

Valuation and Analysis of Cultiba

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Company Information

Cultiba is a Mexican holding company that owns 40% of Grupo Gepp. Grupo Gepp is one of the biggest beverage bottlers in Mexico and the exclusive bottler of Pepsico. It was founded in 2011 as a co-investment between Cultiba (40%), Poltex (40%), and Pepsico (20%). The company also owns Epura, one of the most popular water brands; and has a 58% market share in the jug water market.

In 2022, the company spun off its sugar business due to low profitability, and to focus on its beverage segment. As a result, the subsidiary became a private company and Cultiba stopped accounting for its operations.

Competitive Advantage

The competitive advantages of Grupo Gepp are its distribution and production scale, and its exclusive partnership with Pepsico. The company's nationwide distribution network gives it access to 770,000 points of sale which enables it to be a great partner for big beverage companies (Pepsi and Keurig Dr. Pepper). Likewise, the company's distribution advantage allows for a direct-to-home strategy to sell jug water. In regards to production, Grupo Gepp owns 44 bottling plants, with 76 production lines in total for bottled beverages (excluding jug), and 49 production lines for jug water. The total production capacity is 1,224 million cases of bottled beverages and 1,238 million cases of jug water. As a reference, Arca Continental, the second largest Coca-Cola bottler in Mexico, produced 1,096 million cases, excluding jug, in Mexico in 2022. Finally, the company's partnership with Pepsico allows it to exclusively sell a strong portfolio of brands that includes Pepsi, Gatorade, 7up, Mirinda, and Manzanita Sol.

Durability of Competitive Advantage

The bottling industry presents great barriers to entry for new competitors. High capital requirements to build/buy the necessary bottling plants, distribution centers, and transportation fleets are needed to achieve sufficient scale. Successful beverage bottlers also need a franchise agreement with one of the 2 main beverage companies to compete successfully: Coca-Cola or Pepsi. Both companies already have established bottling partners in Mexico. Currently, 3 beverage bottlers dominate the Mexican market: KOF, Arca Continental, and Grupo Gepp. Thus, without the opportunity to bottle and sell the products from these brands, it is unlikely that a competitor would want to invest the necessary capital for a chance to compete. 10 years from

now it is likely that the same beverage bottlers will continue to hold a similar market share to today.

Durability of Business and Products Sold

Current trends that negatively affect the consumption of soft drinks are: changing consumer preferences towards healthier alternatives, and government actions to make soft drinks less attractive to consumers. In the last 10 years, consumption of soft drinks decreased by 8.6%, while consumption of bottled water increased by 17%.

Going forward, I expect a continued decline in the per capita consumption of soft drinks and an increase in the consumption of bottled water and isotonic beverages. This does not mean that I expect the soft drink market to vanish. The brands that dominate today: Coca-Cola and PepsiCo, will very likely continue to do so. Moreover, the consumption of soft drinks will likely continue to be part of the Mexican diet, tradition, and culture for many years into the future. Thanks to the current popularity of consuming soft drinks at meals, social events, restaurants, and movie theaters. As well as the psychological factors that drive the current consumption of these drinks: familiarity with brands, habit formation, positive reinforcement, and association. All in all, I expect the decline in soft drinks consumption per capita to be upset by the increase in bottled water.

Profitability

From 2017 to 2022, the gross margin of Grupo Gepp increased from 38.8% to 44.2%. As a result of a higher increase in revenue relative to the cost of goods sold; between 2017 and 2022 revenue increased by 40%, while cost of goods sold increased by 30%. Revenue growth was attributed to increases in the average price per unit case. Between 2014-2022, Grupo Gepp increased its average price per unit case by 67%. Competitors increased their prices at similar rates. Moreover, operating expenses as a percentage of revenue remained relatively the same, decreasing from 37.2% to 36.9%. As a result of higher gross margins and stable operating expenses as a percentage of revenue, the EBITDA margin increased from 8.75% to 12.41% between 2017 and 2022.

Going forward, I expect Grupo Gepp to be able to maintain the current average price per unit case, and for the volume of cases sold to remain stable. On the other hand, taking the gross margin of 2022, the highest in the past 5 years, could be too optimistic. To factor in possible increases in the cost of goods sold as a percentage of revenue, I expect a sustainable gross margin to be closer to the average gross margin between 2019 and 2022 of 43.5%. In regards to operating expenses, I expect OPEX to be 38% of revenue, the average between 2019 and 2022.

A 56.5% cost of goods sold as a percentage of revenue and a 38% operating expense as a percentage of revenue, equals a 5.5% operating margin.

Reinvestment Needs

From 2018 to 2022 Grupo Gepp averaged capital expenditures of 4.6% of revenue or \$2,500 million for 2022. This was similar to depreciation expense, as such, an adjustment is not needed.

Main Assets

The company's main assets include 44 bottling facilities, 306 distribution centers, 6,893 transportation vehicles, vending machines, an exclusive franchise agreement with Pepsi, and the proprietary water brand of Epura.

Financial Position

At a holding level, Cultiba has no debt and \$2,563 million pesos in cash. Grupo Gepp has a cash balance of \$2,343, short-term debt of \$5,000 million pesos, and long-term debt of \$1,646 million pesos. The company has a net debt balance of \$4,303 million pesos. Total interest payments for the year were \$817 million pesos. I estimate that Cultiba can generate free cash flow to the firm of \$3,000 million pesos—5.5% operating margin and no need for adjustment in necessary reinvestments since D&A reflects maintenance capex. This equals a Net Debt to FCFF ratio of 1.4, and a FCFF to Interest Expenses ratio of 3.75. Based on the above, I expect Grupo Gepp to be able to cover its debt obligations by using cash on hand and cash from operations. Cash on hand can reduce short-term debt by 50%, the rest can be paid from cash from operations considering maintenance capex and interest payments. If needed, the company can also tap its credit lines, issue long-term debt, or receive a capital injection from existing shareholders. Based on the above, I do not expect the company to be at risk of bankruptcy.

Management

Cultiba's founder and CEO is Juan Ignacio Gallardo Thurlow. He is the main shareholder of Cultiba, with 63% of the shares outstanding. He is also the president of Grupo Gepp. Juan is 75 years old and has a very respected career as a businessman. According to people who know him, he has an excellent reputation. He helped Mexico by acting as one of the principal negotiators of NAFTA and more recently T-MEC. Based on this, I think management is capable and trustworthy, and his interests align with shareholders.

Returns to Shareholders

Dividends

2019: 1,022 million pesos

2020: \$1,283 million pesos

Other

2022: Spinoff of the sugar business

Valuation

I will value Cultiba by adding its NAV plus the equity value of its 40% stake in Grupo Gepp. I will first calculate the intrinsic value of Grupo Gepp, in enterprise terms, by multiplying sustainable free cash flow to the firm times an appropriate multiple. Then, I will subtract net debt from the enterprise value to find the intrinsic equity value of Cultiba's 40% stake in Grupo Gepp.

Cultiba's NAV equals \$2,780 million pesos = \$2,563 million pesos + \$268 million pesos - \$43 million pesos (Cash + PP&E - Total Liabilities).

As mentioned above, a gross margin of 43.5%, and OPEX of 38% revenue, equals an operating margin of 5.5%. I expect the company to be able to maintain trailing revenues of \$54,600 million pesos. As a result, I estimate that Grupo Gepp can generate free cash flow to the firm of \$3,000 million pesos.

Competitors, Arca Continental and KOF, currently sell at an EV/EBIT ratio of 11 and 10. I estimate that these companies currently sell at fair value. In regards to Grupo Gepp, the company is significantly less profitable than its competitors. For example, in 2022 Grupo Gepp's EBITDA margin was 13.2% vs 23% and 21.6% of Arca Continental and KOF, respectively. The higher profitability of competitors is due to their being able to bottle and sell Coca-Cola. Coca-Cola commands a higher average price per unit case than Pepsi. As a result, they can generate a higher gross margin. Furthermore, Arca's direct-to-home strategy and KOF's alliance with FEMSA allow these companies to have lower operational expenses. Based on the above, I think Grupo Gepp should sell at a lower multiple than competitors. I think a reasonable multiple is 8 times EBIT. Free cash flow to the firm of \$3,000 times a multiple of 8 equals an enterprise value of \$24,000 million pesos.

Subtracting net debt of \$4,303 million pesos, to find the equity value of Grupo Gepp, equals \$19,697 million pesos. This means that the intrinsic value of Cultiba's 40% stake in Grupo Gepp is worth \$7,878 million pesos.

Adding the NAV of Cultiba of \$2,788 million pesos plus my estimated value of 40% of Grupo Gepp's equity of \$7,878 million pesos equals an intrinsic value of \$10,666 million pesos.

Upside and Margin of Safety

An intrinsic value of \$10,666 million pesos versus an equity market price of \$8,800 million pesos, offers a 17% margin of safety and an upside of 21%.

Downside Protection

At a holding level, Cultiba offers net tangible assets of \$2,788 million pesos. As for Grupo Gepp, in 2021 the company's book value was \$11,300 million pesos. I estimate that Grupo Gepp has around \$6,600 million pesos in intangible assets and goodwill. Of this, \$1,600 million is goodwill from past acquisitions. Taking goodwill out means that the replication value of Grupo Gepp is around \$9,700 million pesos. Adding Cultiba's NAV plus its 40% stake in the replication value of Grupo Gepp of \$3,880 million pesos equals \$6,668 million pesos in downside protection.

Conclusion

The upside is not significant enough for me to truly like this investment idea, and that is okay. I will continue to have this company on my radar. From this investment, I learned a lot about the beverage industry and I am sure that it will help me in the future.