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Top of Form

**Nestlé's Recipe for Juggling Volatile Commodity Costs**

By [Tom Mulier](http://www.businessweek.com/authors/2673-tom-mulier)March 17, 2011

When then-26-year-old Paul Bulcke moved to Peru in 1980 to help market Maggi bouillon for food giant Nestlé, it wasn't a plum assignment. Hyperinflation was battering the country's economy, forcing the Swiss company to raise prices almost every other day. Some months, inflation reached 1,000 percent. Then the Andean nation in 1985 froze prices at a time when shops were offering holiday discounts. "There's no business school that can prepare you for that," says Bulcke, now 56 and Nestlé's chief executive officer. "What you learn there is how to reconnect the dots very fast."

Bulcke is again using the quick-response skills he honed in Latin America, this time to cope with the volatility in food and raw material costs that's buffeting the world's largest food and beverage company. Few corporations are more exposed to the vicissitudes of fast-changing commodity prices than the maker of everything from Crunch chocolate bars to Nescafé coffee to Purina pet food. Nestlé spends more than $30 billion a year on raw materials, including about 10 percent of the world's coffee crop, 12 million metric tons of milk, and more than 300,000 tons of cocoa. Prices for those ingredients have been anything but stable. "Have you seen the sugar prices? Have you seen grain prices? Have you seen milk prices?" Bulcke asks excitedly. Almost every one of its major commodities has at least doubled within the past four years. Nestlé expects its raw materials bill to rise by as much as $3 billion this year, its biggest increase ever. The International Monetary Fund said this month that it may take years before agricultural output increases enough to put a substantial dent in worldwide food prices.

That's pushed Belgian-born Bulcke to craft a strategy that doesn't depend on commodity prices falling. Instead, he's working to squeeze costs out of operations while raising prices and launching more upscale, higher-margin products in which raw material costs account for a smaller portion of the retail price.

Bulcke aims for a steady stream of gradual price increases, regardless of whether ingredient costs rise or fall. For example, when milk powder peaked at around $5,500 a ton in 2007 and 2008 and later dropped to $1,800, Nestlé didn't rush to lower the prices of its products. It worked on the assumption that milk prices would eventually return to somewhere between $3,000 and $3,500 a ton, Bulcke says. Today, milk powder is back to about $4,000.

To provide guidance on where prices are headed, Nestlé relies on close contact with the 600,000 farmers who supply wheat, sugar, corn, and the other products needed to make brands including Crunch, Lean Cuisine, Dreyer's, and Nescafé. They helped Nestlé foresee that growing populations and economies in emerging markets would lead to a boom in food commodity prices back in 2005, Bulcke says. So the company started gradually raising prices then, getting a head start on rivals. "If you're number 340 in the row knocking on the door of the retailer, he starts getting tired of price increases," he says.

Still, to hold on to customers, Nestlé tries to combat higher raw material costs by educating farmers globally on ways to boost crop yields, and by wringing out internal savings. The company has reduced the amount of plastic in bottles of Poland Spring water by 35 percent over the past four years, reducing its exposure to PET plastic prices, which rose 23 percent last year. Nestlé has cut its use of packaging materials by 518,000 metric tons in the past two decades. In all, Nestlé realized $1.5 billion in savings last year and aims for more this year, which should offset half its increase in costs, Bulcke says. It expects to limit ingredient cost hikes in 2011 to between 8 and 10 percent. Without Nestlé's cost management, Nomura estimates, they would rise about 12 percent.

Creating premium products is another way Nestlé minimizes the impact of commodity prices. By packaging its highest quality coffee in single-serve capsules for its Nespresso coffee machines, Nestlé charges about 10 times the price per cup that rivals ask for unground beans. Nespresso is now a $3 billion business growing at more than 20 percent annually, and Nestlé has introduced a slew of similar machines to try to repeat the success. It's rolling out high-margin brewing systems for cappuccino and even tea.

Likewise, Nestlé in Europe is rolling out Mövenpick, a gourmet ice cream with flavours such as coconut and lemongrass. It sells in very small portions at the equivalent of about $15 a quart. The Swiss company has turned its higher-margin Pure Life bottled water into the world's largest water brand, evidence that its upmarket strategy can work even in emerging markets like Pakistan. And with its 2006 purchase of Jenny Craig, the diet advice company, Nestlé moved even further away from dependence on commodities.

The premium focus across the company means that when Nestlé does have to swallow higher commodity costs, it's hurt less than many rivals since its brands command price premiums on their names alone, Bulcke says. That means ingredients account for a smaller percentage of their retail price. "Private label is raw material cost with a mark up," Bulcke says. "As the raw material cost increases, they are much harder hit than branded products." Like those sold by Nestlé.