



3 Reasons to Be Bearish on Saputo Inc.

Description

Saputo Inc. ([TSX:SAP](#)) has been a terrific stock to hold over the long term. It has helped make thousands of Canadian investors wealthy and made the Saputo family one of Canada's richest.

Including reinvested dividends, Saputo shares have returned 15.38% annually over the last 15 years. A \$10,000 investment in the stock on March 28, 2002 would be worth more than \$85,000 today, excluding taxes and other such expenses. There aren't many companies that can offer that kind of performance.

Saputo has been a growth-by-acquisition story. First, it consolidated the market in Canada, then it moved on to the United States, Europe, South America, and, most recently, Australia. Management has identified other acquisition opportunities in the United States, Brazil, and New Zealand, among others. The company also plans to expand further into China, starting with exporting dried milk products there from Australia.

I'm generally bullish on Saputo, but it's always useful to look at the other side of the equation. Here are three reasons investors should be cautious about the stock.

No clear moat

The other day I was taking out the garbage, which included the recycling. In my recycling were three plastic milk jugs, representing about a month's worth of purchases.

They were all different labels. Two of the three were Saputo brands, while the third was made by Parmalat, which is one of Saputo's main Canadian rivals.

This got me thinking. I realized I couldn't care less about the milk brand I purchase. It's all the same to me. Milk is milk.

It's the same thing with cheese. I'll happily purchase the cheapest brand of cheese. I have no desire to pay an elevated price for a brand name. I just don't see the value in doing so. Like with milk, cheese is cheese.

I'm not alone, either. When you ask someone what their favourite kind of milk is, a brand name is never in the discussion. It's always a type of milk. Someone might like skim milk, while someone else might like whole milk.

Compare that to other food companies. Imagine giving a **Coca-Cola** lover generic cola. Or trying to substitute an Oreo cookie, Doritos, or Heinz ketchup with store-brand alternatives. It just wouldn't be the same.

Little organic growth

There's a reason why Saputo has expanded by snatching up competitors. There's very little opportunity for organic growth.

Fiscal 2016 saw the company do \$11 billion in revenues and earn \$600 million in profits. In 2015, Saputo generated \$10.65 billion in revenue and profits of \$613 million. That is not very exciting growth. In fact, much of the growth can be attributed to one factor — currency fluctuations.

The dairy market in North America is stable. We collectively already consume a lot of milk. There's no indication that consumption will increase meaningfully in the next few years, either. This doesn't bode especially well.

Valuation

Even though Saputo doesn't have many organic growth opportunities, shares still trade hands at 26 times trailing earnings. That's quite expensive.

There are two ways you can look at it. The bull scenario assumes Saputo will make acquisitions and increase its earnings that way. Investors are also relatively bullish on most food manufacturers. It's a nice business to own.

The bear scenario goes something like this: Saputo is a company trading at an elevated valuation, despite having little opportunity for organic growth. Sure, the company could make an acquisition or two, but that's not exactly easy today. Assets are expensive thanks to cheap money and competitors that are flush with cash.

Essentially, investors are not only betting on an acquisition, but they're also speculating that Saputo won't overpay.

The bottom line

Saputo is one of the market's darlings right now. Shares trade at just 5% under all-time highs. It's obvious investors are bullish.

But perhaps a little caution should be in order. Saputo is an expensive stock with products that lack a lot of brand power and little organic growth potential. The company is hardly a slam dunk going forward.

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