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BN.PA - Half Year 2016 Danone SA Earnings Call

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OVERVIEW:

Co. reported 1H16 YoverY reported sales decline of 3%. Expects 2016 like-for-like sales growth to be 3-5%.

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PRESENTATION

Operator

Good day and welcome to the Danone H1 2016 results conference call. Today's conference is being recorded. And at this time I would like to turn the conference over to Regis Massuyeau. Please go ahead.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Good morning, everybody, and thanks for attending the call. I'm with Cecile Cabanis, Chief Financial Officer of Danone, and Celia.

Thanks for your attendance. We're going to go through the presentation that you may have uploaded. Before that, I, as usual, invite you to go through the Safe Harbor statement before we start.

And considering you have done that, I hand over now to Cecile.

Cecile Cabanis - *Danone SA - CFO*

Thank you, Regis. Good morning, everyone. Thank you for your attendance. I will ask you to go to page 4. And before I go into the details, just to give you a few messages. First to say that I think that the results we publish today are fundamental. They are strong and they do reflect the transformation of the Company and, again, another quarter of progresses on our journey towards strong profitable and sustainable growth. It is another quarter of delivery of our commitments and I think that's important to note.

Our agenda does not change. And those results really show the focus on rebalancing our model of growth, which means basically, first, that we continue to improve structurally the profitability of our different businesses in all the regions.

Second, that we're moving, being disciplined in resource allocation to fuel appropriately and at the right pace short, mid and long-term initiatives.

Third, we are progressing on our key battles, and I will come back to that. You can see them on the left of the chart.

And lastly, we keep on being agile to make sure we grasp opportunities for growth for the future.

As we discussed earlier in June, the environment remains very volatile and we have to navigate through fast-evolving dynamics, especially in some emerging markets that you can see on the right. And in this context we make sure that we stick to our plan and that we remain focused on our core agenda, making sure we properly manage our risks and opportunities and driving safely on our journey towards 2020, delivering consistently quarter after quarter.

So the results basically that you see at the bottom of the slide are really the translation of our daily efforts to rebalance the growth equation and continue to demonstrate our capacity on delivering on what we say.

So maybe to go through the figures on page 5, starting on the left. So on the top-line perspective, H1 is showing a growth at 3.8% on a like-for-like basis and minus 3% on a reported basis, driven by unfavorable expected weakening currencies.

When we move to the margin, the recurring margin, operating margin, we are delivering plus 125 basis points' improvement in the reported margin, which is driven mostly by a strong increase on the like-for-like margin at 93 basis points.

Moving on the right to the EPS, we deliver our best ever increase, both in reported and at constant exchange rates. And I think this is really important in terms of results because it reflects what we said, but making sure and being very careful that our profitable growth equation will translate in EPS improvement in a consistent manner.

So I will ask you to move on page 6, going to the classic sales bridge for Q2. The growth for the quarter is 4.1% like for like and minus 3% on a reported basis, going from left to right. As you can see, currencies have had again an unfavorable impact of minus 7.7%, as expected, and with a negative impact basically from mainly the Russian ruble, the Brazilian real, the Argentine and Mexican peso.

The scope effect is 0.6% positive, which is mainly due to the integration of Fan Milk that we made at the end of 2015.

If we move now to the organic performance, the result of 4.1% growth is a combination of a positive volume of 1% and a positive value effect of 3.1%. The value part continued to be the result of the work we do on improving overall mix and portfolio and it of course reflects different dynamics between the regions and the categories. But overall it continues to build our agenda in a consistent manner and show progresses on key battles, as you will see in a moment.

So what I propose is that we go first to the regional dynamics, which you can see on page 7. And I will start with Europe. Europe is roughly flat this quarter and it's a mix of different dynamics between categories.

If we start with dairy, we are progressing in our agenda of return to growth. We have a Q2 that is improving versus Q1 on the back of first positive results of the relaunch of some of our global brands.

If we go into the waters division for Europe, it's a solid Q2, driven by volume, and solid despite a high base of comparison and not very favorable weather conditions starting this summer.

On the early life nutrition side, the results are mainly impacted by the sequential conversion of sales from an indirect model based on import from Europe to China to a direct local model in China, as well as the transfer of part of some traders business from Europe to Oceania.

Moving to NORAM and CIS, the 4.8% growth that you see this quarter is confirming the momentum that we described recently, i.e. successful and continued reacceleration in the US, where our different initiatives continue to deliver positive results. And at the same time, we continue to face a fragile context in the CIS, where we maintain our efforts to build a more valued portfolio and protect our margin.

Finally, moving to ALMA. Despite a still volatile environment and some special context, especially in Brazil, ALMA strong growth at 8% reflects positive dynamics in important countries, such as Indonesia, Mexico and Africa globally.

In parallel, in ALMA we continue to transition the Mizone brand, which still has a negative impact on the quarter sales. And lastly, we are making progress on the Chinese ELN agenda, with positive results already this quarter.

So moving now, I propose that we go to the categories and then we will move through our key battles. So categories on page 8, starting with dairy. So we have a dairy division delivering a performance of 3% in top line, sequentially better than in Q1, and despite still negative volume in global the efforts on the portfolio keep paying off and we have a positive value element.

If we look at the margin, we have H1 margin improving by 56 basis points, which is mainly driven by, first, the continued efforts to build structural improvement in the gross margin, through both portfolio optimization and cost discipline and efficiencies.

Second, we continue to have in Europe and NORAM a favorable milk context.

And third, we have been able to reinvest significantly behind the brand, especially Europe and NORAM, by about 75 basis points, and all this with delivering a 56-basis-point margin improvement.

So the division is fully in line with its agenda of return to profitable growth. All the efforts made to structurally improve the gross margin to support future value creation are paying off.

Moving to waters, the growth remains strong, around 8% excluding China, so fully in line with our 2020 agenda, and including a high growth in volumes.

We continue to have the transition of Mizone that is impacting negatively the global division, both in volume and value, due especially to a geographical negative mix. Other than that, the aquadrinks continued to be a positive contributor to the global mix of the division and we pursue our global investment to keep developing this unique promising segment.

Moving to margin on waters, the slowdown of Mizone, as it was the case in H2 last year, led to an unfavorable geographical mix impact. The rest of the division continues to rely on the profitable model of growth and we continue to reinvest behind our platform.

Moving now to early life nutrition, we have a growth of 7.2%. We are, as expected, accelerating our growth, leveraging solid underlying trends in all the regions and progressing in the agenda of building a more sustainable model in China, which I will come back as part of our key battles in a minute.

The margin of early life nutrition is especially strong and driven with different elements. Part of them are structural and some are one-offs. First, on the structural side, margin improvement is of course driven by the growth and the favorable mix associated with the growth.

Second, the milk, the powder milk is bringing a favorable impact of around more than half of the gross margin improvement.

And third, we benefit this semester from the reversion of the negative one-offs that we had last year, especially on Dumex and on the fire in our Cuijk factory.

Finally, medical nutrition, which delivered again another quarter of strong growth, relying on a well-balanced model of growth and a solid growth in all the regions and double-digit growth in some countries, like Brazil and China.

So all in all, looking at this set of results, I think it really illustrates Danone's focus on, first, making sure we deliver in a consistent manner quarter after quarter a profitable growth equation; second, that we are monitoring in a disciplined manner the growth agenda and the way we allocate resources behind this growth; and third, that we are managing and controlling risks and opportunities in order to make sure we secure our road towards 2020 ambition.

So maybe I think it's important that we'll go into more details in our key battles that we've been following with you every quarter. And I will start with the dairy and with US, on page 10.

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So in the US, as you can see, Q2 performance confirms the momentum of reacceleration of the growth that we started end of last year. Innovations are really proving their success. And despite a fierce competitive environment, Danone is improving its market share by more than 1 point versus 2015. And at the same time we are able to structurally increase the profit equation of our US business.

We continue to be confident in the potential of the US market for this category. And in that sense we are building for the long term. This is the reason of our partnership with Healthier America and, more recently, as you have seen, our pledge on sustainable agriculture, naturality and transparent.

End of April Danone US announced indeed a pledge to its partners, retail customers and consumers to further improve sustainable agriculture practices for its milk supply, to increase transparency for its portfolio of products and evolve to more natural and fewer ingredients, especially for the flagship brands. All those to provide more choices to consumer.

Two weeks ago what we did is that, in line with this pledge, Danone announced the implementation of the first of those many major changes by bringing non-GMO ingredient option and clear label commitment. This is the beginning of the transformation. Danimals, Oikos and Danone brand will evolve to contain non-GMO ingredient. And additionally and starting now, all Danone products in the US that have GMO ingredients will be clearly labeled as such.

I think this kind of engagement is fully in line with our mission and our view on alimentation for the future. It's a key distinctive approach. And this is what will guarantee that we are building for sustainability rather than for short term.

On page 11, travelling to Europe. So in Europe the agenda is unchanged and consists to bring back safely Europe to profitable growth. As we have shared in the past, 2016 is a year of reinvestment to support the relaunch of our key global brands.

Basically what you have in Q2 confirms the positive signs on the relaunch of Actimel and Danonino, bringing Europe already back to low single-digit negative this quarter, so improving versus previous quarter.

There are still important milestones to go, especially the relaunch of Activia that will occur later in this year in order to really complete the transformation and return to profitable growth.

So basically, this semester on our key battles in dairy, as for US, we are fully on track also in Europe. And all this has been done with a margin improvement including a reinvestment around 100 basis points. So this is a very clean and healthy P&L.

Let's switch now to waters and Mizone in China on page 12. So basically while we are moving into the Mizone transition, I think it's important to look at waters in two separate parts. First, outside China, where we continue to expand the portfolio across the different markets. We are leveraging both plain waters and aquadrinks. And we keep delivering strong results, globally above 8% again this quarter, supported by volume growth and supported also by market share gain on the global Danone universe.

Innovation remains a key driver to deliver the ambition on providing healthier hydration to people. You have some examples on the chart. And all these initiatives are getting positive traction.

In parallel, moving on the right part of the chart, we continue to transition Mizone in China. In Q2 we maintain efforts in order to protect market share and adapt to the new pattern of growth of the category. Q2 last year was a very high base of comparison as we had the opportunity to comment already in June due to high preseason loading. So the sell-in, we are still negative this quarter but we are sequentially improving.

In this context, of course, we continue to also pursue the adaption of the organization, to protect the profitability equation so that we can prepare the model for the after transition and maintain a steady and disciplined approach of investment around Mizone.

Basically if we look at the outlook of Q3, you have to remember that we have a base of comparison for waters which is quite high, especially due to a hot season last year in Europe, as well as the fact that the transition of Mizone started only within the Q3 last year. And on top of that, in the recent weeks there has been important flooding in China that might also have some impact on the Q3 performance for the division.

So we will monitor this impact. But overall it does not change the direction. We still believe in the long-term potential of the brand and in its attributes and we continue to invest to build the future for the brand.

Let's now move to another key priority, which is ELN China, on page 13. So basically, as I mentioned earlier in the call, the overall ELN division is strongly positive, with a growth of 7.2%, showing overall solid underlying trend and key successes of the plan behind our brand.

Now if we move to China, China, as we shared, is a very fast-moving market. We have today mum-and-baby store channel and ecommerce that are the key drivers of the category growth, category growth which is now around low to mid single digit. As expected, we also have many new elements on cross-border ecommerce regulation that are being implemented. And in this context our agenda remains unchanged. We continue a strategy to build a sustainable platform for the long term, relying on strong assets which are the strength of our brands and our number-one position on the Internet.

So if we look at Q2, as such, the results show progresses on sustainable channel. We are sequentially converting indirect business into direct business. As expected, the traders adapt progressively their model until the regulation will be fully in place. We will observe a decrease of indirect sales, especially coming from Europe. And this will continue to create short-term volatility as we expressed earlier. And we know that the conversion will be sequential and will take some time.

In parallel, the good news is that we are growing sustainably and solidly our local sales in each channel, especially in mum-and-baby stores where we have a great potential of growth for the future. And that gives us confidence that we are in the right direction. Again, a safe and disciplined approach to allocate resource, coupled with accurate solution for future growth is paying off.

So this is really our everyday focus and we are happy with the current developments of our ELN Chinese business.

So I think for the business tour, that's all. And I would like to move to more financial metrics of the performance of H1, starting with the classical margin bridge on page 15. So as I said, we have a strong increase of the recurring operating margin on a reported basis, plus 125 basis points, which includes, on top of the strong like-for-like performance, a positive impact of scope and ForEx.

So starting with the left of the bridge. First, on scope, as expected we have a positive impact which is 14 basis points. It is mainly the result of the sale of Dumex in China that occurred at the end of May. You have to note that the major part of this impact has been captured in H1 2016 due to a higher level of losses in H1 versus H2 and particularly in June. That's why even if we closed at the end of May, the impact is quite important only for one month in scope.

Overall for the full year we anticipate a positive scope effect more around 10 basis points for the Company.

Moving right, on ForEx, so currencies have a favorable impact on the equation. They reflect mostly our country mix effect on the back of strengthening euro. In H2 this favorable trend should fade away. The weakening of emerging currency started approximately at the same time last year. So as a consequence here as well, for the full year we do anticipate only a very minor positive impact.

Maybe let's turn to the like-for-like performance, which is really what is measuring the health of the business. And here we have generated a strong increase of 93 basis points, which again demonstrates key progresses in the way we are rebalancing Danone model of growth.

So looking at the main building blocks, the first one is the strong improvement of margin from operation of 146 basis points, which is a combination of, first, the growth, with volume and also favorable mix and price management, especially portfolio optimization and mix. Second is built with structural efficiencies, productivity and gains in our cost base, with a permanent effort to optimize our operating model. And at the same time, a continued favorable context of raw materials, especially for liquid milk in Europe and NORAM for Dairy and milk powder for early life nutrition.

If you look at milk and [PET] as a whole, it's around 50% of the gross margin improvement impact for H1.

Second, moving to the pink box, we have continued to invest significantly this semester to continue to fuel the future growth. And investment is at 100 basis points. We continue, of course, to do that in our new way of looking at resource allocation, in a more disciplined, regular and flexible manner. And basically when it comes to the content of the reinvestment A&P would account for the major part, but we also invest in salesforce and in innovation and reformulation.

This reinvestment will continue in the second half and we will continue to make sure we have the same approach of being disciplined and making sure we fuel the right initiative.

Third, just I would like to stop on the box other, which is reflecting mainly a positive base of comparison. You remember that last year we had a negative box, which included both the cost associated with Dumex deleverage and adaptation plan and, to a lesser extent, costs linked to our -- the fire we incurred in our Cuijk factory. And on Dumex, remember that you have to look at it with this box, but also in the scope effect where you have the other 14bps to have it comparable to last year base.

So it's really about the reverse of the effects of 2015. There's nothing specifically new or strange in that box.

In H2, we anticipate and we discussed it already in previous call to have a lower increase of the margin, especially because we will have, on one side, the different base of input cost, so the gap in input cost will reduce. We will have also a less contribution of the other box, because last year most of the impact was in H1. But we will continue to make sure that we deliver profitable growth and that we are very disciplined, balancing properly the equation, the risks and opps and the investment in order to create a healthy equation for the future and in a sustainable manner.

Moving to the EPS on page 16, so the EPS performance I think well reflects what Emmanuel and I told you about making sure that profitable growth will flow into EPS in a consistent manner. And I will propose to focus first on the like-for-like performance. So we have H1 EPS increasing by 13.5%, which is basically really the reflection of the growth and margin improvement of H1. We also have some favorable impact of financial charges. And overall, if we look at the reported performance of 10.7%, you have to add to the like-for-like performance a negative currency impact of 5%, minus 5.4%, and a positive scope impact of 2.6%, here again linked to Dumex.

Overall you can be sure that we are committed to consistently improve our EPS in line with our agenda of strong, sustainable, profitable growth.

Page 17, moving on the free cash flow. So free cash flow has increased by 28.8% in H1 2016, reflecting more than the NOPAT increase on the back of the top line and margin improvement. We have spent around 3.2% of our sales in CapEx, which is reflecting a good balance between discipline in the way we allocate resources and also rhythm at which we do that.

On a phasing perspective, however, CapEx will increase in H2, especially due to some investment in Africa and to the planned construction that we have for ELN in the Netherlands that we announced a few months ago. And we will, of course, remain within our commitment to be between 4% and 5% of CapEx on total sales.

On working cap, we are ending the semester at minus 6% and we continue to work on maintaining a strong negative level of working capital, equivalent to 2015 for the full year.

Overall, again, fully committed in free cash flow generation, because this is what supports our capacity to invest behind the transformation, the brand and the categories. And we will make sure and be cautious that NOPAT development transforms itself into additional cash.

Page 18, debt. Let's now just look quickly at the evolution of debt. Nothing much. The net debt increase of EUR497 million is really linked to the cycle of the cash. We have paid the dividend of EUR1 billion. So basically that's it. We have some variation in M&A, which reflects, on one side, the positive impact of the Dumex sales and, on the other side, the remaining payment of minorities in Spain and some purchase of minority in central Danone. You can see a positive impact in the change in put to minority shareholders.

Moving to page 19, before the conclusion I would like to spend one minute on this slide that you know by heart by now, because it's in each of my presentations. First to remind that we continue to have one commitment for the teams and us all together, which is to make sure that we are progressing in our journey, safely, in a disciplined manner, and that we continue to deliver behind the ambition and the objective quarter after quarter until we reach our first destination of 2020.

Then, again, as I shared in June, we are evolving in a volatile environment. We have some fast-evolving dynamics in some of our key markets, especially China, Argentina, Brazil and CIS. And we really need to continue to use 2016 to rebalance our model, make it more resilient because volatility will continue. And that means that we need to be very disciplined also not to push for short-term growth at any cost in 2016, but really make sure that we give priority to margin improvement and to increasing the resilience of our model before we accelerate.

So this is really our agenda. Nothing has changed. We are committed to do that. And we are committed to do that every quarter until we reach our destination.

So no surprise, on page 20, when I tell you that I am confirming the 2016 guidance, first on the sales growth to be within a range of 3% to 5% and on margin improvement to be within 50 basis points and 60 basis points like for like.

Thanks a lot for having listened to me. And I'm opening the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). We take our first question from Eileen Khoo from Morgan Stanley. Please go ahead. Your line is open.

Eileen Khoo - *Morgan Stanley - Analyst*

Thank you. Morning, Cecile, and congrats on really good numbers today. I had a question on China ELN actually. Can you help us to understand a bit better what's going on in China, so specifically what's your growth rate there? It seems like the market slowed to low to mid single digit. If you are growing faster than that, does that mean you're actually increasing share?

And then you mentioned that MBS is a big focus for you. Can you talk a little bit about the margin difference between your three channels now? And would you expect margins to come under pressure in ELN in China if you are continuing to invest more in MBS?

And then just on cross-border sales as well, why do you think they're shifting from Europe to Oceania? Thanks very much.

Cecile Cabanis - *Danone SA - CFO*

Okay. Thank you, Eileen. So overall on the ELN China, there is no change to the agenda that we are building. And I think we have to be very clear in being careful not to confuse the short term, which is not always very readable because there are many movements, and looking at what we are building for the longer term.

So basically today, starting with your question on traders, I think it's a question to ask to them. But basically I think what is happening is that some of the traders are really waiting to see exactly how the regulation will finally be put in place and they are probably getting more volatile into what they're doing. I think there can be also some tactical choice because of their own value chain to go to Oceania rather than Europe. But other than that, I don't talk to them so I cannot comment further on the way they're handling the transition on their part.

On our part, yes, the market is today low to mid single digit in China on the back of demographics, lower urbanization speed as of today. We continue to grow, especially accelerating in mum-and-baby stores. Overall we continue to have a market share of around 15%.

What we can say in terms of differential of margin is two things. The first one is that, given everything that happened, the milk price on the modern channel, the different movement in terms of traders and local market, there has been some volatility in margin and some adaptation last year and in the short term. But we don't see any risk going forward on the business model because what we said is that the P&L has overall remained the same, but the lines within the P&L might change between investment and price and things like that. So it will evolve to a different business model, but we don't see a risk overall on the ELN margin part.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Thank you. We go to the second question, please.

Operator

We take the second question from Jon Cox. Please go ahead. Your line is open.

Jon Cox - *Kepler Cheuvreux - Analyst*

Yes. Good morning, guys. Thanks for taking the questions. Just two. One on the milk prices. Did you say that the Group gross margin, around half of the improvement was lower milk prices? And to add into that, obviously there was a big step up in the early life nutrition and medical nutrition. What should we think about sustainable margin there, i.e. if milk prices start to go up, will that have an impact on the margin there in those businesses?

And then a second question on cash flow. That looks very strong indeed. But I'm surprised to see that a negative working capital as a proportion of sales has actually gone down. What are your assumptions for working capital as a proportion of sales for the year as a whole?

And maybe just a non-result question, just on the WhiteWave deal, I just wondered if you could just reiterate that it's all going according to plan as far as you're aware. Thank you.

Cecile Cabanis - *Danone SA - CFO*

Thank you, Jon, for your many questions. So first, what I said around the impact of milk was that milk, plus PET, and milk whether it's liquid milk or milk powder, and PET altogether are indeed around 50% of the improvement of gross margin, so the 146 basis points that you see in the bridge. So that's first.

The second part of the step up in early life nutrition and medical margin, I think you have also to look at it on the way they build the profitable agenda of the Company because both are growing above the average rate of the Company, with high level of margin. So they are bringing a very nice [relution] to the overall margin of the Company and they will continue to do so. So I don't think there is a risk on having a big adjustment in margin, whether it's in medical or in early life nutrition.

Of course there are some specific elements, especially when it comes to early life nutrition this semester because of negative impact last year. But other than that, we are really continuing to build a profitable growth agenda of each division.

Then on cash flow, so your remark on working capital is correct for H1. You have to take into account that there have been some movements especially in inventory in early life nutrition given the fire that we had last year. Overall we continue to commit to be a full year at minus 7%, which is the rate we committed to be around when we closed last year. So there is no change at all on that.

Regarding WhiteWave, so basically we are going to file the proxy, as expected, in the coming days. And then basically the process with the SEC will continue and there will be -- once it's filed, there will be the AGM of WhiteWave and they will vote on the deal and then we will be in a different position in terms of certainty of the deal. But everything is moving according to plan so far.

Jon Cox - *Kepler Cheuvreux - Analyst*

Great. Thank you.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Third set of questions?

Operator

We take third question now from Warren Ackerman from Societe Generale, London.

Warren Ackerman - *Societe Generale - Analyst*

Good morning. Good morning, Cecile. Good morning, Regis. It's Warren here at Soc Gen. Two questions, please. The first one is about price/mix. This was the main reason for the top-line beat today, it was very strong in dairy and also in early life. I wonder whether you can split the 3.1% between price and mix. And can you talk about why price/mix was so high in dairy and baby. And was there any in-quarter pricing going on in Q2? It seems like dairy input costs are starting to go back up.

And then secondly on dairy volumes, can you talk a bit about Russia and also Brazil. You're saying that volumes overall still down 2% in Q2, same as Q1. So if Europe's getting better, what's getting worse I guess is the question? How big an impact is Russia and what would volumes have been in dairy ex Russia? Thank you.

Cecile Cabanis - *Danone SA - CFO*

Okay. Thank you, Warren. So on the 3.1% of price/mix, it's mostly mix. We have not been taking -- and especially given the context of input costs, we have not been taking any specific price increases, except some very specific one, for example, Brazil, where we took a price increase on the back of milk inflation and inflation overall. But it's really in some specific context of inflation. Other than that, there is no big price movement so it's mostly around mix.

And what is in there, it's basically, I would say, different things. First is the continued work on the portfolio valorization of the dairy. So we've been doing the work in Europe. But we are also implementing PRGM in the US. In Russia we've been very cautious in making sure that we are putting focus on the valorized part of the portfolio. That's also linked to your question on volume. So we are overall resisting in growth in Russia because there is a big value part element, which is linked to the fact that we are putting our focus on valorized brand and we have very negative volume on the traditional/milk part of the portfolio. So we continue to be really focused that we have a portfolio that is creating value and mix.

On the volume part of the dairy, so yes, we still have a negative volume. I would say it's two things, but you basically mentioned them. It's Russia and Brazil. Russia we have volumes that are negative on the context that it has been very difficult for a long time. We are really making sure that we put the full focus on valorized brands. And it's paying off because we continue to perform in those brands and getting a very big gap in value, protecting the margins. But we still have very negative volume, especially in milk in Russia.

And then Brazil, we have also strong negative volumes. We had to pass a price increase around 7% in Q2. And this has deteriorated the volume part. So that's basically the overall reason behind the volume not improving.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Thank you. We go to another question.

Operator

We take the third question now from Martin Deboo from Jefferies. Please go ahead. Your line is open.

Martin Deboo - *Jefferies - Analyst*

Yes. Morning, everybody. Martin Deboo at Jefferies. Cecile, I just had two questions on early life. I just want to understand in terms of the transition from the trader channel to direct to market, just -- can I just be clear what is the influence on the price point you're selling at between the two? And you touched in your comments to Eileen on the implications for margin. I'm not entirely clear whether the direct model is a higher-margin model than the trader model or not.

And the related question on early life is where do we expect margins to go directionally in H2 given that you're lapping the Dumex headwinds? Do we expect positive margin progress in H2 but presumably a lot lower than in H1? Those are the questions. Thanks.

Cecile Cabanis - *Danone SA - CFO*

Okay. Thank you, Martin. So on ELN, on the transition between indirect and direct, basically major impact on price was last year. We had some opportunities to comment that. There was some price deleveraging last year on the portfolio. Now you need to be careful when you look at margin because, as I said, it's different business model. So you had strong price, very high A&P, and then the new model in direct is different in terms of how the equation is working, so it's less price. But then we will overall adjust the way we are making investment. It's not done the same way. So overall in margin, in the long run we shouldn't have a major impact between both channels. So basically this is really what you have to take into account.

And again, as far as we are concerned during the transition is that if there are some movements and some impact on margin, we are very careful on the way we allocate resources, the way we are building the model and looking at risks and opps to make sure we continue to deliver profitable growth overall for Danone.

Then in the second half, basically we will continue to have a profitable growth model. But of course, as you mentioned, the impacts or the positive reverse impact from last year cost will be much lower, and on the input cost as well because on early life nutrition, gross margin improvement, more than half is the effect of the positive impact from powder milk. This you will not have as well. So it will be, of course, much less of an improvement that 353 basis points that you had in H1.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Thank you. I think we have a last question now.

Operator

We take the next question from Jeremy Fialko from Redburn. Please go ahead. Your line is open.

Jeremy Fialko - *Redburn - Analyst*

Hi. Good morning. It's Jeremy Fialko from Redburn here. Thanks for taking this final question. Just two from me. First one on Mizone. Can you just talk about what the sellout is currently running at, at the moment, and then also clarify this point about some important loading that you're seeing in Q3? Is that some reloading or is it a further destock?

And then secondly, can you comment on the ELN performance outside of China? I know we focused a lot on China, but if you could talk about some of the other important markets for that division and how they've done, that would be helpful. Thanks.

Cecile Cabanis - *Danone SA - CFO*

Okay. So on Mizone -- so it's two final questions actually. On Mizone, basically we continue to have negative performance of Mizone, which is linked to the fact that the transition is not completed. So we have different effects. The first one is that the transition only started in the middle of Q3 last year. And we are facing very high base of comparison in Q2 and Q3 because the high season is just happening now. And last year we had stocked for the high season, but we expected to be still at the previous normal pattern of growth. And then within the Q3 the category growth came down to come back to a new normal. And so we are really being in this base of comparison, which is impacting significantly the performance.

We are sequentially improving. However, as I said as well, we have unfortunately some flooding in China, which will impact the performance for the season. So we need to monitor that and really evaluate that. We will be -- we will have better visibility at the end of Q3 once the season is complete on where we stand in the transition.

What you really need to keep in mind is that Mizone still has very strong attributes to the brand. And we still believe in the potential, so it's really about how the transition is operating and how long it takes and some specific external events as the flooding. And it's not the fact that we are seeing the brand differently or the potential of the brand differently.

Then on ELN, so on ELN outside China, we are really basically having a good growth pattern, where we have very solid underlying trend in most countries on the back of our strong brands, innovation and plan. So there is a good momentum of growth outside China.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Okay. Thank you very much. Thank you to all of you. Thanks for your attendance this morning. We wish you all, I guess, good holidays.

Cecile Cabanis - *Danone SA - CFO*

Good rest.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

We will follow up with you guys during the day with Celia obviously.

Cecile Cabanis - *Danone SA - CFO*

Thanks a lot. Have a good day.

Regis Massuyeau - *Danone SA - Head of IR & Financial Communication*

Bye-bye.

Operator

This concludes today's call, ladies and gentlemen. Thank you for your participation. You may now all disconnect.