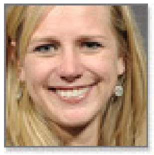
Sysco Corporation SYY |

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

Despite recent bumps in the road, Sysco's competitive prowess is relatively unscathed.



by
Erin Lash

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

Analyst Note

Competitive Pressures Take a Bite Out of Sysco's Profits; Shares Only Modestly Undervalued
by Erin Lash, 08/12/13

Discuss

See what other investors are saying about SYY

Analyst Note 08/12/13

The fourth quarter tends to be particularly strong for Sysco, in light of the Mother's Day holiday, which is usually one of the busiest days for restaurants during the entire year; however, this year was a marked retreat from tradition. Fourth-quarter sales ticked up just 2.8%. While food cost inflation remains favorable at 2% (at the low end of the firm’s ideal 2%-3% inflation range), case volume growth was uninspiring at just 0.8% (down from 3.3% in the year-ago period but up from a fall of 0.2% in the third quarter). However, what we found particularly troubling was the deterioration in profitability, which came at the hand of intense competitive pressures. More specifically, gross margins contracted 60 basis points to 17.6%, while adjusted operating margins fell a similar amount to 4.9%. This isn’t the first time Sysco has faced these headwinds during the past few years, and we doubt aggressive competition will subside anytime soon. However, we’re encouraged that Sysco is keenly focused on trimming additional fat from its already lean operating structure, by working to more efficiently route deliveries as well as optimize its product sourcing and supplier relationships.

Despite this lackluster performance, results for the full year came in about where we expected, and while we intend to update our model to account for recent results, we don't anticipate a material change to our $36 per share fair value estimate beyond accounting for additional cash generated since our last update. Overall, we take a longer-term view of the firm's prospects and believe that Sysco

Morningstar's Take SYY

Analyst

Price 08-12-2013	**Fair Value Estimate**	**Uncertainty**
32.99 USD	36.00 USD	Medium
Consider Buy	**Consider Sell**	**Economic Moat**
25.20 USD	48.60 USD	Wide
Stewardship Rating		
Exemplary		

Bulls Say

- Sysco is the largest food-service distributor in North America, with 17.5% share of this $225 billion market. It's followed by U.S. Foodservice with 9% share and Performance Food Group with 5%.
- The firm's supply chain initiatives should allow Sysco to consolidate inventory and negotiate more favorable procurement terms with suppliers.
- We are encouraged by the diversity of the firm's customer base, as no single customer accounts for more than 10% of Sysco's consolidated sales.

Bears Say

- Erratic changes in energy prices, which affect packaging and distribution costs for Sysco, as well as volatile input costs, are proving to be a major headwind for food-service distributors.
- Given that more than 60% of Sysco's sales result from the restaurant sector, we don't expect volume pressure to meaningfully abate over the near term, as today's consumer remains fragile.

should be well positioned when there is a more consistent, positive cadence to restaurant sales. Although we expect sales volume to remain lumpy in the near term, we believe Sysco's expansive distribution network (which fortifies its wide moat) will enable the firm to remain the dominant player. From our view, the market's concerns regarding sluggish restaurant traffic and food cost inflation are overdone. At 17 times consensus fiscal 2014 earnings, we view the shares as only modestly undervalued.

Investment Thesis 05/14/13

Sysco is the leading food-service distributor in the United States and Canada, with about a 17.5% share of this $225 billion market. Although food distribution is generally a low-margin, capital-intensive business, economies of scale have allowed Sysco to post returns on invested capital that have consistently exceeded our estimate of its cost of capital. The firm distributes more than 400,000 traditional food and nonfood products, serving 400,000 customers in various industries, and has expanded into other profitable niche segments, such as health care, education, and lodging. In an effort to solidify customer relationships, Sysco has made it a priority to consult with clients on how they can drive sales and minimize costs (an advantageous undertaking, given that about 80% of its sales are derived from smaller customers). We think its expansive distribution network and extensive product offering afford Sysco a wide economic moat.

Over the past 40-plus years, Sysco has actively participated in the industry's consolidation, completing more than 150 deals, and management's hunger for deals has yet to subside, with acquisitions expected to contribute around 1% of sales growth each year. While smaller local and regional distributors (sales of $10 million-$400 million) remain the most likely prospects, Sysco's openness to pursuing deals outside its home market is in contrast to its stance just a short time back. When we asked CFO Chris Kreidler about this apparent shift in strategy last year, he said that although scale is not possible in Europe the way it is in North America (due to different legal and regulatory environments in each country), the firm is still able to leverage the knowledge and experience it's gained, such as in brand management and customer service. In our view, the biggest challenge related to any deal would result from constraints on personnel rather than financial resources. However, given the firm's preference to complete smaller deals and

- Sysco is undergoing a major business transformation, the results of which are far from a guarantee. In addition, any implementation challenges could distract management from the firm's core business operations.

Competitors SYY — More...

Name	Price	% Chg	TTM Sales $ mil
Sysco Corporation	**$32.99**	**-5.77**	**43,856**
Olam International Ltd ADR	$26.96	1.35	15,485
Jeronimo Martins ADR	$42.86	-0.37	15,020
Colruyt ADR	$14.48	0.56	10,796
Bunzl PLC ADR	$105.90	0.36	8,322
Glanbia PLC	$—	—	2,953

Compare These Stocks

Video Reports SYY — More...

management's exemplary stewardship of capital, we don't anticipate potential deals to materially affect our fair value.

Despite being a low-cost operator, Sysco is keenly focused on trimming additional fat from its already lean operating structure, by working to improve its supply chain by more efficiently routing deliveries, as well as optimizing its product sourcing and supplier relationships. However, what has been most impressive to us is the pace at which Sysco is rolling out this vast undertaking. The firm has spent more than four years designing and testing these new processes and procedures, and after some performance issues surfaced, Sysco extended the testing phase in order to minimize problems on a broader scale--a wise move, from our perspective. The firm took another step back in the fall of 2012 when additional challenges arose following its first simultaneous launch at two separate facilities. Management still expects the cost savings from this project to amount to around $600 million over the next few years, and we forecast operating margins to improve to 5.3% by fiscal 2017 (up from 5.0% adjusted operating margins in fiscal 2012). In our view, the potential for higher customer retention, the ability to better serve customers, and improved reporting should prop up revenue and limit unnecessary expenses. That said, because the project is still in the very early stages, we don't forecast any meaningful benefit over the near term.

Sysco is not immune to headwinds, including lackluster restaurant traffic and food cost inflation, but some underlying positive trends support our thesis that an expansive distribution network will enable the firm to remain the dominant player in the category, generating strong cash flows and outsize returns for shareholders longer term. Food cost inflation, while still a challenge, remains moderate at just 2%-3%, which is ideal for Sysco. Historically, the company has been able to pass along these higher costs to its customers, but double-digit inflation in categories such as meat and produce makes this pass-through more challenging. And we recognize that unfavorable weather conditions (similar to the drought experienced throughout the U.S. Corn Belt last summer) could once again drive food costs higher. In addition, case volume performance had been trending higher, but the third quarter of fiscal 2013 (historically one of the firm's smallest with regards to sales and profits) was a marked contraction, as underlying case volume fell 0.2%. We anticipate that volume will remain lumpy; however, the fourth fiscal quarter tends to be particularly strong for Sysco in light of Mother's Day--which is usually one of the busiest days for restaurants during the year--and as a result, we expect to garner a better read on the overall economic climate over the coming months.

Economic Moat 05/14/13

Sysco operates in a capital-intensive, low-margin industry. However, it has established a wide economic moat through economies of scale that far surpass those of its peers. These, together with a focus on efficiencies, drive the company's robust returns on invested capital. With about 17.5% share of the highly fragmented food-service distribution industry, Sysco is the undisputed industry leader, distributing more than 400,000 traditional food and nonfood products to 400,000 customers in various industries. Being the market leader has allowed Sysco to grab share from weaker rivals through prime access to new customers and acquisitions, as nearly 70% of its market remains highly fragmented. In addition, Sysco's scale lets it realize lower procurement and delivery costs, cementing its position as the low-cost provider in an industry plagued by high fixed costs. As a result, despite operating margins of just 5%, Sysco consistently generates returns on invested capital in the high teens.

Valuation 05/14/13

After reviewing Sysco's results through the first nine months of fiscal 2013 and the assumptions underlying our discounted cash flow model, we're maintaining our $36 fair value estimate, which implies forward fiscal 2014 price/earnings of 19 times, enterprise value/EBITDA of 10 times, and a free cash flow yield of 5.1%. Given the fragile state of today's consumer, we expect that restaurant traffic and ultimately consumer spending levels could remain lumpy, hindering near-term sales, but that food cost inflation, as well as the firm's string of recent acquisitions, props up sales growth, offsetting the pressures created by soft consumer spending. As a result, we forecast that sales will increase 5.5% in fiscal 2013 compared with the year-ago period. Longer term, we forecast that Sysco will benefit as consumer spending picks up, resulting in just north of 4% annual sales growth through fiscal 2017. Looking out through fiscal 2015, management thinks the firm will expand its underlying business at a 4%-6% rate, which seems reasonable, in our eyes. This assumes that there will be little to no real industry growth and nominal sales growth of 4%-6%.

While the firm's business transformation efforts are taking longer and costing more than its initial plans (similar to other firms that have undertaken such an endeavor), we view the measured pace of the rollout (which should prevent a major service disruption on a larger scale) as a plus. In our view, the constant focus on improving its cost structure will enable Sysco to offset volatile input costs. By fiscal 2017, we forecast operating margins of 5.3% (about 30 basis points above the firm's average operating margin over the past five years). We expect returns on invested capital to average 15% compared with our 8.5% cost of capital assumption during the next five years, providing support to our opinion that Sysco maintains a wide economic moat.

Risk 05/14/13

If global economic headwinds persist and food inflation accelerates, Sysco's financial results could be pressured. Furthermore, given that around 60% of sales result from the restaurant industry, the firm depends on the strength of consumer spending, which has been fragile, partly as a result of high unemployment. Because input costs (such as food and fuel) are a significant component of Sysco's cost structure, high commodity costs can also weigh on results. Finally, Sysco's business transformation is taking longer and costing more than its initial plans, similar to others that have undertaken such an effort. While this is far from a positive, we've been encouraged that management is taking a measured approach to the implementation of this initiative, which should ensure that it avoids a major service disruption on a larger scale. As a result, we assign Sysco a medium uncertainty rating.

Management 05/14/13

Overall, we think management has proved to be an exemplary steward of shareholder capital. The firm has returned in excess of our cost of capital estimate each of the past 10 years. In addition, while Sysco has used acquisitions to build out its geographic footprint and assume the dominant position in the North American food-service industry, we contend it has been a disciplined acquirer. For instance, Sysco sat on the sidelines when the economic environment became more challenging a few years ago, stating that because of the reduced capital investments required, smaller competitors weren't suffering as much as Sysco, or we, had anticipated. As a result, the valuations of potential targets weren't attractive enough to warrant a deal. As case volume growth has picked up steam, Sysco has once again become an active acquirer, completing more than 11 deals so far this year (which in the aggregate are expected to add around $1 billion in annual sales), and we expect the firm will remain an active acquirer when valuations warrant.

Bill DeLaney, 56, assumed the role of CEO in 2009. With his 25 years at Sysco, we believe DeLaney's experience is a huge asset to this food-service distributor, particularly given the challenging economic landscape. While Sysco has historically prided itself on the internal experience of its management bench, the firm has been actively recruiting external talent (including Bill Goetz as senior vice president of marketing, Tom Bene as chief merchandising officer, and Wayne Shurts as chief technology officer) of late to provide a fresh perspective, which we view positively. In our opinion, executive compensation appears reasonable, with about 80%-90% of management's annual pay based on the firm's performance. We commend executive management for taking a 5% reduction in its base pay in 2008 in light of the difficult economic environment. We believe this was a strong signal to the rest of the managers as to how committed the firm is to maintaining strict expense control. We're pleased that Sysco operates with different individuals holding the CEO and chairman positions. Manuel Fernandez, 66, was appointed as executive chairman in April 2012 (he had served as nonexecutive chairman since June 2009). The firm has already enacted majority voting for board members, which we applaud, and we're encouraged that it is moving away from its staggered three-year election structure.

Overview

Profile:

Sysco operates as the largest North American food-service distributor, controlling 17.5% of the $225 billion market. The firm distributes more than 400,000 food and nonfood products to 400,000 customers, including restaurants, health-care and educational facilities, and lodging establishments. Since its founding in 1969, Sysco has acquired more than 150 companies or divisions of companies to expand its footprint. Nearly 100% of the firm's sales are derived in North America.