Raytoei's Write up on Unilever

Company name: Unilever
Country of Origin: Anglo-Dutch
Industry: Diversified Consumer Staple
Market: Dual Listed on London and Amsterdam, ADS on NYSE as UN or UL.
Recent Price: $25.00

1. Is this a great business run by great managers?

2. How much is the company worth?

3. How is the market pricing the company currently?

4. What are the catalysts that will unlock the company value? How likely is the most realistic catalyst?

5. What is the margin of safety if the catalyst does not occur? How much can we expect the share price to fall?

Appendix I : Finncap SWOT analysis of Unilever

Appendix II: DCF Calculations

(**Disclosure**: I am loosely following the process of equity valuation based on a very good book by J. Dennis Jean-Jacques. I currently own a very small position in Unilever. Please send your comments to raytoei@gmail.com 4th August 2009)

1. Is this a great business run by great managers?

(Rather than use the previous format of doing P5F and TOWS analysis, I am going to use the following list to qualify whether Unilever is a Consumer Monopoly. See Appendix I for FinnCap's SWOT analysis of Unilever.)

1. Is success solely dependently upon management's ability to efficiently utilize tangible assets? Are Patents, Copyrights and Brand name are present, the company product or services are easy to identify.

Unilever's success is due to a strong product brand and relatively affordable fast moving consumer goods. Many of the products are house-hold names, its top 25 brands account for over 70+% of its revenue.

World No.1	World No.2	Local strengths
Savoury	Laundry	Household cleaning
Spreads	Daily hair care	Oral care
Dressings		
Tea		
Ice cream		
Mass skin		
Deodorants		

	Unilever 1bn Euros p.a. Brands
Foods	
Blue Band	Margarine products also sold as Rama, Country Crock and Doriana.
Becel/Flora	Heart healthy spreads containing Omega 3 and 6 and including spreads containing plant sterols marketed as pro.activ.
Hellmann's	Dressings and sauces including the global No.1 mayonnaise. Has sister brands being Amora, Calve and Wish-Bone.
Lipton	Tea-based drinks.
Knorr	Includes soups, bouillons, sauces and seasonings. Unilever's largest brand with sales of circa €4bn p.a.
Wall's/Algida	2 of the main ice cream brands that Unilever sells under its international Heart brand.
Home care	
Omo	Laundry product that helps to support the 'Dirt is Good' advertising platform (emphasizing how it is perfectly normal and part of the learning process for children to get dirty).

Personal care	
Dove	Cleaning and personal care products for skin and hair. Now includes Dove Pro.Age (beauty products for older women).
Lux	Soap, shower gels, bath additives, shampoos and conditioners.
Rexona	Also sold under the Sure and Degree brands and the first deodorant brand to surpass €1bn p.a. Inclusive of its other brands such as Axe/Lynx, Unilever now sells circa €2bn p.a. of deodorants with Axe/Lynx the world's No.2 deodorant brand.
Sunsilk	Meets women's everyday hair needs. Also sold under the Seda/Sedal brands.

(Source: Finncap 2007 report on Unilever)

2. Does the industry have substantial excess production capacity as a result of too many multiple producers?

According to Datamonitor (March 2009, Industry profile of Global Household & Personal Products), the industry is fragmented despite a tendency towards consolidation. The presence of large players account for less than 40% of the global revenues. The rivalry among players will remain intense, however rivals tend to dilute the rivalry through diversification and many have presence in different segments of the market. Unilever has 400 brands in over 100 countries. The other factor affecting production capacity is the stocking policy of the large retailers like Wal-Mart or Carrefour who are buyers and stockist of these products and are influenced by the preference of the end-users.

3. Do the historical earnings show a strong and upward trend ? Does it suffer from erratic profit or low margins and low inventory turnover?

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	TTM	Financials
44012	44412	45969	45306	48299	50095	49655	49599	54994	59225	59225	Revenue EUR Mil
48.5	51.1	10.0	50.2	50.4	50.2	48.6	49.3	48.8	47.3	47.3	Gross Margin %
21356	22695	4617	4810	6255	4309	6651	6766	7178	10475	10475	Oper Income EUR Mil
48.5	51.1	10.0	10.6	13.0	8.6	13.4	13.6	13.1	17.7	17.7	Operating Margin %
2976	1032	1640	1998	3125	2340	4975	6275	5660	7347	7347	Net Income EUR Mil
0.92	0.33	0.53	0.67	1.03	0.77	1.56	2.00	1.79	2.53	2.53	Earnings Per Share EUR
6.8	2.3	3.6	4.4	6.5	4.7	10.0	12.7	10.3	12.4	12.4	Net Margin %

Operating income is a little lumpy with 2 years of negative growth; including restructuring charges, the EPS shows three years of negative growth, however the trend is clear, there is an upwards growth in earnings. Margins are healthy and fairly consistent, but a little low compared with its peers. Inventory turns is slightly better than P&G but not as diligent as Church & Dwight.

Company	Inventory turns 2008	Average of past 5 years
Unilever	5.5	5.2
Procter & Gamble	5.2	5.8
Church & Dwight	7.0	7.1

(source: morningstar)

4. Is the company conservatively financed. Is there an absence of excessive debt?

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	TTM	
1862	12306	13379	12146	11516	10344	8075	6116	.	8845	8845	Long Term Debt

While the 8bn long term debt may looks scary, the Debt / Equity ratio is only 0.34. With a current annual free cash flow of 3988, it will take slightly over two years to repay its long term debt.

5. Does the company have to spend a high percentage of its retained earnings to maintain its current operations ? Or is the company free to invest the retained earnings in new businesses or used it to repurchase the company shares?

2005	2006	2007	2008	TTM	
5448	5644	5304	5658		Oper Cash Flow Mil
-1144	-1267	-1431	-1669		Capital Spending Mil
4304	4377	3873	3988		Free Cash Flow Mil
2728	3289	3401	3317	3197	Shares Mil
0.83	0.84	0.99	1.07		Dividend Payout

Unilever generates a lot of free cash flow after paying for its capital expenditure. The free cash flow is used for dividend payouts as well as share buy back.

6. Will value added by retaining earnings lead to an increase in the stock market value of the company ?

2000	2001	2002	2003	2004	2005	2006	2007	2008	YTD	
2.27	2.12	2.04	2.47	2.49	3.26	4.90	5.99	4.57	4.66	Book Value Per Share
71089	58088	62222	65438	67263	69219	82428	110287	74261	83094	Market Cap USD Mil

No yet. While the Book value per share has doubled from 2.27 to 4.57, the market-cap is only marginally higher between 2000 and the present. From the peak in 2007, the market gradually lost confidence in Unilever. However, this is a temporary phenomenon, once Unilever achieves the unit volume growth, the market will respond positively.

7. Does the company consistently earn a High rate of return on shareholder's equity?

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	TTM
9.5	2.6	3.3	4.4	6.7	5.2	10.9	13.1	11.1	13.7	13.7 ROA
44.5	13.9	23.9	32.6	46.9	32.8	57.2	51.2	35.0	45.0	45.0 ROE
6.8	2.3	3.6	4.4	6.5	4.7	10.0	12.7	10.3	12.4	12.4 Net Margin

Yes. ROE and ROA are high and growing, according to Bear Sterns, Unilever's Return on invested capital (ROIC) is above its industry peers:

	2003	2004	2005	2006E	2007E
Unilever (%)					
ROIC	14.5%	13.3%	14.3%	15.0%	14.2%
Unilever ROIC Spread Versus Peers (%)					
Peer Group Average	10.6%	10.0%	11.3%	11.5%	12.5%
Unilever	14.5%	13.3%	14.3%	15.0%	14.2%
Deviation	3.9%	3.3%	2.9%	3.5%	1.7%

8. Is there an absence of Organized labour ?

Unilever has been present in many emerging markets for decades, and in many case more than half a century, unions have been organized in many of the Unilever plantations. There have been four complaints which has been brought to the OECD by the Unions against Unilever which relate to site closure, freedom of association, collective bargaining and the use of temporary and contracted labour.

9. Is the company free to adjust prices to inflation?

Yes. Unilever has successfully passed on the higher commodity costs onto its customers. In fact, the 2008 revenue increase is due to higher unit price, to quote from the annual report: *"Underlying sales growth of 7.4% was broad-based across categories and in line with our markets overall. Growth was primarily driven by increased prices, with volumes essentially flat. "*

2. How much is the company worth?

A peek in the past history of EPS earnings of Unilever:

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
EPS	0.92	0.33	0.53	0.67	1.03	0.77	1.56	2.00	1.79	2.53
%Growth		-64.13%	60.61%	26.42%	53.73%	-25.24%	102.60%	28.21%	-10.50%	41.34%

Average CAGR from 1999 to 2008: **11.90%**

Despite its lumpy earnings growth, Unilever has managed to grow at around 11.9% a year for the past 10 years.

I will model the following EPS growth scenarios for Unilever using the operating EPS of $1.87. Please refer to the appendix for the calculations.

Scenario	EPS Growth	DCF Valuation
Optimistic	10 years of 9 ~ 12% growth followed by long term growth rate of 5%	$74.23
Realistic	10 years of 6 ~ 8% growth followed by long term growth rate of 5%. I am matching this with P&G's 2009 forecast of a core earnings growth of 6~8%. (Page 2 , Deutsche Bank Conference handout, http://www.pginvestor.com/phoenix.zhtml?c=104574&p=irol-presentations)	$55.23
Conservative	Company grows only the rate of the world wide population growth, at roughly 5%	$46.24

My assumptions are a discount rate of 9% and a long term growth rate of 5%. This isn't rocket science, most analysts have the discount pegged at 8% WACC for Unilever, and a long term rate of 3%, however I am being consistent across my equity valuation for international consumer brands.

To comment on the Conservative scenario, if I totally discount management's restructuring efforts ("Path to Growth", "One Unilever" etc) as well as ignore it's past history of 11.9% annual EPS growth, I would use another metric to measure long term growth: long term GDP growth of the world, approximately at 5% a year. At EPS growth of 5% less debt, Unilever is worth around $46.24.

Using a range approach, I would put the value of Unilever between $46.24 - 55.23 per share. With a lower 25% margin of safety for this high quality blue chip company, that would put the buy price of Unilever between $34.68 and $41.42.

Unilever	Low	High	Remarks
Intrinsic Value	$46.24	55.23	Assumes only either 5% (LOW) or 6~8% (High) EPS Growth.
Buy In Price	$34.68	$41.42	Based on 25% Discount to IV
Recent Price		$25	P/E of 13.36 based on adj EPS of 1.87

An alternative valuation: Sum of parts valuation

Using a modified method from a 2007 Bear Sterns report, I am going to value Unilever by looking at the separate businesses and try to compare those disparate businesses to its peers. The modification I have done is to remove Parmalat and Royal Numico N..V. as there have spun off or de-listed.

Food & Beverage		Recent Price	Adj 2008 EPS	Adj P/E	Reported 2008 EPS	P/E
Nestle	NESN.VX	40.92	2.82	14.51	4.84	8.45
Danone	BN	35.17	2.74	12.84	2.75	12.79
Cadbury	CBRY	520.00	30.10	17.28	22.60	23.01
Kellogg	K	47.50	2.99	15.89	2.99	15.89
General Mills	GIS	58.91	3.52	16.74	3.52	16.74
Heinz	HNZ	38.46	2.63	14.62	2.63	14.62
Cambell Soup	CPB	31.03	2.01	15.44	2.09	14.85
Associated British Foods plc	ABF	763.00	54.90	13.90	45.10	16.92
Hershey	HSY	39.95	1.88	21.25	1.92	20.81
Lindt	LISN	26,340.00	1140.40	23.10	1140.40	23.10
Givaudan	GIVN.VX	698.00	51.22	13.63	51.22	13.63
Tate & Lyle	TATE	364.9	34.60	10.55	34.60	10.55
Barry Callebaut	BARN	628	39.57	15.87	40.29	15.59
Average Multiple				15.82x		15.92

Personal Care		Recent Price	Adj 2008 EPS	Adj P/E	Reported 2008 EPS	P/E
L'Oreal	OR	60.52	3.49	17.34	3.49	17.34
Beiersdorf	BEI	35.39	2.19	16.16	2.19	16.16
Avon	AVP	32.29	2.04	15.83	2.04	15.83
Estee Lauder	EL	36.47	2.23	16.35	2.12	17.20
Average Multiple				16.42x		16.63

Household		Recent Price	Adj 2008 EPS	Adj P/E	Reported 2008 EPS	P/E
Reckitt Benckiser Group Plc	RB	2,831	157.80	17.94	157.80	17.94
Colgate	CL	71.74	3.87	18.54	3.87	18.54
Henkel	HEN3	25.5	2.19	11.64	2.19	11.64
Clorox	CLX	58.64	3.61	16.24	3.24	18.10
P&G	PG	55.35	3.56	15.55	3.56	15.55
Church & Dwight	CHD	57.84	2.86	20.22	2.78	20.81
Average Multiple				16.69x		17.10

Next, using Jeff Co data to splice the earnings by segment.

Segmental Revenue Breakdown Percentages (%)									
Total Food	**55.3%**	**54.4%**	**53.8%**	**53.7%**	**54.2%**	**54.7%**	**54.8%**	**54.7%**	**54.6%**
Savoury, Dressings & Spreads	36.3%	35.3%	34.7%	34.8%	35.2%	35.4%	35.6%	35.7%	35.6%
Ice Cream & Beverages	19.1%	19.1%	19.1%	18.9%	18.9%	19.2%	19.3%	19.1%	19.0%
Total Home and Personal Care	**44.7%**	**45.6%**	**46.2%**	**46.3%**	**45.8%**	**45.3%**	**45.2%**	**45.3%**	**45.4%**
Personal Care	26.3%	27.3%	28.1%	28.1%	28.1%	28.6%	28.6%	28.7%	28.8%
Home Care	18.4%	18.3%	18.1%	18.2%	17.8%	16.8%	16.6%	16.6%	16.6%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Segmental EBIT Breakdown Percentages (%)									
Total Food	**46.5%**	**51.9%**	**53.5%**	**54.7%**	**52.6%**	**56.3%**	**57.4%**	**55.7%**	**56.1%**
Savoury, Dressings & Spreads	47.2%	39.9%	36.9%	39.3%	39.2%	39.6%	40.7%	38.9%	38.8%
Ice Cream & Beverages	-0.8%	12.0%	16.6%	15.4%	13.4%	16.7%	16.8%	16.8%	17.2%
Total Home and Personal Care	**53.5%**	**48.1%**	**46.5%**	**45.3%**	**47.4%**	**43.7%**	**42.6%**	**44.3%**	**43.9%**
Personal Care	37.9%	35.3%	35.4%	34.1%	27.1%	33.4%	33.2%	32.7%	32.7%
Home Care	15.6%	12.7%	11.2%	11.3%	20.3%	10.3%	9.4%	11.6%	11.3%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Company data, Jefferies International estimates

2008	Percentage EBIT	Adj EPS per segment	Peer Multiples	Price per Segment
Food	52.60	0.98	15.82	15.56
Personal	27.10	0.51	16.42	8.32
Homecare	20.30	0.38	16.69	6.34
Adjusted EPS 1.87	100%	1.87		30.21

Using this sum of parts valuation, Unilever is worth considerably less, at $30.21

3. How is the market pricing the company currently?

At the recent $25., the market is pricing EPS growth at around 2.5% a year. The key issues with the lower valuation are:

1999 – 2004 "Path to Growth" initiative did not bring in the top line revenue growth that the company was hoping for, instead of 5 ~6 %, the company managed 3 ~ 4% revenue growth. With the changes of Chairman, CEO and CFO in 2007 / 2008, the market does not think the "One Unilever" initiative can recapture the growth albeit the lower growth targets set by management: 3 ~ 5% Revenue growth by 2010 and Operating margin of 15%.

EBIT Margin (2007 data)	%
Kraft	12.8
Nestle	14.0
Danone	14.0
Unilever	14.5
L'Oreal	16.5
PepsiCo	18.4
Proctor & Gamble	20.2
Colgate	21.0
Reckitt Benckiser	22.6
Coca Cola	26.0
Unweighted Average	18.0

Source: finncap analyst report August 2008

Other issues include the increase in commodity prices will not help the margins in the short-term, operating margins have been declining for the past three years. In the most recent quarter, the management indicated lower margins due to increased R&D spending. Perhaps the reason for the low valuation of Unilever is due to its competitors, chiefly Procter & Gamble, making inroads into the emerging countries. Having a high market share in India means that its growth will slow at some point.

In my opinion, the short-term nature of the capital markets has resulted in a low valuation of Unilever, and a buying opportunity for the patient.

4. What are catalysts and how likely are the scenarios?

a. Management Changes

The chairman, CEO and CFO are relatively new, having being in Unilever only in the last three years. This is a catalyst since Unilever has historically hired from within.

Chairman **Treschow, Michael**	Turnaround Chairman at Electrolux and Ericsson	Since 2007
CEO **Polman, Paul**	Previously Group President Europe, P&G 2001-2006. CFO Nestlé S.A, EVP for the Americas 2008.	Since Jan 2009 (announced in 2008)
CFO **Lawrence, James**	Vice Chairman at CFO of General Mills. Various positions in PEPSICO	Since2007

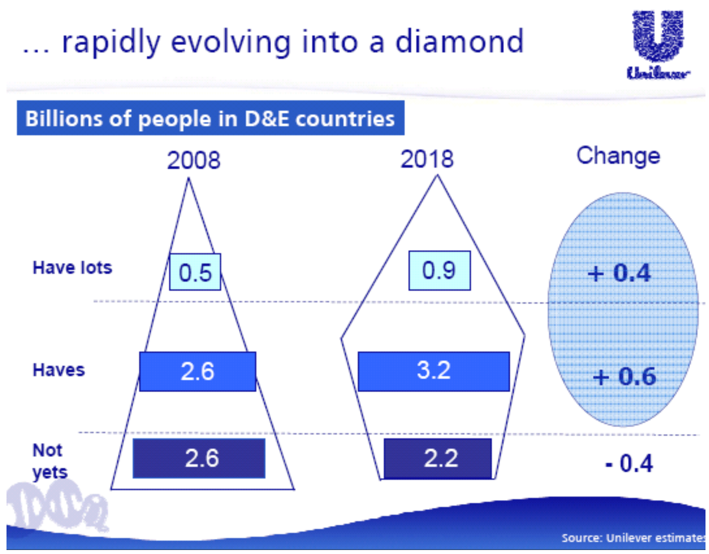
b. "One Unilever" and other company initiatives

Since 2001, Unilever has cut various product lines from 1600 down to 400. And reduced the number of operating units from 200 down to 30 at the end of 2008 and a final target between 20 ~ 25 units. Since 2005, it has started to move away from localized programs in favor of centrally managed global brands, where global roll-outs marketing plan is coordinated and executed in various countries at the same time.

It will spend more on R&D and product development, and funnel customers to spend more on higher margin items like Personal care where it is growing fast, products like deodorants (eg, Rexona) and Mass skin (eg. Dove) are number 1 while Daily Hair care (eg. Sunsilk) is no.2. Oral care (eg,. "Close Up") enjoy local strengths. The keyword is "Vitality" this is a combination of well-being that meets basic nutrition, hygiene and personal care. For example, the Lipton "Lipton Linea" slimming tea is a good example of a Vitality product.

c. Lastly, Unilever wants to replicate its success in India and Indonesia into other D & E (developing and emerging) countries. Hindustan Unilever is no.1 in all categories except Ice Cream while in Indonesia, it is no.1 in all categories except Fabric Cleaning and Savory where it is no.2. The growth rates in D & E countries has averaged 9% a year despite some country specific issues. In China, it's grow has averaged 20+ % a year, effectively doubling in three years.

Unilever sees the addressable market to expand by 1bn by 2018 in the D&E market, this is due to overall increase in the standard of living in emerging countries as well as the population with the greatest growth. Unilever wants to increase its 50% of unit volume currently derived from the D&E countries.



d. Other Catalysts

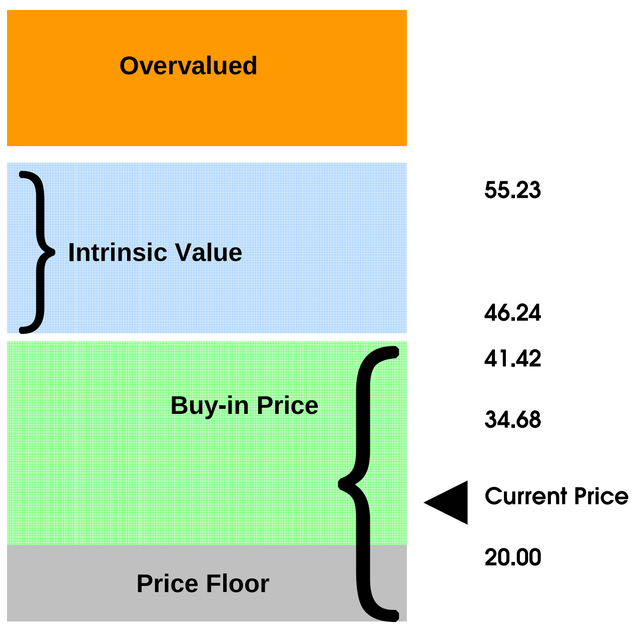
While I have not read any company announcements on this, a possible catalyst could be the abandonment of its Dual Listing Company structure (DLC). The company shares are traded in Netherlands as well as in London. There is a consistent arbitrage situation, where the share price of each twin trades a discount to each other, and a discount to its peers. Add in the additional costs of managing a dual listing, unlocking the share price from change of structure is a real catalyst. According the following article, 10 of the top 12 companies have abandoned the DLC structure.

(http://paguntaka.org/2007/02/12/bhp-set-to-ditch-its-dual-listing/)

Of the above catalysts, I would rank (C) as the most credible. Catalysts (A) and (B) are interrelated and it is dependent on the management's ability to execute its strategy. Catalyst (C) is a bet that the emerging countries will grow in population demographics and GDP per capita will increase; that brand loyalties are not easily displaced and lastly, low ticket items such as shampoo and personal care products will not suffer cut-backs during recession or price increases during commodity inflation.

5. What is the margin of safety if the catalysts do not occur? How much can we expect the share price to fall?

If none of the above catalysts materialize, then the earning power of Unilever would be calculated as EPV / (Discount rate), assuming no growth at all. This works out around $20 a share. In other words, if Unilever experiences no growth forever, then it is valued at $20 a share. At the recent price of $25.00, this would be a negative 20% swoon to $20.00.



However, a -20% drop is cushioned by two shareholder friendly actions that the company has done consistently: a 3.6% dividend yield and a 2% share buyback. This brings the negative returns for a worst case scenario to -20% + 5.6% = 14.4% share loss if the catalyst does not occur.

Note that there is a difference between valuation price and trading price. Ie. A security may trade higher or lower than the valuation, whether at a reasonable EPS growth rate or zero growth rate. A good example would be the 2009 March sell-off, where Unilever traded at slightly above $17.

Appendix I.

TOWS	Analysis
Strengths	An excellent portfolio of well known brands, including many leading global ones with powerful category rankings; the marketing expertise to capitalise upon the scope of these brands; a world-wide presence, including 44% of sales from fastgrowing D&E markets; immense financial strength with the disposal programme which is well underway set to cut debt further; strongly cash generative with a record of returning surplus cash to shareholders; and recession-resistant qualities since people must still eat, wash and use personal hygiene products.
Weaknesses	The 'large elephants do not gallop' theme (revenues are already €40bn+); margins are also growing off a high starting base, limiting the EBIT improvement scope despite the active measures underway to grow margins; and reports that head-hunters are seeking a replacement for the current CEO next year have added an uncertainty factor given his successful role in Unilever's restructuring since early 2005.
Opportunities	D&E markets offer strong volume growth scope with increases in per capita GDP likely to be translated into marked increases in consumption of the products that Unilever provides; the One Unilever programme and subsequent accelerated rationalisations outlined in August 2007 imply that the clean operating margin will be uplifted by at least 110 bps by 2010 compared to the 2007 result of 14.5%; and the top line growth aim of 3-5% p.a. appears readily attainable. It is also quite feasible that the ultimate margin improvement scope will surpass the minimum target cited by Unilever – the group has itself cited how the 15%+ 2010 objective post normal restructuring costs of 0.5%-1% will be the starting point for further improvement.
Threats	World economic slowdown could spread from developed countries to D&E markets; the concentration upon fewer and larger brand roll-outs raises the risk of one or more of these proving a flop/only a minor success; the group still needs to work hard near term to pass on higher commodity costs; and rival FMCG concerns may seek to capture market share from Unilever in growth areas.

(Source: From Finncap Analyst report , dated August 2008)

Appendix II.

Earnings Per Share	Euros	USD (1E= 1.44)	Remarks
Reported EPS	1.79	2.57	
ING Adj EPS	1.44	2.07	
Jeff Co Adj EPS	1.32	1.90	
Credit Suisse Adj EPS	1.30	1.87	We will use this since this is most conservative.

At the end of 2008, debt per share is calculated as 8,012.00 debt divided by 2,810 number of shares = $2.85.

Assumption: EPS of $1.87 is a proxy to Free Cash Flow.

Ticker	UL		%
		Growth (Y1 to 5)	12.00
Free Cash Flow	1.87	Growth (Year 6 to 10)	9.00
SharesOut	1	Discount Rate	9.00
Long Term Debt	2.85	Long Term Growth Rate	5.00
		Long Term Discount Rate	9.00
DCF-IV	**74.23**		

Ticker	UL		%
		Growth (Y1 to 5)	8.00
Free Cash Flow	1.87	Growth (Year 6 to 10)	6.00
SharesOut	1	Discount Rate	9.00
Long Term Debt	2.85	Long Term Growth Rate	5.00
		Long Term Discount Rate	9.00
DCF-IV	**55.23**		

Ticker	UL		%
		Growth (Y1 to 5)	5.00
Free Cash Flow	1.87	Growth (Year 6 to 10)	5.00
SharesOut	1	Discount Rate	9.00
Long Term Debt	2.85	Long Term Growth Rate	5.00
		Long Term Discount Rate	9.00
DCF-IV	**46.24**		