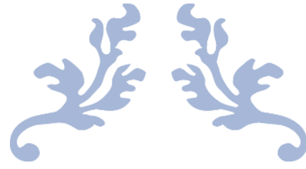

INITIAL PURCHASE: JM SMUCKER [SJM]

November 2018

Overview

JM Smucker ("SJM") is a smaller-sized, large-cap stock that is historically well-run, delivers consistent returns on capital and produces significant cash flow. The business is focused on a diversified portfolio of simple brand names that are found in most kitchens throughout the United States. SJM is at an inflection point in which its top line growth has decelerated, margins have compressed, and management must optimize their portfolio through prudent balance sheet management and strategic initiatives. In addition to current negative macro trends, I believe investors have been overly pessimistic given the firm's recent headwinds and have oversold the stock, leading to an attractive price to initiate a long-term position in a quality company.

SJM's market cap is $11.9 billion and their enterprise value is $19.2 billion. They sell and distribute consumer food, beverage, and pet food products. In addition to their spreads business sold under the brand name, the firm owns many other famous U.S. brands, including Jif, Folgers, Crisco, Milk-Bone, and Kibbles 'n Bits. They also produce and sell Dunkin' Donuts-branded coffee under a licensing agreement. Over 90% of sales are generated in the U.S. and are split among coffee, consumer food, and pet food.

The Buying Opportunity

Over the past summer the company missed consensus earnings expectations and announced a soft guidance for 2019. Growth in the consumer product industry has been sluggish and margins have compressed. A look at the last 5 quarters is a pretty good display of recent headwinds.

	Jul-17	Oct-17	Jan-18	Apr-18	Jul-18
Gross Margin %	37.9%	39.3%	38.3%	38.8%	35.7%
Operating Margin %	15.0%	17.7%	18.1%	17.5%	12.3%
Net Margin %	7.3%	10.1%	43.7%	10.4%	7.0%
FCF Margin %	13.4%	3.6%	20.4%	11.4%	7.5%

And you can see the impact this trend has had on the stock price:

Growth, Margins, and The Product Portfolio

However, historically, the company's fundamentals have been exceptional; displaying steady growth rates and high overall margins that demonstrate the strength of the business. I particularly like the high free cash flow margin (TTM

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~11%) because this is money that can be reinvested, used to pay down debt and, of course, return capital to shareholders. There is a reason for the phrase, "cash is king", and steady cash flow it is often the mark of a strong competitive advantage and a well-run business model.

Revenue Growth		EBITDA Growth	
1-Year Revenue Growth Rate	4.70%	1-Year Total EBITDA Growth Rate	1.90%
3-Year Revenue Growth Rate	5.60%	3-Year Total EBITDA Growth Rate	18.50%
5-Year Revenue Growth Rate	4.60%	5-Year Total EBITDA Growth Rate	6.90%
10-Year Revenue Growth Rate	5.30%	10-Year Total EBITDA Growth Rate	11.60%
Net Income Growth		**Free Cash Flow Growth**	
1-Year Net Income Growth Rate	136.40%	1-Year FCF Growth Rate	-1.10%
3-Year Net Income Growth Rate	57.20%	3-Year FCF Growth Rate	18.50%
5-Year Net Income Growth Rate	16.50%	5-Year FCF Growth Rate	9.30%
10-Year Net Income Growth Rate	13.60%	10-Year FCF Growth Rate	13.50%

Average Margins	3yr	5yr	10yr
Operating Margin	16.77%	16.33%	16.38%
Net Margin	11.67%	10.23%	9.65%
FCF Margin	13.34%	11.79%	10.41%

Looking at the product portfolio you can see that there are some clear winners (pet food) and losers (Baking ingredients & Juices). The management team has a portfolio of iconic brands, but like most businesses, from time-to-time management will need to re-optimize the portfolio mix by shifting away from laggard products and investing in growth opportunities. Managements most valuable job is to find strong brands gaining momentum, add them to their product mix, and scale them.

Product	2018	2017	Growth
Coffee	$ 578.30	$ 572.30	1.0%
Dog food	$ 308.50	$ 188.70	63.5%
Peanut butter	$ 199.20	$ 200.50	-0.6%
Cat food	$ 189.00	$ 165.80	14.0%
Pet snacks	$ 187.80	$ 180.70	3.9%
Fruit spreads	$ 85.60	$ 87.60	-2.3%
Baking mixes and ingredients	$ 84.30	$ 91.80	-8.2%
Frozen handheld	$ 64.50	$ 50.00	29.0%
Shortening and oils	$ 52.90	$ 56.30	-6.0%
Portion control	$ 40.90	$ 39.70	3.0%
Juices and beverages	$ 32.20	$ 37.10	-13.2%
Other	$ 79.30	$ 78.40	1.1%
Total net sales	$ 3,920.50	$ 3,765.90	4.1%

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The Management Team

In order to be confident in this stock pick, or in any purchase really, I need to see a management team that is incentivized to improve the firm's prospects. SJM's management team takes a long-term approach to the business and has significant stake in the success of the company. For over 120 years the company has remained under the leadership of the Smucker family, having been founded by Jerome Smucker in 1897. The executive chairman- Richard Smucker, the President & CEO- Mark Smucker, and the Vice Chairman, Timothy Smucker, combined, own roughly 4% of the outstanding shares with a market value of approximately $500 million. With such wealth tied up in the success of the company, the Smucker's have incentive to ensure the company is performing. Historically, they have done just that with

a successful track record of managing the balance sheet and investing the company's capital. SJM has an investment grade credit rating of BBB/Baa2 by S&P/Moody's and a "Return on Invested Capital " (ROIC) of 15.5% - more than 4x its current cost of capital of 3.7% (WACC). Timothy and Richard Smucker must also believe that shares are enticing at current levels given that they have purchased a total of 30,000 shares ($3,000,000) in the most recent quarter.

Strategic Initiatives

So how are the Smucker's going to "right the ship"? Management has been making strategic moves to shift away from struggling products and into their growth products. Take, for example, their two most recent moves, the first was their divesture of their baking business for $375 million and the second being their May acquisition of Ainsworth Pet Nutrition for $1.9 billion.

As shown above, the baking and ingredients business declined by 8% YoY. The business only represented about 2% of annual revenues and was not worth the capital expenditures. The sale of the business will only impact revenues by a measly $84 million, but the added cash, though small, can help shore up the balance sheet while they sort out their newest purchase – Ainsworth Pet Nutrition.

The acquisition of Ainsworth Pet Nutrition was an all-cash transaction valued at $1.9 billion ($1.7 billion after a $200 million tax benefit), all of which was funded through additional debt, in this case a bank term loan and borrowing through the commercial paper program. You can see in the product breakdown above, Dog and Cat food growth have been the bright spots in the company's revenue, growing 64% and 14%, respectively. 48% of households in the US own dogs and 38% of households own cats with pet ownership displaying a consistent upward trend over more than two decades, according to the American Pet Products Association (APPA), a not-for-profit trade association. SJM expects the addition of the high-growth ("Nutrish") brand will increase the scale and further accelerate the growth profile of the company's current pet food business. Adding Ainsworth's complementary, strongly-performing pet brands will strengthen the Company's presence in the higher growth premium segment of the pet food and pet snacks category. Management anticipates the acquisition to be immediately accretive to the bottom line with cost synergies of $25 million and EBITDA of approximately $110 million in the first year. After the acquisition pet food can be expected to represent roughly 17% of revenues with net sales of ~$800 million. The purchase price represents a multiple of roughly 12x EBITDA.

Debt Load and Capital Structure

Even with the recent acquisition and resulting elevated levels of debt the balance sheet remains strong. As of the latest quarterly, SJM has $6.2 billion in debt, all of which is fixed at low cost interest rates at staggered maturities over the next decade. This should allow the company to ease into a higher interest rate environment without putting pressure on their interest coverage ratio that currently sits at 6.6x - lower than their historical median of 10.3x. They do not have significant principal coming due all at once that would put pressure on their liquidity. Furthermore, the $375 million received from the sale of the baking business can be used to pay down debt.

	Principal Outstanding		Carrying Amount	
2.20% Senior Notes due December 6, 2019	$	300.0	$	298.8
2.50% Senior Notes due March 15, 2020	$	500.0	$	498.1
3.50% Senior Notes due October 15, 2021	$	750.0	$	773.8
3.00% Senior Notes due March 15, 2022	$	400.0	$	397.5
3.50% Senior Notes due March 15, 2025	$	1,000.0	$	994.6
3.38% Senior Notes due December 15, 2027	$	500.0	$	495.9

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4.25% Senior Notes due March 15, 2035	$	650.0	$	643.2
4.38% Senior Notes due March 15, 2045	$	600.0	$	585.6
Term Loan Credit Agreement due May 14, 2021	$	1,500.0	$	1,497.4
Total long-term debt	$	6,200.0	$	6,184.9

Here is a look at the company's capital structure which shows a debt to equity ratio of .85.

Capital	Amount
Short-term borrowings	$ 530.0
Long-term debt	$ 6,184.9
Total debt	$ 6,714.0
Shareholders' equity	$ 7,930.8
Total capital	$ 14,644.8

Free Cash Flow and Stability/Predictability of the Business

The debt load is not worrisome to me given the company's extremely high and stable free cash flow ("FCF") generation. As I mentioned before, I am a big advocate of business that create generous amounts of cash, as that allows for greater financial flexibility. The business has generated an average FCF margin of 12% and annualized growth of 7% over the past 5 years. The $896 million in free cash flow generated in the company's 2018 annual report provided ample coverage to the firm's capital providers with dividends and interest payments collectively totaling $524 million. This leaves roughly 42% of FCF for reinvestment or as I expect, for management to aggressively pay down debt in the near term. The management team doesn't seem to be a fan of having a leveraged balance sheet either. In fact, the company held nearly zero debt until after the financial crisis in 2008,when management selectively decided to take advantage of low funding costs given rock bottom interest rates. Since then it looks like the firms target debt/equity ratio is around .5.

The stability of cash flow brings me to my next point, which is the reliability of the of the business model through times of stress. Seeing that the firm added debt and interest rates are on the rise, I need to ensure that a spike in funding costs don't cripple the business. As you can see below, the firm continued to grow through the largest financial crisis since The Great Depression. I think the mechanics for this are straight-forward; people won't stop feeding their pets, they won't stop feeding themselves, and most people probably wont stop drinking coffee during stressful times.

(000's)	Apr-06	Apr-07	Apr-08	Apr-09	Apr-10
Revenue	$ 2,154.73	$ 2,148.02	$ 2,524.77	$ 3,757.93	$ 4,605.29
Operating Income	$ 254.40	$ 259.24	$ 295.38	$ 539.04	$ 824.49
Net Income	$ 143.35	$ 157.22	$ 170.38	$ 265.95	$ 494.14

Dividend

The company's shares yield over 3%. The last time the company's shares yielded this much were during the tech bubble burst and the financial crisis of '08/'09. The dividend survived both periods of stress, even continued to grow. In fact, management has paid uninterrupted dividends since 1997 when they first started paying one and the growth rate has continuously outpaced inflation. There's not much to dislike about the table below. You can see that the dividend growth rate has decelerated in the past few years, but I expect the dividend to revert towards it's ten-year average as growth on the top-line picks up.

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Dividend Info	
Forward 12M Dividend	3.40
Dividend Yield %	3.31%
Dividend Payout Ratio	27.00%
Dividend Payout Ratio (10y High)	75.00%
Dividend Payout Ratio (10y Low)	26.00%
1-Year Dividend Growth Rate	5.30%
3-Year Dividend Growth Rate	7.30%
5-Year Dividend Growth Rate	8.70%
10-Year Dividend Growth Rate	10.50%

Multiple Valuation

From a valuation standpoint the company is trading at multiples below that of their ten-year median. At only 8x earnings, 9x operating cash flow, and 13x free cash flow, shares look cheap on a historical basis, and with a PEG ratio of less than 2, the price still looks attractive when you factor in growth.

Multiples	Current	(10y Median)
Price-to-Free-Cash-Flow	12.93	16.71
Price-to-Operating-Cash-Flow	9.04	12.38
PE Ratio	8.33	18.68
Forward PE Ratio	12.64	
PE Ratio without NRI	8.33	18.68
PEG Ratio	1.76	2.12

I prefer to make valuation judgements based on discounted cash flow methods (next) as opposed to multiple expansion because I believe mood swings in the market make that a less-reliable method of valuation. I do, however, use this technique to help develop context and get a picture of upside vs. downside. I see much more room to the upside given that if the following multiples were to revert towards their ten-year median, the returns from multiple expansion alone would be significant.

Metric	Base	Multiple (10yr median)	Price	Upside
EPS (2019 low end guidance)-->	$ 8.00	18.68	$ 149.44	48%
FCF-->	$ 7.11	16.71	$ 118.76	18%
Operating-->	$ 10.23	12.38	$ 126.70	25%

Discounted Cash Flow Valuation Scenario Analysis

Given that I believe the strength of the firm lies in its ability to produce cash flow, I decided to value the firm's operating assets using a FCF discount model and then incorporate debt on the balance sheet to arrive at an equity valuation. Below you will see my base case model, as well as a conservative bear case (assuming stressed cash flows with increased costs of capital) to get an idea of what the stock price could look like given different scenarios. Both valuations assume that the long-term WACC reverts towards the firm's long-term average of 7%.

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Base Case

Valuation		Assumptions
Short Term Growth Rate		7.0%
Long Term Growth Rate		3.5%
LT WACC		7.0%
ST WACC		4.0%
Free Cash Flow	$	858.30

Free Cash Flow		Discounted	
$	918.38	$	887.15
$	982.67	$	916.98
$	1,051.45	$	947.80
$	1,125.06	$	979.66
$	1,203.81	$	1,012.60
$	35,598.39	$	29,943.94
		$	34,688.14

Value of Operating Assets	$	34,688.14
Cash & Securities	$	171.20
Value of Assets	$	34,859.34
Subtract Liabilities	$	(9,144.20)
Subtract Minority Interest	$	-
Value of Equity	$	25,715.14
Shares O/S (MM)		113.76
Value / Share	$	226.05
Upside		124%

Stressed

Valuation		Assumptions
Short Term Growth Rate		4.0%
Long Term Growth Rate		3.0%
LT WACC		8.0%
ST WACC		4.0%
Free Cash Flow	$	858.30

Free Cash Flow		Discounted	
$	892.63	$	862.28
$	928.34	$	866.28
$	965.47	$	870.29
$	1,004.09	$	874.33
$	1,044.25	$	878.38
$	21,511.62	$	18,094.71
		$	22,446.28

Value of Operating Assets	$	22,446.28
Cash & Securities	$	171.20
Value of Assets	$	22,617.48
Subtract Liabilities	$	(9,144.20)
Subtract Minority Interest	$	-
Value of Equity	$	13,473.28
Shares O/S (MM)		113.76

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Value / Share	$ 118.44
Upside	17%

The market is pessimistic about the firm's future growth in operating cash flow and valuing the company as if it's its growth days are behind it.

Earnings Based Valuation

Because of the predictability of the firm's business, I believe it also makes sense to check the value of the firm's stock using an earnings-based discount model. I also used a discount model using earnings per share. Again, I used conservative assumptions in my analysis. I normalized the firm's trailing 12-month net income using a 9% net margin (current ~11%) and used a two-stage discount model to price the stock. Furthermore, I used a required return of 10% which significantly more conservative than using the required return derived from the Capital Asset Pricing Model, which would be approximately 7%.

Revenue (TTM) (000's)	$ 7,510.70
Normalized Net Margin	9.0%
Net Income (000's)	$ 675.96
Shares O/S (000's)	113.74
Normalized EPS	$ 5.94
ST Growth	6.0%
LT Growth	3.0%
Req. Ret.	10%

Year	EPS	Discounted
1	$ 6.30	$ 5.73
2	$ 6.68	$ 5.52
3	$ 7.08	$ 5.32
4	$ 7.50	$ 5.12
5	$ 7.95	$ 4.94
Terminal	$ 117.02	$ 72.66
		$ 99.29

Conclusion

At $99 this is roughly where the stock price sits today. I believe the historic success of the company tells us that management can return the company back to higher growth. In the meantime, I do not mind paying fair price for a cash cow, a reliable and growing dividend stream, management that is incentivized to create returns, a balance sheet that can weather a financial crisis, and a business model that produces returns on invested capital that greatly exceed the firm's cost of capital. As such, I have averaged into SJM with two purchases and hold a cost basis of about $105. The company makes up roughly 5% of my satellite portfolio which, at the time of writing, holds 18 positions. As with all my purchases, I expect to hold on to the stock indefinitely, unless the price reaches astronomical levels relative to its fundamentals or there are negative developments that change my long-term outlook.

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