This Cheese Company Is Facing Serious Challenges but Is Fighting Back

Description

Saputo Inc. (TSX:SAP) reported its fiscal 2018 third-quarter results on February 1. The stock dropped by more than 3% during that day, as the dairy processor missed analysts' estimates and is facing many challenges.

Profit boosted by tax savings, but hurt by market conditions

Following changes approved by Trump's administration just before the holiday break, the U.S. federal corporate tax rate dropped from 35% to 21%. As a result, Saputo recorded tax savings of $179 million, which boosted its net income to $337 million, or $0.86 per share, up 70.7% compared to the third quarter of fiscal 2017.

Revenue totaled $3.02 billion, up 1.7% from a year ago.

Excluding non-recurring items, Saputo's adjusted earnings decreased by 7.2% to $183.2 million. Per share, adjusted earnings dropped by 4.1% to $0.47 and missed estimates of $0.50.

The U.S. market, where Saputo generates more than half of its operating income, has given the company a hard time for a second consecutive quarter due to challenging market conditions.

The lower block market price of cheese was a major factor in the 23% decline in U.S. operating income, which has forced the cheese company to devalue stocks.

Saputo must deal with the impact of the Trans-Pacific Partnership Agreement and NAFTA's renegotiations, which will ultimately facilitate the entry of new competitors in its main markets.

Internationally, sales and operating profit increased by 19% and 22%, respectively, thanks to higher volumes and selling prices, particularly in Argentina and Australia.

The dairy company expects a weakening in international cheese and dairy ingredient prices for the first half of this year.

Saputo's earnings are expected to grow by 14.6% next year and at an annualized rate of 9% for the next five years.

The cheese maker pays a quarterly dividend of $0.16 per share for a yield of 1.6%. The dividend is well covered by earnings with a dividend cover of $2.98, given annual EPS of $1.91 and dividend of $0.64 per share.

Saputo's shares are trading at a P/E of 17.8, which is lower than the company's five-year average of 23.6 and the industry's average of 23.7. Saputo has a high ROE of 20%.

Growth through acquisitions and consolidation of operations

Saputo reiterated that it still has an acquisition capacity of at least $3 billion and suggested that the buying pipeline is increasing, as other market players suffer even more from the dairy industry's challenges.

During the quarter, Saputo recorded restructuring charges totaling $25.1 million as a result of various acquisitions, including Murray Goulburn Co-Operative Co., Australia's largest dairy producer.

National Bank of Canada's analyst Vishal Shreedhar believes that Murray Goulburn's acquisition has the potential to add $0.21 to Saputo's annual profits. The deal is expected to close early this year. Saputo acquired Montchevre and Southeast Milk Inc. in the U.S. last year.

To ease market challenges and consolidate its operations, the Montreal-based company announced the closure of a cheese manufacturing plant in Wisconsin by June 1, 2018.

As traditional white milk consumption is decreasing, Saputo is open to look at other options, such as plant-based protein beverages, if the right opportunity presents itself.

Bottom line

In the short term, Saputo is going to be impacted by volatile dairy market conditions, so expect volatility in the stock price.

Over the medium to long term, I believe that this well-managed company will grow through strategic acquisitions with opportunity for global dairy consolidation.

As Saputo's share price is down more than 10% year to date, it may present an opportunity to buy this dairy processor on the dip if you intend to keep the stock for a long time. However, I think there are better opportunities out there in the market now if you are looking for a stock in the food sector or in another defensive sector.

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Date
2025/08/27
Date Created
2018/02/08
Author
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