

This article by Tom Russo has been excerpted from a letter of Semper Vic Partners.

Nestlé has long been a featured investment in Semper Vic Partners, largely because of its vast “capacity to reinvest” and its management’s belief in their “capacity to suffer” near-term pain for long-term gain. Nestlé does not possess these capacities because of family control. Rather, I believe, they have enjoyed special success in long-term investing despite short-term pain due to the remarkable culture within Nestlé that has a built-to-last Swiss mindset focused on building for long-term value.

Indeed, I conceptualize my investments through Nestlé in two parts. On the one hand, through our investment in Nestlé, we participate in one of the most attractive “bonds” in financial markets anywhere. This “bond” is the cash flow producing engines that are represented by long-standing product categories and geographies that Nestlé has long dominated. These categories are particularly cash generative and the Nestlé bond can be valued independently of its reinvestment potential. As such, you can imagine how much appreciation has occurred in Nestlé’s “bond value” as declines in global interest rate environments have driven fixed income valuations sharply upwards over the past decade. Nestlé’s “bond” of existing businesses, that support cash flows that could serve as interest, has soared in value over the same period, along with fixed income investments in general.

Nestlé, however, is blessed to have, attached to the Nestlé bond, a Nestlé “venture capital fund.” However, Nestlé is not just any venture capital fund, but one that rather enjoys enormous competitive advantage, as its brands offer product platforms that respond favorably to product innovation due to high consumer loyalty to brands around which such innovation can take place. Nestlé’s venture capital fund enjoys the benefit of industry-leading consumer product experts deploying its almost boundless cash flow streams into regions and products offering promising reinvestment. These managers are multilingual, multicultural – fluent in language and mores of regions of the world through which successful venture capital investments from “Nestlé’s nest” will flourish. Finally, few venture capital operations have access to state-of-the-art deep insights into health, nutrition, and wellness that Nestlé can offer its venture capitalists, both from in-house talent in Nestlé’s Health Science department, with its focus on nutrition and wellness, and from outsourced innovations from a network of global third-party, industry-leading research partners and providers.

Nestlé Corporate Culture - A Look Back, A Look Forward

Nestlé has succeeded during four decades of my ownership largely because they have been able to create and sustain a corporate culture more focused on long-term wealth creation than on meeting near-term earnings’ targets. I knew that I had come upon a different corporate culture as early as the late 1980s and early 1990s, when I first met Nestlé’s then rising star and, more recently, long-standing chairman of the board, Peter Brabeck. I knew after my first few meetings that Mr. Brabeck would be just the sort of leader and caretaker of corporate culture for whom I searched.

I believe that it may even have been during my first meeting with Mr. Brabeck, back in the late 1980s or early 1990s, when Mr. Brabeck first began to interact with Wall Street, that he

was confronted with two questions; his answers for which I found to be inspiring.

First, he was asked by a Wall Street analyst, with slight derision due to the general belief at the time in Nestlé’s sleepy culture, what the planning horizon was when Nestlé looked out for investments. Clearly, this particular sell-side analyst and his financial-world colleagues’ worst fears were met when Mr. Brabeck, without missing a beat, responded “35 years, but we break specific plans down into five-year increments.” This was music to my then, still nascent, “long-term gain” mindset, but was obviously not what impatient Wall Street sell-side analysts wanted to hear.

Second, an analyst asked what Mr. Brabeck’s plans were to reduce expenses throughout their presumably bloated operations. Mr. Brabeck’s attempts to describe steps to over time increase efficiency and effectiveness were dismissed as insufficient by this and by several subsequent analysts. In desperation, Mr. Brabeck threw up his hands and exclaimed, “Look, Europe is not the United States; we operate largely in Europe. What do you want from me ... to go through the organization with a ‘machine gun’?”

Clearly, Mr. Brabeck suggested again that theirs was a longer-term planning horizon than that which US analysts desired to hear, leaving the audience quite deflated and me elated to have found, in Mr. Brabeck, a leader who could oversee a considerable amount of my investors’ funds. Mind you, part of the appeal, as well, involved just how few other long-term-minded investors there were investing in even as global a leader in its field as was Nestlé. It was extremely difficult in the late 1980s for Americans to invest in Nestlé. When I began to invest in Nestlé, in fact, I was only permitted, on behalf of US investors, to invest in participating certificates of non-voting bearer shares. On top of those limitations, it was also nigh impossible to simply settle, through US-based custodians, Swiss trades for most of my early clients in the mid-1980s.

Caretaker of Corporate Culture

I plan to spend my remaining time in this letter on Nestlé focused more on the culture which I have so admired, first under Mr. Brabeck’s tenure as chief executive officer and, thereafter, during his tenure as board chair. I will refer to many interactions over the three decades of my holdings in Nestlé to reflect how they cumulatively build the culture which today, for the first time ever, will be led by a chief executive officer who did not grow up within the Nestlé family. I hope to provide you with an idea of many of the cultural values shared historically, as well as provide an update into what Nestlé might very well look like under leadership of recently appointed chief executive officer, Mark Ulf Schneider.

I knew at once that Mr. Brabeck would be a person with whom I could safely entrust a substantial portion of my capital under management. Indeed, for most of the 30-year existence of Semper Vic Partners, L.P. and for accounts separately managed over this period in a fashion parallel to Semper Vic, Nestlé, Philip Morris, and Berkshire Hathaway have consistently represented my largest holdings. (Today, for example, their combined positions represent nearly 30 percent of my assets under management.) Currently, Nestlé represents slightly less percentage weight in Semper Vic Partners, L.P. than Berkshire Hathaway shares (10 percent versus 11.5 percent, respectively) and slightly higher than

Philip Morris’ shares (10 percent versus 9.25 percent, respectively).

Before addressing overarching aspects of Nestlé’s general corporate culture, a brief review of one of Nestlé’s key innovations, Nespresso, which highlights Nestlé’s “capacity to reinvest” and “capacity to suffer,” should prove instructive. The Nespresso investment was as disruptive at the time proposed to Nestlé’s board as must have been Philip Morris’ then proposed investment into reduced-risk, heat-not-burn tobacco devices to Philip Morris’ board four years ago. Both firms were massive leaders in their long-standing, immensely profitable historic businesses. Both plotted launch of disruptive new products that threatened to obsolete the very business that formed the core of their long-standing franchises.

In the case of Nestlé, the product proposed was a single-serve, high-quality espresso product to be named Nespresso. Given that Nestlé, at the time of proposed investment in Nespresso, had over 40 percent of the global market for soluble coffee, the thought of producing a premium product that could cannibalize the high end (and high margin end) of the supermarket coffee business was very likely not an idea about which Nestlé’s board would have felt most comfortable. Indeed, I understand that the board so feared Nespresso’s cannibalization threat that, over the 15 years that it took before Nespresso broke even, the product was threatened with closure by the board at least a dozen times.

The project, under Mr. Brabeck, stayed on course even with challenges from the board about its wisdom. Mr. Brabeck was most impressed, however, by the premium price point into which Nespresso promised to move Nestlé’s otherwise more mainstream coffee business.

Maybe even more importantly, Mr. Brabeck fancied the end run that he felt Nespresso gave Nestlé’s coffee business around the vice-like grip that supermarkets exercised over instant and ground coffee brands that went to market through supermarkets. Their then threatened endless rise of private label, and pricing pressures that promised to ensue, drove Mr. Brabeck to seek an alternative route to market upon which Nespresso envisioned to entirely rely (e.g., boutiques, Nespresso cafes, telephone marketing, and an e-commerce-exclusive closed route to market).

While Nespresso struggled to make its way to market, Nestlé invested ceaselessly in perfecting the technology, the coffee sourcing by global region, etc. to present consumers with high-end, single-serve products to serve needs of at-home premium coffee not previously thought to exist. Despite Nespresso not breaking even for its first 15 years, the product management team felt that they had the “capacity to suffer” burdening those already high coffee margins in their search for a competitive and premium solution. Though not supported by family owners, Nestlé’s long-term-minded culture endured pain for nearly 15 years. Today, Nespresso generates nearly \$5 billion of system revenues and continues to show growth rates well in excess of overall global coffee markets and continues to provide Nestlé with incremental “capacity to reinvest” funds into more boutiques and into opening up more jurisdictions into which to launch Nespresso’s line-up.

Nestlé’s culture had been shaped, for as long as I have invested in its shares, by a host of

fitting metaphors and allegories shared to its staff by chief executive officer, and ultimately chairman, Mr. Brabeck. My belief is that the ease by which his motivating expressions could be understood helped keep the firm fiercely focused on building wealth tomorrow despite burdens upfront investments placed on reported results today. A handful of culture-inducing metaphors from Mr. Brabeck appear below.

Athletic shoes. One of the first profound expressions of aspiration to move Nestlé forward, with an enhanced sense of urgency from the culture which Mr. Brabeck first addressed, involved the metaphor of athletic shoes. Mr. Brabeck, a well-known technical mountain climber and sportsman, whose reputation preceded his arrival as chief executive officer, shaped his expressed goals for Nestlé’s culture around shoes. He said that he observed a culture that, upon his ascent to the chief executive officer suite, was lounging about in bedroom slippers. Recognizing how challenging it was to transform culture, he implored all Nestlé members to consider steps it would take for them to migrate up gradually into a more athletic orientation.

From bedroom slippers, to walking shoes, to running shoes, to racing shoes. From hiking shoes, to climbing shoes, to mountain climbing shoes, etc. The culture Mr. Brabeck inherited, he feared, was set with too slow a pace and his metaphors were intended to drive his firm to pick up the pace.

Why not Hershey? A second expression of Mr. Brabeck’s views on cultural awareness of the firm, over which he served as chief executive officer, involved an earlier reputed attempt by Nestlé to acquire US-based The Hershey Company. At the time, Mr. Brabeck had denied interest in the transaction even though the conference room, in which a meeting that I attended at the time, was filled upon my arrival with bowls overflowing with samplings of all of Hershey’s most iconic offerings. In any case, with such indicting confectionary removed from the room before other investors/analysts arrived for lunch, the questions arose from a young sell-side analyst as to “Why was Mr. Brabeck not willing to reach to acquire Hershey? Was it because he was too conservative and preferred to retain his AAA credit rating?” To which Mr. Brabeck’s following reply was instructive again of his ambition for Nestlé’s culture:

Mr. Brabeck responded with several points. First, he suggested that, since he had not indicated a position on the deal, he resented being told by a young analyst that he lacked daring by not being willing to risk his balance sheet to accomplish the acquisition. Mr. Brabeck replied that, as is so often the case, the young analyst thought it would be great to reach for the big deal, diminish Nestlé’s credit rating, and take on incremental financial risk that Mr. Brabeck preferred not to absorb. Second, Mr. Brabeck said that as a mountain climber, he recognized that the most difficult part of a climb was not the ascent, but rather the descent. The descent is where those who deplete their resources racing up the hill find that they run out of reserves and strength to navigate the decline. Mr. Brabeck suggested that the youthful analyst’s declaration that Mr. Brabeck was simply too cautious to take on the easy-to-close acquisition was akin to urging one to race up a mountaintop with reckless abandon, discarding needed clothing and fuel along the way to ascend in record time. So, too, did he wish Mr. Brabeck to abandon his AAA rating which he had, and needed, to reach

for a distant mountaintop that he neither needed nor likely could afford. Staying power to have a stronger tomorrow remains part of Nestlé’s culture today, even though analysts today, much like 25 years ago when Mr. Brabeck revealed his mindset for not racing after The Hershey Company, would prefer more action today even if risking tomorrow in doing so.

Route to market. Mr. Brabeck has long suggested that Nestlé will need to maintain flexibility regarding route to market. He excoriated British supermarkets in the 1980s and 1990s over their inexorable march towards ever greater space dedicated to private label. He warned them that consumer preference for branded varieties formed the core for healthy comparison shopping. He suggested that moves too far over to private label would end up pushing consumers away.

Fast-forward to today, e-commerce has assumed the disruptive role once played by private label and Mr. Brabeck and his colleagues today search for solutions through partnerships, joint ventures, etc. to continue to pursue non-traditional routes to markets for their products. Nespresso’s boutiques and cafes continue to roll out to capture such direct-to-consumer benefits. Similarly, partnerships with Alibaba Group in China and Amazon.com, Inc. point to Nestlé’s efforts to follow consumers where they shop.

Health, nutrition, and wellness. Nestlé’s pioneering work in health, nutrition, and wellness provides focus for all its business lines as they attempt to globally deliver, at accessible price points, socially responsible food and beverage offerings. Mr. Brabeck and the rest of Nestlé’s culture understands that a growing world and a growing urban world will massively stress traditional practices in sourcing and delivering protein efficiently in an increasingly resource-starved world. Nestlé bears expenses in the billions of dollars annually focused on innovations in product features, routes to market delivery technology, environmental impact of their food and beverage line-up, etc. Today, Nestlé bears such expenses for enhanced future returns, realizing only too well that businesses today operate only by the thinnest social permission to do so, which can be revoked in seconds if firms are viewed to fall short of their social responsibilities.

Nestlé experienced the pace of such challenges over the past several years when forced to respond to allegations, wholly undeserved it turns out, regarding its leading Maggi noodle soup staple of the Indian market. Allegations suggesting that Nestlé intentionally exposed consumers of Maggi’s products to avoidable, potentially lethal, product impurities sent Nestlé’s Indian market consumer trust scores from the high 90s (98 percent) to the high-single digits (approximately 8 percent). Nestlé bore over \$500 million in costs remediating their reputation for expenses incurred for claims wholly without merit in the first place. Nestlé and our other consumer products companies, who touch consumers in such daily ways, realize the responsibilities that they must bear at all times to respect and overdeliver on socially responsible standards their communities demand of them.

Nautical Mr. Brabeck. Three expressions over the years involving Mr. Brabeck’s observations about Nestlé’s businesses have surfaced through Mr. Brabeck’s love of the sea. One pair of such observations involved the America’s Cup boat on which Mr. Brabeck was privileged to crew during races years ago. I recall his view on the role of the chief executive

officer evolved as a result of that excursion.

When Mr. Brabeck asked his friend, on whose boat he sailed, why his friend did not intervene at all with the skipper who manned the wheel and exclusively sailed the race, his friend replied, “That’s easy ... even though I own the boat, the pilot is charged with sailing it. Rather than try to impose my views as owner on the pilot’s choices, I would prefer to let the pilot sail and replace him with another if I felt that he regularly made poor decisions.” Mr. Brabeck found the notion of accountability and ownership/involvement to be quite interesting. I do believe he felt that it had analogues in the relationships between chair (speaking on behalf of owners) and corporate chief executive officers. Second, Mr. Brabeck reflected on a sense of irony with pride when he observed that even though the racing boat’s spinnaker proclaimed allegiance to one of their corporate sponsors, illycaffè, down below deck, Nespresso was the coffee of choice!

Aircraft carrier to speedboats. Finally, Mr. Brabeck began, late in his tenure as board chair, to worry about the possibility of institutional sclerosis. He realized how difficult it was to turn a battleship set in motion and hence began to commend that the model of Nestlé ought to transform from big platforms, that felt as impregnable as battleships, to a flotilla of fast-moving, quick-to-strike speedboats covering the same ground but doing so with greater flexibility and agility.

Works right in practice, though terrible in theory. Mr. Brabeck voiced frequent discontent with Wall Street sell-side researchers (and, more recently, Wall Street activists) who for a long time have pressed on a single-minded drumbeat that Nestlé ought to be only in the business of operating companies and that large equity stakes in other public companies should have played no role in Nestlé’s future since, after all, investors themselves could easily invest added cash in those other businesses if they so desired, not needing, therefore, to have Nestlé tie up its balance sheet in such companies.

Mr. Brabeck’s response to such pleas over the years was “give me a break.” Both investments, L’Oréal and Alcon, were made for modest amounts (i.e., if my memory serves me correctly, no more than \$100 million in each case at the start) which had over the years grown in value to well over \$40 billion for each holding.

However, in a drumbeat of consensus opinions by analysts over the years, the dream of the ideal (i.e., “purely operating company, no public equity holding”) would have long served as the enemy of the good. The notion that businesses had to be solely operational and had to rid themselves of perfectly productive strategic holdings carried little weight with Mr. Brabeck. The businesses cumulatively added, I believe, nearly \$80 billion of value to Nestlé over the decades, an accomplishment for which there should be praise rather than demands for full divestiture of what remains.

Two hundred dinners at home per year. Finally, I learned more about Nestlé’s culture from listening to how Mr. Brabeck participated in Nestlé talent management. Mr. Brabeck suggested how important he took his task, as both chief executive officer and later as chairman, in determining plans for succession planning and career development. Mr. Brabeck suggested that he kept his list of potential candidates for “higher office” well

updated and ready to assist when change inevitably occurs. Mr. Brabeck suggested that he felt it to be part of his responsibility, as regularly as his travel schedule permitted, to visit with promising executives, ideally at their home, and ideally over dinner with the executives’ spouses.

While the thought of what I recall he said, about which in hindsight seems almost impossible, that he even attempted to have visits with the top 200 of his most promising reports annually, if possible, impressed me deeply. I was particularly impressed with what I recalled him saying that, whenever possible, he preferred to have such meetings at his colleague’s home, along with spouse, to be equally wise. After all, as a judge of character and capability, a visit to one’s house can be extremely revealing. While individuals can conceal stress indefinitely with the help of support staff at the office, if one is indeed beginning to reach the limits of his or her capacity, where it will likely most show up is in the home and on the faces of their spouses. One who is reaching limits of capacity can be revealed by the ease with which their spouse suggests the executive handles his time away from work. Moreover, the capacity-constrained executive, who seems to still manage smoothly affairs at work, may have a fairly disrupted home setting, which again could suggest that the individual, rather than having additional bandwidth for further responsibility, may have already begun to reach personal limits.

Whether or not the portion of Mr. Brabeck’s comments to me have withstood the passage of time or whether or not I embellish them into what I believe to have been a remarkable practice, I do find the notion of keeping under close scrutiny the list of skilled managers eligible for advancement, whose prior success placed them in running for higher office, to be illuminating.

Advancing up in the list, however, depends on whether Nestlé can independently verify if they had already reached the limits of their managerial bandwidth. Avoiding appointing someone in that later condition will avoid a host of other consequential damages that would inevitably arise when the limited bandwidth of that improperly advanced associate snaps.

Nestlé continues to invest organically to extend existing and already deep franchises in global food, health, and nutrition. Blessed with mature market free cash flows available for reinvestment, Nestlé’s corporate culture rewards management for their search to deliver more gain tomorrow even when such investments cause pain today. Nestlé’s culture continues to allow its management to invest behind roll-out of new products in existing geographies or behind roll-out of Nestlé into altogether new categories or geographies, even when doing so sharply burdens near-term profits. I believe Nestlé’s new chief executive officer plans to continue with the “Nestlé model” while adding enormous talent at setting and at rewarding management for meeting ambitious, long-term specific goals.