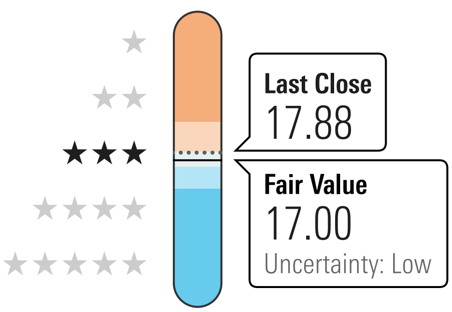
Reckitt Benckiser Group PLC ADR RBGLY ★★★

Rating as of Jun 19, 2020

Morningstar's Analysis

Valuation Jul 30, 2019
Currency in USD

RBGLY is trading within a range we consider fairly valued.



1-Star Price
> 21.25

Economic Moat
Wide
Trend: Stable

5-Star Price
< 13.60

Stewardship
Standard

Tweaking Our Valuation for Reckitt Benckiser's Strong First Quarter

Philip Gorham
Director

Analyst Note | by Philip Gorham Updated May 01, 2020

Reckitt Benckiser, or RB, posted a strong first quarter, as expected, although the growth rates in some categories took us by surprise. We think most of the first-quarter upside will unwind throughout the rest of the year, but we expect some medium-term benefit as well. We are nudging our fair value estimate a little higher to GBX 6,700 from GBX 6,600 to account for a slightly higher revenue growth assumption this year. RB is a high-quality, wide-moat business but the stock's recent rally means it now trades close to our fair value estimate.

First-quarter like-for-like revenue grew 13%, with the hygiene division up 13% and the over-the-counter, or OTC, sales up a remarkable 33%, beating our estimates. The infant nutrition business, facing difficult comps from a year ago, declined by 1.6%, although we think this would have been worse but for pantry stocking by consumers. We anticipate another year of moderately declining sales in infant formula.

We think there are three factors that boosted RB's first-quarter sales so significantly. First, consumers stocked up on products with long shelf-lives, particularly home-cleaning and health products, ahead of the lockdowns announced at various times during the quarter. We think this primarily explains the strong OTC performance. The impact of this is likely to unravel through the rest of 2020 and does not impact our valuation. Second, consumers are making more frequent purchases of detergent such as Dettol and Lysol to keep their homes clean during the pandemic. This is incremental volume to RB but will probably only be a one-time benefit during the pandemic. Third, penetration of cleaning materials has almost certainly increased, and if new consumers make repeat purchases, this would raise RB's medium-term secular growth rate slightly. We are not making changes to our long-term growth rate assumptions at this stage, but this possibility gives us increased conviction in our steady-state forecast of 4% sales growth.

Business Strategy and Outlook | by Philip Gorham Updated May 01, 2020

We think Reckitt Benckiser's, or RB's, recent portfolio restructuring will position the company for above-industry growth in the long term. The acquisition of Mead Johnson may not be rich in cost synergies, but it gives RB exposure to another consumer health business with pricing power and wide margins. Price/mix has deteriorated in several food, household, and personal-care categories in recent years, amid greater competition from the hard discounters' private-label lines and lower barriers to entry in the e-commerce channel. However, consumer health and near-food categories such as infant formula are among the product categories that we believe retain pricing power, and RB's focus on consumer health and its entry into formula are likely to ensure price/mix remains a growth driver for several years to come.

We regard the restructuring of the business under RB 2.0 as a likely precursor to further transformative portfolio changes. RB now operates under two business units: RB Health, which incorporates the former Mead Johnson business as well as the legacy health portfolio, and RB Hygiene Home, which will comprise everything else (RB's food assets were sold to McCormick for $4.32 billion last July). We think the restructuring is an indication that Kapoor's long-term vision for RB lies in the consumer health business.

After a decade of fairly steady profitability gains, we think RB's margin expansion may slow going forward. Project Supercharge, which was intended to deliver GBP 100 million-GBP 150 million in annual cost savings, expired in 2017. In addition, RB's overall margin premium seems to be derived from its lower spending on brand investments. In

2018, the firm spent 1.8% of its net sales on R&D and 2.7% of sales on capital expenditures, both at the low end of its peer group. After several operational missteps and the emergence of allegations of some unethical marketing practices in Australia and in Indivior, RB's former pharmaceutical unit, investors should be aware of the risk that RB has been underspending, and there will be limited upside to margins, particularly if RB is forced to increase its brand equity spending in the face of increasing competition.

Economic Moat | by Philip Gorham Updated May 01, 2020

We believe RB has a wide economic moat, reflecting recent transactions that have given the firm more leading positions in advantaged categories. The acquisition of Mead Johnson and the disposal of the foods business has transformed RB's portfolio such that almost half of its EBIT will be generated from leading positions in categories conducive to pricing power. We believe these transactions have significantly strengthened the group's intangible assets, which serve as the source of its wide economic moat.

The applicable sources of competitive advantages in the consumer product space are cost advantages and intangible assets (comprising both an entrenchment in retailers' supply chains and brand strength). Although RB generates best-in-class margins among the large-cap food and HPC companies, this is more reflective of its relatively lower spending on discretionary costs such as R&D and marketing. When adjusted for expenses not directly linked to the production and distribution process, RB's profitability and costs per employee appear to be around average for the HPC space. This gives it the financial flexibility to outmanoeuvre startup new entrants, but little in the way of a cost advantage over its large-cap competitors. The consolidation of Mead Johnson will do little to improve the firm's cost positioning, as Mead is also a midtier operator on costs, based on the same analysis.

In our view, the strongest competitive advantage in consumer staples manufacturing is supply chain entrenchment. This is a virtuous cycle, beginning with scale, that gives the manufacturer a symbiotic relationship with the retailers. Arguably the greatest challenge facing consumer goods manufacturers (and the primary reason for the high level of competition among the leading players) is the finite nature of shelf space and distribution capacity in the traditional grocery channel. Category leaders tend to be in an advantaged position to gain and retain shelf space, especially in Western markets, through the deployment of category captains into the channel to share local and category-level data with retailers. This creates a mutually beneficial relationship, in which the vendor becomes an important partner to the retailer, developing sales strategies to maximize volumes and retailers' margins, while at the same time prioritizing its own brands.

As vendors rarely disclose the number of category captains they employ, we use the number of category leadership positions (defined as being the category leader or a strong number two), proportionate to sales, as a proxy for category captaincies. We believe that materially, all of RB's 18 "powerbrands" fall into this leadership bracket when the categories are narrowly defined. For example, Nurofen is the number-one painkiller in the U.K. with a share of roughly 25%, and is a close number two in Australia with a 22% share. Mucinex is the number-one cough brand in the U.S., and KY and Durex have a share of almost 75% of sexual lubricant in the U.K. Furthermore, the addition of Mead Johnson further improves the company's category-leadership position in a favourable category. In the U.S., Enfamil holds a 29% share, almost a dead heat with Abbott and Nestle, in a "highly concentrated" category, as defined by the U.S. Department of Justice. RB is the market leader in China, with 13% share in a more fragmented market (we estimate the 2016 Herfindahl-Hirschmann index to be 971, versus 3,333 in the U.S.). However, we expect the market to become more concentrated over the next two years, as some local manufacturers will fail to meet incoming regulations on formula standards, and appear likely to exit the market.

A less frequently occurring intangible asset economic moat source is brand equity, and we think RB has substantial pricing power in its consumer health and infant formula franchises, which in aggregate represent 50% of the company's EBIT, before the divestiture of the low-return food business. Our brand equity framework scores businesses by pricing power, the conspicuousness of consumption of the products, the risk aversion of the consumer in the category, and industry structure, as measured by private-label penetration and the Herfindahl Index. We measure pricing power using three metrics: 1) the historical rate of price increases relative to inflation, 2) price gaps over unbranded substitutes, and 3) the price premium achieved by line extensions. The legacy RB business scores above average across the HPC group. It has strong pricing power in its consumer health business, led by high risk aversion in the pain medication and sexual health categories, and favourable industry structures. The consolidation of Mead Johnson should further enhance this profile, as Mead scored top of the pile on the pricing power metrics within the packaged-food category. The brand is based upon scientifically proven value-added products in a category in which parents are reluctant to trade down and to pay a premium for familiar brands.

In addition to the generic measures of cost advantage and brand strength that we apply to our global consumer staples coverage, Mead Johnson contributes some franchise and category-specific competitive advantages. Infant formula is an engineered food product designed to replicate the benefits of human breast milk as closely as possible. The fact that the industry was historically dominated by multinational pharmaceutical companies (Abbott, Wyeth, Bristol-Myers Squibb, GlaxoSmithKline, and Numico all operated or continue to operate a baby food business) indicates that the category straddles the boundary between packaged food and pharmaceuticals. Mothers are therefore willing to pay a premium for higher-quality (or perceived higher-quality) formula, particularly one tolerated by the baby. Although the marketing of infant formula direct to consumers is highly restricted in many markets, in an attempt by governments to promote breastfeeding, Mead Johnson’s historical marketing spending has been at the high end of the FMCG group, at 14%-15% of net sales, posing a financial barrier to entry for startups. The company has targeted its marketing to health officials, who then recommend the brand to new mothers while still in hospital. This has a powerful effect because the recommendation comes from a trusted source.

In the U.S., where Mead held a near-30% share, the USDA’s Women, Infants and Children program, or WIC, benefits incumbent brands by subsidizing formula purchases. As parents of approximately half of children born in the country qualify for WIC benefits, the contracts under which states select a single manufacturer as the exclusive provider of WIC formula are essential to meaningful participation in the marketplace. Companies receiving a WIC contract tend to post 85%-95% market share in that state, as the subsidies produce indirect effects such as improved placement within stores, word-of-mouth marketing to non-WIC participants, and the cross-marketing of other products not covered by the program.

Our wide moat rating is supported by RB’s ability to sustain excess returns on invested capital. Even when goodwill is included, ROICs have averaged 14% over the past five years and 17% over the past 10, despite a subpar performance last year. Although Mead Johnson generated much higher ROICs, with returns above 50%, we think it was acquired at a value-neutral price, meaning it has no material impact on our forecasts. Nevertheless, with continued cost savings in the legacy business, we think RB can sustain ROIC in the midteen range over the next five years and in the mid- to high-teen range in the steady state.

Fair Value and Profit Drivers | by Philip Gorham Updated May 01, 2020

Our fair value estimate for RB's ordinary shares is $17, which implies 2021 multiples of 24 times earnings and 17 times EV/EBITDA, a free cash flow yield of around 4%, and a dividend yield of almost 3%. Our valuation assumes a cable rate of 1.28, the spot rate on March 4. These multiples are higher than most of RB's large-cap consumer product competitors because we expect the company to underearn in the next two years as it increases its brand equity investments.

The key drivers of our valuation of RB are the organic sales growth rate and profitability. We believe both the infant formula and consumer health categories possess strong pricing, and when RB’s portfolio repositioning to increase exposure to these businesses is complete, we believe the firm will have a stronger price/mix growth driver than most of its competitors. We assume a 4% normalised organic growth rate, roughly 30 basis points above the rate we assume in most of our European large-cap consumer staples coverage, with pricing the major difference to the rest of the group. This growth rate would be structurally higher if RB was to divest the hygiene home segment. We assume a 4.5% midcycle growth rate for the health business, including Mead Johnson.

RB already has one of the best-in-class margin profiles, but we think limited margin expansion is likely in the medium term. Mead Johnson is a lower-margin business, with EBIT margins in the low to mid-20% range, which will act as a short-term drag on profitability. We expect most of these savings to be reinvested into the business, however, in order to absorb higher customer acquisition costs across the business.

We assume a 5% stage II EBI growth rate, reflecting RB's price/mix growth driver, and a discount rate of 7.1%.

Risk and Uncertainty | by Philip Gorham Updated May 01, 2020

As a large-cap consumer staples multinational, RB is a relatively stable operator, but after recent operational mishaps, we now believe the firm carries an above-average risk of a black swan event that could materially affect the financial performance of the business.

Volumes, price, and mix, the three primary drivers of the business, are all somewhat sensitive to macroeconomic conditions. Packaged-goods manufacturers have taken advantage of the recently benign commodity cost environment to lower prices in some markets, a strategy designed to help mitigate the loss of middle-market retailers to both discounters and high-end stores, but it has weighed on most manufacturers' organic growth. It is possible that when commodity costs rise, margins could be squeezed if the retail environment remains deflationary, but past cycles suggest that RB and its competitors will be able to pass through commodity cost inflation to consumers.

We admire Reckitt's best-in-class operating margin, but we suspect that the firm is underspending on marketing and R&D relative to its peers. RB does not disclose its marketing costs, but we estimate it at around 14% of sales, and its R&D expenditure of around 1.8% of sales in 2018 implies that it is spending less on customer acquisition than its competitors. RB may be vulnerable, therefore, to shelf space loss if competitors' heavier brand investments lead to share gains.

In the consumer health business, RB has some patents (on some Mucinex SKUs) that are likely to ultimately face generic competition. In the pharmaceuticals, it is not uncommon for sales of branded drugs to drop by 85% when generic competition is introduced. We think the impact to RB's brands will be less pronounced, however, as it is the consumer, rather than insurance companies, who makes the purchase decision in RB's categories. Consumers are likely to be less sensitive to price.

Stewardship | by Philip Gorham Updated May 01, 2020

We believe RB's stewardship of shareholder capital is Standard. Although executive compensation at the company has left a nasty taste in some shareholders' mouths in recent years, and the company has been prone to operational missteps over the last three years, we think RB's management is pursuing the right course to build strong long-term shareholder returns.

With an adjusted 2018 EBIT margin of just below 27%, RB boasts best-in-class profitability among the mid- and large-cap household and personal-care product manufacturers. This is in no small part due to management's continuous pursuit of cost reduction, as demonstrated by Project Supercharge. We like management's focus on consumer health, as we believe this is a category that will gain share of disposable income in the long term.

The primary use of free cash flow over the past decade has been on acquisitions, followed closely by dividend payouts. Given the fragmented structure of many HPC categories, this capital-allocation strategy has the potential to create value. We believe there is strategic value in continuing to acquire in categories that offer long-term profitable growth. Transactions, including the demerger of Invidior, the former Reckitt Benckiser Pharmaceuticals, have been consistent with outgoing CEO Rakesh Kapoor's clearly defined strategy of refocusing the business on its core categories in health and hygiene. However, some of the firm's acquisitions have come at a rich price. The $1.4 billion acquisition of Schiff in 2013 valued the target at 16.5 times EBITDA, around 4 times the market value of the shares a year earlier. Nevertheless, Reckitt has driven improved performance from MegaRed, amongst other products, and has realised cost synergies from the deal. Reckitt walked away from a potentially transformational acquisition of Merck's consumer health business in 2014 and in 2018 from talks over Pfizer's consumer health business, because it could not agree on a price. We think the deal for Mead Johnson is modestly value-enhancing, assuming the synergies target is met, which we believe demonstrates improved financial discipline since the Schiff transaction.

The issue in South Korea, in which a humidifier disinfectant sold by RB killed around 100 people, leading to a GBP 300 million exceptional charge in 2016, is a significant stain on RB's corporate governance.

However, the events occurred before the tenure of Laxman Narasimhan, who took over the top job from Rakesh Kapoor in September 2019.

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