Stock Strategist

Strategy Change Not Enough to Make Us Scoop Up Kellogg

The move to a warehouse system from direct-store delivery is prudent, but the stock price isn't compelling.

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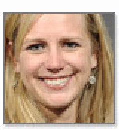
In an industry where sales growth has proved elusive as efficiency efforts have taken top billing, packaged food companies are pursuing more drastic actions to ignite financial performance. However, we don't think these efforts justify elevated valuations.



About the Author
Erin Lash, CFA, is a director of consumer sector equity research for Morningstar.
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Kellogg (K) intends to part ways with its direct-store delivery system and move entirely to a warehouse model, an action rebuffed by some global snack food peers as unwise. Management has suggested that an evolving retail landscape, including growing e-commerce penetration, amid intense competition made now the right time to pounce on this opportunity; this reasoning strikes us as sound. We believe this shift affords Kellogg the ability to more effectively reinvest behind its brand set and further entrench its relationships with retailers. But the shares still don't represent a compelling proposition, trading at a modest discount to our fair value estimate. Instead, long-term investors looking to stock up in the space should consider narrow-moat Blue Buffalo Pet Products (BUFF), which trades nearly 20% below our fair value estimate.

Efficiency Initiatives Alone Unlikely to Prop Up Sales

Since the marriage of Kraft and Heinz (KHC) in 2015, a heightened sense of urgency to extract excess costs has permeated the packaged food landscape. Kellogg's current cost-saving target of approximately $600 million-$700 million equates to about 6% of cost of goods sold and operating expenses, excluding depreciation and amortization expense, which generally aligns with the 5%-9% savings that other domestic food and beverage manufacturers target.

However, recent efficiency gains have done little to bolster top-line momentum. Growth in the U.S. packaged food landscape remains elusive, particularly in the center of the grocery store, which has been losing out as consumers opt to shop the perimeter in search of fresh and healthy fare. According to IRI, while total food and beverage sales in the U.S. grew at just around a 2% clip of late, the growth of fresh

Securities mentioned in this article

Ticker	Price($)	Change(%)	Morningstar Rating	Morningstar Analyst Report
KHC	87.66	0.27	★★	
BUFF	22.42	-2.22	★★★★	
K	67.31	-0.38	★★★	
CL	73.00	1.32	★★★	
LNCE	35.78	-1.54	★★★	
PEP	117.19	0.64	★★★	
CPB	52.61	0.15	★★★	
MDLZ	44.22	-0.06	★★★★	
PG	89.26	0.11	★★★★	
SJM	120.71	-0.26	★★★★	
UN	58.30	0.88	★★★	

perimeter offerings chalked up growth that was more than 2 times this pace, topping 4.5%. A number of packaged food companies have subsequently lowered their long-term sales growth outlooks to the low single digits, as these pressures are unlikely to abate over the near to medium term.

Kellogg's languishing sales performance has been particularly pronounced in its U.S. morning foods segment, which accounts for more than one fifth of sales and houses the cereal offerings. Segment organic sales growth (on a quarterly basis) has trended into positive territory in just 5 of the last 21 quarters.

However, we think this sales decline primarily reflects category dynamics as opposed to an erosion in the company's market share as consumers opt for other breakfast alternatives, such as yogurt and snack bars, with these categories recently growing at a low- to mid-single-digit rate annually. Kellogg continues to lead the cereal aisle, controlling around 36% of the ready-to-eat cereal category, generally consistent with the share it held in 2012. Given its position as a leading packaged food company, combined with the resources it maintains to reinvest in its brands and drive traffic in retail outlets, we continue to believe Kellogg is a valued partner for retailers, supporting the intangible asset source of its narrow economic moat.

Kellogg's sluggish sales growth despite its strong brands is emblematic of industrywide trends, and so we aren't surprised that companies across the packaged food category are exploring other avenues to prop up top-line momentum. In that vein, we view Kellogg's decision to pivot away from direct-store distribution and transition completely to a warehouse model as a means to free up resources to invest behind its brands. We believe this to be prudent, particularly relative to its peers, which in general have been looking to juice margins by siphoning off brand spending. We think more effective brand spending could enable Kellogg to better weather competitive pressures from other branded operators, small niche peers, and lower-priced private-label offerings.

Direct-Store Delivery Loses Some of Its Clout

In its simplest form, direct-store delivery entails a manufacturer delivering product directly to a retail store. The Grocer Manufacturers Association has estimated that historically, nearly one fourth of unit sales and more than half of retail profits have ensued from direct-store delivery. Benefits result from lower inventory days of fast-turning and often fresh offerings to traditional grocers, which reduces lost sales due to spoilage. In this context, direct-store delivery has been believed to result in fewer out-of-stocks as well as better inventory replenishment.

However, these benefits came at a cost--primarily a more complex and costly distribution platform, given that this method centers on a manufacturer shipping directly to individual retail stores rather than aggregating shipments. With warehouse distribution, Kellogg has a more simplified delivery network: It will ship product directly to the retailer's warehouse, at which point the retailer will take control of the inventory and ensure products make it to the shelf.

While this shifts responsibilities to the retailer, we don't expect objections, as retailers depend on leading brands to drive traffic in their outlets. Further, the center-store categories where Kellogg plays have been losing out to the perimeter as consumers seek healthier and fresher fare; as a result, we think retailers would welcome the more focused brand investments that Kellogg has earmarked with the savings that are likely to result from this change.

The added costs of direct-store distribution, which is concentrated in Kellogg's snack operations, are evident when examining Kellogg's segment operating margins. Profitability in Kellogg's U.S. snack segment (where around 60% of sales have come via direct-store delivery, equating to around one fourth of consolidated operations) has historically trailed the remainder of the North American operations (which rely exclusively on warehouse distribution) as well as the consolidated total, with operating margins running at less than 12% on average over the past four years, versus the midteens to low 20s the rest of Kellogg's domestic and consolidated operations have chalked up.

Despite Kellogg's ability to reduce complexity of its operations and elevate its brand spending in this pursuit, we don't think direct-store delivery is dead. We expect wide-moat PepsiCo (PEP) and Mondelez (MDLZ) will continue to exploit their large, established direct-store delivery networks to leverage relationships with retailers and ensure product quality doesn't falter, particularly since their chips and cookies may not be handled as gingerly through the multiple touch points of a retailer's warehouse distribution. We also think it's unlikely that no-moat Snyder's-Lance (LNCE) and

NSRGY	86.35	-0.22	★★	
UL	57.09	0.76	★★★	

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wide-moat Campbell Soup (CPB) will move the way of Kellogg for distribution of their snack fare; this would fail to free up substantial capital, given that neither has invested in its own direct-store delivery network but instead outsources the direct delivery of its offerings to independent contractors.

Although the opportunities resulting from direct-store delivery seem unique to Kellogg, why is now the right time for the company to forge ahead with such a drastic move? In our discussions, the company said the timing seemed attractive now because of the investments retailers have been making in their own store logistics and route-to-market systems, which have made retailers less dependent on manufacturers for assistance in product placement. In addition, we believe the increasing penetration of consumer product sales through digital and alternative channels--as opposed to the traditional grocery trade, which has been the primary user of direct-store delivery--makes the timing prudent.

A decreasing number of individuals consider traditional grocery stores (where we estimate that leading packaged food manufacturers derive north of three fourths of total sales) as their primary outlet. In 2016, less than 50% of consumers viewed the grocery channel as the prime shopping outlet, compared with nearly 70% just five years ago, according to the Hartman Group/FMI U.S. Grocery Shopper Trends 2016 survey. Further, more consumers are shopping at supercenters and limited-assortment outlets, and many are migrating online--Nielsen research shows that 23% of American households are buying food on the Internet. This is particularly notable given that warehouse distribution--not direct-store delivery--has historically facilitated the delivery of nearly all products to alternative outlets, including drug, dollar, and club stores, which now account for more than 50% of shopping trips. This appears to support Kellogg's decision. But despite this shift, we don't expect a material change in competitive positioning. We believe consumer packaged goods companies with significant resources to invest behind their brands (both in innovation and marketing) can entrench themselves with online retailers and support their brand intangible assets. Further, given the small size of the category and the increased logistics costs, we doubt expansion in the online channel will ultimately bolster a company's cost edge.

We think Kellogg's exposure to lackluster categories and its challenge to consistently price in excess of inflation over the past several years could have accelerated its decision to make this switch and free resources to invest in its brands. In our view, branded manufacturers should be able to garner value from their portfolio mix and pass through inflationary pressure to customers. However, the fact that Kellogg plays in challenged categories (particularly cereal, which accounts for more than 40% of its consolidated sales base) could impede its ability to sustainably price in excess of inflation, justifying the decision to invest further in its brand mix as a means to weather the current competitive onslaught.

Gains at Hostess Give Credence to Kellogg's Shift

Kellogg is not the first to go down the path to a warehouse model. Hostess opted to cut ties with its direct-store delivery network in favor of warehouse distribution when it emerged from bankruptcy under new owners in July 2013. At the time of its 2012 bankruptcy--beyond operating a direct-store delivery network--Hostess faced a barrage of challenges, including rising labor and commodity costs, a highly leveraged balance sheet, and a product set that failed to align with evolving consumer trends. So we don't believe its recent financial performance (which includes high teens to low 20s operating margins, in excess of peers' mid- to high teens) is completely comparable with its history of consistent operating losses. However, given Hostess' positioning as a more pure-play snacking operator with a warehouse distribution system, we think examining its current margin profile relative to wide-moat Mondelez, which operates a sizable direct-store delivery network, could provide insights into the degree of financial gains that may be in the cards for Kellogg.

Since Hostess transitioned to warehouse distribution and emerged from bankruptcy, its cost of goods sold has approximated 58% (versus 61% at Mondelez), while selling, general, and administrative costs have hovered around 10% of sales (versus 14% at Mondelez more recently), leading to operating margins of around 20% (above Mondelez's 14%). A portion of this differential probably reflects a varied product mix and ultimately commodity cost basket; as an example, we estimate dairy could amount to 5%-10% of Mondelez's raw material costs (versus negligible at Hostess) but can't be directly hedged like other inputs. In addition, we think Mondelez's heavier exposure to lower-margin emerging markets (one third of its sales, but just about one fourth of operating profits) could be driving a portion of the differential. But despite these factors, we still believe this comparison showcases the lower cost profile that characterizes a warehouse distribution model.

To put these metrics into perspective, we adjusted the likely gains Kellogg may realize based on the 20%-25% of sales and profits it presently derives from its direct-store delivery network. On this basis, we would expect about 50-100 basis points of leverage at both the cost of goods sold and SG&A lines for Kellogg. We presently forecast that Kellogg will chalk up a 40-basis-point improvement in average gross margins over the course of our explicit forecast to nearly 37% annually and a 110-basis-point reduction in average SG&A expenses as a percentage of sales through fiscal 2026 to around 7.3%. We view these estimates as reasonable in the context of the company's efforts to drive efficiencies through its supply chain and implement zero-based budgeting, which, when combined with the efforts to transition to warehouse distribution, are expected to result in $600 million-$700 million in annual savings.

More-Focused Brand Spending Should Prove Advantageous
While we view Kellogg's efforts to drive supply chain efficiencies, implement zero-based budgeting, and transition toward warehouse distribution as wise, we don't believe management is merely looking to beef up its profit prospects. Rather, we think these savings should provide the fuel to reinvest behind brands, both in product innovation and marketing. Given that consumer preferences are evolving rapidly, we think the onus is on packaged food manufacturers like Kellogg to ensure that new products consistently win at the shelf with end users, but also that companies maintain or increase marketing spending to ensure brand awareness doesn't falter.

Cost-reduction efforts have not always proved beneficial in the past. Five to 10 years ago, Kellogg failed to invest for growth, prompting a handful of recalls as quality control faltered. This hurt sales by a low-single-digit rate and operating profits at a mid- to high-single-digit rate in the quarter after to the recall. We think Kellogg's recent efforts to harness its cost structure are more surgical in nature, and our discussions with management support our view that the company has learned from its past missteps and intends to avoid repeating them.

Despite its cost-efficiency efforts, we forecast that Kellogg will continue to expend slightly more toward cost of goods sold as a percentage of sales than others in the industry (at 63% versus 62% on average for its competitors, which could partly be attributable to the composition of its product mix and commodity cost basket). In addition, we expect Kellogg will edge up its brand reinvestments slightly (from the 5.6% and 1.4% of sales it spent on marketing and research and development, respectively, in fiscal 2016) to 6.7% and 1.5% on average over the next 10 years, which marginally exceeds our outlook for other packaged food operators that apportion just less than 8% of sales in total on marketing and R&D. Despite modestly higher brand spending, we forecast that Kellogg's average operating margins will generally align with its peers' at just north of 18% over the next 10 years.

We expect the degree of improvement will be most pronounced in Kellogg's U.S. snack operations, as the added costs and complexity resulting from its use of direct-store delivery (which had accounted for around 60% of segment sales) no longer are a constraint. We think the domestic snack operations are poised to realize nearly an 800-basis-point improvement in operating margins by fiscal 2021 to the high teens, about the level of profitability we forecast for its consolidated business.

Kellogg Still Looking for a Top-Line Pop
Unlike most of its peers, which strike us as laser-focused on driving pronounced margin improvement even at the expense of sales gains, Kellogg sees the importance of chalking up profitable top- and bottom-line improvement over the longer term, in our view. While sales gains have been elusive for most center-store packaged food operators in the past few years, we think that with more-focused brand spending, Kellogg can drive low-single-digit sales growth over our 10-year explicit forecast as it taps opportunities across its product and geographic footprint.

We believe Kellogg stands to leverage insights more effectively across its organization, like learning from Kashi, its organic brand, and to align its new products to better reflect evolving consumer trends, such healthier fare made with simpler, more natural ingredients. This should ultimately lead to accelerating growth opportunities. However, we don't think the avenues to boost the top line are limited to bringing new flavor and ingredient profiles to market; in our view, the company is also poised to adjust its pack sizes to more effectively penetrate alternative outlets. In the past, only 5%-10% of Kellogg's U.S. snack sales came from single-serve offerings; this is one half to one third the level at Mondelez and PepsiCo. As such, Kellogg has failed to cater to consumers looking for convenient, on-the-go offerings. We think these opportunities are particularly notable for its Pringles brand, which has been growing at a high-single-digit rate since its acquisition from Procter & Gamble (PG) five years ago. Kellogg has doubled the brand's manufacturing capacity to four facilities and should post further gains as it penetrates alternative distribution channels, particularly convenience, drug, and mass outlets.

We forecast 3% long-term sales growth in Kellogg's U.S. snacks segment, generally in line with our expectations for snack category growth. We take a more tepid outlook for the company's cereal and frozen segments, which we foresee posting just 1% and 2% growth, respectively, as we doubt intense competitive pressures and lagging category trends in these segments will abate. As a result, we anticipate the snacking segment will represent around 55% of Kellogg's total sales by the end of our 10-year explicit forecast as cereal's contribution to the business mix continues to shrink.

We expect the pace of emerging-market growth will trump that of more developed markets, which account for more than 80% of the company's total sales base. Growth prospects in several emerging regions have slowed over the past several quarters, but we still believe that populations will grow exponentially, urbanization and private investment will create disposable income tailwinds, and a younger consumer base will offer the potential for a lifetime of consumer product transactions. Even though Kellogg's ready-to-eat cereal mix has struggled to win over emerging-market consumers, we think the Pringles addition affords the company a vehicle through which it can garner a more meaningful presence in these attractive regions and gain a better sense of consumer tastes and preferences. As such, we forecast mid-single-digit annual top-line gains in the company's Latin America and Asia-Pacific regions (excluding the impact of foreign currency movements), above the low-single-digit growth we anticipate for the company's North American and European operations over our explicit forecast.

In the aggregate, we think these untapped opportunities position Kellogg to generate nearly 3% sales growth longer term, and that this performance will be fairly balanced between increased volume and higher prices. We expect foreign currencies to continue to hinder sales growth in fiscal 2017, but given the company's geographic concentration in North America and the impact of recent tie-ups, any negative impact from exchange rates is likely to be minimal. We don't incorporate foreign currency impacts beyond our current-year outlook.

Modest Improvement in Financial Prospects Doesn't Make Kellogg an Outsize Bargain

We think the market is appropriately accounting for the risk/reward surrounding Kellogg's prospects. Our $72 fair value estimate incorporates low-single-digit annual sales growth, about 200 basis points of gross margin improvement (relative to the average in fiscal 2014-16) to 37.5% by fiscal 2026, and around 350 basis points of consolidated operating margin expansion to more than 19% by the end of our 10-year explicit forecast.

However, in light of the headwinds Kellogg faces--namely persistent input cost risk and aggressive competition, which could prove more challenging as the company transitions to warehouse distribution and works to reignite its core business--we think long-term investors should demand a larger margin of safety. The shares presently trade at a modest discount to our valuation, but we'd suggest investors await a larger margin of safety before building a position.

We think recent stock prices across the packaged food space fail to account for the intense competition from other branded companies, lower-priced private-label offerings, and smaller niche operators, combined with the need to reinvest additional dollars in brands, partially to enhance the stickiness of retail relationships. We think these factors will ultimately impede the ability to drive more outsize earnings growth. In this context, and relative to the 5%-7% earnings growth we forecast for several branded packaged food operators, these valuation levels appear even more lofty.

We also think a portion of the market's favor for packaged food companies reflects speculation regarding additional consolidation. While we expect consolidation will persist, we doubt that Kellogg will be a prime target. The W.K. Kellogg Foundation Trust owns around 20% of the company's outstanding shares and is unlikely to opt to offload this ownership position. Kraft Heinz's reluctance to pursue a hostile deal--as evidenced by its quick decision to end its pursuit of Unilever (UL)/(UN) earlier this year--supports our contention. Further, Kellogg's exposure to the more lackluster cereal aisle could negate interest from others in the industry that may be more apt to scoop up targets with exposure to faster-growing categories, including confectionery and/or the natural and organic aisle.

We suggest investors looking to amass a presence in the packaged food space instead consider narrow-moat Blue Buffalo, which is trading at a nearly 20% discount to our $28.50 fair value estimate. We anticipate that humanization and premiumization trends in pet food will prove durable and should enable the company to realize a high-single-digit rate of sales growth annually over our 10-year explicit forecast and about 500 basis points of operating margin expansion to nearly 28% by fiscal 2026.

Although Blue Buffalo competes against large packaged food and personal care companies such as wide-moat Colgate-Palmolive (CL), narrow-moat Smucker (SJM), wide-moat Nestle (NSRGY), and Mars, we think its strong brand portfolio presents a sustainable competitive advantage in an industry that has seen pet owners increasingly favor differentiated, upscale products that align with human trends--items consistent with Blue Buffalo's product positioning. As pets are seen as family members by millennials choosing to delay parenthood and by older households where children have left the home, we think pet owners resist curbing expenditures on their cats and dogs, in line with behavior through the 2008-09 recession. Furthermore, pet owners' reluctance to switch away from tolerated brands should favor incumbents like Blue Buffalo, which currently enjoys a mid-30s share of the wholesome natural segment (which accounts for nearly 20% of the overall pet food market or around $5 billion). As the company builds relationships with veterinarians as it establishes its new therapeutic food lineup, we anticipate its intangible asset-based advantage will strengthen. In addition, we expect the company's efforts to use digital commerce to combat scaled competitors' advantages in the grocery and mass-market channels (where Blue Buffalo does not participate) should bear fruit, helping to diversify distribution away from pet specialty stores, which presently account for more than 60% of sales.