The InvestR Centre

Uncovering value for investors

Value in the US Global Consumer Franchise Stocks

www.investRcentre.com

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This series has been written by Rory Gillen, founder of www.investRCentre.com .

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Stockmarkets can be a rollercoaster. Downturns bring volatility and uncertainty which can impact your confidence, judgement and desire to invest in a certain asset class. Bull markets do the opposite and bring over confidence, trapping you to overlook fundamental information. To consistently maintain and grow your assets, you need an approach that removes emotion, can be managed in a busy life and takes account of the significant volatility that is part and parcel of stockmarket investing.

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Introduction

The US Global Consumer Franchise Stocks - A Decent Port in a Storm!

To say that the 2000s have been a difficult period for investors in risk assets is an understatement. Equities have suffered two significant bear markets and the bursting of the property bubble brought the global economy to its knees. And the ordinary saver, looking for a risk free return, is suffering too with generational low interest rates. And to cap it off, the Greek debacle has highlighted that even governments bonds are not risk free. One might justifiably ask – is there any port in this seemingly endless financial storm?

The US global consumer franchise stocks offer the most basic of products or services yet have unique attributes that investors often overlook. They offer defensiveness in their earnings, no financial risk, mixed currency and emerging markets exposure and, following the decade long bear market in equities, better value than they have in possibly two decades. This series, which starts today, takes a look at a collection of these global giants.

The enclosed table which highlights the earnings and dividend statistics of the US market (i.e. the Dow Index) and the US global consumer franchise stocks makes a number of striking points.

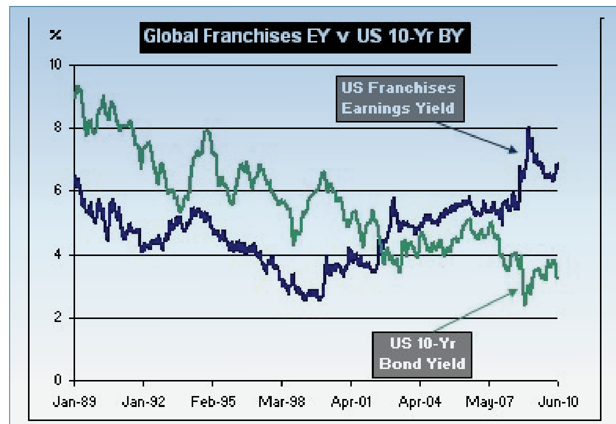
The first point is that the overall US equity market was substantially overvalued in late 1999. Investors were paying 27 dollars for every dollar of earnings. Looked at another way, investors were buying an earnings yield of 3.6% (100 / 27.4 = 3.6%). At the same time in late 1999, the US 10-year government bond was offering a substantially higher, and risk free, yield of 6.5%.

The second point is that at that same time in late 1999, the US global consumer franchise stocks were, in aggregate, trading on 35 times earnings and offering a dividend yield of only 0.8%. Hence, these stocks were priced at a significant premium to an already overvalued market at that time.

Fast forward to late June 2010, and the market (as represented by the DOW Index) offers much better value compared to 1999 - trading on 15.2 times historic earnings and offering a dividend yield of 2.8%.

And the US global consumer franchise stocks, in aggregate, are trading at an average of 14.9 times historic earnings (or an earnings yield of 6.7%) and offer a dividend yield of 3.0%. Hence, these stocks are now trading at a modest discount to the market, a highly unusual occurrence. The earnings yield of 6.7% compares to the US 10-year government bond yield of 3.2%. Bonds were the better investment in 1999…but not anymore!

Company	Latest Price	Current P/E Ratio	Current Div Yld	2000f P/E Ratio	2000f Div Yld
Coca Cola	50.26	16.5	3.3%	39.1	1.1%
Johnson & Johnson	58.70	12.6	3.4%	28.9	1.2%
McDonalds Corp	67.42	16.1	3.1%	34.2	1.1%
Procter & Gamble	59.79	15.9	2.9%	26.2	0.5%
Wal-Mart	48.80	13.3	2.3%	47.3	0.3%
Average *(Global Franchises)*		14.9	3.0%	35.1	0.8%
DOW Index	10,144	15.2	2.8%	27.4	1.5%



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Coca Cola - Cheap Again After a Decade of Ranging

In this second article looking at some of the US global franchise stocks, we take a look at the Coca Cola Company, the world's largest owner and marketer of non-alcoholic beverages. Its products are sold in 200 countries the world over. Growth is driven via geographic expansion, new brands and brand extensions.

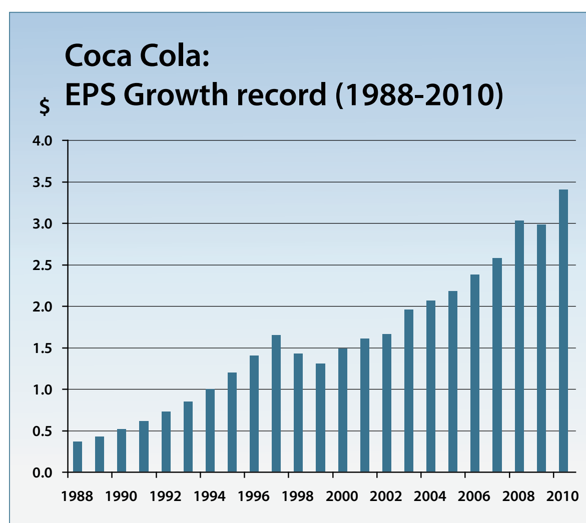
Coca Cola's share price has languished for years following the peak in markets in late 1999. But its sales, profits and cash flows have continued to grow since then. The graph highlights that, at 15.7 times earnings, Coca Cola now offers substantially better value compared to what investors on average have paid for the company's earnings over the last 20 years.

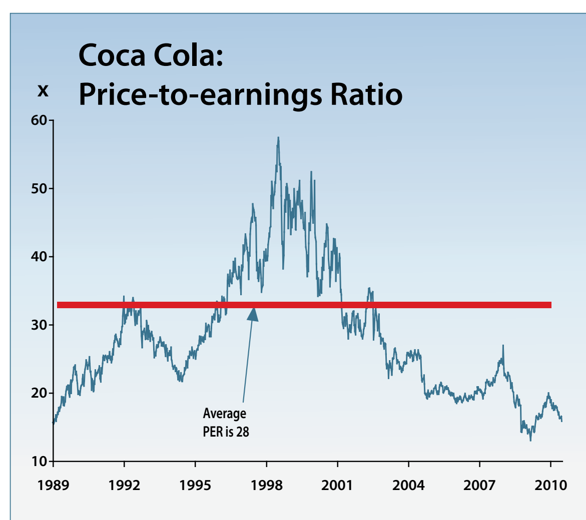
Paying 15.7 times earnings is equivalent to obtaining an earnings yield of 6.4% out of which Coca Cola is currently paying a dividend yield of 3.4%. If Coca Cola continues to grow its earnings, then this initial 6.4% earnings yield will grow, allowing it to pay out an increasing dividend.

So what are the risks? In terms of financial risk, I see none. The group had circa $3 billion of debt at the end of March 2010 but has over $8 billion of annual cashflows.

And the business risks look minimal also. Coca Cola's return on equity (ROE) is a huge 29% reflecting the massive competitive advantage that its brand gives it, delivering both immense pricing power and hence high margins. Its brand and global reach are unrivalled and give it an ability to launch new products and into new markets more easily than any competitor. In addition, the demand for Coke's products varies little with the economic cycle. This combination of attributes provides the all elusive 'reliable growth' which is normally highly prized by investors. It is these qualities that have allowed the group to average 11% growth per annum since 1988.

While growth in the future could easily be less than the past, the lower price-to-earnings ratio already factors that in, in my view. An initial 3.3% dividend yield plus annual growth of even 5% would translate into a total return of 8% per annum over time from here. While that may not sound overly exciting to investors, the risk free alternative is a static 10-year return of 3% per annum from a US government bond. Throw in Coca Cola's emerging market exposure and mixed currency earnings base and it is hard to see a better investment on a five to ten year view.





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Johnson & Johnson
As Cheap as it Has Been in Years

In this the third article in the series, we take a look at another well-known US global consumer franchise company, Johnson & Johnson. Its $62 billion of annual sales is split across medical devices ($23 billion, 37%), pharmaceuticals ($23 billion, 37%) and consumer products ($16 billion, 26%). In terms of geographic spread, the US accounts for $31 billion of sales (50%), Europe $16 billion (26%), Asia Pacific & Africa $10 billion (16%) and the Western Hemisphere emerging markets $5 billion (8%). Clearly, there is decent exposure to emerging markets.

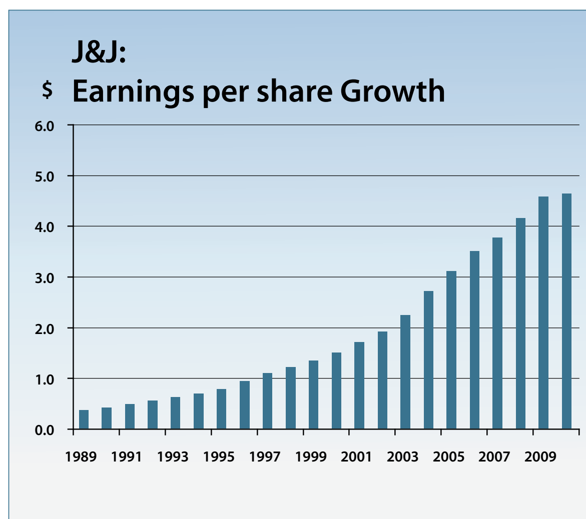
Revenues declined in 2009 at J&J for the first time in 76 years reflecting the severity of the global recession and some key drug patent expiries in its pharmaceutical business. Nonetheless, its growth model - which includes (i) research and development to deliver a stream of new products across all segments of the business (ii) geographic expansion into the BRIC countries of Brazil, China and India and (iii) acquisitions - is tried and tested and should continue to deliver growth in the future.

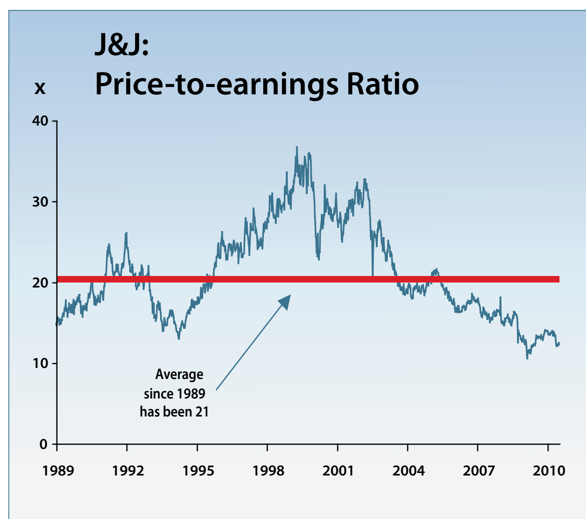
All investors can identify with the iconic consumer brands within the consumer products division of J&J (26% of sales). Competitive advantages in the pharma and medical devices & diagnostics divisions rely more on product development and customer service. In that respect, J&J's brand is not equal to that of Coca Cola.

But the group knows how to grow. From 1988 to 2010, revenues grew by 9% per annum, earnings by 13% per annum and its dividend by 14% per annum. Return on equity (ROE) has been consistently high at 27% after tax, a rate few companies in the world can achieve consistently. With net cash of nearly $5 billion, there is virtually no financial risk in J&J.

J&J operates in growth markets that are resistant to the economic cycle. Management obviously has a well honed strategy for growth which is not without its risks but has been applied in a focused manner in the past. At $60.4, the shares are trading on 12.1 times forecast earnings of $5 for 2010 (Valueline estimates). As the accompanying price-to-earnings graph shows, the shares are as cheap relative to earnings as they have been in a long time.

A p/e ratio of 12.1 equates to an earnings yield of just over 8%. Of that, 3.4% is paid to shareholders by way of a dividend which with growth of even 5-6% per annum from here holds out the very real possibility of double-digit returns on a five year view. As a pension-type investment, it's hard to see the downside.





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McDonalds
Business Model Humming

In this the fourth article in the series, we take a look at another US global consumer franchise company, McDonalds. With 32,500 restaurants in 117 countries and annual system-wide sales of $57 billion, McDonalds is the world's largest food service operator. The US accounts for 35% of revenues, Europe 41%, Asia / Pacific, Middle East & Africa 18% and other regions the remaining 5%.

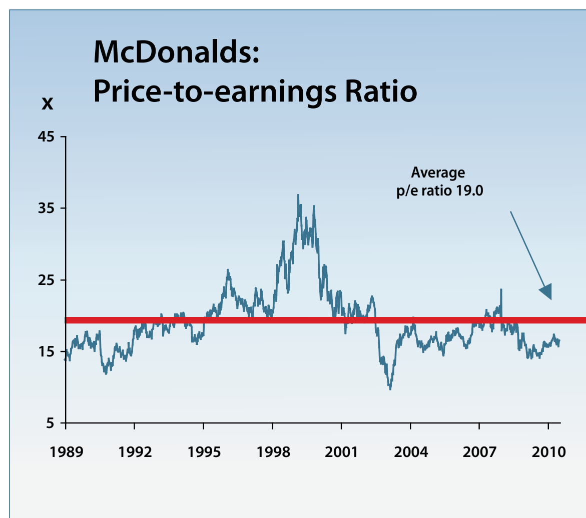
McDonalds' sheer scale, convenience and value offering is a knockout combination providing it with recession-proof earnings and a true competitive advantage. These attributes not only allowed the company to recover from a decade of mismanagement from the mid 1990s to the early 2000s but to grow earnings, cash flows and dividends at a rapid pace since the turnaround gathered momentum in 2004.

The turnaround started in 2002 when management halted the previous policy of adding 'restaurants to customers' and instead focused on adding 'customers to restaurants'. The results were dramatic. New store openings were slashed and an emphasis was placed on customer satisfaction, which led to the development of new convenient and innovative menu offerings, improved hygiene within restaurants and increased speed of service. System-wide revenues have increased 37% from $41.5 billion in 2002 to $56.9 billion in 2009 and the group now serves 60 million customers a day compared to 46 million a day in 2002, with only a 4% increase in system-wide restaurants.

With annual cash flows of $5.7 billion, $2 billion of short term cash reserves and net debt $8.5 billion there is no financial risk in McDonalds.

The shares currently trade on 16 times earnings which is a 15% discount to the long term average price-to-earnings ratio of 19 that investors have afforded the shares in the past (see chart). The defensive growth nature of its earnings profile is rare and, in that regard, a price-to-earnings ratio of 16, which equates to an earnings yield of 6.25%, represents good value when you consider that the US 10-year government bond currently only yields 3%.

While the surge in growth following the turnaround may be over, same store sales growth remains positive, further geographic expansion opportunities lie ahead and strong cash flow generation underpins the ongoing earnings-enhancing share buy-back programme. All in all, McDonalds looks capable of sustaining mid to high single digit earnings growth which together with a dividend yield of 3.2% should underpin 9-10% annual returns to shareholders over the medium term.



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The US Global Consumer Franchise Stocks - A Value Proposition

This is the last article covering the US Global consumer franchise stocks and this week we take a look at the average value on offer in a basket of these stocks compared to what is available in non-risk assets like government bonds.

An earnings yield describes the amount of earnings you are buying compared to the price you are paying and is more easily compared to a rental yield on property or the yield on government bonds.

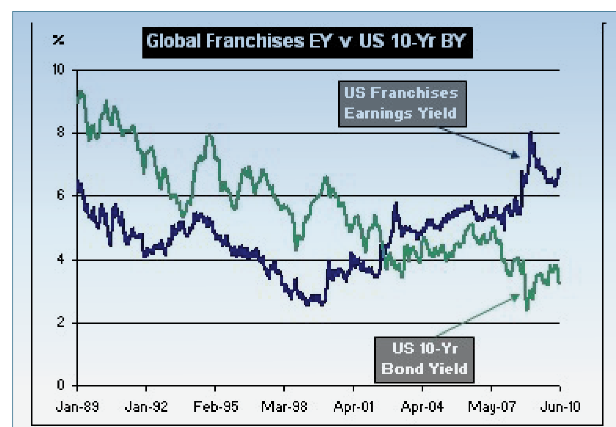
As the chart highlights, the US 10-Year government bond currently yields 3.0%. In comparison, the earnings yield available from a collection of six US global consumer franchise companies is closer to 6.7%. The collection of companies includes Coca Cola, Johnson & Johnson, Wal-mart, Proctor & Gamble, Kraft and McDonalds.

The earnings yield was higher in early to mid 2009 when markets were lower and reeling from the global backing crisis. Other than that, however, the earnings yield available from this basket of blue-chips has rarely been higher. Back in early 1990, the earnings yield was an attractive 6%. But at that same time the US government 10-year bond was offering a yield of 8.0% and was competing hard for investor's money at that time. Today, however, the US government bond yields a paltry 3%. In early 1990, the earnings yield from the global franchises represented 0.75 times the bond yield. Today, the earnings yield represents 2.2 times the bond yield.

The resilience of earnings in these franchise stocks and their ability to grow those earnings over time marks them apart. The repetitive nature of the demand for Coca Cola's products in difficult as well as buoyant economic conditions, its bullet proof brand and global distribution power provide its earnings with this resilience. Likewise, McDonalds low price points, speed of service and consistency of product globally have allowed it to consistently dominate the fast food industry globally and to deliver reliable growth over time. Proctor & Gamble has a collection of multi-billion dollar brands in household and personal care products where, again, demand is steady in good times and bad.

If earnings from the US global consumer franchise stocks are as reliable as the income from a government bond, and they have been in the past, then surely the value now lies with these stocks and not with the bonds. Throw in emerging market and mixed currency exposure and the value proposition is even more promising. Most likely, investors' fears of a double-dip recession have driven them to bonds. But the value is clearly in the US global consumer franchise stocks double-dip economic recession or not.

We hope you have found the analysis useful. For further details of our 1-day training seminar, website offering and further investment advisory services please contact us at **info@investRcentre.com** or call us on **(01) 2871400**. You can subscribe to the website directly at **www.investrcentre.com** – the annul subscription cost is **€149** and is available at a discounted price of **€99 until 1st October** next.



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