



Fatten Your Nest Egg with Sanderson Farms

Chicken producer stocks have been on a tear this year. The group's best performer has been Sanderson Farms (SAFM, +51%), followed by Pilgrim's Price (PPC, +44%) with Tyson (TSC +7%) lagging. We selected SAFM and PPC as [Long Ideas](#) in mid-2015. In this update report, we are honing our focus in on SAFM over PPC as the idea with more legs (or wings) among chicken producers.

These companies look similar from a high level. However, a closer look shows a number of factors favoring SAFM, including: a) higher [NOPAT](#) margins and return on invested capital ([ROIC](#)); b) a narrower gap between GAAP profit and [economic earnings](#); c) higher free cash flow ([FCF](#)) yield and a lower price-to-economic book value ratio ([PEBV](#)); d) stronger revenue growth and e) minimal debt relative to PPC and TSN.

Figure 1: Poultry Producer Comparison

Company	Revenue Grw. (TTM)	NOPAT Margin	Capital Turnover	ROIC	Economic / GAAP EPS	FCF Yield	PEBV
SAFM	10.8%	7.3%	2.4	17.6%	74%	1.0%	0.76
PPC	1.8%	6.4%	2.4	15.3%	70%	-2.0%	0.86
TSN	-2.5%	5.1%	1.6	8.0%	56%	-7.0%	0.70

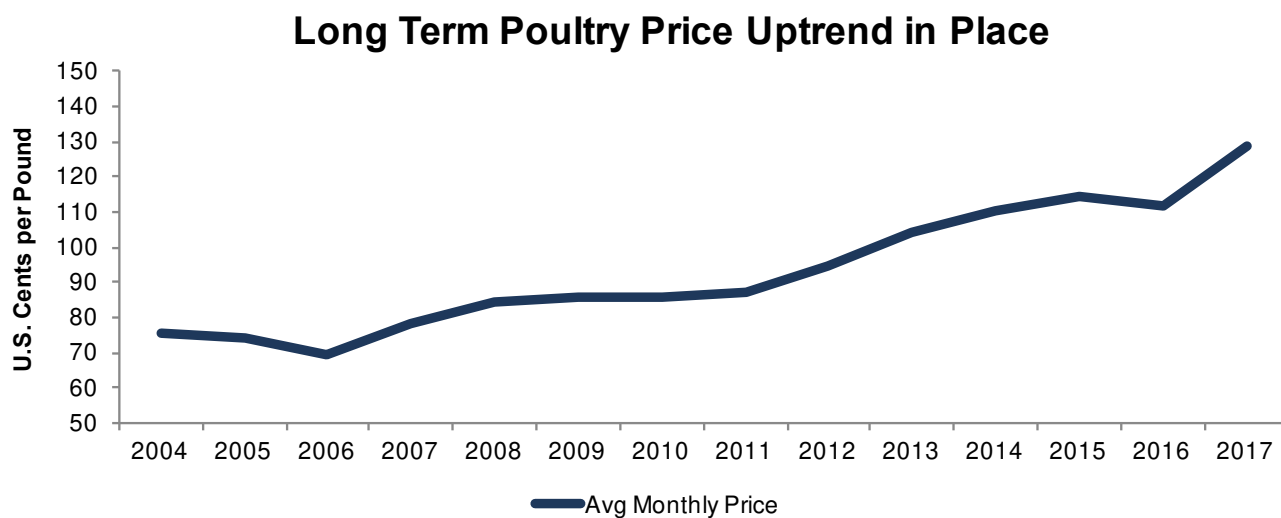
Sources: New Constructs, LLC and USDA Market News

SAFM currently earns a [Very Attractive rating](#) and was upgraded from Attractive on March 8, 2017. PPC currently earn a Neutral rating and was downgraded from Attractive on August 4, 2017. Due to these changes and the relative attractiveness of SAFM as shown in Figure 1, we are closing our long position on PPC. Investors should focus on SAFM as the best way to play growing chicken demand.

Commodity Prices Create Tailwinds for Poultry Producers

Per Figure 2, poultry prices remain in a well-established long-term uptrend. Several years back, it was established that Americans are now [consuming more chicken than beef](#) for the first time in over 100 years. Further, increased protein demand from emerging markets favors the smaller, more versatile and more efficient chicken over the cow. Add in growing concerns about [over-fishing the world's oceans in search of protein](#), and the case for [rising chicken demand](#) as a long-term secular growth driver becomes even more compelling.

Figure 2: Poultry, Whole Bird Spot Price, U.S. Cents Per Pound

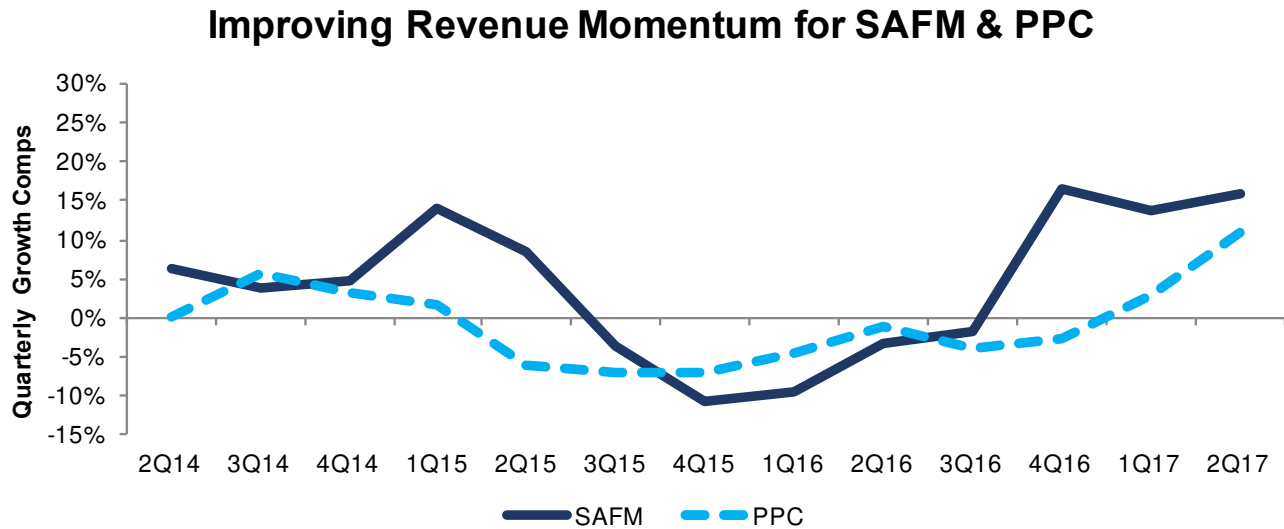


Sources: New Constructs, LLC and USDA Market News



Per Figure 3, revenue growth for chicken producers bottomed in late-2015 and has been accelerating ever since. SAFM generated 16% revenue growth in 2Q17 vs. 2Q16, compared to -3% growth in 2Q16 vs. 2Q15. PPC generated 11% revenue growth in 2Q17 vs. 2Q16, compared to -1% growth in 2Q16 vs. 2Q15. Given the strong YTD uptrend in poultry prices combined with added seasonal demand from now through the Super Bowl, we do not expect this momentum to fade in the near term.

Figure 3: Quarterly Revenue Growth for SAFM and PPC



Sources: New Constructs, LLC and USDA Market News

Price-Fixing Lawsuit a Potential Industry Overhang

In September of 2016, food distributor Maplevale Farms [filed an anti-trust lawsuit](#) against Koch Foods (Perdue Farms), Pilgrim's Pride, Tyson and third-party market data firm [Agri-Stats](#) for conspiring to fix chicken prices. The suit alleges the industry colluded by sharing information through Agri-Stats, a firm which has been in business for 27 years, employs over 100 people and has clients around the world.

The rationale for the lawsuit appears to be the following: the chicken production industry naturally experiences boom-and-bust chicken price cycles because when prices rise, chicken producers flood the market with supply, thereby crashing prices. Ultimately, production is taken off line, and the supply surplus/shortage cycle starts all over again. However, in the mid-2000's the industry's production cycle began to transform from chaotic to something more predictable. It must be through illegal collusion, according to Maplevale Farms.

The lawsuit does not hypothesize why every other commodity production industry is not afflicted by the same degree of production, supply and price volatility that the chicken industry was exhibiting. The lawsuit also does not seem to account for the agriculture industry's adoption of new technologies and 'big data' analysis, factors that have improved the efficiency and productivity of nearly every other industry on the planet.

While SAFM was not named in the original lawsuit, the company has publicly denied any involvement in an industry price fixing scheme. The most recent notable news on the matter came in February of 2017 when TSN disclosed it had received a subpoena from the SEC concerning the allegations. It remains too early to handicap the outcome of the case or quantify any potential impact.

The price fixing allegations are an industry risk worthy of note, although not one that currently warrants the high level of negative sentiment surrounding SAFM stock. SAFM is one of the most shorted stocks on the NASDAQ at 26% of the float and 14 days to cover. We note the negativity pre-dates the industry lawsuit. Short interest was 34% of the float at the time of our original Long Idea report.

Sanderson Farms (SAFM: \$144/share) – Maintaining Long Position – Up 90% vs. S&P +17%

Sanderson Farms was selected as a [Long Idea on 8/12/15](#). SAFM received a Very Attractive rating at the time of the report. Our investment thesis highlighted: 1) a history of strong NOPAT growth; 2) growing demand for the company's products; 3) overblown fears about avian flu and corn feed prices; and 4) the company's depressed 0.3 PEBV valuation.

During the subsequent 734 day holding period, SAFM has outperformed as a long position, rising 90% compared to a 17% gain for the S&P 500. SAFM got off slow start, trading sideways for the first six months as a brief revenue growth slowdown played out. Since the start of 2016, SAFM has delivered better-than-expected results five out of six quarters while exhibiting a steady improvement in revenue growth. Over the past year, forward expectations for revenue and earnings (EPS) expectations have increased 5% and 57%, respectively.

SAFM's earning power has yet to exceed 2014's peak (9% NOPAT margin, 27% ROIC), but it appears to be well on its way. SAFM's current NOPAT margin of 7.3% (TTM) is up from 6.8% earned in full-year 2016. SAFM's current ROIC of 18% (TTM) is up from 16% earned in full-year 2016.

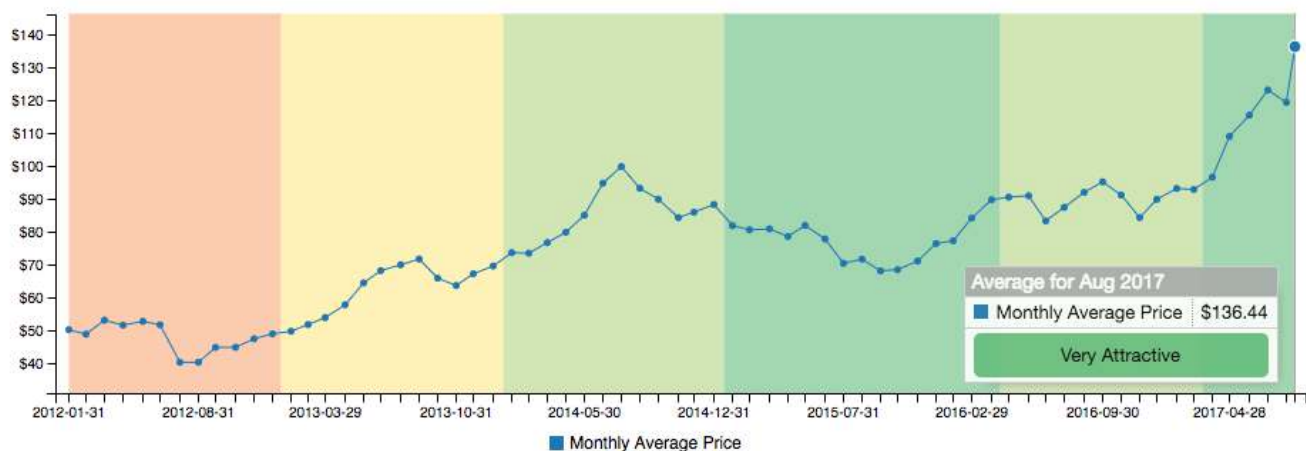
Since our original Long Idea report, SAFM has retained an Attractive-or-better. The shares currently receive a Very Attractive rating. We are sticking with SAFM as a Long Idea due to the improving fundamentals (revenue, margins and ROIC) and the modest valuation.

SAFM's current PEBV ratio of 0.8 means the market expects the company's NOPAT to permanently decline by 20%. This expectation seems overly pessimistic in light of SAFM's 12% compound annual NOPAT growth over the past decade and the favorable long-term outlook for chicken (protein) demand noted above.

If SAFM can [grow NOPAT by just 3% compounded annually for the next ten years](#), the stock is worth \$205 today – a 42% upside. This scenario assumes that NOPAT margin averages 6% (vs. 7.3% TTM) and revenue grows 5% compounded annually vs. 12% compounded annually over the past ten years. The scenario also assumes that invested capital growth equates to 65% of revenue growth vs. 50% over the past ten years.

Figure 4: SAFM Stock Price and Risk/Reward Rating History

▼ **Normalized Rating History - Monthly Average***



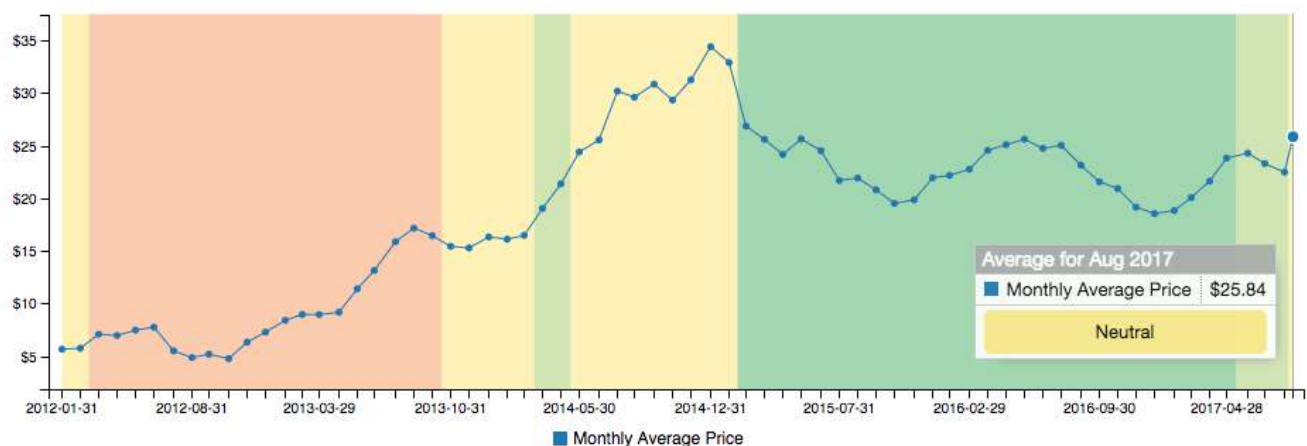
Sources: New Constructs, LLC and company filings

Pilgrim's Pride (PPC: \$29/share) – Closing Long Position – Up 18% vs. S&P 500 +17%

Pilgrim's Price was selected as a [Long Idea on April 9, 2015](#). PPC received a Very Attractive rating at the time of the report. Our investment thesis highlighted: 1) a top-quintile ROIC; 2) a well-above average FCF yield; 3) overblown concerns about chicken oversupply; and 4) the company's relatively low 0.8 PEBV valuation.

During the subsequent 859 day holding period, PPC has slightly outperformed the market as a long position, rising 18% compared to a 17% gain for the S&P 500. PPC's positive performance has largely been a year-to-date event (+47%). The stock declined -34% in 2015 and -15% in 2016 (vs. -17% and +29%, respectively, for SAFM), largely due to earnings coming in below market expectations for seven straight quarters (3Q16 to 1Q17). During this period PPC's quarterly revenue growth averaged -4% year-over-year vs. 0% for SAFM.

Since our original Long Idea report, PPC has been downgraded in our system to Neutral from Attractive. Our methodology indicates a more attractive risk/reward trade-off for SAFM than for PPC. Given PPC's fundamentals relative to SAFM, we are closing our PPC long position in favor of recommending SAFM.

Figure 5: PPC Stock Price and Risk/Reward Rating History
▼ Normalized Rating History - Monthly Average*


Sources: New Constructs, LLC and company filings

This article originally published on [August 17, 2017](#).

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

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