

October 24, 2012

Stock Rating:  
**Sell**

**Market Weight**

12-18 mo. Price Target \$38.00  
SAP-TSX (10/24/12) \$43.09

Key Indices: Toronto, TSX

52-week Range \$37.28-\$46.36  
Shares Outstanding 197.0M  
Market Capitalization \$8,488.7M  
Dividend/Div Yield \$0.84/1.9%  
Fiscal Year Ends March

**Earnings Per Share**

2011 \$2.22A  
2012 \$2.47A  
2013 \$2.12E  
2014 \$1.76E

**P/E**

2011 19.8x(A)  
2012 17.4x(A)  
2013 15.6x(E)  
2014 13.9x(E)

**Company Description**

Saputo Inc. is a leading North American dairy processor with international operations in Argentina and Europe.

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Consumer Products

**Saputo Inc.**

**Cheese spread is thinning**

- **Domestic Markets in North America (US and Canada) under eminent threat.** The unfavorable market conditions and regulatory constraints in US and Canada make it unsustainable for Saputo. We estimate a sharp drop in growth (8%) and EBITDA (4%) in the combined domestic markets. We anticipate a loss of 0.2/share in each market for both FY2013 and FY2014.
- **Market conditions and potential growth in Latin America is inflated.** Fragmented dairy segment, political uncertainty, rising domestic inflation, non-existent supply chain infrastructure, unregulated labor force and environmental conditions are challenges prevalent in this division. We estimate an annual drop of 2% growth in Saputo's Argentinian division.
- **Saputo's management unprepared to meet the bipolar challenges in domestic and emerging markets.** No timelines and plans to overcome domestic regulations and meet emerging market challenges in effect. Management is working on a one-dimensional model of M&A. Recent management re-structure is unproven.
- We have made our forecasts and valuation metrics. Looking ahead, we project a target price of \$33 and \$24.40 for FY2013 and FY2014 respectively.

**Stock Price Performance**



Source: Capital IQ

**This report was prepared by a student(s) enrolled at Rotman School of Management, and who is (are) not registered as a research analyst(s) under FINRA rules. For disclosure statements, please refer to the back pages.**

## Overview

Saputo Inc. produces, markets and distributes an array of dairy products in Canada, the United States, Argentina and Europe, as well as bakery products in Canada. It produces, markets and distributes products, including cheese, fluid milk, yogurt, dairy ingredients and snack-cakes. The Company has two operating sectors: Dairy Products and Grocery Products. The Dairy Products Sector principally includes the production and distribution of cheese, fluid milk and dairy ingredients. The activities of this Sector are carried out in Canada, Europe and Argentina, and in the United States. The Grocery Products Sector consists of the production and distribution mainly of snack-cakes. It markets dairy products to the retail, foodservice and industrial segments. The Company offers a selection of specialty cheese. On March 25, 2011, the Company acquired Fairmount Cheese Holdings, Inc., the parent company of DCI Cheese Company, Inc.

Figure 1

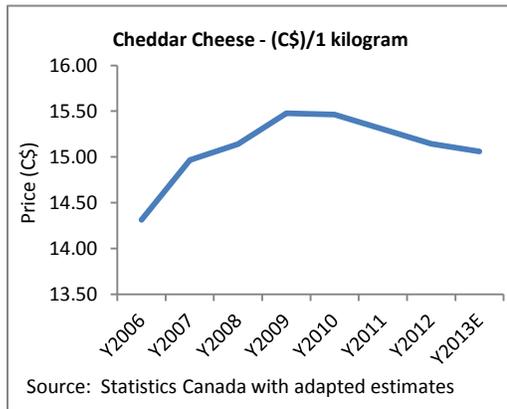


Figure 2

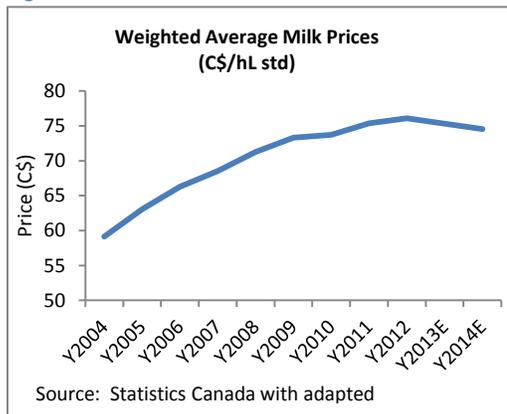
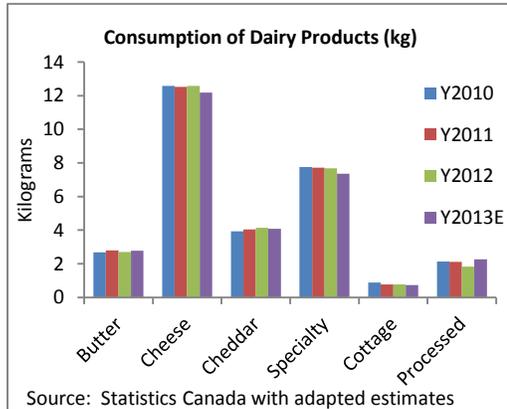


Figure 3



## Investment Thesis

### Wholesale Cheddar block price and milk prices starting to impact Canadian market

The average wholesale cheddar lb. block price is estimated to decrease by 2% for the FY2013 based on the average Y/Y% rate (Figure 1). Milk prices continue to increase steadily experiencing a 27.4% increase over the past 9 years (Figure 2). This trend is expected to continue over the next couple of years before stabilizing at a saddle point. We estimate a drop in growth of 4% and EBITDA of 2% due to upward trend to milk prices and drop in cheddar price. We are projecting a drop of 0.2/share in both FY2013 and FY2014 due to this trend.

### Canadian consumption of dairy products rates remain flat

The consumption of butter and cheese (including specialty cheese) over the past 4 years has remained flat (Figure 3). Along with increased competition in Q1 and Q2 of FY2013, Saputo has been forced to put more focus on product marketing and awareness on certain products in Q3 FY2013. Recent product recalls, rejection of plea in the Supreme Court of Canada, and lack of infusion of fresh ideas has hampered growth in the Canadian Market.

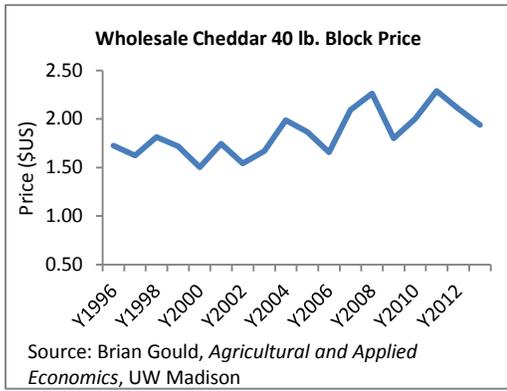
### Regulations in Canada

With Canada formally joining the Trans-Pacific Partnership (TPP) trade negotiations, uncertainty in opening up the dairy products create immense market competition and eroding market share for Saputo in Canada. Free trade deal in effect will increase market competition and need for innovative strategies from the management to fend off new competition.

### Wholesale Cheddar block price follows a negative trend impacting export prices in the US

The average wholesale cheddar 40 lb. block price is estimated to decrease by 10% for the FY2013 based on the average Y/Y% rate (Figure 4). US

Figure 4

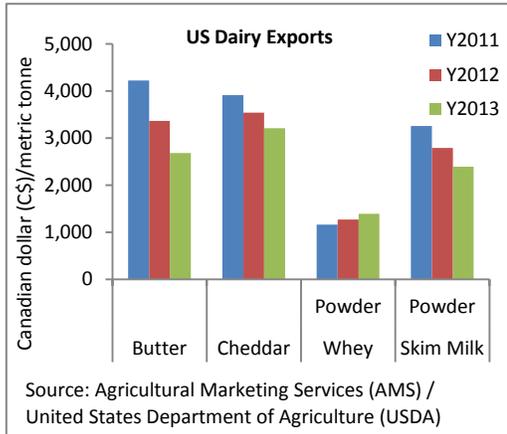


dairy export prices continue to decrease in the US for the next fiscal impacting projected revenue by 5% from US operations (Figure 5).

**US Milk price is estimated to follow an increasing trend**

The milk price is estimated to increase by 13% for the FY2013 based on the average Y/Y% rate and the temporary increase in milk price due to drought conditions (to offset increase in farm feed) (Figure 6). This estimate of 13% includes the variations due to the permanent change in place in the milk pricing formula based on whey price. The increase in milk price hamper growth prospects in the US in the next fiscal year. Market factors such as high labor costs and fuel costs have impacted operational cost in the Q1/FY2013 (EBITDA decreased by 14 million). It is estimated that this trend will continue into Q3 and Q4 of FY2013 with dairy prices forecasted to go up making it an unsustainable in the tough US market.

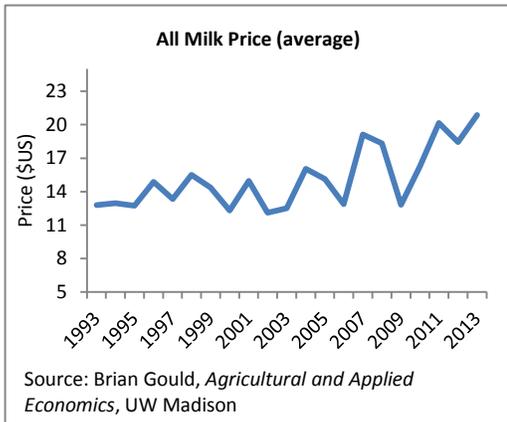
Figure 5



**US Consumption of Cheese and Fluid milk has been stagnant**

The average per capita consumption of cheese (-0.5%) and fluid milk (-1%) over 2007-2010 has been stagnant (Figure 7). This is attributed to trend towards other alternative specialty health and nutrition dairy products in North America. Recent statistics show that an increase of 70% growth in consumption of lactose-free drinks in North America and Europe.

Figure 6

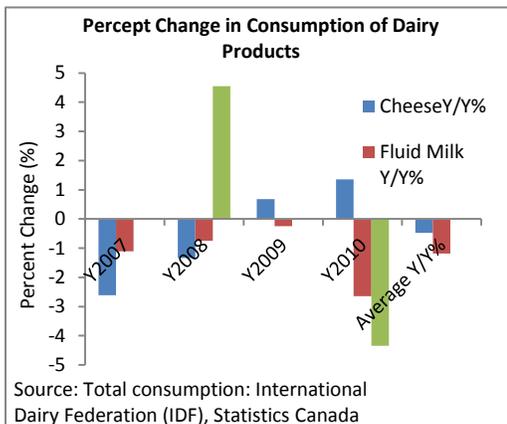


**Regulations in US**

Regulations have an impact of growth in US markets. California department of Food and Agriculture (CDFA) has recently amended the type of milk to be used in cheese processing thus impacting Saputo's earnings by 0.01/share. Recent, California farm bill (2011) of limiting milk supply to dairy processors will impact exports for FY2013. Drought conditions in the US have led to temporary increase in milk prices (until March 2013). Saputo's operations have most negative impact due to the pricing of milk based on whey price. The political uncertainty and the growing economic volatility of commodities in the US have led the government to check measures to control milk price volatility in the US.

**Impact:** These regulations have had a direct impact on Saputo's operations in US, they have now downsized their California operations by 9%. Considering the market condition, regulatory constraints, and high operating costs due to labor costs and fuel costs and complex intrinsic dynamics of inflation, political uncertainty, we forecast a decrease in revenue of 4% and EBITDA of 2% with a net impact of decrease of \$0.2/share over the next fiscal year.

Figure 7



**Market Condition in Argentina**

Economy is burdened by excessive government relations and labor market problems. Approximately 97% of the labor force in Argentina is uncontrolled by the government increasing operational risk. Transport infrastructure in Argentina needs to be improved. The supply chain network is porous with risks of informal transactions and distribution. Although, Argentina's milk prices are lowest in the world, the price of milk

Figure 8



is still high within the country. A drop of 2% in profits for FY2013 is projected due to recent writeoffs of \$2.5 million in the Argentinian division. Additionally, the recent floods in Argentina impact the quality of farm feed and the market conditions, thus we forecast a decrease in 0.05/share for FY2013.

Argentina’s dairy industry shows a high level of fragmentation (Figure 8), and holds similar challenges faced by Saputo in the US market. Price of milk lacks fixed pricing formula and is unregulated by law in the Argentinean dairy industry. There are no legal or formal contracts between parties and milk prices in Argentina resulting in extreme volatility (US\$0.09-US\$0.31, standard deviation of \$0.06) due to recurrent cycles of over and under supply of milk and erratic economic policies.

### Market Condition in Brazil

As in Argentinian markets, a large amount of dairy products in Brazil occur in the informal sector, leading to an occasional disjointed supply chain. Recent government policies in the dairy export markets in Brazil have produced a self-sufficient dairy industry that is capable of focusing on the export market. A major factor contributing to this process is Brazil’s participation in MERCOSUR, which has the effect of discouraging imports from non-MERCOSUR countries.

Saputo’s business model of growth by acquisitions and post-acquisition realization of synergies prove to be wrong in Latin America. Latin America model has been traditionally focused on long-term viability and not short-term profitability. Investments and physical presence of major international firms with proven track record on research and development, especially Nestlé, have allowed the dairy industry to develop rapidly in Brazil. Finally, recent inflation in land and other input prices are a disadvantage for Saputo to go into Brazil.

### Management needs to plan for uncertainties

Recent re-structuring of the management is unproven to take over the complex challenges facing Saputo. Management is not investing in research and development and product differentiator segments compared to their peers especially Nestlé. Management has no definite plan with timeline to combat regulations and market competition in US and Canada.

Table 1

	Target price (12-18 month) \$38			
	FY2011A	FY2012A	FY2013E	FY2014E
EPS	2.22	2.47	2.12	1.76
P/E	19.8	17.4	15.6	13.9
PEG			-1.1	-0.81
EBITDA	790	831	798	766
EV(\$m)	7771	8957	7532	6700
EV/EBITDA	9.8	10.8	8.1	6.2
EPS Y/Y%	21.3	11.2	-14.1	-17
Revenue (\$m)	6002	6930	6376	5866
Price (\$)	43.75	43.2	33	24.4

## Valuation

We arrive at the target price of \$38 (12-18 month), by looking at earnings/share in US (\$0.2/share drop), Canada (\$0.2/share drop) and Argentina (\$0.05/share drop) for both FY2013 and FY2014. Our (12-18 month) target price of \$38 is based on depreciation of P/E ratio of 5% both FY2013 and FY2014 (Table 1). Our projected P/E multiples for FY2013 and FY2014 are 15.6x and 13.9x. We have projected EBITDA to drop by 4% annually (2% each from operations in US and Canada) during FY2013 and FY2014. We arrive at our forecasted EV/EBITDA multiples of 8.1x and 6.2x respectively for FY2013 and FY2014.

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## Recommendation

We value Saputo as a leading dairy processing company, fundamentally based on good principles in acquisitions and post-acquisition realization of synergies for growth. However, with the economic uncertainty, slowness in domestic markets, stiff market competition, high operating costs, and erratic inflation, we estimate a sharp decrease in growth potential for Saputo in FY2013 and FY2014. Following up on the valuation metrics, we performed technical indicators to confirm our recommendation. The technical indicators based on current month's average Stochastic Oscillator show %K=86 and %D=87. Furthermore, On Balance Volume (OBV) show a constant trend and Relative Strength Index (RSI) value of 66. **We strongly recommend a SELL.**

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## Key Risks

Some of the key risks to our target price include: US market condition improving after the US elections, favorable environmental conditions, higher by-product prices and positive impact of the California farm bill. In Canada, we forecast advertising in Q3 and Q4 of FY2013 to improve growth forecasts. In Argentina and Brazil, improving environmental and inflation rates provide positive gains. Investment in research and development and product differentiators in emerging markets provide incentives for long term growth. Management's re-structuring and looking for immediate strategic M&A opportunities in Oceania or Asia provide positive growth potential.

## Disclosures

Ownership and material conflicts of interest:

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