Stock Pick of the Week: Pilgrim's Pride Corp (PPC)

This week we're highlighting a company that operates in one of the most popular markets in America. This company's products can be seen in grocery stores, restaurants, and fast food eateries. The company is vertically integrated across the entire production process, from production to marketing to distribution, giving it tight controls on safety and quality. What product does this company provide?

Today we're talking about chicken.

This company has a long and storied history and presents a very attractive investment opportunity at its current price. Our stock pick of the week is Pilgrim's Pride Corporation (PPC)

What Is Pilgrim's Pride?

Pilgrim's Pride, founded in 1946, is involved in the production, processing, marketing, and distribution of fresh, frozen, and value-added chicken products to retailers, distributors, and foodservice companies. Pilgrim's Pride operates in the United States, Mexico, and Puerto Rico. The company provides chicken products to companies such as Chick-fil-A, Sysco, Kroger (KR), Wal-Mart (WMT), and Costco (COST). Chicken remains the largest protein source in the United States, with an estimated 32 billion pounds to be consumed in 2015. Globally, chicken is the second most consumed protein by mass, behind only pork. By selling diverse chicken products to destinations in over 95 countries, Pilgrim's Pride is one of the largest chicken producers in the world, and produced almost 8 billion pounds of chicken products in 2014.

Why Invest Now?

Pilgrim's Pride has done an excellent job of growing its business over the past three years, and after fears of chicken oversupply, the stock is now deeply undervalued. Pilgrim's revenues grew by 2% year over year in 2014. This may not sound like much, but for a company of Pilgrim's scale equates to over $170 million dollars in additional sales. This revenue growth led to Pilgrim's Pride's operating income to increase by 82% year over year and its 2014 after-tax profit (NOPAT) to increase 18% year over year.

Pilgrim's Pride has also been benefitting from lowered feed costs in recent years, and this cost savings can be seen in the company's increased return on invested capital (ROIC). Pilgrim's Pride's ROIC was a top-quintile 26% in 2014, up from only 9% in 2012. Pilgrim's Pride also has a free cash flow yield of 9% and free cash flow of $808 million in 2014.

Chicken Supply a Concern?

In late March, chicken oversupply fears were attributed to Pilgrim's Pride's stock price dropping nearly 10%. This warning stated that chicken supply was growing faster than demand and risked causing a decline in pricing. Adding to the confusion, the prior week it was announced by the USDA that bird flu had been found in chickens in Missouri and Arkansas, potentially cutting into total supply and raising the price of chicken products. However, events like these are business as usual in an industry that relies on factors like feed prices, and is extremely sensitive external supply and demand. Pilgrim's Pride's strong profit growth, increased efficiency, and quality balance sheet give it the ability weather these fluctuations in expectations and market noise.

These Adjustments Reveal Pilgrim's Pride's Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following major adjustments to Pilgrim's earnings in 2014:

- Removed $103 million non-operating expenses included in operating earnings.
- Removed $14 million in non-operating expenses hidden in operating earnings.
- Added $42 million in taxes due to non-operating expenses lowering operating earnings.

These three adjustments to Pilgrim's Pride's earnings have the net effect of raising its after-tax operating profit by over $77 million, or 11% above its net income.

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When considering Pilgrim's Pride's valuation, we also add $50 million in off-balance sheet debt (<1% of PPC's market cap) to Pilgrim's total debt. This adjustment brings Pilgrim's total debt to only $102 million.

Kneejerk Price Decline Has Created a Buying Opportunity

After the report about chicken supplies putting downward pressure on pricing, Pilgrim's stock price has dropped nearly 11%. This large price decline is unwarranted given the improved operations of the business.

At ~$24/share, Pilgrim's has a price to economic book value (PEBV) ratio of just 0.8. This ratio implies that the market expects the company's profits to permanently decline by 20%. Such low expectations, when coupled with the company's strong fundamentals, allows PPC to earn our Very Attractive rating.

Even if we assume Pilgrim's pretax margin declines to 12% (from 14% in 2014), if the company can grow NOPAT by just 3% compounded annually for the next eight years, the stock is worth $34/share today — a 42% upside from current levels. You might want to take a chance on this undervalued company in a growing market.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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