

Pilgrim's Pride Corporation: Turnaround Story Not Fully Valued, Target Price US\$33.11

23 April 2014

Pilgrim's Pride Corporation (PPC:NASDAQ)

Rating: **BUY**

Target Price: US\$33.11

Current Price: US\$22.51

Potential Upside: 47.1%

Average 3-mth Trading Volume: 883,567

- **Performance Driven Management Team** – Since coming on board in Jan-11, CEO William Lovette has driven a locally focused strategy, emphasizing on profitability optimization at the plant level. This has led Pilgrim's growth with a 6.9% CAGR in net sales over the past 3 years.
- **Limited US Growth, Greener Pastures Overseas** – While the US has witnessed tremendous growth in its meat consumption from 108.5 pounds per person in 1909 to 165.9 pounds in 2012, the 2012 number only matches a similar figure in 1983. US annual chicken exports are forecast to hit record high of 7,500m pounds in 2014. Pilgrim's revenue derived from export and other chicken-by product grew at 8.4% on a 3-year CAGR basis, outpacing over net sales growth. Atop, Pilgrim's is exploring new geographical markets by leveraging of its major shareholder, JBS USA's network.
- **Strong Operating Efficiency** – Pilgrim's FY13's 9.6% EBITDA margin came in better than Tyson's 5.8%, a result of cost reduction, improving gross profit margin from 5.4% in FY12 to 10.1% in FY13 and higher capacity utilization. For FY13, Pilgrim's achieved an average utilization rate of 91.6%, compared to Tyson's 87%.
- **Healthy balance sheet** – Despite undergoing a bankruptcy situation in FY08/09, Pilgrim's has managed to lower its total debt every year since FY11. A strong financial performance in FY13 has left Pilgrim's flushed with cash, in time to pay off its loans maturing in FY14. Coupled with FY14 forecast cash inflow, Pilgrim's D/E ratio is expected to fall from 0.27 to a zero net debt position, with sufficient cash to pursue its capital expenditure plans.

Pilgrim's: Fiscal year end 31-Dec

Income Statement (US\$'m)	FY12	FY13	FY14E	FY15E	FY16E
Revenue	8,121.4	8,411.1	8,789.7	9,229.1	9,690.6
Gross Profit Margin (%)	5.37%	10.05%	14.00%	16.00%	16.00%
EBITDA Margin (%)	4.90%	9.62%	13.39%	15.31%	15.22%
EBIT Margin (%)	3.08%	7.83%	11.65%	13.77%	13.76%
PATMI Margin (%)	2.15%	6.53%	7.32%	8.77%	8.82%
Earnings Per Share (US\$)	0.70	2.12	2.48	3.13	3.30

Growth rates (%)	FY12	FY13	FY14E	FY15E	FY16E
Revenue	7.77%	3.57%	4.50%	5.00%	5.00%
EBITDA	N.A.	103.49%	45.44%	20.03%	4.39%
Pre-tax profit	N.A.	274.97%	72.57%	25.85%	5.62%
EPS	N.A.	204.78%	17.02%	25.86%	5.60%

Balance sheet (US\$'m)	FY12	FY13	FY14E	FY15E	FY16E
Total assets	2,913.9	3,172.4	3,426.0	4,235.4	5,102.6
Total liabilities	2,004.9	1,679.8	1,293.1	1,294.1	1,308.0
Total equity	909.0	1,492.6	2,132.9	2,941.3	3,794.6

Cashflow statements (US\$'m)	FY12	FY13	FY14E	FY15E	FY16E
Operating cashflow	199.6	878.5	670.5	938.2	929.8
Investing cashflow	(60.4)	(181.8)	(135.5)	(160.7)	(119.4)
Financing cashflow	(111.0)	(250.2)	(410.2)	(0.3)	(0.2)
Foreign exchange effect	(1.6)	(6.5)	0	0	0
Net change to cash position	28.2	446.5	124.8	777.2	810.2
Beginning cash balance	41.6	68.2	508.2	633.0	1,410.2
Ending cash balance	68.2	508.2	633.0	1,410.2	2,220.4

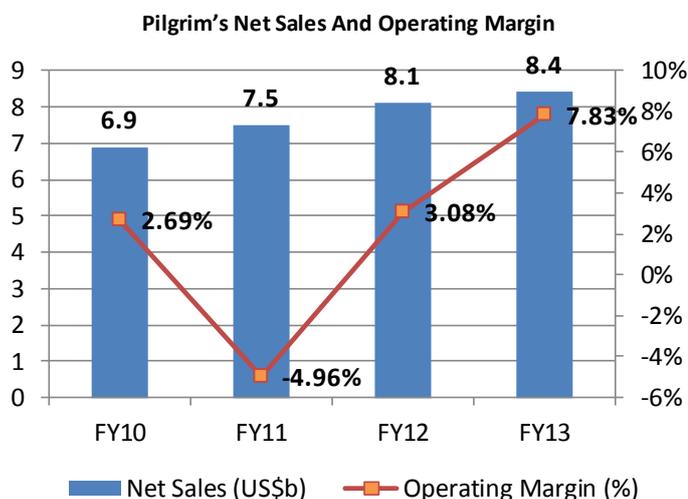
Background: Rising From the Brink Of Bankruptcy

Pilgrim's is the second largest US chicken producer. Pilgrim's main products are fresh and prepared chicken. Pilgrim's provides its products to the food service, retail and export industries. Key customers include Yum!, Burger King, Walmart and Costco. Apart from Walmart which contributed 9.7% of Pilgrim's FY13 turnover, no other customer accounted for more than 7% of PPC's revenue. Key export markets include Mexico, Russia and Angola.

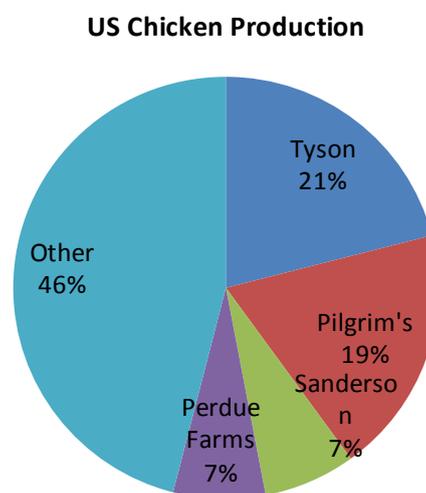
Following the acquisition of Gold Kist (the third largest US chicken producer then) in December 2006, Pilgrim's filed for bankruptcy in December 2008 due to a credit crunch, and surfaced from the bankruptcy in December 2009 through a capital injection from JBS USA Holdings, which now owns 75.3% of the shares outstanding. Apart from providing a strong financial backing, JBS USA, which is a subsidiary of JBS S.A., the largest multinational food processing company in the world, has enabled cost savings opportunities and opened up new geographical markets for Pilgrim's, especially for chicken parts that are not widely consumed in the US.

Atop, a new management team, changed in 2011, has brought a locally focused strategy to Pilgrim's, stressing profitability optimization at the plant level. CEO William Lovette has enforced a performance driven culture guided by intensive industry benchmarking. From FY10 to FY13, net sales, operating income and net income has grown at compound annual growth rate (CAGR) of 6.9%, 52.6% and 84.6% to US\$8,411.1m, US\$658.9m and US\$549.6m respectively.

Aside from improving operating efficiency, Lovette is striving to steer Pilgrim's product mix from 55% branded/45% private label to 75% branded/25% private label. This would increase the value-add mix and improve margins. To achieve this goal, Pilgrim's has hired Chad Baker, former Senior Vice President of Sales & Marketing with Smithfield Foods.



Source: Company



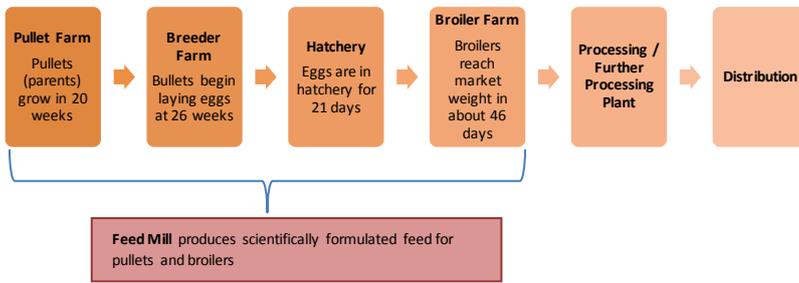
Source: Watt Poultry USA, March 2013

Chicken Supply Chain

The chicken production process begins with the supply of pullets (parents). Once the pullets have grown (20 weeks), they begin laying eggs at 26 weeks. The eggs are kept in the hatchery for 21 days and grow into broilers, which reach market weight in about 46 days. These steps form the upstream portion of the supply chain. Lastly, the broilers are sent for processing before distribution. This is the downstream portion of the production process. There are 4 large players in the upstream segment, Pilgrim's accounts for 19% of it. Tyson Foods Inc., Sanderson Farms Inc. and Perdue Farms Inc. make up the other 3 names.

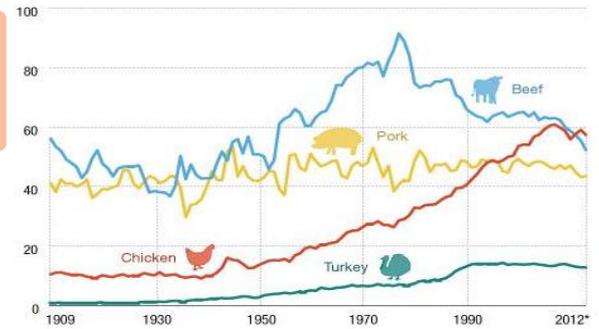
In the US, meat consumption has risen from 108.5 pounds per person in 1909 to 165.9 pounds in 2012. One key thing to note is the rise of chicken as a protein choice. In 2010, it surpassed beef as the highest form of meat consumed in the US. In 2012, the average person consumes 57.4 pounds of chicken in a year, or 34.6% of the total meat consumed. However, total US meat consumption has somewhat stagnated with 2012's figure similar to 1983's 165.5 pounds per person. This offers limited upside for protein producers.

US Chicken Supply Chain



Source: Tyson 2013 Fact Book

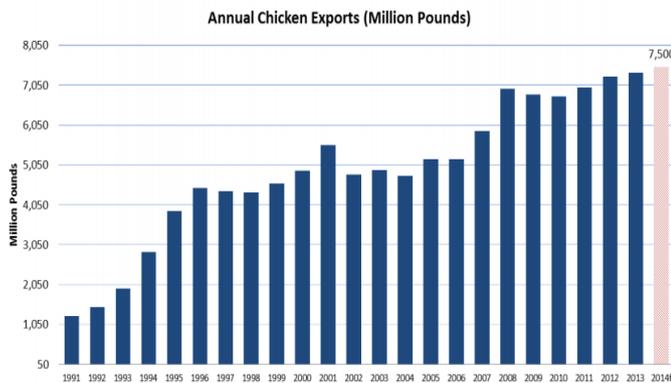
US Meat Consumption, Pounds Per Person



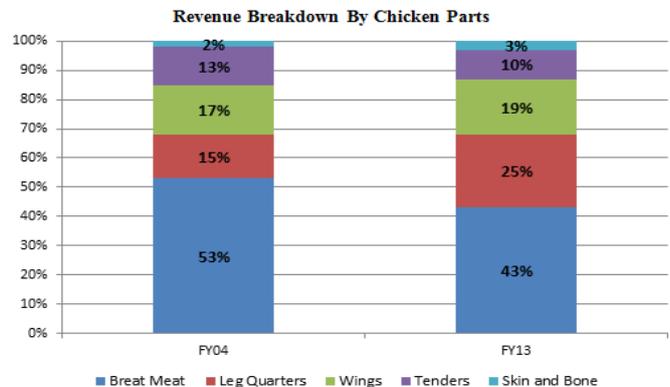
Source: Earth Policy Institute

The key demand drivers of chicken include export agreements, dietary preference and demand in different countries. US annual chicken exports are forecast to hit a record high of 7,500m pounds in 2014. From FY09 to FY13, Pilgrim’s revenue derived from exports and other chicken by-products has grown 8.4% CAGR to US\$1,580.4m. Notably, this rise is faster than Pilgrim’s net sales CAGR of 6.9%. With a surge in export figures, Pilgrim’s sales by chicken parts have changed as well. Additionally, Pilgrim is able to leverage JBS’s global network to expand its geographical reach.

In the US, customers prefer the chicken’s white meat portion (i.e. breast meat and wings), while the Asian consumers favors the dark meat parts (i.e. leg quarters). In FY04, breast meat and leg quarters made up 53% and 15% of Pilgrim’s net sales respectively. In FY13, breast meat fell to 43% while leg quarters accounted for 25% of Pilgrim’s turnover.



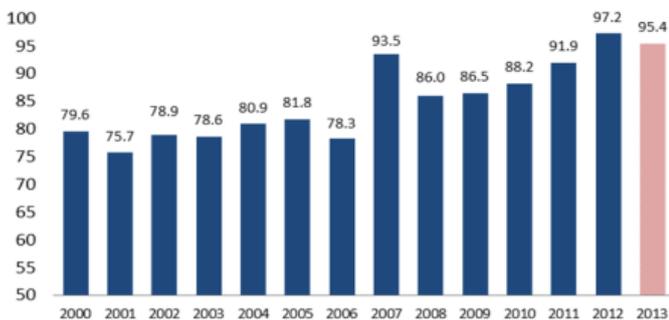
Source: National Chicken Council



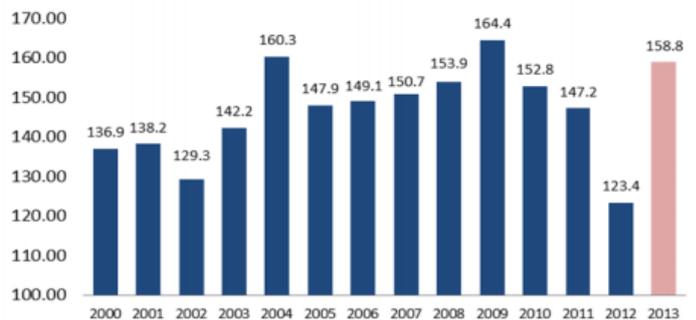
Source: Company

The key supply drivers of chicken are a potential disease outbreak and feed costs. An outbreak is hard to predict and thus, difficult to protect against. Corn and soybean meal accounted for 50% and 27% of Pilgrim’s cost of sales in FY13. For the 2013/2014 crop, corn will have fewer planted acres of 95.4m acres, compared to 97.2m acres the year before. However, good weather in the Southern US is set to push corn yields, at 158.8 bushels per acre, to its highest levels since 2009. On a global level, corn stocks are forecast to rebounds close to 2009 levels on the back of increased production.

US Corn Planted Acres (Million Acres)



US Corn Yield (Bushels Per Acre)



Source: USDA-WASDE

Strong EBITDA Margin Backed By High Capacity Utilisation

Based on trailing price-to-earnings (P/E) ratio, Pilgrim's came in the lowest at 10.8, compared to Tyson's 17.6 and Sanderson's 11.5. Although its sales 3-year CAGR is the joint-lowest with Tyson at 6.9%, its earnings-before-interest-tax-depreciation-and-amortization (EBITDA) margin was considerably higher at 9.6% compared to Tyson's 5.8%. On the earnings-per-share (EPS) front, Pilgrim's has recorded a 3-year CAGR of 76.3%, far ahead of the other two companies.

Higher capacity utilization during FY13 of 91% compared to Tyson's 87% coupled with lower percentage of sales directed towards research and development (R&D) and advertising and promotion (A&P) expenses led to the improvement in Pilgrim's bottom line. The performance validates Lovette's push towards a performance driven culture measured against an industry benchmark.

In terms of capital structure, Pilgrim's possesses the highest net debt-to-equity (D/E) ratio of 0.27 compared to Tyson's 0.20 and Sanderson's negative ratio (i.e. zero net debt). While this may raise a red flag, a closer look into Pilgrim's financials shows that of the total long-term debt (US\$912.2m), 45% or US\$410.2m will be maturing in FY14. As of end FY13, Pilgrim's held US\$508.2m in cash, which is sufficient to pay off the debt. Factoring in this reduction, and Pilgrim's FY14 forecast cash inflow, Pilgrim's D/E ratio hold zero net debt as well.

Company	Share Price	Mkt Cap (US\$b)	Trailing P/E	Fwd P/E	P/B	D/E	Sales Growth	EPS Growth	EBITDA Margin	Capacity/wk	Capacity Utilization	R&D To Sales	A&P To Sales
Pilgrim's	22.51	5.83	10.83	13.79	3.91	0.27	6.90%	76.30%	9.58%	35.7m heads	0.91	0.05%	0.06%
Tyson	43.25	14.72	17.59	14.82	2.34	0.20	6.90%	1.00%	5.75%	47m heads	0.87	0.15%	1.61%
Sanderson	82.38	1.90	11.39	12.03	2.73	N.A.	11.70%	-2.20%	12.07%	9.4m heads	N.A.	N.A.	0.12%

Valuation

Due to the cyclical nature of Pilgrim's earnings ability, with regards to a potential flu outbreak impacting demand and profitability, using the discounted cash flow approach may not be appropriate. This led me to opt for P/E instead.

Given its strong market share, higher EBITDA margin (compared to Tyson), higher capacity utilization rate and expected lowering of its leverage ratio, I expect Pilgrim's to trade at a P/E closer to Tyson. Based on its trailing P/E, Tyson's share price is trading at 17.6. However, if we use the industry average of 13.3 as a benchmark, I think that it's more conservative.

In the base scenario, I assume a 4.5% sales growth, which is higher than FY13's figure but lower than Pilgrim's 3-year CAGR. I also reduced its cost of goods sold as a percentage of its net sales, in line with the improving operation efficiency. With a projected EPS of US\$2.48, Pilgrim's target price comes in at US\$33.11, providing a 47.1% upside based on its closing price of US\$22.51. Consensus estimates from FactSet had a hold rating on Pilgrim's with the mean target price at US\$20.75, or a 7.8% decline from its closing price.

Assumption	Sales Growth	EBITDA Margin	EPS Growth	EPS (US\$)	ROE	D/E	P/E	TP (US\$)	Consensus TP (US\$)	Consensus P/E	Consensus EPS
Bull	7.2%	17.9%	69.0%	3.59	38.4%	0.21	17.57	63.08	20.75	13.8	1.63
Base	4.5%	13.4%	17.4%	2.48	30.2%	0.24	13.3	33.11			
Bear	1.8%	6.8%	53.8%	0.98	14.5%	0.29	7.56	7.41			

Risks To the Valuation

A change in consumer dietary preference away from chicken to other protein products such as pork and beef would result in a decline of Pilgrim's revenue.

Food contamination of its products would lower revenue and weaken Pilgrim's brand image with its clients.

A spike in feed cost would increase Pilgrim's cost of goods sold and weigh on profitability.

Due to a revenue surge in the export market segment, particularly Mexico, any disruption in the distribution channels or export agreements with other countries could have a substantial impact on Pilgrim's total turnover.