GT Research

GT RESEARCH – Consumer Products

SAPUTO INC. (SAP:TSX)

Recommendation: BUY

Market Cap (CAD):	**8.56bn**
Shares Outstanding:	196.95m
Shareholder Structure:	
Jolina Capital	33.9%
CDPQ	2.3%
BlackRock	1.4%
Leith Wheeler	0.8%
Ave. 3M Daily Volume:	0.33m
Float Outstanding:	65.80%
Current Price (23-Oct-12):	$42.94
52-Week Range	$36.51 - $46.39
Book Value per Share	$10.98
Price to Book	3.9x
Dividend per Share	$0.84
Current Dividend Yield	2.0%
EPS*	
Q113 LTM (adj.)	$2.44
2013e	$2.60
2014e	$2.88
2015e	$3.24
P/E	
Q113 LTM (adj.)	17.6x
2013e	16.5x
2014e	14.9x
2015e	13.3x

Near-Term Pressures, Long Term Gains

- Saputo has successfully integrated the most recent extension of its acquisition strategy in the US (DCI Cheeses). In the near term, market trends suggest a challenging operating environment for Saputo. However, in the long run, we expect the company's growth strategy to provide ample growth opportunities and solid returns.
- In the short term, we expect negative input cost dynamics, particularly for Class III milk, to put pressure on Saputo's margins, especially in the US. Meanwhile, weakening demand dynamics in Saputo's core markets, the US and Canada, are likely to weigh on revenue growth.
- One of the core attractions of Saputo is its ability to generate strong cash flow from operations coupled with low balance sheet leverage, thus giving the company flexibility to pursue an aggressive acquisition growth strategy. Moreover, in lieu of acquisition opportunities, the company is an active dividend grower and regularly uses excess cash to repurchase shares.
- With the company currently trading at a slight discount to its seven-year historical price-earnings ratio, low balance sheet leverage, high cash flow from operations, and a high amount of flexibility to carry out its corporate strategy, we believe that Saputo represents a long-term value opportunity.

RECOMMENDATION

Recommend a buy at current valuations, as the company's exceptional cash generating ability and low balance sheet leverage, founded on an entrenched market position in Canada, will allow the company to weather near-term margin pressures and successfully pursue acquisitions and growth opportunities. We have used the 7-year historical average price-earnings ratio of 18.7x as our target multiple, giving us a 12-18 month price target of $55.00 based on a blend of consensus 2013 and 2014 earnings estimates, representing upside potential of 28.1% from Saputo's closing price on October 23.

Company Overview:

Saputo's primary business manufactures, sells, and distributes dairy products such as fluid milk, whey proteins, and cheeses. It also has a grocery division focusing on baked goods, in particular snack-cakes. The company has operations in Canada, the US, Argentina, and Europe. It is the largest dairy producer in Canada as well as the 12th largest dairy producer globally, with market presence in over 50 countries. The company is also the 3rd largest cheese producer in the US after its acquisition of DCI Cheeses in 2011.

In terms of sales and EBITDA, the bulk of company revenues come from its core dairy products business. Dairy accounts for 98.1% of the net revenues, as well as 98.5% of EBITDA, with the remainder being formed by the grocery division. According to the company's results from the first quarter of fiscal year 2013, Canada, Europe, and Argentina (CEA) garnered some 61.5% of total dairy revenues as well as 63.9% of EBITDA, reflecting higher margins outside of the US (12.5% versus 11.3%).

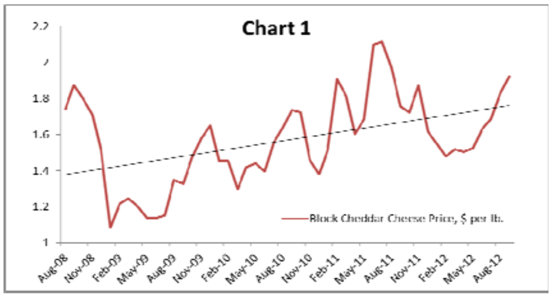
Q113 FINANCIAL RESULTS	CEA	USA	Grocery
Revenues	$1,025.0	$640.4	32.9
EBITDA	$127.8	$72.2	3.1
Revenues, % of Total Revenues	*60.4%*	*37.7%*	1.9%
EBITDA, % of Total EBITDA	*62.9%*	*35.5%*	1.5%
EBITDA Margin, %	*12.5%*	*11.3%*	*9.4%*

Canada: Entrenched Competitive Advantages

Key to Saputo's persistent robust financial health has been the company's solid business position in its home country of Canada. With a long-standing supply management program in place, which allocates quotas based on historical production, the Canadian market operates as a mature oligopoly with three dominant producers viz. Saputo, Agropur, and Parmalat Canada. The supply management system means that there is little competition between the existing producers and high barriers to entry. Overall, this allows Saputo to consistently and comfortably exhibit high margins, especially when compared to its US operations. To us, the entrenched competitive advantages enjoyed by Saputo in Canada provide stable results and afford management the flexibility to focus on its expansion opportunities abroad.

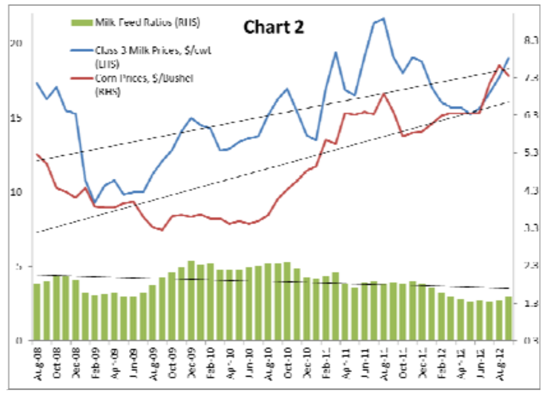
Saputo Margin Dynamics

The prices of output for Saputo that is the Saputo cheese products in the US market have shown an increase over the last five years as shown in Chart 1. However, it is important to note that the price of inputs for Saputo, (i.e. prices of Class III milk) have also shown an upward trend during the same period. Any significant changes in the prices of Class III milk has a substantial impact on Saputo's bottomline since milk comprises more than 80% of cost of goods sold. At the farm level, milk-feed ratios play an important role in determining the profitability of milk production and therefore affect the price of Class III milk. Corn, alfalfa hay and soybeans are the common ingredients of a common dairy feed and corn and alfalfa hay are the primary feed items used to calculate the milk feed ratio, while soybeans comprise

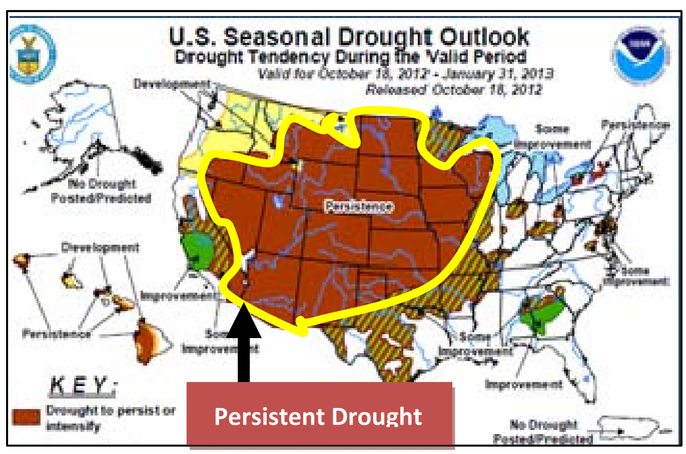


a smaller portion of the ratio calculation. The price of corn is thus a major determining factor in the price of feed and hence the milk-feed ratios. The rising price of feed puts upward pressure on milk prices in order to maintain the same milk-feed ratios. In the last five years, both the price of corn and price of Class III milk show an upward trend but the milk-feed ratios have remained fairly steady (Chart 2). This implies that the rise in the price of corn is feeding into the prices of milk through the milk-feed ratio dynamics.

The price of corn has increased by 5.0% (month-on-month) on average in the three months leading to September 2012 as a consequence of US experiencing its worst drought in 56 years including major feed crop producing regions. The USDA projects that the poor harvest, coupled with unmitigated demand, will lead corn stocks to hit their lowest levels in the last 17 years. In turn, we expect that prices of corn would remain elevated through the winter as supplies remain tight and this will keep upward pressure on milk prices.

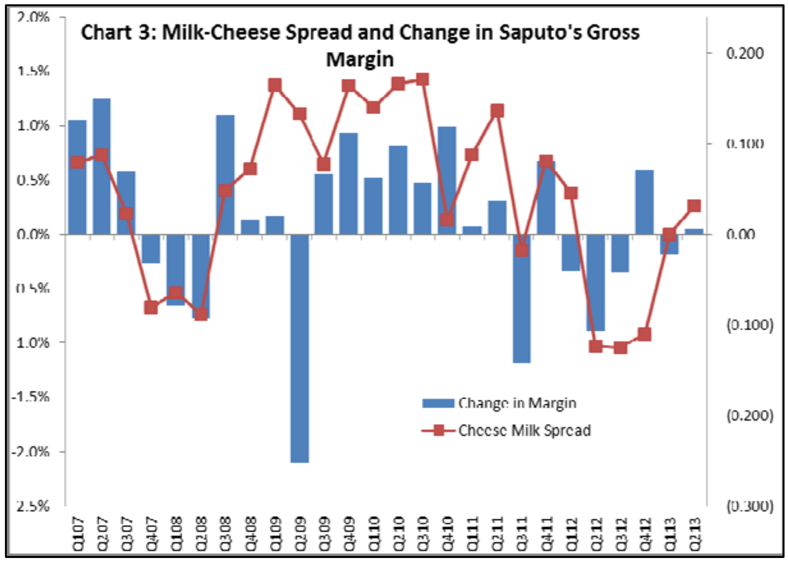


With a higher price of milk, Saputo's margins will be negatively affected via a tightening of the milk-cheese spread, defined as difference between the price of Class III milk per hundred weight and price of Cheddar Cheese per pound. The Chart 3 shows that in the last five years, an increase (decrease) in milk cheese spread shown by the line graph has coincided with the increase (decrease) in margin of Saputo.



Thus, in the short term, with corn prices expected to remain elevated, pushing up the cost of milk inputs for Saputo, the company's margins are likely to come under pressure. If Saputo raises its cheese prices in the US market to cover for the increasing price of Class III milk, its total revenues would be impacted negatively. The price elasticity of demand for cheese in USA is elastic and the own price elasticities for various cheese types (Natural, Cottage, Processed, Grated, Shredded, Others) are in the range of -1.32 and -2.07 with average elasticity being -2.10. With such elastic demand, any increase in cheese price would lead to a more than proportionate fall in total revenues.

In the short run, therefore, Saputo could face challenging market dynamics, particularly in the US.

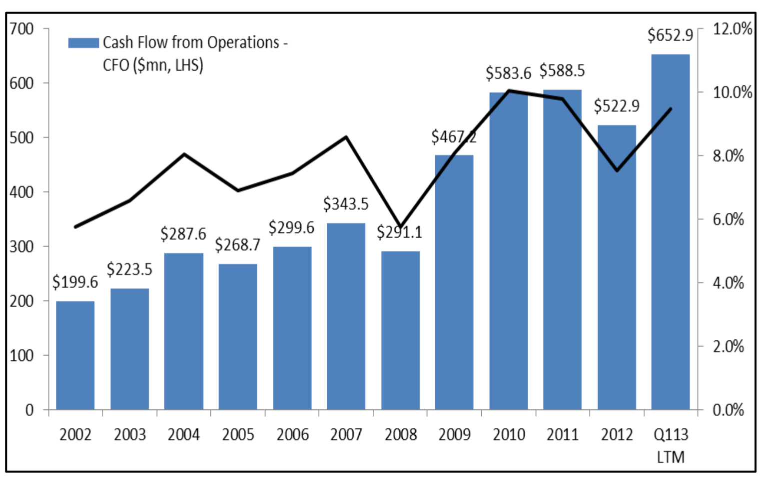


Saputo Operations and Corporate Strategy: "Leveraging" Business Strengths

Saputo's corporate growth strategy has been to expand through acquisitions, as outlined in the table below. The company's most recent purchase was of DCI Cheeses in the US in 2011. Saputo has a proven track record of absorbing its purchases effectively and rationally from an operations perspective. We believe that this strategy reflects the economic fundamentals of the dairy industry, where overall volume growth is low, distribution and supplier agreements are well established, and new production facilities require large amounts of capital expenditure. Growth via acquisitions presents Saputo with an effective expansion route.

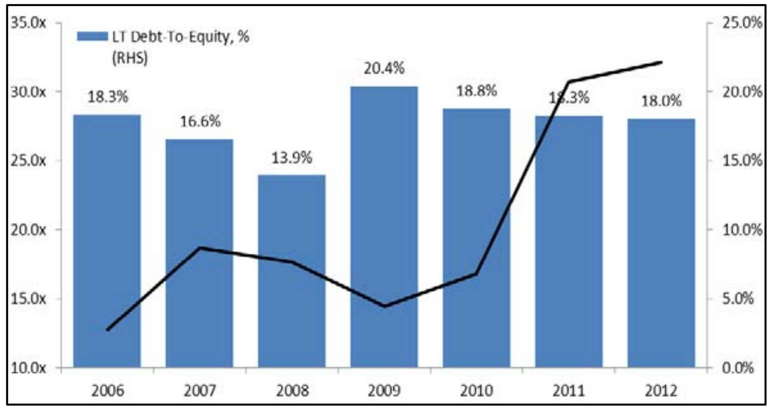
ACQUISITION HISTORY	Announce Date	Location	Price (Loc. Curr.)
Cayer-JCB Group Inc	24-Jan-00	Canada	$20.4
Dairyworld Foods	18-Dec-00	Canada	$407.3
Land O'Lakes	21-Feb-07	US	$216.0
Alto Dairy Co-Op	29-Jan-08	US	$160.0
Neilson Dairy	22-Oct-08	Canada	$465.0
F&A Dairy of California	23-Jun-09	US	$44.5
DCI Cheese Company	25-Mar-11	US	$270.5

This strategy is particularly effective when harnessed to the company's strong operational fundamentals. The bedrock of Saputo's operations is found in the company's ability to turn sales into cash. Cash flow from operations reached CAD652.9mn on an annualized basis in the first quarter of the companies' 2013 fiscal year, representing a cash flow from operations to sales ratio of 9.5%.



In conjunction with these robust cash flows from operating activities, Saputo also exhibits low levels of balance sheet leverage, with long-term debt-to-equity and net debt-to-equity of just 18.0% and 11.0% respectively. Annual interest charge coverage is also robust at 32.1x in FY2012. This low level of leverage across Saputo's balance sheet should give the company the flexibility to pursue its corporate growth strategy through acquisitions.

Valuation



As mentioned on Page 1, we believe that the current valuation of Saputo's future earnings is attractive based on the multiple of expected future earnings. The company is well positioned to execute on its acquisition growth strategy. Moreover, Saputo's ability to achieve superior returns on a strong operational track record plays in its favour. Saputo's 8-year average return on equity (ROE) is 17.2%, with 2011 and 2012 yielding ROEs above 20% annually.

Strong cash flows and low balance sheet leverage are also attractive, meaning that the flexibility for management to deliver on the company's stated acquisition and consolidation strategy is there.

Even in the absence of clear acquisition opportunities, the company's fundamentally strong cash generating abilities means that management would be able to return company profits to shareholders via dividends and share buybacks. Saputo has a strong record on both. Dividends, which are paid quarterly, have more than doubled since 2007, rising from $0.10 to $0.21 per share. We expect the amount of cash returned to shareholders to rise commensurately with historical norms going forward.

Risks

We have identified two risks to our valuation assumptions that could undermine Saputo's attractiveness and materially increase the difficulty associated with the company's long-run growth strategy.

Supply Management in Canada

A material risk to our positive outlook on Saputo is the threat of changes to the supply management structure in Canada. The Canadian government is currently pursuing trade talks with the Trans-Pacific Partnership (TPP), as well as with the European Union. For the TPP, a willingness to have dairy supply management on the bargaining table is viewed as the price of entry for Canadian negotiators. Canada's negotiations with the European Union are centered upon a bilateral free trade agreement. Both of these developments, if they result in greater competition within the Canadian dairy space, would likely force Saputo to expend materially more energy protecting its market share at home, and thus undermine its strategy of growth via acquisitions abroad.

Acquisition Absorption Difficulty

Saputo has enjoyed success thus far in terms of absorbing and consolidating its acquisitions into existing operations. However, we highlight that Saputo's strategy carries significant implementation risks. Moreover, recent news that Saputo could be shifting acquisition focus away from US markets and towards Latin America, specifically Brazil, raises this implementation risk even further.