Unilever PLC ADR UL ★★★

Rating as of Jul 27, 2020

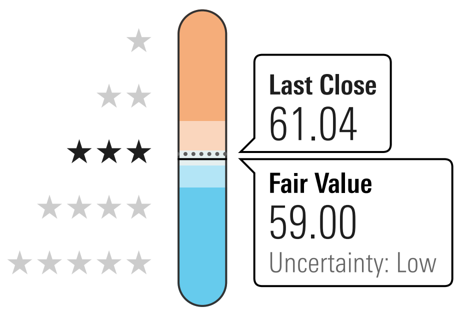
Quote | Stock Analysis | News | Price vs Fair Value | Trailing Returns | Financials | Valuation | Operating Performance

Morningstar's Analysis

Summary | Competitors | Bulls Say/Bears Say

Valuation Jul 27, 2020 | Currency in USD

UL is trading within a range we consider fairly valued.



1-Star Price
> 73.75

Economic Moat
Wide
Trend: Stable

5-Star Price
< 47.20

Stewardship
Standard

Market Reacts Positively to Unilever's H1 Beat, but Margin Preservation Strategy Not Without Risks

Philip Gorham
Director

Analyst Note | by Philip Gorham Updated Jul 23, 2020

Unilever reported a solid first half to the year, all things considered, with flat sales and impressive margin expansion. We are making minor alterations to our forecasts but reiterate our EUR 50 fair value estimate for the Amsterdam-traded share class and wide moat rating. After a positive market reaction to the results in early trading July 23, the shares are now trading at our fair value estimate. We see greater value in other categories such as brewing and tobacco.

Second-quarter sales were flat, consistent with the first quarter and in line with our forecast, although there was upside in the Americas segment due to share gain in North America. However, the consolidated number masks a bifurcation in performance between the home care division versus the personal care and food businesses. The home care unit posted 3.2% volume growth on top of positive price/mix as consumers stocked up on items such as detergents. The beauty and personal care business was down by a single percentage point in value terms, but we suspect this would have been much worse if not for personal hygiene products such as hand sanitiser. Although consumers have been eating more at home, the food business suffered a 3.2% volume decline, driven by ice cream and a decline in the food-service channel.

The early read from global staples manufacturers that have reported so far is that the market appears to have its arms around the volume impact of the lockdown measures that have been implemented in recent months. There is less visibility into margins, however. Like Philip Morris International, Unilever beat our margin estimates, posting an increase in its underlying EBIT margin of 50 basis points. Not surprisingly, this was driven by operating leverage in the the home care division margin improvement of 130 basis points, as well as some cost-cutting that we think will have to be reversed in the recovery. The food division suffered a modest 20-basis-point margin contraction.

Business Strategy and Outlook | by Philip Gorham Updated Apr 24, 2020

Amid fragmentation in consumer profiles and retail and marketing channels, along with lower barriers to entry for startups, most consumer staples multinationals are fighting strong organic growth headwinds, and many are cutting costs in order to spend to drive growth. With value growth in most categories currently running at little more than 2%, not all of the large caps will be successful in regenerating growth to the 4%-5% range they used to enjoy. In the case of Unilever, however, we think the management team is taking the right steps to reignite growth in some highly competitive categories.

The law of large numbers is unfavorable for the large-cap consumer companies, and moving the needle on Unilever's EUR 50 billion top line in a low-growth environment is challenging, especially as growth is largely being driven by niche, local, and artisanal brands. Unilever has struggled to adapt its business model, with management recently admitting that in its strategy to give more product development autonomy to regional management, the company had lost focus on scalable innovation. We do not think this is a problem that will easily be solved, and will require higher levels of customer acquisition spending, financed through cost savings from elsewhere.

Strategies to streamline the cost structure include 5S, which is focused on supply-chain and gross margin efficiencies; zero-based budgeting, which has replaced budgets and spending targets with operational KPIs and primarily focuses on marketing spending and overheads; and Connected 4 Growth, which has delivered a 15% reduction in middle and senior management.

The financial targets accompanying these strategies include EUR 6 billion in cumulative cost savings by 2020, two thirds of which will be reinvested; a 20% operating margin and 100% free cash flow conversion; and increased acquisition activity and direct returns to shareholders. With a wide economic moat, built around its supply-chain advantages, Unilever has a better chance than most of its peer group of reigniting growth in the medium term, in our opinion, but it remains in categories with relatively weak pricing growth drivers.

Economic Moat | by Philip Gorham Updated Apr 24, 2020

We think Unilever has a wide economic moat derived from two sources: its entrenchment in the supply chain of retailers (an intangible asset) and a cost advantage. The firm's broad portfolio of products across multiple categories and supermarket aisles creates a virtuous cycle of competitive advantages, comprising intangible assets and cost advantages that new entrants simply could not replicate. Unilever's portfolio spans multiple household and personal product categories as well as food and, to a lesser extent, beverages, and the firm generates over EUR 50 billion in revenue. This makes Unilever one of the most important suppliers to retailers globally and differentiates it from narrow-moat competitors with smaller product portfolios.

In our opinion, one of the biggest challenges facing consumer product manufacturers, and the primary reason for the intense competition among the leading players, is the finite nature of shelf space and distribution capacity. Retailers, whose business model is dependent on volume, are unwilling to take risks with untested stock-keeping units and suppliers unless they receive slotting fees large enough to transfer the risk of consumer adoption to the manufacturer, and they give priority shelf space to high-velocity products in order to maximize fixed-cost leverage. For large manufacturers, breadth of portfolio offers the best chance of owning at least a few of the category-growing brands at any point in time and on a consistent basis; this makes them an important partner to retailers and distributors. In turn, this puts them in a strong position to negotiate for limited physical shelf space.

Another key industry challenge is the high cost of customer acquisition (primarily marketing expenses and research and development costs). Unilever's scale and scope help the firm achieve levels of cash flow generation that allow it to invest behind its brands and to finance the slotting fees necessary when introducing new products, an intangible asset that cannot be replicated by new entrants. In 2019, Unilever spent over 14% of its revenue on advertising and promotion, or A&P, expenses, the most in the household and personal-care space aside from the prestige beauty manufacturers. This spending has steadily ticked up from 13% of sales in 2011, although it was down from 15% in 2015, and it excludes costs directly related to shelf space, which are deducted from gross revenue. This figure may rise again as the customer acquisition cost increases and it will remain a significant competitive advantage against new entrants. The firm spent a further near-2% of its sales on research and development in 2019, around average for the group. This level of spending creates a virtuous cycle for the larger players because higher spending on marketing and line extensions can drive volume and category growth, assuming execution is effective. This makes the products more appealing to distributors and retailers, in turn increasing the likelihood that they will win shelf space.

It is, of course, possible for new entrants to penetrate the market, and startups can give a retailer price leverage over the large manufacturers. Burt's Bees, which entered the market in the 1980s and 1990s, is an example of a niche brand taking shelf space in the HPC category. However, there are significant risks to supply-chain disruption with the smaller players, which is a risk to the retailer that can be mitigated by allocating shelf space on a localized, trial basis. This gives large players such as Unilever time to adjust to the entrance of a new brand, and through cost advantages generated from economies of scale, incumbents are well positioned to replicate the competitive product and offer it to retailers at a lower cost. This limits the shelf space awarded to the new entrant and prevents it from achieving the scale necessary to invest behind its emerging brand. This self-reinforcing combination of moat sources creates high barriers to entry that protect the vendors most entrenched in the retailers' supply chains.

Unilever has one of the strongest cost advantages within the diversified HPC space, according to our framework. It is a fairly efficient manufacturer, with among the lowest costs per employee, behind only prestige beauty-care names Estee Lauder and L'Oreal. Within the mass beauty segment, only Beiersdorf operates on a lower cost structure, as measured by our framework, which excludes discretionary expenses such as advertising. Beiersdorf's narrow product portfolio and more-focused production process makes it a slightly more efficient operator than Unilever.

Notably, brands are not a particularly strong competitive advantage for Unilever in aggregate, and the firm generates average scores across all metrics in our brand strength framework. The firm has achieved pricing in line with, but not in excess of, inflation during the past three years.

Our wide moat rating is supported by Unilever's ability to sustain excess returns on invested capital. Even when goodwill is included, ROIC has averaged 18% during the past five years and 20% during the past 10. We expect that figure to rebound to the 20% mark over the next five years, supported by Unilever's cost-savings program, which should help mitigate pressure from the intensely competitive environment.

Fair Value and Profit Drivers | by Philip Gorham Updated Jul 27, 2020

Our fair value estimate of Unilever plc's ADRs is $59, which assumes a euro/dollar rate of 1.17, the spot rate on July 27, and implies 2021 multiples of 21 times earnings, 13 times EV/EBITDA, a free cash flow yield of 5%, and a dividend yield of 3%. These valuation multiples are on the high end of Unilever's own historical valuation range, but we believe the firm will be slightly underearning over the next two years as demand is likely to be fairly weak.

We think exposure to home and personal care will limit the volume downside amid the global lockdown. We forecast a 1% decline in sales in 2020, along with gross margin degradation of around a percentage point. The drivers of our valuation are the medium-term organic sales growth rate and operating margin that we think the company can achieve. On the top line, we think the historical growth rate of 5% will be difficult to achieve, given the structural pressures on pricing, so we assume a steady state revenue growth rate of 3.4%. In the immediate term, we think Unilever will be fairly well-shielded from the impact of COVID-19. In fact, demand is likely to be fairly strong in the first half of the year due to consumer pantry stocking of products with long shelf lives, although this could unwind in the second half of the year. Mainstream retail channels are likely to lose share to hard discounters in some developed markets, and some of that channel shift may not revert back to the supermarket channel in the upswing. Accordingly, we shave 20 basis points from our medium-term growth assumption, which at 3.4% is above the 2.9% organic growth achieved last year, but any return of global inflationary pressures should help drive stronger pricing in a normalized environment.

The medium-term EBIT margin is another valuation driver, and we think there is enough low-hanging fruit for Unilever to make significant strides toward raising the profitability of the business. We no longer believe Unilever will meet its 20% margin target in 2020 due to macroeconomic pressures, and we suspect that as customer acquisition costs increase, further margin expansion will be limited by increasing customer acquisition costs. Our normalized margin estimate is 20.2%. This assumption is a key variable in our scenario analysis.

We discount our cash flow forecasts at 7% and assume a 4.5% stage II EBI growth rate, slightly higher than some peers due to Unilever's emerging-market presence.

Risk and Uncertainty | by Philip Gorham Updated Apr 24, 2020

Even within the relatively defensive consumer staples space, Unilever has delivered some of the most consistent organic growth of its peer group in recent years. The firm's breadth of portfolio across geographies and product categories limits brand and execution risk, and we assign Unilever a low uncertainty rating. Nevertheless, beyond marketing spend, management has few self-help levers to pull to stimulate top-line growth, so volume, price, and mix, the three primary drivers of the business, are all somewhat sensitive to macroeconomic conditions. At the gross margin, too, the firm is exposed to the economic cycle. Around 20%-25% of Unilever's cost of goods sold is linked to energy prices, and this could rise if economic growth re-accelerates. 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.

If commodity inflation returns, margins could be squeezed if the retail environment remains deflationary, although past cycles suggest that Unilever and its competitors should be able to pass through the majority of its raw material inflation to consumers. Mergers and acquisitions will be a key strategic pillar in the medium term. The firm has said it will dispose of the spreads business, and we would not be surprised if other food brands were to follow. We expect management to be acquisitive in personal care. Having already acquired REN Skincare, Kate Somerville, Dermalogica, and Murad, Unilever is close to achieving a critical mass of volume in the prestige beauty industry that should give it competitive advantages. It is likely, however, that the firm will be interested in further bolt-on acquisitions to bolster its scale. This strategy of portfolio-tweaking through M&A comes with the risk that management could overpay for targets or not realize fair value for assets for sale.

Stewardship | by Philip Gorham Updated Apr 01, 2020

We rate Unilever's stewardship as Standard. It is difficult to argue with the company's 10-year high-single-digit total returns, but the 2017 approach from Kraft Heinz that sparked management into life indicates that Unilever was operating with inefficiencies in its cost base for too long, and that management had not been sufficiently focused on the financial performance of the business. Nevertheless, there has been a significant amount of executive churn at Unilever since mid-2015, not least the replacement of Paul Polman with Alan Jope in 2019, and we do not necessarily hold the current team of product and regional heads responsible for this inertia. We believe the new set of financial targets is both necessary and achievable, although not without risk, and we see no reason to doubt that this management team can deliver on their commitments. However, with the firm having rebuffed the approach from Kraft and denied shareholders a potentially material takeout premium, we think the pressure will be on management to deliver on the new set of targets and make the recent uplift in the share price a sustained rerating.

Unilever has historically delivered strong shareholder returns, outstripping the returns of the AEX and FTSE over the past decade. Dividends have been the preferred vehicle for returning capital to shareholders, and Unilever has delivered slightly above-industry-average payout ratios of at least 60% since 2012. Share repurchases have contributed relatively little to shareholder returns, but when management has bought back shares, it has generally done so at a level that has created value for shareholders, more than likely including the recent EUR 6 billion buyback program. We expect the firm to maintain its high dividend payout ratio and to be opportunistic when it comes to repurchasing shares, although mergers and acquisitions will probably remain a higher priority, particularly in prestige personal-care categories.

Although Unilever has been highly acquisitive in recent years, it has financed a substantial portion of its purchases through asset sales. The firm's spending on acquisitions (net of disposals) has been just EUR 1.6 billion since 2010, less than 4% of the cumulative free cash flow to the firm over the same period. By and large, Unilever's activity in mergers and acquisitions has added value. The $3.7 billion Alberto Culver deal, for example, was executed at a fairly high 15 times EBITDA, but significant geographic whitespace for the brand allowed Unilever to roll it out in some large markets, including Brazil. The $1 billion acquisition of Dollar Shave Club, which we do not believe was profitable as a stand-alone entity, was also a rich multiple, but will give Unilever a leading presence in the emerging business-to-consumer channel, with opportunities to expand its online subscription channel platform. Conversely, the disposal of the spreads business rids

Unilever of a highly competitive and commoditized category that was unlikely to contribute positively to growth in the medium term.

The company has a complex ownership structure, with Amsterdam-listed Unilever NV and London-listed Unilever PLC owning a combination of separately owned and joint-owned operating companies. In 2018, the company made a botched attempt to simplify the structure, which would have in our view, made acquisitions more straightforward, but would also have removed one of the defences to a takeover of Unilever itself.

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