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BTN EQ Review

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EQ Review of J.M. Smucker (SJM)

J.M. Smucker (SJM) has not been immune to the troubles faced by packaged food companies. Over 30% of the company's sales come from coffee, but growth from selling *Dunkin Donuts* brand Keurig cups is being offset by floundering sales of its *Folgers* instant brand. Its second largest segment, Pet Food, faces increasing competition, while its more familiar consumer food brands are under pressure from consumers switching to more fresh products. With 92% of sales in the US and 6% in Canada, SJM has essentially no diversification and no exposure to faster growing, less developed markets. The company continues to attempt to diversify into higher growth areas as evidenced by its announcement this week it is selling its baking business which includes the iconic *Pillsbury* brand.

Despite these challenges, SJM's reported earnings appear to be some of the highest quality in the food industry. Our observations include:

- SJM has some of the most efficient working capital management in the industry. Accounts receivable days-of-sales are low and declining while inventories days-of-sales are low and stable.

- Accounts payable in the 3/18 quarter increased by over 4 days versus the year-ago period. However, we note that the increase was more muted than some of its peers and its absolute level of payables relative to cost of sales is the lowest in the group.

- Capital spending has been on the rise to support the buildout of new factory capacity and is projected to increase another $40 million in FY 2019. This will continue to be a drain on free cash flow but should start to reverse in FY 2020.

- SJM has postponed its buyback and did not purchase any shares in the fiscal year ended 4/18. Management plans to reduce leverage after the Ainsworth acquisition back to 3 times EBITDA over the next couple of years which will likely prioritize debt reduction over the buyback. Lower share count boosted EPS by 1% in the quarter, a benefit which will be gone moving forward.

- SJM has taken multiple goodwill and intangible write-offs in the last few years related to its Pet Food segment which accounts for 30% of total goodwill and over 20% of total shareholders' equity. However, impairment testing revealed that the carrying value of goodwill only exceeds fair value by less than 1% and just a 50 bps drop in long-term growth assumptions drop fair value below carrying value, meaning more write offs are possible.

Receivables and Inventory Are Under Control

SJM's accounts receivable days of sales (DSOs) fell to 19.8 in the 4/18 quarter, down from 22.4 in the 4/17 quarter, continuing several quarters of such declines. We would also note that the company's DSOs in the low 20s are some of the lowest in the industry. Likewise, inventory days (DSI) declined slightly to 71.5 from 72.7 in the year-ago period.

From this perspective, the company has little room to improve its cash flow growth by tightening up receivables collection. However, while we don't advocate the practice, it seems the company could be in a position to drive some sales growth by extending better payment terms with customers if it needed to.

Accounts Payable Up

The following table shows accounts payables on a days-of-cost-of-sales basis for the last eight quarters:

	4/30/2018	1/31/2018	10/31/2017	7/31/2017
COGS	$1,091	$1,175	$1,169	$1,087
Accounts payable	$512	$471	$507	$478
Accounts payable DSPs	42.8	36.6	39.6	40.1

	4/30/2017	1/31/2017	10/31/2016	7/31/2016
COGS	$1,137	$1,156	$1,171	$1,093
Accounts payable	$477	$429	$436	$452
Accounts payable DSPs	38.3	33.8	34.0	37.7

The 4.5-day year-over-year increase in days payable continues a trend of rising payables which is boosting cash flow. The trend of rising payables is something we are seeing in many industries and it is particularly pronounced in the packaged food industry. However, we must note that the company's levels of payables relative to COGS is one of the lowest in the group and the increase, while significant, is still relatively modest when compared to some if its peers including Mondelez (MDLZ) and Kellogg (K). This could be an indication that the company still has room to boost cash flow growth by lengthening payments terms. As with extending receivables terms, we do not condone the practice as a healthy solution, but simply observe that SJM appears to not have stretched as far as some of its peers meaning it has more "dry powder" at its disposal.

Capex Is Rising and Share Buyback Is Stalled

SJM has forecast free cash flow in fiscal 2019 of $850 million, an approximate $50 million decline from FY 2018. The below table shows a breakdown of cash flow for the last eight trailing-12 periods:

	4/30/2018	1/31/2018	10/31/2017	7/31/2017
T12 Operating Cash Flow	$1,218	$1,168	$1,118	$1,124
T12 Capex	$322	$266	$238	$212
T12 Free Cash Flow	$896	$902	$880	$913
T12 Dividends	$350	$349	$348	$346
Dividend % of FCF	39%	39%	40%	38%
T12 Stock Repurchases	$7	$426	$426	$426
Cash After Buyback	$539	$128	$107	$140

	4/30/2017	1/31/2017	10/31/2016	7/31/2016
T12 Operating Cash Flow	$1,059	$1,131	$1,254	$1,393
T12 Capex	$192	$177	$168	$199
T12 Free Cash Flow	$867	$954	$1,086	$1,194
T12 Dividends	$339	$332	$325	$318
Dividend % of FCF	39%	35%	30%	27%
T12 Stock Repurchases	$438	$452	$453	$452
Cash After Buyback	$90	$169	$308	$424

Capex has been on the rise for the last several quarters, driven partly by the buildout of new factory capacity. Management is currently expecting capex of $360 million in FY 2019.

The increased pace of capital spending and one-time integration costs has led management to put the share buyback on hold. The company did not repurchase shares in the fiscal year ended 4/18. The lower share count added about 1% to EPS growth in the most recent quarter which is a benefit that will be gone in the next quarter absent the buyback. Once the accelerated capital spend is complete in FY 2019, free cash flow should normalize, freeing up more cash for capital allocation. Net debt as of the end of the 4/18 quarter was approximately 2.8 times EBITDA. The company added another $1.9 billion to its quarter-end debt load of $4.8 billion for the May acquisition of Ainsworth which will bring its total to $6.7 billion. We estimate Ainsley generates about $140 million annually in EBITDA, implying a post-acquisition debt-to-EBITDA of about 3.7. Management has stated it would like to pay down debt to 3 times EBTIDA over the next couple of years, implying debt reduction of around $1.2 billion. The $375 million in proceeds from the sale of the baking business will help, but the company will obviously have to divert most of its post-dividend free cash flow to paying off debt to reach that goal. Therefore, we would not expect a meaningful return to the buyback anytime soon.

Pet Food Goodwill Impairments and Possibly More on the Way

During fiscal 2018, SJM took a $145 million goodwill impairment charge to write down the value of goodwill related its Pet Food division. In addition, the company recorded another $31.9 million in charges to reduce the carrying value of certain indefinite lived-intangibles, also related to the Pet Food segment. The Pet Food goodwill and intangibles balances mostly stem from the company's 2015 acquisition of Big Heart. The company also disclosed in its 10-K that the estimated fair value of the goodwill of its Pet Foods segment (30% of total goodwill) exceeded its carrying value by only 1%, and that a 50 bps decrease in the long-term growth assumptions or the cost of capital would result in a fair value below carrying value. Therefore, future goodwill impairment charges seem very possible.

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