

## Equities

18 April 2012 | 28 pages

# Danone (DANO.PA)

## Superior Growth and Receding Risks; Upgrade to Buy

- **Superior EPS growth** — We forecast 2012-15 EPS CAGR of 12%; notably higher than the 9% that consensus expects for Nestlé and Unilever. Danone trades on 14.8x 2013E P/E, a discount to Nestlé and in-line with Unilever, which we view as an opportunity because we expect newsflow in 2H12 to alleviate the market's lingering concerns over US Dairy and Unimilk, as well as the potential divestment of Pfizer Nutrition. Danone is one of only 3 stocks in Europe that meets all of our Equity strategists' 'defensive growth' criteria. Combined with improving fundamentals we upgrade to Buy and make Danone our Most Preferred name in the Food sector.
- **Conservative guidance, downside risks priced in** — Guidance for 2012 margins to be flat looks conservative. Factoring in cost savings and raw material inflation, our analysis suggests Danone could have 55bps of surplus margin to potentially reinvest in A&P which could be increased 14% while still holding margin flat. Recent commentary around softness in Southern Europe means our previous concerns around Western European volumes are probably now priced in.
- **US and Russia should accelerate through 2012** — We expect a sequential improvement in Unimilk sales trends now that volumes have stabilized, and forecast mid-single digit sales growth by 2Q12. Double digit growth looks achievable in 2013. Increasing confidence that Danone is delivering in its largest market should support a re-rating. In the US, additional capacity from June should enable the company to rebalance its portfolio to fully capture the growth opportunity in Greek yoghurt, and we forecast a return to double digit growth in FY13. We have raised our estimates to reflect a more robust outlook for Unimilk/US dairy. Our target price increases to €62 as we move to P/E based valuation from DCF to ensure consistency of valuation approach across our European consumer staples coverage universe.
- **Free option from Souvenaid** — Nutricia is currently discussing the profile of its Souvenaid product for Alzheimer's disease with the medical community, and a country-by-country launch is expected towards the end of 2012. We believe consensus forecasts do not reflect the potential opportunity for this product, and we view it as a 'free option' in a market that could be worth up to €1bn.

### Danone (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (€M)	17,010.1	19,317.7	20,949.4	22,408.4	23,976.3
Net Income (€M)	1,669.0	1,748.7	1,930.5	2,165.3	2,426.2
Diluted EPS (€)	2.71	2.89	3.20	3.58	4.02
Diluted EPS (Old) (€)	2.71	2.89	3.13	3.49	3.92
PE (x)	19.5	18.3	16.5	14.8	13.2
EV/EBITDA (x)	12.0	11.1	9.8	8.7	7.7
DPS (€)	1.30	1.39	1.53	1.67	1.81
Net Div Yield (%)	2.5	2.6	2.9	3.2	3.4

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

<b>Buy</b>	<b>1</b>
<i>from Neutral</i>	
Price (17 Apr 12)	€52.88
Target price	€62.00
<i>from €48.00</i>	
Expected share price return	17.2%
Expected dividend yield	2.9%
<b>Expected total return</b>	<b>20.1%</b>
Market Cap	€32,203M
	US\$42,312M

### Price Performance (RIC: DANO.PA, BB: BN FP)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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**Danone (DANO.PA)**

18 April 2012

DANO.PA: Fiscal year end 31-Dec						Price: €52.88; TP: €62.00; Market Cap: €32,203m; Recomm: Buy					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	17,010	19,318	20,949	22,408	23,976	PE (x)	19.5	18.3	16.5	14.8	13.2
Cost of sales	-7,701	-9,111	-9,881	-10,569	-11,308	PB (x)	2.7	2.6	2.5	2.3	2.2
Gross profit	9,310	10,207	11,069	11,839	12,668	EV/EBITDA (x)	12.0	11.1	9.8	8.7	7.7
Gross Margin (%)	54.7	52.8	52.8	52.8	52.8	FCF yield (%)	5.0	5.3	6.3	6.2	7.7
<b>EBITDA</b>	<b>3,172</b>	<b>3,486</b>	<b>3,795</b>	<b>4,130</b>	<b>4,492</b>	Dividend yield (%)	2.5	2.6	2.9	3.2	3.4
EBITDA Margin (%)	18.6	18.0	18.1	18.4	18.7	Payout ratio (%)	48	48	48	47	45
Depreciation	-545	-583	-642	-701	-763	ROE (%)	14.8	13.9	15.1	16.0	16.8
Amortisation	-49	-60	-60	-60	-60	<b>Cashflow (€m)</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>
<b>EBIT</b>	<b>2,578</b>	<b>2,843</b>	<b>3,093</b>	<b>3,369</b>	<b>3,669</b>	EBITDA	3,172	3,486	3,795	4,130	4,492
EBIT Margin (%)	15.2	14.7	14.8	15.0	15.3	Working capital	77	9	81	-205	-68
Net interest	-9	-294	-259	-221	-151	Other	-773	-934	-954	-1,010	-1,010
Associates	121	46	61	65	70	<b>Operating cashflow</b>	<b>2,476</b>	<b>2,561</b>	<b>2,922</b>	<b>2,915</b>	<b>3,414</b>
Non-op/Except	-80	-114	-50	-40	-20	Capex	-832	-869	-901	-919	-959
<b>Pre-tax profit</b>	<b>2,610</b>	<b>2,481</b>	<b>2,845</b>	<b>3,173</b>	<b>3,569</b>	Net acq/disposals	279	92	0	0	0
Tax	-576	-626	-752	-819	-915	Other	1	0	0	0	0
Extraord./Min.Int./Pref.div.	-164	-184	-213	-229	-248	<b>Investing cashflow</b>	<b>-552</b>	<b>-777</b>	<b>-901</b>	<b>-919</b>	<b>-959</b>
<b>Reported net profit</b>	<b>1,870</b>	<b>1,671</b>	<b>1,880</b>	<b>2,125</b>	<b>2,406</b>	Dividends paid	-737	-815	-890	-964	-1,044
Net Margin (%)	11.0	8.6	9.0	9.5	10.0	<b>Financing cashflow</b>	<b>-1,586</b>	<b>-1,315</b>	<b>-890</b>	<b>-964</b>	<b>-1,044</b>
Core NPAT	1,669	1,749	1,930	2,165	2,426	<b>Net change in cash</b>	<b>410</b>	<b>469</b>	<b>1,130</b>	<b>1,032</b>	<b>1,411</b>
<b>Per share data</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>	<b>Free cashflow to s/holders</b>	<b>1,644</b>	<b>1,692</b>	<b>2,021</b>	<b>1,996</b>	<b>2,455</b>
Reported EPS (€)	3.04	2.77	3.11	3.52	3.98						
Core EPS (€)	2.71	2.89	3.20	3.58	4.02						
DPS (€)	1.30	1.39	1.53	1.67	1.81						
CFPS (€)	4.02	4.24	4.84	4.83	5.65						
FCFPS (€)	2.67	2.80	3.35	3.30	4.06						
BVPS (€)	19.51	20.07	21.30	22.78	24.54						
Wtd avg ord shares (m)	614	604	604	604	604						
Wtd avg diluted shares (m)	616	604	604	604	604						
<b>Growth rates</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>						
Sales revenue (%)	13.5	13.6	8.4	7.0	7.0						
EBIT (%)	12.4	10.3	8.8	8.9	8.9						
Core NPAT (%)	18.2	4.8	10.4	12.2	12.1						
Core EPS (%)	5.3	6.8	10.4	12.2	12.1						
<b>Balance Sheet (€m)</b>	<b>2010</b>	<b>2011</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>						
Cash & cash equiv.	1,098	1,098	1,098	1,098	1,098						
Accounts receivables	2,692	3,508	3,718	4,161	4,485						
Inventory	975	1,148	1,218	1,303	1,394						
Net fixed & other tangibles	4,604	4,846	5,062	5,280	5,477						
Goodwill & intangibles	16,106	16,046	15,986	15,926	15,866						
Financial & other assets	1,394	1,394	1,394	1,394	1,394						
<b>Total assets</b>	<b>26,869</b>	<b>28,041</b>	<b>28,477</b>	<b>29,162</b>	<b>29,714</b>						
Accounts payable	2,637	3,070	3,330	3,562	3,811						
Short-term debt	1,702	1,702	1,702	1,702	1,702						
Long-term debt	6,470	6,267	5,136	4,104	2,693						
Provisions & other liab	3,854	4,465	4,818	5,185	5,584						
<b>Total liabilities</b>	<b>14,664</b>	<b>15,504</b>	<b>14,986</b>	<b>14,553</b>	<b>13,790</b>						
Shareholders' equity	11,987	12,120	12,862	13,752	14,819						
Minority interests	218	416	629	858	1,105						
<b>Total equity</b>	<b>12,205</b>	<b>12,536</b>	<b>13,491</b>	<b>14,610</b>	<b>15,924</b>						
<b>Net debt</b>	<b>7,074</b>	<b>6,871</b>	<b>5,740</b>	<b>4,708</b>	<b>3,297</b>						
Net debt to equity (%)	58.0	54.8	42.6	32.2	20.7						

For further data queries on Citi's full coverage universe please contact CIRA Data Services Europe at CIRADataServicesEMEA@citi.com or +44-207-986-4050  
For definitions of the items in this table, please click [here](#).



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Danone one of only three stocks in Europe that meet all of CIRA's Equity strategists' 'defensive growth' criteria

Increasing confidence on delivery in Russia should support re-rating

Catching up in Greek yoghurt in the US, growth to accelerate in 2H12

# Superior Growth and Receding Risks Should Drive Re-rating

## Better EPS growth and cheaper valuation than peers plus strong defensive growth credentials

We forecast Danone to deliver 12% EPS CAGR over the next 3 years. This is more than the 9% consensus expects for Nestlé and Unilever, yet Danone trades at a discount to Nestlé and in-line with Unilever. In our view Danone's multiple is currently compressed by the market's lingering concerns over Unimilk, US Dairy and the potential acquisition of Pfizer Nutrition. We believe that positive newsflow during 2012 will be supportive on all 3 of these issues and lead the stock to re-rate. Danone is one of only 3 stocks in Europe that meets all of our Equity strategists' 'defensive growth' criteria, which combined with improving fundamentals in key markets, sees us upgrade to Buy and make the stock our Most Preferred name in the Food sector.

## Margin guidance conservative and earnings risks now priced in

Company guidance for margin to be flat in 2012 appears conservative. Our cost base analysis indicates that Danone could have around 55bps of surplus margin to invest in A&P (equivalent to 14% growth) and still deliver a flat margin this year. We also believe that the potential earnings risks for the stock are now priced in following management's recent comments around softness in Southern European markets.

## Unimilk set to accelerate from 2Q12

Following the acquisition of Unimilk in 2010, Russia is now Danone's largest market at 11% of group sales. 2011 saw Unimilk volumes decline by 9% as Danone aggressively rationalized SKUs and price increases of 13% weighed on consumer demand. Now that now volumes have stabilized, improved mix should lead to mid-high single digit growth from 2Q12 onwards and the targeted double-digit growth looks achievable in 2013. Increasing confidence that Danone is delivering in its largest market should support re-rating.

## US portfolio being rebalanced to reverse underperformance

In US Dairy Danone has been caught flat footed by the explosion in the growth of Greek yoghurt over the last 2 years. Following the relaunch of the Oikos brand in 3Q11 Greek yoghurt is now 20% of Danone's portfolio. If current market trends persist through 2012 than we expect Greek yoghurt to be over 25% of the portfolio by the end of the year, and over 30% by the end of 2013, which should rebalance Danone's exposure to the key growth opportunity in the market. We forecast 8% growth in US Dairy in 2012 as capacity expansion accelerates growth in the second half of the year and 12% growth in 2013. For a detailed analysis of the dynamics of the US Greek Yoghurt market please see the recent report from Citi's US Food analyst, David Driscoll, [U.S. Yogurt Deep Dive—Greek Yogurt Takes Center Stage; General Mills Lags](#).

## Acquisition risk receding?

In our 6 January note [Chinese Baby Boom for Danone not Nestlé?](#) we concluded that Danone could be a more likely potential buyer of Pfizer Nutrition than Nestlé due to Danone's relatively limited EM expansion opportunities, historically aggressive acquisition strategy and possibility of a clear market leadership position in the lucrative Chinese Infant formula market. Recent commentary has suggested that in fact Nestlé is probably the clear front-runner, likely due to its significantly greater balance sheet firepower and Pfizer's probable preference for a single bidder (there had been suggestions that Danone would bid jointly with Mead Johnson). Pfizer expects to announce the disposal/spin-off strategy for its Nutrition business in 2H12/1H13 and either a spin-off or an acquisition by Nestlé could remove concerns

around Danone potentially overpaying for the asset and stretching its balance sheet/issuing equity to fund the deal.

### Multiple should expand to reflect long-term growth prospects

Amongst the best organic revenue and EPS growth in consumer staples but trading at a discount

Longer-term we still expect Danone to deliver organic growth of 7%, supported by its exposure to the highly attractive Baby and Medical Nutrition categories, the Emerging market bias of its Water business and per capita consumption expansion opportunities for the Dairy business in the US and Russia. This organic growth is one of the strongest in consumer staples and we expect the valuation discount to peers with a similar growth profile to close over the next 12 months.

Our target price of €62 assumes that in 12 months time the shares will be trading at c.17x forward, a modest premium to 16x currently and 5% above the 5 year average. However in 12 months time this would be based on our 2013 EPS estimate of €3.58. We believe that this multiple is justified on the basis that Danone should trade at a modest premium to the broader European consumer staples given its superior EPS growth of 12% versus the peer group of 9%. We have moved from using DCF to a P/E based valuation in order to ensure consistency across our European consumer staples coverage universe.

Figure 1. European Consumer Staples P/E Valuations

	Rating	Price	2011	2012E	2013E	2014E	2015E	12-15E CAGR	PEG ('13E P/E)
AB Foods	2	£ 12.09	16.3	14.4	13.0	11.5	10.5	11.2%	1.2
Danone	1	€ 52.34	18.3	16.5	14.8	13.2	11.8	12.0%	1.2
Nestle	2	SFr 56.5	18.4	16.9	15.7	14.7	13.8	9.0%	1.7
Unilever	2	€ 25.17	17.9	16.0	14.8	13.7	12.9	8.0%	1.9
<b>EU Food Average</b>			<b>18.2</b>	<b>16.6</b>	<b>15.3</b>	<b>14.2</b>	<b>13.2</b>	<b>8.0%</b>	<b>1.9</b>
Beiersdorf	3	€ 49.59	26.5	24.2	22.3	20.3	18.5	9.3%	2.4
Henkel	2	€ 54.8	17.6	15.6	14.4	13.3	12.3	8.1%	1.8
Reckitt Benckiser	2	€ 92.71	14.5	15.3	14.4	13.4	12.4	7.2%	2.0
L'Oreal	1	£ 35.83	21.5	19.8	18.3	16.9	15.9	7.7%	2.4
<b>EU HPC Average</b>			<b>19.7</b>	<b>18.6</b>	<b>17.3</b>	<b>16.0</b>	<b>14.9</b>	<b>7.8%</b>	<b>2.2</b>
AB Inbev	1	€ 55.41	19.1	16.1	14.6	12.9	11.6	11.6%	1.3
Carlsberg	2	DKr 460.4	13.5	12.3	10.7	9.9	9.2	10.2%	1.0
Diageo	2	£ 15.48	17.7	16.1	14.6	13.3	12.1	10.0%	1.5
Heinken	2	€ 41.98	15.5	15.8	14.6	12.8	11.5	11.2%	1.3
Pernod-Ricard	1	€ 76.95	17.9	16.3	14.4	12.5	10.9	14.4%	1.0
SAB Miller	1	£ 25.65	20.2	17.2	15.3	13.6	12.1	12.4%	1.2
<b>EU Beverages Average</b>			<b>18.4</b>	<b>16.2</b>	<b>14.6</b>	<b>13.0</b>	<b>11.6</b>	<b>11.6%</b>	<b>1.3</b>
BAT	2	£ 31.48	16.2	14.7	13.2	12.1	11.0	10.2%	1.3
Imperial	1	£ 24.74	13.0	12.1	11.1	10.2	9.4	8.8%	1.3
Swedish Match	1	SKr 271.7	22.2	18.3	16.5	14.9	13.5	10.7%	1.5
<b>EU Tobacco Average</b>			<b>15.7</b>	<b>14.2</b>	<b>12.9</b>	<b>11.7</b>	<b>10.7</b>	<b>9.9%</b>	<b>1.3</b>
<b>EU Staples Average</b>			<b>18.1</b>	<b>16.4</b>	<b>15.0</b>	<b>13.7</b>	<b>12.5</b>	<b>9.4%</b>	<b>1.6</b>

Source: Citi Investment Research and Analysis

## Eating Cake – Danone screens strongly on our Equity Strategists' Metrics

Our European Equity Strategists continue to advocate owning defensive growth and are Overweight the Food & Beverage sector. In their 29 March note [European Portfolio Strategist - UK/Pan-European — Eating Cake](#) they suggest that investors who pursue a 'defensive growth' strategy can "have their cake and eat it" through picking stocks that offer 1) low earnings volatility, 2) earnings outperformance during earnings recessions and 3) strong forecast earnings growth.

Danone is one of only 3 stocks in Europe with a market capitalization of greater than €10bn that meet all of the 'defensive growth' criteria which are;

- At least 8% forecast EPS 2 year compound growth.
- Companies whose earnings fell by less than half the market fall in each recession back to 2002-3.
- Net debt/EBITDA of less than 2x.
- No dividend cut since 2001 and dividend growth ahead of the market over the next 2 years.

Danone has re-rated along with rest of the consumer staples universe over the last 6 months and is still trading slightly below its 5 year average forward P/E. Our strategists consider this to be part of a structural re-rating of defensive growth which they expect to continue over the medium term.

**Figure 2. Danone Consensus 12m Forward Consensus P/E**



Source: Citi Investment Research and Analysis, Datastream

## 2012 Margin Guidance looks Conservative, Earnings Risks Priced In

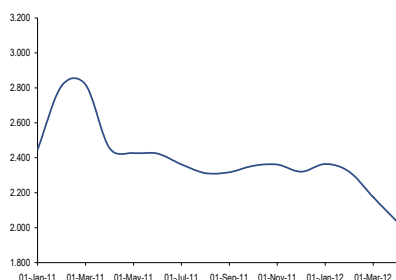
Prior to FY11 results in February we (and consensus) had forecast a 20bps improvement in trading margin in 2012. Guidance is for a stable trading margin because Danone has decided to reinvest any benefits from easing raw material inflation in the business through A&P, the sales force or R&D spend.

Figure 3. FY12 Gross margin

	€m	Margin Impact
Cost savings	500	+255
Raw material inflation	386	-200
Net	114	+55

Source: Citi Investment Research and Analysis

Figure 4. Western and Eastern Europe Skimmed Milk Powder Price



Source: Citi Investment Research and Analysis, USDA

In Figure 3 we assume that Danone's expected FY12 cost savings of ~€500m more than offset the expected mid-single digit raw material inflation and provides a theoretical gross margin benefit of 55bps. In Figure 5 we illustrate that if this 55bps of benefit was reinvested in A&P then this would imply a potential 14% growth in A&P should Danone fully reinvest. We don't expect A&P to grow 14% in FY12 as we believe high single digit growth would seem more realistic given management's comments at FY11 results around the total 'fuel' for the business growing in line with the sales of the company. This is consistent with our assumption of 5bps of margin progression.

Whilst this analysis is somewhat simplified in that it does not take into account the impact of leverage and mix in estimating gross margin, nevertheless we think it is indicative the level of reinvestment that Danone has chosen to pursue in FY12, particularly given our assumption that 'Other S,G&A' and General Admin costs grew in line with sales growth, which is conservative in our view.

Although we have not incorporated the potential impact of leverage and mix here, we would highlight that in FY11 operating leverage provided 90bps of margin tailwind, with pricing and mix contributing 110bps. On a like-for-like basis Unimilk contributed 20bps to group margin improvement and we would expect a similar contribution in FY12 given management's guidance for ~100bps of margin improvement. Directionally we would expect the lower organic growth of Waters (+8.7% organic growth vs. +15.7% in FY11) to provide a mix benefit to margin given the lower profitability of this division. This should in turn be supported by further operating leverage as our forecast of group volume growth of 3.1% is similar to the 3.0% in FY11.

Figure 5. Illustrative FY12 Margin Mix

	2011	2012	Growth
Sales	19,318	20,949	8.4%
Gross margin	52.8%	53.4%	55 bp
SGA	(5,238)	(5,795)	10.6%
S,G&A ex A&P	(3,255)	(3,530)	8.4%
A&P	(1,982)	(2,265)	14.2%
General Admin	(1,658)	(1,798)	8.4%
R&D	(261)	(283)	8.4%
Other	(208)	(225)	8.4%
<b>% Sales</b>	<b>2011</b>	<b>2012</b>	
SGA	27.1%	27.7%	55 bp
S,G&A ex A&P	16.9%	16.9%	0 bp
A&P	10.3%	10.8%	55 bp
General Admin	8.6%	8.6%	0 bp
R&D	1.4%	1.4%	0 bp
Other	1.1%	1.1%	0 bp
Trading margin	14.72%	14.72%	0 bp

Source: Company Reports, Citi Investment Research and Analysis

### Earnings Risks now Priced In

At the beginning of 2012 we had been concerned about the potential for weakness in Western European volumes to be a risk for earnings across the Food sector. Danone has relatively the greatest exposure within the group to Western Europe at 38% of group sales.

We now believe that this risk is largely priced into the stock following management's comments at the CAGE conference on 21 March indicating that the difficult trading environment in Southern Europe meant that the middle of the FY12 organic growth guidance range was the most likely outcome. In addition at 1Q12 results the company commented that performance across Western Europe was broadly in-line with their expectations at the start of the year, despite the weak performance of Spain (7% group) which probably declined mid-single digits in 1Q12.

Assuming Western European Dairy organic growth is 0% in 2012 (UK and France offsetting Southern Europe) then we still view our forecast of 4.2%, which is in line with consensus, to be reasonable.

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**Figure 6. 2012 Dairy organic growth assumptions**

	<b>% Sales</b>	<b>Assumed growth</b>
W.Europe	35%	0%
E.Europe	25%	4%
North America	15%	8%
Latin America	15%	10%
ROW	10%	5%
<b>Total</b>	<b>100%</b>	<b>4.2%</b>

Source: Citi Investment Research and Analysis

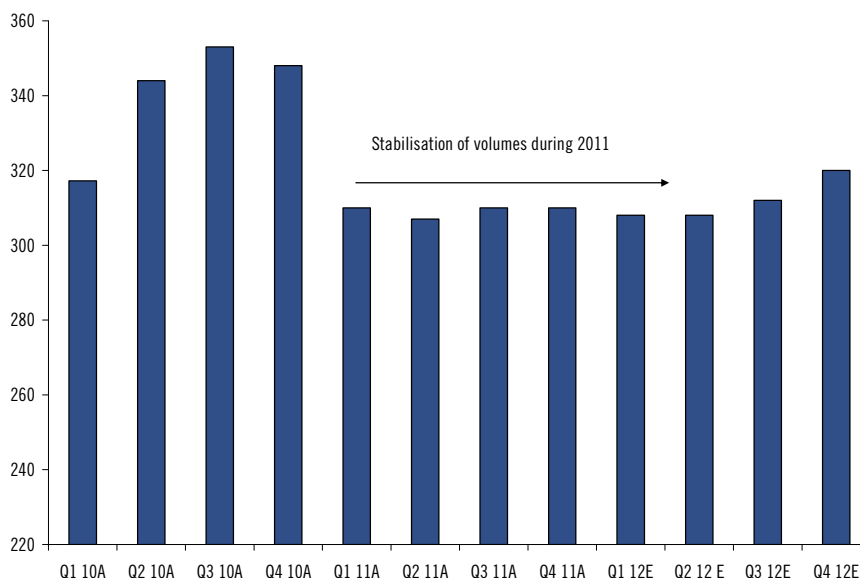
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## Unimilk set to accelerate from Q2

Following the acquisition of Unimilk in 2010 the restructuring of its portfolio was hampered by soaring milk prices due to a drought in Russia which forced significant price increases. This exacerbated the volume declines caused by Danone's rationalization of SKUs within the Unimilk portfolio.

Figure 7. Unimilk Volumes



Source: Citi Investment Research and Analysis, Company reports

As can be seen in Figure 7, Unimilk volumes have now stabilized and from 2Q12 we expect the improvement in mix to generate mid-single digit sales growth from 2Q12 as the gradual improvement in Rubles per kg seen through 2011 is carried forward, see Figure 8. 1Q12 showed encouraging signs as volume growth turned positive and management indicated that the base level of growth from 1H12 should be mid-single digits, which is consistent with our forecast of 5%.

Figure 8. Unimilk Model

	FY10A	Q1 11A	Q2 11A	Q3 11A	Q4 11A	FY11A	Q1 12A	Q2 12 E	Q3 12E	Q4 12E	FY12E	FY13E	FY14E
Volume (ktons)	1,362	310.0	307.0	310.0	310.0	1237.0	312.0	312.0	312.0	320.0	1,256	1,295	1,340
Volume growth		-2.3%	-10.8%	-12.2%	-10.9%	-9.2%	0.5%	1.6%	0.6%	3.2%	1.5%	3.1%	3.5%
RUB per kg	38.20	43.62	41.80	41.35	45.75	43.13	44.5	44.5	44.5	47.0	45.13	48.00	51.00
Price/mix growth		17.6%	17.1%	11.5%	6.6%	12.9%	2.0%	6.5%	7.6%	2.7%	4.6%	6.4%	6.3%
Sales (KRUB)	52,076	13,522	12,833	12,819	14,183	53,356	13,884	13,884	13,884	15,040	56,692	62,180	68,355
growth		14.9%	4.5%	-2.1%	-5.0%	3.6%	2.7%	8.2%	8.3%	6.0%	6.3%	9.7%	9.9%
Quarterly sales (EUR m)	1,293	338	318	311	337	1,305	351	359	359	389	1,458	1,605	1,765
EURRUB	40.28	40.03	40.30	41.21	42.05	40.89	39.57	38.68	38.68	38.68	38.90	38.68	38.68

Source: Citi Investment Research and Analysis, Company reports

The improvement in mix should also facilitate improvement in Unimilk's margin. Guidance is currently for ~100bps of improvement in 2012. We believe that Unimilk should be able to achieve management's targeted margin of 10-11% given that we estimate gross margins in 2010/11 to be around 25% which should be able to be substantially improved through the shift in mix.

**Growth in Modern Brands should drive favourable mix**

Figure 9 illustrates our estimates for how Unimilk's mix shifted during 2011. Traditional brands with an average price index of 82 declined in volume terms by -18% we estimate, which led to an overall decline in volumes of -9%. In 2012 we expect that the volume growth of Modern brands and Baby/Kids should provide a favourable mix impact given their price index is substantially above traditional brands.

**Figure 9. Unimilk Categories**

	Price Index	FY11 Volume		Sales		
		% Weight	% Growth	% Growth	2011 Sales €m	2012 Sales Growth
Modern Brands	104	55%	-6%	5%	744	7%
Traditional Brands	82	40%	-18%	-7%	431	-2%
Baby/Kids	188	5%	35%	35%	117	35%
<b>Unimilk</b>	<b>100</b>	<b>100%</b>	<b>-9%</b>	<b>4%</b>	<b>1,305</b>	<b>6.2%</b>

Source: Citi Investment Research and Analysis, Company reports

**Double digit growth forecast in FY13**

We expect 6% organic growth in FY12 followed by 10% in 2013/14 as volume growth returns through Danone leveraging Unimilk's distribution platform.

**Figure 10. Unimilk Organic Growth Forecasts**

	FY10A	FY11A	FY12E	FY13E	FY14E
Sales (EUR m)	1,293	1,305	1,448	1,605	1,765
Volume	9%	-9.2%	1.5%	3.1%	3.5%
Price	15%	12.9%	4.6%	6.4%	6.3%
Organic Growth	24%	3.6%	6.2%	9.7%	9.9%

Source: Citi Investment Research and Analysis, Company reports

## Long-term opportunity intact

While the smooth integration of Unimilk's portfolio was compromised by volatile milk prices, the longer-term attractions of the acquisition remain intact. These include;

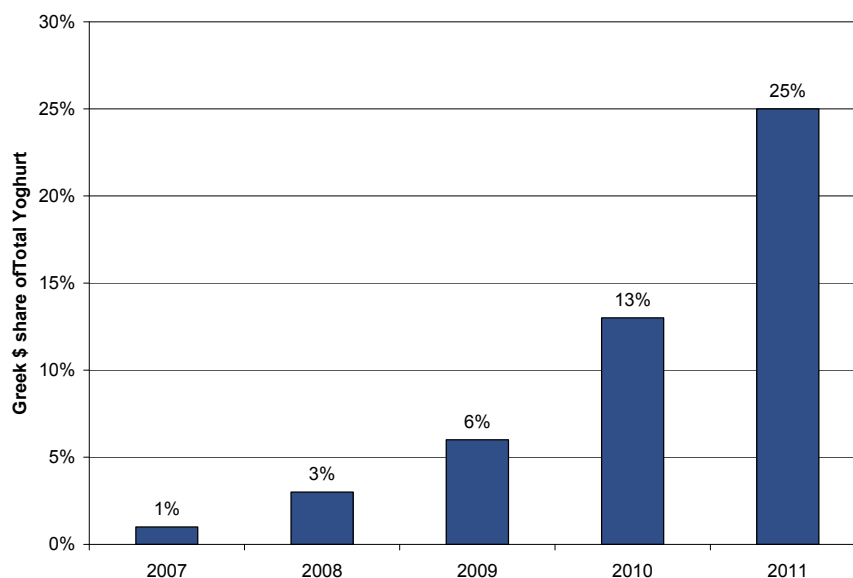
- White space expansion opportunities for Danone in the east of Russia.
- Increased opportunity to develop the category in Russia. Per capita consumption is around 2 cups per week compared to European markets where consumption ranges from 3-7 cups per week.
- Greater penetration for Danone in traditional retail outlets.

## Playing Catch-Up in US Greek Yoghurt

*"I was really angry about the situation a few months ago (now) I start to smile again about our situation in the US":*  
Danone CEO, Franck Riboud, FY11 Earnings Call February 2011

The growth of Greek Yoghurt in the US has been remarkable and fuelled by US consumers' demand for yoghurt that is high in protein and low in fat. The supercharged growth of the category caught Danone and General Mills by surprise and has been initially driven by the market-leading brand, Chobani, which has over 50% share of the Greek segment in the US. Overall yoghurt category growth has almost entirely been driven by the expansion of Greek yoghurt from less than a \$100m in 2008 to over \$1bn in 2011. It now constitutes around 25% of the overall market in the US.

Figure 11. Greek Dollar Share of Total Yoghurt



Source: Nielsen, Citi Investment Research and Analysis (David Driscoll, Citi's US Food Analyst)

**Danone gradually taking market share in Greek yoghurt**

Following the relaunch of its Greek offering under the Oikos brand in July 2011, Danone is now trying to fully capture the opportunity in the US and currently has approximately 20% share compared with its overall yoghurt category share of 32% according to IRI. While it is still underweight the Greek segment, this should be improved by the planned manufacturing capacity expansion by June 2012. We estimate that the expansion is likely to double Danone's internal Greek capacity, which is currently around a third of its total capacity (two-thirds of capacity is from co-packers). The doubling of internal capacity should result in a 17% increase in manufacturing capacity which will facilitate sales acceleration from July onwards.

**Portfolio should be rebalanced by 2013**

The acceleration of Danone's Greek product should mean that current US growth of mid-single digits can accelerate to double digit growth in the second half of the year resulting in FY12 growth of 8%, accelerating to 12% in FY13. We estimate that by the end of 2012 Greek yoghurt should be over 25% of Danone's US yoghurt portfolio and over 30% by the end of 2013.

In the near term we don't expect any changes to the market dynamic of Greek yoghurt cannibalizing the growth of Core brands, however the manufacturing expansion should reduce Danone's relative disadvantage. Longer term we would expect some pricing pressure within the Greek segment as Danone, Chobani, General Mills and Fage all compete for share in this highly attractive category (Greek yoghurt is priced at ~100% premium to traditional brands).

**Figure 12. US Yoghurt Market Forecasts (\$m)**

	2011	2012	2013
<b>Market split</b>			
Non -Greek	75%	67%	62%
Greek	25%	33%	38%
Total	100%	100%	100%
<b>Market size \$m</b>			
Non -Greek	3,131	2,943	2,825
Greek	1,040	1,456	1,747
Total	4,171	4,399	4,573
<b>Market growth</b>			
Non -Greek	-6%	-6%	-4%
Greek	112%	40%	20%
Total	9.8%	5.5%	3.9%
<b>Danone share</b>			
Non -Greek	35%	35%	35%
Greek	14%	22%	30%
Total	30%	31%	33%
<b>Danone sales (\$m)</b>			
Non -Greek	1,106	1,030	989
Greek	146	320	524
Total	1,251	1,350	1,513
Growth	4.0%	7.9%	12.0%

Source: Nielsen, Citi Investment Research and Analysis (David Driscoll, Citi's US Food Analyst)

## Souvenaid Upside a Potential Wildcard, We estimate a potential market of €1bn

Souvenaid is a medical food being developed by Danone's healthcare division, Nutricia. The product is a multi-nutrient drink designed to improve cognitive function and is being investigated for its potential use in treating early-stage Alzheimer's disease (AD). The product contains a patented mixture of nutrients called 'Fortasyn Connect' which are designed to stimulate the formation of nerve connections called synapses. The loss of synapses is postulated to be an underlying cause of memory loss and cognitive function in AD.

Nutricia presented data from the 1<sup>st</sup> clinical trial in July 2008 at the International Congress on Alzheimer's Disease (ICAD) in Chicago. This proof of concept study showed that 40% of patients randomly assigned to receive Souvenaid experienced improvements in verbal memory versus 25% taking a control drink.

Following this Nutricia initiated 3 further clinical trials of the product; a US study 'S-Connect', and 2 European studies 'Souvenir II' and 'LipiDiDiet' each involving 500 patients. The results from Souvenir II were presented at CTAD in November 2011 which confirmed positive results. The 'S-Connect' trial did not demonstrate positive results as patients within the trial had more severe AD and were already receiving existing AD treatments.

### Launch by end of 2012

Nutricia is currently in discussions with the scientific and medical community to determine the most effective and appropriate use for Souvenaid. Much will depend upon the ongoing analysis of electroencephalogram (EEG) confirmation of brain changes which would indicate the extent of biological efficacy. The product is expected to be launched on a country-by-country basis towards the end of 2012.

### More likely to be used in prevention,

We expect that Souvenaid is likely to be deemed to have most appropriate use in patients with mild cognitive impairment and to be used as a preventative product. The potential market for the product is very large given the number of Alzheimer's patients globally (US/EU population estimated at 12m) and the lack of efficacious drugs available on the market. However the challenge for Nutricia will be in convincing the medical community of the product's benefits given that it will need to be prescribed. AD drug development has been a notorious area of failure for the pharmaceutical industry over the years and there is considerable skepticism towards the potential for new products to work in the area. We note that Citi's US Pharmaceutical analyst, John Boris, assigns a <10% success probability for Lilly's solanezumab in AD and excludes any contribution for Pfizer's bapineuzumab in his forecasts.

**Estimated market potential of €1bn**

In Figure 13 we attempt to provide a sense of the potential market opportunity for Souvenaid through identifying the estimated number of patients with mild AD in the US and EU and assuming a treatment cost of €2 per day. This indicates a potential market of ~€1bn and assuming a 20% penetration of the product, sales in the region of €200m. We don't believe that the potential opportunity for Souvenaid is currently reflected in consensus forecasts and although clearly high risk, we think that this is almost a 'free option'.

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**Figure 13. Souvenaid Market Opportunity**

US/EU Alzheimer's Population	12,000,000
Percentage of Patients with Mild AD	45%
Mild AD Population	5,400,000
Mild AD Diagnosis rate	25%
Diagnosed population (m)	1,350,000
Souvenaid cost per annum (€)	730
Potential market (€m)	986
Assume Souvenaid achieves 20% penetration (€m)	197

Source: Citi Investment Research and Analysis, Alzheimer's Disease International

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## Risk of Pfizer Nutrition Acquisition Receding?

In our 6 January note [Chinese Baby Boom for Danone not Nestlé?](#) we concluded that Danone could be a more likely potential buyer of Pfizer Nutrition than Nestlé due to Danone's relatively limited EM expansion opportunities, historically aggressive acquisition strategy and the acquisition providing a clear market leadership position in the lucrative Chinese Infant formula market.

### Nestlé appears to be the front runner

Recent commentary has suggested that Nestlé is more likely to be the clear front-runner (Reuters March 2), probably due to its significantly greater balance sheet firepower and Pfizer's probable preference for a single bidder (there had been suggestions that Danone would bid jointly with Mead Johnson). Danone's management has also reiterated its commitment to maintaining its current A- credit rating in recent conference calls. This suggests that the balance sheet would not be stretched to over 3x net debt/EBITDA which we estimate would be necessary to fund an acquisition of 70% of the business (assuming 30% disposal due to anti-trust issues).

### Expect news flow from 2H12 onwards

Pfizer expects to announce the disposal/spin-off strategy for its Nutrition business in 2H12/1H13 and either a spin-off or an acquisition by Nestlé could remove lingering concerns around Danone potentially overpaying for the asset and stretching its balance sheet/issuing equity to fund the deal.

## Forecasts

Figure 14. Danone Divisional Organic Growth Forecasts FY12

	Q1 2012	Q2 2012E	H1 2012E	Q3 2012E	Q4 2012E	H2 2012E	FY 2012E
<b>Dairy</b>							
Volume	-0.1%	1.0%	0.4%	2.0%	3.0%	2.5%	1.5%
Pricing	3.9%	3.0%	3.5%	2.0%	2.0%	2.0%	2.7%
Organic growth	3.8%	4.0%	3.9%	4.0%	5.0%	4.5%	4.2%
<b>Waters</b>							
Volume	7.7%	3.7%	5.4%	3.7%	3.0%	3.4%	4.4%
Pricing	8.7%	2.0%	4.9%	5.0%	2.0%	3.6%	4.3%
Organic growth	16.4%	5.7%	10.3%	8.7%	5.0%	6.9%	8.7%
<b>Baby Nutrition</b>							
Volume	3.8%	5.0%	4.4%	6.0%	6.0%	6.0%	5.2%
Pricing	5.2%	4.0%	4.6%	3.0%	3.0%	3.0%	3.8%
Organic growth	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
<b>Medical Nutrition</b>							
Volume	7.1%	9.0%	8.1%	9.0%	7.0%	8.0%	8.0%
Pricing	-0.7%	-0.5%	-0.6%	-0.5%	-0.5%	-0.5%	-0.5%
Organic growth	6.4%	8.5%	7.5%	8.5%	6.5%	7.5%	7.5%
<b>Total Group</b>							
Volume	2.2%	2.7%	2.5%	3.5%	3.9%	3.7%	3.1%
Pricing	4.7%	2.8%	3.7%	2.5%	2.0%	2.3%	3.0%
Organic growth	6.9%	5.5%	6.2%	6.0%	5.9%	6.0%	6.1%

Source: Citi Investment Research and Analysis, Company reports

Figure 15. Danone Divisional Organic Growth Forecasts

	2010	2011	2012E	2013E	2014E	2015E
<b>Dairy</b>						
Volume	7.5%	-0.1%	1.5%	2.5%	2.5%	2.5%
Pricing	-1.0%	4.7%	2.7%	2.9%	2.9%	2.9%
Organic growth	6.5%	4.6%	4.2%	5.4%	5.4%	5.4%
<b>Waters</b>						
Volume	7.8%	8.8%	4.4%	4.0%	4.0%	4.0%
Pricing	-2.5%	6.9%	4.3%	4.0%	4.0%	4.0%
Organic growth	5.3%	15.7%	8.7%	8.0%	8.0%	8.0%
<b>Baby Nutrition</b>						
Volume	7.6%	5.6%	5.2%	6.0%	6.0%	6.0%
Pricing	1.3%	5.1%	3.8%	3.9%	3.9%	3.9%
Organic growth	8.9%	10.7%	9.0%	9.9%	9.9%	9.9%
<b>Medical Nutrition</b>						
Volume	8.7%	9.9%	8.0%	7.0%	7.0%	7.0%
Pricing	0.3%	-0.5%	-0.5%	2.0%	2.0%	2.0%
Organic growth	9.0%	9.4%	7.5%	9.0%	9.0%	9.0%
<b>Total Group</b>						
Volume	7.6%	3.0%	3.1%	3.7%	3.8%	3.8%
Pricing	-0.7%	4.8%	3.0%	3.2%	3.2%	3.2%
Organic growth	6.9%	7.8%	6.1%	7.0%	7.0%	7.0%

Source: Citi Investment Research and Analysis, Company reports



**Figure 16. Danone Income Statement Forecasts (€m)**

	2010	2011	2012E	2013E	2014E	2015E
Dairy	9732	11235	11878	12520	13196	13908
Waters	2868	3229	3583	3869	4179	4513
Baby Nutrition	3355	3673	4101	4507	4953	5443
Medical Nutrition	1055	1181	1388	1512	1649	1797
<b>Total Turnover</b>	<b>17010</b>	<b>19318</b>	<b>20949</b>	<b>22408</b>	<b>23976</b>	<b>25662</b>
CoGS	-7701	-9111	-9881	-10569	-11308	-12103
Gross profit	9310	10207	11069	11839	12668	13558
Gross margin	54.7%	52.8%	52.8%	52.8%	52.8%	52.8%
SGA	-4782	-5238	-5701	-6087	-6501	-6945
General Admin	-1528	-1658	-1766	-1844	-1926	-2010
R&D	-239	-261	-283	-301	-321	-341
Other	-183	-208	-225	-238	-252	-266
<b>Trading Operating Income</b>	<b>2578</b>	<b>2843</b>	<b>3093</b>	<b>3369</b>	<b>3669</b>	<b>3996</b>
margin	15.2%	14.7%	14.8%	15.0%	15.3%	15.6%
Exceptional items	-80	-114	-50	-40	-20	-20
Operating income	2498	2729	3043	3329	3649	3976
Operating margin	14.7%	14.1%	14.5%	14.9%	15.2%	15.5%
Underlying net interest	-143	-174	-159	-121	-51	20
Other financial income/expenses	-91	-107	-100	-100	-100	-100
Exceptional gain on disposal of financial stake	225	-13	0	0	0	0
Underlying pre tax profit	2344	2562	2835	3148	3518	3917
Reported Pre tax profit	2489	2435	2785	3108	3498	3897
Underlying tax	-590	-661	-752	-819	-915	-1018
Underlying Tax rate (%)	25.2%	25.8%	26.5%	26.0%	26.0%	26.0%
Tax on exceptional	14	35	0	0	0	0
Total tax	-576	-626	-752	-819	-915	-1018
Reported tax rate (%)	23.1%	25.7%	27.0%	26.3%	26.1%	26.1%
Share of associate	121	46	61	65	70	77
Exceptionals on associates	41	0	0	0	0	0
Minorities	-164	-198	-213	-229	-248	-269
Exceptionals on minorities	1	14	0	0	0	0
Underlying Net Profit	1669	1749	1930	2165	2426	2706
Reported Net Profit	1870	1671	1880	2125	2406	2686
<b>Fully Diluted Underlying EPS</b>	<b>2.71</b>	<b>2.89</b>	<b>3.20</b>	<b>3.58</b>	<b>4.02</b>	<b>4.48</b>

Source: Citi Investment Research and Analysis, Company reports

**Figure 17. Danone Cashflow Forecasts (€m)**

	2010	2011	2012E	2013E	2014E	2015E
Net Income attributable to group	1,870	1,671	1,880	2,125	2,406	2,686
Net Income attributable to minority interests	164	198	213	229	248	269
Net Income from discontinued operations	0	0	0	0	0	0
Net (income) loss of affiliates	-121	-46	-61	-65	-70	-77
Depreciation and amortisation	594	643	702	761	823	889
Dividends received from affiliates	52	57	63	69	76	84
Other non-cash items	-82	43	43	0	0	0
Changes in working capital	77	9	81	-205	-68	-54
<b>Investing activities</b>						
Capital expenditure	-832	-869	-901	-919	-959	-1,026
Acquisitions and purchase of investments (net of cash and equivalents)	-327	0	0	0	0	0
Disposals and sale of investments (net of cash and equivalents)	606	92	0	0	0	0
(Increase) decrease in long term loans and other long-term assets	1	0	0	0	0	0
Changes in cash/cash equivalents of discontinued operations	0	0	0	0	0	0
Cash flows from investing activities	-552	-777	-901	-919	-959	-1,026
<b>Net cash flow before financing activities</b>	<b>1,924</b>	<b>1,798</b>	<b>2,021</b>	<b>1,996</b>	<b>2,455</b>	<b>2,770</b>
<b>Financing activities</b>						
Increase in capital and additional paid-in capital	36	0	0	0	0	0
Purchases of treasury stock (net of disposals)	-233	-500	0	0	0	0
Dividends	-737	-815	-885	-964	-1,044	-1,153
Of which to equity holders	-479	-504	-550	-604	-655	-730
Of which to minorities	-258	-311	-335	-360	-389	-423
Increase (decrease) in non-current financial liabilities	234	0	0	0	0	0
Increase (decrease) in current financial liabilities	-285	0	0	0	0	0
(Increase) decrease in marketable securities	-601	0	0	0	0	0
Cash flows from financing activities	-1,586	-1,315	-885	-964	-1,044	-1,153
Effect of FX on cash and cash equivalents	72	0	0	0	0	0
<b>Net increase/(decrease) in cash and cash equivalents</b>	<b>410</b>	<b>483</b>	<b>1,136</b>	<b>1,032</b>	<b>1,411</b>	<b>1,617</b>
Opening net debt	6,562	7,074	6,871	5,734	4,702	3,291
Net increase/(decrease) in cash and cash equivalents	410	483	1,136	1,032	1,411	1,617
Other	-922	-280	0	0	0	0
Closing net debt	7,074	6,871	5,734	4,702	3,291	1,674

Source: Citi Investment Research and Analysis, Company reports

**Figure 18. Danone Balance Sheet Forecasts (€m)**

	2010	2011	2012E	2013E	2014E	2015E
<b>ASSETS</b>						
<b>Current assets</b>						
Inventories	975	1,148	1,218	1,303	1,394	1,492
Trade accounts and notes receivable	2,051	2,302	2,411	2,763	2,989	3,213
Other accounts receivable and prepaid expenses	641	1,206	1,308	1,399	1,497	1,602
Short-term loans	41	41	41	41	41	41
Marketable securities	454	454	454	454	454	454
Cash and Cash equivalents	644	644	644	644	644	644
Total current assets	4,806	5,795	6,075	6,603	7,019	7,446
Assets held for sale	0	0	0	0	0	0
<b>TOTAL ASSETS</b>	<b>26,869</b>	<b>28,041</b>	<b>28,477</b>	<b>29,162</b>	<b>29,714</b>	<b>30,279</b>
<b>LIABILITIES</b>						
<b>Current Liabilities</b>						
Trade accounts and notes payables	2,637	3,070	3,330	3,562	3,811	4,079
Accrued expenses and other liabilities	2,091	2,702	3,051	3,418	3,817	4,262
Financial liabilities	1,702	1,702	1,702	1,702	1,702	1,702
Total current liabilities	6,431	7,474	8,083	8,682	9,330	10,043
<b>Non-current Liabilities</b>						
Financial Liabilities	6,470	6,267	5,131	4,098	2,687	1,071
Pension Liabilities	319	319	319	319	319	319
Deferred taxes	1,037	1,037	1,037	1,037	1,037	1,037
Other non-current liabilities	407	407	407	407	407	407
Total non-current liabilities	8,233	8,030	6,894	5,861	4,450	2,834
<b>TOTAL LIABILITIES</b>	<b>14,664</b>	<b>15,504</b>	<b>14,976</b>	<b>14,543</b>	<b>13,780</b>	<b>12,876</b>
<b>EQUITY</b>						
Capital Stock	162	162	162	162	162	162
Additional paid-in capital	3,596	3,596	3,596	3,596	3,596	3,596
Retained earnings	10,373	10,506	11,257	12,147	13,215	14,414
Cumulative translation adjustments	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200
Treasury stock	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200
Net income recognised directly in equity	256	256	256	256	256	256
Equity attributable to the group	11,987	12,120	12,871	13,761	14,829	16,028
Minority interests	218	416	629	858	1,105	1,375
<b>TOTAL LIABILITIES + EQUITY</b>	<b>26,869</b>	<b>28,041</b>	<b>28,477</b>	<b>29,162</b>	<b>29,714</b>	<b>30,279</b>

Source: Citi Investment Research and Analysis, Company reports

## Danone

### Company description

Danone is a major international food manufacturer. It is the global leader in fresh dairy products and also has businesses in water-based beverages, baby nutrition and clinical nutrition. Major brands include Activia, Actimel, Dannon, Evian, Milupa, Cow & Gate and Nutricia. Danone's fundamental criterion is category leadership in the countries where it is present.

### Investment strategy

We rate Danone Buy. Danone has historically traded at a premium to the sector, based on its superior top-line growth. This premium has disappeared due to concerns over growth in the key markets of the US and Russia. We believe Danone will re-rate due to evidence of a sustained recovery in the US and Russian dairy markets through 2012. Danone's forecast EPS growth is also superior to peers as well as the broader consumer staples sector.

### Valuation

We value Danone using P/E. We assume that in 12 months time the shares will be trading at c.17x forward, a modest premium to 16x currently and 5% above the 5 year average. However in 12 months time this would be based on our 2013 EPS estimate of €3.58. We believe that this multiple is justified on the basis that Danone should trade at a modest premium to the broader European consumer staples given we forecast superior EPS growth (12% versus consensus estimate of 9% for the peer group). On this basis our target price is €62.00.

### Risks

Risks to our price target (both upside and downside) include raw material price volatility, especially in milk and PET, emerging market FX volatility and large-scale value-destructive M&A. A significant change in dairy trading and hence the return of Danone's traditional P/E premium to the peer group, or a substantial derating, is the biggest risk to our recommendation and price target.

## Notes

## Notes

# Appendix A-1

## Analyst Certification

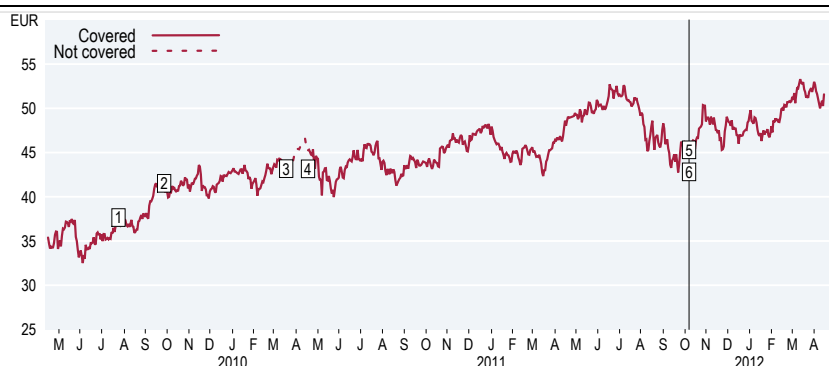
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### Danone (DANO.PA)

#### Ratings and Target Price History Fundamental Research

Analyst: Robert Dickinson, CA  
Covered since August 26 2011



	Date	Rating	Target Price	Closing Price
1	24-Jul-09	2M	*35.00	36.78
2	28-Sep-09	2M	*43.00	41.36

\* Indicates change

	Date	Rating	Target Price	Closing Price
3	18-Mar-10	Coverage terminated		
4	18-Apr-10	*2L	*48.00	45.56

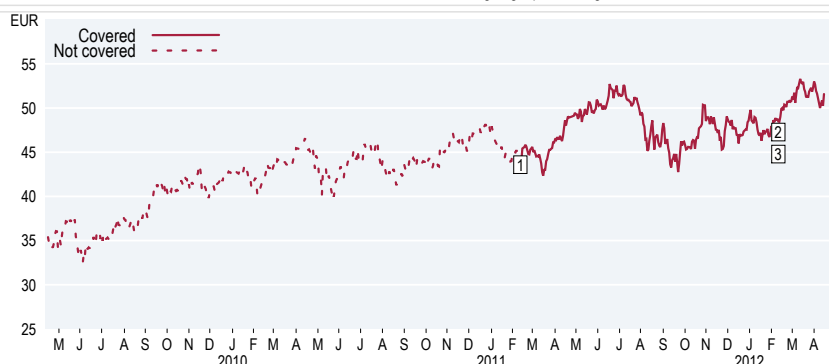
	Date	Rating	Target Price	Closing Price
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*2	48.00	45.59

Rating/target price changes above reflect Eastern Standard Time

### Danone (DANO.PA)

#### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Robert Dickinson, CA  
Covered since August 26 2011



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	43.59

\* Indicates change

	Date	Rating	Target Price	Closing Price
2	10-Feb-12	*REM LP	-	48.47

	Date	Rating	Target Price	Closing Price
3	10-Feb-12	*ADD LP	-	48.47

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