Fundamental Equity Analysis

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Group 2
Aritro De, Ryan Idowu,
Elliot Lyons & Daniel Madaghjian

Contents

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Part 1 – Business Model & Competitive Position

1.1) Business Model

Kerry Group is the "world's leading taste and nutrition partner for the food, beverage and pharmaceutical markets"[1]. They produce a wide range of products including flavours, enzymes, meat, and chilled foods[2].These products reach over 1 billion consumers based in six continents[1]. Kerry Group is headquartered in Tralee, has 26,000 employees, 75 shareholders and 331 subsidiaries[3]. Their operating revenue was $8.7 billion and they ranked 1202nd in the global 2000 in 2022[4]. They placed 16th in 'Ireland's Top 1000'[5].

Kerry Group claims to create value for their community and government[6]. In terms of bettering the community, they're strong advocates of human rights. They outline their stance in the company's Code of Conduct for their employees[7]. With such a reliance on suppliers, the Group needs to make sure they also adhere to a certain standard of behaviour. This is enforced in their Supplier Code of Conduct[8]. Kerry Group sponsors County Kerry GAA, and are believed to pump between €600,000 – €750,000 into the county every season[9]. Kerry Group created value for the Irish government through the payment of a €96.2 million tax bill.[10]

Kerry details their core UN Sustainable Development Goals (SDGs): 2 (Zero Hunger), 3 (Good Health and Well-Being) and 12 (Responsible Consumption and Production)[7]. MSCI denoted Kerry Group as a 'leader' amongst 82 companies in the food products industry, giving them an AAA rating[11]. Sustainalytics aren't convinced; grading them a medium Environmental Social Governance (ESG) risk. They compare quite well to their in-industry competitors, ranking 66 out of 592, but rank 6471 out of 14912 in all sectors[12]. This demonstrates the unsustainable nature of the food industry. Kerry Group is setting the standard for their sector. Unfortunately, these standards need to be higher. The company's main stakeholders are investors, the community and government. Just like any large public company, investors are regarded as important stakeholders[13]. Moreover, society is negatively affected by their contribution to climate change. Agriculture and food retail are the fourth and fifth most polluting industries in the world[14]. Kerry Group employing as many as it does, means that the governments are also stakeholders. The more employed in a country, the less welfare payments the government has to make (Rosen, 2015). Thus, the government benefits as stakeholders in Kerry Group.

1.2) Externalities

We have alluded to a few of the Group's externalities above. Kerry Group employs 26,000 people. This employment is a positive for both the employees and the communities. Their three headquarters in Ireland generate value in their respective towns. Having been in the neighbouring 'Applegreen' to the Naas offices at lunchtime myself, it's evident that a portion of the revenue Kerry Group creates in the community is being retained there. We've mentioned the Group's stance on human rights. If the company is true to that claim, they are potentially helping prevent another multi-national company from abusing those human rights. A notorious sinner in that regard is Nestlé (Wijesinghe, 2018), (Lecture, 2022).

We have highlighted the negative externalities above; the most serious being climate change. Kerry Group is attempting to internalise this issue. They pledge to reduce their greenhouse gas emissions by 55% by 2030[15] and to be at net-zero by 2050[15]. One means of internalising is through their sustainably linked bond (SLB). This ensures all financing under this framework will have a sustainability-linked feature[15]. Although we state the Group's positive stance on human rights, their actions suggest otherwise. In 2019, they were criticised for failing to address human rights issues[16]. To internalise this, Kerry Group have since published the aforementioned Code of Conduct and a Modern Slavery and Human Trafficking Statement in 2020[17]. Despite this, they scored poorly in the most recent Corporate Human Rights Benchmark in 2020[18]. It will be interesting to see how effective their policies are in the next CHRB rankings for 2022-2023.

With regards to ESG material issues, the MSCI believes Kerry Group is misaligned with global climate goals, despite an AAA rating[11]. They outline the firm is lagging behind other ESG-aligned firms with its packaging mentality and that it's only average with its water usage, illustrating a need for internalisation. In an attempt to do so, the Group aims to make all plastic packaging reusable, recyclable or compostable by 2025 and improve its water efficiency by 15% by the same year[15]. As the MSCI ratings are more up to date than the CHRB rankings we hope this demonstrates they have successfully eliminated their Human Rights issues. If they haven't, this should be at the forefront for addressing. In a recent talk Paschal Donohoe, (2022) outlines the global economy is changing rapidly to a carbonless future. Kerry Group needs to be ESG aligned to remain successful in the future.

1.3) Competitive Position

Kerry Group ranks 1st in the Irish food industry in terms of size and turnover[19]. Internationally, the Group is rated 1202nd in the 'Global Top 2000'[20]. This puts them slightly behind its international competitors General Mills and DuPont.

Given that Kerry Group competes at such an international level, it has a competitive advantage in the Irish market due to its sheer size. A trend that could affect this position is the emergence of deglobalisation. Recent events such as COVID-19 and the war in Ukraine have fuelled this phenomenon. Martin Wolf (2022) outlines how such events have forced countries to be more introspective for necessity goods, realising the localisation movement.

This trend will further assert Kerry Group's dominance in the Irish market. However, Kerry Group's operations reside around the world. Their sales are geographically distributed by: Ireland (6.3%), Europe (30.7%), Americas (44%) and Asia/Pacific/Middle East/Africa (19%)[21]. Should deglobalisation continue, it will dampen their competitive position as a whole.

The heightening of Climate Change related taxes and restrictions is a trend that will affect Kerry Group. Here in Ireland, the tax rate is increasing from €33.50 per tonne of CO2, to €41[22]. Kerry Group acknowledged this threat. They highlight how it poses a financial obstacle in their operational costs which will subsequently affect their value[6]. This is only going to increase going into the future with leading nations aiming to be carbon neutral by 2050[23]. This will increase Kerry Group's costs, hampering their competitive position.

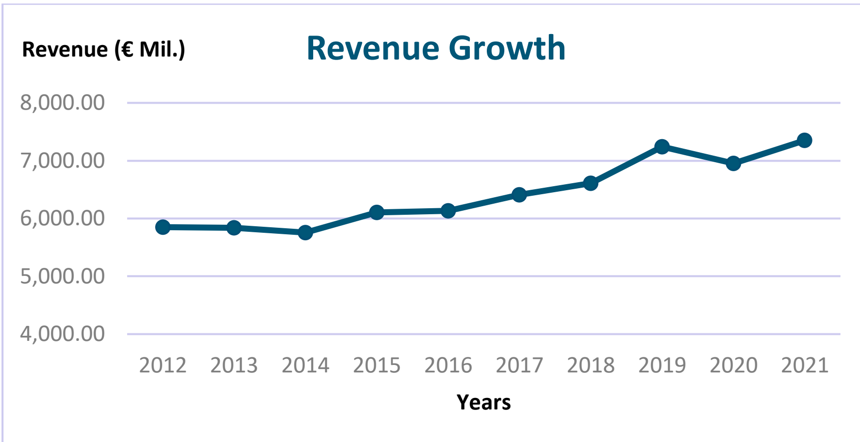
1.4) Impact

Kerry Group finds itself in an unsustainable market. They may be sustainable compared to their competitors but their impact is still extensive.
Kerry Group reports on its impact[24]. We sensed an element of greenwashing in their reporting. They mention the favourable overall results of the MCSI report[11] but omit the reports comments on their malpractices in packaging. We appreciate Kerry Group is attempting to address the issue. This is a desired result of MSCI reporting. However, it does make you wonder how much of Kerry's goals are due to their own stance on climate change.
The aforementioned report is done all in-house, rising a conflict of interest. The lack of third-party assessment leads to the possibility of greenwashing. One of the very common pitfalls of the ESG rating system in general is that they are self-reported, neither audited or standardised. We cannot solely blame Kerry Group for this but it would certainly be more accurate if a third-party conducted the report.
We got the impression that they are not doing enough for environmentalism and that they are covering up their shortcomings with their strength in governance. We can see from the World Benchmarking Alliance[25] that they are very strong in the Governance and Social Inclusion aspect. Their Environment rating is quite poor in comparison. This could be improved by a shift in the attitude of governance so that they place more emphasis on achieving more ambitious and sustainable goals to improve their sustainability and social ratings.

Part 2 – Value Drivers

2.1) Sales Growth

Kerry Group has seen Revenue rise to €7.4bn in 2021, driven by volume growth of 8.0% [1]. The following graph captures this upward trajectory in revenue over the last 10 years.



(Source: https://www.kerry.com/investors/financial-highlights/financial-history.html)

Drivers of sales include the Groups acquisitions and disposals, along with their innovations across their two segments. Last year, Kerry agreed the sale of its Consumer Foods's Meats and Meals business for €819m. Moreover, they completed 5 acquisitions totalling €1,106.5m last year, with a further 3 acquisitions this year, signalling they have no sign of letting up[1].
Furthermore, the companies' new launches in healthier and sustainable products across their different regions, continue to match the ever-growing shift in consumer preferences, proactively diversifying their offerings and enhancing their level of sales going forward.

2.2) Margins

Mirroring the sales growth, Kerry EBITDA increased to €1.1bn, with an EBITDA margin of 14.7%[1]. One of the main drivers is operating leverage. The reopening of the food service sector following the onslaught of Covid-19, provided growth of 18.0% in the foodservice channel.
Other drivers include the cost of raw materials (up 27.8% in the last year) along with the companies (in)ability to manage volatility in the global markets such as the war in Ukraine[2]. This depends on their management and capability of offsetting these costs. We believe Kerry's global reach operating across 36 countries makes them resilient against this, and will drive profit margins in the future.

2.3) Capital Structure

Kerry Group's levered beta is 0.5[3] on a 5-year monthly basis. The company has an even lower unlevered beta (0.5/(1+(1-0.13)*0.38)), at 0.37 due to its low leverage (Net Debt/Equity =

€2,124.1m/€5,601.2m = 0.38). Due to a low leverage Kerry Group can be considered a fairly non-volatile stock.
With a cost of equity of 7.55%, a cost of debt of 3.65%, an effective tax rate of 13.3% and equity and debt weights of 90.39% and 9.6% respectively, Kerry Group's WACC becomes 7.1% ((90.39%*7.55%)+((9.6%*3.65%)*(1-13.3%)). However, given the current inflationary climate it is very unlikely that this figure reflects an accurate reading of their current cost of capital. Intuitively we look at 7.1% as a lower bound for Kerry Group's actual cost of capital.

2.4) Discounted Cash Flow Valuation

Khan, Serafeim and Yoon (2016), find that companies with good performance on ESG issues significantly outperform firms with poor performance, in the stock market.

Value Driver	Our Assessment for The Next Decade
Sales Growth	8%
EBITDA margins	17%
WACC	7.1%

This results in a fair value of €118.99. Our calculations to arrive at this solution based on the DCF can be found in the appendix.

This indicates a positive outlook for the Group. Although they face short term obstacles in the form of supply chain costs and global tensions, the Group is resilient and is still capable of yielding strong returns above the current share price.
This fair value of €118.99 reflects an implied upside of 26% from the current stock price. This reveals that Kerry Group is significantly undervalued, signalling that the market has not priced in Kerry Groups proactiveness towards sustainability practices.
Our estimations align with the hope and assumption that we will see a transition more towards the adaptive market hypothesis, and the market will begin to incorporate the social and environment dimensions of firms. A sustainable economy is one that will leave behind the argument of Friedman (1970), being that the only responsibility of a firm is to increase profits (F), and therefore Kerry will be rewarded in the future for their efforts in holding accountable for the E and S factors as well.

2.5) Material Sustainability & 2.6) Effect on Valuation

Kerry Group's proactiveness in tackling sustainability issues, inflicts positive effects on our three value drivers.

Value Driver	Positive/Negative/Neutral	Explanation
Sales Growth	Positive	Product diversification across their global operations scope, to meet the ever-growing shift in consumer preferences towards sustainable products, will drive sales growth by 200 bps.
Profitability	Positive	Significant emphasis on Environmental management and product stewardship through their targets set in their 'Beyond the horizon' strategy, will give them a cost advantage in the long run, boosting profit margins by 100 bps.
Capital	Neutral	Their management of controlling the rise in supply costs and global tensions, on top of their sustainable investment strategies suggest no indication to apply a higher discount rate. However, considering the current heightened inflationary period, we appreciate the current estimation is not a good representation, and therefore remain conservative and neutral in the assumptions regarding the Groups Capital.

Our analysis illustrates that this positive outlook on growth and margins, results in a 28% higher target price for Kerry Group, as referenced below.

Value Driver	Kerry Group excl. ESG advantage (%)	Kerry Group incl. ESG advantage (%)	Kerry Group advantage (basis points)
Sales Growth	6%	8%	200 bps
Margins	16%	17%	100 bps
Cost of Capital	7.1%	7.1%	0 bps
DCF Value	€92.97	€118.99	€26.02 (22% of value, 28% higher than without)

Part 3 – Investment Conclusions

3.1) Investment Attractiveness

We find Kerry Group to be a very attractive investment. However, we believe the company's not without its faults.

On the environmental front, Kerry Group suffers from being in a notoriously unsustainable industry. However, we predict Kerry Group is at the forefront of the industry's turnaround to more environmentally friendly practices. Kerry Group's industry leading ESG Rating, coupled with their sustainable finance orientated 'Beyond the Horizon plan'[1], indicate a positive, future environmental performance.

Social problems are still present within the company. We've alluded to the breach of Human Rights by the Group in section 1 as a point of concern and unattractiveness for Kerry Group. However, we remain optimistic this incident is fully resolved, and should not play a role in an investor's future decision-making.

Kerry Group's value drivers illustrate an impressive future company image. We've outlined their strengths in regards to revenue and sustainable innovations in section 2 as a pointing to future confidence. This is reflected in our DCF calculations, illustrating an implied upside of 26% predicted for the Group. The Group's diversification in global markets renders an investment in the firm less risky, also increasing its attractiveness.

Finally, this prediction is strengthened by the industry in which Kerry Group presides in. Alexis Fortune (2022) emphasises, "The food industry will always grow with population growth". The world's population's recent milestone of 8 billion only suggests future growth for the food industry and industry leader Kerry Group alike.

3.2) Transition Preparedness

Investors are highly factoring a company's ESG targets when considering investment opportunities. The current research suggests that this trend will continue and we'll transition to an economy where these goals may be as important as profit to an investor in the future[2].

We have mentioned how Kerry Group can improve their ESG rating. This will help them prepare for such an event. The challenges of improving ones Environment aspect are detailed by Neil Kellard (2022); "Environmental proactiveness has a negative effect on firm performance in the short-term." This short-term suffering may inflict a prudent approach by Kerry Group as it suffers from the 'Tragedy of the Horizon' (Carney, 2015). It's important Kerry Group weathers this storm as improving their ESG ratings further will offer them an immense competitive edge in the near future.

We appreciate Kerry Group's attempt to create long-term value with their SLB. Shoenmaker and Schramade (2019) argue that to create long-term value as an investor, one should expand their investment horizons. Kerry Group should facilitate this through both their debt and equity policies. Their equity policy should shadow their debt framework and be sustainably linked. Their debt policy should also incorporate longer maturity dates. All previous bonds issued by Kerry Group have a 10-year lifespan, not just the SLBs. Kerry Group aims to be net zero by 2050. We believe the next time they raise debt; the maturity date should be for 2050. This will echo the sentiment that the Group is preparing for the future to their shareholders and will promote the idea of long-term value creation.

3.3) Part of the Problem or the Solution?

In terms of transitioning to a sustainable economy, we believe Kerry Group is contributing to a more circular economy. However, to state that they are ‘part of the solution’ would be an overstatement. Our argument stems from society falling victim to the ‘fallacy of composition’ (Shoenmaker & Schramade, 2019). This arises when one concludes that something is true of the whole, at the macro level, due to it being true of every part, at the micro level. As we have discussed, Kerry Group finds themselves in a highly unsustainable industry. We make the argument that although Kerry Group is proactive in their internalisation of externalities and targeting to hit their sustainable strategies for 2030, this does not mean that planetary boundaries are not being crossed. Dyllick and Muff (2015), coin this idea ‘the big disconnect’.

To conclude, Kerry Group’s transition preparedness is very positive, but not enough. The need for Government interventions is more important than ever. Regulations and taxes need to continuously be heavily enforced across these industries, ensuring these planetary boundaries are not being crossed. If they’re not, we will never achieve a sustainable economy.

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Appendix

DCF Calculation

		WACC	7.10%													
		Terminal growth rate	2%													
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Sales Growth	3.10%	9.6%	-4.0%	5.7%	6%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	2%
EBIT margin	14.3%	15.1%	14.4%	14.7%	16%	17%	17%	17%	17%	17%	17%	17%	17%	17%	17%	17%
tax rate	8.2%	7.3%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%
Depreciation/sales	2.0%	2.6%	2.9%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%
CAPEX/sales	4.3%	4.4%	4.5%	4.3%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%	5.50%
WC/sales	9.40%	9.1%	12.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%	19.9%
Sales	6,607.60	7,241.3	6953.4	7350.6	7792	8415	9088	9815	10600	11448	12364	13353	14422	15576	16822	17158
EBITDA	942	1,094.1	997.9	1077.0	1247	1431	1545	1669	1802	1946	2102	2270	2452	2648	2860	2917
Taxes on EBITDA	77.4	79.4	81.2	53.3	312	358	386	417	451	487	525	568	613	662	715	729
NOPLAT	864.6	1014.7	916.7	1023.7	935	1,073	1,159	1,251	1,352	1,460	1,576	1,703	1,839	1,986	2,145	2,188
Depreciation	134.1	191.4	200.7	201.5	214	231	249	269	291	314	339	366	395	427	461	470
Gross CF	998.7	1206.1	1117.4	1225.2	1,149	1,304	1,408	1,521	1,642	1,774	1,915	2,069	2,234	2,413	2,606	2,658
CAPEX	285.5	315.3	310.7	315.2	343	379	418	461	509	561	618	681	750	826	908	944
increase in WC	156.7	37.6	240.3	565.0	88	124	134	145	156	169	182	197	213	230	248	67
Gross Investment	442.2	352.9	551.0	880.2	431	503	552	606	665	730	800	878	963	1055	1156	1011
FCF	556.5	853.2	566.4	345.0	718	801	856	915	977	1,044	1,115	1,191	1,272	1,358	1,450	1,647
																32,301
				period	0.87	1.87	2.88	3.88	4.88	5.88	6.88	7.88	8.88	9.88	10.88	10.88
				DF	0.942	0.880	0.821	0.766	0.716	0.668	0.624	0.582	0.544	0.508	0.474	0.458
				PV	676	704	702	701	699	697	695	694	692	689	687	15,548
				Sum PV = enterprise value (EV)	23,186											
				Stake in Kerry Group	0											
				Net debt	2,124.10											
				Equity value	21,062											
				Number of shares outstanding	177											
				Fair value stock price euro	118.99											
				Current stock price	94.56											
				implied upside	26%											

Cost of Equity using the CAPM

$$R_E = R_f + \beta * (R_m - R_f)$$

Components	Value
Risk-Free rate of interest ***(Rf)***	1.50%
Beta ***(β)***	0.5
Market Return ***(E(Rm))***	13.60%
Cost of Capital ***(Rf + beta(E(Rm) - Rf)***	7.55%

WACC Calculation

$$WACC = \frac{E}{E+D} * R_E + \frac{D}{E+D} * R_D * (1 - T)$$

Trinity College Dublin
Coláiste na Tríonóide, Baile Átha Cliath
The University of Dublin

Components	Value
Total Debt	20028.10
Total Equity	2124.10
We	90.40%
Wd	9.60%
Re	7.55%
Rd	3.65%
Tax Rate	13.30%
WACC	7.10%

$$WACC = W_E R_E + W_D R_D (1 - T_C)$$