BUFFETTS BOOKS

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INTRINSIC VALUE ASSESSMENT OF

SANDERSON FARMS, INC. (SAFM)

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This article was written in collaboration with Christoph Wolf
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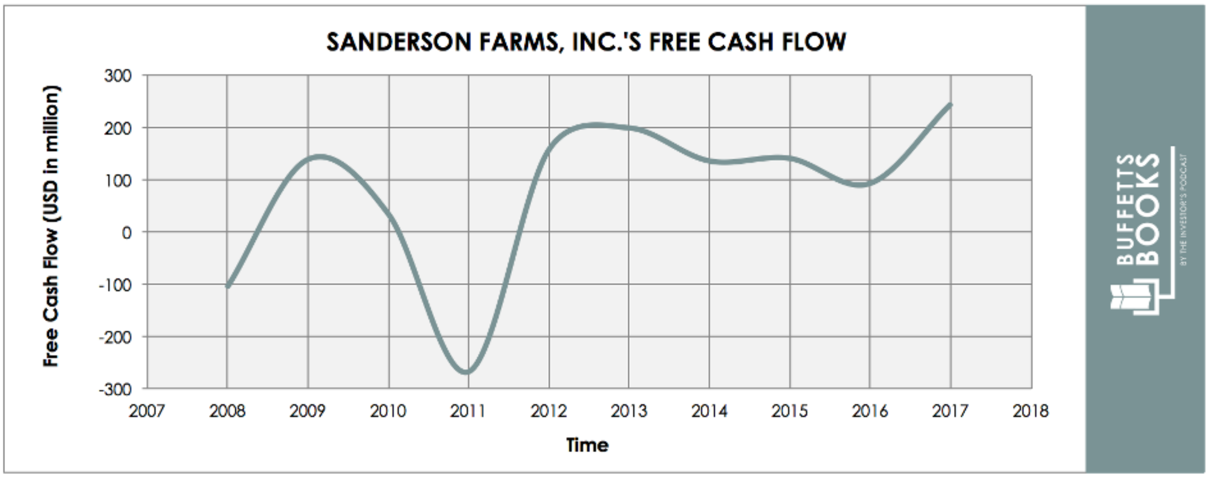
Introduction

Sanderson Farms (SAFM) is a vertically integrated poultry processing company engaged in the production, processing, marketing, and distribution of chicken products. The company is the third largest poultry producer in the US and 2017, processed about 567 million chickens. Their products include both fresh and frozen chickens, and all the company's operations are located in the U.S. Also, most of its sales were achieved in its domestic market (which were $ 3.15 billion in 2017), while export sales accounted for $268 million in 2017.

Considering that SAFM's stock price has fallen from its high of $173 at the end of 2017 to a current price of only $102, should investors now consider the stock?

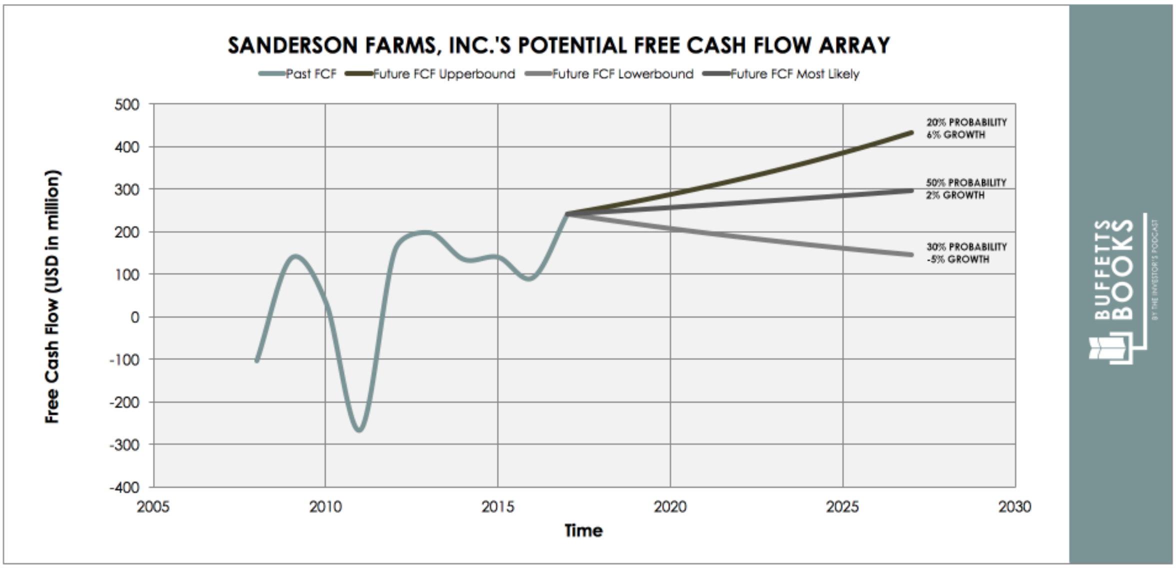
The Intrinsic Value of Sanderson Farms, Inc.

To determine the value of SAFM, let's start by looking at the company's history of free cash flow. The free cash flow is important because it represents the company's ability to retain earnings and grow the business. Most importantly, it demonstrates a return on the principal that might be invested into the ownership of equity of the business. Below is a chart of SAFM's free cash flow over the past years.



As one can see, the cash flows have been quite volatile during the last ten years, which illustrates the highly cyclical poultry business.

Due to this high uncertainty, we will use a conservative estimate for SAFM's future cash flows.



Each line in the above graph represents a certain probability for occurring. The upper growth rate of 6% is based on the approximate annual growth between 2009 and 2017 and is given a 20% probability. As most probably we consider a small annual increase of 2%. This most likely growth rate is therefore assigned a probability of 50%. The worst case is assumed to be a decline of 5% per year, and we guess the chances for this scenario at 30%. This rather narrow band reflects the fact that SAFM, despite being in a cyclical market, also operates in a comparatively recession-proof business segment. Food prices might be very volatile, but supply and demand always fall back into line after a while. The same is true for the prices of the agricultural inputs of SAFS's business, such as the poultry feed (mostly corn and soybeans). Since chicken meat is both comparatively cheap and liked, the future for SAFM's business seems destined to grow.

Assuming these growth rates and probabilities are accurate, SAFM can be expected to give a 10.8 % annual return at the current price of $102. Now, let's discuss how and why those free cash flows could be achieved.

Image courtesy of Sanderson Farms

The Competitive Advantage of Sanderson Farms, Inc.

Sanderson Farms, Inc. possesses some unique advantages that should allow it to be very successful in the future.

- **Intact Business Model.** There will always be a market for food. Poultry is delicious and nutritious, which guarantees solid and growing demand – especially since the middle class in the world is projected to rise enormously in the next years. Since chickens are also comparatively cheap, even a recession should not meaningfully dent demand.
- **Vigilant management.** SAFM was founded in 1947 and has since then run by the Sanderson family, focusing on long-term success. This approach attempts to limit risk, which can be observed on the balance sheet. Right now, SAFM holds more cash than it has total liabilities.
- **Huge international growth potential.** At the moment, SAFM almost exclusively operates in the United States. If the company manages to sell more abroad, there is an immense market waiting to be conquered. Especially the fast-growing middle classes in countries like China or India offer huge potential.

Opportunity Costs

When looking at various investment opportunities in the market today, let's compare the expected return of SAFM to other ideas. First, one could invest in the ten-year treasury bond which is producing a 2.8% return. Considering the bond is completely impacted by inflation, the real return of this option is likely only around 1%. Currently, the S&P 500 Shiller P/E ratio is 31.3. As a result, the U.S. Stock market is priced at a 3.2% yield. If one were to invest in the S&P500, they might purchase a low-cost ETF to take advantage of this return.

Macro Factors

The poultry business is expected to grow worldwide by 3% annually. Since chicken is in high demand due to its low price and the fast-growing middle class, this business is also not threatened by a recession or other economic shocks. That said, the prices both for chicken feed and chicken products can be very volatile, which increases uncertainty and makes it hard for chicken producers to plan for the future.

Risk Factors

Several risks might limit the growth prospects of Sanderson Farms, Inc.:

- **Competitors.** SAFM is dwarfed by its much bigger U.S. competitors Tyson Foods Inc. and Pilgrim's Pride Corp. Since this business is all about scale and getting good deals from suppliers and buyers, the comparatively small size of SAFM is a disadvantage.
- **Controversy over use of antibiotics.** SAFM is the only major U.S. chicken producer that has not pledged to limit the use of antibiotics. While antibiotic-free chicken is more expensive to raise, this decision of the company is hugely unpopular (43% of shareholders have urged the company to stop using antibiotics) and means negative publicity. Also, many important buyers of chicken meat like McDonald's, KFC, or Chipotle, have either already cut back on antibiotic-raised chicken or are planning to do so in the future.
- **International headwinds.** When trying to expand abroad, there are many headaches: Shipping costs take longer and are more expensive. Protectionist politics and different food standards especially are current concerns. These are all problems SAFM must overcome, if the company wants to significantly increase its business outside the U.S.

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Conclusion

SAFM is a solid company which operates in a sector of the economy that is expected to remain relevant. The business has grown organically, and the company has a long tradition with good management focused on the long-term success of the company. Its strong focus on its domestic home market in the US is both a weakness and a big chance for the future. If the U.S. market shows less appetite for chickens, SAFM will feel the effect very strongly. On the other hand, the rest of the world still offers vast opportunities to grow the business – but this is complicated by factors such as protectionist policies, different food standards, and more complex supply chains.

Also, the price of inputs like feed or medicine is out of SAFM's hands, which further adds uncertainty. Despite these headwinds, SAFM is a very solid company with vigilant management operating in a business segment that is destined to remain important. The expected annual return of 10.8% seems to offer a decent margin of safety.

This assessment was conducted from the tools provided in Preston and Stig's Intrinsic Value Online Training Course.