

Engagement with Nestlé

Nestlé has been a Burgundy portfolio company for over 20 years. As part of our research process, we regularly engage with management to make sure our investment thesis is on track and to explore issues that could be material to our assessment of the company's intrinsic value. We have engaged with management on a variety of issues over the years, including on ESG matters.

This year, our newly formed Sustainability Team conducted an ESG-specific engagement with Nestlé in collaboration with our European Equity investment team. The engagement was the culmination of in-depth ESG-specific research conducted by the Sustainability Team. It was led by Yasin Salyani (Analyst, Sustainable Investing) and Mike Elkins (Director of Research and Analyst, European Equity). They met (virtually) with several important sustainability leaders at Nestlé, including its Group Head of ESG, Sustainability Strategy and Deployment, Global Head of Climate & Sustainable Sourcing, and Environmental Impact Lead Global Public Affairs.

During the engagement, we discussed a variety of ESG issues. These included Nestlé's use of carbon credits (following our learnings from the training session

highlighted in the previous section), its approach to emission reductions (particularly the challenging Scope 3 emissions discussed earlier), how Nestlé's ESG function interacts with its commercial organization, the costs associated with its emission reduction objective, and how regulation impacts operations.

Use of Carbon Credits

Following our training session on carbon credits, we sought to understand whether Nestlé uses credits and whether it is part of its net-zero roadmap.

We learned that Nestlé does not use carbon credits. It has previously used high-quality restoration-based credits (as opposed to the controversial forestry and renewable credits) to offset emissions from some of its brands. However, Nestlé stopped using credits and turned its focus on investing in its value chain instead, finding this to be a more effective and efficient method of reducing emissions. Nestlé works with farmers, for instance, to promote regenerative agriculture, which helps make soil healthier by increasing soil organic matter. This improves the soil's ability to sequester carbon and helps to make food supply chains more sustainable.

Nestlé does not intend to use credits to achieve its net-zero targets either. Its focus is on emission reductions in its value chain and on carbon removals, which consists in using natural climate solutions, such as restoring wetlands, enhancing natural habitats, and planting shade trees to increase the storage of carbon in land and soils.

We believe that Nestlé has taken a thoughtful approach by investing in its value chain to achieve some of its emission-reduction targets in lieu of using the high-quality restoration-based credits it employed in the past. While the restoration-based credits were effective, we believe investing in its value chain is more practical, sustainable, and provides Nestlé with better control over the outcome. It is also likely to meaningfully improve the circumstances of the farmers and communities that Nestlé works with in this capacity.

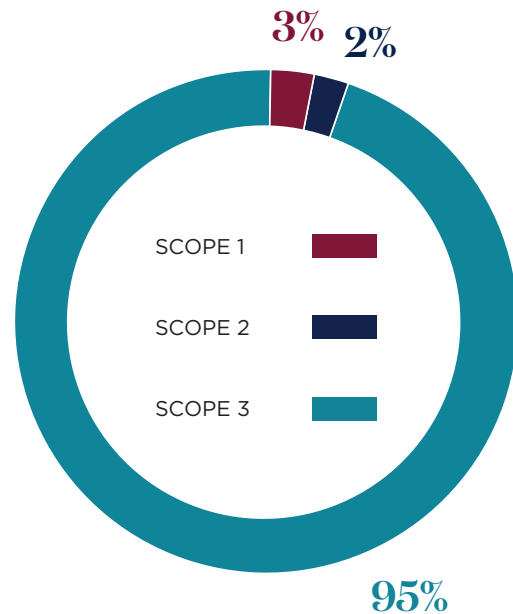
Nestlé's Approach to Emission Reduction

Nestlé has set ambitious targets to reduce its emissions by 50% by 2030 from a 2018 baseline and to achieve net-zero emissions by 2050. In its comprehensive [net-zero roadmap](#), Nestlé disclosed that its emissions target will cover all of its Scope 1 and 2 emissions and approximately 80% of its Scope 3 emissions. We sought to understand Nestlé's rationale for its target and how it was going to achieve it.

As a reminder, Scope 1 emissions are direct emissions that occur from sources that are controlled or owned by the organization. Scope 2 emissions are indirect emissions associated with the purchase and use of electricity, steam, heat, or cooling by the organization. Scope 3 emissions are indirect emissions from activities and assets not owned or controlled by the organization, but that the organization indirectly impacts in its value chain.

FIGURE 1

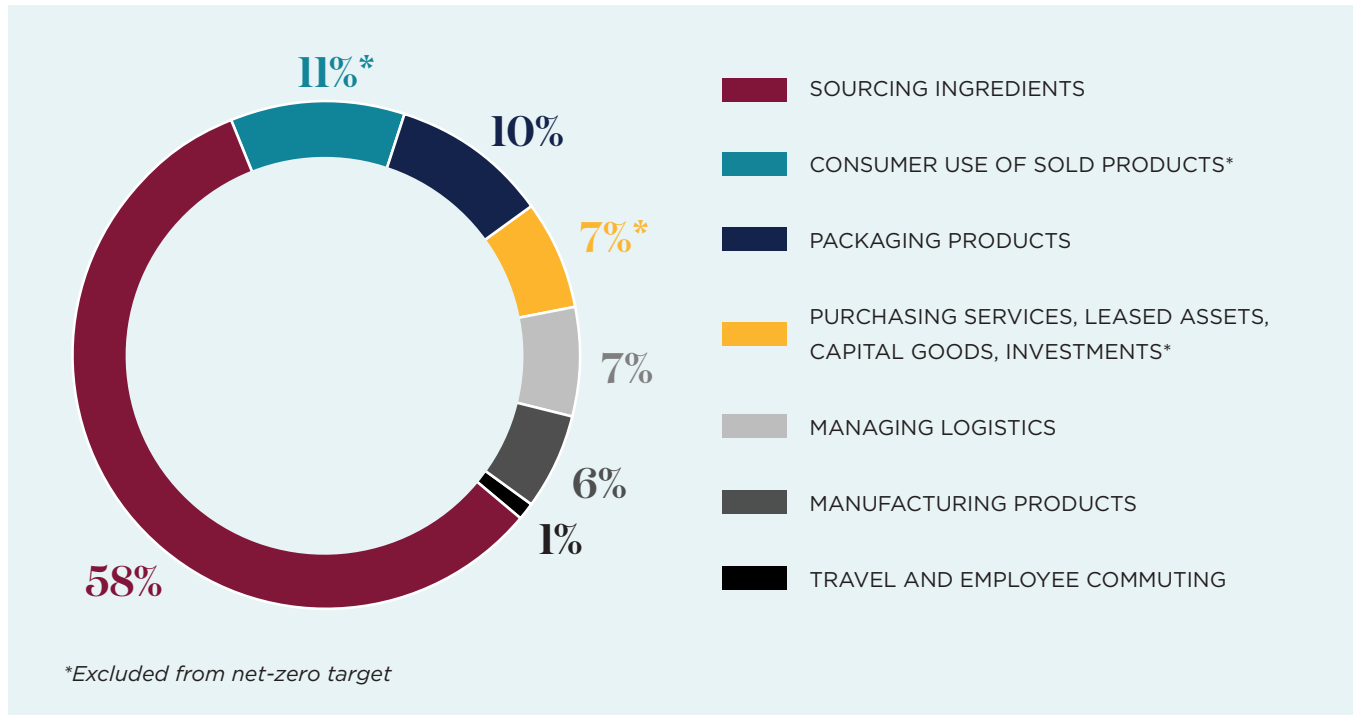
Nestlé's Emissions by Scope (2018 Baseline)



Importantly, Nestlé's emission reduction targets have been validated by the [Science Based Targets initiative \(SBTi\)](#), which is the leading global organization for independent validation of climate targets. Targets are considered "science-based" if they are in line with what the latest climate science says is necessary to meet the Paris Agreement's goal of limiting global warming to 1.5°C above pre-industrial levels. The SBTi requires companies to set their net-zero targets in proportion to their footprint and their impact on nature. Given that Scope 3 emissions make up 95% of Nestlé's total emissions, the company must include the majority of its Scope 3 emissions in its target. Figure 1 shows the distribution of Nestlé's total emissions.

Nestlé included all of its agriculture related emissions in its 2030 and 2050 emission reduction targets but excluded emissions related to consumer use of sold products. We learned that it did so because

FIGURE 2
Nestlé's Emissions by Activity (2018 Baseline)



working with farmers and suppliers of agricultural raw materials is the most effective and efficient way to reduce emissions. Trying to decarbonize consumer use of sold products would be complex and outside of Nestlé's direct control. For example, emissions from boiling water to make a cup of Nescafe would be categorized as Nestlé's Scope 3 emissions from consumer use of products. The difficulty in decarbonizing these emissions is apparent.

Nestlé works with farmers, suppliers, and communities to source ingredients in ways that protect ecosystems, reduce emissions, and enhance livelihoods. Its focus on regenerative agriculture, reforestation, and training farmers on sustainable ways to increase productivity not only helps Nestlé in meeting its important obligations to society and the environment, but also mitigates the risk of raw material supply disruption.

A majority of Nestlé's emissions come from sourcing dairy and livestock ingredients (as shown in Figure 2).

Nestlé's work to reduce emissions here involves helping farmers increase the efficiency of their dairy farms by maximizing output while using minimum energy, training farmers on better herd management, and investing in developing solutions to cut the methane produced by animals. Nestlé is also working to reduce emissions from the sourcing of key agricultural ingredients such as cocoa, coffee, and palm oil. Its work here involves working with farmers and suppliers in preventing deforestation in its supply chains, training farmers on improved agricultural practices like cover cropping, using organic fertilizers and multiple crop rotation, and encouraging them to practice agroforestry on their farms (i.e., planting shade trees among their crops such as cocoa and coffee, which leads to better crop growth and improved water management, protects biodiversity, and absorbs carbon from the atmosphere to drive down emissions).

We believe that Nestlé has taken a thoughtful approach towards achieving its emission-reduction targets. We think that Nestlé's involvement in the value chain and the work it is doing with farmers, suppliers, and communities is practical and is likely to be impactful. It is also likely to yield sustainable benefits to Nestlé in mitigating the risk of disruption of raw material supply, which is a business risk associated with climate change.

Interaction of ESG Function with Nestlé's Commercial Organization

There can, at times, be a natural conflict between an organization's sustainability and commercial objectives. We sought to understand how Nestlé resolves those conflicts when they arise and ensures that its commercial organization is committed to, and successfully executes on, the company's sustainability objectives and that the sustainability group is cognizant of the commercial realities of its sustainability goals.

We learned that Nestlé accomplishes this through its governance and organizational structure. The company's sustainability strategy and objectives are determined by an ESG and Sustainability Council. The council is comprised of senior members of both Nestlé's sustainability and commercial organizations, including all of Nestlé's powerful regional CEOs, its CFO, and several other important executives. This structure is designed to ensure that Nestlé's commercial organization is committed to, and accountable for, executing on the company's sustainability objectives and that the sustainability objectives are crafted in accordance with the company's commercial realities.

We think this approach makes sense and has likely been an important driver behind the success Nestlé has had so far crafting and executing on impactful sustainability objectives while at the same time delivering strong operational performance.

Costs Associated with Emission-Reduction Objectives

In our research, we found that Nestlé has committed to investing CHF 3.2 billion by 2025 into its emission-reduction efforts (for context, Nestlé's revenue in 2022 was CHF 94.4 billion). This is a significant amount, and we sought to understand which of Nestlé's stakeholders is likely to bear the costs associated with it. We were concerned about the potential costs to shareholders in the form of a lower total shareholder return and to consumers in the form of price inflation, which could impact affordability and raise social concerns.

We learned that most stakeholders, including shareholders, are likely to bear some of the cost of reducing emissions, but that Nestlé has been working with a variety of organizations to thoughtfully reduce the cost of doing so for the benefit of those stakeholders. This includes important initiatives with governments, suppliers, and industry coalitions.

Nestlé's emissions reduction goals are closely aligned with those of governments around the world. Nestlé believes that this leads to huge potential for co-financing models to develop emission-reduction projects, which help both the company and governments achieve their emission-reduction objectives. Nestlé is involved in several projects where it works with governments to lower the cost of reducing emissions for the benefit of all stakeholders.

Nestlé also does advocacy work, particularly in high subsidy environments like the EU and the U.S., around making subsidies work in a smarter way when it comes to decarbonizing agriculture and incentivizing farmers. It advocates governments not to incentivize practices which would make it more difficult for Nestlé to convince farmers to shift to better, more environmentally friendly practices.

Nestlé also works with its suppliers and is involved in [coalitions and partnerships](#) to help advance its emission-reduction efforts. Nestlé worked with one of its largest suppliers, for instance, to help the supplier launch its own program to reduce emissions. Partnerships such as these help Nestlé share its cost of reducing emissions.

On passing costs to consumers, Nestlé believes it has a social obligation to provide affordable food to vulnerable customer segments and is intensely committed to doing so. It is taking steps to ensure that the cost of reducing emissions is not borne by these groups.

We believe that Nestlé has taken a considerate approach towards achieving its emission-reduction targets. It works with important stakeholders to find increasingly effective ways to reduce emissions and to diminish and share the cost of doing so. It is also important to note that while there are explicit costs to reduce Nestlé's

emissions that are partially borne by its shareholders, we believe they are a necessary business expense. Inaction in this area risks falling short of customer expectations and damaging the company's wholesome brand.

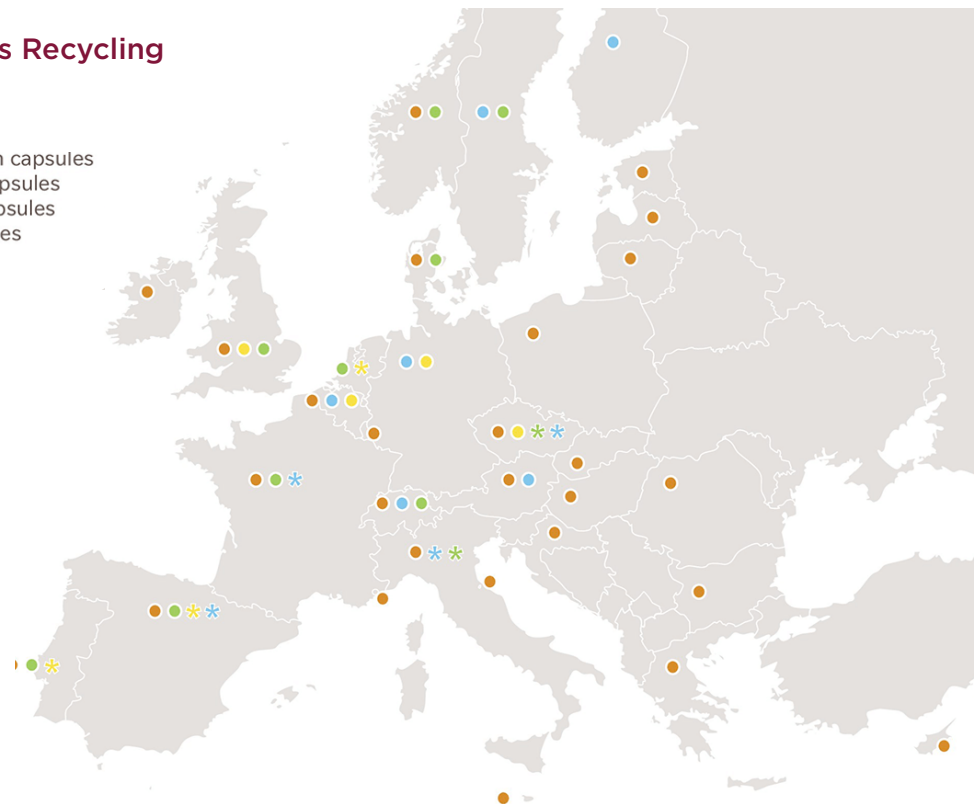
Regulation

In our research, we came across a proposed piece of regulation in the EU that would effectively ban the use of some non-compostable food packaging. We were concerned about the impact this would have on Nespresso, Nestlé's coffee business that is sold in aluminum capsules. We were also aware that Nestlé had started rolling out paper-based compostable Nespresso capsules in Switzerland and France as its pilot markets. We sought to understand what impact the proposed regulation would have if passed, how Nestlé's compostable capsules were received in their pilot markets, and what Nestlé's longer-term plan was with the Nespresso capsules.

FIGURE 3

Nestlé's Coffee Capsules Recycling Infrastructure in Europe

- Dedicated system for aluminum capsules
- Dedicated system for plastic capsules
- Public system for aluminum capsules
- Public system for plastic capsules
- * In certain regions



We learned that while there is uncertainty over whether the new regulation will pass (because of concerns about the impact paper-based compostable capsules could have on deforestation), Nestlé, which provides both the aluminum and compostable options to its customers, is prepared. The key for Nestlé is that the packaging does not end up in the environment. Nestlé chose aluminum for its Nespresso capsules because of its unique combination of product-quality protection, lightness, and recyclability. 80% of the aluminum used for home-use capsules is recycled aluminum. Nestlé has an extensive recycling program for its Nespresso aluminum capsules (Figure 3, Page 19), with over 100,000 collection points in 74 countries and an 88% capsule recycling capacity. Nespresso's compostable capsules have also been well-received in its pilot markets.

We believe that Nestlé is well positioned to deal with this change in regulation should it happen. The company has been proactive in developing compostable Nespresso

capsules, which not only provides optionality to consumers but also offers protection to Nestlé from regulatory risk. Nestlé's commitment to recycling its aluminum Nespresso capsules and the infrastructure it has put in place to do so is commendable. We will continue monitoring this and other pieces of regulation that can potentially impact Nestlé.

Conclusion

Nestlé is a global leader in sustainability and among the best performers in this area in our portfolios. We believe it has a thoughtful, practical, and cost-effective approach to ESG considerations and our conviction in this perspective was strengthened after speaking with several of the company's sustainability leaders. We were impressed with the depth of their knowledge on a variety of ESG issues and with their determination and progress in finding practical and effective solutions to them. **B**

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