quarter for us. The team is very focused on delivering the agenda I've been talking about. I'd like by the way to thank all the 100,000 Danone people that have been behind these numbers and my executive committee team for this.

And I would like to hand over now to Cecile for the details of our numbers. Thank you.

Cecile Cabanis - *Danone SA - CFO*

Thank you Emmanuel and good morning to all. I must say that I'm very pleased to share with you today our solid H1 results and I propose that we continue with the top line results highlights, maybe starting by saying that with a plus 8.8% reported top line growth and a plus 4.6% like-for-like top line growth in H1 the performance is solid and fully on track with our agenda and full year guidance.

Moving to the sales bridge, we are reporting Q2 top line growth at plus 9.5%. As you can see and as expected, currencies continued to have a favorable impact of 5.5% in Q2. This is mainly driven by US dollar, Argentinian peso, Chinese renminbi, Indonesian rupiah and British pound. In terms of scope, the scope effect is slightly negative of minus 0.5%. It's in line with Q1 and mainly due to the deconsolidation of our dairy operation in China, in July last year and the divestment of our dairy operation in Indonesia in Q4 last year. This has a positive impact on margin that I will comment in a few slides.

Coming back to the underlying performance and the organic growth, the 4.5% organic growth is made of positive volume impact of 1.5% -- this is improving versus Q1 -- and a positive price/mix effect of 3%. The value growth continues to beat the result of last year price increase as well as the one that we did around improving our portfolio efficiency and competitiveness across categories and geographies. It obviously reflects different dynamics between geographies, as Emmanuel commented earlier, and also between categories that I will comment in a minute. But overall it continues to reflect the steps that we are taking towards sustainable profitable growth.

Moving to page 14 and looking at the sequence, the overall top line performance is fully in line with our agenda and guidance, as this was the case also in Q1. Regarding now trading operating margin, we delivered this semester a solid like-for-like improvement of plus 53 basis points. This reflects our strategy of building the conditions for sustainable profitable growth and this margin increase is mainly driven by on, one hand a significant gross margin improvement through global mix management, productivity efficiency and helped by a favorable milk price, and, on the other hand a strong reinvestment to reignite or continue to support the growth in our different platforms.

Both top line and bottom line results show a very positive progress in our agenda. I will comment the margin equation in more details, but I would like now to move to each category to have a better understanding of the dynamics.

And I will start with fresh dairy. The fresh dairy products division reported sales down 1.1% like for like in the second quarter. This reflects a fall of 3% in volume and a plus 2% price/mix effect. As anticipated, this reflects an improvement in volume which is offset in the second quarter by a less favorable basis for comparison in price and mix, and this is the case particularly in Russia.

Overall the division is sequentially moving in the right direction during Q2 and is in line with its roadmap across regions. It continues to optimize the way it operates and build the right conditions and opportunities of investment to ignite the growth.

Sales in Europe have continued to decline, impacted by the basis for comparison in volume which is linked, as Emmanuel reminded us, to the streamlining of the product portfolio started in mid-2014. This is now almost complete and the efforts on the portfolio have helped to increase the gross margin significantly, enabling the division to reinvest in H1 behind its key initiatives. Emmanuel mentioned earlier the 150 basis point A&P reinvestment in Europe dairy in H1, and we see some positive results. Actimel is stabilized and positive for the second quarter in a row and we continue to have promising results around indulgence and Activia in Spain.

Going to the CIS region, with still fragile consumer pattern the sales there remain solid, even if more moderate than in Q1. The key brands like Prostokvashino, Tema as well as the recent launch of Danone, have continued to do well.

In the US, Danone is consolidating its leading position in a transitioning market, fueled in particular by a strong momentum in the children's segment with the Danimals brand and also the launch of Light & Fit protein drink and Oykos Triple Zero are confirming their positive results.

The ALMA zone continues to expand and this is particularly driven by a solid performance in Mexico.

So overall, as we shared in Q1, we continued to see a contraction between volume and value and we should see starting in Q3 sequential improvement of top line of the dairy division on the back of Europe.

All in all, the H1 dairy equation is solid with a plus 50 basis points of margin improvement this semester, which is the result of a structural margin improvement and a favorable mix context and which includes significant reinvestment.

Moving to the waters division on page 16. The waters division continues to display a solid broad-based growth, which continues to be well balanced between volume and value. Europe and plain waters continued to deliver solid progression on the back of positive market dynamics and aqua drinks continued to perform above average in all regions. All countries are growing and all regions are contributing to improve market shares.

Aquadrinks continue to be a key engine of growth, and in China Mizone performance was very good in Q2. However, we recently observed some slowdown on the global market for non-alcoholic beverages where Mizone continued to over-perform the category. Contrary to Europe, the weather has been quite mild in China so far and we can probably forecast softer quarters to come. The segment of aquadrinks remains of course still very promising and we continue to support it.

Overall, the division showed its capacity to build a sustainable growth through innovation, through better mix and geographical expansion, and continues to focus on all platforms and geographies to make sure that the growth is sustainable.

Regarding margin, the water division delivered a favorable 10 basis point increase like-for-like including a strong level of support to keep building its different platforms.

Let's move now to Early Life Nutrition division. As Emmanuel said, with 11.1% growth in Q2 early life nutrition growth continued to be strong and overall, market dynamics are close to the one that we observed in Q1.

I will not come back on China as it was already commented by Emmanuel, but just to say that we are working on strengthening our model, adapting our resources to market change and prospect evolution. By merging Dumex and Yashili we are building a strong platform of local brands with important synergies in a consolidating market. And in parallel, we continue to leverage and support the success of our international brands. We are convinced of the growth potential of the Chinese market in this category.

The division sales in the rest of the world remained robust. We have double-digit growth in the rest of Asia, Latin America and Middle East. With very strong growth, we delivered a margin improvement, despite the negative performance of Dumex in H1.

So let's turn now to medical nutrition division. Just to say that this is another solid quarter for medical nutrition with an organic growth of 7.1% and a margin improvement of 50 basis points in H1. All the regions are growing. We have a strong H1 mix improvement, driven by the segments of pediatrics and metabolics and a continued strong performance of Neocate. We can say that medical is well on track to continue creating value for Danone.

So that's for the category dynamics highlights, and I propose that we now move to the margin. Overall, the trading operating margin has improved by 53 basis points on a like-for-like basis and by 85 basis points on a reported basis. And I propose to move to the bridge to understand the building blocks.

And before commenting on the like-for-like improvement, just one word about currencies and scope. The currencies continue to have a favorable impact and for H1 19 basis points favorable impact. That reflects mostly our country mix, mainly in dairy and waters. On scope we have, as expected, a positive impact of 13 basis points, which is the result of capital allocation discipline and strategic decisions that we made last year on divesting our dairy operation in Indonesia on one hand, and partnering with Mengniu in Dairy in China on the other hand.

Turning to our underlying organic performance, let's focus on the main building blocks, the first one being the significant improvement of margin from operations of 240 basis points. This increase includes the benefit from the lower price of strategic raw materials, and milk in particular that is down from its record highs in the first half of 2014. On milk price, the positives are mainly in Europe and in NorAm. And what I can say is that with today's assumptions we expect now a later rebound in the milk price driver, probably first half of next year, and we continue to assume inflation back in 2016.

In addition to the favorable mix/price environment, the margin from operations is also improving structurally through growth, including portfolio mix improvement, in particular with the example of the profitable revenue growth management program in Dairy in Europe. The improvement is also coming from ongoing productivities and efforts to optimize our cost base. This structural improvement fully reflects our agenda of building a sustainable profitable growth model. We have also invested significantly this semester; investment is up 65 basis points. It's mostly A&P but it's also product innovation, reengineering and sales force.

So as a total, Danone increased margin by 53 basis points despite the negative performance of Dumex in China, which includes a deleverage impact and some costs associated to the start of Dumex adaptation plan, especially on route to market. This is the biggest item you have in the negative 122 basis points box of the bridge.

Overall, we are focused on carefully building our sustainable profitable growth agenda and we continue to balance our four essential blocks that Emmanuel commented earlier, optimize, invest, build and nurture, in order to make sure that the profitable growth turns into long-term value creation. And I must say that to that extent, H1 is another good step in our journey.

I would like to move now to EPS, page 21, and talking about EPS I will be talking about the underlying fully diluted EPS. The H1 EPS is at EUR1.37, increasing by 6.8% in like-for-like and 18.5% on a reported basis. I propose that we look at the bridge.

What we can say is that the EPS growth is fully in line with our H1 profitable growth equation and also includes positive impact from our associates. This is mainly related to the increase of net income of our partnership with Mengniu in China and the net income resulting from our equity interest in Yashili. Regarding tax, we have a strong negative impact this semester as we have written off our deferred tax assets related to Dumex. The reported EPS includes positive scope impact of 4.5% and a positive currency impact of 7.2%, which brings the total reported growth of EPS at 18.5%.

Moving to free cash flow on page 23, free cash flow is at the end of H1 EUR576m. This is above H1 last year. It reflects the NOPAT increase on the back of top line and margin growth, which remained the most important objective in our model. One word on capital expenditure, where the level is below last year this semester, but this is rather an element of phasing and we maintain our objective to dedicate 4% to 5% of sales on capital expenditure for the full year. On working capital, the level is stabilized around minus 7% of sales.

Let's now have a look at the evolution of the debt. The net debt increased slightly this semester and there are three major elements which I would like to comment. The first one, as you may remember, we purchased shares of Danone Spain early 2015 from our Spanish minorities. So this amount has impacted the M&A box, but is netted in the box changes in puts to minority shareholders on this chart.

Second, the genuine M&A element this semester is then closer to EUR600m and it's related to our investment in Yashili early this year and most recently the acquisition of Trefle in Algeria.

Finally, the dividend payment is very comparable to last year as we decided again to propose the option of a dividend payment in shares. Almost 66% of rights have been exercised in favor of the payment in shares.

On the balance sheet there are no major changes. The shareholders' equity increase is mostly related to the translation impact we have on currencies in H1 and overall, the debt remains stable in proportion to the balance sheet at 27%.

So as a conclusion I would say again that H1 is fully on track with our roadmap, delivering a solid profitable growth, and at the same time building the conditions for profitable sustainable growth. And we are strongly focused on delivering this agenda day after day. As a conclusion, these solid results lead me to confirm the full-year guidance of organic growth between 4% and 5%, and a trading operating margin slightly up.

That's it for the presentation. Thanks a lot for your attention, and I propose that we move to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). David Hayes, Nomura.

David Hayes - *Nomura - Analyst*

Good morning all. Thank you. If I can just focus on the China baby food business with a couple of questions, if I can, talking to some of your and listening to some of your competitors in China over the last few weeks it feels like it seems like some of that competitive intensity, the pricing that you mentioned, the discounting, may have become more prolific towards the end of the second quarter. Just wonder whether you can talk about from your perspective whether that is something that you are also seeing.

And I guess related to that, we're also hearing of more people coming into the ecommerce channel with more aggression. Is that something which you expect to feel through the second half?

And then related to that success that you've had with the international brands and the focus now with the Dumex sale or merger with international brands, I guess from the authorities' point of view it feels to some extent slightly contradictory to what China authorities are talking about in terms of encouraging local participation, sales in the category. Do you see any kind of risk here that the authorities basically come in and put duties on or in some way restrict that increasing flow of international product?

And then my final question just on the deal with Yashili that you announced today. Clearly that partnership with Yashili COFCO continues to get deeper. As you look forward to the next 6 to 12 months, how do you see that relationship evolving even further? Do you see other assets potentially being included in that baby food unit? Is that something that you're looking for in terms of more and more scale in that market? Thank you very much.

Emmanuel Faber - *Danone SA - CEO*

Thank you David. I don't think that we could say that the pricing activities and promotional activities have been accelerating at the end of the period. I think the acceleration of the retail shift to mum and baby stores has been somewhere in the early part of Q2, although it already existed and, as you know, this channel decreased by 9% last year, so this is nothing new.

But I think what happened was that there was a bit of a question overall, I think, in everyone's mind as to how long would the Chinese relief on the milk price was going to last. Depending also on the ban on Russia, which has now been extended to August next year, which is one of the reasons why Cecile said we'll probably see a little bit longer period of less inflationary situation in milk.

And I think that in the course of the Q2 indeed people started to move on pricing and promotion, reflecting probably a level of comfort that the pricing in milk would not go back very soon in China, very soon meaning a matter of months. We continue as far as we're concerned to have the same scenario that this is just a pause and everything is going to get back at some point.

The other aspect on this pricing issue is that one of the other specific points about China is that it is heavily advertised country and we would expect that also with some margin pressure in the modern trade the oldest players, as they're playing with promotion and pricing, may play less on the A&P side. And so there will be a balance basically. But overall there has been gradually a pool in competition in modern trade. The end of the quarter was probably no better than or potentially a little worse, but that's a gradual change. And I think it's going to last for at least a few quarters until there are some changes on the price of milk situation in China.

What you -- sorry, you said also ecommerce and some people aggressively moving into it. Well, yes, and at the same time this is really a demand-driven business, where Internet sites are basically opening brand sites on which consumers are visiting. And so it's not like you can make big advertising on Internet and try to get your brand on top of it. It's really a long-term investment that needs to happen and it's investment that's made by Alibaba, T-mall and the others, and they are obviously pushing the brands that work most.

And the brands that work most after the big Fonterra food alert of 2013, which has created a complete mess for a number of players in China, including Dumex, the whole Chinese mums have been turning to Europe as being the safe, first in the world, harbor to get high quality milk. And we have seized this opportunity two years ago. I think there is clearly a first mover advantage in this market. Having said that, it's a very fluid situation.

The point that you're making about a little bit of a contradiction between the fast growth of Internet ecommerce and local brands, I expect that some of the good quality and the best local brands in China would play gradually more on Internet than today. That will take a bit of time and I definitely believe that Yashili and Dumex are going to be part of it. So, yes, I think that there will be a bit more of the best brands, not the smallest ones; not any of the 600 ones, but probably the top two, three, four, five brands should be on the Internet tomorrow. It's very fair and I don't see that as a big problem.

Now the overarching question is the one that I was pointing to in my introduction about how does the government go about structuring this big ecommerce business, which, as you know, is like about 30% of the total baby food market in China today. We are working with and we will continue obviously to work even closer with the Chinese authorities now as part of our alliance or further alliance with COFCO and Mengniu to ensure that there is a long-term sustainable solution for this business.

We are not there yet, as I said, and that's why we're not satisfied on that front. I think our business is not sustainable as much as it should be, when it comes to traders importing our top brands into China.

Your last point about Yashili and COFCO, well, I think there is no further plan as than what's unfolding day by day in this alliance. We are extremely pleased with the performance of our joint venture in fresh dairy, which we own 20% of. It's managed by a Danone guy with a mixed team of people from Danone and Mengniu. It's the number one player in fresh dairy, close to EUR1b sales, profitable and growing. Mengniu being a listed company, I'm not going to comment further; they will in due course on that part of their business. But that solid performance now for two years is really creating a lot of trust and confidence in what we're building on both sides.

We welcome COFCO's stewardship of Mengniu as the leader of the total Dairy business with a market value of close to $10b. It's definitely the right partner for us and we continue to be happy to influence that business and collaborate, cooperate with the team, as much as they wish us to do and as long as we see a profitable opportunity for us.

In the baby we are really going to focus on putting together Yashili and Dumex. As Cecile mentioned, there are very significant synergies to be expected in all the P&L of the two companies, and cross support, and in many ways given the complementarity of their positioning. And so this is really going to be the agenda for the next few months.

David Hayes - *Nomura - Analyst*

Okay, that's great. Thank you very much, Emmanuel. Bye.

Operator

Warren Ackerman, Societe Generale.

Warren Ackerman - *SG Securities - Analyst*

Good morning everybody. It's Warren here from Soc Gen. Also a couple of questions on ELN. The first one, Emmanuel, just can you talk a bit on how Nutrilon Platinum and how Nutrilon are doing in China? Is pricing coming down on those brands? And are you thinking about trying to close

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the pricing gaps between Europe and China, to try and squeeze that parallel trade? And how do free trade zones help you to do that? That's the first question.

The second one, can you talk about the accounting impact on Dumex? I assume if you're selling it you must be deconsolidating it from your sales and EBIT. What impact on your sales, margins, like-for-like, associates will there be on that accounting change? And is there any impact on guidance for the full year, if you are deconsolidating that business? If you could just confirm that, that would be helpful.

And then just finally, what is your expectation for ELN like-for-like growth in the second half of the year, given very, very tough comps that you have? Thank you.

Emmanuel Faber - *Danone SA - CEO*

Thank you Warren. I'll take the first question and let Cecile answer the two next ones.

Just to be more precise, so our mum and baby stores business, which is really where Nutrilon is focused, have seen significant, very significant growth on the first half of this year, both on the back of the growth itself of the channel. That has continued to be well into double digits; it's 20% growth plus. And the fact that we have gained market share, both through Nutrilon Platinum and our officially imported, the rest of our officially imported brands in mum and baby stores.

Having said that, and I would probably need to add the fact that some of the mum and baby stores are also sourcing on the Internet and we just need to make sure that there is no double counting there.

Nutrilon Platinum has been launched recently. It's still a small portion of our mum and baby store business, which itself is not the biggest of our three pillars in the Chinese market, but it's growing well.

The pricing, overall I think that we should expect in mum and baby stores some pricing impact due to the pricing in modern trade. And of course the fact also that ecommerce is coming at a lower price given the price at which the traders are getting the product because essentially all the ecommerce sales for us are booked at our European price basically and not at the Chinese price. And so I think that mum and baby stores are squeezed in the middle between modern trade, deflation and price and promotion activities short term and the overall pressure of mounting ecommerce competition. And so, yes, we are expecting also some pressure on the price in mum and baby stores.

Having said all of that, again, this is a very, very advertised market and I expect that a bit of what is put in pricing or promotions is going to be mitigated by less advertising. And, frankly, given the growth of both MBS and Internet, we don't feel any pressure to support our brands more than what they are today.

The free trade zone is still very small. The best estimate stats that we have is probably it's like 5% to 10% maximum of the total market in China. So it's growing obviously. The estimate that we have is that our brands are even bigger in market share in this nascent free trade market than in the global ecommerce, where they are already number one. So I think the dynamics for the demand for our brand and the support is really there.

We have no way to influence the price at which these traders are dealing with our brands, again, so far because, again, they are buying in Tesco and Carrefour and whatever it is, and then they are shipping all that to China. They are the ones who decide competitively what the right price should be when that lands into China.

So we don't have the ability to monitor that. And it's very likely that the free trade zone scheme, if it's down to grow, is going to be a trade off for these traders to trade in a more secure -- and actually simpler from a logistics standpoint and supply chain and everything, and administrative tariffs, procedures entering into China -- so much safer, probably less costly for the system in free trade zone than the current parallel market, but probably squeezing a little bit of their own margin in exchange for that sustainability. And, again, I don't think that it will have any significant impact on our own profitability accounting for Danone.

I'll leave to Cecile the answer for the Dumex and like-for-like growth for ELN. Just mentioning one thing about Dumex is that we are not closed yet so there will be a timing effect of course before we close that deal.

Cecile Cabanis - *Danone SA - CFO*

Thank you very much. So maybe first I will clarify H1. You have to note that in H1 when I presented the bridge margin, page 20, there is a 122 basis points of others impact. In that box a significant portion is linked to Dumex's negative performance and in H1 it's made of two things. First, it's made of the deleverage given the underlying performance. And second, it's made of some specific costs because we have started an adaptation plan for Dumex in road to market, and we are closing some distributors and getting some returns. So part of it is underlying performance that we continue to have on H2, and part of it will fade away as the adaptation plan will be finalized.

The other thing is that, as Emmanuel mentioned, we are not closed so we have signed a preliminary agreement. Today we expect that the closing will probably happen at the end of the year so this year there shouldn't be any impact of the transaction. That obviously could impact as from the date with the consolidate, so probably next year.

In terms of the guidance for ELN and H2, you're right to say that the basis for comparison will be tougher in H2 and we believe that this basis for comparison will lead to a lower growth of ELN in H2.

Maybe it's worth to remind the different dynamics of the H2 top-line growth. So this is one dynamic. The other one is that there will be a sequential improvement of Dairy Europe, leading to an acceleration of the growth in total Dairy. And the third one is what I commented earlier on, probably softer quarters to come in Mizone. But all these elements basically are taken into account when we confirm the full-year guidance of the growth between 4% and 5%.

Warren Ackerman - *SG Securities - Analyst*

And Cecile, just to clarify one thing, can you just maybe -- I get the point about the deconsolidation at the end of the year, but can you tell us how big Dumex is at the moment in terms of sales and EBIT? How big is it? I know it's obviously getting smaller. What percentage of China does it account for in terms of revenues? And is it actually profitable?

Cecile Cabanis - *Danone SA - CFO*

So you remember in the Q1 what we said is that basically in terms of size we were globally close to the market share that we used to have before from Fonterra false alert, but what was two-thirds Dumex was now probably more than one-third. And as Q2 has shown in acceleration in the change it's now probably less than that.

And in terms of performance the impact on our margin, now that we have isolated in others, is negative given the fact that we have some deleverage linked to the acceleration of the ecommerce and the degradation of Dumex, and we have this one of course in terms of adaptation plan as we're reacting to the deleverage to mitigate it.

Warren Ackerman - *SG Securities - Analyst*

Okay. Thank you.

Operator

Alain Oberhuber, MainFirst.

Alain Oberhuber - *MainFirst - Analyst*

Yes, good morning everybody. Just two questions. The first question I have regard again about ELN in China. So just to understand, the reason for the lower margins we have seen is obviously the stronger competition from modern trade and the high input costs, but also about the product mix change and there I'm more interested. How much is the negative impact about this change of different channels, product mix?

The second question is on the Russian business and the dairy business. Could you explain how much the margin development in the Russian business was and give us more insight how much your premium products now are in Russia fresh dairy?

Emmanuel Faber - *Danone SA - CEO*

Thank you, Alain. Well, just to clarify, if you look at the three channels in China again, modern trade is now less than a quarter of the total market whereas it was nearly 100% three or four years ago. And this is the market in which there has been most of the pricing competition recently. Also due to the fact that this market is shrinking and it's an overpopulated market by many domestic brands. And so this is in any case the market in which, as far as we are concerned, this is a less profitable market.

Then you have mum and baby stores, in which we have increased significantly from a low base our market share, which is growing fast, which is more than 40% of the total market today, where margins are good, pricings are good, but as I commented to Warren's question, there is a dual pressure impact that comes from both the deflation of the modern trade and the increased competition from ecommerce.

And then ecommerce, as far as we're concerned, the margin is basically our European margins, in the sense that these are all products that we sell as finished goods to our retail in Europe and that traders are then shipping on Internet or via Internet systems, landing physically in China. And so they are the guys who are making the margins. So there is absolutely no margin decrease on our Chinese business, other than what specifically Cecile explained on the adaptation plan of Dumex because we right-sized Dumex in the course of the Q2, and led actions that are consistent with the market dynamics that I described. So that's the situation as far as the margin is concerned in ELN China.

When turning to Russia, I think Cecile shared the fact that our key brands in Russia continued to perform well, positive in Russia. That includes Prostokvashino, which is the big heritage modern brand that we got in the Unimilk transaction, which is 40% of the total sales of our Russian operations, a mega brand that's doing very well. Same for Danissimo, our indulgence brand. Same for Tema, our toddlers' brand there. Even Activia had a reasonably good performance in the back end of Q2.

And so there is a lot of work that's being done by the Russian team to basically manage the revenue growth of Russia, skewing that growth towards a higher value added product, which, in answer to your question, leads to the fact that our Russian margin is well under control, despite the difficult environment in Russia.

As I think we shared with you in the past, we have been conducting a significant reorganization of the company starting last year already, addressing immediately what we saw as consequences of the Russian ban, a new environment coming. That includes simplification of a number of factories, simplification of our number of layers of management, simplification of our number of regions, on top of the top line activities that I just described.

And so, speaking under the control of Cecile, I can say that I'm very committed to our long-term agenda that you know of, increased margin of Russia, and that we continue to drive, in these difficult circumstances in Russia we continue to drive this agenda successfully.

Alain Oberhuber - *MainFirst - Analyst*

Okay, Emmanuel. Just a follow on question. Does it mean that it's guiding to the direction that you improve margins in Russia every year between 20 to 50 basis points that it is in the past?

Cecile Cabanis - *Danone SA - CFO*

I don't think we gave any guidance in terms of improvement. What we said is that in the current context we have the objective to protect margins through what Emmanuel was describing. First, a very resilient platform of brands in terms of top line. We had the Q2 that is growing even if the growth is more moderate. And all the reorganization and simplification plan that is currently conducted in the organization. And this is to protect margins. What we are saying is that we don't see any reason why once the context is eased Russia will not continue to improve margin again.

Alain Oberhuber - *MainFirst - Analyst*

Thank you very much, Cecile.

Operator

Jon Cox, Kepler.

Jon Cox - *Kepler Cheuvreux - Analyst*

Yes, good morning guys. Thank you. A couple of questions for you. Maybe first with Cecile on the margin expansion, which actually, when you strip out what's happening with Dumex, is very interesting. There's 240 basis points expansion we see there, margin for operations. I wonder if you can just break that down a little bit more in terms of is half of it due to lower milk prices and then the other half is really operational efficiencies and what you're doing in Russia?

And maybe you could try and split that into the bulk of it really is Europe. I know your gross margin in Europe I think has been down 500 basis points before you started the whole factory retooling. Just wondering, how much you've recovered and what you see going forward on that.

And then a second question maybe for Emmanuel, more of a big picture question potentially and maybe this has to wait until November in Evian, but you gave an interview a few weeks ago with Le Figaro and you were developing this idea of a model, saying that Dairy doesn't have to grow 7% or 8%; it just has to grow 2% to 4% you were saying at the time, to reach a model, and you were talking about high single digit, if not double digit, with the rest of the businesses. This would point to somewhere around 6% organic sales growth going forward. Is that what you were trying to communicate there? Maybe you can elaborate a little more on what you were saying in that interview? Thanks very much, guys.

Cecile Cabanis - *Danone SA - CFO*

Okay, so I will start with the margin expansion.

So, when you look at the margin from operation improvement of 240 basis points, you can take the assumption that around 100 basis points it is linked to the favorable context in milk and PET price, most of it being milk. The rest is obviously about the growth. It's about mainly, as you pointed out, improvement of the portfolio and mix, management coming from the Europe dairy through the profitable revenue growth management that is delivering a significant margin improvement. And then the rest being the productivities and the other efficiencies we've described. That's what I could tell you in terms of based on the breakdown.

And then Emmanuel.

Emmanuel Faber - *Danone SA - CEO*

Hi, Jon. Thanks for the question. I didn't mean to mean any number otherwise they would probably be published today. But what I think I was hinting to, is that where we see the two -- put it this way. We said 2015 is going to be a year of profitable growth and we want that to be sustainable, and this is really what we're focusing on today.

And, as you know, in the charts that we are sharing about our guidance, the direction to 2020 has another term, which is strong, so it characterizes the fact that we do not measure or assess our level of growth this year of 4% to 5% as being particularly strong. It's steady. It's solid. It's made in a complex environment, everything you want.

But we continue to see as much as you do the fact that it's a bit two-tier between a big dairy business that gradually and sequentially moves hopefully in the right direction, and three other engines, where frankly I wouldn't count on the fact that any of them is going to be significantly accelerating from where they are. If we have medical nutrition anywhere between 6% and 8%, and water between 7% and 10%, and baby anywhere between, I don't know, 7% and 10% or 11% or 12% sometimes. Of course there could be good and/or bad quarters, but this is basically where I think, if I look at the next two to three years, four years, where I think these divisions on a like-for-like basis can deliver.

And so we are very confident that this is what they can deliver and we continue to believe that they have the right category spin, the right segments and the right geography platforms to nurture that kind of growth.

So the two ways that now we will see in the longer term acceleration of growth, is the fact that, first of all, these businesses are growing faster than Dairy, and if you look at the long term mix of our business including EBIT mix, and not only sales, there is a move towards these categories overall as part of our portfolio, which is good news in terms of both sales growth and margin. And second -- so that's a portfolio mix impact. And second, we are absolutely confident and serious and committed to get our business of dairy back to growth. And this is the big engine that is restarting.

I think my comment to Le Figaro was in the context where Danone has delivered 6%, 7%, 8% top line growth in the last ten years, some quarters, some half years etc, in a context where Dairy was driving that growth. So Dairy was among the top end of our engines whereas I think now we don't need that to add in two to three years' time the word strong to our guidance. What we need is Dairy back from minus 2% or minus 1% and gradually zero to indeed 2%, 3%, 4%.

And so I think the point is that we can't have a strong growth, characterized as strong with everything that I just said, without Dairy being somewhere in what Le Figaro has quoted me to say. But I do not expect dairy to be driving that growth. It will basically create the sustainable base for coming from a growth, solid growth of this year, to, to a strong growth, when we would have turned it around. And when I look at our brands, their potential and everything, I'm very confident that we can be back into positive territory for the global Dairy business.

So, in so many words, this is what I meant when I didn't mention a number at Le Figaro.

Jon Cox - *Kepler Cheuvreux - Analyst*

Just as a bit of an add on, maybe next year the 2% to 4% in dairy is a bit early, but should we be penciling in something like 1% to 2%?

Cecile Cabanis - *Danone SA - CFO*

I think today it's still early, but H1 I'm reconfirming the guidance for the year and we did not have the willingness to guide for next year.

Emmanuel Faber - *Danone SA - CEO*

Yes, I don't have my papers with me basically so we need to discuss that.

Jon Cox - *Kepler Cheuvreux - Analyst*

Alright. Thanks guys.

Emmanuel Faber - *Danone SA - CEO*

Thanks Jon.

Operator

We will now take our last question from James Edwardes Jones, RBC.

James Edwardes Jones - *RBC - Analyst*

Yes, morning everyone. Could you just explain a little bit more about the negative 122 basis point impact on margins you've called other? I'd just like to understand a bit more detail about what's included in there, please.

Cecile Cabanis - *Danone SA - CFO*

Yes, sure. So it's 122 basis points negative impact, which is made mostly by what we explained around the mix performance. We also have an impact of costs that were incurred following a fire in one of our factories in January. So this is part of it. And lastly, we continue to have -- we just discussed Russia. We continue to have certain numbers of adaptation plan for our cost base and optimization, and the restructuring costs of these programs are there.

James Edwardes Jones - *RBC - Analyst*

Thank you very much.

Emmanuel Faber - *Danone SA - CEO*

Let us close this call now. Thank you very much for attending. The team is as usual available for any further questions, numbers and everything that you need. We were, as I think Cecile and I shared with you, we are very happy about these numbers. A lot of things going on at Danone and we expect to post more news about this transformational path next quarter. Thank you very much. Have a good day.

Cecile Cabanis - *Danone SA - CFO*

Thanks a lot. Bye-bye.

Operator

That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.