Sanderson Farms Inc.

NASDAQ: SAFM

Analyst: Kevin Akbaraly
Sector: Consumer Staples

BUY

Price Target: $110

Key Statistics as of 4/23/2015

Market Price:	$76.06
Industry:	Packaged Food
Market Cap:	$1,768M
52-Week Range:	$74.95 - $103.30
Beta:	0.50

Thesis Points:

- Avian flu concerns over the poultry industry might be overestimated by the market.
- Current corn and soybean prices are highly benefiting the company's operating margins and are expected to remain stable in coming years.
- The company offers the highest margins relative to its peers and is currently the most undervalued company within the industry.

Company Description:

Sanderson Farms, Inc., an integrated poultry processing company, produces, processes, markets, and distributes fresh, frozen, and prepared chicken products in the United States. The company sells ice pack, chill pack, bulk pack, and frozen chicken in whole, cut-up, and boneless form primarily under the Sanderson Farms brand name to retailers, distributors, and casual dining operators in the southeastern, southwestern, northeastern, and western United States, as well as to customers who resell frozen chicken in the export markets. Its prepared chicken product line includes institutional and consumer packaged partially cooked or marinated chicken items for distributors and food service establishments. Sanderson Farms, Inc. was founded in 1947 and is headquartered in Laurel, Mississippi.

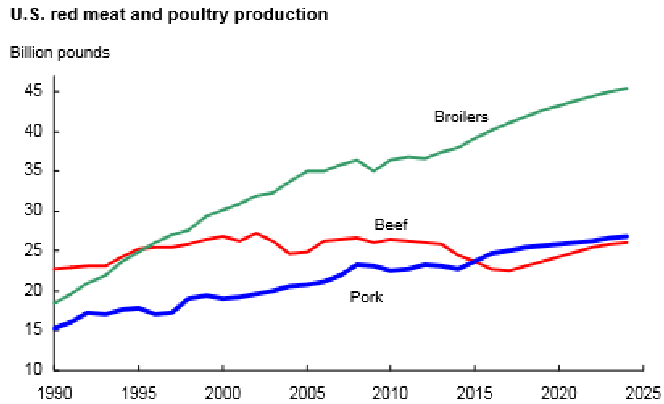
Thesis

Sanderson Farms Inc. is the third largest poultry processor company within the US with $2.9 billion of revenue. The company is well established and has consistently showed positive revenue growths coupled with competitive operating margins over the past 10 years. Recent concerns over cases of avian flu detected around the country have raised skepticism among investors. The market is concerned about China's restrictions over the import of broiler meat produced by the US, which is expected to negatively impact companies exporting their poultry products in Asia. However, the company is currently well positioned to benefit from current market conditions, enjoying higher operating margins thanks to lower corn and soybean prices. The company's financials are strong and decrease the risks associated with a potential decline in poultry exports. Sanderson Farms Inc. seems to be the most undervalued stock within this market, which creates a good opportunity for investors to enter into a long position at current levels. A BUY is therefore recommended on SAFM with a target price of $110, representing an upside potential of 46% based on the current market price.

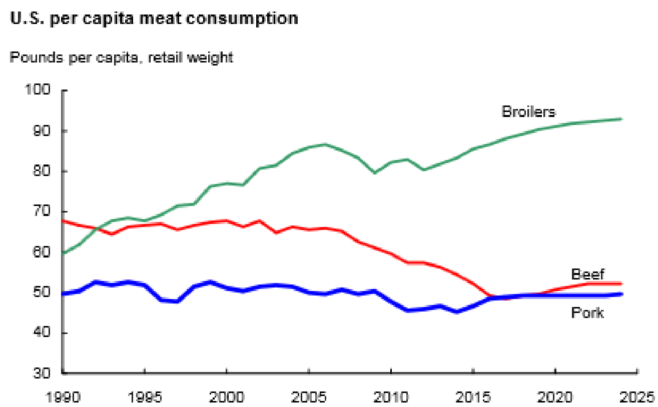
Macro Outlook

The United States is the world's largest poultry producer and the second-largest exporter of poultry meat after Brazil. The country produces over 43 billion pounds annually, of which 80% represents broiler meat with most of the remaining representing turkey meat. The U.S. poultry market exceeds $20 billion, representing 20% of the total world production, followed by Brazil and China which produce about 15% each of the total world production. The United Stated exports between 14 and 17 percent of its boiler meat production internationally with Russia accounting for the major importing country, followed by China and Mexico. These 3 markets accounted for over half of the U.S. broiler product exports on a quantity basis. The U.S. imports only a small amount of broiler products, accounting for less than 1 percent of the domestic production.

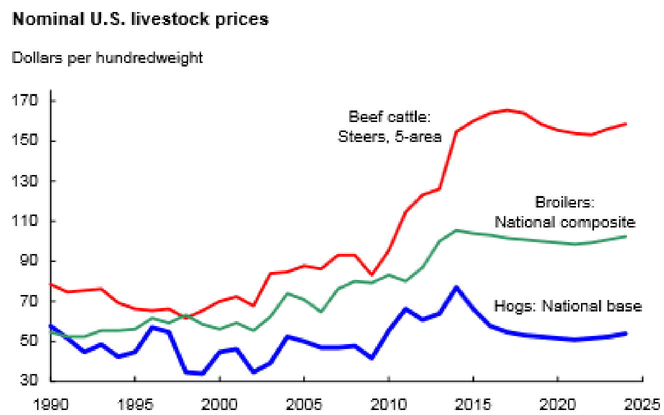
As a result of lower grain commodities' prices (corn and soybean), livestock producers are enjoying higher margins, providing incentives for increasing production. The pork sector has rebounded from reduced production in 2014 due to the Porcine Epidemic Diarrhea virus, leading to an expected increase in production through 2025. Beef's increase in production is not expected until 2018 due to a decline in output leading producer to retain their stocks to build beef cow inventories rather than feed for slaughter. Poultry's production has been expanding faster and is expected to do so over the next 10 years due to a higher number of birds and higher average weights per bird (USDA).



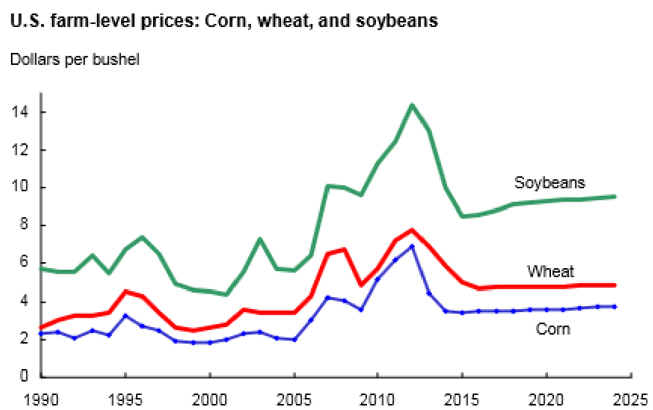
On the supply side, due to increased prices since 2007, per capita consumption has declined. The annual average consumption of red meats and poultry fell from over 221 pounds per capital in 2004-07 to under 202 pounds in 2014. Following the expected increase in production, per capita meat consumption is also expected to rise to about 214 pounds by 2024, led by poultry consumption compared to a more stagnant trend for beef and pork consumption. Indeed, due to higher red meat prices, poultry consumption is expected to reach new highs over the next 10-years, showing consumers' tendency to choose broiler meats over other more expensive substitutes (USDA).



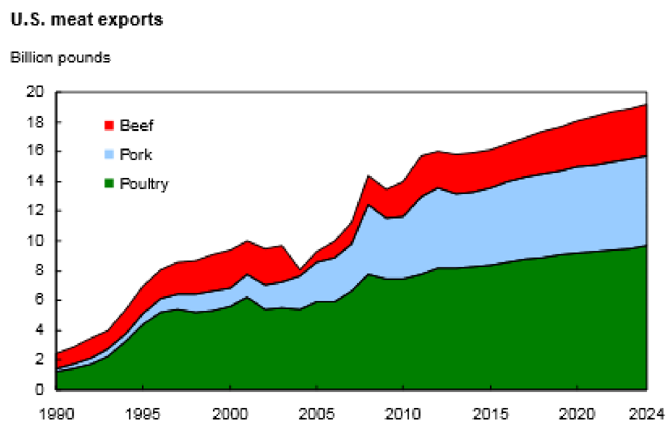
After the decline in production that occurred from 2007 to 2014, prices have increased to new highs for every different category. The modest expected increase in beef production would lead prices to further expand over the next 10 years, while broilers' consumption offsetting higher production is expected to help stabilize prices over the same period. Hog prices on the other hand are expected to see a significant decline due to higher expected production coupled with modest increase in consumption.



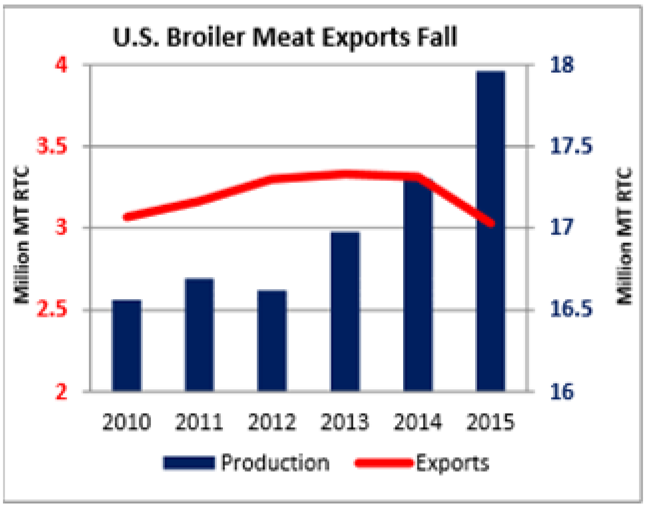
Corn, wheat and soybean prices have recently reached their lower levels since 2005/06 following an increased production. Those commodities are used by producers on a daily basis and represent a consequent portion of their operating expenses. Thanks to lower prices, producers are currently enjoying higher operating margins, which are expected to remain relatively stable over the next 10 years. Indeed, prices are expected to increase only moderately in the future due to increased stock piles and lower demand. With stabilizing poultry prices, producers are therefore expected to enjoy higher margins over the next 10 years. Thus, a slight pressure according to the moderate increase in commodity prices is expected.



Expected economic growths of foreign countries increasing their demand for selected meat cuts and parts from the U.S. market are still expected to lead to additional exports over the next 10 years. Major export markets such as China and Mexico have been followed by an increasing number of other countries due to an increasing demand. The international demand for broilers remains strong because of its lower cost relative to beef and pork, but increased competition is also expected from other major exporters, particularly Brazil.



In early January 2015, China, Mexico and other countries totaling more than 20 different countries have started to restrict the import of U.S. poultry in their territory because of avian flu (H5N8) cases detected on different birds. A poultry industry detected traces of H5N8 influenza in backyard flocks of chicken and guinea fowl in Oregon with similar cases in Washington and California. That discovery was later confirmed by the US Department of Agriculture, which stated that no commercial bird has been detected with the pathology yet. After China issued its restriction over U.S. broilers imports, the U.S. poultry & Egg Export Council condemned China's decision, saying that avian flu outbreaks have occurred far in the Pacific Northwest and away from the major commercial poultry production regions. The bulk of poultry production in the US comes largely from the Midwest and Southern states like Arkansas, Alabama and Georgia. "There's absolutely no justification for China to take such a drastic action", said president of the poultry trade council, Jim Summer. "In fact, these isolated and remote incidents are hundreds of thousands of miles away from major poultry and egg production areas. Most all of our other trading partners have taken some sort of regionalized approach and have limited their restrictions to the state or, in in some cases, to the country. We would have expected China to do the same" he said (Bloomberg News). Following China's decision, analysts have revised the poultry US exports to only 3.0 million tons in 2015, which represents 9 percent from previous estimates. Other traders have estimated the impact on exports to only 5% in 2015.



However, analysts feel also confident that this restriction won't remain in place indefinitely; some expect a withdrawal of the policy by 2016. Mexico for example has already started to ease its import restriction during March 2015, signaling that the disease's threat to US poultry exports is starting to subside. Mexico is now considering the acceptance of some poultry coming from the US if the products are destined for further domestic processing. A New-York-based analyst for Stephens Inc. stated that "over time, China and South Korea will likely lift their trade restrictions, but no actions are expected in the near term. The increased access to Mexico is a positive sign for US poultry companies". Will Sawyer, a Vice President of US animal-protein research for Rabobank International also said that "the industry is feeling a lot better about the whole situation" (Bloomberg News).

Company's Operations

Sanderson Farms Inc. is a fully-integrated poultry processing company engaged in the production, marketing and distribution of fresh and frozen chicken products. The company also engages in the processing, marketing and distribution of prepared chicken through its wholly-owned subsidiary. The products that are sold are ice pack, chill pack, bulk pack and frozen chicken, in whole, cut-up and boneless form, primarily under the Sanderson Farms brand name to retailers, distributors and casual dining operators principally in the U.S. The company also engages in transactions involving customers who resell frozen chicken into export markets. During the year ended October 31, 2014, the company processed about 452 million chickens representing about 3 billion dressed pounds. According to 2014 industry statistics, Sanderson Farms Inc. was the third largest processor of dressed chicken in the US based on average weekly processed pounds. The farm is selling only 10% of its products internationally. The company is currently operating through 8 hatcheries, 7 feed mills and 9 processing plants. The farm has added new facilities in Palestine, Texas where it started hatchery activities in November 2014 and processing operations in February 2015. The new facilities will add an additional 1.25 million chickens per week in term of capacity, now totaling 10.625M chicken a week or over 550M chickens per year. The company's facilities are located in Mississippi, Texas, Georgia, North Carolina and Louisiana where no avian flu case has been founded, increasing the chance for the company's products to be selected among authorized importers if China decides to ease its current poultry restriction.

Sanderson Farms' main operating costs consist of transportation, feeding, processing, cooking and packaging of broiler meat. Most of them are considered to remain stable over time as they rely on company's equipment and machinery. However, the company is also subject to cost variations related to its poultry feeding operations. The farm relies on corn and soybeans prices, which could see high fluctuations over time in terms of market price following prevailing market conditions. The company does not enter into financial derivative instruments allowing it to control and hedge related costs, but instead enter into agreements with its suppliers involving real options to buy or not related commodities at a specific price from 1 to 9 months in advance. Also, the company buys and stocks these commodities internally when the management thinks it could take advantage of lower prices at current market price. The management is highly concerned by future market conditions in order to anticipate future price fluctuations to better control its costs and optimize its margins over time. Following the recent decline in commodity prices, the company is currently well positioned to increase its operating margins for at least the coming 9-months compared to its competitors entering into financial derivatives. As of October 31st, 2014 the company's average feed cost per pound of broilers processed totaled $0.3338 for the fiscal year 2014 compared to only $0.2911 for the first quarter of 2015, representing a decline of 12.8%. This decline in commodity prices has allowed the company to lower its cost of revenue to only 79.2% relative to revenue over the last 12-months, compared to 81.2% for the Fiscal Year 2014 and 88.6% for the Fiscal Year 2013. As stated in the macro outlook, corn prices, which are the most sensitive commodity for Sanderson Farms Inc. are expected to remain stable over the next 10-years, which should highly benefit the company in terms of operating margins.

Financials and Key Statistics

Sanderson Farms Inc. generated $2,775M of revenue during FY2014, a 3.4% increase compared to FY2013 with $2,683M, which represents an increase of 12.4% compared to FY2012 with $2,386M of revenue. Gross Profits were $520.9M in FY 2014 representing a gross margin of 18.8% compared to only 11.4% in FY2013 and 7.3% in FY2012. SG&A expenses represented 5% of revenues during FY2014, but generally ranged between 3.1% and 4.5% annually. SG&A expenses are expected to rise slightly to 5.4% of revenues during the upcoming months due to related expenses allocated to the new facility in Palestine, Texas before decreasing to average levels. The Net Margin reported by the company increased to $242.3M in FY2014 representing a 8.7% Net Margin over the period, compared to only 4.7% and 2.2% over FY2013 and FY2012 respectively. LTM figures show an increase of Gross Margin to 20.8% due to a further decrease in corn prices leading to an increase of Net Margin representing 9.8% of revenues.

The company spent $199M in Capital Expenditures over the last 12-months following the construction of new facilities in Palestine, Texas that has been initiated in 2013. The company used its cash on hand combined with cash generated from operations to finance the project. Capital Expenditures are expected to decrease to $121M in both 2015 and 2016 and then only $71.1M in 2017.

Following current concerns over the poultry market, the company has decreased its inventory levels to 17.2% of total assets by the end of FY2014 while it averaged 22% over the past 5 years. Sanderson Farms Inc has $165.6M in cash in its balance sheet, representing 15% of total assets while it ranged only 1.3% to 9.3% over the past five years. SAFM's current ratio is 3.5 while its quick ratio is 11.9. The company reported only $10M of short term debt in the last fiscal year representing less than 1% of total assets, while long-term debt has been decreased to $10M only, also representing less than 1% of total assets, compared to 3.2% in 2013, 16.8% in 2012 and 28.9% in 2011. The company has now a TIE ratio of 148.2x compared to 33.5x in 2013 and 10.5x in 2012.

The company has been very consistent at turning its inventory into cash over the past 10 years. The inventory period was 32.1 days in FY2014 after having ranged 32 to 37 days over the past 5-years. Account Receivable period was 15 days in FY2014 after having ranged 14 to 17.2 days over the past 5-years and the Account Payable period was 10.6 days after having ranged 9.6 to 12.8 over the same period. This lead the company's conversion cycle period to 36.5 days only, while it ranged 35 to 39.3 days over the past 5-years, meaning that the company has to finance its operations by its own during 36.5 days only. This is in line with Tyson (the biggest poultry processor in the U.S.) which averaged 31 days over the past five years, but way better than Pligrim's Pride Corp. who averaged 47.4 days over the same period.

The company's Board of Directors approved a share repurchase program of up to one million shares expiring in February 2017. The company repurchased a total of 44,985 shares during the year representing $3.8M. Following the recent company's build up in cash and the recent launch of its new facilities in Palestine, Texas, it is not expected that the company will conclude an acquisition, which could increase the chance that the company takes advantage of the current market price to invest in its own shares. The company also issued a special dividend of $0.50 per share right after its shares repurchase in last September. Additionally, the company distributes a quarterly dividend representing a dividend yield of 1.8%.

Valuation

The valuation of Sanderson Farms Inc. has been made using a proforma that is presented on the last page of this report. The valuation method that has been used is based on a Discounted Cash Flow model using Return on Invested Capital metrics.

The revenue growth rate for the FY2015 and FY2016 has been set at 0% compared to an average of 2.4% estimated by analysts in order to reflect the risks associated with China's restrictions on poultry imports. This is a very conservative assumption that assumes a decline in international sales offset by the company's newly increased capacity that will allow the farm to sell additional broiler products domestically and in other countries that have not put in place or eased their import restrictions. Revenues growth rates for the FY2017 has then been set at 2.6% in line with analysts' consensus, which will remain at the same level over the following 8-years. The long-term growth has been set at 2% in order to reflect increased competition both domestically and internationally within the poultry industry.

Operating costs over revenue has been tapered from the current 81.2% level to 92% over the long-term in order to reflect potential changes in grain commodity prices which affect negatively the company's margins. Also, due to an increasing competition and an increasing production, the industry could potentially see an additional pressure on broiler meat prices, which would also negatively impact the company's margins.

Sanderson Farms' forward P/E is about 6.6x compared to an average of 15.3x for competitors. The company's P/E ratio has averaged 15.6x over the past 5 years. The current level shows market concerns over the poultry industry, which makes a good opportunity for investors to enter into a long position at the current price. Additionally, the forward EV/EBITIDA equals only 3.3x while it averaged 6.6x over the past 5-years and equals 11.6x for competitors. The Price-to-Book ratio is currently about 1.8x compared to 2.8x for respective peers. On the other hand, Sanderson Farms Inc. shows to have an operating margin of 15% compared to an average of 12% for competitors, and are the only companies along with PPC that have almost no debt outstanding. That makes it the most attractive poultry processor company relative to its peers at current level.

All the assumptions that have been made above are extremely conservative and could see further improvements over the coming-months. However, due to current market conditions and concerns, these assumptions take into consideration potential declines in revenues growths and increased pressure on operating margins. Nevertheless, the company seems to be pretty attractive at current level. As a result, a buy is recommended on Sanderson Farms Inc. with a target price of $110 per share. This represent a potential upside of 46% based on the current market price. Current concerns over the poultry industry have led the stock to be undervalued relative to peers, which creates a good opportunity for investors to enter into a long position. Once the avian flu concern will stabilize in coming months, China might ease its actual import restrictions, which would lead the stock to appreciate again, offering investors interesting returns for the risks they carried.

Conclusion

Current concerns regarding avian flu cases detected around the country has raised skepticism among investors. China's restriction over the import of US broiler meat is expected to negatively impact companies exporting in Asia. However, the market seems to be overreacting, which creates a good opportunity for investors to take advantage of the current market price. The Chinese restriction is not expected to remain in place indefinitely, with analysts expecting an ease of the policy by 2016. Other countries such as Mexico have already started to ease their own restrictions, excluding the import of meat coming from concerned regions only. Additionally, following the decline in grain prices, the company is currently enjoying higher operating margins, which are expected to remain stable over the next 10-years. Sanderson Farms Inc. seems to be the most undervalued company within the poultry industry, currently enjoying higher margins relative to competitors. As a result, a BUY is recommended on SAFM with a one-year target price of $110. This represent a potential upside of 46% based on current price.

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Sanderson Farms, Inc.	SAFM	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	BULLISH
		Kevin Akbaraly	$76.06	$97.95	$109.99	1%	1-y Return: 45.77%	

General Info

Sector	Consumer Staples
Industry	Food Products
Last Guidance	Feb-24-2015
Next earnings date	5/29/2015

Market Data

Enterprise value	$1,609.51
Market Capitalization	$2,032.29
Daily volume	0.25
Shares outstanding	23.17
Diluted shares outstanding	22.47
% shares held by institutions	99.58%
% shares held by insiders	5.39%
Short interest	41.96%
Days to cover short interest	18.55
52 week high	$103.90
52-week low	$74.95
5y Beta	0.20
6-month volatility	33.16%

Peers	Market Cap.
Pilgrim's Pride Corporation	$6,134.11
Tyson Foods, Inc.	$15,721.15
Pinnacle Foods Inc.	$4,770.43
Hormel Foods Corporation	$14,460.54

Current Capital Structure

Total debt/market cap	1.13%
Cost of Borrowing	17.74%
Interest Coverage	10.4x
Altman Z	10.37
Debt Rating	AA
Levered Beta	0.50
WACC (based on market value weights)	5.47%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Sanderson, Joe	Chairman and Chief Executive Offi	$3,441,123	$2,824,155	$5,931,371
Butts, Lampkin	President, Chief Operating Officer	$1,180,904	$1,702,063	$2,126,958
Cockrell, D.	Chief Financial Officer, Treasurer a	$1,022,181	$1,445,142	$1,732,919
Rigney, Timothy	Chief Accounting Officer, Controll	$137,223	$300,769	$404,151
Romano, Brian	Director of Administration	$0	$0	$0
Robinson, Robin	Director of Organization Developi	$0	$0	$0

Historical Median Performance

	SAFM	Peers	Industry	All U.S. firms
Growth	9.7%	4.1%	7.2%	7.4%
ROIC	14.9%	7.3%	17.4%	14.3%
NOPLAT Margin	5.3%	2.8%	7.0%	10.4%
Revenue/Invested Capital	2.80	2.66	2.49	1.37
Excess Cash/Rev.	1.2%	2.8%	13.5%	12.9%
Total Cash /Rev.	1.2%	2.8%	12.3%	15.2%
Unlevered Beta	0.49	0.48	0.64	0.95
TEV/REV	0.5x	0.5x	1.5x	2.5x
TEV/EBITDA	5.6x	18.4x	14.6x	13.1x
PE (normalized and diluted EPS)	9.2x	19.0x	24.1x	23.5x
P/BV	1.8x	1.9x	2.6x	2.2x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	2.3%	10.2%	-5.3%
Last Quarter-1	0.4%	2.2%	0.5%
Last Quarter -2	0.2%	-8.5%	-14.5%
Last Quarter -3	5.0%	23.2%	26.3%
Last Quarter -4	2.5%	36.8%	47.1%

Non-GAAP Adjustments in estimates computations

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions

Money market rate as of today	0.54%
Annual increase (decrease) in interest rates	0.1%
Yield Spread accelaration	1.2
Marginal Tax Rate	37.5%
Risk-Free rate	2.6%
Tobin's Q	0.80
Op. Cash/Rev.	7%
Growth in PPE	NPPE Growth follows Revenue Growth
Long term Growth	2.0%
Base Year Unlevered Beta	is equal to 0.49
Long term Unlevered Beta	0.64

Forecast

Period	Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
LTM	3.4%	81.2%	$1,010.00	10%	28.9%	5.5%
NTM	0.0%	82.4%	$1,033.84	11%	29.9%	5.6%
NTM+1	0.0%	83.5%	$1,053.28	10%	26.6%	5.8%
NTM+2	2.6%	84.6%	$1,081.74	9%	24.5%	6.0%
NTM+3	2.6%	85.7%	$1,110.85	8%	22.3%	6.2%
NTM+4	2.6%	86.9%	$1,140.58	7%	20.3%	6.4%
NTM+5	2.6%	88.0%	$1,170.91	7%	18.2%	6.5%
NTM+6	2.6%	89.1%	$1,201.74	6%	16.3%	6.7%
NTM+7	2.6%	90.2%	$1,232.87	5%	14.3%	6.9%
NTM+8	2.6%	91.4%	$1,263.59	4%	12.3%	7.1%
Continuing Period	2.6%	92.5%	$1,566.88	5%	8.0%	7.2%

Valuation

Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding
LTM	$0.00	$20.00	$46.77	23.17
NTM	$245.42	$20.00	-$195.84	23.17
NTM+1	$215.04	$20.00	-$406.70	23.17
NTM+2	$194.62	$20.00	-$592.69	23.17
NTM+3	$174.56	$20.00	-$762.49	23.17
NTM+4	$154.33	$20.00	-$915.67	23.17
NTM+5	$133.42	$20.00	-$1,051.68	23.17
NTM+6	$111.58	$20.00	-$1,169.72	23.17
NTM+7	$88.66	$20.00	-$1,269.05	23.17
NTM+8	$64.63	$20.00	-$1,349.38	23.17
Continuing Value	$170.64			

Pricing Model

DCF (Weight = 100%)	Relative (Weight = 0%)	Distress (Weight = 0%)	Weighted Average Price Per Share
$98.40	$188.92	$93.22	$98.40
$110.35	$199.39	$107.54	$110.35
$111.92	$209.74	$109.29	$111.92
$114.02	$222.78	$111.38	$114.02
$116.03	$235.26	$113.37	$116.03
$118.24	$247.15	$115.25	$118.24
$119.69	$251.47	$117.03	$119.69
$121.39	$239.07	$118.77	$121.39
$123.03	$224.84	$120.57	$123.03
$124.30	$208.78	$122.90	$124.30

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Country Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	2%	N/A	3%	10%	Triangular

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$98.40	$110.35
σ(ε)	$0.15	$0.12
3 σ(ε) adjusted price	$97.95	$109.99
Current Price	$76.06	
Analysts' median est.		$88.86