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Unilever facing difficult balancing act

Dear Unilever investor, dear depositary receipt holder,

At the start of 2009 Unilever was under pressure from an uncertain economy and so it abandoned its 2010 targets. It was felt that aiming for an underlying turnover growth of 3 to 5 percent as well as an operating profit margin of 15 percent was too restrictive. For this reason, concrete forecasts for the current financial year have not been given.

Unilever's focus was to have been on volume growth, protecting operating margins and cash flows. When Paul Polman became Unilever's new CEO, he was faced with the daunting task of implementing this new focus. At the same time, the fact that Unilever had abandoned all concrete targets meant that Polman was able to start with a clean sheet. The business culture was to become more achievement orientated and that is why Polman made a clean sweep of Unilever's senior management.

Abandoned targets almost reached after all

In retrospect Unilever's new strategy has paid off, so the business could perhaps have retained its targets after all. Last year the underlying turnover growth amounted to 3.5 percent and the operating profit margin before incidental items was 14.8 percent. In the course of the year the underlying volume growth picked up. In the first quarter volume fell by 1.8 percent, but by the fourth quarter it had risen 5 percent. Overall the 2009 volume rose by 2.3 percent.

The operating margin performed in a similar way. It shrunk in the first half of the year, only to progress really well in the second half. On balance the margin rose by 20 basis points. Margins rose in spite of an 80 basis points increase in marketing expenses. This was counter-balanced by a cut of EUR 1.4 billion in costs. Increased margins and a reduction in working capital were responsible for a EUR 1.4 billion rise in the operational cash flow to 6.8 billion.

So Paul Polman's first year as Unilever's CEO seems to have been successful. In the recent past the business has hardly ever realised a growth in turnover and a margin improvement simultaneously. The new CEO himself said: '2009 has been our first step towards consistent, long-term growth in turnover and profit', but he admitted there was still a lot of work to be done. Unilever is now facing the daunting task of equalling this performance in the next few years. While turnover might be boosted by investing in innovation and marketing, the current economic situation may necessitate price cuts, which may put margins and cash flows under pressure. Thus Unilever is facing the challenge of balancing turnover growth and further improvement in profit margins and cash flows. In 2010 cost cuts of at least EUR 1 billion will be made to maintain this balance.

Western Europe ‘problem child’

Unilever’s results for Western Europe are in sharp contrast with the results for the other two regions, i.e. Asia, Africa, Central and Eastern Europe on the one hand and the American continent on the other. Unilever itself says trends in volumes have been improving for a number of key markets, but the company does not give any insight into these trends, so we are left with a less favourable impression of a decrease in turnover brought about by slightly lower volumes and falling prices. The operating margin was also under pressure from higher marketing expenses. The 2008 margin was higher in Western Europe than in other regions, yet a considerable fall of 2.4 basis points runs counter to the trend of improving margins in other regions.

A growing part of Unilever’s turnover is made in emerging markets. European trends show that it is rather difficult for the company to achieve good results in more mature markets. The means Unilever deploys – innovation and reinforcing the brand portfolio – are also used by Unilever’s competitors. In the current economic climate, in which consumers are tightening their purse strings, the danger is always lurking that competition will be at the cost of the margins – especially if price is competed for as well. The VEB urges Unilever to supply additional and concrete information about the company’s strategy for improving mature markets, especially in Western Europe.

Focus needed to reduce complexity

According to Polman Unilever is still too complex. In an industry in which the greater part of the competition opts for a clear focus, splitting Unilever up into two businesses focusing on food solutions on the one hand and care solutions on the other seems an obvious choice. However, the business does not embrace this point of view. Unilever also fails sufficiently to justify their present company structure with figures or examples of synergy advantages, whether actual or potential.

Depository receipt structure still in place

Despite Unilever’s intention to end the depository receipt structure, the company has not yet taken any steps to do so. According to Unilever a prerequisite for the abolishment of depository receipts is the buy back of the outstanding preference shares, but it does not provide any insight into the steps it has actually taken to indeed do this. At the annual shareholders’ meeting in May 2009 it was reported that Unilever was trying to resolve this issue, but apparently no solutions have yet been found.

At Unilever’s shareholders’ meetings the depository receipt structure allows the allied trust office to influence the outcome of the voting, because the trust office can vote on behalf of depository receipt holders that do not vote themselves. In this way depository receipt holders are deprived of effectively influencing important issues. This lack of effective voting power causes ongoing pressure on Unilever’s market capitalisation. It is high time this unsatisfactory situation was resolved.

On behalf of the VEB NCVB (Dutch Investors' Association)

A handwritten signature in black ink, appearing to be 'JMS' or similar initials, written in a cursive style.

Jan Maarten Slagter, managing director

If you would like to respond to this letter, please email info@veb.net

Note: On submitting this letter on 5 March 2010, neither the annual report for 2009 nor the agenda for the shareholders' meeting was yet available.